Resolving Large Complex Financial Institutions: The Case for Reorganization

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Abstract

The recently enacted provisions of the Dodd-Frank Act for resolving systemically important non-bank financial institutions, like the existing means of resolving commercial banks on which they were based, are aimed at placing the institution into receivership and then liquidating it. However, receivership is likely to trigger a number of adverse consequences, including conflicts between jurisdictions, increased size of any "bailout" and increased moral hazard. In a financial system where institution size and industry concentration are sources of systemic risk, preserving a competitor avoids enhancing the systemic importance of survivors. The alternative of rehabilitating distressed firms through Chapter 11, with appropriate modifications to recognize the special nature of systemically important financial firms, may mitigate or eliminate these problems, preserve market discipline to a greater degree and minimize costs to third parties.

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> *The federal government's responses to the impending bankruptcy of Bear Stearns, Lehman Brothers, and AIG were complicated by the lack of a statutory framework for avoiding the disorderly failure of nonbank financial firms, including affiliates of banks or other insured depository institutions.*[1]

Prior to the passage of the Wall Street Reform and Consumer Protection Act, popularly known as the Dodd-Frank Act (DFA), in July 2010, the means of resolving failing financial firms were as follows: banks were resolved under the Federal Deposit Insurance Act (FDIA); insurance companies were resolved by state courts, brokerage firms were resolved under the Securities Insurance Protection Act, and all other financial firms, including holding companies, whose subsidiaries included banks, insurance companies, and/or brokerage firms, were resolved under the U.S. Bankruptcy Code.[2] This statutory structure reflects the history of U.S. political and financial development.[3]

What the government and financial regulators discovered during the 2007-09 financial crisis was not so much that they lacked the authority to deal with failing large non-banks financial institutions as they wished to. This was clear from long-standing statutes. That they might have need of intervening in non-banks in a financial crisis seems to have been insufficiently foreseen. This failure of foresight reflected a historical focus on "banks" rather than financial institutions, and an accompanying focus on traditional banking issues (deposits and deposit insurance, loan credit quality and bank capital, and the payments system) as sources of potential risk to the financial system. Furthermore, while regulators noted risks to the financial system and economy from bank failures, they tended to focused on reducing the probability of individual bank failures the means of dealing with failures when they occur. The bank resolution

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[1] U.S. Treasury (2009). p.76.

[2] This multiplicity of regimes, statutes and jurisdictions, to which must be added the international dimension, is a receipt for confusion, cost and conflict. Bliss (2003 and 2007). DFA has done nothing to reduce the jurisdictional complexity, merely moving the resolution of some firms and parts of firms previously generally resolved under the Bankruptcy Code to a new separate regime, leaving the piecemeal resolution of complex financial firms unaltered.

[3] For a brief history of the development of bankruptcy and bank insolvency regimes in the U.S. see Bliss and Kaufman (2007).

regime in the FDIA is primarily focused on dealing with the assets (loans) and liabilities (deposits) that are typical of small and medium sized banks, rather than the more complex financial structures and funding sources that are typical of SIFIs.

What the financial crisis revealed was not so much that banks were not special, but rather that there were non-bank financial institutions that also appeared to present systemic risks to the financial system, as well as demonstrating that distressed large complex banks presented problems qualitatively different from small and medium sized domestic banks. The response of the government, regulators, and Congress was to look to enhanced bank resolution procedures as what was needed to avoid future "bail outs" and "disorderly resolution" which were blamed on the lack of statutory powers to seize and dispose of problem institutions which were not banks as and when regulators and the government felt necessary, as is done in the bank resolution process.

This paper will lay out what the authors see as the salient issues surrounding the distress and failure of systemically important institutions, the strengths and weaknesses of both bankruptcy and bank insolvency regimes, evaluate the Orderly Liquidation Authority (OLA) that is introduced in DFA, and propose an alternative hybrid regime that addresses the objectives of minimizing bailouts, which imposes direct costs to unrelated third parties; disruptions to the financial system; and preserving market discipline by requiring creditors to suffer losses reflecting the agreed terms of their contracts and the risks they have assumed.

Preliminaries

Bankruptcy and Bank Insolvency

The U.S. Bankruptcy Code explicitly excludes banks, insurance companies and brokerage firms, as well as some other types of debtors that need not concern us here.[4] Prior to DFA most other financial institutions are resolved under Chapter 11 of the Bankruptcy Code. Banks are resolved under FDIA. Bliss and Kaufman (2007) detail the differences between these two regimes as well as providing some of the historical reasons for why these developed as they did.

For purposes of this paper, the salient differences are:

[4] 11 U.S.C. § 109.

