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Statement of the Shadow Financial Regulatory Committee

Resolution and Bailout of Large Complex Financial Institutions

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The “Restoring American Financial Stability Act” (The Dodd bill) that will be debated in the Senate attempts to limit the ability of the government or government agencies to protect stakeholders at - failed large complex financial institutions from sharing in the losses suffered by the institution. The bill explicitly prevents payments to stockholders of the failed institution and revokes its charter. This effectively wipes out the shareholder-interests (except where there is possible positive residual value after satisfying all creditors).

But while the entity may cease to exist, the creditors remain and the fear is that regulators, concerned more about an orderly resolution than maintaining market discipline, may be tempted to protect some or all of the creditors and counterparties. History suggests that the regulators will favor short-term market stability, particularly in a period of crisis, regardless of whether it sacrifices the benefits of market discipline and the reduction in the likelihood of future crises. To reduce the incentive to bail out creditors, the bill incorporates restrictive language that limits the creditors of a failed institution from receiving assistance that would leave them better off than if the institution was liquidated.

A recent report by the Government Accountability Office (GAO) that examined the use by the regulators of the systemic risk exemption (SRE) under FDICIA found that regulators and the Treasury used creative interpretations of this language to broaden its

coverage, in the name of ensuring market stability. The intent of the SRE was to relieve the regulators from having to resolve troubled institutions by methods that would produce the least cost to the FDIC insurance fund, if there was a threat to market stability. Yet the regulators and the Treasury used the exemption to protect large groups of creditors of all healthy as well as troubled institutions under the FDIC's Temporary Liquidation Guarantee Program (TLGP) and to provide "open bank" assistance to Citibank.

As the Committee argued previously in Statement 286, *Resolution Regime for Troubled Financial Institutions* (February 22, 2010), because of the history of unfettered discretionary decisions by the regulators, the use of a modified Chapter 11 bankruptcy approach would minimize the likelihood of the ability of regulators to provide assistance to creditors, thereby reducing the undesirable consequences that such support would have on moral hazard behavior going forward.