from ***Making Failure Feasible: How Bankruptcy Reform Can End "Too Big To Fail"***
with Kenneth Scott and Thomas Jackson (eds.)
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Preface

John B. Taylor

Motivated by the backlash over the bailouts during the global financial crisis and concerns that a continuing bailout mentality would create grave dangers to the US and world financial systems, a group of us established the Resolution Project at the Hoover Institution in the spring of 2009. Ken Scott became the chair of the project and George Shultz wrote down what would be the mission statement:[1]

> The right question is: how do we make failure tolerable? If clear and credible measures can be put into place that convince everybody that failure will be allowed, then the expectations of bailouts will recede and perhaps even disappear. We would also get rid of the risk-inducing behavior that even implicit government guarantees bring about. "Heads, I win; tails, you lose" will always lead to excessive risk. And we would get rid of the unfair competitive advantage given to the "too big to fail" group by the implicit government guarantee behind their borrowing and other activities. At the same time, by being clear about what will happen and that failure can occur without risk to the system, we avoid the creation of a panic environment.

This book—the third in a series that has emerged from the Resolution Project—takes up that original mission statement once again. It represents a culmination of policy-directed research from the Resolution Project of the Hoover Institution's Working Group on Economic

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1. George P. Shultz, "Make Failure Tolerable," in *Ending Government Bailouts as We Know Them*, ed. Kenneth Scott, George P. Shultz, and John B. Taylor (Stanford, CA: Hoover Press, 2010).

Policy as its members, topics, and ideas have expanded and as the legal and market environment has changed.

The first book, *Ending Government Bailouts as We Know Them,* published in 2010, proposed a modification of Chapter 11 of the bankruptcy code to permit large failing financial firms to go into bankruptcy without causing disruptive spillovers while continuing to offer their financial services—just as American Airlines planes kept flying and Kmart stores remained open when those firms went into bankruptcy.

The second book, *Bankruptcy Not Bailout: A Special Chapter 14,* published in 2012, built on those original ideas and crafted an explicit bankruptcy reform called Chapter 14 (because there was no such numbered chapter in the US bankruptcy code); it also considered the implications of the "orderly liquidation authority" in Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, which was passed into law after the first book was written.

This third book, *Making Failure Feasible: How Bankruptcy Reform Can End "Too Big To Fail,"* centers around Chapter 14 2.0, an expansion of the 2012 Chapter 14 to include a simpler and quicker recapitalization-based bankruptcy reform, analogous to the single-point-of-entry approach that the Federal Deposit Insurance Corporation (FDIC) proposes to use under Title II of the Dodd-Frank Act. And while Chapter 14 2.0 is the centerpiece of the book, each of the chapters is a significant contribution in its own right. These chapters provide the context for reform, outline the fundamental principles of reform, show how reform would work in practice, and go beyond Chapter 14 2.0 with needed complementary reforms.

Recent bills to modify bankruptcy law in ways consistent with the overall mission of the Resolution Project have been introduced in the US Senate (S. 1861, December 2013) and House of Representatives (H. 5421, August 2014). We hope that this new book will be helpful as these bills and others work their way through Congress in the months ahead. Importantly, in this regard, a major finding of this book is that reform of the bankruptcy law is essential even after the passage of the Dodd-Frank Act. First, that act requires that bankruptcy be the standard against which the effectiveness of a resolution process is measured; and, second, that act requires that resolution plans must be found credible under the bankruptcy law, which is nearly impossible for existing firms without a reform of bankruptcy law.

Ken Scott's leadoff chapter, "The Context for Bankruptcy Resolutions," examines several key regulations that are still being proposed or adopted which would affect the resolution process, and it considers how Chapter 14 might deal with them. Scott recommends other measures that would facilitate successful resolutions and emphasizes that there may be cases in which a great many firms need to be resolved simultaneously and therefore may be "beyond the reach of Title II or Chapter 14." This speaks to the need for further reform efforts to reduce risk along the lines George Shultz emphasized in his original "Make Failure Tolerable" piece.

The detailed proposal for Chapter 14 2.0 and its rationale are carefully explained by Tom Jackson in the chapter "Building on Bankruptcy: A Revised Chapter 14 Proposal for the Recapitalization, Reorganization, or Liquidation of Large Financial Institutions." The chapter outlines the basic features of the initial Chapter 14 proposal and then focuses on the provisions for a direct recapitalization through a holding company.

