THE BANKRUPTCY OF BANKRUPTCY

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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
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
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
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
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
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