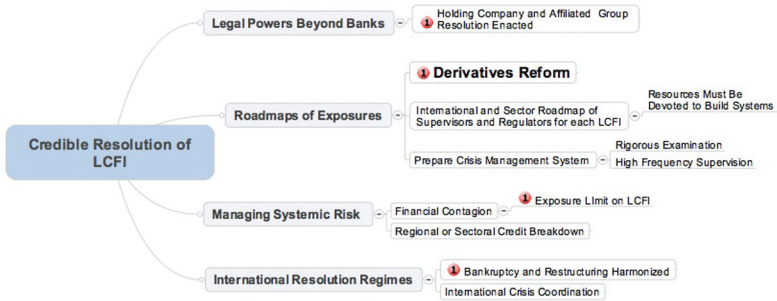


CREDIBLE RESOLUTION

WHAT IT TAKES TO END TOO BIG TO FAIL

Robert Johnson



The market system depends upon the discipline of failure.

This is the basis of dynamic evolution of the economy and is essential to the legitimacy of the market system. When failure occurs, corporate finance has well-developed principles and procedures for bankruptcy and the restructuring of failing firms. We have all seen these procedures in action in the failure of airlines, auto companies, the bankruptcy of nonfinancial businesses both small and large, like Kmart, Texaco, and Converse, Inc. We have seen them in the failure of venture capital start-ups, and even with smaller financial institutions. Well-known individuals – from P.T. Barnum to Walt Disney to Donald Trump – have gone through bankruptcy.

But the discipline of bankruptcy and restructuring has not been applied to the large complex financial institutions (LCFIs) in the recent financial crisis. The inability to apply market discipline to LCFIs is not only unsound; it has forced the citizens of the United States to support them with a great deal of money via bailouts and guarantees.¹ When LCFIs are not penalized for failure, it sets a terrible precedent for their future behavior— creating an unhealthy dynamic in which bailouts are assumed and risky behavior is underwritten. Worse still, when society perceives a distance between how individuals and businesses are disciplined, anger and demoralization flourish. The resulting distrust in government makes it even more difficult to fix a broken regulatory system.

The defenders of the treatment of LCFIs appeal to the notion of systemic risk, which is an unclear concept, but suggestive of spillovers from the failure of LCFIs to other parts of the economy. Top management of the LCFIs argues vociferously against regulation of their activities. At the same time, they invoke and amplify the fear of systemic spillovers when appealing to the authorities for bailouts in the throes of a crisis.² Under the current broken system of regulation of LCFIs, there are no doubt many potential spillovers that could cause harm to the wider economy. Yet many of these spillovers or externalities are either unnecessary or unnecessarily large.

The goal of this chapter is to make recommendations to eliminate the distance between how insolvent LCFIs are treated and how individuals and other businesses are treated when on the cusp of failure, after carefully examining the context in which the resolution authorities cope with a failing LCFI.

The method to achieve the goal is to examine the impediments that stand in the way of the practice of sound corporate finance principles that apply to failure and restructuring of an LCFI, and to recommend structural and legal changes that will remove those impediments.

THE CHALLENGE FACING THE RESOLUTION AUTHORITIES

The resolution authorities have to consider a number of dimensions of cost when resolving an insolvent financial institution in order to impose the least cost on society. There are several dimensions to consider when looking at that cost:

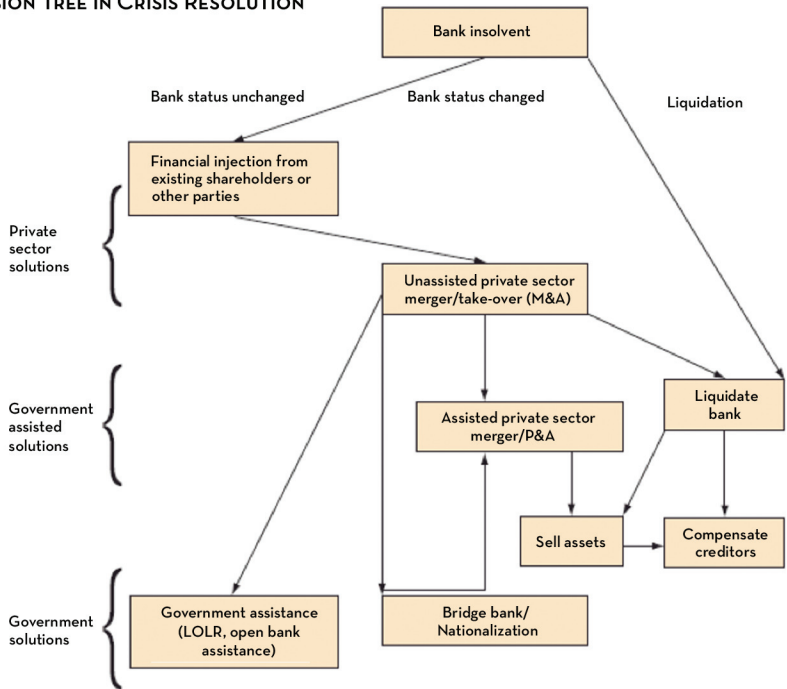
1. The budgetary cost of the bailout/restructuring. (Fiscal Bailout Costs)
2. The costs in lost output and employment associated with any spillovers from the failing financial firm to the real economy. These include:
 - a. Costs that spill over onto sectors or regions of the economy whose credit allocation depend upon the specific LCFI that is failing. (Direct Spillovers)
 - b. Financial contagion, those costs created by spillovers to other financial firms with exposures to the firm being restructured. These firms, in turn, harm the real economy through the weakening of the credit allocation process. (Financial Spillovers)
3. The costs of the precedent this resolution example sets when it becomes imbedded into LCFI management expectations about the incentives they will face in the future. (Moral Hazard)
4. Costs associated with how the burden of the bailout/restructuring influences the public's trust in government. (Reputation of Government)

