

International Financial Conglomerates: Too Complex to Fail?

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October 9, 2003

Washington, D.C.

Overview

- ✓ The problem: increasing size & complexity of large, international financial conglomerates situated at the core of the international financial system
 - International payments
 - FX trading
 - OTC derivatives
- ✓ Legal, regulatory and geographic complexity impede the effectiveness of traditional tools
- ✓ The too-complex-to-fail issue

The problem

- ✓ An international financial conglomerate is likely to be managed in an integrated fashion along lines of business without regard for
 - Legal entities (perhaps 1000s)
 - National borders (perhaps 100)
 - Functional regulatory domains (perhaps 3 or more per country)
 - With substantial intra-group transactions that are difficult to disentangle

In the event of financial distress...

- ✓ Formidable coordination and information sharing challenges at a minimum
- ✓ May have differing approaches to bankruptcy across regulators within countries
 - Conflicts over objectives
 - Differences in policy tools to meet objectives
 - Conflicts over when and how to take action
 - Conflicts over information sharing
 - Other public policy interests may override regulatory processes

Conflicts are apparent even in the US

- ✓ A failed insured depository institution is subject to FDIC procedures
 - Constrained by least cost resolution requirements of FDICIA (1991)
 - Domestic depositor preference law (1993)
- ✓ A failed broker/dealer is subject to Securities Investor Protection Act
- ✓ An Edge Act subsidiary could be liquidated by the Fed
- ✓ A failed insurance subsidiary may be subject to special state-specific procedures
- ✓ The parent holding company & most non-bank entities subject to bankruptcy proceedings
- ✓ RICO proceedings may trump other procedures

Conflicts multiply when conglomerates cross borders

- ✓ May have conflicts
 - Re: objectives
 - Re: how lines of business map into legal entities
 - Re: who initiates process
 - Re: which law applies
 - Re: who executes the process
 - Re: treatment of custody assets
 - Re: insolvency set-off regimes
 - Re: repayment priorities
 - Re: depositor protection schemes and rights of deposit insurer
 - Re: public policy exceptions such as RICO proceedings in the US

ISDA Master Agreements designed to cut through complexity

- ✓ A statutory exception to override the automatic stay provisions in most bankruptcy laws
- ✓ In the event of default, may close out all contracts with defaulting counterparty, net them and liquidate the collateral
 - In US applies to REPOs, securities contracts, commodity contracts, swap agreements and forward contracts

But has Given Rise to an Additional Systemic Risk Concern

1. Bank runs

- LLR
- Deposit Insurance
- Prompt corrective action

2. Payments system gridlock

- Central bank support & extension of work day
- Continuously linked real time gross settlement

3. Market illiquidity because of forced liquidation of illiquid positions

Policies to Deal with Illiquidity

- ✓ Private Sector Solution
 - Chief creditors devise and implement a financial restructuring
 - Difficult to arrange in practice
 - Especially difficulty for international financial institution
 - Ambiguity over which law to apply clouds the default option and undermines bargaining leverage of creditors
 - Free-riders may thwart solution

Illiquidity policies (cont'd)

- ✓ Officially “facilitated” creditor consortium, with no official resources
 - Ex post risk sharing may differ from ex ante exposure because of variation in vulnerability to regulatory pressure among creditors
 - May convey the impression of enhanced probability of a future bailout

Illiquidity policies (cont'd)

✓ LLR

- Okay if solvent & a penalty rate
- In practice too often a subsidization for risk taking
- In some countries, key institutions may not be eligible

Illiquidity policies (cont'd)

- ✓ Explicit government guarantees
 - Can they be properly priced?
 - If not, distorts competition
 - Moral hazard: can induced risk-taking be adequately controlled?
 - Shift risk of loss to taxpayers

Illiquidity policies (cont'd)

- ✓ Implicit government guarantees
 - Unpriced and thus will distort competition
 - Uncertain
 - Invites political manipulation
 - Open-ended and thus difficult to control fiscal costs

Illiquidity policies (cont'd)

- ✓ Improvised bailouts
 - Unwarranted subsidy
 - Increased risk-taking
 - Increased probability and size of future bailouts
 - Open-ended fiscal costs

In the absence of credible bankruptcy procedures...

- ✓ Ill-considered bail-outs
 - Too big to fail
 - Too complex to fail
- ✓ Moral hazard exacerbated
 - Dulls incentives to demand disclosure
 - Weakens market discipline
- ✓ Inefficient crisis management procedures may undermine crisis prevention efforts

A credible procedure must address a series of questions...

- ✓ Within financial conglomerates, how to map lines of business into the legal entities to which bankruptcy procedures must be applied?
- ✓ Within countries, how to coordinate actions of various functional regulators?

Issues continued...

- ✓ Across countries, how to harmonize national approaches to ensure a cooperative process?
- ✓ Across OTC derivatives markets and clearing & settlement systems, how to meet the needs of the bankruptcy administrator for time without impeding ability of market participants to continue trading?

Need to consider...

- ✓ Special bankruptcy procedures for systemically important financial firms?
 - Authorization for bridging institution that can unwind the affairs of a failing firm in a orderly way
 - Maximize going-concern value
 - Avoid scramble for assets or forced liquidations
- ✓ For market discipline to work, the system must be made safe for the failure of any financial firm