Week 18
Reorganizing or closing banks

As usual, we didn’t quite finish the previous chapter last week, so we begin with the discussion of the model dealing with emergence of LLRs. Having dealt with this, we move to Chapter 17 about reorganizing or closing banks. In the previous chapters, we have considered institutions which can prevent that life-threatening events happen, or can act so as to prevent that the effects become more serious than they are already. We proceed along these lines, but now we add a further touch to the discussion, presuming that the unpleasant effects have already happened and that some action must be taken. Our main question is now whether the right or proper type of action will be taken – and also who is going to take action.

Simplifying (as always) the situation, we consider a particular form of regulation of banks, namely that concerned with banks experiencing some form of trouble, where it has to be decided whether the bank should actually be liquidated, or whether it shall be given assistance so as to carry on.

The first line of regulation would be the owners of the bank who must take action depending on signals. Given that they are owners but not managers this boils down to a decision of reorganizing and sacking the manager. Our model is actually an adaptation to the field of banking of a model originally designed to consider the contractual relationship between shareholders and management, so it doesn’t smell of bank, but it can of course be used also in the present context. In actual practice shareholders are however far from having the influence that the model assumes. The incentive scheme for the manager is a bonus which will be lost when she is fired. The owners have only the option of sacking the manager (reorganizing) or keeping her. It turns out that there is a tradeoff between incentives and pure profit: it is optimal for the bank owners to include information which is irrelevant for the future payoff of the bank’s investment, but which says something about the manager’s effort.

The next model considered is the Repullo model, which considers the question of who should be given the authority to decide whether a bank should be assisted or closed. The model is very simple but even so it can be used to show that the central bank and the deposit insurer will have different viewpoints on this. As a consequence, the way in which they would regulate is not the same, and it may be better for society to delegate the competence to one of the two in a way that depends on signals received rather than once and for all. The particular perspective
which makes it interesting is that one has to use a signal which is observable and contractable in the sense that it can be use for legally binding decisions, whereas the signals that really matter may not have the latter property.

Next, the simple model due Mailath and Mester illustrates the point that even if a bank has done something which can be considered as bad business, it may often (in the meaning: for many constellations of the parameters describing risk and cost of liquidation) be in the interest of the authorities to let the bank proceed rather than closing it down right away.

In the lecture I comment briefly on the section dealing with the too-big-to-fail problem and systemically important banks, but we do not reed this section.

We read: Chapter 17 except section 5.