The History and Rationale for a Separate Bank Resolution Process

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Everyone recognizes the need to have a credible resolution regime in place for financial companies whose failure could harm the entire financial system, but people disagree about which regime is best. The emergence of the parallel banking system has led policymakers to reconsider the dividing line between firms that should be resolved in bankruptcy and firms that should be subject to a special resolution regime. A look at the history of insolvency resolution in this country suggests that a blended approach is worth considering. Activities that have potential systemic impact might be best handled administratively, while all other claims could be dealt with under a court-supervised resolution.

Lehman Brothers’ filing of a petition to reorganize under Chapter 11 of the Bankruptcy Code in September 2008 was a watershed event in the recent financial crisis. The ensuing market turmoil led to heated debate about whether bankruptcy is an appropriate mechanism for resolving the insolvency of a systemic financial company. On one side of this debate are those who believe that with some adjustments the judicial process of bankruptcy is a viable option for handling the failures of most types of financial firms. On the other side are proponents of an administrative process akin to that used to resolve insured depository institutions.

In one sense, the Dodd–Frank Consumer Protection and Wall Street Reform Act of 2010 settled this debate. Notable among its reforms is the Orderly Liquidation Authority, a process for resolving systemic nonbank financial companies that parallels a Federal Deposit Insurance Corporation (FDIC) bank receivership. In another sense, Dodd–Frank has fueled further debate: It has made orderly liquidation an exceptional power by mandating that financial companies create and maintain plans for resolution under the Bankruptcy Code; it has also ordered studies of possible reforms to the Code that would allow for more orderly resolution of systemic financial companies through bankruptcy.

Government policy for resolving insolvent financial institutions is at a crossroads. There is little dispute about the importance of designing and implementing a credible resolution regime for systemic financial companies. However, there is considerable debate about the best method for doing so. When deciding between bankruptcy and an FDIC-like administrative process to resolve nonbank financial companies, it is natural to ask why bank failures were ever handled differently. Today, there seems to be general agreement that banks’ payments-related functions (from issuing bank notes and taking checkable deposits to clearing and settling payments) require special treatment, but it was not always so. This Commentary seeks to inform the debate by examining how resolution policies for failed banks evolved in U.S. history.

Bank Resolutions in the Pre-Bankruptcy Era
The United States did not enact a permanent federal bankruptcy code until the end of the nineteenth century. Although there had been many attempts to enact such a code, these were either defeated in Congress or, if enacted, were soon repealed. Hence, for much of U.S. history, banking and commerce operated in a world without any federal bankruptcy code. For corporations, including banks, resolution had to take place by other means.
Before enacting the National Currency Act of 1863 and the National Banking Act of 1864 (“the Acts”), the federal government was not in the business of chartering banks (the First and Second Banks of the United States being notable exceptions). Banks were state-chartered corporations, subject to oversight by the state in which they operated; most were designed to self-liquidate when their charters expired, generally after 20 years. However, banks were different from other corporations in one particularly important way: they issued bank notes, which were an important part of the nation’s money supply. Deposit-taking was another vital activity of banks during this era, but failure to redeem bank notes was the primary driver of failed-bank resolution policies.

For state-chartered banks, the resolution process usually entailed a determination of insolvency whose main criterion was the bank’s ability to redeem its notes in a timely fashion. Failure to do so would result in the state redeeming the bank’s notes and then asking a state court to revoke the bank’s charter, forcing it to shut down operations. If the court determined that the bank was insolvent, a receiver would be appointed by either the court or the banking commissioner. Over time, states began to adopt balance-sheet insolvency as a separate criterion for closing a bank, but the resolution process remained largely unchanged.

With the exception of banking law’s focus on issuing and redeeming notes, banks’ insolvency resolution process was not all that different from that of other corporations. In most cases, they were identical: Before New York pioneered a special bank-insolvency regime, some states used the same resolution mechanism for all corporations. Even after New York enacted its law, failed banks were resolved like any other corporation, except that note redemption provisions applied to them. This would change in one important way, however, when the federal government began chartering banks at the height of the Civil War.

The establishment of a national bank system and a uniform national currency gave rise to the first noteworthy distinction between banks and nonbank corporations in the process of insolvency resolution. National banks would be chartered by the Office of the Comptroller of the Currency, a subagency of the U.S. Treasury and as such, it is unclear whether states had the power to resolve them. The absence of federal insolvency law meant that the Acts needed to provide a process for winding up the affairs of national banks that were forcibly closed or voluntarily shuttered their operations.

