

Resolution Authority: Alternative Approaches

Jeffrey N. Gordon

Columbia Law School

*Transatlantic Corporate Governance
Dialogue*

General framework

- In fall 2008 events on both sides of the Atlantic demonstrated the need for a process to address the failure of systemically important financial institutions
- Two different senses of “systemically important”:
 - with respect to a single country
 - with respect to the international financial system

General framework, 2

Actions to create resolution authority:

- US: Adoption of “Orderly Liquidation Authority” in Dodd-Frank

- EU: European Commission

- “Communication” of Oct. 20, 2010:

 - sketches out a framework but leaves open many specific, critical terms

General framework, 3

- To help the “transatlantic dialogue” on resolution authority, this presentation will describe how Dodd-Frank addressed some of these critical terms
- And cautions against some of Dodd-Frank’s problems

Dodd Frank's Dangers

- My view is that Dodd-Frank is dangerously incomplete, on two dimensions
 - First, although its procedures may successfully resolve a failing financial firm, it provides no way to resolve a *financial crisis*
 - Drafted amidst anti-bailout fervor, Dodd-Frank stripped the FDIC, the Fed, and Treasury of preexisting emergency authorities that were critical elements in restoring systemic stability, no less important than TARP

Dodd-Frank's Dangers, 2

- As explained below, the consequence in the next financial crisis is likely to be the highly disruptive nationalization of much of the US financial sector
- Second, Dodd-Frank does not address the cross-border fall-out from the resolution of an international financial firm.
 - Unless the FDIC is prepared funnel funds borrowed from the US taxpayers to pay off foreign counterparties, even a successful resolution of Lehman US would still precipitate a bankruptcy of Lehman UK

Caution for the EC

- Not clear that the current EC Communication contemplates tools to address a general financial crisis that may arise despite (or because of) the resolution of a failing financial firm
- Cross-border resolution is a hope rather than a plan
at best, within EU, not cross-Atlantic

Approaches to Cross-border Resolution

Four possibilities:

First, strong form harmonization and coordination of resolution and insolvency regimes for financial institutions: **Unlikely**

Second, national schemes that require ring-fencing of assets and liabilities of national subsidiaries of international financial institutions: **Could disrupt international capital flows**

Approaches to Cross-border resolution, 2

- Third, “Failure is Not an Option”: Extra-Tight regulatory regime, including high capital requirements and/or activity and size constraints: **Even if otherwise desirable despite its costs, likely to erode over time**
- Fourth, “Failure is Not an Option”: Various “bail-in” mechanisms, such as contingent capital or convertible debt

Approaches to Cross-border resolution, 3

- Such “self-help” resolution-avoidance regimes require relatively low international consensus
- Can be implemented by a local statutes/regulations that require designated financial firms to enter into appropriate debt contracts
- Particularly appealing in light of “too big too save” problem: financial firms whose size exceeds the national rescue capacity, e.g., Iceland, Switzerland

Approaches to Cross-border resolution, 4

-- **Many technical problems:** triggers for “conversion” or “debt for equity swap” or “debt write-down”: when and who decides

Resolution Authorities Before the Crisis – the US Case

- Banks: Federal Deposit Insurance Corporation had authority to seize banks via receivership
 - **Ordinarily**, resolution could proceed in two ways:
 - 1) “Purchase and assumption” transaction: “good” assets and liabilities transferred to another bank, non-insured depositors and other unsecured creditors to bear any losses
 - 2) “Bridge bank”: where immediate transfer cannot be arranged, FDIC sets up a bank with “good” assets and liabilities to preserve going concern value

Pre-Crisis US Resolution Authority, 2

- Critically**: the FDIC Deposit Insurance Fund can protect transferee on losses on assets/liabilities assumed and can provide working capital to a bridge bank
- Deposit Insurance Fund is “**prefunded**” by assessments on banks

Pre-Crisis US Resolution Authority, 3

- Where “least cost” resolution would threaten “financial stability,” the FDIC could pursue other approaches, including open bank assistance.
- Historically, for large banks, non-insured depositors were protected against loss
- Consequently, bank balance sheets contained relatively small percentage of subordinated debt

Pre-Crisis US Resolution Authority, 4

- FDIC resolution authority was poorly adapted to large bank holding companies that arose after deregulation in the 1990s
- FDIC resolution authority did not address non-bank financial firms, which gained critical size as financial intermediation increasingly took place through markets rather than inside banks (e.g., securitization)
- FDIC resolution authority was poorly adapted to international financial firms

Ad Hoc Resolution in 2008

For non-bank financial firms, the only alternatives to bankruptcy were merger (Bear-Stearns) and recapitalization (AIG)

Merger requires: target shareholder approval and, for financial firm, guarantee of target obligations between signing and closing.

- Shareholders are not wiped out and creditors, even unsecured, are fully protected
- Counterparties are fully protected

Ad Hoc Resolution in 2008, 2

- For Lehman, Barclays was unable to provide guarantee because of shareholder approval rights that the UK government would not wave.
- Fed could not/would not provide open-ended guarantee
- Cross-border resolution problems were simply unanticipated and proved disastrous:
 - US kept Lehman (NY) broker-dealer sub afloat pending a sale;
 - UK did not for London broker-dealer sub

Ad Hoc Resolution in 2008, 3

- Recapitalization (AIG) with 3d party assistance requires: shareholder approval (which limits extent of dilution)
- Creditors, even unsecured, are protected
- Counterparty claims are protected
- Requires 3d party funder (here: the Fed, lending on assets it believed made it adequately collateralized)

