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A Macroeconomic Perspective

"Dealing with Too Big to Fail"

Andrew Crockett

The existence of financial institutions that are perceived as too big (or too important) to be allowed to fail can impose economic costs by enhancing the incentives for socially undesirable risk taking. If providers of funds to financial institutions regard themselves as protected by the prospect of government support, they will be willing to commit more resources and engage in less oversight than if they believe borrowers will be subject to normal commercial disciplines. As a result, some "too big to fail" institutions may be tempted to assume higher levels of risk than warranted by optimal resource allocation. To the extent that this is true, economic distortions are created while such institutions are active, and a potential charge on taxpayers arises when they run into difficulties. Prudently managed and successful enterprises, of whatever size, are penalized by comparison.

It should not be difficult, therefore, to agree on the principle that all institutions in a competitive market economy should face the threat of failure as a result of bad business judgment. Indeed, it will not be possible to say that a financial system is fully capable of meeting its function of guiding resources to their most efficient uses until the anomaly of "too big to fail" is dealt with. This is, in fact, a major goal of much financial reform legislation being enacted around the world.

To make the threat of failure credible, however, it must be possible for any troubled financial institution that cannot be recapitalized as a going concern to be sold, merged, or wound down without creating unacceptable costs or risks to the broader economy. This is not perceived to be the case at present. Despite legislative initiatives following the recent crisis, many observers believe that governments would nevertheless feel obliged to step in to protect key financial institutions during future periods of stress. They argue that the failure of a large and interconnected institution would be so disruptive to the financial system in general that, whatever governments might say now, they will feel obliged to intervene in the event of crisis to support such institutions.

A corollary of this argument is the view that the institutions concerned should either be broken up or carry such high levels of equity capital as to be effectively safe from failure. But such a policy prescription carries its own risks of resource misallocation by (1) diverting possibly excessive levels of capital into financial intermediation, (2) distorting competition between regulated and unregulated institutions, and (3) substituting administrative judgment for market processes in determining the most efficient structure of the financial industry. Developing techniques to make failure a tolerable option—such as the new Chapter 14 of the U.S. Bankruptcy Code, discussed in chapter 2—would not only restore market discipline and protect taxpayers but also avoid potentially costly measures that seek to eliminate the possibility of failure.

An important consideration that can lead to an institution being viewed as too important to fail is the degree of its interconnectedness with other parts of the financial system. The more that one institution's distress is perceived as creating problems for others, the greater the expectation it may have to be rescued by the authorities.

It is therefore of key importance to reduce the vulnerabilities created by interconnectedness as much as possible.

In a modern financial system, of course, institutions are connected by a variety of trading links and counterparty relationships. These links are essential for risk management and diversification, as well as for efficient credit allocation. There are, however, techniques for reducing gross exposures through netting and the use of central counterparties (CCPs). By utilizing a small number of CCPs, managed and regulated separately from the institutions that use their services, the overall exposures in the system may be reduced considerably. Much reform effort has therefore been devoted to channeling transactions toward regulated exchanges, central clearinghouses, and real-time settlement systems. Standardization of transaction instruments is helpful in this regard, though it should not prevent the creation of bespoke transactions where this is warranted.

Of course, the reduction of risk for trading institutions is achieved by concentrating exposures within clearing and settlement systems. It will also be important, therefore, to have robust oversight of CCPs and well-conceived recovery and resolution plans in case these institutions themselves encounter difficulties. It is probably also necessary to have a suitable safety net in place to ensure that key functions performed by infrastructure utilities are not interrupted. Admittedly, this may lead to moral hazard, but moral hazard is a less-pressing concern when the entity involved is a regulated utility rather than a purely profit-maximizing enterprise. Indeed, it may be worth considering whether a not-for-profit model might be more suitable for certain key infrastructures.

Even if the transactional infrastructure is strengthened in the way just suggested, financial institutions will still be vulnerable to periodic stress, and the authorities will need to respond when they are. The issue is complicated by the currently well-recognized fact that standard bankruptcy procedures are not well suited for financial institutions. A financial institution cannot function in bankruptcy in the same way as a commercial enterprise. It cannot obtain temporary protection from its creditors because access by creditors is its raison d'être. As a result, when bankruptcy occurs, it is liable to be much more disruptive to the institution's creditors and counterparties than is the case with a nonfinancial enterprise. Moreover, when the institution concerned is large, it may play such a pivotal role in an economy that the government may be reluctant to accept the consequences of its failure. Such potential systemic consequences have motivated past rescues of troubled financial institutions.

