The Cost of Bank Insolvencies: A Socio-Economic Rights Analysis

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Introduction

High risk banking practices were a central factor of the financial crisis of 2007-2008 and the world is still feeling the aftershocks. Sovereign debt, austerity, and the degradation of social benefits, employee rights, and even the democratic framework of sovereign nations have been only some of the negative results. Given the complicated nature of modern financial markets, complex and remote financial instruments, and the banking industry, it is uncertain as to whether the current banking regulation and reforms can provide an effective safety net to avoid the social costs associated with future financial crises. It could be that it is time for a paradigm shift in the way in which banking and lending are approached from a philosophical perspective, taking into account a renewed understanding of the purpose and character of debt and lending, particularly when dealing with those debt transactions affecting individuals. Considering the juxtaposition of wealth maximisation, a fundamental aim of banking and finance, to the potential social costs when profit focussed activities go wrong, it could be possible that a neo-liberal and economically focussed approach to banking regulation and reform may need to be shifted to reflect the actual social costs of capitalism.

The purpose of this paper is to examine the fundamental underpinnings of the UK's approach to banking and lending with a focus on the apparent theoretical or philosophical approach to banking and regulation within the economy with reference to Coase's "The Problem of Social Costs"[1] and whether or not his framework of analysis is relevant to the regulation of today's financial markets. The origins of the financial crisis in irresponsible banking and lending practices will be explored as well as the social costs the financial crisis and the specific impact of lending practices on the consumer. Historic views on debt will be presented with a view to tracing how those views have changed in the modern age, particularly in consideration of the banking industry's approach to debt selling. There will also be brief look at some of the post crisis regulatory reforms that have occurred and a critical analysis of the neo-liberal economic approach in this area, followed by a conclusion that will comment on whether or not the current approach and underpinning theoretical framework can be adequate to circumvent the social costs of irresponsible banking practices in the future.

Origins of Financial Crisis

It is fairly well known that the most recent global recession was triggered by a subprime mortgage crisis in the United States in 2007, which then led to a global liquidity crisis due to the interconnectedness of many financial institutions, both banks and non-banks, which were affected by the "credit crunch."[2] It was common to transfer certain repackaged debt obligations to increase liquidity, thereby giving creditors a means of trading debt obligations on the market. Without debt instruments to facilitate trading, debt remains an obligation from one party to another. When debt instruments are used as a means of facilitating debt trading, debt obligations can be removed from one party and given to another quickly and efficiently. Complex debt relationships have evolved among the financial institutions of the world, thus when mistakes are made by one, whether through negligence or mismanagement or simply overly risky behaviour, all institutions are affected, or perhaps *infected* as a result.[3] Thus when banks ceased to function in the provision of credit on the scale to which the world economy had become accustomed, states often intervened in order to protect the national economies from complete collapse.[4]

Once confidence was shaken in Lehman Brothers in 2008, fewer market participants were willing to purchase securities from them as the trust that the company would eventually be able to repurchase them at a higher price

[1] R. H. Coase, "The Problem of Social Costs" (1960) 3 Journal of Law and Economics 1.
[2] S.J. Lubben & S.P. Woo, "Reconceptualising Lehman" (2014) 49 Texas Int'l LJ 297; T. Jiang and others, "Dynamics in Bank Crisis Model" [2015] Mathematical Problems in Engineering <http://dx.doi.org/10.1155/2015/378463> first accessed 15 September 2015; G.A. Walker, "Financial Crisis – UK Policy and Regulatory Response" (2010) 44(2) International Lawyer 751.
[3] T. Jiang and others, "Dynamics in Bank Crisis Model" [2015] Mathematical Problems in Engineering <http://dx.doi.org/10.1155/2015/378463> first accessed 15 September 2015.
[4] D. Singh, "UK Approach to Financial Crisis Management" (2013) 19 Transnat'l L&Contemp Probs 869.

