Columbia Business School

Derivatives, Bankruptcy, and the Dodd-Frank Act

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Questions Addressed

- How are derivatives treated differently than most other creditors under the Bankruptcy Code?
- What is the “systemic risk” rationale for the “special treatment” of derivatives and does it make sense?
- What are the problems with treating derivatives differently?
- How does Dodd-Frank treat derivatives?
- What should be done?

Bankruptcy Code: Key Objectives

- Provide mechanism for collective action by creditors to realize value of firm's assets in an orderly manner.

- Retain the "going-concern-value" of any part of firm that can be operated profitably via a "reorganization."

- Adhere to "absolute priority" of claims and equal treatment of claimants in the same category.

The "Automatic Stay"

- Code prohibits self-help remedies by creditors ("…to collect, assess, or recover a claim against a debtor ….")
  - Cannot terminate or close-out contracts;
  - Cannot offset or net out any termination value, payment amount, or transfer obligation in connection with one or more contracts with debtor;
  - Cannot seize, use or sell margin or other collateral (even in the possession of creditor)

The Code and Derivatives (QFCs)

- *Qualified Financial Contracts*: repo's, interest rate and currency swaps, credit default swaps, and other derivatives.
- QFC counterparties are given "special treatment": safe harbors from the "automatic stay" and preference law, and therefore free to:

1. Close-out derivatives contracts
2. Offset or net out contracts with debtor
3. Seize, use, sell margin or other collateral
4. Not return "preferential" payments or additional collateral received within 90 days of bankruptcy filing.

Why This Special Treatment?

- Rationale offered by Congress and the International Swaps and Derivatives Association (ISDA):
  - To mitigate systemic risk that could be triggered by defaulting derivatives counterparties
  - Failure of a major counterparty could destabilize other counterparties and significantly reduce market liquidity.
- Permitting the prompt liquidation of an insolvent counterparty's position "minimizes the potentially massive losses and chain reaction of insolvencies that could occur."
- What is the evidence?

The LTCM Crisis: What Lessons?

- The special treatment of derivatives under the Code exacerbated, rather than mitigated, systemic risk by threatening a counterparty "run" on LTCM
  - Threatened a 'fire-sale" of LTCM's assets and extreme price changes, with knock-on effects on counterparties (especially banks)
  - Freezing-up of credit markets due to uncertainty of asset values
- Fed organized a creditor-bailout to facilitate an "orderly" unwind of LTCM
  - Neutralizing adverse systemic consequences of Code's special treatment of derivatives

Other Problems

- Shifts relative “prices” of credit: favors derivatives contracts versus other types of credit contracts, resulting in increased “short-term” borrowing by debtors and a more fragile liability structure (“hot money”).
- Reduces market (creditor) discipline by reducing incentive of sophisticated creditors to monitor counterparty risk, resulting in increased risk-taking.
- Has unjustified distributive effects among creditors.
- May have fed explosive growth of OTC derivatives.

Conclusions

- The Code's special treatment of derivatives is ill-conceived and may increase systemic risk by
  - facilitating a counterparty "run" on the failing firm causing the disorderly unwinding of its derivatives positions.
  - reducing creditor monitoring incentives and encouraging more risk-taking.
  - causing a more fragile liability structure
- See Edwards and Morrison, "Derivatives and the Bankruptcy Code: Why the Special Treatment?" Yale Journal on Regulation, 2005.

Current Views

- Harvey Miller: testified (re Lehman bankruptcy) that a "…massive destruction of value…" could have been averted if an automatic stay had been in place for derivatives contracts. (October 22, 2009)

- Mark Roe: "As Edwards and Morrison have insightfully pointed out [in their 2005 article] about … the derivatives counterparty priorities, 'systemic risk is a red herring,' ...," ("Bankruptcy's Financial Crisis Accelerator: The Derivatives Players' Priorities in Chapter 11, 2010, p. 16.)

