A Lack of Resolution

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FAIR GAME

Moral hazard tossed out as Fed saves Bear Stearns

By Gretchen Morgenson

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NEW YORK — What are the consequences of a world in which regulators rescue even the financial institutions whose recklessness and greed helped create the titanic credit mess we are in? Will the consequences in the United States be an even weaker currency, rampant inflation, a continuation of the slow bleed that we have witnessed at banks and brokerage firms for the past year?

Or all of the above?

Stick around, because we'll soon find out. And it's not going to be pretty.

Agreeing to guarantee a 28-day credit line to Bear Stearns, by way of JPMorgan Chase, the Federal Reserve Bank of New York conceded Friday that no sizable firm with a book of mortgage securities or loans out to mortgage issuers could be allowed to fail right now. It was the most explicit sign yet of the Fed's "Rescues 'R' Us" doctrine that has already helped to force the marriage of Bank of America and Countrywide.

But why save Bear Stearns? The beneficiary of this bailout, remember, has often operated in the gray areas of Wall Street and with an aggressive, brass-knuckles approach. Until regulators came along in 1996, Bear Stearns was happy to provide its balance sheet and imprimatur to bucket-shop brokerages like Stratton Oakmont and A.R. Baron, clearing dubious stock trades.

And as one of the biggest players in the mortgage securities business on Wall Street, Bear provided munificent lines of credit to public-spirited subprime lenders like New Century (now bankrupt). It is also the owner of EMC Mortgage Servicing, one of the most aggressive subprime mortgage servicers out there.

The New York Times

The Creditors of Lehman Can Do Little but Wait

By JULIA WERDIGIER
Published: November 14, 2008

LONDON — Creditors of Lehman Brothers' international business, arriving at London's gigantic O2 concert hall on Friday, had no illusions about getting their money back any time soon.

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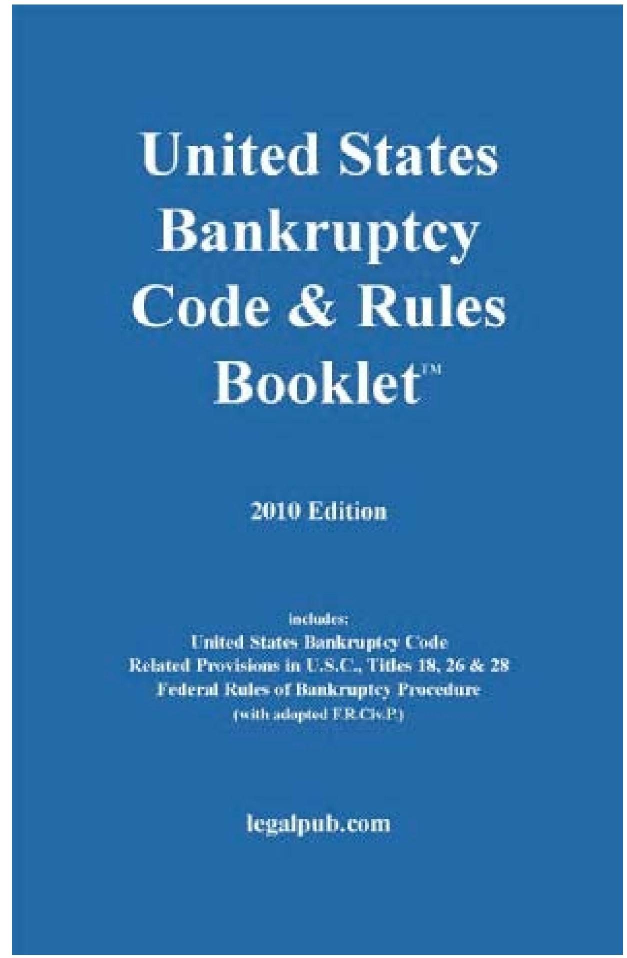
The Last Crisis: Poison Choosing



What Can The Government Do About Lehman Brothers, Bear Stearns, &c?

- Given the choice between bailout and resolution or bankruptcy, the government almost always “selected the bailout option” – Dan Tarullo.
- Bailouts are expensive, unpopular, and reduce market discipline
- The alternative, instant bankruptcy, could destroy the financial system
  - Lehman → MMFs

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Resolution Authority: The Little Used Power to Destroy

- "There is a clear need for a new resolution authority." – Paul Volcker

- "How few there are who have courage enough to mend their faults, or resolution to own them!" – Benjamin Franklin

Resolution Authority

- the polite term for seizing failing financial institutions, and either shutting them down or selling them off for the best possible price.
- nationalization, but in ways that discomfits depositors as little as possible.
- FDIC: banks tend to fail on Fridays, and open on Monday under new management, with new signs on the door, but with the same old depositors in the books, their savings entirely intact, and their banking relationship smoothly shifted from an insolvent institution to a solvent new one.

