Creditor Rights and Bank Losses: Some Comments

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Summary of paper

- Other papers find strengthening creditor rights
  - Increases risk
  - Lowers cost of capital

- This is odd result

- This paper finds strengthening creditor rights
  - Reduces risk to banks
  - Lowers cost of capital

Policy implications

- Strengthen creditor rights
  - Reduces risk to banks
  - Lowers cost of capital
- Sounds good!
  - Helps banks
  - Helps borrowers
- But can it really be so simple?

A question

- What creditor rights should be strengthened?

- Key variables:
  - Making banks secured creditors
  - Restricting firms’ abilities to engage in Chapter 11

- But:
  - First policy helps banks at expense of other creditors
  - Second policy helps banks at expense of debtors

Second question

- Do we always want to reduce risk?
- If we want, we can eliminate risk!
  - Just forbid banks from lending
- More generally, we want economy to grow rapidly, and that requires banks and firms to take risk
- So there is an optimal level of risk
- Clearly need to think about creditor rights and risk more carefully

Another question

- What do we mean by risk?
- Paper defines risk as loss to banks (L)
- L = probability of default (PD) * loss given default (LGD)
- LGD is largely a question of dividing the “pie”: more for banks, less for other creditors
- PD is the real variable of interest

Framework

- Go back to first principles

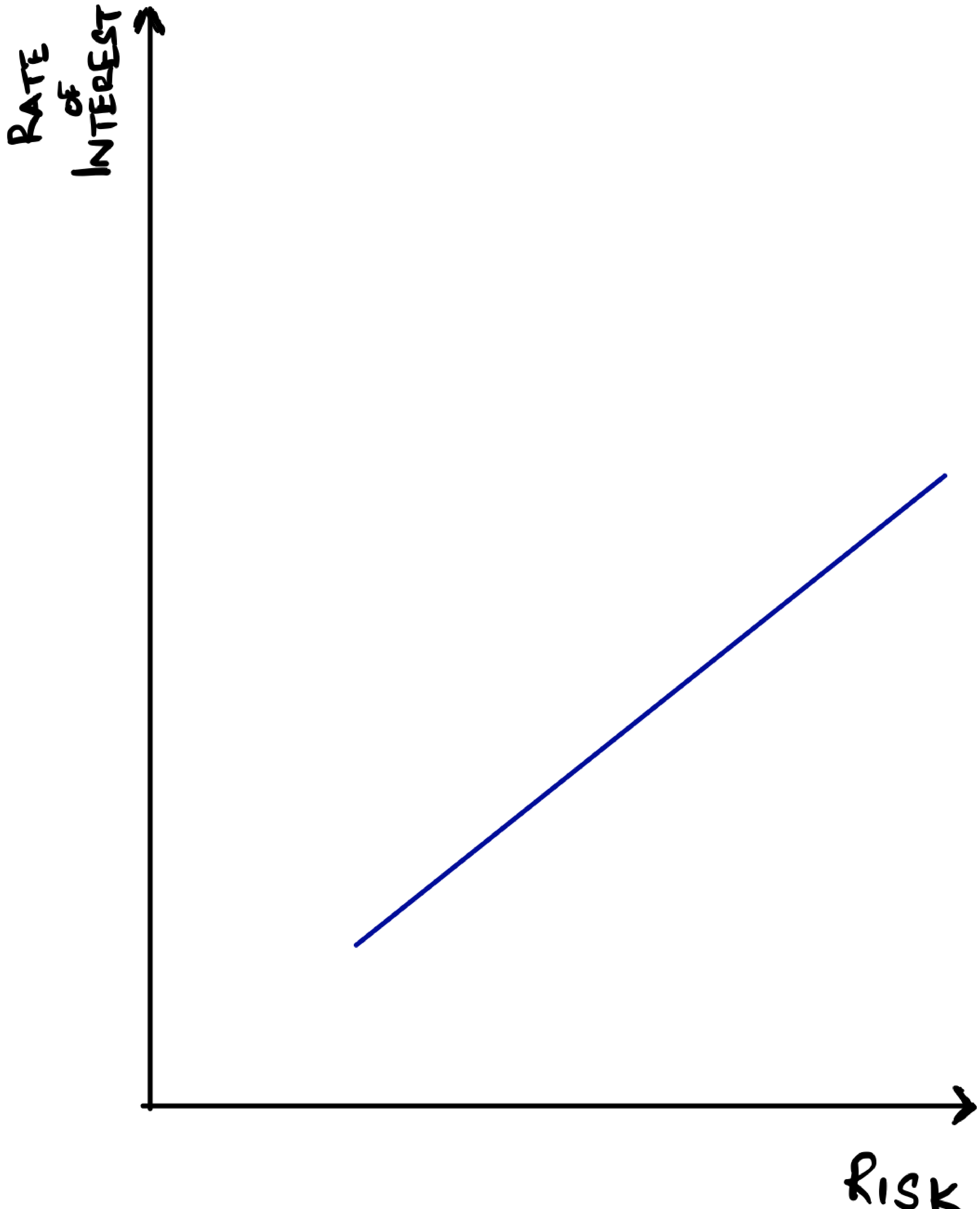
- Policy objective:
  - Firms, banks should take “reasonable” risk
  - Where risk is measured as PD

