The Dodd-Frank Act & Resolving LCFIs

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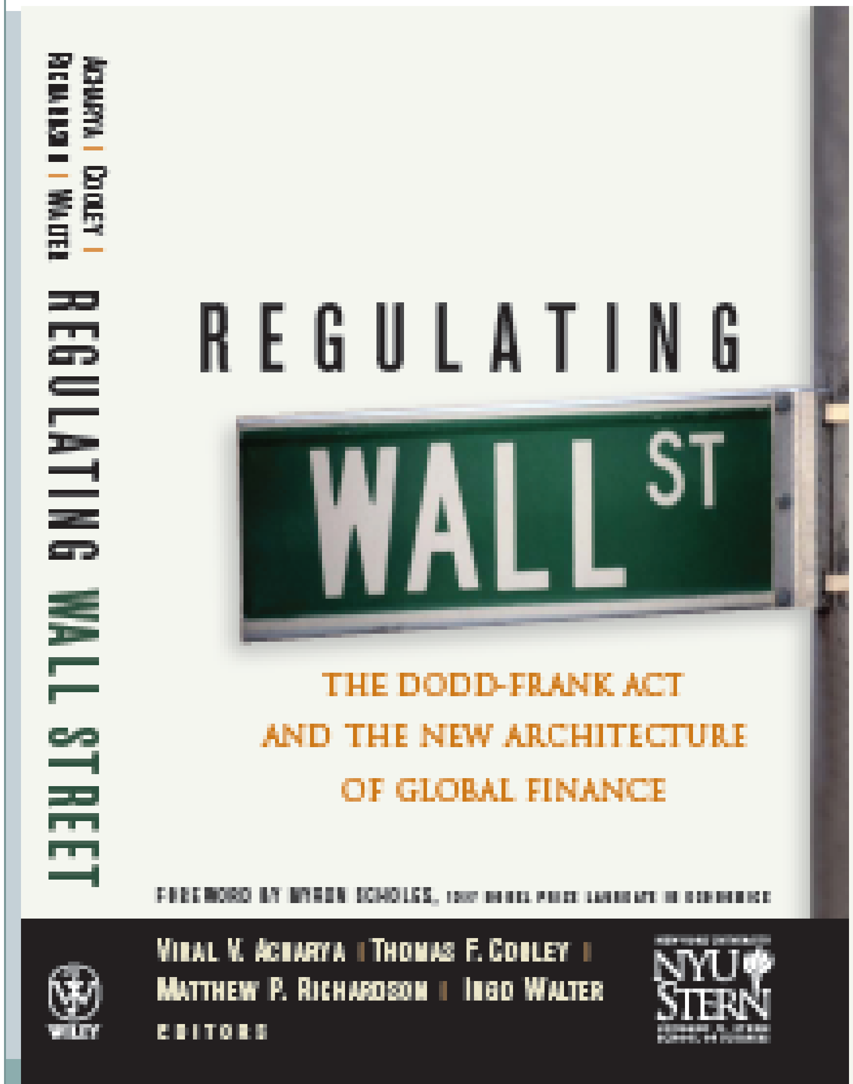

RESOLUTION AUTHORITY

Presentation based on

Chapter 8,
"Resolution Authority", by Acharya, Adler, Richardson and Roubini

"A Proposal to Resolve the Distress of Large, Complex Financial Institutions", By Acharya, Adler and Richardson

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Resolution Authority under the Act

- Hangs its hat on the creation of Orderly Liquidation Authority (OLA)
- Balancing act between two forces that (potentially) work against each other
  - Mitigate moral hazard, bring back market discipline
  - Manage systemic risk
- How well does the Dodd-frank do?
  - We highlight four problem areas

Problem #1: Act's Misplaced Focus

- Focused on the orderly liquidation of an individual institution and not the system as a whole.
  - Funeral plans and orderly liquidation for unwinding SIFI's
    - Management be fired
    - Wind down costs be borne by shareholders and creditors

- What is unique about a financial firm's failure is its impact on the rest of the financial sector and the broader economy.
  - Passing losses to SIFI creditors wipes out capital of other SIFIs

- Need an ***ex-ante*** Orderly Liquidation Fund (OLF)

Problem #2: OLA's Incentives Are Wrong

- If the system fails, and monies cannot be recovered from creditors, *surviving* SIFIs must make up the difference *ex post*.

