The argument against a government resolution authority

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The administration's plan for regulatory reform of the financial system includes a proposal that existing government agencies have the authority to resolve failed or failing "systemically important" nonbank financial institutions.[2] In support of this idea, the administration argues that authorizing the government to resolve failing nonbank financial firms is necessary to assure that these firms are resolved in an "orderly" way. The administration's concern seems to be that allowing a systemically important nonbank financial institutions to enter an ordinary bankruptcy proceeding may be "disorderly," and thus contribute to a systemic breakdown.

Nonbank financial institutions that might be systemically important include bank holding companies, insurance companies, securities firms, finance companies, hedge funds, private equity firms, and any other financial-related firm that might—because of its size, role in the financial system or interconnectedness-- cause a systemic breakdown if it fails.

This note argues that while the terms "systemic risk," or "systemic breakdown" can be defined in words, they cannot be used as an effective guide for policy action. We have no way of knowing when or under what circumstances the failure of a particular company will cause something as serious as a systemic breakdown—as distinguished from a simple disruption in the economy. Government officials' inability to forecast or predict the effect of a particular company's failure will mean that the government will take over or rescue from bankruptcy many companies that should be allowed to fail in the normal way. The effect will be to introduce moral hazard into the financial system, as creditors come to believe that large financial companies will be rescued; the financial system will be weakened as inferior managements and business models are saved from extinction by inappropriate government action; and the taxpayers will be required to bear needless costs.

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[2] United States Treasury Department, "Financial Regulatory reform: A New Foundation," June 2009

In addition, a resolution system for nonbank financial institutions is unnecessary to prevent a systemic breakdown because these institutions cannot create a systemic breakdown. A systemic breakdown occurs when the failure of one financial institution causes immediate cash losses to others, rendering them unable to meet their own obligations, and causing losses to cascade through the entire economy. This condition can only be caused by the failure of a large commercial bank, which deprives other banks of the funds they were expecting to be paid, deprives businesses of access to their payroll funds, and deprives individuals of the funds they use for their daily needs. The losses that occur as a result of the failure of a nonbank financial institution are not of this character; they occur over time as obligations that come due are not paid, and affect creditors who are generally diversified, and able to withstand an occasional loss. No business deposits its payroll with a securities firm.

Accordingly, as argued in this note, there is no sound policy basis for providing the government with authority to resolve to nonbank financial institutions, and granting such authority would be harmful to the financial system and the economy generally. Instead, failing nonbank financial institutions, both large and small, should be allowed to go into bankruptcy.

The administration's plan compared to bankruptcy

The administration's plan includes two possible scenarios—a conservatorship, in which the institution is managed back to viability, and a receivership, in which the institution is probably sold or liquidated.

- A conservatorship resembles a chapter 11 bankruptcy proceeding, in which the debtor remains in possession of its assets and continues to operate the business. In both cases, the objective is to return the firm to viability rather than to unwind it. However, in a conservatorship the firm is managed by a government agency, while in chapter 11 the operations of the company remain in the hands of its management.
- A receivership resembles a chapter 7 bankruptcy, in which the debtor is simply wound up—its assets sold and creditors paid off based on their priority.

There are two requirements for a successful exit from chapter 11—the necessary financing (known as debtor-in-possession, or DIP financing) to keep the debtor operating as a going concern, and the agreement of the debtor's creditors to take something less than what they would get in a liquidation in the hope that the debtor will eventually be able to pay them in full. In chapter 11, the debtor prepares a

plan for recovery, for approval by the creditors voting by class. If the creditors decide that the company's prospects for eventual profitability are not sufficiently good to give them a chance at recoupment of their losses, they can vote down a plan for recovery and the debtor will be liquidated.

Similarly, if the resolution agency (acting as a conservator) established under the administration's plan determines that there is no further danger of a systemic breakdown, it can liquidate the company—perhaps reimbursing itself for the funds it has extended—or return the company to financial viability if that is feasible and warranted by the circumstances.

