

The Case for an Orderly Resolution Regime for Systemically-Important Financial Institutions

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Summary

The Obama Administration has proposed that the government be given special authority to resolve a nonbank financial institution if its failure could have serious systemic effects. This new Orderly Resolution Regime (ORR) is needed because the existing regime confronts US economic and regulatory authorities with two very unappealing options: allow the institutions to go into corporate bankruptcy, thereby accepting the associated systemic risk, or to weigh in (often over a weekend) with a large government rescue.

Arguments that this new ORR will be over-used and will increase moral hazard are weak for four main reasons. First, the expansion of the (de facto) official safety net that occurred during this crisis took place without any ORR in place. Second, appropriate safeguards have been proposed that should limit its use. Third, as proposed, it is not clear that an ORR will necessarily weaken market discipline and, finally, while the Systemically Significant Financial Institution (SIFI) distinction is often described as similar to the Government Sponsored Entity (GSE) distinction, the latter actually represents a unique set of circumstances.

The chief counter proposal to the ORR, an amendment of the existing corporate bankruptcy code, suffers from four potential flaws. First, corporate bankruptcy is focused almost exclusively on the interests of creditors of the firm, with little concern for “third party” effects such as systemic risk. Second, the restrictions on the claims of creditors inherent in bankruptcy will likely result in counterparties (and employees) refusing to do business with a financial institution either in or approaching bankruptcy. Third, court proceedings are likely to move slowly, as opposed to administrative proceedings like an ORR. Finally, whereas the ORR would permit the government to intervene in various ways before the firm “fails,” traditional corporate bankruptcy would not.

Other important considerations include the proposal that any ORR should have a dual mandate (both to seek a least-cost resolution and to minimize adverse spillover effects), provide a system of prompt-corrective-action (PCA), and cover any SIFI not subject to the FDIC’s resolution authority. The decision to discuss whether the ORR should be used should be initiated by the firm’s prudential regulator or the market stability regulator, with the decision to activate the ORR vested in the Treasury, subject to certain additional requirements. Any ORR should be funded from an assessment and on a pre-arranged line of credit from the Treasury, with the FDIC acting as the operational resolution authority.

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Introduction

The Obama Administration has proposed – as a fundamental part of its comprehensive program for financial regulatory reform – that the US Government be given special authority to resolve a nonbank financial institution if its failure could have serious systemic effects.² The FDIC has long had such resolution authority for banks.³ Under the proposed new resolution authority, the US Government would be allowed to place a failing, Systemically-Important Financial Institution (SIFI) into conservatorship or receivership, and then to administer its orderly reorganization or wind-down. Any financial institution – be it a securities firm, an insurance company, a hedge fund, a private equity firm, or a bank holding company – which is not now subject to the resolution authority of the FDIC would be covered if its failure poses systemic risk.

In this paper, we provide, in section two, answers to three key questions about such a new Orderly Resolution Regime (ORR) for SIFIs: (i) why is a new ORR for SIFIs needed; (ii) will a new ORR be over-used, and will it increase moral hazard; and (iii) could the resolution of failed SIFIs be handled better by amendment of the existing corporate bankruptcy code than by creating a new ORR? Finally, in section three, we offer recommendations and raise some unresolved issues for the design of a new ORR for SIFIs.

² “Financial Regulatory Reform: A New Foundation,” US Treasury Department, Washington DC, June 17, 2009 (referred to hereafter as US Treasury White Paper). Such resolution authority for systemically significant financial institutions might also be introduced as free-standing legislation; see, for example, the draft bill (“Resolution Authority for Systemically Significant Financial Companies Act of 2009”) sent to the US Congress in late March, 2009, by the Treasury Department.

³ The FDIC was made the sole receiver for national banks in 1933 under the National Banking Act. In 1987 (under the Competitive Equality Banking Act, CEBA), the FDIC received additional authority to charter a national bridge bank as an alternative to receivership or conservatorship. Under the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991, the FDIC was granted expanded authority to serve as the statutory receiver for state-chartered banks.

Three Key Questions about a New Orderly Resolution Regime for Systemically-Important Financial Institutions

Why is a new ORR for SIFIs needed?

