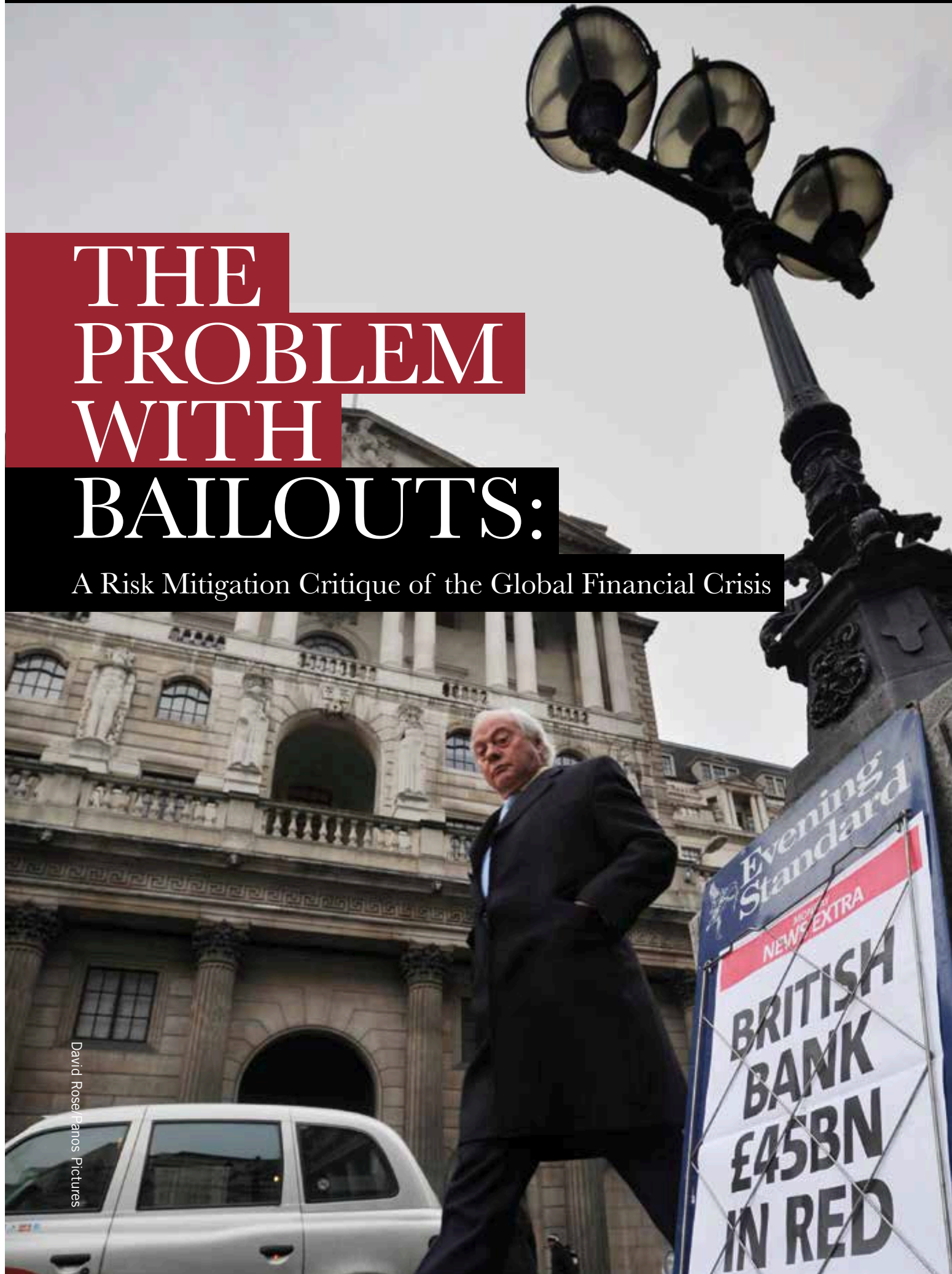


THE PROBLEM WITH BAILOUTS:

A Risk Mitigation Critique of the Global Financial Crisis

David Rose/Fanos Pictures



FOLARIN AKINBAMI argues that government rescues of banks should be avoided to mitigate financial risk

