

Report Type

Mid Term Award Report

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Faculty/Department

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Project Title

Liquidation, Bailout, and Bail-In: Insolvency Resolution Mechanisms and Managerial Risk-Taking

Project Start Date

Jan 01, 2017

Project End Date

Sep 01, 2018

Project Abstract

We present a continuous-time model in which risk averse managers set a bank's investment, payout, and debt policy, and the exposure of bank assets to economic downturns that follow Poisson arrivals. After a downturn, solvent banks sell assets and repay debt to restore the bank's optimal debt ratio. Banks with too large an exposure become insolvent and undergo liquidation, bailout, or bail-in. Banks are most (least) prone to insolvency under the bailout (liquidation) regime. The bailout (bail-in) regime generates the highest (lowest) loan volume and bank value net of recapitalization costs. Liquidations (bail-ins) create the largest (smallest) loss in default.

Activities and Achievement

Ever since the financial crisis there has been a hot debate around how an insolvent financial institution should be resolved. The current project has significant policy implications as it predicts how corporate policies and loan risk taking behaviors differ under various resolution mechanisms. Some results may not be trivial from the outset. For example, a bailout would result in a bank issuing loans with higher quality relative to a liquidation because managers retain "skin in the game" in the former regime encouraging them to load up shock-resilient assets. Moreover, bailout also results in the highest net value created in our framework (at least from a micro-prudential perspective). In spite of the widespread public anger towards bailouts during the recent turmoils, the results from the paper suggest they should not be entirely disregarded.

Dissemination

The paper has been presented in "CERF in the City" by Professor Bart Lambrecht, and has also been submitted to several major finance conferences such as EFA and AFA. We would like to receive more comments on the working paper before submitting to a journal.

Outputs

The working paper paper is available on the SSRN (3123170)

Major Difficulties and Any Other Issues

None

Web Links

https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3123170