had been lost.[5] Its collapse and bankruptcy led to great market uncertainty and, failing to secure a government rescue package, revealed a fundamental cause of the crisis: excessive risk-taking. The loss of confidence in the financial system caused by the collapse of Lehman led to a global market collapse, which frightened many governments into action to try to avoid additional bank collapses by providing bail outs to many banking institutions. It impacted not just banks, but a number of financial type institutions, such as the insurance group AIG, which had linked itself to complex mortgage backed securities market, providing guarantees for collateralised debt obligations without making adequate provision in capital for any claims that could arise.[6] The complex financial instruments to which the risks were attached lured considerable interest due to promised high returns, leading to additional repackaging and securitising and rapid growth in this market due to the perceived efficiency and high returns on investment. Eventually the demand for these kinds of products overwhelmed the need for due diligence regarding their product quality, which fuelled demand for the securitisation of lower forms of assets, such as subprime mortgages.[7]

While massive bank collapses were viewed as an imminent threat to the global economy, there remained a question of moral hazard as to whether it could be justified for governments to intervene with taxpayer's money to rescue banks from collapse when essentially the primary cause of their distress was mismanagement.[8] Essentially, governments would be taking money from the people they were trying to protect from the effects of banking collapses caused by mismanagement of the very debt that belonged to the people governments were trying to protect! Of course, the banking industry also has an intimate connection to the lives of ordinary people as it is to the banks that people turn in order to acquire loans for housing, entrepreneurial business activities, and pensions to see them through to the end of their days. Thus when the banking industry suffers, regardless if the taxpayer is forced to bail them out, the ordinary man will also suffer due to difficulties in attaining credit.

The financial crisis exposed existing problems in the financial markets and the banking industry in terms of financial supervision, theory and practice. In addition, the intangible nature of debt securities and credit derivatives calls into question the value that can be placed on a promise when it has passed through numerous "hands" and has been split, combined, and amalgamated subject to additional promises that rely on all previous promises being met, until the original "promise" is no longer recognisable. This sounds more like fantasy than any real transaction between financial entities and/or individuals.

Modern Views on Debt[9]

Debt used to have an intrinsic moral dimension tied to the human condition. While early banks could only lend against the deposits held within the bank, this is no longer banking norm. Today dispensing with debt has become a financial decision as institutions tend to treat individual debt obligations as profit-making and capital freeing instruments. Granted, in order for banks to lend to individuals, they must first have capital to provide to borrowers and capital can only be freed if banks can also free themselves from the debt of their borrowers, often by selling it on through the complex securitization transactions, such as those that were at least partially indicted by assessments of the financial crisis. However, the extent to which debts can now be separated from the individual who owes them is reflective of fundamental changes in how debt is perceived in the modern financial context, particularly when compared to the anthropological origins of debt as a concept.

Debt and credit have an extraordinarily long history lying well outside their current financial aspects. It has been said that the origin of modern debt and credit lies in a sense of human community, mutual obligations, and morality.[10] It has been viewed as a product of humanity's existential condition owed by virtue of the natural mutual protections afforded by living in a society or, from a religious standpoint, the existential debt owed to a supreme being.[11] Those living proper and moral lives are obliged to constantly repay the existential debts owed to one another. This evolved into a social obligation over time related to a reputation for honesty and charity,[12] something that can be traced to the early developments of social contract theory as well.

[5] This refers to a repo-agreement in which securities are sold with an agreement for the seller to buy them back at a later date and normally at a higher price.
[6] D. Singh, "UK Approach to Financial Crisis Management" (2013) 19 Transnat'l L&Contemp Probs 869, at 873-874.
[7] Ibid, at 875-876.
[8] Ibid, at 871-872.
[9] The research in this section has also contributed to the author's PhD thesis, "Rescue before a Fall: an Anglo-French Analysis of the Balance between Corporate Rescue and Employment Protection", pending completion in 2016.
[10] D. Graeber, *Debt: the First 5000 Years* (2011, Melville House Publishing, Brooklyn NY), at 1-19.
[11] This is a primordial debt "owed by the living to the continuity and durability of the society that secures their individual existence" from G. Ingham, *The Nature of Money* (2004, Polity Press, Maldon MA), at 90.
[12] D. Graeber, above note 10, and J. H. Munro, "The Medieval Origins of the Financial Revolution: Usury, Rentes and Negotiability" (2003) 25(3) The International History Review 505-562, at 506.

