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Bank Recapitalizations: A Comparative Perspective

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BANK RECAPITALIZATIONS: A COMPARATIVE PERSPECTIVE

We have been here before. No matter how different the latest financial frenzy or crisis always appears, there are usually remarkable similarities with past experience from other countries and from history.¹

I. Introduction

The Trouble Asset Relief Fund (“TARP”)² was created in panic. Faced with a financial crisis unprecedented in scope and severity, Congress gave the United States Department of the Treasury $700 billion, with enormous latitude on how to spend the funds.³ By all accounts, TARP was instrumental in stabilizing the financial system and setting the foundation for economic recovery.⁴ Yet its expiration, on October 3, 2010, was little mourned.⁵ As the crisis faded, government officials publicly expressed their intentions to never again deploy a TARP-like program: “[t]here will be no more taxpayer funded bailouts—period.”⁶

The fundamental problems of TARP are widely acknowledged on editorial pages and amongst academic commentators.⁷ In particular, the robust oversight TARP received throughout its lifetime provided illuminating as-

¹ Carmen M. Reinhart & Kenneth Rogoff, This Time Is Different: Eight Centuries of Financial Folly xxv (2009).
assessments of the program’s design and performance. The overseers identified various problems, such as the failure to improve small business’ access to credit, the lack of transparency in its implementation, and most importantly, the creation of moral hazard. Although the merits of these criticisms have been much debated, there has been little discourse on reforms were a similar crisis to arise in the future.

The central reason for this failure to plan for a scenario where the government is once again forced to bail out financial institutions is regulators’ burgeoning faith in the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) and its newly-created tools to address the fundamental failures in the financial system. Passed in the wake of the government interventions of 2008 and 2009, Dodd-Frank gives the Federal Deposit Insurance Corporation (“FDIC”) the authority to resolve and break apart certain large financial firms whose imminent failure would threaten the stability of the financial system. The FDIC and other financial regulators have promised that this new tool will reduce the chance that future taxpayer bailouts will be necessary.

But the success of Dodd-Frank is far from certain. Importantly, the future of taxpayer bailouts hinges on the ability and willingness of the FDIC to use its new authority, in coordination with other federal regulators, and to insist on organizational changes well before the onset of a crisis. Reflecting the general skepticism on this point, the Nobel laureate and Columbia University Professor Joseph E. Stiglitz has argued that the Dodd-Frank resolution authority “has made little difference, because few believe that the government will ever use the authority at its disposal with [ ] too-big-to-fail banks.” In January of 2011, Moody’s Investors Service, one of the world’s most influential credit rating agencies, announced its belief that the resolution regime “will not work as planned, posing a contagion risk and most

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8 When Congress created TARP, it also created two independent overseers. EESA mandated the appointment of a Special Inspector General for the TARP program (“SIGTARP”) and required the SIGTARP to submit quarterly reports to Congress. Emergency Economic Stabilization Act of 2008, Pub. Law No. 110-343, §121(a), (f), 122 Stat. 3765, 3788, 3790. It also created a bipartisan Congressional Oversight Panel (“COP”) and required it to submit regular reports to Congress. Id. § 125.


11 See, e.g., Has Dodd-Frank Ended Too Big to Fail?, supra note 4, at 6.


likely forcing the government to provide support in order to avoid a systemic crisis.”

Because of the potential for future taxpayer bailouts, it is prudent to develop a framework for a rescue program if the time came—one that addresses TARP’s perceived failures. This Article surveys recent foreign recapitalization schemes to provide insights into how such a program should be designed. It focuses on recapitalization schemes because the cornerstone of TARP was a capital injection initiative, the Capital Purchase Program (“CPP”). For the most part, it examines the most acute phase of the global financial crisis, between September 2008 and December 2009, because comparisons between the U.S. and European policy responses is least tainted by contextual differences in this timeframe.

This Article offers six suggestions for improving the CPP. First, a future TARP should differentiate between beneficiaries according to their risk profiles. Had the Treasury differentiated in its treatment of healthy and distressed banks, it could have obtained more appropriate compensation for the taxpayers’ risk and reduced moral hazard by imposing harsher behavioral constraints on distressed banks. Second, capital injections to weaker institutions should be conditioned on more stringent non-price terms. The recapitalization programs under TARP created distorted ex ante incentives by their failure to include restructuring requirements or punish incumbent executives. Third, the Treasury should prevent major institutions from opting out of the program to avoid undesirable market responses towards participating banks. Fourth, large and small banks should be recapitalized under different terms, tailored to their respective needs and ability to repay. Fifth, the Treasury should avoid lending requirements, which appear ineffective, and instead consider direct lending to small businesses and credit mediation. Finally, the Treasury should, in budgeting and management considerations, prepare for the possibility that multiple tranches of capital could be necessary in order to stabilize the financial sector.

This Article is divided into four sections. In Part II, I present a critique of the CPP, arguing that its design hindered the effectiveness of the bailout and created moral hazard. In Part III, I survey the recapitalization programs

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15 Has Dodd-Frank Ended Too Big to Fail?, supra note 4, at 21 (statement of Neil Barofsky, Special Inspector General of TARP).
16 Specifically, this Article does not address the deepening of the European banking crisis that began around 2011, as sovereign-funding concerns in some euro area countries raised doubts about the viability of the European financial sector; because the U.S. and European financial markets had significantly different exposures to the countries at the heart of the sovereign debt crisis. See, e.g., Patrick Jenkins & Megan Murphy, Bank Contagion Fear Resurfaces in the Eurozone, FIN. TIMES, July 12, 2011, http://www.ft.com/intl/cms/s/0/f3efcbe2-aca7-11e0-a2f3-00144feabd0c.html#axzz2Jxrv51K5 (observing that “European banks account for about 90 per cent of international banking exposure to Italy”); Financial Stability Oversight Council Annual Report to Congress: Hearing Before the S. Comm. on Banking, Hous., & Urban Affairs, 112th Cong. 5 (2011) (statement of Timothy F. Geithner, U.S. Treasury Secretary) (stating that “[t]he U.S. [direct financial exposure to] European governments and their financial institutions is quite small.”).
implemented around the world, both in response to the 2008–2009 global financial crisis and the Asian banking crisis in the late 1990s. I compare the CPP with alternative recapitalization strategies that other governments have adopted, and explore the relative effectiveness of various approaches. Based on this analysis, I propose in Part IV that a future U.S. recapitalization program should modify six aspects of the CPP.

II. AN ANALYSIS OF THE CAPITAL PURCHASE PROGRAM

A. Characteristics of an Optimal Recapitalization

Public recapitalization of private financial institutions was a widely adopted response to the global financial crisis. Typically, private enterprises raise capital through voluntary market transactions. However, when financial stability erodes, as it was in 2008, access to the private markets may be limited. With the exception of Warren Buffett’s investment in Goldman Sachs and Mitsubishi UFJ’s investment in Morgan Stanley, the funding available to U.S. banks in 2008 was limited to sovereign wealth funds. Financial institutions also faced the problem of “debt overhang,” whereby the presence of existing debt was sufficiently large that creditors were not confident of repayment. The crisis also increased the difficulty for financial institutions with large portfolios to disclose sufficient details to overcome the informational asymmetry vis-à-vis investors. Moreover, investors hoarded liquidity either to satisfy regulatory requirements or because they expected fire-sale prices in the future.

Where the social value of a moribund institution’s existence is larger than the social cost of the government bailout, a subsidized recapitalization may be justified. An oft-cited example is the 2008 rescue of the insurance giant, American International Group (“AIG”). At the time, AIG’s insurance subsidiaries owned more than eighty-one million life insurance policies with a face value of $1.9 trillion. Had AIG failed, its subsidiaries would have been seized by state regulators, leaving policyholders facing considerable

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18 The concept of debt overhang was first formalized in Stewart C. Myers, The Determinants of Corporate Borrowing, 5 J. FIN. ECON. 147 (1977).


uncertainty about the status of their claims. AIG was also a significant counterparty to a number of major financial institutions, and its failure could have exacerbated the severe liquidity and insolvency challenges faced by the financial sector. Because regulators feared that AIG’s failure would result in an “intensification of an already severe financial crisis and a further worsening of global economic conditions,” government intervention seemed both necessary and appropriate.

In theory, public recapitalizations have three main goals. First, the intervention should stabilize the banking system and facilitate a prompt return to normalcy. To this end, it is important that the assistance is temporary, aimed at restructuring unhealthy banks and reverting them back to private ownership in a timely manner. A prominent example of a failure in this respect is the Japanese “lost decade.” In response to the collapse of its stock and real estate market in the 1990s, the Japanese government injected ¥1.8 trillion into the banking system in 1998, followed by another ¥7.5 trillion injection in 1999. Although the recapitalizations effectively stabilized the financial markets, it failed to address the non-performing loans problem at the center of the crisis. As a result, Japanese banks continued to be thinly capitalized, resulting in a decade of marginally functioning “zombie banks” that struggled to remain solvent. Five of the twenty-one recapitalized banks have yet to fully repay the Japanese government’s investments as of February 2013.

