International & Comparative Bankruptcy

Recorded session 2. TOO BIG TO FAIL

"It is unconscionable that the fate of the world economy should be so closely tied to the fortunes of a relatively small number of giant financial firms. If we achieve nothing else in the wake of the crisis, we must ensure that we never again face such a situation. "
Bernanke Speech: Preserving a Central Role for Community Banking, March 20, 2010

Johan T. Jol

Legal Houdini Academy

Understanding Legal Hocus Pocus

THOMAS JEFFERSON SCHOOL OF LAW SAN DIEGO

Overview Course

Live, 2 hour sessions

1. Economic drivers behind restructuring and bankruptcy
2. Purpose of Bankruptcy: Basic Concepts
3. Bankruptcy law in US
4. Consumer bankruptcy in Europe and US
5. Claims Issues: Treatment of secured creditors, priorities, claim procedure
6. Fraudulent Treatment, Voidable Preferences and Set off
7. Bankruptcy in the Netherlands
8. Cross Border Insolvency, Chapter 15
9. Mexico (including cross border aspects)
10. Restructuring of business (including EU perspective and forum shopping and cross border work outs)

Pre-recorded, 1,5 hour sessions

1. Multicreditors workouts
2. **How to avoid bankruptcies of too big too fail institutions and governments going forward, suggestions and alternatives?**
3. Bankruptcy law in US, cases
4. Business Bankruptcy Systems Comparisons and Consumer Insolvency Systems Comparison
5. EU Initiative on harmonisation of Bankruptcy law
6. Third Party Issues (Corporate Officers, Directors, Shareholders and Related Entities; Spousal Liability)
7. Bankruptcy in China
8. Cross Border Insolvency EU
9. Directors and other in the twilight zone, the Dutch Experience
10. Samples of Cross borders cases

Overview Today

- **TBTF**, Too Big to Fail, what is it?
- **Samples** of TBTF
- **TBTF** versus **TBTR** / **TBTS**, limitations of debt assumption
- **Avoiding** Failure?
- Sovereign bankruptcies
- What if debt needs **restructured**:
  - Formal bankruptcy proceedings
  - Alternative Restructuring Possibilities
    - SDRM
    - Collective Action Clauses
    - Cocos
    - Samples, Credit Suisse and Rabobank

Legal **Houdini** Academy

Understanding Legal Hocus Pocus

TBTF I

- "During a hearing on the rescue of **Continental Illinois**, Comptroller of the Currency C. Todd Conover stated that federal regulators would not allow the 11 largest "money center banks" to fail. This was a new regulatory principle, and within moments it had a catchy name. Representative Stewart McKinney of Connecticut responded, "**We have a new kind of bank. It is called 'too big to fail'—TBTF—and it is a wonderful bank**"."
  - "Congressman McKinney in Congressional hearings Continental Illinois, Too big to fail, the hazards of bank bailouts, Gary H. Stern and Ron J. Feldman, paperback edition (2009), p. 13
  - Financial Crisis Inquiry report, p. 37

- **Why**, Reasons:
  - Essential and undispensible key function for economy, f.e. Key function of banking system, process payments
  - No replacement
  - **Too interconnected to fail**, one failure would lead to another, Too Corelated to fail, everone same assets value depreciation
  - Enormous detrimental effects on whole of economy

Legal **Houdini** Academy

Understanding
Legal Hocus Pocus

TBTF II, Definition

- Systemically important banks are banks, financial groups and bank-dominated financial conglomerates whose failure would do **considerable harm** to the Swiss economy and the Swiss financial system.

