Testimony

The Role of Bankruptcy Reform in Addressing Too Big To Fail

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A. Main Points

1) Some financial sector firms have become so large and so complex that handling any potential insolvency through standard bankruptcy procedures is difficult and costly. The precise distribution of losses across creditors and counterparties is hard to predict, often with unforeseen consequences around the globe. Such bankruptcy events can therefore have major destabilizing effects on financial markets and the real economy in the United States and internationally.
2) The systemic risks posed by the failure of large complex financial institutions have been understood for several decades—and use of the term "too big to fail" in this context dates back at least to the 1980s.[2] But in mid-September 2008 the US authorities took the view that the failure of Lehman Brothers could be handled through the bankruptcy courts and might even have a cathartic effect on the financial system. Within 24 hours of Lehman's bankruptcy, the leadership at the Treasury Department and the Federal Reserve Board of Governors realized that this was most definitely not the case—the negative spillover effects of Lehman's bankruptcy on the US and global economies were huge.[3]

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[1] Also a member of the Federal Deposit Insurance Corporation's Systemic Resolution Advisory Committee, the Office of Financial Research's Financial Research Advisory Committee, and the Systemic Risk Council (created and chaired by Sheila Bair). All views expressed here are mine alone. Underlined text indicates links to supplementary material; to see this, please access an electronic version of this document, e.g., at http://BaselineScenario.com. For important disclosures, see http://baselinescenario.com/about/.
[2] See Gary Stern and Ron Feldman, *Too Big to Fail: The Hazards of Bank Bailouts*, Brookings Institution Press, 2004.
[3] See Andrew Ross Sorkin, *Too Big to Fail: The Inside Story of How Wall Street and Washington Fought to Save the Financial System – and Themselves*, Viking, 2009. The assets and liabilities of Lehman Brothers were just over $600 billion, about four percent of US GDP.

3) Lehman's bankruptcy led directly to the US government's bailout of AIG, a large insurance company, and to the unprecedented support provided to money market mutual funds. When this failed to stabilize the system, Goldman Sachs and Morgan Stanley were allowed to become bank holding companies, which increased their access to Federal Reserve support. The Troubled Asset Relief Program (TARP) was rushed through Congress and quickly became the largest injection of capital into private financial firms in the history of the United States. Additional unprecedented bailouts were provided to Citigroup in November 2008 and to Bank of America in January 2009. Further statements of guarantee were provided by top officials in February 2009, and a stress test process—assuring market participants that the government believed leading banks had enough loss-absorbing equity—was conducted in spring 2009.
4) These and related enormous forms of selective government support were not sufficient to prevent the most serious recession since the 1930s from which, after seven years, the US economy is still struggling to recover.[4]
5) There has long been a "resolution" process, run by the Federal Deposit Insurance Corporation (FDIC), that handles the insolvency of banks that have insured retail (i.e., small-scale) deposits. For over 70 years, the FDIC has protected insured depositors and not incurred any liability for taxpayers. Shareholders are often wiped out and bondholders face losses in FDIC resolution, in accordance with well-defined and transparent criteria. However, prior to 2010, this FDIC procedure could only be applied to banks with insured deposits.
6) In July 2010, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act. Title II of this Act created an Orderly Liquidation Authority that essentially broadened the mandate and powers of the FDIC to include the resolution of nonbank financial companies.[5]
7) However, this power is intended only as a back-up, in case bankruptcy is determined—by the Secretary of the Treasury, with the Federal Reserve and the FDIC—to be infeasible or likely to cause unacceptable levels of collateral damage. Titles I and II of Dodd-Frank make it clear that all firms should be able to go bankrupt—and the point of the "living wills" process is to force firms to change in order to become resolvable through bankruptcy (more on the difficulties of bankruptcy in Section B below).
8) Since 2010, the FDIC has developed a resolution strategy for large complex financial institutions in which there is likely to be a single point of entry in the resolution of any group of firms under a bank holding company.[6] In this strategy, shareholders in the holding

[4] For a recent comprehensive and accurate assessment, see "The Cost of the Crisis: $20 trillion and Counting," a report by Better Markets, July 2015. Massive government assistance was provided to big banks and some other parts of the financial sector but not generally to the nonfinancial sector—and hardly at all to families who owed more on their mortgages than their homes were worth.
[5] See Section 204, creating the Orderly Liquidation Authority, and all related parts of Title II.
[6] See "A Progress Report on the Resolution of Systemically Important Financial Institutions," speech by Martin J. Gruenberg, chairman of the FDIC; May 12, 2015. Mr. Gruenberg makes it clear that the single point of entry is only one option for the FDIC's approach to resolution.

company would be wiped out (if the losses are large enough) and debt would be converted to equity—in order to recapitalize a new enterprise as a going concern, presumably without the activities that incurred the devastating losses. There would be a one-day stay on creditors of all kinds.[7] There are also moves to end the automatic termination of derivative contracts in the event of resolution.[8] This is intended to give the FDIC time to complete the resolution process—and to allow operating subsidiaries to continue in business.

