

# The Economic Perspective of Bank Bankruptcy Law

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# Overview

Bankruptcy law, why do we need it?

Are banks different?

Optimal bank bankruptcy law

Bank bankruptcy laws around the world

U.S., UK, German and EU framework for bank bankruptcy

Two cases: Lehman Brothers and Fortis

# Bankruptcy law: Coordination problems, ex-post & ex-ante efficiency

Many creditors → Excessive liquidation

**Be the first to collect debt**

**Ex-ante efficiency:  
creditor-friendly  
bankruptcy law**

**Why debt is optimal?**

- Prevents excessive risk taking & strategic default
- Induces desired effort



**Ex-post efficiency:  
debtor friendly  
bankruptcy law limits**

- Postponing bankruptcy
- Gambling for resurrection
- Looting
- Exploits skills & info of the existing management

# Are banks special?

## Liquidity providers

**Demand deposits (Diamond and Dybvig, 1983)**

**Loan commitments (Ivashyna and Scharfstein, 2010)**

**Difficult to impose an automatic stay**

## Externalities of bank failure

**Contagion, public confidence is crucial**

**Damage to the real sector (SMEs)**

**Damage to payment system**

**Costs of 15-20% of GDP (Hoggarth, Reis and Saporta, 2002)**

## Bank operations are special

**Asset substitution problem is severe (Flannery, 1994)**

**Bank assets are opaque (Morgan, 2002)**

**Bank risk taking can be**

Unnoticed

Fast changing

# Banks may be special but we have prudential regulation

Not always effective (current crisis)

## **Deposit insurance & lender of last resort**

Additional risk taking (Demirgüç-Kunt and Detragiache, 2002)

Bank zombies (Japan, 90s, Berglöf and Roland, 1995)

Gamble for resurrection

## **Capital regulation & regulatory intervention**

Forbearance & regulatory capture

### **Too-big-to-fail**

**Reputational reasons from the regulators (Boot and Thakor, 1993)**

**Political costs of closing a failed institution (Brown and Dinç, 2005)**

**Fragmented regulatory framework**

**PROPOSAL 1: THERE IS A NEED FOR SPECIAL BANK BANKRUPTCY LAW**

# Bank bankruptcy law: Timely intervention

Timely intervention mitigates

**ex-ante & ex-post risk taking**

**bank runs & systemic concerns**

**problems due to fragmented regulatory framework**

**Political pressure against closure**

Trigger should be based on

**Clear and verifiable (hard quantifiable data, not too complex)**

**Discretion of the regulator**

## **PROPOSAL 2: A PRE-INSOLVENCY PHASE SHOULD EXIST**

**Proposal 2a: In a pre-insolvency phase corporate governance control should start gradually shifting to bank creditors**

# Ex-ante & ex-post optimality

Should bank bankruptcy law be creditor- or debtor-friendly?

Creditor-friendly due to

**Liquidity provision**

**Acute info problems**

**Systemic concerns**

Debtor-friendly due to

**prudential regulation (if successful)**

**superior information of bank management (if not responsible for collapse)**

**PROPOSAL 3: BANK BANKRUPTCY LAW SHOULD BE LESS DEBTOR-FRIENDLY THAN CORPORATE BANKRUPTCY LAW.**



# The design of bank bankruptcy law

## **PROPOSAL 4: AN EXPLICIT OBJECTIVE OF BANK BANKRUPTCY LAW SHOULD BE TO PREVENT SYSTEMIC BANKING CRISIS**

Minimize costs for taxpayers, maximize the value of a bankrupt bank, respect APR

## **PROPOSAL 5: AN AUTOMATIC STAY MAY BE OVERRIDDEN**

## **PROPOSAL 6: THE REGULATOR SHOULD LEAD THE RESTRUCTURING AND NOT THE COURT**

Higher power than the court in the corporate bankruptcy (SPEED & INFO vs. FAIRNESS)

remove management and shareholders

impose a “haircut” on bank creditors

transfer contracts (forced takeover of a part or the whole bank)

