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Administrative Office
c/o Professor George Kaufman
Loyola University Chicago
820 North Michigan Avenue
Chicago, Illinois 60611
Tel: (312) 915-7075
Fax: (312) 915-8508
E-mail: gkaufma@luc.edu

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For Information Contact:

George Kaufman
312.915.7075

Robert A. Eisenbeis
770.416.0047

Kenneth E Scott
650.723.3070

Statement of the Shadow Financial Regulatory Committee on

Resolution Regime for Troubled Financial Institutions

February 22, 2010

Numerous policy makers, including those from the Treasury and Federal Reserve, have argued that the lack of a bank-type failure resolution process severely hampered their ability to resolve the insolvencies of large complex financial institutions, such as AIG and Lehman Brothers, during the current crisis. Creating this capability has become a critical component of financial reform. The task is to design an efficient resolution mechanism that provides for either the liquidation or reorganization of large banks and other large complex financial institutions without depending upon taxpayer funds.

The Shadow Financial Regulatory Committee sees little reason to change the current process for dealing with small banks and their parent bank holding companies, other than to consolidate the parent holding company with the bank during the resolution process.

The Committee believes that the existing judicial corporate bankruptcy process is preferable to the current administrative process used to resolve failed banks, since it is more transparent, predictable and, most importantly, poses less risk to taxpayers. Therefore it

should be extended to large complex financial institutions currently exempt from bankruptcy statues, with suitable modification to deal with the unique problems that financial institutions present. This structure should be the cornerstone of any new resolution process rather than adapting the current bank resolution process to financial institutions broadly defined. The primary objective of any revised bankruptcy process should be to pay claims among creditors in order of their legal priorities and not shift losses to taxpayers.

The Committee believes that creditors or the responsible regulators of a troubled financial holding company and its bank or any other subsidiaries should be able to force it into involuntary bankruptcy under a new Chapter 11. The grounds for creditors to trigger a Chapter 11 proceeding would be either equity insolvency (which means that the institution was unable to meet its obligations as they became due) or economic insolvency (which means that the value of the institution's assets were less than its liabilities). In addition to the grounds available to creditors, the regulators would be able to force the institution into bankruptcy on the basis of the broader criteria currently applicable under the FDI Act. If an institution is deemed to be in such dire financial condition to warrant liquidation, the responsible regulator should be able to force it into the new Chapter 7 proceeding. Chapter 7 is, and should be, less favorable to management since it would typically be excluded from control of the process during the liquidation whereas under Chapter 11 management is usually initially involved in any reorganization. Additionally, management should always have the option of electing voluntary bankruptcy under either Chapter 11 or Chapter 7 of a revised bankruptcy code.

The Committee recognizes that situations may arise that would require government intervention to protect some classes of creditors in order to preserve financial stability and avoid systemic risk and that use of public funds may be warranted during such a financial crisis. Should this condition arise, then the Committee believes that this intervention should take place outside the bankruptcy process. Use of public funds should be difficult, transparent and require that an accounting of the full costs be provided. The proposed resolution procedures are intended to make government intervention less necessary economically and less likely politically.