9) Repealing Title II of Dodd-Frank would be a mistake. Title II is a backstop, in case bankruptcy proves infeasible (see Section C below). Title II creates a clear mandate for advance planning for private sector firms and for officials and makes it possible to create a structure for cross-border cooperation on resolution.[9]

10) At the same time, we should recognize that:
    a. Title I of Dodd-Frank requires credible living wills, in which firms would be able to fail through bankruptcy. We are a long way from having satisfactory living wills. Officials need to press harder on this front; more on this in Section C below.
    b. The largest and most complex financial firms need to become much simpler and, most likely, smaller in order for either bankruptcy to work (as required under Title I) or for the FDIC's single point of entry strategy to work (if Title II powers are used).
    c. The FDIC's primary resolution strategy relies on there being enough "loss absorbing capital" at the holding company level. But only equity is really loss absorbing. "Loss absorbing debt" is an oxymoron—when creditors suffer major losses on a mark-to-market basis, there is real potential for a systemic panic, particularly as other related assets will be immediately reduced in value.
    d. We should be very concerned about the current international push towards a Total Loss Absorbing Capacity (TLAC) approach for bank holding companies.[10] We currently have only 4 to 5 percent equity (and 95 to 96 percent debt) in our largest bank holding companies.[11] Resolution as designed by the FDIC will likely not work

[7] See "A Dialogue on the Costs and Benefits of Automatic Stays for Derivatives and Repurchase Agreements," by Darrell Duffie and David A. Skeel, University of Pennsylvania Law School, January 2012.

[8] This stay is supported by the International Swaps and Derivatives Association (ISDA) Resolution Stay Protocol, but the coverage of this is still incomplete—it currently only includes major banks, not "buy side" investors.

[9] The FDIC and the Bank of England have a memorandum of understanding on resolution-related issues; this would likely not apply if a large complex financial institution were to file for bankruptcy.

[10] This push is being led by the Financial Stability Board, but it almost certainly represents a European attitude towards how to handle financial distress. Given that the European authorities are much more comfortable with continuing some version of too big to fail—and providing bailouts to creditors under a wide variety of circumstances—it is most unwise to follow their lead on this matter.

[11] See the December 2014 edition of the Global Capital Index, produced by Thomas Hoenig, vice chairman of the FDIC. Mr. Hoenig converts US GAAP [generally accepted accounting principles] accounts to their International Financial Reporting Standards (IFRS) equivalent, as this better reflects the risks inherent in derivative positions. The new reporting of risk exposures to the Fed (the Banking Organization Systemic Risk Report FR Y-15) produces numbers that are similar to those of Mr. Hoenig.

in this scenario—the losses imposed on creditors will have serious systemic effects. Bankruptcy would be even more of a disaster. The result could easily be some new form of government-sponsored bailout, through the Federal Reserve or through new powers granted by Congress (as happened in September 2008). It is imperative that officials move to greatly increase loss absorbing equity in the largest, most complex financial firms (see Section D below).[12]

B. The Problem with Bankruptcy

There are two variants of the "bankruptcy-only" proposal. In both approaches, Title II of Dodd-Frank would be repealed—so the FDIC could not be involved in the failure of any bank holding company (or any financial firm, other than a bank with retail deposits).

In the first variant, the bankruptcy code would be modified, for example to grant the kind of automatic stay now available only under FDIC resolution, but there would be no debtor-in-possession financing provided by the government.

The problem with this scenario is that it would be very difficult for a bankruptcy judge to enable any part of the financial firm to continue in business. The bankruptcy would be akin to complete liquidation or winding down, as was the case with Lehman Brothers. The losses to creditors in this scenario are large while the precise incidence of losses would take many years to determine fully. Under such an approach, the failure of a large complex financial institution would most likely result in chaos, along the lines experienced in September 2008.

