The High Costs of the Banker Bail-out: What should be done?

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Abstract: Historical experience suggests that the choices made by the administration in financial resolution policies have not yielded the best outcomes for the economy. Compared to following a policy of prompt corrective action, policies such as forbearance have added substantially to fiscal costs. If the average losses in other countries from adopting these policies are experienced in the US, the society could lose 10% of the gross domestic product.

> "Sweden, ... had a problem like this. They took over the banks, nationalized them, got rid of the bad assets, resold the banks and, a couple years later, they were going again. So you'd think looking at it, Sweden looks like a good model. Here's the problem; Sweden had like five banks. We've got thousands of banks. You know, the scale of the U.S. economy and the capital markets are so vast and the problems in terms of managing and overseeing anything of that scale, I think, would -- our assessment was that it wouldn't make sense. And we also have different traditions in this country." — *Barack Obama, February 10, 2009*

As several commentators pointed out even at the time this comment was made, President Obama's reasoning for not adopting a policy of nationalization or other sort of prompt corrective action to resolve financial institutions was rather suspect. The stress test of spring 2009 was applied to the 19 largest banks and bank holding companies that really mattered. Reasonably so, since it is in the balance sheets of those few firms that much of the critical problems in the US and global financial system lie. Nothing that was known then appeared to suggest that the fundamental problems required substantially new remedies or that the number of banks in the country obviated the efficacy of well established resolution principles.

More to the point, the policies that *have* been undertaken to address the U.S financial crisis are not in any sense novel (with the notable embarrassment of the PPIP proposal). Forbearance, repeated recapitalization, blanket guarantees, extensive liquidity support and other such policies have been regular features in the numerous systemic crises around the world over the last two decades. Sweden and Japan (the cases the president cited) are certainly not the only recent cases of severe financial crises from which we can learn. Indeed, by some counts there have been over fifty in the last two decades. What the President did not acknowledge was the substantial existing evidence available to analysts arising from these earlier crises on the impacts of various bailout policies. While each crisis has its own genesis and evolution, it would be foolish to disregard the wealth of experience that has accrued in the past in thinking about effective responses. This is especially true when one considers the fiscal cost of financial crises. The state has an ethical responsibility to ensure that any cost borne by those not directly responsible for the crisis (i.e. the taxpayer) is minimized. Equally, making sure that fiscal costs are minimized frees the state to undertake more productive and socially beneficial expenditure with its tax revenues.

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Learning From Other Countries

In this regard in particular, the historical precedents are decidedly unfavorable for the administration's chosen path. At the moment we have various estimates of the size of the hole in the balance sheets of the banks (the latest IMF numbers suggest that the global shortfall is close to $4 trillion) (*IMF Global Financial Stability Report 2008*) . And we also know the full value of government guarantees (which runs close to 100% of GDP). While this is almost certainly unlikely to be the actual value of expenditures, the experience of countries undertaking similar policies suggests that the final fiscal cost will nevertheless be substantial. Besides well documented in-depth studies of country experiences such as that of the Scandinavian economies (see for e.g. the report of the Norwegian Central bank) there have been more rigorous econometric studies that have attempted to quantify the costs of the various sorts of crisis resolution policies.

Most informative is the exercise undertaken by Patrick Honohan and Daniela Klingebiel of the World Bank in 2003. Using the experience of 40 episodes of systemic financial crisis, they find a wide range of costs, ranging from about 3% of GDP in the Swedish case to about 50% in the case of Indonesia. The kind of policies that they reviewed included forbearance (or not recognizing losses and forcing credit write-downs), extensive liquidity support (providing plentiful liquidity to failing institutions), repeated recapitalizations (taking repeated equity stakes in companies) and so on. They undertake a careful collation of data from these cases to identify the cost of various policies using the best available techniques to avoid statistical problems in interpreting their results.

The major finding from their exercise is that having strict resolution policies (extending liquidity to those with the best collateral or closing down technically insolvent firms) resulted in substantially reduced costs and quicker recovery than otherwise. The table below reproduced from their paper provides an indication of the costs of particular policies. The columns show the average effect of adopting what they term lax policies (forbearance versus liquidation and resolution for example).

