Bank Closure Policies and Capital Requirements: a Mathematical Model

ELETTRA AGLIARI DI
Department of Economics
University of Bologna
Piazza Scaravilli, 2, Bologna
ITALY

detelli.agliardi@unibo.it

Abstract: A bank closure policy problem is analysed in a mathematical model within a Black-Scholes framework where an appropriate notion of capital adequacy is introduced. The value of the deposit insurance liabilities and bank equity are derived. The effects of capital requirements on risk-shifting and bank reorganization are discussed, with a comparison of the impact of the two Basel I and II Accords on bank's behaviour.

Key words: bank closure policies, Black-Scholes framework, deposit insurance.

1. Introduction

The objective of this paper is to analyze a major question of bank regulatory policy, which has renewed its urgency in view of the recent Basel II Accord on capital ratios: that is, should regulatory agencies close (reorganize) a near insolvent but insured bank? If so, when? What are the effects of the new regulatory capital levels on bank's closure policies?

Although there has been a sizeable literature on deposit insurance pricing since the pioneering work by [5],[6], who first suggested to model deposit insurance as a put option on bank assets - and since then there have been a few contributions on the impact of deposit insurance on risk-shifting and on bank equity capital - little guidance has been offered about the timing of bank reorganizations and the impact of regulatory capital requirements.

In this paper we examine the effects of capital adequacy rules on banks' behaviour using a dynamic framework. Most papers on capital requirements develop static models on the asset-substitution effect, that is, capital requirements should be useful instruments to reduce the incentive to increase risk, by limiting the bank investments in risky assets. Others show that capital requirements may sometimes have a perverse incentive, that is, banks take on more risk. These latter do not address bank's closure policies.

The objective of this paper is twofold. First, we study the timing of bank reorganization, formulating a bank closure policy and the corresponding pricing of deposit insurance in a setting that is more complex than the one studied in the literature, because we introduce a more appropriate notion of capital adequacy. Our notion is in keeping with the basic standardized model of the Basel II Accord on capital ratios and allows us to make a comparison of the impact of the two Basel I and Basel II accords on banks' behaviour. Second, we build on a model which extends [6] in two directions. We introduce two risky assets instead of one in order to have different risk weights and a more appropriate notion of capital requirements; moreover, we allow for dividends payouts and consider the cost of reorganization when bank capital proves to be inadequate. We examine the effects of capital requirements on risk-shifting, bank's reorganization and bankruptcy. In common with much of the literature we study the present value of the deposit insurance liabilities as a metric for riskiness. Our paper is more closely related with [2] and [7], although these papers do not deal with bank's closure policies.
Moreover, [2] considers a two-period model with a single risky asset and uses a very special definition of risk. [7] deal mainly with risk management strategies and their main results are obtained with numerical simulations only.

2. The Model
We consider a bank which will remain in operation unless the regulator/insurer intervenes to close (or reorganize) the bank. The bank holds some specialized assets, notably loans, and is financed by equity and a variety of other liabilities, collectively referred to as deposits, which are assumed to be all insured. The insurer charges a premium for the deposit insurance, which is paid by the bank's equity holders. Bank managers make decisions in the interest of the equity holders. Bank assets are classified into two categories, according to their riskiness and the credit quality of the obligor. We denote by $V_i$, $i=1,2$, the two categories of the same type of financial asset which enter the total asset value with weights $\theta_i$ and assume that 

$$dV_i = \mu_iV_i dt + \sigma_i dZ_i,$$

where $\mu_i$ and $\sigma_i$ are constant, $dZ_i$ denotes a Wiener process and $E(dZ_1 dZ_2) = \rho dt$. Denote by $D$ the value of the bank's aggregate deposits. Let $g$ be the rate of growth in deposits, $r_D$ the rate of interest paid by the bank on deposits and suppose that depositors withdraw a constant fraction $\gamma$ of interest paid by the bank on deposits and of the value of deposits. Let $\theta_D$ be the rate of growth in deposits, thus, the remaining fraction $(1-\gamma)$ is added to the value of the bank's deposits. The dynamics for aggregate deposits are non-stochastic and described by 

