MORAL HAZARD AND ORDERLY BANK EXIT

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David G Mayes

Bank of Finland

IMPROVING BANKING SUPERVISION

by

David G Mayes, Liisa Halme

and Aarno Liuksila

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IMPROVING FINANCIAL SUPERVISION - 3 PILLARS

- **control of right of establishment (i.e. entry and exit)**
- **supervision substantially complemented by market discipline from public disclosure**
- **efficient system for handling problems and crises**

BASEL COMMITTEE PROPOSALS

- **3 pillars**
  - **improved capital adequacy**
  - **supervisory review**
  - **market discipline**
- **enhancing the third pillar**

PROBLEMS IN CRISIS RESOLUTION

- **Not Lender of Last Resort Problem!**
- **Co-ordination across EEA**
  - **Home Country control**
- **Lack of information**
- **Moral Hazard - too big to fail**

  - herding
- **Need power to act early or taxpayer/insurer will always pay**
- **Overcoming history**

A BRIEF REVIEW OF MARKET DISCIPLINE

WHY REGULATE BANKS?

- **Mismatch between liquidity of assets and liabilities makes them vulnerable**
- **Information poor - difficult to monitor**
- **Cannot enter and exit like other companies**
- **Moral hazard and herding**
- **Consequential losses and contagion**
- **Major costs to society from financial crises**
  - **deposit insurance**
- **Money different from other goods and services**

SUPERVISORS EXPLOIT THEIR ADVANTAGES

- **Assessing entrants' quality**
- **Identifying threats to the system**
- **Focusing on potentially fragile institutions**
- **Prompting early corrective action**
- **Ensuring compliance**

MARKET DISCIPLINE

- **Responsibility for prudent management of banks lies with directors and managers**
- **network of incentives for shareholders, directors, management, depositors, analysts, competitors & supervisors**
- **still a role for supervisors**
- **still need to work on other sources of systemic risk eg settlement systems**

THE BASIS OF THE INCENTIVE STRUCTURE

- The idea is to maximise the chance of having well run banks
- It is in the interests of all those concerned for bank managements to follow prudential behaviour
- Everybody has something at risk

  jobs, incomes, wealth, reputation
- Moral hazard reduced

TRYING TO AVOID THE INFORMATION PROBLEMS

- **Less opportunity to cover up problems - either for banks or for regulators**
- **Avoid private information**
  - **Regulator implicitly responsible if knew**
- **Make the information available to those who can use it.**
- **Reveal externally what you need to be able to make good internal judgements**

BACK TO
EXIT POLICIES

CRISIS RESOLUTION SYSTEM IS PART OF THE INCENTIVE

- Credible inability to bail out - structure makes it difficult
  - Arms length funds - German model
- progressive precommitted actions as difficulties emerge
- Solutions if bank still trading
  - Choices cf. new NZ proposals
- Avoid ‘go for broke’

HANDLING CRISES

- **What can the market achieve?**

  Raise new capital - debt, equity

  takeover, lifeboat

- **Roles for the authorities**

  marriage broker, enforce risk sharing

- **Who does what? CB, Finance, supervisor?**
- **Protection of the insurance fund a la US?**
- **Lack of ability to act**

  too little information, difficult to co-ordinate, too little power to act

EFFICIENT BANK EXIT

- Avoid expanding losses - weakens the good
- But under exit it is a long time before people get much back
- Need to act before there is a run. Run is unfair selection
- Need powers of temporary administration
- To recapitalise in a hurry may need to over-ride existing shareholders

EXIT

- **Administrator can act faster than courts**
- **Bank has more value as a functioning entity even if split into viable and impaired assets**
- **Always difficult to establish extent of (in)solvency in a hurry - cannot be sure**
- **Need redress for mistakes if write down assets**
- **No new grand institution required**

DIFFERENCES BETWEEN US AND EU

- **In EU state is not a party to insolvency proceedings - it is part of private law**
- **In US state charters and terminates banks - agencies takeover problem banks and as successors liquidate their assets and succeed to creditors claims and shareholder interests**
- **Our recommendation is to follow a version of the US scheme**

REQUIREMENTS

- **Problem with US scheme is that it makes disposal as a going concern impossible - need powers to sell as in NZ**
- **Administrator needs full range of choices - private law system cannot cope, need to switch to public enforcement - act in the public interest rather than just creditors - cannot delay - can revalue claims upfront**

THE PROPOSAL

- Intervene on prescribed benchmarks
  - Economic insolvency
- Appoint administrator
  - from agreed panel
- Value claims up-front
- Choose solution best in the public interest

(In EEA – home country responsible but hosts can require EEA level administrator)

OVERCOMES SOME PROBLEMS

- **State does not have liabilities unless it chooses to bailout - but does not have sovereign immunity from those divested of their rights**
- **In public system the value of claims can be quickly established whereas in private system everything has to be resolved first**
- **In our scheme shareholders cannot block equity restructuring**

A SYNTHESIS

- **Similar to NZ statutory management**
- **By writing off shareholders and creditors moral hazard is reduced as their expected position is known**
- **expedition, efficiency, economy**
- **acting in the interests of the stability of the system**

DISCLOSURE REQUIREMENTS IN NEW ZEALAND

- Income and expenditure accounts and balance sheet (5 year summary)
- directors and their interests
- asset quality and provisioning
- large exposures including interbank
- related party exposures
- sectoral exposures
- capital adequacy including off balance sheet
- market risk exposures
- credit rating