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Statement of the Shadow Financial Regulatory Committee

**Resolving Systemically Important, International Financial
Institutions**

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The recent G20 meetings demonstrated the substantial divide between policymakers over the right approach toward the “too-big-to-fail” problem for large, global financial institutions. Some policymakers accept that some financial firms will inevitably be too-big-to-fail and wish to focus policy efforts on facilitating orderly bailouts and agreeing in advance on “burden-sharing” arrangements for allocating bailout costs among countries. Other policy makers reject that view and argue that policies could be introduced that would substantially reduce the chance of a failure by a large financial institution. Furthermore, they believe that it would be possible to reform the process of resolving failed institutions to permit large, complex institution to fail, and to be wound down with significant losses to its creditors, but without generating intolerable spillovers or systemic risk.

The G20 had asked the IMF to present an array of options, including funding a bailout facility financed by the taxation of large financial institutions. At the meetings, however, several countries, most outspokenly the Canadians, who will host the next G20 meeting, expressed their opposition to taxing well-managed Canadian institutions, which avoided the crisis, to assist in bailing-out less well-managed institutions elsewhere. Opponents of such global

burden-sharing arrangements urged that countries improve their supervision and resolution processes to prevent spillovers. Unfortunately, Secretary of the Treasury Geithner expressed a strong American commitment to taxing financial institutions and planning for international burden sharing.

The Shadow Financial Regulatory Committee strongly supports the Canadian view. We believe that funding potential bailout costs likely will encourage larger and more frequent bailouts. The members of the G20 should be focusing instead on strengthening their regulatory, supervisory and resolution systems to minimize or even eliminate bailouts so that the thorny issue of ex ante burden sharing would become largely irrelevant.

Like the Canadians, we favor a well-supervised system that would rely heavily on market discipline through higher capital requirements, including newly required issues of contingent capital. A properly structured contingent-capital requirement would provide a substantial buffer against loss for systemically important institutions, and most importantly, incentivize large financial institutions to raise additional equity capital during the early stages of financial crises. The required issue of contingent capital must rely upon a non-discretionary, market-based trigger (e.g. a large cumulative decline of the firm's equity) and be calibrated so that if conversion is triggered shareholders would suffer substantial dilution. That prospective dilution would motivate managers (who would care about dilution either because of its effect on shareholders as a group, or because of its effect on their own equity-based compensation) to take every possible measure to sell assets or raise more equity capital before hitting the mandatory conversion trigger.

If, despite the improved incentives for risk management and capital raising implied by the new contingent capital requirement, an institution were to trigger the conversion of its contingent capital, the new equity would relieve the institution from the pressure to pay interest to former holders of contingent debt and it would strengthen its equity capital buffer against loss. At that point, prompt corrective action measures should also kick in. In essence the faltering institution should be treated very much like the institution itself would treat a faltering borrower. FDICIA outlined an effective sequence of such actions, but unfortunately regulators established a trigger based on the book value of capital. Book value is measured by accounting, regulatory, and supervisory rules and actions, which are both slow to adjust and prone to manipulation. Thus, book value triggers are inadequate to reflect the rapid deterioration in many institutions.

If the effects of new contingent capital requirements and Prompt Corrective Action measures (intended as sources of simulated market discipline administered by the supervisory authorities) fail to motivate the institution to find a private solution to its problems, and its condition continues to deteriorate, it will hit the regulatory insolvency trigger. To minimize any potential burdens on taxpayers from bailing out failed financial institutions, it is essential that this regulatory insolvency trigger be set at a point substantially above zero economic net worth.

Once the regulatory insolvency trigger is breached, a newly mandated wind-down plan of the institution would be implemented. The G20 has endorsed such planning, but so far

only the United Kingdom has experimented with implementation. The Committee believes that a careful wind-down plan, developed and approved in advance as part of an ongoing iterative process with regulators, is a crucial feature of market discipline.