Second, the recapitalization should support credit supply to the private sector. Contractions in bank credit cause a decrease in economic activity and

22 See id.
23 Edmund L. Andrews et al., Fed’s $85 Billion Loan Rescues Insurer, N.Y. TIMES, Sept. 17, 2008, at A1 (warning that if A.I.G. had collapsed, “institutional investors around the world would have been instantly forced to reappraise the value of those securities [that AIG was counterparty to]... and that in turn would have reduced their own capital and the value of their own debt”). It was later revealed that AIG’s financial counterparties may have in fact hedged most of their exposure, either by shorting AIG stock or by collateral calls. Carrick Mollenkamp et al., Behind AIG’s Fall, Risk Models Failed to Pass Real-World Test, WALL ST. J., Nov. 3, 2008, at A1. However, accurate information regarding counterparty exposure was likely unavailable at the time the bailout decision was made.
26 See id. at 401.
an increase in unemployment. Put another way, “one bank’s decision to forgo profitable lending . . . reduces payments to households, which increases household defaults and thus worsens other banks’ conditions.” By subsidizing bank capital, recapitalizations aim to stimulate the real economy by increasing business lending.

Finally, the recapitalization should minimize moral hazard. Bailouts, in general, present the omnipresent concern that excessive risk-taking will be subsidized, and hence encouraged. Government rescue undermines the market discipline of creditors and counterparties, and decreases investors’ incentives to monitor bank performance. Particularly with the rise of “too-big-to-fail,” large financial institutions may now rationally decide to take excessive risk on the expectation of a bailout. While moral hazard cannot be eliminated, it can be reduced by the government’s willingness to replace the top management as a condition to recapitalization. Because corporate decisions are often shaped by the interests of senior executives, increasing their personal costs in the event of a bailout should strengthen incentives to engage in prudent risk management.

B. Criticisms of the Capital Purchase Program

The Capital Purchase Program (“CPP”) symbolized for the general public the U.S. government’s bailout of Wall Street. On October 14, 2008, the Treasury announced that the CPP would directly invest in “healthy, viable banks to promote financial stability, maintain confidence in the financial system, and permit institutions to continue meeting the credit needs of American consumers and businesses.” Over the life of the program, Treasury purchased $205 billion in preferred stock and subordinated debt from 707 different financial institutions in forty-eight states, the District of Co-
lumbia, and Puerto Rico. Treasury also received ten-year warrants equal to approximately fifteen percent of the investment. As of January 31, 2013, 497 institutions, including nine with the largest CPP investments, had paid back all or a portion of their principal for an aggregate total of $220.85 billion of repayments and income.

It is widely agreed that the CPP has been effective in reducing the banks’ default risk. The price of credit default swaps—a type of financial insurance contract—and the LIBOR-OIS spread—which measures the differences in bond yields—are commonly used as proxies for market perceptions of the likelihood of default: an increase in either metric reflects heightened fears of bank insolvency while a decrease signifies improvements in market confidence. Within three months of the CPP’s announcement, the price of credit default swaps for the eight largest United States banks declined approximately 275 basis points, and the one-month and three-month LIBOR-OIS spreads declined about 202 and 147 basis points, respectively. The fact that no major credit event took place in the United States after the implementation of the CPP is certainly an indication of the success of the program in stabilizing the financial system.

At the same time, the CPP has fallen short of achieving the three goals described above. Put simply, it has no clear exit in sight, has failed to stimulate lending, and has created enormous moral hazard.

1. No Clear End in Sight

To avoid tilting the playing field in favor of larger institutions, the CPP is open to any “bank, savings association, bank holding company and savings and loan holding company” organized under domestic law—not merely systemically important institutions. In fact, eighty-seven percent (625) of the 707 CPP recipients have total assets of less than $1 billion. The Treasury invested in all recipient institutions under a “one-size-fits-all” ap-

38 Office of the Special Inspector Gen. for the Troubled Asset Relief Program, SIG-QR-10-03, Quarterly Report to Congress 70 (2010).
39 Id. at 69.
42 Kashkari, supra note 4.
proach. Although different terms were adopted for public, private, S-corporations, and mutual banks, the basic provisions—coupon rate, dividend restrictions, and limits on executive compensation—were similar.\footnote{See id. at 12 n.21 ("Because S corporations are legally allowed to issue only one class of equity, and it must be held by a natural person, Treasury structured subordinated debenture transactions, which pay interest quarterly at 7.7 percent per year for the first five years . . . and 13.8 percent per year thereafter.").}

However, smaller banks are often privately held, have limited access to capital markets, and do not benefit from the “too big to fail” guarantee; it is thus harder for them to meet the required dividend payments or raise sufficient capital to repay the government.\footnote{Id. at 3.} As a result, small banks have increasingly become “trapped” within the CPP. According to the February 13, 2013 monthly report to Congress on TARP, approximately thirty percent (210) of the total 707 CPP beneficiaries remain in the program.\footnote{U.S. Dep’t of the Treasury, supra note 40, at 7.} All of these remaining institutions have total assets of less than $10 billion.\footnote{Id. at 9.}

The role of the government as a shareholder is expected to become more significant as the remaining 210 institutions fall behind on required dividend payments. Approximately 139 of the remaining institutions have missed at least one scheduled dividend or interest payment, and 117 of these institutions have missed six or more.\footnote{See U.S. Dep’t of the Treasury, Cumulative Dividends, Interest and Distributions Report as of January 31, 2013 20–28 (2013).} This number will likely grow substantially in 2013, as the dividend rate charged to recipients rises from five percent to nine percent.\footnote{Id. at 17, at 28.} Under the terms of the CPP, the Treasury has the right to appoint two board members when a bank misses six dividend payments.\footnote{Id. at 41.} On July 19, 2011, the Treasury appointed, for the first time, four board members to two CPP banks—First Banks, Inc. and Royal Bancshares of Pennsylvania, Inc.\footnote{U.S. Gov’t Accountability Office, GAO-12-301, Capital Purchase Program: Revenues Have Exceeded Investments, but Concerns about Outstanding Investments Remain 15 (2012); U.S. Dep’t of the Treasury, Troubled Asset Relief Program (TARP): Monthly 105(a) Report—July 2011 8 (2011), available at http://www.treasury.gov/initiatives/financial-stability/reports/Documents/July%20105(a)%20Report.pdf.} Since then, the Treasury has elected twelve board members to seven CPP institutions.\footnote{See id. at 16.}

2. Failure to Stimulate Lending

The CPP contains only non-binding language that the recipient institution “agrees to expand the flow of credit to the U.S. consumers and businesses on competitive terms to promote the sustained growth and viability of the U.S. economy.”\footnote{MASSAD, supra note 17, at 37 (internal citations omitted).} The Treasury justifies this feature in the context of a
top-down approach to increasing lending and unfreezing the credit markets. By increasing the capital base of an array of healthy, viable institutions, banks will have the capability and incentive to increase their lending if good lending opportunities exist.\(^{55}\) Where there is reduced credit demand or a failure of businesses in the real economy, banks would not be forced to originate a rash of bad loans.\(^{56}\) This lending flexibility also enables recipients to increase their capital buffer in response to instability in the banking system or uncertainty regarding future changes in regulatory capital standards.

There is mounting evidence, however, that this top-down model is not working. Data from the Federal Reserve’s opinion survey on bank lending practices indicates that credit demand rebounded after July 2009.\(^{57}\) At the same time, bank lending to small and medium-sized enterprises ("SMEs") in the United States remained sluggish. Indeed, in the first half of 2010, fifty-nine percent of the businesses polled by the Federal Reserve applied for credit, but only half of the small business applicants were approved.\(^{58}\) A study by the Organization for Economic Cooperation and Development ("OECD") found that the pace of small-business lending fell by over six percentage points ($43 billion) in 2010 from 2009.\(^{59}\) Large lenders with over $50 billion in assets, the majority of whom received CPP investments, had the largest dollar volume decline, with a loss of more than $18 billion.\(^{60}\)

Measuring the direct effect of the CPP investments on the credit supply is difficult, particularly because the effects of the capital injection is entangled with that of other policy-based and macro-economic factors at work. For example, the total outstanding amount of loans on a bank’s balance sheet can reflect new loans, or alternatively, the effect of businesses drawing on their preexisting revolving credit facilities.\(^{61}\) Subject to these caveats, evi-

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\(^{55}\) See CONG. OYERSIGHT PANEL, JANUARY OYERSIGHT REPORT: ACCOUNTABILITY FOR THE TROUBLED ASSET RELIEF PROGRAM 19–20 (2009); see also Press Release, U.S. Dep’t of the Treasury, Statement by Secretary Henry M. Paulson, Jr. on Capital Purchase Program (Oct. 20, 2008) ("Our purpose is to increase confidence in our banks and increase the confidence of our banks, so that they will deploy, not hoard, their capital . . . . [I]ncreased confidence will lead to increased lending. This increased lending will benefit the U.S. economy and the American people."); available at http://www.treasury.gov/press-center/press-releases/Pages/hp1223.aspx; Bert Ely, Don’t Push Banks to Make Bad Loans, WALL. ST. J., Feb. 2, 2009, http://online.wsj.com/article/SB123353296384237547.html.