Bankruptcy (Chapter 11)[5]

- A judicial process, supervised by a bankruptcy court judge, assisted by a trustee appointed by the court.
  - Initiated either by management or by creditors (requires an event of default) through a petition to the court.
  - Insolvency is not a cause for creditors to initiate proceedings.
- Filing of bankruptcy petition results in a "stay" which stops actions by creditors to attach security, recover collateral, and other self-help actions.
  - Exceptions to the general stay include, most importantly, certain financial contracts including derivatives and repurchase agreements, which may be terminated if an event of default occurs.[6]
- Management and creditors, divided into "classes" with similar claims, have standing to appear before the court and participate in the proceedings.
- Parties must agree a reorganization plan through a process of negotiation and voting.
  - If they fail to agree, the court can "cram down" its own plan subject to certain constraints.
- The objective of Chapter 11 is to maximize the value of the firm for all creditors through reorganization to preserve going concern value. If this fails the case may be transferred to Chapter 7 liquidation.[7]

Bank resolution

- An administrative receivership (liquidation) process conducted by the FDIC.
  - Initiated when the bank's primary regulators places the bank into receivership.
    - Early intervention and closure under "prompt corrective action" (PCA) are designed to allow closure before the firm becomes insolvent.[8]
    - Regulators may also close a bank based on their judgment that the bank is in danger of failing.

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[5] As large firm bankruptcies invariably are Chapter 11 proceedings, at least initially, this is the relevant part of the bankruptcy code for our purposes.

[6] See Bliss and Kaufman (2006 and 2007) for details.

[7] Chapter 11 is sometimes used, even if the intention is to liquidate the firm through selling off its parts. This was done with Washington Mutual, Inc (the holding company) and Lehman Brothers.

[8] 12 USC 1831o.

- The bank's charter is revoked and managers are fired.
- FDIC assumes all control rights as administrator.

- There is no stay. Instead, the FDIC may repudiate and contracts deemed burdensome in a "reasonable time".[9]
    - The FDIC may transfer derivatives contracts to another institution, if it does so within one business day.[10]
- Creditors file claims but have no other role in the receivership (they have no standing).
    - There is limited right of appeal for judicial review.
- The FDIC makes all decisions as to how to dispose of assets and on what terms.
- The objective of bank resolution is liquidation of the failed bank. The payment of deposits and other creditor claims is governed by the "least cost resolution rule" (LCR).[11] LCR is subject to a "systemic risk exemption" (SRE) which allows the FDIC to selectively pay non-depository creditors, thus imposing additional costs on the DIF.[12]
- The FDIC has the power to create a new temporary bridge bank, into which it can transfer some or all of the assets and those liabilities and contracts it wishes to affirm. The remainder of the original banks assets and creditor claims remain in the receivership. The FDIC then runs the bridge bank.

OLA has most of the relevant bank resolution provisions of FDIA, excepting the LCR requirement. Placing a covered financial institution into the OLA is a process that similar to the requirements for invoking the SRE.[13] As OLA covers non-banks there are no deposits, deposit insurance and DIF loses to be minimized. DFA contemplates the establishment of a fund to cover the costs of resolving non-bank SIFIs under OLA. However, OLA lacks any requirement that resolutions be conducted to minimize losses to such a fund, or any other party. Instead the FDIC

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[9] 12 U.S.C. § 1821(e)(1) and (2).

[10] See 12 U.S.C. § 1821(e)(9) and (10). The 1-day rule applies to receiverships, not conservatorships. Conservatorships of failing banks are rarely used. Rights to close-out derivatives under 12 U.S.C. § 1821(e)(8) appear to be preserved.

[11] This requires the FDIC resolution minimize costs to the deposit insurance fund (DIF). LCR is achieved when depositors, but not other creditors, are paid in full.

[12] 12 U.S.C. § 1823(a)(4)(A) and (G). The SRE, introduced in the FDIC Improvement Act (FDICIA) of 1991, was not used until 2008. It was then invoked a five times to justify widely different regulatory interventions. See GAO (2010). While it requires a complex approval process, the SRE is likely to be involved in the resolution of any individual SIFI or in wide-based responses to a financial crisis.

[13] There is a requirement that the Secretary of the Treasury petition a special panel of judges, but this requirement is so constructed as to ensure no chance of the petition being declined.

is empowered to "liquidate, and wind-up the affairs of a covered financial company, … , in such manner as the Corporation deems appropriate."

In the discussion that follows the distinctions that will be most important are 1) between receivership (liquidation) and reorganization; 2) between an administrative process with no participation by creditors and a judicial proceeding where creditors represent their own interests, and 3) between a process overseen by a court which is not itself an interested party and cannot impose costs on third parties and a process overseen by an administrator which is both an agency of the government and in principle a major creditor with the power to allocate losses to third parties.