We need a new ORR because the existing regime for dealing with failing SIFIs has shown itself to be unworkable. Under the existing regime, the impending failure of a SIFI confronts US economic and regulatory authorities with two very unappealing options. Option 1 is to allow the SIFI to go into corporate bankruptcy (Chapter 11 or Chapter 7), and to accept the systemic risks associated with the inflexibility and narrow focus of this traditional bankruptcy process (i.e., the adverse effects on financial markets of creditor stays, lack of attention to third-party effects of insolvency, potentially long delays in obtaining approval of reorganization/liquidation plans, fragmented resolution authority for complex financial institutions, and inability to intervene prior to insolvency). These risks are inherent in the bankruptcy process because the bankruptcy code was not designed with the challenges of resolving today's large, interconnected, global financial institutions in mind. Option 2 is to weigh in (often over a weekend) with a large government rescue of the failing SIFI so that the financial institution does not default on its obligations and the bankruptcy outcome can be avoided. But such a government rescue often has to be conducted under severe constraints that threaten its effectiveness and raise its financial and political cost. Frequently, the rescue has to be put together so quickly that crisis managers have little time to think through the best resolution strategy, or to carry out appropriate due diligence on the failing institution, or to search out the most suitable purchaser, or to benefit from an eventual rebound of fire sale prices for the failing firm's assets.

The crisis conditions of the past year have also shattered the illusions that financial institutions (other than banks themselves) are so resilient that we needn't worry about their failure, and that such failures are devoid of adverse systemic implications. We have seen that investment banks – like commercial banks – can be subject to “runs,” that even collateralized borrowing may be not available during a crisis to financial institutions perceived as insolvent or illiquid, and that large losing bets in the derivatives market can bring a previously AAA-rated and diversified giant nonbank financial company to its knees. It is likewise instructive: that the five largest US investment banks at the start of this crisis have failed, been pushed by market forces to be acquired, or have elected to become bank holding companies

regulated by the Federal Reserve (Fed); that the Fed's unprecedented extensions of guarantees and liquidity assistance during this crisis have been directed in large part at the nonbank financial sector (where about half of aggregate US credit flows originate); and that concerns about the systemic effects of an AIG bankruptcy have led both the Bush and Obama Administrations to put over \$180 billion of public funds toward its rescue.

The global turmoil that followed the bankruptcy of Lehman is likely to make the bankruptcy option for SIFIs seem even less attractive to policymakers going forward – even if much of that turmoil may have reflected the market reaction to the treatment of Lehman's bondholders as an unexpected change in the unwritten "rules of the game" on resolution, rather than the inter-connectedness of Lehman per se. And contrary to what is sometimes suggested, there are SIFIs left. Suppose, for example, that GE Capital, or Metropolitan Life, or Goldman Sachs, or one of our largest "traditional" bank holding companies were, at some point down the road, to run into serious financial difficulties. Given their size and inter-connectedness in global markets, who among us would feel comfortable recommending that they go into Chapter 11 or Chapter 7 "free-fall" bankruptcy or, alternatively, that the US Government decide over a weekend to mount a massive bailout package.

The proposed ORR for SIFIs offers a "third way." It would give the authorities an additional crisis management tool that combines three desirable characteristics of an effective resolution regime for SIFIs: (i) the ability, when necessary, to continue temporarily the core operations of the firm (possibly, after transferring the assets and liabilities of the failing SIFI to a government-operated "bridge bank"), so as to minimize market lockups and fire sales of assets; (ii) good moral hazard properties (docking shareholders, changing management, and paying off some senior creditors at estimated recovery costs), so to minimize the incentives to repeat the excesses of the past at government expense; and (iii) considerable "flexibility" for the government conservator or receiver to manage the resolution process, so as to minimize damage to the wider economy and to lower taxpayer costs.⁴ Such a resolution regime could contribute critically to the successful management of any future SIFI failures.

⁴ The conservator or receiver of the firm under the ORR for SIFIs would have authority to take control of the operations of the firm, to sell or transfer all or part of the assets of the firm to a bridge institution or other entity, to transfer the firm's derivative contracts to a bridge institution, and to renegotiate or repudiate certain of the

Won't a new ORR for SIFIs be over-used, and won't it increase moral hazard going forward?

We think not – for at least four reasons: the current safety net, appropriate safeguards, market discipline, and the uniqueness of GSEs.

