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The Cyprus 'Bail-In' Exposes 'Too Big To Fail' As All Too Timid

By: Louise Bennetts – April 18, 2013

The Cyprus bank ‘bailout’ drama contains one major positive for U.S. observers: finally someone has found the courage to execute a credible solution to large bank failure that is not backstopped by taxpayers.

It also contains a warning: uncoordinated *ad hoc* measures don’t work well in a crisis. This should serve as a call to action for creating a workable bankruptcy procedure for U.S. megabanks.

The ‘bail-in’ model used to address the insolvency of Cyprus’s two largest banks has its roots in the Federal Deposit Insurance Corporation’s megabank recapitalization proposal. Importantly, this is the first time that the model has been used where the banks in question are ‘too big to fail’ in their local economy. And, as it turns out, banks aren’t too big to fail, and ‘bail-in’ works rather well to limit the systemic effects of a bank failure, all the while shielding taxpayers. It is also a warning to creditors: be more vigilant about the institutions you do business with.

Admittedly, Cyprus is not the ideal poster child for bail-in as a crisis management tool. For one thing, the FDIC model doesn’t quite work in Cyprus because Cypriot banks have hardly any bondholders, leaving uninsured depositors to absorb the blow. For another, the promised $10 billion capital injection from the EU and IMF is likely to be perceived as a bailout even though the banks receive only temporary liquidity.

But what really let Cyprus down was poor planning and communication. The European bail-in proposal was floated over a year ago and analysts waited anxiously for European authorities to release detailed rules about how it would work. The rules never came, adding to the general chaos and confusion when the time arrived to apply them.

The FDIC is looking to be more prepared with rules promised this summer. But there is a problem. The FDIC’s recapitalization proposal works within the Dodd-Frank Act’s ‘orderly liquidation authority’ (OLA). As with anything related to Dodd-Frank, this authority is flawed at best, and possibly unconstitutional. Dodd-Frank gives unprecedented power to the Treasury secretary to determine whether an insolvent financial company will be subject to OLA. The Act sets a high standard for invoking the authority, but the process is unnecessarily tainted by the involvement of a political appointee, even if he or she is acting in good faith.

Worse, OLA is not limited to the financial companies whose structure and complexity would subject them to multiple messy bankruptcy procedures. After all, these were the firms in need of a new bankruptcy process. Instead, it extends to any nonbank financial company the Financial Stability Oversight Counsel determines is 'systemic.'

This is unnecessary. Most nonbanks, such as insurance companies and hedge funds, have perfectly adequate bankruptcy processes already (the recent MF Global bankruptcy is a case in point).

Regulators are fond of pointing out that OLA is a "last resort" to be invoked only if other bankruptcy processes are deemed unworkable. But as the Cyprus confusion shows, this logic is exactly backwards. Congress and its regulators should commit themselves to a path *now* so that creditors, bondholders and depositors can understand and price their risk accordingly. If we want market participants to exercise discipline over the largest institutions, we need to give them the incentive to do so.

This argument applies equally to the rules that will be applied *during* an OLA proceeding. In the absence of a binding playbook, the temptation of regulators to succumb to short-term political considerations during a crisis is too great. During the FDIC-led WAMU bankruptcy, regulators ignored established FDIC precedent by protecting certain third-party creditors ahead of bondholders, a move that almost certainly contributed to the 2008 capital market shutdown. And during The Clearing House's recent OLA simulation (which mirrored a large bank failure), observers noted that whenever the rules governing the process weren't clear, participants tended to panic and make irrational decisions.

The good news is that these problems can be addressed with some statutory modifications, but they require the attention of Congress. House Republicans have been vocal about their desire to repeal Dodd-Frank's OLA provisions, and for good reason. But absent a replacement, this would leave the U.S. without a coherent bankruptcy proceeding for megabanks, and even more incentive to bail out large institutions that fail.

The Cypriot 'bail-in' solution undermines those who argue that megabanks cannot be allowed to fail because they are too big. If a small and economically weak country has the courage to subject its two largest banks, whose activities account for much of its GDP, to the bail-in mechanism, there is no reason why the same process cannot be applied in the United States.

The comparative success of the Cypriot solution also acts as a challenge to Congress: is it really serious about addressing TBTF once and for all? Or are its members using TBTF to increase Washington's sway over banks by threatening them with break-up? If the former, the time to act is now.