How Bankruptcy Reform Can Address "Too Big to Fail"

Testimony before the Subcommittee on Financial Institutions and Consumer Protection
Committee on Banking, Housing, and Urban Affairs
United States Senate

John B. Taylor[1]
July 29, 2015

Chairman Toomey, Ranking Member Merkley, and other members of the Subcommittee on Financial Institutions and Consumer Protection, I thank you for the opportunity to testify at this important hearing on "The Role of Bankruptcy Reform in Addressing Too-Big-To-Fail."

Bankruptcy reform is essential to addressing the problem of too-big-to-fail. A well-designed reform that handles large financial firms and makes failure feasible under clear rules without disruptive spillovers would greatly reduce the likelihood of government bailouts. It would thereby diminish excessive risk-taking, remove uncertainty due to an inherently ad hoc bailout process, and cut the implicit subsidy to "too big to fail" firms.

In the seven years since the financial crisis, much economic research and legal analysis has been devoted to finding the best way to proceed with bankruptcy reform.[2] And good reform bills have now been introduced in the Senate, "The Taxpayer Protection and Responsible

[1] Mary and Robert Raymond Professor of Economics at Stanford University, George P. Shultz Senior Fellow in Economics at Stanford's Hoover Institution, and former Under Secretary of Treasury for International Affairs, 2001-2005. I am most grateful to Emily Kapur for advice and suggestions in preparing this testimony which draws directly from her research on how a Chapter 14 reform of the bankruptcy code would work in practice.
[2] See, for example, the work of the Resolution Project at Stanford University's Hoover Institution in the books by Scott, Jackson and Taylor (2015), Scott and Taylor (2012), Scott, Shultz and Taylor (2010), the Bipartisan Policy Center report by Jackson, Guynn, and Bovenzi (2013), the Cleveland Fed study by Fitzpatrick and Thomson (2011), the Board of Governors of the Federal Reserve (2011), and Government Accountability Office (2011).

Resolution Act" (TPRRA) and in the House, "The Financial Institution Bankruptcy Act of 2015."

Current Bankruptcy Law and the Failure of Large, Complex Financial Institutions

Under current bankruptcy law, a failing firm can be reorganized under a Chapter 11 proceeding in which 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. Chapter 11 ensures that creditors bear losses and this reduces moral hazard and excessive risk-taking.

Thus, Chapter 11 has many benefits. However, Chapter 11 is designed as a general procedure for a wide variety of businesses. Large complex financial institutions present special considerations which warrant a reform of the bankruptcy code. The existing bankruptcy process is likely to be too slow for the fast moving markets that these types of firms deal in. The bankruptcy judges might not have enough financial experience to understand the market implications of their judicial decisions. Many exceptions to bankruptcy (for example, for brokerage and insurance companies) also complicate Chapter 11 proceedings for large multi-product financial firms.

Perhaps most importantly, under Chapter 11 it is difficult to maintain adequately the operations of a large complex financial institution that is failing in ways that will prevent a run. Because of government policymakers' concerns about the systemic consequences of such a run, the use of Chapter 11 will not be credible, and market participants will expect the government to use either Title II of the Dodd-Frank Act or a direct bailout.

Concerns over the experience with Lehman Brothers' Chapter 11 may make it more likely in the future that creditors would run before a Chapter 11 proceeding and that policymakers would therefore resort to Title II or a bailout. In the case of Lehman, losses were allocated to short-term unsecured creditors that had continued to fund Lehman because they expected its treatment to be similar to Bear Stearns' bailout. Even if these concerns are unwarranted, they lead market participants to expect that Chapter 11 will not be used.

