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### Monkey Cage

# Bailing out banks is not a lucrative business

BY HENRY FARRELL June 24 [Follow @henryfarrell](#)

[Cornelia Woll](#) is professor of political science at Sciences-Po in Paris, and the author of “[The Power of Inaction](#)“, a new book on the different approaches countries took to bailing out banks in the financial crisis. I asked her a set of questions about the politics of bailouts in the U.S. and Europe.

*HF – People tend to think that the banking crisis hurt all the advanced industrialized democracies very badly, and that all of them bailed out their banks in similar ways. Yet your book shows that there was a lot of variation. What were the broad differences in how countries bailed out their banks?*

CW – The big differences in the rescue schemes depended on how much governments coordinated with the financial industry and how much the bailouts imposed punitive conditions on the banks. In France and Denmark, the finance industry contributed to its own rescue, for example, by pooling banks’ collateral so that they could issue collective securities that provided fresh liquidity, or by paying into a rescue fund used to recapitalize or unwind ailing institutions. These arrangements were not private – they were only possible because they were backed by a public guarantee. But they did a very good job in signaling stability without relying exclusively on taxpayer money. In the end, both countries managed the crisis very well despite considerable

### Business

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challenges. In Denmark, for example, a dozen financial institutions had to be unwound between 2008 and 2012.

In addition to the involvement of the financial industry, conditions attached to the rescue scheme varied widely. Some bailouts were very favorable to the financial sector and some were highly punitive. Vikram Pandit, CEO of Citigroup, famously described the U.S. recapitalization through TARP as “really cheap capital,” while Fred Goodwin, Royal Bank of Scotland’s (RBS) former CEO described the intervention of the British government as “a drive-by shooting.”

*HF – The U.S. and the UK have similar approaches to financial regulation. However, they dealt with their banking crises in very different ways. Why was this?*

Both countries have finance sectors that are based on free wheeling liberal markets, not on banks that have stable long-term relationships. The U.S. and UK governments knew the private sector would be unlikely to come up with a coordinated response to the crisis. The question they then faced was how to make the financial sector comply with conditions that individual companies might not have wanted.

In the U.S., the approach was to make support as painless as possible, to ensure that everyone in the sector would accept it. The advantage to this approach is that the market will not be able to single out the banks in most difficulty, which would destabilize them even more. The downside is that it makes public support look almost attractive and does little to send signals that would reduce reliance on the aid or decrease future ‘moral hazard,’ the risk that financial institutions might take big risks because they know that the taxpayer will always be there to break their fall.

The British government decided not to attempt a painless collective arrangement. They single-handedly imposed their solution without much consultation and only banks that were in dire need of the support accepted it. For example, the rate charged for capital injections was 12 percent in the UK, just days after the U.S. authorities had offered initial recapitalization of the largest investment banks at 5 percent. The UK banks that

accepted aid therefore carried a stigma; those in good health chose not to participate. The upside of the UK solution is that it sent very stark signals to banks, which will make it less likely that they take risks in the future. The downside was that the government had to intervene massively to help those banks that did fail, since they do not have a lot of means to recover on their own. The UK government continues to hold substantial stakes in Lloyds and RBS, and will probably have to take big write-offs.

In essence, the choice is between saving the sector as a whole or getting individual incentives right. This tension is impossible to solve in a satisfactory way if the solution depends on government action alone. I argue that it is much easier to handle this tension in situations where the financial sector has to contribute collectively to its own rescue.

*HF – France and Germany have similar approaches to banking, but there were very important differences in how their responses worked. Why was this?*

CW – France and Germany initially both responded in comparable ways. In both countries, banks play a crucial intermediary role in the economy, so that governments were determined to keep banks from failing. The governments of both countries gathered the major representatives of the financial sector together and asked them to come up with a solution. This worked in France and failed in Germany.

The French banking sector is highly concentrated with only a handful of large banks. After initial shocks to Dexia and Natixis, the French banking sector coordinated to put into a place a liquidity scheme and collectively accept recapitalization in exchange for a series of conditions. Banks played a key role in

designing these instruments and in essence ran the liquidity scheme. Although experts would have liked the government to earn more for their equity, both schemes effectively warded off a collapse and actually provided the government with a profit.