The Cost of Bank Bailouts

	Increase in average crisis cost if other policies are at sample mean value
Forbearance A	5.6%
Repeated capitalization	5.2%
Forbearance B	0.9%
Liquidity support	3.4%
Blanket guarantee	1.5%
Debt relief program	3.6%

Source: Honohan, Patrick & Klingebiel, Daniela, 2003. "The fiscal cost implications of an accommodating approach to banking crises," *Journal of Banking & Finance*, Elsevier, vol. 27(8), pages 1539-1560, August

The results in the table show the effect of adopting a policy assuming that the other policies are being undertaken at the average level for the sample. Thus for example, if the crisis was that occurring to the ‘average’ country a policy of forbearance (such as has been applied with Citibank and Bank of America for example) would add a cost of 5.6 % of GDP[a].

If the U.S experience turns out to be similar to that of the typical country, then some of the policies undertaken by the Obama administration will have severe deleterious consequences for the public purse. Early on the government decided not to restructure the claims of the most vulnerable banks and instead allowed them to function while undercapitalized. As a result, mark to market was allowed to be suspended and banks which were in a technical sense insolvent were allowed to continue business because they retained franchise value. Such a policy corresponds to the variable ‘Forbearance A’ in the table. Similarly, TARP funds were utilized to undertake repeated recapitalization of firms which were marginally solvent or indeed insolvent. Instead of forcing a debt-equity swap and restructuring claims, the taxpayer was asked to fill the hole[b]. Such a policy corresponds to the variable ‘Repeated Capitalization’ the table. ds

The Social Costs of the Bail-Outs

The upshot is that the Administration’s failure to undertake a program of nationalization (notwithstanding the plea that the U.S is not Sweden) and instead to implement policies of endless forbearance and recapitalization could --under reasonable assumptions and simulations—therefore lead to an added fiscal cost of around 10% of GDP. Only in the countries which adopted the strictest policies (certainly more stringent than in the U.S) that final costs came in at less than that amount. If the U.S does end up spending 10% of GDP -1.5 trillion dollars- it will place the country firmly in the bottom third of countries in terms of final fiscal costs. Note that this number is extremely large: 1.5 trillion dollars represents tremendous social opportunities that will forever be lost. For those understandably concerned about fiscal burdens, it will dampen enthusiasm for social expenditures, however worthy. The US is rich and in the end it is an expenditure that will be absorbed, but this is nonetheless a significant cost in terms of foregone uses of public wealth. For example, most estimates of the health care reform bill suggest that it is projected to cost about $ 1 trillion over the next ten years, a number which is dwarfed by the cost of bank forbearance and recapitalization. Similarly, the International Energy Agency’s *World Energy Outlook* (WEO) 2008 estimates around US$ 550 billion needs to be invested in renewable energy and energy efficiency each year till 2030 in order to limit concentrations to 450ppm CO_2. While daunting, the US could undertake 3 years worth of global investment by itself if the fiscal costs of forbearance and recapitalization were used instead for this purpose. Other expenditures such as the total required to provide clean drinking water or housing to the entire world would be covered many times over by this amount. In the long term, given these trade-offs, the performance of this administration and other public and private officials will be evaluated by the manner in which they handled this crisis and whether they minimized social losses to the country and the world. At the moment, that judgment looks bleak.

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[a] It should be noted that moving from strict to lax policies when all other policy variables are lax leads to much larger effects.

[b] If the claims of the congressional oversight panel are to be believed, we are not even sure about what exactly the public has gotten in return for the equity that it has purchased.

What Can be Done Now?

What can be done now? First, an immediate and thorough accounting of all the government assistance is essential both for efficiency and transparency reasons. Second, a genuine examination of troubled institutions and a regime of prompt corrective action could still reduce the long term fiscal costs and avoid the problem of making the financial institutions too big to fail. The threat of public receivership should be made real. To the extent that these hard but necessary decisions are avoided, the US and the world will continue to pay dearly.

References

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