$$dD = (g + r_D(1-\gamma))D dt = nD dt$$

with $r \geq r_D$ and $\delta = g - r_D \gamma \leq 0$ (in order to avoid that the bank may run a "Ponzi game"). Thus, the dynamics of the value of total bank's assets follow: 

$$dV_t = \theta_1(\mu_1V_t dt + \sigma_1 dZ_t) + \theta_2(\mu_2V_t dt + \sigma_2 dZ_t).$$

The regulator charges the bank a premium to insure all the deposits of the bank in perpetuity, provided that the bank is solvent, that is if $\theta_1 V_1 + \theta_2 V_2 > D$. Following [6] we suppose that solvency of the bank is ascertained by audit. The regulator may appraise the economic value of the bank's assets and liabilities on an appointed date. The residual capital position is then compared to the capital adequacy standard, which is computed as follows, in keeping with the basic standardized model of the Basel II Accord on capital ratios. The book value of each asset category is multiplied by a risk weight $y_i$ according to the different risk bucket into which the loan is classified and then by 8% (which is the coefficient required by the Basel Accords on capital ratios to generate the minimum capital requirement). Let:

$$\left(1\right) \, \theta_1 V_1 + \theta_2 V_2 - D \geq 0.08(y_1 \theta_1 V_1 + y_2 \theta_2 V_2)$$

Suppose $\sigma_2 > \sigma_1$. Then $y_2 \geq y_1$, in keeping with most standard default prediction models. If (1) is satisfied, then bank capital is judged to be adequate and there is no regulatory interference. Notice that if $y_1 = y_2 = 1$, then expression (1) states the notion of capital adequacy for the same type of financial instrument as from the Basel I Accord on capital ratios. Under the foundation approach of the new Basel II Accord the same type of financial instrument is assigned different risk weights, that is $y_i = 20\%, 50\%, 100\%, 150\%$, depending on the credit quality of the obligor. If (1) is not satisfied, then bank capital proves to be inadequate and its classification varies with the extent of the deficiency. As a condition for continued insurance, we assume that bank managers are expected to make up some of the deficiency by restricting current and subsequent dividends. Denote by $\alpha$ the proportional dividend that is assumed to be distributed to equity holders in case of solvency. We suppose that if (1) is not satisfied, then $\alpha = 0$ as a condition for continued deposit insurance. Finally, when the book value of equity is assessed to zero, the regulator declares the bank "technically insolvent". We can consider also the case where it can force a bank to technical
insolvency only when the market value of assets falls seriously below that of its deposit liabilities, so that forbearance is allowed. In this case, an insolvency resolution occurs if the asset value falls below $\beta D$ where $\beta \leq 1$ (that is if $\theta_1 V_1 + \theta_2 V_2 - \beta D \leq 0$). If $\beta = 1$ the liabilities facing the insurer reduce to the familiar put option: then the regulator liquidates the bank and exercises the put option to pay the depositors off. In any case there is a cost of audit, which is assumed to be $c(D) = k D$, borne by the insurer and taken into account when the insurance premium is computed.

