Public Policy Responses to Distressed Non-Bank Financial Institutions

Professor Franklin R. Edwards

fre1@columbia.edu

COLUMBIA BUSINESS SCHOOL

Systemic Risk and Banks

- Past concerns about financial instability and systemic risk centered on the potential for the failure of one or more banks to spread to all banks and cause a general loss of public confidence in financial markets, resulting in the
  - Disruption of the supply of liquid deposits (money).
  - Freezing-up of the payments system.
  - Reduction of credit availability for businesses.

Systemic Risk and Non-Bank Financial Institutions

- Today concerns about systemic risk extend to the failure of non-bank financial institutions.
  - Financial institutions rely heavily on short-term financing and depend on investor confidence to refinance their obligations.
  - The collapse of investor confidence can precipitate a liquidity "run" on debtor firms resulting in forced asset sales at fire-sale prices, which can ultimately cause the insolvency of the debtor.
  - Acceleration clauses in debt and derivatives contracts, which are common, can precipitate a liquidity run well before balance sheet (or market value) insolvency.

Recent Central Bank Assistance to Non-Bank Financial Institutions

- Long Term Capital Management (LTCM), 1998 – a hedge fund
  - Engineered a private “bailout” of LTCM, protecting LTCM’s derivatives counterparties and large creditors (mostly banks).
  - Fed acted in effect as an unofficial “trustee in bankruptcy” because the Bankruptcy Code would not have been effective in preventing a counterparty liquidity run on LTCM.
- Engineered and supported a takeover of Bear Stearns by J.P.Morgan Chase (2008).
- Extended traditional discount window privileges to selected investment banks (2008).

Recent Government Assistance to Non-Bank Financial Institutions

- Bailout of Thrifts (1989)
  - Resolution Trust Corporation established to purchase "bad" assets from failing thrifts and the recapitalization of thrifts.
- Fannie and Freddie (2008)
  - Treasury seeks powers to provide unlimited financing to Fannie and Freddie and to recapitalize them through the purchase of equity.
  - The nationalization of Fannie and Freddie?

Problems With These Ad Hoc Rescue Mechanisms

- Lack of market certainty -- which institutions qualify for assistance and what assistance?
- Creditors do not effectively penalize risk-taking.
- Increased risk-taking by all financial institutions.
- Lack of oversight (or governance) to control institutional risks-taking.
- Potential taxpayer liability, exemplified by recent Treasury actions in response to the problems at Fannie and Freddie.

Implications for Financial Stability

- The “forest fire” analogy.
- Result is likely to be an increase in financial instability and systemic risk.

Implications for Taxpayers

Bankruptcy As An Alternative for Dealing With Distressed Non-Bank Institutions

- The Federal Bankruptcy Code (Title 11 of U.S. Code)
  – Note that banks are excluded under section 109.
- Objectives of Bankruptcy Code
  – Restoring the firm to financial solvency by renegotiating creditor claims if debtor firm has "going concern value." (Chapter 11).
  – Coordinating debt collection efforts of multiple creditors to maximize overall recovery value. (Chapter 7)
  – Maximizing the realized value of the bankrupt firm's assets. (Chapter 11)
- Concerns about systemic risk and broader economic impacts are not considerations.

Creditor Runs and the Automatic Stay

- Under the Code <u>most</u> contracts are automatically "stayed" by courts (temporarily preventing creditors from pursing their claims).
  - Considered central to preventing a creditor run on debtor that can result in a fire-sale of assets.
  - Note that the objective of the Code is to maximize realized value of the firm's assets, not to prevent or contain potential systemic effects.

“Derivatives Securities” Exemption

- Derivatives securities counterparties are treated differently under the Code: they are exempt from the “automatic stay.”
- The rights of these counterparties are derived from contracts or agreements, as opposed to the Bankruptcy Code, which generally permit such counterparties to

  1. Terminate or modify contracts.
  2. Liquidate debtor’s assets irrespective of whether debtor is actually in default under the contract.
  3. If counterparties hold other assets of debtor they can “offset” (so long as they can enforce their rights against such assets).

Why Does the Code Offer This Special Treatment to Derivatives Counterparties?

