



Resolving Large, Complex Financial Firms

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How to best manage the failure of systemically important financial firms was the theme of a recent conference at which the latest research on the issue was presented. Here we summarize that research, the discussions that it sparked, and the areas where considerable work remains.

One of the most pressing policy issues facing those who supervise financial firms these days is the problem of systemically important financial institutions. Sometimes referred to as *too big to fail*, systemically important financial institutions are ones whose failure has potential destabilizing spillover effects on other financial companies, financial markets, and the real economy. The resolution process for such firms too often includes the passing of their losses on to society at large through bailouts of creditors and sometimes shareholders. This reduces market discipline, and the attendant moral hazard leads to more risk taking by systemically important financial companies, which in turn reduces the overall stability of the financial system.

In April 2011, on the heels of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (DFA), the Federal Reserve Bank of Cleveland held a conference on Resolving Insolvent Large and Complex Financial Institutions. The goal of the conference was to bring together legal and economic scholars, industry practitioners, and policy-makers to address the challenges associated with closing insolvent systemically important financial companies and to consider some potential policy responses. This *Commentary* summarizes the issues discussed at the conference.


Complexity as a Challenge

There is an extensive literature on what makes a financial firm systemically important and the difficulty of resolving such firms when they become insolvent. For instance, James Thomson argues that in addition to size, there are four general sources of systemic importance: contagion, correlation, concentration, and conditions (Thomson 2010). A recurring theme across the papers and presentations at this conference was complexity—of financial firms, markets, and products—as a source of systemic consequence. Complexity was discussed in three contexts: transparency (complexity reduces it), firm resolution (complexity makes it more difficult), and regulatory forbearance (complexity encourages regulators to forebear or bail out firms). The 2007-2009 financial crisis exposed a number of breakdowns in the structure of

corporate governance and in the internal risk controls of large and complex firms. Complexity impedes corporate governance by reducing transparency of the firm, its operations, and its connections in the financial system. It was noted that a systemically important financial institution's operational structure often does not reflect its legal structure. This reduces the ability of internal stakeholders (boards of directors, shareholders, creditors) and external stakeholders (regulators and markets) to effectively discipline the firm. Naturally, some of this complexity arises because firms must contend with overlapping regulatory jurisdictions—both within the United States and across sovereign borders.

In addition to causing suboptimal corporate governance, complexity is also a major issue when attempting to resolve systemically important financial companies. A large internationally active financial company can have a legal structure that includes several hundred legal entities, has a presence in as many as 100 different national jurisdictions, and may face oversight by three or more financial market supervisors in each of the jurisdictions in which it operates. Because managing these companies is likely to be conducted along functional or business lines without regard to legal entities, there are complex relationships across the subsidiaries of the conglomerate. This means that intrafirm connections and exposures may be as important a constraint on the orderly resolution of the systemically important financial company as are external connections.

Complexity also serves as a constraint on the ability of financial supervisors to close and unwind the operations of the firm—at least without fear of systemic spillovers. Because of this, complexity can be a source of regulatory forbearance. Research presented at the conference suggests that when regulators have overlapping jurisdictions but different objectives, they are individually less likely to close a systemically important financial company than a single regulator with both objectives. Additionally, firms may choose to be complex even when the only value of complexity is an increased probability of a taxpayer funded bailout. This



research is consistent with the observation that complexity is form of regulatory and tax arbitrage.

Living Wills

One partial remedy to complexity covered at the conference was living wills. In a regulatory context, living wills refer to plans by financial firms for the unwinding of their operations in the event of financial distress, including how the financial firm would be resolved in bankruptcy. Living wills are of particular interest because they provide a disincentive for firms to become complex for complexity's sake and increase the ability of bankruptcy courts and financial system supervisors to wind down the affairs of systemically important firms without fears of destabilizing systemic spillovers from the failure.

The discussion of living wills pointed to benefits beyond those associated with handling a firm's failure and the challenges presented by the adoption of living wills as a standard. It was noted that constructing living wills may force firms to rationalize their corporate structure, leading them to become less complex and more transparent, and potentially improving corporate governance. Of course, simply mandating that systemically important financial firms have a living will in place does not guarantee that the will is going to be beneficial. The challenge facing policymakers and financial firms is ensuring that the costs of constructing these plans do not exceed the benefits.

To avoid this outcome, legal and industry practitioners argued at the conference that the design of the first generation of credible living wills should include certain core elements, such as access to critical counterparty and collateral information, triggers for activating recovery or resolution plans, and a menu of available actions related to capital, liquidity, and the declining value of assets as the weaknesses of the firm become evident. Regulators' use of living wills should also be guided by core principles. To maximize their effectiveness, living wills should be coordinated across supervisors and jurisdictions; that is they need to be part of the larger supervisory framework. In addition, living wills need to be risk-based and iterative (allowed to evolve as firms and financial supervisors gain experience in drafting and implementing them).