3. The regulator’s policy

The regulator chooses the insurance premium $P$ and the closure policy. Given the audit report, it may either liquidate the bank or keep it in operation, deciding what $P = P(V_1, V_2, D)$ to charge the bank. We suppose the event of audit to be Poisson distributed, with the probability of an audit over the next instant equal to $\lambda dt$ the probability of no audit is equal to $1 - \lambda dt$ and the probability of more than one audit of order $O(dt)$. It is assumed that the Poisson process and $dZ_i$ are independent. Following [6], we put $\delta = 0$ for simplicity and indicate cash outflows as positive inflows, so that the derived values are positive instead of negative. In the absence of costs and if there are no dividends, $dP = (\mu_1 \theta_1 V_1 \frac{\partial P}{\partial V_1} + \mu_2 \theta_2 V_2 \frac{\partial P}{\partial V_2} + \frac{1}{2} \sigma_1^2 \theta_1^2 V_1^2 \frac{\partial^2 P}{\partial V_1^2} + \frac{1}{2} \sigma_2^2 \theta_2^2 V_2^2 \frac{\partial^2 P}{\partial V_2^2} + r(\theta_1 V_1 \frac{\partial P}{\partial V_1} + \theta_2 V_2 \frac{\partial P}{\partial V_2}))dt$

$$+ \rho \sigma_1 \sigma_2 \theta_1 \theta_2 V_1 V_2 \frac{\partial^2 P}{\partial V_1 \partial V_2} + \frac{\partial P}{\partial D} nDt$$

Suppose now there are dividends, so that $dV_i = (\mu_i - a) V_dt + \sigma_i dZ_i$. Then:

$$+ \rho \sigma_1 \sigma_2 \theta_1 \theta_2 V_1 V_2 \frac{\partial^2 P}{\partial V_1 \partial V_2} + \frac{\partial P}{\partial D} nDt$$

$$+ r(\theta_1 V_1 \frac{\partial P}{\partial V_1} + \theta_2 V_2 \frac{\partial P}{\partial V_2}) - rP = 0$$

To simplify the notation let $G(V_1, V_2, D)$ be

$$+ \rho \sigma_1 \sigma_2 \theta_1 \theta_2 V_1 V_2 \frac{\partial^2 P}{\partial V_1 \partial V_2} + \frac{\partial P}{\partial D} nDt$$

Therefore, $P$ must satisfy:

1. $G(V_1, V_2, D) + (r - \alpha)(\theta_1 V_1 \frac{\partial P}{\partial V_1} + \theta_2 V_2 \frac{\partial P}{\partial V_2}) - rP + \lambda kdD = 0$

2. if $\theta_1 V_1 + \theta_2 V_2 - D \geq 0, 0.08(\gamma_1 \theta_1 V_1 + \gamma_2 \theta_2 V_2)$

3. $G(V_1, V_2, D) + (r - \alpha)(\theta_1 V_1 \frac{\partial P}{\partial V_1} + \theta_2 V_2 \frac{\partial P}{\partial V_2}) - rP + \lambda kdD = 0$

4. if $0 < \theta_1 V_1 + \theta_2 V_2 - D < 0, 08(\gamma_1 \theta_1 V_1 + \gamma_2 \theta_2 V_2)$

They have the following interpretation. If the bank is solvent and (1) is satisfied, then bank capital is judged to be adequate and there is no regulatory interference, as from (2); otherwise, as from (3), the bank cannot pay any dividends ($\alpha = 0$) and reorganization is required. In any case, if an audit takes place there is a cash flow of $c(D) = k D$. Finally, if the market value of assets falls seriously below that of its deposit liabilities, like in (4), there is a second cash flow of $D - \theta_1 V_1 - \theta_2 V_2$ and the liability of the insurer ceases. To simplify the notation let us define $\sigma = (\sigma_1 \theta_1 V_1 + \sigma_2 \theta_2 V_2)/V$ where $V = \theta_1 V_1 + \theta_2 V_2$. Under a suitable change in variables and choice of parameters, with $x = V/D$ and $p = P/D$, the equation system
(2)-(3)-(4) becomes:

\[(5) \quad \frac{1}{2} p'' \Sigma x^2 + p'(r - \alpha - n)x - p(r - n) + \lambda k = 0 \quad \text{if } x > 1/(1 - \xi) \]

\[(6) \quad \frac{1}{2} p'' \Sigma x^2 + p'(r - n)x - p(r - n) + \lambda k = 0 \quad \text{if } \beta < x \leq 1/(1 - \xi) \]

\[(7) \quad \frac{1}{2} p'' \Sigma x^2 + p'(r - n)x - p(r - n + \lambda) + \lambda (k + 1 - x) = 0, \quad \text{if } x \leq \beta \]

Here \( \Sigma = \sigma_1^2 \theta_1^2 + \sigma_2^2 \theta_2^2 + 2 \rho \sigma_1 \sigma_2 \theta_1 \theta_2 \) and \( \xi = 0.08 (y_1(\sigma_2 - \sigma) + y_2(\sigma - \sigma_1))/ (\sigma_2 - \sigma_1) \).

