

The Case Against Favored Treatment Of Derivatives

The Deal

By Robert Teitelman

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Andrew Ross Sorkin in The New York Times today [reviews a Michael Milken conference](#) in California in which members of a financial panel a) lament the flaws, even the utter debility, of resolution authority provisions in Dodd-Frank and b) predict another big mess soon. By the end of the column, Sorkin sounds like he's heading to the basement. Sorkin's not wrong to pick up on the fact that resolution authority is widely viewed as both essential and problematic. Its advocates argue that it will contain "too big to fail," while its critics -- and purely objectively, if anecdotally, the number of critics appears larger than the fans -- believe it will never work, that the complexities of size and global scope will overwhelm the Federal Deposit Insurance Corp., and that, for complex technical reasons, resolution authority may make things worse in a crisis, not better.

Perhaps the best widely available review of resolution authority issues comes in University of Pennsylvania law professor and bankruptcy expert David Skeel's "[The New Financial Deal: Understanding the Dodd-Frank Act and its \(Unintended\) Consequences](#)," which was published earlier this year (and reviewed [here](#)). Skeel recognizes problems in resolution authority and enumerates them in two chapters; but, rather than yelling apocalypse in a crowded theatre, he calmly offers reasonable fixes. Skeel is a big believer in the capacity of the bankruptcy system to handle financial failure and whenever possible argues that bankruptcy serves as the default option, as it did, pretty effectively under tough conditions, in Lehman.

In fact, one of Skeel's most-promising fixes -- promising in the sense that it would have a big effect without necessarily ugly consequences -- is to simplify the bankruptcy treatment of financial assets by eliminating the waiver on derivatives. As Skeel suggests, this protection arose 30 years ago in an era when "the Federal Reserve, Treasury and derivatives trade groups persuaded Congress that derivatives markets could regulate themselves and needed to be protected from interference. It became clear during the financial crisis," he notes dryly, "that the special treatment of derivatives was a mistake."

Now Skeel gets some academic support. Harvard Law School's Mark Roe [has a new paper](#) in the Stanford Law Review, "The Derivatives Market's Payment Priorities as Financial Crash Accelerator," that tackles the same subject and makes roughly the same recommendations. Roe focuses on the failures of AIG, Bear Stearns Cos. and Lehman Brothers and argues that this "favored treatment" of derivatives and repurchase agreements, which gives them super-priority status in a bankruptcy situation, sapped "the failed firms' counterparties' incentives to account well for counterparty risk -- the risk that their financial trading partner would fail." In short, the favored treatment of repos and derivatives encouraged the construction of fragile, highly leveraged and short-term financial arrangements and blunted any incentives by counterparties to monitor the situation carefully. Roe offers a devastating collection of Alan Greenspan statements to the effect that derivatives were safe because a counterparty like J.P. Morgan Chase & Co. "thoroughly scrutinizes the balance sheets of firms it lends to."

Roe offers his own dry rejoinder to Greenspan: "We all know that such scrutiny was less than

thorough." Don't we.

Roe provides some benefits for this treatment. Super-priority status creates risk-free investments that "have major efficiency potential." In other words, if you feel nothing is at risk, the liquidity will flow. "The problem, though, is that today the major super-priority vehicles come packed with systemically dangerous government backing, because it's systemically central institutions that disproportionately use the bankruptcy-safe package." Can we separate out the efficient flows from the dangerous ones? If we can, Roe can't figure out how. We need to choose, he says. "Given our recent experience, the best choice is to strengthen the system in the most important dimension of systemic stability. To do so, we need to sharply cut back the priority package."

A few things can be said about this issue. First, compared to the complex, even experimental quality of resolution authority, fixing the treatment of derivatives in bankruptcy is pretty straightforward. Second, we know the arguments in which these instruments were favored, which the financial crisis rendered mostly moot; derivatives are no longer immature and in need of nurturing, and private monitoring clearly failed. Third, while there might be less liquidity for short-term instruments -- Roe's "efficient" flows -- that would only contribute to financing structures with the widely accepted virtues of having less leverage, greater durations and more assiduous private oversight. Who could argue with that? You chuckle. Unlike resolution authority, with its very real technical difficulties, the issue of protection for derivatives in bankruptcy is pretty clearly neither ideological nor catering to a special interest except public safety.

That said, Dodd-Frank did not touch favored status, and despite all the sound and fury over IPO quiet periods or excessive rulemaking, there are very few signs from either party that anyone with any clout is suddenly about to revisit that decision and simplify bankruptcy treatment. Why? Because for all its relative straightforwardness compared to more difficult fixes, derivatives remains a mysterious black box to most Americans, sinister perhaps (didn't Warren Buffett say something about derivatives?), but very distant from their lives. Who understands derivatives out there on Main Street? And thus as the sense of urgency to reform passes -- in fact, that train long ago left the station -- we return to a situation of technical interest to only a few, most of whom have their own particular self-interest in mind.

Is this cynical or defeatist? Perhaps. But it's the nature of a profoundly complex financial system, with its overseers and policymakers and powerful practitioners, embedded deep within a large and diverse democracy with lots of other preoccupations like wars and unemployment. One might think of favored treatment of derivatives in bankruptcy as a kind of litmus test of our seriousness to wrestle with these issues. As long as we just let this one rest, we're really not very serious at all. Sorkin can make room for us in his basement.