What will occur under the administration's plan?

Taking the administration's proposal at face value, it is clear that an "orderly" resolution will begin as something like a conservatorship. This seems essential because—under the administration's assumptions-- the failure of a systemically important company will, by definition, cause a systemic breakdown. In order to avoid that result, the company will have to be kept in operation for a period of time. Assuming that the necessary financing is provided by the government (an issue discussed later), the failed financial institution will be operated by the conservator, at least for a period of time necessary to assure that there is no systemic breakdown when the institution is eventually closed. Under these circumstances, there are three possible outcomes for the failed institution's creditors.

Option 1

If the objective of an orderly resolution is to avoid a systemic breakdown, then all creditors whose loans mature when the government controls the institution will likely be paid in full as these obligations mature. Immediately stopping payments to creditors could—under the rationale for a resolution agency—cause the systemic breakdown that is feared.

Option 2

Another possibility is that the institution's long term creditors are paid currently, but advised that they will not be paid in full at the end of the government's control. This would presumably prevent the immediate losses that would occur if payments to creditors were stopped entirely. In this scenario, the short-term creditors might be paid in full or paid a portion of what they are owed when their loans

mature. These options would not be available in bankruptcy, where pre-bankruptcy creditors can only be paid in special circumstances.

Option 3

A third option might be to stop all payments to creditors. This would be closest to a bankruptcy, where the debtor in possession is not generally able to pay pre-bankruptcy creditors unless there is an exemption from the stay provisions that normally apply.

For purposes of the following discussion, we will assume that the administration's plan will involve the use of either option 1 or 2.

Is a resolution authority necessary?

What is the problem for which a resolution authority is the solution? The administration's argument is that the collapse of a large nonbank financial institution could cause a systemic breakdown; to avoid this outcome, the government should have the authority to take over any such firm and resolve it in an orderly manner. However, this idea raises a number of questions.

Systemic breakdown vs. economic disruptions

Is it possible to know in advance whether the failure of a particular firm will cause a systemic breakdown—rather than simply an economic disruption of some kind? The failure of any large company will cause disruption—loss of jobs, losses to creditors, or perhaps the disappearance of an important intermediary. It would not be good policy to set up a resolution system that is used to prevent mere disruption. That would create extensive moral hazard, and have the effect of preserving companies and managements that should be eliminated. If weak business models and bad managements are preserved by government action that would weaken our economic system overall by preventing better business models and better managements from moving up to take their place. The administration has not suggested how a systemic risk would be distinguished from a mere risk of economic disruption, and I do not believe that it is possible to determine, in advance, whether a failing company will create a systemic breakdown or simply a temporary disruption in the economy. Before the government is given the authority to take over failing financial institutions, there should be some understanding of the limits associated with this power. Without such limits, it is highly likely that the power will be used to prevent

ordinary disruptions in the economy. The recent rescues of General Motors and Chrysler are examples of government action to prevent economic disruption; no one has contended that the failure of either company—or both—would have created a systemic breakdown.

The recent internal administration debate about whether to rescue CIT is a good example of the pressures that will be brought to bear on the government if a resolution authority exists, and the arguments that will be advanced to promote its use. Again, as in the case of GM and Chrysler, no one, I think, would argue that CIT is a systemically important company. Yet, if newspaper reports are credited, there was active consideration within the administration about rescuing CIT with TARP funds, primarily because its financing was said to be essential for the survival of many small businesses. It is impossible to know whether CIT would have been rescued if a resolution authority had been in place when this debate was carried on, but the political pressure to do so would have been substantial. The only valid reason for setting up a special government resolution authority for financial institutions is to prevent a systemic breakdown, but since it is impossible to tell in advance whether a firm like CIT will create a systemic breakdown if it were to fail, there will be compelling grounds for a government rescue if the authority to do so exists.

What causes a systemic breakdown?