In principle, debt requires a relationship between individuals who do not consider each other fundamentally different and who are potentially equals. The balance of debt and credit addresses this equality in the sense that the urge to repay a debt is also the need to reinstate the equality between the debtor and creditor. If one is then unable to reinstate that equality, the person who is in debt must be at fault. Thus a debt is an exchange between individuals that has not yet been reciprocated.[13] Given the association of creditworthiness with reputation for honesty and integrity, financial debt obligations eventually became indistinguishable from moral obligations.[14] Hence the development of laws prohibiting usurious lending which was viewed as a type of theft as the charging of interest had no representation in goods. As money was meant to be only to be a representation of value in goods and services, interest was equated to taking money from an individual for nothing in return.[15]

The growth of capitalism precipitated the gradual collapse of economic reliance upon traditional communities due to the growing power of an impersonal market. There was a gradual transformation of moral networks by the intrusion of impersonal market rules and the powers of the state. The legalisation of interest led to the evolution of signed legal bonds agreeing terms of loans, which in turn required the evolution of a court system that could deal with the influx of commercial claims.[16] While today debts and credits have taken on an impersonal and purely financial character within a specific legal framework, their derivation is in good faith, socially acceptable behaviour and reputation that create the “credit” of an individual in society.[17]

Whether or not the origins of debt can truly be said to be in this ideal of human community and the obligations owed to one another for the safety of living in society, it can certainly be agreed that debt was once a personal obligation that most individuals would seek to escape as soon as possible. This could be due to the feeling of being subordinated to another human being due to what is owed, or perhaps just the consequences of not repaying. Today, however, it is rare to find an individual who does not live in a perpetual state of financial debt: it is the accepted status quo of the human condition, which has essentially commoditised the value of debt into something that has been separated from its moral roots. It has become abstracted from any proprietary interest that a debtor may have had over it; banks do not ask a mortgagor if they can sell their “IOU” on to hedge funds, insurance companies, or other financial institutions, despite that by all appearances, debt has a proprietary nature. While it could be that banks are exchanging funding now for money later as the debt is repaid, the question remains as to how if debt is an obligation, how can it be sold free from consent? It is admitted that this is a highly controversial assertion, given that these transactions have been going on for centuries, essentially in a sense like a bookmaker laying off large bets to other book makers in order to reduce their exposure. Applying the analogy, these transactions can effectively spread the risk across the financial market rather than

Social Costs of Financial Crisis

The banking origins of the financial crisis fed into the sovereign debt problems in Europe, which led to a severe economic slowdown and eventually a crisis of the Euro in 2010. This crisis was due in part to differentials in macroeconomic development between the member states in the Euro, with the previously more expensive and developed countries becoming balanced with those states that used to benefit from their less expensive production environment. Thus the economic advantages of states like Greece, Portugal, Spain and Italy that could benefit from the imbalance in competitiveness prior to the introduction of the Euro, lost their edge. This combined with mounting current account deficits, led to the sovereign debt crisis.[18] The situation in Europe in 2010 has been described as a twin sovereign and banking crisis that mutually feed each other, resulting in a gradual contagion to more countries and more asset classes. Government bailouts of national banks further added to the public debt and as private debt became public debt, sovereign debt became critical.[19]

Since the financial crisis and following the sovereign debt crisis there have been massive changes in national approaches to the regulation of aspects of national and supranational economies and social policies. This is particularly evident in the changes that have occurred throughout the EU in its reduced emphasis on social

[13] D. Graeber, above note 10, at 120-121.
[14] W. Hunt, *The Puritan Moment: the Coming of Revolution in an English County* (Harvard University Press 1983) 146.
[15] D. Graeber, above note 10, at 289.
[16] Ibid, at 332-333.
[17] Ibid, at 56-57; according to J. H. Munro, “The Medieval Origins of the Financial Revolution: Usury, Rentes and Negotiability” (2003) . 25(3) The International History Review 505-562, at 506, usury is defined as the exaction of interest or of any specified return beyond the principal value of a loan.
[18] B. Moro, “Lessons from the European Economic and Financial Great Crisis: A Survey” (2013) 34 European Journal of Political Economy s9.
[19] Ibid, at s11.