The current safety net

First, it is important to recognize that the huge expansion of the (de facto) official safety net that has occurred during this crisis took place when there was *no* ORR for SIFIs. An extraordinary economic and financial crisis was underway and the consequences of throwing banks and SIFIs into resolution/bankruptcy were much feared. Part of the policy response to the crisis was a wholesale and ad hoc expansion of official guarantees and of government recapitalization for financial institutions (including the TARP), along with unprecedented use of the Federal Reserve's emergency lending authority (that is, Section 13(3) of the Federal Reserve Act for extensions of credit to individuals, partnerships, or corporations in "unusual and exigent circumstances").⁵ Recall too that the FDICIA resolution regime for banks was created after the US savings and loan crisis, precisely because of the negative reaction to the "regulatory forbearance" and large public bailout costs that occurred when there was no ready and permanent alternative resolution framework either to corporate bankruptcy or to large ad hoc bailout operations for thrifts and banks. The current situation for SIFIs is analogous to the pre-FDICIA situation for banks. The relevant question is whether an ORR will be overused and will increase moral hazard *relative* to the alternative of no ORR.

firm's contracts, including contracts with certain of its employees. In addition, the conservator or receiver would be authorized to borrow from the Treasury when necessary to finance its activities (with the proceeds of an assessment on bank holding companies and perhaps other financial institutions used to repay the costs of any such loans from the Treasury). See the US Treasury's White Paper.

⁵ The US Treasury's White Paper argues (p. 74) that the federal government's responses to the impending bankruptcies of Bear Stearns, Lehman, and AIG were "... complicated by the lack of a statutory framework for the avoiding the disorderly failure of nonbank financial firms..." and that in the absence of such a framework, "... the government's only avenue to avoid the disorderly failures of Bear Stearns and AIG was the use of the Federal Reserve's lending authority."

Appropriate safeguards

The Obama Administration’s plan for an ORR for SIFIs contains safeguards that should limit its use. Specifically, the plan calls for the US Treasury to activate this regime only after determining that the firm is in default or in danger of defaulting, that failure of the firm and its resolution under otherwise applicable law would have serious systemic effects, and that use of the ORR would avoid or mitigate these effects. Moreover, the Treasury can invoke resolution authority only after consulting with the President and only upon written recommendation of two-thirds of the members of the Federal Reserve Board and two-thirds of the members of the FDIC Board.⁶ These are the same kinds of safeguards against excessive use that are in the systemic risk exemption for bank resolution under FDICIA. This systemic override for banks under FDICIA has been only rarely used. The Treasury also emphasizes that bankruptcy should remain the dominant tool for handling the failure of a bank holding company when concerns about systemic risk are not paramount. As for the charge that, once the government intervenes, it will be very reluctant to pull out, we would note that FDIC resolution authority has been used much more frequently to sell or liquidate failing banks than to rehabilitate them; we would expect the same to be true of an ORR for SIFIs.

Market discipline

It is not obvious (at least to us) that designating a limited set of nonbanks as “systemically important or significant,” or as “Tier 1 FHCs” (financial holding companies), will automatically weaken market discipline, or give these firms an unfair comparative advantage over nonbanks not so designated, or turn the designated institutions into de facto GSEs .

As suggested earlier, there is nothing in the proposed ORR for SIFIs that prevents the government receiver from forcing a change in management, or from leaving common shareholders of the resolved firm with little or no recovery, or from paying off creditors and counterparties at estimated recovery cost rather than at par; to the extent that these stakeholders of the resolved firm are not “made whole” by the resolution process, market discipline should continue to operate. Also, even if some or all debt holders of the resolved firm are paid more than they would be in the case of bankruptcy, this higher

⁶ If the firm is a broker-dealer, invoking resolution requires a written recommendation of two-thirds of the SEC.

payment may be justifiable if the ORR produces a higher value for the firm than would a liquidation under fire sale prices. Moreover, one should not exaggerate the positive influence of market discipline in the run-up to this crisis. After all, creditors and counterparties of Bear Stearns, Lehman, and AIG did not exert much discipline until near the end – despite well-publicized problems that existed months before those institutions’ demise or intervention.

Yes, if some financial institutions are regarded as subject to the ORR, they may be able (at least initially) to fund themselves more readily and on better terms, and they may attract customers who highly value stability and certainty. But is also true that even without official designation as SIFIs, many market participants will regard large and highly interconnected nonbank financial institutions as “too big to fail” (TBTF) and those nonbank financial institutions will reap the benefits linked to that market expectation. Just as relevant, the Obama Administration’s financial regulatory plan calls for financial firms designated as Tier 1 FHCs to be subject to more stringent prudential measures and to a higher capital requirement (and perhaps to a special assessment to help fund an ORR).⁷ These measures may compensate for much or all of the competitive advantage that designation as an SIFI confers.