David Skeel's chapter, "Financing Systemically Important Financial Institutions in Bankruptcy," considers the issue of providing special government financing arrangements for financial firms going through bankruptcy. Currently, Chapter 11 does not provide such arrangements, and some recently proposed legislation explicitly prohibits government funding. Critics of bankruptcy approaches (especially in contrast with Title II resolution, which provides for funding from the US Treasury) point to the absence of such funding as a serious problem. Skeel argues, however, that a large financial firm in bankruptcy would likely be able to borrow sufficient funds from non-government sources to quickly finance a resolution in bankruptcy. Nevertheless, he warns that potential lenders might refuse to fund, especially if a firm "falls into financial distress during a period of market-wide instability." He therefore considers prearranged private funding and governmental funding as supplements.

The chapter by Darrell Duffie, "Resolution of Failing Central Counterparties," explains the essential role of central counterparties (CCPs) in the post-crisis financial system and notes that they too entail substantial risks. However, as he points out, it "is not a completely settled matter" whether Dodd-Frank "assigns the administration of the failure resolution process" to the FDIC under Title II. Since Chapter 14 would exclude CCPs, this leaves an area of systemic risk that still needs to be addressed.

In "The Consequences of Chapter 14 for International Recognition of US Bank Resolution Action," Simon Gleeson examines an extremely difficult problem in the resolution of failing financial institutions: "the question of how resolution measures in one country should be given effect under the laws of another." He notes that "most courts find it easier to recognize foreign bankruptcy proceedings than unclassified administrative procedures which may bear little resemblance to anything in the home jurisdiction." Thus, after comparing Chapter 14 and Title 11, he concludes that "replacing Title II with Chapter 14 could well have a positive impact on the enforceability in other jurisdictions of US resolution measures."

In the chapter "A Resolvable Bank," Thomas Huertas gets down to basics and explains the essence of "making failure feasible." He considers the key properties of a bank that make it "resolvable" both in a single jurisdiction and in multiple jurisdictions. As he explains, "A resolvable bank is one that is 'safe to fail': it can fail and be resolved without cost to the taxpayer and without significant disruption to the financial markets or the economy at large." A separation of "investor obligations" such as the bank's capital instruments and "customer obligations" such as deposits is "the key to resolvability." If customer obligations are made senior to investor obligations, then a sufficiently large amount of investor obligations can create a solvent bank-in-resolution which can obtain liquidity and continue offering services to its customers.

In "The Next Lehman Bankruptcy," Emily Kapur examines how the September 15, 2008, Lehman Brothers bankruptcy would have played out were Chapter 14 available at the time, a question essential to understanding whether and how this reform would work in practice. The chapter finds that "under certain assumptions, applying Chapter 14 to Lehman in a timely manner would have returned it to solvency and thereby forestalled the run that occurred in 2008." Chapter 14 "could have reduced creditors' direct losses by hundreds of billions of dollars" and these more favorable expectations would have reduced the "risk of runs" and avoided some of the worst consequences of Lehman Brothers' bankruptcy.

William Kroener's chapter, "Revised Chapter 14 2.0 and Living Will Requirements under the Dodd-Frank Act," considers the important connection between bankruptcy reform and post-crisis reforms already passed in Dodd-Frank. As Kroener points out, Dodd-Frank now requires that resolution plans submitted by large financial firms show how these firms can be resolved in cases of distress or failure in a "rapid and orderly resolution" without systemic spillovers under the existing law, which of course includes existing bankruptcy law. However, thus far the plans submitted by the financial firms have been rejected. He shows how Chapter 14 would facilitate the ability of a resolution plan to meet the statutory requirements.

The chapter "The Cross-Border Challenge in Resolving Global Systemically Important Banks," by Jacopo Carmassi and Richard Herring, concludes the book with a warning that, even with the Chapter 14–style reforms proposed here, there is more work to do. They argue, "More effective bankruptcy procedures like the proposed Chapter 14 reform would certainly help provide a stronger anchor to market expectations about how the resolution of a G-SIB [Global Systemically Important Bank] may unfold," but they conclude, "Although too-big-to-fail is too-costly-to-continue, a solution to the problem remains elusive."

So one might look forward to yet another book in this series, or at the least to more policy-driven research by the members of the Resolution Project on the ongoing theme of ending the too-big-to-fail problem by making failure of financial institutions safe, tolerable, and feasible. In the meantime, the material in this book provides a detailed roadmap for needed reform.