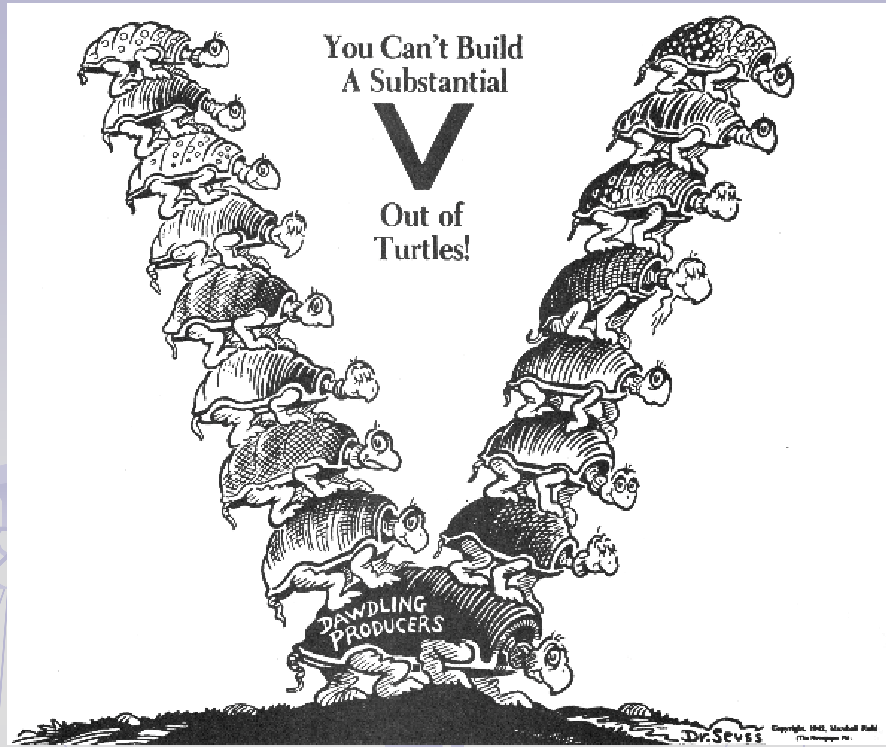
- The systemic importance of a bank depends on its **size**, its **interconnectedness** with the financial system and the economy, and the **short-term substitutability** of its services. It is evaluated based on the following criteria in particular:
    a. **Market share** of domestic banking business, in particular in the area of deposits and loans as well as in payment transactions;
    b. The amount of protected **deposits** in accordance with Article 37h that exceed the system limit;
    c. The relationship between the bank's **balance sheet** total and Switzerland's annual gross domestic product;
    d. The **risk profile** of a bank, which is determined by its business model, its balance sheet structure, the quality of its assets, its liquidity and leverage ratio.

  - Switzerland, Final report of the Commission of Experts for limiting the economic risks posed by large companies, Switzerland, Credit Suisse and UBS, p. 65, section 8 http://www.sif.admin.ch/dokumentation/00509/00510/00622/00624/00695/index.html?lang=en

NYT October 4, 2010: 2 Swiss Banks Facing Higher Capital Standards

http://www.nytimes.com/2010/10/05/business/global/05basel.html?_r=1&adxnnl=1&pagewanted=print&adxnnlx=1299960171-uSqoWcI5PywVnY2R0mSoQA

Samples TBTF I



- Bigger institutions means more TBTF:
  - Increased concentration banking assets
  - Greater complexity banks
  - One bail out leads to another
  - **TBTF across Sovereigns**:
    - the **ABN/Fortis example**!
    - UK Government refuses to approve take of **Lehman by Barclays**
      - Darling:"I spoke to Hank Paulson and said 'Look, there's no way we could allow a British bank to take over the liability of an American bank,' which in effect meant the British taxpayer was underwriting an American bank. "
        - Financial Crisis Inquiry report, p. 336

- Banks are inherent subject to bank run due to conversion long assets – short term debt

Legal **Houdini** Academy

Understanding Legal Hocus Pocus

Samples TBTF II

- **Only Banks** are TBTF?
  - What about **insurers, electricity, public transport and retail**, Final report of the Commission of Experts for limiting the economic risks posed by large companies, Switzerland, **Credit Suisse and UBS**, p. 15 e.f.
- The **LTCM Example 1998**
  - In September, the Federal Reserve Bank of New York orchestrated a 3,6 $ billion recapitalization of Long-Term Capital Management (LTCM) by 14 major OTC SECURITIZATION AND DERIVATIVES derivatives dealers. An enormous hedge fund, LTCM had amassed more than 1,1 $ trillion in notional amount of OTC derivatives and 125 $ billion of securities on 5 $ billion of capital without the knowledge of its major derivatives counterparties or federal regulators. Greenspan testified to Congress that in the New York Fed's judgment, LTCM's failure would potentially have had systemic effects: a default by LTCM "would not only have a significant distorting impact on market prices but also in the process could produce large losses, or worse, for a number of creditors and counterparties, and for other market participants who were not directly involved with LTCM."
    - Financial Crisis Inquiry Report, p. 48
    - See also, When Genius Failed, the Rise and Fall of Long-Term Capital Management, Roger Lowenstein (2000)