Liquidation, recapitalization (forced/voluntary), good bank/bad bank

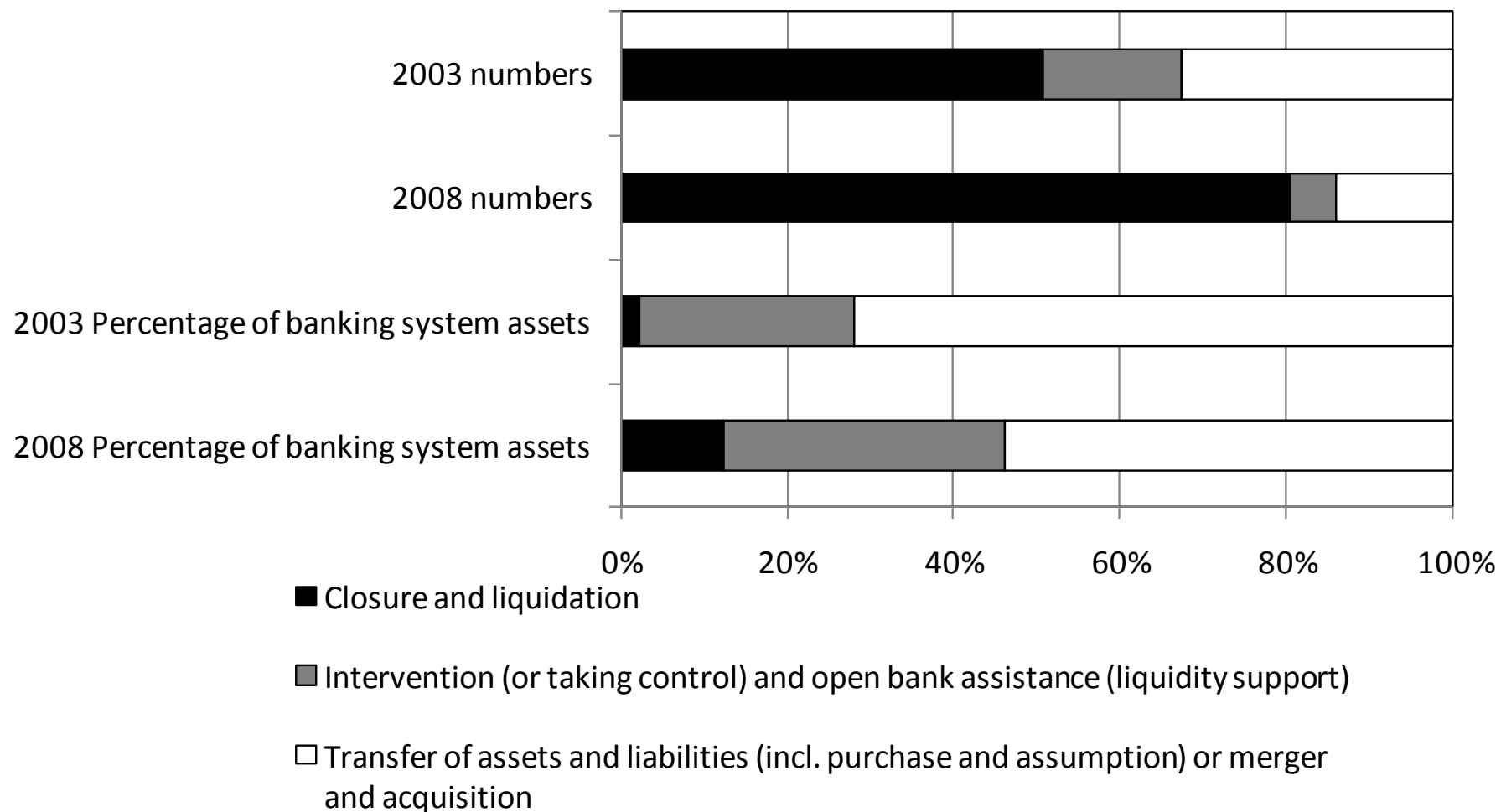
# Bank bankruptcy & prudential regulation