The resolution authorities are entrusted by the public to consider all of the tools of resolution to minimize the cost to society when an LCFI fails. (See Diagram 1) When this is done well – when burdens are shared fairly and in a way that is mindful of all of these costs – the government's reputation is not tarnished.³

The principles of proper resolution of a failed corporation are nothing new.⁴ They include:

1. Conservation of the value of the assets, including the going concern value if that is possible, of the firm.
2. Dilution or wipe out of common equity.
3. Restructuring of creditors, in accordance with priority to convert some portions of debt into equity.
4. Submission of letters of resignation by top management of the failing firm that can be accepted or rejected by the owners of the new organization.

**DIAGRAM 1:
DECISION TREE IN CRISIS RESOLUTION**



For most businesses, including smaller financial firms and nonfinancial corporations – even those that garner public assistance – this has largely been the process and the practice. Businesses like airlines, along with hundreds of small banks, are handled according to the tried and true criteria.

The LCFIs clearly were not handled in the traditional manner, revealing U.S. government reluctance to apply the known principles of proper resolution, including the wiping out or dilution of common equity or the firing of the LCFI top management that failed in their responsibilities and imposed upon the taxpayers.

What costs deterred the resolution authorities from restructuring the LCFIs in the same way that any other corporate failure is handled? What impediments to credible resolution can be removed so that both policymakers and officials treat a LCFI in the same manner as any other failing corporation? If these obstacles cannot be removed, then society must either 1) regulate LCFIs much more aggressively or; 2) Break them up so that the authorities no longer fear restructuring them.

Credible resolution of LCFIs is necessary to restore the legitimacy of the market system of discipline in the United States and around the world.

OBSTACLES TO RESOLUTION OF LCFI

Creating a credible resolution regime requires removing the impediments to resolution of an insolvent LCFI when it is on the doorstep of failure. In what follows, we will address the key impediments that push policy makers to engage in forbearance⁵ when they should be restructuring the LCFI. The primary obstacles are:

1. Fear of amplifying systemic risk, most focally financial contagion, because an LCFI is deeply intertwined with other LCFIs and likely to come into the hands of the resolution authority on the verge of failure precisely when other financial institutions are also extremely fragile.
2. Legal impediments under current U.S. law that must be changed to enable the resolution of financial services holding companies, including bank holding companies – not just the banks that are subject to the provisions of “prompt corrective action” enacted to facilitate resolution of a failed firm by the FDIC.
3. The resolution authorities’ lack of a roadmap of the LCFIs’ exposures and an understanding of the transmission of losses that their resolution would ignite. The pervasiveness of often-complex and sometimes-unregulated derivative instruments leaves the resolution authority paralyzed with the dread of igniting unintended and unforeseeable consequences. Authorities are steering a ship through treacherous waters around many icebergs – without proper charts, sonar and navigational equipment.
4. The global ramifications of the resolution. The resolution authorities must understand the consequences of their actions. The propagation of losses outward from the failing LCFI to foreign LCFI and other commercial interests must be understood before resolution authorities take action. Understanding these consequences is vital, and requires foreign governments to be enlisted to cooperate in the proper supervision and monitoring of a global firm. Most, if not all, LCFIs operate in many countries, in many legal and regulatory jurisdictions, and with branches or subsidiaries operating under a myriad of supervisory regimes. In fact, some elements of the matrix of operations exist with no regulation or supervision. This prevents authorities from understanding clearly the impact and consequences of an LCFI’s resolution across the entire planet. Another major international obstacle is the difficulty of restructuring the liabilities of a failing LCFI according to sound principles of corporate finance and of apportioning a balanced share of the burden of loss across all creditors when operating across a myriad of separate legal jurisdictions.

In what follows, each of these impediments to credible resolution is discussed, along with available means to remove the obstacles that induce the authorities to adopt a strategy of forbearance for an insolvent LCFI.

FINANCIAL CONTAGION AN OBSTACLE TO CREDIBLE RESOLUTION.

Many proposals for financial resolution set out principles and action guidelines

that are based on the vision of resolving one isolated troubled institution. Yet in practice, when an LCFI is in danger of insolvency, many other financial institutions will also likely be fragile and on the threshold of insolvency. The difficulties are compounded when the cross-exposures between these institutions are substantial. Undeniably there were marked differences in the quality of management across the large firms, but if the question “Are you solvent?” were posed to a chief financial officer at many, if not all of the 9 largest U.S. firms in 2008, the officer would have been forced to reply with a contingent statement like, “It depends upon how the other 8 are resolved and what action the government takes.” When one considers the challenge of 2008 and early 2009 in the U.S., it is very clear, from pre-Bear Stearns failure to the decisions to forbear when Citigroup and Bank of America’ equity capitalization were dwindling, that the context to evaluate resolution was one where a constellation of LCFIs were all in jeopardy together.