\(^{56}\) See Ely, supra note 55.


\(^{59}\) United States, supra note 57, at 159.

\(^{60}\) Id.

dence from academic literature portrays a contradictory picture as to whether that the CPP achieved the goal of stimulating lending. A Federal Reserve Board study using panel data on gross commercial and industrial (“C&I”) loan originations found no economically significant difference between the loan volume of CPP recipients and non-recipients.62 Similarly, a study by University of Michigan professors Ran Duchin and Denis Sosyura used loan-level data on twenty-five million mortgages and twenty-eight thousand corporate loans and concluded that the CPP investments did not stimulate credit origination.63 As discussed in the next sub-part, both studies also found that CPP recipients increased their risk profile—investing in riskier asset classes and tilting their portfolios to higher-yielding securities—after receiving government funding.64 A working paper by Lei Li using Call Reports published on the Federal Reserve Bank of Chicago’s website and controlling for local economic conditions, however, concludes that CPP investments increased recipients’ credit origination by an annualized rate of 6.43 percent.65 In addition, Li found no evidence that CPP recipients made loans of lower quality than non-recipients.66 Most recently, a 2012 report commissioned by the U.S. Small Business Administration using the Federal Reserve Bank of Chicago’s Call Reports found that CPP recipients not only decreased SME lending by twenty-one percent between 2008 and 2011, the decline was dramatically greater than that observed for non-CPP participants (fourteen percent).67

3. Creation of Moral Hazard

In the fall of 2008, the Treasury feared that the weakness of some of the largest banks would “be a surprise to the market” and create instability.68 It therefore designed the CPP with standardized terms to “avoid stigmatizing any one bank as being a weak bank” or provide a negative signal about the true value of the recipients’ assets.69 To prevent the stronger institutions from opting out, the terms and conditions of TARP were “intentionally gener-

64 See id. at 4; Black & Hazelwood, supra note 62, at 3.
66 Id. at 4.
68 CONG. OVERSIGHT PANEL, supra note 32, at 62.
69 Office of the Special Inspector Gen. for the Troubled Asset Relief Program, SIGTARP 10-001, Emergency Capital Injections Provided To Support The Viability Of Bank Of America, Other Major Banks, and The U.S. Financial System 17 (2009), avail-
ous.” The initial dividend rate was five percent, half of what Warren Buffett received from a similar transaction with Goldman Sachs. There were no binding lending or restructuring requirements, and dividends on ordinary shares were allowed to continue at the last quarterly level declared. The executive compensation restrictions in the original CPP terms only limited the severance payments of the top five officials and required recipient institutions to adopt compensation schemes that do not encourage unnecessary and excessive risk. Congress later placed additional limits on bonus payments to a number of top executives after four months of public outcry.

While much of the moral hazard created by TARP was inherent in any large-scale government recapitalization, the CPP’s use of attractive “one-size-fits-all” terms likely exacerbated the problem in at least three ways. First, as the Congressional Oversight Panel’s Advisory Committee on Finance and Valuation explains, the Treasury’s decision to provide capital on uniform terms “effectively offered weaker participants greater subsidies than it offered to stronger participants.” Notably, Citigroup, which had been forced to take billions of dollars in write-downs in the run-up to the crisis, received $25 million from the Treasury in exchange for securities valued at $15.5 million. In contrast, Wells Fargo, widely regarded as one of the banking industry’s healthiest players in 2008, gave approximately $23.2 million worth of securities for the same $25 million investment. In general, riskier investments have greater potential gains along with a considerably increased chance of significant losses; banks typically balance their investment portfolio to ensure a meaningful return while insulating themselves from the potentially catastrophic losses that accompany a risky portfolio. However, the “one-size-fits-all” distribution of capital magnifies incentives for banks to incur excessive risk by allowing institutions to keep the large returns from successful gambles while ensuring that losses would be borne by the Treasury.

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70 See Phillip Swagel, The Financial Crisis: An Inside View, BROOKINGS PAPERS ON ECON. ACTIVITY, Spring 2009, at 1, 52, available at http://www.brookings.edu~/media/projects/bpea/spring%202009/2009a_bpea.swagel.pdf (recounting that the CPP “had to be the opposite of the ‘Sopranos’ or the ‘Godfather’—not an attempt to intimidate banks, but instead a deal so attractive that banks would be unwise to refuse it”).

71 See MASSAD, supra note 17, at 24.

72 See id. at 35, 37–41.


74 See 31 C.F.R. § 30.


76 DUFF & PHelps, VALUATION REPORT I-10 (2009) (valuations derived from the average of the reported “low” and “high” estimations).

77 Id.
Second, by failing to hold senior executives accountable for the consequences of their errors, the CPP reinforced the “heads I win, tails the government will bail me out” incentive system. The Treasury avoided removing the managers at the helm of even the most fundamentally troubled institutions. Of the nine largest beneficiaries, only Bank of America saw an unexpected chief executive officer change in 2009. Although the Treasury eventually placed limits on the bonus payments to top management, the restrictions were seen as “mild,” and were frequently not enforced. Moreover, Harvard professors David S. Scharfstein and Jeremy C. Stein have noted that because no explicit suspension of dividends was included, top executives and equity holders at many distressed institutions continued to receive compensation through dividends on common stock during the crisis period. They estimate that the amount of dividend payments directed to officers and directors of the nine largest CPP recipients—including Citigroup and Bank of America—amounts to approximately $250 million in the first year of the program. As the Congressional Oversight Panel for TARP points out, had bank executives instead been forced to accept tougher executive compensation and corporate governance restrictions as a condition to the CPP, “they would be less willing to repeat the experience, reducing moral hazard.”

Finally, by steadfastly refusing to condition CPP funding on balance sheet reductions, the Treasury entrenched the existence of “too big to fail.” Banks that were “too big to fail” in 2008 have only gotten bigger; between the end of 2007 and September 2009, Wells Fargo, Bank of America, and J.P. Morgan Chase grew by 100 percent, 35 percent, and 25 percent, respectively. In a March 2010 speech, Federal Reserve Chairman Ben Bernanke warned that large banks now face “limited market discipline, . . . [thereby] allowing them to obtain funding on better terms than the quality or riskiness of their business would merit and giving them incentives to take on exces-

80 Johnson & Kwak, supra note 3, at 176–79; see Mary Williams Walsh, U.S. Faulted Over Pay at Rescued Firms, N.Y. TIMES, Jan. 24, 2012, at B4 (reporting that despite the restriction, “[f]orty-nine [executives] received packages worth $5 million or more from 2009 to 2011”).  
81 Johnson & Kwak, supra note 3, at 180.
sive risks.”

The Congressional Oversight Panel echoed this sentiment in noting that the CPP has created a perverse incentive for “too big to fail” institutions to “disregard risk, since when it comes to their all-important cost of capital, the markets will no longer penalize them for recklessness or short-sightedness in lending, nor will they reward responsibility or prudence.”

As it turns out, the Treasury’s efforts to portray all recipients as “healthy” had little effect. The market had a fairly accurate perception of each bank’s relative health during the crisis. Despite participation in the CPP by all major U.S. banks, the stock prices of Citigroup and Bank of America were consistently at the bottom of the group and the General Counsel of the Federal Reserve Bank of New York told the Special Inspector General for the TARP that “the market still perceived Citigroup as an institution ‘less strong than others.’”

Moreover, moral hazard is emerging as one of the CPP’s most significant legacies. A 2009 study by the Center for Economics and Policy Research showed that the advantages large banks—those with more than $100 billion—enjoy over small banks in the cost of funds have increased from 0.29 percentage points to 0.78 percentage points, translating to an annual subsidy of $34 billion for the 18 largest U.S. banks. A working paper by New York University Professor Viral V. Acharya and his co-authors similarly found that, after the crisis, the price of borrowing for large financial institutions did not reflect the institutions’ risk profile. Specifically, the authors determined that larger intuitions have enjoyed a 100 basis point borrowing cost advantage over smaller ones since 2008, despite having pursued riskier strategies. Looking at the investment and lending strategies of recipient banks, both the Federal Reserve Board study and the study by Duchin and Sosyura found an increase in the risk exposure of large CPP recipients. Specifically, Duchin and Sosyura estimated that beneficiaries increased their investments in risky securities, such as mortgage-backed securities and equi-

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85 CONG. OVERSIGHT PANEL, supra note 5, at 97–99.
86 CONG. OVERSIGHT PANEL, supra note 32, at 59–60.
87 OFFICE OF THE SPECIAL INSPECTOR GEN. FOR THE TROUBLED ASSET RELIEF PROGRAM, SIGTARP 11-002, EXTRAORDINARY FINANCIAL ASSISTANCE PROVIDED TO CITIGROUP, INC. 8 (2011).
90 Id. at 11–12; 37.
91 See Black & Hazelwood, supra note 62, at 3; Duchin & Sosyura, supra note 63, at 3.
ties acquired to profit from short-term price movements, by ten percent, moving away from safer assets such as Treasury bonds.\footnote{Duchin & Sosyura, supra note 63, at 3.}

III. AN ANALYSIS OF COMPARATIVE RECAPITALIZATION PROGRAMS

As mentioned earlier, other countries have adopted a variety of different approaches to recapitalizing their respective banking sectors. Since many of these alternative strategies were announced and implemented around the same time as the CPP, this section contrasts them to the CPP framework and explores the merits of the alternative measures with reference to the recapitalization goals described in Part II: prompt return to normalcy, expansion of credit supply to the private sector, and limitation of moral hazard.