It is very difficult to identify a mechanism through which the failure of a large *nonbank* financial institution could create a systemic breakdown. Although many observers seem to assume that what followed the bankruptcy of Lehman was a systemic breakdown, this is far from clear. First, as John Taylor's analysis has shown, the global freeze-up in lending occurred several days *after* the Lehman failure, and was actually coincident with the Treasury-Fed request for what ultimately became TARP funds. Second, what happened after Lehman is better described as the result of a *common shock* to the market rather than a systemic event. A common shock can occur as a result of any major event that creates widespread uncertainty about the future. Lehman was such a shock, largely because of the moral hazard created by the rescue of Bear Stearns six months earlier. After that rescue, market participants were justified in believing that any firm larger than Bear would also be rescued. When that did not occur with Lehman, all market participants had to recalibrate the risks they faced in dealing with others and the hoarding of cash began. Under this analysis, what followed Lehman's bankruptcy could have been provoked by the assassination of an important world leader, the collapse of the government

of a major oil exporting country, or an earthquake in major developed country. A common shock caused by any of these events would of course not be prevented either by regulating systemically important companies or setting up a special government authority to resolve them when they fail.

On the other hand, the term "systemic risk" (what precedes a systemic breakdown) usually refers to the possibility that the failure of a single large firm will cause the failure of others through a contagion-like process in which a cascade of losses flows through an economy. The administration's concern about "systemically important firms" seems based on this idea. However, if a systemic breakdown is the result of losses others actually incurred because of the failure of a large *nonbank* financial institution, then the mechanism by which this contagion or cascading series of losses actually occurs has to be explained. Lehman's bankruptcy did not seem to cause major or systemic losses; with the single exception of the Reserve Fund, no such Lehman-caused failures have been reported. In a market in which there was none of the panic that existed in September 2008, Lehman's failure would not have caused a freeze-up that many have identified as a systemic breakdown. It is noteworthy in this connection that when the large securities firm Drexel Burnham Lambert failed in 1990 there was no major adverse effect on the markets, even though Drexel Burnham was as significant a firm at that time as Lehman was 18 years later.

It is not clear that there *is* a mechanism through which the failure of a *nonbank* financial institution, say, a bank holding company, would be able to transmit losses to other institutions so as to cause the cascade of losses that characterizes a systemic event. It is easy to see how such a cascade of losses could be caused by the failure of a *bank*. Bank borrowings—deposits—are withdrawable on demand. Businesses deposit payrolls in banks, individuals use bank accounts to pay their daily obligations, small banks deposit funds in large banks and rely on large banks for access to the payment system. If a large bank fails, all these parties and many others suffer immediate cash losses and may be unable to meet their obligations, creating a cascade of losses through an economy. This is why the FDIC has the powers it does to step in and resolve a bank immediately.

However, nonbank financial firms borrow for long and short terms, and their short-term borrowings are usually collateralized through repos or asset-backed commercial paper. If such an institution fails, there are no or very few immediate cash losses. The long-term creditors are generally diversified and can take

the eventual losses without failing themselves, and the short term or repo creditors have collateral with which to reimburse themselves.

Thus, a strong argument can be made that systemic risk or a systemic breakdown cannot be created by the failure of a *nonbank* financial institution, and if so there is no reason to create a special resolution authority to prevent the failure of such an institution. The same reason also nullifies the argument that a resolution authority would be more flexible in treating pre-bankruptcy creditors (option 2 above), since these creditors do not need special treatment in order to avoid a systemic breakdown.

Even if nonbank financial firms could create a systemic breakdown, is a resolution authority a good idea?

Even if we concede that the failure of a nonbank financial institution *could* create systemic risk, there are still several reasons why a government resolution agency for nonbank financial institutions would be bad policy.