When firms are so intricately intertwined, resolution authorities are tempted to avoid action. They are likely to fear that a proper restructuring of any one LCFI’s liabilities may just transmit the losses to other LCFI and take other financial institutions into insolvency. Firm A’s losses, once realized, lead to a write-down of its exposures on the balance sheet of Firm B. If they have large cross-exposures, that may make Firm B insolvent, too.

We need large preemptive action rather than fear and inaction. A resolution process that resembles a bank holiday and comprehensive examination, where the insolvency of some or all firms and the cross-consequences of restructuring shared exposures, would lead to a broad based recapitalization of the LCFI firms in parallel. In the 1930s, under Franklin Roosevelt, similar procedures were undertaken by the Reconstruction Finance Corporation. Such comprehensive recapitalization is intended to fortify the financial system as a whole, with capital injections from the public sector and apportioning of the dilution of equity shares across the constituent firms.

There are formidable obstacles to a prompt resolution of this nature, even though it would distribute losses appropriately and mitigate gross unfairness. First, current information requirements are beyond what are available on a timely basis to examine and supervise each of the LCFI. The scenario planning and knowledge of cross-exposures between LCFIs must be known and up to date before the onset of a crisis. We need a formidable, well-compensated infrastructure in order to conduct ongoing real time examination. Such a process, prepared well in advance, is necessary to give the authorities the confidence to act decisively and rapidly.

A second obstacle to a prompt parallel resolution⁶ is political: the different LCFIs have varying degrees of confidence in their ability persuade and manipulate government. Because of these differences, one could predict that the bailouts would be sequential rather than undertaken in parallel, and that the politically weaker firms would bear the brunt of the loss of equity and manage-

ment compensation. The politically stronger firms go hide in a closet and wait for the weaker firms to be resolved and fortified, all the while working to make sure that the restructuring was done in a manner that did not damage their net worth if they had significant cross-exposures. Once the resolution authorities had moved through the weaker firms and fortified them with taxpayer funds, the CFOs at the politically stronger firms could emerge from hiding and give an honest “Yes” to the question of whether their firms were solvent.

Society should not tolerate the costs of resolution authorities working in this sequential manner, in deference to the politically stronger LCFIs. The likely costs are significant:

1. A sequential intra-financial sector political struggle may deepen the crisis as the financial system freezes up for prolonged periods when the fear of counterparty default risk is widespread. The costs to output, employment, and the eventual cost of bailout are likely to be significantly larger than would result from a prompt parallel corrective resolution.
2. A sequential process is likely to deter the authorities from writing down the elements of the liabilities of the failing firms for fear of transmitting greater fragility to the remaining unresolved systemically significant financial institutions.
3. This reluctance to amplify systemic contagion is understandable. But it implies that the resulting taxpayer burden in resolution is likely to be greater, and the politically strong firms, their creditors, stockholders and managements made better off, through undeserved subsidies that powerfully diminish public trust in the financial authorities.

Fear of financial contagion on the part of authorities, coupled with the political power games that the LCFIs play to influence the management of crisis episodes, inhibit timely, credible and cost-effective resolution of failing financial institutions. Three recommendations for reform to address this challenge are:

1. Significant limits on the cross exposures that can be maintained on balance sheets between systemically significant institutions must be specified so that the constellation of LCFI cannot wrap themselves in the blanket of each other and deter resolution on the grounds of financial contagion.
2. Substantial investment in information systems and quality, well paid, personnel for high level supervision is needed to invigorate the examination of LCFI and to diminish uncertainty about the “roadmap” of exposures between financial firms. Indeed, a timely roadmap of all exposures of each LCFI is important to understanding the impact of resolution on the economy and the world.⁷
3. LCFIs should be severely limited in the lobbying and campaign contributions that they can make to the Presidential candidates and Congress. We need a rule that prohibits those sitting on financial committees, Senate Banking, House Financial Services, Senate Agriculture and House Agriculture, from receiving contributions from LCFIs. In

addition, House and Senate Leadership should also be subject to the same prohibition.⁸

COMPLEX, OPAQUE AND MARK-TO MODEL DERIVATIVES AS AN OBSTACLE TO CREDIBLE RESOLUTION⁹

The recent crisis in the U.S. centered on the collapse of the housing bubble and the role of leverage, off balance sheet exposures, and complex OTC derivatives. Chapter (8) on off balance sheet reform and Chapter (9) on derivatives market reform address the structural remedies that are required to restore integrity and transparency to these dimensions of our financial system that directly involve LCFI. For credible resolution, I believe that proper derivatives reform, given the sheer size of derivative markets and the extent to which they constitute a large portion of the cross exposures between financial firms, must be done to render these exposures both transparent and simplified. A resolution authority cannot function with confidence when the spider web of exposures of an LCFI is opaque, complex and not properly valued.

America cannot end Too Big to Fail without derivatives reform. It is the San Andreas fault of the global financial system.

