Resolution Authority Redux

By Barry E. Adler and Thomas Philippon

The economic and financial crisis of 2007-2009 caused the collapse or near collapse of several Systemically Important Financial Institutions (SIFIs), such as Bear Stearns, Lehman Brothers, Merrill Lynch, Fannie Mae, Freddie Mac, American International Group (AIG), and Citigroup in the U.S. and many others in the rest of the world. Except for Lehman, these financial giants were not allowed to fail, and many were bailed out by the taxpayers. The debate regarding the desirability of these bailouts will never be settled because it is impossible to assess the systemic consequences that disorderly failures would have had on the financial system and the broad economy. What is clear, however, is that citizens around the world do not want to be presented with the too-big-to-fail dilemma again. The job of regulators is therefore to make the system safer, and to create a process whereby SIFIs can fail in an orderly manner.

In 2010, Congress enacted the Dodd-Frank Act, which, among other provisions, took a dual approach to the prevention of systemic collapse. In this discussion, we focus on Dodd-Frank Title I—Systemic Risk Regulation and Oversight—and Title II—Orderly Liquidation Authority (OLA) for Systemic Risk Companies.

Title I insists that SIFIs maintain a sound capital structure and plan for dissolution in the event of crisis, i.e., create a Living Will.[29] A Living Will should ensure that a failed bank holding company can be resolved under the US bankruptcy code, as are other corporate debtors.

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[29] Title I establishes the Financial Stability Oversight Council (FSOC) and the Office of Financial Research (within the Treasury), and it expands the authority of the Board of Governors of the Federal Reserve System to allow for supervision of certain nonbank SIFIs.

There are, however, legitimate doubts about whether the bankruptcy code in its current form can handle the failure of a SIFI, especially amidst a global crisis. In that spirit, Dodd-Frank Title II provides for orderly restructuring or liquidation of a SIFI that is severely distressed.[30] Title II provides an alternative to bankruptcy, in which the Federal Deposit Insurance Corporation (FDIC) is appointed as a receiver to carry out the bank's resolution over three to five years. OLA is meant to protect financial stability in the US economy.

Ever since Dodd-Frank's enactment, a debate has raged about the pros and cons of Title II. Now, the Financial CHOICE Act before Congress seeks to alter both Title I and Title II of Dodd-Frank. There are elements of the CHOICE Act that we admire, but also some elements that we consider dangerously counterproductive. The CHOICE Act relaxes or removes Dodd-Frank safeguards that providence mandates—safeguards such as required stress tests and Living Wills—and it fails to fill the gap, left by Dodd-Frank, in the government's ability to address systemic crisis as opposed to the mere failure of isolated institutions. While our primary task here is to address the CHOICE Act's treatment—proposed replacement, in fact—of Dodd Frank's Orderly Liquidation Authority, a proper analysis of that treatment necessarily includes consideration of Regulation and Oversight as well, the topic to which we turn next (and offer analysis described more fully in the chapter entitled Should There Be an Off-Ramp for Banks?).

[30] Although the title of the OLA refers to "liquidation," the Act does not envision a necessary winding up of a SIFI's business operations, but rather permits a restructuring of those operations, including through a refinancing of a holding company's subsidiaries. For this reason, we refer to restructuring or resolution, not merely to liquidation, in our discussion of the OLA.

The CHOICE Act's Dodd-Frank Off-Ramp

Per the report of the House Committee on Financial Services, under the Financial CHOICE Act, "banking organizations that maintain a leverage ratio of at least 10 percent and have a composite [Capital adequacy, Assets, Management capability, Earnings, Liquidity, Sensitivity, i.e.] CAMELS rating of 1 or 2, at the time of the election, may elect to be exempted from a number of regulatory requirements, including the Basel III capital and liquidity standards and the 'heightened prudential standards' applicable to larger institutions under [Title I] of the Dodd-Frank Act." The stated goal is to free the financial sector from what the drafters of the CHOICE Act see as a crippling regulatory burden imposed, in part, through strict and invasive stress tests.

In principle, sufficient capitalization is a solution to any problem of insolvency risk, including the risk of systemic financial collapse. But there is an ongoing debate about the proper level of capital in practice. An important study by researchers at the International Monetary Fund (IMF) shows that "bank capital in the range of 15–23 percent of risk-weighted assets would have been sufficient to absorb bank losses in the vast majority (85 percent) of past banking crises in OECD countries."[31] The costs of such capital requirements are more difficult to assess. Although the long-run (steady state) costs of additional equity capital may be small, probably less than ten basis points per additional percentage point of bank capital, recent papers have shown that the transition costs can be

[31] Jihad Dagher, Giovanni Dell'Ariccia, Luc Laeven, Lev Ratnovski, and Hui Tong, *A New Look at Bank Capital*, Oxford Business Law Blog (April, 2016).

substantial.[32] In any case, because the CHOICE Act's off-ramp is optional, banks might well choose to endure the costs and thus reduce their regulatory burden.

