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## Corporate Law: Resolution Triggers for Systematically Important Financial Institutions

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**Corporate Law:**  
*Resolution Triggers for*  
*Systematically Important Financial Institutions*<sup>1</sup>

John Crawford

One of the great regulatory challenges to emerge from last decade's financial crisis was the problem of "too-big-to-fail" financial institutions—those firms whose failure could trigger widespread runs in the financial system. When such firms faltered in 2008, regulators faced the dilemma of either acquiescing to financial panic and the attendant economic wreckage, or putting taxpayer money at risk to bail out the firm and its creditors. Regulators have made significant progress in designing mechanisms to avoid this dilemma.<sup>2</sup> This progress has, however, primarily centered on what happens once a systematically important financial institution (SIFI) is *in* resolution. The lack of robust mechanisms to ensure a SIFI is *placed* in resolution in a timely manner lingers as a major weakness in these schemes. This chapter summarizes the costs and causes of delay in triggering resolution and evaluates different approaches to mitigating these costs and causes.

*The Costs of Delay*

Delay in triggering resolution for a bank or SIFI is pernicious because losses are likely to worsen at firms with razor-thin or negative capital;<sup>3</sup> weak firms thus have an incentive to "gamble for resurrection," taking imprudent risks to climb back to solvency, confident that the costs of bad outcomes will be borne by creditors or taxpayers.

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1. Summarized and excerpted from John Crawford, *Resolution Triggers for Systemically Important Financial Institutions*, 97 NEB. L. REV. 65 (2018) and from John Crawford, *Resolution Triggers and TLAC Tradeoffs*, OXFORD BUSINESS LAW BLOG (2018).

2. For detailed analyses of these mechanisms, see John Crawford, "Single Point of Entry": *The Promise and Limits of the Latest Cure for Bailouts*, 109 NW. U. L. REV. ONLINE 103 (2014), and John Crawford, *Credible Losers: A Regulatory Design for Prudential Market Discipline*, 54 AM. BUS. L.J. 107 (2017).

3. "Capital" in the banking context, and as used here, refers roughly to a firm's balance-sheet equity—that is, the difference between the value of the firm's assets and its liabilities.

To illustrate this dynamic, consider the stylized example of a firm whose liabilities exceed the value of its assets by \$20, but which has not yet been placed in bankruptcy or resolution proceedings. The firm is considering two investments. Investment A has a 10-percent chance of gaining \$100 and a 90-percent chance of losing \$100; and investment B has a 90-percent chance of gaining \$10 and a 10-percent chance of losing \$10. Investment A has an expected value of *negative* \$80; B has an expected value of (positive) \$8. Investment B is thus the superior choice from the aggregate perspective of all stakeholders in the firm: while it will not return the firm to solvency, it will mitigate the losses to creditors. The shareholders, however, do not bear any of the losses in either scenario: because capital is already negative, any *further* losses will be borne by creditors. Therefore, the expected return to *shareholders* from the two investments yields a different result: The expected return to shareholders from investment A is \$8,<sup>4</sup> while the expected value of B is zero.<sup>5</sup> The shareholders will thus prefer investment A in this stylized example, even though both the probability of loss and the magnitude of loss in the downside scenario will be much greater. It is worth emphasizing that the thicker a firm's capital cushion, the less shareholders and managers will be able to shift losses onto other claimants, and the less these perverse risk-shifting incentives will apply.

While the example above is highly stylized, the dynamic of "gambling for resurrection" was central to the savings and loan (S&L) crisis of the 1980s. Hundreds of S&Ls failed during the 1980s, but a large number were permitted to continue operating for extended periods—often years—with capital buffers that were razor thin, or even negative by some measures. At the outset of the crisis, trouble arose primarily from rising market interest rates, rather than from rising defaults by those that had borrowed from the bank. Rising interest rates increased the interest the S&Ls had to pay to their depositors, but did not increase the money flowing into the S&Ls from their existing stock of assets—primarily long-term fixed-rate mortgages. (The rates

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4. This is equal to  $0.1 * (\$100 - \$20)$ . Note that even in this good state of the world, the shareholders will need to spend \$20 to climb out of their capital hole. The \$100 in (further) losses in the event of failure is ignored by shareholders in this stylized example: Again, shareholders have already lost everything, and, due to limited liability, do not bear any further liability for the firm's losses.