Note that the presumption in Chapter 11 is that the firm is worth more as a going concern, than its liquidation value. In bank insolvency, reorganizing the existing firm is not an option. However, some portion of the going concern value may be transferred to any acquiring institution, whether a bridge bank or a purchaser. How much going concern value is lost (or gained, as there may be synergies in a P&A sale) with the change in legal status to "in liquidation", to "transferred to new bridge institution" or "sold to acquiring institution" and who realizes those losses and/or gains will necessarily be dependent on circumstances and will difficult to determine.

While in Chapter 11, a firm's ongoing funding needs are met through "debtor in possession" (DIP) financing. DIP funding is made attractive to potential creditors by being given seniority over all pre-filing unsecured claims. A bridge bank's operations are funded through the FDIC's own resources, which include lines of credit with the Treasury.

Sources of Individual Firm Systemic Risk

Under DFA a financial firm is deemed to be systemically important if "the failure of the financial company … would have serious adverse effects on financial stability in the United States."[14] SIFIs are generally very large and complex firms.[15] Two points need to be considered:

1) It is unlikely that all parts of the SIFI are systemically important.

[14] DFA Section 203(b)(2).

[15] One can imagine that some smaller, less complicated financial institutions such as central counter parties or clearing banks may also be systemically important.

2) Failures of parts of a SIFI can bring down otherwise healthy parts of the firm as was observed in the failure of Donald, Lufkin & Jenrette in 2001. Such internal contagion can materially increase the costs of resolving a distressed firm.

The functions that appeared to have been seen as directly causing systemically concerns in the recent financial crisis were derivatives portfolios, prime brokerage accounts, and transaction services, including foreign exchange dealing.[17]

Indirect concerns which arose included the potential that default on commercial paper held by money market mutual funds could lead to runs on money market mutual funds and a collapse of the commercial paper market, as indeed happened. Another indirect concern was that fire sale of assets to meet liquidity demands would trigger a distresses elsewhere as firms were forced to write down their own portfolios leading to further liquidations.

In the financial crisis the government used a combination of individual firm rescues (Bear Sterns, AIG, Citigroup, Merrill Lynch, Bank of America) and broader market interventions (Term Loan Facility, Troubled Asset Relief Program, unlimited deposit insurance, etc.) The individual interventions were all preceded by liquidity crises that developed rapidly. It was evident from stock prices and credit default swap spreads that all was not well for almost all big banks in 2007 and 2008. Against this uneasy background individual crises took the form of whole sale funding runs,[18] calls for collateral (another form of liquidity squeeze), or runs by prime brokerage customers which would have required returning collateral that was not available.[19]

From these observations we offer two thoughts. Intervention in individual SIFIs, if it is driven by a liquidity crisis, has to be rapid and effective to prevent the contagion that is at the core of systemic concerns. However, intervention does not necessarily have to immediately

[17] See *inter alia* SIGTARP (2011).

[18] These can take several form: increases in haircuts demanded on collateral used in repo transactions, forcing the firm to find more collateral to continue to roll over their repo funding or funds to pay down existing repos; refusal of normal counter parties to rollover unsecured short term loans (primarily commercial paper), forcing the firm to find alternative sources of funds to repay its existing short term debt.

[19] Prime brokers frequently "rehypothicated" customer collateral, that is used it for their own purposes, either to obtain funding through repos or to post as collateral against their own position. Returning customer collateral would have required the bank to find new funding or collateral on short notice. Request for return or additional collateral thus raise the same need for immediate liquidity as do deposit withdrawals and inability roll over short term funding.

resolve the whole of the distressed firm, only those parts that would cause the systemic crisis to propagate need to be immediately addressed. To borrow from the medical field, in a crisis the immediate concern is triage, that is to stabilize the patient, to prevent him from becoming worse, rather than to operate on the "patient" to repair the damage. Treating the patient properly could then be delayed until resources, including time, were available to do so. It is worth noting that this concept was developed in the context of battlefield hospitals and natural disasters as a means of dealing with crisis situations where time, resources and information are severely limited.

Timing

By adopting a modified the bank resolution regime, the DFA rejects the bankruptcy regime. The major reason used by regulators and the Treasury to reject bankruptcy as a viable means of resolving SIFIs was that bankruptcy takes too long and is too costly. A financial institution experiencing a liquidity crisis can collapse in a matter of days, and bankruptcy typically takes months or years to complete. Bank resolution on the other hand is thought to be rapid; typically a bank is closed on a Friday and reopened the next Monday under new ownership. Both these "facts" require closer scrutiny.