A. A Snapshot of Government Responses

Figure 1 illustrates the international bailout efforts from 2008–2009. Before October 2008, state interventions were generally \textit{ad hoc} support for individual institutions, including AIG, the Icelandic banks, Fortis, and Dexia.\footnote{See Fabio Panetta et al., \textit{An Assessment of Financial Sector Rescue Programmes}, BIS PAPERS (Bank of Int’l Settlements, Basel, Switz.), July 2009, at 7.} As the bankruptcy of Lehman Brothers reverberated around the world, many countries introduced comprehensive recapitalization and guarantee packages passed by the legislative bodies, including the U.S. TARP.\footnote{See id.} The rollout of these programs slowed towards the end of 2008 as governments turned once more to standalone actions, but increased again at the beginning of 2009.\footnote{See id. at 9.} Unlike the first set of comprehensive schemes, the 2009 packages focused more on removing troubled legacy assets.\footnote{See id.} By the end of 2009, several large banks had fully or partially repaid the government support, including all of the large U.S. and French beneficiaries.\footnote{See id.; see also \textit{Agence des Participations de l’État, French State as a Shareholder} 15 (2010), available at http://www.ape.minefi.gouv.fr/sections/rapports_sur_l_etat/annual_reports_on_go/downloadFile/attachedFile_3/2010_Report_on_the_Government_as_a_shareholder.pdf?nocache=1298909773.82.}

Table 1 provides a snapshot of the recapitalization measures undertaken by each country. Four aspects of the U.S. CPP program immediately stand out. First, although the CPP, often described as a “big bazooka,” is the largest in \textit{absolute} commitments and outlays, it is relatively small when scaled by the size of GDP.\footnote{See, e.g., Gillian Tett, \textit{America’s Six Key Lessons for a ‘Euro Tarp’}, FIN. TIMES, Oct. 6, 2011, http://www.ft.com/intl/cms/s/0/0a8a8ae0-f034-11e0-977b-00144feab49a.html#axzz2P9qogGpN.} Instead, the Netherlands has the largest exposure, with recapitalization commitments of around 4.1 percent of GDP. While this measure of the magnitude of state aid is imperfect because it does not take...
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Figure 1. Timeline of Select State Interventions (2008–09)

- France invests €1 billion in Dexia, as a part of joint Belgium-France-Luxembourg intervention.
- Dutch Ministry of Finance and De Nederlandsche Bank takes Fortis' Dutch operations into temporary public ownership for €16.8 billion.
- Dutch Ministry of Finance and De Nederlandsche Bank commits €20 billion to recapitalize fundamentally sound and viable financial institutions.
- U.K. H.M. Treasury announces capital investments in RBS and Lloyds totaling £37 billion.
- U.S. Treasury announces the CPP and initial commitments to invest a total of $125 billion in nine institutions.
- France passes the Finance Amendment Act, which sets up the SPPE.
- Germany announces the passage of the Financial Market Stabilisation Act, and the establishment of SoFFin.
- Dutch Ministry of Finance and De Nederlandsche Bank announces purchase of €10 billion in Core Tier 1 securities from ING Group.
- French Ministry of Finance announces plans to invest €10.5 billion in six banks through the SPPE.
- Dutch Ministry of Finance and De Nederlandsche Bank announces purchase of €3 billion in securities from Aegon Group.
- U.S. Federal Reserve agrees to provide $85 billion credit line to AIG.
- Commerzbank announces agreement with SoFFin for investment of €8.2 billion in the form of silent participation.
- U.S. Treasury announces purchase of $40 billion in preferred shares from AIG through the SSFI.
- Dutch Ministry of Finance and De Nederlandsche Bank announces purchase of €750 million in securities from SNS Reaal N.V.
- U.S. Treasury announces plans to invest additional $20 billion into Citigroup under the TIP.
- French Ministry of Finance provides additional €1.7 billion in non-voting preference shares to Société Générale through the SPPE.
- Irish Department of Finance nationalizes Anglo Irish Bank.
- U.S. Treasury provides additional $20 billion to Bank of America under the TIP.
- Irish Department of Finance announces plans to provide €4 billion to Anglo Irish Bank.
- Irish Department of Finance announces capital investments in Allied Irish Bank and Bank of Ireland totaling €7 billion.
- U.K. H.M. Treasury commits an additional £25.5 billion to RBS as part of Asset Protection Scheme.
- Irish Department of Finance announces plans to invest €5.5 billion in three of its largest banks.
- U.S. Treasury commits additional $30 billion to AIG through the SSFI.
- French Ministry of Finance provides additional €5.1 billion in non-voting preference shares to BNP Paribas through the SPPE. Simultaneously, BNP Paribas redeemed €2.55 billion of the securities issued to SPPE in 2008.
<table>
<thead>
<tr>
<th>Program</th>
<th>Amount Committed (^1) Outlay ($bn)</th>
<th>Recipients</th>
<th>Instrument</th>
<th>Dividend/ Interest rate</th>
<th>Covariates and Restrictions</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total ($ bn)</td>
<td>% GDP (2008)</td>
<td>#</td>
<td>% Assets (^2)</td>
<td>Exec Comp</td>
</tr>
<tr>
<td>U.S. (TARP)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CPP</td>
<td>$250</td>
<td>1.7</td>
<td>$204.9 (10.56)</td>
<td>$204.9 (10.56)</td>
<td>703</td>
</tr>
<tr>
<td>TIP</td>
<td>–</td>
<td>–</td>
<td>$40 (0)</td>
<td>2 (0)</td>
<td>--</td>
</tr>
<tr>
<td>SSFI</td>
<td>$69.8</td>
<td>0.05</td>
<td>$67.8 (13.3)</td>
<td>1</td>
<td>--</td>
</tr>
<tr>
<td>U.K. (GRS)</td>
<td>$64.7</td>
<td>2.9</td>
<td>$103.4 (103.4)</td>
<td>$2 (2)</td>
<td>27.4</td>
</tr>
<tr>
<td>Germany (SoFIn)</td>
<td>$109.3</td>
<td>3.8</td>
<td>$39.7 (23.7)</td>
<td>(4)</td>
<td>(4)</td>
</tr>
<tr>
<td>France (SPPE)</td>
<td>$53.7</td>
<td>2.6</td>
<td>$26.4 (60)</td>
<td>6 (6)</td>
<td>91.9</td>
</tr>
<tr>
<td>Ireland</td>
<td>$7.7</td>
<td>4.0</td>
<td>$14.7 (14.7)</td>
<td>3 (3)</td>
<td>26.6</td>
</tr>
<tr>
<td>Netherlands (^2)</td>
<td>$27.3</td>
<td>4.1</td>
<td>$18.0 (3.95)</td>
<td>3 (2)</td>
<td>65.5</td>
</tr>
<tr>
<td>Japan</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1998 Financial Functions Stabilization Act</td>
<td>$102.6</td>
<td>3.5</td>
<td>$14.5 (2)</td>
<td>21 (2)</td>
<td>--</td>
</tr>
<tr>
<td>1999 Early Stabilization Act</td>
<td>$214.7</td>
<td>7.3</td>
<td>$71.8 (7.43)</td>
<td>32 (7)</td>
<td>--</td>
</tr>
</tbody>
</table>

Source: Data used in compiling the information in this table is derived from a variety of sources. For further information, a separate listing of the sources used is available online at the Journal on Legislation website at http://www.harvardjol.com/wp-content/uploads/2013/04/sourcesPDF.pdf.