In the second bankruptcy-only variant, proponents argue that debtor-in-possession financing should be provided by the government—precisely because the private sector is highly unlikely to provide the scale of funding needed. To make this more palatable, this kind of funding is sometimes referred as a "liquidity" loan.

But providing large scale funding from the government to a bankruptcy judge is both a bad idea economically and politically infeasible. Judges lack the experience necessary to administer such loans. In all likelihood, this would become a form of bailout that keeps existing management in place. To support a large complex financial institution, the scale of loans involved—from the Treasury or the Federal Reserve—would be in the tens of billions of dollars (in today's prices), and there would be a very real possibility of taxpayer losses. The extent of executive branch

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For example, in Mr. Hoenig's index, the largest bank in the world at the end of 2014 was JP Morgan Chase, with a balance sheet of $3.827 trillion (under IFRS); on its FR Y-15, JP Morgan Chase states its total risk exposure as $3.743 trillion.

[12] The Federal Reserve is moving capital requirements in the right direction, including with a higher requirement for loss-absorbing equity in the largest firms. But, as Mr. Hoenig's Global Capital Index shows, these buffers against losses remain very small relative to true risk exposures. For the integrated and persuasive case for higher capital requirements, see Anat Admati and Martin Hellwig, *The Bankers' New Clothes: What's Wrong with Banking and What to do About It*, Princeton University Press, 2013.

engagement and congressional oversight would be limited. Most likely there would be both scope for both genuine concern and a dangerous broader collapse of legitimacy.

It makes sense to examine ways to improve the bankruptcy code to make it easier for financial firms to fail through bankruptcy—and this is completely consistent with making Title I of Dodd-Frank more effective. But any threats to rely solely on bankruptcy for the largest, most complex, and massively global firms are simply not credible. This would be the same kind of tactics that the Treasury resorted to under Hank Paulson in 2008—until the policy was dramatically reversed after the bankruptcy of Lehman Brothers. It was that reversal under President George W. Bush and President Barack Obama that created the modern expansive version of too big to fail that haunts us still.

Bankruptcy cannot work for the largest and most complex banks at their current scale and level of complexity. This is not a viable option under current law for the largest bank holding companies with their current scale and structure, even if the law is tweaked to allow for a longer stay on creditors. And changing the law more dramatically to add a bailout component (or "government-backed liquidity loans") to bankruptcy procedures—but only for very large complex financial institutions—would not lead to good outcomes.

C. Bankruptcy and Living Wills

Under current law—and as a matter of common sense—the Federal Reserve now needs to take the lead in forcing large complex financial institutions to become smaller and simpler.

The legal authority for such action is clear. Under section 165 of the 2010 Dodd-Frank financial reform legislation, large nonbank financial companies and big banks are required to create and update "the plan of such company for rapid and orderly resolution in the event of material financial distress or failure." The intent is that this plan—known as a "living will" —should explain how the company could go through bankruptcy (i.e., reorganization of its debts under Chapter 11 or liquidation under Chapter 7 of the Bankruptcy Code), without causing the kind of collateral damage that occurred after the failure of Lehman Brothers.

This bankruptcy should not involve any government support. It is supposed to work for these large financial companies just like it works for any company, with a bankruptcy judge supervising the treatment of creditors. Existing equity holders are typically "wiped out"—meaning the value of their claims is reduced to zero.

The full details of these living wills are secret—known only to the companies and to the regulators.[13] But based on the publicly available information these living wills are not currently credible because the big banks remain incredibly complex, with cross-border operations, and a

[13] Public portions of living wills are available on the FDIC website. Plans filed on July 1, 2015, show some progress towards more disclosure. But there is nothing in the latest published living wills that suggests bankruptcy is currently a plausible approach to the potential failure of the largest bank holding companies.

web of interlocking activities.[14] When one piece fails, this triggers cross-defaults, the seizure of assets around the world by various authorities, and enormous confusion regarding who will be paid what. All of these effects are exacerbated by the fact that these firms are also highly leveraged, with much of this debt structured in a complex fashion (including through derivatives).

What then are the implications? The Dodd-Frank Act has some specific language about what happens if "the resolution plan of a nonbank financial company supervised by the Board of Governors or a bank holding company described in subsection (a) is not credible or would not facilitate an orderly resolution of the company."

