

Banking  
Resolution:  
Lessons from  
the Crisis

Introduction

The banks'  
resolution  
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Comparison

Resolution in a  
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The ex ante  
design

Cross-Border  
regulation

Conclusion

# Banking Resolution: Lessons from the Crisis

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# Motivation

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## The recent crisis Some precedents

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

# Cost benefit at the margin

$\Pi$  = Shareholders' profits

$S$  = Supervision,

$K$  = Capital requirements and

$D$  = Deposit insurance

$$\max \alpha \Pi + (1 - \alpha) p \text{Cost}$$

$$\Pi = \Pi(S, K, D)$$

$$p = p(S, K, D)$$

$$\text{Cost} = \text{Cost}(S, K, D)$$

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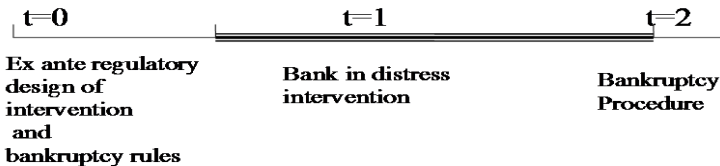
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# What intervention?

## Regulatory objectives

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



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# 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

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What's different about banks?

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

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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

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Why is it different? Contagion

Fostering a favourable macroeconomic environment

Limiting Contagion

Implication: a systemic risk board is required



# Banking system resilience

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- 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

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Hardy and Nieto 2008

$S$  =Supervision,

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$$\max \alpha \Pi + (1 - \alpha) p \text{Cost}$$

$$\Pi = \Pi(S_1, S_2, D_1, D_2)$$

$$p = p(S_1, S_2, D_1, D_2)$$

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# Cross-Border Resolution

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Universality vs. Territoriality  
Branches vs. Subsidiaries  
The Financial Trilemma

# Europe at a cross-road

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- the European banking structure
- Lessons from the Icelandic crisis

# 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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## What is better regulation?

### Right incentives

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 either and resort to capital increases combined with generalized bail-outs will lead to an inefficient banking industry.