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2. Percent of total banking assets in program, calculated using 2008 data.
3. “Effective” ban on dividends. For example, the TIP limited dividends to $0.01, and the SSFI prevented AIG from increasing its dividends from $0 for five years. However, restrictions on dividends that are not effective through a companion aid programs are excluded.
4. Only effective after nonpayment of dividends for four quarters or interes tes are not consecutive for the CPP and TIP, effective after nonpayment of dividends for four quarters for SSFI.
5. Does not include in calculations because its recapitalization arose in different isolated event, and was also recapitalized using SPPE funding in coordination with Belgium and Luxembourg.
6. ABN/AMRO/Fortis not included in calculations because its recapitalization arose in different isolated event, and was nationalized in coordination with the Benelux states.
7. Includes convertible preferred shares, nonconvertible preferred share, and subordinated debt. Loan amount, coupon rate, and step-up date varied across institutions.
into account companion aid through liquidity support, debt guarantees, and asset purchases, scholars that have considered aid programs in the aggregate have portrayed a similar story.\textsuperscript{99}

Second, the CPP has the largest number of beneficiaries, over twenty times as many as the second largest program (the 1999 Japanese Early Strengthening Act). This is because, as noted above, the CPP is open to any U.S. financial institution, not merely systemically important ones.\textsuperscript{100} The only other program in this analysis available to all financial institutions regardless of size is the Dutch recapitalization scheme, but regulators limited the scope of the program by approving only three applications from mid-size to large banks.\textsuperscript{101}

The CPP’s participation rate appears lower when measured as a percentage of total assets in the banking system. Under this metric, the French Société de Prise de Participations de L’État (“SPPE”) is by far the most significant intervention, with banks holding approximately 92.6 percent of the total banking assets participating in the program. France is followed by the United States, Ireland, and the Netherlands, with banks holding 75.8 percent, 74.2 percent, and 65.9 percent, respectively, of the total banking assets receiving public aid. The high participation rate in the United States and France is almost certainly driven by the political pressure both governments placed on systematically important banks to partake in the program;\textsuperscript{102} by contrast, large banks in Germany (Deutsche Bank) and the U.K. (Barclays PLC) were given the option to opt out. The magnitude of the French intervention, as a percentage of total banking assets, is also likely influenced by its highly consolidated banking system.\textsuperscript{103}

Third, the CPP appears significantly cheaper than its international counterparts. While renumerations for other Western investments range from eight to twelve percent, the dividend rate for the CPP preferred shares is a fixed five percent, with a step-up to incentivize the beneficiaries to exit as soon as normal market conditions resume. Moreover, as described in Part II.B.3, the CPP provided additional subsidies to weaker participants through its use of standardized coupon rates, which make no reference to the sound-
ness of the recipient in the form of risk and profit-linked parameters. Only two other programs—the U.K. GRS and the Irish recapitalization scheme—use standardized forms.

Several commentators have suggested that the CPP’s low dividend rate is misleading because it ignores the value of the warrants—financial instruments that allowed the holder to gain from potential stock price increases—that the Treasury simultaneously acquired. However, the instruments used in the German, Irish, and Dutch recapitalization schemes also include warrants and convertibility options that carry additional value. The Irish recapitalization, in particular, is directly comparable to the CPP as it similarly issued ten-year warrants in combination with nonconvertible preferred stock. Moreover, the CPP warrants have had limited dilutive impact in practice, as they have generally been repurchased by the issuing banks—either at a negotiated fair market price or through a public auction—upon exit from the program.

Finally, the CPP contains relatively lenient non-price conditions; for example, it does not require participating banks to maintain a target level of lending and it places few limits on executive compensation. For comparison, Table 2 summarizes the non-price conditions of the comparative recapitalization programs. In addition, the European Commission (“Commission”) has conditioned its approval of the capital assistance to Commerzbank, UBS, ING Groep (“ING”), Royal Bank of Scotland (“RBS”), and Lloyds-HBOS on business-model restructurings and balance sheet reductions—by as much as forty-five percent in the case of ING and Commerzbank. The Commission also subjected Commerzbank and ING to a price leadership prohibition, preventing them from offering their products and services at the most favorable terms on the market for several years.

Two features found in the other recapitalization programs are also distinctive. First, only the U.K. injected common shares in the first recapitalization tranche (the second tranche in Commerzbank, for example, was also in ordinary shares). This was not intentional. As part of the GRS, U.K.’s Her

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104 Cf. CONG. OVERSIGHT PANEL, FEBRUARY OVERSIGHT REPORT: VALUING TREASURY’S ACQUISITIONS 34 (2009) (recognizing that “warrants have a value independent of the preferred shares themselves”). See generally MASSAD, supra note 17, at 5 n.3, 34, for an explanation of warrants.

105 Some institutions such as Goldman Sachs and Morgan Stanley have directly repurchased the warrants from the Treasury at a negotiated price. See SCOTT & GELPERN, supra note 41, at 432–38. Other institutions including Wells Fargo and J.P. Morgan Chase have elected to have the Treasury conduct an open public auction of the warrants but have reportedly bid on their own warrants to pick up slack. See id. Wells Fargo, for example, purchased sixty-four percent of its own warrants at the open auction. See David Henry, Wells Fargo Bailout Warrants Sell for $849 Million as Bank Bids in Auction, BLOOMBERG (May 21, 2010), http://www.bloomberg.com/news/2010-05-21/wells-fargo-warrants-said-to-fetch-849-million-in-auction-to-repay-tarp.html.


107 Id.
Bank Recapitalizations: A Comparative Perspective

Table 2. Summary of Non-Price Conditions for Comparative Programs

<table>
<thead>
<tr>
<th>Country</th>
<th>Conditions</th>
</tr>
</thead>
</table>
| U.K. (GRS)    | • Prohibits all common stock dividends without regulator consent for as long as the preferred shares were outstanding.  
               | • Prohibits bonuses for 2008 and requires “any severance package for a dismissed director be reasonable and perceived as fair.”  
               | • Requirement to restore and maintain mortgage lending to SMEs at the 2007 level and to provide reports on their lending activity. |
| Germany (SoFFin) | • Limitations on common stock dividends (temporary ban on dividends for first tranche in Commerzbank).  
                   | • Caps compensation to senior executives at €500,000 a year without bonus.  
                   | • Requirement to increase in loans available to SMEs (€2.5 billion for Commerzbank). |
| France (SPPE) | • Prohibits bonuses and severance payments where there are “large-scale lay-offs”  
                   | • Prohibits stock options and free shares to senior executives, and limits authorization of bonuses to one year.  
                   | • Requirement to maintain a three to four percent annual growth rate in overall lending level and to provided monthly reports. |
| Ireland       | • Requires a 25%–33% reduction in compensation for senior executives, 25% for non-executive directors, and bans both bonuses and salary increases in 2008 and 2009.  
                   | • Commitment not to commence foreclosure proceedings for principle private residences for twelve months after arrears appearing.  
                   | • Requirement to establish a €100 million environment and clean energy innovation fund. |
| Netherlands   | • Prohibits bonuses for 2008, and limits severance payments to one year’s fixed salary.  
                   | • Requirement to increase lending to SMEs (unspecified goal which varied by individual restructuring plans). |
| Japan (1999 Early Strengthening Act) | • Requirement to increase lending to SMEs (unspecified goal which varied by individual restructuring plans). |
| U.S. (TIP)    | • Prohibits all common stock dividends in excess of $0.01 per share per without the consent for as long as the preferred shares were outstanding.  
                   | • Prohibits severance payments and bonuses to executive, and requires a portion of 2008 bonuses be payable as deferred stock or cash awards and a portion be subject to performance based vesting.  
                   | • Requirement to provide quarterly reports on use of purchase price. |
| U.S. (SSFI)   | • Prohibits increase in common stock dividends for five years (AIG had eliminated ordinary dividends at the time of the transaction).  
                   | • Prohibits severance payments to Senior Partners (approximately top seventy officials), and limits annual bonus pools of Senior Partners to 2006 and 2007 levels.  
                   | • Prohibits use of purchase price for executive compensation. |

Source: Data used in compiling the information in this table is derived from a variety of sources. For further information, a separate listing of the sources used is available online at the Journal on Legislation website at http://www.harvardjol.com/wp-content/uploads/2013/04/sourcesPDF.pdf

Majesty’s (“HM”) Treasury had pledged to purchase up to £25 billion of preference or ordinary shares in the event that the banks did not raise suffi-
cient capital from existing shareholders. When existing shareholders purchased less than one percent of the total shares offered to them, the government was forced to invest about £15 billion in ordinary shares of RBS (a 57.9 percent stake) and £13 billion in that of Lloyds TSB-HBOS (a 43.4 percent stake).

Second, in the 1999 Early Strengthening Act, Japan uniquely recapitalized each beneficiary with multiple instruments that contain varying terms and non-price conditions. Critics of the Japanese program have speculated that the unusual complexity of the recapitalization was an effort by the Japanese Financial Revitalization Commission (“FRC”) to obscure the cost of the government assistance. Indeed, the Japanese Ministry of Finance (“MOF”) gave repeated public assurances throughout the mid-1990s that no public assistance would be needed to rescue the banking sector. When the MOF ultimately pledged ¥680 billion to resolve the problem of failing housing loan companies known as jusen, a public outcry ensued. Recognizing that a large rescue package was necessary, the Japanese government may have purposefully designed a recapitalization scheme that was difficult to value in order to deflect the intense public criticism that would likely come their way.