Dodd-Frank 2010

- Title II (Orderly Liquidation Authority) creates a new failure procedure for liquidating non-bank financial institutions
  - Institutions designated in advance as SIFIs by the Financial Stability Oversight Council, and
  - *Any* financial company that the Secretary of Treasury determines to be in danger of default and whose default could potentially pose a threat to financial stability (LTCM, Enron, Lehman, AIG, and such).

Policy Goal of Title II ("déjà vu")

- Prevent a systemic collapse of financial system by government takeover and resolution of any financial company whose default would have serious adverse effects on U.S. financial stability.
  - Failure of such company may trigger the insolvency of counterparties and a "chain reaction" of insolvencies.
  - A "systemic risk" rationale similar to that used to justify the "special treatment" of derivatives under Bankruptcy Code.
  - AIG, Lehman Brothers, and Bear Stearns cited as examples.

New Powers and Procedures

- Government given authority to quickly put a distressed SIFI or other financial company firm into an involuntary resolution process *outside the bankruptcy law* that would otherwise apply.
  - Treasury Secretary must petition DC district court to appoint the FDIC as receiver.
  - Court has 24 hours to hold (1) a closed and secret hearing, (2) consider all evidence submitted, and (3) issue an order authorizing the receivership or a written opinion supporting denial of petition.
  - If court cannot accomplish this within the allotted time, petition is granted by operation of law.

Why FDIC Resolution Procedure?

- FDIC has considerable experience and expertise.

- FDIC resolution process has superior procedure for the treatment of "QFCs": automatic stay applies for *one day (a*fter which QFC counterparties are exempt from the automatic stay).

- FDIC has "deep-pocket" financing to facilitate unwinding of bankrupt firm due to its ability to obtain immediate financing from the U.S. Treasury.

Criticisms of FDIC Choice

- Absence of standard bankruptcy rules
  - Does not have to adhere to rules regarding absolute priority of claims and equal treatment of claimants in the same category.
- No judicial review
  - No provisions for creditors to contest receiver's decisions; no creditor votes
- Applying a one-day stay to QFCs will not cure the adverse systemic effects associated with the special treatment of derivatives.

Criticisms of FDIC Choice

- Lack of transparency of resolution process
  - Potential for Increased political influence and manipulation.

- Expansion of FDIC's resolution authority, together with its resolution history, may be viewed as expanding the federal safety net, resulting in less creditor discipline, increased moral hazard, and a greater risk of systemic instability.
  - Enhanced ability of FDIC to use government (taxpayer) funds to resolve failing institutions bolsters this view.

What Are the Alternatives?

- Amend the Bankruptcy Code to enable the timely and efficient resolution of distressed "systemically important financial institutions." (Hoover Institution's "Chapter 14" proposal)

- Create an ex post settling-up procedure that would maintain creditor rights and judicial review while still allowing regulators to deal rapidly with SIFIs.
  - Example: Judicial procedures for compensating owners of property expropriated by government for public uses.

Chapter 14 Proposal

- Procedure for resolution of companies with assets more than $100 billion(including subsidiaries) substantially engaged in providing financial services or products.
- Primary federal regulator could initiate the proceeding and would have the option of petitioning to have the FDIC appointed as trustee.
- Specialized panel of district court judges would oversee Chapter 14 cases.
- Automatic stay would apply to QFCs for a period of *three days* from the filing of bankruptcy petition.

Conclusions

- Treat QFCs counterparties under the Bankruptcy Code like other creditors.
  - Eliminate any exemption from the automatic stay in Chapter 14.
  - Eliminate exemption from the automatic stay in the Bankruptcy Code.
    - Dodd-Frank's adoption of provisions to regulate SIFIs and to adopt special bankruptcy resolution procedures for such companies effectively removes the "systemic risk" need to give special treatment to derivatives under the Bankruptcy Code.

Conclusions

- Adopt the proposal for a new Chapter 14 in the Bankruptcy Code but with an amendment to eliminate "special treatment" for derivatives.
  - Retains standard bankruptcy rules: absolute priority of claims and equal treatment of claimants in the same category
  - Provides greater transparency
  - Judicial review
  - With amendment eliminates systemic effects of special treatment of derivatives