

1st June 2011

SPECIAL TREATMENT OF REPOS AND DERIVATIVES IN BANK BANKRUPTCY RULES WORSENS SYSTEMIC LIQUIDITY RISKS

ICFR conference on future of bank funding hears policy options including removal of bankruptcy 'superpriority' for repos and derivatives, taxing of such bankruptcy exceptions, and a broader stability risk charge to underpin funding stability

An International Centre for Financial Regulation (ICFR) conference today brought together industry representatives, regulators and academics to discuss the impact of changing regulation on the future of bank funding. The lack of stable bank funding became a critical issue in the financial crisis, particularly given the increasing extent to which interbank funding became and now remains increasingly short-term and collateralised. Current proposals such as Dodd-Frank do not seem to adequately address this issue which some argue played a key role in the propagation of the crisis.

Professor Enrico Perotti (Professor of International Finance, Amsterdam Business School, Duisenberg School of Finance) discussed the relationship of bank funding to systemic risk, focusing especially on the role of contingent obligations (repos, derivatives etc). Professor Perotti outlined how over the 2002-2005 period, bankruptcy laws were changed in all EU countries and the US, and secured financial credit (repos) and derivative counterparties gained a strong bankruptcy privilege, amounting to de facto 'superpriority', as counterparties could gain immediate repossession of collateral in default (so-called "safe harbor claims", as opposed to having to accept the "automatic stay" which protects the debtor in Chapter 11 for example).

As often in financial regulation, this leads to unintended consequences. As a default leads to repossession of collateral for all safe harbor claims, repossession accelerates fire sales, resulting in a disorderly resolution, with a rush to sell collateral ahead of others, creating a downward spiral in valuations. The timing of the jumps in risk spreads on Lehman, two days after the default, demonstrates this effect, as does AIG.

Professor Perotti recommended the creation of a public registry of collateral, as a necessary condition to enjoy any bankruptcy privilege, and a risk charge or levy for this bankruptcy privilege, to help reduce excess credit creation and to reduce the risk of fire sales of collateral. Critically this should cover any intermediary (unlike Basel III) and include unlisted derivatives.

Such a levy would be less disruptive than strict quantity limits and easy to adjust counter cyclically, with a low cost in normal times. It would also ensure the monitoring of the stock of contractual and contingent liquidity risk, as it is not net but rather gross liquidity that has systemic risk effects. Professor Perotti likened the charge, to 'charging for drinks once the party gets going,' instead of the classic central banker concept of taking away the punchbowl.

Professor David Skeel (S. Samuel Arsht Professor of Corporate Law, University of Pennsylvania Law School) discussed whether or not the US Dodd-Frank Act adequately deals with these bankruptcy privileges given to derivatives and collateral with financial institutions. While Dodd-Frank seeks to tackle information asymmetries by forcing derivatives onto exchanges and into clearing houses, it does not in any way alter the unusual position of derivatives and repos in bankruptcy. He argued that this treatment has had negative unintended consequences, seen most clearly in the case of AIG. The exception gives a perverse incentive to be a derivatives counterparty rather than a direct lender, and meant non-traditional intervention was needed for troubled institutions with significant collateralized positions such as Bear Stearns, Lehman Brothers and AIG.

He outlined how a shift to “transaction consistency” for derivatives and repos could be reasserted. For repos, removing the bankruptcy exceptions would not change much, as he would propose that cash or cash-like repos could still be terminated with a limited delay, with only non-cash repos needing to go into the bankruptcy process. For swaps/derivatives there would be a bigger impact, with loan-like swaps automatically terminated, but with hedging swaps limited to a three day stay, to enable the orderly winding down of positions.

Today’s conference has not surprisingly included some differing perspectives, with academic thinkers focusing on systemic effects and unintended consequences of policy, while practitioners are naturally concerned how any regulatory changes would work in practice in complex wholesale markets. Patricia Jackson, Head of Ernst & Young’s prudential advisory practice in EMEA, commented on the presentations, argued that a funding ‘tax’ was inappropriate until the results of all the other currently proposed liquidity charges can be assessed, and stressed the critical importance of more and better quality capital.

Barbara Ridpath, CEO of the ICFR summed up: “Given that banks should be best placed to assess bank counterparty risk, since banks are now increasing only lending to each other on secured terms, it raises real questions about why others, such as asset managers or non-financial companies, should lend to banks on an unsecured basis. There clearly is a risk that senior unsecured deposits are being effectively pushed down the credit hierarchy.

“It has been a very useful exchange of ideas and views - liquidity risk and the funding of banks has rightly become recognised as one of the principal risks in the system, without a consensus on how best to address it, and that’s why we organised the conference today.

“It is critical that the investors’ voice be heard in this debate which is why the ICFR will be following up with further discussions between investors and banks on issues around funding and deposits.”

Full summary and conference proceedings will be available on the ICFR’s website: www.icffr.org.

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