

*Resolving a Large, Complex
Financial Institution:
Domestic & Foreign Challenges*

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Complex Financial Institutions**

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The problem

- ✓ An international financial conglomerate is likely to be managed in an integrated fashion along lines of business without regard for
 - Legal entities (perhaps several 100)
 - National borders (perhaps 100)
 - Functional regulatory domains (perhaps 3 or more per country)
 - With substantial intra-group transactions that are difficult to disentangle

In the event of financial distress...

- ✓ May have conflicting approaches to bankruptcy
- ✓ Across regulators within countries
 - Objectives
 - Obligations
 - Powers

In the event of financial distress

(cont'd)...

- ✓ Across countries, differences re:
 - Objectives
 - Who initiates the process
 - Treatment of foreign creditors
 - Which law applies
 - Carveouts

In the event of financial distress

(cont'd)...

- ✓ Ambiguity about the allocation of business units to legal entities & regulatory domains raises questions re:
 - Who allocates assets to legal entities?
 - Who allocates legal entities to regulatory authorities?
 - Who allocates legal entities to bankruptcy authorities, if different?

In the event of financial distress

(cont'd)...

- ✓ Which jurisdiction will be the insolvency jurisdiction?
 - Chartering jurisdiction?
 - Seat of management?
 - Principal place of business?
 - Largest concentration of assets?
 - Largest concentration of creditors?
- ✓ At a minimum, formidable coordination and information sharing challenges

Conflicts are not just potential

- ✓ Even the US has multiple regimes
 - A failed insured depository institution is subject to FDIC procedures
 - Constrained by least cost resolution requirements of FDICIA (1991)
 - Domestic depositor preference law (1993)
 - A failed broker/dealer is subject to Securities Investor Protection Act
 - An Edge Act subsidiary could be liquidated by the Fed
 - A failed insurance subsidiary may be subject to special state-specific procedures
 - The parent holding company & most non-bank entities subject to bankruptcy proceedings
 - RICO proceedings may trump other procedures

Glimpses of int'l dimensions of problem from a series of earlier disasters

✓ **Herstatt**

- Disruption of clearing and settlement
- Power of entity that initiates bankruptcy to control distribution of losses
- Settled 35 years later: Courts move slowly, markets at the speed of light

✓ **Drexel Burnham Lambert**

- Reputation risk: even transparent, solvent securities dragged down
- Necessity of official intervention in unwind
 - Evidence of tendency to grab now and litigate later

More precursors...

✓ **BCCI**

- Conflicts of laws and procedures
- Ring-fencing of assets
- Ability of criminal code to trump all priorities