protections, in favour instead of a more neo-liberal approach designed to support its weakened economic status. Member State reforms under these revised EU policies as well as the austerity measures required in those States that are party to Memoranda of Understanding[20] in return for financial support have seen the steady erosion of workers' rights generally, while the "rescue culture"[21] has been steadily infused into Member State legal systems. While the presence of good rescue mechanisms may mitigate to some extent the loss of social protection, it is questionable whether or not such reforms are capable of going far enough to protect the most vulnerable of those EU citizens affected by the financial crisis.[22] There has thus been a fundamental shift in welfare state politics with austerity becoming a key measure to combat growing budget deficits. While a number of economists have now discredited the economic research that allegedly supported the push toward austerity, it remains a central feature of the recovery efforts that continue to exist, particularly in those countries whose sovereign debt spiralled to the point of needing or nearly needing supranationally supported loans to avoid insolvency.[23] This in turn has created a democratic deficit due to the requirements of these loans to reform the affected countries' legal systems, regardless of whether or not the government has been elected on an austerity platform or otherwise.

Beyond the impact on employment and business failure, the financial and sovereign debt crises have also affected individual borrowers seeking to finance business ventures or to purchase family homes. Repossessions became a common claim due to the inability to repay mortgages as a result of the fall in housing prices. Social benefits have been cut back everywhere as a part of austerity measures. This has often had the most severe effects on the most vulnerable individuals in society: the elderly and the disabled. Suicides among those vulnerable members of society who have been put through the rigours of defending their need to receive certain benefits have risen due to the stress and hopelessness that changes to benefit to which changes in applications have led. While public support for the welfare state has not changed, rather indications are that it has become even more beloved due to the fact that it shields people from losing their jobs and protects income in case of unemployment, there has been a steady erosion of social rights and benefits.[24] It has been argued that a number of countries had gone too far in their social protections, causing some of their debt related problems by failing to balance social policy with the requirements of capital. However, the social impact on individuals due to the instigation of austerity is manifest.

A Legal Economic Analysis of Debt Instruments

The financial sector has long benefitted from a neo-liberal economic approach to its regulation. This has allowed innovation in investment and profit-making, creating new and different debt instruments and ways of selling and packaging them in order to increase bank liquidity, permitting more and greater lending to individuals and businesses. However, the roots of the crisis in high risk debt trading have shown that such an approach does not afford the social benefit that highly liquid financial markets were meant to provide. Rather, it has required input from tax-payers to make sure the economy did not implode entirely. It must be queried, then, if a purely economic approach to regulation of the financial market is adequate, particularly given the distance that has evolved between debt and the human element of it and the ease of which it is now disposed.

The principles of Law and Economics provide an analytical framework within which a balance between social and commercial interests is sought. The basis of an economic approach to legal rules assumes that the people involved in a legal system will act rationally to maximise their own satisfaction.[25] In an economic analysis of the law, if two opposing sides of an issue behave rationally, they will find a balance that maximises the benefits/happiness of each side when an outcome is uncertain at the outset.[26] Rational maximisation within a legal system suggests that by putting a conceptual price on legal rights and remedies, it will be possible to create legal rules that maximise effectiveness by finding the perfect balance of economic efficiency between competing aims.[27]

