POLICY RESPONSE: LESSONS FOR INVESTMENT BANK AND HEDGE FUND REGULATION

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Road Map

- The two issues:
- Bankruptcy vs. firm specific bailouts for financial institution failure
  - Source: Ayotte & Skeel (2009); Skeel (2008)
- Do we need new hedge fund regulation?

What's So Bad About Bankruptcy?

- Examples: treated as non-option in Bear, Stearns and AIG; criticized in Lehman
- The two main concerns:
  - Loss of value in bankruptcy (delay or fire sale)
  - Systemic risk

Benefits of Bankruptcy

- Key concerns
  - Inability to borrow even if viable
  - Panic runs
- Bankruptcy's responses
  - Special financing provision (authorized DIP financing)
  - Allows sales free and clear of liabilities (section 363)
  - Automatic stay

Costs of Ad Hoc Resolution

- Moral hazard
  - Bear, Stearns: addressed equity moral hazard, created debt moral hazard
- Corporate governance determined by public opinion
  - AIG example

- Costs of uncertainty
- May delay needed restructuring
  - Chrysler in 1980s
  - The Big Three today?
- May short circuit the political process
  - Continental Illinois in 1980s
  - Bear, Stearns in 2008

What About “Prompt Corrective Action?”

- Seems to support direct governmental intervention
- But virtues are specific to commercial banking
  - Protecting payment system
  - Government guarantee of deposits

Will Bankruptcy Invite Systemic Risk?

- Lehman: a mixed example
  - Key issue was effect on commercial paper market
- Bankruptcy isn't a substitute for system-wide responses to systemic risk
  - Investments in banks under TARP
  - Insurance of money market deposits
  - Purchase of troubled assets

Credit default swaps in bankruptcy

- Exclusion of derivatives from automatic stay
- ISDA's Rationale: protecting financial system
- Problem: exclusion may be worse
- Lessons from Lehman:
  - Counterparty termination doesn't mean counterparties can collect
  - The framework is (accidentally) working?

2) Hedge Funds and the Crisis

- Major concerns before the crisis
  - Value destroying manipulation of markets (Perry in Mylan-King)
  - Effect of 2/20 compensation
- Evidence so far
  - Criticism of shorting Bear, Stearns
  - Few smoking guns on compensation

Regulatory implications?

- Revisit the SEC audit rule
- Disclosure, disclosure, disclosure (but not hedge fund specific)