We begin by noting that there are three distinct timeframes involved in the resolution of a SIFI: 1) the initiation of intervention which may begin before asserting legal control, 2) the stabilization of the situation in the event of a liquidity crisis, and 3) the final disposition of creditors' claims or restructuring.

When we see a bank closed and reopened quickly, we are seeing the conclusion of a complex and longer process. The favored means of resolving banks now used by the FDIC is Purchase and Assumption (P&A).[20] Except when a bank is liquidated or a bridge bank is formed, the P&A terms are announced at the same time as the legal closure. This means that the resolution process is begun before the bank is formally closed, when the bank is "shopped around" to potential buyers. It also means that, so long as a run does not force the hand of the primary regulator and the FDIC, the closure is usually delayed until a buyer is found, PCA closure requirements notwithstanding. P&A transactions typically leave some assets and liabilities in the receivership; the liabilities include uninsured depositors' claims (receivership

[20] Since 2000 there have been a handful (perhaps five) bridge bank resolutions and less that twenty straight liquidations out of more than 400 bank closures. Liquidations occurred when no buyer could be found and involve the FDIC paying off insured depositors taking the assets for later disposition.

certificates) and other creditors' claims. The assets include those the purchaser did not wish to assume, typically low quality, and any net proceeds from the P&A transaction. Final resolution of the receivership, as opposed to the P&A, typically takes much longer and can last years. Thus, the rapidity of bank resolution needs to be qualified. It is rapid 1) when there is a ready buyer, and 2) for those creditors whose claims are transferred in the P&A transaction. For the remaining creditors, bank resolution may not be materially faster than bankruptcy.

Bankruptcy can also be expeditious. The U.S. bankruptcy of Lehman Brothers quickly sold the U.S. operations to Barclays, forestalling collapse of those business units, much as a bank resolution P&A would have done. The bankruptcies of General Motors and Chrysler were substantially completed in a few weeks by means of pre-packaged restructuring.

Initiation

Where bank resolution is potentially superior to bankruptcy is in the initiation of the intervention. PCA rules are intended to force remediation prior to failure and to force closure and resolution prior to insolvency. Judgmental closure—if the bank is thought unlikely to be able to meet its obligations, or is seen to be being run in an unsafe and unsound manner—also allows for preemptive initiation of the resolution process. Prior to the recent financial crisis, the beneficial effects of these early intervention powers appears to have been to encourage those undercapitalized banks that could do so to recapitalize or merge. For the remainder, virtually none were closed with positive net worth. Why this might have been so is beyond the scope of this paper (all the banks concerned were small). Since the beginning of the financial crisis early intervention, both self-help by banks and early intervention by regulators have been hampered by the sheer volume of distressed banks needing to be merged (by management) or sold (by the FDIC). The use of loss sharing agreements in P&A transactions significantly reduced the risks attached to acquiring a distressed bank's assets and arguably increased their returns.[21] As a result, potential acquirers have frequently had a positive incentive to wait for a bank to fail, rather than assist in a pre-closure resolution.

[21] It is too soon to know this for sure and the relevant data are and will be opaque. However, we have observed conservatively run bank holding companies (e.g., BB&T), hedge funds and newly formed private equity groups actively participating in these transactions. This suggests that that view the risk/return trade-offs as favorable, even given the uncertainties—financial, regulatory, and political—plaguing financial markets.

Early intervention in a SIFI, be it a bank or non-bank financial institution, is going to be hampered by the paucity of potential buyers. The largest bank closure to date has been Washington Mutual with $307 billion in assets, the second largest is IndyMac at $32 billion.[22] This is dwarfed by the size of potential SIFI-designated financial institutions (up to $2 trillion). Nonetheless, the power to do so is there.

Bankruptcy can be preemptively initiated only by the firm's managers. This is frequently done ahead of default for strategic reasons; to force discharge of onerous contracts (typically pension and medical plans), or renegotiation of employment contracts or debt. Involuntary initiation of bankruptcy by creditors requires a positive event of default. Thus, General Motors was able to survive for years with substantial negative net worth.

Waiting for an event of default could be highly detrimental for a SIFI. As we have seen, efforts to avoid default caused by liquidity crises leads to fire sales of assets that further damages the firm's viability and leads to greater losses for remaining creditors. Markets seeing this begin to withdraw business from the firm leading to its collapse, critically endangering those functions and relations that make the firm systemically important. Contagion, precipitated by one firm's obvious distress, may spread through the markets.

While preemptive and judgmental closure of banks has had practical problems, we still believe the concept of PCA and regulator judgment are important tools in SIFI resolution. Both could be incorporated into the bankruptcy code as it applies to SIFIs by giving regulators powers to intervene standing to petition the bankruptcy court to place the firm into Chapter 11.[23] As the creditors may have other views (preferring a market solution) and are the ones who stand to bear the losses, we recommend that at least the major creditors be given standing to participate in the decision.