[20] Hereafter referred to as "MoU".
[21] An economic policy emphasising the priority of rehabilitating viable companies in financial distress for the purposes of preserving their economic value as well as the livelihood and well-being of those dependent upon an enterprise, including unsecured creditors, employees, communities and other stakeholders.
[22] A full exploration of the impacts of the sovereign debt and financial crises on employment protection and corporate rescue was explored at the IEAF Conference in Istanbul in 2014 in a paper entitled, "The Road to Recovery: A Comparative Analysis of the Impact of the Financial Crisis on the Rights of Workers in Greece, Portugal, France and the United Kingdom and their Insolvency Legal Systems" written with Dr Alexandra Kastrinou.
[23] For an exploration of the economic arguments against austerity, see P. Krugman, "The Austerity Delusion" (2015) <http://www.theguardian.com/business/ng-interactive/2015/apr/29/the-austerity-delusion> accessed 30 April 2015.
[24] B. Vis, K. Van Kersbergen and T. Hylands, "To What Extent Did the Financial Crisis Intensify the Pressure to Reform the Welfare State?" (2011) 45(4) Social Policy & Administration 338, at 342.
[25] R.A. Posner, "Utilitarianism, Economics and Legal Theory" (1979) 8(1) JLS 104.
[26] R.A. Posner, "Observation: The Economic Approach to Law" (1974) 53 Tex L Rev 761.
[27] Ibid, at 764

Law and economics defines a good legal system as one that keeps the profitability of businesses and the welfare of people aligned, so that the pursuit of profit also benefits the public. This is somewhat reflective of the ideals of utilitarianism, a fairly hedonistic and secular political theory that places the overall pleasure or perhaps satisfaction of humanity as the defining characteristic of what is "right" for humanity in terms of political and legal structure.[28] However, while classical utilitarianism seeks to maximise the sum of all individuals' functions in terms of utility, law and economics aims to try to maximise social wealth rather than social utility. Goods should be awarded to those individuals who are willing to pay the most, not to those for whom those goods will have the highest utility. Fines and sanctions then become a deterrent if they are set at a level that people are unwilling the "pay the price" for doing the unwanted behaviour. The trick is to set the price at a level that deters the behaviour, but does not deter one from engaging in some risk, particularly if applied to economic activity.[29] While true that sanctions may prevent unwanted and costly behaviour, it would be economically inefficient in terms of regulating the financial market to set those sanctions at such a level that no one would want to lend, invest, or follow entrepreneurial ideas. Thus a balance needs to be struck in order to find the point that deters enough behaviour to retain some order in the market, while not discouraging some risk in the market.

One problem with the law and economics theoretical framework is that it has been perceived as being of a specifically free-market, capitalistic ideology and even an apology for conservatism. While it is not intended to paint capitalism as "evil", it must also be acknowledged that it does not often consider those elements of society that fall outside of the markets and profit. If economic efficiency depends on what people are willing to pay, then by association, a person's willingness to pay is directly connected to what they are able to afford. Thus the more wealth one has, the more likely it is that it can be increased in a system built on models of pure economic efficiency. Its precept tends to support unequal income distribution, which tends to be a highly political subject.

Ronald Coase's theory, developed in the 1960s, on social costs posits that in circumstances where two activities conflict, the costs should be assessed as the combination of both activities. The classic example used was a scenario where a train travels through a farmer's field and causes crop fires on occasion due to flying sparks. While many would view it as axiomatic that the farmer should be compensated for the losses incurred, Coase's view was that it was not merely the case that without the railway there would have been no fire, but that if the farmer had not planted crops so close to the railroad tracks, there would similarly have been no fire. This approach has allowed the application elements of supply and demand on how damage may be allocated. The economic analysis of law has an underlying capitalistic foundation and the fault-based approach would require far more government regulation than a profit driven society could accept.

The train in Coase's example had a social benefit. It provides transportation of the very crops that the farmers grow. It allowed for quicker access between cities and represents a kind of progress that has effectively benefitted all. There is an argument to be made for ensuring that the damage caused by trains, were a fault based approach applied, might lead to changes and limitations in rail travel that could reduce its overall usefulness to society. As such, a balanced approach that allocates the costs to both farmers and railways can allow for both to continue to co-exist and provide their benefits to society as a whole.