Excessive use

The existence of authority to take over a nonbank financial institution will make takeovers more likely. As discussed above in connection with the CIT issue, once the authority is institutionalized through legislation, regulators will use it to prevent relatively minor disruptions in the economy, not just to prevent systemic risk. Regulators will fear being criticized for the disruption that the failure of a large nonbank financial institution will cause—unemployment, a decline in stock prices, the temporary dislocations that occur to some counterparties or customers—but will be congratulated and treated as heroes if they step in to prevent these events. This is especially likely to occur because, as noted above, there is no effective way to determine in advance whether a particular failure will cause a systemic breakdown or simply a temporary disruption in the economy. And of course, when a rescue has occurred, there will be no way to know whether a particular failure would have resulted in a systemic breakdown if officials had not acted.

Another important factor to consider is the ability of large companies and their managements to influence the government. This cannot be underestimated. There will be pressure on regulators to rescue firms with influential managements, or from states or districts that are represented by influential

lawmakers. If the resolution authority exists, it will be used to favor these companies, to the detriment of others, and the probably the taxpayers.

Finally, rescues of firms that should otherwise have failed hurt the firms with better business models and better managements that might have moved up to take the place of the failed firm. Even in the unlikely event that a rescued firm is eventually liquidated, the time between the takeover by the government, the introduction of government funds to keep the company operating and competing, and the prospect that the firm might one day return as a competitor will weaken other, better managed firms in the same market.

Moral hazard

The frequent use of the resolution authority will create moral hazard. A strong case can be made that the rescue of Bear Stearns did just this. After the Bear rescue in March 2008, creditors apparently expected firms larger than Bear to be saved. When Lehman was allowed to fail this expectation was shattered, causing every market participant to reassess the safety and soundness of its counterparties.

So the danger is that, as the resolution authority is used more frequently to prevent economic or financial disruptions, it will tend to create similar expectations for more and more firms , resulting in more moral hazard—and maybe even common shocks on a global scale—any time the authority is *not* used.

Cost

The FDIC administers a fund maintained by deposit insurance levies on all insured banks, and uses that that fund to finance the closing of failed banks and the compensation of the insured depositors. It then reimburses itself by selling off the assets of the failed institution. Any remaining funds are used to pay off the uninsured depositors and other creditors. If the resolution authority were to use options 1 or 2 outlined above in order to avoid what the government believes will be a systemic breakdown, the funds to keep the failed institution operating will have to come from somewhere. One source might be the industry in which the failed company operated; another might be all large nonbank financial institutions. In either case, it would be difficult to set up a fund similar to the bank insurance fund, because the amount necessary for a credible fund would be very high. The total government contribution to AIG is about $175 billion at this point and is likely to go higher. To collect this in advance

or to recover it afterward would be a serious tax on the companies called upon to make the contribution, perhaps jeopardizing their health. The likelihood, then, is that the government would have to put up the funds in advance, as it has with AIG, and hope to recover its advances at some later point.

The question then becomes whether the creditors of the failed institution (through bankruptcy), or the taxpayers, should bear this risk or take this loss. There is a credible argument that the taxpayers should pay for something that prevents a systemic breakdown—it is after all something that protects them—but given the difficulty of determining whether a failure will be a systemic event or merely a disruption, this could be a needless expense for the taxpayers, who should not be called upon to pay for mere disruptions. In a very real sense, the administration's proposal could become a permanent TARP system, with the government standing by to rescue any firm that can muster the necessary political backing.

Of course, the more frequently the rescue authority is used, the larger the companies eligible for resolution will become. This is because moral hazard will encourage their creditors to believe they are protected and the restraints of market discipline will grow weaker.

Lack of Expertise

The administration's plan does not propose to establish a new agency for resolving nonbank financial institutions, but rather to turn over the resolution responsibility to the existing supervisor of the failed institution. This is problematic; even if the existing supervisor is familiar with the way institutions of this kind operate, it's unlikely that the agency will have the specialized expertise that is necessary to resolve a failed institution. Nor is it likely that the agency would maintain this expertise on its staff as the FDIC does. The number of institutions that are likely to be resolved through this process—even if the authority is used excessively—is not likely to be large enough to warrant a permanent staff. Even in the current crisis—which is unlikely to be repeated any time soon—there were only three nonbank financial institutions that would have been candidates for special resolution—Bear Stearns, Lehman and AIG.