On a broader level, there is also a trade-off to be considered in the (joint) decision to announce who is / is not an SIFI, and to subject the designated institutions to tougher prudential standards. If the government identifies the SIFIs ex ante, then it incurs any (additional) moral hazard risks linked to that designation, but it also retains the opportunity to reduce the risk of failure by subjecting the designated SIFIs to tougher regulation/supervision. Alternatively, if the SIFIs are identified only ex post (by the government’s rescue efforts), any moral hazard reduction associated with a policy of “constructive ambiguity” is retained, but the government gives up the option of “internalizing the externalities” associated with de facto TBTF (leading to the popular criticism that the present regime privatizes the gains from excessive risk-taking but socializes the losses). After the massive injections of government funds during this crisis to avoid the failure of financial institutions, it appears that the greater risk may lie in pretending ex ante that certain large and inter-connected nonbanks may not be TBTF but then acting as if they are TBTF once failure is imminent.

⁷ Note that, if more stringent prudential measures and/or higher capital requirements are to be imposed on a set of nonbanks, it would be very difficult to keep the identity of those institutions confidential. Moreover, any measures must be carefully calibrated to avoid undue competition or economic harm.

The uniqueness of GSEs

Fourth, the GSEs have long had a unique status among nonbanks because of their hybrid public-private structure, because of the huge size of their balance sheets, because of the important role of housing and home ownership in the economy and in the American Dream, and increasingly because of the large holding of GSE obligations by foreign governments and foreign central banks. The systemic consequences of allowing Fannie or Freddie to fail are of a different order of magnitude than those for other nonbanks. We do not see how designating some nonbanks as SIFIs turns them into de facto GSEs. Plans for the future of the GSEs – including the ultimate resolution regime – will have to be sui generis.

Could the resolution of failed SIFIs be handled better by amending the existing bankruptcy framework (perhaps by adding a new chapter 16 for financial institutions) than by creating a new ORR?⁸

On a theoretical level, it is possible to think of a new special chapter of the bankruptcy code that would be specifically designed for SIFIs and that would contain many of the components of an ORR. In that case, the differences between the proposed new ORR and “bankruptcy” would be, of course, much smaller than at present (almost by definition). On a practical level, however, differences between traditional corporate bankruptcy and special resolution regimes for financial institutions are so fundamental as to make us highly skeptical about taking the bankruptcy route for SIFIs. If there are concerns about the US Treasury plan, they would be better addressed by amending the ORR than by creating a new “fish out of water” chapter of the bankruptcy code.

A comprehensive analysis of the differences between corporate bankruptcy and special resolution regimes for financial institutions has been put forward by Bliss and Kaufman (2006).⁹ For our purposes, it is sufficient to summarize four of the distinctions that they emphasize: priorities, stays, management of the process and proactive action.

⁸ It is not always clear whether those who prefer handling the impending failure of a systemically significant financial institution within the bankruptcy code want a new chapter only for nonbank financials, or whether they would also favor dismantling the existing FDIC resolution regime for banks. We assume that the FDIC regime for banks is retained.

⁹ Robert Bliss and George Kaufman, 2006, “US Corporate and Bank Insolvency Regimes: An Economic Comparison and Evaluation,” Federal Reserve Bank of Chicago Working Papers. No. 2006-01, Chicago: Federal Reserve Bank of Chicago, January.

Priorities

Special resolution regimes for financial institutions typically give considerable attention to the impact of resolution on the wider economy and on financial markets. Put in other words, beyond their immediate objectives (e.g., achieving “least-cost resolution” for the deposit insurance fund, subject to legally-mandated claimant priorities, under FDICIA), such special resolution regimes give weight to “externalities.”¹⁰ In contrast, corporate bankruptcy is focused almost exclusively on the interests of creditors of the firm, with little concern for “third party” effects. A regime that ignores externalities and “systemic” effects seems ill-suited to resolving “systemically important” nonbank financials. This difference between the two regimes reflects the assumption that failure of a bank is potentially more costly for the broader economy than is the failure of a normal corporation. We do not claim that SIFIs are just like banks. But we do argue that large and interconnected nonbank financials engage in many of the same financial activities (and sometimes at similar scale) as do their large and interconnected bank counterparts, that the failure of SIFIs can generate adverse spillovers for the broader economy, and that the resolution of SIFIs raises many of the same challenges as the resolution of systemically-important banks. In this sense, SIFIs are closer to systemically-important banks than they are to many non-systemically-important nonbanks. Put in other words, we think it makes more sense to place a Morgan Stanley or an AIG in a resolution regime that is similar to that which would be used for a Bank of America or a Citibank, than to put it in the Chapter 11 or Chapter 7 bankruptcy regime that would be used for an IBM or an AOL.

