Zombie Bank: What it Means, How it Works, Examples

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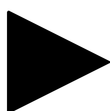
What Is a Zombie Bank?

A zombie bank is an insolvent financial institution that is able to continue operating thanks to explicit or implicit support from the government.

KEY TAKEAWAYS

- A zombie bank is an insolvent financial institution that is able to continue operating thanks to explicit or implicit support from the government.
- Zombie banks are kept afloat to prevent panic from spreading to healthier banks.
- The term zombie bank was first coined by Edward Kane of Boston College in 1987, in reference to the savings and loan crisis (S&L).
- Restoring zombie banks back to health can cost hundreds of billions of dollars, weigh on economic growth, and prevent investors from pursuing better opportunities elsewhere.



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The Curse Of Zombie Banks

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Understanding Zombie Banks

Zombie banks have large amounts of nonperforming assets on their balance sheets and are kept afloat to prevent panic from spreading to healthier banks. Normally, a bank running at a significant loss will eventually be forced into bankruptcy, at which point its assets will be sold off to pay down as many debts as possible. That is unless they are bailed out by governments.

Zombie banks are creatures of financial repression. When loans go bad, a capital flight takes hold and the value of assets plummet, central banks sometimes decide to keep debt-burdened banks, corporations, and households on life support, instead of allowing nature to take its course and creative destruction to do its work.

Previously, banks were left to die. Government intervention surfaced later on when it became clear that struggling financial institutions incite panic. Policymakers wanted to avoid healthier ones getting caught in the crossfire and decided to take action. Since then, debates have raged about when is the right time to pull the plug.

The term zombie bank was first coined by Edward Kane of Boston College in 1987, in reference to the savings and loan crisis (S&L). Commercial mortgage losses threatened to wipe out savings and loans institutions. Rather than let them go under, policymakers allowed many of them to stay in business.[1] They hoped that keeping them afloat would pay off should the market rebound. Eventually, policymakers gave up on this strategy—when the losses of the zombies had tripled.

Shutting down struggling banks can incite widespread panic. However, evidence shows that enabling them to continue operating comes with several drawbacks as well. Restoring banks back to health can cost hundreds of billions of dollars and weigh on economic growth.

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By not liquidating zombie banks, investors' capital is trapped, instead of being put to more productive use. Plus, rather than strengthening healthy companies and supporting economic recovery, zombie banks prop up rotting corporations. By distorting market mechanisms, the resulting misallocation of resources weakens the whole financial system.

Zombie Bank Examples

Japan

When its real estate bubble collapsed in 1990, Japan kept its insolvent banks going, rather than recapitalizing them or letting them go bust, as the U.S. did during the S&L crisis. Nearly 30 years later, Japan's zombie banks still have large amounts of non-performing loans on their books. Instead of helping Japan to recover, these banks locked its economy into a deflationary trap that it has never escaped from.[2]

Europe

In its desperation to avoid becoming Japan after the 2008 global financial crisis, the eurozone made the same mistake. Zombie banks, stuffed with toxic liabilities, have increased lending to existing impaired borrowers, instead of financially healthy or new borrowers. This zombie lending behavior by distressed banks, designed to avoid realizing losses on outstanding loans, has led to a significant misallocation of credit, which has hurt creditworthy firms. No other economy has taken longer to recover.[2]

The European Central Bank (ECB) has warned that debt sustainability is the biggest risk to financial stability if interest rates rise. In other words, zombie banks that are dependent on ECB liquidity may be unable to absorb the losses if zombie companies, which have also only survived thanks to the ECB's regime of artificially cheap finance, go under.[3] Europe's banks are still sitting on $1 trillion of bad loans.[4]

The United States

What about the U.S.? Bank stress tests were more rigorous in the U.S. than in Europe, in the wake of the financial crisis. They forced the weakest banks to raise private capital and sell off toxic legacy assets.

However, there may be just as many zombie firms, whose interest expenses exceed the earnings before interest and taxes (EBIT), stalking the economy in America as there are in Europe, according to the Bank of International Settlements (BIS). So, quantitative easing (QE) may have only postponed the day when banks in Europe and America will have to write off bad debt.[5]

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