‘Bail-In Bonds’ Signal Coming Financial Crash

by Paul Gallagher

April 1—The simultaneous appearance in Europe and Japan of “bail-in bonds” issued by large universal banks, indicates that the huge non-performing holes in the megabanks’ asset books, particularly those in Europe, are soon to be exposed, and those banks are facing a new financial crash. “Bail-in bonds” are more or less openly worthless securities, made to absorb large losses when the toxic assets filling the biggest banks’ books are revealed again, as they were in 2007-08. Banks have started issuing these bail-in bonds largely to one another, and to shadow banks.

The *Financial Times* reported March 31 that Mizuho Bank in Tokyo will kick off “bail-in bonds” in Japan on April 3, with an issue “worth” $1.5 billion. These are essentially deep subprime bank bonds; they bear high interest (nearly 5% in the Mizuho Bank case); and they are officially, instantly, permanently worth zero if the bank is even ordered to recapitalize, let alone threatened with insolvency.

The issuance of such “bail-in bonds” by big banks in Europe has been occurring since early March; even known-bankrupt behemoths like the Monte dei Paschi di Siena bank in Italy—the oldest surviving bank in the world, and Italy’s third largest, are selling “bail-in bonds.” Their qualification as so-called Tier II bank capital is part of the requirements of the European Commission’s mandatory bank bail-in regime announced March 20 as the so-called Single Resolution Mechanism (SRM) of a European Banking Union. That long title is intended to establish that, as of 2016, “bail-in” will be the only procedure permitted for resolving “systemically important” megabanks which are insolvent.

The “investors” who are buying these bail-in bonds, which are clearly made for speculative trading, securitization, and derivatization, will be other banks and shadow banks, hot money looking for high yield before the crash. Ironically, the “credit” to buy them is right now fleeing out of the “emerging markets’ carry trades,” which were created by Federal Reserve and other central banks’ quantitative easing bailouts, and which are now sinking as the Fed tries to “exit” from that hyperinflationary policy. Some of the hot money now running around from losses in the China, Brazil, et al. carry trades is now flowing into the most collapsed economies of Europe and buying such instruments as banks’ bail-in bonds.

‘Black Boxes’ of Losses To Open

The megabanks’ assets books in the trans-Atlantic area alone are bloated to roughly $30 trillion for the dozen biggest banks each in the United States and Europe, having been pumped up by $8 trillion through the “quantitative easing” bailout policies of the U.S. Federal Reserve, Bank of England, and Bank of Japan. In Europe alone, it is estimated that at least $2-2.5 trillion represents non-performing and largely worthless assets.

The policy of “bail-in” for large banks threatened with insolvency, has been put in place by the European Commission and its European Banking Union so that the balance sheets of these banks can finally be wrung out, with the banks’ creditors, depositors, *and taxpayers* paying for the huge losses. This will be done through an “asset quality analysis” of the 130 largest European banks, conducted by the European Central Bank (ECB) from now until November, in which it is expected by the SRM’s regulators that 25-30 of these banks will be found insolvent, sold off, or shut down.

Wolf Richter, a bank analyst and former regulator writing Investing.com, described the process as follows:

“European banks, like all banks, have long been hermetically sealed black boxes.... The only thing known about the holes in the balance sheets of these black boxes, left behind by assets that have quietly decomposed, is that they're deep. But no one knows how deep. And no one is allowed to know—not until Eurocrats decide who is going to pay for bailing out these banks."

Richter quotes ECB head Mario Draghi about the asset quality reviews, or bank stress tests:

"The effectiveness of this exercise will depend on the availability of necessary arrangements for recapitalizing banks—including through the provision of a public backstop.... These arrangements must be in place before we conclude our assessment."

"These arrangements" are the bank bail-in process just "legislated" by the European Union Finance Ministers and the European Commission, the March 20, 2014 Single Resolution Mechanism noted above. But Draghi's reference to "provision of a public backstop" gives away the fact that bail-in is always combined with taxpayer bailout—even though it is touted by promoters of the Dodd-Frank Act and the like as meaning "the end of taxpayer bailouts of banks."

For example, in the infamous Cyprus case of bail-in, called "the template" by the head of the European Finance Ministers Council, 41% of all depositors' money in Cyprus's two biggest banks was confiscated, including business payrolls and operating accounts, and the island's economy was crushed by austerity. But at the same time, one of those two banks was bailed out by the European Stability Fund with EU9 billion (about $12 billion) from European taxpayers, so that the Bank of Cyprus could repay its loan from the European Central Bank.

As economist Ellen Brown of the Public Banking Institute wrote in a March 29 analysis of the oncoming bail-in crash titled "Banking Union Time Bomb":

"Only after the taxpayers—and the depositors—are stuck with the tab, will the curtain be lifted and the crippling insolvency of the banks be revealed. Predictably, panic will then set in, credit will freeze, and the banks will collapse, leaving the unsuspecting public to foot the bill."

Glass-Steagall or Chaos

A Bank of England policy document of September 2012 which was instrumental in the adoption of the European bail-in, made clear that its origin is the refusal to break these big banks up before they crash, by implementing Glass-Steagall, "in particular for G-SIFIs [global systemically important financial institutions—ed.] whose operations are too large, complex, or interconnected to split up without threatening the critical services that the bank provides the bail-in power may be used to ensure creditors are exposed to losses without disrupting critical functions." The depositors are sacrificed to preserve the megabank.

In the deadly austerity of the "bank bail-in" process now adopted for Europe's 130 biggest banks, the first step after a bank's collapsing assets have wiped out part, or all of its capital, and fallen below its liabilities, is for a national government to attempt to bail the bank out. But bailouts and austerity have largely exhausted the national governments' capacity for more national bailouts. And the EU bail-out funds now supposedly will not contribute until *after* bank bondholders and depositors have been confiscated. Thus to step two: The bank defaults on its unsecured creditors, "bailing them in" by issuing them probably worthless bank stock shares in place of their defaulted bonds. "Bail-in bonds" go here.

Step two might improve the megabank's balance sheet, and even pretend to increase its "capital," were it not for the fact that these banks' "assets" are dominated by financial derivatives, so-called "qualified financial contracts" in huge volumes, whose counterparties—other banks and shadow banks—can seize collateral from the bank. The City of Detroit, Mich., as it was pushed into bankruptcy, has been made a glaring example of this brutal looting by derivatives counterparties. In the face of this tidal wave washing over capital and "assets," it's on to the next stage: bailing in uninsured deposits. These are wiped off your deposit book and, again, replaced with dubious bank stock. Liabilities of a European megabank held in the United States or in Asia, for example, are also supposed to be taken and "bailed in." And European bail-out funds, taxpayers funds, are now used as well, in an "EU Bank Resolution Fund" and other vehicles.

But the sheer mass of these derivatives contracts, each taking its pound of flesh, still wipes out the new "capital" as fast as bail-in creates it. The bail-in goes on to stage four: bailing in insured deposits, secured creditors, etc.

Nor should this bail-in process wait until the bank crash actually begins, when it can help to start the crash instead. Thus, "bail-in bonds."