Stays

A second distinction between the two regimes is in the treatment of creditor stays. Such stays contribute to the coordination of creditor claims and prevent creditor runs. Although the corporate bankruptcy code has some exemptions from stays for derivative contracts, other creditor claims are subject to such stays and they are a key element in Chapter 11 reorganizations. In contrast, in special resolution regimes for financial institutions, the ability of the receiver to impose such creditor stays is strictly limited. One of the reasons why there is often such pressure to complete over a weekend the

¹⁰ For example, Bliss and Kaufman (2006) note that the FDIC, when conducting asset sales, is directed to “... fully consider adverse economic impact.”

purchase and assumption of a failing, systemically important financial institution is to avoid the creditor stays (and its domino effects) that would otherwise be triggered if that institution chose (or were forced) to go into traditional Chapter 11 or Chapter 7 bankruptcy.¹¹ Financial institutions that are not able to transact continuously with their short-term creditors are not likely to be able to stay in business long. The currency of the realm in financial markets is “trust,” and if that trust is lost by restrictions on the claims of creditors, then counterparties (and employees) may soon refuse to do business with a financial institution in a bankruptcy process (or even at an earlier stage, causing the business to “fail” even if it is not yet insolvent or even illiquid). Operating a railroad or an airline under Chapter 11 bankruptcy is one thing. Operating a SIFI under Chapter 11 is quite another.

Management of the process

Difference number three relates to the overall “flexibility” that the receiver/trustee has under the two regimes. That flexibility is much more limited under corporate bankruptcy because such bankruptcies are conducted in federal bankruptcy courts, each creditor group must vote to approve the plans of the management and receiver/trustee, and the court must approve the decisions taken by the receiver/trustee. The potential for long time delays is thus considerable. Contrast this with special resolution regimes for financial institutions. As Bliss and Kaufman (2006) explain, these are considered to be administrative proceedings; creditors, management, and shareholders can file claims and request information, but they do not participate in the decision-making process. In effect, once the receiver is appointed, the receiver runs the show. Assuming that adequate financing is available and that the resolution protocol is respected, the receiver then has considerable discretion in managing the resolution of the failed institution. This flexibility cum discretion can be very helpful in minimizing adverse systemic effects or in limiting losses to the taxpayer.

Suppose, for example, that the failed SIFI is a bank holding company with bank, securities, and insurance subsidiaries. Absent an ORR for SIFIs, the resolution process could be highly fragmented and inconsistent – as the FDIC resolved the bank subsidiary, SIPIC resolved certain of the securities subsidiaries, several state insurance departments sought to resolve the insurance subsidiaries, and the

¹¹ Creditor stays can also make it impossible to implement dynamic hedging strategies that call for continuous access to markets.

bankruptcy court resolved the holding company and all its other subsidiaries. But the receiver of the bank holding company under a new ORR for SIFIs could potentially avoid much of these inefficiencies and competing claims by coordinating the resolution process under a central plan. In a similar vein, the receiver of the new ORR might be able to obtain better prices for the firm's assets by transferring them to a bridge bank and then selling them at a later date when market conditions had improved.

Alternatively, the receiver of the new ORR could decide that speed of resolution was essential to limiting adverse spillover and confidence effects of the impending failure and hence could decide to sell the SIFI to a healthier institution over the weekend.

As we know from other “rules versus discretion” issues in economics, granting policymakers wide discretion is a two-edged sword. It can produce good results if the policymaker uses the discretion wisely, but can lead to bad outcomes if that discretion is exercised in a biased or incompetent manner. The discretion/flexibility accorded to a government receiver of an ORR for SIFIs would be no different. But if there are concerns that the government receiver will abuse his discretion – say, because some of his decisions on modification of contracts will be politically motivated, or because he may aim to enhance his influence by seeking to rehabilitate too many SIFIs, or because he will not have sufficient experience dealing with resolution of SIFIs – there are ways to limit that discretion without discarding all the other potential advantages of an ORR.

A few examples illustrate the point. The receiver will have less discretion if the funds he has on hand to manage the resolution process are not unlimited. Although the US Treasury proposal puts no limits on the funds that the ORR could borrow from the Treasury, the Congress could decide to allocate a given initial amount but require the ORR to get Congressional authorization for any additional amounts. Similarly, if the aim is to provide some protection against capricious or politically motivated decisions by the receiver, the bill creating the ORR could subject some decisions of the receiver to ex post judicial review, and the fundamental strategic decisions (e.g., to sell the SIFI) to an inter-governmental collaborative process. And if the concern is inexperience, the Congress could insist that the government agency managing the ORR for SIFIs be one that has demonstrated experience in operating special resolution regimes; the FDIC has such experience – albeit with banks. The first two of these

amendments to an ORR would reduce the “flexibility” and “discretion” of the receiver, but they may still be justified on a wider cost-benefit calculus.