Samples TBTF III

- Why was **Lehman not** saved?
- But several others, including **Bear** and **AIG** were?
  - "**Bear Stearns**, which is not that big a firm, our view on why it was important to save it—you may disagree—but our view was that because it was so essentially involved in this critical repo financing market, that its failure would have brought down that market, which would have had implications for other firms," Bernanke told the FCIC.
    - Financial Crisis Inquiry Report, p. 291: **Too Interconnected Too Fail**
  - **Lehman**, "There was a criticism of bailing out Wall Street. It was a combination of political unwillingness to bail out Wall Street and a belief that there needed to be a reinforcement of moral hazard. There was never a discussion about the legal ability of the Fed to do this." He noted, "There was never discussion to the best of my recollection that they couldn't [bail out Lehman]. It was only that they wouldn't."
    - Thain of Merrill, Financial Crisis Inquiry report, p. 341
  - **Lehman**, "We went back to the headquarters, and it was pandemonium up there— it was like a scene from [the 1946 film] *It's a Wonderful Life* with the run on the savings and loan crisis. . . . [A]ll of paparazzi running around.
    - Harvey Miller quoted in Financial Crisis Inquity Report, p. 339

Samples TBTF IV

- **AIG, "**The Fed stated that "a disorderly failure of AIG could add to already significant levels of financial market fragility and lead to substantially higher borrowing costs, reduced household wealth, and materially weaker economic performance."
  - Financial Crisis Inquiry Report, p. 350
- **AIG**, "AIG was so **interconnected** with many large commercial banks, investment banks, and other financial institutions through counterparty credit relationships on credit default swaps and other activities such as securities lending that its potential failure created systemic risk. The government concluded AIG was too big to fail and committed more than $ 180 billion to its rescue. Without the bailout, AIG's default and collapse could have brought down its counterparties, causing cascading losses and collapses throughout the financial system.
  - Financial Crisis Inquiry Report, p. 352

Legal **Houdini** Academy

Understanding Legal Hocus Pocus

See also **Too Big Too Fail, Inside the Battle to save Wall Street, Andrew Ross Sorkin (2009)**

Limitations of debt assumptions I

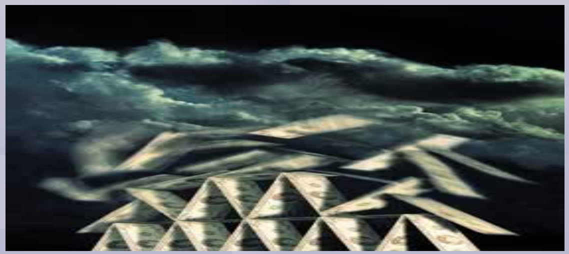
- If in the case of a **TBTF** company state intervention would exceed the capacity of the state, the company is to be classified as **too big to be rescued** (**TBTR**). An attempt to rescue such a company would mean that the state itself would have to take unacceptable risks.
  - Final report of the Commission of Experts for limiting the economic risks posed by large companies, Switzerland, p. 13, http://www.sif.admin.ch/dokumentation/00509/00510/00622/00624/00695/index.html?lang=en
- **Too big to be saved (TBTS)**, and if saved, banking crisis leads to sovereign debt crisis, the research of Reinhart en Rogoff, Banking Crisis most often either precede or coincide with debt crisis.
  - FROM FINANCIAL CRASH TO DEBT CRISIS, Carmen M. Reinhart and Kenneth S. Rogoff, Working Paper 15795, http://www.nber.org/papers/w15795

