

Resolving Insolvent LCFIs: The Case for Reorganization

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Purpose

- Deconstruct distress/failure process
 - Note strengths and weakness of alternative regimes
- Propose a hybrid regime
 - Primarily based on bankruptcy
 - Selective incorporation of FDIA/DFA-OLA elements

Overview of Arguments

- Liquidation is often least desirable outcome
- Judicial bankruptcy court is best forum
 - For many reasons
- Government involvement should be “least necessary”
- Government financing and/or selective “bailout” are likely to be necessary
 - Need to separate “bailout” from resolution

Why SIFIs are Special

- Parts of SIFIs are special. Other parts are not.
- Critical functions
 - Cannot be replaced immediately
 - Continuity critical to market functioning
- Contagion
 - SIFI large player in concentrated market
 - Impact on other market participants
 - Replacing contracts (derivatives)
 - Price declines (fire sale liquidations)
 - Impact of losses on others

How SIFIs Fail

- During times of market stress (usually)
 - Many SIFIs may become fragile simultaneous
- Distress may become gradually apparent
 - When to intervene is difficult to determine
 - Intervention may itself lead to problems
- Final crisis develops rapidly through runs
 - Forces rapid decisions under adverse conditions
 - Living wills may be of limited help (too static).

FDIA/OLA Resolution

- Liquidation (w/ FDIA bank charter revoked)
- Administrative, not judicial
 - Administrator makes all decisions
- Creditors have no legal standing in process
- Effectively no stays
 - Affirm, transfer or disavow almost immediately
 - Bridge bank structure is available
 - Guaranteed by FDIC
- Opaque
- Limited judicial review

Bankruptcy Resolution (Chapter 11)

- Judicial (bankruptcy court)
 - Court approval for major actions
 - All creditors have legal standing
- Stays, except for qualified financial contracts
- Reorganization
 - Firm does not change legal status immediately
 - Intended to keep firm functioning
 - May transfer to liquidation (Chapter 7)
- Transparent
- Requires DIP financing by private sources

Dodd-Frank Act (DFA) Title II

- Orderly Liquidation Authority (OLA)
 - Modeled closely on FDIA bank insolvency resolution
 - Differences not important for analysis
 - FDIC is administrator
 - Protection above recovery value funded by assessments on large financial institutions
- Purpose
 - Orderly
 - End Too Big to Fail
 - End government “bailouts”

The Trouble with Liquidation

- Remaining SIFIs more concentrated (more SI)
- Most likely to trigger
 - Adverse (self help) responses from foreign authorities
 - (I.e., NOT orderly)
 - Termination of critical contracts and customer relations
 - Unless guaranteed, i.e., increases “bailout”
- Change of legal status likely to have unanticipated legal consequences

FDIA Resolution in Practice

- Most closures are announced with simultaneous P&A transaction
 - I.e., Resolution is structured before closure
 - This is why FDIA resolution is “quick”
 - Will not work if run develops
- Bridge bank is rarely used
- Liabilities not sold or bridged remain in receivership
 - Final resolution of receivership can take months or years.

Timing

- Pre-failure
 - Failure avoidance
- At time of failure
 - Dealing with immediate crisis
- Post-crisis
 - Deciding final resolution

Pre-Failure Intervention

- Bankruptcy laws do little
 - Management may file strategically
- FDIA
 - Early intervention (PCA)
 - Can “encourage” recapitalization or merge before resolution regime is triggered
 - Early closure
 - While bank has positive book value net worth
 - Does not happen in practice
 - Why?

At Time of Failure

- Immediate distress is usually specific
 - Wholesale funding, liquidity squeeze
 - Customer flight, collateral withdrawal
 - Losses on derivatives
- Many parts of firm remain sound
- Stopping immediate crisis
 - Address immediate systemic concerns
 - Need not involve resolving whole firm
- Limited/targeted intervention can suffice
 - E.g., AIG, Citigroup

At Time of Failure

- Crisis triage requires
 - Immediate action
 - Restoration of counter party confidence
 - Immediate provision of funds or guarantees
- Bankruptcy
 - Lacks means to make overnight decisions
 - Except stays
 - Court cannot provide funds or guarantees
- FDIA/OLA resolution
 - Can do both
 - But only in context of overall resolution

Post-Crisis Resolution

- FDIA resolution makes all major decisions at time of closure
 - What is transferred to bridge bank is effectively guaranteed
- Problem is timeframe for making these decisions
 - Forced by lack of stays
 - Little time to gather information
 - No standing for stakeholders limits information input
- Likely outcomes:
 - More is transferred to bridge than is necessary
 - For SIFIs finding buyer may be difficult
 - P&A at cheaper prices than is necessary

Post-Crisis Intervention

- Bankruptcy
 - Court assumes no financial responsibility
 - Stays allow time for development of solution
 - Information gathering
 - No fire sales
 - More parties with standing leads to more information and better considered decision
 - Restructuring need not involve sale of major portions
 - Does not lead to greater concentrations of SIFs
 - Greater ability to restructure liabilities

Government Involvement

- SIFI failure is going to involve at least temporary government commitment of funds
 - Losses may be mutualized later
 - Loans may be repaid
- Government may be only party able to provide bridge/DIP financing
- Objective should be to minimize commitment
 - Just what is necessary to arrest crisis
 - Minimize costs to loss bearers
 - Minimize moral hazard consequences

Incentive Issues in FDIA/OLA

- FDIC as administrator
 - “Agent” for institutions who will absorb losses
 - Actions determine losses to creditors
 - “Agent” for the public interest
 - Subject to political considerations/pressures
 - Threatening its independence
- May lead to problem for some/all “principals”
 - Agency theory
 - Experience in other areas
 - Regulators are only human

Incentives in Bankruptcy

- Court has no financial interest
- Court is less subject to political interference
- No separation of loss bearers and creditors
- Court cannot commit outside funds
 - Keeps direct costs from being externalized
- Creditors represent their own interests in proceedings

Proposal #1

- Adapt PCA framework for early intervention by regulators
 - Regulators can mandate changes prior to failure
- Regulators can petition court to initiate proceedings
- Requires
 - Powers to intervene outside of bankruptcy
 - Already in FDIA/DFA
 - Changes in bankruptcy
 - To grant standing to regulators

Proposal #2

- Separate triage from resolution
 - Regulators intervene only in systemically important functions as firm goes into reorganization
 - Regulators subrogate claims of creditors they protect
 - Need not be at par value
 - Regulators then become creditors in bankruptcy
 - This separates “bailout” and resolution decisions
 - Simplify structures and provide legal powers to enabled selective intervention in parts of SIFI
 - Living will process important here

Proposal #3

- Post-crisis resolution
 - Conducted as modified Chapter 11 reorganization
 - Creditors and government agree trustee
 - Management retained only if creditors agree and not disqualified for cause by regulators
 - Government provides DIP financing if necessary
 - Government given standing to
 - Represent public & international interests
 - Advisory role
 - But not to alter allocation of losses to creditors
- Chapter 7 option still available

Last Thought

- Are bank SIFIs more like
 - Small/medium domestic banks, or
 - Non-bank SIFIs?
- Should all SIFIs have the same resolution regime?

Thank you