  - Increases moral hazard because of a free rider problem.
    - JPMorgan Chase asked to pay for mopping up Lehman Brothers!

  - Increases systemic risk because
    - (i) firms will herd and a race to the bottom can ensue; and
    - (ii) it is highly pro-cyclical, requiring prudent firms to provide capital at the worst time.

Problem #3: Has Systemic Risk Increased?

- Restricts the Fed's 13(3) LOLR ability to deal with non-banks unless a system wide crisis emerges
- One scenario:
  - A firm runs into liquidity issues
  - Fed can't provide aid, so OLA is triggered
  - Other likewise firms are experiencing stress too
  - These other firms suffer liquidity runs because of fears of OLA being triggered, paradoxically triggering their own OLA
  - With multiple OLAs, a systemic crisis has emerged
- Second scenario:
  - OLA and funeral plans fail the first time they are tried out…

Problem #4: Is Receivership the Right Approach?

- Trade off flexibility versus uncertainty
- Do we have experience for an FDIC approach to LCFIs?
  - Incomplete ex-ante information on scenarios
- Jackson (2009), e.g., has argued for a more standard bankruptcy model with adjustments, “Chapter 11F”:
  - Trigger possibly by involuntary petition
  - “Experienced” judiciary
  - QFCs divided into two types
  - Government could provide DIP financing albeit subject to rules of priority

Problem #4 cont'd – Living Will approach

- Academic concept of a "living will" (Adler)
  - Divide a firm's capital structure into hierarchy of priority tranches
  - In the event of a default on a debt obligation, equity would be eliminated, and lowest-priority debt tranche would be converted to equity
  - If this is isn't sufficient, the process is repeated until all defaults are cured or the highest tranche is converted to equity. Only at this point would senior debtholders have reason to foreclose on collateral.
  - Creditors pay but the cost of financial distress is avoided. Issues like "what is the trigger?" and "what happens if the living will can't stop the collapse or contagion?" remain.

Need automatic stabilizers

Resolution Method	Proposed by	How are systemic liabilities dealt with?	Pros	Cons
Orderly Liquidation Authority (OLA)	Dodd-Frank Act, FDIC	Pass on losses; Can use Orderly Liquidation Fund	Deals with incentives	Does not deal with systemic risk / contagion
Contingent capital	Flannery; Squam Lake Report	Protected through CoCo's that convert to equity	Creates time for orderly resolution	What next? Does not spell out resolution
Bail-in / Living will	Credit Suisse; Adler	Progressive losses that are pre-programmed	Spells out an orderly resolution	Adequate to deal with contagion?
Automatic stabilizers + Bail-in	Acharya, Adler, Richardson	Deposit insurance, clearinghouse, LOLR, …, Bail-in	Pre-arranges system-wide capital for resolution	Requires capital mgt at DI Fund, CCH,…

International coordination of SIFI resolution

1. Identify classes of systemically important liabilities (deposits, repos, derivatives, SIFI exposures)
2. Ensure DI funds are pre-funded, counter-cyclically
3. Standards for initial and variation/stress-margin requirements at clearinghouses; manage their risks
4. Require central banks to spell out *a priori* eligible collateral for LOLR and charge for these liquidity facilities
5. Harmonize on "living will" for all liabilities that are not systemically important and don't have built-in stabilizers

Questions for the OLA?

- Back to the future? - If the purpose of the resolution authority is to handle Citigroup, Merrill, Lehman, AIG, etc...then they should be able to explain exactly how they would have done it for the known cases.

- Systemically important liabilities - Suppose a systemically important financial institution fails - how would they treat *pari passu* unsecured liabilities that have different systemic qualities, e.g., interbank loans versus long-term debt?

- Bankruptcy safe harbors - With respect to qualified financial contracts (QFCs), how are they going to determine whether to allow the exemption and then face the problem of illiquid QFCs all coming to the market with resulting fire sales and funding illiquidity, OR instead transfer all the contracts, but then have the counterparty lose liquidity and face uncertainty by not having access to its liquid QFCs?