

# Banking Resolution: Lessons from the Crisis

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# Motivation

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An analytical  
framework

Cross-Border  
regulation

Conclusion

## The recent crisis Some precedents

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

All characterized by massive bail-outs at high cost to taxpayers  
Failure of regulation has led to propose capital increases and/or  
strict regulation

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

# A long list of resolution procedures

## 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).
- Capital Insurance (Kashyap, Rajan and Stein).
- Nationalization, Bridge bank.
- Good bank / bad bank separation.

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## 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 Northern 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

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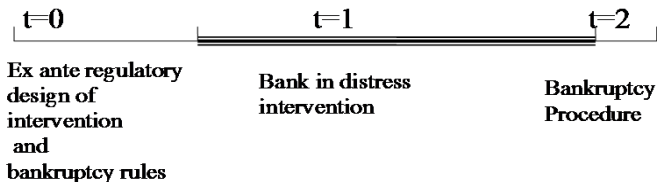
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Regulatory authorities mandate is to preserve the domestic financial industry financial stability  
FSA mandate is also to promote London as a financial center.  
No serious conflict of interest but definitely a trade-off

# What intervention?

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



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# Asset prices process

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- 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)

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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

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# This difference justifies a Lex Specialis

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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.

# Ex post comparison of alternative interventions ( $t=1$ )

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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

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## 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

# The ex ante design

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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

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Hardy and Nieto 2008

The host country supervision, regulation and deposit insurance schemes generates a positive externality on the host country supervision and regulation..

# Issues in Cross-Border Resolution

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Universality vs. Territoriality  
Branches vs. Subsidiaries  
The Financial Trilemma

- The European banking structure
- Lessons from the Icelandic crisis
- 1 The regulatory framework is not the regulatory framework
  - 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)
- Regulatory mandates are home biased
- Regulatory competition
- Complete failure of "improvised cooperation" failed

# Recommendations

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- 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,...)

# New proposals

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- 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

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The efficient regulatory reform should go to the source of the problem: design the right legal environment (bankruptcy rules, specialized agencies, corporate governance,...)

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