- Cannot define target PD
  - Typically policymakers just want to adjust risk up or down
  - In mid-2000s, goal was to reduce risk (because risk-taking was excessive)
  - After Global Financial Crisis, wanted to increase risk (because firms were too cautious)

- Note: only talking about lending risk, not trading risk!

Next step

- How should we think about the interaction between creditor rights and risk?


RATE of INTEREST
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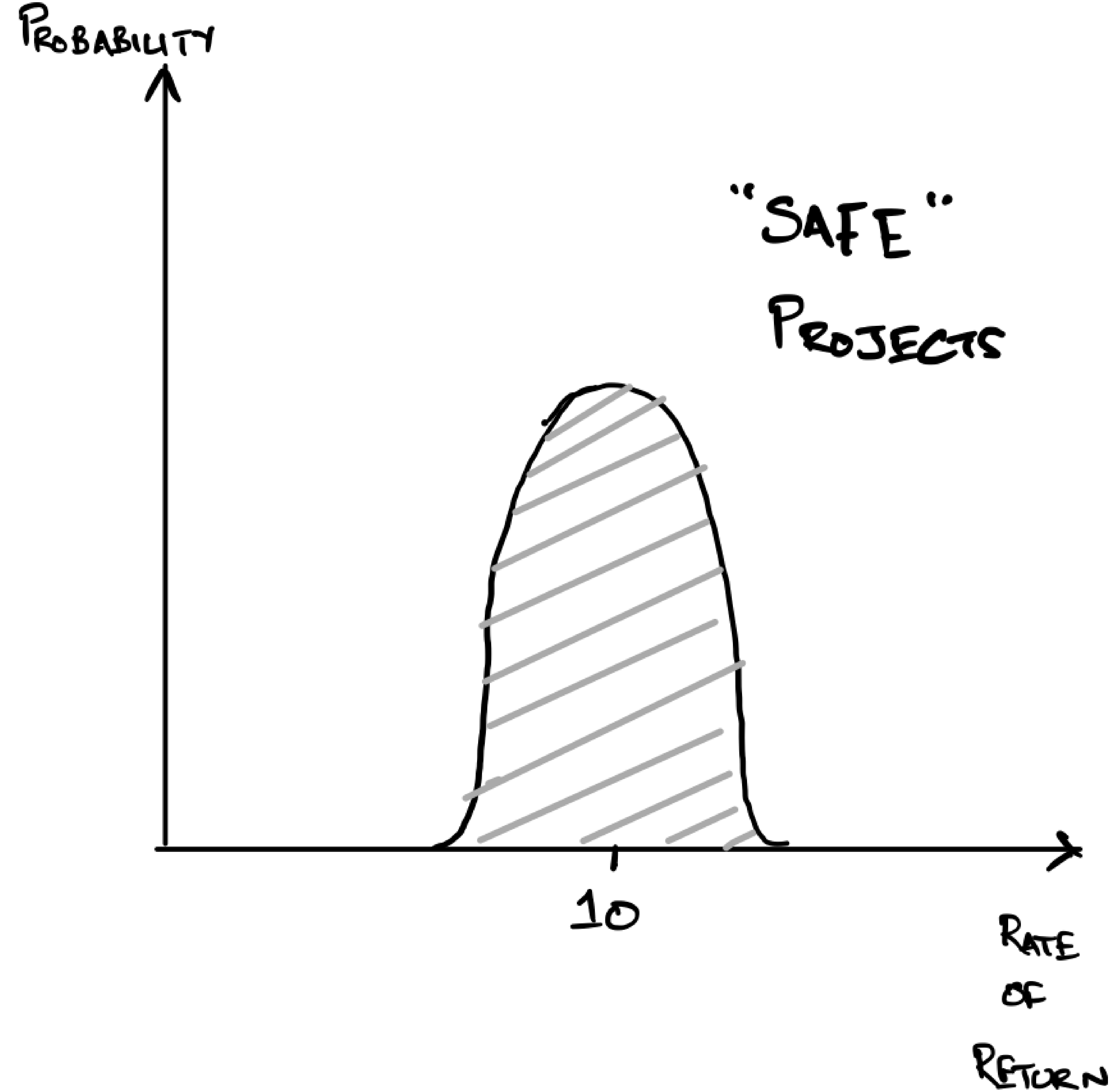
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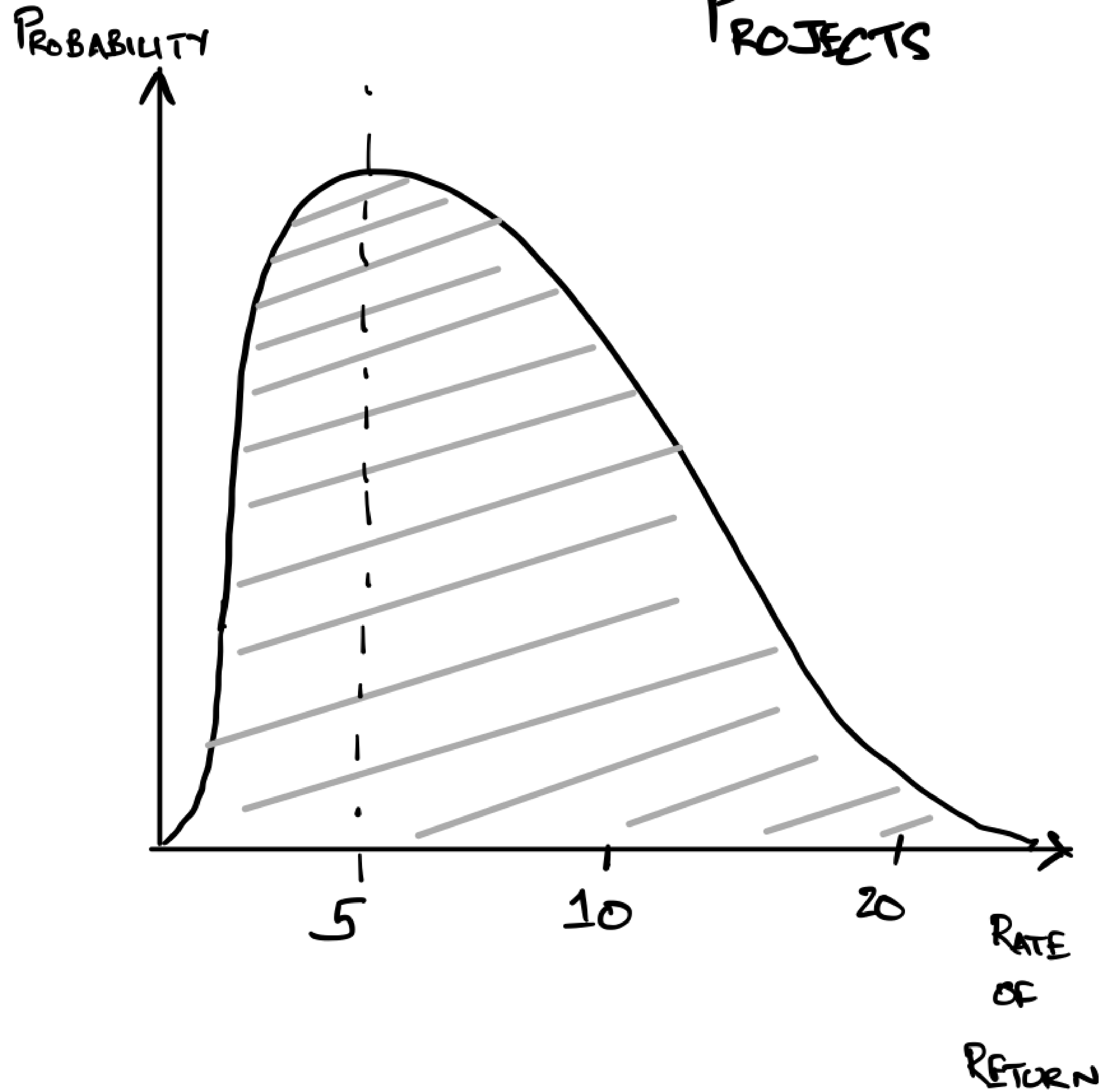