B. Effectiveness in Achieving Recapitalization Goals

1. Return to Normalcy

Initial empirical evidence suggests that the European recapitalization programs have been successful in reducing banks’ default risk. According to a 2009 event study by Banca D’Italia, the announcement of the recapitalization programs reduced the price of credit default swaps (the “CDS premium”) for European banks by about sixty basis points in the three days surrounding the announcement. The CDS premium on all of the European banks remained steady until the early part of 2009, in contrast to the volatil-

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110 See Hoshi & Kashyap, supra note 25, at 408–09 (noting that “[m]ost banks sold multiple instruments to the government”).
111 See id. (“The use of multiple securities with various terms [ ] obscured the cost of the bailout.”). See also Heather Montgomery & Satoshi Shimizu-tani, The Effectiveness of Bank Recapitalization Policies in Japan, 21 JAPAN WORLD ECON. 1, 5 n.10 (2009) (noting that the FRC was established in 1998 under the Prime Minister’s Office to oversee the bank recapitalization and restructuring; the Commission closed on January 6, 2001).
112 See Hoshi & Kashyap, supra note 25, at 400.
113 See id.
114 See Panetta, supra note 93, at 33.

ity of the CDS premium on U.S. banks during that time.\footnote{See id.} A 2009 International Monetary Fund ("IMF") report similarly found that by the end of June 2009, LIBOR-OIS spreads of Euro area countries, on average, declined seventy-five percent from their respective crisis peaks.\footnote{INT’L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT 134 (2009), available at http://www.imf.org/external/pubs/ft/gfsr/2009/02/pdf/chap3.pdf.}

The pace of exit from the European comparative recapitalizations differs substantially across countries. By March of 2011, all six French banks that received public funds had reimbursed the SPPE.\footnote{See supra note 97, at 15 (describing the reimbursements of four of the six beneficiary banks in October and November of 2009 (Crédit Mutuel, Oct, 1, 2009; Crédit Agricole, Oct. 27, 2009; BNP Paribas Nov. 3, 2009; Société Generale, Nov. 4, 2009)); MOODY’S INVESTOR SERV., BPCE COMPANY PROFILE 1 (2011) (on file with author) (BPCE, the bank that emerged from the Caissed’Épargne and Banque Populaire, fully reimbursed SPPE by the end of March 2011).} Beneficiaries of two of the remaining comparative recapitalizations, SoFFin and the Dutch recapitalization program, have partially repaid the state, with approximately sixty-seven percent and twenty-eight percent, respectively, outstanding to date.\footnote{See supra Table 1; see also Eyk Henning, Laura Stevens, & William Boston, Tightrope for Commerzbank, WALL ST. J., Dec. 15, 2011, http://online.wsj.com/article/SB10001424420529702048445457098704190064547.html ("This summer, the bank raised capital and was able to pay back about €11.5 billion [out of €18 billion] to the German government, which retains a 25% stake."); Transactions with Dutch States, ING, http://www.ing.com/Our-Company/Investor-relations/Transactions-with-Dutch-State.htm (last visited Apr. 27, 2012); Greg Roumeliotis, UPDATE 2-Insurer Aegon Finishes Repaying Dutch State Aid, REUTERS, June 15, 2011, available at http://www.reuters.com/article/2011/06/15/aegon-idUSLDE75E09Z20110615.}

However, the largest beneficiaries in both countries, Commerzbank and ING, have stalled repayment since 2012 in light of the ongoing Eurozone crisis and increased regulatory capital requirements.\footnote{See, e.g. UPDATE 2-ING Cuts Target, No Dividend Until Aid Repaid, REUTERS, Jan. 13, 2012, available at http://www.reuters.com/article/2012/01/13/ing-idUSL6E8CD08X20120113 (quoting an ING representative saying "][i]deally we would like to complete the state repayment this year, however given the ongoing crisis in the euro zone and increasing regulatory capital requirements, we need to take a cautious approach and maintain strong capital ratios in the Bank"); cf. Commerzbank Shares Fall on Nationalisation Report, BBC NEWS (Dec. 5, 2011), http://www.bbc.co.uk/news/business-16029418 (reporting that the German government may increase its stake in Commerzbank in 2012 if the bank cannot raise the necessary capital to meet the most recent European stress test results). On March 13, 2013, Commerzbank announced its plans—subject to shareholder approval—to raise €2.5 billion in new capital to repay SoFFin a portion of the outstanding state aid. See Ulrike Dauer, Commerzbank Moves to Repay More State Aid, WALL ST. J., Mar. 13, 2013, http://online.wsj.com/article/SB1000142412142142788732077045758358043760853724.html.} Funding provided through the remaining two recapitalization vehicles, the GRS and the Irish recapitalization program, is expected to become long-term investments.\footnote{See, e.g., Louise McBride, Irish Banks Could Take 20 More Years to Pay Debts, IRISH IND. REP., Apr. 3, 2011, http://www.independent.ie/business/irish/irish-banks-could-take-20-more-years-to-pay-debts-2607469.html; Jill Treanor, UKFI Has to Stay to Deliver Fair Returns on Taxpayers’ Investment, GUARDIAN BUS. BLOG (Nov. 28, 2011, 3:33 PM), http://www.guardian.co.uk/business/blog/2011/nov/28/ukfi-fair-returns-taxpayer-investment.}
The divergent exit experiences of banks in the European comparative recapitalizations provide two important insights. First, the use of risk-based recapitalization terms do not significantly affect market perceptions of weaker institutions or prevent their successful exit.\textsuperscript{121} BNP Paribas and Société Générale paid interest rates of 7.75 and 8.18 percent, respectively.\textsuperscript{122} Figure 2 shows the stock prices of the two banks between September 2008 and December 2009. The share prices for both banks dipped in the fall of 2008, but recovered to approximately seventy-five percent of their peak 2008 value by December of 2009. The price movements suggest that the market did not view the different SPPE-calculated interest rates as a negative signal about the true value of assets in place or draw any other inference of unexpected weakness. And despite the different coupon rates, both BNP Paribas and Société Générale were able to raise the private capital necessary to reimburse the SPPE in early November of 2009.\textsuperscript{123}

Second, the lack of participation by any major bank may obstruct the ability of participating banks to access private capital. In theory, concerns about the expected future government interference in the beneficiaries’ affairs may negatively affect investors’ perceptions of the recipients’ long-run profitability, causing a depression of stock prices.\textsuperscript{124} Put another way, when a major bank can opt-out, there is a signaling effect associated with the participation decision that, in turn, affects recipients’ ability to raise private capital. Figure 3 shows the stock prices of five of the largest European recapitalization recipients. While all of the five banks clearly saw dipping stock prices in the fall of 2008, the three banks participating in recapitalization programs in which a major competitor was allowed to opt-out of state aid—namely, RBS and Lloyds (nonparticipant: Barclays PLC), and Commerzbank (nonparticipant: Deutsche Bank)—diverged significantly from the others in 2009, and consistently tracked the bottom of the group. The probative value of this analysis, however, is limited as the divergence may simply reflect the comparatively healthier conditions of the French banks.

\textsuperscript{121} The deeply subordinated debt (“TSS securities”) originally subscribed by the SPPE had a fixed initial rate calculated using the following risk-based formula: the five-year BTAN + 300 bps + 5 x CDS (senior five years). Decision (EC) N 613/2008 of Aug. 12, 2008 (C 8278) 7.


\textsuperscript{123} See AGENCE DES PARTICIPATIONS DE L’ÉTAT, FRENCH STATE AS A SHAREHOLDER, supra note 97, at 15.

\textsuperscript{124} See Panetta et al., supra note 93, at 2 (suggesting that “concerns about national governments becoming important stakeholders” depressed stock prices); see generally Jenny Corbett & Janet Mitchell, Banking Crises and Bank Rescues: The Effect of Reputation, 32 J. Money, Credit & Banking 474 (2000) (discussing importance of reputation and market perception in a bank’s decision to participate in a government intervention).
2. Restoring Lending to the Economy

Lending to small and medium-sized enterprises ("SMEs") in European countries declined significantly in the fourth quarter of 2008, prompting all but the Netherlands to include lending requirements as a non-financial con-

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dition of the public investment. It is unclear, however, whether these lending mandates have impacted the supply of small business loans. According to the European Commission’s Survey on the Access to Finance of SMEs, small business lending increased by 2.4 percent in France between 2008 and 2010, but decreased by 1.2 percent, 13.4 percent, and 27.7 percent in Germany, the U.K., and Ireland, respectively. SME credit availability in the Netherlands, the only country that did not impose a lending target, grew by 5.4 percent during the same period.

There are also indications that lending mandates have spurred some amount of imprudent lending activity. As illustrated by the Japanese experience during its “lost decade,” politically-driven lending requirements may force recipient banks to lend to failing SMEs, which in turn may cause a surge in non-performing loans. Figure 4 shows the asset quality of the loan portfolios in Europe and the United States. Between 2009 and 2011, the percentage of non-performing loans increased in the four countries that conditioned recapitalization funds on a lending commitment—U.K., France, Germany, and Ireland—but decreased in the two countries—the United States and the Netherlands—that did not impose a lending target. Ireland shows the most extreme movement, with the percentage of non-performing loans doubling between 2009 and 2010.