The use of mark to model accounting methods for OTC derivatives, particularly CDOs and the various concoctions of remixed CDOs, did not prove to be a reliable guide to their value in the marketplace. As a result, the value of assets and the resulting measures of firm capital adequacy were rendered invalid and subject to marked discontinuities in price. They gave no guide to the value of assets or the value of the firms holding them. When a LCFI is in trouble – and there are substantial holdings of complex and opaque OTC derivatives on the balance sheets of all of the LCFI firms – resolution authorities have difficulty unraveling the spider web of exposures and valuing them properly.¹⁰ A roadmap of exposures, both on the asset and liability side of the balance sheet, along with the valuation of those exposures, is key to understanding the implications for systemic risk in an LCFI resolution. Unfortunately, it is easy to understand why resolution authorities could be induced to forbear rather than resolve an LCFI when they have no clarity about its structure and patterns of exposures. In such a circumstance, it may be easier to incur the risk that the insolvent LCFI's balance sheet could continue to deteriorate. Simplifying derivatives – and making them trade on exchanges where there are real prices, and real margin set asides – clears the fog that currently surrounds the roadmap of exposures of an LCFI in danger of failing. It also gives authorities greater confidence in resolving the LCFI at least cost to the taxpayers.

These significant policy changes will be resisted, inevitably. A LCFI with a lucrative derivatives business benefits from the profit margin in complex derivatives. It also gains from customers' inability to discern their fair value when compared with simple transparent exchange traded instruments. The complexity of a derivative can deter competitive imitation and support profitability. It has been estimated that the 5 largest OTC derivatives dealers in the United States

(who are expected to earn more than 35 Billion USD from OTC derivatives in 2009) would lose 15 percent or more of those earnings if they were forced to clear them. They would lose even more when forced to trade on an exchange. Loss of earnings of more than six billion USD constitutes substantial impetus for those firms to resist proper reform. That is a socially tragic – the firms do not calculate the social costs associated with a riskier, more opaque and un-resolvable financial system that depends upon the taxpayer to bail it out in times of stress. Compounding the problem, that very prospect of taxpayer support tends to subsidize and engender overuse of these OTC derivatives that are created around the “OTC marketplace hubs” of the LCFIs.

Finally, it is important to comment on the specific role of credit default swap derivatives in the difficulties of credible resolution. Because naked CDSs¹¹ are permitted, and because they have been an unregulated segment of the market, the resolution authorities find it nearly impossible to comprehend the roadmap of contingent exposures that are triggered when a restructuring of a LCFI takes place. In the CDS market, Firm A can buy or write a CDS on LCFI Firm B with counterparty Firm C. The resolution of Firm B can then send one of the others, A or C, into jeopardy – and the authorities have little or no way of anticipating that consequence. As a result, the entire structure of the CDS market needs to come out of the dark to restore market integrity. For credible resolution, it is key to eliminate resolution authorities’ fear of unforeseen side effects that result from the “credit events” created by LCFI resolutions. We need comprehensive reporting of CDS positions to examiners and to a systemic risk regulator. We also need to confine LCFIs to using CDSs to insure a specific risk, thus prohibiting them from so-called naked buying of CDSs. These changes must be a part of derivatives reform if we are to restore market integrity.¹² LCFIs sit in a delicate position adjacent to the public treasury. That is why they should not be permitted to engage in the high intensity leveraged speculation that naked CDS positions offer.

LEGAL ASPECTS OF CREDIBLE RESOLUTION¹³

We must enact legislation to create resolution powers for the authorities that pertain to financial services holding companies, insurance companies and bank holding companies that would allow them to undertake prompt corrective action in response to an impending insolvency of one of these organizational firms in the event that it was considered a “systemic risk.” This should be done instead of proceeding under the traditional Bankruptcy Code or, in the case of registered broker dealers, the Securities Investor Protection Act (SIPA).¹⁴ The legislation should be designed to give the authorities an array of tools that the FDIC has with regard to a bank but does not have the right to exercise in the larger universe of financial institutions. The law should allow resolution authorities to utilize the tools that are available to the FDIC under the FDI Act. These include conservatorship, bridge banks, various forms of open bank assistance, liquidation, or assisted purchase and assumption.¹⁵

There are many reasons that new resolution powers could create lower-cost

bailouts, cause less systemic disruption, and permit authorities to be more confident in resolving an LCFI. First, a holding company may have solvent subsidiaries that could be sold off as going concerns and preserve value under the bridge bank structure that the FDI Act provides for. Under the Bankruptcy Code, this is a more cumbersome and lengthy process.

In addition, there is a class of exposures referred to in the law as Qualified Financial Contracts (QFC) that include certain swap agreements, forward contracts, repurchase agreements, commodities contracts, and securities contracts, and, importantly, derivatives contracts. They are not subject to the “stay” put on creditors at the time of insolvency that stop them from seizing assets. As a result, these “safe harbored” contracts can be closed out promptly. In periods of extreme market-wide stress, when many LCFIs are in jeopardy, the ability to transfer to a bridge bank or to place the QFCs with a going concern is likely to insure that a myriad of counterparties would not simultaneously close out their QFCs, thus igniting a distress sale in markets that would lead to extreme declines in prices. This, in turn, could feed back onto the balance sheets of the LCFIs and amplify financial stress leading possibly to further insolvencies.¹⁶

Advocates of giving derivatives QFI status argue that subjecting derivatives to the “stay” would lead many dealers who run a hedged derivatives book to take abrupt action when one side of that hedge entered into the bankruptcy process in order to rebalance their risk exposure. This could also lead to disruptive market behavior.

