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FDIC Posits Alternate History for Lehman

BYLINE: Joe Adler

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WASHINGTON - To support its case that the Dodd-Frank Act has ended "too big to fail," the Federal Deposit Insurance Corp. engaged in an activity usually reserved for Civil War buffs, painting an alternate history detailing how it might have handled the collapse of Lehman Brothers if its new powers had been in place.

In a study released Monday, the FDIC argued that had the regulatory reform regime been law in 2008, market chaos would have been avoided and losses would have been smaller. The study also provides specifics on how the FDIC intends to use its additional authority in a real-world scenario, including resolution of creditor claims and marketing the institution to bidders.

The study is "clearly designed to validate the [resolution] approach ... against all of the assertions that continue that Dodd-Frank permits bailouts," said Karen Shaw Petrou, managing partner at Federal Financial Analytics Inc. "This is a highly, highly complicated new regime with a lot of unanswered questions."

The FDIC's most critical point is that the very existence of resolution powers would have avoided much of the fallout surrounding Lehman's collapse.

"The very availability of a comprehensive resolution system that sets forth in advance the rules under which the government will act following the appointment of a receiver could have helped to prevent a 'run on the bank' and the resulting financial instability," the study said.

If Dodd-Frank had been enacted in 2008, for example, Lehman would have had to submit a resolution plan to regulators long before it began struggling, providing a road map for its dismantling. The FDIC would have had a seat at the table as the company teetered, allowing it to prepare a takeover, and its presence could have motivated Lehman to pursue a private-sector sale more aggressively.

Indeed, the FDIC study argued that Lehman did not pursue options that might have saved it because the company believed it would eventually receive assistance from the government.

"If Title II of the Dodd- Frank Act had been in effect, the outcome would have been considerably different," the FDIC said in the study.

"Lehman's senior management would have understood clearly that the government would not and could not extend financial assistance outside of a resolution because of the clear requirements in the Dodd-Frank Act that losses are to be borne by equity holders and unsecured creditors."

With time to prepare, the agency could have begun to value the firm's assets, market it to potential buyers and begin the process of potentially operating Lehman as a bridge institution to keep open its most vital operations.

"A quick resolution of" Lehman "that maintained the operational integrity of the company including its systems and personnel could have left general unsecured creditors with substantially more value than projected from the bankruptcy," the study said. "By preserving the going-concern value of the firm, creditors could have been provided with an immediate payment on a portion of their claims through either an advance dividend or the prompt distribution of proceeds from the sale of assets."

In a press release, the agency said the case study is a way to promote understanding about how the new system would work.

"The Lehman failure provides an excellent model to contrast the tools available to the FDIC to effectuate an orderly resolution of a large financial institution against the process used in bankruptcy, which, unlike our process, is not specifically designed to deal with the failure of a financial entity," FDIC Chairman Sheila Bair said in the release.

In the FDIC's alternate scenario, Barclays would likely have acquired Lehman (it mounted a bid to buy Lehman shortly before its collapse) under a loss-sharing agreement or after segregating most of Lehman's bad assets.

Of Lehman's $210 billion of assets, potential acquirers had identified $50 billion to $70 billion as impaired or of questionable value, the FDIC said.

If losses had been $40 billion (a 60% to 80% loss rate), then $35 billion in equity and subordinated debt would have left a $5 billion loss to be distributed among creditors. The FDIC estimated that the recovery rate would have been roughly 97 cents for every $1.

"This is significantly more than what these creditors are expected to receive under the Lehman bankruptcy," the FDIC said. "This benefit to creditors derives primarily from the ability to plan, arrange due diligence and conduct a well-structured competitive bidding process."

Some observers said the report presents a concrete simulation of how the new regime could be used to clean up failed firms more smoothly than under bankruptcy.

"Does it prove that Title II ends too big to fail? No. Does it demonstrate that the orderly liquidation authority is superior to the bankruptcy process? Yes," said Dwight Smith, a partner at Morrison & Foerster.

David Min, associate director for financial markets policy at the Center for American Progress, agreed that the Lehman failure proved that bankruptcy can have harmful aftereffects if it is used for a large financial company with broad connections to the entire market.

The study "strongly makes the case that if this orderly liquidation authority had been in effect that you would have had the capacity to smooth out markets, providing liquidity during that panic period and an orderly process for disposing of assets," Min said.

But others questioned whether Lehman could be a case study for using the authority in a future crisis when the facts on the ground will inevitably be different.

"If it all worked out the way that they've written it, then I think they have made a good case. But I am skeptical that in real time that it would play out this way," said Bradley Sabel, a partner at Shearman & Sterling LLP and a former official at the Federal Reserve Bank of New York. "In a crisis situation, news gets out, people start running, and taking action as fast as you need to take it is very problematic."

Sabel added: "You have to recognize it's a 'what-if' piece. They obviously have the benefit of hindsight and ... the ability to reconstruct what the decision-making would have been after all it's over."

Some said the study overplays the negative effects of bankruptcy in future resolutions.

"The costs, complexity and length of a bankruptcy compared to receivership have been grossly exaggerated," said Mark Calabria, director of financial regulations studies at the Cato Institute. "The argument that they would resolve Lehman a lot more quickly than a bankruptcy court I just don't think is true."

James Barth, the Lowder Eminent Scholar in Finance at Auburn University, said a real FDIC takeover of a systemically risky firm could prove too complicated for officials to execute, raising the potential of more government assistance. Under Dodd-Frank, the FDIC takes the reins only when the Treasury Department - with concurrence from others - deems a firm should be subjected to the new authority rather than bankruptcy.

"I don't think we'll get to the stage at which it would be even allowed to be tried because of all the complications associated with these giant institutions," Barth said.

Smith pointed out that even though Dodd-Frank established a policy prohibiting government assistance, "if the [orderly liquidation authority] seems insufficient, the federal government will step in, even if it requires new legislation."

But observers agreed with the FDIC that the existence of such authority may have spurred Lehman to take actions it did not take three years ago.

The FDIC recalled how Lehman could have been more aggressive in pursuing a private-sector sale - even if it meant shareholder losses - but had expected government assistance similar to what Bear Stearns had received previously.

In a future scenario, with an FDIC resolution more realistic and government assistance abolished, a firm teetering on the edge might make that sale happen.

"This would have clearly focused Lehman's board of directors on the urgency of the matter and encouraged the board to accept the best nongovernment offer it received, notwithstanding its dilutive nature," the study said.

According to Min, "They made a good point that if those clear lines had been drawn as far as that orderly liquidation was in effect and shareholders would be wiped out, that the shareholders probably would have sought to make a sale earlier on."

Observers said the FDIC's study also reinforced the importance of living wills, which the Fed and FDIC are jointly requiring large, systemically important financial institutions to write.

But the Financial Stability Oversight Council has yet to spell out which firms fall into that category, and several sources say the regulators disagree, with the FDIC favoring the inclusion of more companies.

"They want to have the resolution plan done ahead of time," said Sabel. "I am sure that this is part of their battle with other agencies about how many SIFIs should be chosen."

Meanwhile, the FDIC is still at work crafting rules to implement the new authority.

"I don't think you can yet say how it would work because we don't know some very critical details," said Petrou. "The FDIC is looking at the law and how they hope it would work, but that's making assumptions about issues that are still up in the air - like what creditors would do based on set-off rights - that are still questions on which comment is being solicited."

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