We will consider parameter values such that \( \xi < 1 \) for any \( \sigma_1, \sigma_2, \sigma \) and \( y_1, y_2 \) as requested in the foundation approach of the Basel II Accord. Observe that if \( y_1 = y_2 = 1 \) then \( \xi < 0.08 \), as from the Basel I Accord. By solving equation system (5)-(6)-(7) we get Proposition 1, where \( a^\pm \) are the solutions to the algebraic equation related to (5), \( 1, a^- \) the solutions to the algebraic equation related to (6) and \( b^\pm \) the solutions to the algebraic equation related to (7):

**Proposition 1.** The present value of the deposit insurance liability (\( p \)) chosen by the regulator has the following expression:

\[(8) \quad \bar{p}(x) = \left(\frac{x}{\bar{x}}\right)^\alpha (a^- - 1) (x^*(1 - b^+)) - \Gamma b^+ \Psi^{-1} + \frac{\lambda k}{r - n}, \quad \text{if } x > \bar{x}, \]

\[(9) \quad p(x) = \left(\frac{x}{\bar{x}}\right)^\alpha (a^- - q^-) + \left(\frac{x}{\bar{x}}\right)^\beta (q^- - 1)(x^*(1 - b^+)) - \Gamma b^+ \Psi^{-1} + \frac{\lambda k}{r - n}, \quad \text{if } x < \bar{x}, \]

\[(10) \quad p_0(x) = \left(\frac{x}{\bar{x}}\right)^b \left(\frac{x}{\bar{x}}\right)^\alpha (q^- - 1)(x^*(1 - a^-) - \Gamma a^-) + (x^*/x^*) (q^- - a^-) \Gamma \Psi^{-1} + \frac{\lambda (k + 1)}{r + \lambda - n} - x, \quad \text{if } x \leq x^*, \]

with \( \bar{x} = 1/(1 - \xi), \quad x^* = \beta, \quad \Gamma = \frac{\lambda k}{r - n} - \frac{\lambda (k + 1)}{r - n + \lambda} \)

\[\Psi = \left(\frac{x^*/\bar{x}}{\bar{x}}\right)^\alpha (q^- - 1)(b^+ - a^-) + \left(\frac{x^*/\bar{x}}{\bar{x}}\right)(a^- - q^-) (b^+ - 1).\]

Observe that if \( \beta = 1 \) and \( \alpha = 0 \) then expressions (8)-(9)-(10) collapse into Merton's expressions for the regulator's liabilities [6]. We obtain the following results from a comparative static analysis.

**REMARK 1.** \( p \) is not a monotonically decreasing function of \( x \).

Such result follows from the property of the audit cost, that is a monotonically increasing function of \( x \). For \( x \) sufficiently large, the expected number of audits prior to an audit where the bank is found to be insolvent increases: thus, the cost increases with \( x \), which completely offset the "put option part" which is decreasing in \( x \).

**REMARK 2.** If capital forbearance is in place, cash payments resulting from the deposit insurance guarantee are higher, other things being equal.

Straightforward computation shows that for \( x > x^* \), the derivative of \( p \) with respect to \( \beta \) is negative, given the other parameter values. Therefore, the future liability increases as a result of continuing to provide insurance when the market value of assets falls seriously below that of its deposit liabilities and the regulator allows for forbearance. If \( \beta = 1 \) the liabilities facing the insurer reduce to the familiar put option.