The FDIC and Resolution Authority During the Financial Crisis

100+ small institutions

+

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The Failure of Resolution Authority 2008-2009

- Legal: FDIC resolution authority reaches only banks and thrifts, but not financial holding companies: e.g., Bear Stearns, Lehman Brothers, AIG
    - The Volcker concern
- Factual: the deeper a crisis gets, the less useful the efforts to goad the FDIC to take action have become

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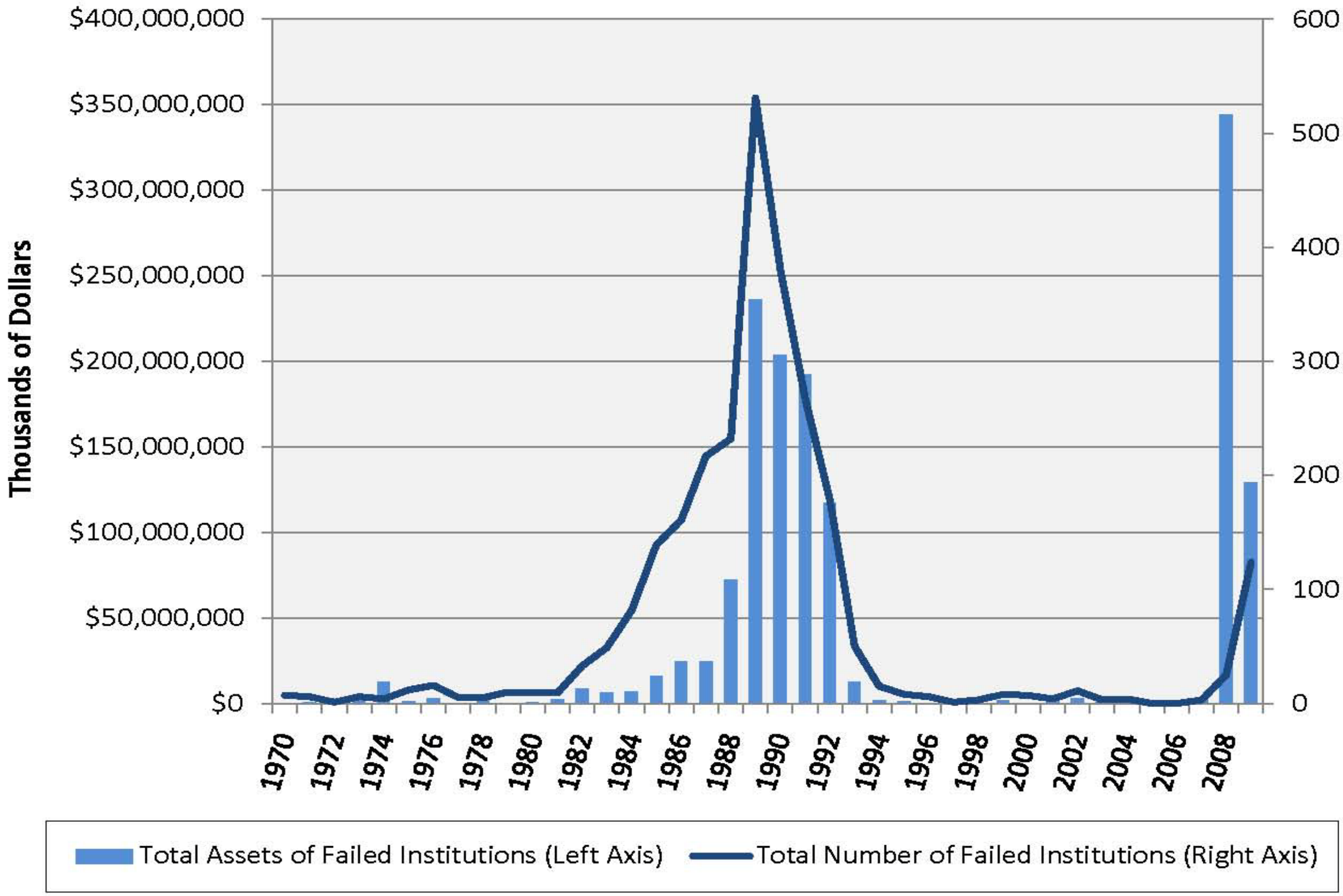
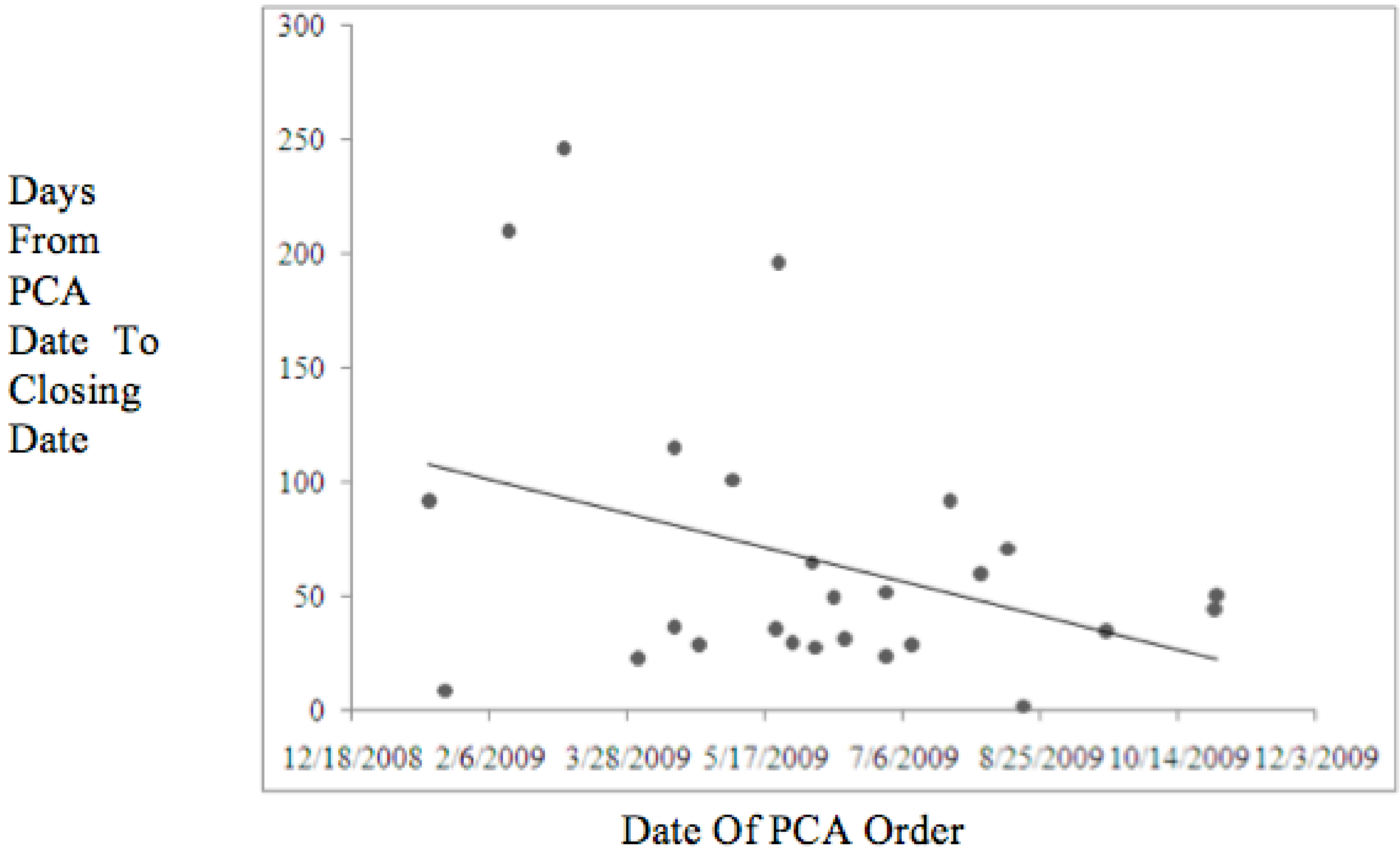
Resolution Authority is Exercised Procyclically



