Confronting Financial Crisis: Dodd-Frank’s Dangers (and the Case for a Systemic Emergency Insurance Fund)

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The Dangers of Dodd-Frank

- Dodd-Frank is dangerously incomplete, on two dimensions
- First, although its procedures may successfully resolve a failing financial firm, it provides no way to resolve a financial crisis
  - Drafted amidst anti-bailout fervor, Dodd-Frank stripped the FDIC, the Fed, and Treasury of preexisting emergency authorities that were critical elements in restoring systemic stability, no less important than TARP
Dodd-Frank’s Dangers, 2

– As explained below, the consequence in the next financial crisis is likely to be the highly disruptive nationalization of much of the US financial sector

• Second, Dodd-Frank does not address the cross-border fall-out from the resolution of an US-based international financial firm.

– Unless the FDIC is prepared to funnel funds borrowed from the US taxpayers to pay off foreign counterparties, even a successful resolution of Lehman US would still precipitate a bankruptcy of Lehman UK
Additional Concern: Poor Fit with Emerging International Regime

• Other countries that host systemically important financial institutions (“SIFI’s”) do not have US bank resolution “tradition” and have limited capacity to resolve a large failing financial firm

• Key problem is not “Too Big to Fail,” but “Too Big to Save”
  — US may be only OECD country in which assets of top 5 banks are less than 100% of GDP
  — (Eg, US = 55%; UK = 400%; Switzerland = 600%)
Poor International Fit, 2

– Thus the int’l focus on
  • Capital in excess of Basel III requirements (Switzerland; UK)
  • “bail-ins” – debt for equity conversion: at endgame (to preserve “gone concern” value) and midstream (to preserve “going concern” value)

The Problem:
D-F’s belief in possible successful resolution of large SIFI makes US regulators more resistant to high-capital/bail-in regime, which makes it harder for other countries to impose such a regime on their own financial firms
The case for a “Systemic Emergency Insurance Fund” as part of D-F

• First: systemic crises in financial sector are inevitable

• Second: Effective firm-specific resolution mechanisms for failing financial firms – an important part of the current regulatory reform -- are hard to design
  
a) The Fed & Treasury were stuck with “merger” for Bear & Lehman: inadequate
b) FDIC-style resolutions will be harder for large financial firms
The Case, cont.

• Third: We need standby emergency authority
  a) Because firm-specific resolutions may be very expensive in important cases
  b) Because “resolutions” are firm-by-firm but crises may require a systemic approach entailing large capital infusions to many firms
  c) Because systemic approach may call for Fed credit facilities that require capitalization
  d) Because future crises may unfold in unforeseeable ways; standby emergency authority is a hedge against uncertainty
The Case, cont.

• Fourth: Standby authority should be in form of industry-funded systemic risk “insurance” fund, to avoid taxpayer-funded “bailout”

• Fifth: Net effect of such a facility on ex ante systemic risk-taking is indeterminate, but likely will be small

• Sixth: We live with similar devolutions of emergency authority to the Government in many cases, esp. involving national security
Resolution per Dodd-Frank

• Dodd-Frank gives the FDIC new resolution authority for the systemically important failing financial firm
  -- displaces bankruptcy regime for such firms
  -- similar to the FDIC regime for failing banks but more focused on “orderly liquidation” of the failed firm and imposing losses on creditors
Resolution per Dodd-Frank, 2

• **Covered firms**: financial firms that have previously been designated and regulated as “systemically important”.

• **Covered firms**: Depending on current FDIC rule-making, other firms that turn out to be systemically important ex post (eg: Long Term Capital Management), so could reach a hedge fund or PE fund not previously regulated as such.

• **Standard for triggering**: that a financial firm is “in default or in danger of default” and that alternative ways of resolving the financial distress “would have serious adverse effects on the financial stability of the United States”
Resolution per Dodd-Frank, 3

-- This is taken as meaning that commencement of a bankruptcy case is likely; FDIC resolution deemed to be less disruptive than bankruptcy
Resolution per Dodd-Frank, 4

- **Who decides**: “triple key approach” – need agreement among the Treasury, the FDIC (board vote) and the Federal Reserve (board vote)

- Strong likelihood that the board of the failing firm will consent, but if not, judicial review is narrow and expedited
FDIC “Receivership” under D-F