**REMARK 3.** The value of deposit insurance increases as capital requirements increase, other things being equal.

For \( x > x^* \), the derivative of \( p \) with respect to \( \xi \) is positive, given the other parameter values. Thus, increasing capital requirements may limit the bank's ability to exploit its rents in the future, so that it can lead to an increase in the value of deposit insurance liability. Such result has to be compared with the usual asset-substitution effect which has been emphasized in the literature.

**REMARK 4.** Under Basel II Accord, the range of values of \( x \) where bank's reorganization is
required may reduce relative to Basel I. If the bank chooses assets so that \( y_1 / y_2 < 1 \) as a consequence of Basel II Accord (for example, 20%, 50%), then \( \xi \) is lower than under Basel I. Since \( \frac{\partial \xi}{\partial x} > 0 \), then \( \bar{x} \) decreases as \( \xi \) decreases. Actually, [1] and [4] show that minimum required capital under Basel II Accord (for example, 20%, 50%), then \( \xi \) is lower than under Basel I. Since \( \frac{\partial \xi}{\partial x} > 0 \), then \( \bar{x} \) decreases as \( \xi \) decreases.

4. Bank Equity

Let us consider now the bank that has paid its premium to the regulator. Following the same procedure as above, we can derive the value of equity per units of deposits, denoted by \( e = E/D \), which satisfy the following equations:

\[
\text{(11)} \quad \frac{1}{2} e'' x^2 + e'(r - \alpha - \lambda) x - e(r - n) = 0
\]

if \( x > 1/(1 - \xi) \)

\[
\text{(12)} \quad \frac{1}{2} e'' x^2 + e'(r - \beta - \lambda) x - e(r - n) = 0
\]

if \( \beta < x \leq 1/(1 - \xi) \)

\[
\text{(13)} \quad \frac{1}{2} e'' x^2 + e'(r - n) x - e(r - n - \lambda) = 0
\]

if \( x \leq \beta \)

By solving equation system (11)-(12)-(13) we get Proposition 2:

**Proposition 2.** The equity per units of deposits (e) has the following expression:

\[
\text{(14)} \quad \bar{e}(x) = \frac{x^*}{(q^- - q^+)(b^+ - a^-)}. \\
\left\{ (x/\bar{x})^\nu \cdot ((\bar{x}/x^*)^\nu - (1 - b^+)(q^- - a^-) \right\}
\]

where \( \bar{x} = 1/(1 - \xi) \) and \( x^* = \beta \).

If \( \beta = 1 \) and \( \alpha = 0 \) then expressions (14)-(15)-(16) collapse into Merton's expressions for the bank equity evaluation [6]. From (14), (15), (16) the equity per units of deposits is a monotonically increasing function of \( x \) for \( x \leq \bar{x} \). It is strictly convex for \( x \leq x^* \), as is usually the case for limited liability levered equity, and strictly concave for \( x > x^* \). Since the equity position can be viewed as ownership of the assets levered by a riskless debt issue (the rate paid on which is \( n \)) combined with an implicit put option on the value of the assets ([6]), in the case of the bank equity it is the positive spread \( r - n \) that induces the concavity. The spread becomes lower if dividends are paid out.

**REMARK 5.** The value of equity does not increase as capital requirements increase, other things being equal. For \( x > \bar{x} \), the derivative of \( e \) with respect to \( \xi \) is negative, given the other parameter values, while it is equal to zero for \( x < \bar{x} \). Capital requirements limit the bank's ability to invest in risky assets. An effect of regulation is the reduction of bank's equity: capital requirements do lower "bank's profits", and may lower bank's incentive to preserve future rents.