Ad Hoc Resolution in 2008, 4

- One person's "resolution" is another person's "bailout"

Resolution per Dodd-Frank

- Dodd-Frank gives the FDIC new resolution authority for the systemically important failing financial firm
 - displaces bankruptcy regime for such firms
 - similar to the FDIC regime for failing banks but more focused on “orderly liquidation” of the failed firm and imposing losses on creditors

Resolution per Dodd-Frank, 2

- **Covered firms:** financial firms that have previously been designated and regulated as “systemically important”; others that may turn out to be (eg: Long Term Capital Management), so could reach a hedge fund or PE fund not previously regulated as such
- **Standard for triggering:** that a financial firm is “in default or in danger of default” and that alternative ways of resolving the financial distress “would have serious adverse effects on the financial stability of the United States”

Resolution per Dodd-Frank, 3

-- This is taken as meaning that commencement of a bankruptcy case is likely; FDIC resolution deemed to be less disruptive than bankruptcy

By contrast: EC Communication has a different triggering approach:

-- “before a firm is balance sheet insolvent”

-- “serious distress without any realistic possibility in a timeframe that is appropriate to the risks to financial stability posed by the institution’s distress and *likely* failure”

Resolution per Dodd-Frank, 4

- **Who decides:** “triple key approach” – need agreement among the Treasury, the FDIC (board vote) and the Federal Reserve (board vote)
- Strong likelihood that the board of the failing firm will consent, but if not, judicial review is narrow and expedited

FDIC “Receivership”

- Dodd-Frank receivership gives the FDIC similar authority as in case of failing bank, including discrimination among creditors of the same class
 - Constraint: creditors cannot receive less than they would otherwise have received in a bankruptcy liquidation
 - How meaningful is this protection? Fire sale values in the circumstance (Lehman bonds: valued at 8 cents on the dollar in the CDS auction)
 - Similar issue for EC Communication

Differences from Bank Receivership

- First: Mandatory Loss Imposition
 - Unsecured creditors must bear losses, even to the extent of claw-back of previous payouts if necessary to cover losses
 - Creates uncertainty about the value of prior claims/obligation in the post-receivership period
 - Remaining losses are to be recovered by ex post assessment on large financial firms

FDIC Receivership

FDIC has already begun to back away: newly proposed rule that contemplates protection of short-term creditors (even if not secured) to mitigate run risk

-- Similar to FDIC's prior de facto extension of deposit insurance to wholesale bank deposits

-- Will require regulatory policing of financial firm balance sheets to avoid adaptive shift to short term

Differences from Bank Receivership

- Second: no pre-existing fund (unlike DIF)
 - FDIC-provided working capital will come from Treasury (i.e., taxpayer) loans
 - No pre-funding because political reluctance to face “bailout” characterization
 - Undercuts FDIC resolution threat, creates invitation to regulatory forbearance, postponement of intervention to more systemically fragile moment
 - EC Communication calls for pre-funding

Dangers of Dodd-Frank

- **Step One:** Single firm resolution works best if reasons for failure are idiosyncratic
- If the distress is systemic, resolution of a single firm may exacerbate, not reduce, distress
 - “Resolution: of a large systemically important firm is not a science; after all, US regulators thought they understood the consequences of permitting Lehman to fail
- Even if “contagion” is controlled, other financial firms that have followed similar business strategies may present similar solvency risks
- In response to such uncertainty, capital suppliers begin to withdraw
 - Interbank and other short term markets begin to freeze-up

Dangers of Dodd-Frank, 2

- **Step Two:** Dodd-Frank (and prior legislation) withdrew prior emergency authority
 - **Treasury** can no longer guarantee Money Market Funds after one has “broken the buck”
 - **Fed** can provide funding only through general facilities – no firm-specific loans – and the collateral requirements are stiffer.
 - Some critical Crisis credit facilities probably would not qualify

Dangers of Dodd-Frank, 3

- **FDIC** can no longer guarantee the obligations of banking firms that are solvent but that face liquidity squeeze because of systemic financial distress
 - Critical addition to Fed discount window access, because FDIC guarantees do not require collateral
 - In the crisis, the FDIC authorized up to *\$1.7 trillion* to protect uninsured depositors and to guarantee new issuances of unsecured debt
 - TARP was \$700 billion

Dangers of Dodd-Frank, 4

- **Step Three:** going to Congress for either TARP II or FDIC Guarantees II or additional Fed or Treasury authority is politically unattractive, especially given available receivership option that can avoid financial system collapse

Dangers of Dodd-Frank, 5

- **Consequence:** For both the liquidity-constrained firm and the firm that is “solvent” in normal market conditions, FDIC receivership becomes the necessary source of funds
 - **Result: Close-in-time serial receiverships – falling dominos – that result in nationalization of significant share of US financial system**

Dangers of Dodd-Frank, 6

- **Further result:** acceleration of course from financial instability to financial distress, as capital suppliers withdraw from entire financial sector, not just firms deemed most likely to fail
- **Further result:** Wide-ranging receiverships of US firms may destabilize non-US firms, adding to international financial distress

Core difference between US and EU?

- US: liquidation of a failing financial firm is conceivable; need to solve “too big to fail”
- EU: large financial firms, esp. banks, are seen as instruments of state policy, and they are “too important to fail”
- Seems reflected in EC Communication re “resolution funds” apart from deposit insurance funds: funded ex ante by banks “subject to crisis management framework”

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- Gordon & Muller: *Facing Financial Crisis: Dodd-Frank and the Case for a Systemic Emergency Insurance Fund*
 - -- available on SSRN, forthcoming in Yale J. on Regulation (Winter 2011)