[22] Washington Mutual was a simple, if huge, firm that found a ready buyer in JPMorgan. It involved virtually none of the complicating factors we discuss in this paper. IndyMac experienced a depositor run and was closed in July 2008. Most of its $32 billion in assets and $18 billion of insured deposits were placed in a bridge bank. By January 2009 the bridge bank had shrunk to $23.5 billion of assets and $6.4 billion of deposits. Most, but not all, of the bridge bank was sold to the newly charter OneWest Bank in March 2009.

[23] This is in addition to necessary supervisory powers including the ability to demand remediation (recapitalization, restructuring, etc) and limiting potentially adverse actions such as mergers and payment of dividends. These powers however fall outside the resolution process which is distinct and begins when legal control of the firm is transferred to the bankruptcy court or receiver.

Intervention

Bankruptcy gains time to make considered decision by means of stays, but it lacks the means of stemming a liquidity crisis. What is seen as the strength of bank insolvency—the ability to quickly dispose of most of the firm's assets and liabilities—is a two edged sword. FDIAs bank insolvency regime and the OLA under DFA both lack stays.[24] Thus, once the bank (SIFI) is closed and placed into receivership, the FDIC must act immediately to transfer the assets, liabilities, and those operating functions it intends to preserve into another operating entity—either an acquiring firm or a bridge institution. Where the regulators have time to find a buyer or buyers before the closure this is not a problem. However, finding buyers for SIFI's will be difficult due to their size and organizational and international complexity. In the event that there is a liquidity crisis, as we saw with Bear Sterns, Lehman, AIG, Citigroup, Wachovia and IndyMac, the regulators' hands will be forced and closure will happen before the ultimate disposition can be known. This in turn will force regulators and the FDIC to craft a resolution plan under extreme time pressure and limited information.[25] The likely result will be that the FDIC will move most of the SIFI into a bridge institution leaving only the long term creditors in the receivership. Once the liabilities, including not just debt but customer accounts, derivatives books, collateral positions, etc., are in the bridge institution they become the responsibility of the FDIC and for all practical purposes of the government; that is they become guaranteed. because liabilities are transferred in a bridge institution at par value, the absence of stays and the resulting decision making under time pressure will result in the "bailing out" of a large portion, likely a majority, of the firm's counterparties, be they systemically important or not.[26] Certain critically important liabilities such as customer accounts and derivative positions will need to be transferred as they cannot continue functioning in a firm in liquidation (the receivership as opposed to the bridge bank) as they might well do in a firm in reorganization. What the FDIC

[24] The exception is the ability to stay closeout of qualified financial contracts for one day.

[25] Living wills will only provide limited help. Ideally they will reduce some of structural complexity and ensure better information systems are in place. They cannot, however, solve the immediate problems of valuations and identifying potential buyers.

[26] The FDIC is limited to transferring liabilities into the bridge bank at their full value or leaving them in the receivership for later settlement at whatever recovery value is left at the end of the resolution. The FDICs powers under OLA to distribute losses to creditors as they see fit applies only to creditors who remain in the receivership. DFA includes a requirement to study the feasibility of imposing haircuts on secured creditors. Kaufman (20??) has proposed amending OLA to permit imposing a standard haircut on liabilities transferred into a bridge institution. Experience with the UK deposit insurance scheme, which provided less than 100 percent coverage, showed that such announced haircuts can exacerbate runs.

lacks is the ability to decide later, that is a sufficient time after resolution begins, and when information is more complete and alternatives have been considered, how much to pay all creditors.

Adding stays to the bank insolvency laws (FDIA) and OLA (DFA) will not be sufficient to solve this dilemma. The major problem stems from the fact that under these resolution regimes the firm is in liquidation. If a bank, it ceases to be chartered and cannot do business. If a non-bank, its counter parties may be prevented from doing business with a firm in liquidation for legal or prudential reasons. Some of the operating entities may lose their legal ability to operate due to the status of their parent. Stays can suspend collection of debts but they cannot force continued rolling over of funding or provision of services. Repos were designed to allow creditors to liquidate collateral and walk away in exactly these situations. Furthermore, U.S. bankruptcy court writ ends at the border; and foreign creditors, jurisdictions, and regulators are not bound by any such stays.

Bankruptcy does have the stay, but the major advantage is that in Chapter 11, the firm continues without a change in its legal status and the purpose is to restructure the firm as a going concern rather than to liquidate it. We have seen time and again firms in Chapter 11 continuing to do business with no interruption of their services. As long as the customers, employees, suppliers, and counter parties, except those creditors whose contracts are going to be restructured (and who are stayed), feel assured that the firm will continue operations and that they will not be adversely affected, there is no cause for them to run.