THE GLOBAL ECONOMY is still recovering from the devastating global financial crisis of 2007-2009. The global financial crisis was caused, in large part, by excessive risk-taking by banks and other financial institutions, and by the eventual bursting of asset price bubbles in housing markets in many western countries such as the UK and the US. The global financial crisis saw the near-collapse of several banks and the subsequent need for governments to use taxpayers' funds to rescue such banks.¹ The financial rescue packages for the troubled banks are popularly referred to as 'bank bailouts'. However, bank rescues need not be funded by the government, and sometimes they are funded by the banking industry itself. Examples include some of the bank rescues under the so-called 'lifeboat' during the secondary banking crisis of 1973-1975.² On this occasion the magnitude of the financial problems faced by the troubled banks meant that their fellow banks were either unable or unwilling to come up with the funds necessary to rescue them. The costs of these bank rescues are substantial; for example the UK's National Audit Office (NAO) reported in 2010 that the scale of financial support provided to the UK banks was £512 billion.³

The bank bailouts that resulted from the global financial crisis have been subjected to criticism on several fronts. For example, economists argue that bailouts encourage moral hazard, while social commentators (social justice advocates) have complained about the inequity of the bailouts, and argue that it resulted in an unfair transfer of wealth from the less affluent to the more affluent in society. Both sets of criticisms are, arguably, very strong. But another perspective is needed, in this case a 'risk mitigation' perspective. Risk mitigation refers to the ways of dealing with or managing risk, that is, the way in which risk is assessed, measured, prevented or managed.

The risk mitigation critique here is not a critique of the failures of the banks' risk assessment models or their risk management techniques.¹ Rather, it is a broader critique of how individuals and society as a whole approach risk, and the ways in which we deal with (mitigate) risk of damage when a banking crisis occurs. For this critique it is helpful to draw upon a well-known risk mitigation device that is prevalent in society today – insurance. Insurance is not necessarily the only risk mitigation technique one might compare with bailouts, but is useful for considering key features of a taxpayer-funded bank bailout. The objective is to compare the ways in which both insurance and bank bailouts are used to deal with the fallout from a bank failure and to highlight some of the more problematic features of bank bailouts.



Northern Rock was one of the first banks to be bailed out by UK government during the banking crisis.

A BRIEF EXPLANATION OF INSURANCE

INSURANCE is a method of risk mitigation whereby individual people, corporations and other organisations facing a particular type of risk take action to protect themselves from the potential losses if that risk materialises. It therefore differs from risk mitigation or risk management techniques that try to prevent risk.

Rather than try to prevent the risk altogether, insurance looks to protect the insured i.e. to compensate them for potential losses arising if the risk should happen. It is an *ex ante* (before the event) way to tackle the risk of a damaging event. It accepts the fact that risks cannot always be prevented and that they can occur.

With most types of insurance today, a number of people come together to collectively share the cost of protecting themselves from the potential losses they may individually suffer if the risk arises for them individually. This can either be done privately, for example fire insurance, buildings and contents insurance, or through a public, social insurance scheme, whereby the pool of insurance funds are collected and administered by a public authority, or some other social insurance fund (for example social security or publicly-funded health insurance schemes such as the UK's National Health Service). **/// CONTINUED**

¹ For a critique on this see 'Is meta-regulation all it's cracked up to be? the case of UK financial regulation'. *Journal of banking regulation*. 14:16-32. <http://dro.dur.ac.uk/10250/>

² R Cranston, *Principles of Banking Law (Second edition)*, Oxford: Oxford University Press (2002) p. 95

³ National Audit Office (NAO), *Monitoring the Financial Stability of UK Banks: Update on the Support Schemes*, HM Treasury (2010) HC 676 Session 2010-2011, at pages 3 and 6. http://www.nao.org.uk/publications/1011/support_for_banks.aspx

FEATURES OF INSURANCE

Highlighting three key differences between insurance and bailouts helps us to see what problems bailouts have in terms of risk mitigation:

1) EX ANTE PAYMENT OF PREMIUMS

A key feature of insurance is that all the insured pay an insurance premium (a monetary contribution) to the pool of funds that is kept and used to protect them from risk. The funds are held by an insurance company (in the case of privately organised insurance) or by the State or one of its agencies (in the case of social or public insurance), which disburses funds to those who have paid their premiums and then subsequently suffered the misfortune of the insured risk occurring. Insurance premiums are paid *ex ante* to the insurance pool of funds. This is hugely beneficial because it means that each individual's contribution (i.e. their insurance premium) is pre-determined and therefore each individual knows, from the outset, the full extent of their ultimate liability to the insurance fund. It is also advantageous because there is an attempt, when setting premiums, to calculate each individual's insurance premium according to the risk that person poses to the insurance fund, for example people living in flood-prone areas might pay flood insurance premiums higher than for those in areas of low flood risk. This apportioning of premiums based on the risks posed by the individual represents a much fairer way of spreading the cost of disasters than most other risk protection strategies.

