

# Resolving LCFIs: The Case for Reorganization

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# Purpose

- Is Dodd-Frank resolution regime likely to achieve its goals?
  - Are unintended consequences likely?
- Advantages/disadvantages of alternatives
- Proposal for hybrid regime
  - Primarily based on bankruptcy
  - Selective incorporation of FDIA elements

# 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)
  - SIFI failures not isolated events
  - 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 Resolution for Banks

- Liquidation
- Administrative, not judicial
  - Administrator makes all decisions
- Creditors have no legal standing in process
- Effectively no stays
  - Affirm, transfer or disavow immediately
- Bridge bank structure is available
- Opaque

# 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

# Dodd-Frank Act (DFA) Title II

- Orderly Liquidation Authority
  - Modeled closely on FDIA bank insolvency resolution
    - Differences not important for analysis
  - FDIC is administrator
  - Losses funded by assessments on large financial institutions
- Purpose
  - Orderly
  - End Too Big to Fail
  - End “bailouts”

# 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 (e.g., IndyMac?)
- Bridge bank 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 force changes before resolution regime is triggered
  - Early closure
    - While bank has positive 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
  - Cannot provide funds or guarantees
- FDIA 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 or sold in P&A is effectively guaranteed
- Problem is timeframe for making these decisions
  - Forced by lack of stays
  - Liquidation leads to
    - Defensive actions by other jurisdictions
    - Counter party responses
- Likely outcome:
  - More is transferred to bridge that is necessary
  - Sales 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
  - 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 government commitment of funds
  - Losses may be mutualized later
- Objective should be to minimize commitment
  - Just what is necessary to abort crisis
  - Minimize costs to loss bearers
  - Minimize moral hazard consequences
- Government may be only party able to provide bridge financing

# Incentive Issues in FDIA

- FDIC as administrator
  - “Agent” for institutions who will absorb losses
  - Actions determine losses to creditors
  - “Agent” for the public interest
  - Is part of the government
    - Subject to political considerations/pressures
- 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

# International Dimension

- US resolution process cannot bind foreign jurisdictions
- Liquidation will trigger foreign proceedings
  - Ring fencing and “self help” may be disruptive/costly
- Reorganization has better chance of cooperation/coordination with foreign courts/regulators

# 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
    - 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

# Proposal #3

- Post-crisis resolution
  - Conducted as normal Chapter 11 reorganization
  - Government provides DIP financing if markets cannot
  - Government given standing to
    - Represent public & international interests
    - Advisory role
    - Not to alter allocation of losses to creditors

# 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