• Dodd-Frank receivership gives the FDIC similar authority as in case of failing bank, including discrimination among creditors of the same class

  -- **Constraint**: creditors cannot receive less than they would otherwise have received in a bankruptcy liquidation

  --How meaningful is this protection? Fire sale values in the circumstance (Lehman bonds: valued at 8 cents on the dollar in the CDS auction)
Differences from Bank Receivership

• First: Mandatory Loss Imposition
  -- Unsecured creditors must bear losses, even to the extent of claw-back of previous payouts if necessary to cover losses
  -- Creates uncertainty about the value of prior claims/obligation in the post-receivership period
  -- Remaining losses are to be recovered by ex post assessment on large financial firms
FDIC Receivership

FDIC has already begun to back away:
proposed rule that contemplates protection of short-term creditors (even if not secured) to mitigate run risk
-- Similar to FDIC’s prior de facto extension of deposit insurance to wholesale bank deposits
-- Will require regulatory policing of financial firm balance sheets to avoid adaptive shift to short term
Differences from Bank Receivership

• Second: no pre-existing fund (unlike DIF)
  – FDIC-provided working capital will come from Treasury (i.e., taxpayer) loans
  – No pre-funding because political reluctance to face “bailout” characterization
  – Undercuts FDIC resolution threat, creates invitation to regulatory forbearance, postponement of intervention to more systemically fragile moment
Dangers of Dodd-Frank

• **Step One:** Single firm resolution works best if reasons for failure are idiosyncratic

• If the distress is systemic, resolution of a single firm may exacerbate, not reduce, distress

  -- “Resolution: of a large systemically important firm is not a science; after all, US regulators thought they understood the consequences of permitting Lehman to fail
Dangers of Dodd-Frank, 2

• Even if “contagion” is controlled (meaning, just because one firm fails, other counterparty firms will fail), other financial firms that have followed similar, correlated business strategies may present similar solvency risks.

• In response to such uncertainty, capital suppliers begin to withdraw
  -- Interbank and other short term markets begin to freeze-up
  -- “Liquidity” crisis becomes “solvency” crisis as asset values become unstable and “fire sale” valuations may hasten the unraveling.
Dangers of Dodd-Frank, 3

• **Step Two:** Dodd-Frank (and prior Crisis legislation) withdrew prior emergency authority
  -- **Treasury** can no longer guarantee Money Market Funds after one has “broken the buck”
  -- **Fed** can provide funding only through general facilities – no firm-specific loans – and the collateral requirements are stiffer.
    -- Some critical Crisis credit facilities probably would not qualify
Dangers of Dodd-Frank, 4

-- **FDIC** can no longer guarantee the obligations of banking firms that are solvent but that face liquidity squeeze because of systemic financial distress

-- Critical addition to Fed discount window access, because FDIC guarantees do not require collateral

-- In the crisis, the FDIC authorized up to $1.7 trillion to protect uninsured depositors and to guarantee new issuances of unsecured debt

-- TARP was $700 billion
Dangers of Dodd-Frank, 5

• **Step Three**: going to Congress for either TARP II or FDIC Guarantees II or additional Fed or Treasury authority is politically unattractive, especially given available receivership option that can avoid financial system collapse

  -- FDIC has *uncapped* authority to provide support to firms in receivership, using a combination of direct liquidity support and guarantees
Dangers of Dodd-Frank, 6

• **Consequence:** For the liquidity-starved firm and the firm that is “solvent” in normal market conditions, FDIC receivership becomes the necessary source of funds

  -- **Result:** Close-in-time serial receiverships – falling dominos – leading to nationalization of significant share of US financial system
Dangers of Dodd-Frank, 7

- **Further result**: acceleration of course from financial instability to financial distress, as capital suppliers withdraw from entire financial sector, not just firms deemed most likely to fail

- **Further result**: Wide-ranging receiverships of US firms may destabilize non-US firms, adding to international financial distress
Systemic relief

• Single firm resolutions may work, depending on circumstances, or may require general creditor guarantees (the common FDIC approach)
• May need back-up emergency funding authority for single firm cases depending on size
• But the best approach may be systemic if:
  – The source of failure is not idiosyncratic
  – Single firm resolutions threaten to spread distress.
• For systemic relief: need emergency funding source (for e.g., capital infusions)
Systemic relief, cont.