These considerations suggest that, to make the ending of "too big to fail" truly credible, a specialized resolution regime for large financial institutions needs to be developed. Such an approach (as discussed in chapter 2) could involve a special chapter of the U.S. Bankruptcy Code that takes account of the specific characteristics of large financial institutions. Such a resolution regime would need to ensure that an institution encountering difficulties could continue to serve socially essential functions and would not be liquidated in a manner that disrupted financial intermediation more generally or destroyed value unnecessarily. Moreover, to avoid moral hazard, it would require that owners and creditors of the institution bore losses that were predictable and in accordance with their position within the capital structure of the enterprise. It would need to protect taxpayers from direct losses due to the provision of solvency support, as well as, to the extent possible, indirect losses due to the wider economic effects of the enterprise's failure. Finally, for globally active institutions, it would need to ensure there was a mechanism that defined fairly the relative roles of the authorities in each of the jurisdictions in which the institution was active.

It is important to note that, for a financial institution, "failure" does not inevitably mean bankruptcy and immediate liquidation. It can cover a number of different responses to a situation in which the enterprise is unable to continue operating in its preexisting form. The possibility of failure arises whenever a financial institution faces difficulties in attracting funding to meet its commitments. There are a variety of possible responses to such a situation—which means there would need to be a variety of tools to secure a socially optimal result in particular circumstances. These tools fall loosely into two categories: (1) "recovery" of the troubled institution through sale as a going concern or recapitalization, and (2) "resolution" through breaking it up and liquidating some or all of its assets.

Normally, it would be preferable to first attempt to sell a troubled institution to a stronger competitor, which may be possible if it has a strong franchise value, and provided there are no negative consequences from a competition perspective. Naturally, the search for an acquirer would have to start well in advance of the prospect of imminent failure, and may be facilitated by actions from the firm's supervisor. It is important, however, for any official assistance to avoid financial commitments that, in effect, bail out creditors of the failing firm. If no purchaser is available or suitable, another approach is to write down the value of existing unsecured debt (or convert part or all of it to equity) in a sufficient amount to restore the viability of the enterprise. This would have to be done in such a way that no creditor would be disadvantaged by comparison with their position in liquidation. Again, to avoid moral hazard, taxpayer funds should not be put at risk, though temporary liquidity, suitably collateralized support need not be ruled out.

Only if sale or recovery is impossible would it become necessary to "resolve" a failing institution. But resolution is unlikely to be most efficiently accomplished by immediate liquidation. There will almost certainly be activities that can be spun off and made profitable; and there may be other activities that are deemed essential from a social point of view (e.g., utility functions, such as clearing and settlement). Even those activities that are deemed nonviable in the longer term may well involve avoidable social costs if terminated abruptly.

Part of any resolution regime should therefore be to develop techniques that enable certain functions of a failing financial institution to continue to be performed, while running down over time those activities or parts of the balance sheet that have become unviable. At the same time, to avoid moral hazard, it is essential that equity and debt holders bear their appropriate share of the losses involved. The first loss should always fall on equity owners, with further losses being borne by subordinated debt holders, unsecured creditors, and so on up the capital structure.

One means of resolving a troubled financial institution while maintaining incentives and preserving as much value as possible—which has been successfully applied in a number of countries—is to separate the balance sheet into a "good bank" and a "bad bank." The good bank would retain the assets that continue to perform in accordance with their contractual terms, along with their sources of funding (which, in the case of a bank, would include insured deposits). Such an institution would be potentially profitable and, perhaps after a period of publicly provided liquidity support, could be returned to full private ownership relatively quickly. The bad bank would contain most of the impaired assets, together with, on the liability side of its balance sheet, the subordinated and unguaranteed sources of funding. These assets would be run down over time (in order to maximize recovery values) and the creditors repaid whatever share of their investment was realizable from asset sales.

