Criteria for a Good Bank Resolution Regime

Anil K Kashyap

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1. Why banks are special and need different treatment
2. Principles for a good resolution regime
3. Implications of the principles

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What makes banks special?

1. Two basic theories: liquidity provision or monitoring

2. Both imply linkages between the asset and liability linkages and failure of Modigliani-Miller assumptions

3. Both naturally lead to demandability, which leads to the risk of "runs"

The incompatibility of demandability and normal bankruptcy principles

1. Normal bankruptcy procedures presume value creation is driven purely by the asset side of the balance sheet. ➔
   - Court should maximize asset values and pay off liabilities

2. Doesn't work when enterprise value depends on liability structure. Worse still, as trouble worsens, debt maturity shortens. ➔
   - You can't haircut short term debt
   - Can't use slow motion liquidation or reorganization

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Which institutions need special rules?

1. Guiding rule: when short-term debt is critical part of the capital structure these problems arise

2. Leading non-bank examples:
   - Money market mutual funds
   - Broker-Dealers
   - Special purpose funding vehicles (e.g. asset backed commercial paper)

Five Principles for a Good Regime

1. Resolution must work for non-banks too

2. Recognize the special problems caused by runs

3. Attack the threat of runs directly

4. Make mandatory recapitalization time consistent with respect to break up options

5. Anticipate macroprudential implications

Implications of covering all cases

1. Regime must be flexible enough to cross-supervisory boundaries

2. Probably needs to sit on top of the normal bankruptcy code (or be set up in parallel)

3. Needs to be cognizant up front of cross-border issues

Implications of run risk

1. Time is of the essence

2. Should anticipate it will be hard to tell the boundary between solvency and illiquidity
   - BSC vs. LEH?

3. Accept/submit to the fact that haircutting short-term debt is impractical

Implications of directly battling runs

1. Pre-wired recapitalization is essential for buying time

2. Don’t count on discretion

3. Any debt to equity conversion should be large enough to credibly buy time (size also helps with the moral hazard).

4. Swiss plan for convertibles is a good recipe

Implications of preserving the break-up option

1. Living wills provisions ought to be triggered once the recap occurs

2. Trigger for the recap should be higher for more complex institutions to buy more time

3. Avoid “discrete” thresholds for actions

4. Deal with derivative contracts and the dissipation of value if they have to be liquidated.

Macroprudential implications

1. Regulation via capital *ratios* invites deleveraging

2. Be cognizant of fire sales that can results from forced selling

3. Anticipate the spillovers across institutions and markets from fire sales

Conclusions

1. Financial intermediaries do need special rules and a different way of thinking about bankruptcy

2. Diamond's dictum: follow the short-term debt

3. Cross-border challenges are the "elephant in the room"

4. Pay attention to macroprudential ramifications