• For systemic relief: may also need funding source to capitalize Fed credit facilities, since Fed is not built to take credit risk

The Systemic Emergency Insurance Fund ("SEIF") fills this gap
A “Systemic Emergency Insurance Fund”

- Scaled to size of US economy, so $1 trillion (2% of credit market assets)
- Partially pre-funded by assessments (risk-adjusted) on large financial firms, including hedge funds and others who rely on systemic stability
- Losses covered in a similar way
The Proposal, 2

• Analogy: FDIC Deposit Insurance Fund.
  -- “Depositor protection” is merely instrumental to systemic stability protection
  -- With growth of non-banking financial intermediaries like money market funds and commercial paper market (“shadow banking system”), need to change the mechanism
Further Reading

• For further analysis and defense of the SEIF idea, see:

Gordon & Muller: *Facing Financial Crisis: The Dangers of Dodd-Frank and the Case for a Systemic Emergency Insurance Fund*

-- Yale J. on Regulation (Winter 2011)
The Proposal: 
A “Systemic Emergency Insurance Fund”

- Use by regulators in systemic crisis:
  - To support “wind-up” of very large failing firms when other funding mechanisms would be insufficient
  - To backstop guarantees and to provide capital support for financial firms, to avoid disruption throughout financial sector
  - Support for Fed credit facilities
Would SEIF Add to Systemic Risk?

• “Moral Hazard” is a blunt instrument; what behaviors would change?

• SOURCES OF INCREASED SYSTEMIC RISK: 1. Capital suppliers’ interaction with firms

  Capital suppliers:
  1. Would know that regulators will not let financial sector collapse even if particular firm(s) fail
SEIF and Systemic Risk

2. Therefore pursue diversification strategy while seeking high returns
3. Will also bring more capital to systematically important firms (i.e., likely beneficiaries of SEIF capital infusion) than otherwise
SEIF and Systemic Risk

-- Financial firms:
1. Because diversifying investors will still favor firms with highest returns, competitive firms will adopt higher risk/return profile
   So, undiversified firm managements “see” resolution/liquidation risk but also see counter-pressure from diversified capital suppliers
2. This increases the likelihood of failure of systemically important firm
3. And, because they have more capital, the systemic consequences
II. Regulators will be too “soft”

Knowing of SEIF backstop, regulators will tend to less stringent regulation and less quick to tamp down emerging systemic threat
SEIF and Systemic Risk

• SOURCES OF REDUCED SYSTEMIC RISK:
I. With SEIF backstop, diversified capital suppliers will be less likely to withdraw in early stages of crisis;
   -- run risk is reduced; firms have better chance of raising additional capital
SEIF and Systemic Risk

II. More credible resolution/liquidation threat because regulators are less fearful of triggering a financial crisis

1. With SEIF backup, regulators more willing to “resolve” a systemically important firm rather than engage in forbearance strategies
2. Regulators more willing to impose higher loss ratio on creditors because of SEIF backup if misjudge;
   thus increase creditors’ and shareholders’ monitoring incentives
SEIF and Systemic Risk

III. Funding mechanism/ Mutualization of Systemic Risk disseminates incentives to warn regulators of emerging systemic concerns

1. Parties who do not directly benefit from risk-taking activity by banks, like hedge funds, have new incentives to warn

2. Such parties will have special credibility and increase regulators’ confidence in rule-tightening
SEIF and Systemic Risk

Result: off-setting effects. **Net effect is likely to be small**

But: even assuming that capital suppliers and firms engage in marginally greater risk taking than otherwise, is this undesirable?

Risk-taking and economic growth are linked

Alternative to government as protector of financial stability is Hobbesian finance, and insurance scheme is an attractive mechanism of protection
SEIF and Systemic Risk

- Avoid a repeat of A. Greenspan’s mistake: assuming that if incentives are right (here: penalize creditors in addition to shareholders), parties will all behave well
  - The mistake restated: The assumption that “moral hazard” is the key driver of financial crisis and that this variable can be controlled
  - “Wouldn’t it be pretty to think so?” E. Hemingway, *The Sun Also Rises* (1926)
SEIF and Systemic Risk

• Ignores possibility of miscalculation, multiple agency costs, and systemic distress from even single firm failure

• Ignores, more generally, the inevitability of systemic crisis