**REMARK 6.** Insolvent banks increase value by increasing portfolio variance; sufficiently capitalized banks maximize value by minimizing variance. It is straightforward to compute...
\[
\frac{\partial \xi}{\partial x} = \left(\frac{x}{x^2}\right)^{y^*} \left(\frac{1-a^-}{b^-a^-} \cdot \frac{\partial}{\partial x} \ln\left(\frac{x}{x^2}\right) + \frac{\partial}{\partial x} \left(\frac{1-a^-}{b^-a^-}\right)\right)
\]
which is positive for \( x < x^* \), since \( \frac{\partial}{\partial x} \) and \( \ln\left(\frac{x}{x^2}\right) \) are negative and the first term in parenthesis dominates the second for small enough \( x \). On the contrary, \( \frac{\partial \xi}{\partial x} = \left(\frac{x}{x^2}\right)^{y^*} \left(\frac{1-a^-}{b^-a^-} \cdot \frac{\partial}{\partial x} \ln\left(\frac{x}{x^2}\right) + \frac{\partial}{\partial x} \left(\frac{1-a^-}{b^-a^-}\right)\right) \) is negative for \( x > x^* \), since \( \frac{\partial}{\partial x} \) and \( \ln\left(\frac{x}{x^2}\right) \) are positive, hence the first term in parenthesis dominates the second for large enough \( x \). It is in keeping with the observation that as long as it is solvent, the bank pays less than the riskless rate on its deposits. Therefore, as long as \( x > x^* \) an increase in portfolio volatility would increase the probability of becoming insolvent, and thus of losing this rent. Thus, sufficiently capitalized banks would like to minimize variance. On the contrary, if the bank is insolvent, that is \( x < x^* \), the bank may find it more convenient to increase portfolio volatility, gambling for resurrection by the time of the next audit. Actually, we can obtain the following:

REMARK 7. If \( x < x^* \), the bank would choose the portfolio with the highest possible risk level. If \( x > x^* \), such strategy is no longer optimal.

Here we have to look for the optimal \( \theta_1 \) such that equity is maximized. Suppose \( \sigma_1 < \sigma_2 \). If we compute \( \partial e_0 / \partial \theta_1 \) an interior solution for a maximum does not exist; indeed, the only optimal solution is \( \theta_1 = 0 \) for \( x < x^* \). It is no longer true for \( x > x^* \) since \( \partial e / \partial \Sigma < 0 \).

Then, sufficiently capitalized banks would prefer to invest a strictly positive fraction of their total assets in the less risky asset class too.

REMARK 8. Under Basel II riskiness reduces relative to Basel I, other things being equal.

Straightforward computation shows that \( \frac{\partial e}{\partial \theta_1} < 0 \) if \( y_1 < y_2 \), while \( \frac{\partial e}{\partial \theta_1} = 0 \) if \( y_1 = y_2 \). Moreover, \( \frac{\partial^2 e}{\partial \theta_1^2} > 0 \) if \( y_1 < y_2 \) while \( \frac{\partial^2 e}{\partial \xi^2} = \frac{\partial^2 e}{\partial \theta_1} \frac{\partial \xi}{\partial \theta_1} = 0 \) if \( y_1 = y_2 \). If different risk weights are assigned, that is \( y_1 \neq y_2 \), the optimal portfolio choice shifts to the less risky asset. Therefore, under Basel II with \( y_1 \neq y_2 \) riskiness is reduced relative to the case \( y_1 = y_2 \).

REMARK 9. Under Basel II equity does not decrease relative to Basel I.

If we can conjecture that under Basel II relative to Basel I \( \xi \) is expected to decrease, as it is suggested by [1], then for \( x > \bar{x} \) an increase in equity is expected \( (\partial e / \partial \xi < 0) \) while for \( x < \bar{x} \) equity is unchanged \( (\partial e / \partial \xi = 0) \).

REMARK 10. Empirical evidence seems to agree with our predictions.

[4] surveys empirical evidence about the effects of Basel I and II and provides a simulation study whose results are in line with ours. Furthermore, it is estimated that capital relief for high (average) quality portfolios is 50% (18%) going from Basel I to Basel II.

References: