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Book Review

Zur Sanierungs- und Reorganisationsentscheidung von Kreditinstituten (On Bank Restructuring Decisions)

David J. Rapp
Wiesbaden, Germany: SpringerGabler, 2014, 295 pp.

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The most recent financial crisis has engendered various actions by institutions aiming—or at least pretending to aim—to end the crisis and to stabilize the economy in general and the banking sector in particular. Not only have central banks flooded the markets with cheap money, but governments have also introduced new regulations intended to prevent the banking sector and, consequently, the entire economy from blundering into another crisis. These initiatives will in fact make everything worse, or are—at best—pointless. Apart from revised rules for banking

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supervision ("Basel III"), laws concerning the restructuring or formal liquidation of banks were passed in several countries. In Germany, the government created a Banking Restructuring Act ("Gesetz zur Reorganisation von Kreditinstituten") aiming at 1) the successful restructuring of (especially) so-called "systemic" banks without affecting the stability of the banking system as a whole and 2) the involvement of both equity and debt holders in solving a bank's crisis rather than the taxpayer.

While the German Banking Restructuring Act has been the subject of thorough jurisprudential research, David Rapp was the first to analyze the Banking Restructuring Act from a business economics perspective, based upon Austrian insights. His German-language dissertation *Zur Sanierungs- und Reorganisationsentscheidung von Kreditinstituten (On Bank Restructuring Decisions)* starts with a useful introduction which is not only able to inform the reader about the subject matter of Rapp's work as well as its importance and relevance, but it also clearly provides the main research questions and the corresponding structure of the book.

In section II, Rapp deals with three main topics. First, he discusses the causes and course of the recent financial crisis. While his analysis is based upon contemporary Austrian insights on this issue, Rapp's remarks go beyond the general Austrian scope, since he not only discusses economic reasons for the crisis (especially the monetary policy in the aftermath of the dot-com bubble), but also business economics oriented facets of the crisis which contributed to and exacerbated the crisis. He particularly analyzes the role of securitized assets and their international exchange, market participants' deficient risk awareness (which he consistently relates to the almost axiomatic application of neoclassical finance theory in investment decisions), dubious rating agencies, and the fair value accounting under IFRS and US-GAAP. Secondly, Rapp examines the rules of the Banking Restructuring Act. His detailed analysis and insightful critical comments complement his descriptive remarks. Thirdly, the author shows that the initiation of the restructuring process as determined by the law is problematic. His conclusion is drawn from the fact that the law requires an objective approach by focusing on certain ratios originally prepared for banking supervision purposes. Rapp rejects this approach, particularly because he characterizes the selection of the time to initiate restructuring as a typical entrepreneurial act. Based on this insight, he is able to show that the ratios are useless for entrepreneurial decision-making, because they are nothing but arbitrary conventions, heavily influenced by the underlying accounting and banking supervision rules as well as balance sheet policy, and focusing on more or less irrelevant past data.

Then, in section III, Rapp presents an alternative entrepreneurial approach to answer the crucial question of when such restructuring should be initiated by a bank, based on applied Austrian economics. The author emphasizes that subjective valuation is at the core of entrepreneurial judgments rather than some pseudo-objective regulatory ratios. In this context, Rapp also rejects judgments based upon neoclassical finance theory (as recommended in the respective literature on the valuation of financially distressed or bankrupt firms) as inappropriate, particularly because—besides other inherent flaws and fallacies—by definition, these methods exclude the mere possibility of financial distress or a potential bankruptcy of a bank, given that every market participant has unlimited access to lending at market interest rate i in the perfect capital market. Rapp points out that models that exclude the mere possibility of financial distress—which is actually the cause for initiating a bank's restructuring process—are useless to a bank that faces such a situation in practice. His proposal, therefore, is based upon Austrian value theory, i.e., it considers real-world circumstances, especially the imperfection of markets, the subjective element of every entrepreneurial judgment, and the necessity of future-orientation. With his proposed heuristic based on both methodological individualism and subjectivism, Rapp provides a practical tool for decision-makers in banks that allows them to approximate a suitable point in time to initiate a restructuring process properly. Consequently, he argues for a rejection of the objectified judicial approach to the question of when the restructuring should be initiated, in favor of a voluntary entrepreneurial decision.

Within section IV, Rapp discusses the second main issue relevant to business economists: the debt-equity-swap. This is believed to be the most important means of restructuring. As he points out, while a debt-equity-swap creates certain advantages for the bank itself and may be beneficial to some equity holders, it might be detrimental to other equity holders. Even though the effects of such restructuring may reduce some shareholders' wealth, these shareholders might be forced to accept it, since the debt-equity-swap only requires 50 percent approval (66.67 percent in some cases) of the shareholders according to German law. Therefore, the Banking Restructuring Act demands an adequate compensation for the shareholders in case of a debt-equity-swap, as they might have to accept an individually disadvantageous restructuring. Rapp analyzes this arrangement in depth. He not only recognizes that the assessment of such compensation necessarily requires a business valuation of the respective bank, but also step by step constructs a model which allows calculation of adequate compensation and respects both the legal requirements as well as fundamental Austrian principles. The author illustrates the effects which the debt-equity-swap causes from a shareholder's perspective and, thereby, applies both methodological individualism and subjectivism. As he points out, a debt-equity-swap does not only affect a shareholder's stake in the company, but also the magnitude of future payouts, e.g., because the respective bank's debt service decreases in response to the debt-equity-swap, allowing it to invest the saved money and to distribute the gained income to the shareholders. To conclusively assess the adequate compensation requires the juxtaposition of the advantageous and disadvantageous effects a debt-equity-swap has from a particular shareholder's perspective. Rapp shows that if and only if the shareholder suffers a reduction in welfare from the debt-equity-swap, he needs to be compensated to an extent equal to the reduction in wealth.

Section V serves as a suitable summary of Rapp's findings.

From an Austrian perspective, one might certainly argue that the entire Banking Restructuring Act should be rejected, since it cannot really solve any problems but only combats some symptoms—as long as the monetary system remains unchanged and central banks go on distorting markets. However, I appreciate Rapp's pragmatic approach, because he takes the law as it is—given in the real world—and provides important guidance especially to decision-makers in banks, shareholders, judges, and consultants on how to deal with it. However, his insights are not strictly limited to the German Banking Restructuring Act; Rapp's findings can be applied in widely varying circumstances. Furthermore, in criticizing various parts of the law and proposing consistent alternatives, Rapp resolutely counsels politicians to revise the law in order to facilitate more voluntary entrepreneurial judgments rather than strict governmental regulations.