

# [The comprehensive analysis of banking failures](https://assignbuster.com/the-comprehensive-analysis-of-banking-failures/)

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## Introduction

The premise of a bank failure is the existence of a banking crisis.“ Banking crises can be caused by inadequate governmental oversight, bank runs, positive feedback loops in the market and contagion” (Lumen, 2015). Essentially, banks are over-involved (or lending to businesses) in high-risk industries (such as real estate, stocks), which leads to a serious imbalance in assets and liabilities. So, generally speaking, when banks are unable to pay their debts and deposits to depositors and other creditors, the bank has closed down.

When a bank failed, it would tend to have a negative impact on the masses and society. Hence, there is no doubt that governments will have some important factors to consider when dealing with a failing bank. Based on one example of reading about Overend and Gurney Bank, the key factors considered by the governments are public confidence, conductivity of financial risks and negative externality when dealing with a failing bank.

The following content will be mainly revolved around the main factors needed to consider by government and how creditors are effectively and properly repaid on the basis of priority under the situation of bank failure, as well as how European financial stability policies has evolved to adapt to the solutions for tackling the failing bank.

## Main body

### Main factors considered by government

In the case of Britain’s Overend and Gurney Bank, its core business is to buy and sell bills of exchange at discounted prices. It has been the world’s largest discount store for 40 years. After Samuel Gurney retired, the bank expanded investment portfolio, mainly invested heavily in rail and other long-term investments rather than holding short-term cash reserves as was necessary for their role. It found itself in debt at about 4 million pounds and its current assets were only 1 million pounds. In order to restore its liquidity, the company was registered as a incorporated company in July 1865 and sold its 15 pounds stock at a premium of 9 pounds, taking advantage of the active market from 1864 to 1866. This period, however, was followed by a rapid collapse in stock and bond prices, accompanied by a contraction of commercial credit. Also, railway stocks were particularly affected. Overend and Gurney Bank’s monetary difficulties increased, and it asked the Bank of England for assistance, but it was rejected. The bank suspended payment on 10 th of May 1866. The next day, London, Liverpool, Manchester, Norwich, Derby and Bristol were filled with panic. A large crowd of people took out deposits around the headquarters office of Overend Gurney at 65 Lombard Street. Finally, Overend and Gurney Bank went bankrupt. Influenced by Overend and Gurney Bank, more than 200 companies, including other banks, have closed down.

As can be seen from the above example, first of all, Overend Bank’s financial risk increased as its assets were not offset the debt. Once financial risks are accumulated to a certain amount and are made public, financial risks are highly conductive. Under the principle of free deposit and withdrawal, once the liquidity risk of a commercial bank is made public, the depositor will withdraw the deposit from the bank. When the amount of advance withdrawal increases, or a run is formed, the bank will have liquidity crisis. However, when the liquidity crisis causes a failing bank, it may trigger a crisis of depositors’ confidence in the banking system. Hence, huge financial risks will be conducted to other banks in the banking system, causing banks that are already operating normally to be involved in the risk of bankruptcy, forming a systemic crisis in the financial industry. Therefore, when dealing with bank failures, the government needs to consider the conductive effects of financial risks.

Secondly, the direct reason why the crowds around Overend Gurney’s headquarters office form a run and indirectly affect the normal operation of other banks is because people’s expectations for the UK economy are bleak so that they lack confidence for the financial industries. Thus, when dealing with bank failures, public confidence in the UK economy is also a major factor for the government to consider.

Thirdly, overend failures tend to cause strong negative externalities. “ A Negative externality is an undesirable impact on an unrelated third party because the production or consumption of a good or a service. In other words, it’s an unforeseen negative consequence from some market activity” (My Accounting Course, 2018). Obviously, the bankruptcy of large-scale banks will cause unbearable losses to all depositors in the above example. What is more, deposit insurance institutions will not be able to provide sufficient liquidation funds. Finally, the entire society will not be able to eliminate the negative impact of its bankruptcy. Hence, the negative externality is still an important factor that the government needs to consider when dealing with bankruptcy.

### Repaying creditors based on priority

Compared with general enterprises, commercial banks are in a special position and play a special role in the social economy. Their bankruptcy involves a wide range of stakeholders, especially a large number of stakeholders. Once a commercial bank goes bankrupt, its depositors, other creditors, shareholders or investors, employees and so on will face greater losses. More seriously, the conductivity of the commercial bank crisis causes that the bankruptcy of a commercial bank likely cause a chain reaction and spread to other banks. Correspondingly, the negative externalities caused by the bankruptcy of commercial banks are strengthened along with the spread of the crisis, which will affect the interests of more depositors, creditors, shareholders and employees. Consequently, when banks are liquidating, it is also an important issue about how various types of creditors get repaid.

Generally speaking, in terms of banks, creditors are divided into 5 categories, namely insured depositors, uninsured depositors, preferential creditors, general creditors and shareholders.