Not unreasonably, under section 165 of Dodd-Frank, the Fed and the FDIC

> "may jointly impose more stringent capital, leverage, or liquidity requirements, or restrictions on the growth, activities, or operations of the company, or any subsidiary thereof, until such time as the company resubmits a plan that remedies the deficiencies."

The company may also be required "to divest certain assets or operations identified by the Board of Governors and the Corporation, to facilitate an orderly resolution."

Some supporters of the big banks argue in favor of skipping bankruptcy and going directly to Title II resolution. But this Title II (of Dodd-Frank) authority is intended as a back-up—only to be used if, contrary to expectations, bankruptcy does not work or chaos threatens.

As it is currently obvious that bankruptcy cannot work, the legislative intent is clear. The Fed and the FDIC must require significant remedial action, meaning that something about the size, structure, and strategy of the megabanks must change, and these changes must be sufficient to allow bankruptcy (without massive systemic damage) to become a real possibility.

D. Global Issues and the Need for Additional Capital Requirements

Writing in the March 29, 2011 edition of the *National Journal*, Michael Hirsch quotes a "senior Federal Reserve Board regulator" as saying:

> "Citibank is a $1.8 trillion company, in 171 countries with 550 clearance and settlement systems," and "We think we're going to effectively resolve that using Dodd-Frank? Good luck!"

[14] For a glimpse into the complexity of corporate structures across borders within individual large complex global financial firms, see the corporate network visualizations available at https://opencorporates.com (e.g., for Goldman Sachs). As one global regulator reportedly has said, large banks live globally but die locally—so any bankruptcy (or resolution) has to sort out a myriad of intertwined obligations across multiple jurisdictions.

This regulator has a point.[15] The FDIC can close small and medium sized banks in an orderly manner, protecting depositors while imposing losses on shareholders and even senior creditors. But it is a stretch to argue that such a resolution authority will definitely "work"—i.e., prevent spillover systemic damage and negative impact on the real economy—for any failing large bank with significant cross-border operations.

The resolution authority granted under Dodd-Frank is purely domestic, i.e., it applies only within the United States.[16] The US Congress cannot make laws that apply in other countries—a cross-border resolution authority would require either a treaty-level agreement between the various governments involved or some sort of synchronization for the relevant parts of commercial bankruptcy codes and procedures.

There are no indications that such treaties will be negotiated—or that there are serious inter-governmental efforts underway to create any kind of cross-border resolution authority, for example, within the G-20.[17]

The best approach for the United States today would be to make all financial institutions small enough and simple enough so they can fail—i.e., go bankrupt—without adversely affecting the rest of the financial sector. The failures of CIT Group in fall 2009 and MF Global towards the end of 2011 are, in this sense, encouraging examples. But the balance sheets of these institutions were much smaller—about $80 billion and $40 billion, respectively—than those of the financial firms currently regarded as too big to fail.

To the extent that the authorities are unwilling or unable to make some banks smaller and simpler, they should substantially increase the required amount of loss absorbing equity for those firms.[18] Concerns about complexities associated with the failure of cross-border operations also

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[15] However, it must be pointed out that Citigroup's total risk exposure at the end of 2014 was $2.766 trillion, substantially larger than the number mentioned by the official, who must have been thinking only about on-balance sheet assets. One lesson from the experience of 2007–08 and from the data now reported in FR Y-15 (Banking Organization Systemic Risk Reports, required by Dodd-Frank) is that we should think more in terms of total risk exposure.

[16] For a discussion of what would happen if global banks fail post-Dodd-Frank, see Marc Jarsulic and Simon Johnson, "How a Big Bank Failure Could Unfold," *New York Times Economix* blog, May 23, 2013.

[17] The Memorandum of Understanding between the FDIC and the Bank of England is helpful in this regard but unlikely to prove sufficient to eliminate significant cross-border difficulties in the event of the failure of a large complex financial institution. This understanding also only applies in the case of FDIC resolution; it would not apply in the event of bankruptcy (i.e., without FDIC involvement).

[18] Senators Sherrod Brown and David Vitter have proposed a scale for capital requirements, with greater focus on the leverage ratio (i.e., less value attached to the importance of risk-weights), that would increase steeply for the largest and most complex financial institutions. This is a promising approach that deserves further legislative and regulatory attention. Given the issues with bankruptcy and resolution, discouraging scale and complexity makes sense. For further discussion, see Simon Johnson and James Kwak, *13 Bankers*, Pantheon, 2010.

strengthen the case for higher capital requirements (in the form of loss absorbing equity, not an illusory TLAC requirement).