There are two caveats to this sanguine outlook. First there is the problem of financing during restructuring. Debtor in possession (DIP) financing was created to deal with this problem. Lenders who provide DIP (that is post-bankruptcy-initiation) financing are granted seniority over all other unsecured creditors. This usually suffices to attract the needed operating funds. However, financial firms rely on short term funding to a greater extent than most other corporations, SIFIs financing demands may be more than the usual providers of DIP financing (who tend to be SIFIs) are able to provide. Furthermore, SIFI failures are apt to occur at times of market stress when other firms are hoarding liquidity as we saw during the beginnings of the financial crisis. Thus, private DIP financing may be difficult to obtain. However, the government can also provide DIP financing. This is in principle no different than the pre-bankruptcy senior, secured loans provided to AIG and loans provided to banks under the Troubled Asset Relief Program (TARP). Such lending is in principle not different from the idea of lender of last resort, which has long been a key function of central banks. The wrinkle is that the principle of freely lending to solvent institutions against good collateral may have to be loosely applied. Solvency and the value of collateral (not unrelated) are difficult to determine in the midst of a financial crisis, and may be crucially impacted by the actions of the lender of last resort. However, unless the regulators have serious misjudged or there is little unsecured debt to be subordinated to the DIP loans these loans would be relatively safe, as experience has shown, at least for larger rescues.[27]

The second problem is that some counter parties, such as derivatives counter parties, or customers with accounts and posted collateral at risk may adapt a “better safe than sorry” approach and move their business elsewhere. For a SIFI, this is apt to lead to problems as derivatives and prime brokerage relations are two of the areas that are apt to be systemically important. The solution to both involves a de jure or de facto change in priority.

Derivatives can be handled by marking the positions to market as of the time of filing, but not closing out the positions. Marking to market needs to be done in any case to determine closeout values if the positions are closed under existing carve outs from stays.[28] The difference under our proposal is that the positions would stay open and the court rather than the solvent counter party (in the first instance) would make the determination of applicable values. Extending the idea of priority given to post-filing DIP financing, subsequent changes from the “reset” values of derivatives contracts would be given senior status or, if necessary, guaranteed by regulators. Post-insolvency gains would be netted against pre-insolvency losses (if these remain unpaid) in the final accounting. However, pre-insolvency credits would be netted against post-insolvency losses or added to post-insolvency gains only to the extent of general creditor

[27] Unfortunately, DFA has prohibited the FDIC, Treasury or Federal Reserve from making loans to targeted individual distressed financial firms, this despite the fact that virtually all of the SIFI-related loans were repaid. This will prove a costly constraint in future crises, until it is seen to be counterproductive.

[28] The special protections that derivatives enjoy in both bank insolvency and bankruptcy procedures are detailed in Bergman *et al* (2003). Bliss and Kaufman (2006) discuss the systemic risk reduction arguments for these carve outs and conclude that they may have increased systemic risk.

recovery values.[29] This will help to preserve market discipline on the part of derivatives counter parties while reducing their incentives to close out their positions. In contrast, transferring the derivatives into a bridge institution at par relieves derivatives parties of counter party credit risk and reduces market discipline.

The second issue is prime broker customer accounts and customer collateral. These have proven to be major problems, particularly in the case of Lehman, the one SIFI failure, but also in earlier smaller failures such as Refco in 2005. These experiences point to a critical need to restructure the handling of collateral and customer accounts. These are changes that can be addressed by markets with suitable encouragement by regulators, as was done by the New York Fed prior to the crisis to solve back office problems in the credit default swap market. Differences in relevant laws across jurisdictions need to be considered and addressed. Collateral recovery risks can be mitigated though third party trustees and prohibitions on rehypothication. Once the collateral risks to customers are reduced to a minimum their accounts can be guaranteed against operational losses, including collateral problems, by the government perhaps in conjunction with an insurance scheme to keep the customers from running, and in the process, destroying the going concern value of that part of the business.

The collateral and custodial problems that have arisen and which need to be addressed are instances of legal risk rather than credit risk. Arguments that market participants should be exposed to credit losses in order to encourage market disciple do not carry over to those any beneficial effects of imposing legal risks on market participants.

