Columbia Business School

Discussion:

Rules versus discretion in bank resolution

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Main Idea

Regulator's decision to bail in bank debt reveals regulator's private information => triggers bank run by short-term creditors

Implications:

- in discretionary equilibrium, regulator is "too soft"
- commitment to sometimes act solely based on public signals can alleviate this issue
- this can be implemented using contingent convertible capital

A "commitment theory" of market-based CoCo bonds

Liquidity and capital regulation are complementary to CoCos

Quick Recap: Model Ingredients

- Three dates t=0,1,2
- Bank has an asset that pays v at date 2
- Bank has uninsured deposits D, subordinated debt B
- At date 1
  - regulator observes v
  - depositors observe imperfect public signal s
- Regulator chooses debt write-off a(v,s)
- Depositors update to $E(v|a,s)$ and run with prob π if $\lambda E(v|a,s)<D$
- NB: regulator can trigger run (off-equilibrium) through debt write-off

Comment 1: The Regulator's Objective Function

The model is very tractable, partly because of **exogenous regulator objective function:**

$$U(E(a,v)) = U(v + a - (D + B)) - (1-\lambda)\sigma v$$

Downside: How does this expression correspond to total surplus?

– "too little equity is bad, too much equity is good." A little vague

– also, why does B have to be written off at date 1? At date 2 it would not cause a run…

Alternative:

– regulator maximizes surplus

– frictions internal to the model give rise to objective function

Comment 2: The Bank's Objective Function

The bank takes no decision:

– assets V and liabilities D and B are taken as given

– asset payoff exogenous

Assume bank makes issuance decision

– would the bank issue contingent capital?

– would incentives for contingent capital be aligned with regulator?

– would we even need regulator?

Comes back to the objective function question - paper would gain by being clearer about bank's objective and why it differs from regulator's objective

Comment 3: Regulators and Private Information?

The paper raises in interesting broader question:

Agencies like the OFR are now collecting lots of proprietary data.

This paper suggests there are limits to using such information

– particularly when public information is bad.

– but then why collect the data?

Question:

– How to design a system where regulators can and will make use of private information? Is it a matter of acting “early enough”?

Summary

Very nice paper

Contingent capital as commitment device when regulator has private information

Suggestion:

Make objective functions and underlying frictions more explicit

- Regulator
- Bank