Legal **Houdini** Academy

Understanding Legal Hocus Pocus

Limitations of debt assumptions II

- **Size matters**, William Buiter in FT Jun 24, 2009
  - "The '**too large to fail**' category is sometimes extended to become the '**too big to fail**', '**too interconnected to fail**', '**too complex to fail**' and '**too international**' to fail problem, but the real issue is size. **The real issue is size**."
  - ".. the dangers of the '**inconsistent quartet**': a small open economy with a large internationally exposed sector, its own 'small' non-global reserve currency and limited fiscal spare capacity. Apart from Iceland, which imploded, this category includes Switzerland and possibly the UK. **Ireland, the Netherlands and Belgium** have 3 of the four inconcistent characteristics. But for their membership in the Euro Area, their banking systems might have been toast already."
  - http://blogs.ft.com/maverecon/2009/06/too-big-to-fail-is-too-big/



Legal **Houdini** Academy

Understanding Legal Hocus Pocus

Limitations of debt assumptions III

- Escaping the **Bail out**:
  - **Danmark**: Moody's downgrades five Danish banks' senior ratings following reduction of systemic support.
    - **Daily The Pak Banker**, February 18, 2011
    - http://professional.wsj.com/article/TPPAKBNK0020110218e72i000ik.html#printMode
  - **Ireland**: the Credit Institution Stabilisation Bill: amend subordinated liabilities of banks without the consent of its creditors.
    - http://www.oireachtas.ie/documents/bills28/bills/2010/5810/b5810d.pdf

Limitations of debt assumptions IV

- **Fannie and Freddie** were **TITF** and **TBTF** and were saved
  - He (FHFA Director Lockhart) said: “What happened after Lehman would have been very small compared to these $ 5,5, trillion institutions failing.” Major holders of GSE securities included the Chinese and Russian central banks, which, between them, owned more than half a trillion dollars of these securities, and U.S. financial firms and investment funds had even more extensive holdings.
    - Financial Crisis Inquiry report, p. 321: **Too Interconnected Too Fail and Too Big Too Fail**
  - Escaping a **future Bail out**: Fannie and Freddie downsizing
    - REFORMING AMERICA’S HOUSING FINANCE MARKET A REPORT TO CONGRESS
    - http://www.treasury.gov/initiatives/Documents/Reforming%20America%27s%20Housing%20Finance%20Market.pdf

Legal **Houdini** Academy

Understanding Legal Hocus Pocus

Avoiding failure I

- **Limited Purpose Banking**, different and smaller, I?
  - "**Public utility banking**' with just retail deposits on the liability side and with reserves, sovereign debt instruments and bank loans (secured and unsecured) on the asset side would take care of the retail payment, clearing and settlement system and deposit banking."
    - William Buiter in FT Jun 24, 2009
  - "This simple and easily implemented pass-through mutual fund system, with its built-in firewalls, would preclude financial crisis of the type we're now experiencing"
    - Laurence J. Kotlikoff in Jimmy Stewart is dead, ending the world's ongoing financial plague with limited purpose banking (2010), it'a wonderfull life (1946) movie with James Stewart as banker

      You tube, http://www.youtube.com/watch?v=pA3rx1FPW6M

Avoiding failure II

- **Limited Purpose Banking**, different and smaller, II?
  - **Move your money**
    - http://moveyourmoneyproject.org/
    - http://www.youtube.com/watch?v=Icqrx0OimSs
  - **Grameen Bank**, the Microfinance example
    - Yunus, http://muhammadyunus.org/
  - **Principles of responsive finance**
    - An investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact
    - http://www.unpri.org/files/2011_01_piif_principles.pdf

Avoiding failure III

- Strong **opposition**: STUDY OF THE EFFECTS OF SIZE AND COMPLEXITY OF FINANCIAL INSTITUTIONS ON CAPITAL MARKET EFFICIENCY AND ECONOMIC GROWTH, January 2011
  - "The limited literature on combining traditional banking and nontraditional higher-risk operations does not support either strict separation or unrestricted mixing. Some researchers find that allowing banks to engage in nontraditional financial activities appears to have been socially beneficial. Other researchers find that removing the barriers separating bank and nonbanks appears to have increased systemic risk. In many cases, however, the evidence concerning segregation of banking and nonbanking financial activities is still quite limited, suggesting a robust agenda for future research."
  - http://graphics8.nytimes.com/packages/pdf/business/Section123-FINAL.pdf

- **Critics**: Tunnel Vision, or Worse, From Banking Regulators, SIMON JOHNSON, NYT January 20, 2011
  - http://economix.blogs.nytimes.com/2011/01/20/tunnel-vision-or-worse-from-banking-regulators/