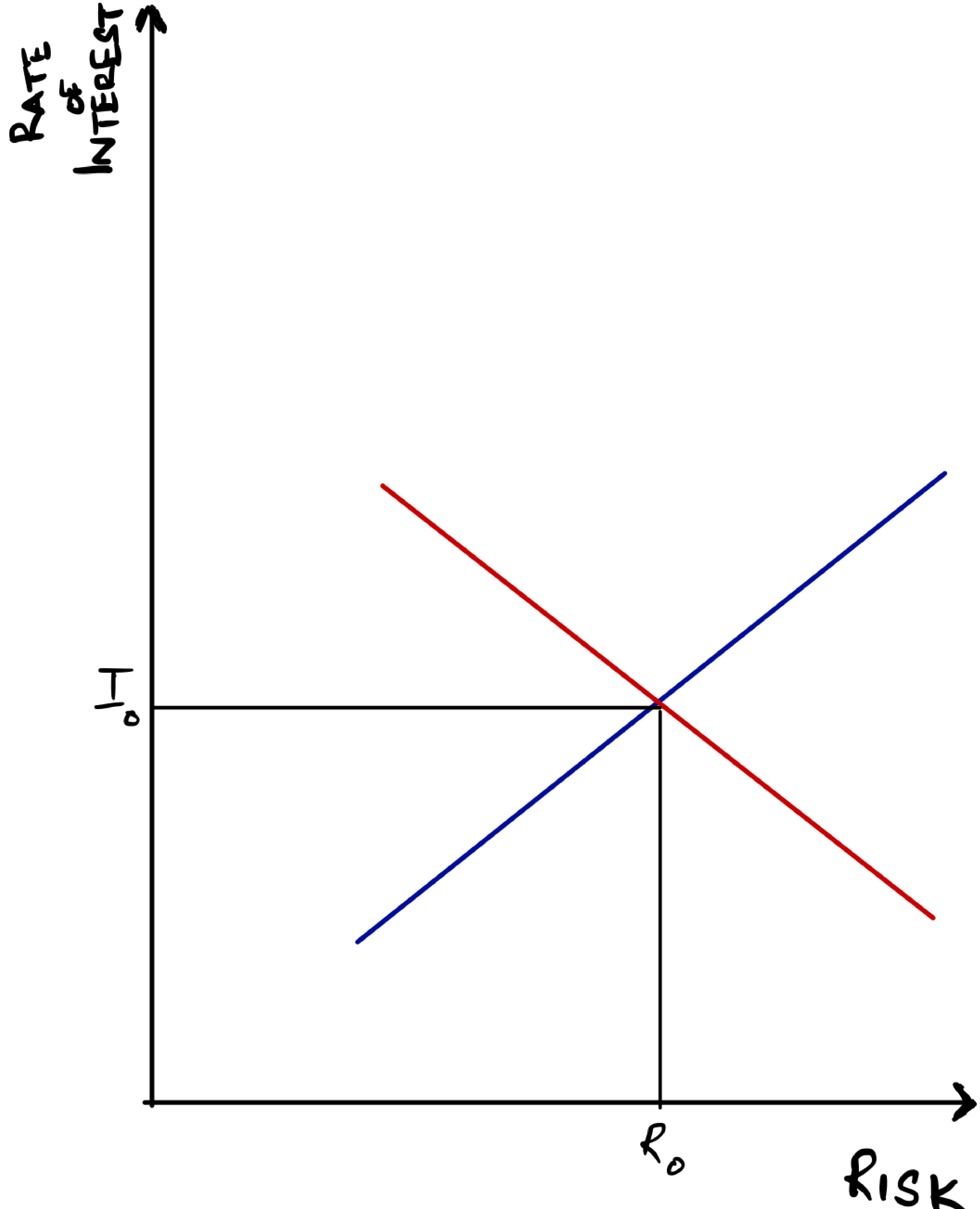
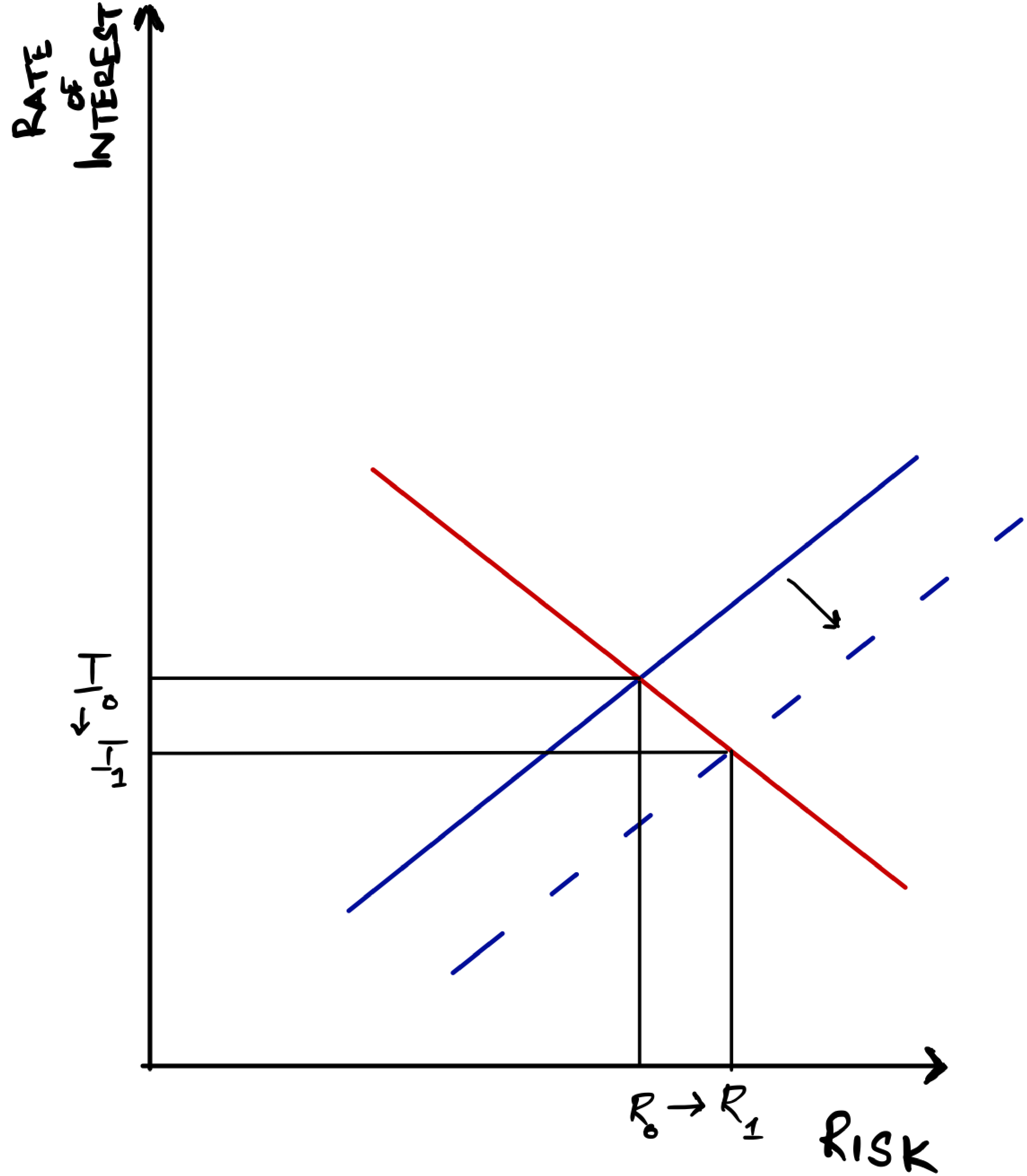
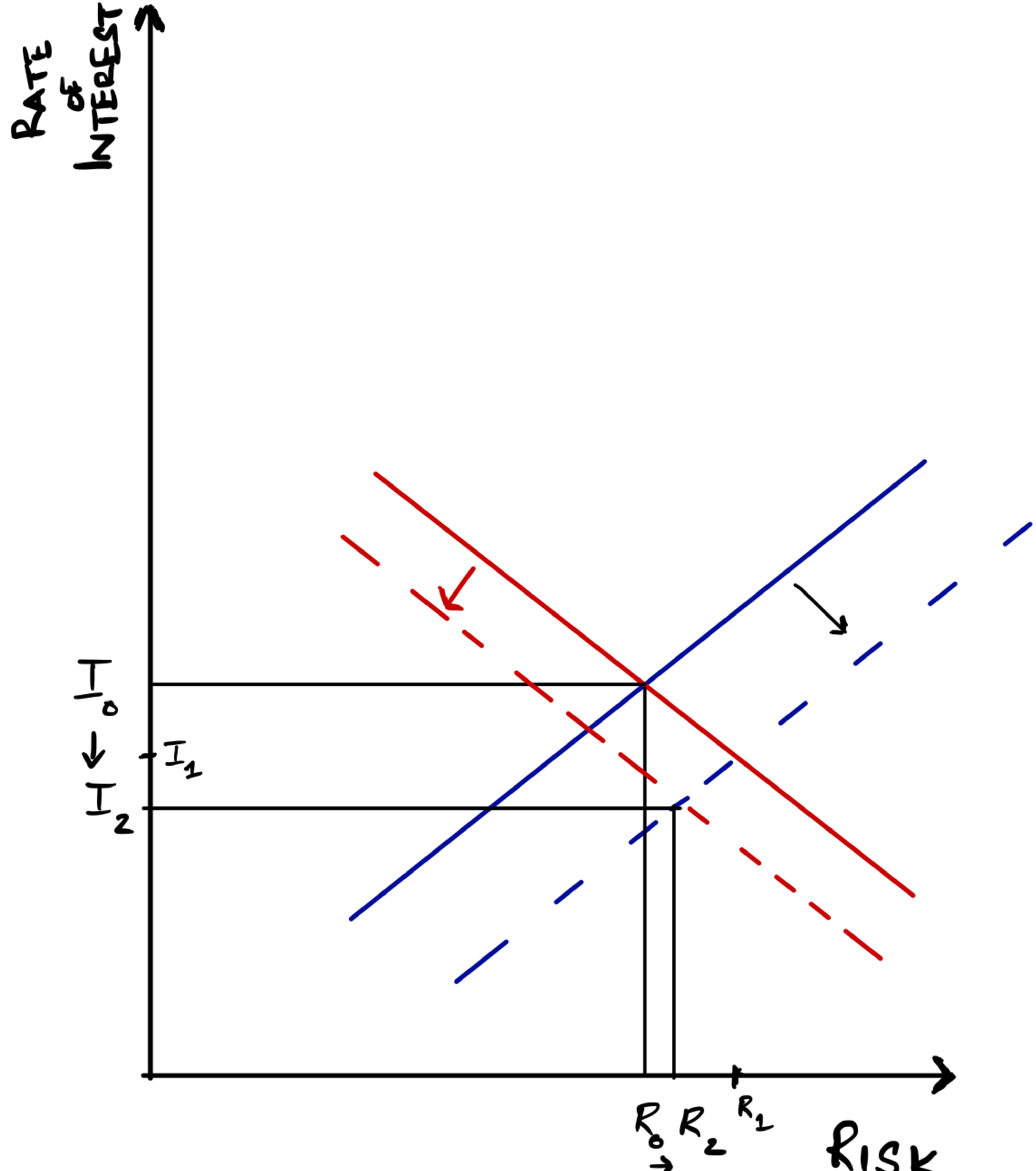
RATE
OF
RETURN