As we noted earlier, a primary objective for establishing the national banking system was to create a uniform national currency. This required that national bank notes be uniformly backed by eligible U.S. government bonds and that there be a seamless process for redeeming and retiring the notes of failed banks. National banks that could not redeem their notes in a timely way would have their charters revoked by the Comptroller of the Currency and be subject to an administrative receivership process. The focus on note redemption as a solvency test and the use of a receivership to resolve bank failures mirror the resolution process for state-chartered banks.

Somewhat paradoxically, in 1867, three years after the federal bank resolution mechanism went into effect, a federal bankruptcy law that applied to banks was passed. Although the 1867 Bankruptcy Act does not explicitly discriminate between state and national banks, subsequent court rulings would determine that it did not apply to national banks. Though it lasted only a few years before being repealed, the federal mechanism for bankruptcy resolution established in the 1867 Act required court oversight and was used to resolve a number of state-chartered banks. Unlike its state-chartered counterpart, a national bank’s closure would receive no judicial oversight under the 1863 and 1864 Acts.

It would be 35 years after the establishment of the national banking system before the nation would have a permanent bankruptcy code. By that time, over half of the states had bank insolvency regimes in place. Congress would exclude banks from the bankruptcy code because mechanisms were already in place at both the state and federal levels:

> There are now in force very stringent laws for the control and liquidation of national banks. The government is responsible for the currency issued by these banks, and hence in the event of their failure ought to control their liquidation. They are, therefore, exempted from the operation of the act.²

Insurance companies, railroads, and any other companies for which a well-established, state-level resolution mechanism was in place were also excluded from bankruptcy.

**New Deal Reforms**

On the heels of massive bank failures, the Banking Act of 1933 established a system of federal deposit guarantees and created a new entity, the Federal Deposit Insurance Corporation. The FDIC would be charged with insuring depositors’ bank accounts and would (for national banks and most state-chartered banks) operate and administer the receivership of failed banks; this was expanded in the late 1980s to include all FDIC-insured depository institutions.

By protecting depositors, federal deposit guarantees would prevent runs and provide for the stability of the payments system because demand deposits had become an increasingly important part of the narrow money supply—that is, money held largely for transactions purposes—the equivalent of M1 (coin and currency, checkable deposits, and travelers checks) today. Bank notes were not a concern in Depression-era banking legislation because Federal Reserve notes had largely replaced them as payment instruments. In 1934, the first year of the FDIC’s operations, national bank notes made up only 17 percent of all currency in circulation, 4 percent of the narrow money stock, and only around 2 percent of bank liabilities. Demand deposits, on the other hand, accounted for 79 percent of the narrow money stock and more than 65 percent of the liabilities of FDIC-insured commercial banks.
At this time, there were two noteworthy changes in the bank resolution process. First, the receivership’s focus shifted from redeeming notes to minimizing the costs of the failure for the deposit insurance fund. The second change was the placement of bank receivership authority in the FDIC, the largest creditor of an insured bank’s estate. While out of step with practice under bankruptcy law, this novel arrangement would be consistent with the objective of bank resolution policy—that is, minimizing the losses to depositors and the FDIC when a bank failed.

Depression-era banking reforms were not enacted in a vacuum. As the banking bills were being debated in Congress, legislative attention was also directed toward revamping the Bankruptcy Code. Years of debate culminated in the Chandler Act of 1938, which continued to exclude banks, savings and loans, and insurance companies. This is not surprising, perhaps, when one considers that the financial reforms of the 1930s sought to segregate banking from other financial activities. Further embedding the closing and resolution of insolvent banks as regulatory functions by placing bank receivership under the FDIC is consistent with the 1930s banking reforms aimed at partitioning the financial system.

Recent Developments in Bank Resolution Policy
Over time, with periodic guidance from Congress, the judicial system of bankruptcy and the administrative process of bank resolution evolved as separate regimes, with differing objectives. Reorganizing and preserving a firm’s value remain the centerpiece of the Bankruptcy Code for corporations. Ironically, although bank insolvency law and bankruptcy have remained separate resolution regimes, financial innovation, coupled with legislative and regulatory reform, has increasingly blurred the distinction between banks and nonbank financial companies. As a result, a firm’s organizational form, not the types of activities or functions it undertakes, would be the determining factor in whether bankruptcy law or bank insolvency law would apply when it failed.