The entire legal structure surrounding derivative instruments, their priority in the event of insolvency, and the incentives created by making them QFIs to foment the use of derivatives relative to underlying securities, is a foundation stone in the architecture of the marketplace. The large cross-exposures between LCFIs that make it so difficult to resolve them without exacerbating financial contagion are fostered by making derivatives senior to other elements of the capital structure. The granting of QFI status to derivatives may have inspired a much more heavily-intertwined set of intra LCFI exposures than would otherwise be the case. While there may be some benefit from “netting” QFC derivative contracts in an insolvency and resolution during a closeout, it also appears that allowing long dated derivatives that are a close substitute for senior elements of the capital structure to “leap frog” to the top of priority leads to greater reliance on instruments that are currently poorly supervised and regulated. The risk of financial contagion must be diminished to permit credible resolution of LCFIs. Seen in that light, it may be necessary, as recommended earlier in this chapter, to put position limits on the cross-exposure between LCFIs to offset the incentives created by granting QFI status to derivative instruments.¹⁷

In summary, the legal creation of a resolution authority giving powers akin to those of the FDIC under the FDI Act – so that resolution authorities can treat systemically important financial organizations like the bank holding companies and financial services holding companies, insurance companies, and mega sized

hedge funds like the FDIC treats banks – aids the efforts to remove the obstacles to credible resolution of LCFIs. It is helpful to have proper powers, but nowhere near sufficient to enable the resolution authorities to use them when faced with an LCFI in distress.

INTERNATIONAL IMPEDIMENTS TO CREDIBLE RESOLUTION

Another challenge that deters officials contemplating the resolution of impaired LCFIs is their global presence. The LCFI often has a myriad of affiliates, branches and subsidiaries that inhabit a broad array of regulatory, supervisory and legal regimes around the world. Some of the affiliates are likely to be unregulated. This situation compromises the quality of information that the resolution authority is likely to have about the LCFI. It obscures the roadmap of exposures abroad and potential systemic spillovers.

There are several obstacles to obtaining a high quality portrait of the LCFI and its international positions and exposures. First, national supervisors tend to be very proprietary about sharing information. This is particularly true in times of crisis, when protecting the solvency of home country firms becomes paramount. Second, international supervisory regimes are quite heterogeneous with regard to the quality and frequency of information generated and reported. Third, there are many unregulated segments in the international marketplace. Fourth, some nations have secrecy laws, and some authorities are quite unwilling to share information with foreign authorities for fear of inappropriate leaks of proprietary information that is the essence of a home country firm's strategy and profitability.

Supervisors face a formidable set of challenges in developing a clear picture of the international context that surrounds a troubled LCFI. We recommend that the following challenges be met to inform and empower the resolution authorities and allow them to resolve a failing LCFI without unforeseen global consequences. The Resolution Authority needs:

1. A map showing the pattern of exposures emanating from the relatively small number of LCFIs around the world that can impact the American economy in the event of failure.
2. The cross-exposures between the troubled LCFI and other LCFI based in other countries.
3. The structure and positions of the troubled LCFI around the world, including an understanding the roadmap of affiliates, authorities having regulatory power over the affiliates, and legal regimes that are germane to the firms operation.
4. The contingency plans of communication between authorities around the world that are relevant to the failing LCFI and a plan for real time crisis management.

Fortunately, these challenges have been widely researched and discussed by a number of working groups within the Bank for International Settlement's Basel Committee on Bank Supervision Cross Border Bank Resolution Group, the

G20, the Financial Stability Board (formerly Financial Stability Forum), and the IMF and World Bank.^{18,19} But the recommendation to invest in these systems to provide the authorities with information has yet to be emphatically embraced by political leaders.

A second impediment to resolution that emanates from the global reach of LCFIs is the difficulty of sharing burdens in credit restructuring across the different legal bankruptcy/resolution regimes in the different countries where the affiliates of the LCFI operates.²⁰ We have reached a time when the market for these behemoths is worldwide, and only a resolution regime that can treat creditors comparably, regardless of location, is sensible. The regime must be created to contribute to the credible ability of national resolution authorities to resolve and restructure LCFIs and require market participants who invest in them to bear the appropriate risk.

Harmonization of resolution regimes across the G20 is important for two reasons:

1. Any attempt by a national resolution authority to diminish the taxpayers' burden at home through the practice of restructuring of creditors of the LCFI must consider the power it has to impose debt for equity conversions or haircuts on the various types of creditors abroad. The resolution of the LCFI, using proper corporate finance methods, may be inhibited by this set of obstacles. The harmonization of resolution regimes across the major market centers (G20) is essential to ensuring that no national authority must choose between induced forbearance, with all of its potential dangers, and putting an undue burden on the domestic taxpayers of the home country of the LCFI in distress.
2. The harmonization of bankruptcy regimes across nations is also important to mitigate the credit-amplifying moral hazard characteristics of the incentives that are created for issuers of debt to concentrate their financing in locations where creditors are most insulated from restructuring risk and receive a lower yield on their liabilities as a result. The lower cost of funds that results from this bankruptcy resistance inspires more risk taking by the LCFI. It transfers burdens away from creditors and onto the back of taxpayers in the home country of the LCFI in the event of insolvency.

