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Bankruptcy Law and the Lender of Last Resort: two Generic Instruments of Crisis Management

1. How they work

- Bankruptcy is a procedure that:
  - Starts with a declaration by a judge
  - Suspends immediately a large number of the rules of the contractual game (eg acceleration of debts, control over assets, imprisonment, etc)
  - Impose a single forum to all parties and given rules of decision-making
  - Is typically close by another decision by the judge – like the confirmation of majority vote

>>> Its overall effect is to allocate losses and rewrite contracts

1. How they work

- The Lender of Last Resort (LLR)
  - Is not a procedure, or a collective action, but a unilateral intervention
  - It is operated by a Central bank, not a court
  - It has a systemic dimension, whereas bankruptcy is a retail institution
  - Its key objective is to prevent a default by a bank (typically), rather than curing it
  - Hence the LLR works from within market transactions, whereas Bankruptcy comes in after they brake up

2. How they compare

- What Bkcy and the LLR have in common
  - Both are core State institutions: they are typically never privatized or sub-contracted
  - They are old institutions, established before the emergence of the progressive, regulatory, interventionnist (etc) state
    - Bky emerged in the Medieval Italian trading cities and was part of the first liberal compact, see for instance Sienna, Florence, Lucca, etc.
    - The LLR emerged in the Britain in the 1860s
  - They also have a long history of evolution and mutation, in conjunction with eg the financial system and the political system

2. How they compare

- What Bkcy and the LLR have in common
  - They are exclusive one to the other, yet complementary, though (in good doctrine) never supplementary
  - They are the two generic institutions of crisis-management or, more generally, the ultimate regulators of market discipline
  - And: both respond to problems of asymmetric, incomplete information (with full info, you don't need them).

2. How they compare

LLR is about	Bkcy is about
Liquidity	Solvency
Money and the payment system	Property rights
Defending market coordination	Substituting market coordination by a judicial coordination
It preserves contracts and the distribution of private wealth	It rewrites contracts and reallocate private wealth
It is the easy way to address a financial crisis, it may mitigate or compensate individual losses	It is a hard-hitting, socially-violent instrument – though only on a case-by-case basis

2. How they compare

LLR fails when

It distabilizes monetary policy (ask Trichet, Bernanke, etc)

Is operated by a second-tier Central Bank, with open capital account

It bail out firms (or countries) which debt should be restructured (TBTF syndrom)

Bkcy fails when

The money market is volatile, hence sorting out firms is difficult

The secondary market for capital goods is illiquid, so returns are low

It is manipulated by classes of creditors

It excludes some debtors, eg in the informal sector

3. How they coordinate

- The Bagehot rule (1871)
  - The Central Banks lends freely
  - … against the best collateral
  - … at punitive interest rates
  - To illiquid but solvent banks

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  - In other terms: the LLR requires an effective Bankruptcy procedure – though it may work ex post

3. How they coordinate

- The IMF experience
  - It became de facto a kind of LLR as soon as it was immerged in a decentralized, competitive, intl financial markets (about e. 1970s)
  - Immediately had to address the bail-out risk, … and called for a restructuring/ negotiated rule during the 1980s
  - Was overwhelmed by the intl. capital markets crisis of the 1990s, especially when confronted with a TBTF (or TNTF) country
  - Proposed a variety of exit roads
    - Insurance schemes (contingent credit line, etc)
    - A 'Bankruptcy Court for Sovereigns'

3. How they coordinate

- The ECB experience
  - First was confronted to a systemic crisis in the private, financial sector; and was part of a most impressive, collective “international LLR”
  - Second was confronted to a funding crisis by some member-states, with systemic implications
    - Supported massively the market (bought T. Bonds)
    - Coordinated with Imf & EU, i.e. working as a true LLR with two multilateral lenders, *under Imf conditionality*

3. How they coordinate

- The ECB experience
  - Third entered a complex tactical game with EU-member states around a restructuring procedure that would help:
    - Protect the money issuing function
    - Restore, or establish a solvency rule
  - Yet, it is primarily confronted to the systemic (liquidity) implication of the first step in any bankruptcy rule – suspending payment and exiting market.
    - That is: the transition from LLR to Bkcy