Ex post resolution and ex ante incentives

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Lessons from the crisis

- Why has the use of bail-outs been the most frequent answer to the crisis?
- Avoid banks’ bankruptcies
  - Preserve the payment system
  - Limit contagion
  - Preserve relationship banking
- This is at taxpayers’ cost

Why is resolution important?

- The reason for banking regulation is the social cost of banks bankruptcies
- Consequently it is efficient to have an efficient bank bankruptcy procedure.
- But, how should we define «efficiency»?

The objectives of a resolution procedure

- Non financial firms:
  - Preserve the claim-holders rights
  - Maximize claim-holders values
- Banks:
  - Limit contagion and preserve the payment system possibly implying the bank should continue in operation
  - Orderly
  - Quick

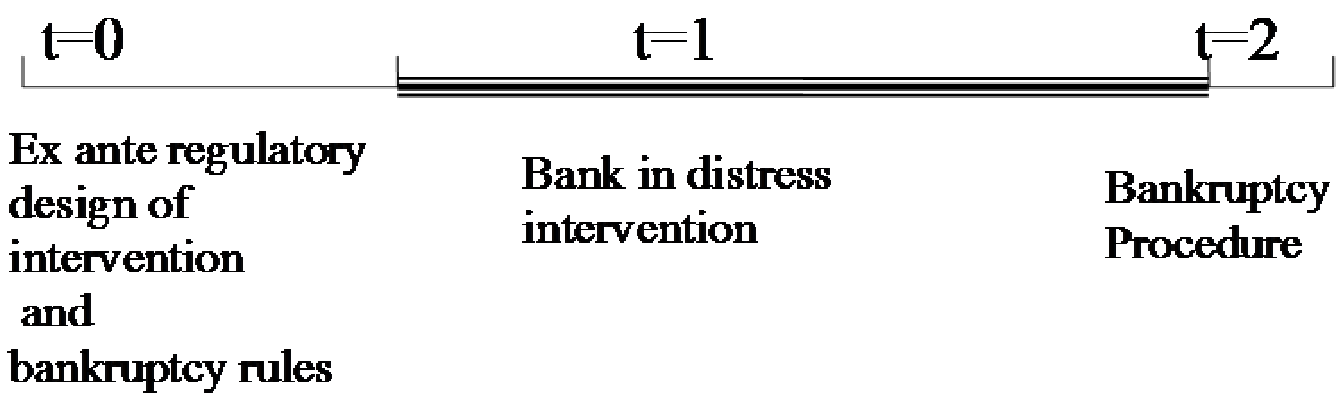
A preliminary point

- Why are banks highly leveraged?
- Tax shield justification
- Agency problem justification
- Insufficient capital requirements (Admati et al.)
- Contingent capital solutions provide debt in good times and equity in bad times

The bank in distress condition

- Bank are highly leveraged
- A bank in distress has a high cost of funds
- A bank in distress is destroying resources

The bargaining game



Why bank specific bankruptcy procedures?

- They improve the regulator/treasury position in the bargaining game
- They allow for a quick orderly resolution

Ex post efficiency

- Debt equity swaps constitute the efficient procedure
- They have to be imposed
- Perfect solution if tax shield is the justification for debt

Ex ante incentives

- In a MM world market discipline should make the debt-equity swap ex ante efficient.
- Yet, because of insufficient market discipline (banks opacity, expected bail-outs,…) banks may take excessive risks.
- Implication: trade-off between ex post efficiency and ex ante incentives

Contingent capital, convertibles and bail-ins

- The current structure is equivalent to a subsidized « capital » insurance scheme and generates incentives for risk taking
- Contingent capital is better than the current system but does not wipe out shareholders
- Bail-ins will improve the trade-off ex post efficiency and ex ante incentives

Back to the bargaining game

- A coco's automatic recapitalization does not penalize the managers or shareholders. It is an extreme form of subordinated debt. At time t=0 banks may take more risk even if their incentives to gamble for resurrection decrease at t=1 (Martynova and Perotti 2013)
- A bail-in is closer to an orderly bankruptcy procedure that forces a restructuring of liabilities according to ex ante well established procedure

Problems with cocos

- Should be triggered by market price
  - Possibility of multiple equilibriums
  - Death spirals
  - Price manipulation through derivative markets
  - Coco holders may prefer bankruptcy

Problems with bail-in

- Subject to regulatory decision and therefore to regulatory biases:
  - Regulatory capture
  - Regulatory reputation
- Precedents: Bear Stearns and Lehman bro. had sufficient regulatory capital: cocos based on market values would have helped but not if based on regulatory capital.

Performance in a systemic crisis

- At an early stage Cocos perform better as bail-ins lead to contagion (collapse of the CD market and short term debt)
- At a crisis stage cocos are useless and only bail-ins help to reduce the strain on public finance that bail-outs generate.

Multinational banks

- Their bail-out poses the problems of funding of a public good.
- Their liquidation poses the problem of conflicting legislations (universality vs. Territoriality)
- Bail-ins would may be the way out