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Statement No. 300

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Statement of the Shadow Financial Regulatory Committee

Principles to Guide the Implementation of the Orderly Liquidation Authority Called for Under the Dodd-Frank Act

December 13, 2010

The Dodd-Frank Act recognizes that investor understandings about endgame rules influence a firm's appetite for risk and that, without changing existing rules, higher capital requirements on systemically important financial institutions (SIFIs) cannot by themselves end creditor perceptions that in most circumstances SIFIs are economically, politically, and administratively too difficult to fail and unwind.

The current financial crisis has underscored the particular danger of allowing highly leveraged SIFIs to fund risky positions with instruments whose average duration is substantially shorter than the maturity of the assets they hold. This business model gained prevalence because of creditors' widespread understanding that, without formulating and rehearsing a plan about how to resolve the affairs of complex insolvent firms, authorities would find it difficult to resist bailing out a SIFI if and when it incurred significant financial losses.

This statement sets forth some principles that the Shadow Financial Regulatory Committee believes ought to govern insolvency resolution procedures to render this understanding inoperative. The first and over-riding principle is that resolution procedures must be credible, carefully rehearsed, predictable, and widely publicized. Credibility requires that authorities acknowledge that insolvencies will occur from time to time and that the costs of resolving these insolvencies are seldom going to be zero. The goal of regulators cannot be to end bailouts once and for all, but to limit their size and frequency by timely interventions. Although quick action can stem bailout costs, the Dodd-Frank Act introduces a three-part series of potentially time-consuming checks and balances aimed at strengthening a failing firm's due process rights. Before an institution can be subjected to the Act's special resolution procedure, the Federal Reserve and a specified other federal regulator must jointly recommend that the Secretary of the Treasury put the firm into an FDIC-managed receivership. For the recommendation to go forward, the Treasury Secretary must undertake a number of specific determinations about the condition of the institution and the benefits of resolving its insolvency in this way. If and when the Secretary—after consulting with the President—decides to support the recommendation of the regulators, the consent of the institution's board is solicited. If the board refuses to consent, the Treasury's decision and findings undergo a nominal 24-hour judicial review. Although the last two steps could be traversed quickly, the agencies involved in the first step could take some time to achieve agreement. Once this three-step process is underway, the institution's knowledgeable counterparties may be expected to take action to improve their position at the government's expense.

It is important to keep the systemically important parts of the firm operating. The second broad principle is that the costs of doing this should fall as far as possible on the firm's stockholders and creditors. To minimize the costs of taxpayer help, the receiver ought to be required at the outset to impose preliminary haircuts on unsecured creditors and stockholders of failing firms. Appropriate haircuts should be inflicted on all uninsured claimants, regardless of maturity. A strategy of favoring short-term debtors in the initial process will encourage the kinds of short-funding strategies that create trouble in the first place.

In resolving the losses that the receivership or bridge institution experiences, the priority of creditor claims should be respected. When the Treasury is reviewing regulators' recommendation, a scramble for liquidity, could occur, motivated by uncertainty about the depth of an intuition's insolvency. This is a legitimate concern. Scrambles can be mitigated by giving the receiver a limited *ex-post* right to reverse transactions that can be demonstrated to have occurred as part of a scramble or by capping individual-counterparty losses in the resolution process at a specified percentage.

It is important to recognize that whatever funding or other credit support the Fed and FDIC provide to a receivership or bridge institution is a "tax expenditure". Government support and decisions to levy ex-post assessments to fund this support are forms of fiscal policy.

Because SIFIs are likely to be global institutions, U.S. resolution strategies have to be coordinated explicitly with those of other countries. The Committee's third and final principle is that explicit international coordination of individual-country resolution plans is necessary to limit regulatory arbitrage and cross-country scrambles for the good assets of failing firms. The absence of cross-country loss-sharing arrangements is greatly aggravating the financial stresses that are currently unfolding in Europe.