We are sympathetic to the CHOICE Act's emphasis on capitalization, but it is misleading to present the threshold capitalization as a way to solve the too-big-to-fail problem. Specifically, the roughly 20% of risk-weighted assets described in the IMF study corresponds roughly to 11% of total assets, so the ratio proposed in the CHOICE Act *could* give significant protection to taxpayers. That ratio would *not*, however, guarantee that banks do not fail, and it would not, by itself, guarantee that a SIFI could be resolved.

To understand the limitations in the proposed capitalization requirements, compare the ratio proposed in the CHOICE act to the one proposed in the 2016 Minneapolis Plan to End Too Big to Fail.[33] The Minneapolis Plan would increase capital requirements for all bank holding companies larger than $250 billion to 23.5% of risk-weighted assets, counting as capital only common equity and not long-term debt. Under that plan, if the Treasury Secretary deems a bank systemic, the capital requirement increases further, up to 38%. These ratios translate roughly into pure leverage requirements of 15% and 24%, respectively.

It is also useful to compare the CHOICE Act capital requirements to the actual ratios of U.S. Global Systemically Important Banks.

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[32] For a comprehensive discussion of the literature, see Jihad Dagher, Giovanni Dell'Ariccia, Luc Laeven, Lev Ratnovski, and Hui Tong, *Benefits and Costs of Bank Capital*, IMF Discussion Paper (2016). These authors observe that "the long run impact of a 1 percentage point increase in capital requirements on lending rates ranges from merely 2 basis points to 20 basis points." They conclude, however, that in the short run "a 1 percentage point negative shock to capital (or increased capital requirement) is associated with a 5–8 percentage point contraction in lending volumes."

[33] See Federal Reserve Bank of Minneapolis, *The Minneapolis Plan to End Too Big to Fail* (November 16, 2016), available at https://www.minneapolisfed.org/publications/special-studies/endingtbtf

(GSIBs). According to FDIC estimates based on Generally Accepted Accounting Principles (GAAP), U.S. GSIBs have $10.7 trillion of assets and a leverage ratio of 8.24%. In this case, an increase to 10% would not be significant.[34] Moreover, for global banks with large derivative positions, it is not clear that GAAP is the right benchmark. International Financial Reporting Standards (IFRS) accounting rules are more conservative in their treatment of derivative exposures. According to FDIC estimates based on IFRS, U.S. GSIBs have $15.2 trillion of assets and a leverage ratio of only 5.75%. By this measure, an increase of capitalization from above 8% to 10% would be an anemic response to the risk that GSIBs in fact present.

In our view, it is simply incorrect to assume that a 10% leverage ratio would be enough, by itself, to negate the need for other forms of regulations. More generally, we are skeptical that any capital requirement lenient enough to permit the proper functioning of a large financial institution can be strict enough to be a one-stop solution.

There is an additional problem with the off-ramp proposed by the CHOICE Act. The proposal is to treat minimum capitalization as a substitute for extensive oversight. In our view, this is misguided because it assumes that the proper ratio will be maintained at all times despite relaxed supervision. In fact, in the absence of extensive oversight, one wonders whether minimum capitalization will be maintained. Violations of regulatory requirements are not unheard of, and without scrutiny, there is the concern that the first sign of insufficient capitalization at a SIFI may appear too late.

For these reasons, we believe that there is continuing benefit in multiple approaches to the prevention of crisis. The off-ramp should, perhaps, allow the SIFI to escape some regulation, but the

[34] The capital ratios are estimated by the FDIC. The numbers refer to 2016 Q2, available at https://www.fdic.gov/about/learn/board/hoenig/capitalizationratio2q16.pdf

requirement for stress tests should be retained. The Dodd-Frank requirement of Living Wills, made optional by the CHOICE Act's off-ramp, is another regulation that should be maintained for large banks—even those that make a qualifying capital election.

Living Wills (Bail-In and Single Point of Entry)

The Dodd-Frank Act requires that every designated company, typically a bank holding company with $50 billion or more in assets, prepare and file with the Federal Reserve Board and the FDIC a resolution plan commonly known as a Living Will.[35] While the legislation requires that a Living Will describe the firm's assets and obligations, and provides that the plan should facilitate bankruptcy resolution, it does not offer detail on what a financial distress plan must include to receive approval. There is, however, a developed academic literature on just such an arrangement. As we discussed in an earlier policy paper,[36] the sort of Living Will suggested in the literature can help to accomplish an orderly resolution of financial distress in an automated fashion.

