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Restoring Incentives and Liability – Bank Regulation and Bank Risk in the Post-Crisis Era (Kumulativ)

Catharsis - The Real Effects of Bank Insolvency and Resolution

Key take-away

- **We need incentive compatible bank insolvency regulation that makes catharsis work for the real economy!**

Key hypothesis

- **'Catharsis effect': Rules-based resolution of failed banks (re)established incentives in financial intermediation and improves banking and economic performance**

Great thoughts ...

"Tragedy, is [...] serious, complete, and of a certain magnitude; through pity and fear effecting the proper catharsis [=purgation].
Aristotle

"The problem [is not] how capitalism administers existing structures, [but] how it creates and destroys them. This creative destruction causes continuous progress. Situations emerge [...] in which many firms may have to perish.
Joseph Schumpeter

Abstract

This paper analyzes the impact of rules-based bank insolvency resolution on real economic growth. Resolving insolvent banks can positively affect the real economy by overcoming moral hazard problems and improving banks' credit allocation and monitoring. We propose a new indicator to measure the strength of 'catharsis', i.e., how strictly banks are resolved, and use a large firm-level dataset to test its effect. We find that a relatively stronger implementation of bank resolution rules has a statistically and economically significant positive effect on firm growth – particularly with respect to firms that are structurally more dependent on bank financing. Our findings are robust to various specifications.

Investigating the transmission channels of this 'catharsis effect' reveals that it essentially works by means of benefiting higher quality firms (quality channel) and reallocating credit to firms that need it most (quantity channel). Additional analysis suggests that the 'catharsis effect' works best in banking systems that offer access to international financing because such access mitigates the potentially negative credit supply effects of liquidating insolvent banks. Taken together, our findings indicate that more attention should be focused on developing incentive-compatible bank resolution regimes.

... and their application to failed bank treatment

Bank insolvency resolution can be thought of as a process of catharsis: Resolving failed banks in a rules-based and prompt way increases real economic performance

- Cleans out existing moral hazard (=purgation from corrupted incentives)
- Improves functioning of the banking system, e.g. its credit allocation
- Prevents regulatory forbearance