According to European deposit insurance scheme, if the deposit is below 10, 000 Euro, the bank will protect the principal from loss. In other words, when the bank is liquidating, it must pay off to the creditor. This is the so-called insured depositor. On the contrary, if it exceeds 10, 000 euros, the uninsured depositor may suffer certain losses when the bank is put into liquidation. Meanwhile, Preferential creditors generally refer to employees as they spend times and skills on the post. Also, general creditor is generally an unsecured lender, such as the owner of a bond.

In terms of the important issue of how various types of creditors are repaid, there is a good way: “ An official ‘ hierarchy’ laid down by the Insolvency Act, 1986, determines which group of creditors is paid first during an insolvent liquidation” (Begbies traynor, 2018). So, the issue of how creditors are repaid should be based on priority.

In accordance with the provisions of the law, after the insured depositor is paid, the preferential creditor is paid, followed by the uninsured depositors, then the general creditor and finally the shareholder. So, it is very clear that the liquidator makes liquidation in accordance with the priority right in liquidation.

### How European financial stability policy has evolved

Since the beginning of 2016, the negative news of the European banking industry has continued. The problems of the high non-performing loans, the difficult to improve earnings, the excessive risk exposure of derivatives, the poor ability to handle bad debts and the drag on government debt have deeply dragged down the major banks in Europe such as Italian banks and Deutsche Bank. Once these problems cannot be effectively addressed, banking crises will erupt. European banks have closed down, which will have far-reaching effects and may even trigger the breakup of the European Union.

Therefore, in terms of European financial stability policy, it is very important for regulators to formulate the “ bank resolution” policy.

“ A bank resolution occurs when authorities determine that a failing bank cannot go through normal insolvency proceedings without harming public interest and causing financial instability” (European commission, 2014a). After the recent financial crisis, the European Union had taken a series of measures to formulate the “ bank resolution” policy to coordinate and improve the tools of for dealing with the banking crisis in its member states.

“ Thebank recovery and resolution directive (BRRD)was adopted in spring 2014 to provide authorities with comprehensive and effective arrangements to deal with failing banks at national level” (European commission, 2014b).

To begin with, the policy measure available to the regulator is a “ bail-in” mechanism. Thebank recovery and resolution directive (BRRD), which has been in force since 2015, specifies that the government cannot use taxpayer funds to bail out banks before shareholders and creditors of banks bear losses, so banks may need to bail in first.

“ The EU’s bank resolution rules ensure that the banks’ shareholders and creditors pay their share of the costs through a “ bail-in” mechanism. If that is still not sufficient, the national resolution funds set up under the BRRD can provide the resources needed to ensure that a bank can continue operating while it is being restructured” (European commission, 2014c).

However, if banks save themselves, many retail private investors will suffer losses. For example, Financial Stability Report of 2016 in the central bank of Italy showed that retail private investors contributed nearly 70% of the funds of banking sector; residents held bank debts amounting to 920 billion euros, accounting for about 23% of the total assets of the residential sector, of which about 420 billion were at risk of loss. Once the bank risk breaks out, bank bail-in will lead to heavy losses in the residential sector, which is no different from the ordinary taxpayer’s loss.

Therefore, after that, the special provision in the BRRD regulations were initiated, which is the temporary assistance of the government. Although EU regulations do not allow direct government assistance, if the situation becomes serious, the government will reach a compromise with the EU, categorizing the outbreak of banking risks or the impact of Brexit as “ force majeure”. In this way, it is possible to implement a policy of temporary assistance from the government to protect the interests of the bank’s retail investors. The Italian government has acted like this.

Nevertheless, given the potential collapse of the EU financial system by defaults of “ big but not down” banks such as Deutsche Bank or Seattle Bank, Germany and the European Central Bank will not dare to risk getting these banks into bankruptcy protection. The EU has now approved the Italian government to bail out the banking industry. Since it has already begun, it will certainly not be a one-time bailout. Just as the EU’s aid to Greece was the same, in order to prevent Greece’s collapse and withdrawal from the EU, EU policy was kidnapped, and the scale of aid was expanding. The rescue of Italian banks may be like a bottomless pit, causing the EU to fall into debt again.

Therefore, the policy of the final solution is the unification of fiscal policy and monetary policy. Due to the particularity of the EU system, the implementation of its fiscal policy is very difficult. If fiscal policy and monetary policy can be combined, it is possible to exert the maximum effect of the government. Using the “ helicopter drop” (“ deficit monetization“), the government can directly bail out banks in distress without worrying about the debt burden.

## Conclusion

The implementation of the European financial stability policy is necessary because of the negative effects of bank failures. In other words, the impact of bank failures is the main factor considered by the government, i. e. the public confidence, conductivity of financial risks and negative externality. Also, it is also an important issue about how creditors to get repaid when banks are liquidating, which is derived from these three factors. Obviously, Creditors get repaid based on priority.

Thus, the EU provides a framework for regulators to manage bank failures effectively. According to thebank recovery and resolution directive (BRRD), based on the certain problem of policies, the European financial stability policy extends from the policy of the bail-in mechanism to the policy of government assistance, and finally proposes policy measures that unify the fiscal and monetary policies.

## References

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