Avoiding failure IV

- But **Limit growth**:
  - "Section 622 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Act" or "Dodd-Frank Act") establishes a financial sector concentration limit that generally prohibits a financial company from merging or consolidating with, or acquiring, another company if the resulting company's consolidated liabilities would exceed **10 percent of the aggregate consolidated liabilities of all financial companies**",
  - http://www.treasury.gov/initiatives/Documents/Study%20on%20Concentration%20Limits%20on%20Large%20Firms%2001-17-11.pdf

Legal **Houdini** Academy

Understanding Legal Hocus Pocus

Avoiding failure V

- Increase **Capital Buffers**

Component Proposed calibration
I. Minimum requirement 4.5% common equity
II. Buffer 8.5%, comprising
- at least 5.5% common equity,
- up to 3% CoCos
(trigger at 7% common equity)
III. Progressive component 6% CoCos subject to big bank status quo
(trigger at 5% common equity)
Total 19% of total capital, comprising
- at least 10% common equity
- up to 9% CoCos

Final report of the Commission of Experts for limiting the economic risks posed by large companies, Switzerland, p. 31

Legal **Houdini** Academy

Understanding
Legal Hocus Pocus

Avoiding failure VI

- **Lower Leverage** ratio
- **Link duration Asset** side **to duration Liability** side
  - "In the years leading up to the crisis, too many financial institutions, as well as too many households, borrowed to the hilt, leaving them vulnerable to financial distress or ruin if the value of their investments declined even modestly. For example, as of 2007, the five major investment banks—Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley—were operating with extraordinarily thin capital. By one measure, their leverage ratios were as high as **40 to 1**, meaning for every $ 40 in assets, there was only $ 1 in capital to cover losses. Less than a 3% drop in asset values could wipe out a firm. To make matters worse, much of their borrowing was short-term, in the overnight market—meaning the borrowing had to be renewed each and every day."
  - Financial Crisis Inquiry report, p. XIX

Legal **Houdini** Academy

Understanding
Legal Hocus Pocus

Avoiding failure VII

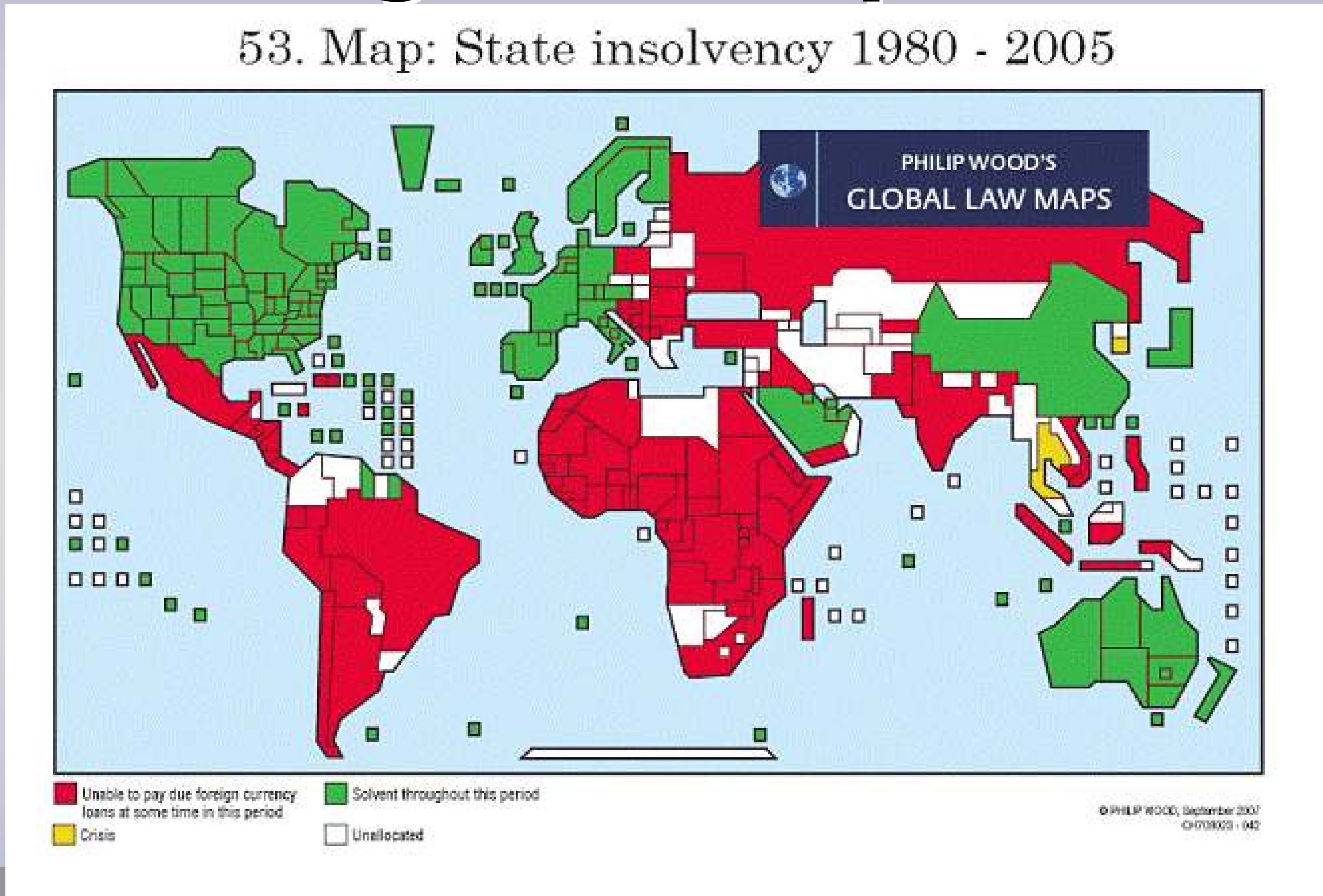
- Create central **clearinghouses**
  - These platforms should be viewed and regulated as public utilities.
  - William Buiter in FT Jun 24, 2009