In Germany, the government routinely invited the representatives of the major banks and banking associations to come up with some solution for the worst hit financial institutions. Banks partially contributed to the rescue of IKB and later HRE, but the amounts that were required quickly outweighed the capacity of the sector. There are three different kinds of banks in Germany – commercial banks, mutual banks and saving banks – and it is difficult for the few very large banks such as Deutsche Bank to find a common position with the large group of much smaller institutions. These differences meant that the German financial industry was unable to broker a compromise that was in the interests of all of its participants, even when the German finance ministry stayed away until the end of negotiations. Savings banks did not want to extend their deposit insurance to large commercial banks that they suspected of gambling on international markets. Some commercial banks were much bigger than others, and Deutsche Bank refused to keep paying for everybody else. Although its CEO Joseph Ackermann helped negotiate the national rescue plan, he publically distanced himself from the scheme, emphasizing that Deutsche Bank would be ashamed to ask for government money. This statement meant that the German plan stopped providing a collective signal and instead carried the same stigma for individual banks as government support in the UK.

*HF – You describe bailouts as a game of chicken between the government and the banking industry, where neither wants the*

*financial sector to collapse, but neither wants to pay the cost of saving it. When are governments able to make banks carry much of the burden, and when are banks able to force government to carry the can?*

CW – Financial institutions can only shoulder part of the burden when they agree to engage in a collective solution, as they did in the bailout of Long-Term Capital Management in 1998. In the middle of a crisis, who gets what depends on who can most credibly say that they will not intervene no matter what – what I call the power of inaction. If financial institutions usually do not have to engage in collective action, they have a particularly easy time arguing that they cannot find a joint solution at the height of the crisis. Put differently, if the government wants the financial industry to contribute, it needs to get the industry to think systematically about its collective interests, way ahead of an actual crisis.

The main challenge of financial regulation is a collective one – systemic risk. This means that banks' individualized political responsibility can be a big problem. Lloyd Blankfein, CEO of Goldman Sachs, reportedly asked Hank Paulson, "we must be responsible for our own balance sheets and now we are responsible for others?" It's hard for a government to plead for the financial industry to find collective solutions, if major banks are used to only looking after their own individual political interests. The countries where the financial sector responded collectively are the ones where ties between financial institutions were well established prior to the crisis.

*HF – As you argue, no country relied on a pure market solution of letting banks sink or swim as market forces determined. Every country intervened in some way. What options do the U.S. and other states have to make it less likely that they have to intervene again in the future, and to make sure that if they do intervene, it is relatively cheap and effective?*

CW – It's no good trying to wish bailouts away – they are going to happen. Tim Geithner is right to argue against legislative restrictions on government authority during financial crises. The effects of such restriction on moral hazard are infinitely smaller than the usefulness of these tools in the middle of a crisis. In all of the cases I have studied, the government had a central role, if only as a public guarantee behind private arrangements. Moreover, the most effective bailouts are the ones that happen quickly and without much hesitation. Routinized procedures, clear guidelines and explicit resolution authority are key factors. In the U.S., the desire to avoid repeating the experience is curtailing some of these important discussions, especially discussions about the role of the private sector.

Burden sharing can involve bondholders being 'bailed-in,' but it can also work through privately financed resolution funds. Public-private bailout arrangements, like those in France or Denmark, limit government expenditures in two ways. First, competitors monitor each other's claims and can sometimes provide more accurate assessments than government officials of the crisis situation. The purely imaginary numbers produced by Anglo-Irish executives who were trying to trick the Irish government into public support might have been refuted if they had they been presented to the Irish financial industry instead. Second, in order to limit costs, private actors will rush to end collective schemes that they think are no longer necessary. Public-private rescue scheme thus last for a shorter period than purely public support mechanisms.

It is therefore useful for governments to build processes of routine joint consultation with the financial industry to clarify collective responsibilities in preparation for future crises. This can be institutionalized through contributions to a bailout fund, but it should also include discussion of what aid would involve. Any individual institution has an interest in making support difficult to obtain, to prevent its competitors from abusing it, but it will also want to maintain the possibility of support in case it

gets into trouble itself. The financial sector will therefore be able to think of solutions and analyze the challenges in ways public officials may not be able to do.

There is no magic solution that can assure that bailouts will be inexpensive. However, I argue that private sector involvement can reduce the burden on taxpayers, and that some public bailouts have been comparatively “cheap.” If we look only at the return on equity the government has taken in various companies, the U.S. rescue scheme might be possibly counted as one of them. However, the final costs of bailouts depend on a multitude of factors – the recovery of the economy as a whole and the size of the country for example – making it hard to draw any definite conclusions. My best guess is that bailing out banks is not a lucrative business. If it was, we would see others take it away from the government.