The alternative—authorizing the FDIC to resolve nonbank financial institutions—is not attractive either. Resolving a bank is nothing like resolving a failed nonbank financial institution. For one thing, most banks are small and are resolved over a weekend. There is almost always a buyer for the assets, and unless the bank is so large as to create a danger of a systemic effect the only creditors the FDIC has to be concerned about are the insured depositors; these are often made whole simply by transferring the

deposits to a healthy institution. Because the objective of the resolution authority will be to make sure that the failed institution does not cause a systemic breakdown (assuming it can), the resolution authority will have to be concerned about all its creditors. This factor makes it likely that when a nonbank financial institution fails, there will be no useful expertise anywhere in the government to take it over and resolve it. If we want an example of what that will be like, AIG provides it. Moreover, the FDIC is no paragon. Despite the requirements of prompt corrective action (which means the bank can be closed before it is actually insolvent), the FDIC's average loss on the banks it has closed in 2008 and 2009 has been close to 30%.

Bankruptcy, if necessary, can be improved, and is a better foundation to work from

The absence of any expertise in resolving failed nonbank financial institutions anywhere in the federal government is one strong reason for relying on bankruptcy for most failures. If there is likely to be expertise anywhere in resolving failed financial institutions, it would be in the bankruptcy courts. Bankruptcy judges are appointed for terms of 14 years and develop expertise in all aspects of insolvency and workouts. In particular, bankruptcy judges, magistrates and special masters in large cities are likely to have acquired the specialized knowledge necessary to resolve financial institutions—certainly more knowledge than government officials who have never seen an insolvent securities firm, insurance company, finance company or hedge fund. Any deficiencies in the bankruptcy system for handling large nonbank financial institutions can be addressed by legislation if these deficiencies can be identified. For example, if in a special case the government believes that it has to provide DIP financing, the Treasury could have an advance permanent appropriation of an amount that would be necessary to tide over a bankrupt estate until Congress can act.

Bankruptcy as the first choice for disposing of a failed nonbank financial institution would avoid many of the problems, discussed above, that are associated with creating a government resolution authority. It would assure that the pre-bankruptcy creditors take losses of some kind—avoiding moral hazard and maintaining market discipline—and the rules are known in advance, so creditors will be aware of their rights as well as their risks. Both the Drexel Burnham Lambert bankruptcy in 1990 and the Lehman bankruptcy show that very large nonbank financial institutions can be resolved by the bankruptcy courts without difficulty. Finally, bankruptcy provides a market-based judgment on whether a firm should return to viability. The creditors ultimately decide whether they believe the company has prospects to

repay them that outweigh the risk of throwing good money after bad. When a firm is taken over by the government, however, political pressures are more likely to be the determinants of whether the company is returned to viability.

Availability of Debtor-in-possession (DIP) financing

In all but the most extreme cases, debtor in possession financing is likely to be available in bankruptcy. DIP lenders have priority over all pre-bankruptcy creditors, who cannot receive any payment before the DIP financer has been fully paid. So when a distressed nonbank financial institution files for bankruptcy, it is likely to be able to obtain private financing to continue its operations under chapter 11. Again, unless the losses to the pre-bankruptcy creditors are so large that they can cause a systemic breakdown—an outcome that I have argued cannot occur in the case of a nonbank financial firm, no matter what the size-- there seems no reason to set up a government authority to do what the bankruptcy system can do on its own. If, for some reason, DIP financing were unavailable, the government could, as noted above, be authorized to provide the necessary DIP financing to allow the debtor-in-possession to continue operating, but this authority should be available only if there is a showing not only of need but of no available credit elsewhere at any cost.

