Too Big to Fail, Title II of the Dodd-Frank Act and Bankruptcy Reform

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Testimony Before The
Oversight and Investigations Subcommittee
Committee on Financial Services
U.S. House of Representatives
May 15, 2013

Chairman McHenry, Ranking Member Green and other members of the Subcommittee, thank you for the opportunity to testify at this hearing on "Who Is Too Big to Fail: Does Title II of the Dodd Frank Act Enshrine Taxpayer-Funded Bailouts?" My testimony endeavors to address the questions raised in the invitation letter about the continuing likelihood of bailouts and incentive effects under Title II of the Dodd-Frank Act.

Concerns about Bailouts with Title II

Large financial firms still seem to be enjoying a huge subsidy on their borrowing costs due to market expectations of bailouts. For example, according to a widely-cited Bloomberg calculation, based on an International Monetary Fund study, the subsidy mounts to $83 billion per year.

To be sure there is disagreement about this assessment of the likelihood of bailouts. For example, in response to questions about market expectations of firm bailouts in recent Congressional testimony, Federal Reserve Chairman Ben Bernanke argued that "Those expectations are incorrect" because "We have an Orderly Liquidation Authority," referring to Title II of the Dodd-Frank Act which gives the Federal Deposit Insurance Corporation (FDIC) the authority to resolve those large financial firms if they fail.[2] However, Federal Reserve Board Governor Jerome Powell—reflecting on his experience with government bailout decisions going back a quarter century, questions whether the FDIC's new resolution authority under Title II would prevent bailouts. "The too-big-to-fail reform project is massive in scope," he says, predicting it "will take years to complete. Success is not assured."[3] And Jeffrey Lacker, President of the Federal Reserve Bank of Richmond, argues that the FDIC's "considerable regulatory discretion" under Title II "could encourage creditors to believe they may continue to receive protection from losses," summing up that "we didn't end too big to fail."[4] Charles Plosser, President of the Federal Reserve Bank of Philadelphia argues that "Title II resolution is likely to be biased toward bailouts," because of the "wide range of discretionary powers" granted to the FDIC and the likely "excessive delay" in implementing the procedure.[5]

[1] Mary and Robert Raymond Professor at Stanford University and George P. Shultz Senior Fellow in Economics at Stanford's Hoover Institution. This testimony draws on my keynote speech at the April 9, 2013, Atlanta Fed Financial Markets Conference (Taylor, 2013).
[2] Bernanke (2013)
[3] Powell (2013)
[4] Lacker (2013)
[5] Plosser (2013)

Understanding these alternative views and taking a position on the likelihood of bailouts requires defining what one means by bailout, examining the Orderly Liquidation Authority (OLA) of Title II, and assessing—based on practical experience—how it would actually work. Doing so leads me to take the position that bailouts and too-big-to-fail are preserved rather than eliminated under Title II.

To see this, first note that while full liquidation with wiped out shareholders was a major selling point of the Dodd-Frank Act—that is the reason for the in L in OLA—in the years since the Act was passed the focus of the FDIC has been on how to resolve and reorganize the failing firm into an ongoing concern, rather than on how to liquidate it. That is how simulations of the new authority—such as the one organized by The Clearing House—have played out.[6] To achieve such a re-organization under this new authority the FDIC would transfer part of a failing firm's balance sheet and its operations to a new bridge institution.

In order to carry out this task, the FDIC would have to exercise considerable discretion. The degree of discretion would be especially large in comparison with more transparent and less uncertain bankruptcy proceedings through which nonfinancial firms are regularly resolved and reorganized through the rules of the bankruptcy laws. As a result there is confusion about how the reorganization process would operate under Title II, especially in the case of complex international firms. Indeed, some argue that this uncertainty about the Title II process would lead policymakers to ignore it in the heat of a crisis and resort to massive taxpayer bailouts as in the past. Hence, the concern about bailouts remains.

But even if the Title II process was used, bailouts would be likely. As the FDIC exercised its discretion to form a bridge bank, it would most likely give some creditors more funds than they would have expected or been entitled to under bankruptcy law. For example, they might wish to hold some creditors harmless, or nearly harmless, in order to prevent a perceived contagion of the firm's failure to other parts of the financial system. This action would violate the priority rules that underlie decisions about borrowing and lending in the entire credit market. Under the reasonable definition that bailout means that some creditors get more than they would under bankruptcy laws or under the normal workings of the market, such action would, by definition, be a bailout of the favored creditors.

This expectation of bailout of some creditors increases the risk of financial instability. Government regulation through capital or liquidity requirements and supervision is not the only way a financial firm's risk-taking decisions are constrained. Discipline is also imposed on the firm by its counterparties, so long as they perceive a need to monitor the firm and protect themselves from losses by demanding collateral or simply cutting off credit.