The starting point for a new regulatory requirement for wind-down planning would be a clear template established by the resolution authority that would delineate the necessary ingredients of a wind-down plan. That template would describe the elements of the plan that the regulatory authority in charge approving wind-down plan (which should be the resolution authority) would use to evaluate any wind-down plan. Requiring regulators to take the lead in establishing the criteria for an acceptable wind-down template increases the accountability of regulators for ensuring a workable wind-down plan.

What should the wind-down plan achieve? First, the existence of a wind-down plan would make clear to all creditors and counterparties that no institution is too-big or too-complex or too-opaque to fail.

Second, by confronting boards of directors and managers with the worst case scenario long before troubles arise, the plan may reduce their preferences for taking excessive risks.

Third, the resolution authority and the college of international regulators appointed to oversee the institution would have a powerful policy option that most have not had before. In most countries, like the United States in August 2008, the authorities felt that they faced two distasteful choices: either send the institution to bankruptcy court (as we did with Lehman Brothers) and hope that the spillover consequences are not too damaging, or alternatively, bail out the institution (as we did with AIG two days later for an amount that ultimately totaled \$186 billion). Because the authorities generally face an asymmetrical information problem vis-à-vis the troubled firm, and because they are understandably risk-averse about possibly setting off a financial crisis, they are often bullied into bailing out a large firm by a self-serving parade of horrors – none of which can be known ahead of time. The wind-down plan strengthens the power of authorities by reducing their asymmetric information disadvantage and reducing the costs of winding down a large institution.

In barest outline, the wind-down plan begins with the assumption that the institution is insolvent. Given the resolution regime, the institution is required to describe in advance exactly how the management of its wind-down would proceed. This means mapping the institution's subsidiaries, which may number in the thousands, into its lines of business, identifying interlinkages across affiliates, both financial and operational, describing the notifications that must be made to regulatory authorities and others, and making a good faith estimate of how long it would take to implement the plan. Most critically, the plan would have to identify systemically important services that are provided and how the provision of those services could continue uninterrupted. The need to construct a credible wind-down plan would encourage management to better align the structure of its subsidiaries with its lines of businesses by reducing the perceived protection the firm would enjoy from a bailout.

The plan would then be submitted to the board of directors, who would be required to review the plan just as they are now required to oversee business continuation plans. If they

find the plan inadequate they would return it to management and request appropriate changes such as the consolidation of a number of subsidiaries or financing a systemically important service entirely with capital so that it could be easily transferred to another owner. In fact, this should become one of the requirements of good corporate governance within large financial institutions.

Because these plans would be subject to regulatory approval, they would have to be adjusted to comply with regulators' reactions. The need for regulatory approval would further encourage the consolidation of subsidiaries and other rationalization of the firm's structure to better align with lines of business, and to facilitate an orderly wind-down. Regulatory feedback on the feasibility of the wind-down plan should be obtained from the resolution authority that would be in charge of the wind-down. That authority is best positioned to determine whether the plan is feasible, whether it can be implemented with sufficient speed, and whether it adequately protects the systemically important functions performed by the institution. If the resolution authority were not satisfied, it would return the wind-down plan to management and suggest a range of options for reducing the complexity of the resolution process. If management does not comply in a satisfactory manner with the need to restructure the institution and the plan in light of regulatory feedback, then the resolution authority would be empowered to require specific simplifications of the institution's structure.

The approved plan would then be shared with the international college of supervisors, who have been designated by the G-20 to oversee the institution. Each supervisor must make a judgment about whether the plan deals adequately with the operations of the institution within its borders. The international college of supervisors should also engage in simulations under a variety of stress conditions to assure themselves that the plan is workable and to make clear how they would deal with the parts of the institution over which they have control.

The wind-down plan should be updated at least once a year or, if the institution engages in a merger or reorganization, more often. This means that if the worst happens – and it is less likely to happen if the contingent capital requirement is properly structured and if prompt corrective is strictly applied – then the resolution authorities in all of the countries that are likely to be most seriously affected better know how to proceed to minimize damage.