A reckless banking industry is a drag on the economy

From Prof. Anat Admati and Mr Martin Hellwig.

Sir, John Plender, in “Financial reforms will make the next crisis even messier” (September 2), argues that regulatory developments since the crisis have made arrangements for dealing with troubled banks even more unworkable than they were before: US authorities’ making Bank of America and JPMorgan Chase pay for the misdeeds of their crisis acquisitions Merrill Lynch, Countrywide and Washington Mutual has destroyed the device of having troubled banks acquired by sound banks. Moreover, Mr Plender argues, EU and US legislation imposing losses on creditors of troubled banks will be “a recipe for panic” if creditors are themselves systemically important institutions. Bailouts, he concludes, are thus still likely and the next crisis may be even messier than 2008-9.

Mr Plender seems to suggest that we should abandon the notion of bail-in. Whereas such a suggestion may please the banking industry, however, it violates a basic principle of a functioning market economy, namely that participants should be liable for the consequences of their decisions. This basic liability principle should apply to banks and their investors as it applies to everybody else.

If banks incur losses, these losses should be borne by their shareholders and if that is not enough, by their creditors. Bail-in may sound fancy, but it is nothing more than the notion that creditors might not be paid in full, which is taken for granted when the borrowers are not banks. If bail-in makes bank borrowing more expensive, the reason is that creditors would no longer expect to be bailed out, and taxpayer subsidies to bank borrowing (including through the tax preference of debt over equity) would be smaller.

If the bail-in principle is not credible and taxpayer money may still be used for bailouts in a crisis, as Mr Plender asserts, it becomes ever more critical to try to prevent banks’ distress and failure. Mr Plender should thus support higher equity requirements, structural separation, and/or size limits for banks to protect taxpayers and prevent the mess he is concerned about.

Much higher equity requirements, in particular, are very cost effective for this purpose and bring about additional benefits. Not only do higher equity requirements reduce the risks of crises and the costs of bailouts, they also help restore the basic principle of liability and counteract the distortions and inefficiencies associated with excessive indebtedness and implicit guarantees. Our reckless and ineffectively regulated banking industry is a drag on the economy.

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