Creditors have significant advantages over government regulators, in terms of current knowledge, ability to act quickly, and financial stakes. And they are less subject to regulatory capture. As Mervyn King, Governor of the Bank of England recently explained, regulatory capture does not necessarily mean that "people were bought off, but that the sheer weight of

[6] The Clearing House (2012)

resources, time and legal effort put in by banks to try to persuade regulators that what they were doing was compliant with the rules made life extraordinarily difficult for the regulators."[7]

The expectation of bailouts of creditors weakens the incentives for them to monitor their loans and thereby provide this constraint on risk taking. Because the bailout reduces the risk incurred by large creditors expecting to be favored, they charge a lower interest rate, creating the subsidy of big financial firms.

It is important to recognize that the perverse effects of such bailouts occur whether or not the source of the extra payment comes from the Treasury financed by taxpayers, from an assessment fund financed by financial institutions and their customers, or from smaller payments for less favored creditors.

Thus, bailouts and too-big-to-fail are still alive and well with Title II. Even if shareholders are not protected, some important creditors will likely be. And discretionary actions will determine who the bailed out creditors will be.

Other Concerns

Contrasting the resolution of a failing financial firm under Title II with resolution under bankruptcy procedures reveals additional concerns with Title II. Under bankruptcy reorganization, private parties, motivated and incentivized by profit and loss considerations, make key decisions about the direction of the new firm, perhaps subject to bankruptcy court oversight. But under Title II a government agency, the FDIC and its bridge bank, would make the decisions. This creates the possibility that the FDIC would be pressured to ask the bridge firm to grant special favors to certain creditors as in the case of the Government Sponsored Enterprises.

In addition, the resolution of a firm through a government-administered bridge company could give the new firm advantages over its competitors in comparison with a bankruptcy resolution. The Treasury is authorized to fund the FDIC which can fund of the bridge firm, creating a subsidy, and under Title II the bridge firm can be given lower capital requirements and forgiven tax liabilities.

One can understand why the FDIC or any government agency in charge of resolutions would want to use such legal provisions to nurse the bridge firm with special advantages for a while before setting it free to compete on a level playing field. But with such a large amount of discretion and strong incentives to make the resolved firms a success, there is a concern that in practice these advantages granted by a government agency could become excessive and prolonged.

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[7] Question and answer session reported by Edwards (2013), p. 20. In the same session, Mervyn King also says that "One of the major problems in regulation in the last 10 to 20 years has been that of regulatory capture."

A Bankruptcy Reform Proposal

A reform of the bankruptcy code designed to handle the big interconnected firms would alleviate too-big-to-fail and the problems it creates. In the five years since the financial crisis, there has been much useful work and discussion on why and how to proceed with bankruptcy reform—both before and since the passage of the Dodd-Frank Act. Books and articles have been written[8] and reports have been issued by the Federal Reserve Board and the Government Accountability Office.[9]

Under bankruptcy, a failing firm can either go into liquidation under Chapter 7 or reorganization under Chapter 11. Let us focus on reorganization. Under bankruptcy law, losses are calculated according to prescribed and open procedures, known in advance. If the failed firm's liabilities exceed its assets, then the shareholders are wiped out. The remaining difference between liabilities and assets is then allocated among creditors in the order of priority stipulated by the law, which is also known in advance. The creditors' debts are written down and, sometimes, converted into equity in the reorganized firm. In the end, the firm continues in business with either the old or new managers.

The bankruptcy law, however, is now designed as a general procedure for a wide variety of businesses. Large financial institutions present special considerations which warrant the enactment of a new chapter in the U.S. bankruptcy code. Certain principles should guide such a reform:

> The new chapter should apply to all financial groups with assets over a certain amount—say $100 billion.
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> The bankruptcy should include, in a single proceeding, all the parent's subsidiaries, including insurance and brokerage services unlike current law where insurance and brokerage services are treated separately, adding considerable complexity. The one exception would be insured depository institutions, which would continue to be handled by the FDIC
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> The proceedings should be overseen by a specialized panel of Article III judges and special masters with financial expertise.
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> The new chapter should allow the primary federal regulator of the firm to file a bankruptcy petition in addition to creditors and management. This would expedite the process especially in cases where management, fearing a loss of equity or employment, has incentives to put off a filing. The examiner's report on Lehman makes it very clear there was no preparation for bankruptcy proceedings before the filing, which increased the size of the disruption.

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[8] See, for example, Scott, Shultz and Taylor (2010), Fitzpatrick and Thomson (2011), Scott and Taylor (2012). The following discussion draws on the studies in the Scott and Taylor (2012) book. .
[9] See Board of Governors of the Federal Reserve (2011), Government Accountability Office (2011).

