BANKRUPTCY CODE AND FINANCIAL INSTITUTION INSOLVENCIES

HEARING

BEFORE THE

SUBCOMMITTEE ON
REGULATORY REFORM,
COMMERCIAL AND ANTITRUST LAW

OF THE

COMMITTEE ON THE JUDICIARY
HOUSE OF REPRESENTATIVES

ONE HUNDRED THIRTEENTH CONGRESS

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DECEMBER 3, 2013

BANKRUPTCY CODE AND FINANCIAL INSTITUTION INSOLVENCIES

TUESDAY, DECEMBER 3, 2013

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON REGULATORY REFORM,
COMMERCIAL AND ANTITRUST LAW
COMMITTEE ON THE JUDICIARY,
Washington, DC.

The Subcommittee met, pursuant to call, at 1:54 p.m., in room 2141, Rayburn Office Building, the Honorable Spencer Bachus (Chairman of the Subcommittee) presiding.

Present: Representatives Bachus, Goodlatte, Marino, Holding, Collins, Smith of Missouri, Cohen, DelBene, and Garcia.

Staff present: (Majority) Anthony Grossi, Counsel; Ashley Lewis, Clerk; and (Minority) James Park, Minority Counsel.

Mr. BACHUS. Well, good afternoon.

The Subcommittee on Regulatory Reform, Commercial and Antitrust Law hearing will come to order.

Without objection, the Chair is authorized to declare recesses of the Committee at any time. And, if we have votes, we will recess for those votes.

Now, I will recognize myself for an opening statement.

I would like to enter into the record the Committee memo that was prepared for this hearing. In my view, it is an excellent overview of the issues involved with improving the Bankruptcy Code in its role as a primary mechanism for dealing with distressed or insolvent financial institutions.

[The information referred to follows:]

M E M O R A N D U M

To:	Members of the Subcommittee on Regulatory Reform, Commercial and Antitrust Law
From:	Subcommittee Chairman Spencer Bachus
Date:	Wednesday, November 27, 2013
Re:	Subcommittee Oversight Hearing on "The Bankruptcy Code and Financial Institution Insolvencies," Tuesday, December 3, 2013, at 1:00 p.m., Room 2141, Rayburn House Office Building

INTRODUCTION

On December 3, 2013, the Subcommittee on Regulatory Reform, Commercial and Antitrust Law will hold an oversight hearing entitled "The Bankruptcy Code and Financial Institutions Insolvency" to examine policy issues attendant to the orderly resolution of distressed and failing financial institutions.

Witnesses at the hearing will include: the Honorable Jeffrey M. Lacker, President of the Federal Reserve Bank of Richmond; Professor Mark J. Roe, David Berg Professor of Law, Harvard Law School; and for the Minority, Donald S. Bernstein, Esq., partner and head of Davis Polk & Wardwell LLP's Insolvency and Restructuring Practice and past chair of the National Bankruptcy Conference.

PURPOSE AND BACKGROUND

I. PURPOSES OF THE HEARING

The orderly resolution of financial companies presents unique challenges to the U.S. Bankruptcy Code for many reasons, including these institutions' interconnectedness and, in the case of larger institutions, a potential to pose "systemic risk." The purpose of the oversight hearing is to hear testimony regarding issues related to the orderly resolution of distressed financial institutions, and to examine whether the Bankruptcy Code could be better equipped to facilitate resolution proceedings for financial companies of all sizes. Given its jurisdiction over the Bankruptcy Code, the Judiciary Committee has long had an interest in this matter. A proposal for an enhanced bankruptcy process was debated during the development of what ultimately became the Dodd-Frank Act.

II. BACKGROUND

A. Title I of Dodd-Frank and the Resolution of SIFIs and Non-SIFIs Pursuant to the Bankruptcy Code

In the fall of 2008, the United States was confronted by a financial crisis widely judged to be the most severe to face the financial sector and overall economy in decades. The crisis resulted in emergency government support to help stabilize the financial and nonfinancial system, and caused significant losses to the American economy that adversely affected households across the Nation. Thereafter, Congress began to consider financial reform legislation to address perceived deficiencies in the oversight of major participants in the sector, the regulation of financial institutions, and the resolution of distressed financial institutions. The resulting legislation, the Dodd-Frank Act, was signed into law on July 21, 2010.

The bankruptcy process has been the traditional mechanism for handling the orderly resolution of distressed companies in the U.S. because of its established history of laws, precedent and impartial administration. According to a report by the Federal Deposit Insurance Corporation (FDIC) and the Bank of England (*Resolving Globally Active, Systemically Important, Financial Institutions*, December 2012), "The U.S. would prefer that large financial organizations be resolvable through ordinary bankruptcy." However, the report added that "the U.S. bankruptcy process may not be able to handle the failure of a systemic financial institution without significant disruption to the financial system." One response of the Dodd-Frank Act was to require banking organizations with $50 billion or more in total assets and systemically important nonbank financial companies ("Systemically Important Financial Institutions" or "SIFIs") as designated by the Financial Stability Oversight Council to submit resolution plans or "living wills" to federal regulators. The living wills provide detailed information on how a financial company "would be resolved in a rapid and orderly manner under the Bankruptcy Code in the event of the [company's] material financial distress or failure." The first group of filers submitted their plans on July 1, 2012, the second group of filers submitted their plans on July 1, 2013, and the third wave of filers is scheduled to file on December 31, 2013.

Federal Reserve Bank of Richmond President Jeffrey Lacker, who will testify at the hearing, has observed, "resolution planning in some sense reverses the usual bankruptcy planning exercise. Instead of asking how to take a given financial institution through bankruptcy, (T)itle I asks us to work backward from bankruptcy resolution and determine what the institution needs to look like in order for that bankruptcy to be orderly."

Smaller financial companies are also eligible to restructure their operations under the Bankruptcy Code in the event of material financial distress or failure. These smaller companies are not required to submit living wills. Smaller financial institutions may also present challenges that the Bankruptcy Code as written may not be adequately equipped to address.

B. Reports by the Federal Reserve and GAO and Other Proposals to Address Financial Institution Insolvencies

The Dodd-Frank Act directed the Federal Reserve and the Governmental Accountability Office (GAO) to study the Bankruptcy Code and international issues related to the insolvency of financial institutions as part of an overall goal of reducing systemic risk within the financial sector.

1. Federal Reserve and GAO Studies

The Federal Reserve study (*Study on the International Coordination Relating to Bankruptcy Process for Nonbank Financial Institutions*, July 2011) and the GAO study (*Complex Financial Institutions and International Coordinate Pose Challenges*, July 2011) identified a number of issues specific to the resolution of insolvent financial institutions and discussed theories regarding how to address such issues. However, the reports did not make specific recommendations or independent opinions regarding potential revisions to the Bankruptcy Code.

Both studies noted that the Bankruptcy Code, in its current form, is structured to enhance the recoveries of a debtor's creditors while providing an opportunity for the debtor to either reorganize or liquidate in an orderly fashion. The Bankruptcy Code, however, generally has not provided an effective means for the consideration of systemic risk associated with the reorganization or liquidation of a debtor.

While not endorsing any specific policy recommendations, the full reports discussed several areas of potential reform to the Bankruptcy Code. The proposals generally fell into one of the following categories of action: "(1) increasing opportunities for bankruptcy planning, (2) providing for regulatory input in the bankruptcy process, (3) modifying safe harbor exceptions to the automatic stay for [qualified financial contracts], (4) treating firms on a consolidated basis, and (5) improving court expertise on financial issues." The reports also discuss existing international impediments to orderly cross-border resolution under the Bankruptcy Code for financial institutions with global operations.

2. Single Point of Entry

"Single point of entry" is a resolution approach that relies on placing a parent holding company into receivership while maintaining the operations and solvency of its operating subsidiaries. This is a regulatory concept advocated in a paper by the FDIC and the Bank of England and is the FDIC's intended method for implementing its resolution/orderly liquidation authority under Title II of the Dodd-Frank Act.

Under this approach, the FDIC would be appointed receiver of the parent holding company and could transfer the parent company's assets into a bridge financial holding company, impose losses on the shareholders and creditors of the parent company, and eventually transition ownership of the bridge financial company into private hands.

Some commentators have suggested that the single point of entry approach should also be made available in the Bankruptcy Code. The hearing will examine ways the Code might be tailored to facilitate the use of the bankruptcy process for eligible institutions.

3. The "Chapter 14 Approach"

The Chapter 14 approach, advocated by, among others, the Hoover Institution of Stanford University, introduces an entirely new chapter to the Bankruptcy Code. This new chapter (a proposed "Chapter 14") would solely govern the insolvency of large financial institutions. This is also among the potential approaches discussed in the Federal Reserve study, and many of the issues raised by the Chapter 14 approach are separately discussed in the GAO reports.

As suggested in concept, the new Chapter 14 would, among other elements: apply to large financial institutions; allow the financial institution's primary regulator to initiate, and have standing in, the institution's bankruptcy proceeding; allow the financial institution's management to initiate the bankruptcy; designate a select group of district and bankruptcy judges to oversee Chapter 14 bankruptcies; and provide specialized rules for derivative transactions. Advocates of the Chapter 14 approach argue that a transparent judicial process that allows for the reorganization, rather than liquidation, of a large financial institution is a preferable resolution strategy. The hearing is not intended to be an evaluation of the Chapter 14 approach, but certain issues raised by the proposal may be examined.

C. Certain of the Challenges of Financial Institution Insolvencies and Potential Constraints of the Existing Bankruptcy Code

A challenge presented in resolving distressed or insolvent financial institutions is that material distress may need to be addressed quickly to prevent significant disruption to the marketplace. The existing Bankruptcy Code is structured to afford creditors and parties-in-interest due process by allowing sufficient notice for such parties to respond to actions taken by the debtor during various aspects of the proceedings, including the sale of the debtor's assets. As discussed in part by the GAO report, existing due process protections may need to be modified to accommodate for the faster response that may be required when a failing institution is deemed to pose a systemic risk to the general economy. Additionally, Professor Roe likely will testify that certain incremental changes to how derivative contracts are treated in bankruptcy may be necessary to facilitate an orderly resolution.

CONCLUSION

The bankruptcy process has long been favored as the primary mechanism for dealing with distressed and failing companies because of its impartiality, adherence to established precedent, and grounding in the principles of due process and rule of law. As financial institutions move towards organizing their corporate structures to allow for an orderly bankruptcy process, it is proper that the Subcommittee begin the discussion of whether the current Bankruptcy Code is properly equipped to address challenges that may arise in connection with the resolution of both systemically important financial institutions and smaller financial institutions in order to help prevent a repetition of scenarios that were experienced during the last financial crisis.

Mr. BACHUS. One of our witnesses today is the president of the Federal Reserve Bank of Richmond, Jeffrey Lacker. And let me say that there are statistics in an essay prepared by the Richmond Fed that underscore the importance of what we are talking about. And let me read from the essay directly.

And I quote, this was I think 2011 essay and it was on "too big to fail." According to—and I quote, "according to Richmond Fed estimates, the proportion of total U.S. financial firms liabilities covered by the Federal financial safety net has increased by 27 percent during the past 12 years. The safety net covered $25 trillion in liabilities at the end of 2011 or 57.1 percent of the entire financial sector. Nearly two thirds of the support is implicit and ambiguous."

And I think you see that two-thirds portion when we talk about Lehman and Bear Stearns. Where Bear Stearns received financial support from the government several months later. People are thinking, maybe that it is implied, that they will do the same thing with Lehman. And it didn't happen. And one of the results was people didn't prepare for it. It surprised people. And the uncertainty that ensuring—the government, the taxpayer ensuring that large portion of the financial assets of our country, the great majority, and then two thirds of that support being iffy is, I think, is a condition that all of us, in a bipartisan way, ought to be concerned about.

Those are very significant financial liabilities to place on the Federal Government and ultimately on taxpayers. It is a structure that can tilt the field toward government intervention and bailouts. In my view, statistics like this strengthen the case for improving the bankruptcy process so that risks are borne by private parties and cases are handled in a consistent way, based on established precedent and rule of law.

And let me say, this hearing is not about Dodd-Frank. But Dodd-Frank actually set up the mechanism for utilization of bankruptcy. So this hearing is not an attempt to substitute something for Dodd-Frank. In fact, Dodd-Frank called for a GAO hearing and Fed studies on how to improve bankruptcy. So, nothing we are saying today is an indictment of Dodd-Frank. In fact, "living wills" have been one of the few things that I think almost everyone, in a bipartisan way, has said that was a good thing. Although there is a—we discussed earlier witnesses, you have to be cautious that you don't set up a corporation structure as if it is going to bankrupt. But you ought to—there ought to be planning of what you are going to do in the case there is a bankruptcy.

With that, let me recognize the Ranking Member of the Subcommittee, Mr. Cohen of Tennessee, for his opening statement.

Mr. COHEN. Thank you, Mr. Chair.

And I couldn't not start this hearing without congratulating you on your Auburn victory. What an unbelievable game. And you were there. I would like to yield to you. Would you tell us—we heard what the Auburn announcer said, when the kick was returned. Can you tell us what you said as the kick was returned? [Laughter.]

Mr. COLLINS. The Alabama perspective was, "Oh, God."

Mr. COHEN. And the Auburn perspective was, "Thank God?" [Laughter.]

Mr. BACHUS. Well, you know, I am—having represented Tuscaloosa County, the home of the University of Alabama for 20 years, I am not all that vocal sometimes. But, I was thinking how lucky Auburn had been two games in a row. And I thought that after that immaculate catch against Georgia that we had had all the luck we deserved. But, we got some more of it. It was something to see.

Mr. COHEN. But, what did you say? Did you say anything at all? I mean——

Mr. BACHUS. No. I sort of had that expression, if you seen number 56, that freshman at Auburn that has been on ESPN where—— [Laughter.]

He is trying to put this all together. That's what we did. My wife is a University of Alabama graduate too. So——

Mr. COHEN. That was a smart move on your part.

Mr. BACHUS. So, I was telling her how sorry I was. But she knew I wasn't very sincere. [Laughter.]

Mr. COHEN. You are the kind of the opposite of McKaren and his girlfriend.

Mr. BACHUS. Yeah, she is an Auburn brat.

Mr. COHEN. I know it.

Mr. BACHUS. That is how it is going to be. [Laughter.]

All right.

Mr. COHEN. Did you go to Toomer's Corner and throw toilet paper?

Mr. BACHUS. No. You know what, an Alabama fan poisoned those trees and killed them. That is true, I don't know if you knew that.

Mr. COHEN. They pled guilty and should have gone to jail for a long time.

Mr. BACHUS. Yeah.

Mr. COHEN. Bad guy.

Mr. BACHUS. But the—— [Laughter.]

That is actually—that is true he went—but, you know, he was responding to Auburn students putting an—after the 2010 victory over Alabama, Cam Newton, they put an Auburn jacket on Bear Bryant's statute. So, he felt like that was——

Mr. COHEN. That was disrespectful.

Mr. BACHUS. Yes.

Mr. COHEN. But, not worthy of killing trees.

Mr. BACHUS. No, they didn't kill Bear Bryant's statue.

Mr. COHEN. Innocent there.

Mr. BACHUS. All right. I am sorry.

Mr. COHEN. Back to Dodd-Frank—— [Laughter.]

Which I voted for and proudly then, and support to this day and continue to.

Its passage by Congress in 2010 was an acknowledgment that insufficient regulation led to the problem of the so-called "too big to fail" financial institutions. Those were institutions that became so big and so interconnected that their insolvencies threatened to paralyze the entire financial system and the economy of the world. This situation in turn resulted in extreme pressure for taxpayer bailouts when those institutions fell under financial stress. And the bill, I think, was somewhat bipartisan, pretty bipartisan to save the country and bail out the banks because we had to.

The bankruptcy filing of Lehman Brothers in 2008, which was the largest bankruptcy in our history, involved more than $600 billion in assets and illustrates this problem. The bankruptcy filing greatly exacerbated the financial panic on Wall Street, leading to a severe crisis in the greatest economic downturn since the Great Depression, now we call it the Great Recession. The financial markets' reaction to Lehman Brothers' bankruptcy highlighted potential limitations of the Bankruptcy Code in handling the resolution of these financially distressed institutions and the systemic effect they would have on financial institutions in general. Dodd-Frank has certain enhancements in it that are strong ways that we have dealt with and responded to that problem.

I support legislation to increase the minimum required amount of capital for covered financial institutions under Dodd-Frank. We should also consider the potential need for other enhancements like adding a representative of the Antitrust Division of the Department of Justice to the Financial Stability Oversight Council, which was created by Dodd-Frank to oversee the stability of the financial system.

It is in this spirit that I approach today's hearing, which will focus on whether current Bankruptcy Code is sufficient to allow for the early reorganization or liquidation of systemically important financial institutions under title I of Dodd-Frank.

Whether one supports or doesn't support Dodd-Frank, we can agree that today's inquiry is an important one to the extent that modest revisions to the Bankruptcy Code will help ensure that we avoid the need for additional future taxpayer bailouts of financially struggling large financial institutions. We should be able to work together in crafting such changes.

Just as the Chairman of the full Committee brought us together on patent reform, I feel confident that the Chairman of the Subcommittee, that great Auburn war eagle, can bring us together on something to solve this problem too.

With that, I yield back the balance of my time.

Mr. BACHUS. I thank Mr. Cohen for that opening statement.

And, at this time, I recognize Chairman Goodlatte, the full Committee Chairman.

Mr. GOODLATTE. Well, thank you, Mr. Chairman. I appreciate your holding this hearing.

The Bankruptcy Code has existed in this country for well over a hundred years. Over this time, our bankruptcy system has evolved to become one of the most sophisticated regimes in the world. The bedrock principle embedded in the bankruptcy system of providing for the efficient resolution and reorganization of operating firms, has allowed our economy to grow and flourish. Nevertheless, a periodic evaluation of the Bankruptcy Code to ensure its adequacy to address the challenges posed by the changing nature of operating firms, is one of the fundamental responsibilities of this Committee.

I applaud Chairman Bachus for holding today's hearing to examine whether the existing Bankruptcy Code is best equipped to address the insolvency of large and small financial institutions.

The bankruptcy process confers a number of benefits to all operating companies, including financial firms. The bankruptcy court provides transparency and due process to all parties involved. Furthermore, bankruptcy case law has been developed over decades providing consistency and predictability. Additionally, the bankruptcy process has been sufficiently dynamic to administer the resolution and restructuring of complex operating companies with billions of dollars in assets, as well as smaller companies and individuals.

But, despite the bankruptcy system's ability to accommodate complex operating companies, financial firms may possess unique characteristics that are not yet optimally accounted for in the Bankruptcy Code. For example, efficient and orderly resolution of financial firms can require an unusual level of speed. Refinements to the code might be considered to provide—to better provide that speed, while still assuring due process. Additionally, in some circumstances, the failure of financial firms can pose unique threats to the broader stability of the economy. To account for that, title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires certain firms to prepare "living wills" to plan for resolution in bankruptcy in the event of failure.

The Bankruptcy Code is well crafted to maximize the recoveries of a debtor's creditors, while providing an opportunity for the debtor to either reorganize or liquidate in an orderly fashion. It might, however, bear improvements designed specifically for the efficient execution of title I living wills. There are some of the—these are some of the issues that may need to be examined as part of the broader evaluation of the existing Bankruptcy Code's adequacy to address financial institution insolvencies.

I look forward to the testimony from today's excellent panel of witnesses on these important issues.

And, Mr. Chairman, I thank you and yield back the balance of my time.

Mr. BACHUS. I thank you.

And without objection, other Members' opening statements will be made a part of the record.

And I do agree with the Chairman when he says that we have an excellent panel of witnesses, because we do have three of—really people that, in a bipartisan nature, we consider experts on bankruptcy and how it can be enhanced to address complex situations.

I will first begin by introducing our witnesses.

Governor Lacker is the current president of the Federal Reserve Bank of Richmond, where he began his term on August 1st, 2004. Prior to serving as the president of the Richmond Federal Reserve, he was a research economist with the bank for 25 years, serving in various capacities including vice president, senior vice president and director of research. He is the author of numerous articles and professional journals on monetary financial and payment economics. And he has presented his work at universities and central banks worldwide. He received his BA in economics from Franklin and Marshall College, and a doctorate in economics from the University of Wisconsin.

Mr. Bernstein, Donald Bernstein, is a partner of Davis Polk here in Washington. Is that right or New York? New York, okay. Where he heads the firm's insolvency and restructuring practice. During his distinguished 35-year career, he has represented nearly every major financial institution in numerous restructuring, as well as leading a number of operating firms through bankruptcy including Ford, LTV Steel, and Johns Manville. Mr. Bernstein has earned multiple honors for his practice including being elected by his peers as the chair of the National Bankruptcy Conference, the most prestigious professional organization in the field of bankruptcy. Mr. Bernstein received his AB cum laude from Princeton University and his JD from the University of Chicago Law School. And we welcome you.

Professor Mark Roe is a professor of law at Harvard Law School where he teaches business bankruptcy and corporations courses. Professor Roe has authored countless articles and opinion pieces that have been published across the globe including in the law reviews and—the law reviews of Penn, Virginia, Columbia, Michigan, Stanford, Yale, and Harvard. He also literally wrote the book on corporate restructuring that is used in law schools across the country. Prior to joining Harvard's faculty, Professor Roe taught law at Columbia University, the University of Pennsylvania and Rutgers University. Prior to joining academia, he worked at the law firm of Cahill Gordon and at the Federal Reserve. Professor Roe received his BA from Columbia University summa cum laude, and his JD from Harvard Law School.

Each of the witnesses' written statements will be entered into the record in its entirety. I ask that each of the witnesses summarize his testimony or her testimony. I am not going to restrict you to 5 minutes, I think it is too important. If you go over that, that is fine.

And so I am not going to read this about the light and all that.

So, we—at this time, Governor Lacker, you are recognized for your opening statement.

TESTIMONY OF JEFFREY M. LACKER, PRESIDENT, FEDERAL RESERVE BANK OF RICHMOND

Mr. LACKER. Thank you, good morning.

I am honored to speak to the Subcommittee about why I believe it is important to improve our Bankruptcy Code to make it easier to resolve failing financial firms in bankruptcy.

At the outset I should say that my comments reflect my own views and do not necessarily reflect those of the Board of Governors or my other colleagues at other Federal Reserve banks.

I think the events of 2008 provide strong evidence of glaring deficiencies in the way financial institution distress and insolvency are handled, particularly at large institutions. The problem, widely known as "too big to fail," consists of two mutually reinforcing expectations.

First, many financial institution creditors feel protected by an implicit government commitment of support should the institution face financial distress. This belief dampens creditors' attention to risk and it leads to overuse of types of borrowing such as short-term wholesale funding that are more fragile, more prone to runs, more prone to volatility.

The second of these two mutually reinforcing expectations is that if a large financial firm is highly dependent on short-term funding, policymakers are often unwilling to let it file for bankruptcy under the U.S. Bankruptcy Code fearing that it would result in undesirable effects on counterparties. This fear leads policymakers to intervene in ways that allow short-term creditors to escape losses such as through central bank lending or public sector capital injections.

This behavior just reinforces creditors' expectations of support. That in turn reinforces firms' incentives to grow large and their incentive to rely on short-term funding which in turn reinforces policymakers' proclivity for intervening to support creditors. The result is more financial fragility and more rescues. The path toward a stable financial system requires that policymakers have confidence in the unassisted failure of financial firms under the U.S. Bankruptcy Code and that investors are thereby convinced that unassisted bankruptcy is the norm. This is why I believe it is vitally important to ensure that our bankruptcy laws are well crafted to apply to large financial institutions.

In response to the experience of 2008, title I of the Dodd-Frank Act laid out a planning process for the resolution of failed financial institutions. A resolution plan or "living will," as they are popularly called, is the description of a firm's strategy for rapid and orderly resolution under the U.S. Bankruptcy Code without government assistance. It spells out the firm's organizational structure, key management information systems, critical operations, and a mapping of the relationship between core business lines and legal entities. The heart of the plan is the specification of the actions the firm would take to facilitate rapid and orderly resolution and prevent adverse effects of failure, especially the firm's strategy to maintain critical operations and funding.

The Federal Reserve and the Federal Deposit Insurance Corporation can jointly determine that a plan is "not credible" or would not facilitate the orderly resolution—an orderly resolution under the Bankruptcy Code. And, in that case, the firm would be required to submit a revised plan to address deficiencies. If the Fed and the FDIC jointly determine that the revised plan does not remedy identified deficiencies, they can require more capital, increase liquidity requirements, reduce reliance on short-term funding, or restrict the growth, activities or operations of the firm. In essence, regulators can order changes in the structure and operations of a firm to make it resolvable in bankruptcy without government assistance.

Note the implication here that if a firm would require, the way it is running itself now, an unrealistically large amount of "debtor-in-possession" financing, regulators can require ex ante, pre-bankruptcy changes in the firm's funding structure so that plans for funding operations in bankruptcy are realistic and credible.

Title II of the Dodd-Frank Act gives the FDIC the ability to take a firm into receivership under its so-called "Orderly Liquidation Authority," if there is a determination that the firm's failure under the U.S. Bankruptcy Code would have serious adverse effects on U.S. financial stability. Title II receivership differs from the Bankruptcy Code in that the FDIC would have the ability to borrow funds from the U.S. Treasury to support creditors, and would have broad discretion to treat similarly situated creditors differently. This is likely to replicate the two mutually reinforcing expectations that define "too big to fail." And this is why improving the Bankruptcy Code to facilitate orderly resolution of large financial firms is so important. It would position us to wind down the Orderly Liquidation Authority at an appropriate time and to wind down other financing mechanisms such as the Federal Reserves' remaining 13(3) powers to lend in "unusual and exigent circumstances."

Without winding these down, I think that those mutually reinforcing conditions are likely to arise again. Expectations of support, in the absence of clear guidance as to when and where support will be forthcoming, will encourage excessive risk taking. That risk taking will trap policymakers. It will put them in a box and force them to respond with rescues and support, in the event of distress.

The Dodd-Frank Act itself clearly envisions bankruptcy without government support as the first and most preferable option in the case of a failing financial institution, and for good reason, in my view. The expectation of resolution in bankruptcy without government support would result in a much better alignment between the incentives of market participants and our public policy goal of a financial system that effectively allocates capital and risk.

Thank you very much.

[The prepared statement of Mr. Lacker follows:]

Statement

Subcommittee on Regulatory Reform, Commercial and Antitrust Law of the Committee on the Judiciary

December 3, 2013

Jeffrey M. Lacker
President
Federal Reserve Bank of Richmond

The Committee on the Judiciary
Rayburn House Office Building
Washington, D.C.

Good morning. I am honored to speak to the Subcommittee about the bankruptcy code and financial institution insolvency. In my remarks, I will discuss why I believe it's so important to improve our bankruptcy code to make it feasible to resolve failing financial firms in bankruptcy. At the outset, I should say that my comments today are my own views and do not necessarily reflect those of the Board of Governors of the Federal Reserve or my colleagues at other Federal Reserve Banks. My views have been informed by both my experience leading the Fifth Federal Reserve District over the last seven years and as a research economist studying banking policy for the prior 25 years.

The events of 2008 provided evidence, in my view, of glaring deficiencies in the way financial institution distress and insolvency are handled, particularly at large institutions.[1] The problem — widely known as "too big to fail" — consists of two mutually reinforcing expectations. First, many financial institution creditors feel protected by an implicit government commitment of support should the institution face financial distress. This belief dampens creditors' attention to risk and makes debt financing artificially cheap for borrowing firms, leading to excessive leverage. Moreover, it leads to overuse of types of borrowing — such as short-term wholesale funding — that are more fragile and more likely to prompt the need for such protection. Second, policymakers may well worry that if a large financial firm with a high reliance on short-term funding were to file for bankruptcy under the U.S. bankruptcy code, it would result in undesirable effects on counterparties, financial markets and economic activity. This expectation induces policymakers to intervene in ways that allow short-term creditors to escape losses, such as through central bank lending or public sector capital injections. This reinforces creditors' expectations of support and firms' incentives to grow large and rely on short-term funding, resulting in more financial fragility and more rescues.

Expectations of creditor rescues have increased over the last four decades through the gradual accretion of precedents. Research at the Richmond Fed has estimated that one-third of the financial sector's liabilities are perceived to benefit from implicit protection, based on actual government actions and policy statements.[2] Adding implicit protection to explicit protection programs such as deposit insurance, we found that 57 percent of financial sector liabilities were expected to benefit from government guarantees as of the end of 2011. This figure was about 45 percent at the end of 1999.

In response to the experience of 2008, Title I of the Dodd-Frank Act laid out a planning process for the resolution of failed financial institutions. A resolution plan, or "living will," is a description of a firm's strategy for rapid and orderly resolution under the U.S. bankruptcy code, without government assistance, in the event of material financial distress or failure. Among other things, it spells out the firm's organizational structure, key management information systems, critical operations and a mapping of the relationship between core business lines and legal entities. The heart of the plan is the specification of the actions the firm would take to facilitate rapid and orderly resolution and prevent adverse effects of failure, including the firm's strategy to maintain critical operations and funding.[3]

The Federal Reserve and the Federal Deposit Insurance Corporation can jointly determine that a plan is "not credible" or would not facilitate an orderly resolution under the bankruptcy code, in which case the firm would be required to submit a revised plan to address identified deficiencies. A resubmission could include plans to change the business operations and corporate structure in order to eliminate deficiencies. If the Fed and the FDIC jointly determine that the revised plan does not remedy identified deficiencies, they can require more capital, increase liquidity requirements or restrict the growth, activities or operations of the firm. In essence, regulators can order changes in the structure and operations of a firm to make it resolvable in bankruptcy without government assistance.

If there is a determination that, among other things, the firm's failure under the U.S. bankruptcy code would have serious adverse effects on "U.S. financial stability," Title II of the Dodd-Frank Act gives the FDIC the ability, with the agreement of other financial regulators, to take a firm into receivership. One difference between a Title II receivership and the bankruptcy code is that Title II gives the FDIC the ability to borrow funds from the U.S. Treasury (specifically, the Orderly Liquidation Fund at the Treasury) to make payments to creditors of the failed firm or to guarantee the liabilities of the failed firm.[4] The funds are to be repaid from recoveries on the assets of the failed firm or from assessments against the largest, most complex financial companies.

While the FDIC is to pay creditors no less than they would have received in a liquidation of the firm, the Act provides the FDIC with broad discretion to treat similarly situated creditors differently.[5] This can encourage short-term creditors to believe they would benefit from such treatment and therefore continue to pay insufficient attention to risk and invest in fragile funding arrangements. Given widespread expectations of support for financially distressed institutions in orderly liquidations, regulators will likely feel forced to provide support to these short-term creditors to avoid the turbulence of disappointing expectations. This would replicate the two mutually reinforcing expectations that define "too big to fail."

Clearly, the Dodd-Frank Act envisions bankruptcy without government support as the first and most preferable option in the case of a failing financial institution, and for good reason, in my view. If resolution in bankruptcy without the expectation of implicit government guarantees comes to be expected as the norm, the incentives of market participants would be better aligned with our public policy goal of a financial system that effectively allocates capital and risks. Large financial firms themselves would want to be less leveraged and less reliant on unstable short-term funding. Institutions and markets would, accordingly, be more resilient in response to financial stress, and policymakers could credibly commit to forgo the creditor rescues that do so much damage to incentives.

The alternative to robust plans for resolution in bankruptcy is to institutionalize the capacity to provide public sector rescues for financial firm creditors outside of bankruptcy, through Title II. This would be a far less desirable path, I believe. Trying to correct these incentive distortions through the regulation of firm size, structure and capital is likely to fall short. This path thus would fundamentally undermine the incentives of financial institutions and their creditors to plan effectively for Title I resolution. And it would continue to tilt financial innovation toward bypassing regulatory constraints and relying on the fragile short-term funding methods that are most likely to elicit government protection. The result would be ever-increasing regulatory costs and repeated bouts of financial instability.

Reducing the probability that a large financial firm becomes financially distressed — through enhanced standards for capital and liquidity, for example — is useful, but will never be enough. The path toward a stable financial system requires that policymakers have confidence in the unassisted failure of financial firms under the U.S bankruptcy code and that investors are thereby convinced that unassisted bankruptcy is the norm. This is why I believe it is vitally important to ensure our bankruptcy laws are well crafted to apply to large financial institutions.

In evaluating alternative approaches to insolvency and bankruptcy provisions, it would be a mistake to assume that the behaviors of financial firms and their creditors will remain unchanged. For example, I have stressed that the heavy reliance of large financial institutions on wholesale funding markets evolved under the growing expectation of public sector rescues, and is likely to depend sensitively on that expectation. In the absence of that expectation, firms and their creditors would have strong incentives to reduce reliance on fragile short-term funding.

This is relevant to the frequently heard claim that the large "liquidity needs" of failing financial institutions is a stumbling block to resolving such firms in bankruptcy. The U.S. bankruptcy code allows the bankrupt firm to obtain, subject to court approval, "debtor-in-possession," or DIP, financing that is generally senior to pre-existing creditors. Such financing can be useful to fund ongoing operations — for example, to pay off certain creditors, such as vendors, rather than retain them in bankruptcy proceedings. Other creditors often find it advantageous to approve DIP funding, despite the dilution of their own claims, because it ensures the continuation of ongoing operations.

The point is that if repayment of short-term obligations in bankruptcy depends on large amounts of DIP financing that would be difficult for a financial institution to obtain, one would expect to see less reliance on short-term credit (at least as long as government-provided DIP financing was not expected to fill the gap). Moreover, an inability to fund necessary operations in bankruptcy is likely to compromise the credibility of a Title I resolution plan. In this case, regulators would be warranted to require less reliance on short-term funding in the first place.

The FDIC's authority to lend to distressed institutions under its Orderly Liquidation Authority amounts to government-provided DIP financing. The beneficial feature of privately provided DIP financing is the presumption that, because it's provided by market participants and approved by creditors and the court, it's fairly priced and thus unsubsidized and does not unduly disadvantage any particular class of creditors. Indeed, this is why unassisted bankruptcy is so critical to ending "too big to fail" and why firms were instructed not to assume extraordinary government support in their submitted resolution plans. Public sector support can be underpriced and distortionary, and can reallocate returns between creditor classes outside the procedural safeguards of bankruptcy. Discretionary government provision of DIP financing would undermine the integrity and purpose of the bankruptcy code.

Some recent proposals to address the "too big to fail" problem would make structural changes to financial firms — imposing quantitative limits on their size or prohibiting certain risky activities. I am open to the notion that such restrictions may ultimately be necessary to achieve a more stable financial system, but I do not believe we have a strong basis yet for determining exactly what activity and size limits should be adopted. The living will process, however, should provide an objective basis for decisions about how the structure, financing or activities of large financial firms need to be altered in order to assure orderly unassisted resolution. In addition, the process of writing credible living wills should illuminate efforts to identify ways in which the bankruptcy code could be improved to make the resolution of financial firms more orderly.[6]

Robust and credible resolution plans will position us to wind down the Orderly Liquidation Authority and other financing mechanisms, such as the Federal Reserve's remaining 13(3) powers to lend in "unusual and exigent circumstances." By allowing creditors to escape losses, such lending distorts incentives and exacerbates moral hazard. Eliminating the ability to provide ad hoc support to firms in financial distress would cement our commitment to orderly unassisted resolutions in bankruptcy, thereby contributing to a more stable and competitive playing field.

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[1] The inherent problems have been widely noted by economists going back decades before the crisis. See John H. Kareken and Neil Wallace, "Deposit Insurance and Bank Regulation: A Partial Equilibrium Exposition," Journal of Business, July 1978, vol. 51, pp. 413-38; John H. Kareken, "Deposit Insurance Reform or Deregulation Is the Cart, Not the Horse," Federal Reserve Bank of Minneapolis Quarterly Review, Spring 1983, vol. 7, no. 2; Douglas Diamond and Philip Dybvig, "Bank Runs, Deposit Insurance and Liquidity," Journal of Political Economy, June 1983, vol. 91, no. 3, pp. 401-19; Marvin Goodfriend and Jeffrey M. Lacker, "Limited Commitment and Central Bank Lending," Federal Reserve Bank of Richmond Economic Quarterly, Fall 1999, vol. 85, no. 4, pp. 1-27; Gary Stern and Ron Feldman, "Too Big To Fail: The Hazards of Bank Bailouts," Washington, D.C.: Brookings Institution Press, 2004. See also Huberto M. Ennis and Todd Keister, "On the Fundamental Reasons for Bank Fragility," Federal Reserve Bank of Richmond Economic Quarterly, First Quarter 2010, vol. 96, no. 1, pp. 33-58; Federal Reserve Bank of Richmond Economic Quarterly, First Quarter 2010, A Special Issue on the Diamond-Dybvig Model and Its Implications for Banking and Monetary Policy.

[2] The Richmond Fed's estimates of the size of the federal financial safety net are available at https://www.richmondfed.org/publications/research/special_reports/safety_net.

[3] For more on resolution planning, see Jeffrey Lacker, "Ending 'Too Big To Fail' Is Going to Be Hard Work," Speech at the University of Richmond, Richmond, Va., April 9, 2013. The Federal Reserve's Regulation QQ governing resolution planning can be found at http://www.gpo.gov/fdsys/pkg/FR-2011-11-01/pdf/2011-27377.pdf.

[4] For a comparison of the Orderly Liquidation Authority provisions with the U.S. bankruptcy process, see Sabrina R. Pellerin and John R. Walter, "Orderly Liquidation Authority as an Alternative to Bankruptcy," Federal Reserve Bank of Richmond Economic Quarterly, First Quarter 2012, vol. 98, no. 1, pp. 1-31.
[5] See Pellerin and Walter, pp. 16-19.
[6] See Kenneth E. Scott and John B. Taylor (eds.), "Bankruptcy Not Bailout: A Special Chapter 14," Stanford, CA: Hoover Institution Press, 2012.

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Supplemental Materials

1. 2013 Estimates of the Safety Net, Federal Reserve Bank of Richmond.

2. Orderly Liquidation Authority as an Alternative to Bankruptcy, Sabrina R. Pellerin and John R. Walter, Federal Reserve Bank of Richmond *Economic Quarterly*, First Quarter 2012.

3. "Too Big to Fail," Our Perspective, Federal Reserve Bank of Richmond, February 2013.

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2013 Estimates of the Safety Net (Using Data as of Dec. 31, 2011)

As used by Walter and Weinberg (2002) and Malysheva and Walter (2010), the phrase government guarantee means a federal government commitment to protect lenders from losses due to a private borrower's default. Following this definition, our estimate of the safety net includes insured bank and thrift deposits, certain other banking company liabilities, some government-sponsored enterprise (GSE) liabilities, selected private-employer pension liabilities, the dollar value of money market mutual fund shares, as well as a subset of the liabilities of other financial firms.

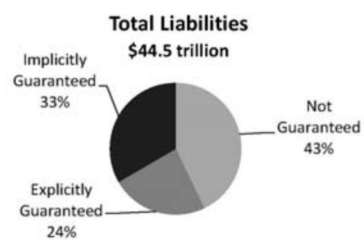
Our estimate (using data as of Dec. 31, 2011) includes a mixture of elements. Some of the liabilities, such as insured deposits, are *explicitly* guaranteed. Others, such as short-term liabilities of the largest banking companies, some deposit balances not explicitly covered by deposit insurance, and the liabilities of certain government-sponsored enterprises, are *believed* by many market participants to be *implicitly* guaranteed by the federal government. Our approach to implicit guarantees is to ask, "Based on past government actions, what might market participants reasonably expect future government actions to be?" Of course, identifying exact market expectations is largely impossible. We therefore provide two estimates—found in our "Most Inclusive" and "Least Inclusive" tables below—that can be thought of as the bounds within which market perceptions are likely to be found.

See the Methodology and Sources section for greater detail on what we have included in our explicit and implicit categories for each liability type contained in our two estimates.

Most Inclusive Estimate

Financial Firms (in billions)	Explicitly Guaranteed Liabilities (A)	Implicitly Guaranteed Liabilities (B)	A+B	Total Liabilities
Banking & Saving Firms (includes BHCs & SLHCs)	$7,146	$5,571	$12,718	$17,369
	41.1%	32.1%	73.2%	
Credit Unions	$795		$795	$883
	90.1%		90.1%	
GSEs				
Fannie Mae		$3,278	$3,278	$3,278
Freddie Mac		$2,204	$2,204	$2,204
Farm Credit System		$196	$196	$196
Federal Home Loan Banks		$726	$726	$726
Total		$6,405	$6,405	$6,405
		100.0%	100.0%	
Private Employer Pension Funds	$2,630		$2,630	$2,994
	87.8%		87.8%	
Money Market Mutual Funds		$2,691	$2,691	$2,691
Other Financial Firms		$170	$170	$14,126
Total for Financial Firms	**$10,572**	**$14,838**	**$25,409**	**$44,468**
Percentage of Total Liabilities	**23.8%**	**33.4%**	57.1%	**100.0%**

Note: Total guaranteed liabilities ($25,409 B) as a share of GDP ($14,991 B) equals 169%, using this table's estimate.

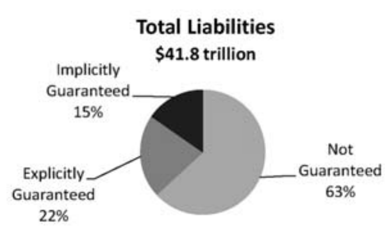


Least Inclusive Estimate

Financial Firms (in billions)	**Explicitly Guaranteed Liabilities (A)**	**Implicitly Guaranteed Liabilities (B)**	**A+B**	**Total Liabilities**
Banking & Saving Firms (includes BHCs & SLHCs)	$5,577 32.1%		$5,577 32.1%	$17,369
Credit Unions	$795 90.1%		$795 90.1%	$883
GSEs				
Fannie Mae		$3,278	$3,278	$3,278
Freddie Mac		$2,204	$2,204	$2,204
Farm Credit System		$196	$196	$196
Federal Home Loan Banks		$726	$726	$726
Total		$6,405 100.0%	$6,405 100.0%	$6,405
Private Employer Pension Funds	$2,630 87.8%		$2,630 87.8%	$2,994
Money Market Mutual Funds*				
Other Financial Firms				$14,126
Total for Financial Firms	**$9,003**	**$6,405**	**$15,407**	**$41,777**
Percentage of Total Liabilities	**21.5%**	**15.3%**	**36.9%**	**100.0%**

*Money market mutual fund shares are not treated as liabilities in this estimate.

Note: Total guaranteed liabilities ($15,407 B) as a share of GDP ($14,991 B) equals 103%, using this table's estimate.



Methodology and Sources

Banking and Savings Firms

Explicitly Guaranteed Liabilities – FDIC-insured deposits of all commercial banks and savings institutions (up to the $250,000 insurance limit), which includes transaction accounts covered by the FDIC's Transaction Account Guarantee (TAG) program[1] plus debt guaranteed by the FDIC's Debt Guarantee Program (DGP).[2] (Both of these FDIC programs expired Dec. 31, 2012.)

Implicitly Guaranteed Liabilities In our most inclusive estimate of the safety net, we include total liabilities of the four largest banking institutions (those larger than $1 trillion in assets)[3] minus insured deposits (included in explicit column); plus short-term liabilities (federal funds, repurchase agreements, commercial paper, and other short-term liabilities as reported in financial reports)[4] and uninsured deposits[5] of the 34 bank and savings and loan holding companies (beyond the four largest) with assets greater than $50 billion.

Four largest banking institutions – During the financial turmoil of 2008 and 2009, the government promised to provide capital if needed by any of the largest 19 bank holding companies (BHCs) such that their operations could continue uninterrupted, encouraging the view that all liability-holders of these firms would be protected. However, the Orderly Liquidation Authority (OLA) provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) may reduce the likelihood that these companies would receive capital injections to allow their uninterrupted operation. Nevertheless, one can imagine that many market participants will remain skeptical that the government would allow operations of the very largest and most systemically important institutions to be disrupted, even if the interruption might be minimized and carefully managed by the OLA process.[6] As a result, our most inclusive estimate includes all of the liabilities of the four largest companies.

Short-term liabilities – Market participants might expect that the short-term liabilities of large financial firms would be protected if the firms are resolved under the OLA. All bank and savings and loan holding companies (SLHCs) with assets greater than $50 billion have been designated as systemically important financial institutions (SIFIs). While a SIFI designation does not necessarily imply OLA treatment in resolution, market participants are likely to expect that these institutions would not be allowed to enter bankruptcy because it seems ill-suited to handle the failure of SIFIs (Pellerin and Walter 2012, p. 14–16). The OLA provisions of Dodd-Frank permit the FDIC to pay some creditors more than bankruptcy might allow (Pellerin and Walter 2012, p. 16), and the FDIC's OLA implementing rule suggests that this treatment could apply to short-term creditors (FDIC final rule, July 15, 2011, 12 CFR 380, p. 41644). Therefore, we include short-term liabilities of the SIFI-designated banking institutions in our most inclusive estimate.

Uninsured deposits – Historically, uninsured depositors in the largest institutions have been protected (Walter and Weinberg, 2002, p. 380). Additionally, most uninsured depositors were protected during the bank failures that occurred following the financial crisis that began in 2008. Given these facts, market participants are likely to expect uninsured depositors at the largest banking companies (those with more than $50 billion in assets) to be protected from losses in future financial crises.

Least Inclusive Estimate

Explicitly guaranteed liabilities – Drops (compared to Most Inclusive Estimate) liabilities covered by TAG and DGP given that such deposits and debt lost their FDIC coverage as of Dec. 31, 2012. In future failures, such programs may not be in place.

Implicitly guaranteed liabilities – Drops all liabilities of the four largest banking companies based on an assumption that these four BHCs will be handled through the OLA process and liability holders will suffer losses. Drops short-term liabilities of banking companies with assets greater than $50 billion, based on an assumption that OLA treatment may not provide any special protection for such liabilities. Uninsured deposits at banking companies larger than $50 billion are dropped under the assumption that the FDIC might not protect such depositors in future bank failures.

Total Liabilities – Includes total liabilities of BHCs[7] and SLHCs,[8] plus total liabilities of banks and thrifts not owned by BHCs or SLHCs,[9] plus total liabilities of U.S insured branches of foreign head offices.[10]

Credit Unions

Explicitly Guaranteed Liabilities – Total credit union shares at or below the $250,000 National Credit Union Administration coverage limit.[11]

Total Liabilities – Total credit union liabilities.[12]

GSEs

Implicitly Guaranteed Liabilities of:

Fannie Mae – Total liabilities, unconsolidated Fannie Mae mortgage-backed securities held by third parties and other Fannie Mae guarantees.[13]

Freddie Mac – Total liabilities, non-consolidated Freddie Mac securities and other guarantee commitments.[14]

Farm Credit System – Total liabilities and Farmer Mac guarantees.[15]

Federal Home Loan Banks – Total liabilities.[16]

Pension Funds

Explicitly Guaranteed Liabilities – Liabilities of all pension funds insured by the Pension Benefit Guaranty Corporation (PBGC), which insures only defined-benefit plans, were $2,570 billion in 2009, the latest date for which data are estimated.[17] This figure is inflated by twice the average annual growth rate (because 2009–2011 involves two years of growth) of PBGC-insured pension liabilities from 1999–2009 to obtain our estimate of all liabilities in pension funds insured by the PBGC as of Dec. 31, 2011 ($2,769 billion). Since the PBGC covers pensions only up to a specified maximum payment per year, a portion of beneficiaries' pensions in guaranteed plans—those with pensions paying above this maximum—are not insured. According to the PBGC, this portion is estimated to be 4 percent to 5 percent.[18] To arrive at the guaranteed portion of PBGC guaranteed pension fund liabilities, we multiplied total 2011 fund liabilities ($2,769 billion) by 0.95 to yield $2,630 billion.

Total Liabilities – There appears to be no published data estimating total liabilities of all private-employer defined-benefit pension funds. Therefore, we develop our own estimate of total liabilities based on PBGC data. The PBGC insures a portion of private sector single-employer defined-benefit plans, but almost all multi-employer plans.[19] The PBGC does not insure certain single-employer plans, importantly those offered by religious organizations and professional service employers (for example, those employing doctors and lawyers) with fewer than 26 employees. In the following, we refer to this uninsured group as Group U.

In order to calculate the dollar amount of all insured and uninsured pension funds in the United States, we inflate the amount of pensions insured by the PBGC (estimated above at $2,769 billion) to account for the Group U pensions. As a starting point for our calculation, we use the Bureau of Labor Statistics' (BLS) Quarterly Census of Employment and Wages to determine Group U's total wages as a percent of total private wages in the United States. The BLS provides data on the number of employees who work for professional service employers and for religious organizations and their wages. We use these data to calculate the proportion of wages earned by workers in these sectors relative to all U.S. workers (10 percent). We then inflate our total liability figure by this proportion.[20]

To derive our figure for total pension fund liabilities, we divide the single-employer portion of all PBGC-guaranteed pensions ($2,029 billion) by 0.9, which is 1 minus the percent of United States wages earned by Group U, thereby inflating it to account for the Group U employees. That results in a total of $2,254 billion in liabilities for single-employer programs. We then add the multi-employer portion ($740 billion) to arrive at $2,994 billion in total liabilities for all insured and uninsured pension funds in the United States.[21]

Money Market Mutual Funds

Implicitly Guaranteed Liabilities – Total net assets of money market mutual funds (MMFs).[22] Included because the federal government protection that was granted to MMFs in 2008 implies that market participants could view MMFs as being likely to receive government protection in future financial crises.

Least Inclusive Estimate – Walter and Weinberg (2002) and Malysheva and Walter (2010) excluded MMF balances because the principal value of mutual fund investments, including MMF investments, can decline, without the mutual fund defaulting, if the entity in which the funds are invested defaults. As a result, these investments are akin to equity and unlike private liabilities—the focus of our estimates—which typically must pay back full principal (or else be in default). For example, an investor in an MMF, which in turn invested in financial firm commercial paper, could lose principal if the commercial paper were not repaid, but the MMF can continue to operate (i.e., not default). We drop MMF balances in our least inclusive table for this reason and based on the idea that they might not be protected by the government in future crises.

Other Financial Firms

Implicitly Guaranteed Liabilities – Short-term liabilities (repurchase agreements, commercial paper, and other short-term liabilities with original maturities less than or equal to one year) of those non-banking financial companies that could be deemed to be SIFIs by the Financial Stability Oversight Council (FSOC)—meaning those firms that appear likely to move past FSOC's stage-one designation rule analysis announced on April 3, 2012. (See FSOC's final rule, April 11, 2012, 12 CFR Part 1310, p. 21643.) To move past the stage-one test, the firm must have assets exceeding $50 billion and also exhibit at least one of the following features:

- Have more than $30 billion in outstanding credit default swaps;
- Have more than $3.5 billion in derivative liabilities;
- Have more than $20 billion in outstanding loans or bonds;
- Have a leverage ratio (assets to equity) of greater than 15-to-1;
- Have a short-term debt-to-total assets ratio of greater than 10 percent.

Market participants might expect that the short-term liabilities of large financial firms that are designated as SIFIs would be protected if the firm is resolved under the OLA. While a SIFI designation does not necessarily imply OLA treatment in resolution, market participants are likely to expect that these institutions will not be allowed to enter bankruptcy because it seems ill-suited to handle the failure of SIFIs (Pellerin and Walter 2012, p. 14-16). The OLA provisions of Dodd-Frank permit the FDIC to pay some creditors more than bankruptcy might allow (Pellerin and Walter 2012, p. 16), and the FDIC's OLA implementing rule suggests that this treatment could apply to short-term creditors (FDIC final rule, July 15, 2011, 12 CFR Part 380, p. 41644). Therefore, in our most inclusive estimate, we include short-term liabilities of these firms that may be designated as SIFIs.

Least Inclusive Estimate – Excludes short-term liabilities of financial firms that may be designated as SIFIs, based on the possibility that OLA might not provide any special protection for such liabilities.

Total Liabilities – Includes the aggregate amount of liabilities outstanding as of Dec. 31, 2011, from each nonbank financial sector as reported in the Board of Governor's Flow of Funds Statistical Release. Those financial sectors include:

- Property-Casualty Insurance Companies
- Life Insurance Companies
- Issuers of Asset-Backed Securities
- Finance Companies
- Real Estate Investment Trusts
- Security Brokers and Dealers
- Funding Corporations

[1] Federal Deposit Insurance Corporation. *FDIC Quarterly*, 2012, vol. 6, no. 1, pp. 18. "Table III-B: Estimated FDIC-Insured Deposits by Type of Institution." http://www2.fdic.gov/qbp/2011dec/qbp.pdf.

[2] Federal Deposit Insurance Corporation. "Monthly Reports Related to the Temporary Liquidity Guarantee Program, Debt Issuance under Guarantee Program." Dec. 31, 2011.
http://www.fdic.gov/regulations/resources/tlgp/total_issuance12-11.html

[3] Consolidated Statements for Bank Holding Companies (FR Y9C)

[4] Our primary source is corporate annual reports because they report short-term liabilities with original maturities of less than one year. FR Y9C uses a broader definition of "other short-term liabilities," one that includes liabilities that may have had original maturities greater than one year. When the top tier was a foreign holding company, we gathered data on specific short-term liabilities (federal funds, repurchase agreements, and commercial paper, almost all of which have original maturities of less than one year) from FR Y9C because FR Y9C contains data only on the U.S. subsidiaries, so it excludes liabilities of foreign subsidiaries. To capture as many liabilities as possible that would likely fall into the FR Y9C's "other short-term liabilities" category, we then reviewed the call reports to find any additional U.S. subsidiary short-term borrowings (e.g. FHLB advances with original maturities of less than one year) that the FR Y9C does not separately report. When available, we used average figures. We also added "securities loaned" when it was included as a separate line item from repos.

[5] "Deposits held in domestic offices" minus "estimated insured deposits" from the FDIC's report that collects data from individual call and thrift financial reports (TFRs) of the insured subsidiaries of a BHC or SLHC.

[6] See, for example: http://www.bloomberg.com/news/2012-04-16/obama-bid-to-end-too-big-to-fail-undercut-as-banks-grow.html;
http://www.nypost.com/p/news/opinion/opedcolumnists/too_big_to_fail_grows_cVFocOFPEAJyQ4LgCR2ilO;
http://www.reuters.com/article/2011/07/12/financial-regulation-research-idUSN1E76B1II20110712; and
https://www.law.upenn.edu/blogs/regblog/2012/09/11-lipson-orderly-liquidation-authority.html.

[7] From FR Y9C and FR Y9SP.

[8] From a memorandum item on the TFRs that provides total liabilities consolidated across the holding company.

[9] Bank data from Consolidated Reports of Condition and Income for a Bank, FFIEC 031 and FFIEC 041, and thrift data from TFRs.

[10] FFIEC 002 Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks.

[11] *National Credit Union Administration 2011 Annual Report*. Page 76.

[12] Board of Governors of the Federal Reserve System. "Credit Unions, Table L.115." Federal Reserve Statistical Release Z.1, March 8, 2012. "Flow of Funds Accounts of the United States."
http://www.federalreserve.gov/releases/z1/20120308/z1.pdf.

[13] Fannie Mae Form 10-K. Dec. 31, 2011. Page 83.
http://www.sec.gov/Archives/edgar/data/310522/000119312512087297/d282546d10k.htm

[14] Freddie Mac Form 10-K. Dec. 31, 2011. Page 203 and page 209.
http://www.sec.gov/Archives/edgar/data/1026214/000102621412000039/f71787e10vk.htm

[15] Federal Farm Credit Banks Funding Corporation. "2011 Annual Information Statement of the Farm Credit System." Page 3 and page 12, Feb. 29, 2012. http://www.farmcreditfunding.com/farmcredit/serve/public/pressre/finin/report.pdf?assetId=199279

[16]Federal Home Loan Banks. "2011 Combined Financial Report." Page F-4, March 29, 2012. http://www.fhlb-of.com/ofweb_userWeb/resources/11yrend.pdf

[17] Pension Benefit Guaranty Corporation. 2010 Pension Insurance Data Tables. "Table S-44: Funding of PBGC-Insured Plans (1980–2009) Single-Employer Program" and "Table M-9: Funding of PBGC-Insured Plans (1980–2009) Multiemployer Program." http://www.pbgc.gov/Documents/pension-insurance-data-tables-2010.pdf

[18] Pension Benefit Guaranty Corporation. *Pension Insurance Data Book 2006*. Page 20, footnote 11. http://www.pbgc.gov/documents/2006databook.pdf. And,
Pension Benefit Guaranty Corporation. *Pension Insurance Data Book 1996*. Footnote to Table B-5. http://www.pbgc.gov/documents/1996databook.pdf

[19] Pension Benefit Guaranty Corporation. *Pension Insurance Data Book 2008*. Page 5. http://www.pbgc.gov/docs/2008databook.pdf

[20] Note that our estimate could slightly overstate or understate the amount of total liabilities from private pension funds because the PBGC does not insure pensions provided by employers in these sectors with fewer than 26 employees, while the BLS's closest comparable category breakdown is fewer than 20 employees.

[21] Bureau of Labor Statistics. "Quarterly Census of Employment and Wages." Annual and quarterly data from 2011. http://www.bls.gov/cew/

[22] Investment Company Institute. *2012 Investment Company Fact Book*. Page 170. "Table 37: Total Net Assets and Number of Shareholder Accounts of Money Market Funds by Type of Fund." http://www.ici.org/pdf/2012_factbook.pdf

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Orderly Liquidation Authority as an Alternative to Bankruptcy

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When a large nonbank financial firm becomes troubled and in danger of default, government policymakers traditionally have had two options: they could 1) allow the firm to enter bankruptcy, or 2) if policymakers believed bankruptcy is likely to produce widespread (system-wide or "systemic") financial difficulties, the government could provide aid (i.e., a bailout) to forestall failure. In 2010, a third option was made available by the Orderly Liquidation Authority (OLA) provisions, contained in the Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). This legislation authorizes the Federal Deposit Insurance Corporation (FDIC) to pursue an agency-administered wind down for certain troubled financial firms. The OLA provisions are modeled, in part, after the process long followed by the FDIC for handling troubled banks.

The OLA provisions are a reaction to policymakers' and legislators' dissatisfaction with the two options previously available for handling failing nonbanks. For example, Ben Bernanke, chairman of the Board of Governors of the Federal Reserve System, argued, in 2009 testimony before the House Committee on Financial Services, that bankruptcy was not an effective option for certain failing financial firms (Bernanke 2009):

> In most cases, the federal bankruptcy laws provide an appropriate framework for the resolution of nonbank financial institutions. However, the bankruptcy code does not sufficiently protect the public's strong interest in ensuring the orderly resolution of a nonbank financial firm

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> whose failure would pose substantial risks to the financial system and to the economy. Indeed, after Lehman Brothers and AIG's experiences, there is little doubt that we need a third option between the choices of bankruptcy and bailout for such firms.

In a 2010 speech, Chairman Bernanke expanded on his testimony and noted two goals for this "third option," or "orderly resolution" authority (Bernanke 2010):

> The government instead must have the tools to resolve a failing firm in a manner that preserves market discipline—by ensuring that shareholders and creditors incur losses and that culpable managers are replaced—while at the same time cushioning the broader financial system from the possibly destabilizing effects of the firm's collapse.

Legislators focused on these two goals in the language of the Dodd-Frank Act itself when explaining the purposes of the OLA provisions (or the OLA "title"):

> It is the purpose of this title to provide the necessary authority to liquidate failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard.

In this article we review the features of bankruptcy and the OLA. We identify some problem areas when large nonbank financial firm failures are resolved through bankruptcy. We then describe two important features of the OLA that are meant to improve on bankruptcy as a means of handling these types of failures, and discuss how they attempt to achieve the goals of mitigating risk to financial stability while also minimizing moral hazard—goals that are not easily achieved simultaneously.

1. FAILURE RESOLUTION

Goals of any Failure Resolution Regime

Any resolution regime, whether bankruptcy, bailout, or OLA, must address two fundamental problems that arise when a firm faces financial troubles and becomes unable to repay creditors. These three regimes each take different approaches to solving these problems, and these differing approaches are at the core of each regime. The first problem (detailed below) is preserving "asset complementarities" and "going-concern value" in the face of detrimental creditor incentives to rush in and grab the firm's assets immediately upon a firm's default. Resolution methods must take these incentives into account and prevent the detrimental actions. The second problem is determining whether to "liquidate" or "reorganize" the troubled firm. Beyond addressing these two problems, an additional concern arises when the troubled firm is a large financial firm or one with many interconnections with other financial firms: What so called *systemic effects* might the liquidation or reorganization have? Will there be a significant negative effect on other financial firms or on the macro economy in response to actions taken to resolve the troubled firm? As noted in the introduction, policymakers are likely to have a strong interest in any systemic effects when deciding on the appropriate resolution method.

Preserving Complementarities and Going-Concern Value

Following a firm's default on a debt, creditors are likely to rush to seize, and separately sell, assets that, if sold together with other assets, could produce a higher sale price (assets that are "complementary"). For example, one can imagine that with numerous creditors vying for a manufacturer's assets, individual components of an assembly line might be sold off separately, when, if sold as a complete assembly line, these components would be of greater value and produce a higher price. Therefore, this incentive can reduce the total amount that creditors, as a group, receive and can also undercut productivity and economic efficiency. Creditors who manage to be the first to seize assets are likely to recover a higher proportion of their debts than creditors who are slower to react. As a result, creditors have a strong individual incentive to move quickly to undertake such seizures. Preserving complementarities can be important whether the firm is liquidated or is preserved via a reorganization process.

If creditors are allowed to rush in and seize assets, they are also likely to grab those assets that are fundamental to the firm's continued operations, so called "going-concern assets." Such assets might include, for example, necessary operating equipment for a manufacturing firm, or buildings for a financial firm. For a firm that is going to be closed and liquidated, protecting going-concern assets is unimportant, but for firms that might be successful if reorganized, creditors will be made better off, as a group, if their removal is prevented. Indeed, if creditors are allowed to seize going-concern assets, a troubled firm that might otherwise become quite productive in reorganization could be doomed to fail by the asset seizures.

In bankruptcy, the automatic stay (discussed in detail below) prevents immediate asset seizures, and creates a court-overseen process for allocating assets in a way that preserves complementarities and going-concern value.[1,2] The OLA process also involves a stay, but grants the FDIC this preservation role. Bailouts, by (typically) preventing the troubled firm's default on debts, remove the ability of creditors to seize the troubled firm's assets.[3]

Determining Whether to Liquidate or Reorganize

When a firm becomes unable to meets its debt payments, one of two outcomes are possible. First, as already mentioned, the firm might be closed and its assets liquidated. Alternatively, if the firm can be returned to profitability by restructuring (typically reducing) its debts, then, in many cases, it should be reorganized, allowing it to continue operating after a debt restructuring process. If the firm is unlikely to return to profitability, even with a lowered debt burden, because the firm's assets are unlikely to produce a market rate of return, then the firm should be liquidated: The firm should be shut down and its assets sold to the highest bidders. In this case, liquidation will distribute assets to firms that can make more productive use of them, enhancing economic

[1] According to Boul (2006): "Traditionally, the automatic stay has served to 'prevent dismemberment of the [bankruptcy] estate and insure its orderly distribution.' *SEC v. First Financial Group*, 645 F.2d 429, 439 (5th Cir.1981), *citing* S. Rep. No. 95-989, 95th Cong., 2d Sess. 50 (1978); H.R.Rep. No. 95-595, 95th Cong., 2d Sess. 341 (1977), U.S.Code Cong. & Admin. News 1978, pp. 5787, 5836, 5963, 6297, 6298. In that capacity, the automatic stay serves the interests of both the debtor and the creditors of the bankruptcy estate. For the debtor, it provides a 'breathing spell' by 'stopping all collection efforts, all harassment, and all foreclosure actions.' S. Rep. No 95-989, 95th Cong., 2d Sess. 54-55 (1978); H.R. Rep. No 95-595, 95th Cong., 1st Sess. 340 (1977), U.S.Code Cong. & Admin. News 1978, pp. 5787, 5840, 5841, 5963, 6296, 6297. However, the stay also serves the interest of creditors, insofar as it 'eliminate[s] the impetus for a race of diligence by fast-acting creditors.' *SEC v. First Financial Group*, at 439. The stay ensures that assets are distributed according to the order of priorities established by Congress. *Id. at 341.*"

[2] Note that if the troubled firm had only one creditor, there would be no need for bankruptcy since that one creditor would always take actions that maximize complementarities and going-concern value. Only in the case where there are many creditors, who, because of their large number, cannot easily coordinate with one another, is bankruptcy necessary.

[3] One might imagine that an ideal solution—when a firm has suffered losses such that its capital level is low and default seems likely, but it could be profitable with a lower debt load—one that requires no intervention by bankruptcy courts or government agencies, is for the firm to gather new funding by issuing new equity shares. The new funding could be used to purchase new, profitable assets that will increase revenues available to service debt (lowering the ratio of debt to assets) and reduce significantly the chance of default. This course may be impossible, however, because of the so-called "debt overhang problem" and, as a result, bankruptcy and the reorganization of debt may be the only course available. Because of the overhang problem, existing equityholders will not vote in favor of a new equity issuance. They will not do so, at least in many cases, because most or all of the benefit flows to the debtholders by improving the market value of their debt, and the existing equityholders will suffer dilution because future earnings must be shared with the new equityholders (Duffie 2011, 43–4). The likelihood that new issues of equity might offer a solution is further reduced by an "adverse selection problem." Weak firms issuing new equity, and especially those firms whose assets are opaque, i.e., financial firms, will have to offer to sell shares at a very low price, because equity investors are likely to conclude, based on the fact that the firm wishes to issue new shares, that the firm is in exceptionally poor health (even worse health than it really is). As a result, existing shareholders will suffer a great deal of dilution and vote against new issues.

productivity and efficiency. Any resolution regime is faced with a decision between liquidation and resolution, and, ideally, will choose the one that produces the most economically efficient outcome.

Addressing Systemic Risk[4] and Moral Hazard

When faced with the failure of a large financial firm, or one with many connections with other financial firms, government decisionmakers will not only wish to ensure that complementarities and any going-concern value are preserved, and that the choice between liquidation or reorganization is optimally made, but they will also care greatly about systemic effects. Simply bailing out the troubled firm will prevent its failure, preserve complementarities and going-concern value, as well as avoid systemic effects. But any bailouts will create a "moral hazard" problem: the view, among investors, that large financial firms are likely to be protected, such that in the future, creditors of such firms will reduce their risk-monitoring efforts and these firms will be willing to undertake an inefficiently large amount of risk-taking. Therefore, any method employed to resolve a large or interconnected financial firm must balance systemic dangers against the danger of excessive risk-taking. Bailouts prevent current systemic problems but are likely to lead to less efficient resource allocation choices in the future. Relying on bankruptcy can avoid future moral hazard because, as discussed later, bankruptcy provides no source of funds for bailouts, but the bankruptcy of a large financial firm carries the risk of heavy current systemic problems. As such, when Congress crafted the OLA, addressing systemic risk was a priority, but so was resolving firms in a manner that does not simultaneously increase moral hazard. The OLA aims to address systemic risks that may otherwise be present when resolving systemically important financial institutions (SIFIs) through bankruptcy, in part, by 1) giving the FDIC broad discretion in how it funds the resolution process and pays out creditors, as well as by 2) changing the way derivatives and repurchase agreements (repos)—known as qualified financial contracts ("QFCs")—are treated.

Overview of Bankruptcy and OLA

When comparing bankruptcy and OLA, understanding their overarching goals is important. The goal of a bankruptcy proceeding is to maximize recoveries for creditors, through liquidation or the rehabilitation of the debtor. The goal of the OLA, on the other hand, is to resolve "failing financial companies that

[4] There is no clear consensus about the definition of "systemic risk" (See Taylor 2010). For purposes of this article, we will define systemic risk as "the risk that the failure of one large institution would cause other institutions to fail or that a market event could broadly affect the financial system rather than just one or a few institutions" (Government Accountability Office 2011).

pose a significant risk to the financial stability of the U.S. in a manner that mitigates such risk and minimizes moral hazard."

Bankruptcy achieves its goals through a court-overseen process that relies largely on the troubled firm's creditors and other investors to decide how best, and most profitably, to resolve the firm's troubles. Funding for a bankruptcy resolution typically comes only from the assets of the troubled company and from any funds that might be provided by private investors. See Table 1 for an outline of the bankruptcy process.

OLA borrows several important ideas from bankruptcy, but moves beyond bankruptcy because of policymakers' dissatisfaction with possible outcomes under bankruptcy. The OLA attempts to capture the firms whose resolution through bankruptcy could be detrimental to the broader financial system. Therefore, the OLA can be differentiated from bankruptcy based on several notable features that are designed specifically with SIFI, or covered financial company (CFC), resolution in mind. See Table 2 for a review of OLA's main features.

During the 2007–2008 financial crisis, an unwillingness to trust large firm failures to bankruptcy often resulted in government assistance to firms popularly described as "too big to fail," such as Bear Stearns and AIG. Yet the grant of government assistance sent strong signals to the market that other, similar firms would receive assistance as well if they were to experience trouble, thereby expanding credit subsidies for certain firms and moral hazard. For example, bond prices for the largest financial institutions remained relatively high during the crisis and prices for Lehman credit default swaps (CDS) may not have accurately reflected default risk (Skeel 2010). In contrast, allowing Lehman to fail can be seen as an attempt to mitigate moral hazard; however, some argue this was done at the cost of creating systemic risk.[5] These objectives are inextricably linked, and focusing on the reduction of one has the likely result of increasing the other. Therefore, the OLA, which charges the FDIC with administering these provisions, was an attempt to address this conflict. How does the FDIC meet this challenge?

[5] The apparent worsening of the 2008 financial crisis following Lehman's entrance into bankruptcy provides, for many observers, an illustrative example of the deleterious effect of resolution by bankruptcy for large financial firms. Yet there is some debate about the conclusions one should draw from the Lehman experience. Some observers maintain that the cascading losses following Lehman's bankruptcy filing were not a result of troubles or anticipated troubles related to the bankruptcy process itself, but were instead the result of a shock to market expectations and therefore to the risk assessments of those who had previously anticipated that Lehman, and firms like Lehman, would certainly be bailed out (see Testimony from Skeel before the Subcommittee on Commercial and Administrative Law, Committee on the Judiciary, U.S. House of Reps., October 22, 2009). Available at http://judiciary.house.gov/hearings/pdf/Skeel091022.pdf.

Table 1 Corporate Bankruptcy

Types of Bankruptcy	
Chapter 7	Chapter 7 bankruptcy (liquidation), the troubled firm is closed down, with the longer-run outcome being the sale of all the company's assets (liquidation) because creditors or management do not believe it can be successfully reorganized.
	Assets of the troubled firm are assembled by the *bankruptcy trustee* and then sold in a manner that maximizes the sum of the payouts to the creditors.
	The trustee typically must sell all of the bankrupt firm before distributing funds to creditors [11 U.S.C. 704(a)1].
Chapter 11	Under Chapter 11 bankruptcy (reorganization), the troubled firm's debts are reorganized: debt maturities are lengthened, or interest rates or principal amounts are reduced.
	Creditors will only agree to a reorganization if they believe that preserving the firm as a *going concern* will produce larger payments than if the firm is liquidated.
Corporate Bankruptcies are Overseen by Federal Courts	
	The operating arm of the bankruptcy courts is the Justice Department's Trustee program, so that most bankruptcies are largely handled by trustees.
Circumstances Under which a Firm Enters Bankruptcy	
Voluntary Bankruptcy	When a firm's management petitions the court to place the firm in bankruptcy because it is unable to pay all its creditors in full. A firm will file for bankruptcy when unpaid creditors will otherwise seize complimentary or going-concern assets.
Involuntary Bankruptcy	When a firm's creditors petition for bankruptcy. Creditors have incentive to seek a firm's bankruptcy when they believe that other creditors might seize complementary or going-concern assets or that the firm might dissipate assets.

Table 1 (Continued) Corporate Bankruptcy

Automatic Stay

Immediately, upon the filing of a bankruptcy petition with the clerk of the bankruptcy court, creditors' are prohibited ("stayed") from attempting to collect on their claims.

The stay allows a government-appointed trustee to ensure that assets of the bankrupt firm are liquidated in a manner that maximizes the total pool of funds available for creditor repayment.

As a result, the stay allows the trustee to produce a better result for creditors in aggregate than if creditors were simply acting in their own self interest. The trustee can be thought of as solving a joint action problem. Similarly, the stay is also the means in bankruptcy by which creditors are prevented from seizing going-concern assets.

Qualified financial contract (QFC) holders are typically exempt from the automatic stay: They can retrieve their collateral in the event of bankruptcy.

- Under bankruptcy law a number of financial instruments are QFCs, including repurchase agreements (repos), commodity contracts, forward contracts, swap agreements, and securities contracts.
- Reasons for the QFCs exemption:
  - Observers worry that preventing QFC holders from retrieving their collateral could create systemic financial problems.
  - Some observers believe that QFCs are not complementary with one another or with other assets, and can be removed without undercutting the troubled firm's going-concern value.

Priority Rules	
In Liquidation	Payouts coming from asset sales are divided among creditors based upon the creditor's location in the priority order, which is established in the Bankruptcy Code.
	Secured creditors are repaid from the assets that secure their debts prior to payments to unsecured creditors.
	A secured creditor will be fully repaid if the value of his security exceeds the amount he is owed.
	If not, he joins unsecured creditors and must depend on the sale of other assets for repayment.
	Unsecured claimants are paid based on the following priority list (White 1998, 1):
	First to be repaid are those owed any administrative expenses produced by the bankruptcy process.
	Second, claims are given statutory priority, such as taxes owed, rent, and unpaid wages and benefits.
	Third are unsecured creditors' claims, including trade creditors' claims, long-term bondholders, and holders of damage claims against the bankrupt firm.
	Last, equityholders receive any remaining funds.
In Reorganization	Payments to creditors and equityholders will often differ from those that would arise based simply on priority rules, because reorganization payments typically arise from negotiation between creditors and equityholders (White 1998, 8).
	Reorganization negotiations are driven by two rules: 1) each class of creditors and equityholders must consent to the bankruptcy plan adopted in the negotiation, and 2) if the negotiation produces no plan that is acceptable to all classes, then the firm is liquidated and payments are determined by the priority rules listed above.
	Because of the mutual consent requirement, some classes can be expected to receive more than would be expected if the priorities rules were strictly followed. For example, if assets are insufficient to repay all creditors, abiding by the priority rule would mean equityholders could expect to receive nothing.
	But creditors are likely to allow equityholders to receive payments in exchange for the investors' agreement to a plan that allows reorganization rather than liquidation, because the reorganization preserves some going-concern value for all classes. In other words, an equityholder agreement is achieved by paying them more than they would get if they held up the plan.
Debtor-in-Possesion (DIP) Loans	
	Loans made to a firm in reorganization, post-bankruptcy filing.
	Such loans are often senior to all pre-bankruptcy debts.

When the FDIC is appointed as the receiver of a failing financial firm designated as a CFC, it assumes complete financial and operational control of the institution. The FDIC has the authority to manage, sell, transfer, or merge all the assets of the failing firm, as well as provide the funds needed for an orderly liquidation, giving it broad discretion.[6] The FDIC's guiding principles in carrying out these responsibilities include using its best efforts to maximize returns, minimize losses, and, unique to this regime, mitigate the potential for serious adverse effects to the financial system and minimize moral hazard.[7] Moreover, the language of the OLA forces the FDIC to balance two competing interests. On one hand, it is to pay creditors no more than what they would receive in bankruptcy[8] and ensure that creditors bear losses in order to promote market discipline. On the other hand, it is to minimize adverse effects on financial stability. In bankruptcy, creditors only inject additional funds when the firm seems viable. The FDIC, on the other hand, may find it necessary to prop up a firm or perhaps protect certain creditors, at least for a time, to prevent any potential systemic consequences even though the firm may not be viable. The Dodd-Frank Act granted the FDIC a line of credit from the Treasury to fund these efforts. Because the FDIC has broad discretion over the way in which it balances these competing objectives, market participants may find it difficult to predict which objective might receive more weight in any given failure.

2. KEY FEATURES OF BANKRUPTCY, ITS WEAKNESSES, AND OLA AS AN ALTERNATIVE

In the United States, the failure of a business firm typically results in that firm entering *bankruptcy*, and actions taken by the firm shift from being determined by management to being guided by rules established under federal law, specifically under the U.S. Bankruptcy Code. What are the core features of bankruptcy? What features lead observers to conclude that bankruptcy is not an appropriate way to handle a SIFI whose failure could pose substantial risk to the financial system? What are the alternative resolution arrangements created by Dodd-Frank's OLA provisions?

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[6] The OLA gives the FDIC authority to operate the company "with all of the powers of the company's shareholders, directors and officers, and may conduct all aspects of the company's business." Dodd-Frank Act § 210(a)(1)(B).

[7] Dodd-Frank Act § 204(a) and § 210(a)(9)(E).

[8] Dodd-Frank Act § 210(d)(2). Under § 210(d)(4)(A) additional payments (in excess of what would be received in bankruptcy) are authorized only with approval of the Treasury Secretary and only if determined to be necessary or appropriate to minimize losses to the receiver.

Table 2 OLA

Who Qualifies as a "Covered Financial Company" (CFC)?
A "financial company" whose failure would have serious adverse effects on financial stability.

Process for Designating a Firm as a CFC
1. Recommendation by Federal Reserve and either FDIC, Securities and Exchange Commission, or Federal Insurance Office, based on their findings that the following is true for the financial company:
    - It is in default or in danger of default
    - A resolution under the Bankruptcy Code would produce serious adverse consequences
    - There is no viable private-sector alternative
2. Determination made by the Treasury Secretary in consultation with the President
3. Appointment of FDIC as receiver of CFC

The FDIC's Powers and Duties
- They can 1) sell the CFC, or any portion of the assets or liabilities to a third party; 2) establish a temporary bridge financial company to preserve the company's value prior to being sold to a third party; or 3) liquidate the company.
- Use their best efforts to maximize returns, minimize losses, and mitigate the potential for serious adverse effects to the financial system.
- Must ensure unsecured creditors bear losses and ensure the directors and management team responsible for the company's condition are removed.
- Has authority to make additional payments to certain creditors (over what their priority would demand and possibly more than similarly situated creditors) if determined to maximize value or limit losses (excess may be "clawed back"), see below.

FDIC's Access to Funding
- Treasury: FDIC may immediately borrow funds from the Treasury (up to 10 percent of the CFC's pre-resolution book-value assets within first 30 days; 90 percent once fair-value is determined and liquidation and repayment plan is in place and approved by Treasury)
- If funds from disposition of failed firm's assets are insufficient to repay Treasury:
    - Creditors (who were paid more than they would in bankruptcy) would have to return excess funds ("claw backs")
    - Large financial institutions can be assessed

Notes: "Financial Company" includes bank holding companies, nonbank financial firms, and securities broker-dealers. Nonbank financial firms are characterized as firms that are supervised by the Fed (because of SIFI designation) or that derive at least 85 percent of their revenues from activities that are financial in nature.

Key Bankruptcy Feature: The Automatic Stay

The "automatic stay" is a primary component of bankruptcy and one that underlies many of the complaints raised against bankruptcy as a means of handling SIFI failures. The stay works as follows. Immediately upon the filing of a bankruptcy petition with the clerk of the bankruptcy court, creditors are enjoined from attempting to collect on their claims.[9] This feature of bankruptcy allows a government-appointed trustee to ensure that assets of the bankrupt firm are liquidated in a manner that maximizes the total pool of funds available for creditor repayment. Without the stay, as discussed earlier, creditors can be expected to rush in, grab, and then sell the bankrupt firm's assets. In so doing, creditors could destroy asset complementarities. The stay typically lasts for the length of the bankruptcy process, though the courts may grant exceptions.

In a Chapter 7 bankruptcy (liquidation),[10] the type of corporate bankruptcy in which the troubled firm is closed down (liquidated), the court-appointed trustee typically must sell all of the assets of the bankrupt firm before distributing funds to creditors.[11] The goal of the trustee is to sell the assets in a manner that maximizes the sum of payouts to creditors. Achieving this maximization goal can result in a lengthy process, so that creditors' funds may be inaccessible for an extended period. Based on a study of all corporate bankruptcies from two federal bankruptcy court districts between 1995 and 2001, the average liquidation lasts 709 days (Bris, Welch, and Zhu 2006; 1,270). It seems likely that for the largest, most complex financial firms the process will take at least as long as average or perhaps longer.

Compared to liquidation, a corporate Chapter 11 bankruptcy (reorganization) process tends to last longer still, 828 days on average according to Bris, Welch, and Zhu (2006), though in reorganization creditors will often be repaid well before this process ends. In reorganization, the troubled firm's debts are rescheduled or cut—but it continues to operate.[12] A corporation that finds itself unable to repay all creditors in full can seek protection from creditors' claims by petitioning the bankruptcy court to enter reorganization. This protection from creditors, which includes a stay of claims, is important when a firm is being reorganized because the stay prevents creditors from seizing "going-concern" assets (assets that might be necessary to keep the firm running). The stay can mean that, in aggregate, creditors receive more than

[9] 11 U.S.C. § 362

[10] In the remainder of the article, for the sake of simplicity, we will typically replace the phrase Chapter 7 bankruptcy with "liquidation" and the phrase Chapter 11 bankruptcy with "reorganization." We will use the phrase "orderly liquidation" or the acronym OLA when referring to a Dodd-Frank Orderly Liquidation Authority process.

[11] 11 U.S.C. 704(a)1

[12] The airline industry provides many well-known examples of reorganization, in which planes continue to fly and contracts are renegotiated with creditors and employees.

they would if individual creditors had been allowed to seize assets to protect themselves. Because creditors must agree to the troubled firm's proposed reorganization plan—if not, the firm is likely to proceed to a liquidation—firms receiving reorganization treatment are those for which creditors, as a group, believe going-concern value exceeds the value of firm assets if such assets are sold, i.e., if the firm is liquidated (White 1998, 2–3).

While reorganization can last longer than liquidation, payouts to creditors will often be made well before the end of the reorganization process. As part of the reorganization, creditors may agree to lower repayments and some may receive these repayments quickly. Further, additional funding can flow into the troubled firm fairly quickly to help keep it afloat.

A source of funding often available to a firm in reorganization is "debtor-in-possession" (DIP) funding. In reorganization, the troubled corporation, the debtor, continues to operate, or "possess," the troubled entity. Any loans to the troubled corporation are therefore loans to the DIP. Such loans are often senior to all former—prior to the bankruptcy filing—debts of the bankrupt firm. The prospect of being senior to other creditors allows funding to flow as long as creditors can be convinced that the firm is likely to survive and therefore repay.

Key Bankruptcy Feature: Limited Sources of Funding

Repayment of a bankrupt firm's creditors and funds to sustain a firm reorganized under bankruptcy can only derive from two sources: the assets of the troubled firm, and, in the case of reorganization, added (DIP) loans that might flow to the troubled firm. While bankruptcy law and practice do not prohibit government aid to troubled firms, such funding is not typically available. As a result, creditors have an incentive to carefully evaluate the riskiness of any firm prior to providing funding and to monitor its activities once funding has been provided. Such monitoring will tend to ensure that the firm undertakes only those risks with a positive expected return. Yet, the government has often provided aid to troubled firms because of the sluggishness with which creditors are often repaid following failure and because of the apparent difficulty of lining up DIP funding. In some cases this aid has been provided prior to bankruptcy, in others during bankruptcy.[13] Therefore, the

[13] Bear Stearns and AIG provide examples of financial firms that received government aid prior to bankruptcy. In 2009, both General Motors and Chrysler received aid from the federal government during their reorganizations. Earlier cases of government aid include Penn Central Railroad in 1970, Lockheed Aircraft in 1971, and Chrysler in 1980.

monitoring advantage offered by bankruptcy can be diminished by the expectation of government aid for certain (especially large) financial firms.[14]

There is no DIP financing in a liquidation. In liquidation, a "bankruptcy estate" is created, including all of the assets of the bankrupt firm. One of the responsibilities of the trustee is to locate all assets and gather them into the estate. The estate assets are sold by the bankruptcy trustee and the proceeds of the sale provide the funds from which creditors are repaid. Funds from no source beyond the assets of the failed firm are available to the trustee and therefore to the creditors.

In a reorganization proceeding, debts are restructured in a manner such that the firm can continue operating. For example, the creditors of a firm might come together and all agree to reduce the amounts the bankrupt firm owes each of them by 30 percent, and extend the maturity of all debts by two years. As a result, the bankrupt firm faces lower monthly debt payments, payments that it might successfully manage. The creditors will only agree to such a plan if they believe that sustaining the operations of the firm is likely to mean larger payments than if the firm descends into liquidation. The debt restructuring and the mode of future operation is called the "reorganization plan" and is subject to court review and creditor appeal to the bankruptcy court. Typically the current management of the troubled firm operates the reorganized firm. If the firm's liabilities exceed its assets, owners are wiped out and the creditors inherit the decisionmaking rights formerly enjoyed by owners. The debtor can acquire funding for the reorganized firm because it can offer very favorable terms to the lenders who provide DIP funding because the new lenders have a claim that is senior to all other creditors. Thus, lenders will have an incentive to provide DIP funding if they believe that the reorganized firm is likely to be able to repay their loans from future earnings—that the reorganized firm will be profitable.

Weaknesses of Bankruptcy

A Weakness of Bankruptcy for Financial Firms: The Stay Threatens Short-Term Debtholders

While the automatic stay, in liquidation or reorganization, may cause no spread of losses when the creditors of the troubled firm are typically long-term debtholders (who are not counting on quick receipt of their funds), in the

[14] One might argue that there could be times in which government aid is appropriate, for example if credit standards have become inefficiently (or irrationally) strict, as in a financial panic. If market participants believe that government aid will only be forthcoming at such times, and will only provide the amount of funding that private lenders would provide if they had not become irrationally strict, then the expectation of government aid will not diminish private investors' risk-monitoring efforts.

case of a failing financial firm, creditors are likely to include a large contingent of those with very short-term claims. Funds invested in financial firms (such as investment banks) often have maturities of one or a few days. Creditors with such short maturity claims are likely to be dependent on the immediate access to their funds in order to pay their own creditors. If funds are tied up for an extended period, as assets are gathered and sold in a liquidation process or as a reorganization agreement is negotiated, the bankrupt firm's creditors may find themselves unable to make payments to their own creditors. As a result, the bankruptcy of one firm may result in the failure of some of its creditors, especially if some of these creditors are also financial firms with their own very short-term debts to repay. Therefore, while the automatic stay may have significant value in preventing creditors from separating complementary assets in liquidation and preserving going-concern value in reorganization, the stay, if it continues more than a very short time, may cause financial distress to spread. The importance of short-term funding, which is often present for nonbank financial firms, may make policymakers unwilling to rely on bankruptcy when such firms become troubled.

A Weakness of Bankruptcy for Financial Firms: Opacity Reduces Availability of DIP Financing

New funding, quickly available, will often be necessary in order for a troubled firm to be successfully reorganized. After all, funds from former sources may have dried up because of the losses these creditors suffered on former loans to the troubled firm. But, financial firms may find it to be relatively difficult, compared to nonfinancial firms, to quickly obtain DIP funding. Such firms often have quite opaque assets: assets that are difficult for outsiders, such as lenders, to value. For example, assets of financial firms often include a heavy concentration of loans to other firms. The value of such loans may depend importantly on information that can be gathered only by performing detailed analyses of the financial condition of the borrowing firms.[15] As a result, DIP loans may be available only after lenders spend a great deal of time reviewing the troubled firm's assets. Further, DIP loans made to financial firms are likely to involve unusually high interest rates to compensate for time spent in asset review and for the potential risk of lending to a firm with highly opaque assets.

[15] Using statistical analysis to measure firm opacity, by comparing the frequency of bond rating disagreements, Morgan (2002, 876) finds that banks and insurance firms are the most opaque of major industry groups. Large nonbank SIFIs are likely to have a portfolio of assets that are fairly similar to bank asset portfolios so can be expected to be similarly opaque. Interestingly, Morgan notes that the industry grouping "Other Finance and Real Estate" seems to be among the least opaque, though, according to Morgan, this is likely because the securities being analyzed for this group are "asset-backed bonds backed by a pool of specific, homogeneous assets 'locked' up in special purpose vehicles. This structure, which reduces the risk of asset substitution, seems to make the securities relatively safe and certain to outsiders" (2002, 877).

The opacity of financial firm assets contributes to the desire to employ some method (i.e., bailouts or OLA) for their resolution instead of bankruptcy.[16]

Key Features of OLA and OLA's Weaknesses

As in bankruptcy, when a troubled financial firm enters the OLA process, creditors—with the exception of holders of QFCs, discussed below—are stayed (prevented) from collecting their debts. The stay lasts the duration of the period in which the financial firm is in the OLA process. During the stay, the FDIC will typically establish a receivership estate into which most assets and liabilities will be placed. Assets placed in the receivership will be sold by the FDIC in the manner that results in the largest returns to creditors—so that the receivership may last, and creditors wait, an extended period while the FDIC lines up buyers. In addition, some of the bankrupt firm's assets and liabilities can be moved into a "bridge entity," a separate company formed by the FDIC, which might be sold off as a whole entity to a private buyer or might even be capitalized by some of the creditors of the bankrupt firm, and continue as a going concern.[17] One purpose of a bridge can be to preserve going-concern value of portions of the troubled firm.[18]

The Dodd-Frank OLA process also abides by a priority schedule similar to the one defined in bankruptcy law (see Table 1 for an overview of bankruptcy priorities). But Dodd-Frank authorizes the FDIC to violate the priority list established in OLA under certain circumstances. Specifically, section 210(d)(4) of the Dodd-Frank Act permits the FDIC to pay a creditor more than priority rules might otherwise allow "if the Corporation determines that such payments or credits are necessary or appropriate to minimize losses to the Corporation as receiver from the orderly liquidation of the covered financial company." According to the FDIC's discussion of its proposed rules related to this section of the Dodd-Frank Act, such additional payments may be made if they are necessary to "continue key operations, services, and transactions that will

[16] An alternative to bailouts or OLA that would address the problem of a lack of DIP funding as a result of SIFI opacity is to allow a troubled SIFI to enter reorganization, and permit the government to make DIP loans to the bankrupt firm. The government could quickly provide DIP funds to keep the firm operating but the bankruptcy process could handle all other aspects of the resolution.

[17] See Acting Chairman Martin J. Gruenberg's (2012) presentation before the Federal Reserve Bank of Chicago Bank Structure Conference for a discussion of how a bridge bank might be capitalized and continue operations as a private entity.

[18] Acting FDIC Chairman Gruenberg (2012) discussed the formation of a bridge, and noted its advantages for protecting going-concern (franchise) value: "... the most promising resolution strategy from our point of view will be to place the parent company into receivership and to pass its assets, principally investments in its subsidiaries, to a newly created bridge holding company. This will allow subsidiaries that are equity solvent and contribute to the franchise value of the firm to remain open and avoid the disruption that would likely accompany their closings... In short, we believe that this resolution strategy will preserve the franchise value of the firm and mitigate systemic consequences."

maximize the value of the firm's assets and avoid a disorderly collapse in the marketplace."[19]

Beyond the authority to, in some cases, make greater payments to creditors than their priority might allow, the Dodd-Frank Act also provides the FDIC with Treasury funding that might be used to make payments to creditors. The Act provides that the FDIC can borrow, within certain limits, from the Treasury. Immediately upon their appointment as receiver of a firm, the FDIC can borrow 10 percent of the value of the firm's pre-resolution assets. For a large financial firm, this initial amount can be significant. In the Lehman failure, for example, 10 percent of assets would have amounted to $63.9 billion. Once the fair value of the failing firm's assets is determined and a liquidation and repayment plan is in place, the FDIC may borrow an additional 90 percent of the value of the firm's assets (with approval from the Treasury). The Act provides that these funds are to be repaid to the Treasury from the sale of the liquidated firm's assets. But, importantly, the Act also specifies a means of repayment if such assets are not sufficient for repayment, first by attempting to "claw back" any "additional payments" (payments beyond what would have been received in a liquidation) made to creditors, and, if that is insufficient, by taxing all large bank holding companies and other SIFIs (Dodd-Frank Act § 210(o)(1)(A)).[20, 21, 22] The fact that assets might not be sufficient to repay the Treasury in full, and that the legislation authorizes taxes (on large financial

[19] http://edocket.access.gpo.gov/2011/pdf/2011-1379.pdf; 4,211

[20] The Dodd-Frank Act § 210(o) specifies that assessments (taxes) to repay the Treasury are to be imposed on bank holding companies with assets greater or equal to $50 billion and on nonbank financial companies supervised by the Board of Governors of the Federal Reserve (meaning nonbank SIFIs). Assessments are to be sufficient to repay the Treasury within 60 months, with the opportunity for extension if repaying in 60 months would have a "serious adverse effect on the financial system." Assessments are to be graduated based on company size and riskiness. When determining assessment amounts, the FDIC, in consultation with the Financial Stability Oversight Council, should take account of "economic conditions generally affecting financial companies so as to allow assessments to increase during more favorable economic conditions and to decrease during less favorable economic conditions...the risks presented by the financial company [being assessed] to the financial system and the extent to which the financial company has benefitted, or likely would benefit, from the orderly liquidation of a financial company under this title," and any government assessments already imposed on the firm under such government programs as deposit insurance or securities investor protection insurance.

[21] The Dodd-Frank Act § 210(o)(1)(D)(i) prohibits the FDIC from imposing claw backs on creditors who receive "additional payments" if such payments are "necessary to initiate and continue operations essential to implementation of the receivership or any bridge financial company." The FDIC's implementing regulation, at 12 CFR 380.27, seems to imply that a good portion of any additional payments made by the FDIC will be for such essential purposes so will be protected from claw back. Note that if all additional funds could be clawed back, there might be little reason to be concerned about the potential moral hazard problem created by FDIC payments. But, given that the FDIC is likely to be prohibited from imposing claw backs on some significant portion of payment recipients, the moral hazard concern seems to be in play.

[22] Analysts (Acharya et al. 2009, 31–2; Acharya et al. 2011, 10–1) have noted that it would be more appropriate to impose this tax prior to any failure, and base the tax rate on a firm's riskiness. Such a tax would discourage risk-taking. The current tax does not discourage risk-taking, since the failing firm does not pay it. In fact, because it is paid by survivors, it punishes, and therefore discourages, caution.

firms) to repay the Treasury, implies that creditors may be repaid more than the sum of funds generated by asset sales—more than they would have been repaid in liquidation.

It seems likely that Congress intended to provide the FDIC with a good bit of discretion to bypass strict priority as well as discretion over whether to borrow Treasury funds in order to mitigate systemic risk. For example, given the FDIC's ability to pay some creditors more than they would receive in bankruptcy, these creditors may be less likely to pass on losses to other firms, lowering the risk of a systemic problem.

One might argue that legislators' intention for providing the FDIC with the authority to borrow from the Treasury was simply to allow the FDIC the ability to move quicker than bankruptcy courts. By providing an immediate source of funds, the FDIC could gather funds, which it could then use to make payments equivalent to what would be paid in bankruptcy. In this way creditors would not be denied access to their funds for months or years (as in liquidation), and the FDIC could slowly sell the assets of the failing firm such that fire sales are avoided. Under such an arrangement, legislators could have required the FDIC to immediately estimate the value of the failing firm's assets (similar to the type of analysis currently performed by the FDIC when it determines—and announces in a press release—the cost to the FDIC of a bank's failure), and then limit itself to paying creditors no more than their pro-rata share (given priorities) of this estimated amount. Yet, Congress did not choose this course, i.e., it did not require the FDIC to limit the sum of its payments to be no more than the estimated value of the failing firm's assets. Instead it left the FDIC to determine payments to creditors and authorized taxes on large financial firms if payments exceed the liquidation value of assets. Therefore, it seems clear that Congress intended for some creditors of a failing firm to receive larger payments than bankruptcy allowed, as a means of mitigating systemic risk.

Investors certainly realize that the OLA provisions provide the FDIC with the authority to make larger-than-bankruptcy payments to creditors. As a result, they will tend to under price risk-taking by nonbank firms that might get OLA treatment and such firms will engage in more risk-taking than if they did not enjoy the potential benefits of receiving government aid.[23] Congress was aware that larger payments would have this moral-hazard-exacerbating impact on firm risk-taking and took steps to mitigate the impact in the OLA provisions of the Dodd-Frank Act. Broadly, the legislation requires that the FDIC attempt to liquidate SIFIs "in a manner that . . . minimizes moral

[23] Some authors, such as Jackson (2011), argue that a modified bankruptcy procedure can address this excessive risk-taking weakness and better resolve SIFIs. According to them, a system of established rules, judicial oversight, and full public disclosure has a better chance of both reducing bailouts and making the costs of them known than does a non-bankruptcy resolution authority.

hazard."[24] More specifically, the law calls on the FDIC to ensure that any member of the management or the board of directors of the failed firm who is deemed responsible for the failure is fired. Similarly, the OLA provisions require the FDIC to "ensure that the shareholders of a covered financial company do not receive payment until after all other claims and the Fund are fully paid and ensure that unsecured creditors bear losses..."[25,26] The provisions requiring the removal of management and directors are likely to encourage these corporate leaders to limit risk-taking. However, the OLA contains provisions for certain creditors to receive better treatment than they might in bankruptcy, even if some creditors suffer losses, so that creditor oversight is likely diminished by the prospect of OLA treatment.

Dealing With Systemic Risk in Failure Resolution: Exceptions to the Automatic Stay

The class of financial contracts, which are exempt from the automatic stay, are commonly referred to as "qualified financial contracts" (QFCs).[27] Therefore, investors who are holding QFCs have the ability to immediately terminate and net-out their contracts or liquidate the collateral on their claims once a party has defaulted or filed for bankruptcy. Today, under bankruptcy law, a number of financial instruments are QFCs, including repos, commodity contracts, forward contracts, swap agreements, and securities contracts.[28] The treatment of QFCs in bankruptcy (and under OLA provisions) has been the focus of a great deal of public debate.

A possible explanation for exempting QFCs is that the collateral that typically backs QFCs is not directly tied to the defaulting firm's going concern value. A primary objective of the automatic stay in bankruptcy is to prevent

[24] Dodd-Frank Act § 204(a)

[25] Dodd-Frank Act § 206(1-5)

[26] The Dodd-Frank Act includes other provisions intended to minimize moral hazard including 1) a requirement that SIFIs create resolution plans ("living wills") to increase the likelihood that they would be resolved through bankruptcy [Dodd-Frank Act § 165(d)]; and 2) a requirement that the FDIC have a plan in place, before borrowing greater than 10 percent of the failing firm's asset, for repaying the Treasury [Dodd-Frank Act § 210(n)(9)(B)].

[27] In the Bankruptcy Code, contracts exempt from the automatic stay are referred to as "safe harbor contracts." The Federal Depository Institution Act and the Dodd-Frank Act refer to the safe harbor contracts as QFCs. Since safe harbor contracts and QFCs generally refer to the same types of contract, we will use the term "QFC" to refer to both, which is consistent with industry practice.

[28] The types of contracts exempt from the stay are listed in the following sections of the Bankruptcy Code: 11 U.S.C. § 362(b)(6), (b)(7), (b)(17), 546, 556, 559, 560. All terms are defined in 11 U.S.C. § 101 with the exception of a "securities contract," which is defined as "the purchase, sale, or loan of a security, including an option for the purchase or sale of a security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any option entered into on a national securities exchange relating to foreign currencies, or the guarantee of any settlement of cash or securities by or to a securities clearing agency" (11 U.S.C. § 741).

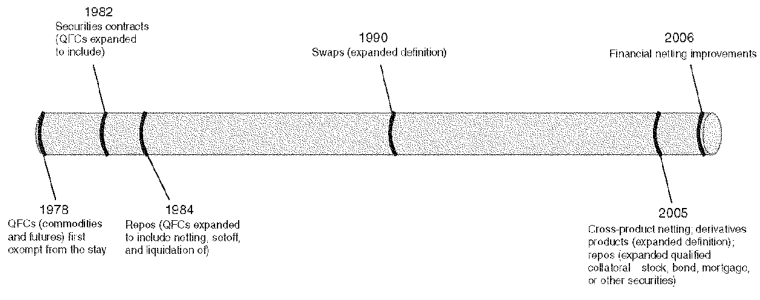
the separation of complementary assets (an important goal of the trustee in liquidation) or to preserve the going-concern value of a firm (typically a goal in reorganization). QFCs can be immediately closed out because the collateral backing them will typically not be complementary to other assets of the firm, nor will QFC collateral be important to the firm's going-concern value. For instance, collateral consisting of highly marketable or cash-like securities (for example Treasury bills or mortgage-backed securities) can be removed from the firm without necessarily undercutting the firm's ability to produce loans or other financial products, since the production of these products depends on such resources as the skill of lending staff, staff contacts with possible borrowers, IT assets, office space and equipment, and funding (liabilities) from which to make loans. However, some argue that the collateral backing certain QFCs can be firm-specific (e.g., a pool of mortgage cash flows used as repo collateral) and therefore not all QFCs should be treated equally (Jackson 2011).

Another possible explanation for exempting QFCs is that the markets in which QFCs trade are special, such that delaying creditor recovery attempts in these markets (by imposing a stay on QFC counterparties) is especially destructive, compared to staying creditors operating in other markets. More specifically, proponents who hold this view seem to be arguing that staying QFCs is more likely to create systemic problems than staying the collection of other debts. This explanation for special treatment—what we will call the "systemic risk" rationale—appears to stand out as the argument used by policymakers supporting the expansion of the list of QFCs that took place over several decades through numerous reforms to the Bankruptcy Code. The rationale offered by those supporting the exemption is that in a fast-paced, highly interconnected market, a counterparty to a QFC may need the proceeds from the contract to pay off other debts in a timely manner. If this counterparty is unable to meet other obligations as a result of having its contracts held up in bankruptcy, other firms relying on that counterparty may become exposed and experience financial distress, which could bleed to other counterparties, and so on, causing a ripple effect and possibly "destabilizing" markets (Edwards and Morrison 2005).[29]

Today, the transactions and agreements covered under the definition of a QFC include a wide range of instruments. However, when the automatic stay

[29] In a letter dated September 30, 1998, to Hon. George W. Gekas, Chairman, Subcommittee on Commercial and Administrative Law, Committee on the Judiciary, Robert Rubin, former Treasury Secretary, argued that applying traditional insolvency laws, such as the stay, to QFCs could cause a "possible domino effect that could turn the failure of one market participant into a failure of the market." See www.wilmerhale.com/files/Publication/eacecfbd-0400-4cb1-80a0-cf3a2c3f1637/Presentation/PublicationAttachment/29b1ce6d-1ce1-4544-a3ec-63ecd65d11e1/Bankruptcy%20%20Derivatives%20outline%20-%20_final_.pdf.

Figure 1 History of QFC Exemptions from the Stay



was first created as part of the new Bankruptcy Code in 1978,[30] only commodities and futures contracts were exempt.[31] At the time, these protections were intended to "prevent the insolvency of one commodity firm from spreading to other brokers or clearing agencies and possibly threatening the collapse of the market."[32] In the decades to follow, various reforms to the Bankruptcy Code expanded the types of contracts classified as QFCs, as well as expanding the types of collateral that could be used to back them (see Figure 1 timeline).

Legislation enacted in 2005 and 2006[33] expanded the safe harbor treatment significantly by broadening the definition of a QFC to such an extent that it would capture any newly created derivatives product that may otherwise not be explicitly included.[34] Moreover, the most recent reforms also expanded contractual netting rights to allow for "cross-product netting" of QFCs (Figure 1). Netting occurs when a non-defaulting counterparty of a defaulting bankrupt firm is allowed to offset debts it owes to the defaulting firm against debts owed it by the defaulting firm.[35] Cross-product netting allows contracts

[30] The *stay* existed as a fundamental feature of bankruptcy before 1978. The Bankruptcy Reform Act of 1978, however, created the "automatic stay," which takes effect immediately upon the filing of a bankruptcy petition. Prior to the Bankruptcy Reform Act of 1978, the stay typically took effect only after the grant of an injunction by a court. Such grants were typical, but were often not immediate, and certainly not automatic (Jessup 1995).

[31] U.S.C. §362(b)(6)

[32] See H.R. Rep. No. 97-420, at 2 (1982).

[33] The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (Pub. L. 109-8, 119 Stat. 23) and the Financial Netting Improvements Act of 2006 (Pub. L. 109-390, 120 Stat. 2692).

[34] The following language was added to the definition of commodities, forward, repo, and securities contracts: "any other agreement or transactions referred to" in the definition and "any combination of the agreements or transactions referred to" in the definition.

[35] For example, in the simplest case of two contracts, the non-defaulting firm is owed $1,000 by the bankrupt firm on, say, an interest rate swap (derivative) contract, and owes the defaulting

of differing types to be netted against one another, for example a debt owed on a swap to be netted against a debt owed on an option contract. Netting, whether the netting of like product contracts or cross-product contracts, can reduce the credit exposure of firms that use financial contracts. In turn, the chance that the bankruptcy of one firm might lead to large losses for its financial contract counterparties is reduced, which some observers argue could reduce systemic risk (Jones 1999).[36]

Observers explain that the expansion of special treatment for QFCs occurred in order to account for the considerable growth in the number and diversity of complex financial products over the previous decade (Jones 1999, Skadden 2010). These instruments grew in popularity as they served as mechanisms for financial firms to insure and hedge against risk, helping to reduce uncertainty and stabilize earnings. This increasingly expansive protection for derivatives and repos was intended to achieve the goal of "minimizing the systemic risks potentially arising from certain interrelated financial activities and markets."[37,38]

Some Possible Weaknesses of Bankruptcy's QFC Exemption

The onset of the financial crisis led many observers to reexamine whether this systemic risk rationale was consistent with the events that occurred when financial markets became severely stressed during the recent financial crisis. Therefore, the idea that QFCs should be exempt from the stay was revisited in the lead up to Dodd-Frank and ultimately addressed in the OLA. The systemic risk argument is the prominent justification given by those supporting the expansion of the special treatment given to QFCs. However, there is another cohort, which argues that any reduction in systemic risk, because of QFC exemptions, may be offset by another form of systemic risk

firm $800 on a different interest rate swap contract. Under bankruptcy law, the creditor firm may net the two contract debts such that the $800 it owes the defaulting firm is cancelled (netted against the $1,000) and the defaulting firm ends up owing only $200 to the non-defaulting firm. The non-defaulting firm will have to wait for the bankruptcy process to proceed before being repaid any portion of the remaining $200 it is owed. This outcome is superior for the non-defaulting party compared to the case in which netting were not allowed. Here the non-defaulting party would be required to pay the defaulting party the $800 it owed, but wait for the bankruptcy process to be completed before getting any of the $1,000 defaulting party owes it. Of course, in reality, the defaulting firm and the non-defaulting firm are likely to have many contracts outstanding with one another at the time of default, all of which might be netted (Mengle 2010).

[36] This may have magnified the concentration of the derivatives industry according to Bliss and Kaufman (2006, 67–8), who argue that "by explicitly protecting these netting agreements, the 2005 bankruptcy changes reinforced the competitive advantage of the biggest counterparties."

[37] See Jones 1999.

[38] "Immediate termination of outstanding contracts and liquidation of collateral facilitates the acquisition of replacement contracts, reduces uncertainty and uncontrollable risk, improves liquidity and reduces the risk of rapid devaluation of collateral in volatile markets" (Yim and Perlstein 2001, 3).

involving runs on repos[39] and fire sales[40] of the collateral underlying closed-out derivatives contracts (Edwards and Morrison 2005, Taylor 2010, Acharya et al. 2011). The simultaneous termination and liquidation of numerous QFCs (which is allowed by the exemption of QFCs from the stay) may lead to fire sales and possibly further insolvencies. In Lehman's case, of their 930,000 derivatives counterparties, 733,000 sought to terminate their contracts upon their bankruptcy filing on September 15, 2008 (Miller 2009).

Additionally, some observers note that the 2005 bankruptcy laws, which, among other things, extended QFC protections to repos backed by all types of collateral, including all mortgage-related securities, may have encouraged use of mortgage-backed securities as repo collateral (Lubben 2010), and thereby contributed to losses during the financial crisis (Skeel 2010, Government Accountability Office 2011). As Skeel (2010) points out, mortgage values could have spiraled down even more had AIG's counterparties been forced to sell a significant amount of the mortgage-related securities they had posted as collateral on their QFCs (which was avoided when AIG was bailed out).

The idea that QFC fire sales might result from their exemption is not new. In fact, it appears to be what led the Federal Reserve to step in and encourage private firms to come to the aid of Long-Term Capital Management L.P. (LTCM), preventing it from entering bankruptcy (Edwards and Morrison 2005).[41]

As discussed, the bankruptcy process can be long, but among other things, this is intended to give the troubled financial firm and its creditors the time to develop plans to salvage the value of the firm. However, with the exemption from the stay, a large financial firm facing possible default (because of a number of factors, such as a recent credit downgrading or an overall crisis of confidence) has a strong incentive not to file for bankruptcy since doing so would likely trigger simultaneous termination of all QFCs (Skeel and Jackson 2012). Thus, a troubled firm may put it off until the last moment and be forced into a rapid liquidation that significantly depresses values to the detriment of other market participants. These arguments suggest that bankruptcy's current treatment of QFCs may not be optimal.

Observers also find that the special treatment given to QFCs—in order to prevent the perceived systemic risks that arise when these instruments are

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[39] By "runs on repos" we mean when counterparties, en masse, seize the collateral underlying these deposit-like instruments.

[40] The phrase "fire sale" typically refers to the possibility that the sale of an asset might yield a lower-than-typical price if holders of one type of asset attempt to sell en masse. In comparison, the "typical" (non-fire sale) price will result if sales are distributed over time.

[41] Krimminger (1999, 1) notes that, "[i]n the case of LTCM, the absence of any mechanism under the Bankruptcy Code to 'slow' the liquidation of assets and collateral, [a power granted to the FDIC under the Federal Deposit Insurance Act] and the resulting 'dump' upon the markets, was a key motivation for the pre-insolvency facilitation provided by the Federal Reserve Bank of New York."

subjected to the automatic stay—not only create a different form of systemic risk, but weaken market discipline (Edwards and Morrison 2005, Scott 2011). The special treatment awarded to QFC counterparties in bankruptcy essentially places them ahead of all other creditors in the bankruptcy repayment line, allowing QFC counterparties to get out of their contracts when all other creditors cannot. As a result, their incentive to monitor the debtor prior to bankruptcy and base their pricing and investment decisions on the perceived risk of the counterparty may be significantly reduced, increasing moral hazard (Edwards and Morrison 2005, Roe 2011). It is argued that this leads to market distortions whereby debtors favor short-term repo financing over traditional sources of funding, encouraging a more fragile liability structure (Edwards and Morrison 2005, Skeel and Jackson 2012). For example, at the time of Bear Stearns' failure, a quarter of its assets (approximately $100 billion) were funded by repos (Roe 2011). Roe (2011) suggests that, without the priority given to these instruments in bankruptcy, it is plausible that Bear would have financed a much larger proportion of its assets with longer-term debt, which would have allowed for a more stable funding structure during the financial turmoil.

Some observers who support these arguments maintain that QFCs should be subject to the automatic stay provisions in the Bankruptcy Code, although there are a range of views concerning the length of the stay and whether all QFCs should be treated equally. According to Harvey Miller (2009), lead bankruptcy attorney for the Lehman bankruptcy, the automatic stay, as originally contemplated, is intended to provide a firm with the "breathing space" to find a third party source of liquidity or to carry out an "orderly, supervised wind down of its business assets." Miller argues that, had the special treatment given to QFCs not applied, Lehman's failure may have been avoided and certainly would not have been as "systemically challenging." For instance, Lehman suffered a significant loss of value when nearly 80 percent of their derivatives counterparties terminated their contracts upon their filing of bankruptcy (Miller 2009).

The OLA's One-Day Automatic Stay for QFCs

Given the controversy—with some experts arguing the exemption from the stay is necessary to prevent systemic risk and others arguing that the exemption creates systemic risk—it is natural that Congress chose a solution that leaves the FDIC with discretion to determine the treatment of QFCs for covered financial companies. Under Congress's solution, QFCs are subject to a one-day automatic stay upon appointment of the FDIC as receiver, whereas QFCs are subject to no stay in bankruptcy.[42]

During the one-day stay under the OLA, the FDIC, as receiver of the failing financial company, must quickly identify how to manage the SIFI's QFC portfolio. The one-day stay is aimed at addressing fears associated with a failing firm's QFC counterparties cancelling their contracts all at once and driving asset prices down. Instead, counterparties' rights to cancel their contracts are put on hold for one day while the FDIC determines how to treat these contracts. The FDIC has this same type of authority when dealing with bank failures. Under the OLA, during this short period, the FDIC has the option to retain the QFCs in receivership, transfer QFCs to another financial institution (to an outside acquirer or to a bridge company created by the FDIC), or reject the QFCs.[43] However, in all instances, the FDIC must retain, reject,[44] or transfer *all* of the QFCs with a particular counterparty and its affiliates.[45,46]

Each action taken by the FDIC has different implications for QFC counterparties of the debtor, as well as the failing firm. Retaining the QFCs in receivership is most similar to bankruptcy in that after the one-day stay expires, QFC counterparties may terminate or net-out their contracts.[47] What differs significantly from bankruptcy, but is very similar to the FDIC's resolution process for depository institutions, is the FDIC's ability to transfer or reject QFCs. If the FDIC chooses to transfer all of the QFCs with a particular counterparty and its affiliates to a third party (including a bridge company), the counterparty is not permitted to exercise its rights to terminate or close out the contract.[48] This awards the FDIC an opportunity to possibly preserve the value of the contracts by removing the ability of counterparties to terminate contracts early and sell off the collateral at fire sale prices (Cohen 2011).

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[42] The one-day stay lasts until 5:00 p.m. on the business day following the date the FDIC is appointed as receiver. Therefore, the "one-day" stay could last four days if the FDIC is appointed as receiver on a Friday.

[43] For the most part, the FDIC's powers under the OLA to reject or transfer a QFC during their limited one-day stay are much like the powers of the FDIC and bankruptcy trustees under the Federal Deposit Insurance Act and the Bankruptcy Code, respectively, with the exception that they are not supervised by a court nor do they receive counterparty input (Skadden 2010).

[44] In bankruptcy, only contracts or leases that are executory—a contract where both parties have unperformed obligations—may be rejected.

[45] Dodd-Frank Act § 210(c)(9)(A). This is intended to eliminate "cherry picking" (selective assumption and rejection) of QFCs by the debtor.

[46] This differs from the Bankruptcy Code's setoff provision, which allows a creditor to offset all obligations under a single master agreement but not all of the contracts with a single counterparty and its affiliates (Skeel 2010, Cohen 2011). When Lehman filed for bankruptcy, they were a counterparty to 930,000 derivatives transactions documented under 6,120 master agreements (Summe 2011).

[47] If a nondefaulting counterparty has an unsecured claim after terminating a QFC and liquidating any collateral, the claim would then be subject to the same claims process as other unsecured creditors.

[48] If the counterparty were to default at a later time on a separate occasion, they may exercise their close-out rights.

Moreover, a QFC counterparty may find that their contracts are held with a new, and presumably more stable, counterparty or a temporary bridge bank following the one-day stay and, therefore, may have no incentive to terminate (in addition to the fact that it has no ability to terminate), leaving the market undisrupted by their original counterparty's failure while also maintaining what are possibly valuable hedge transactions. Finally, the FDIC may reject (or repudiate) the QFCs of a given counterparty to the debtor, effectively closing them out at the current market value, if they determine that they are somehow burdensome or doing so would otherwise promote orderly administration.[49] However, counterparties may recover, from the FDIC, any damages suffered as a result of the FDIC's rejection of QFCs.[50]

Possible Weaknesses of OLA's One-Day Stay

Some commentators find that the one-business-day stay does not provide the FDIC with sufficient time to identify the potential recipients of the failed firm's derivatives portfolio (Skeel 2010, Bliss and Kaufman 2011, Summe 2011). Given this time constraint coupled with the "all or nothing" approach to the treatment of QFCs (where the FDIC must retain, reject, or transfer all QFCs with a particular counterparty) and the potential systemic risks from its failure to protect a SIFI's QFCs, some suggest that the FDIC is highly likely to transfer all QFC contracts of a given counterparty to a bridge financial institution (i.e., protecting or guaranteeing them in full) (Skeel 2010). After all, if the FDIC does not protect all contracts, then the non-defaulting counterparties may close out and liquidate their contracts upon the expiration of the one-day stay, effectively resulting in the systemic problems previously discussed related to the QFC exemption—closing out the contracts and selling collateral at fire sale prices. Thus, even if various QFC counterparties have differing risk exposures to the defaulting firm, they are all likely to be treated the same and "bailed out." If counterparties believe that their QFCs are likely to be protected by placement in a well-funded bridge company, they are likely to provide more funding (or provide lower-cost funding) to a risky firm than they otherwise would. Further, counterparties may care little about the differing risks associated with the various types of QFCs, because all QFCs of a given counterparty are treated the same. Therefore, while bridge company placement of QFCs may limit systemic risk, it is likely to do so at the cost of increasing moral hazard.

In response to the concern that a one-day stay is likely to lead to the protection of most QFCs, some observers, such as Thomas Jackson, author of a proposal to create a new chapter in the Bankruptcy Code tailored to the

[49] Dodd-Frank Act § 210(c)

[50] Damages are calculated as of the date of repudiation. The word "damages" is defined as the "normal and reasonable costs of cover or other reasonable measures of damages utilized in the industries for such contract and agreement claims" Dodd-Frank Act § 210(c)(3)(C).

resolution of SIFIs (Chapter 14), proposes an extension of the duration of the automatic stay for QFCs to three days. Jackson and others argue that a longer stay duration will give the FDIC additional time to make an informed decision regarding how to handle the failing firm's QFC portfolio (Jackson 2011). Jackson's three-day stay appears to be an attempt to balance the desire to give the FDIC more time, against the danger of producing QFC counterparty failures.[51]

Moreover, the protections for derivatives contracts have broadened over the last several decades and this legislation does not account for the differences across QFC products (such as between repos and swaps), or the types of collateral backing QFCs, which some observers believe should be considered. For instance, several observers find that special treatment (i.e., exemption from the stay) should be limited to derivatives collateralized by highly liquid collateral, such as short-term Treasury securities, since there is little reason to assume that such instruments are important for the going-concern value of the bankrupt firm (Herring 2011, Jackson 2011). In Jackson's 2011 Chapter 14 proposal, highly liquid, or otherwise highly marketable, instruments with no firm-specific value remain exempt from the stay so that creditors who rely on the immediate availability of their funds can get them back quickly and without disruption upon the failure of a firm. On the other hand, the exemption is removed (i.e., the stay would apply) for less liquid instruments, such as CDS, in an effort to prevent these creditors from running on the troubled firm. Clearly, there remains a good bit of controversy about the best way to handle the QFC exemption, in both bankruptcy and the OLA, with no obvious best solution.

3. CONCLUSION

While bankruptcy probably provides the ideal failure resolution mechanism for most corporations, it may not be optimal for some financial firms (i.e., SIFIs). Financial firms are typically more heavily dependent on short-term funding, often including a heavy reliance on QFCs, and their balance sheets are opaque. Because of this dependence on short-term funding, a long stay, while the bankruptcy process plays out, is likely to result in financial difficulties for some of the troubled firm's counterparties. Moreover, DIP funding, which is the usual means of keeping a troubled, but viable, firm alive during reorganization, is likely to be quite difficult to arrange, given the opacity of most financial firms. Because of these weaknesses, handling a SIFI through bankruptcy is likely

[51] While the three-day stay may not provide significantly more time than one day to make such valuations, the Dodd-Frank requirement that SIFIs create resolution plans or "living wills" and provisions forcing swaps to be traded on exchanges could expedite the QFC valuation process, improving the ability of the FDIC to make appropriate decisions within a three-day stay period.

to result in significant risks to financial stability. Policymakers are therefore understandably reluctant to allow SIFIs to enter bankruptcy, given that these risks can be mitigated through bailouts. But bailouts, or the expectation that they could be forthcoming, drive down economic efficiency by exacerbating moral hazard problems.

In an effort to address these difficulties, the OLA was created with the explicit goals of mitigating risk to the financial system and minimizing moral hazard. Specifically, the OLA adjusts the way that QFCs are handled and how creditors are paid out. Despite the attempt to achieve these well-founded goals, because they are conflicting, reducing one inevitably leads to an increase in the other. The one-day QFC exemption does not clearly resolve potential risks to financial stability and it also does not go far to ameliorate the moral hazard problem that is apparent when giving QFCs special treatment. Additionally, the ability to pay some creditors more than they would be likely to receive in bankruptcy may reduce systemic risk, but at the cost of increasing moral hazard. In conclusion, the threat of a SIFI's failure, or the failure itself, presents policymakers with a daunting challenge that neither bankruptcy nor the OLA seems capable of fully resolving.

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Our Perspective

Our Perspective is a series of essays that articulates the Richmond Fed's views on issues of particular importance to the Fifth District and the national economy, and their policy implications. The following essay is the Richmond Fed's view on "too big to fail."

Too Big to Fail

The federal financial safety net is intended to protect large financial institutions and their creditors from failure and to reduce the possibility of "systemic risk" to the financial system. However, federal guarantees can encourage imprudent risk taking, which ultimately may lead to instability in the very system that the safety net is designed to protect.

Introduction

Occasional turbulence in financial markets is inevitable. There will always be short-term "shocks" that spark new awareness of previously unknown risks, just as the housing market decline that started in 2006 made clear that some financial institutions had taken on greater risk than many investors had realized.

Shocks, however, do not easily or frequently lead to large-scale panics like the global financial crisis of 2007 and 2008. Many complicated factors led to that outcome. Among the most important factors was a long history of government interventions that led market participants to expect certain firms to be rescued in the event of distress. That "safety net" may make market participants less inclined to protect themselves from risk, making instability and financial panic a more common and severe occurrence.

Part of the government's financial safety net is explicit, such as deposit insurance that protects relatively small investors such as households and small businesses. Commercial banks are charged fees for that service and are supervised, which limits their incentive to take risk.

A large portion of the safety net is ambiguous and implicit, however, meaning that it is not spelled out in advance. For decades the federal government has proven its willingness to intervene with emergency loans when institutions seen as "too big to fail" (TBTF) are on the brink of collapse. Market participants conduct their business making educated guesses about which institutions may be supported in times of distress.

The trouble caused by implicit guarantees is that they effectively subsidize risk. Investors feel little need to demand higher yields to compensate for the risk of loss in their contracts with protected firms since losses are expected to be cushioned by the government. Implicitly protected funding sources are therefore cheaper, causing market participants to rely more heavily on them. At the same time, risk is more likely to accumulate in institutions believed to be protected. The expectation of access to government support reduces the incentive for firms that might be protected to prepare for the possibility of distress by, for example, holding adequate capital to cushion against losses. Meanwhile, investors who have made loans to support activities assumed to be guaranteed face less incentive to assess the risks and related costs associated with extending funds to those firms or markets. This is the so-called "moral hazard" problem of the financial safety net — expectation of government support weakens the private sector's ability and willingness to limit risk.

In essence, the implicit public safety net provides incentive for firms to make themselves relatively more fragile and makes creditors less likely to pay attention to that fragility. Both effects endorse risk and make the firm or activities more likely to require a bailout to remain solvent. This self-reinforcing cycle is the essence of the TBTF problem.

Although the term "too big to fail" has become the popular way to talk about financial safety net issues, it is actually something of a misnomer. The incentive problems created by the safety net stem from the belief on the part of a firm's creditors that they may be protected from losses if the firm experiences financial distress. Protection of some creditors can happen even if the firm fails — that is, even if the shareholders lose everything and management is replaced.

How extensive is the TBTF problem? The nature of the problem does not lend itself easily to study, as argued by Gary Stern, former president of the Federal Reserve Bank of Minneapolis, and Ron Feldman, the Minneapolis Fed's current head of Supervision, Regulation, and Credit, in their book on the subject (Stern and Feldman 2004). There is no list of institutions that governments implicitly view as TBTF, and there is no direct way to observe private markets' suspicions about firms or activities that would appear on such a list. Moreover, the amount of the subsidy provided by implicit support exists only on the margin and is likely to vary across firms and activities. These characteristics make it difficult to directly identify the effects of TBTF treatment on, for example, the relative performance of large and small banks(Ennis and Malek 2005).

Economists have accumulated some evidence, however. Financial institutions ostensibly viewed as TBTF have enjoyed better credit ratings and favorable financial market treatment after mergers expanding their size. Perhaps the most salient evidence of TBTF lies with Fannie Mae and Freddie Mac, the two firms that were most broadly viewed as implicitly supported by a government backstop. For decades markets have been willing to lend more cheaply to these institutions than to competitors that do not benefit from government support. Economist Wayne Passmore at the Federal Reserve Board of Governors has estimated the value of that subsidy between $122 billion and $182 billion (Passmore 2005). Suspicions of government support were proven correct when the firms were taken into government conservatorship during the financial crisis.

While the extent of the TBTF problem has not been conclusively determined, the Richmond Fed believes that it is significant. This intuition is based on past experience. The history of government interventions — from the bailout of Continental Illinois National Bank and Trust Company in 1984 to the public concerns raised during the Long Term Capital Management crisis in 1998 — shaped market participants' expectations of official support leading up to the events of 2007–08.

Why Does This Problem Exist?

It is easy to see why the TBTF problem developed. The potential damage from a large firm's failure is so great that governments feel compelled to intervene. That damage comes from at least three forms of spillovers. Most directly, when a firm fails, it may be unable to honor its financial obligations to other firms, which can snowball until other firms are jeopardized despite being fundamentally sound (Athreya 2009). To some extent, firms will protect themselves from this possibility by charging a premium to counterparties whose risks are unclear. However, the expectation of safety net protection reduces the likelihood that a firm will face the full cost of that risk, so it will be less likely to charge those higher premiums.

A large failure also can provide information about real risks in the economy. However, it is not obvious that it would be desirable or even possible to stop that kind of information from spreading.

Finally, a large firm's failure can cause market participants to scramble to reassess which of their counterparties are likely to receive government support. This type of panic contributed to the most tumultuous days of the financial crisis after the failure of investment bank Lehman Brothers in September 2008.

Earlier that year, the investment bank Bear Stearns was rescued when the Federal Reserve lent funds to JPMorgan Chase to purchase the ailing bank, the first time the Fed had directly extended financing to an investment bank. This unprecedented action, along with others taken to treat the financial market strains, likely signaled that similar support would be available for other firms. Yet in September, Lehman Brothers, at nearly twice the size of Bear Stearns, was allowed to fail.

The government appeared to be offering support on a case-by-case basis in a time of already extraordinary market uncertainty (Steelman and Weinberg 2008). But by that time, many investors were too entrenched in their contracts to charge premiums for the risks to which they now understood they were exposed — in particular, the risk that the government would not prevent failures. Lehman's failure was a turning point after which the financial crisis escalated severely, leading to extraordinary volatility and worsening the downturn in global economic activity. This type of panic — resulting from reassessment of the likelihood of protection — would cease to exist if the government's safety net boundaries were made explicit and transparent in advance.

In other words, the negative, long-term effects of a large firm's failure can be amplified by government support. In the short term, the spillovers create pain. In the extreme, they could translate to reduced economic activity, increased unemployment, and restricted credit to households and businesses. They make the case for intervention appear stronger, even as policymakers understand the moral hazard problems that intervention creates for the future.

For this reason, ambiguity around the implicit safety net nearly guarantees that it will grow ever larger over time (Lacker and Weinberg 2010). According to Richmond Fed estimates, the proportion of total U.S. financial firms' liabilities covered by the federal financial safety net has increased by 27 percent during the past 12 years. The safety net covered $25 trillion in liabilities at the end of 2011, or 57.1

percent of the entire financial sector. Nearly two-thirds of that support is implicit and ambiguous (Marshall, Pellerin, and Walter 2013).

What Can Be Done?

In the wake of the financial crisis, most policymakers agree that TBTF is a problem that must be addressed to reduce the frequency and magnitude of future financial crises. There is no consensus on solutions, however.

Many advocate broadening the scope of regulation to include all institutions and markets that could be a source of shocks that lead to financial crises. This is often referred to as systemic risk regulation. However, more regulation alone cannot be the answer. Regulations impose burdens of their own, creating incentive to innovate around them, forcing regulators and rule makers to carefully follow and adapt to an ever-changing financial landscape (Lacker 2011). Staff at the Federal Reserve and other regulatory agencies put significant resources toward understanding the institutions and markets they supervise. Yet it will always be a challenge for them to be as intimately familiar with the complex financial arrangements into which a given firm has entered as that firm is itself.

Therefore, it is essential for firms to face incentives, separate from the requirements of regulators, to limit their own risk. This is called market discipline, and it is a critical element of a well-functioning and stable financial system (Hetzel 2009). Market discipline is created when creditors expect to face the full costs of a firm's losses, and so they have a greater interest in monitoring the risk of firms with which they do business. By definition, implicit guarantees erode market discipline.

As regulatory reform continues, it is critical to create rules and policies that support market discipline rather than merely attempting to supplant it with regulation. In the Richmond Fed's view, adopting stronger regulations without changing what people believe about the boundaries of the implicit public safety net would fail to address a major source of the very risks that regulations attempt to minimize.

A useful first step would be for policymakers to publicly commit to adhering to a safety net policy that is transparent and limited in scope. Reasonable people can debate the exact contours of the safety net's boundaries. In the Richmond Fed's view, the safety net should focus on smaller creditors because, as discussed, a larger safety net has proven to grow inexorably over time. Regardless of where the safety net boundaries ultimately are drawn, making those boundaries explicit should be at the forefront of policymakers' efforts to address the TBTF problem.

The actions of the federal government, including the Federal Reserve, over the past several years have no doubt made it harder for commitments against intervention to be credible. In fact, due to that complication, some view bailouts as inevitable, believing it would make more sense for the government to make its guarantees explicit and then charge the associated firms fees for that service to make those activities rightfully costly.

However, the Fed has some experience dealing with seemingly insurmountable credibility problems. Many onlookers thought it would be impossible for the Fed to establish credibility that it would fight inflation in the late 1970s. The solution then was to build a reputation for being willing to tighten monetary policy to dampen inflation even if it meant higher unemployment in the short run. Similarly, only building a reputation to limit lending powers — perhaps by letting large firms fail, which could cause disruptions for parts of the financial sector — can avoid the moral hazard the central bank's lending authority has the potential to create (Goodfriend and Lacker 1999). The stance of the Richmond Fed is that, like in the 1970s, the long run benefits of credibility are likely to outweigh the short-term costs of the measures taken to establish it.

One step that could help establish credibility against intervention without enduring an institution's costly failure is the creation of "living wills." Living wills are blueprints, written by firms and approved in advanced by regulators, for winding down large financial institutions in the event of financial distress. The purpose of living wills is for firms to plan for how their operations could be unwound in a manner that minimizes spillovers and is unassisted from government protection of creditors, preferably with lower costs than a process featuring government assistance. Therefore, living wills present policymakers with a viable alternative to emergency "bailouts" in a crisis. The more precisely living wills are written, the more likely regulators would be to invoke them instead of bailouts in a crisis, and the more likely that firms and creditors would be to operate without the expectation of government assistance (Lacker and Stern 2012). Living wills have the potential to truly end the TBTF problem by making the government safety net the less attractive option in a crisis.

The Dangers of Discretion

To help reduce the possibility that a large firm would have to fail for the Fed's commitment to be demonstrated, an additional option is for policymakers to be "tied to the mast" with explicit rules that limit their ability to intervene. A guiding principle for ongoing regulatory reform should be limiting policymakers' discretion to provide loans or other means of support to distressed firms. This would prevent market participants from pricing the possibility of that support into contracts (Lacker 2010).

Some aspects of reform have the potential to broaden policymakers' discretion if not implemented carefully. For example, regulating systemic risk requires some specificity about what makes an institution systemically important. That alone is a difficult question. Despite the notion that some firms are "too big to fail", size is not the only determinant of riskiness. A firm's connectedness to others in the financial system is also important. Connectedness, however, is often hard to determine; there are many possible direct and indirect avenues through which one firm may be exposed to others, and those exposures evolve continuously with innovation (Price and Walter 2011). Therefore, the basic task of identifying systemically important firms necessarily entails discretion (Grochulski and Slivinski 2009).

One provision of regulatory reform gives the government authority to step in to unwind the liabilities of failing large financial institutions and allocate losses among creditors. It is difficult to specify in advance the terms of such arrangements since designating any threshold for which creditors will bear losses creates considerable incentive for investors to place themselves on the beneficial side of the line, subsidizing activities located there. For example, the Orderly Liquidation Authority, established by recent regulatory reform efforts, gives the Federal Deposit Insurance Corporation broad discretion over how it balances the competing goals of maintaining financial stability (perhaps bailing out short-term creditors) and limiting moral hazard (perhaps allowing creditors to bear losses) (Pellerin and Walter 2012). To the extent that such discretion is unavoidable, it should include clear terms of accountability like the least-cost resolution requirements that apply to the Federal Deposit Insurance Corporation when it unwinds failing banks (Lacker and Weinberg 2010).

Conclusion

Many onlookers believe financial crises and excessive risk-taking are inherent features of a market system. The view of the Richmond Fed is that poor incentives, often provided by well-intended but unwise market interventions, are more likely to be behind episodes of financial panic. The financial crisis of 2007–08 was the culmination of many factors, but chief among them was the long history of government intervention that extends back at least to the early 1980s. Such interventions created incentives for increased risk-taking. These incentives are much harder to correct than they were to create, but doing so is imperative to financial stability in the future.

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"Ending 'Too Big to Fail' Is Going to Be Hard Work"
April 9, 2013 speech by Richmond Fed President Jeffrey M. Lacker

Too Big to Fail
A full list of related research and speeches from the Richmond Fed

Mr. BACHUS. Thank you.
Mr. Bernstein?

TESTIMONY OF DONALD S. BERNSTEIN, CO-CHAIR, INSOLVENCY AND RESTRUCTURING GROUP, DAVIS POLK AND WARDELL L.L.P.

Mr. BERNSTEIN. Well, thank you for inviting me to testify.

I have spent a lot of my practice life dealing with the failures of financial institutions, starting with Drexel Burnham many years ago. And, in recent years, I have done a lot of work on resolution plans, "living wills."

I too am here in my individual capacity, however, and the views I express are my own. They are not to be attributed to my firm or clients or organizations with which I am affiliated.

I want to begin with a few observations about the Lehman Brothers bankruptcy and its implications for the bankruptcy of other large financial institutions. Then I am going to provide a bit of an overview of how orderly liquidation authority is being contemplated to be used, including the single point of entry resolution strategy that has been developed by the FDIC. And then, I am going to turn to the Bankruptcy Code and talk a bit about how resolution planning has interfaced with the Bankruptcy Code in its current form. And I will end with a few suggestions as to the way the code might be amended to make it easier to resolve financial firms.

The unplanned failure of Lehman Brothers as we all know had an enormously disruptive effect on the U.S. economy. Financial firms are very vulnerable to a loss of confidence. Even if their economic fundamentals haven't changed once the confidence is lost because they are in the business of so-called maturity transformation. They incur short-term liabilities like deposits and some of the other short-term liabilities that were just mentioned and they invest them in long-term assets like mortgages and corporate loans and the like. And when short-term creditors lose confidence they run. They take their money and they run.

And if a run is prolonged and intense, it can force the firm to sell assets at fire-sale prices and distress markets and exacerbate any losses that might otherwise exist. And that also results in depressing market values generally, which has a follow-on effect to other firms. So, if you have this process of unwinding of maturity transformation from what it has been called, "contagious panic," you end up with a very destabilizing situation. And, in fact, that is how Lehman Brothers' unplanned failure actually unfolded.

Now, to avoid this disrupt—this abrupt unraveling of maturity transformation, distressed firms need to be able to meet sudden liquidity needs without being forced to abruptly sell their assets. And, over the longer term, they need to be able to either be recapitalized or wound down in an orderly way that doesn't create the risk of fire sales of assets. In 2008, neither the regulators nor the firms had the tools to accomplish these goals without financial support from taxpayers. And though the large institutions ended up repaying those investments, there was wide recognition that more tools were needed to avoid having taxpayer funds put at risk again.

Many regulators and commentators believe that some of the tools that are being developed, under title II of Dodd-Frank, actually accomplish this goal. And I am going to describe the single point of entry tool, which is the most—the one that is most frequently discussed. In a single point of entry resolution, only the holding company for the financial institution is put into an insolvency or receivership proceeding. All of the losses are borne by the holding companies, creditors and shareholders. And the operating subsidiaries, like the bank or the broker-dealer, wouldn't fail. They would be recapitalized using assets that are maintained for that purpose at the holding company and they would continue in business as a newly created—as subsidiaries of a newly created holding company which, under orderly liquidation authority, is called a bridge holding company.

There are a number of reasons why many people think this approach has some viability. The first is that the holding company structure used by large financial institutions creates an additional layer of loss-absorbing debt that is effectively subordinated to operating liabilities and especially the short-term liabilities that were just mentioned that are down in the operating subsidiaries. The firms have also substantially increased the amount of loss-absorbing capital and debt that are in the holding companies and new rules are expected to be forthcoming that require them to maintain sufficient loss-absorbing debt and assets at their holding companies. So financially the firms should be in a position to execute the type of recapitalization that is being contemplated with all of this additional loss absorbency that they have.

In addition, because the firm's operating subsidiaries keep in business, single point of entry eliminates the need for multiple insolvency proceedings for different entities, both domestically and in foreign countries, which greatly reduces the complexity of the resolution process. That was one of the big problems in Lehman Brothers. You had a siloing of each entity, one from the other, that resulted in the inability to effectively resolve because you had too many people, too many parties to consult with and the inability to deal with entities on a regular-way basis.

To supplement this, there have been initiatives on a multinational level including those at the Financial Stability Board and crisis management groups that have been organized by key regulators of individual firms that are creating increased alignment among the national regulatory authorities regarding the benefits of what are called single point of entry and bail-in approaches to the failure of financial firms. And this is evidenced by joint work that has been done by the FDIC and the Bank of England on the subject.

Finally and importantly, orderly liquidation authority does include certain special tools that are not currently available under the Bankruptcy Code. And that is going to lead me into my discussion of bankruptcy. But, those tools really are not that—there aren't that many of them. There are three very important ones.

One is the clear path that orderly liquidation authority provides to creating a bridge holding company and transferring the stock of recapitalized subsidiaries to the bridge holding company. That separates them from the debt and the equity of the old holding company and effectively creates a recapitalized entity.

The second important feature is the orderly liquidation fund which is underwritten by the private sector and provides fully secured interim liquidity, if needed, to stabilize the recapitalized firm.

And the third is the preservation of financial contracts by briefly staying closeouts and having provisions that override cross-defaults and bankruptcy defaults so the contracts can be assumed by the ongoing entities. Again, a problem that was faced in Lehman Brothers because of the safe harbors in the Bankruptcy Code.

Recognizing that progress is being made in developing the single point of entry strategy, just a couple of weeks ago, Moody's Investor Service announced that it was removing the two notch uplift provided to ratings of debt of the largest bank holding companies to account for the possibility of government support. Effectively, they have reached the conclusion that that government support is going to be unnecessary because of the progress that is being made on resolution.

So, let us turn to the Bankruptcy Code now. I agree completely that traditional bankruptcy proceedings do provide a path that, despite the Lehman Brothers' experience, can be utilized to resolve financial firms provided that there is appropriate preplanning. The Bankruptcy Code provides transparency. It provides the opportunity for effected parties to receive notice and be heard in court and ex ante judicial review prior to major actions. All of which serve to inspire market confidence. And, if you talk to people who are investors, all of them like—uniformly like the Bankruptcy Code. They like the transparency.

In my view, these are clear benefits of the bankruptcy process. However, the absence of the special tools available under orderly liquidation authority makes it harder for financial firms in bankruptcy to utilize a single point of entry strategy. As a result, the title resolution—title I resolution plans typically adopt a hybrid approach in which some operating businesses are contemplated to be sold or recapitalized, while others are allowed to wind down in an orderly way. First, the resolution plans identify the material operating entities that, because of their capital structure or the nature of their business, are unlikely either to suffer losses or that can be recapitalized as they would be under orderly liquidation authority.

And then, there are tools, such as Section 363 of the Bankruptcy Code that can be used to accomplish a speedy sale or transfer of the stock of those entities that are not going to fail to a debt-free holding company or to a third party. And the debt-free holding company might be owned by a trust for the creditors of the bankruptcy estate so that the creditors in fact are not losing value, but they are actually preserving the going concern value and it is being held for their benefit by a fiduciary. The new holding company can then be sold in private transactions or public transactions, pieces of it can be sold or its shares can be distributed to the left-behind creditors in a conventional Chapter 11 plan of reorganization.

This is all possible under the current code. Now, entities that can't be sold or recapitalized need to be wound down in an orderly way. And the wind downs need to be carefully planned taking into account the impact of the different insolvency regimes; the reactions of regulators, customers, counterparties, financial market utilities, and others that need to be anticipated in the resolution plan. Liquidity needs, through the wind down, need to be conservatively anticipated and the maintenance of shared services and technology, and the transition of critical operations to other firms, and the distribution of customer assets and property need to be provided for.

Today, liquidity levels at the firms allow them to sustain in addition a pre-failure runoff of some of their balance sheet. You may recall that in 2008 one of the problems that faced Lehman Brothers was——

Mr. BACHUS. Let me——

Mr. BERNSTEIN. Sorry.

Mr. BACHUS. We have a pending vote series——

Mr. BERNSTEIN. Okay.

Mr. BACHUS [continuing]. On the House floor. So, we are going to stand in recess. We will come back and I will allow Mr. Bernstein to complete that very good opening statement.

And the Committee stands in recess, subject to the call of the Chair.

And we ask Members to return immediately so we may resume the hearing as soon as possible. And we anticipate doing that fairly soon, but the staff will keep you abreast.

Thank you.

[Recess.]

Mr. BACHUS. We will go ahead and commence the hearing so that the Committee is called to order.

And, Mr. Bernstein, you are recognized for your——

Mr. BERNSTEIN. Thank you, Mr. Chair.

So, I was just describing how the resolution plans seem to be evolving into hybrid strategies involving continuation of some entities and wind down of others. And I was giving an example of how today, with the liquidity levels that the firms have, some of that wind down can actually happen prior to failure because they have got the ability to address liabilities that are running for a period of time because of the liquidity on their balance sheets. And I was mentioning the example of prime brokerage accounts, which were one of the precipitating liquidity factors in Lehman's bankruptcy. And that is something that can be planned for. And it can actually make the resolution process less complex and less systemically disruptive.

And I also note in my written statement a number of other ways that the plans contemplate taking steps, either well in advance or immediately prior to the failure of the firm, to reduce the complexity of the wind downs of entities that are not being recapitalized or sold.

So, to summarize, the title I plans rely on a combination of approaches to orderly resolution under the code. They adjust some current operating practices to simplify resolution. They plan for client-driven reductions in the firm's balance sheet, prior to resolution. They preplan the marketing and sale of some of the firm's businesses. They contemplate recapitalization and continuation of others and the wind down of still others. Those hybrid approaches can actually be quite robust with appropriately detailed planning. And I can't emphasize that enough. The plans are extremely detailed and they need to be.

So, part of making these things work is not only the planning process, but also appropriate consultation with regulators in advance and education of both regulators, market participants and those who administer the bankruptcy process so they understand how these plans work and are in a better position to implement them.

Now all of that being said, I think the hybrid approaches do entail complexity and more risk than the single point of entry approach. So, I believe that reforms to the Bankruptcy Code that add tools to facilitate the single point of entry approach, perhaps in the form of a modified Chapter 14, which I know people have been talking about, should be considered.

These changes would include, among other things, clarifying that bank holding companies can indeed recapitalize their operating subsidiaries prior to commencement of bankruptcy proceedings; clarifying that Section 363 of the Bankruptcy Code can be used to create a new bridge holding company, in the manner that I described; briefly staying closeouts and allowing the assumption and preservation of financial contracts, including overriding bankruptcy defaults or cross defaults to facilitate resolution; and providing a fully secured resource, like the OLF, to be available if DIP financing, debtor-in-possession financing, is not available in the market.

Expanding resolution options in bankruptcy will minimize systemic risk and better avoid putting taxpayer money at risk. But, importantly, even if the Bankruptcy Code is amended, I think it is important that we retain all of our options. That single point of entry in bankruptcy is not the only option, but that the orderly liquidation authority be retained as a backup option; not necessarily the first choice, but just to have it there in case it is needed.

We can't know what the contours of the next crisis will be. And we should want regulators to have the greatest variety of tools in their toolkit. In addition, host country regulators, regulators in other countries who are less familiar with our bankruptcy system, will take comfort from the fact that, if all else fails, U.S. regulators have the power to act.

I want to thank you for allowing me this opportunity to present my views.

[The prepared statement of Mr. Bernstein follows:]

STATEMENT OF

DONALD S. BERNSTEIN

BEFORE

SUBCOMMITTEE ON REGULATORY REFORM, COMMERCIAL AND ANTITRUST LAW

THE COMMITTEE ON THE JUDICIARY

U.S. HOUSE OF REPRESENTATIVES

WASHINGTON, D.C.

DECEMBER 3, 2013

THE BANKRUPTCY CODE AND FINANCIAL INSTITUTION INSOLVENCIES

Thank you for inviting me to testify today. I am Donald Bernstein, co-chair of the Insolvency and Restructuring Group at Davis Polk & Wardwell LLP. I am on the Board of Editors of *Collier on Bankruptcy*, a Commissioner on the American Bankruptcy Institute's Commission on the Reform of Chapter 11 and a past Chair of the National Bankruptcy Conference. I am also a member of the Legal Advisory Panel that advises the Financial Stability Board regarding resolution issues, and, during the last few years, I have spent a significant portion of my time working on resolution plans for large financial firms under Section 165(d) of the Dodd-Frank Act -- commonly known as Living Wills. I am here today in my individual capacity, and the views I express are my own, and not those of Davis Polk, any client or any organization with which I am affiliated.

I have been asked how financial firms can fail and be resolved in a rapid and orderly way in proceedings under the Bankruptcy Code. This requires consideration not only of the Bankruptcy Code, but also the insolvency and resolution laws applicable to domestic banks (the Federal Deposit Insurance Act), domestic broker-dealers (the Securities Investor Protection Act), and, in the case of non-U.S. affiliates of U.S.-based financial firms, foreign insolvency and resolution laws (like special administration in the United Kingdom).

As a prelude, I will make a few observations about the Lehman Brothers bankruptcy and its implications for the bankruptcy resolution of other large financial firms. I will also provide an overview of the single-point-of-entry resolution strategy being developed by the FDIC under Title II of the Dodd-Frank Act's Orderly Liquidation Authority or OLA. I will then turn to how firms can be resolved in an orderly way under current bankruptcy law if – unlike Lehman Brothers – they do appropriate advance planning. Finally, I will identify several changes to the Bankruptcy Code that would facilitate the resolution of financial firms in bankruptcy.

Lehman Brothers and Contagious Panic

The unplanned failure of Lehman Brothers, the largest failure of a U.S. financial firm during the financial crisis, had a very disruptive effect on the financial stability of the United States, even though the losses ultimately suffered by creditors in the Lehman bankruptcy were not themselves catastrophic. There is no doubt that Lehman's bankruptcy exacerbated a crisis of confidence in the financial services sector and was a major factor in the subsequent decisions to provide federal government support of a variety of kinds to the financial system during the financial crisis.

Financial firms, both large and small, are vulnerable to a loss of confidence because they engage in the economically crucial business of maturity transformation. They incur short-term liabilities (for example, liabilities to depositors) to permit them to invest in long-term assets (such as mortgages and corporate loans). When short-term creditors lose confidence in a financial firm, they run for fear that the firm will be unable to pay their claims. Such a run strains the financial firm's liquidity resources and, if prolonged and intense, ultimately can force the firm to sell its assets to raise cash, regardless of the condition of the financial markets at the time. Selling into depressed markets can lead to further losses, turning a fear of insolvency into reality. Such fire-sales can also depress market prices, which reduces the mark-to-market value of similar assets on the books of other firms.[1] This contagious downward spiral resulting from a loss of confidence in financial firms has been called contagious panic in a recent report of the Bipartisan Policy Center entitled *Too Big to Fail: The Path to a Solution* (the BPC Report).[2]

Lehman's unplanned failure unfolded in just this way. A run led to a liquidity crisis as Lehman struggled to liquify assets to meet the claims of short-term creditors, the liquidity crisis led to bankruptcy, which in turn led to wholesale close-outs of open trades, the selling of collateral into distressed markets and ultimately the sale of Lehman's businesses and assets at fire-sale prices. This cycle in turn led to the fear in the markets that other firms might suffer the same fate – contagious panic.

The goal of an effective strategy for resolving distressed financial firms, whether large or small, should be to avoid the abrupt unraveling of the firms and the crucial maturity transformation service they offer through fire sales into distressed markets. Distressed firms must be able to meet sudden liquidity demands without being forced to abruptly sell their assets into the markets at distressed prices. Over the longer term, they must be able to fail and either be recapitalized or be wound down in an orderly manner –

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[1] *See, e.g.*, Andrei Shleifer & Robert W. Vishny, *Fire Sales in Finance and Microeconomics*, 25 Journal of Economic Perspectives 29 (2011). Fire sales also impose deadweight losses on the wider economy. *Id.*

[2] John F. Bovenzi, Randall D. Guynn & Thomas H. Jackson, *Too Big to Fail: The Path to a Solution*, A Report of the Failure Resolution Task Force of the Financial Regulatory Reform Initiative of the Bipartisan Policy Center, p. 1 (May 2013). *See also* Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, *Toward Building a More Effective Resolution Regime: Progress and Challenges*, Remarks at the Federal Reserve Board and Federal Reserve Bank of Richmond Conference, Planning for the Orderly Resolution of a Globally Systemically Important Bank (Washington, D.C., Oct. 18, 2013); Hal S. Scott, *Interconnectedness and Contagion* (Nov. 20, 2012); Randall D. Guynn, *Are Bailouts Inevitable?*, 29 Yale Journal on Regulation 121 (2012).

in either case with adverse consequences for shareholders, debt holders and management. This allows them to obtain appropriate values for their assets, avoids market panic, and does not involve the rapid and disorderly liquidation of their balance sheets.

Since 2008, the resiliency of the financial system has increased substantially, with enhanced capital and liquidity requirements as well as enhanced supervision of non-bank financial companies. As a result, the ability of the firms to recover from financial shocks has increased and the probability of failure has been significantly reduced. In addition, the ability to implement resolution strategies that avoid the abrupt unraveling of the firms' balance sheets has increased.

One Approach to Addressing Contagious Panic: The FDIC's Single-point-of-entry Recapitalization Strategy

In 2008, regulators attempting to stem contagious panic and resolve distressed financial institutions without fire-sales of assets and the unraveling of maturity transformation had a very limited set of tools, and the inadequacy of those tools and the lack of pre-failure planning led to the investment of taxpayer funds to support the financial system. Though all large financial institutions repaid those investments with interest, there was wide recognition that other tools were needed to deal with the failure of financial firms. Title II of the Dodd-Frank Act (Orderly Liquidation Authority or OLA), provides a valuable additional tool. Regulators and commentators, including the BPC Report, have increasingly come to favor the single-point-of-entry approach to addressing the failure of financial firms proposed by the Federal Deposit Insurance

Corporation (the FDIC) under OLA.[3] In its purest form, single-point-of-entry involves commencing resolution proceedings only with respect to the financial firm's top-level holding company, with all losses being borne by shareholders and creditors of that entity and not by taxpayers. Operating entities, like the firm's banking or broker-dealer subsidiaries, would not be placed in insolvency or resolution proceedings, but instead would be recapitalized using assets of the holding company and would continue as subsidiaries of a newly created debt-free bridge holding company. Instead of being liquidated, the firm would be restructured and recapitalized, leaving behind the holding company's creditors and shareholders in the OLA receivership, and creating a viable recapitalized firm the value of which would be preserved for the holding company's stakeholders without requiring a prolonged resolution process for the operating entities.

By recapitalizing the firm's operating subsidiaries with holding company assets, the single-point-of-entry approach preserves the value of those operating businesses and pushes the firm's operating losses up to the old holding company to be absorbed by the holding company's shareholders and creditors. The holding company's stakeholders nevertheless benefit from the strategy because liquidation of the firm's valuable operating

[3] *See, e.g.*, Federal Deposit Insurance Corporation & Bank of England, Joint Paper, *Resolving Globally Active, Systemically Important, Financial Institutions* (Dec. 10, 2012) (jointly proposing the single-point-of-entry approach); Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, *Toward Building a More Effective Resolution Regime: Progress and Challenges*, Remarks at the Federal Reserve Board and Federal Reserve Bank of Richmond Conference, Planning for the Orderly Resolution of a Globally Systemically Important Bank (Washington, D.C., Oct. 18, 2013) ("The single-point-of-entry approach offers the best potential for the orderly resolution of a systemic financial firm…"); William Dudley, President and Chief Executive Officer, Federal Reserve Bank of New York, Remarks at the Federal Reserve Board and Federal Reserve Bank of Richmond Conference, Planning for the Orderly Resolution of a Globally Systemically Important Bank, P. 1 (Washington, D.C., Oct. 18, 2013) ("I very much endorse the single-point-of-entry framework for resolution as proposed by the Federal Deposit Insurance Corporation (FDIC)."). For step-by-step diagrams illustrating the FDIC's single-point-of-entry resolution strategy, see BPC Report, pp. 23-32.

businesses and assets at fire-sale prices is avoided and the going concern value of the operating subsidiaries is preserved. This value ultimately is available for distribution to the stakeholders in the receivership.

The United States is fortunate that large U.S. financial firms rely on a holding company structure, where significant amounts of long-term unsecured debt issued by the parent holding company are structurally subordinated to deposits and other operating liabilities of financial subsidiaries. This structure creates an additional layer of loss absorbency at the holding company level, providing the ability, as the FDIC suggests, to keep systemically critical operating subsidiaries out of resolution proceedings despite the failure of the parent. Other countries are adopting similar recapitalization approaches as they pursue local and regional law reform, though in countries that have a unitary bank model (where there are no holding companies), the recapitalizations must be accomplished through bailing in (conversion to equity) of operating entity debt.[4]

As I have already noted, large financial firms have undergone substantial changes since 2008 that facilitate the implementation of the single-point-of-entry strategy and improve their resiliency, including a substantial increase in loss-absorbing capital and

[4] *See, e.g.*, Martin J. Gruenberg, Chairman, FDIC, Remarks at the Volcker Alliance Program, Washington, D.C. (Oct. 13, 2013) (describing endorsement of single-point-of-entry resolution model by the U.K., Germany and Switzerland as the preferred strategy for resolving global financial institutions, and progress being made in Europe, China, Japan and elsewhere); European Commission, Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms (2012), including the power to bail-in debt (convert it to equity) through a single-point-of-entry resolution strategy; Paul Tucker, Deputy Governor for Financial Stability at the Bank of England, *Solving too big to fail – where do things stand on resolution?*, Remarks at the Institute of International Finance 2013 Annual Membership meeting, Washington, D.C. (Oct. 12, 2013) (describing the single-point-of-entry resolution strategy as workable now in the United States and predicting it will be workable soon in the U.K. and Europe generally); Federal Deposit Insurance Corporation & Bank of England, Joint Paper, *Resolving Globally Active, Systemically Important, Financial Institutions* (Dec. 10, 2012).

balance sheet liquidity to meet regulatory requirements and risk management needs,[5] the de-risking of the balance sheets of U.S. financial firms and capital restructuring to address anticipated requirements for minimum amounts of loss absorbing debt and assets in the holding companies of financial firms.[6]

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[5] *See* Federal Reserve and OCC, Regulatory Capital Rules, 78 Fed. Rev. 62, 018 (Oct. 11, 2013) (to be codified at 12 C.F.R. Pts. 3, 5, 6, 165, 167, 208, 217, and 225); FDIC, Regulatory Capital Rules, 78 Fed. Reg. 55, 340 (Sept 10, 2013) (to be codified at 12.C.F.R. pts. 303, 308, 324, 327, 333, 337, 347, 349, 360, 362, 363, 364, 365, 390, and 391); Federal Reserve, OCC and FDIC, Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring (Proposed Rule), 78 Fed. Reg. 71, 818 (Nov. 29, 2013). According to the Federal Reserve, the largest U.S. bank holding companies have increased their common equity to more than twice the amount they had during the financial crisis of 2008. Specifically, the weighted tier 1 common equity ratio, which is the ratio of common equity to risk-weighted assets, of the 18 bank holding companies that participated in the Federal Reserve's Comprehensive Capital Analysis and Review (CCAR) has more than doubled from 5.6% at the end of 2008 to 11.3% in the fourth quarter of 2012, reflecting an increase in common equity from $393 billion to $792 billion during the same period. *See* Federal Reserve, Press Release – Federal Reserve Announces Results of Comprehensive Capital Analysis and Review (CCAR) (Mar. 14, 2013), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20130314a.htm. The results of the Federal Reserve's 2013 Dodd-Frank and CCAR stress tests show that the largest U.S. bank holding companies have enough common equity to absorb all of their projected losses under the Federal Reserve's severely adverse stress scenario and still have enough common equity left to exceed the minimum risk-based and leverage capital requirements. *See* Federal Reserve, Comprehensive Capital Analysis and Review 2013: Assessment Framework and Results (Mar. 14, 2013), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/ccar-2013-results-20130314.pdf. Besides a significant increase in levels of loss-absorbing capital, U.S. banks have also substantially improved their liquidity profiles. For example, U.S. banks' holdings of cash and high-quality liquid securities have more than doubled since the end of 2007 and now total more than $2.5 trillion. *See* Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, Stress Testing Banks: What Have We Learned? (Apr. 8, 2013), *available at* http://www.federalreserve.gov/newsevents/speech/bernanke20130408a.pdf.

[6] *See* Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, *Toward Building a More Effective Resolution Regime: Progress and Challenges*, Remarks at the Federal Reserve Board and Federal Reserve Bank of Richmond Conference, Planning for the Orderly Resolution of a Globally Systemically Important Bank (Washington, D.C., Oct. 18, 2013) (announcing that the Federal Reserve expects to propose minimum long-term debt and eligible assets requirements applicable at the bank holding company level for the largest U.S. banking groups within the next few months in order to ensure they have sufficient loss-absorbing resources to facilitate a single-point-of-entry resolution). *See also Progress and Next Steps Towards Ending "Too-Big-To-Fail" (TBTF)*, Report of the Financial Stability Board to the G-20 (Sep. 2, 2013) (announcing that the Financial Stability Board is developing minimum gone-concern loss-absorbing capacity requirements to ensure that global and domestic systemically important financial institutions have enough loss-absorbing capacity in the form of equity, long-term debt and assets to recapitalize the institutions without the need for taxpayer capital in the event of severe financial distress). *See also*, Morgan Stanley Research North America, Large and Midcap Banks, *OLA: More Debt Sooner?* (Dec. 13, 2012); Goldman Sachs Research, *Loss Absorbency in Banks* (Dec. 2012); J.P. Morgan North America Credit Research, *Tarullo Speech Increases Momentum for Debt Buffers* (Dec. 6, 2012)

Moreover, because of initiatives at the multinational level, including those of the Financial Stability Board and the crisis management groups organized among key regulators of individual firms, there is increasing alignment among national regulatory authorities regarding the benefits of recapitalization and bail-in approaches to dealing with failure.[7] A single-point-of-entry recapitalization, for example, protects host-country interests by making resolution proceedings for host-country operations unnecessary. Since the operations of the largest financial firms are highly concentrated in a few jurisdictions, like the US and the UK,[8] coordination and alignment among the relevant authorities can readily occur if appropriate advance planning among regulatory authorities can be done. Key to these efforts is the fact that recapitalization and bail-in strategies allow the firms to continue their business and meet their operating obligations in the ordinary course in both home and host countries. As a result, local regulators do not feel compelled to take precipitous actions that can hinder the resolution of the overall group.

[7] *See, e.g.*, Financial Stability Board, *Key Attributes for Effective Resolution Regimes of Financial Institutions* (Oct. 2011) (endorsing recapitalization (bail-in) within resolution strategies and advocating the creation of legal tools to effect such strategies); Federal Deposit Insurance Corporation & Bank of England, Joint Paper, *Resolving Globally Active, Systemically Important, Financial Institutions* (Dec. 10, 2012) (endorsing and advocating single-point-of-entry resolution strategies for systemically important financial institutions); *Progress and Next Steps Towards Ending "Too Big To Fail" (TBTF)*, Report of the Financial Stability Board to the G-20 (Sep. 2, 2013) (endorsing single-point-of-entry and multiple-point-of-entry resolution strategies and announcing plans for minimum gone-concern loss-absorbing capacity requirements to ensure the feasibility of such strategies).

[8] *See* FDIC Presentation to the FDIC Systemic Resolution Advisory Committee Meeting, Panel on International Resolution Strategy (Dec. 10, 2012) (over 90% of the total reported foreign activity for the top seven U.S. SIFIs is located in three foreign jurisdictions, with the UK having the largest footprint). Video available at http://www.vodium.com/MediapodLibrary/index.asp?library=pn100472_fdic_SRAC. Presentation slides from the meeting are available at http://www.fdic.gov/about/srac/2012/2012-12-10_international-resolution-strategy.pdf.

Orderly Liquidation Authority includes special tools that facilitate implementation of a single-point-of-entry resolution strategy. Among the most important of these tools are the following:

- *The Bridge Holding Company Tool.* OLA provides a very clear path to creating and transferring the stock of recapitalized operating subsidiaries to a new bridge holding company, leaving holding company debts and equity behind in the FDIC receivership. The Bridge Holding Company Tool allows the operating businesses to be quickly and clearly separated from the failed holding company, and also simplifies the governance of the operating subsidiaries, allowing them to maximize their value in the most efficient manner possible.[9]
- *The Liquidity Support Tool.* OLA includes the Orderly Liquidation Fund (OLF), [10] which is ultimately underwritten by private sector financial firms[11] and provides fully-secured interim liquidity support if necessary to help stabilize the recapitalized financial firm and avoid any fire-sale of the firm's assets.
- *The Financial Contract Preservation Tool.* OLA includes special provisions to permit the preservation of financial contracts by briefly

[9] Section 210(o) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), 12 U.S.C. § 5390(o).

[10] Section 210(n) of the Dodd-Frank Act, 12 U.S.C. § 5390(n).

[11] Section 210(o) of the Dodd-Frank Act, 12 U.S.C. § 5390(o), providing for the imposition of risk-based assessments on large financial firms to cover any losses of the OLF.

> staying close outs due to bankruptcy defaults,[12] or, in the case of contracts of subsidiaries, invalidating cross-defaults arising out of the failure of the holding company, so such contracts can be assumed and preserved.[13]

Market participants increasingly recognize the viability of the single-point-of-entry approach to resolution of financial firms. A few weeks ago, for example, Moody's Investor Service announced that, on the strength of the progress being made on single-point-of-entry resolution, the two-notch uplift provided to ratings of the debt of the largest bank holding companies to account for the possibility of government support would be eliminated. [14]

An Alternative Approach: Pre-Planned Resolution of Financial Firms in Bankruptcy

While single-point-of-entry under OLA offers a clear path to the orderly resolution of distressed U.S. financial firms, more traditional bankruptcy proceedings provide another path that, despite the Lehman Brothers experience, can be utilized with appropriate pre-planning. The Dodd-Frank Act makes clear that the use of Orderly Liquidation Authority is to be limited to situations where bankruptcy is not a viable resolution strategy,[15] and the FDIC has announced that it supports the idea that

[12] Section 210(c)(8), (9), (10) of the Dodd-Frank Act, 12 U.S.C. § 5390(c)(8), (9), (10).

[13] Section 210(c)(16) of the Dodd-Frank Act, 12 U.S.C. § 5390(c)(16).

[14] Moody's Investors Service, Rating Action: Moody's Concludes Review of Eight Large U.S. Banks (Nov. 19, 2013).

[15] Section 203(b) of the Dodd-Frank Act provides in relevant part that the Orderly Liquidation Authority of Title II of the Dodd-Frank Act may not be legally invoked unless the Secretary of the Treasury determines that "the failure of the financial company and its resolution under otherwise applicable Federal or State law [e.g., the Bankruptcy Code] would have serious adverse effects on financial stability in the United States" and "any action under section 204 [of the Dodd-Frank Act] would avoid or mitigate such adverse effects . . . ."

bankruptcy, not OLA, should be the presumptive resolution procedure.[16] The Bankruptcy Code provides transparency, the opportunity for affected parties to receive notice and be heard in court, and ex-ante judicial review prior to major actions. Bankruptcy is also well-established and well-understood by market participants, even though banks, insurance companies and securities firms have long been excluded from ordinary bankruptcy proceedings. Thus, it is not surprising that Dodd-Frank provided that bankruptcy should be used to resolve the failed holding company of a financial firm wherever possible.

The goals of a bankruptcy resolution should be to assure market participants that the liquidity needs of the distressed firm can be satisfied and fire sales can be minimized, that the firm's critical operations, including intercompany support services, will be continued or exited in an orderly way, and that the firm's losses will be imposed on shareholders and private creditors, such as long-term debt holders of the firm's holding company, while obligations of the operating subsidiaries (such as deposit liabilities and other money-equivalent liabilities) are paid in full.

Of course, multi-entity financial firms will be resolved not only under the Bankruptcy Code, but also their different operating subsidiaries will be subject to multiple insolvency regimes, both in the United States and in other countries. There is no

[16] *See* Remarks by Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation, on Implementation of the Dodd-Frank Act before the Volcker Alliance Program (October 13, 2013) *available at* http://www.fdic.gov/news/news/speeches/spoct1313.html; *See also* Statement of Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation on Implementation of the Dodd-Frank Act before the Committee on Banking, Housing and Urban Affairs, United States Senate (December 6, 2011) ("If the firms are successful in their resolution planning, then the OLA would only be used in the rare instance where resolution under the Bankruptcy Code would have serious adverse effects on U.S. financial stability"), *available at* http://www.fdic.gov/news/news/speeches/chairman/spdec0611.html.

question that the multiplicity of insolvency regimes and the related multiplicity of controlling parties and conflicting interests greatly complicated the Lehman Brothers bankruptcy proceedings.[17]

The simplest way to avoid competing resolution proceedings would be to have a clear path to a single-point-of-entry approach to financial firm insolvencies under the Bankruptcy Code. However, the absence of an express Bridge Holding Company Tool, a Liquidity Stabilization Tool and a Financial Contract Preservation Tool in the Bankruptcy Code makes it harder for financial firms to implement a pure single-point-of-entry approach in bankruptcy. As a result, under current law, resolution plans typically adopt hybrid approaches, in which some operating businesses and entities continue and are sold or recapitalized, while others are allowed to wind-down in an orderly way.

First, the resolution plans typically identify those material operating entities or businesses that, because of their capital structure and the nature of their businesses, are unlikely to suffer material losses and can be continued without resolution proceedings if their liquidity needs are met. The plans then specify how the liquidity needs of such entities will be met, and provide for their sale, either in advance of or immediately after the firm's failure, or their continuation along with other subsidiaries that are recapitalized as described below. The sale of such entities or their assets would be analogous to the

[17] More than 100 different insolvency proceedings were ultimately commenced for Lehman Brothers legal entities. *See* Presentation by Harvey R. Miller and Maurice Horwitz, *available at* http://www.stern.nyu.edu/cons/groups/content/documents/webasset/con_041232.pdf. This led to complex interaffiliate disputes between entities that once operated together as a global business, but were now being administered under different resolution proceedings as separate legal entities.

speedy sales that took place in the Lehman case, but would be more orderly and value-preserving because they would be pre-planned to achieve these objectives.

Second, the resolution plans typically identify those entities in the financial firm's group that may suffer losses but can be recapitalized, provided with liquidity and continue in business for the benefit of stakeholders, just as they would be in a single-point-of-entry resolution under Orderly Liquidation Authority.[18] OLA's Bridge Holding Company Tool can be replicated under the Bankruptcy Code using section 363 of the Bankruptcy Code to authorize a transfer of the recapitalized subsidiaries to a debt-free holding company that is set up in advance or at the time of failure, perhaps owned by a trust for the benefit of creditors and other stakeholders left behind in the bankruptcy case. The new holding company would be separated from the risks of the bankruptcy process and once its business was stabilized, it could be sold in one or more private or public transactions, or its shares could be distributed to creditors of the old holding company under a conventional chapter 11 plan of reorganization. The trust could be structured to replicate the governance advantages offered by the Bridge Holding Company Tool, with appropriate modifications approved by the Bankruptcy Court.

Finally, for any entities that cannot be sold or recapitalized, and as a back-up strategy even for those that can be, the resolution plans typically provide for such entities

[18] Among other things, any insured depository institution that is fully recapitalized in a single-point-of-entry resolution would have access to secured liquidity from the Federal Reserve's Discount Window. In addition, despite the absence of the Financial Contract Preservation Tool in the Bankruptcy Code, it may be possible to recapitalize entities that have portfolios of financial contracts. If, for example, some or all of the financial contracts housed in a bank or broker-dealer subsidiary are not guaranteed by the parent or cross-defaulted by the parent company's bankruptcy, or depending on the number of contracts that contain such cross-default provisions, losses, if any, on financial contracts could simply be absorbed by the recapitalized entities.

to be wound down in an orderly way that avoids asset fire sales. These orderly wind-downs require advance planning. The impact of different insolvency regimes and the reactions of regulators, customers, counterparties, financial market utilities and others need to be anticipated and addressed in the resolution plan, and the plan needs to provide for the management of liquidity needs, the orderly transition of systemically critical operations to other providers, the maintenance of the continuity of shared services and technology during the wind-down, and the orderly distribution of customer assets and property.

One of the characteristics that facilitates an orderly wind down is that the firms' enhanced capital and liquidity levels allow them to sustain a pre-failure client-driven run so that significant parts of their balance sheets can be wound down in an orderly way prior to or immediately after failure. Prime brokerage accounts are a good example of this. In 2008, one of the factors that precipitated the liquidity crisis at Lehman was a race to the exits by prime brokerage customers, requiring rapid liquidation of Lehman's assets to meet the demands of exiting customers.[19] Not only was the liquidity strain of meeting the run too much for the firm; neither the firm nor its customers were in a position to quickly move the accounts even if there had been sufficient liquidity to meet the run. This

[19] *See, e.g.*, Gary B. Gorton & Andrew Metrick, Securitized Banking and the Run on Repo, 104 Journal of Financial Economics 425-51 (2012); Gary B. Gorton, Slapped by the Invisible Hand: The Panic of 2007 (2010); Council on Foreign Relations Squam Lake Working Group on Financial Regulation, Working Paper: Prime Brokers and Derivatives Dealers (April 2010) ("[Prime brokerage asset] runs, together with runs by short-term creditors, precipitated Bear Stearns' and Lehman's demise"), *available at* http://www.cfr.org/thinktank/cgs/squamlakepapers.html. *See also* Darrel Duffie, Bank for International Settlements Working Papers, No. 301: The Failure Mechanics of Dealer Banks, Section 4.3 (March 2010), *available at* http://www.bis.org/publ/work301.pdf.; Remarks of Daniel K. Tarullo, Governor, Federal Reserve Board, Americans for Financial Reform and Economic Policy Institute Conference, Washington, D.C. (Nov. 22, 2013), available at http://www.federalreserve.gov/newsevents/speech/tarullo20131122a.htm.

is, however, a contingency that can be planned for as part of resolution planning. Balance sheet liquidity can be used to meet the run, and a virtually complete orderly pre-failure transition of the firms' prime brokerage customers to other financial intermediaries can be accomplished in a matter of days.[20] Customers would be protected, systemic risk from the possible suspension of access to prime brokerage accounts in bankruptcy would be eliminated, and the complexity and systemic impact of any subsequent bankruptcy would be substantially reduced.

Financial firms can take other steps, either well in advance of or immediately prior to failure, to reduce the difficulty and complexity of bankruptcy wind-downs. These steps might include, among many others:

- pre-positioning employees and service assets within the group and documenting service relationships to maintain continuity of intercompany support services in wind-down;
- licensing or repositioning technology and related infrastructure within the corporate group to assure ongoing availability to all relevant entities after failure;
- replication or repositioning of data resources to assure their availability to all relevant entities after failure;
- using available liquidity to return collateral to the firm's balance sheet prior to failure to avoid it being dumped on the market post-failure;

[20] The now prevalent market practice of prime brokerage customers of maintaining accounts with multiple prime brokers will also facilitate rapid account transfers.

- positioning liquidity where needed for purposes of facilitating an orderly wind-down of wind-down entities; and
- advance discussions with relevant host-country authorities regarding how host-country interests will be protected and how insolvencies in different jurisdictions can be coordinated to minimize systemic risk.

Resolution plans under current bankruptcy law thus rely on a combination of approaches: revising current operating practices to facilitate resolution should it become necessary, anticipating a client-driven reduction in the firm's balance sheet prior to resolution supported by the firms' enhanced capital and liquidity positions, pre-planning of the marketing and sale of some the firm's businesses, pre-planning the recapitalization and continuation of other entities and businesses, and detailed pre-planning of the wind-down of still others. Hybrid approaches of this type can be very robust with appropriately detailed resolution planning. They also can benefit from advance consultation with and education of regulators, market participants and those who administer the bankruptcy system in each relevant jurisdiction, as well as thoughtful changes in market practice to facilitate resolution.[21]

Possible Modifications to Existing Bankruptcy Law

All of the above being said, the benefits of whole-firm recapitalization of the kind represented by the FDIC's single-point-of-entry approach cannot be denied. Because of their complexity, hybrid approaches entail execution risk and the likelihood of larger

[21] For example, several regulators recently sent a letter to the International Swaps and Derivatives Association ("ISDA") urging ISDA to revise its standard forms to eliminate cross-defaults arising from the resolution of a parent holding company in a single-point-of-entry resolution strategy. Joint Letter to ISDA dated Nov. 5, 2013 from the Bank of England, the Bundesanstalt für Finanzdienstleistungsaufsicht, the Federal Deposit Insurance Corporation and the Swiss Financial Market Supervisory Authority.

losses for holding company creditors and shareholders than a pure single-point-of-entry approach. Accordingly, reforms to the Bankruptcy Code to add tools that facilitate using a single-point-of-entry approach to resolution in bankruptcy, perhaps in the form of a modified version of the chapter 14 proposal made by certain commentators,[22] would facilitate the resolution of large financial firms. Such provisions should, in my view, include:

- Clarifying that bank holding companies can recapitalize their operating subsidiaries prior to the commencement of bankruptcy proceedings.
- Clarifying that section 363 of the Bankruptcy Code can be used to transfer recapitalized entities to a new holding company using a bridge structure of the kind I have described.
- Adding provisions that permit a short stay of close-outs and allow the assumption and preservation of qualified financial contracts, and overriding ipso facto (bankruptcy) defaults or cross-defaults that might impede the resolution process.
- Providing some form of fully secured liquidity resource that would offer financing to help stabilize the recapitalized firm and prevent fire sales until access to market liquidity returns.

[22] *See* Thomas H. Jackson, *Bankruptcy Code Chapter 14: A Proposal*, in BANKRUPTCY NOT BAILOUT: A SPECIAL CHAPTER 14 (Hoover Institution, Kenneth E. Scott & John B. Taylor, eds., 2012). Professor Jackson recently disclosed that the Hoover Institution has been working on version 2.0 of its Chapter 14 proposal, which will include provisions specifically designed to facilitate a single-point-of-entry strategy under the Bankruptcy Code. See Remarks of Thomas H. Jackson, Panel on Resolution & Recovery – Bankruptcy Not Bailout, Annual Conference of The Clearing House Association (Nov. 21, 2013). *See also* BPC Report, pp. 11-14 (recommendations for amending the Bankruptcy Code to facilitate the execution of a single-point-of-entry strategy under the Bankruptcy Code).

Lastly I would note that no single resolution procedure will be perfect for all situations. Expanding the options available by continuing to develop resolution approaches under both OLA and the existing Bankruptcy Code, as well as considering amendments to facilitate resolution under the Bankruptcy Code, will maximize the flexibility to resolve distressed financial firms in a manner that minimizes systemic risk and does not put taxpayers at risk.

For these reasons, even if the Bankruptcy Code were amended to add tools to facilitate single-point-of-entry recapitalization in bankruptcy, I believe it is crucially important to retain Orderly Liquidation Authority as a back-up resolution option for large financial firms. Among other things, since we cannot know the causes or contours of the next crisis, we should want regulators to have a variety of sensible tools in their toolkit so they can use the right one when the time comes. In addition, key host-country regulators, who are less familiar with our bankruptcy system, will take comfort from the fact that if all else fails, United States regulators have the power to implement a recapitalization of distressed financial firms. Finally, as evidenced by the recent Moody's action, retaining OLA will also reinforce the idea that U.S. taxpayer money will never again be put at risk to support distressed financial firms.

I want to thank the Subcommittee for allowing me this opportunity to present my views. I would of course be delighted to answer any questions you may have about my testimony.

Mr. BACHUS. Thank you very much.

And, Professor Roe?

Now, let me say this, I think that the testimony so far has been very substantial and very helpful. And it—a lot of good discussion on policy. So, thank you.

TESTIMONY OF MARK J. ROE, PROFESSOR OF LAW, HARVARD LAW SCHOOL

Mr. ROE. I will do my best to maintain that.

So, Chairman Bachus, thank you for the gracious introduction earlier.

I am Mark Roe. I am a law professor who focuses on corporate law, business law, business bankruptcy issues. And I do appreciate the opportunity to be here to provide you with my views on the Bankruptcy Code's adequacy in dealing with failing, failed financial institutions.

I am going to focus my testimony on the exemptions from bankruptcy for derivatives and short-term financing, the so-called "bankruptcy safe harbors." Simply put, the Bankruptcy Code, as it is set up now, cannot effectively deal with most large failing financial institutions. And a core reason for that is that the safe harbors are far too wide. They exempt too much short-term financing and risky investments from the normal operation of American bankruptcy law. They thereby make an effective resolution in bankruptcy without regulatory support harder than it needs to be, quite possibly impossible. They undermine market discipline in the prebankruptcy market making the financial system riskier and more prone to suffer major failures. They subsidize short-term lending over stronger, more stable longer-term financing for financial institutions. We get more subsidized short-term debt and less stable, but unsubsidized, longer-term debt. They also make it harder for financial upstarts and regional banks to compete with the big money center banks.

Five years ago Lehman Brothers propelled forward the financial crisis, when it filed for bankruptcy. The Lehman bankruptcy proved to be chaotic and the country suffered a major economic setback from which it is still recovering. Yet, if a Lehman-class bankruptcy occurred today, the Bankruptcy Code and the bankruptcy system really couldn't do any better than it did in 2008. So, if a major financial failure gets by the regulators for whatever reason, we still really can't count on bankruptcy to catch the ball.

Complex systems, and our financial world is one very complex system, need redundancy in dealing with failure. If one stabilizer fails in a complex system, we want another mechanism to take over to avoid a catastrophic failure. Engineers know that and we should start to make bankruptcy a more viable option than it is today.

Second reason for acting on this is that bankruptcy is the first line of defense by statute and regulatory preference. Financial regulators say that they will play the Dodd-Frank title II card only if bankruptcy fails. But, regulators cannot allow a bankruptcy for even a day to see if it works, if we have a major, systemically important financial institution with significant safe harbored securities, because, under today's bankruptcy rules, as soon as the financial institution with major safe harbored financing files for bankruptcy, the exemption for bankruptcy for much of its short-term debt and for its derivatives portfolio will lead its counterparties to rip apart the bankrupts portfolio. There will be no chance to put Humpty Dumpty back together.

The third reason to work on bankruptcy as a viable alternative: it is possible that title II may not work. It hasn't been tried. And we should be wary of untested systems.

What are the kinds of things we should be thinking about doing for the Bankruptcy Code?

First, the kind of collateral that is allowed for short-term lending safe harbors that are exempt from normal bankruptcy should be narrowed. Yes, for United States Treasury securities. No, for mortgage-backed securities.

Second, the broad exemption from bankruptcy for safe harbored counterparties should be curtailed. They should be required to stay in bankruptcy for long enough so that the court can sell off bundles of the failed firm's derivatives book intact. The chaotic closeouts in Lehman Brothers are said to have cost Lehman about $50 billion in value. We could do better with a better Bankruptcy Code.

Third, the blanket preference safe harbor needs to be better targeted. Preference law has long reduced creditor's incentives to grab collateral and force repayment on the eve of bankruptcy, driving a weak but possibly survivable firm into bankruptcy. Preference law reduces the incentives to grab and demand repayment on the eve of bankruptcy.

So, if John owes Jane $1 billion in normal debt and if she holds a gun to John's head and says, "Repay me," when he is on the verge of bankruptcy, she would go to jail for extortion and the $1 billion will be recovered from Jane as a preference in John's bankruptcy for the benefit of all of John's creditors. And the $1 billion preference forced out of John prior to his bankruptcy, will be recoverable even if Jane exerts much less pressure than with a gun. But, if John owes $1 billion to Jane in derivatives debt and she holds a gun to his head to collect, then she will also go to jail for extortion, but she won't have to return the $1 billion as a preference. The derivative safe harbors will fully protect her from the operation of preference law.

I would submit that this exempting of blatant grabs from basic preference law is one of the several overly wide aspects of the safe harbors that need correction and narrowing to fit markets better. And there is reason to believe that the collateral grabs that AIG suffered, as it sank in 2008, would have been preferential had the safe harbors not existed. AIG might have failed, would probably have failed and quite plausibly would have been bailed out anyway, but maybe it wouldn't have been done in such dire circumstances and there would have been more regulatory options available, if so much of AIG's obligations were not safe harbored.

So, overall, bankruptcy should support financial safety better than it does now. Bankruptcy should be capable of resolving a nonbank, systemically important financial institution with major positions in safe-harbored financing. But, as of today, it cannot. Because it cannot, bailouts are more likely than otherwise and, perhaps even more importantly, system-wide costs to the economy are more likely than they would be otherwise. Bankruptcy should not subsidize the riskiest forms of financing and investment, the shortest-term debts in our financial system. And they shouldn't be facilitating riskier, weaker, systemically important financial institutions. Today, bankruptcy subsidizes this extra risk and short-term finance.

Bankruptcy should promote market discipline. Today it tends to undermine that market discipline via the safe harbors, making our financial institutions weaker than they otherwise would be. Several of these problems can be fixed. They are not that hard to fix. And we should fix them.

Thank you.

[The prepared statement of Mr. Roe follows:]

Testimony of Mark J. Roe

David Berg Professor of Law, Harvard Law School

Before the

Subcommittee on Regulatory Reform, Commercial and Antitrust Law

of the

Committee on the Judiciary

United States House of Representatives

Hearing on

The Bankruptcy Code and Financial Institution Insolvencies

December 3, 2013

Chairman Bachus, ranking member Cohen, and members of the committee:

I'm Mark Roe, a law professor at Harvard Law School, where I teach corporate law and bankruptcy law, and do research in the same subjects. I appreciate the opportunity to be here to provide you with my views on the adequacy of the Bankruptcy Code to deal with failing financial firms. I will focus my testimony on the exemptions from bankruptcy for derivatives and short-term financing—the so-called bankruptcy safe harbors.

The safe harbors are too wide. They exempt much short-term financing and risky investing from the normal operation of American bankruptcy law. By treating short-term financial debt and derivatives trading much better than regular lenders and ordinary suppliers to the bankrupt, the safe harbors make an effective resolution in a bankruptcy without regulatory support difficult, and for some financial firms, impossible.

Worse yet, they undermine market discipline in the pre-bankruptcy market, making the financial system and the American economy riskier than it needs to be and more prone to suffer major failures. The safe harbor exemptions from normal bankruptcy rules subsidize short-term loans over stronger, more stable longer-term financing for financial institutions.

Five years ago, the bankruptcy filing of Lehman Brothers, the major investment bank, propelled the financial crisis forward. Its bankruptcy was chaotic, as derivatives counterparties closed out their positions, dumped collateral on the markets, and helped to push mortgage-backed securities into an asset-price spiral that threatened the solvency of other major financial institutions. In short order the venerable Primary Reserve Fund, which owned Lehman debt, failed, leading the Federal Reserve to conclude that it had to guarantee the entire money market industry. AIG was on the verge of failure, with catastrophic consequences to its counterparties around the world, and the government bailed out AIG.

The country suffered from a deep financial crisis and sank into a major economic setback from which it is still slowly recovering.

If a Lehman-class bankruptcy occurred today, the bankruptcy code would do no better in 2013than it did in 2008. The close-outs would be chaotic, with great potential damage to the financial system and the American economy.

We have exempted a wide range of securities and transactions from the normal operation of bankruptcy law. This is not a long-standing exemption, but one that has grown and expanded over recent decades, with a major expansion as recently as 2005. Even today, after the financial crisis, if a counterparty to a bankrupt financial institution has a favored investment, it can fully opt out of the failed financial institution's bankruptcy process—despite the fact that bankruptcy is an institution that has served this country well. Bankruptcy could help to stabilize the firm and the surrounding financial market, but for financial firms with these a heavy dose of these bankruptcy-exempt obligations, it cannot. Opting out of bankruptcy is often good for those opting out but destabilizes the debtor and its other business partners.

The potential for chaotic close-outs and an unstable bankruptcy is only the first reason to rethink the safe harbors. The safe harbors also subsidize short-term debt at the expense of more stable longer-term debt. When we favor one form of debt over other debt, we get more of the subsidized debt and less of the rest. That's what we've done. And, third, the safe harbors sap market discipline. We want to harness market incentives to discipline the financial system. The safe harbors do the opposite. They tell counterparties that they can pay less attention, or none, to the credit quality of their counterparties and to the extent of their own exposure. We destroy market discipline where we need it. Fourth, the safe harbors can be best used by America's largest financial institutions. The safe harbors give the bigger money center institutions an artificial competitive advantage over regional and mid-sized institutions. Narrowing the overly-wide safe harbor exemptions will facilitate a more competitive financial market in which regional and mid-sized institutions can participate more effectively.

Each of these four problems would justify a sharp cutback in the safe harbors. Together the policy path is clear and compelling. The only questions should be when, how, and to what extent.

Thus far, our governmental reaction to the financial crisis has been to shore up financial regulation, with greater capital requirements, with activity restrictions, and with administrative controls like living wills and the single point of entry structure. These efforts have much that is admirable. But if a major financial failure gets by the regulators, we still cannot count on the bankruptcy system to catch the ball. Indeed, we should expect a miss as big as bankruptcy's miss for Lehman.

First, we should want redundancy in complex systems. If one stabilizer fails in a complex system, we want another mechanism to take over, to avoid catastrophic failure. Engineers know that, and likewise financial regulators and now Congress should turn to improving bankruptcy by stabilizing and narrowing its safe harbors.

Second, bankruptcy is the first line of defense by statute and regulatory preference. Financial regulators say they'll play the Dodd-Frank Title II card only if bankruptcy fails. But regulators cannot allow bankruptcy to go for even a day to see if it works, and then decide whether or not bankruptcy is getting the systemic risks under control. Under today's bankruptcy rules, as soon as a financial institution with major safe harbored financing files for bankruptcy, the exemption from the automatic stay for the safe harbored transactions will lead the financial firm's counterparties to rip apart the bankrupt's portfolio.[1] There will be no putting Humpty Dumpty back together.

Third, Title II may not work. It hasn't been tried.

Be wary of untested systems.

Fourth, the safe harbors encourage excessive risk-taking and short-term financing that put more of our big institutions at risk. When Bear Stearns failed, one-quarter of its liabilities were in short-term, often overnight debt that did not have to comply with basic bankruptcy rules. When Lehman failed, one-third of its liabilities were in short-term, bankruptcy exempt, safe harbored debts. Part of the reason they

[1] The automatic stay stops creditors from acting against the bankrupt until the court and the bankruptcy process can ascertain whether the firm is more valuable kept intact. If it is, the firm is continued and creditors are compensated later. Ipso facto provisions in bankruptcy law limit the impact of loan clauses that make the debtor's bankruptcy an irremediable default under the loan documentation.

were in short-term safe harbored debt is that the safe harbors subsidize short-term debt over longer-term, more stable financing.[2] This short-term debt has become a big part of the financial system. Evening up the legal status of short-term and long-term debt would shift some financing away from short-term, often overnight and unstable repo financing to longer-term financing. Same for derivatives.

What to do?

First, the kind of collateral allowed for the short-term lending safe harbors should be narrowed: United States Treasury securities, yes; mortgage-backed securities, no.

Second, the automatic stay should be brought back in for derivatives, but in a limited way: long enough to package the failed firm's derivatives book and sell bundles off intact. The chaotic close-outs are said to have cost Lehman $50 billion or more in value.[3] A modest stay will make an alternative to chaotic close-out possible. Sophisticated derivatives industry leaders are now recognizing that the rapid close-out mechanisms are potentially destructive not just of the economy but of the derivatives players themselves.[4]

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[2] In financial markets, these short-term, typically safe-harbored loans, are made by one firm selling the collateral and agreeing to repurchase (or "repo" it) shortly thereafter, often the next day. The collateral is repurchased at a slightly higher amount than its sales price, with the difference constituting the loan's interest.

[3] The return of the automatic stay would need to be coordinated with other bankruptcy rules, such as by bringing back the long-standing bankruptcy bar on effectiveness in bankruptcy of ipso facto contract clauses—those contract terms that allow counterparties to cash out if their debtor goes bankrupt.

[4] Whittall (2013) reports that the derivatives industry was told in the keynote speech from one of their leaders at the International Swaps and Derivatives Annual General Meeting:

> Derivatives users should be prepared to make amendments to one of their most-treasured legal rights to help in the fight to end too-big-to-fail, attendees ....
>
> Wilson Ervin — vice-chairman in the group executive office at Credit Suisse and a leading architect of the so-called debt bail-in framework — argued in a keynote speech to ISDA delegates that modifying legal documentation that currently allows swaps counterparties to leapfrog other creditors of bankrupt firms was "essential".
>
> To highlight the severity of the issue, Ervin cited the US$40bn in costs the Lehman Brothers administration had to swallow in order to comply with early termination requests from its swaps counterparties, hugely exacerbating the extent of the losses racked up by the bankrupt estate.
>
> The swaps termination costs dwarf the estimated US$25bn of losses from real estate and private equity holdings Lehman was harbouring on its balance sheet before it went under, and contributed substantially towards the estimated final bill of US$150bn to wind up the firm.

Related, the ipso facto clause ban as now constituted makes the regulators' single point of entry harder to work. This problem is now well-known in regulatory and derivatives circles. But there are other safe-harbor-induced technical problems.[5]

Third, the blanket preference safe harbor needs to be better targeted. Preference law has long served American bankruptcy well, by reducing the incentives for creditors to grab collateral and force repayment on the eve of bankruptcy, at the expense of other creditors. If John owes Jane $1 billion in normal debt and she holds a gun to John's head to force him to repay, she goes to jail for extortion and assault with a deadly weapon. And the $1 billion will be recovered from Jane in bankruptcy as a preference. It will be recoverable even if Jane exerts less pressure than with a gun. *But* if John owes Jane $1 billion in derivatives claims and she hold a gun to John's head to collect, then, while she will also go to jail for extortion, she will *not* have to return that $1 billion as a preference. The derivatives safe harbors will protect her from preference law. Exempting even blatant collateral grabs from basic preference law, and expecting that other legal institutions will remedy the situation, is one of many overly-wide aspects of the safe harbors that need correction.

The rapid collateral grab that AIG suffered as it sank would likely have been preferential had the safe harbors not existed. AIG might have failed and been bailed out anyway. But maybe not in such dire circumstances. More options might have been available.

Fourth, the Code's netting is overly-broad. It is perfectly appropriate for the counterparty to be able to net all of its transactions—both winners and losers—in the same product (say, foreign exchange, or interest rate swaps, or weather derivatives) with the same counterparty and then pay (or be paid) a single amount to (or from) the bankruptcy debtor, as long as the two parties contracted for this kind of offset. This does allow the counterparty to come out better than if the debtor could cherry-pick and take

[5] For example, if the holding company redeems some of its long-term debt, under creditor pressure, and in advance of its failure, the redemption would under normal bankruptcy law be recoverable as a preference. But that redemption can be made to be safe harbored and beyond recovery in the holding company's bankruptcy. Regulators should wish to have a bankruptcy legal team do a bankruptcy forensic review to help make bankruptcy work under the regulators' plans.

the contracts it's ahead on while rejecting those that it's behind on. But the Code now safe harbors much more: obligations in otherwise unrelated derivatives businesses can be netted. This not only allows the counterparty to do even better than others, but, more importantly, this wide netting (1) makes it harder to sell a single business line of the debtor in its bankruptcy, because the wide netting expands any sale from being a sale of one product line to another firm in the same product line to being a sale of the bankrupt's entire derivatives business a single buyer. But the market may better be served by selling the segmented businesses, one-by-one. Furthermore, (2) the wide netting rules encourage financial supermarkets that become too-big-to-fail financial institutions, because they can take advantage of cross-product netting better than single-product line financial firms can. Upstarts in a single product line cannot compete as easily because they cannot get the subsidy from cross-product netting. Eliminating cross-product netting should be on the agenda to give the little guy and regional banks—the financial upstart—a fighting chance to compete.

Fifth, while the safe harbors need narrowing, so that we do not continue to subsidize these transactions at the expense of ordinary financing, not all of the evening up that needs to be considered is in narrowing the safe harbors. The safe harbors allow favored creditors to escape from poorly structured parts of the Bankruptcy Code that apply to all creditors. These poorly structured parts should be fixed up.

Here is one aspect of basic Code rules that could be changed overall, although it is tricky: A major advantage of short-term, safe harbored financing is that the counterparty does not need to worry about bankruptcy's baseline rules, which would not assuredly pay the stayed creditor interest, and which usually would not. But interest is the life blood for a financial creditor. The safe harbored creditor, however, can cash out and get the time value of its investment, because it can reinvest its funds. The non–safe harbored counterparty can find itself providing a no-interest loan to the debtor. Rethinking, and reconstructing, the interest payment rules to non–safe harbored creditors could bring the attractiveness of stable financing more in line with safe harbored financing. (Reconstruction will be tricky because of the impact on other creditors, but this could be done fairly and efficiently. One possibility: for financial firms, the obligation to pay interest shall continue after any bankruptcy filing, at the prebankruptcy contract rate, with a standard rate used for noncontract creditors.) When Bear Stearns failed it owed about a quarter of its value in short-term repo, which was about eight times its equity. Yet, as recently as 1989, it had only 6% of its value, not 25%, exposed to short-term repo.[6] The safe harbors may have played a role in its unstable financing choices.

Safer finance is possible. Were the safe harbors better targeted, American finance would be safer and the potential call for bailouts less likely to happen.

Other bankruptcy rules fit badly with the derivatives and short-term repo market, and the Code should accommodate the derivatives and repo markets, but do so without endangering American financial markets. For example, basic bankruptcy rules give the debtor a nearly unlimited right to assume or reject its prebankruptcy contracts. Derivatives counterparties, who are selling protection from volatility, can then be slammed by the bankrupt debtor who waits, sees if the pricing has become good for the debtor and then assumes the contract, or, if the pricing is bad for the debtor, rejects the contract. Returning to the baseline bankruptcy rule is inappropriate, unfair, and destructive of the entire derivatives market. But our current safe harbors reverse the situation, allowing the counterparty to choose—a result that is no better. A middle ground is possible.

Sixth, we want bankruptcy judges prepositioned to deal with major financial institutions. Bankruptcy law should require each Circuit Court to designate a judge who is on-call for such efforts. That judge presumably would already have the needed bankruptcy and financial expertise, would keep acquiring more, and would follow financial developments so that he or she would be ready to roll if a non-bank systemically important financial institution filed for bankruptcy. We may wish to confront the problem of Article III vs. Article I authority for this class of judges.

* * *

[6] Bear Stearns 10-K's; Roe (2011: 563).

Overall, we should want bankruptcy to support financial safety better than it does now. Bankruptcy should be capable of resolving a systemically important nonbank financial institution even if it has major safe harbored financing. As of today, it cannot. Because it cannot, bailouts are more likely than otherwise and the costs to the American economy would be higher than they would otherwise be. Bankruptcy should not subsidize the riskiest forms of financing and investment, facilitating riskier, larger, and less stable financial institutions. Today it does. Bankruptcy should promote market discipline. Today it undermines market discipline, making our major financial institutions weaker than they otherwise would be.

We can fix these problems and we should.

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Mr. BACHUS. Thank you very much.

Mr. Smith, do you have any questions or do you want me to? I can go first and then you can. All right thank you.

Hearing your testimony, I think we are all thinking back to 2008 in our mind. And we are talking about the failures of what is now called SIFIs and there was obviously almost a "domino effect." I mean, everyday there was a Merrill Lynch or there was a Lehman. For a while there AIG was just—you pick up the paper and what is next?

I do think, as we consider what we are going to do, you mentioned redundancy. I think that was your testimony Professor Roe, which I think is tremendously important in a case like that, because I—when you said, you know, title II might work, but it might not work. Or enhanced bankruptcy may work, but it may not. But you have two tracts. And I have told people that 2008 was almost like the economy had a stroke or a heart attack. And it was—you know, as with a stroke or heart attack, you need to get to the patient, time is of the essence.

And knowing that, we also add the political theater of what, you know, as these companies either begin to—they become insolvent—there is probably only going to be maybe two or three—it would be unusual to have one, because I think some of the regulations we have now on short-term financing and over leveraging, hopefully we won't have that. But it may be almost a systemic event. And you wonder whether you have to also factor in, is Congress going to try to intervene which even complicates that.

I think it is important for us to address this now, not do it in the middle of a crisis where we are being pushed around by changing sentiment. And I think you have all given us a roadmap.

One thing that I am struck by, that I did not know at the time, AIG was credit default swaps. I mean this was all pretty risky stuff. It was their insurance business, which was their core business, was totally reserved, there was no—but it was one of their subsidiaries. And I am just wondering, and I—my first question, Mr. Bernstein, in that case you had a subsidiary where the liability was overwhelming the whole company. That single point of entry, does that work in that situation?

Mr. BERNSTEIN. I am going to answer this one in the abstract because we had a major involvement in AIG, so I would prefer to keep it to the general.

I think if you have significant liabilities in one subsidiary, first of all, if you made some of the changes that permitted you to assume the credit default swaps and other types of instruments rather than having them terminate on bankruptcy, you would have many more options. You could put that subsidiary into bankruptcy and you could preserve those contracts as a book which had value. Or you could recapitalize that entity or do other things. Whereas, you know, currently, with the way bankruptcy works, bankruptcy wasn't an option.

Mr. BACHUS. Right. And, you know, from your testimony, I think both of you mentioned that the safe harbor includes derivatives. So, it probably included credit default swaps. So, which took, in the case of AIG, almost all their liabilities were outside of bankruptcy or were in the safe harbor. You know, one—there was a lot of discussion back then about good bank, bad bank. Though that is not what you are proposing, is it?

Mr. BERNSTEIN. No. It is the single point of entry approach is not really so much good bank, bad bank. It is really taking a group of stakeholders that are subordinated and imposing the losses on them in the private sector, rather than having the public sector support the institution.

Mr. BACHUS. Yeah.

You know, there is. I think Senator Vitter has a bill to basically do away with our largest financial institutions. I know this isn't the subject of this hearing and there is a lot of discussion on that. But, I want to say this, I don't think that is the best alternative because we have to compete on a global marketplace. And I think one of our strengths is we do have some very large companies and financial institutions they are, of course, and I know I am not going to ask you all, at this point, you know, unless you want to discuss that. Does anyone want to volunteer?

Mr. Lacker?

Mr. LACKER. I will just comment that there is a relevance. There is a connection between bankruptcy reform and strategies like Vitter's or my colleague—former colleague Tom Hoenig, who have advocated dividing up the institutions either by size or activities. You know, what you want to achieve. What those strategies are designed to achieve is a situation in which those firms are resolvable in bankruptcy without government support. I think that is their general objective. And the planning work, that Mr. Bernstein described so eloquently and in detail, that is the way you would deduce, that is the way to figure out exactly what they have to look like now in order for us to feel confident in the future, in extremis, that you could take them through bankruptcy with a fair amount of confidence that it would be orderly enough to be workable.

At this point in the process of those "living wills" we have just been through, we have just had a second round of submissions, I don't think we know enough now to know exactly what changes we need to make. Whether it is—I am not sure size is the right criteria and I am not sure activities are. I think it is likely to be more—it is more likely to be things like what Mr. Bernstein pointed to, having clear plans, having detailed plans; organizing your legal entities in conformance to your operating activities in a way that makes them severable, if need be, in bankruptcy, if you ever feel the need to spinoff a foreign subsidiary, for example, or handle a foreign subsidiary differently than domestic subsidiaries.

So I think all those things are well motivated. But, I think the "living will" and the planning process centered around a bankruptcy filing and the fine details of what that looks like, I think that is going to be more informative and more reliably get us to the right kind of solution.

Mr. BACHUS. You know, AIG, in all of this, is a great example to look at because for—on several different angles. But you did have a foreign subsidiary in London that really was making bets it couldn't afford to lose and in staggering percentages.

You also, if you are dealing with a global financial institution headquartered here or even headquartered somewhere else, you—and I am sure somewhere in the Bankruptcy Code, I am not sure how you would—there would have to be some cooperation globally between regulators or between really the court system in different countries. And what would you—how would you address a company that was operating major subsidiaries and business across the globe?

Mr. BERNSTEIN. This is also an area where resolution planning is important because, one, you can't assume that local jurisdictions are going to act outside their own self-interests. So, you have to assume self-interest will be the driving force. And you have to design plans that demonstrate that the self-interest of the local jurisdiction is going to be fulfilled by cooperating with the resolution.

Many of them do not have a bankruptcy process like we do. They have got a purely administrative process. Some countries go in the other direction and have processes which are purely common law. So, you have to really look at each entity and look at how you demonstrate it is in the local interest to cooperate.

Mr. BACHUS. All right.

You know, again, derivatives would have, if there was a derivative, if they weren't in a safe harbor, if there were some provisions in dealing with those, as opposed to sort of a fire sale, both Lehman and AIG, I think, you know, would be some benefit if that had been in the code.

Mr. ROE. Well that—the difficulty with the safe harboring that causes problems for financial institutions with a major derivatives portfolio is that the portfolio is put together as a unit: buy pounds on this side and sell pounds on that side. And the best way to be able to reposition the portfolio is to sell it intact or to sell obvious units of the portfolio intact. The safe harbors make this very difficult because I may have packaged selling pounds with buying pounds together, but my counterparty will tend to closeout this part of the portfolio and my other counterparty might close out that part of the portfolio on terms that aren't particularly favorable to me and make it impossible for me to sell the portfolio somewhere else, if I have a buyer. With some cutback on the safe harbors, we have the potential to be able to put the portfolio together and reposition it and sell it presumably quickly in a bankruptcy. We can't really do that in bankruptcy now. It is possible to do that under title II, but it is not really viable for a firm that has significant derivatives that actually does the filing for bankruptcy.

Mr. BACHUS. Would, under the Bankruptcy Code that you envision, would all safe harbors be—would there be no safe harbors or would you do it incrementally?

Mr. ROE. Incrementally.

And there are several things in the Bankruptcy Code that make it difficult or impossible for the good functioning of the derivatives market to work. So, one example, when somebody buys or sells a derivative, they are basically trying to protect themselves against volatility in whatever they are buying or selling. The Bankruptcy Code gives the debtor a nearly unlimited right to reject or assume that contract without any real time limits on that capacity to reject or assume.

So, if we had a derivatives contract and I went bankrupt, you would be very worried, legitimately worried that I just might play the market to wait for the moment when the contract has turned favorable to me. So there ought to be some fairly sharp limits on the debtors' capacity to reject or assume a contract. Something along the lines of a few days, a short period in which the portfolio could be assumed and sold intact to somebody else.

Mr. BACHUS. Okay.

And, of course you know, to a certain extent, the Fed assumes some of those to do that, I think. I mean, their book. I mean they assume some of those. I guess they assume some of them were derivatives and that the Fed took on there.

Mr. LACKER. Are you talking about the AIG case? I am not familiar with the details of what they assumed——

Mr. BACHUS. Yeah. I guess well they mortgaged——

Mr. LACKER [continuing]. How much, I am not sure.

Mr. BERNSTEIN. Yes.

Mr. BACHUS. Mr. Bernstein?

Mr. BERNSTEIN. One point to make, which I think was being made by Professor Roe is that—now I think there are really two separate issues here. One, is what it takes to do an effective resolution of a financial institution, in terms of changes to the safe harbors which might be a limited stay and it might be the ability to quickly assume and move the contracts. The separate issue and I think it is, you don't necessarily need to deal with it in financial institution insolvencies, is the more general question of the scope of the safe harbors. And there is a lot of good work being done on that by the National Bankruptcy Conference, the American Bankruptcy Institute Commission and I know Professor Roe is involved in that. But I think it is worth separating those two issues for purposes of this hearing because it is really the former that we really need to focus on for financial firms.

Mr. BACHUS. All right. I appreciate it.

Now, mortgage-backed security, is that a derivative? Excuse my ignorance, but I am just trying to——

Mr. LACKER. No.

Mr. ROE. The principal place where mortgage-backed securities would come into the safe harbors would be as a repo. So, if I lent to you with a mortgage-backed security as my collateral, this transaction would be safe harbored under the Bankruptcy Code. One of the problems in the financial crisis is that there was a lot of dumping of the mortgage-backed securities when people realized they weren't worth as much as they hoped they were going to be worth in 2005 and 2006. They turned out to be worth less in 2008.

The safe harbors facilitate some of those quick sales in that, if you have done a repo on a mortgage-backed security with me and I go bankrupt, you can take the mortgage-backed security and immediately sell it. In a traditional bankruptcy you can't immediately get to the mortgage-backed security and sell it. The judge has to promise that you will be adequately protected. But, that adequate protection can be realized sometime later on.

Mr. BACHUS. All right.

Mr. ROE. So, that is where——

Mr. BACHUS. And I am not——

Mr. ROE [continuing]. The mortgage-backed securities——

Mr. BACHUS [continuing]. Thinking that mortgage-backed security wouldn't be a derivative because it is just a basket of mortgages. So, it doesn't derive its value from anything external, I guess, is that correct?

Governor Lacker?

Mr. LACKER. It is not traditionally thought of—mortgage-backed security is not traditionally thought of as a derivative.

Mr. BACHUS. Right.

Mr. LACKER. There are derivatives that are written to replicate——

Mr. BACHUS. Right.

Mr. LACKER [continuing]. The returns on mortgage-backed——

Mr. BACHUS. And that's what——

Mr. LACKER [continuing]. Securities or to reference those returns.

Mr. BACHUS. Well, and I, you know——

Mr. LACKER. So, that happens.

Mr. BACHUS. Some of those were—bets were made to do just that.

Mr. LACKER. Yeah. There is a lot of that.

Mr. BACHUS. Mr. Jason Smith of Missouri.

Mr. SMITH OF MISSOURI. Thank you, Mister——

Mr. BACHUS. A Missouri Tiger fan.

Mr. SMITH OF MISSOURI. Absolutely. Is there any other?

Thank you, Mr. Chairman.

Mr. BACHUS. When there is not a miracle on the Auburn side?

Mr. SMITH OF MISSOURI. I hope not. It is a miracle for both of us right now. [Laughter.]

Mr. SMITH OF MISSOURI. My question is to Mr. Lacker.

In your view, what are the benefits of resolving the financial firms through the bankruptcy process?

Mr. LACKER. So, the alternative are worse, essentially. And the alternatives that we have utilized involve the discretionary deployment of public funds to protect creditors. I think that is an unstable and unsustainable approach. And that is what concerns me about title II as well.

The dynamic—the expectation, I talked about that creditors view large financial institutions as "too big to fail" and likely to get government support, arose over several decades from the early 70's and it was the accretion of—slow accretion of various precedents that led to the expectation that that is how we are going to behave. We ended up—those precedents resulted from situations in which, faced with a choice between rescuing or not and having the ability to do that, policymakers erred on the side of caution and protected creditors.

And this came home, this was most vividly illustrated in the Bear Stearns case. The Bear Stearns had a substantial amount of RP borrowing that was maturing overnight every day, every morning actually. And there were—there was a substantial amount of lending overnight, via purchase agreements, to several other investment banks. And the fear was that, should Bear Stearns not get support and should those lenders get collateral back instead of their cash and have to sell the collateral for an uncertain value, that that would cause lenders to pull away from other financial firms as well.

The ambiguity about that was what drove—is what created this awful dilemma for policymakers. And that is an example of the kind of dynamic that set up the precedence that led to the widespread expectation coming into the crisis for this. I think that providing that discretion to policymakers is likely to lead to this dynamic replicating itself in the future.

Mr. SMITH OF MISSOURI. So, if the Bankruptcy Code was adequately equipped to handle these insolvencies for the financial institutions, what is your belief on this "too big to fail" policy?

Mr. LACKER. I think that the combination of good improvements to the Bankruptcy Code and the "living will," the resolution planning process, can get us to a position where regulators are comfortable and confident that, should a large financial institution experience financial distress, they are willing to take it through bankruptcy without extraordinary government assistance. And once they are confident about that, we can convince creditors that that is going to be the norm. That will shift incentives in financial markets. That should lead to less short-term funding, less of the fragility that we see, less of the maturity transformation that creates so many problems to begin with. So—and that maturity transformation, that short-term lending like in the Bear case I described, is what gives rise to these terrible dynamics. And that is, I think, our best hope for getting out of the "too big to fail" box.

Mr. SMITH OF MISSOURI. Is the bankruptcy—this question could be for anyone. But, is the Bankruptcy Code prepared for a big company, other than just a financial institution but a big company that may be the largest employer in the United States let us say, that decided to, you know, be insolvent? I mean, is that going to be the same type of situation where it comes back to Congress and we have to bail out this big corporation? Or is the Bankruptcy Code prepared right now to handle a situation that has maybe 200,000 employees?

Mr. ROE. I think I could address that. I believe that the bankruptcy system now is capable of handling the bankruptcy of a very large industrial firm. And you could put some of this in, not historical perspective, but perspective over the decades, something I was mentioning while we were offline. When the Bankruptcy Code was passed in 1978, the general thinking was that a large industrial firm, such as the kind of firm you are describing, could not survive Chapter 11.

And, in fact, we bailed out Chrysler right after the Bankruptcy Code was passed. And Lee Iacocca, the president and chairman of Chrysler, persisted and was very convincing with the argument that, if Chrysler entered Chapter 11, it would not exit Chapter 11 intact, that consumers would simply not buy cars from a bankrupt Chrysler.

Over the subsequent decades, the system has learned how to reorganize very large industrial firms effectively. You know, in the last few weeks I flew American Airlines in bankruptcy and US Air outside of bankruptcy. And I might have been the only one on the plane who just noted that when I got on I was flying a bankrupt airline. It has just become a normal part of business. It will be very good for the economy of the United States if, over the next couple of decades, we could routinize the bankruptcy of financial institutions so that it just happens in the background and works effectively.

So, one additional cost of—one additional advantage of bankruptcy over alternatives is, for example, that to use title II, somebody has to be saying this is a systemically important financial institution whose failure would be very detrimental to the American economy. That is the kind of thing that could help propel more panic than we really need to have. If this entity could go right into bankruptcy and be handled by the bankruptcy institutions, which I believe an amended Bankruptcy Code could do, the waters would be calmer and bankruptcy would do better for us.

Mr. BERNSTEIN. I would like to comment on that question also.

First of all, the Bankruptcy Code was designed for the biggest companies. In fact, it really was designed to follow the pattern of equity receiverships in the 19th century which took the railroads, which were the biggest companies that existed at that time, and reorganized them.

But there are two issues that it is very hard for the Bankruptcy Code to deal with. One is, will the company be able to continue in business? And I think what Mark is saying is that, in a lot of instances where people thought companies couldn't continue in business, they have actually been able to sell their product in bankruptcy. Now, whether that would have been true, had the auto manufacturers stayed in bankruptcy for more than 6 weeks, would somebody buy a car with a 5-year warranty and the like? The answer may be that they would, as long as somebody stood behind the warranty other than the debtor.

And that gets to the second question, which is somebody has to be willing to finance these entities in order for them to reorganize. And one of the problems in a downturn that goes beyond just the individual company and effects the whole economy is the money may not be available to finance you until you can reorganize. You know, the Tribune Company went into bankruptcy about 4 or 5 years ago. And, at the beginning of that bankruptcy case everyone thought its value was one-third what it turned out to be when it emerged from bankruptcy.

And, because of the degradation of value in a depressed market, it may be difficult to find private financing. And there has to be some form of bridge financing, probably other than DIP financing, in that kind of market that is available. And that is why it may be difficult without that sort of liquidity backup for the largest company in America to fail. And that was the experience with the auto companies recently.

Mr. BACHUS. Thank you.

I have got some prepared questions that I would like to go through. There are two for Governor Lacker. These are from staff members or the Chairman.

Can you explain why you believe that shifting away from short-term financing for financial firms will increase the probability that they may be orderly resolved through the bankruptcy process?

Mr. LACKER. So, Mr. Roe has argued this eloquently in his statement.

Mr. BACHUS. Right.

Mr. LACKER. There is a great deal of maturity transformation that goes on outside the banking system, outside of deposit taking. And it is the type of financial arrangement that is most likely to pin down a policymaker, put him in a box and make him feel as if he needs to rescue creditors rather than let bankruptcy proceed.

I think setting the criteria for these large financial institutions that they ought to structure themselves so that they can be resolved in bankruptcy without government-provided "debtor-in-possession" financing, with just the debtor-in-possession financing they have planned for is a good criteria. If that means they do less maturity transformation, if that means that they do less borrowing short and holding longer in liquid assets, then I think so be it. I think that the system we have now is—artificially favors the maturity transformation that goes on in qualified financial contracts, particularly in RP lending. And I think reforms to the Bankruptcy Code and the kind of planning, the kind of resolution planning that Mr. Bernstein described, can help us get to a situation where we have a more socially appropriate quantity of maturity transformation going on.

Mr. BACHUS. You know, look Bear Stearns—in Bear Stearns I have had knowledgeable people that have said to me, "You should have been able to look at the balance sheet and told they were insolvent." So, I think maybe a more clear accounting or examination of their balance sheet. But also they were going through some, what I call, some financial shenanigans of shifting things back and forth. But I am just—you know there are ways in bankruptcy, there are ways to go back and capture some of that, I think. So that would probably be another advantage of bankruptcy.

But anyway, I will get back to it. One of the questions I think sort of tracks on the question I have just asked Governor Lacker, for you Professor Roe. If the safe harbor exemptions create incentives for short-term financing, in your view, how does that make the financial system more difficult to resolve through bankruptcy?

Mr. ROE. This will parallel Jeffrey Lacker's comments, in this way, if we have safe harbors for short-term debt but don't have it for long-term debt, we will tend to get more short-term debt that can run off very quickly in a bankruptcy or during a financial failure. So we have rules that facilitate the runoff when we should either want the rules to be neutral or maybe to slow down that sort of runoff. And this actually feeds into the point that Donald Bernstein was making. One of the big problems in a large financial institution bankruptcy would be financing.

And this—the remark that I am going to make now is not going to make the problem go away. But, the safe harbors increase the difficulty of financing because some significant portion of the financial structure of a failed financial institution, if they are in safe harbored repo, will runoff immediately and then, in the extreme case, will have to be replaced. If it couldn't runoff immediately the financial pressure would be less on the firm.

So, one example, when Bear Stearns filed—when Bear Stearns failed and was taken over by JP Morgan Chase, it had about a quarter of its liabilities in repo. Only a couple decades before its repo level was only about 6 percent of its total liability. When it failed in 19-—in 2007, 2008, it is much more difficult for it to go through a bankruptcy because so large a portion of its structure is going to be immediately withdrawn.

Mr. BACHUS. And I think, just from reading you all's testimony and sort of coming into this, it is just clear that the safe harbors does create some big problems. And the one you have described is pretty clear. I don't know that—Mr. Bernstein, that is to you——

Mr. BERNSTEIN. I definitely agree that——

Mr. BACHUS. Yeah.

Mr. BERNSTEIN [continuing]. In order to resolve financial institutions you have got to give them the ability to preserve the book of financial contracts and move it on to the continuing entity.

Mr. BACHUS. And, you know, that seems to be a point if we are going to do something. If we don't do something comprehensive incrementally that would be a good first step that I think would beat a little dissension.

This is for Governor Lacker. Do you think there should be any regulatory involvement in the resolution of a financial firm through the bankruptcy process? I guess if we ask 12 different Fed governors, we would get 12 different answers to that question.

Mr. LACKER. I don't know.

Mr. BACHUS. I think that the answer you——

Mr. LACKER. I think it makes—I have seen proposals that give regulators some standing. I think some standing makes sense. But I think you have to be careful about this. I think having a regulator initiate insolvency proceedings seems useful. I think you would want to carefully prescribe through the principles that they ought to be adhering to in making that decision. I think you would want to give them that right, but preserve as much clarity as you can for market participants as to when it is going to be exercised. So, try and do it in a way that provides some bounds around it that provides clarity about when it is going to be exercised.

Mr. BACHUS. I was just thinking the word boundaries. And, you know, statutorily there ought to be some, with some marginal, I mean, you know, some discretion. But, you would need to define the boundaries of that participation. Whether it was to advise, just to offer advice or to assist, as opposed to not to dictate to them.

Mr. LACKER. Yeah. So, the reason I think that is important, is it is important to, in a situation in which there is the potential for creditors to expect government rescues, you want the regulator to be able to force action and force bankruptcy before things unwind, before actions are taken that just make the matters dramatically worse and force the regulator's hand later. So, now, there is other aspects of standing that I don't have a—I really don't have a view on. You know, pleadings and I guess things that these guys are an experts in.

Mr. BACHUS. Okay.

Mr. Bernstein?

Mr. BERNSTEIN. Yeah. I generally agree with what has just been said. The—you know, if in fact you retain orderly liquidation authority as a backup, it will be less likely to be used if the regulator has the option of using bankruptcy. So, I think that is probably, on balance, a good thing. The—as to other matters, I mean, there may be other issues such as, you know, if you did this single point of entry approach in bankruptcy that the regulator would want to be heard on. So, there may be other standing issues the regulator wants to be involved in.

Mr. BACHUS. Well, and I think you could provide for a regulator to actually sit, if not part of the panel, in some position because you would have to assemble people that had the expertise.

Mr. BERNSTEIN. Or at least give the regulator the opportunity to be heard on any issue.

Mr. BACHUS. Okay.

And I think the last question is for you, Mr. Bernstein. Based on your experience working with and developing "living wills," setting aside the question of how a financial firm will be financed through a restructuring, what are the major impediments to efficient resolution of a financial firm through the bankruptcy process as the Bankruptcy Code is currently drafted? And actually, you have covered an awful lot of this.

Mr. BERNSTEIN. Yeah, I did. Well, I strongly believe that the ability to separate the—first of all, I believe the ability to recapitalize rather than liquidate is extremely important. And I think the tools that are there today will permit it for some entities but not for all entities in the group. And it would be good if the tools were there to have that happen for all entities. I do think liquidity is an important issue and I distinguish that very importantly from capital. The capital losses are going to be suffered in the private sector, but if the liquidity is not there to stabilize the firm through a lender of last resort that is problematic. Banks have the discount window, they can do that; but, broker-dealers don't. So, I think that is an important aspect.

And so, I think really focusing on the good work that has been done by the FDIC on single point of entry. And taking that and saying, "How can we do that in a procedurally appropriate way, under the Bankruptcy Code," would be an excellent step.

Mr. BACHUS. Thank you.

Let me—and I am going to conclude with a question that—and more maybe not a question but to sort of try to encourage some action and that is—you know, National Bankruptcy Conference, the American Bankruptcy Institute, the American Bar Association, the regulators. It would be extremely helpful to the Judiciary Committee and I know the Senate is also looking at this, so this is not something that is—in fact they have had ongoing discussions and we have had discussions with them. So there is a willingness and a desire to make changes in the Bankruptcy Code. But, we—it would be so much easier if, as in the case of some other things, we had a model act or we had a something brought to us. And I know the Senate actually has some draft language, but that would be extremely helpful. It would give us quite a bit of comfort because it would be very hard for us to do that. And so, I would encourage the different—the Conference, the Institute, the regulators to continue discussion and give the Congress some guidance. And, if not, a draft.

So, thank you.

This concludes the hearing. Thanks to all our witnesses for attending. This is a very—we, in this case, both the democrats and republican agreed that you were as qualified witnesses as any.

And without objections all our Members of the Committee will have 5 legislative days to submit additional written questions for the witnesses or additional materials for the record.

And this hearing is adjourned.

[Whereupon, at 3:50 p.m., the Subcommittee was adjourned.]

APPENDIX

Material Submitted for the Hearing Record

Statement of Subcommittee Chairman Spencer Bachus
Subcommittee on Regulatory Reform, Commercial and Antitrust Law
Oversight Hearing on "The Bankruptcy Code and Financial Institution Insolvencies"
Tuesday, December 3, 2013 at 1:00 p.m.

Our nation's financial system provides the capital for businesses to develop, grow, hire workers, and prosper. Ensuring that this system functions efficiently in both good times and bad is critical to the ongoing vitality of our economy. One lesson that we learned during the financial crisis of 2008 was that the financial system and existing laws – including our bankruptcy laws – were not adequately equipped to deal with the insolvency of certain financial institutions. As we all well remember, this threatened the stability of the financial system and indeed the global economy.

When established practices like bankruptcy do not work, you end up with ad hoc approaches and a situation where the government can be put in a position of picking "winners and losers," which is not a role we should want for government. Some of you have heard me talk about the bailout of AIG. AIG's largest creditors and counterparties – many of them large domestic and foreign institutions – were made whole, but smaller parties including some in my home state of Alabama were told to take considerable "haircuts." This is but one example of what happens with ad hoc approaches where decisions can vary on a case-by-case basis. There is no consistency or predictability.

We are now about five years out from the low point of the financial crisis in the fall of 2008. Various measures have been taken to try to return to "regular order" after the many emergency decisions that were made during the crisis. The passage of the Dodd-Frank Act was one of them. There are likely differing views on either side of the aisle on this legislation and its provisions for resolving the status of distressed institutions.

Today's hearing, however, is not about that debate. Instead, we will focus on whether the Bankruptcy Code can be improved to provide better for the efficient resolution of large and small financial firms.

The insolvency of a financial firm may present a number of unique challenges to the existing Bankruptcy Code. One such challenge is that these resolutions generally require speed. There must be immediate comfort provided to a financial firm's customers and the market that key obligations will be met. Any uncertainty that is not swiftly and completely addressed may result in severely adverse consequences. So we need to look at whether the existing bankruptcy process provides for this kind of expediency.

We also should examine the impact that the "living will" provision in Title I of Dodd-Frank may have on the bankruptcy process. The "living will" requirement has resulted in financial firms focusing their attention on the structure of their legal corporate entities rather than solely on their lines of business. As the financial industry concentrates their efforts on organizing themselves in a fashion that increases the likelihood of an orderly resolution through bankruptcy, we should assess whether the existing Bankruptcy Code presents any impediments to an efficient resolution.

There have been thoughtful reports by the Federal Reserve and the Government Accountability Office, among others, which have taken a broad look at these issues and possible reforms. So combined with the testimony of our witnesses today, there is a rich pool of scholarship to consider.

Today's hearing will allow the Subcommittee to examine these and other issues, with the goal of beginning the dialogue of ensuring that the Bankruptcy Code provides an up-to-date mechanism to resolve large and small financial firms.

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Prepared Statement of the Honorable Steve Cohen, a Representative in Congress from the State of Tennessee, and Ranking Member, Subcommittee on Regulatory Reform, Commercial and Antitrust Law

I voted for the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 and remain a supporter of the law.

The Dodd-Frank Act's passage by Congress was an acknowledgment of the fact that insufficient regulation led to the problem of so-called "Too Big to Fail" financial institutions—that is, financial institutions that were allowed to become so big and so interconnected that their insolvencies threatened to paralyze the Nation's financial system and its broader economy. This situation, in turn, resulted in extreme pressure for a taxpayer bailout when those institutions fell under financial distress.

The bankruptcy filing of Lehman Brothers in 2008—the largest bankruptcy in U.S. history, involving more than $600 billion in assets—vividly illustrated aspects of the "Too Big to Fail" problem. Lehman's bankruptcy filing greatly exacerbated a financial panic on Wall Street, leading to a severe financial crisis and the greatest economic downturn since the Great Depression, the effects of which we continue to feel today.

More importantly, the financial markets' reaction to the Lehman Brothers bankruptcy highlighted the potential limitations of the Bankruptcy Code in handling the resolution of financially distressed systemically important financial institutions.

I remain a strong supporter of the Dodd-Frank Act, although I also support certain enhancements to it. For example, I support legislation that would increase the minimum required amount of capital for covered financial institutions under Dodd-Frank.

We should also consider the potential need for other enhancements, like adding a representative of the Antitrust Division of the Department of Justice to the Financial Stability Oversight Council, created by Dodd-Frank to oversee the stability of the financial system.

It is in this spirit that I approach today's hearing, which will focus on whether the current Bankruptcy Code is sufficient to allow for the orderly reorganization or liquidation of systemically important financial institutions under Title I of the Dodd-Frank Act.

Whether one supports or opposes the Dodd-Frank Act, we can agree that today's inquiry is an important one. To the extent that modest revisions to the Bankruptcy Code will help ensure that we avoid the need for any future taxpayer bailouts of financially struggling large financial institutions, we should be able to work together on crafting such changes.

Prepared Statement of the Honorable Bob Goodlatte, a Representative in Congress from the State of Virginia, and Chairman, Committee on the Judiciary

The Bankruptcy Code has existed in this country for well over a hundred years. Over this time, our bankruptcy system has evolved to become one of the most sophisticated regimes in the world. The bedrock principle embedded in the bankruptcy system of providing for the efficient resolution and reorganization of operating firms has allowed our economy to grow and flourish.

Nevertheless, a periodic evaluation of the Bankruptcy Code to ensure its adequacy to address the challenges posed by the changing nature of operating firms is one of the fundamental responsibilities of this Committee.

I applaud Chairman Bachus for holding today's hearing to examine whether the existing Bankruptcy Code is best equipped to address the insolvency of large and small financial institutions.

The bankruptcy process confers a number of benefits to all operating companies, including financial firms. The bankruptcy court provides transparency and due process to all parties involved. Furthermore, bankruptcy case law has been developed over decades, providing consistency and predictability.

Additionally, the bankruptcy process has been sufficiently dynamic to administer the resolution and restructuring of complex operating companies with billions of dollars in assets as well as smaller companies and individuals. But despite the bankruptcy system's ability to accommodate complex operating companies, financial firms may possess unique characteristics that are not yet optimally accounted for in the Bankruptcy Code.

For example, efficient and orderly resolution of financial firms can require an unusual level of speed. Refinements to the Code might be considered to better provide that speed while still assuring due process.

Additionally, in some circumstances the failure of financial firms can pose unique threats to the broader stability of the economy. To account for that, title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires certain firms to prepare "living wills" to plan for resolution in bankruptcy in the event of failure.

The Bankruptcy Code is well-crafted to maximize the recoveries of a debtor's creditors while providing an opportunity for the debtor to either reorganize or liquidate in an orderly fashion. It might, however, bear improvements designed specifically for the efficient execution of title I "living wills."

These are some of the issues that may need to be examined as part of the broader evaluation of the existing Bankruptcy Code's adequacy to address financial institution insolvencies. I look forward to the testimony from today's excellent panel of witnesses on these important issues.

Thank you Mr. Chairman, and I yield back the balance of my time.

Prepared Statement of the Honorable John Conyers, Jr., a Representative in Congress from the State of Michigan, and Ranking Member, Committee on the Judiciary

This hearing examines whether current law would adequately address the insolvency of a significant financial institution given what we learned from the near collapse of our Nation's economy just five years ago.

As we consider this issue, it is critical that we keep in mind what precipitated the Great Recession.

Basically, it was the regulatory equivalent of the Wild West.

In the absence of any meaningful regulation in the mortgage industry, lenders developed high risk subprime mortgages and used predatory marketing tactics that targeted the most vulnerable by promising them that they could finally share in the Great American Dream of homeownership.

This proliferation of irresponsible lending caused home prices to soar even higher, ultimately resulting in a housing bubble.

In the absence of any meaningful regulation in the financial marketplace, these risky mortgages were then bundled and sold as investment grade securities to unsuspecting investors, including pension funds and school districts.

Once the housing bubble burst, the ensuing 2008 crash stopped the flow of credit and trapped millions of Americans in mortgages they could no longer afford, causing vast waves of foreclosures across the United States, massive unemployment, and international economic upheaval.

And, to this day, we are still dealing with the lingering effects of the Great Recession of 2008 in the form of a sluggish national economy, neighborhoods blighted by vast swaths of abandoned homes, and municipalities struggling with reduced revenues.

Fortunately, the Dodd Frank Act reinvigorates a stronger regulatory system that makes the financial marketplace more accountable and institutes long-needed consumer protections.

It also establishes a mandatory resolution mechanism to wind down a systemically significant financial institution that cannot be resolved under bankruptcy.

The Act also imposes various requirements on financial institutions that will allow regulators to better assess the risks such institutions present to Wall Street and, most importantly, Main Street.

A key component of the Dodd Frank Act process requires these companies and the regulators to assess resolution under current bankruptcy law.

In recent years, some of the Nation's largest companies have used the Bankruptcy Code to regain their financial footing, including General Motors, American Airlines, and Washington Mutual.

Questions have been raised, however, as to whether the Bankruptcy Code can be improved upon to better accommodate large inter-connected financial institutions like those subject to the Dodd Frank Act.

Some have even suggested that a new form of bankruptcy relief that specifically deals with these institutions may be the most expedient.

There may, in fact, potentially be consensus that some changes to the Bankruptcy Code may be warranted.

In any event, today's hearing should elicit some helpful guidance and I look forward to the testimony from these experts.

Thank you Mr. Chairman, and I yield back the balance of my time.

Questions for the Record from
Representative Doug Collins
for the Hearing on "The Bankruptcy Code and Financial Institution Insolvencies"

December 3, 2013

<u>Questions for Jeffrey Lacker</u>

Mr. Lacker, your testimony makes the case that, to end "too big to fail" and to prevent public resources being used to inappropriately benefit creditors of financial institutions, bankruptcy is better than Title II of Dodd-Frank and other alternatives.

1. *Fannie Mae and Freddie Mac are the last two distressed financial institutions from the 2008-09 financial crisis. They are now in conservatorship and many members of Congress want to wind them down. Isn't it better to use the bankruptcy system to do so instead of writing a new legal regime for an untested agency like FHFA to do so?*

I'm an economist, not a lawyer or expert on insolvency regimes, and my answers to your questions stem from my personal points of view as a Reserve Bank president and member of the FOMC who's concerned about the financial stability of the U.S. My understanding is that bankruptcy protection, at least as the Bankruptcy Code is currently written, is most likely unavailable to Fannie and Freddie. Federal bankruptcy is unavailable to "governmental units" (11 U.S.C. § 101(41)), the definition of governmental units includes "federal instrumentalities" (11 U.S.C. § 101(27)), and Fannie and Freddie bear many of the hallmarks of federal instrumentalities (for example, they serve an important governmental purpose, face extensive government regulation, and enjoy significant tax exemptions). In fact, federal courts have repeatedly classified GSEs, including Fannie, Freddie, the Federal Home Loan Banks, and the Farm Credit System, as federal instrumentalities.

Meanwhile, the Housing and Economic Recovery Act gave FHFA receivership powers (12 U.S.C. § 4617), so while FHFA receivership may be untested and may not be the exact equivalent of bankruptcy, the FHFA could in theory wind down Fannie and Freddie in a manner that roughly approximates bankruptcy. The advantage of a court-administered bankruptcy process lies in the relative predictability it provides to counterparties and future housing finance market participants, compared to an at-times politically-influenced process.

2. *Is the bankruptcy system flexible enough to handle solvent companies like Fannie and Freddie, where there is stockholder equity and the enterprise is meeting its financial obligations to creditors, but it needs to be restructured or put into run-off?*

My understanding is that the Code doesn't exclude solvent companies. A debtor filing for Chapter 7 or Chapter 11 doesn't have to be "insolvent" as the Code defines the term (11 U.S.C. §§ 109(b) and (d)). Bankruptcy courts have confirmed this, noting that as long as a debtor's petition has a valid reorganizational purpose and the debtor's board of directors consents to it, the debtor doesn't have to be insolvent to seek bankruptcy protection. Fannie and Freddie, however, aren't typical companies and would likely remain ineligible for bankruptcy because of their legal status and the Code's current language.

In general, the question of whether the firms need to be restructured or put into run-off is itself a public policy decision that goes beyond narrow legal issues of financial restructuring.

Questions for the Record from
Representative Doug Collins
for the Hearing on "The Bankruptcy Code and Financial Institution Insolvencies"

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Questions for Mark Roe

Mr. Roe, your testimony states that bankruptcy is the first line of defense by statute and regulatory preference, and the government should only look to other systems like Title II if bankruptcy fails.

1. Would you [also] favor a long-standing legal system like bankruptcy to restructure or wind down Fannie Mae and Freddie Mac, instead of receivership carried out by a government agency with a politically appointed head?

2. Your testimony addresses the problems with safe harbors on certain types of financing. Because Fannie and Freddie are meeting their financial obligations to creditors, shouldn't we make a Fannie and Freddie bankruptcy filing leave derivatives contracts and other financing arrangements in place?

Roe: Thank you for the additional questions. For both of these questions, I have not studied the financial structure and the legislation governing Fannie Mae and Freddie Mac. Accordingly, I am unfamiliar with their organizational structure, their liability structure, and what reasonable expectations their statutory environment should have created. So, I am poorly positioned to address these two questions as to Fannie and Freddie.