
Extending Resolution Authority Beyond Banks

Douglas Elliott, The Brookings Institution
AEI Conference: Addressing Systemic Risk
June 3, 2009

Why not stick with regular bankruptcy process for all financial institutions?

- Designed to allow creditors to split losses fairly and minimize size of the collective loss
- Assumes that effects on public are small or are optimized by minimizing the collective loss
- Chapter 11 reorganization v. Chapter 7 liquidation
 - Reorganization preserves “franchise value”
 - Usually minimizes aggregate losses of other stakeholders
- Bank failure produces societal losses that cannot be effectively managed by traditional bankruptcy

Why are banks different?

- Banks provide secure place to store funds
 - Converts short-term money into longer-term loans and other investments
 - Enhances efficiency of financial system
- This role is incredibly important
 - We back it explicitly with deposit insurance
 - Implicitly, the government guarantees it
- Deposit insurance gives government a stake in minimizing bank insolvencies

Benefits of bank resolution authority

- Gives government control of the insolvency process to protect the public interest
 - Protection of depositors
 - Avoidance of disruption of the payment system
 - Swift resolution of claims
- Expanded to include “prompt corrective action” steps
 - Allows government intervention prior to insolvency
 - Includes taking outright control while a bank is still theoretically solvent

Benefits of resolution authority, cont'd

- Prompt corrective action regime theoretically reduces losses by seizing a bank before insolvency
- In practice losses can still be large
- Also increases regulators' leverage to force risk reduction or capital-raising

Modern financial institutions are increasingly important to the economy

- Financial institutions are both bigger and more interlinked with each other
 - Web of financial transactions more complex
 - Size of transactions relative to economy ever larger
- “Too Big to Fail” often means “Too Interlinked to Fail”
- Failure would have ripple effects
 - Harms trading counterparties and creditors
 - Actual losses, uncertainty and illiquidity create damage
- Ripple effects create rationale for resolution authority extending beyond banks

Resolution authority over banks alone is insufficient

- Some Too Big to Fail institutions not covered by resolution authority for banks
 - Securities firms
 - Insurers
 - Other non-banks
- Banking groups themselves have numerous connections between banks and non-bank affiliates, especially a bank holding company

An Illustration: Seizing Citi

- See: “Pre-emptive Bank Nationalization Would Face Thorny Issues” (Elliott 2009)
- What if: regulators conclude that Citibank needs to be taken over quickly
- Citigroup could inject up to \$100 billion of additional capital to avoid immediate seizure
 - Could endanger the entire group by using up liquidity reserves
 - Would be rational for the holding company in order to avoid losing main bank

Seizing Citi cont'd

- No current resolution authority to seize the bank holding company
- Leaves buying the group or main bank from shareholders as only reasonably quick answer
 - Politically difficult
 - Unpalatable as public policy

An Illustration: AIG

- Lack of federal resolution authority adequate to seize control of AIG
- A major reason why the government proceeded with complex intervention
- Existence of such resolution authority might have caused AIG to reduce risk earlier
 - Concern about future regulatory action
 - Direct regulatory pressure

Counterarguments

- Argument 1: The existence of financial institutions that are Too Big to Fail is the real problem
- Argument 2: Broader resolution authority distorts the financial system by introducing considerable regulatory risk.
 - Confers almost dictatorial powers on the FDIC.
 - Only justifiable if the alternative really is as bad as portrayed

Counterarguments cont'd

- Argument 3: The traditional bankruptcy process is now streamlined enough to swiftly and fairly handle financial insolvencies.
 - Depositor priorities can be embedded in law
 - No need for near-dictatorial regulatory power
- Argument 4: Changing insolvency rules is unfair to existing creditors who lent under different rules