Repos and Bankruptcy Priority

And Taxation, Tobin and Pigovian

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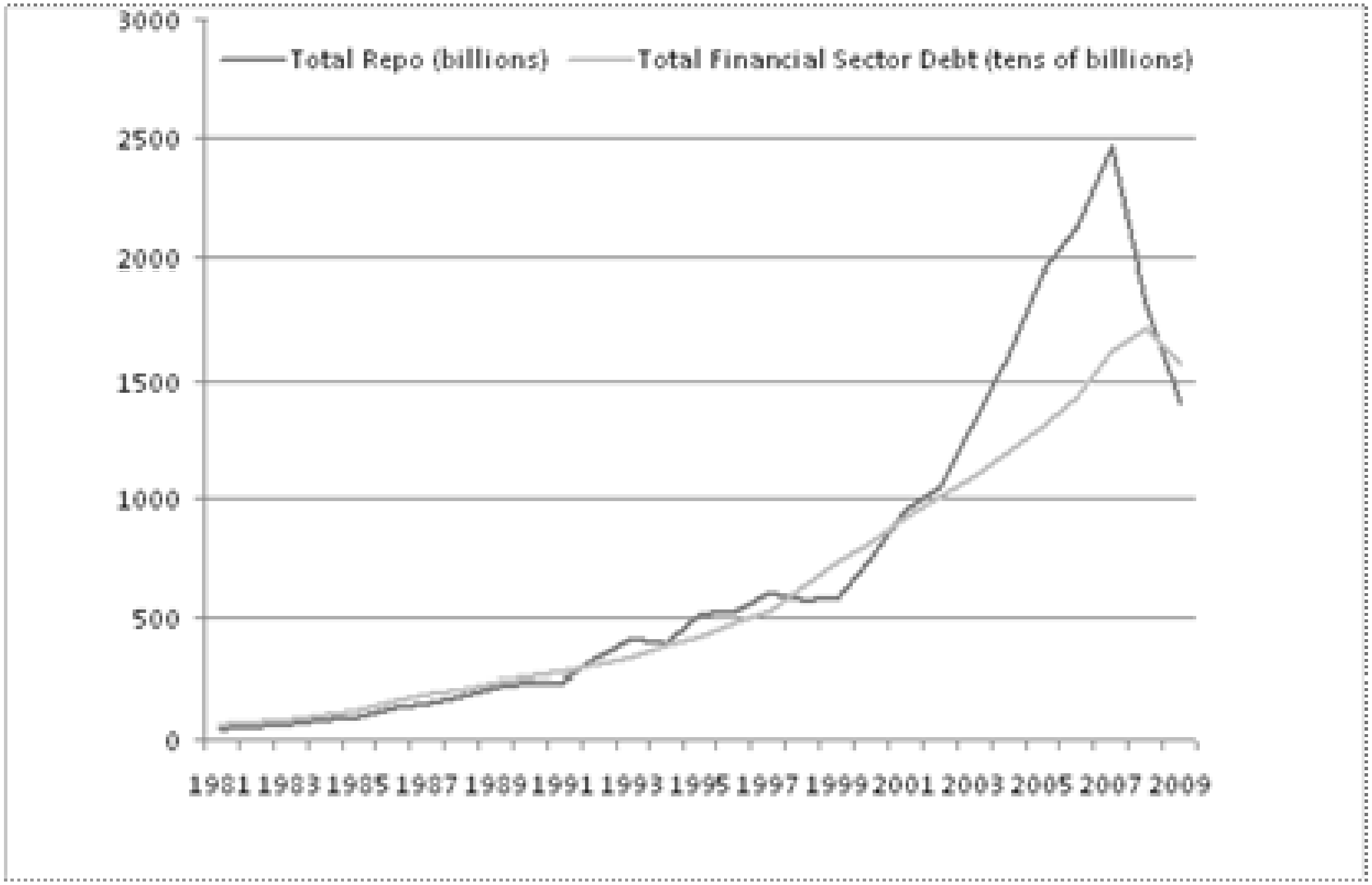
Source

- This talk is derived from and extends:
  - Roe, 2011. The Derivatives Market's Payment Priorities as Financial Crisis Accelerator, *Stanford Law Review* 63: 539-590; and
  - Roe, forthcoming. Derivatives Markets in American Bankruptcy.

