Institutional Investor

Five Reasons Banks Should Provide Their Own Bailout Fund

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High fives accompanied the recent bank stress test results that gave improved marks to 16 of 19 systemically important financial institutions, dubbed SIFIs. But banks and regulators should steer clear of too much optimism, warns George Washington University law professor Arthur Wilmarth. Big banks can fail even with new safeguards in place and none are required to post collateral in case they do. If there were a repeat of 2008-'09, who would pay to stabilize the banking system?

Not big banks, says Wilmarth, without a standing liquidation fund. Last December Wilmarth and three other leading experts furnished testimony to the U.S. Senate Committee on Banking, Housing & Urban Affairs on "Enhanced Supervision: A New Regime for Regulating Large, Complex Financial Institutions." Pitfalls lurk, warns Wilmarth, not least in a lack of funding for Dodd-Frank’s Orderly Liquidation Authority, which is charged with settling the affairs of big banks that implode.

No one today requires schooling in what happens to stock markets when banks abuse risk on a massive scale and leave taxpayers with the bill. As a preventive measure, The Dodd-Frank Act created a federal receivership process for big banks that fail. The Orderly Liquidation Authority puts the FDIC in charge, armed with authority but no extra money to back it up after lobbying by banks ensured that the original version of the OLA was watered down.

Under the present legislation, banks do not have to contribute to a standing fund that would be tapped in the event of the collapse of one of the banks. Instead, the process would be for Uncle Sam to provide the bailout funding, which would later be paid back by the banks collectively.

Orderly liquidation of the biggest banks is no cakewalk even with a funded authority. There would remain the challenge of coordinating cross-border resolutions with foreign authorities, Wilmarth notes. But shared interest in curtailing systemic risk gives regulators in other countries a powerful incentive to cooperate with the U.S. In the U.K. the influential Financial Stability Board has signaled its willingness to take steps in this direction.

So long as handsome payoffs can lure bankers to excessive risk, and they can find loopholes in regulations, some banks are going to fail. In a two-part article for the March and April 2012 issues of the *Banking and Financial Services Policy Report*, Wilmarth lists five reasons why systemically important banks should capitalize an orderly liquidation fund:

- When economic circumstances decline so far that one or more big banks fold, rivals under similar pressures must foot the tab.
- Ex post funding of the liquidation fund dumps the consequences of ill-advised risk-taking on prudent banks that abide by the rules.
- Building and sustaining an orderly liquidation fund will remind big banks of what’s at risk, instead of granting a free pass until one goes off the track. The reminder might prompt healthy banks to notify regulators the moment they see a rival on shaky ground.
- A bank-financed liquidation fund would ease or eliminate the up-front burden on taxpayers when bank failures rock the financial system.
- Wilmarth cites a fifth reason, first advanced by Jeffrey Gordon and Christopher Muller in their research paper "Confronting Financial Crisis: Dodd-Frank’s Dangers and the Case for a Systemic Emergency Insurance Fund." The thesis is that funding adds clout to forced liquidation — besides unraveling a bank failure, a credible authority might compel banks to obey regulators before liquidations become necessary.

How much is needed? Wilmarth states that federal authorities ponied up $290 billion to rescue the 19 largest bank holding companies and AIG during the recent financial crisis, all with assets exceeding $100 billion. A fund with $150 billion would give regulators a stick, but liquidating any of the largest SIFIs would require at least $300 billion, he says.

That’s a lot of cash out of circulation where it cannot foster economic growth or boost banks’ returns, to be sure. But if a funded orderly liquidation plan averts the next ugly collapse of a systemically important bank without massive economic and political fallout, it sounds like a bargain.