The good, the bad and the ugly: the challenge of failing banks

Olivier Davanne

Paris-Dauphine University

Risk Premium Invest

November 2018

It is very bad to bail out financial institutions! This creates very perverse incentives, especially for weak institutions. When banks have suffered significant losses and have little equity, shareholders are encouraged to take even more risks because they enjoy a very skewed situation: the potential gains will be for them and the losses for taxpayers. There is a term dedicated to this behavior: “gambling for resurrection”. And creditors are ready to provide fuel for these new risky bets as they hope to be bailed out by taxpayers.

Thus, there is a consensus to end decades of bailouts and for shareholders and creditors (with the exception of insured depositors) to pay the losses. This is a rather difficult exercise, and the previous governments did not follow this bad way simply because they were friends of the bankers … The main difficulty with the banks is that they are essential suppliers of “liquidity services”: they issue short-term debts that they use to make long-term loans. As a result, a large number of economic agents depend on the ability of banks to keep their promises and repay all their creditors quickly in the short term. If this promise is broken, many agents will find themselves in a very difficult situation, including the financial counterparts of the failing institution. Indeed, if there is the sheer suspicion that the promise may be broken, a run will result on the failing and similar institutions with devastating consequences. With maturity transformation at the heart of the banking model, it is almost impossible to trigger the “creditor stay” at the center of all effective bankruptcy procedures. This suspension provides the time needed to liquidate or properly restructure the failing company so as not to destroy too much value. It also allows a careful allocation of losses among different categories of creditors according to the hierarchy of claims (see Chapter 11 bankruptcy procedure in the United States).

Yet, the international community believes that it has found the solution in the aftermath of the 2007-2009 crisis. Let’s leave the impossible court process aside and let’s regulators spread the losses between shareholders and various creditors over the weekend. In all countries, the legal system has been modified to allow this rapid process. Now, two LLRs cohabit: the traditional Lender of Last Resort, which is nice, and the Liquidator of Last Resort, which can turn its ugly face on weekends … They need each other: the Lender of Last Resort helps troubled banks pay their bills in the short term but needs the threat of the Liquidator of Last Resort to avoid overly perverse incentives. And the latter knows too well that Monday morning can be pretty chaotic for all the institutions still alive and in private hands every time he’s hit over the weekend. It will probably need the resolute help of the Lender of Last Resort to stabilize the situation.

As far as shareholders are concerned, the two LLRs act in dramatically different directions: the Lender of Last Resort subsidizes the bank by providing credit on better terms than market conditions. The Liquidator of Last Resort punishes the shareholders. There is no doubt about that. The Financial Stability Board has stated that “the resolution regime should provide for timely and early entry into resolution before a firm is balance-sheet insolvent and before all equity has been fully wiped out” (key attribute 3.1). The priority is to protect the taxpayer and the shareholders will lose their remaining equity over the weekend.

This new process involving subsidies and sanctions has never been put to the test in the context of a general economic crisis in which many institutions are seriously injured at the same time. In Europe, it has been used in recent years in a globally favorable environment to solve the specific problems of a few isolated institutions.

The main problem with this new approach is that it assumes that it is possible to form a reasonable opinion on the real value of a bank by examining its audited balance sheet. If this were the case, regulators could decide in a transparent and predictable way to switch to Lender mode of Last Resort or to switch to Liquidator mode of Last resort. Yet, in times of severe economic crisis, no one is able to determine the value of most assets while many debtors are struggling to repay their loans. In addition, these periods are generally characterized by high and volatile risk premia. Thus, the regulator would have a lot of latitude to classify banks between creditworthy and insolvent.