✓ **LTCM**

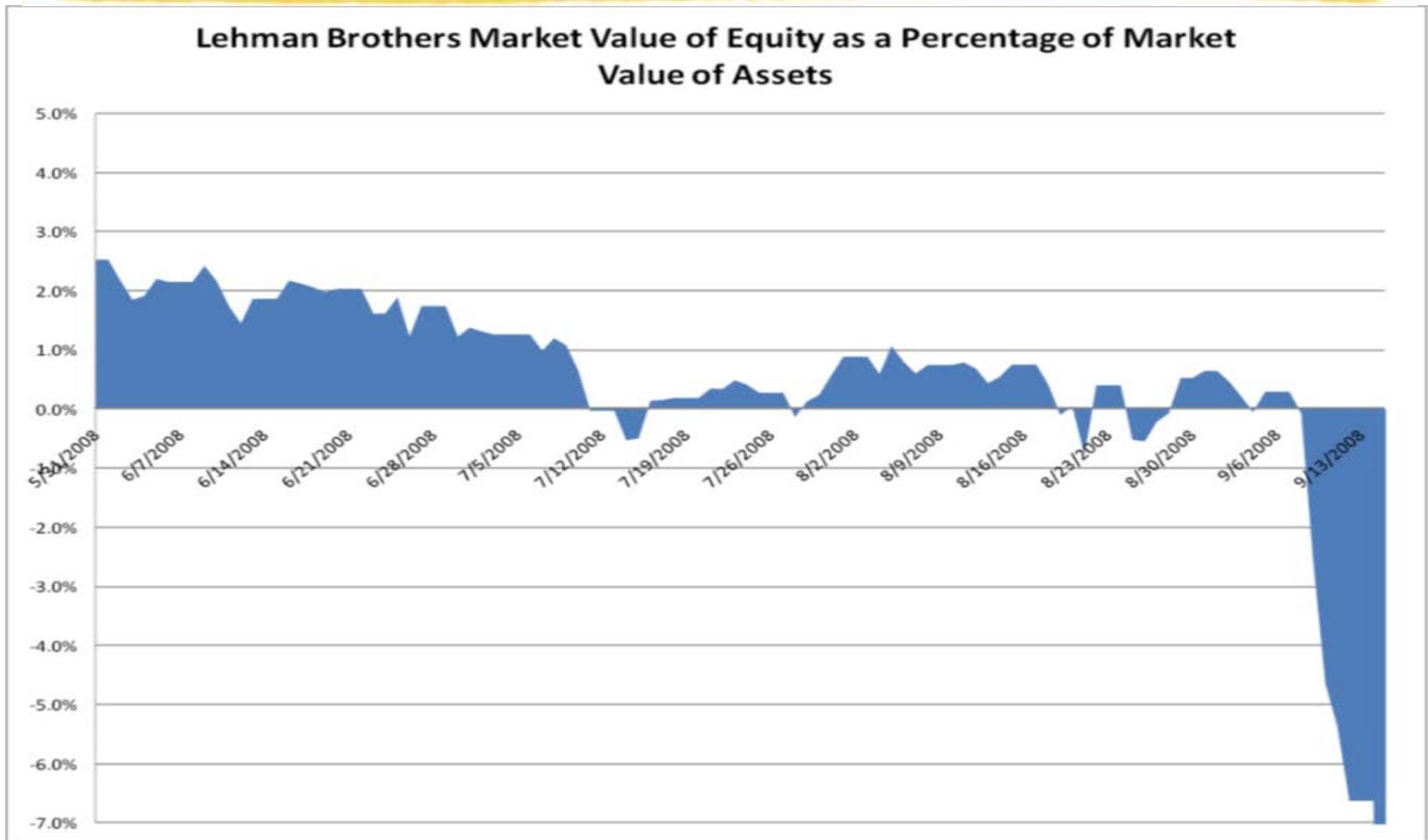
- The darker side of close-out netting
- Convinced the NY FED that if didn't meet margin calls would cause a cascading sale of illiquid assets in illiquid markets, bringing down the system

More precursors...

✓ Barings

- Demonstrated
 - Lack of coordination among functional regulators
 - Lack of coordination among home and host country regulators
 - The danger of contagion through exchanges
 - The potential systemic impact of applying a judicial stay to an active trading firm

These precedents + market evidence raise questions about why Lehman appeared to a bolt from the blue



The Bankruptcy of Lehman Brothers (LB) highlighted these & additional problems

- ✓ Centrally managed with minimal regard for legal entities that must be resolved in the event of bankruptcy
 - Treasury operations centralized in LB Holdings International (LBHI)
 - Followed zero cash balance policy. At end of local business day all cash swept into LBHI. At beginning of local business day returned to subsidiaries
 - Huge intra-firm transactions
 - Many solvent subsidiaries rendered bankrupt because of lack of cash
 - Data operations decentralized – 2,300 servers, 6,700 programs, many proprietary
 - Sold broker dealer and asset manager rapidly because bleeding human capital, but acquiring firms now own data and software
 - London administrator can still not verify assets

Differences in Restructuring (US) vs. Administration (UK)

- ✓ Chapter 11 liquidation of LBHI in US
 - Debtor remains in possession & is authorized to continue its operations
 - Can seek DIP financing to continue operations
 - Provides stay on past debts
- ✓ Administration of UK LB UK Holdings Ltd
 - Licensed insolvency practitioner took over, more focused on trying establish and realize value for creditors
 - No authorization for super-priority rescue financing
 - Does not provide for stay, but does provide moratorium on legal action

LB (cont'd)

- ✓ London administrator, who is continuing to unwind Enron, says LB is at least 10x more complicated
 - Predicts creditors will not be repaid for years & the amount they will recover is entirely unclear
- ✓ Mingling of hedge fund collateral with LB's own funds led to collapse of several hedge funds.
 - FSA permitted mingling of client funds and firm's own funds
- ✓ LB demonstrated that international corporate complexity is itself a source of systemic risk

In the absence of credible bankruptcy procedures...

- ✓ Ill-considered bail-outs
 - Too big to fail
 - Too complex to fail
 - Too opaque to fail
 - Too interconnected to fail
- ✓ Moral hazard exacerbated
 - Dulls incentives to demand disclosure
 - Weakens market discipline
- ✓ Inefficient crisis management procedures may undermined crisis prevention efforts

Tom Huertas: "Too big to fail is too costly to maintain."

How much government support has been provided?

Andrew Haldane estimates that the US, UK & the euro area have provided **\$14 trillion** – equivalent to about 25% of World GNP & that's before the \$400 bn for the GSEs

(\$ Trillions)	UK	US	Euro
Central Bank			
- "Money creation"	0.32	3.76	0.98
- Collateral swaps	0.30	0.20	0.00
Government			
- Guarantees	0.64	2.08	>1.68
- Insurance	0.33	3.74	0.00
- Capital	0.12	0.70	0.31
Total (% GDP)	74%	73%	18%

Source: Bank of England *Financial Stability Report*, June 2009. Figures for UK updated to November 4th 2009.

Notes: (1) Exchange rates used: FSR Euro / US dollar exchange rate of 0.710. Sterling / US dollar exchange rate of 0.613.

(2) Money creation includes both monetary and financial stability operations.

How should the costs of bailouts be measured?

- ✓ Not just cost to taxpayers
- ✓ Not just increased incentives for risk-taking
- ✓ Not just strain on public finances
- ✓ But also waste of resources in sustaining huge, zombie-like institutions that warehouse large amounts of dodgy debt rather than serving as useful intermediaries
 - Delays economic recovery
 - Delays creative destruction that is heart of dynamic capitalism

Response from G-20: The Rapid Resolution Plan (RRP)

- ✓ Agreed to at G20 Pittsburgh Summit: “Systemically important financial firms should develop internationally-consistent firm-specific contingency and resolution plans.”
- ✓ Also Known As
 - Recovery & Resolution Plans
 - Wind-Down Plans
 - Living Wills
 - Funeral Plans
- ✓ Section 165 D of Dodd-Frank requires the Fed & FDIC to develop a “Resolution Plan,”
 - Short on details

But long on ambition Senator Dodd:

“Never again will we face the kind of bailout situation as we did in the fall of 2008 where a \$700 billion check will have to be written.”

- ✓ A dangerously naïve view of what has been accomplished or
- ✓ A totally unwarranted faith in implementation by regulators
- ✓ A delusion

RRP Should Accomplish Several Different Objectives

1. Protect taxpayers from necessity of bailing out SIFIs
2. Make clear to SIFIs, the market in general, and creditors and counterparties in particular, that no SIFI need be bailed out
3. Force SIFIs & their boards to anticipate and internalize some of the spillover costs that might occur
4. Make supervisor/resolution authority aware of what it must be prepared to do
5. Make college of supervisors/resolution authorities aware of what they must do to minimize spillovers

Begins with identification of a “SIFI”

- ✓ Awkwardly
 - Some believe they should be identified ex ante
 - Some believe that they should not
 - Some believe that they cannot
- ✓ This makes it very difficult to regulate them differently from other financial institutions
- ✓ RRP cannot be implemented unless identified early and publicly
 - Counter moral hazard by making it very unpleasant to be a SIFI

How Should Systemically Important Financial Institutions be Identified?

✓ By characteristics, not by charter

- Degree to which systemically important
 1. Size relative to economy
 2. Complexity as measured in terms of # of affiliates
 3. Complexity as measured in terms of operational & financial interdependencies
 4. Performance of systemically important functions
 5. Number of regulatory agencies or counts that would have to approve a resolution of group
- Degree of vulnerability to a shock
 1. Amount of leverage employed by group
 2. Vulnerability to liquidity shock
 3. Alignment between subsidiary structure and lines of business
 4. Resolvability of SIFI as measured in estimate time it would take to resolve

DF Process to declare nonbank FI a SIFI to be resolved under Title II

- ✓ Sequential triggers may make difficult to exercise authority quickly
 - Team of designated federal agencies must recommend receivership to Sec. of Treasury
 - Sec. of Treasury after consultation with President may then recommend firm be placed in receivership. Must make many findings
 - In default or danger of default
 - Adverse effect on financial stability
 - Bankruptcy would not be appropriate and no private sector solution
 - Resolution would mitigate adverse effects
- ✓ Need consent of board (who must be removed)
- ✓ If no consent case undergoes 24 hour review in DC District Court
 - Can the court possibly assimilate findings
- ✓ All banks over \$50 bn in total assets are automatically SIFIs

A RRP Should Start with Assumption of Insolvency

1. Must map lines of business into the corporate entities that must be taken through some sort of bankruptcy process
 - The purpose and location of each separate entity must be justified to the board and supervisors
2. Must identify key interconnections across affiliates
 - Financial interdependences such as cross-guarantees, stand-by lines of credit, or loans
 - Or operational interdependencies such as IT systems, liquidity and risk management systems that would impede separation of one entity from another

