

GAO Highlights

Highlights of [GAO-13-622](#), a report to congressional committees

Why GAO Did This Study

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) mandates that GAO report on an ongoing basis on ways to make the Code more effective in resolving certain failed financial companies. This report examines advantages and disadvantages of certain proposals, based on those identified in GAO's first report, to revise the Code for financial company bankruptcies—specifically, proposals (1) to change the role of financial regulators in the bankruptcy process; (2) affecting funding of financial company bankruptcies; and (3) to change the safe-harbor treatment of QFCs. For this report, GAO held two expert roundtables in which participants evaluated the proposals using criteria for orderly and effective bankruptcies that GAO developed in earlier reports. The criteria are minimizing systemic risk, avoiding asset fire sales, ensuring due process, maximizing value, and limiting taxpayer liability. GAO identified these criteria by reviewing literature and interviewing government officials, industry representatives, and legal and academic experts.

What GAO Recommends

FSOC should consider the implications for U.S. financial stability of changing the role of regulators and the treatment of QFCs in financial company bankruptcies. FSOC agreed that a disorderly financial company bankruptcy could pose risks to financial stability, but stated that it would be premature for FSOC to consider proposals to change the Code. GAO reiterated that its recommendation was consistent with FSOC's statutory role and responsibilities.

View [GAO-13-622](#). For more information, contact Alicia Puente Cackley at (202) 512-8678 or cackleya@gao.gov.

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FINANCIAL COMPANY BANKRUPTCIES

Need to Further Consider Proposals' Impact on Systemic Risk

What GAO Found

Because the Bankruptcy Code (Code) does not specifically address issues of systemic risk, experts have proposed giving financial regulators a greater role in financial company bankruptcies. However, according to experts at a GAO roundtable, such proposals may have limited impact and raise certain implementation issues. For example, a proposal to require notification before bankruptcy depends on when (number of days) notification would be required and with whom (which regulators). Experts noted financial companies may not know that they will declare bankruptcy even a few days before the event and could have many regulators to notify. Experts also noted ways regulators already can compel financial companies to declare bankruptcy, and that changing the Code to allow regulators to place firms in bankruptcy involuntarily could temporarily place a firm in an uncertain legal status, eroding firms' values and endangering market stability. Other options, such as having regulatory standards forcing the firm into bankruptcy, could improve the likelihood of an orderly resolution, according to these experts. Although the proposals reflect the need to minimize systemic effects of financial company bankruptcies, the Financial Stability Oversight Council (FSOC)—charged with responding to threats to financial stability—has not considered changes to the Code. Consideration could improve FSOC's ability to address such threats in a timely and effective manner.

Experts emphasized that funding is needed to facilitate orderly and effective financial company bankruptcies. They generally agreed that prohibiting all federal funding or guarantees of private funding likely would lead to fire sales of assets. They agreed that fully secured funding should be used only to provide short-run liquidity and not for bailouts of insolvent firms' creditors. Experts suggested a private-sector fund could be created for this purpose. Such funds could be collected voluntarily, through routine assessments (before a bankruptcy), or through a facility similar to the one created for the Orderly Liquidation Authority, which allows federal funding at the time of a bankruptcy and later recovery of funds through an industry assessment. Experts noted some difficulties associated with these proposals, including determining whether a firm was insolvent or needed liquidity, and identifying permissible types of collateral.

Generally, experts did not agree on advantages or disadvantages of proposals to change the safe-harbor treatment of qualified financial contracts (QFC). The Code exempts QFCs, such as derivatives, from the automatic stay that generally prevents creditors from taking company assets in payment of debts before a case is resolved. It also exempts QFCs from provisions that allow bankruptcy judges to "avoid" contracts entered into within specified times before a filing. Proposals to change QFC treatment—subjecting all or some contracts to the automatic stay on a permanent or temporary basis and removing the avoidance exemptions—might address issues raised by extensive contract terminations in the early days of financial company bankruptcies. Experts said it was unclear what lessons should be learned from those experiences. Many noted that narrowing the exemptions would reduce the size of derivative markets, but views varied about whether such narrowing would increase or decrease systemic risk. Some experts said that the current safe harbors decrease systemic risk, while others said they increase it by making firms more dependent on less-reliable short-term financing.