When resolution plans are not feasible or cannot be executed in a reasonable time, it was noted that the supervisors may benefit from the power to compel systemically important financial firms to take some actions. These may include proposing alternative plans, simplifying their legal structure, improving information technology infrastructure, spinning off activities, and so on.

Challenges with International Coordination

The challenges of resolving insolvent systemically important financial institutions are compounded by international operations. A potential response to the challenges posed by large, complex, internationally active financial institutions would be to directly address the complex firm structures that impede cross-border resolution. One proposal presented at the conference is for internationally active firms to oper-

ate as a single entity under a single bank charter—without a parent holding company, affiliates, or subsidiaries. The single charter proposal may be an unreachable goal, in part because it would require dramatic changes to the law. However, it provides a framework for examining the benefits of simplifying legal structures, and better aligning them with operating structures for the resolution process.

Under the single-charter proposal, the resolution of a failed financial firm would be placed under the jurisdiction of the home country, which would draw on input from the members of a supervisor college or other consultative body. The objective of the home country supervisor would be to maximize the value of the global estate for the benefit of all stakeholders regardless of location. Host-country supervisors need leverage within this regime to ensure they are fully informed and necessary efforts are taken to coordinate the disposition of local affiliates, assets, or activities. This necessary leverage could be provided by giving the host-country supervisor the ability to call a meeting of the supervisory college or to take independent action if the home-country supervisor is unresponsive. A unified resolution process, grounded in territoriality but moving toward universality, may help counter the destructive nature of national ring-fencing of assets and increase overall value.

Discussion of international coordination also emphasized the importance of the use of coordinating bodies such as an international college of financial market supervisors. The activities of such international bodies could include conducting annual simulations of a resolution under varying stress conditions. These types of simulations could greatly improve scenario planning. The exercise would allow supervisors to anticipate what might happen and to make appropriate preparations, such as developing modes of cooperation or making clear their intent to ring-fence assets. Although these exercises would not be legally binding, they could provide additional clarity as to the likely responses of national financial market supervisors in a crisis situation as the personal integrity of supervisors would provide an incentive for them to be candid in simulated responses to crisis scenarios.

Internationalization of the supervisory process to protect against under-reaching by supervisors may also be valuable. History shows that supervisors consistently forbear in the worst cases, relaxing standards for failing institutions to avoid resolving them. Greater involvement of an international body, such as the Basel Committee, in coordinating cross-border strategies would prompt action by domestic supervisors. Guidance and announcements by an international committee can limit second-guessing of supervisory decisions by providing domestic supervisors with the support of experts and insulation from political pressure. This is consistent with Kane's (1989) analysis of the 1980s thrift debacle, where he finds that concerns about potential career damage and political pressure underlay the failure of thrift regulators to respond forcefully to the growing insolvency of the U.S. savings and loan industry.

Judicial versus Administrative Resolution

There are basically two distinct regimes used to resolve financial companies in the United States. One is the judicial regime under the Bankruptcy Code. The other is the administrative resolution authority of the Federal Deposit Insurance Corporation (FDIC). Before the DFA was enacted, the FDIC's authority extended only to insured depository institutions. Most other types of financial companies (a notable exception is insurance companies) are subject to resolution under either Chapter 11 or Chapter 7 of the Bankruptcy Code. The DFA's Orderly Liquidation Authority subjects "covered financial companies" to an administrative resolution by the FDIC, if resolution under the Bankruptcy Code would have adverse financial stability effects. Under the DFA, bankruptcy is still treated as the default procedure for all nonbank firms, systemic or not.

Possibly the widest divergence of opinion encountered at the conference surrounded resolution authority. This is perhaps not surprising, as the academic debate on judicial versus administrative resolution remains fractious. It was generally accepted that the trend in the United States and Europe seems to be moving towards FDIC-type administrative resolution for financial companies—at least for systemically important ones. Not everyone sees this as a positive trend.

Bankruptcy

Generally, three advantages of a bankruptcy resolution were discussed at the conference. First was that bankruptcy proceedings proceed in a transparent manner according to a predefined set of rules, which allows for better ex-ante planning. Additionally, creditors in a bankruptcy bear the risk of losses of the failed firm because the court does not guarantee asset purchases the way that a government agency would, which may create better incentives for creditors to monitor the firm's condition. Finally, commentators argue that Bankruptcy courts are more independent and less subject to political influence than a regulator acting as receiver would be.