RRP(cont'd)

3. Must maintain a virtual data room containing all information an administrator or resolution authority would need to make an expeditious resolution such as
- The location and methods used to maintain and record transactions
 - How daily reporting is used for monitoring and managing risk
 - Specific risk exposures including products, sectors, counterparties and countries
 - Account numbers with settlement banks
 - Businesses and crucial cut-off times
 - Regulatory permissions and business units carrying them out

RRP(cont'd)

4. Must identify key information systems, where they are located, and the essential personnel to operate them
 - Plans must be made to make systems available to all entities during the resolution process through a bankruptcy-remote structure
 - If outsourced, must demonstrate the contracts are insolvency proof

RRP(cont'd)

5. SIFI must identify any activities or units it regards as systemically relevant and demonstrate how such units could continue to operate during a RRP by ensuring they are bankruptcy remote & easily transferred
6. SIFI and systemic infrastructure must identify how SIFI can disconnect from highly automated systems such as exchanges, clearing houses and custodians without creating serious knock-on effects

RRP(cont'd)

7. SIFI must identify precisely the procedures it would follow in a RRP. If no resolution authority
 - Identify potential bankruptcy counsel
 - Identify potential bankruptcy administrator
 - Notifications to be made & who will make them
8. The RRP must be updated annually or more often if a substantial merger or restructuring creates additional complexity

The Role of the Board

- ✓ Management of SIFI must demonstrate to board that plan is complete and feasible
 - An efficient wind-down plan should be seen as much a part of good governance as a strong business continuation plan
 - When insolvency approaches, the board has a fiduciary duty to creditors who will be the new owners
 - Lack of a plausible wind down plan should be considered a de facto indication of failure to fulfill fiduciary duty

The Role of the Primary Supervisor

- ✓ Then primary supervisor/resolution authority must examine the plan in detail and certify that the plan is feasible and the estimated time for wind down is plausible
- If plan is not sufficiently swift or plausible the regulator should be empowered to compel SIFI to redraft plan. The SIFI may choose to
 - Simplify its corporate structure,
 - Improve its IT infrastructure or
 - Spin-off activities that cannot be unwound without intolerable spillovers

Implementation Risk: Corporate complexity will be tolerated

- ✓ Citi is a \$1.8 trillion company in 171 countries with 550 clearance and settlement systems and 2,435 majority-owned subsidiaries
 - Without simplifying its corporate structure, how can it possibly be resolved in an orderly manner
 - In general, SIFIs have 2.5 times more subs than non-financial corporations of comparable size
 - And a higher proportion in tax havens
 - Regulatory arbitrage and tax avoidance seem clear motives

The International Dimension

- ✓ RRPs should be equally useful to courts or to resolution agency
- ✓ But DF stops at the water's edge
- ✓ Where the bankruptcy approach may suffer a disadvantage is in international coordination
- ✓ Simply no tradition of international cooperation across national courts to preserve going concern value
- ✓ Resolution agencies are at least making a start

FDIC Claims an Advantage in this Regard Because

- ✓ As receiver of top tier corporation
 - Can exert better control of cash flows throughout the group preventing defaults or winding down non-essential operations
 - Can negotiate with foreign regulators to minimize preemptive or ex post ring-fencing
- ✓ Is negotiating MOUs
- ✓ Is pushing through FSB for reforms in foreign laws
- ✓ Is a direct participant in crisis management groups

Huge Harmonization Challenge

<u>Fully Harmonized</u>	<u>Current Reality</u>
Identical objectives	Set in national statutes and vary widely
Identical scope	Differs widely across regulators
Identical powers	Powers based on national statute, bankruptcy law and deposit insurance
Identical risk preferences	Objectives typically have a domestic focus
Identical approach	Different emphasis on inspection, prudential standards, etc.
Skills and willingness to use powers	Skills vary widely as do enforcement traditions

Even EMU

- ✓ Under substantial prodding from the IMF and the European Commission
 - Has failed to create a cross-border resolution mechanism
 - Countries refuse to credibly commit to what approach they would take to a large bank failure
 - Example of Fortis is not promising
- ✓ Ring-fencing may be inevitable under current conditions
 - If so, consolidated supervision is a foolish waste of time

Conclusion

- ✓ We cannot (and should not) make SIFIs failsafe
- ✓ But we should make them safe to fail