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Bail-in has become the favourite focal point, or rather the favourite provocative term in the policy debate about bank rescue programs in Europe. For instance, over the past few weeks, the German government has insistently requested a substantial participation of the private sector in any further debt restructuring. Others, like the President of the European Central Bank has vigorously opposed any step towards a true bail-in. Likewise, most European governments and some prominent economists have warned of the devastating consequences a spreading of default expectations would have on the financial stability of the European banking system.

Such warnings are not without reason. The gradual acceleration of the crisis over the past three years has left many financial institutions holding considerable amounts of once-high quality debt that has turned sour over time. The existing accounting system, however, has trapped these assets in the banks' balance sheets. Selling downgraded debt is tantamount to realizing the accumulated losses – many banks can simply not afford to take the hit, given their rather meagre equity cushions.

The reason why many economists, and a few policy makers, keep on requesting bail-ins is their trust in the general concept of market discipline. A bail-in for private bond holders is the natural counterpart to risk premiums earned by bond holders over the expected life of the bond. A rise of the risk premium exerts healthy pressure on the debtor, as new funding becomes more difficult and more expensive. New bonds will have more stringent covenants, alerting bank management to reduce risk exposure. As funding costs adequately reflect bank risk, it is eventually the shareholder who is punished for excessive risk taking. The concept of market discipline is effective under normal market conditions, as witnessed by the influence rating agencies exert on the valuation of firms across many markets.

Note that the healthy role of bond markets critically hinges upon strict bankruptcy enforcement, which serves to allocate losses to creditors by seniority. This is the simple mechanics of debt market corporate governance.

However, bank markets do not quite work as they should. Under the current conditions of a global financial crisis, notably in Europe's banking industry, the governance role of bond markets is defunct. In fact, investors have understood that bank debt will almost always be rescued with taxpayers' money. No wonder that CDS prices grossly underestimate true *bank* default risk for almost all major banks in Europe and the US, while no such inefficiency is found for non-bank firms. A recent study by two Goethe University doctoral students, Z. Tsesmelidakis and F. Schweikhard finds, for the crisis years until 2009, bank default risk to be underestimated by several hundred basis points. Their analysis is based on CDS prices (Schweikhard, Frederic and Tsesmelidakis, Zoe, The Impact of Government Interventions on CDS and Equity Markets, Working Paper, March 2010).

The widespread practice of government-led bank bailouts has thus severely corrupted the bond market, leading to the underestimation of risk and, as a consequence, the destruction of market discipline.

Any feasible solution to the *bank-debt-is-too-cheap* problem will have to re-install true default risk for bank bond holders. This is exactly the task of the restructuring laws that are currently introduced in several countries in Europe. Consider the new German restructuring law. It is designed to allow the supervisor to intervene when a bank threatens to trigger a banking crisis, creating a good bank and a bad bank over-night. The good bank will be fully protected by government money, while the bad bank will be liquidated and its creditors are likely to suffer big losses.

The new restructuring law, a landmark legislation engineered in the middle of the biggest banking crisis in many decades, is effective January 1, 2011. This is the good news. The bad news is: we do not see any bail-ins. Why not? Even worse, far from being hailed as the much-needed remedy, the term "bail-in" has become a good candidate for the "Unwort" (non-word) of the year, the most-abhorred term in European politics. Why? The answer to both questions is rather simple. Implementing a bail-in in the current situation is expected to trigger contagion among banks, likely leading to a collapse of national and international financial markets.

The crux is evidently that bank creditors, who supposedly should expect to get a haircut during an imminent bank default, can confidently expect to be spared any haircut at all. The reason is that bank creditors way too often are banks themselves. A haircut would thus have disastrous consequences.

Thus, what is required to render the restructuring law workable is a certain minimum of bank bond holders that are permanently situated *outside* the banking system. Such bondholders are capable of absorbing losses ('haircuts') without simultaneously triggering a systemic banking default. I will call such bond holders *haircut-abl*e, as they are capable to break the vicious circle of bank systemic risk.

Life-insurance companies and pension funds are the prototype *haircut-able* investors. Of course, these institutions do not like the idea of being haircut-able, and will probably be very quick in selling any sort of "haircut-prone" assets in their portfolios, like bank bonds, whenever they see a banking crisis approaching.

This brings me to the main policy conclusion: facing the moral hazard problem. In order to have bond holders carry the burden of a potential *bank default,* banks need a sufficient amount of truly defaultable debt, and a commensurately sized group of haircut-able debt holders. Since, sadly, the free market fails on ensuring bank "defaultability", regulatory intervention is warranted. The amendment to the restructuring laws in all countries is rather straightforward: Banks must issue bonds, from which they – and any other institution within the core financial system-- are barred from purchasing. Haircut-able institutions, like pension funds are supposed to buy and hold such haircut-prone bonds. The rate required to hold such debt will again be determined by the market – this time it will be high enough to compensate adequately for expected losses, as a government bailout no longer can be taken for granted.

As a result, curing the contagious disease of systemic banking risk in Europe, and similarly in the US, requires one new treatment, in addition to the measures already taken. This new medicine consists of an active involvement of long-term investors in bank funding. While defaultability may not taste all that well to bondholders, its attractive coupon will be a convincing sweetener, bringing the cost of bank debt back to its true level.