Proactive action

Last but not least, whereas special resolution regimes for financial institutions permit the government to intervene in various ways before the firm “fails,” traditional corporate bankruptcy does not. Thus, for example, FDICIA lays out a set of “prompt corrective actions” (PCA) that a bank (and the FDIC) should take once bank capital falls below certain pre-specified thresholds. Unless the systemic risk exemption is activated, FDICIA can also require the receiver (FDIC) to close the bank when it still has positive net worth. None of this is possible under traditional corporate bankruptcy. Again, we see this as an advantage for an ORR because such corrective pre-failure measures could increase the institution’s chance of avoiding failure – or at least reduce the cost of such failure if it occurs. Admittedly, the PCA tripwires in FDICIA have not been very effective in this crisis, but improvements to the design of the PCA mechanism – in light of lessons learned during this crisis – should be possible.¹²

Recommendations and Unresolved Design Issues for an ORR for SIFIs

If the existing bankruptcy/resolution regime for SIFIs is broken and a new ORR is needed, then the number one operational question is: what should this ORR for SIFIs look like? We think the outline of an ORR for SIFIs provided in the US Treasury’s recent White Paper represents a good start on how such a regime might be constructed and how it might operate.¹³ In what follows, we offer recommendations on the design of such a new ORR, along with some unanswered questions about its operations. We focus on the ORR mandate, its coverage, a PCA component, initiation of the process, funding, selection of the operational resolution authority, the resolution protocol, and international considerations.

1. Mandate – *The ORR for SIFIs should seek to resolve SIFIs in a way that seeks to minimize both adverse systemic effects on the financial system and the US economy, as well as the cost of resolution to the US taxpayer.*

¹² See “Principles for Reforming the US and International Capital Framework for Banking Firms,” US Treasury Department, Washington DC, September 3, 2009.

¹³ See pp.76-78 in the US Treasury White Paper.

Commentary – Although a single mandate would provide clearer direction, a dual mandate is more appropriate for such an ORR. Because the resolution authority will be dealing only with systemically-important institutions, least-cost resolution (as under FDICIA) cannot be the sole objective; minimizing adverse spillover effects on the financial system and the US economy is also very important. Likewise, ignoring the cost of resolution to the taxpayer would be misguided given the large size of institutions to be covered by this regime, the need to limit the moral hazard effects of government intervention, and the desire to avoid sticking taxpayers with a large bill for problems that were not of their own making. In seeking to avoid systemic risk, the resolution authority will likely face three types of problems: taking action at the resolved institution (e.g., a total wipeout of shareholders) can cause pressure at other institutions; defaults to creditors and counterparties of the resolved institution can cause other institutions to fail because of their actual and perceived exposure to the resolved firm; and uncertainty about the form and extent of the resolution could cause a systemic freezing of payments and/or credit. The impact of the resolution on taxpayers will depend on many factors, including: whether the resolved firm is liquidated rather than rehabilitated or sold, how much financial assistance the government provides, the form of the government’s assistance (e.g., guarantees versus cash liquidity), and the prioritization of the government’s claim.

The mandate should also be broad enough to provide the resolution authority with sufficient flexibility to achieve its objectives in the face of considerable diversity and uncertainty across types of financial institutions and economic circumstances. We would also hope that the resolution authority would use this flexibility to address the TBTF problem when doing so would not conflict with its main objectives; for example, it may be easier to break up a very large failing nonbank into smaller parts when the failing institution is being resolved than by confronting TBTF with “size limits” or via a change in the antitrust laws.

2. Coverage – *Any financial institution, the failure of which poses systemic risks, and which is not subject to the FDIC’s resolution authority under FDICIA, should be covered by the new ORR for SIFIs. All institutions covered by the ORR would also be subject to whatever tighter prudential standards, including higher capital requirements, deemed appropriate for “systemically-important” financial institutions, i.e.,*

Tier I FHCs – be they banks or nonbanks. There is a strong argument that these standards should be applied on an individual institution basis, rather than arbitrarily and automatically to all SIFIs.

Commentary – The selection of SIFIs to be included in the new ORR should be based mainly on size and inter-connectedness – regardless of the institution’s charter (although banks would still be covered under the existing FDIC regime).¹⁴ We don’t think the government should have to disclose (or be irrevocably bound by) the specific quantitative metrics it uses for these criteria. Some would go further and argue that it will be difficult in advance to develop specific criteria that would cover every institution that should be subject to special resolution and, hence, that the government should have discretion to include some institutions that don’t meet the usual criteria. To reflect changes in economic weight and circumstances over time, it must be possible to add/delete institutions from the list.

