

THE BANKRUPTCY OF BANKRUPTCY

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In a nutshell

▣ The problem

- *Procedures for resolving debt distress in both sovereigns and SIFIs are woefully inadequate*
 - ▣ *Sovereigns and SIFIs are above the law*
 - ▣ *Adequate “soft law” procedures have not been developed*
- *Problem is particularly pernicious: debt distress of one (SIFI or state) makes the debt distress of the other worse*

▣ The solution

- *Develop a resolution framework embodying common principles and practices*
- *Use existing institutions and processes*

Objectives of insolvency procedures

- Individual welfare objectives
 - Maximise recovery value for the debtor. (Debtor friendly principle)
 - Permit the debtor to retain his “tools of his trade”. (Creditor friendly principle)
 - Observe basic legal principles of predictability, due process, fairness

Objectives of insolvency regimes

- ▣ Public good objectives
 - Preserve critical functions
 - Promote economic efficiency
 - Avoid negative externalities
 - Reconcile the rights of the individual and the interests of society

Current resolution regimes for sovereign debtors

- ▣ Typical procedure is a negotiated debt exchange, with varying use of sticks and carrots
- ▣ Carrots
 - collateralisation,
 - participation in the upside (GDP linked bonds)
- ▣ Sticks
 - default
 - change of non-payment terms
 - exit consents

Current sovereign resolution regimes for TBTF institutions

- ▣ Typical procedure involves “assisted” merger or **quasi-nationalisation**
- ▣ Creates institutions that are even bigger and costlier to save
- ▣ In some cases (Iceland, Ireland) risks bankrupting the state

Common and idiosyncratic problems

- ▣ Contagion
- ▣ Time consistency
- ▣ Public good considerations
- ▣ Difficulty of enforcement
- ▣ Asset grabs and litigation
- ▣ Need for speed for banks – stays don't work.
- ▣ Banks are complex – states are simple – legally

Solutions

- ▣ A framework for debt resolution should
 - Cover all “large” exposures, irrespective of the nature of the creditor
 - Take systemic or public good considerations into account
 - Contain suitable incentives to foster time consistency

Treaty based or “soft law”?

- ▣ International treaty – neat but difficult
- ▣ Soft law is more likely to work – but slow
 - Refine existing institutions and arrangements – ICSID, standard contract documentation
 - Ensure national resolution authorities adhere to the same principles and have the same powers
 - Use comity to achieve consistency across jurisdictions

No soft options

- ▣ Resolution systems will not be used if there is a soft option in the form of hard cash
 - Eliminate asymmetries in incentives arising from the socialisation of losses and the privatisation of gains
 - Use of “bail-inable” debt to increase predictability of loss allocation

Principles

- ▣ Balance individual rights with the need to serve the public interest
 - Priority in bankruptcy should be determined by broad public policy considerations
- ▣ Promote predictability and avoid discontinuities
- ▣ Be impartial and fair
- ▣ Maximise value of assets

Practices - a continuum of measures

SIFI

- Early strategic re-orientation by the board
- Regulatory intervention
- Operation as a going concern under an administrator
- Merger or purchase and assumption
- Dismemberment, with viable operations being transferred to a third party and others wound down
- Liquidation

SOVEREIGN

- Policy adjustment by the government
- IFI advice (for example through Article 4 consultations)
- Meet objectives under a Fund adjustment programme
- Change of government
- Change of regime
- Failed state

Practices - comprehensive coverage

- ▣ All stakeholders need to be involved in the resolution
 - Provide for formation of creditor committees
 - Use comparability provisions across classes of creditors
 - Respect priorities subject to a public interest override

Preserve critical functions

- ▣ Ensure continuity of key funding markets
- ▣ Serve as market maker of last resort
- ▣ Replace markets with official flows; with the cb becoming a financial conduit
- ▣ Hive off systemically important activities and leave unviable ones in the rump

Make systems incentive-compatible

- Reconsider use of limited liability
- Increase civil liability of managers
- Reduce size and complexity of banks

Make sure the timing is right

- ❑ Procrastination makes matters worse
- ❑ A measured pace permits the system to prepare for restructuring (build up reserves; price in default)
- ❑ Permit debtor to continue essential operations during the resolution process
- ❑ Recognise that serial restructurings allow adjustment of incentives

Change structure and operation

- ▣ (Legal) form must follow (economic) function
- ▣ Create utilities for settlement and clearing
- ▣ Restrict operations that augment contagion or discontinuities
 - Close out netting
 - CDSs that use a common trigger

Create consistent priorities

- ▣ Adopt common priorities across jurisdictions to reduce forum shopping and competition among authorities
- ▣ Provide seniority for debtor-in-possession financing
- ▣ Extend “preferred creditor status” to any entity providing “debtor in possession” financing
- ▣ Rescind seniority if preferred credit becomes a large portion of total financing

Address the difficulty of enforcement

- ▣ Use collateral in debt swaps
- ▣ Use collective action clauses so
- ▣ supermajorities can enforce agreements on holdouts
- ▣ Respect public interest, for example by ensuring integrity of payment systems