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The legal foundations of financial collapse

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Purpose

The purpose of this paper is to analyze the consequences of the "safe harbor" provisions of the US Bankruptcy Code that were enacted from 1984 through 2005 and that protect certain financial contracts from standard bankruptcy procedures.

Design/methodology/approach

Qualitative methods are used to evaluate whether these provisions of the Bankruptcy Code were successful in their stated goal of reducing systemic risk in the financial system. A model of systemic risk is presented verbally in order to frame the discussion.

Findings

Recent evidence indicates that the "safe harbor" provisions, in fact, destabilized the financial system by encouraging collateralized interbank lending, discouraging careful analysis of the credit risk of counterparties and increasing the risk that creditors will run on a financial firm.

Practical implications

This paper indicates that the rewriting of the Bankruptcy Code to favor financial firms has had a profoundly destabilizing effect on the financial system. To put the financial system on more secure foundations, the author proposes that large complex financial institutions be prohibited from posting collateral on over the counter derivative transactions and that the repo-related bankruptcy amendments passed in 2005 be repealed.

Originality/value

This paper proposes an original framework for understanding systemic risk which drives the results in the paper.

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