Restructuring fund

Closeout netting with regulator scrutiny vs. closeout without netting

Harmonize bank bankruptcy laws & deposit insurance schemes

# Overview of bank bankruptcy frameworks I: Frequency of restructuring methods in 2003/2008



(WorldBank, 2008, averages; No = 0, Yes = 1)

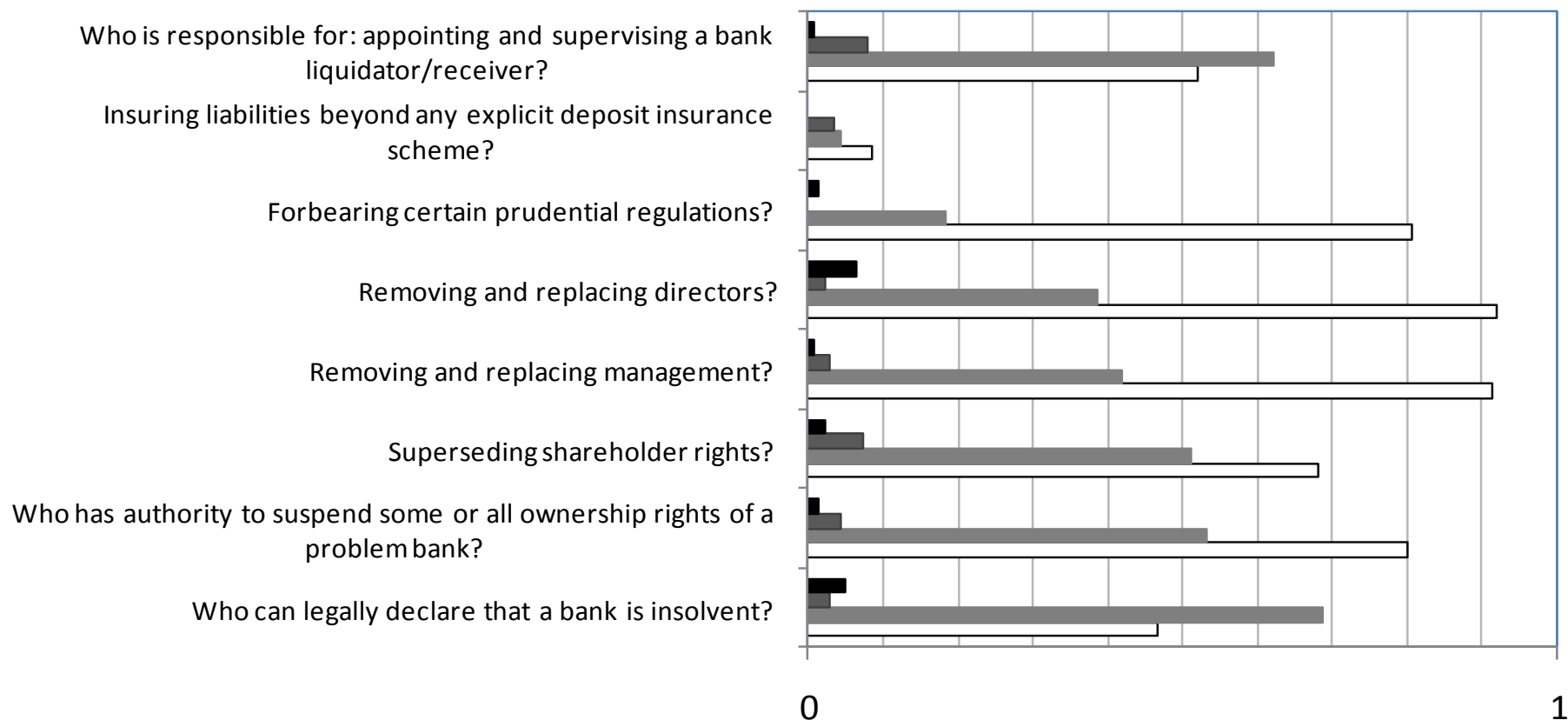
# Overview of bank bankruptcy frameworks II: Characteristics of an average bank bankruptcy law