On the other side, four specific concerns were raised about using the Bankruptcy Code to resolve systemically important firms. First, there is fear that bankruptcy proceedings can drag on for a significant length of time, which would delay the recovery of the bankrupt firm's creditors. A second but related concern is that the Bankruptcy Code focuses on maximizing returns to creditors without consideration of systemic spillovers. Third, in order for a firm to be reorganized under the bankruptcy code, there must be a creditor who is willing and able to finance the firm through the bankruptcy. Finally, there is a sharp disagreement on the treatment of qualified financial contracts under the Bankruptcy Code.

It is possible that the perceived shortcomings of the Bankruptcy Code could be fixed by amending the Code for nonbank financial institutions. Subjecting qualified financial contracts to a stay that is similar to the stay imposed under the Orderly Liquidation Authority, discussed in the next section, may improve systemically important financial firm resolution under the Bankruptcy Code. Carving out the systemically

important pieces of a firm and placing them in an administrative liquidation would allow regulators to focus on containing systemic risk, while maximizing the use of bankruptcy courts. Though there are many suggestions for amending the Code, generally it is accepted that depository institutions need special bankruptcy laws that are less debtor friendly than the Bankruptcy Code to ensure expedited liquidity access for critical groups of creditors, such as depositors.

Administrative Liquidation

Title II of the DFA created an Orderly Liquidation Authority to resolve troubled systemically important institutions. The process of placing a company into an orderly liquidation under Title II is no quick or easy task, as there are a number of procedural hurdles that must be cleared. If a firm meets the criteria to be considered a "financial firm," and it is in default or danger of default, the Secretary of the Treasury and a number of federal governmental regulators must agree that the resolution of the company under other laws would have serious adverse effects on the financial stability of the United States, and those effects could be mitigated by using the Orderly Liquidation Authority. The collective-decision making aspect of the Orderly Liquidation Authority may encourage greater information sharing between regulators, which, according to research presented, should lead to fewer suboptimal resolution decisions.

In an FDIC-style administrative resolution, be it a systemically important nonbank financial company placed into a DFA orderly liquidation or a traditional bank receivership, the FDIC as receiver of the failed institution looks to minimize losses associated with the financial firm's failure. Banking law grants the FDIC nearly complete authority in the disposition of a failed financial company's estate, subject to a least-cost-to-the-deposit-insurance-fund test. Unlike bankruptcy, the FDIC can self-fund the receivership. This provides the FDIC with significant flexibility relative to a reorganization or liquidation under the Bankruptcy Code.

While an administrative resolution authority may be a valuable and legitimate way to maintain stability in the financial system, it is not without its shortcomings. Time-consistency problems can lead to the underuse of resolution authority during good times and overuse during bad times. One of the presenters noted that in the midst of the financial crisis in 2009, the FDIC issued prompt corrective action orders only in 19 percent of the cases in which the banks ultimately failed, an observation consistent with the underuse/overuse hypothesis. The Orderly Liquidation Authority is likely to suffer from this problem, as the DFA provides insufficient protection against overuse and underuse of the resolution authority by supervisors.

Recapitalization as a Resolution Option

The resolution of insolvent systemically important financial companies does not always mean liquidation as implied under an FDIC receivership process for banks and some systemically important nonbank financial companies. Nor does it necessitate reorganization in bankruptcy proceedings, or a hybrid bankruptcy-FDIC resolution process. In a systemic

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banking crisis, solvency resolution may mean the recapitalization of insolvent firms by taxpayers. While there is general agreement that recapitalization is vastly overused, is not always done in a directly accountable way (as a fiscal policy action or regulatory forbearance), and creates moral hazard, it still may be required in some situations and needs to be considered.

Why would recapitalizations be desirable as an option for resolving insolvency, especially when considerable time and thought has been directed toward ending bailouts of financial firms? The answer is simple: the failure of a systemically important financial company is likely to come at a time of deteriorating financial market conditions, when a large share of assets in the financial sector will be held by insolvent financial firms. In other words, recapitalization is probably not an option to consider when a single systemically important financial company fails, but it may be a viable option when dealing with a systemic financial crisis.

Systemic financial crisis management entails three distinct phases: containment of the crisis; recovery of the financial system; and restoration of credit flows. When dealing with multiple firm failures, recapitalization may be the best option for restoring credit

flows. The presentations at the conference included a cross-sectional study of banks in 15 developed countries during the 2007-2009 financial crisis that looked at the impact of public recapitalizations of banks and other financial firms on lending. The results suggest that recapitalizations tend to increase lending, but the effect is far from uniform. The largest effect occurs when large banks are recapitalized and when the form of recapitalization is common equity, as opposed to preferred equity. However, the results imply that partial recapitalization of the financial system is likely to have immaterial effects on lending, as increases in lending by recapitalized financial firms are offset by reductions in lending by those remaining in financial distress.

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Conference papers are available at <http://www.clevelandfed.org/research/conferences/2011/4-14-2011/index.cfm>.

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