Timely Triggering of Bank Resolution

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Need for a credible SIFI resolution

- Stricter supervision is necessary but not sufficient
- Shrinking systemically important financial institutions (SIFIs) may help at the margin but is inadequate
- Breaking banks up along functional lines is unlikely to work better than mere size caps

Timeliness essential to credible resolution

- Private investors should bear (almost) all of the losses
- Timely resolution essential to having the creditors bear all of the losses
- Timely resolution also minimizes disruptive runs and facilitates post-resolution recovery

Timely resolution of banks

- Inability to meet obligations or assets less than liabilities
- Forbearance provided to thrifts and money center banks in the1980s
- FDICIA’s prompt corrective action provisions in 1991
- In practice, prompt corrective action depends on supervisory enforcement of loss recognition

Timely resolution of bank holding companies

- Bank holding companies chartered under general state corporate charter laws
- Ordinarily only subject to federal bankruptcy code
- Banks are largest asset so bank resolution likely to lead to holding company bankruptcy

Timely resolution of bank holding companies

- Dodd-Frank Act Title II provides for FDIC resolution of nonbank firms if
- Federal Reserve and other agency recommend and
- Treasury determines that
  (a) "the financial company is in default or in danger of default," and
  (b) the financial company's failure would have "serious adverse effects on financial stability in the United States."

Supervisory incentives to forbear

- Supervisors know their estimates of capital are just estimates
- Even if insolvent, bank might recover if economic conditions improve
- If the financial system is on brink of instability, they might tip it into instability
- Banks will likely resist

Implications for timely resolution

- Bankruptcy code and DFA not structured to encourage timely resolution

- Supervisory incentives are stacked in direction of forbearance rather than timely resolution

Alternative of using a market trigger

- Market participants with money at risk don’t have the same incentive to forbear

- Various proposals to use market data that could incent earlier action

- Counterarguments
  1. Supervisors know better
  2. Market prices contain noise
  3. Use of market prices may manipulated
  4. No single equilibrium

Method to test market prices

- If forced to choose we have a dilemma

- But we can use both
  - Supervisors can trigger without market signal
  - Market signal set at failsafe level
  - Require a persistent signal
  - Supervisors follow market signal or explain why not

- Advantages
  - Provides potential test of market signals
  - May change supervisory and bankers incentives

Conclusion

- Timely resolution with positive economic value equity essential for credible, low cost resolution

- Current system discourages timely resolution in a variety of ways

- Test of market signals could provide feasible path to timely resolution

Further discussion

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