Uncertainty and unpredictability

Finally, the existence of a government resolution authority creates uncertainty about when it will be invoked. Although, as argued above, it is likely to be invoked more frequently than it should—i.e., to prevent disruption rather than a real systemic breakdown—there will always be companies just on the other side of the "disruption line" that will not be rescued. The unpredictability about whether these borderline cases will be rescued will create arbitrary gains and losses and otherwise be harmful to investors, counterparties and creditors.

The reasons for authorizing a government resolution regime are weak

Most of the reasons to support a federal resolution authority are weak, or can be accommodated equally well in bankruptcy.

Panic runs

Highly leveraged financial institutions are subject to "panic runs" because their liabilities tend to be short-term while their assets are long term. The mismatch means that creditors who can run first are better off than those who run later. This is true, but not relevant. Above, I argue that a nonbank financial institution cannot create a systemic breakdown. Under these circumstances, there is no reason to be concerned about runs at these institutions. To be sure, runs on financial institutions are disruptive and distribute losses arbitrarily by penalizing those who do not act quickly enough to withdraw their assets from a failing institution. However, these are not sufficient reasons for the government to step in and prevent runs. Indeed, the possibility of a run on a financial institution causes investors to pay more attention to monitoring, especially monitoring of leverage. Moreover, a run causes an institution quickly to shut down, putting a stop to its losses and preserving its assets for its creditors. It is also likely to cause a change in management, which in many cases will be an improvement.

Fire sales

Without a government rescue facility, it is argued, a failing nonbank financial institution might be required to engage in a "fire sale" of its assets, driving down the value of the same assets held by other companies that are still solvent. Assuming that the institution is insolvent rather than merely illiquid (in which case Fed liquidity lending under 13(3) would be adequate), a bankruptcy filing invokes an automatic stay on collections by creditors, which prevents the necessity for a fire sale. Of course, this leaves the creditors with losses, but again there is a question whether these losses would result in a systemic breakdown.

Some experts have proposed that bankruptcy law be amended so that repo lenders and credit default swap counterparties—both of which are now exempt from the automatic stay in bankruptcy—would in the future be subject to the stay in cases where systemically important firms enter bankruptcy. There appear to be two reasons for this. First, it is argued that allowing these counterparties to sell their collateral all at once could drive down asset values and weaken other firms that hold the same collateral, and second, subjecting these creditors to the stay would force them to monitor the activities of the borrower more closely. However, it is questionable whether the sale of the collateral of a single institution, no matter how large, would have a significant effect over any extended period in the value of collateral that is otherwise of good quality, and there are many other creditors with the incentives to monitor. In addition, allowing CDSs to retain their exemption from the automatic stay may be necessary

because the management (in a DIP case) or the trustee in bankruptcy has discretion whether to accept or reject CDS contracts. This can take time, and meanwhile the CDS counterparty does not know whether to buy a replacement hedge. Finally, and probably most important, there is the difficulty of identifying systemically significant companies in advance; the uncertainty about whether a particular company is within that charmed circle—and thus will have all its repos and CDS transactions stayed—could impair financing or the ability to hedge for companies that are not ultimately rescued.

Bank holding companies

Although there is a procedure (through the FDIC) for working out failed banks, there is no such procedure for BHCs. There is no obvious reason why BHCs should be treated any differently than other nonbank financial institutions. All the arguments above about whether nonbank financial institutions can create a system breakdown apply to BHCs, which are nothing more than ordinary corporations. Banking laws severely restrict transactions between banks and their holding companies, so that the failure of a holding company would not have any adverse impact on the condition of the bank. There may be ways for holding companies to make it difficult for the FDIC to resolve failing banks (For example, the FDIC has a found cases where the failed bank had no employees—they were all employees of the BHC), but the FDIC has sufficient regulatory authority to address minor issues like this. They are not an argument for a special regulatory system for BHCs.

