Resolving Troubled Systemically Important Cross-Border Financial Institutions: Is a New Corporate Organizational Form Required?

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The Scope of the Problem

- The crisis exposed the
  - Break downs in the structure of corporate governance
  - Break downs in institution internal risk controls and
  - Incentive problems that include:
    - Excess financial risk-taking in a limited liability structure
    - Organizational complexity
    - Instrument complexity
    - Regulatory complexity due to overlapping jurisdictions and
    - Regulatory and tax arbitrage incentives
- The current approaches involve tweaking the current regulatory and financial structure but the coordination and jurisdictional problems seem virtually insurmountable
- Our objective is to establish a workable market environment that
  - Is sensitive to market signals, with strong incentives to monitor
  - Necessitates minimal regulatory micro management
  - Cuts some Gordian knots in the Too-Big-To-Fail problem by seeking to make failures isolated events with minimal externalities

Incentives, Organizational Complexity and Risk Controls

- Paper reviews the weaknesses of limited liability corporate form in controlling risk and that failed when came to governance during the crisis
- We explore some of the benefits of the partnership form and how it functioned to limit risk taking in institutions like investment banks, rating agencies and accounting firms
  - But note that it too suffers from limitations

Organizational Complexity and Regulatory Incentives

- Large, global firms operate in a complex legal and regulatory environment with multiple, often overlapping regulatory jurisdictions and insolvency regimes
- Together, these factors further encourage:
  - Complexity in financial instruments
  - Regulatory arbitrage, exploiting the ability to morph the organizational structure and design new instruments
- Herring and Carmassi (2010) assess the many motives for complex organizational structures in large financial firms

Organizational Complexity	Average
Ave No. of Countries	44
Average No. of Subsidiaries	1005
Ave. No. of Bank Subs	47
Ave. No. of Insurance Subs	20
Ave. No. of Special Purpose Entities	227
Ave. No. of Financial Subs	270
Ave. No. of Non-financial Subs	440

Motives for Complexity

- Herring and Carmassi Identify Several Possible Motives to Explain Complexity Including:
  - the need to mitigate asymmetric information between shareholders and creditors and between shareholders and managers;
  - to avoid customer concerns about potential conflicts of interest;
  - the ability to segment internal agency problems;
  - reducing transactions costs;
  - the consequence of legacy mergers and acquisitions;
  - the desire to reduce the costs of financial distress;
  - the ability to efficiently manage tax liabilities; and the desire to avoid regulation.
  - the ability to segment customer accounts from regulatory scrutiny based upon differential secrecy laws governing the disclosure of customer and account information and
  - the desire to take advantage of more accommodating incorporation and financial reporting requirements.

Incentive for Instrument Complexity

- The incentives to engage in this opaque transformation are many, including:
  - the desire to earn rents on information asymmetries and leverage,
  - to trade on government guarantees inherent in deposit insurance and too-big-to-fail implicit government guarantees,
  - to better manage credit, liquidity and interest rate risk.
  - The demand for AAA rated securities
  - To mimic Freddie and Fannie in the securitization process by
    - by substituting their government guarantees with insurance contracts,
    - quality ratings by rating agencies,
    - models to assess the adequacy of the structure of the securities, and credit enhancements and
    - insurance provided by insurance companies for the oversight and guarantees provided by Freddie and Fannie to create high quality securities for investors such as pension funds, banks, hedge funds and mutual funds.

Result: Costs of Failure Rise to Unsustainable Level, TBTF

- The international coordination problem among supervisors of a failing firm and insolvency regimes for a failed firm impedes preserving value in a failure.
- The uncertainties about exposure, knock-on effects and treatment in insolvency created by complexity are underpriced in good times, and prompt destructive run behavior in distressed circumstances.

Where this leads us

- Issues are central to financial reform if TBTF is to be set aside or greatly reduced.
- Effecting change in insolvency regimes at the international level is difficult and slow
- We conclude: a new charter for LCBOs that could be internationally agreed and
  - Rests atop the current regulatory and insolvency regime structure
  - Addresses the underlying incentive problems

Attributes of New Charter

New Simplified, Single Entity Federal Charter

- Required for institutions greater than some size threshold ($100 B)
- Optional for all other US institutions

Permissible Activities

- Activities permissible determined by chartering authority subject to same standards as those for BHSs.
- Subsidiaries and Affiliates would not be permitted

Accounting – all contracts and liabilities must appear on balance sheet regardless of whether they are contingent claims or not

Federal Deposit Insurance would be require

- Coverage on same bases as exiting banks for deposits
- Fed would be prohibited from extending credit to insolvent institutions analogues to rules governing banks

Attributes of New Charter

- Supervision and Regulation
  - Federal-level designee
  - Supervisory Fees
    - Institution would be charged for supervision based upon time and complexity
  - Supervisory Loss
    - Should FDIC incur a loss the supervisory agency would be responsible to make some compensation and public review would be required
- Supervisory Policy
  - Guided by PCA and early Intervention provisions of FDICIA 1991
    - Intervention would be mandatory rather than discretionary if 1) market value of entity fell below a pre-specified value or 2) mark-to-market value of assets relative to liabilities falls below a per-specified by positive value/
  - Guiding principle should be to minimize loss to FDIC and/or taxpayer and to make failures isolated events
- Advance Resolution
  - Federal Regulator would be required to have in hand a current plan to seize and resolve an institution in no less than a weekend

Attributes of New Charter

- Taxation
  - Dividends would be subject to same tax treatment as interest payments on debt
- Bonus and Incentive Compensation
  - Payments to be made only to the extent they can be funded out of current consolidated profits after allowance for loan losses but at same time as dividend decisions are made
- Creation of New Stakeholder Class
  - Senior management and significant risk-takers required to hold a claim on the firm, such as contingent capital or tradable subordinated debt or escrowed funds, that would absorb future losses for a protracted period.
- Market Priced Debt
  - Institution would be required to issue tradable sub debt and/or tradable contingent capital certificates
  - Contingent capital certificates would have one of two possible triggers depending upon function
    - Recapitalization or
    - Cushion to absorb losses as bankruptcy is evoked

Attributes of New Charter

- Failure resolution
  - FDIC would be named receiver and handle resolution
  - Powers would be the same as available to resolve bank failures
  - Settlement of short term contracts of maturity less than a given number of days would be settled and closed out prior to settlement of claims of other creditors to protect short term market disruption
  - Guiding principle would be universality regardless of nationality of debt holders
- Would seek a similar approach in each country

Conclusion

- The proposed charter is designed to limit complexity
- It ameliorates the incentive alignment problem in the firm
  - It makes loss responsibility of management clear
- It treats foreign and domestic creditors equally
- It deals with supervisory incentive problems
- It focuses supervisory attention on monitoring and risk assessment rather than on setting capital standards
- It provides for advance planning in the event of a likely failure
- It leaves management to management
- It is forward looking rather than backward looking
- It could accommodate different regulatory regimes internationally