How to deal with weak financial institutions?

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There are many signs that the new, powerful resolution powers granted to regulators after the 2007-2009 financial crisis have been badly conceived, introducing a sort of ticking time-bomb in our financial system.

They are based on the idea that regulators are able to judge the fundamental value of a bank and, depending on the equity left, can efficiently switch from a Lender of Last Resort friendly attitude – which offers credits at non-market conditions – to a punishing Liquidator of Last Resort mission, expropriating shareholders “before a firm is balance-sheet insolvent and before all equity has been fully wiped out” (key attributes 3.1 of effective resolution regimes for financial institutions, Financial Stability Board). But in troubled times, the balance sheet is a very poor guide for judging the quality of the material and immaterial assets that the banks hold. This uncertainty about the public authority's attitude – friendly or hostile to shareholders – can trigger huge volatility in the price of the securities issued by financial institutions. This is no theory: it is what we observed in the mini-banking crisis of the spring of 2023. Even worse, this ambiguity can provoke a 'death spiral' in equity prices and kill banks that may be viable. As it is difficult to judge the true value of a bank, especially in times of turmoil, it is very tempting for regulators to give strong weight to the easily observed stock prices. A low market value encourages resolution for many reasons. Banks with a low market value will be unwilling and unable to issue new stocks, and expropriating shareholders of a bank with low stock prices will be politically easier. But if you base your resolution decisions mainly on stock prices, there is no more objective information in these stock prices. As stock prices decline, the probability of resolution rises, and this feeds into the observed fall. Due to this 'death spiral,' it is easy to show that the market will be unable to function.

The spring banking crisis, which included the resolution of Credit Suisse and several regional U.S. Banks, sent a strong signal that we need to fundamentally revise how we deal with weakened banks. However, I am very skeptical that we’ll ever find an efficient resolution process in a world where banks engage in large-scale maturity transformation and are vulnerable to 'runs.' The critical question then becomes how we can more efficiently deal with weakened banks early on, at a stage when their viability is not yet in question. How can we assist or compel them to recapitalize? In this regard, stock prices can play a very useful role, provided they are no more distorted by poorly conceived resolution powers. In well-functioning markets, stock prices are a more accurate indicator of a financial institution's true economic value than audited balance sheets. Furthermore, stock prices are a key factor in determining the ease with which new stocks can be issued to recapitalize a weakened institution. Therefore, an efficient regulator should indeed pay close attention to stock prices, not to decide when to expropriate, but to exert pressure on banks to recapitalize in a timely manner while their market value is still acceptable. Throughout this process, they should maintain a supportive stance and assist banks in their recapitalization efforts. In certain special circumstances, it may be prudent for public authorities to participate in this recapitalization, taking a small share of the newly issued stocks, obviously at market value.

Note that the current resolution framework, which has been long in development, does not necessarily require amendment as it could simply become irrelevant through the introduction of a more effective prevention framework. Dealing more efficiently with weakened institutions would make very unlikely the use of poorly conceived resolution tools. This approach, which is not overly difficult to implement, would restore to stock prices their invaluable 'canaries in the coal mine' function. More fundamentally, it would bolster the much-needed counter-cyclical role of public authorities. When balance sheets are undermined by an unexpected economic shock, investors should be encouraged to inject new capital to circumvent a debilitating vicious cycle. Yet, the current resolution framework does the exact opposite: by expropriating shareholders 'before all equity has been fully wiped out,' it renders investors extremely hesitant to contribute new funds. Regulators will need considerable luck in the next economic crisis if they choose to adhere to this current approach and merely make marginal adjustments to this flawed resolution process.