Banking Resolution: Lessons from the Crisis

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Motivation

The regulatory failure in the recent crisis has led to proposals consisting of

- Higher common equity capital charges
- Higher capital charges for the trading portfolio
- Higher capital charges for SIFIs and
- liquidity regulation.

Still, the key externality justifying banking regulation is the social cost of banks' bankruptcies. Thus the key role of banks' resolution procedures.

Resolution procedures allow for a wide range of possibilities
Still:

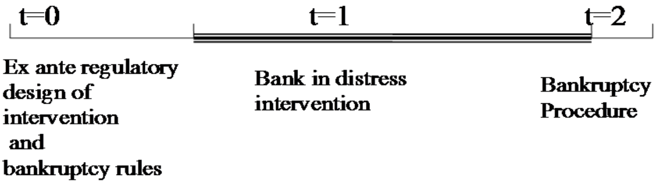
- freezing the bank's payment operations is not an option (so depositors co-responsibility as in the UK before the Northerin Rock crisis is not an option)
- debt holders discounts should be targeted to long maturities, and should be provided with liquidity lines so as to avoid contagion.

The banks' resolution problem: cost benefit at the margin

Regulatory authorities mandate is to preserve the domestic financial industry financial stability
FSA mandate is also to promote London as a financial center.
No serious conflict of interest but definitely a trade-off

What intervention?

The time framework of banks' resolution: a three stage game



Asset prices process

- In good times, that is before t=1, a bank's margin is positive and the bank incentives is to invest in "sound" projects.
- In bad times the bank's margin is negative and the bank's incentives is to gamble for resurrection.

Asset prices process (II)

At any time the regulator may choose to support the financial institution or not on the basis of its information regarding the nature of the crisis: illiquidity or insolvency, the importance of the financial institution and the value of the option to wait.
Remark1: Bankruptcy is an equilibrium as illustrated by the Diamond Dybvig model
Remark2: The regulatory authorities' specific intervention is the result of a bargaining process that takes time and determines the cost to taxpayers.
Remark 3: By backwards induction, this implies that the disagreement point, i.e. banks' bankruptcy regime, is critical in determining the cost of resolution

Bankruptcy (t=2 stage)

Characteristics of a general bankruptcy code:

- Fair treatment
- Maximizing value to creditors

Characteristics of a bank specific bankruptcy code

- Speedy
- Renegotiation free,
- Legal certainty
- Providing liquidity to creditors (Freixas, Parigi and Rochet, 2000)
- Informationally feasible

This difference justifies a Lex Specialis

Equitable insolvency vs. balance sheet insolvency

A bank specific bankruptcy procedure decreases the cost to taxpayer because it reduces the bargaining power of banks' shareholders

A bank specific bankruptcy procedure could introduce contingent claims being issued or swapped.

Some examples of resolution procedures

- Nationalization, Bridge bank.
- Living wills
- Good bank / bad bank separation.

Some examples of early intervention

Liquidity provision

- Open bank finance

Assets revaluation

- Assisted merger and acquisition (Purchase and modified assumption)
- Asset Guarantees
- Asset auctions

Liabilities restructuring and revaluation

- Debt Equity swaps.
- Liability Guarantees.
- Subsidized Debt Buybacks.
- .Recapitalization by Issuing Stock or Preferred Stock.
- CDS triggered equity issue (Hart and Zingales).

Ex post comparison of alternative interventions (t=1)

To begin with, notice that a debt equity swap at market prices is Pareto improving. So, the problem is related to creditors (and shareholders) leverage and the possibility of a bail-out
The bargaining process could be thought of as sequential bargaining.
Regulator's objective: restore market confidence, interpreted as decreasing the probability of a bank's bankruptcy (Landier and Ueda, 2009) or avoiding debt overhang (Philippon and Schnabl, 2010)
Lender of last resort financing
Optimal structure of funding : Debt buy back (Landier and Ueda), a combination of preferred stock and warrants (Philippon and Schnabl)
Optimal timing of the intervention

The specifics of a systemic crisis

Why is it different?

- Contagion
- Cost of a bail-out may be too large with respect to the country fiscal revenue

Implication: promoting a favourable macroeconomic environment is possible

Implication: a systemic risk board is required

Example: Capital Insurance (Kashyap, Rajan and Stein).

The ex ante design

Trade-off between ex ante moral hazard and ex post (credible) bail-out and liquidation decisions
Impacts on incentives and corporate governance
Constraints in the design of a bank restructuring system.

- 1. The legal framework
  2. The regulators' objective function
  3. Commitment vs. non-commitment or rules versus discretion
  4. Multiple domestic regulators
  5. Transparency versus secrecy

International cooperation and competition among supervisory agencies

Hardy and Nieto 2008
The host country supervision, regulation and deposit insurance schemes generates a positive externality on the host country supervision and regulation.
The bail-out of a multinational bank is a public good and cannot be privately financed (Samuelson's theorem).
Improvised cooperation is the equivalent of private contributions to the construction of a public good.

Issues in Cross-Border Resolution

Universality vs. Territoriality
Branches vs. Subsidiaries
The Financial Trilemma


Ceci n'est pas une pipe.

Lessons from the Icelandic crisis

- The regulatory framework is not the regulatory framework

1.
    1. Deposit insurance is not deposit insurance (Iceland)
    2. Capital is not capital (Iceland)
    3. Subordinated debt is not sub debt (Germany)
    4. Corporate governance is not Basel corporate governance (Iceland)

- Complete failure of "improvised cooperation" failed

Recommendations

- The Universality principle of the Reorganization and Winding-Up Directive of 2001 should be enforced
- Deposit insurance should be European
- Burden sharing should be possible for SIFIs (Nordea,...)

To conclude

The efficient regulatory reform should go to the source of the problem: design the right legal environment (bankruptcy rules, specialized agencies, corporate governance,...) and be realistic about the game between the regulatory authorities and the distressed bank liability holders.

Failing to address these issues and resorting to capital increases combined with generalized bail-outs will lead to an inefficient banking industry.