MORAL HAZARD AND ORDERLY BANK EXIT

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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 CRISSES

• 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
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