Too-big-to-fail: the next Chapter

The threat to society of institutions that are too big to be allowed to fail should be solved through a predictable legal framework, rather than punitive regulation. ***David Rowe*** *commends a group of academics formulating the details of such a framework*

In April 2010, I argued that efforts to eliminate the too-big-to-fail problem had been overly focused on minimising the likelihood rather than the severity of such failures (*Risk* April 2010, page 73, www.risk.net/1598893). More restrictive and more complex capital requirements, new liquidity rules and a flood of new and detailed provisions surrounding stress testing and credit procedures are all designed to prevent systemically important financial institutions (Sifis) from failing. Harsh experience should tell us that such efforts, while having some of their intended effects, are ultimately destined to fail.

Instead, I argued, we need a form of the US process of Chapter 11 bankruptcy, where a trustee or debtor in possession takes over management of an insolvent institution while a reorganisation plan is worked out under the authority of a judge. In the case of a financial institution, the doors would open on Monday morning, cheques would clear and insured depositors could access their funds on schedule. Uninsured creditors would be frozen, pending a – hopefully speedy – determination of how to allocate the economic shortfall.

Now, I am delighted to report, a group of academics at Stanford University's Hoover Institution have begun to develop detailed analysis of how such a regime could be structured.[1] They refer to their proposal as Chapter 14 bankruptcy, since it would add an additional chapter to the 13 that currently make up US bankruptcy code.

One of the biggest problems in dealing with the failure of a Sifi is that these behemoths are composed of many legal entities of various types. Furthermore, in the US at least, the different types of entities are subject to different, and sometimes conflicting, legal provisions in bankruptcy. Thus, one of the academics' first proposals is to allow the entire covered institution – including subsidiaries – to be resolved under common rules.

The proposal also sets out an objective criterion to determine which institutions would fall within the scope of Chapter 14 bankruptcy: those engaged in provision of financial services or financial products and with assets in excess of $100 billion (subject to revision over time). This will exempt small local institutions the Federal Deposit Insurance Corporation has proven itself very capable of resolving effectively under current law.

David Rowe is president of David M Rowe Risk Advisory, a risk management consulting firm. Email: davidmrowe@dmrra.com

The plan would also:

- create specialist district court judges with expertise in financial law and powers to hire special expert advisers during the conduct of a bankruptcy process;
- eliminate current exclusions of certain types of institutions, such as insurers, stockbrokers and commodity brokers, from the terms of the federal bankruptcy code when Chapter 14 and related provisions apply;
- allow specific public regulatory and investor protection bodies to be parties in relevant Chapter 14 cases;
- adopt existing rules regarding treatment of customer accounts and make these explicitly apply to proceedings (whether liquidations or reorganisations) under Chapter 14;
- permit an institution's primary regulator to start an involuntary bankruptcy proceeding against a financial institution, in cases where the institution's assets fall short of its liabilities, measured at fair value, or the institution has an unreasonably small capital cushion; and
- clarify in great detail how netting, automatic stays and rights to liquidate collateral are to be applied to repos, swaps and other derivatives, and qualified financial contracts in general.

Much of the avalanche of new regulation almost seems intended to squeeze all possible risk out of banking. If successful, this would seriously undermine the essential contribution banking makes to economic activity. Intermediating saving into real investment, providing maturity transformation and, more recently, risk transformation and risk transfer services are inherently risky activities.

As former Federal Reserve chairman Alan Greenspan once said, the optimal number of bank failures is not zero. Trying to achieve zero failures – at least among the largest banks – is both wrong-headed and counterproductive. On the other hand, protecting wider society from the worst consequences of such failures is both desirable and possible.

As always, the devil is in the details. Nevertheless, the Chapter 14 bankruptcy proposal is an important first step towards addressing the consequences of financial imprudence under a predictable rule of law rather than the whims of politicians. Establishing the certainty that any bank, of whatever size, will be allowed to fail would allow judgements about appropriate levels of risk to be made by bank management, rather than regulators. Market discipline could then be allowed to replace arbitrary and intrusive mandates because society would be largely shielded from the occasional – and inevitable – folly of a few. ■

[1] *Working papers are available at* www.hoover.org/taskforces/economic-policy/resolution-project/publications