There is no doubt that in the next sharp economic slowdown, uncertainty as to how regulators will use their discretionary powers to subsidize or expropriate will create tremendous volatility in the market for securities issued by banks. This will significantly increase their cost of capital and make banks tired of lending just when the economy needs their help. There is also no doubt that banks' stock prices would suffer from the risk of resolution threatening weak banks. One should note that the fall in stocks prices makes it difficult to recapitalize troubled banks. Indeed, during the crisis of 2007-2008, a lot of new capital was provided during the first phase of the crisis, but with a low stock price, Lehman Brother was unwilling and unable to attract new capital in the spring and summer of 2008. We can only imagine what would have been the situation in the winter of 2007-2008 on the stock market, with the risk of resolution hovering around several banks …

It would be interesting to have an idea of the type of discount that investors would require to buy bank shares threatened with resolution. It's hard to say because it obviously depends a lot on how the regulators would analyze the balance sheet of a bank weakened by potential losses difficult to estimate. One possible case is that regulators give significant weight to the stock prices to assess the banks' situation. This can make sense for four main reasons:

- Market value reflects how the investment community assesses the true value of the company. In an uncertain economic environment, regulators may think that it provides more information than the audited balance sheet.
- As noted above, the ability of a company to call on its shareholders and rebuild its depleted capital depends on its market value. Regulators may be concerned about supervising a bank with a low market value that we will not be able to recapitalize in the event of a problem.
- Shareholders are encouraged to "gamble for resurrection" when a company has little value: they have little to lose if new investments go wrong, while benefiting from the rise. A zombie bank with low market value is a pretty dangerous institution!
- Last, but not least, the lower the share price, the easier it will be to expropriate the shareholders without triggering a political and legal reaction.

But if regulators place too much weight on stock prices, they would be sure to trigger a "death spiral". When stock prices fall, this increases the chances of resolution and justifies further falls. It can be shown that there is no limit to this "death spiral": if the decision to expropriate shareholders is solely based on stock prices, they will fall to 0 regardless of the real value of the assets owned by the bank (see riskpremium.com/wp-content/uploads/2018/03/Resolution-stock-prices.pdf)!

For political and economic reasons, it is absolutely necessary to stop bailing out financial institutions. However, I do not believe that the international community has found the solution. With the fear of widespread resolution, the financial system risks to be brought to a standstill when the economy goes into deep recession. But is there a possible solution?

Sometimes governments try very long to do impossible things … The best example is the famous "incompatibility triangle" highlighted by Nobel laureate Robert Mundell. It is not possible to benefit simultaneously from a fixed exchange rate, a perfect mobility of capital and the independence of monetary policy. We must give up one of the three objectives (or a bit of both …). The reason is the rationality of investors who anticipate the next movement of the authorities and who quickly attack a currency when monetary policy may diverge in a country.

The same type of incompatibility triangle exists in financial regulation and for the same reason: the ability of financial markets to anticipate. Thus, you probably cannot simultaneously have a banking sector that plays a key role in maturity transformation (short-term borrowing and long-term lending), a financial sector that is robust enough to finance the economy in times of crisis and no taxpayers' money at risk. The policy "Too big to fail" favored the first two objectives with a potential cost for public finances (bad!). The new "resolution powers" probably give up the second, namely the ability of the financial sector to finance the economy in times of crisis (possibly ugly …).

Is it possible to do better? Probably. The solution appears to further reduce the role of the banking sector's "maturity transformation" (already limited by the introduction of tighter liquidity rules after the 2007-2009 financial crisis). This is probably the least important of the three "goals" and, in fact, the evolution of modern financial sectors means that the provision of "liquidity services" can be more effectively delivered by other mechanisms (a very similar view if defended by John Cochrane who argues for a "run-free Financial System"). Less "maturity transformation" means more time is available to solve the problem of bankrupt banks in a way that fully respects the rights of shareholders and other creditors. Thus, it may be possible to avoid disrupting the financial sector at the worst possible time while protecting taxpayers. This is a complex issue that requires a thorough analysis of how liquidity may be efficiently provided to investors, and this is the main subject of my PhD dissertation (see this post on my website www.riskpremium.com/?p=1005).