[Derivatives and] repos

- Role in financial crisis
  - Bear Stearns: One-fourth of assets financed with repos. Eight times net capital.
  - Lehman: One-third of assets in repo
  - AIG: credit default swaps
  - Fragile
    - Contagion? Runs?

Growth in the Market for Repurchase Agreements and All Financial Sector Debt, 1981-2009



Growth coincides with expansion of safe harbors

- Causal?
- Expert testimony: “[T]he bankruptcy ‘safe harbor’ for repo has been a crucial feature in the growth of shadow banking . . . .”
  - Gorton & Metrick, Regulating the Shadow Banking System (Oct. 18, 2010 working paper).
- Do safe harbors exacerbate financial stress (even if intended to diminish it)?

Counterparty risk

- Alan Greenspan: “[P]rudential regulation is supplied by the market through counterparty evaluation and monitoring . . . . [P]rivate regulation generally is far better at constraining excessive risk-taking than is government regulation.”
- As late as 2008, Greenspan praised “counterparties’ surveillance” as “the first and most effective line of defense against fraud and insolvency. JP Morgan thoroughly scrutinizes the balance sheet of Merrill Lynch before it lends. …”

Favored under Bankruptcy Code

- But safe harbors reduce incentives to monitor and ration in repo and derivatives markets
- Safe harbors for repos (and derivatives) that other financial counterparties lack
  – Unclear how vivid these advantages were to repo/derivatives players during the financial crisis.
  – More vivid now.

Safe harbors

- Exemptions from ordinary bankruptcy law
  - Exempt from the automatic stay
  - Exempt from preference law
  - Exempt from fraudulent conveyance law
  - Option to affirm or reject K's reversed
- Some most relevant for repo, some for derivatives
- Baseline bankruptcy policy questionable ***in general***
  - *Automatic stay IS too broad*
  - *Optionality for debtor lowers value*
  - ***Should** be modified or cut-back across-the-board*
  - *But much worse to **"cherry-pick"** and cutback for one creditor class and not for another, via safe harbors*

Domain

- Bankruptcy
  - Pre-Dodd-Frank: holding companies, affiliates, other financial institutions, not the core bank or insurer
- Post-Dodd-Frank
  - Resolution can extend to systemically vital institutions
  - One-day stay, then can liquidate collateral. Bridge facility can pick up package
- Continuing safe harbors for repos (and derivatives) is questionable policy

Bankruptcy Code

- Safe harbors for derivatives and repos that other financial counterparties don't have
- Several of these rules are poorly constructed **in general and should be reconstructed**
  - **But to reconstruct for only one class of creditors is to subsidize them (relative to other creditors) and to induce substitution away from other forms of credit**
  - If the subsidized, exempted credit is short-term, readily reversible credit ("hot" money) to systemically vital institutions, we have made a serious policy error

Differing treatment

- Why overturn ordinary bankruptcy treatment for derivatives and repos?
  - One, systemic impact, reduce contagion.
  - Two, accommodate useful financial transactions.
- But:
  - Systemic impact militates to minimize. abandoning normal practice, not to reverse it.
  - Accommodate, but don’t subsidize.

Transactional

- Having open-ended obligation with debtor's option especially hurtful to a derivatives K, as bankrupt debtor can play the market
  - Result, optionality shifted to derivatives counterparty
- Repo market needs immediate cash settlement and certainty
  - Hence, exemption from auto stay, preference law, and fraudulent conveyance law
  - A reply: in bankruptcy, everyone says they're special (trade, financial, labor).