DETECTION OF INSOLVENCY

Once a credible resolution regime has been established, minimizing the taxpayer burden depends upon early detection of impaired institutions. The same information requirements that alleviate the fear of resolution authorities are also necessary to develop contingency plans for insolvency just as the LCFI crosses that line. The FDIC has a regime requiring prompt corrective action after several stages of warning indicators are breached to protect taxpayers and the other members paying into the deposit insurance fund from incurring the costs of a deeply insolvent firm.

To achieve early detection, the information requirements include the international challenges discussed, and also depend upon the real pricing of assets. Real pricing of assets depends upon simple and transparent positions that are readily traded. The earlier sections of this report on both off-balance sheet entities and on derivatives reform, which emphasized the benefits of simple transparent assets in assisting market function, monitoring and credible resolution, also benefits the process of preventing deep losses through early detection. The practice of mark-to-model on complex derivatives tends to be used to overstate the value of assets, and, as a result, the value of the capital of the firm. It thereby increases the risk that insolvency will not be detected promptly. The experience of the crisis of 2007-8 showed complex custom OTC derivatives to be subject to large discontinuous changes in reported value that often constituted the difference between full capital adequacy and insolvency.²¹ The revaluations occurred abruptly and the reports to examiners were far behind

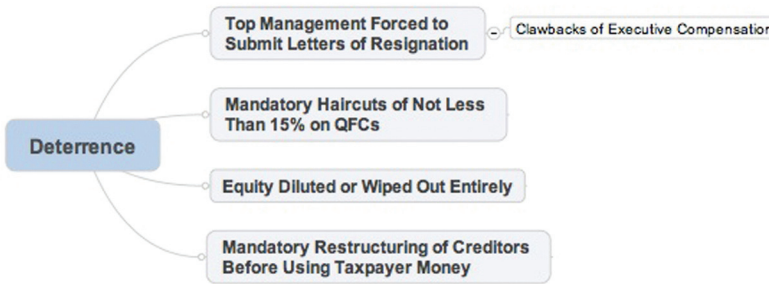


the curve in reporting real valuations. Similarly, the sudden reappearance of “liquidity puts” climbing back onto balance sheets from off balance sheet structures such as Structured Investment Vehicles (SIV) and Conduits lead to market deteriorations in capital from one day to the next. The requirements of high frequency reporting, transparent, simple and frequently valued assets based on real transacted prices, are imperative to early detection of an impaired condition at the firm. Chapters 8 and 9 on off balance sheet reform and the proper structure of derivatives markets address these issues in detail. In light of the burden borne by taxpayers in the recent crisis, there is absolutely no excuse for perpetuating market structures that continue the risks society bears because of opacity.

DETERRENCE

It is characteristic for the resolution authorities to request complete discretion in responding to the challenges of a financial crisis. Yet when they appear to engage in actions that do not seem to protect the people they were elected/appointed to represent, the question of enacting rules that constrain their methods of resolution begin to look more palatable and/or necessary. In this respect, rules that mandate dilution, if not the wiping out of equity of the

impaired LCFI; use of creditor restructuring of debt into equity before any taxpayer money can be touched; mandatory haircuts on Qualified Financial Contracts of up to 15 percent; and mandatory resignation/firing of top management along with potential claw-backs of deferred compensation, can all serve to protect taxpayers. They can also deter top management from crossing into the zone where they depend upon financial support from the public treasury. In a world where money politics, campaign contributions, and lobbying are rampant, we cannot rely on a cops-and-robbers regulatory regime and the willingness of the financial cops to impose pain upon the powerful and wealthy members of the financial sector. It may be better to enact into law deterrent policies that inform creditors, counterparties, management, and stockholders that they will pay a price – with certainty – in the event of insolvency.²²



The debate on rules versus discretion in economic policy-making is applied in many realms. Tying the hands of officials can make expectations of outcomes binding and make the deterrent to excessive risk taking more credible. Given the scale of resources involved, the incentives of LCFI and their top management to lobby and fund political candidates to appoint their favorite crony regulators are enormous. When the policy discretion of a Treasury Secretary, Fed Chairman or FDIC Chairman is diminished by the introduction of mandatory rules of resolution, it takes some of the energy out of the potential political “payoff”. Your favorite crony can no longer alleviate the pain of failure on your behalf. A rules-based regime at the margin also discourages that unseemly and unproductive investment of social resources into lobbying to influence government policy to garner superior private returns.²³

CONCLUSION

Insolvent institutions have to be able to fail. The integrity of the market system depends on it, so we need credible resolution of insolvent financial institutions. Because of the widespread spillovers (externalities) emitted by LCFIs, a process of reorganization is not simple. Of course, we should have preventative measures, including substantial capital requirements; examination and supervision

with vigor and resources; restrictions on the nature or scale of activities that such institutions can undertake; and limits on the exposure of an LCFI to any one counterparty. In addition, we can put in place elements of our resolution regime that are rule-based penalties triggered by insolvency, thereby diminishing the moral hazard associated with the prospect of government support for loss mitigation in a financial crisis. Yet even with preventative medicine, we will on occasion experience the failure of LCFIs with global reach. We need to be able to shut them down, break them up or restructure them.