Bankruptcy Reform for More Credible Resolutions through Bankruptcy Law

To deal with these shortcomings, a reform of the bankruptcy code is needed with a new chapter or subchapters along the lines of the Chapter 14 proposal in the Taxpayer Protection and Responsible Resolution Act[3] or the Subchapter V of Chapter 11 proposal in the Financial Institution Bankruptcy Act of 2015. Under such a reform the procedures to determine asset values, liabilities, sales of some lines of business, write-downs of claims, and recapitalization would be based on the rule of law, as under Chapter 11, and the strict priority rules of bankruptcy would govern. Thus, the resolution regime under bankruptcy would ensure that any failing institution would be resolved through the same known set of processes. One of the biggest problems in the 2008 panic was a lack of predictability, with the government applying widely varying policies.

Unlike reorganization under Chapter 11, however, the Chapter 14 proceedings would be overseen by a specialized panel of Article III judges and special masters with financial expertise.

[3] After first using the term Chapter 11F in Scott, Shultz and Taylor (2010), the Resolution Project at Stanford's Hoover Institution adopted the term Chapter 14 in Scott and Taylor (2012) because there is currently no such numbered chapter in the code. Here I use the term Chapter 14 to refer to this type of bankruptcy reform.

The bankruptcy would involve only a single proceeding, unlike current law where a parent company must go through one proceeding and insurance and brokerage subsidiaries through another, adding considerable complexity.

Chapter 14 would operate faster—ideally over a weekend—and with no less precision than Chapter 11. Unlike Chapter 11, it would leave all operating subsidiaries outside of bankruptcy entirely. It would do this by moving the original financial firm's operations to a new bridge company that is not in bankruptcy. This bridge company would be recapitalized by leaving behind long-term unsecured debt—called the "capital structure debt." The firm's long-term unsecured debt would bear the losses due to the firm's insolvency and any other costs associated with bankruptcy. If the amount of long-term debt and subordinated debt were sufficient, short-term lenders would not have an incentive to run, and the expectation of Chapter 14's use will reduce ex ante uncertainty about runs.

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. The net effect is similar to well-known bankruptcy cases for nonfinancial firms in which people could continue to fly on American Airlines planes, buy Kmart sundries and try on Hartmax suits. The 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.

The new Chapter 14 would also 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 bankruptcy filing, which increased the size of the disruption.

To understand how such a reformed bankruptcy code would resolve a large and complex financial institution, it is very useful to consider how Chapter 14 would have worked in the case of Lehman Brothers in 2008. Emily Kapur (2015) has carefully researched such a scenario using balance sheet and financial data that has been made public through Lehman’s court proceedings, and has prepared a brief and illustrative summary which appears at the end of this this testimony.

Bankruptcy Reform and More Robust Resolution Planning under the Dodd Frank Act

The Dodd-Frank Act requires that resolution plans—living wills—be submitted by the large and complex financial firms to show how these firms can be resolved in cases of distress or failure in a rapid and orderly resolution without systemic spillovers under existing law. Of course, existing law includes Chapter 11 of the bankruptcy code.

Thus far the plans submitted by the large financial firms have been rejected by the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC). The reasons for the rejections are not fully known, but clearly the requirement that the firms would have to go through a Chapter 11 bankruptcy is an impediment as I explained in the first section of this testimony: it is very difficult, if not impossible, at this time to bring one of these large firms through a conventional Chapter 11 bankruptcy.

William Kroener (2015) points out, however, that a Chapter 14 reform would greatly facilitate the resolutions plans’ ability to meet the statutory requirements. Unlike Chapter 11, it would leave all operating subsidiaries outside of bankruptcy entirely as these subsidiaries move to the new firm that is not in bankruptcy. In other words, bankruptcy reform would help greatly in the resolution planning process required in the Dodd-Frank Act.

Shortcomings of the FDIC Resolution Mechanism under Title II of the Dodd-Frank Act[4]

While full liquidation with wiped-out shareholders was a major selling point of the Dodd-Frank Act, 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. 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 international firms. Indeed, this uncertainty about the Title II process would likely 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 were used, bailouts would be likely. As the FDIC exercised its discretion to form a bridge bank, it would likely give some creditors more funds than they would have expected or been entitled to under bankruptcy law. 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 everyday decisions about borrowing and lending. Under the reasonable

[4] This section is based on Taylor (2013)

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 not subject to regulatory capture.

