

PREVENTING BANK FAILURES, BAIL-INS AND BAILOUTS: A REVIEW ESSAY ON ALLEN N. BERGER AND RALUCA A. ROMAN'S "TARP AND OTHER BANK BAILOUTS AND BAIL-INS AROUND THE WORLD: CONNECTING WALL STREET, MAIN STREET AND THE FINANCIAL SYSTEM"

By

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Berger and Roman's book on bank bailouts is a research-based, comprehensive analysis of a rich panoply of *ex ante* and *ex post* policy tools available to regulators for dealing with potential and actual bank failures and financial distress. It draws on over 500 research papers and examines sixteen regulatory policies, including unconventional monetary policy and countercyclical capital requirements.

The book has 29 chapters, divided into five parts. Parts I-III deal with resolutions. Part I contains four chapters of introductory material: descriptions of different tools to resolve failing banks, including TARP, bailouts, bail-ins, regulatory forbearance, bankruptcy, living wills, breaking up large banks, and CoCos, and the conditions under which these are deployed. Relevant theories and data are reviewed. Part II contains eleven chapters covering empirical research on TARP and its causal effects on market discipline, bank leverage and risk, competition, credit supply and the real economy. Part III describes the empirical research on non-TARP resolutions (described in Part I) and their effectiveness, and consists of three chapters. Part IV consists of eight chapters that deal with seven *ex ante* measures—called the “first lines of defense”—to reduce bank failure risk. These include: capital requirements, liquidity requirements, stress tests, bank activity restrictions, supervisory monitoring, deposit insurance, and government ownership of banks. These lines of defense are examined for their effectiveness through a three-dimensional lens of: prudential regulation, certification, and subsidy. Part V has three chapters to close out the book, attempting to integrate the earlier material and step back for a big-picture view, as well as identify directions for future research. A nice table (Table 27.1) is provided to summarize insights about the net social benefits of the sixteen policy interventions.

This book is the most comprehensive summary of policy-germane research on the topic of bank failure prevention and resolution that I know of. It should be valuable to researchers, policymakers, and doctoral students who want to get up to speed on the research in this area.

The book has a plethora of insights, which makes it challenging to condense them into a neat package of a few key takeaways, but its three overarching conclusions are:

- As with most bailouts, TARP had its drawbacks. It doled out huge subsidies and rewarded banks for bad behavior, exacerbated safety-net-induced moral hazard, distorted the competitive landscape of banking, and suffered from political influence and lobbying. But the research also indicates substantial benefits—in the midst of a severe financial crisis, it prevented a collapse of the financial system, recapitalized banks, and boosted the real economy. Overall, the benefits exceeded the costs.
- The sixteen policy tools examined—a mix of *ex ante* measures to minimize the likelihood of financial distress and crises and *ex post* measures to deal with a crisis if it arrive—are best viewed as a comprehensive tool kit for regulators, with the benefit of research that illuminates the relative effectiveness of each tool.
- The choice among policy tools depends on the circumstances. Prior to a crisis, tools like higher capital requirements and bail-in measures are optimal, whereas in the midst of a crisis, regulatory recapitalization of banks through initiatives like TARP may be best.

While my overall assessment of the book is very positive and I highly recommend it, I also think it misses some opportunities to be more informative and assertive. In banking research as well as policy discussions of safety and soundness, the elephant in the room is typically bank capital requirements. Given the divergent views on CoCos and some of its drawbacks (e.g. Goncharenko, Ongena and Rauf (forthcoming)), why should regulators be reluctant to simply ask banks to have substantially higher capital ratios? By posing this question, the book could have highlighted the simplest *ex ante* measure to reduce financial fragility, a measure that obviates the need to consider more complicated tools and permits a beneficial simplification of the regulatory tool kit (see Boyer and Kempf (2020)). I have argued that there is research support for leverage ratios as high as 12-15% (see Thakor (2019)), but regulators seem to be swayed by bankers' arguments that raising capital requirements will be counterproductive and significantly reduce bank profitability. Apart from the obvious divergence between private and social optima when it comes to bank capital, it appears that banks are undercapitalized even relative to their *private* optima—see Mehran and Thakor (2011) and Berger and Bouwman (2013). Emphasizing this point would have helped the book in three ways to provide integrating insights. First, it would have highlighted an unintended *long-run* benefit of the recapitalization of US banks achieved with TARP. Because government capital injections came with government ownership and rules such as executive pay restrictions, it represented an unusual governance intrusion that banks were eager to shed. This induced banks to work hard to buy out the government's stake, thereby replacing government equity with private equity and achieving long-run recapitalization. This did not happen in Europe and may explain why European banks are not as well capitalized as US banks and are experiencing lower market-to-book ratios. Second, it helps to tie together both the *ex ante* and *ex post* tools discussed in the book: higher capital requirements reduce the *ex ante* risk of failure, and *ex post* initiatives like TARP get banks out of distress by providing them capital banks during a crisis. Thus, both come down to making banks better capitalized. Third, it would have helped to address a puzzle the book highlights, namely that the announcement of TARP and intended bank recapitalization generated positive stock price reactions for banks, but the actual capital injections had either insignificant or negative price reactions. A simple explanation is that the market recognized the benefits of more capital for bank market values when the plan to recapitalize was announced, but then saw that the actual recapitalizations did not involve the large government subsidies for banks that it expected.

The discussion of bankruptcy/ failure would have benefited from a closer link to the extensive research on this in corporate finance. In particular, the “no-fault-default debt” proposal of Merton and Thakor (2020) suggests that adopting this kind of debt would

permit a low-cost transfer of control of the bank to its creditors in distress states and thus be Pareto superior to bailouts, CoCos and Chapter 11 bankruptcy.

Finally, while there is some discussion of the research on the influence of politics, the book could have done a bit more on this issue. The Calomiris and Haber book (2014) highlights the massive influence that politics has on banking, influence that is even greater during crises. Viewing its different policy tools from the standpoint of the extent to which each tool is susceptible to politics would be a useful exercise.

To conclude, there is much to like about the book—it is comprehensive in its coverage of topics and relevant research, rich in its institutional detail, and written in an engaging manner, with ample summaries and illustrations to drive home its points. I recommend it highly.

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