- Rationales offered by Congress and ISDA:
  - To mitigate systemic risk that could be triggered by defaulting derivatives counterparties.
  - To prevent the failure of a major derivatives counterparty from destabilizing other counterparties and dramatically reducing market liquidity.
  - To enable the prompt liquidation of an insolvent counterparty's position in order to minimize "the potentially massive losses and chain reaction of insolvencies that could occur." (H.R. Rep. No. 97-420, at 1(1982))

The Case of LTCM

- Derivatives exemption in the Code exacerbated the LTCM crisis
  - Threatened a derivatives counterparty "run," which would have exacerbated LTCM's liquidity shortage and precipitated a fire-sale of its assets.
  - This could have imposed large losses on LTCM's counterparties and creditors (the banks).
- Fed's intervention to arrange a private bailout of LTCM was prompted by the potential systemic consequences of a counterparty run.

Implications of the LTCM Crisis

- Systemic risk might arise in non-bank markets when a massive market player fails.
- In such cases the Bankruptcy Code may exacerbate systemic effects by increasing market illiquidity and facilitating the implosion of a major market player.
- The Code does not provide a “fix” for resolving non-bank financial institutions which threaten systemic consequences.

Is the Bank Insolvency Process an Alternative?

- The insolvency process applicable to banks is very different from that of the Bankruptcy Code for non-banks, and has different goals.
  - A primary goal is “least-cost-resolution” -- minimize the cost to the deposit insurance fund (as opposed to maximizing recovery for creditors under the Bankruptcy Code).
  - But an important second goal is to contain serious adverse effects that bank insolvencies might have on financial stability and the economy (the so-called “systemic risk exemption”).

The Systemic Risk Exemption

- FDIC may bypass the least-cost-resolution requirement if adhering to it "would have serious adverse effects on economic conditions and financial stability and any action or assistance … would avoid or mitigate such adverse effects."
- Similarly, in asset sales FDIC must "…fully consider adverse economic impacts …"

Key Aspects of the Insolvency Process

- Speedy legal closure and resolution of banks by FDIC, acting as Receiver or Trustee.
  - Bank's charter is revoked, shareholder control interests are terminated, and senior management is typically changed.
- Process is administrative as opposed to judicial, with limited judicial review and strong legal certainty.
- Prompt corrective action is required of bank regulators -- early intervention prior to insolvency to protect FDIC interests. (FDICIA, 1991.)
- Authority to charter a temporary national "bridge" bank as an alternative to liquidation under receivership or administration under conservatorship. (Competitive Equality Banking Act, 1987.)

The Bridge Bank Mechanism

- Bridge bank can be an effective mechanism for dealing with potential systemic effects.
- Bridge bank can be used to keep all or parts of an insolvent bank operating under a new FDIC-appointed management and FDIC ownership while the bank is resolved in an orderly manner.

Implications of Extending Bank Insolvency Process to Non-Banks

- Explicit expansion of federal safety net.
- Greater regulation of non-bank financial institutions.
- Increased regulatory costs.
- Potential for expansion of moral hazard risk and increased systemic risk.

Some Unanswered Questions

- Would FDICIA provisions be able to contain systemic effects if a large bank were to fail?
  - Evidence on effectiveness of FDICIA is limited to the resolution of relatively small banks failures.
- Will regulators actually take prompt correction action?
  - Recent IndyMac Bancorp Inc. experience ($19 billion in deposits)

Another Alternative: A Third Insolvency Process?

- Combine elements of both the bank and non-bank insolvency processes to create still another insolvency process applicable to non-bank financial firms.
  - Applicable to which non-bank financial firms? Large investment banks, hedge funds, those too big to fail?
  - What would be its objective?
  - Which elements from each code would be used?
    - The bridge bank mechanism?
    - An administrative or judicial process?
    - Would private creditors be represented?

A Final Alternative: Make Private Markets Work Better

- Create clearing associations for off-exchange derivatives markets to mitigate externalities associated with counterparty failures.
- Reduce reliance on credit ratings as regulatory tools.
- Make credit ratings more accurate and timely by improving the incentive structure of credit rating organizations.
- Increase transparency of financial instruments and institutional exposures.