Rationale for repo exemptions

- ***Avoid contagion***
- A counterparty failure could/would spread throughout the financial system
- Hence, bankruptcy bestows advantages beyond what even a secured creditor would get
  - Can seize immediately: no auto stay
  - Can seize before bankruptcy: no preference, fraudulent conveyance
  - Or can affirm contract, if creditor wants
    - Close-out netting
    - (More a derivatives than a repo issue)

Contagion justification is weak

- Could as readily raise systemic risk, because counterparties grab assets from the weak firm
- More importantly: weakens the market discipline that Greenspan was looking for

Code justifications,

at time of crisis, and at the time of the contract

- Two times to target our analysis
  - At the time of a firm's ***failure***
  - At the time of the derivatives/repo ***contracting***
- Credit contagion: when the firm fails
  - Off-set by run
  - Off-set by collateral contagion
  - Off-set by information contagion

Negative Consequences at K time,
due to weakened market discipline

- Counterparties disincentivized from better market discipline.
- More derivatives and repos than we'd have without the extra protections.
- Often these protections do not reduce risk overall. They transfer it out from the repo market to other creditors of the failing financial firm.

Market discipline mechanisms

- Watch and evaluate (Greenspan)
- Ration counterparty exposure
- Price counterparty exposure
- Insist on superior counterparty capitalization
  - Transactional
    - Longer-term debt, more equity
    - 15% repo for Bear instead of 25%? More medium-term debt substituting for that other 10%
  - Support stronger regulation of repo/derivatives
- Require collateral up-front, not in run
  - (Esp a derivatives issue, vis-à-vis AIG)

Eliminate subsidy

- Easy, minimal: Reduce collateral expansion from 2005
- A stay, even if it's not an endless one
    - Goal is not simply to "tax" the failing firms' repo counterparties
    - It's also to be sure the failing firm isn't immediately sapped of liquidity---to see if it can be reorganized and stabilized

First draft of the cut-back?

- Automatic stay applies
    - Perhaps with hard time limit, but not 1 business day. 30 days?
- Preference law applies
    - And collateral upgrades in 90 days before bankruptcy for long-standing repo relationship not automatically exempt from preference law
- Fraudulent conveyance law applies
- Optionality not reversed
    - – Debtor must exercised in x days. Or all K’s are terminated. (More a derivatives issue.)

Consequence of cut-back

- Greater market discipline.
- Elimination of bankruptcy subsidy vis-à-vis other forms of credit

The subsidy

- Positive firm-by-firm transactional value of repos
- Must policymakers conclude that repo transactions are negative value transactions?
  - ***No.*** Absolutely not.
- It's that the transactional value is less valuable than the systemic risk is costly
- The Code's superpriorities mean that we get more of these instruments than is appropriate
  - Like subsidizing agriculture: it's not that food is bad, it's that subsidies move resources from elsewhere

Reality check

- Is it just too late to **roll-back the safe harbors**?
  - Too many interests think they're right to have them.
  - One, they're influential. Two, unfair/inefficient to quickly alter legal institutions people have built upon is in place
  - Some policymakers believe systemic benefits>costs.
  - Safe harbors too hard for the gen'l public to see.
  - Yes, Congress might trash them, if the Fed told them too.
    - But Fed may be worried about overall strength of banking
- Proposals to treat as **insure**d deposits
  - Potential. But usual consequence of needing further regulatory control of portfolio risk
- Proposals to further **regulate** (and reduce) short-term composition of **capital structure**.
  - Laudable, but usual limits of command & control. Greenspan.
- Hence, ….

A Repo “Tobin tax”

or is it a Pigovian tax??

- First, to offset the subsidy?
- Second, if we have too much of something for systemic stability and we lack a consensus on how to control the risk well, then tax it to cut back quantity.
  - Tobin tax
  - Pigovian tax
- Tax has not been (as far as I know) considered here. Safe harbor roll-back, insurance, capital structure have been.
  - But tax is equally worthy

Conclusion

- Favored treatment is too strong.
- Costs
  - Even if contagion reduced, **runs are exacerbated**
  - **Market discipline undermined**
  - **Too much** systemically-risky knife's edge financing
  - We subsidize short-term credit relative to other financing K's for a nonessential financing channel.
- Hence, cut back the safe harbors
- If we can't (political reality or lack of policy consensus), or as a supplement if we can, but only partly, we need to start considering **a Tobin/Pigovian tax on repo**