3. Pre-insolvency intervention – *A system of prompt-corrective-action (PCA), modeled broadly on the PCA for banks under FDICIA, should be created as part of the ORR to improve the odds – both that insolvency can be avoided by corrective actions and, failing such correction, that intervention is undertaken before the cost of the resolution becomes so large. In designing such a PCA for SIFIs, the FDIC or the Treasury should be given the tasks of evaluating the performance of PCA for banks during this crisis under FDICIA, determining whether different tripwires (than used for banks under FDICIA) would be appropriate for SIFIs under a new ORR, and recommending if and how a minimum capital ratio and other financial metrics should be used as the trigger to initiate the resolution process. In addition, consideration should be given to requiring all SIFIs to file and keep current “living will plans,” explaining how they would be wound down in case of failure. In that case, such plans would be deemed confidential supervisory material and exempt from public disclosure.*

Commentary – Despite the problems that PCA tripwires for banks have encountered during this crisis, a PCA framework is still probably the best protection one has against excessive regulatory forbearance and against intervening far too late in the game to avoid a large loss to taxpayers. It is not clear, however, whether the existing capital-based tripwires need just some minor modification, or whether a more wholesale revamping is needed (especially for SIFIs). Some would argue, for example, that the

¹⁴ Leverage may also be important.

principal regulator should be authorized to intervene whenever there is a significant deterioration in the financial condition of the institution, but that neither the conditions that motivate such intervention nor the corrective actions themselves should be specified in advance; others would regard such a move to greater discretion as destroying the whole motivation and effectiveness of a PCA framework. More thought should be given to how to recognize when an SIFI has “failed.” Does a firm fail when its capital falls to a pre-specified threshold, or when the common shareholders are wiped out and management is replaced, or when, in addition, preferred shareholders and debt holders are wiped out or suffer a significant haircut, or when there is an actual liquidation? The preparation of “living will plans” could help to reduce the uncertainty about the resolution process for SIFIs and should also motivate these firms to consider more carefully the adequacy of their cushions and defenses against extreme stress in financial markets.

4. Initiation of resolution – *The decision to discuss whether the ORR should be used for a particular SIFI could be initiated by the firm’s prudential regulator or the market stability regulator (the Federal Reserve). We also agree with the view taken in the White Paper that the decision to activate the ORR for an SIFI should be vested in the Treasury, after consulting with the President and only upon the written recommendation of two-thirds of the members of the Federal Reserve and FDIC boards; the primary regulator of the resolved institution (if not the Treasury, the Fed, or the FDIC) should also have to give his written recommendation.*

Commentary – Because the institutions to be covered by the new ORR are all required to be “systemically important,” it makes sense to have the input and views of all the relevant government departments in deciding whether to invoke the ORR for a particular failing firm (as opposed to allowing it to go into Chapter 11 or 7 bankruptcy). In addition to their systemic responsibilities, the Treasury, the FDIC, and the Fed also represent the most likely sources for financing the resolution.¹⁵ One potential problem with requiring so many government bodies to “sign off” on invoking the ORR is that a divergence of views among them will prevent them from acting, and that such inaction will prove costly. One way around this problem would be not to require unanimous agreement but instead agreement by

¹⁵ A line of credit from the Federal Reserve would probably be considered only if all other options for financing the resolution were not available.

the Treasury and either the Fed or the FDIC. The counter-argument to this proposal is that the primary risk is that resolution authority will be invoked too often when it is not needed, and that the unanimity requirement will limit its use to cases that are clearly “systemically important.” Some would also argue that the decisions of the Federal Reserve on these matters are apt to be less politically influenced than those of the Treasury, and hence, a Federal Reserve sign-off is essential to maintain the requisite objectivity. And if the FDIC is chosen to be the resolution authority, it may seem odd to prevent it from voting on whether such the resolution regime should be activated.