- Get rid of wrong **incentives**
  - “Compensation systems—designed in an environment of cheap money, intense competition, and light regulation—too often rewarded the quick deal, the short-term gain—without proper consideration of long-term consequences. Often, those systems encouraged the big bet—where the payoff on the upside could be huge and the downside limited.”
    - Financial Crisis Inquiry report, p. XIX
  - Claw back bonus
  - Long term commitment
  - Get rid of Moral Hazard of a bail out

Sovereign bankruptcies I

- **Sovereign** cannot legally go bankrupt, but can become insolvent
- Economic crisis may result in **sovereign defaults**
  - Carmen M. Reinhart & Kenneth S. Rogoff, This Time is different, Eight centuries of Financially Folly) (2009)

Sovereign bankruptcies II



Philip Wood on
http://www.allenovery.com/AOWEB/AreasOfExpertise/Editorial.aspx?contentTypeID=1&itemID=49910&prefLangID=410

Sovereign bankruptcies III

- Insolvent Sovereigns will lead to more losses for banks which are big investors in sovereign debt

  - WSJ March 11, 2011, Europe's Banking Blindfolds, Did someone say sovereign debt risk?

  - http://professional.wsj.com/article/SB10001424052748704823004576192190338457796.html?mg=reno-secaucus-wsj

Legal **Houdini** Academy

Understanding Legal Hocus Pocus

Restructuring I

- **Special Regime for Bankrupty of banks**
  - Highly regulated organizations such as banks and insurance companies may require specialized treatment that can appropriately be provided in a separate insolvency regime or through special provisions in the general insolvency law.
    - Legislative Guide on Insolvency Law Uncitral 2005, Recommendations 9, note 6
    - US: FDIC as receiver Title II (‘**Orderly Liquidation Authority**”), section 201 to 217 Dodd-Frank Act
      - http://docs.house.gov/rules/finserv/111_hr4173_finsrvcr.pdf
      - BAIL-INS VERSUS BAIL-OUTS: Using Contingent Capital To Mitigate Systemic Risk, John C. Coffee, Jr.,

        http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1675015
    - NL: Special Regime under banking laws and proposal to amend

http://www.rijksoverheid.nl/ministeries/fin/nieuws/2011/03/04/consultatie-wetsvoorstel-bijzondere-maatregelen-financiele-ondernemingen-interventiewet.html

Restructuring II

- Dealing with Sovereigns, **Sovereign Debt Restructuring Mechanism**, Elements:
  - Majority Consent
  - Stay on Creditor Enforcement
  - Protecting Creditors Interest
  - Priority Financing
  - Legal Basis: Change of article IMF, Anne O. Krueger (2002)
    - http://www.imf.org/external/pubs/ft/exrp/sdrm/eng/sdrm.pdf
- Initiative not continued
- In any event: Creditors consent required!

