

OPINION

A New Tool for Avoiding Big-Bank Failures: 'Chapter 14'

By Emily C. Kapur
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For months Democratic presidential hopeful Bernie Sanders has been telling Americans that the government must "break up the banks" because they are "too big to fail." This is the wrong role for government, but Sen. Sanders and others on both sides of the aisle have a point. The 2010 Dodd-Frank financial law, which was supposed to end too big to fail, has not.

Dodd-Frank gave the Federal Deposit Insurance Corp. authority to take over and oversee the reorganization of so-called systemically important financial institutions whose failure could pose a risk to the economy. But no one can be sure the FDIC will follow its resolution strategy, which leads many to believe Dodd-Frank will be bypassed in a crisis.

Reflecting on his own experience as overseer of the U.S. Treasury's bailout program in 2008-09, Neel Kashkari, now president of the Federal Reserve Bank of Minneapolis, says government officials are once again likely to bail out big banks and their creditors rather than "trigger many trillions of additional costs to society."

The solution is not to break up the banks or turn them into public utilities. Instead, we should do what Dodd-Frank failed to do: Make big-bank failures feasible without tanking the economy by writing a process to do so into the bankruptcy code through a new amendment—a "chapter 14."

Chapter 14 would impose losses on shareholders and creditors while preventing the collapse of one firm from spreading to others. It could be initiated by the lead regulatory agency and would begin with an over-the-weekend bankruptcy hearing before a pre-selected U.S. district judge. After the hearing, the court would convert the bank's eligible long-term debt into equity, reorganizing the bankrupt bank's balance sheet without restructuring its operations.

A new non-bankrupt company, owned by the bankruptcy estate (the temporary legal owner of a failed

company's assets and property), would assume the recapitalized balance sheet of the failed bank, including all obligations to its short-term creditors. But the failed bank's shareholders and long-term bondholders would have claims only against the estate, not the new company.

**Bernie Sanders is right,
Dodd-Frank doesn't work,
but his solution is wrong.
Here's what would work.**

The new firm would take over the bank's business and be led by the bankruptcy estate's chosen private-sector managers. With regulations requiring minimum long-term debt levels, the new firm would be solvent. The bankruptcy would be entirely contained, both because the new bank would keep operating and paying its debts, and because losses would be allocated entirely to the old bank's shareholders and long-term bondholders.

An examination by one of us (Emily Kapur) of previously unexplored discovery and court documents from Lehman Brothers' September 2008 bankruptcy shows that chapter 14 would have worked especially well for that firm, without adverse effects on the financial system.

Here is how Lehman under chapter 14 would have played out. The process would start with a single, brief hearing for the parent company to facilitate the creation of a new recapitalized company—a hearing in which the judge would have minimal discretion. By contrast, Lehman's actual bankruptcy involved dozens of complex proceedings in the U.S. and abroad, creating huge uncertainty and making it impossible for even part of the firm to remain in business.

When Lehman went under it had \$20 billion of book equity and \$96 billion of long-term debt, while its perceived losses were around \$54 billion. If the costs of a chapter 14 proceeding amounted to an additional (and conservative) \$10 billion, then the new company would be well capitalized with around \$52 billion of equity.

The new parent company would take over Lehman's subsidiaries, all of which would continue in business, outside of bankruptcy. And the new company would honor all obligations to short-term creditors, such as repurchase agreement and commercial paper lenders.

The result: Short-term creditors would have no reason to run on the bank before the bankruptcy proceeding, knowing they would be protected. And they would have no reason to run afterward, because the new firm would be solvent.

Without a run, Lehman would have \$30 billion more liquidity after resolution than it had in 2008, easing subsequent operational challenges. In the broader marketplace, money-market funds would have no reason to curtail lending to corporations, hedge funds would not flee so readily from prime brokers, and investment banks would be less likely to turn to the government for financing.

Eventually, the new company would make a public stock offering to value the bankruptcy estate's ownership interest, and the estate would

distribute its assets according to statutory priority rules. If the valuation came in at \$52 billion, Lehman shareholders would be wiped out, as they were in 2008. Long-term debt-holders, with \$96 billion in claims, would recover 54 cents on the dollar, more than the 37 cents they did receive. All other creditors—the large majority—would be paid in full at maturity.

Other reforms, such as higher capital requirements, may yet be needed to reduce risk and lessen the chance of financial failure. But that is no reason to wait on bankruptcy reform. A bill along the lines of the chapter 14 that we advocate passed the House Judiciary Committee on Feb. 11. Two versions await action in the Senate. Let's end too big to fail, once and for all.

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