5. Funding for the new ORR – *The new ORR for SIFIs should be funded from two sources: an assessment on the designated SIFIs and a pre-arranged line of credit from the US Treasury.*

Commentary – We favor a dual financing structure for the new ORR because the amounts needed are likely to be too large (in the hundreds of billions of dollars) to be satisfied by (exclusively) assessing a limited number of SIFIs. It seems preferable therefore to have the SIFIs bear the loss up to a designated amount, and to arrange a government line of credit for the ORR’s remaining financing needs. Some argue that any limit on the funding for a new ORR would be artificial and arbitrary, that requiring Congress to approve funding beyond an initial allotment would subject the financial system and the US economy to unacceptable risks of delay (if the request for additional funds were turned down), and that the only guideline should be to provide the resolving authority with whatever funds it sees as necessary to meet the ORR’s objectives. The counter-argument is that there is a tradeoff between reducing systemic risk on the one hand, and upholding accountability and limiting excessive discretion on the part of the resolution authority on the other, and that the accountability advantages of a limit on Treasury funding outweigh any increased systemic risk. There is also a debate about ex post versus ex ante assessments on SIFIs. One view is that any Treasury funding should be recouped from ex post assessments so that recourse to the Fed’s emergency lending authority can be avoided. Others argue that ex ante assessments are to be preferred because ex post assessments would not be risk-sensitive, would be subject to a “falling domino” problem (that is, they would take capital out of the remaining institutions when they could least afford it and possibly jeopardize their future), and would allow the failing institution to escape an assessment.

6. Selection of the operational resolution authority – *The FDIC should be the operational resolution authority for the new ORR for SIFIs. Because the FDIC’s expertise is largely limited to banks, it would be desirable to supplement the FDIC’s staff with expertise in the main businesses of the SIFIs (insurance, broker-dealing, etc), as well as the Fed’s expertise.*

Commentary – The FDIC has more experience in resolution than any of the other candidates. It would therefore take significant time for any other government agency to develop both a staff and the necessary experience, and such a hiatus could well be costly under the still-considerable vulnerability of the financial system.

7. The Resolution Protocol – *The protocol should be guided by three principles. First, resolution authority should be activated only under extreme conditions (of systemic risk) but, once activated, the resolution authority should be accorded sufficient “flexibility” to get the job done. This is necessary so that the authority can respond to the variety of circumstances that will inevitably exist; less recognized, the same flexibility can reduce moral hazard. A second principle is that the authority must be able to utilize the basic types of resolution, namely, sale, rehabilitation through a conservatorship, liquidation, and if necessary, ad hoc types. This is desirable because each type of resolution has advantages and disadvantages that can be decisive in particular situations. And a third principle is that any assistance provided by the government during the resolution should have a priority over, at least, existing claims. This is consistent with the mandate of the ORR to minimize cost to the taxpayer.*

Commentary – Flexibility should also permit different resolution procedures to be applied at the operating company and holding company levels. In addition to sale, rehabilitation through a conservatorship, and liquidation, the resolution authority should have the authority to renegotiate or repudiate certain of the firm’s contracts (just as in a bankruptcy proceeding); such modifications in contracts may be necessary, for example, to put a rehabilitated firm on a path to sustainability. If there is concern that such an authority will be misused (say, for political purposes), an “arbitrary and capricious’ standard can be used to for judicial review of these contract modifications. More than one type of resolution may be used in an individual case; for example, there could be a sale of some parts of a resolved SIFI and liquidation of others. Also, one type of resolution (conservatorship) could evolve into another (liquidation).

8. International considerations – *Because virtually every SIFI will have substantial international operations and international “connectivity,” there is inevitably going to be an international dimension to any ORR for SIFIs. The main priority here is to avoid application of a “ring fence” concept that can frustrate otherwise sensible resolution plans, and also invite retaliation from other countries.*

Commentary – The Lehman bankruptcy demonstrated that a strengthened resolution process in any single country will have only limited efficacy if there is no strengthened international resolution process. For this reason, it is essential that the Basle Committee on Bank Supervision expedite its work on developing recommendations for cross-border resolution. Although this is our last point in the chronology of this paper, it has the very highest priority and importance.

Conclusion

The Obama Administration’s proposed ORR is needed because the existing regime confronts US economic and regulatory authorities with two very unappealing options: allow the institutions to go into corporate bankruptcy thereby accepting the associated systemic risk, or to weigh in (often over a weekend) with a large government rescue to attempt to mitigate the systemic risk. Arguments that this new ORR will be over-used and will increase moral hazard are generally weak; notably, the relevant question is whether an ORR will be overused and will increase moral hazard *relative* to the alternative of no ORR. While theoretically possible, the chief counter-proposal to the ORR, an amendment of the existing corporate bankruptcy code, is inferior to the ORR in fundamental ways, including that corporate bankruptcy is focused almost exclusively on the interests of creditors of the firm, with little concern for “third party” effects such as systemic risk. Finally, while workable as proposed, the ORR, as proposed by the Obama Administration, could be improved along several dimensions, including the adoption of a dual mandate to both ensure a least-cost resolution to protect taxpayers, as well as to mitigate spillover effects.