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Bank Resolution: Towards a More «Holistic» Approach

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Macropru Conference, Deutsche Bundesbank, June 26-27, 2024

Objectives of the paper

- Offer a conceptual basis for guiding bank resolution policy, based on **representation theory** : Dewatripont-Tirole (1994, 2012).

- Use this conceptual basis to assess the current state of prudential regulation in the EU Banking Union.

- Suggest directions of improvement.

Incomplete Contracts

- Most of Corporate Finance Theory: based on «**Incomplete Information Paradigm**».
- Goal: explaining the **financing structure of firms**.
- How cash flows are shared between internal and external financiers?
- But does not say anything about **allocation of control rights**.
- Aghion-Bolton (1992) and Dewatripont-Tirole (1994a): «**Incomplete Contract Paradigm»**
- Explains why shareholders should be in control when things go well, and debtholders when things go badly (bankruptcy).

The Representation Theory

- Dewatripont-Tirole (1994b, 2012) apply the incomplete contract paradigm to banks.
- Banks are special: finance a large part of their loans by retail deposits.
- Their main financiers are their **customers**.
- **Source of fragility**: depositors are not able to assess banks' profitability but can easily withdraw their deposits.

The Representation Theory

The two pillars of the safety net:

- **Deposit Insurance** to reduce the risk of bank runs.
- **Bank Supervisors** are there to **represent** the interests of depositors.
- They **exert control rights on their behalf** when things go badly.

Implications of the representation theory

Basel framework roughly consistent with theory.

But the devil is in the details:

- Managers should not be punished for macroeconomic shocks (Holmstrom 1979): introduce capital insurance mechanisms (and improve IRR management!).
- Need to beef-up loss absorption capacity, especially in the EU (market leverage ratios!).
- But BRRD framework has never been applied: 8% rule might provoke financial instability.

Supervision needs to be enhanced

- Dewatripont-Tirole (1994b, 2012) is all about managers incentives!
- Control rights allocation is a very indirect way to influence these incentives.
- Supervisors should have more control on **managers' remuneration**.
- Should not be based only on stock prices.
- Banks are special because they provide value to their creditors (depositors and even bondholders).
- Can representation theory be extended to allow supervisors to intervene **before** it is too late (Credit Suisse)?

Comment 1: bail-in is too complex

- Concept was invented by Wilson Ervin from Credit Suisse(!)
- Allowing supervisors to allocate losses discretionarily between complex hybrid securities: not a good idea (Credit Suisse again).
- What is the social value created by these securities?
- Core equity is best loss absorber: gives shareholders incentives to exert control on bank management.

Comment 1: bail-in is too complex (continued)

- Bankers **never** want to recapitalize**: leverage ratchet effect** (Admati, DeMarzo, Hellwig 2017).
- Banks are addicted to debt by construction (deposit financing).
- Mathias puts this in diplomatic terms: «limited political appetite for higher CET ratios»
- But the fact is that **regulators have yielded to bankers** so that they accept to increase loss absorption.

Main issue: one of control rights

- When and how should banking supervisors be allowed to intervene in the management of banks?
- Broader issue than resolution: should supervisors be allowed to interfere with a bank's management even if the bank satisfies regulatory requirements.
- In other words: can we give a conceptual basis for **Prompt Corrective Action**?

Conclusion

- Very interesting paper, providing lots of food for thought.
- Representation theory: elegant basis for prudential doctrine.

Has broader implications than resolution:

- Managers compensation
- Capital insurance
- Regulatory treatment of Interest Rate Risk

Personal queerie: can the representation theory be extended to give a basis for prompt corrective action?