	2008	2003
Is there a separate bank insolvency law?	0.18	
Does the Banking Law establish levels of solvency deterioration that forces automatic intervention?	0.54	0.52
How many months did each of these resolution techniques take on average?	8.74	9.92
Is court approval required for supervisory actions?	0.04	0.14
Is a court order required to appoint a receiver/liquidator in the event of liquidation?	0.53	0.52
Can the bank shareholders appeal to the court against a decision of the bank supervisor?	0.87	0.86

# Overview of bank bankruptcy frameworks III: Restructuring powers of various regulatory bodies

(WorldBank, 2008, averages; No = 0, Yes = 1)

## 2008



Bank restructuring or Asset Management Agency
  Deposit insurance agency
  Court
  Bank supervisor

	<b>U.S. bank bankruptcy</b>	<b>U.S. Dodd-Frank Act</b>	<b>UK bank bankruptcy law</b>	<b>Germany bank bankruptcy law</b>
<b>Objective</b>	Minimize losses to the FDIC at the systemic risk exception	Address the systemic risks posed by large financial groups and prevent taxpayer-funded bailouts	<ol style="list-style-type: none"> <li>1. Protect the stability of the financial system</li> <li>2. Protect public confidence</li> <li>3. Protect depositors</li> <li>4. Protect public funds</li> <li>5. Avoid interfering with property rights</li> </ol>	<ol style="list-style-type: none"> <li>1. Protect the safety of the assets entrusted to institutions;</li> <li>2. Protect the orderly execution of banking transactions;</li> <li>3. Avoid developments that prejudice the economy at large</li> </ol> Prevent liquidity shortages and improve the capital position of financial institutions
<b>Pre-insolvency phase</b>	Prompt corrective action by the regulator	Early remediation and mitigatory actions by the regulator	In the scope of standard regulatory supervision	The regulator makes a recommendation to the bank to correct the problems within a strict deadline, if the bank breaches prudential standards
<b>Creditor stays</b>	Less general, major exception is insured depositors		Entering special resolution regime (SRR) does not present a legal event of default	The regulator can impose a full or partial suspension of payments and a legal stay against creditor action
<b>Structure of process</b>	Administrative Limited ex-post judicial review and appeal	Administrative Limited ex-post judicial review and appeal	Administrative Limited ex-post judicial review and appeal The government can modify bankruptcy legislation by order with a retroactive effect	Administrative Appeals against regulatory measures are excluded by law

# Lessons from Lehman Brothers and Fortis

## Lehman brothers

Abrupt unwinding is costly for the economy at large

Fragmentation of insolvency laws leads to break up of the FI

Special treatment of derivatives is necessary

## Fortis bank

Late intervention by governments

Fortis shareholders opposed Belgium-BNP Paribas agreement

The need for cross-country restructuring fund

# Conclusions

Banks are special due to:

**Systemic concerns**

**Liquidity provision**

**INFO problems**

**Regulatory inefficiencies**

Optimal bank bankruptcy law

**Pre-insolvency phase**

**Strong power of the regulator**

**Debtor-strict**

**Option to override automatic stay**

The legislators are moving in this direction



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# APPENDIX: Effectiveness of the main features of bank bankruptcy law

