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Viewpoint: Federal Receiver for Broker-Dealers Is a Bad Idea

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By Christopher Whalen

When Federal Deposit Insurance Corp. Chairman Sheila Bair floated the idea of her agency being given [power to act as receiver](#) over failed broker-dealers, it was easy to ignore. But now that Treasury Secretary Hank Paulson, the former CEO of Goldman Sachs, [joined the chorus of approval](#) of the idea of a federal receiver for failed broker-dealers, it is time to get out the old sombrero and do the Mexican hat dance on this very bad, entirely political proposal.

The idea of a federal receiver for failed broker-dealers comes from the bad example of the Bear Stearns rescue. This opaque arrangement essentially has the Federal Reserve Bank of New York on the hook for financing almost \$30 billion in collateral taken from Bear, this in order to convince JPMorgan Chase to take over a failed clearing customer. The "fair value" of the Bear Stearns collateral implies that an unprecedented loss looms for the Fed.

Now, it seems, Bair, Paulson, and others want to enshrine a taxpayer-subsidized federal receivership mechanism for future Bear Stearns-type failures. The reason Paulson put forward for supporting the idea of a federal receiver is that failures like Bear Stearns have "systemic implications."

"It is clear that some institutions, if they fail, can have a systemic impact, so we must give regulators the authorities to limit that impact and facilitate an orderly failure," Mr. Paulson said during a speech in London. "We need to create a resolution process that ensures the financial system can withstand the failure of a large, complex financial firm."

But what, exactly, does Paulson mean by systemic risk? Is he really arguing that the bankruptcy of a firm like Bear Stearns carries sufficient negative economic implications to warrant a public rescue? Or rather, does he mean that allowing a private resolution of Bear Stearns via existing legal mechanisms is inconvenient for Bear's clearing bank, JPMorgan Chase, and large counterparties like Goldman Sachs and Lehman Brothers?

It seems that Paulson and the other "captains" of Wall Street fear a commercial resolution of a large derivatives dealer like Bear Stearns, thus the option of seeking a public subsidy is obviously preferable. But is it really in the public interest to hide the reckless and at times irrational risk-taking of the major dealer firms? If the public knew the huge amounts of leverage employed by nonbank financial firms today, both broker-dealers and hedge funds, would Paulson or Bair dare to support the use of public funds to bail them out? The answer in both cases is no.

If you consider the rescue of Bear Stearns, it is clear that the true parties at interest were JPMorgan Chase, the nonequity claimants on and customers of Bear Stearns, and various government officials seeking to conceal their negligence. Sure, the Bear shareholders were thrown \$10 per share as a consolation prize, but the real point of the rescue was to prevent a very public, commercial liquidation of Bear Stearns using the existing legal and industry mechanisms for a broker-dealer insolvency.

When a broker-dealer seeks bankruptcy protection, the courts and industry groups such as the Securities Investor Protection Corp. already work together to conserve customer assets and manage an orderly wind-down of the firm. In general, the customer assets are segregated from the firm's own funds, thus very quickly making it apparent whether the dealer has sufficient funds to meet all of its commitments.

To their credit, the folks at SIPC do a very good job handling dealer insolvencies. The comments by Bair and Paulson are derogatory and disrespectful to these dedicated members of the securities industry and to the bankruptcy courts. Do Ms. Bair and Secretary Paulson really mean to say that SIPC and the U.S. bankruptcy courts around the country, which handle dozens of dealer failures each year, are doing a bad job?

No, Paulson and the large derivatives dealers have another agenda, namely to hide the true ugliness of Wall Street from public view. They want to conceal the fact that had Bear Stearns gone into a broker's liquidation, there would not be sufficient funds to cover the netting agreements between a firm like Bear Stearns, JPMorgan Chase, and other dealers and customers for the firm's OTC derivatives book.

Remember, any successful broker-dealer has negative net working capital. When the payments required under netting agreements for OTC derivatives could not be made due to a lack of funds, the various counterparties of a Bear Stearns bankruptcy would have been forced to file claims in the bankruptcy court, regardless of the protection that such netting agreements have in theory under the bankruptcy code.

Had the Bear Stearns failure been resolved without a taxpayer subsidy, many of its OTC derivatives trades would have ended up in front of a federal bankruptcy judge — an eventuality Wall Street fears more than any other. The entire Wall Street OTC derivatives market would be revealed for what it is, namely an unfunded Ponzi scheme, and Paulson, former Fed Chairman Alan Greenspan, and many other Washington apologists for Wall Street's excesses, might finally be called publicly to account for their policy decisions.

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