5. Even in the good state of the world, in which the investment yields \$10, this will serve merely to mitigate losses to creditors, and will not fill the capital hole of \$20. The equity position of the firm will continue to be negative.

on these mortgages had been set before market interest rates rose.) Measuring assets by what they could be sold for in the market rather than with historical accounting methods, many S&Ls owed more than their assets were now worth—that is, they were insolvent.

Regulators, however, permitted market-insolvent S&Ls to continue operating, hoping they would dig themselves out of their holes, and slackened various rules to permit them to make the attempt. Many S&Ls responded by getting more aggressive (that is, less careful) in their underwriting and risk management. The unhappy result was that what started as an interest-rate crisis—one that was partially undone once interest rates started falling again—morphed into a crisis of bad loans that significantly worsened losses, which were ultimately borne by taxpayers.

#### *The Causes of Delay*

A bias toward delaying resolution unfortunately seems to infect all key actors. This likely has a variety of causes. Regulators, for example, do not always appreciate the logic behind SIFIs' risk-shifting incentives—after all, these firms surely do not *want* to lose money. Regulators and policymakers might also worry about political backlash when the SIFI's managers and lobbyists contest the finding of nonviability. As former Deputy Governor of the Bank of England Paul Tucker has observed, “if faced with uncertain long-term benefits but an immediate risk of unpopularity, a policy maker might incline toward delaying action until the resilience-eroding threats of exuberance or imbalances were widely perceived.”<sup>6</sup>

Another set of reasons might be grouped under the rubric of “capture”—that is, the excessive identification of regulators with the industry they regulate. Capture can arise from a direct conflict of interest, such as when a regulator acquiesces to decisionmakers at a firm where she hopes one day to work, or from subtler conflicts, such as when a regulator shows “deference to high-status regulated executives [or] to those with whom [she] has face-to-face relationships, because of empathy or the desire to avoid conflict.”<sup>7</sup> While a decision on triggering a SIFI resolution would be made at the highest level, capture could be a problem even if it affected only lower level

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6. Paul Tucker, *The Design and Governance of Financial Stability Regimes*, 3 *ESSAYS ON INTERNATIONAL FINANCIAL* 48 (Sept. 2016).

7. Philip Wallach, *What is Regulatory Capture?*, *THE NEW RAMBLER* (2015).

regulators, if it were to shape the information high-level officials received.

Yet another reason for delay is that the primary measure used for triggering resolution—that is, capital—does not always capture the “real” state of the bank’s balance sheet. Market expectation of a higher percentage of defaults on a bank’s loans, for example, does not necessarily mean that the bank will increase its accounting-based provisions for expected defaults or losses in a timely manner. Thus, regulatory measures of capital are “lagging indicators” of trouble at banks—that is, there is often a significant lag between trouble materializing with respect to a bank’s assets (or the market’s recognition of such trouble), and the reflection of that trouble in the bank’s regulatory accounting measures.

#### *Promoting Timeliness*

Several possible reforms could help promote timeliness in triggering resolution; this chapter addresses two. The first is that regulators should use market-based measures as triggers for remedial actions, up to and including resolution. A Dodd-Frank-mandated rule that was proposed but never finalized would have provided for market-based triggers for early regulatory intervention, and for the continued study and evaluation of such metrics as potential triggers for more drastic regulatory actions, including resolution.<sup>8</sup> This rule should be taken up again and finalized.

A second reform arises in the context of the “total loss absorbing capacity” (TLAC) rules that apply to large bank holding companies, requiring them to maintain long-term debt and equity above prescribed minimums. The advantage of TLAC is that it can absorb losses without triggering panicked runs—a major risk generated by imposing losses on short-term debt. TLAC plays a central role in efforts to facilitate resolution without forcing regulators to face a choice between bailouts and panic.

TLAC’s effectiveness rests first and foremost on whether the overall requirements are set at adequate levels. A related but distinct question ties directly back to the issue of trigger timing: namely, for a given aggregate amount of TLAC, how much should be in the form of long-term debt, and how much in equity? (Currently the proportion is roughly one-third debt and two-thirds common equity.)

