The problem is **severity**

Financial reformers talk endlessly about the too-big-to-fail problem, but they often fail to address the heart of the issue, argues ***David Rowe***

Since that terrible week in September 2008 when Lehman Brothers failed, American International Group was taken into conservatorship and Bank of America was 'encouraged' to acquire Merrill Lynch, too big (to be allowed) to fail has been the central issue on the minds of regulators and politicians. Unfortunately, discussion of this issue has produced more heat than light.

The heart of the problem is that, given current institutional arrangements, failure of the largest financial institutions will have significant secondary and tertiary consequences for society as a whole. I am among those who believe the actions taken in September 2008 probably did prevent an even worse economic contraction than we have seen. I also believe the decision to let Lehman Brothers fail was appropriate and ultimately beneficial in limiting moral hazard, despite the immediate disruption it caused.

Nevertheless, there is an urgent need to revise our institutional arrangements in both the US and the European Union to prevent the need for this kind of devil's choice in the future.

An insolvent institution has made commitments with an aggregate value in excess of the value of its assets, giving rise to an economic injustice – at least some of the creditors will not receive the full value they were promised. In essence, a bankruptcy proceeding is a means of allocating the impact of this injustice across different classes of claimants. In most situations, this is purely a matter to be thrashed out among the various creditors according to established rules and under the supervision of a court. There will be secondary economic effects, but these are usually limited and present no serious systemic risk of cascading losses that inflict severe economic pain on a wide range of innocent bystanders. In the case of an institution deemed to be too big to fail, the fear is that such secondary consequences of a failure will be so severe that a publically funded rescue is the least worst option.

The too-big-to-fail problem can be addressed from two angles: likelihood and severity. Unfortunately, the *ad hoc* responses to the crisis, as well as most of the more recent financial reform proposals, have focused on trying to reduce the likelihood of failure. During the crisis, vulnerable institutions were forced into mergers with others thought to be healthier, assuming this would reduce the likelihood of either institution failing. In the process, this created institutions whose failure would have an even more severe economic impact than that of either of their constituent parts. More recent proposals have similarly focused on reducing the likelihood of failure. These include higher minimum capital requirements, more stringent liquidity buffers, and more detailed and intrusive supervision. Sadly lacking so far are reforms that reduce the severity of such a failure's impact on society.

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The problem is that liquidation in a traditional bankruptcy is an agonisingly protracted legal process. Creditors have their funds tied up for months or even years, with continuing doubt about when and how much will be recouped. Throwing a systemically important financial institution into this process, and allowing lawyers to feast on the carcass for years, clearly runs the risk of severe collateral damage to society at large.

Today, however, supervisors may have at most two or three days to engineer a resolution, force a traditional bankruptcy or initiate a government-assisted bail-out.

What is needed is a process similar to Chapter 11 bankruptcy in the US. When a bank is unable to meet its maturing obligations, regulators could take over its operation as a debtor in possession. The doors would open on Monday, cheques would clear and insured depositors would have their funds available on schedule. All uninsured claims would be frozen subject to a review by the regulators as to how to allocate the economic shortfall.

With proper authority in place, this allocation could be worked out in a matter of weeks or at most a few months. Meanwhile, as in a Chapter 11 proceeding, obligations incurred post-bankruptcy would have first claim on the assets, ranking ahead of all pre-bankruptcy debts, allowing fresh financing to be forthcoming. Equity holders would be wiped out, subordinated creditors would take a substantial haircut and senior secured creditors would suffer somewhat smaller losses. Finally, some debt would be converted to equity in the surviving institution and the government would get out of the way.

Such rough justice would not be pretty and there would be many anguished screams from those sustaining losses. It is hard to imagine, however, that the societal consequences could be worse than those we have observed in the past two years. ■