To do that we need:

- Simple transparent markets
- International agreements on uniform resolution regimes
 - Substantial cooperation internationally in information and production pertaining to LCFI
- Legal methods to resolve LCFIs whatever their organizational structure
- The ability to close LCFIs without bringing down the entire financial system
- The information requirements of these recommendations are formidable and the legislative changes substantial.

It is bad policy to be induced to forbear with the LCFI and then subject society to the impaired credit and aggressive practices of desperate insolvent financial institutions whose fear of being put out of business drives them to impose abusive fees, 30 percent interest rates on credit cards, and block housing foreclosure modification to hide their fragile condition for prolonged periods of time. The economy can regain strength if it is not forced to bear the burden of waiting for the balance sheets of LCFI to be rebuilt by the resources they extract from all of us in a long run of forbearance.

Our society, both in the United States and in other major countries, has yet to come to grips with the challenge that these LCFIs pose to the integrity of our system. It will take substantial resources – albeit small in compared to our losses in the recent crisis – to invest in high frequency, comprehensive and global information gathering for the supervision and regulation of LCFIs.

We must undergo a substantial change in social norms to recognize the legitimacy of demands from well-paid examiners and supervisors to get the information from financial firms that are necessary to govern our financial system. The firms are not doing the nation a favor. Their compliance is compulsory and laws have to be enforced.

We must also summon political will. It will take formidable leadership to pass international agreements for coordination of crisis response, mandate information sharing, and make agreements to harmonize resolution regimes across countries.

Many elements of a healthy design of the domestic and international financial system have been developed, refined and were clearly understood by experts on finance and markets long before this crisis of out of control markets erupted in 2007-8. The design of proper reforms is not too complex to understand. It is not beyond comprehension. The primary ingredients, as outlined in this report, are well understood. They are essential to the confidence and integrity of American capital markets. It is well beyond time to enact them and to enforce them. Finance is a means to serve the economy and society. It is not an end in itself.

ENDNOTES

1. See Chapter 1 on the Doom Loop by Simon Johnson for a discussion of the distortions and dangerous consequences of not having LCFI fail.
2. This schizoprenic approach to financial regulation and resolution has damaged the credibility of financial sector leaders when they assert that they, and they only, have the expertise that entitles them to be architects of their own domain.
3. Just the simple notion that protecting the taxpayers in one country may require officials to tolerate greater risk of systemic risk propagation to counterparties of their LCFI based in other countries illustrates the tradeoffs that we face. See Eugene Fama, Government Equity Capital for Financial Firms, at <http://www.dimensional.com/famafrench/2009/01/government-equity-capital-for-financial-firms.html>
4. Also see Piero Veronesi and Luigi Zingales, Paulson's Gift, at http://faculty.chicagobooth.edu/brian.barry/igm/P_gift.pdf A historical survey of bailouts and restructuring of failed financial institutions with a comparison to the U.S. bailout performance in 2008-9 is provided by the Congressional Oversight Panel of TARP. Available at <http://cop.senate.gov/documents/cop-040709-report.pdf>. See also the unpublished working paper by Charles Ledley, Jamie Mai, and Vincent Mai, distributed to staff and members of the House Financial Services Committee, the FDIC, the Federal Reserve, and the Treasury Department.
5. Forbearance is the term used to describe when officials choose not to restructure or liquidate an insolvent firm. In essence they are avoiding concrete action and betting on a rebound of the firm and a return to solvency. The risk of forbearance is that the firm continues to deteriorate and the losses that eventually must be restructured are larger.
6. Note that the TARP round of capital injection simulated this kind of resolution and fortification action but skipped the step of thorough examination. A certain amount of money was used to fortify firms but the marketplace did not get the kind of reassurance that would have been created by the knowledge that the capital injection was derived from examinations and that the system was sound again.
7. I am skeptical about so called "Living Wills" where the firms are asked to provide the roadmap of their own exposures to authorities. They in fact have little incentive to provide a helpful document when they have the knowledge that a good document will make it more likely that their stock and stockholders share certificates can be wiped out. The roadmap must be prepared by the examiners that have full access to the records and systems of the LCFI in question. The practice of requiring a living will seems to be an attempt to get around difficulties of coordination between regulatory authorities who are reluctant to share information and defend their home turf in times of financial stress.
8. Of course such a rule must be part of a much more comprehensive reform of campaign finances and lobbying. It cannot apply strictly to the financial industry. The recent experience with healthcare reform in the United States, and the difficulties the government is having addressing climate change suggest that a wide sweeping change is called for. The recent Supreme Court decision in the case of *Citizens United vs. FEC* increases the urgency of such reforms.
9. Much of this connection between inadequate regulation of OTC derivatives and their interconnection with LCFI and resolution policy was spelled out in the 1990s by Alfred Steinherr in his provocatively titled book, *Derivatives: The Wild Beast of Finance*. See also the work of Garry Schinasi and his colleagues at the IMF. See especially, *Modern*

Banking and OTC Derivatives: The Transformation of Global Finance and its Implications for Systemic Risk, Occasional Paper 203, 2000.