Facing the Debt Challenge of Countries That Are "Too Big To Fail", Steven L. Schwarcz, http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1635872

Legal **Houdini** Academy

Understanding Legal Hocus Pocus

Restructuring III

- Contractually pre-agreed decision to be bound by decision of (Super) Majority of Creditors, the so called **collective action covenants**
  - IMF Continues Discussion on Collective Action Clauses in Sovereign Bond Contracts, http://www.imf.org/external/np/sec/pn/2003/pn0353.htm
  - Robert Gray, Collective Action Clauses, The Way Forward (2004), http://www.law.georgetown.edu/international/documents/Gray_000.pdf
  - Johan Jol, Forced Cooperation on a debt for equity swap: (Im)Possible? http://www.legalhoudini.nl/images/upload/ENG-DES%20artikel%20versie%20concept%2017_septemberdefuk(1).pdf
- But the Majority should still decide against bankruptcy!

Restructuring IV

- Too little, too late: thus **Contingent Convertible Capital** (Cocos)
  - Forced debt for equity (could be common or preferred equity) swap
    - BAIL-INS VERSUS BAIL-OUTS: Using Contingent Capital To Mitigate Systemic Risk, John C. Coffee, Jr.
      - http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1675015
  - Loss absorption mechanisme (debt cancelled)
- Debt capital which may be converted into corporate capital or written off once a contractually defined threshold (trigger) is reached or state assistance is provided.
  - Final report of the Commission of Experts for limiting the economic risks posed by large companies, Switzerland, p. 25

Restructuring V

- The odd **Irish proposal**, only subordinated creditors get a Haircut
  - In december 2010 Ireland adopted the Credit Institution Stabilisation Bill. This legislation enables the Irish Government (in part 4 Subordinated Liabilities) to amend subordinated liabilities of banks without the consent of its creditors.
  - http://www.oireachtas.ie/documents/bills28/bills/2010/5810/b5810d.pdf
  - Irish Haircut is wrong, are Brussels and Basel doing a better job?, blog Legal Houdini 14-01-2011, http://www.legalhoudini.nl/10/blog/#a0000000020

Restructuring VI

- **RABOBANK SAMPLE, U.S.$2,000,000,000, 8.375 per cent. Perpetual Non-Cumulative Capital Securities,** Cancellation of debt, loss absorption

- "reduce the then prevailing principal amount of each Capital Security by the relevant Write Down Amount."

- "Further, the agreement or approval of the Holders and Couponholders shall not be required in the case of any Write Down of the principal amount of the Capital Securities in accordance with Condition 6(a)".

- http://www.rabobank.com/content/images/Rabobank_Final%20Prospectus_tcm43-134160.pdf

Restructuring VII

- **Credit Suisse**: Agreement to put in place CHF 6 bn of tier 1 buffer capital notes, a form of contingent capital
- Executed agreement with two strategic investors to issue USD 3.5bn 9.5% and CHF 2.5 bn 9.0% tier 1 Buffer Capital Notes (a form of contingent convertible capital)
- Issuance no earlier than October 2013 for cash or exchange of USD 3.5 billion 11% and CHF 2.5 billion 10% hybrid tier 1 capital notes issued in 2008 Agreement
- Trigger ratio definition in line with Basel 3 common equity tier1 capital ratio BCN to convert into **ordinary shares** if the reported ratio falls below 7%
- Conversion price defined as the higher of 5 days volume weighted average in the period preceding conversion or a floor price of USD 20 / CHF 20 per share
  - https://www.credit-suisse.com/investors/en/20110214_contingent_capital.jsp

Legal **Houdini** Academy

Understanding Legal Hocus Pocus