

Resolving Large Financial Intermediaries: Banks Versus Housing Enterprises

by

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Fannie and Freddie's Regulator Have Them?**

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Outline of Paper

- Paper analyzes questions that policy makers must address in resolving the failure of a very large financial intermediary
 - What are the practical problems in resolving a failure of a very large institution?
 - Are such institutions too big to fail?
 - What important powers should regulator/supervisor have
 - How should losses be apportioned?
- Root problem is that there is history of regulatory forbearance for large banks and GSEs
- Congress has responded in case of banks with FDICIA designed to limit forbearance and to minimize potential costs to the FDIC and taxpayers
- Examine resolution processes for large banks and housing enterprises
- Recommend procedural changes for both

Why Are Housing Enterprises “Special”?

- Housing enterprises play a critical role as a conduit of funds to housing
- They also create direct credit exposure to other institutions and creditors through their issuance of debt and mortgage backed securities.
 - Should these assets suffer sudden declines in value than other firms might be forced into bankruptcy
- Failure could result in loss of service to mortgage market securitization
 - The interest rate derivatives market would be disrupted
- Loss of an intended subsidy to housing and mortgage markets

Critical Observations:

- Because of their “specialness” we conclude that a very large bank or housing enterprise would be kept in business rather than liquidated.
 - They are too large and too important to liquidate
- Given (1), problem is to design a system that
 - Avoids moral hazard,
 - Protects the taxpayer,
 - Preserves the critical functions these institutions perform and
 - Addresses the practical problems of resolving a failure
- Large bank resolution model addresses the key issues in housing enterprise resolution

Bank Model for Risk Mediation and Failure Resolution

- Capital-based early intervention and prompt corrective action
- Authority to remove management
- Receivership authority to close troubled institution before book value net worth goes to zero
- Mechanism for establishing priority of claims of creditors and apportioning losses
 - Authority to terminate equity holders' claim on the firm
 - Ability to impose losses on categories of debt holders if equity cushion proves insufficient
 - **Reliance upon resources in subsidiaries and affiliates (bank only)**
 - **Ability to impose losses ex post on healthy banks through assessments and premiums (bank only)**
 - **Charge insurance premiums according to risk (bank only)**

Are OFHEO's Existing Authorities Adequate

- OFHEO has conservator powers but not receivership authority.
- Conservator powers be sufficient to prevent economic insolvency if all of the following conditions hold:
 1. Losses occur slowly so OFHEO has opportunity to intervene
 2. OFHEO identifies the financial distress,
 3. OFHEO has adequate authority to act promptly
 4. OFHEO does not engage in forbearance
 5. Conservator (OFHEO) is able to change portfolio

Why Are OFHEO's Authorities Insufficient?

- Without receivership powers to close, reorganize and impose losses resolution would be left to Congress
 - Congress by its very nature and structure does not deal with such problems promptly and hence delay would seem inevitable.
- Without threat of receivership, management and institution's creditors will also have incentive to lobby for delay reinforcing natural inclination of Congress
- Delay will
 - deepen the problem
 - Increase the probability of a taxpayer bailout and
 - Change the apportioning of losses.
- Most other arguments boil down to the desire to preserve the subsidy to housing through provision of implicit guarantee.
 - Indirect subsidies are inefficient, expensive, risky and generally poor public policy

What Is Required for Process to Be Applied to Housing Enterprises

- Effective market-based PCA based on capital
- Independent regulator not dependent upon Congress
 - Should be empowered to charge for exams to induce more transparency but not as sole source of funding.
- Receivership authority to close institutions
- Authority to create bridge institution
- Authority to create a bridge institution and to preserve going concern value of portions of failed institution
 - Authority to determine which classes of creditors get paid first according to predetermined priority of claims
- Preserve derivative transactions
- Ex ante establishment of priority of claims
- A prearranged resolution plan

Importance of Planning

- Establishment of ex ante claim is critical
 - Increases market discipline by clarifying who is at risk and where they stand in line
 - Constrains regulators and makes their responsibilities transparent
 - Constrains management and limits their ability to lobby for relief
- A credible ex ante plan
 - Reduces likelihood creditor bailout or forbearance
 - Reduces chance of financial problems spilling over into the real sector

Conclusion

- We find weaknesses in existing resolution policies for not only housing enterprises but also large banks that should be addressed
- Argue that the lessons from resolving insolvent banks can be applied to the housing enterprises
- Recommended changes for housing enterprise resolution
 - Use of economic values of capital in setting PCA
 - Give OFHEO receivership power, including a clear priority of payments in resolution

Conclusion

- Give OFHEO the power to create a bridge housing enterprise
- OFHEO should develop a plan to use its authority in the event that a housing enterprise became financially distressed.
- OFHEO should then disclose its plan to reduce market uncertainty and (hopefully) reduce market expectations of a government bailout