Bailouts, on the other hand, often occur without any prior or *ex ante* preparation for them. This is highly problematic because those who end up paying for the bailout (in the case of banks, the taxpayer) do not know in advance the full extent of their liability to the bailout fund. For example, governments in the

UK and US have not really done a good job of explaining to taxpayers the full and final cost of the bank bailouts in those countries. In the US, the initial bank bailout proved to be inadequate and the government had to ask taxpayers for a further, larger bailout. It is also problematic because the costs of the bailout are not borne by those who posed the ultimate risk to the bailout fund. This failure to allocate costs based on the risks posed by the individual represents a very unfair way of spreading the cost of disasters.

2) INSURANCE IS OFTEN VOLUNTARY AND BASED ON PRIOR CONSENT

Another important feature of private insurance is that it is usually voluntary and consensual, although some public insurance is mandatory (for example National Insurance contributions in the UK and social security contributions in the US). Even some privately organised insurance is mandatory, such as compulsory third-party insurance for motorists in the UK. The insured want the benefits of insurance conferred on them, and for this reason, consent to contributing to the pool of funds available to protect the less fortunate amongst them. Insurance is therefore in accordance with the rule of law and the principles of natural justice (duty to act fairly). It is also in accordance with most people's preference for autonomy over themselves and their decisions.

Taxpayer-funded bailouts, by contrast, are never voluntary or consensual as amply demonstrated by the hostility of a vast majority of citizens, in the UK, Ireland, Spain and US to the bank bailouts in those countries. Instead the decision to impose the bailout on taxpayers is carried out by governments who are faced with the threat made by the banking industry, that the consequences of not bailing out the troubled banks will be calamitous. Former US Treasury Secretary Henry Paulson appeared before US Congress warning US lawmakers that if they failed to approve his proposed bank bailout they would be responsible for precipitating *the end of the world as we know it*. Taxpayers are thus faced with a mandatory

Protests around the world from the Occupy Movement were critical of governments bailing out banks during the financial crisis.



payment to the banking industry even though the majority of taxpayers object, in principle, to making such payments and did not know before the banking crisis that they might have to meet these costs. It is unfair to make one group of people pay for the damage incurred by another group in this way. Some would even argue that this is immoral.

3) THE TRANSFER OF FUNDS IS PROGRESSIVE, NOT REGRESSIVE

A further important feature of insurance is that the materialisation of the risk results in a progressive transfer of resources from the more fortunate to the less fortunate. The transfer of funds helps the less fortunate to cope with the consequences of the risk occurring. Privately organised insurance indemnifies the victims of the disaster out of the pool of funds created from premiums paid by all those insured (including those who have not suffered from the disaster). With public or social insurance the less fortunate, such as the sick, elderly or unemployed, are paid out of the social insurance fund that all healthy, employed citizens have to contribute to. These examples represent a progressive and just way of collectively dealing with the occurrence of certain risks.

Taxpayer-funded bank bailouts do not, however, have this feature, and in fact the bank bailouts in the wake of the global financial crisis represented a regressive redistribution of resources, since taxpayers (many of whom are not necessarily wealthy or even 'well-off') had to bail out an industry regarded by many as comprised of well-paid, privileged constituents. Ironically, many of the bankers who took excessive risks were the employees that were being paid the largest amounts, and certainly, for bank employees, compensation often increased in line with their level of risk-taking. This represents a regressive and unfair approach to risk mitigation and it is bound to increase inequality in society, lead to problems of social cohesion and disrupt the very fabric of society. To this extent, taxpayer-funded bailouts can be regarded as very problematic for the financial system and civil justice.

We need an alternative way to govern risk in the banking industry.

The problems associated with taxpayer-funded bank bailouts are made clear by comparing such bailouts with the features of insurance. The comparison has shown that such bailouts are an inefficient and unfair way of dealing with the consequences of financial risk. They are inefficient because they represent an ineffective method of allocating liability for covering the costs associated with the occurrence of risk, and they are unfair because they represent a regressive, rather than a progressive, method of risk mitigation. To this extent, such bailouts should be avoided in the future and governments all over the world should search for ways to help taxpayers recoup the money expended on such bailouts, and ensure that the risk of bank failures is mitigated in the most efficient and fair manner possible.

/// KEY MESSAGES FOR POLICY

- Taxpayer-funded bank bailouts are not voluntary and the decision to impose them lies with governments faced with potentially devastating consequences for the financial system arising from bank failures.
- Bank bailouts as a way to resolve financial crises should be avoided in future, because they unfairly transfer the cost of a disaster onto those who had little role in it.
- The present system means that those who must bear the costs for the bailouts (i.e. the taxpayers), are unaware in advance of the full extent of their potential liability.
- In the aftermath of a taxpayer-funded bank bailout it is important that governments find ways of recouping the public funds spent on the bailout.

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