For both derivatives and prime broker customer accounts we have suggested a role for the government in providing assurances to systemically important counterparties (that is, counter parties in systemically important functions). We contrast this with the blanket implicit guarantees that would apply to all creditors and counter parties rolled into a bridge institution. By selectively applying government guarantees or loans to those parts of the firm that are seen as vital to the financial system while avoiding transferring the losses to other creditors, the government can limit its exposures, vis-à-vis guaranteeing everything in the bridge institution, avoid distorting

[29] This abstracts from the issue of collateral that the solvent counterparties may hold. Stays on liquidating collateral, though preferably only in the case of SIFIs where collateral liquidations would be likely to have adverse consequences (most collateral is held by other SIFIs), would have to be imposed to forestall both fire sale declines in value with concomitant mark-to-market adverse effects on other firms and to reduce incentives to closeout collateralized in-the-money positions.

creditor contractual rights, and prevent the adverse incentives that a firm-wide TBTF approach would have. Furthermore, this selective intervention has a precedent in the successful handling of AIG's credit default swap portfolio.

Disposition

Once the situation is stabilized, either by stays or transfers to a bridge institution, there is time to act with due deliberation. It may be necessary to quickly restore some liquidity to transaction accounts, broadly defined. This can be done by the court applying the concept of advanced dividends based on estimated recovery value as is allowed under the FDIA. This is currently allowed under the Bankruptcy Code.

Where it is in the public interest that certain creditors be paid off in full immediately, as was the case with CitiGroup's commercial paper counter parties, the FDIC or Treasury could undertake to make such payment and then subrogate those creditors' claims as is done with insured deposits. By subrogating the claims of time sensitive creditors and becoming a creditor in due course, the decision of who to protect becomes separate from the resolution problem. The courts can then proceed as normal, and the government can, after the actual recovery on their subrogated claim is determined, decide how to cover any short fall—whether to mutualize the loss across other financial institutions or to have tax payers cover the losses. Such a process would allow the courts to focus on maximizing recovery value, rather than deciding whether to protect systemically important parties (the government's function). This would minimize the distortions of legal priorities and contractual rights that might arise from having an administrator deciding winners and losers from among the creditors at hand.

A bridge bank certainly allows for an orderly and carefully considered disposition of those assets and liabilities that have been transferred into the bridge bank. The problem lies in the haste with which the decision as to what to transfer into the bridge bank and on what terms has to be made. These decisions have to be made by the government with imperfect information and without the input from creditors and counter parties.[30] Because under FDIA and OLA, the resolution authority must affirm or deny all contracts immediately, it is not possible to wait until

[30] The FDIC will hire investment bankers (competitor SIFIs?) and other advisors to help. But this may not be of much use. In the resolution of NextBank, which was placed into a bridge bank, the FDIC was told by the financial advisor it hired *[name]* that it would take 18 months to prepare a valuation to be used as the basis for a sale, due to the state of the firm's books.

valuations and restructuring options are clear before deciding what haircuts to give various creditors.

When the bankruptcy court assumes effective control of a firm it does not assume responsibility for any of the firm's contracts. The trustee has the power to disavow onerous executory contracts (e.g., leases) but failure to disavow does not imply payment in full later. The purpose of the stay is to allow for an orderly determination of how best to resolve to the firm, how to maximize the value of assets or preserve the going concern value of the firm for the collective benefit of all creditors, according to legal priority or voluntary negotiation. Not having to immediately affirm or disavow, buys time for the collection of information. Nonetheless, the court faces the same informational challenges that the FDIC would. Neither is omniscient.

The second advantage of bankruptcy over FDIC bank resolution is that the decisions are made with the input of various creditor groups, as well as by specialists appointed by the court to assist a financially disinterested and presumably politically independent trustee. The availability of time and the factoring in of multiple perspectives, both disinterested and those protecting their own interests, is more likely to approach an optimal resolution given the circumstance, than a rushed decision by a single agent operating alone who has neither a true financial interest nor is necessarily immune to political considerations.

Agency, Incentives and Other People's Money

Not much attention has been paid in this debate to the structure of relations between the interested parties in a SIFI resolution, the structure of incentives or principal/agent relations. This is important because, as we know from the study and experience of corporate governance, improperly structured incentives and relations can result in much higher costs to financial markets.

Without explicitly considering incentive and principal agent issues, bankruptcy has evolved procedures that, at least theoretically, minimize conflicts of interest. The bankruptcy judge, trustee and any advisors to the court are required to be financial disinterested. There has been until recently an expectation that judges would not be subject to political considerations.[31] Creditors who are at risk of similar losses are grouped together, select their own representatives,

[31] The bankruptcy proceedings of General Motors and Chrysler were heavily influenced by the administration and political considerations.

and vote in resolution plans. While managers have had considerable powers to control the resolution, a process exists for creditors to petition the court to remove management and replace it with a trustee of their own choice.[32] Finally there are no unrepresented third parties who will be asked to make contributions to cover the losses. The losses are borne by the existing creditors.[33]

In contrast bank insolvency and OLA create a complex of relations, incentives, and conflicts of interest. The FDIC

- Makes all decisions with little scope for judicial review and almost no transparency.
- Is an agency of the government and thus subject to political considerations.
- Is nominally the agent for the DIF and any OLA fund, but cannot be replaced by the "principals."
- Determines the payoffs to creditors through its decisions of who to protect (transfer into a bridge institution or sell to an acquirer), the net sale price in any P&A, and how to allocate payments to creditors in the receivership (in an OLA).
- May have other objectives such as processing a backlog of failed institutions quickly.

