Testimony

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Subcommittee on Commercial and Administrative Law
Committee on the Judiciary
United States House of Representatives

October 22, 2009

Thank you for the opportunity to provide testimony for this hearing on bankruptcy and non-bankruptcy alternatives for failing non-bank financial institutions.

Concern that failure of a large financial institution could severely damage the economy has created a policy of government bailouts in the United States. As a consequence of that policy, the federal government has committed huge amounts of funds, intervened in many private-sector activities, and induced excessive risk-taking by people expecting bailouts to continue. An alternative to this bailout policy is sorely needed.

Two Alternative Proposals

Two main alternative proposals are currently under consideration. One has been put forth as part of the Administration’s financial reform proposals. It would establish a special resolution regime under which the Secretary of the Treasury, with the approval of the President and agreement of the regulatory authorities, could apply an expanded FDIC-like resolution process to any financial firm if its failure would have “serious adverse effects on the financial system or the economy.” The firm would be placed into conservatorship or receivership and the government could provide the firm with loans, purchase its assets, or guarantee its liabilities.

The other proposal would have the failing financial firm go through a bankruptcy process designed specifically to deal with some of the financial firm’s assets and liabilities, which are an integral part of the financial system. The bankruptcy proposal in H.R 3310 is an example of such an approach. The conceptual idea is that the bankruptcy would permit important financial transactions to continue without significant disruption during bankruptcy.

In my view the expanded resolution regime has significant disadvantages in comparison with a bankruptcy process designed specifically for financial firms. First, the new resolution regime would essentially institutionalize the kinds of bailouts that have occurred in the recent crisis. Hence, rather than providing an alternative to policy of bailouts, it would permanently establish such a policy. Second, the expanded resolution authority would be operated with a considerable degree of discretion about when to start the intervention and about the priority to give different creditors. In contrast a bankruptcy process relies on an established rule of law rather than the discretion, and treats creditors in a known way that is understood by lenders and investors in advance. Compared to the resolution authority, bankruptcy is a more predictable process.
Relevant Lessons from the Crisis

Studying carefully what happened during the recent financial crisis is important for determining which approach to take. Understanding the events surrounding the Lehman bankruptcy is particularly important. Some argue that the cause of the panic in the fall of 2008 was the failure of the government to intervene and prevent the bankruptcy of Lehman. This view gives a rationale for continued extensive government bailouts and now to proposals for a more expansive resolution process. I do not think the evidence supports that view. Of course the surprise decision not to bailout Lehman’s creditors and the run on certain money market funds was a jolt to the markets. But far worse was the chaotic intervention by the government in the following weeks, most significantly the rollout of the TARP, including the less than credible description of how the toxic assets would be removed from banks’ balance sheets, the huge amount of money asked for with only 2-1/2 pages of legislation, and the scare stories of another great depression if legislation were not passed, and even if it were passed.

The government did not articulate a clear predictable strategy for lending and intervening into a financial sector. Such a strategy could have been put forth in the weeks after the Bear Stearns rescue. Instead market participants had to guess what the government would do in other similar situations. The lack of a strategy became quite evident in the confusing roll out of the TARP plan. According to event studies of interest rate spreads in the interbank market this was a more likely reason for the panic than the failure to intervene with Lehman.

My empirical research on the crisis has led me to this view and I first wrote about in November 2008 and later in my book, *Getting Off Track*, published early this year. Consider Figure 1, which is drawn from that book. It examines the spread between longer term interbank loans (Libor) and an expectation of what the overnight interest rate (federal funds rate) will be over the maturity of the loan (OIS). The Libor-OIS spread is one of the leading measures of stress in the money markets. Observe that Figure 1 focuses on events from September 1 through October 2008.

For the year previous to the events in Figure 1, the spread had been mainly fluctuating in the 50 to 100 basis point range which was where it was through the first half of September 2008. The spread moved a bit on September 15th, which is the Monday after the weekend decisions not to intervene in Lehman Brothers. It then bounced back down a little bit on September 16 around the time of the AIG intervention. While the spread did rise during the week following the Lehman Brothers decision, it was not far out of line with the events of the previous year.

On Friday of that week the Treasury announced that it was going to propose a large rescue package. Over the weekend the package was put together and was presented to Congress in testimony the following week. As shown in Figure 1, it was following this testimony that one really begins to see the crises deepening, as measured by the relentless upward movement in Libor-OIS spread for the next three weeks. Things steadily deteriorated and the spread went through the roof to 3.5 per cent.
The Panic of Fall ‘08

Figure 1

Figure 2
The government interventions during this panic period were part of a pattern of ad hoc responses starting with the Bear Stearns bailout. No guidance was given following Bear Stearns about the circumstances under which another firm, such as Lehman, would be intervened. So when the decision was made—without a good legal or economic reason—not to intervene with Lehman, no one was prepared. But the problem was not the lack of intervention per se; it was the unpredictable, unprincipled pattern of intervention that had been followed for months, which the TARP rollout revealed clearly.

With the passage of time, evidence is accumulating that such confusing and unpredictable government interventions made things worse, though we are still very close to the crisis and the issues are complex. The data on equity markets tell a similar story. Consider the S&P 500 shown in Figure 2. The S&P 500 closed at 1252 on Friday, September 12, 2008, before the Lehman bankruptcy. It was off on Monday after the news of the bankruptcy but recovered during the week closing on the following Friday, September 19 at 1255, above the level before the bankruptcy. It was not until the following week and the rollout of the TARP that the market began to fall sharply. And it continued to fall until October 10 when the S&P 500 hit 899 and the government finally clarified that the TARP would actually be used for equity injections.

There were many other events affecting interest rate spreads in the interbank market and equity prices around this time. Careful empirical research is needed to determine their impact on the data provided in Figures 1 and 2. Some of these events involve other government interventions and are thereby very relevant to the analysis of proposals for expanded resolution authority in comparison to bankruptcy approaches. For example, the seizure by the FDIC of Washington Mutual and its sale to JP Morgan Chase was followed quickly by a sharp drop in the price of Wachovia’s bank debt, its aborted FDIC-driven acquisition by Citigroup, and its eventual acquisition by Wells Fargo. Examination of these complex bank resolution cases will help assess how an even more complex non-bank resolution process will work in practice.

Conclusion

An empirical review of the data and corresponding events in the fall of 2008 provides two important lessons. First, it shows that the bankruptcy of Lehman was unlikely the direct cause of the panic during the fall of 2008. Second, it shows that an ad hoc interventionist government policy, which was revealed for the world to see in the following weeks, was what caused the panic. Both lessons favor a rule-like bankruptcy process rather than an expanded discretionary resolution authority.