> The procedure to determine asset values, liabilities, sales of some lines of business, write-downs of claims, and recapitalization should be based on the rule of law with judicial hearings and creditor participation.
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> The strict priority rules of bankruptcy should govern.
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> The new chapter should provide special treatment for derivatives, stays and preferential transfers.
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> The new chapter should provide the court with the authority to give post-petition debt to support advances a top priority, so as to allow the firm to obtain ample debtor-in-possession (DIP) financing from the private sector and to permit limited advance payments.

The goal of these provisions is to let a failing financial firm go into bankruptcy in a predictable, rules-based manner without causing disruptive spillovers in the economy while permitting people to continue to use its financial services without running—just as people flew on American Airlines planes, bought Kmart sundries and tried on Hartmax suits when those firms were in bankruptcy. These provisions make it possible to create a new fully capitalized entity which would credibly provide most of the financial services the failed firm was providing before it got into trouble. Modularization of the firm, which is in principle made easier by the living wills, would expedite the process.[10]

I have found that a simple example is helpful to illustrate the process. Consider the hypothetical dealer bank Alpha, which my Stanford colleague Darrell Duffie (2010) used to illustrate how dealer banks get into financial trouble. Alpha is a holding company involved in a host of financial activities with many subsidiaries. Its business lines include securities trading and market making, underwriting, financial advising, over-the counter derivatives, prime brokerage, private wealth management, and even commercial banking.

Trouble begins when Alpha experiences a gigantic trading loss on both its own account and that of its clients. Then a natural series of events takes place. First, the company tries unsuccessfully to raise more capital. Next it uses some capital to compensate its clients for the trading losses. Then it sees its prime brokerage clients (mainly hedge funds who are hearing the news about Alpha) remove their cash and securities, and its derivative counterparties cut their exposure. Finally Alpha's clearing bank senses Alpha's insolvency and stops processing Alpha's cash and securities transactions in order to cut off its intra-day exposure.

At this time—suppose it is close of business on Friday—Alpha's primary regulator, who has been following these developments, must take action, whether Alpha's management likes it or not. It determines that Alpha is insolvent: its debts exceed the value of its assets. It then decides to place Alpha into the new bankruptcy chapter. The automatic stay and other bankruptcy rules are triggered, and the bankruptcy proceeding starts, overseen by the Article III judges and their master experts.

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[10] Lacker (2013) discusses the general advantages of living wills and subsidiarization.

By Saturday morning a new holding company, Alpha Nu, is created consisting of all the subsidiaries of Alpha and its other assets, and assuming all its secured long-term debt, executory contracts, and short-term liabilities.[11] Alpha, which is now in bankruptcy, is the owner of Alpha Nu: Alpha's long term unsecured creditors remain in the receivership. Importantly, however, Alpha Nu is not in bankruptcy. Indeed, it is ready to open for business on Monday morning.

Alpha Nu no longer has its original long-term unsecured liabilities and is now solvent with its equity owned by Alpha, or more precisely by Alpha's un-transferred creditors. Note how this approach lets Alpha Nu remain open for business on Monday morning providing key financial services without experiencing runs. The firm and its operating subsidiaries are now capitalized, so there is little incentive for counterparties to run, and liquidity should be available from the market on appropriate terms. And because Alpha Nu is a viable firm, there is little chance of contagion.

Of course this process will have to be explained clearly to all participants. The availability of living wills, advanced preparation, and the expert masters working with judges would be essential to make the process credible. It is important to have a clear understanding with regulators that large financial firms should have sufficient long-term liabilities subordinated to short-term debt to capitalize the new firm. Such an understanding could be formalized by law, regulatory rule-making, or private contractual agreement.

Note also how the pressure to bailout has been reduced by making it possible for the failing firm to go through bankruptcy without causing disruption to the financial system and the economy.

Conclusion and a Way Forward

In this testimony I explained why one should be concerned that bailouts and too-big-to - fail have been preserved rather than eliminated by Title II of the Dodd-Frank Act.

I also suggested a proposal for reform—a new Chapter 14 for the bankruptcy code—which would reduce the likelihood of bailouts and deal with the too-big-to-fail problem. Even if Title II remains in the law, such a reform would at least reduce the use of Title II.

Achieving such a reform in practice will be difficult, but experience shows that it is doable with the right strategy. Ten years ago, when I was Treasury Under Secretary for International Affairs, I argued in favor of a proposal to reform the resolution procedures for sovereign debt of emerging market countries and thereby prevent bailouts.[12] The proposal was to incorporate "collective action clauses" into the sovereign debt of emerging market countries—an idea which is analogous to the orderly bankruptcy reform proposal made here. The reform was actually implemented but only because financial institutions, lawyers, investors, academics and government officials worked together to craft specifics which were eventually applied in practice. We need a similar process now.

[11] Technically this is accomplished according to the bankruptcy law through a Section 363 sale.
[12] Taylor (2002)

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