Probably the most dramatic changes in the objectives of bank insolvency resolution were responses to the regional banking and savings and loan debacles of the 1980s. Policies governing the closing and resolution of insolvent banking companies became increasingly driven by the political economy of bank supervisory policy. The rescue of the Continental Illinois Bank and Trust Company of Chicago in 1984 marked the first time insolvency resolution policy would be driven by concerns of systemic risk—the birth of the unofficial policy known as the too-big-to-fail doctrine.

In response to the banking and thrift problems of the 1980s, Congress enacted several pieces of legislation, culminating in the Federal Deposit Insurance Corporation Improvement Act of 1991. This legislation encompassed reforms in the bank supervisory infrastructure, including the powers and objectives of the bank-insolvency-resolution authority. The goal of minimizing a bank failure’s cost to the deposit insurance fund was replaced by the least-cost resolution mandate, which directed supervisors to minimize total costs, not just those to the FDIC fund. In addition, to limit systemic spillovers, lawmakers added prompt corrective action to the objectives of the bank resolution regime and an exemption to the least-cost rule (the systemic risk exemption).

Most recently, in the wake of the rise and fall of the shadow banking system, Congress took a step toward broader use of the administrative bank resolution process to resolve large systemic financial companies. Title II of the Dodd–Frank Consumer Protection and Wall Street Reform Act of 2010 added the Orderly Liquidation Authority to the FDIC’s set of receivership powers (see Fitzpatrick and Thomson, 2011). Although the Authority was meant to be an extraordinary power, it was another step toward broader use of the administrative bank-insolvency resolution process in an increasing set of nontraditional bank activities.

Policy Implications
In recent history, banks have been treated differently from other firms, even other financial firms. The banking industry has long had its own set of supervisory agencies as well as a separate process for closing and winding up insolvent banks. Maintaining the integrity of the payments system required a predictable set of procedures for handling the insolvency of banking companies. The absence of a permanent bankruptcy code in the United States, which persisted until the end of the nineteenth century, necessarily led to the development of a bank-specific insolvency resolution system for banks. Congress has chosen to keep bank insolvency resolution within the bank regulatory system, distinct and separate from bankruptcy.

The emergence of “parallel” or “shadow” banks has led policymakers to reconsider the dividing line between firms that should be resolved in bankruptcy and those that should be subject to a special resolution regime. Understanding what unique features of a depository institution make bankruptcy an unsatisfactory option for insolvency resolution is important for understanding what reforms to the Bankruptcy Code are needed to effectively resolve insolvent nonbank financial companies—or whether bankruptcy can be a satisfactory option for insolvency resolution for some types of firms. Banking history suggests that payments-related activities and functions are where such an inquiry should start.

Finally, the history of bank insolvency law and bankruptcy law suggests a careful reconsideration of whether the choice of an insolvency resolution regime should be made at the firm level or the activity level. One reasonable lesson from the history of insolvency resolution is that we should consider a blended approach—in which only the truly systemic activities of a bank or nonbank financial firm are handled administratively and all other claims are dealt with under a court-supervised resolution.
Footnotes
1. See, for example, the New York Free Banking Act of 1838, one of the earliest and most influential sets of banking regulations. Section four of the Act grants the New York comptroller the power to seize collateral backing and redeem all of a bank’s notes after notice from the comptroller and the bank’s failure to redeem its notes, but the Act said nothing about unwinding the bank once its notes had been redeemed. Federal legislation was heavily influenced by New York law, but by 1876 it would include a balance-sheet insolvency test. (A. T. Huntington and Robert J. Mawhinney, 1910, Laws of the United States Concerning Money, Banking, and Loans, 1778–1909, National Monetary Commission, Washington, D.C.: Government Printing Office; pp. 327–360.)

2. The Need of a National Bankruptcy Law, S. Rep. No. 182, 54th Cong., 2d Sess. 51 (1897). (Memorial from the National Convention of the Representatives of the Commercial Bodies presented by Mr. Warren. Arguments before the Senate in support of the Torrey Bill.)

Recommended Readings


