

2011 Russell Ackoff Doctoral Student Proposal

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Title of Project:

Will the Green Shoots Blossom from the Withered Wood?
Regulatory Intervention, Bankruptcy Reorganization and Distressed
Financial Firms' Recovery

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Will the Green Shoots Blossom from the Withered Wood? Regulatory Intervention, Bankruptcy Reorganization and Distressed Financial Firms' Recovery

What is the appropriate solution for financial firms when they become distressed during financial crisis? Regulators always face such a dilemma: using visible hard hand to bailout may result in huge social cost whereas using bankruptcy reorganization approach may lead to counter party risk. Although there have been furious debates trying to help regulators resolve the dilemma, no assured answers with empirical evidences have been provided. To address this challenge, this work will analyze the data of distressed banks worldwide from 1997-2009 to identify the determinants of choosing different approaches, i.e. bankruptcy reorganization or bailout, and discuss the efficiency of these approaches for firms' recovery.

As a first step, this work will develop a model to describe the decision making process of choosing solutions for insolvent financial firms. This step is critical since the discrepancy between the public's speculative prophecies and the regulators' final decision will cause the spread of panic (Vaugirard, 2005). Systemic risk was believed to be an important consideration when regulators make their decisions (Helwege, 2010). Prior literature has shown that bankruptcy phobia came from the belief that bankruptcy might have the ruffle effects to increase systemic risk (Skeel, 2010; Lubben, 2010). Therefore, a key aspect in the proposed model is how regulators' decisions are influenced by individual firm's contribution to systemic risk. This contribution will be quantified using the systemic expected shortfall (SES) model (Acharya et al., 2010).

Besides systemic risks, other characteristics of distressed firms may influence regulators' decision as well. For example, the firm's political capital can affect regulators' decision on bailout or not (Duggan and Deckert, 2010). In addition to political capital, firm's debt/GDP ratio, size, debt structure and corporation structure may also affect regulators' decision making. The proposed model is expected to include these variables as depicted in Figure 1 of the appendix.

The next important question for this study is how different solutions affect the outcome of firms' recovery. Financial crisis is usually considered as a tough period for distressed firms to recover through bankruptcy organization. During financial crisis, market becomes frozen and assets value drops dramatically. It is hard for the distressed firms to get new financing for debtor in process (DIP), which will in turn lower the possibility of recovery. Because of this, people doubted that financial firms can be efficiently revived through bankruptcy reorganization under such a difficult period (Stiglitz, 2002). In addition, the time delay and cost associated with bankruptcy procedure may further lower the efficiency of bankruptcy (Ayotte, & Yun, 2009). However, counter argument (Miller, 1977) believed that bankruptcy reorganization could be efficient enough to encourage recovery of distressed firms. Distressed firms with potential upside value may survive through its temporary financial distress and eventually become successful. Bailout also can be low efficiency. According to Regulatory Insider Theory, arbitrary regulators will lengthen the capital support to generate additional insider information to permit thorough and sustainable intervention (Kick, 2010). Despite the debates on the two solutions' efficiency, few empirical evidences have been provided to support their arguments.

This study will estimate the conditional recovery probability and the duration of these two resolutions. Since the characteristics of bankruptcy law, judicial system, crisis parameters and firms' status will also affect the decision outcome (Stiglitz, J., 2002), they will be included in the decision outcome model as shown in Figure 2 of the appendix. The empirical test of the decision and outcome models will collect data from multiple sources to exam large scope banking crisis worldwide in the past decade (1997-2009). The data of banking crisis and policy response will come from *World Economic Outlook* (WEO) database of the IMF, banking crisis database, and *S&P Market Insight*. Firms' data can be drawn from *Corporate Library*, *World Scope* database, *Financial Times Excel* database and other commercial databases. Bankruptcy filing and other judicial data can be found in court database.

The findings of this study will contribute directly to the policy making to combat current financial crisis. This work will be a comparative study of banking crisis around the world and will be beneficial to law and policy makers in different countries. Moreover, this project studies banking crises ranging from 1997-2009 and has a potential broad impact beyond combating current financial crisis: it will provide indications for post-crisis law and policy making. The *Russell Ackoff Doctoral Student Fellowship* will support this exciting research by providing fund for data collection, travel for conference and publication. Please see Appendix II for the budget plan and the research agenda.

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Appendix I

Figure 1 decision model for distress financial Firms

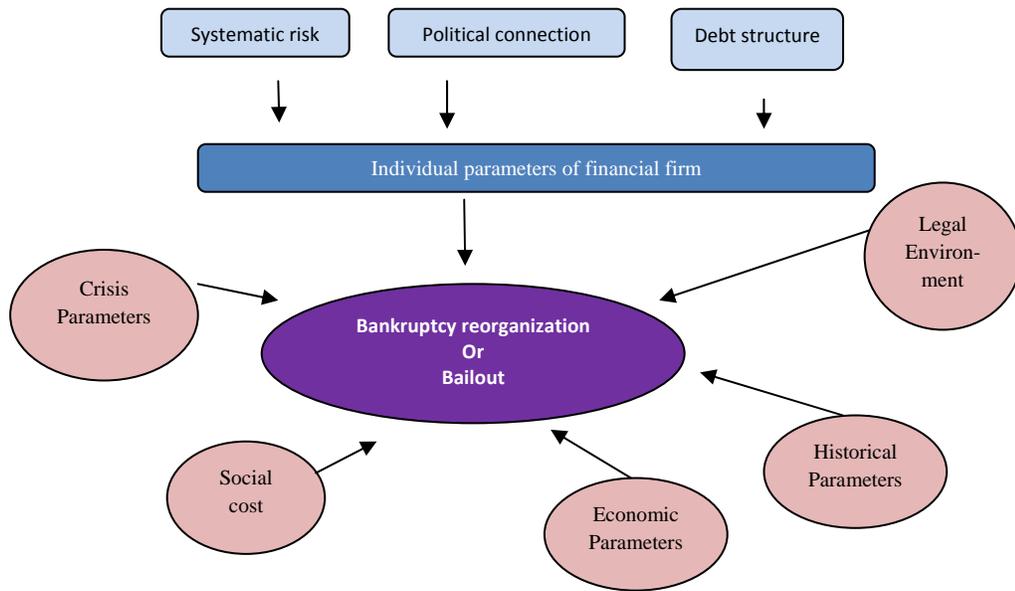


Figure 2 decision outcome model for distress financial Firms