Special feature of banks	Creditor-friendly bank bankruptcy law	Pre-insolvency phase	Strong powers of the regulator	Deposit insurance
Bank runs	4	4	5	4
Bank liquidity provision	5	5	5	5
Regulatory forbearance and regulatory capture	4	4	1	1
Systemic risk	3	3	5	3
Fragmented regulatory structure	3	5	1	2
Information problems	5	4	3	1

**5 = most effective; 1 = least effective**

	<b>U.S. bank bankruptcy</b>	<b>U.S. Dodd-Frank Act</b>	<b>UK bank bankruptcy law</b>	<b>Germany bank bankruptcy law</b>
<b>The treatment of claimants</b>	<p>Insured deposits are repaid (or transferred to a healthy bank)</p> <p>Absolute priority rule is honored</p> <p>The FDIC has the same priority as uninsured deposits</p>	<p>There is no priority rule for any deposit claims over the claims of the general creditors</p> <p>Amounts owed to the U.S. have priority over the claims of general creditors</p>	<p>Insured deposits are repaid (or transferred to a healthy bank).</p> <p>Other claimants should obtain at least the amount they would in liquidation</p>	<p>Unlimited depositor protection is offered by the deposit insurer</p>
<b>The roles in bankruptcy</b>	<p>The FED (or the FDIC) initiates bank bankruptcy, the FDIC is in charge of restructuring</p> <p>Management is ousted</p>	<p>Under the new orderly liquidation authority, the Treasury Secretary has the power to appoint the FDIC as receiver; the determination of the financial institutions covered is made by the Treasury Secretary, upon the recommendation of two-thirds of the Fed board and two-thirds of the FDIC board</p>	<p>The FSA initiates the SRR. The BoE leads it in consultation with the Treasury in the case of involvement of public funds</p> <p>Management may be removed</p>	<p>The BaFin initiates the insolvency procedures and leads the provisional administration</p> <p>The BaFin makes the resolution decision in cooperation with the German Bankers Association representing the deposit insurer</p> <p>Management may be removed</p>
<b>Trigger</b>	<p>Failure to comply with the regulatory standards (with the most critical one of being undercapitalized)</p>	<p>Failure of systemically important financial companies to comply with enhanced regulatory requirements (e.g., risk-based capital, leverage, liquidity, credit exposure reporting, resolution plans)</p>	<p>Failure to satisfy threshold conditions (capital requirements, liquidity and leverage ratios, and perceived inability to repay debt)</p>	<p>Violations of regulatory standards regarding adequate capital and liquidity and a bank's failure in correcting these problems following the regulator's recommendations</p>
<b>Options in bankruptcy</b>	<ol style="list-style-type: none"> <li>1. Purchase &amp; assumption (loss sharing transaction, bridge bank)</li> <li>2. Deposit payoff</li> <li>3. Assistance transactions</li> </ol>	<ol style="list-style-type: none"> <li>1. Purchase &amp; assumption</li> <li>2. Liquidation</li> </ol>	<ol style="list-style-type: none"> <li>1. Transfer to a private sector purchaser</li> <li>2. Transfer to a bridge bank</li> <li>3. Transfer to temporary public sector ownership</li> <li>4. The bank insolvency procedure</li> <li>5. The bank administration procedure</li> </ol>	<ol style="list-style-type: none"> <li>1. Restructuring by the depositor insurance scheme or by the private liquidity supplier</li> <li>2. The provisional administration procedure</li> <li>3. The bank insolvency procedure</li> <li>4. The bad bank procedure</li> </ol>

# Appendix: The EU framework for bank bankruptcy

Directive 24/2001 on the Reorganization and the Winding-Up of  
Credit Institutions

Branches vs. Subsidiaries

Directive 213/2001 on Financial Conglomerates

Delegated supervisor

Communication 561/2009 on EU Framework for Cross-Border  
Crisis Management in the Banking Sector

Early intervention, resolution, and insolvency

ESFS (EBA + ESMA + EIOPA)

Disagreement between national authorities

ESRB

Systemic risk