Figure 4: Bank NPLs to Total Gross Loans (%)

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125 See supra Table 1. The Dutch recapitalization program required the proceeds to be “used to strengthen equity of Issuer and its subsidiaries,” and required DNB approval for the use of proceeds towards non-EU subsidiaries in excess of €300 million. ING Groep N.V., CORE TIER I SECURITIES RANKING PARI PASSU WITH ORDINARY SHARES (2008).


127 See id.

128 See Hoshi & Kashyap, supra note 25, at 413. See generally SCOTT & GELPERN, supra note 41, at 432–38, for a background on the Japanese “lost decade.”
loans increasing from 2.6 percent in 2008 to 9 percent in 2009, holding relatively steady thereafter.\textsuperscript{129} It is, however, inappropriate to conclude that the lending targets associated with the recapitalizations exacerbated the problem of non-performing loans. In order to provide a more accurate assessment of the effect of lending requirements on non-performing loans, it will be necessary to control for the underlying economic conditions and the performance of the real economy.

More generally, it appears that favorable macroeconomic conditions and adoption of direct lending policies played a greater role than lending mandates in improving SME credit availability. In fact, no reports that have considered SMEs’ post-crisis access to credit in the comparative countries have cited the success or failure of lending targets as a significant causal factor. For example, a study by the OECD pointed to a supplemental €10 billion recapitalization of OSEO Garantie, a public body which finances and supports SMEs, as “the most significant measure by far” in contributing to the increased credit access in France.\textsuperscript{130} The OSEO guaranteed loans to SMEs and provided direct funding, allowing more than 73,000 enterprises to obtain €11.5 billion in financing in 2010.\textsuperscript{131} The OECD study also noted the contribution of the French Credit Mediation Program, which boasts an impressive sixty-three percent success rate in assisting businesses that had been refused loans.\textsuperscript{132}

A 2011 report by Deutsche Bundesbank, on the other hand, cited the sharp decline in demand for SME financing as an explanation for Germany’s muted lending growth between 2009 and 2010.\textsuperscript{133} In fact, according to the European Central Bank’s demand-side survey on SME credit conditions, the loan approval rates in Germany increased from fifty-nine percent in the second half of 2009 to seventy-nine percent in the second half of 2010.\textsuperscript{134} The Deutsche Bundesbank also suggested that the restructuring conditions imposed by the European Commission on SoFFin participants reduced the lending growth of Landesbanken, German state-owned lenders, by 1.4 percent between October 2009 and September 2011.\textsuperscript{135} In contrast, German savings and cooperative banks, which were not required to shrink their balance sheets, grew their lending activity during this time.\textsuperscript{136}


\textsuperscript{130} See France, in Financing SMEs and ENTREPRENEURS 2012, supra note 57, at 74, 78.

\textsuperscript{131} See id.

\textsuperscript{132} See id. at 79.


\textsuperscript{135} Deutsche Bundesbank, supra note 133, at 63.

\textsuperscript{136} Id.
3. Limiting Moral Hazard

The degree to which moral hazard has entered the financial system as a result of the comparative recapitalization programs has not been rigorously studied. Nevertheless, two imperfect metrics can provide a sketch of the “moral hazard effect” introduced by recent government bailouts. Because of the difficulty of disentangling the effects of contemporaneous debt guarantees and monetary policy initiatives, these assessments can only capture the effects of all crisis-period government interventions.

Reducing incentives for risk-taking is often mentioned as a possible measure of the effectiveness of moral hazard mitigation.137 Every European country except France took significant steps toward this end. The U.K. prohibited all common stock dividends without the consent of the respective financial regulator for as long as the preferred shares are outstanding, and Germany’s SoFFin prohibited Commerzbank from paying dividends in 2009 and 2010.138 The U.K., Irish, and Dutch recapitalizations were also closely tied to the resignation of senior executives at several of the beneficiary institutions.139 For example, the resignation of RBS’s chairman and chief executive officer (“CEO”) was announced the same day as the U.K. rescue plan.140 The 1999 Japanese recapitalization terms similarly allowed the FSA to force the resignation of a senior executive if a recipient’s actual return on equity was below target;141 the FSA has used this authority to request the resignation of the CEOs of UFJ Holdings, UFJ Bank, and UFJ Trust in 2004.142

The French government justifies its lenient recapitalization terms by noting that the French banking sector was significantly less impacted by the

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140 See Russell & Conway, supra note 139.
141 Cf. Kazuki Onji et al., Capital injection, restructuring targets and personnel management: The case of Japanese regional banks, 26 J. OF THE JAPANESE & INT’L ECON. 495, 500 (2012) (“In the case of unsatisfactory performance, the [Japanese] government considers invoking a business-improvement order, under which a bank may be prohibited or restrained from paying dividends and executive bonuses or, in the worse [sic] case, closed down.”).
142 See Hoshi & Kashyap, supra note 25, at 403.
financial crisis than its European counterparts.\footnote{See Cour des comptes, Les Concours Publics aux Établissements de Crédit: Premiers Constats, Premières Recommandations 86 (2009), available at http://www.ccomptes.fr/fr/CC/documents/RPT/Rapport-concours-publics-etablissements-credits.pdf} According to the French Central Bank, asset write-downs linked to subprime assets represented only sixteen percent of the Tier 1 capital base for French banks in 2009, as compared to thirty-three percent in Germany and the U.K.\footnote{Id.} Where acute weakness was subsequently revealed, as was the case with the new BPCE Group, the French government imposed harsher additional requirements. For example, in 2009, the French state appointed two government representatives to BPCE’s board of directors.\footnote{See Agence des Participations de L’État, supra note 97, at 24.}

Another measure for assessing the impact of government interventions on moral hazard is the changes to the competitive landscape of the financial sector.\footnote{See, e.g., Stijn Claessens et al., Crisis Management and Resolution: Early Lessons from the Financial Crisis 20 (Int’l Monetary Fund Staff Discussion, Note 11/05, 2011), available at http://www.imf.org/external/pubs/ft/sdn/2011/sdn1105.pdf.} Moral hazard is more likely to exist in a highly concentrated financial sector, in which a small number of conglomerates control the bulk of total banking assets and thus enjoy an implicit “too-big-to-fail” safety net. The European Commission required recapitalized institutions to make extensive divestitures—up to as much as forty-five percent of their balance sheets—to ensure a level playing field for small, less complex institutions.\footnote{EC. Eur. Policy Studies, supra note 106, at 16–17.} Nevertheless, the competitive landscape of the financial system has changed little. The aggregate assets of the top thirty European banks experienced only a six percent decline between 2007 and 2009, with significant drops in some state aid recipients, such as RBS (-26 percent), and significant growth in others, most notably BNP Paribas (+21 percent).\footnote{Dirk Schoenmaker, The European Banking Landscape after the Crisis 9 (Duisenberg Sch. Of Fin., Policy Paper No. 12, 2011), available at http://www.dsf.nl/assets/cms/Research/DSF%20Policy%20Paper%20No%2012%20The%20European%20Banking%20Landscape%20After%20the%20Crisis%20April%202011.pdf.} The forced divestitures also appeared to have a muted, if not adverse, effect on the implicit subsidies for institutions perceived as “too-big-to-fail.” A 2012 IMF Working Paper estimates that, between 2007 and 2009, the average implicit subsidy for large banks rose by 1.6 percent and 2.84 percent in Germany and the U.K., respectively—where the recapitalized institutions were forced to make significant divestitures—but decreased by 1.4 percent in France, where no restructuring was mandated as a condition to state aid.\footnote{Kenichi Ueda & Beatrice Weder de Mauro, Quantifying Structural Subsidy Values for Systemically Important Financial Institutions 14 (Int’l Monetary Fund, Working Paper No. 12/128, 2012), available at http://www.imf.org/external/pubs/ft/wp/2012/wp12128.pdf.}
IV. SIX LESSONS FOR A FUTURE CPP

The Japanese and European experiences with alternative recapitalization vehicles provide a number of useful insights for an effective recapitalization design. The cross-country comparisons are admittedly imperfect; differences in the structure of the financial industry and the political environment, among other things, will likely influence the success of the recapitalization. Importantly, some of the European countries were in much stronger positions than others at the onset of the crisis because of their limited exposure to subprime assets. Despite these limitations, this Part offers six lessons for a future CPP.

A. Importance of Differentiating Recipients by Risk

The Treasury feared that structuring the CPP investments with risk-based terms and revealing the fragility of major U.S. banks would create a market panic. This fear was undermined by subsequent domestic and international events. The stock prices of the nine largest CPP recipients diverged following the “one-size-fits-all” infusion, while the stock prices of the major French banks moved in tandem despite having received SPPE investments on different financial terms. Had Treasury instead calibrated the financial and non-financial terms of each CPP investment to the risk-profile of the recipient, it would have captured two significant advantages.