Note that the FDIC does not have a financial interest in the resolution and the losses are borne by others, and these others are involuntary participants (unless they close their businesses).

Unlike bankruptcy courts which are subject to review up to the Supreme Court, the FDIC is not subject to effective review of its decisions. There are some cases where creditors have appealed and won redress, but these are few and the presumption may be that "regulators know best." Material loss reviews mandated by the FDIA apply only to pre-closure decisions by the primary regulator. There is not mandated review of post-closure decisions by the FDIC which also impact the losses to creditors and those who must pay into the DIF and OLA pools.

The multiplicity of roles and absence of oversight places the FDIC in a position of deciding among conflicting interests, including its own, without the feedback that regular judicial and Government Accountability Office review would provide. It does not require a presumption

[32] This happened in the Chapter 11 bankruptcy of Bank of New England (the holding company).
[33] Of course there are many unrepresented parties, such as employees and the community in which the firm operates. These may suffer losses in a resolution—jobs, taxes, business—but they will not be assessed by the court to contribute funds.

of ill will on the part of an agent so encumbered with conflicting demands and incentives to conclude that this structure is likely to increase uncertainty and risks.

Conclusions

The OLA resolution regime legislated in Title II of DFA grants great, and some might say arbitrary, power to regulators to seize financial institutions that they deem to be systemically important and to the FDIC to liquidate the firm as it deems best after it is seized. The government and regulators assert that this would eliminate TBTF, lead to orderly resolutions of SIFIs, and restore market discipline. Government and regulators believed the FDIA bank insolvency regime provided the appropriate model for what to do. We have argued that Chapter 11 provides better basis for a SIFI resolution regime.

We have argued that it is not clear that resolutions conducted under OLA will be orderly. Constraining the solution to be liquidation will trigger legal consequences and adverse responses from other jurisdictions. Making decisions under time pressure and in a crisis are likely to lead the FDIC to assume greater financial burdens than may be necessary under a different resolution regime. This regime may prove so risky and potentially costly that regulators would be forced back on providing open firm assistance as they did during the recent financial crisis, except that this is now technically prohibited.

We next argued that there is nonetheless an important role in the resolution of SIFIs for the government and for some aspects of the FDIA insolvency regime that are not present in Chapter 11. It is likely that during a financial crisis only the government will be able and willing to provide the DIP financing needed to keep a SIFI going while it is being restructured. This expands the old concept of lender of last resort to reflect the exigencies of modern financial crises. With suitable statutory modifications, the government could have the ability to subrogate the claims of systemically important counter parties by paying them in whole or part, thus mitigating the uncertainties that lead to contagion. Finally, PCA in both its preventative and early initiation aspects provides a model for how to bring the government's oversight role to bear on the functioning of SIFIs.

Our proposal is to adapt Chapter 11, by adding standing for regulators through modifications to the grounds for filing a bankruptcy petition, with a concomitant clarification of the powers and obligations of the Federal Reserve to act pre-emptively to avoid insolvency, based on PCA. Once a SIFI is placed in modified Chapter 11, the Federal Reserve and Treasury would have standing through the subrogation of claims they believe to be systemically important and that they assume, and through the provision of DIP financing if private financing cannot be had. Creditors would have the same rights they have under Chapter 11.

Keeping the resolution of SIFIs under a bankruptcy framework, rather than an administrative process, will preserve legal rights, mitigate agency problems, make more certain the enforceability of contracts, reduce costs to direct and indirect creditors, and preserve market discipline. The key is to make only the minimally necessary changes to a bankruptcy process that has evolved over time and has been tested on firms both large and small, rather than throw out bankruptcy altogether and substitute a regime that has been designed for and applied primarily for small-to-medium size simple domestic banks.

Finally, we note that all of the problems that we have discussed apply as much to bank SIFIs as they do to non-bank SIFIs. It is therefore worth considering whether or not bank SIFIs might be best taken out of the bank resolution regime, for which they are as unsuited as are non-bank SIFIs and moved into the modified Chapter 11 process that we have proposed.

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