Fast-forward to the modern day and apply Coase's theory to the prospect of financial regulation. The railway and the farmers' crops both provide a social benefit that has the potential to enrich all of society in one way or another. While the ability to sell debt allows for increased liquidity and releases capital for lending, does the current system effectively put capital in the right places so that all of society can benefit from these transactions, rather than those who do the buying and selling? Regulation has been created to control industrial pollution, noise and other noxious or anti-social effects of industry, but complicated financial transactions and particularly those involving complex, repackaged, depersonalised debt instruments present an entirely different social cost that regulators should probably take into account. If debt is an obligation or promise, what happens when that promise is mixed with other promises, amalgamated, divided, sold and dispersed to the point that it is no longer identifiable? Granted, debt is itself only a concept having no true physical existence, at least not since the un-pegging of majory currencies from the gold standard, and even then money only represented a promise to pay something else of equivalent value, accepted only because it is assumed that others will also accept it as valuable in exchange.[30] That said, if debt is to remain a promise, surely the person who made that promise should remain connected to it in some way.

[28] M. Freeman, *Lloyd's Introduction to Jurisprudence* (9th edn, Sweet & Maxwell 2014) Chapters 2 and 3; B. Bix, *Jurisprudence: Theory and Context* (6th edn, 2012, Sweet & Maxwell, London) Chapter 3.
[29] U. Gneezy and A. Rustichini, "A Fine is a Price" (2000) 29(1) JLS 1.
[30] D. Graeber, above note 10, at 47.

Conclusion

Following the crisis of 2007/2008 reform in banking and finance was firmly on the agenda of many of the most affected countries throughout the world. The United States passed the Dodd Frank Wall Street Reform and Consumer Protection Act, which was a compendium of financial regulations affecting financial institutions and their customers, passed in an attempt to prevent the recurrence of events that caused the 2008 financial crisis. The UK passed the Banking Act in 2009 following the Turner Review which was the regulatory response to the global banking crisis, the Banking Reform Act in 2013, and set up the Prudential Regulation Authority that can hold banks to account for the way they separate their retail and investment activities. The EU has issued the *De Larosiere* Report, which has provided some foundation for reform, though it does not have binding force, while there have also been changes to the institutions dealing with banking by introducing the European Banking Authority and the European Securities and Markets Authority. Many of these reforms have been fundamentally reactive in nature, though they have certainly gone further than any reforms that have come before. That said, it must be queried whether these reforms are treating the symptoms, or the disease, and if the latter, what is the disease?

It has been said that there is nothing inherently "wrong" with the complex financial instruments that were central to the crash of confidence in debt markets that precipitated the financial crisis. It is the people who use them and manage the relevant debt. It would seem that enough people have used them inappropriately that it was possible to provide a part of the cause of the second worst financial crisis of living memory. If the ethics guidelines were not followed then, who is to say that changes to guidelines and ethics will prevent the bad behaviour in the future. It is necessary therefore to find a way to better "enforce" the guidelines, or essentially, in the style of Coase, to make the "price" of breaking the rules too high for bankers or other financiers to be willing to pay. Compare it for example to the arguments about gun laws in the United States. The gun lobbyists and the NRA say it is not the guns; it is the people who use them. With that logic it would seem that given the increase in senseless gun crime in the US over the last several decades, it is clear that the people cannot be controlled with the rules that are in place now. Perhaps then something should be done about access to the guns themselves. They are fine and useful tools if used properly by well trained, sane and appropriate people – but that means making sure that we put our guns – and our money – in those right hands.

While the reasons for the crisis cannot be laid solely at the feet of the banking industry, the way that debt is handled is at least one small aspect that can be reconsidered, perhaps leading to improved institutions for handling debt that could prevent its level of contribution to future problems in the global economy. The complex, interconnected, and dependent structure of financial institutions require an international approach to financial distress amongst financial institutions. Although UNCITRAL provides model laws and promotes the noble goal of coordination among the courts of the world that hear insolvency cases, it has been viewed as being inadequate to the nature of financial institutions as they tend to fail to address the structural dependency inherent in them.[31] A paradigm shift in the way that debt is perceived could lead to a better handling of future economic risks, potentially avoiding a financial crisis having the catastrophic impact of the last one. A more transparent system of banking may also lend itself to a better coordination on the international stage as well. Given the interconnectedness of our economies, better cooperation could only improve the resolution of debt.

[31] S.J. Lubben & S.P. Woo, "Reconceptualising Lehman" (2014) 49 Texas Int'l LJ 297, at 300.