10. See the quarterly derivatives report of the Office of the Comptroller of the Currency. Five institutions, JP Morgan/Chase, Bank of America, Goldman Sachs, Citigroup, and Morgan Stanley account for over 95 percent of the notional value of derivatives exposures of the universe of U.S. bank holding companies.
11. Mason Fleury explains: "A credit default swap is a protection against default of debt. If you can hold a bond, you can buy 'protection' against default. You buy a premium, and if the bond defaults you get the principal back. If you don't hold the bond, then it is called a 'naked' CDS. You pay the premium on a fictitious bond (you never paid the principal) but if it defaults, you get paid the principal, poof! out of bad debt comes more bad debt." See <http://www.thedelphicfuture.org/2009/01/cds-are-good-naked-cds-are-bad-ok.html>.
12. I do note that in July of 2007 Fitch Ratings put out a report that identified a very large concentration of CDS written by AIG Financial Products. Serious analysts in the private and public sector had no reason whatsoever for not understanding that AIG was accumulating these positions at that time. Fitch's report is free online.
13. For well developed exploration of many of these issues see the report from the Committee on Capital Market Regulation entitled "The Global Financial Crisis: A Plan for Regulatory Reform," Chapter 2 section D pages 112 to 127. Available at
14. U.S. Dep't of the Treasury, "Resolution Authority for Systemically Significant Financial Companies Act of 2009" (Mar. 2009), available at <http://www.ustreas.gov/press/releases/reports/032509%20legislation.pdf>.
15. One of the difficulties associated with the LCFI is that the P&A is that there are unlikely to be buyers for the entirety of such large entities given their size, and that continued aggregation is likely to run into conflict with concerns about concentration, aggregation and anti trust concerns. These costs are rarely an explicit part of the calculus in the midst of a crisis.
16. See again the CCMR Report, *The Global Financial Crisis*, Chapter 2, section D, and also *Derivatives and the Bankruptcy Code: Why the Special Treatment?* by Franklin Edwards and Edward R. Morrison, *Yale Journal on Regulation* Volume 22 pp 101-133. Also see *Over the Counter Derivatives and the Commodity Exchange Act* by The Presidential Working Group on Financial Markets, November 1999.
17. See Secret Liens and the Financial Crisis of 2008 by Michael Simkovic, *American Bankruptcy Law Journal*, Vol. 83, p. 253, 2009
18. One can readily see that these challenges pertaining to cross border resolution policy have been studied and analyzed with growing depth and sophistication since the failure of BCCI in 1991. It is somewhat disheartening to read the historic series of reports on international bank resolution challenges, many written well before the crisis of 2007-8, and see how little of this has work has been actualized and made operational. Many of these reports recommendations, had they been implemented in the major market centers, U.S., UK, EU, Switzerland, and Japan, would have certainly given the officials better picture of what was unfolding and more confidence in addressing resolution as the crisis unfolded. It is encouraging that the Financial Stability Board's Cross Border Crisis Management Working Group under the Chairmanship of Paul Tucker, Deputy Governor of the Bank of England, is pressing forward on this agenda once again.
19. Some excellent papers have been done on this subject at a variety of institutions. See for instance, *New Financial Order, Recommendations by the Issing Committee*, Prepared for the G-20 in February 2009. *Regimes for Handling Bank Failures: Redrawing the Banking Social Contract* by Paul Tucker, Deputy Governor of the Bank of England, June 30, 2009. Available at <http://www.bankofengland.co.uk/publications/speeches/speaker.htm#tucker>. Also by Tucker see "The Crisis Management Menu, November 16, 2009. In the speech Tucker emphasizes the ongoing work by the FSB, the Financial Services Authority of the UK and historic work at the BIS dating back to the closing of BCCI. It appears quite clear from the writings of the Governor of the Bank of England, Mervyn King, Deputy Governor Tucker, Andy Haldane, and Adair Turner at the FSA that the British efforts to address the LCFI resolution problems, both domestic and global go far beyond what the Federal Reserve Board and U.S. Treasury have proven willing to address. Within the United States Sheila Bair, the Chairperson of the FDIC and her staff have been the most imaginative in addressing these challenges. Michael Krimminger at

the FDIC has written a number of papers on the themes discussed here and serves on the BIS Cross Border Banking Resolution Group. Also see the prescient work by Garry Schinasi including *Safeguarding Financial Stability: Theory and Practice* (Washington, DC: International Monetary Fund) 2006.

20. See for instance, *Report and Recommendations of the Cross-border Bank Resolution Group*, Basel Committee on Bank Supervision, September 2009. Online at <http://www.bis.org/publ/bcbst162.htm>
21. Lehman Brothers was reported to be well capitalized the day before they ceased operations in September of 2008
22. Many have noticed the heads financiers win - tails the taxpayer loses system of limited liability that the current taxpayer backed system provides. Lucien Bebchuk and others have suggested that top management is drawn to excessive risk taking and that a modification of their payoff incentives in those states of nature when the firm becomes insolvent may be a way to keep management out of the magnetic field of lemon socialism's attractions. See Bebchuk and Spamann, *Regulating Banker's Pay*, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1410072
23. See Thomas Ferguson's *Golden Rule, The Investment Theory of Party Competition and the Logic of Money-Driven Political Systems* for more on the extraordinary role that money and business power has had in shaping American political outcomes.

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