In a world of financial globalisation, foreign investors benefit from bank bailouts in response to a crisis. Research by **Friederike Niepmann** and **Tim Schmidt-Eisenlohr** explores the incentives for governments to act in these circumstances – and the role of international cooperation over financial regulation and crisis management.

Bank bailouts in a global economy:

the challenges for international cooperation

Severe financial crises followed by costly government interventions are not a new phenomenon. Indeed, in the last 30 years, financial crises have occurred frequently: one study counts 117 systemic banking crises in 93 countries between the late 1970s and the early 2000s (Caprio and Klingebiel, 2003). And the costs to the public purse are usually considerable: on average, governments spend 12.8% of their country's GDP on interventions to restore financial stability (Reinhart and Rogoff, 2009, and Honohan and Klingebiel, 2000).

Compared with the more regulated era following the Great Depression, the new feature of crises today is that they are rarely local and often involve banks and consumers worldwide. Two aspects of financial globalisation have been driving this. First, the balance sheets of financial institutions have become increasingly linked internationally. As a result, a crisis can spread rapidly from the financial sector of one country to other countries – a phenomenon known as 'contagion'.

Second, there has been a steep rise in cross-border banking. In a world of global finance, investors from many different countries are directly affected when a bank is in distress. This poses new challenges for policy-makers responding to financial crises. Their decisions have effects both at home and abroad. At the same time, domestic economic outcomes often depend on interventions by foreign governments.

The recent financial crisis has shown how this international dimension to policy interventions can lead to conflicts of interest between countries. One prominent example is the bailout of AIG, an American insurance company with significant global business, which received large-scale support from the US government in September 2008.

The AIG intervention, the cost of which will eventually accrue to US taxpayers, benefitted foreign financial institutions substantially. The asymmetry between those who paid for the intervention and those who gained from it caused much political debate in the United States.

Another example is the Icelandic bank Icesave, in which many UK and Dutch consumers had invested their savings. When the bank went bankrupt in 2008, the Icelandic government did not compensate all creditors, but only absorbed the losses of its own nationals. This caused a severe political confrontation between the UK, the Netherlands and Iceland, culminating in the UK government's application of the Anti-terrorism, Crime and Security Act to freeze Icelandic assets in the UK.

In our research, we formally study the problems that arise when banks operate across borders while government intervention is still limited by national borders. We are interested in how governments should deal with banks in distress when their potential bankruptcy affects depositors from different countries and international balance sheet connections can lead to cross-border contagion.

If governments do not cooperate when dealing with an international crisis but instead behave strategically, this can lead to decisions that are 'sub-optimal' from a global perspective. Different institutional arrangements that allow governments to cooperate within well specified rules could address this concern and improve global crisis management.

Much research has been conducted on financial crises and interventions that are contained within one country, whereas the international aspects of crises and interventions have received far less attention. Two studies have made the case that cooperation between governments can be beneficial when financial stability is a public good that is shared across countries (Freixas, 2003, and Goodhart and Schoenmaker, 2009).

Problems arise when banks operate across borders while government intervention is still limited by national borders

Until now, there has been no analysis that explicitly considers the effects of international financial linkages on governments' incentives to intervene, and which derives the costs and benefits of a bailout from the fundamentals of a country's economy. Our research provides a first step to filling this gap.

When a government decides whether

Restricting banks' cross-border operations may reduce the risk of contagion, but such regulations have other costs

to support a domestic bank in distress with taxpayer funds, it has to strike the right balance between creating distortions in taxation, containing losses from forced liquidation of bank assets and limiting financial penalties for depositors and resulting income inequalities. From a global perspective, the optimal decision requires taking account of additional considerations: contagion effects across borders, losses incurred by depositors worldwide as well as the costs to taxpayers in different countries from financing bailouts.

Governments care predominantly about the wellbeing of their own citizens. When they deal with a financial crisis on their own without cooperating with other governments, crisis management can be sub-optimal for three reasons:

- First, policy-makers do not take account of the positive effects of their actions on the wellbeing of foreign nationals.
- Second, a country may behave opportunistically: anticipating another country's intervention, it may decide not to act itself and thereby spare its taxpayers.
- Third, governments typically do not split the costs of bailouts.

