**Beyond Bankruptcy And Bailouts**

By Sheila Bair

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Meaningful reform of our financial regulatory system is finally within reach. The opportunity to pass such a comprehensive overhaul may not come again in our lifetimes.

Never again should taxpayers be asked to bail out large, failing financial firms. Unfortunately, we still lack a viable way to close financial behemoths without risking market collapse.

The good news is that the FDIC has a well-established process that works for failing banks. Going forward, this model should be available to close large, failing firms. This means banning government assistance to individual companies and forcing them into orderly liquidation.

Financial institutions are unique in that their funding sources can dry up very quickly, disrupting credit flows to the real economy. Bankruptcy can abruptly sever those credit flows, which can cause an immediate systemic impact. The FDIC resolution process for insured banks provides continuity of credit functions, while liquidating the operations of a failing firm.

Over its 76-year history, the FDIC has handled thousands of resolutions of all manner of size and complexity. The FDIC resolution mechanism closes the institution and auctions it to the private sector, reallocating resources to stronger institutions. And it gives the government the right to repudiate executive contracts, eliminate bonuses, require derivatives counterparties to perform on their obligations, and impose losses where they belong: on shareholders and creditors.

Both the already passed House bill, as well as the bill approved by the Senate Banking Committee, draw on the FDIC model to create a resolution authority that specifically applies to large, complex nonbank financial firms. Under both bills, bankruptcy would be the normal process. But under extraordinary procedures, the government would have the option to put the very largest firms into an FDIC-style liquidation process if necessary to avert a broader systemic collapse.

As with banks, the legislation would allow the FDIC to create a temporary institution in order to allow continuity and prevent a systemic collapse while the firm is being liquidated. To provide working capital for this bridge, both bills would require the largest financial firms to pay assessments in advance so that taxpayers would not be at risk. The firms that pose the most risk would pay the most. This orderly liquidation process -- funded by the firms themselves -- would, for the first time, force these institutions to internalize the full costs of the risks they create.

The FDIC process can also facilitate pre-planning and international cooperation when a large, global financial entity gets into trouble. Given the conflicting bankruptcy regimes throughout the world, there is growing international consensus that we need a special liquidation process available as an alternative. Great Britain and the European Union are both seeking to construct special resolution mechanisms. The U.S. should draw on the FDIC's long experience and lead the way.

Some have tried to label the FDIC model as a "bailout" because it is not bankruptcy. Yet the FDIC process is anything but a bailout, as any small bank can attest.

Some are opposed to this reform because the creation of a realistic liquidation process would eliminate the funding advantage that the largest financial firms have. But these changes will strengthen the competitive position of smaller banks whose relative funding costs have grown significantly in the wake of the bailouts. Because of "too big to fail," markets assume that larger institutions do not face the same risk of failure as smaller ones. Real reform will put their shareholders and creditors on notice to do their own due diligence rather than rely on taxpayers.

The disruptions caused by forcing large, nonbank financial institutions through bankruptcy can create significant risks for the real economy, as we saw in the case of Lehman Brothers in the fall of 2008. The disorderly Lehman collapse and the AIG bailout cannot be our only models. The FDIC-style process represents a proven, third way.

We support any constructive improvements to the legislation that will reinforce market discipline and preclude future bailouts, while providing the FDIC with the necessary tools to market and sell a failed institution in a way that maximizes recoveries and protects the government against loss. Any legislation must remove all doubt that bailouts are an option. Misinformed criticisms of the legislation that simply serve to politicize, obfuscate or delay enactment will only perpetuate the favorable market funding these firms receive from their implicit government backing.

We cannot afford to let the status quo continue. We must embrace sensible regulatory changes and send a strong signal to large institutions and those who invest in them that from now on, they must sink or swim on their own. Only then will theoretical market discipline become reality.

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