The creation of a good bank and its eventual return to full private ownership helps answer the concern that the failure of an institution may have an adverse effect on competition within the industry. In those countries where banking systems are already concentrated, there is understandable worry that the disappearance of a major institution would add to oligopoly risks. To the extent that this is a valid concern, other techniques are available to combat it. The competition authorities can prevent the sale of the troubled institution to a dominant competitor and provide instead for independence under new ownership.

In order to achieve the objectives of orderly resolution of a large financial institution facing distress, a clear legislative framework would need to be put in place. Ideally, such a framework would promote certainty by limiting the amount of discretion the authorities could apply in implementing the framework (although it is probably unrealistic to eliminate discretion entirely). A key requirement, as I have already emphasized, would be to enforce losses in accordance with the capital structure of the institution in difficulties.

Such a framework would also need to distinguish between those claims on the institution that would be subject to a "stay" in bankruptcy and those that could be immediately exercised. This is not a simple judgment, as other chapters in this volume make clear. The recent crisis revealed the dangers of exempting illiquid securities from stays. The liquidity of the claims secured by such instruments as collateralized debt obligations depends crucially on the marketability of the underlying instrument. When this comes into question, say because of uncertainty about valuations, creditors demand greater collateral margin (haircuts). However, posting additional collateral immediately squeezes the liquidity of the borrower, prompting concerns about its funding strategy. As the process unfolds, a vicious spiral sets in—which, in the recent crisis, led to a freezing up of the repo market and was a major factor in the failure or near failure of key market players. It thus seems desirable that exemption from stays should be limited to those securities that, with high confidence, will maintain their credit standing and marketability.

Nonexempt transactions would be subject to the normal stay in bankruptcy, going with the bad bank to be liquidated over time with the objective of maximizing value. The bad bank might need liquidity support to finance its portfolio over the period in which its assets were being liquidated. This amount would be small if creditors were only paid out of the proceeds of sales as they occurred, but it could be larger if creditors were allowed early access to funds, based on an estimate of recovery values. This might be desirable to alleviate stress among the creditors. The interest of taxpayers could be protected by employing conservative values for assets, combined perhaps with "clawback" provisions in case recovery values proved to be overestimated. A further protection could be provided by requiring any residual loss to become a charge on the industry. However, this does not fully address the problem of moral hazard, as prudent "survivors" in effect become providers of funds to the less-prudent "victims."

An important issue arises concerning the treatment of the management of a distressed financial institution. Some of the legislation enacted following the recent crisis seems based on a desire to ensure that management is "punished" for its failures. Thus, it is proposed that in future failures, management should be relieved of its position immediately. Although this motivation is understandable, it would be more appropriate, and help to maximize recovery values, to adopt a pragmatic approach. Given that the franchise value of a financial institution is significantly dependent on the human capital of its senior management, there is a case for allowing such capital to be retained as long as necessary to realize the greatest value from ongoing operations.

A final issue arises regarding institutions with international operations. Different legislative philosophies across different jurisdictions complicate the task of ensuring equal treatment in resolution for creditors of large global financial institutions. Realistically, it is highly unlikely that full legislative harmonization will be achieved any time soon. Some observers consider that this points to ring fencing subsidiaries so that each could be resolved within a single national jurisdiction. While this would help, it would not be a full solution and, in any case, it would work against some of the economies that come with cross-border operation.

A better solution would be to make use of the fact that all major jurisdictions are in the process of developing special resolution regimes for large and complex financial institutions, and attempting to make these regimes mutually consistent and supportive. This would include, *inter alia*, provisions for information sharing (both during crises and in "peacetime"), protocols governing common treatment of creditors in different jurisdictions, preexisting understandings (perhaps developed through "living wills") about how a distressed institution would be resolved, and so on.

None of this will be easy. But the Financial Stability Board has provided a set of "Key Attributes" of recovery and resolution regimes that give grounds to hope that, with effort and goodwill, the issue of "too big to fail" can finally be put to rest. Full acceptance that it has ended will probably have to await a successful resolution of a failing institution without taxpayer costs or systemic fallout. But in the meantime, participants in financial markets should be encouraged to act as though the creditors of a stressed institution will no longer be bailed out by the authorities.