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 large and complex 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.

Contrasting the resolution of a failing financial firm under Title II with resolution under a reformed bankruptcy procedure 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 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 that 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 letting it compete on a level playing field. But with a large amount of discretion and strong incentives to make the resolved firm a success, there is a concern that the advantages granted by a government agency could become excessive and prolonged.

Summary

In this testimony I showed why a reform of the bankruptcy law along the lines of the Senate bill, “The Taxpayer Protection and Responsible Resolution Act” (TPRRA) or the House bill, “The Financial Institution Bankruptcy Act of 2015” is essential for ending government bailouts as we know them. Such a reform—which would make failure feasible even for large and complex financial institutions—would play a key role in addressing the problems of excess risk taking, uncertainty, and unfair subsidies associated with too-big-to-fail, which persist under the Dodd Frank Act. If accompanied with an increase in capital and capital structure debt, such a reform would go a long way toward ending too-big-too-fail.

If Title II of the Dodd Frank Act remains in the law, such a reform would likely reduce the use of Title II, and thus lead to more rules-based and less discretionary resolutions. The reform would also repair the resolution planning process now required under the Dodd-Frank Act.

A Lehman Brothers Scenario under Chapter 14, by Emily Kapur, Stanford University

Lehman Brothers, like most of its peers, had a holding company at the top, called Lehman Brothers Holdings Inc., which owned thousands of subsidiaries. These included its New York based broker-dealer Lehman Brothers Inc., or LBI, and its London based broker-dealer Lehman Brothers International Europe, or LBIE. Lehman was involved in many businesses including securities trading, over-the-counter derivatives, prime brokerage, and even commercial banking. But it was Lehman's real-estate-related activities that got it into trouble. No one knows quite how substantial its losses were, but they almost certainly wiped out Lehman's book equity. Researchers have estimated that they exceeded equity by between $10 and $40 billion.[5]

Lehman's problems had been mounting for months but came to a head in early September 2008. At that point, markets still perceived Lehman to be solvent, but thought its assets were worth only $2 billion more than its liabilities. Internally, Lehman was preparing to announce third quarter losses that would be $2 billion more than markets had predicted. Thus, there was every reason to expect this announcement to eliminate markets' perceptions that Lehman was solvent. Sure enough, once Lehman announced its third quarter losses and conceded that its efforts to raise additional capital had failed, creditors and counterparties ran. The firm lost $30 billion of liquidity over a week as repurchase agreement lenders pulled funding, prime brokerage clients withdrew accounts, and derivatives counterparties and clearing banks demanded additional collateral. Entirely out of cash with which to continue operations, on September 15, 2008 Lehman Brothers filed the largest Chapter 11 case in U.S. history.

Importantly, Lehman owed about $100 billion in subordinated and long-term debt upon its demise, far more than any estimate of its excess losses from real estate. This combined with

[5] See Kapur (2015) for references for these and figures cited below

the fact that its liquidity problems were foreseeable make Lehman's the type of case that Chapter 14 would be best structured to address.

To illustrate the process that Chapter 14 would facilitate, consider a hypothetical counterfactual case for Lehman Brothers. Imagine Lehman fails in the market environment of 2008 with the same information, balance sheets, contractual relationships, and operational systems that it had then. But this time, the legal and regulatory environment is different. Both Dodd-Frank and Chapter 14 are in force in the U.S., and thus the Federal Reserve is Lehman's primary regulator. Internationally, banks have implemented the contractual reforms that ISDA has recommended and European authorities have implemented the Bank Resolution and Recovery Directive.

In this environment, the weekend before Lehman planned to announce its third quarter losses, the Fed determines it is time for Lehman to undergo Chapter 14. There is every reason to expect Chapter 14 to prevent any systemic consequences. Consequently, Title II is foreclosed by its own terms, because it cannot be used if bankruptcy will work.

