Banking Crisis and Limited Creditor Protection

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Among its many victims, investors have suffered dearly in this financial crisis. For shareholders of financial institutions, this could be expected: they are the residual claimants, although in fact the state – that is the taxpayer – appeared to be the ultimate risk bearer. In some cases, the rescue operations took place without much regard to the applicable laws or principles: 'Not kennt kein Gebot', they say in German ('necessity knows no law'), and looking back at the financial crisis as it developed and the urgency of the interventions, that was probably the only way out. In the future, however, that blunt approach should be avoided and governments should urge legislators to clearly trace the limits of their sovereign decisions, with due respect for the rule of law and the principles of human rights. Some legislators, for example, the German, have already taken credible measures to ensure that an adequate balance is reached between the legitimate rights of the shareholders and the general interest. A harmonizing intervention of the EU Commission is called for, especially with a view on cross-border cases. Ultimately, this matter deals not only with shareholder protection but also with the ability of the banks to be further capitalized by increasingly risk-averse investors.

The situation of the creditors is more complex: they have generally been spared the hardship of seeing their rights reduced. Governments have made and are still making considerable efforts to avoid a major financial crisis and a further fall in public confidence and have generally left creditors untouched in the reorganization schemes of systemic financial institutions allowing these banks to continue as ongoing businesses.

The question arises, however, whether and to what extent creditors should remain protected against the consequences of a banking crisis, shifting the entire restructuration burden to the state. Of course and for social reasons, the public depositors have to be excepted, and generally, they are sufficiently protected under the deposit protection schemes and the increased thresholds that are now applicable. However, all other creditors, and especially the commercial and interbank creditors, may not always rely on the same favourable treatment. The difference of treatment in a reorganization scheme and in bankruptcy is striking: where in the former, the burden is borne by the equity holders and the state if needed, the burden is more evenly spread in bankruptcy, where all creditors, the depositors excepted, are exposed to the collective pain. These ideas are being considered in Commission proposals on the crisis resolution schemes, where more leeway would be allowed for dealing in the pre-insolvency phase with the position of the different classes of creditors. This innovation would come at a price: the cost of capital is likely to increase, while creditors will even more than today require collateral to be posted, an increasingly rare asset on which all parties in the markets are laying claim. Should one not extend the intervention even to secured loans? A bold movement, but not necessarily unseen in major banking cases, like the Lehman case. In addition, would the principles of equal treatment not require these rules to be applicable to all creditors of a bank and to all companies, and not only to a specific group of 'better informed' – read inter-bank – creditors? Private debtors will probably also claim the same benefit, but is this justified? All this may result in putting our credit system out of balance. Therefore, due consideration is to be given to all interests concerned, while the limits of an intervention should be clearly traced beforehand and probably restricted to systemic institutions. By doing so, the risk premium for the creditors can be better assessed and included in the pricing of the loans. To be followed. . .

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