The Deeper The Crisis, The Less Notice

Figure 2: The Decline in PCA Notice During the 2009 Crisis[81]



Is The Solution To Expand Resolution Authority To Cover FHCs?

- Doing so undoes the grand bargain between thrifts and banks and the FDIC
  - The government is given the power to destroy owners AND creditors
  - The financial intermediaries get deposit insurance = cheap capital
- Which raises a variety of constitutional problems
  - Takings
  - Due Process – *Matthews v. Eldridge*
  - Bias

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Constitutional Resolution Authority

- A public list of systemically significant institutions subject to resolution before the fact
  - Potentially subject to notice and comment, addressing constitutional problems: *pre-deprivation process*
  - Lists are more flexible than classes
    - Dodd-Frank provides for this
- A repurchase opportunity after the seizure by the owners
  - An alternative to *post-deprivation process* like judicial review
  - A market test of the regulatory decision
  - Addressing the WaMu problem?
    - Dodd-Frank *does not* provide for this

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Exercisable Resolution Authority

- Resolution authority is *never* used when it should be; regulatory forbearance and bailouts *always* have been the regulatory choice
- How can we get regulators to exercise broad new powers, once other legal problems are addressed?

Exercisable Resolution Authority

- Alternatives:
  - Carrots: bonuses for failing institutions?
  - Sticks: penalties for failing to act?
  - Expertise: the Basel Committee on Banking Supervision
    - A basis for agency regulation
    - Cross-border problems require expertise
    - A removal from local pressures
    - Policy, not enforcement – but why not?

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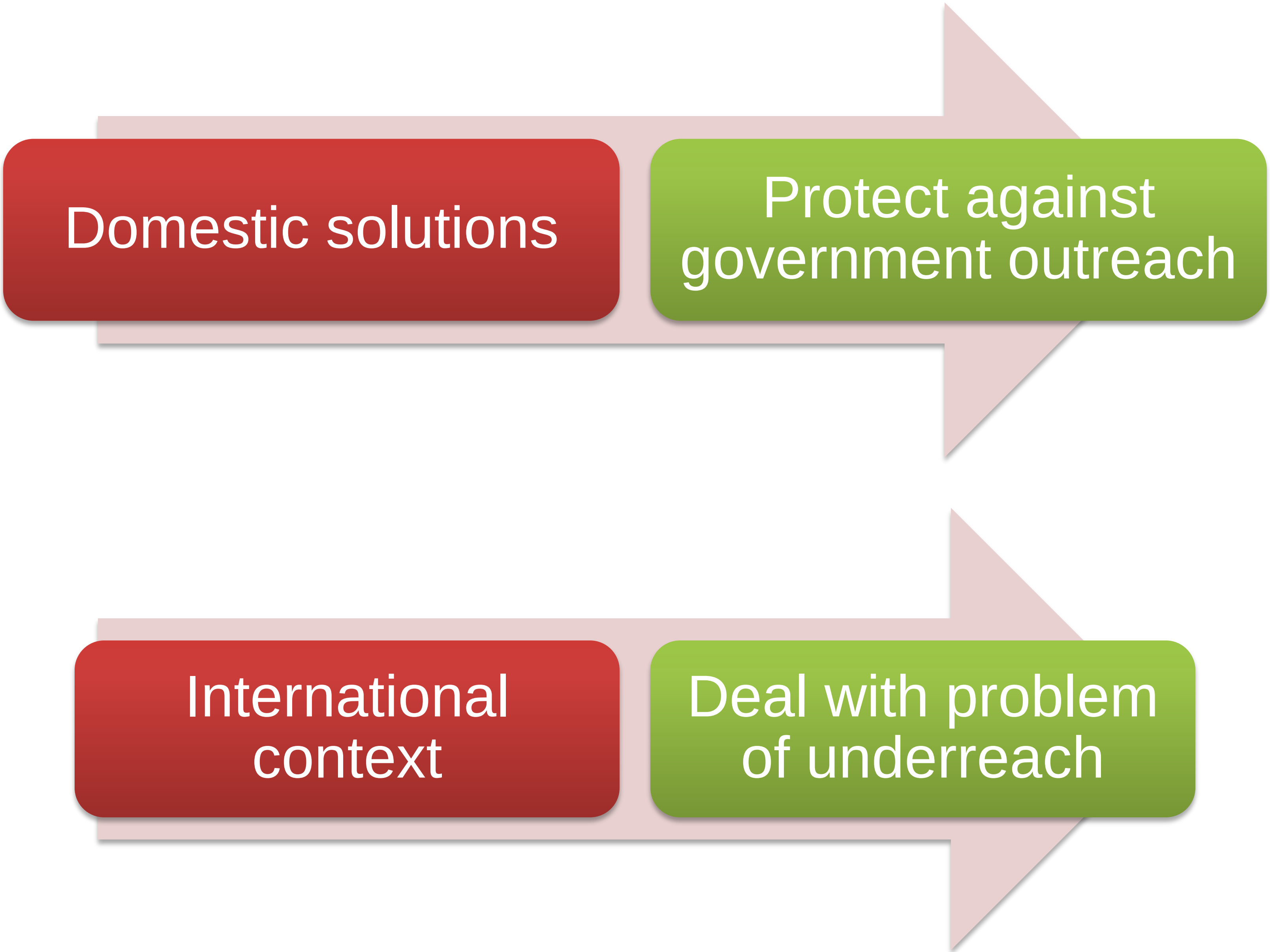
Domestic solutions
Protect against government outreach
International context
Deal with problem of underreach

Thank you!