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Statement of the Shadow Financial Regulatory Committee on

The Resolution of Large, Complex Financial Institutions

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Some proposals being advocated in Congress on the management of "systemic risk" envision the creation of a new administrative resolution authority. The goal is to empower regulators to decide on a discretionary basis when and how to manage the resolution of systemically important firms, including bank holding companies and large, complex nonbank financial institutions that are deemed too important to undergo resolution under existing wind-down procedures (bankruptcy for nonbanks, and insolvency resolution by the FDIC for banks). Regulators would be empowered to impose losses on creditors or bail out creditors as they see fit, and to establish means for recouping from other financial firms some or all of taxpayers' costs relating to bailouts. These proposals reflect the desire to avoid the kinds of outcomes observed in the recent cases of Lehman and AIG. The absence of a resolution authority led regulators to choose between allowing a large financial institution to be resolved under the existing bankruptcy process (in the case of Lehman), or undertaking a bailout in which taxpayers paid all the costs and creditors bore no losses (as in the case of AIG).

The Shadow Committee believes that strengthening of market discipline should be the central objective shaping policy regarding the resolution of large, complex financial institutions. If full bailouts of creditors are expected at designated financial firms, then those firms will reap unfair competitive advantages, will take excessive risks, and will impose costs on taxpayers or other firms (depending on how bailouts are financed).

Recent Congressional proposals to create an administrative resolution authority for large, complex nonbank financial institutions and bank holding companies, however, could undermine rather than restore market discipline. Reforms that would restore credible market discipline would adhere to the following principles.

1. *Legislation should not codify unlimited or even special protection for large, complex financial institutions.* For example, the bill recently passed by the House of Representatives (H.R. 4173) would apply new resolution authority to systemically important financial institutions. The identities of these institutions would largely be forecastable, and the legislation would lead to the designation of some financial institutions for special treatment. The legislation would offer unlimited protection through discretionary regulatory actions undertaken under administrative resolution authority. Thus, the legislation would perpetuate and magnify the problems of "too-big-to-fail" protection, rather than restoring market discipline.

2. *Resolution policy should result in predictable resolution of creditors' claims on financial institutions under clear rules that allocate loss according to contractually assumed priorities.* Suppliers of funds to financial institutions depend on the rules they understand to govern the disposition of their claims. Any reduction in the clarity of those rules would raise the costs of raising debt equity for financial institutions. One of the disadvantages of discretionary administrative resolution, in contrast to judicial bankruptcy, is the lack of long-settled and clearly interpreted process and precedents for deciding how to allocate losses among creditors. Administrative resolution does not provide as predictable a process or outcomes and is, therefore, less desirable.

3. *Resolution policies should be insulated from political interference that would seek to achieve results different from those that would obtain in a bankruptcy proceeding.* For example, the recent Chrysler bankruptcy was marred by government interference to pick winners and losers in the bankruptcy according to political objectives. The result was discrimination against senior creditors in favor of other creditors that were more politically valued. To the extent that the political process seeks to achieve an outcome different from the allocation of loss that would occur in bankruptcy, this should happen transparently in a process apart from a bankruptcy proceeding.

4. *A bona fide objective of either a bankruptcy or an administrative resolution policy should be to limit disruption to the payment system or the flow of short-term financing credit.* Bankruptcy rules already allow for this to a large extent through the exemption of Qualified Financial Contracts (QFCs), including repos, futures, swaps, and other derivatives and securities contracts. Bankruptcy resolution has established effective rules to avoid stays and resulting liquidity problems during the resolution of large, complex financial institutions. Thus, administrative resolution is not necessary to achieve this objective.

5. *Under any administrative resolution authority creditors should expect to have standing similar to, if not identical to, what they would expect under a bankruptcy*

regime. Loss sharing rules should be specified in advance and implemented transparently. Senior creditors should expect to suffer smaller losses than junior creditors, and should not be asked to bear losses greater than those that would occur under a bankruptcy "cram down."

Administrative resolution may subsidize losses among creditors in a given class (as a means of capping the risk that a systemically important creditor might suffer an extreme loss), but such caps should not eliminate the risk of significant loss for any creditor, or eliminate distinctions across creditor classes with respect to the allocation of loss. Assessments on all financial institutions to absorb losses should be employed only for losses that exceed these caps. The amount of these assessments should not be excessive or significantly impair the capital adequacy of contributing financial institutions. Taxpayers should be a third and last tier of loss sharing, used only when losses are so large that they exceed the amounts derived from these special assessments.

Recent legislative proposals regarding the creation of a new resolution authority to deal with systemically important financial institutions fail to satisfy these five principles. The recent House bill (H.R. 4173), in particular, would cross-subsidize risk taking by large financial institutions and thereby promote excessive risk taking. It would reduce the predictability of the disposition of the claims on these financial institutions, expose the resolution of failures to political pressures, and produce creditor outcomes for different classes of claims that could be very different from those that normally occur in bankruptcy. And it remains unclear whether administrative resolution would result in the same rule-based exemptions for QFCs that are employed in bankruptcy law to avoid disruptive interruptions of payment flows. These deficiencies would raise the cost of capital in the financial system, result in arbitrary and inconsistent allocations of loss, and could produce confusion and heightened liquidity risk in response to the failure of a large financial firm—precisely the opposite of the stated intentions of reformers.