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Subject: Resolution of Financial Companies Under the Bankruptcy Code

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Comments:

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Proposal: Studies Regarding the Resolution of Financial Companies Under the Bankruptcy Code
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I am not an FDIC insider nor do I know anyone who is. I am a retired banking attorney. It is very clear that using bankruptcy judges to replace FDIC-arranged purchase and assumption transactions for financial institutions would be a very bad idea. The Bankruptcy Code is completely inappropriate vehicle for the wind-up and resolution of commercial lending institutions regulated by the FDIC. The only problem during the Meltdown was its suddenness. The suddenness of the Meltdown which was the result of a just-as-sudden increase in uncertainty in the pricing of mortgage securities. This uncertainty in the pricing of mortgage securities was so great and happened so suddenly that trading in MBS essentially stopped in the third week of September of 2008. This freeze-up of the market for MBS, combined with Sarbanes and mark-to-market accounting mandates, suddenly made every financial institution under-capitalized as the value of MBS fell to practically zero. But it was an artificial under-capitalization. This was our first recession with Sarbanes and mark-to-market accounting mandates and it is very clear that mark-to-market accounting mandates, when applied to financial institutions, are massively pro-cyclical. That is, it is obvious now that mark-to-market accounting rules deepen downturns when those downturns occur by constricting bank capital and forcing those banks to call in commercial loans, thus constricting the money supply when the economy is already under pressure. When mark to market rules were suspended and bankruptcy cramdown of residential mortgage lenders failed to pass the Senate in March of 2009, the market for MBS, along with bank capital, came right back - recovering about a trillion dollars in lost wealth and allowing (thanks also to Fed purchases of MBS and TARP injections) U.S. banks for the most part to easily pass Treasury's stress tests. The size of the big banks was actually an asset for those struggling to contain the meltdown during the Fall of 2008. It only took a few bank executives in a room with government officials to temporarily recapitalize, with TARP, a large percentage of the

American banking system so as to stave off complete collapse. Normally, FDIC-arranged purchase and assumption transactions would have been facilitated for failing banks so as to preserve outstanding commercial loans and keep the amount of money in circulation from artificially contracting as bank capital artificially contracted. With a few tweaks in the legislation, the assets and liabilities of failing large institutions with no peers of similar size could have been partialed-out to many smaller banks. The government's ability to facilitate FDIC-arranged purchase and assumption transactions for failing financial institutions is one of the primary reasons we haven't had another Great Depression, but because the crisis happened so suddenly in the Fall of 2008, there simply wasn't time to facilitate purchase and assumption transactions for major American financial institutions. And, because the under-capitalization of the major American financial institutions was for the most part artificial, we would have unnecessarily destroyed much beneficial going-concern value in the process. An FDIC-arranged purchase and assumption transaction can happen over a weekend if the FDIC can plan for it in advance. A bankruptcy resolution would take months (or years for large financial institutions) while the money supply craters in the interim, causing massive asset deflations in a self-sustaining, very vicious cycle (lower asset values would undercapitalize more banks which would force them to call in more commercial loans which would lower more asset values which would cause more undercapitalizations, etc.). When you have sudden deflations in a very large market such as we saw for MBS and there is no time for FDIC-arranged purchase and assumption transactions, it helps greatly that the government can step in with vehicles such as TARP, notwithstanding public opinion, to keep the self-sustaining cycle from feeding on itself. When you have sudden deflations in a very large market and there is no time for FDIC-arranged purchase and assumption transactions, there certainly wouldn't be any time for Bankruptcy Code resolutions of those same institutions. Most Americans are not trained to understand how financial institutions have been resolved in this country over the last seventy years. They don't understand the interplay between failing banks and massive historic deflations. They equate government intervention with protection of prior management, and most Americans reject leaving bank officials in place when a government bail-out is required, but that is a completely different subject than using the Bankruptcy Code to resolved failed financial institutions. Go after bank officials if you must, but under no circumstances take the resolution of failed financial institution away from the FDIC.

Require twice as much capital or double the insurance premiums if you must, but under no circumstances take the resolution of failed financial institution away from the FDIC. The irony is that the public doesn't understand that with FDIC-arranged purchase and assumption transactions, prior management does not continue in their roles and most creditors and stockholders (other than depositors) are wiped out. Using bankruptcy judges to replace FDIC-arranged purchase and assumption transactions for financial institutions which are currently facilitated by trained bank regulatory personnel would be a very bad idea. Our system works great - we just need to guard against massive asset bubbles because massive asset bubbles break very quickly and this speed of contraction prevents even the relatively quick FDIC-arranged purchase and assumption transactions from getting facilitated. We can prevent massive asset bubbles just like we prevent all bubbles - you simply do not allow individuals or investors to chase particular classes of assets (whether it be stocks or housing or gold or currencies) with no money down. No-money-down purchasing always leads to a bubble and then a crash. Prevent bubbles by making sure everyone has skin in the game no matter the asset class. Never assume we won't have another severe recession and use the Fed to track asset bubbles by comparing the relative value of the market for particular assets with the relative value of all other assets. When divergence occurs, stop the divergence in its tracks by increasing margin requirements (increasing down payments).   If we do this, we are once again back to the Great Moderation and we don't have to worry ever again about using the Bankruptcy Code to resolve failing financial institutions. We will have plenty of time for the old tried and true FDIC-arranged purchase and assumption transaction.