First, the Treasury would have been better able to protect the taxpayers’ interests by obtaining appropriate compensation for the risk borne. Second, and more importantly, the Treasury would have been able to limit moral hazard by imposing harsher non-price conditions on weaker institutions, including restrictions on dividends, removal of senior executives, and restructuring requirements. Appropriately differentiating beneficiary banks based on risk could have limited the creation of risk-taking incentives by penalizing poorly performing banks, such as Citigroup and Bank of America, for their failure to lend responsibly.

150 See, e.g., Elisa Parisi-Capone, Editor Pick—European Bank Exposure to Subprime Risk, EconoMonitor (Sept. 5, 2007), http://www.economonitor.com/analysts/2007/09/05/editor-pick-european-bank-exposure-to-subprime-risk (noting that “[n]one of the German banks has significant retail operations in the US,” thereby reducing their exposure to U.S. subprime risk, and that “the risks effectively born by French banks due to their exposure to the US subprime market are small and are largely mitigated by these banks’ large equity base, sound business diversification and strong deposit base”); Xiao, supra note 103, at 14 (“The market perception of credit risk of French banks seems to be more favorable than that of their European peers”).

152 See discussion supra Part II.B.3.
B. Condition Recapitalization on Adequate Non-Price Commitments

The scope of non-price commitments in the U.S. recapitalization programs was inadequate. Even the Targeted Investment Program, a subsequent TARP recapitalization program intended for weak systemically-important financial institutions, contained no restructuring requirements and little punishment for incumbent executives. As a result, the U.S. recapitalization schemes exacerbated the moral-hazard effects by generating distorted incentives for senior executives and by allowing large, complex financial institutions to retain “the complexity that virtually assures them access to the safety net.” Indeed, Bank of America has grown by 17 percent since early 2009, while Citigroup has only experienced a modest 3 percent decline in total assets. A future CPP should consider the various non-price conditions imposed by the comparative recapitalization schemes, particularly balance sheet reduction, temporary limitations on acquisition activity, and the elimination of incumbent senior executives. As suggested in Part IV.A, the extent of behavioral safeguards should be calibrated to the risk profile of the beneficiary bank.

C. Prevent Opt-Outs by Large Institutions

Allowing major institutions to opt-out of the recapitalization program can prolong the length of the investment. As seen from the German and U.K. experiences, the failure to include all large, systemically important institutions in the recapitalization scheme substantially obstructs participating banks’ ability to access private capital. Besides the negative signal associated with the request for state aid, private investors could also be reluctant to invest in participating banks for fear that the government would intervene in the institution’s business decisions in a political, rather than profit-oriented, manner. By requiring all systemically important banks to accept government assistance, participating institutions will thus be less likely to suffer adverse market consequences.

153. See Massad, supra note 17, at 10–11, 14–15 (describing the terms of the Targeted Investment Program (“TIP”’s capital injections into Bank of America and Citigroup); see also supra Table 2 (summarizing the non-price conditions of the comparative recapitalization programs).

154. Richard J. Herring, Wind-Down Plans as an Alternative to Bailouts: The Cross-Border Challenges, in ENDING GOVERNMENT BAILOUTS AS WE KNOW THEM 125, 139 (John B. Taylor ed., 2010); accord Has Dodd-Frank Ended Too Big to Fail?, supra note 4, at 18 (“TARP’s most significant legacy may be the exacerbation of the problems posed by ‘too big to fail,’ particularly given the manner in which Treasury executed the bailout.”); Oliver Hart & Luigi Zingales, Curbing Risk on Wall Street, 3 NAT’L AFFAIRS 20, 21 (2010).


156. See discussion supra Part II.B.1.
Both the CPP and the French SPPE demonstrated how political pressure can be coupled with attractive investment terms to induce healthy, systemically important institutions to participate in the recapitalization. The SPPE approach, which incorporated the additional element of risk-differentiated investment terms, is probably more desirable in light of the cost-reducing and moral hazard benefits outlined in Section IV.A above.

D. Dangers of Similar Treatment for Small and Large Banks

Large and small banks need to be recapitalized under different terms, tailored to their respective needs and ability to repay. Unlike large businesses, small businesses are often privately held or thinly traded, and have limited access to the private capital necessary to reimburse the Treasury under the current CPP terms. To effectively provide relief to small banks, the Treasury needs to provide access to capital on more appropriate terms. An example of such a recapitalization scheme is the U.S. Small Business Lending Fund, a 2010 program that injected $30 billion into businesses with assets of less than $10 billion through preferred stock or its equivalent. Under the terms of the program, the dividend rate is initially capped at five percent, and the rate falls to as low as one percent if the bank increases its small-business lending activity. As of March 31, 2012, 137 small banks have used the Small Business Lending Fund to refinance and exit from the CPP, citing the new program as more appropriate for promoting credit availability for healthy small businesses.

E. Advantages of Direct Lending to SMEs and Credit Mediation

The lending requirements attached to the comparative recapitalization schemes did not appear to have effectively increased the provision of credit to SMEs. In fact, lending targets can even be counter-productive. As the Japanese experience illustrates, where the real economy is stressed, lending targets may force banks to lend to insolvent businesses, thereby increasing the number of non-performing loans and turning healthy banks into unhealthy ones. It is perhaps possible to establish lending criteria to eliminate the risk of imprudent lending. However, if the demand for credit is low,
beneficiary banks may find it difficult or impossible to reach a non-trivial target and avoid a potential penalty.

The French experience suggests that direct government loans and increased loan guarantees for SMEs, as well as credit mediation, can more effectively produce positive lending results. Unlike top-down approaches that seek to incentivize bank lending, direct government loans can limit the effects of discouraged demand and maintain socially beneficial credit standards. In the United States, such an intervention can be effected through the Small Business Administration (“SBA”), which has historically provided direct lending to small businesses and now provides guarantees for SME loans up to $5 million. In 2009, the U.S. government increased the public guarantee for qualified loans and eliminated fees for participants, but the amount allocated by Congress—$730 million—was too small to produce an effect. By contrast, the French government injected €10 billion into OSEO Garantie. The twenty-five percent increase in SBA loan volume between 2009 and 2010 suggests that a larger allocation of funds and the re-introduction of direct lending to small businesses could have significantly accelerated the post-crisis recovery of SME lending in the United States.

F. Prepare for Multiple Tranches.

Finally, most of the recapitalization programs analyzed ultimately required more than one tranche of capital injections. This can be due to the insufficient size of the initial tranche, as many have suggested for the Japanese experience, or to deteriorating macroeconomic conditions. Additional tranches have often taken the form of financial instruments ranked pari passu with ordinary shares, raising concerns about the government’s voting stake and role as a major shareholder. Preparations for additional tranches

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162 See discussion supra Part II.B.2.


165 Decision, supra note 130, at 78.

166 See U.S. SMALL BUS. ADMIN., SUMMARY OF PERFORMANCE AND FINANCIAL INFORMATION: FISCAL YEAR 2010 1 (2011) (the amount of loans supported by the agency increased from $17.9 billion (2009) to $22.4 billion (2010)). Direct lending to SMEs has been increasingly debated as a vehicle for increasing credit provision; the Obama Administration has resisted because of the additional bureaucracy direct lending would introduce and its belief that the federal government should not be involved in selecting which businesses receive loans and which do not. See Cong. Oversight Panel, supra note 158, at 79.

in budgeting and management considerations will likely be helpful for a future recapitalization.

V. Conclusion

In the four and a half years since the passage of TARP, U.S. policymakers have taken important steps towards empowering bank regulators and strengthening the financial system. Reform considerations, however, have myopically excluded the worst-case scenario where the government is once again forced to rescue the financial industry. Given the complexity of financial supervision and the difficulty of achieving an orderly resolution, it seems unlikely that taxpayer bailouts can be permanently taken off the table. An optimistic commitment to a “no-bailout” future may thus cause the Treasury to be inadequately prepared when the next financial crisis arises.

This Article argued that if a future large-scale bailout of the financial sector is again needed, the Treasury should not re-implement TARP’s signature initiative, the CPP, without significant changes. The CPP, after all, fell short of achieving the basic goals of a government recapitalization—ensuring a prompt return to normalcy, stimulating the real economy through lending, and mitigating moral hazard. Through a survey of alternative recapitalization approaches adopted by other countries facing similar circumstances, this Article suggested six reforms to improve the effectiveness of the CPP. The most important is the first suggestion: differentiating between beneficiaries’ risk-profiles in the financial and non-financial terms of the investments. As this Article showed, access to capital at identical rates and terms, regardless of financial health, has a substantial impact on the incentives faced by financial institutions and their investors. Distorted incentives will, in turn, cause the economy to be more susceptible to a future crisis.

In many ways, the long-term effects of the recent government interventions have yet to be revealed and further analysis is needed. Going forward, efforts should, in particular, be directed at comparing the extent to which the various recapitalization approaches encouraged excessive risk-taking and rewarded complexity. Consideration should also be given to minimizing the length of financial ownership in distressed firms. Such ownership, if held for a prolonged period, can create confusion between the government’s regulatory and shareholder roles and distort market competition.