"Risky" Projects

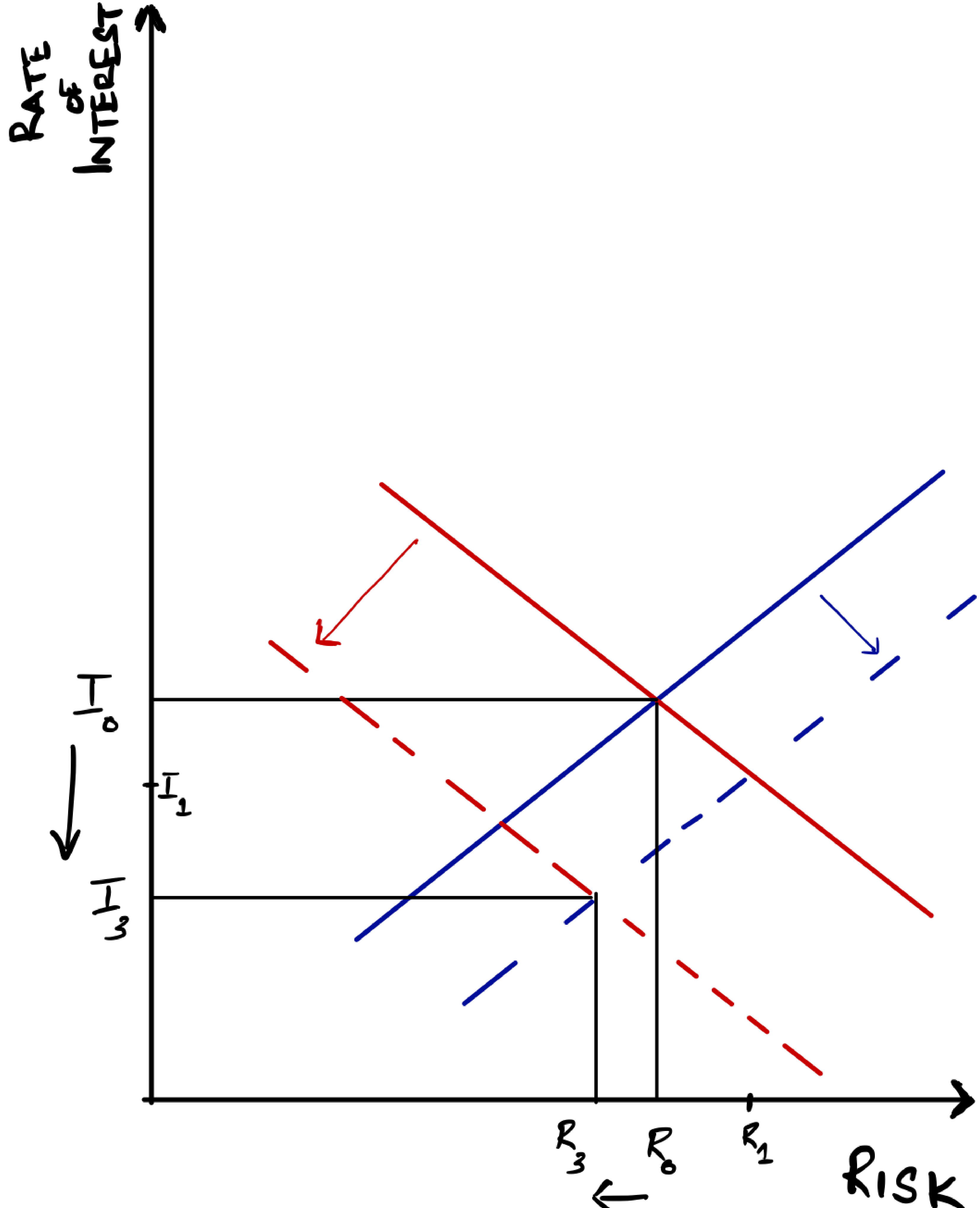



RATE OF INTEREST
I_0
R_0
RISK


RATE OF INTEREST
I_0
I_1
$R_0 \rightarrow R_1$
RISK



RATE of INTEREST
I_0
I_1
I_2
R_0
R_2
R_1
RISK



RATE of INTEREST
I_0
I_1
I_3
R_3
R_0
R_1
RISK

Conclusion

- Creditor rights policies aim to adjust the level of risk-taking
- Different rights will have different effects
- A few policies such as improving speed of resolution can accomplish the paradoxical:
  - Increase risk
  - Reduce interest rates
- But other policies can have the opposite effect
- Which one you choose depends on your objective

- Thank you!