"The Future of Regulatory Reform"

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Bank Resolution: Lessons from the Crisis

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Banking Resolution: Lessons from the Crisis

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Motivation

The recent crisis

Some precedents

- S&L crisis
- Scandinavian crisis
- South Asian crisis

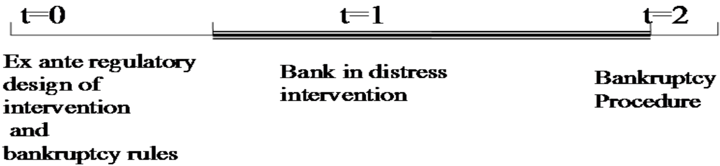
Cost benefit at the margin

Π =Shareholders' profits
S =Supervision,
K=Capital requirements and
D =Deposit insurance

$$
\begin{aligned}
& \max \alpha\Pi + (1-\alpha) pCost \\
\Pi &= \Pi(S, K, D) \\
p &= p(S, K, D) \\
Cost &= Cost(S, K, D)
\end{aligned}
$$

What intervention?

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



A long list of mechanisms
Resolution mechanisms

Assets or liabilities?

- Open bank finance
- Assisted merger and acquisition (Purchase and modified assumption)
- Asset Guarantees
- Liability Guarantees
- Subsidized Debt Buybacks
- Good bank / bad bank separation
- Debt Equity swaps
- Capital Insurance (Kashyap, Rajan and Stein)
- CDS triggered equity issue (Hart and Zingales)
- Recapitalization by Issuing Preferred Stock
- Recapitalization, Nationalization, Bridge bank

Debtholders, maturity and renegotiation

Equitable insolvency vs. balance sheet insolvency

Lex Specialis vs. lex generalis

Characteristics of a general bankruptcy code:

- Fair treatment
- Maximizing value to creditors

Banks specific crises

- Speedy
- Renegotiation free,
- Legal certainty
- Providing liquidity to creditors
- Informationally feasible

Illustrations: the US Prompt corrective action and the EU proposal

Ex post comparison of alternative schemes

Comparing the alternative resolution schemes for a distressed bank
Welfare maximization vs. Cost minimization
Lender of last resort financing
Optimal structure of funding
Optimal timing of the intervention

The specifics of a systemic crisis

Why is it different? Contagion
Fostering a favourable macroeconomic environment
Limiting Contagion
Implication: a systemic risk board is required

Banking system resiliance

- Characteristics of an efficient restructuring system
- Comparing alternative contingent mechanisms
- Impact on incentives and corporate governance
- Limits in the design of a bank restructuring system.
  1. Commitment vs. non-commitment or rules versus discretion
  2. The legal framework
  3. The regulators' objective function
  4. Multiple domestic regulators
  5. Transparency versus secrecy

International cooperation and competition among supervisory agencies

Hardy and Nieto 2008
S =Supervision,
K=Capital requirements and
D =Deposit insurance

$$\max \alpha\Pi + (1-\alpha)pCost$$

$$\begin{aligned} \Pi &= \Pi(S_1, S_{2,} D_1, D_2) \\ p &= p(S_1, S_{2,} D_1, D_2) \\ Cost &= Cost(S_1, S_{2,} D_1, D_2) \end{aligned}$$

Cross-Border Resolution

Universality vs. Territoriality
Branches vs. Subsidiaries
The Financial Trilemma

Europe at a cross-road

- the European banking structure
- Lessons from the Icelandic crisis

New proposals

- Macro-prudential policy
- Basel III
- Tax the banks
- Increased transparency
- Creation of new institutions
- Liquidity regulation
- Living wills
- Incentive banks to be structured as holding companies that allow for partial merger and liquidations

To conclude

What is better regulation?
Right incentives
The efficient regulatory reform should go to the source of the problem: design the right legal environemnt (bankruptcy rules, specialized agencies, corporate governance,...)
Failing to address these issues either and resort to capital increases combined with generalized bail-outs will lead to an inefficient banking industry.