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8. Enhanced Prudential Standards and Early Remediation for Covered Companies, 77 Fed. Reg. 594 (Proposed Rule, Jan. 5, 2012).

Equity has its advantages. It can absorb losses without implicating difficult triggering questions that arise with debt. Moreover, a higher proportion of equity can mitigate perverse risk-shifting incentives on the part of shareholders, as captured by the notion of “gambling for resurrection,” described above. A thicker equity cushion operates like the deductible on an insurance policy, making a firm’s residual claimants more sensitive to the downside risks of aggressive strategies.

Cutting in the other direction, some observers believe that higher debt-to-equity ratios impose discipline on firm managers, helping solve a potential agency problem by limiting the free cash flow firm managers have to hide underperformance or “benefit taking.”<sup>9</sup> Other observers, however, have critiqued this view as misplaced in the context of banks.<sup>10</sup> From this latter standpoint, TLAC shouldn’t include long-term debt at all.<sup>11</sup>

Even if one rejects the view that debt solves an agency problem, there is another factor that counsels against eliminating long-term debt as a component of TLAC—and that, indeed, may support *higher* levels than we currently see. Specifically, long-term debt may help mitigate or counteract the delay-inducing factors cited above—especially regulatory capital’s lag time for indicating real economic developments, and political pressure not to rock the boat.

Long-term debt’s potential role in mitigating the bad effects of capital lag is straightforward: A SIFI should be put into resolution when it is at or near the point of insolvency, and capital lag means that a firm may be (deeply) insolvent by the time it hits a capital-based resolution tripwire. Regulators relying solely on equity to absorb losses in such a case would again face the bailout-or-panic dilemma. But consideration of sufficient long-term debt could reveal credible loss-bearing capacity beyond the point of (real) insolvency.

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9. See, e.g., Caterina Mendicino et al., *Equity Versus Bail-in Debt in Banking: An Agency Perspective*, European Systemic Risk Board, Working Paper No. 50 (2017).

10. See Anat R. Admati & Martin F. Hellwig, *Does Debt Discipline Bankers? An Academic Myth About Bank Indebtedness*, Rock Center for Corporate Governance at Stanford University Working Paper No. 132 (2013).

11. Anat R. Admati, *The Missed Opportunity and Challenge of Capital Regulation*, Rock Center for Corporate Governance at Stanford University Working Paper No. 216; Stanford University Graduate School of Business Research Paper No. 16-6 (2015).

An alternative is to mandate that TLAC be all equity but set a much higher threshold for triggering resolution.<sup>12</sup> But pulling the resolution trigger on a firm when its regulatory measures of capital indicate that it is fundamentally solvent is not a politically stable solution to the problem of timeliness. If the resolution trigger is pulled when a SIFI loses, say, two-thirds of its equity, the SIFI's remaining (ostensible) capital buffer against insolvency would weaken everyone's sense of urgency and strengthen banks' persuasiveness when they argue against specific triggering decisions. Even if one could credibly remove all regulatory discretion and make the higher equity-based trigger automatic, it would be highly vulnerable to bank lobbying and legislative rollback. The fallout of SIFI failure and capital as a lagging indicator are complicated ideas; government seizure of an ostensibly solvent firm is straightforward and presumably distasteful to many elected representatives in the United States. The resolution of a firm that—by regulatory metrics—is insolvent is less likely to invite backlash. Requiring that some portion of TLAC be satisfied with long-term debt, then, can be understood as a way to force regulators' hand and weaken political and institutional inertia when it comes to putting a weak SIFI into resolution.

### *Conclusion*

Timeliness is essential if the resolution mechanisms designed to avoid the bailout-or-panic dilemma are to serve their purpose. Regulators, however, have not yet paid sufficient attention to ensuring timeliness in triggering resolution. Two reforms could help counteract the bias toward delay inherent in the decision to place a SIFI into resolution: the incorporation of market metrics into the triggering framework, and ensuring adequate long-term debt as loss-absorbing capital.

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12. See Matt Levine, *Regulators Want Banks to Rescue Themselves Next Time*, BLOOMBERG VIEW (Nov. 11, 2014).