By taking a closer look at events in the recent crisis, we can learn about the relevance of these three sources of inefficiency. For example, in September 2008, the US treasury decided against a bailout of Lehman Brothers. This triggered worldwide financial distress and governments in many countries eventually gave failing financial institutions within their jurisdictions large financial support. If there had been stronger incentives for the US government to take account of these cross-border effects, it might have been more inclined to decide in favour of a bailout.

Shortly after Lehman's bankruptcy, the US Federal Reserve supported AIG. Without this measure, several foreign financial institutions would probably have suffered severe losses, which might have made government intervention in other countries necessary. While financial contributions by other countries were taken into consideration, ultimately no overseas governments helped to finance the AIG bailout. Our analysis suggests that, anticipating that the US government would support AIG anyway, other countries were 'free-riding' on the bailout.

In the case of Icesave, the cost of providing deposit insurance to all depositors would have been very high for the relatively small Icelandic population given the large size of liabilities. Compensating all depositors by sharing the costs between the UK, the Netherlands and Iceland was not considered an option.

When is cooperation between governments especially important? Increased interbank linkages make cooperation more important as they increase the extent of cross-border contagion. Yet internationalisation in another dimension can reduce the need for more cooperation: if consumers deposit more of their funds abroad, governments start to care about the health of foreign banks too.

As a consequence of the recent crisis, there is a worldwide debate on how to improve global crisis management. Our research contributes to this debate by studying different cooperation regimes and analysing which countries gain or lose from them. Political efforts to improve international cooperation have led to the creation of some new institutions, which roughly correspond to the ones that we consider.

For example, the members of the Nordic-Baltic Stability Group, created in August 2010, have agreed to share not only information but also the costs of intervention in the event of a future crisis. The group corresponds to what we call a central authority with fiscal power. It can decide whether a bailout of a bank in distress is undertaken and how the resulting costs are shared between countries.

Our analysis shows that with such an arrangement, there is no guarantee that at least one country gains from cooperation while no country loses. This may limit the willingness of countries to stick to the agreement when a crisis actually happens.

Another example is the European Systemic Risk Board (ESRB), a European Union institution recently established with the task (among other things) of issuing recommendations on how to deal with banks in distress. So far, the ESRB only has reputational power. Our analysis may help explain why: a central authority that can

prescribe a bailout, which then has to be financed by one country alone, always makes that country worse off compared with a situation where decisions are taken unilaterally.

The willingness of policy-makers to agree in advance on institutions for crisis management and sharing rules for the costs of future interventions is also limited because of concerns related to 'moral hazard'. It is widely agreed that implicit bailout guarantees – that is, expectations among some banks and investors that they will be bailed out if the worst comes to the worst – led to excessive risk-taking in the run-up to the recent crisis. Explicit guarantees could worsen this problem in the future.

As an alternative to formal cooperation, structural reforms of the financial and banking system are being discussed so as to avoid international conflicts in the first place. Restricting the cross-border operations of banks may help to reduce the risk of international contagion. It may also counteract the divergence between which national authorities have the power to intervene in case of distress and which country's citizens have the major stake in the institution concerned. Yet regulations have other costs, such as limiting risk-sharing between countries and reducing international competition among financial institutions.

Financial reform will continue over the next few years. Finding the right balance between the efficiency gains from financial globalisation, the preservation of national sovereignty and optimal cooperation when managing a crisis will remain a challenging task for policy-makers worldwide.

The key is to find the right balance between financial globalisation, national sovereignty and optimal cooperation in crisis management

This article summarises 'Bank Bailouts, International Linkages and Cooperation' by Friederike Niepmann and Tim Schmidt-Eisenlohr, CEP Discussion Paper No. 1023 (http://cep.lse.ac.uk/pubs/download/dp1023.pdf).

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Further reading

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