Ironically, the purpose of separating banks and BHCs has been to keep the “safety net” for banks from extending to the riskier activities of the holding company. Now, some in Congress who always argued for keeping holding companies from engaging in commercial activities want to spread the safety net to the financial activities of the holding company—such as securities and insurance, which are said to be riskier than banking. It is sometimes argued that BHCs should be treated differently from other financial institutions because they have an obligation to provide capital to their subsidiary banks, and if the holding company goes into bankruptcy that downstreaming won’t be possible. The idea that a BHC has an obligation to be a “source of strength” for a subsidiary bank is a Fed policy, not a law. The Fed has many times asked Congress to enact this idea, and Congress has not done so. There is in fact no obligation for BHCs to support their subsidiary banks.

Complexity

It is sometimes argued that large nonbank financial institutions such as BHCs are very complex and involve many different activities carried on all over the world. That's true, but again that doesn't distinguish BHCs or other nonbank financial institutions from other large companies that operate many subsidiaries involved in many different businesses globally. These companies can and do go into bankruptcy, and there's no sound reason to say that financial institutions must be treated differently. It is very difficult to unwind a global company because of many conflicts of laws and national interests, but again that has not been a reason not to use bankruptcy for nonfinancial institutions. The many airlines that went through the bankruptcy process and emerged to continue in business are testimony to the fact that bankruptcy can handle complex international insolvencies. In addition, the continuing progress of the Lehman bankruptcy, without major problems, is strong evidence that no new government based system is necessary.

Loss of franchise value

Unlike operating companies, financial institutions are particularly vulnerable to the loss of assets if they go into bankruptcy. Their counterparties may not want to trade with them, and their employees might leave for firms with better prospects. Operating companies, like airlines, are able to keep going because they continue to own their equipment and it doesn't make any difference to a passenger whether the airline is in bankruptcy as long as it flies from one place to another. However, many counterparties may not want to deal with a bankrupt financial institution. It is true that financial institutions—which rely more than other firms on public confidence—can disappear overnight if that confidence is lost. However, the first question we should ask is why we should care about this particular weakness. There is no obvious reason why *nonbank* financial firms should be preserved, or their creditors protected against loss, unless it can be shown that their failure will cause a systemic breakdown. BHCs, securities firms, finance companies and hedge funds are risk-takers. They should be allowed to fail; not only does the possibility of failure promote market discipline, but failure itself eliminates bad business models and weak managements, strengthening the market as a whole. So we are back to the same question about how a nonbank financial institution can create systemic risk. If that cannot be established, preserving financial institutions from failure would be very bad policy; it would preserve bad managements and business models and prevent better managements and business models from taking their place.

Conclusion

The administration’s proposal to establish a government resolution authority for certain large “systemically important” firms would be a major policy mistake. The administration has not shown how a nonbank financial institutional could cause a systemic breakdown, and in the absence of such a showing there is no reason to create a special resolution authority. Moreover, even if a nonbank financial firm could create systemic risk, the administration has not made clear how officials will be able to determine in advance whether a particular company will cause a systemic break down—rather an merely a temporary economic disruption—if it fails. In the absence of a standard for making such a determination, it is likely that the authority will be used frequently to rescue companies that might only create economic disruption if they fail. This will be especially true with respect to firms with politically powerful backers. Frequent and unnecessary rescues will introduce moral hazard and be costly to the taxpayers, who will end up paying the bills. Under these circumstances, it would be a better policy to use the existing bankruptcy system for failing nonbank financial companies. Not only is there no reason to rescue nonbank financial firms from bankruptcy, sending them through the bankruptcy system provides a degree of certainty to creditors that would not be available in a government run system, and the costs of a bankruptcy are borne by the failed company’s creditors rather than the taxpayers. Most important, the bankruptcy system encourages creditors to monitor the companies they lend to, reducing moral hazard and enhancing market discipline.