On a Friday evening, say September 5, the week before Lehman actually filed, the Fed files a Chapter 14 case on behalf of Lehman Holdings. The filing triggers an expanded automatic stay and other bankruptcy rules. Importantly, this case is only for Holdings. All of its subsidiaries, including both LBI and LBIE, remain outside of the bankruptcy proceeding and the expanded stay safeguards their operations.

Upon filing, the Fed makes a motion to sell all of Holdings' assets and all liabilities except the $100 billion of subordinated and long-term debt. The purchaser is a non-bankrupt company called New Holdings whose equity the bankruptcy estate will own. The Fed sends notice to Lehman's largest creditors and to the regulators of its subsidiaries that parties may raise objections at a hearing scheduled for Saturday evening. Though the timeframe is short, Lehman has worked previously with these parties to develop a living will focused on a Chapter 14 proceeding, so no one is caught by surprise. The court must conclude the hearing by Sunday, but need make only cursory findings based upon the Fed's filings. The structure of the hearing strikes a balance: on the one hand offering parties an opportunity to be heard, especially on issues pertaining to management of the new company, while on the other ensuring that the process moves along quickly enough to prevent systemic effects.

On Sunday, the court approves the transfer. New Holdings now exists entirely outside the bankruptcy system. It is managed by private-sector individuals chosen for their ability to maximize value for Holdings' single owner, the bankruptcy estate. New Holdings owns all assets previously owned by Holdings, including all of Lehman's subsidiaries. The subsidiaries themselves have not gone through bankruptcy and various bankruptcy code provisions have prevented adverse effects from the parent company's filing. New Holdings has also assumed most of Holdings' liabilities, but not the $100 billion of subordinated and long-term debt. Thus, short-term lenders can expect to be paid on time. Moreover, New Holdings' capital ratio is nearly four times that of Holdings, because it shed so much debt.

In the end, then, the bankruptcy proceeding makes clear to markets that, even after recognizing its real estate losses, the company headed by New Holdings—call it New Lehman—is exceedingly well capitalized for a financial firm, with a capital ratio of 10 to 15% depending on the extent of the write-downs. By the time markets open in Asia on Monday morning, LBI and LBIE are able to continue to provide key financial services and there is no reason for creditors to run. Furthermore, because the proceeding was undertaken in a timely manner, New Lehman can withstand a moderate drain on liquidity as markets adjust to its new structure.

In contrast to markets' chaotic response to Lehman's Chapter 11 filing, their response to a Chapter 14 filing is quite sober. There is no reason for investors to run on money market funds and no reason for those funds to curtail lending to corporations. Hedge funds do not flee so readily from prime brokers and investment banks are less crunched for liquidity and less likely to turn to the Fed for financing. Ultimately, there is less of a need for legislation to inject hundreds of billions of dollars into the financial system.

Eventually, New Lehman makes a public offering of stock in order to value the bankruptcy estate's ownership interest. The estate then follows the standard bankruptcy priority requirements to distribute its assets and close up shop. There are only three classes of claimants: long-term debt holders, subordinated debt holders, and shareholders. Most likely, the valuation indicates that there are only enough funds to pay back the long-term debt holders in part. Subordinated debt holders and shareholders are wiped out. All other creditors are creditors of New Lehman and not of the bankruptcy estate and so are paid in full at maturity.

In the end, if Lehman went through Chapter 14, shareholders and subordinated debt holders would make out the same as in Lehman's Chapter 11 case—getting nothing—and everyone else would do better, reducing the overall losses by hundreds of billions of dollars. Consequently, risks of systemic effects would be minimized both because the quick proceeding would allow the firm to continue operating and because all parties would expect lower losses. Nonetheless, unlike in a bailout, a substantial proportion of creditors would come away from the process convinced that the possibility of sustaining losses was a real one. And the procedure would demonstrate that even a Lehman Brothers-type firm is not too big to fail.

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