Americans for Financial Reform
Accountability, Fairness, Security

Resolution Authority

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Bankruptcy Law Is Inadequate for Systemically Significant Nonbank Institutions

The current bankruptcy regime does not work well for bank holding companies and systemically significant nonbanks institutions. The federal government has long had the power to take over and close banks and other deposit-taking institutions whose deposits are insured by the government and subject to detailed regulation. But it has no such "resolution authority" with respect to bank holding companies and non-bank financial institutions such as insurance companies, investment banks, hedge funds, private equity firms and other financial institutions.

The bankruptcy of a systemically significant non-bank can aggravate liquidity problems and destabilize financial markets, but the Bankruptcy Code's provisions for the distribution of the assets of a bankrupt financial institution take no account of the systemic considerations that regulators can and should consider. Because the bankruptcy system was not designed for these circumstances, financial regulators may feel the need to prop up the ailing institution in order to avoid a messy and potentially destructive bankruptcy process.

The government needs new power to seize non-bank financial entities whose collapse might jeopardize the national and global financial systems. In particular, resolution authority is needed so that the Federal Deposit Insurance Corporation (FDIC) can take into conservatorship or receivership bank holding companies such as Citigroup. Current law gives FDIC no authority over bank holding companies, which is where the main mischief—and damage—occurred.

Given the potential risk from triggering acceleration clauses in credit default swap (CDS), there may be value in affording the regulator the authority to perform—as FDIC regulators do—"least cost resolution" analysis. In the case of CDS exposures, resolution authority could include a non-receivership approach. The FDIC could, for example, require the company to sell certain non-core businesses (with regulatory oversight) and disgorge troubled assets at the same time.

The Proposal

The Congressional Oversight Panel, the Treasury Department, and others have proposed establishing a receivership and liquidation process for systemically significant as well as other nonbank financial institutions that is similar to the resolution system for banks. Under most of these proposals, the FDIC would be empowered to appoint itself as conservator or receiver for failed or failing non-bank financial institution holding companies and their subsidiaries.

The FDIC would be charged not just with wielding resolution power but also setting standards that should limit the need to use the resolution authority. It would have responsibility over systemically important and other nonbank financial institutions and would share with Congress the responsibility for establishing resolution implementation standards. The FDIC would further have the authority to:

- Make loans to the covered financial company or any subsidiary;
- Purchase assets of the covered financial company or any subsidiary;
- Assume or guarantee obligations of the covered financial company or any subsidiary;
- Acquire any type of equity interest or security of the covered financial company or any subsidiary;
- Take a lien on any or all assets of the covered financial company or any subsidiary; and
- Appoint itself as conservator or receiver of the covered financial company.

Bailouts Versus Resolution Authority

Resolution authority would be a major improvement on the current bailout strategy, which uses taxpayer funds and loans and guarantees from the Federal Reserve to prop up banks that are, by any reasonable measure, insolvent. The cost of the current strategy is that it prolongs a day of reckoning. It leaves in place seriously wounded banks incapable of serving the nation's credit needs, which prolongs the recession and creates the risk of a Japan-type "lost decade."

The public-private partnership model announced in late March also creates huge opportunities for conflicts of interest, with the government assuming most of the risk and private speculators appropriating most of the gain. It is unlikely to achieve its goal of increasing the market value of depressed securities because the underlying mortgages are only worth a fraction of their nominal value. The bailout process is also almost totally non-transparent.

It would be far better to enact and then use resolution authority so that banks which are effectively insolvent are taken into public receivership by a government agency with the competence and capacity to do true audits rather than hypothetical stress tests. As with resolution of smaller institutions by the FDIC, this agency would assess how large is the hole in the institution's balance sheet, and decide what combination of public capital and bondholder losses should make up the loss. Incumbent management would be replaced, and the institution would be returned to new private ownership as soon as practical. Experience on other nations that have suffered banking collapses (Japan, Sweden) suggest that this approach of acknowledging losses and recapitalizing institutions is preferable to a policy of piecemeal bailout.