The concept of a corporate Living Will was first described in the academic literature as Chameleon Equity.[37] The idea is to divide a firm's capital structure into a hierarchy of priority tranches. In the event of an uncured default on a firm's debt obligations, the equity of the firm would be eliminated and the lowest-priority debt tranche would be converted to equity, just as a chameleon changes its colors as circumstances require. There would be no need for

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[35] The threshold for designation, vehemently criticized by the drafters of the CHOICE Act, is neither capricious nor complicated, though it does present close questions difficult to adjudicate. Metlife is a case in point. One of the authors wrote an amicus brief for the court arguing that Metlife is indeed systemic, but this is a topic on which reasonable people can disagree.

[36] Viral Acharya, Barry E. Adler, Matthew Richardson, and Nouriel Roubini, Resolution Authority, in Acharya et al., editors, *Regulating Wall Street* (Wiley 2010).

[37] See Barry E. Adler, Financial and Political Theories of American Corporate Bankruptcy, 45 *Stanford Law Review* 311 (1993).

further restructuring if elimination of the lowest priority debt tranche reduced the firm's fixed liabilities sufficiently so that the remaining debt obligations could be paid from its assets. If obligations to the higher debt tranches remained in uncured default, the process would repeat until either all defaults were cured or the highest-priority tranche was converted to equity. Only at the point where a firm defaulted on its most senior obligations, after the elimination of all junior debt, would holders of those senior obligations have reason to foreclose on collateral. Elimination of the junior debt classes would, until that point, provide liquidity that could stabilize the firm and perhaps stem any run on the firm's assets.

Significantly, within a Chameleon Equity structure, there is no need for a judicial valuation or determination of which obligations are or are not entitled to satisfaction.[38] The prospect of default-driven transformations of the tranches from debt to equity would theoretically provide the firm with solvency until a class of secured claims was impaired, and without the need for bankruptcy restructuring beyond simple adherence to the prescribed capital structure or, to use the terminology of the current debate, without the need for bankruptcy beyond simple adherence to the firm's Living Will. Therefore, although the Dodd-Frank Act envisions Living Wills as blueprints for the bankruptcy process, a Living Will with the automatic conversion features we favor could also alleviate the need for that process and provide the speed of resolution that financial markets require.

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[38] There are academic proposals to allow for a bankruptcy reorganization distribution of an insolvent debtor's value contrary to the creditors' contractual priority hierarchy if no creditor is thereby deprived of what it would have received in a liquidation. And while a Chameleon Equity structure could be devised to mimic such distribution, in our view deviation from contractual priority is undesirable whether the debtor is an industrial firm or a bank. See generally, Barry E. Adler and George G. Triantis, Debt Priority and Options in Bankruptcy: A Policy Intervention, *American Bankruptcy Law Journal* (forthcoming 2017).

To be sure, there are potential drawbacks to the Living Will we envision. The transformation, or winding down, of the firm must be triggered by an easily verifiable signal, such as default on obligations, rather than a difficult one such as inherent asset value.[39] The key to the proposal, after all, is to provide swift rescue and payment of those obligations that are still in-the-money, despite the firm's inability to make good on all its obligations. Such a transformation, or winding down, runs the risk that a firm in financial crisis will eliminate an interest that might have later proven to be valuable in a traditional bankruptcy reorganization, where time and the debtor's continued search for liquidity might resolve the crisis.[40] This problem could be exacerbated in a systemic financial crisis where a firm's assets are likely to be illiquid particularly so if debtors are permitted to invest in one another's risk securities. If, in such an environment, the firm cannot raise cash to pay even what should be its surviving obligations, creditors could bear large losses, and short-term creditors, despite theoretical seniority, might run or refuse to roll over their claims.

The Chameleon Equity concept—though it offers no panacea—has some empirical support. The concept depends on regulation to impose proper minimum size of loss-absorbing tranches. Prompted in large part by European legislators' or regulators' reaction to last decade's worldwide financial crisis, large banks have issued what is referred to as Bail-In capital, senior to common equity, but

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[39] A modification of the Chameleon Equity approach could be designed specifically for large banks. Under this modification, a government administrator could be granted constrained discretion to initiate the conversion of a debtor's capital structure even before default, when a bank's equity market value sunk below a prescribed threshold, for example. See generally Stephen G. Cecchetti and Kermit L. Schoenholtz, Living Wills or Phoenix Plans: Making Sure Banks can Rise from Their Ashes, *Money & Banking* (October 13, 2014). Such an approach could alleviate the problems, described here, of a transformation occurring too late, but would introduce regulatory complexity and uncertainty.

[40] There are costs, too, to a traditional reorganization, including uncertainty and the potential paralysis of the financial markets that led to the Dodd-Frank requirement of Living Wills.

designed to absorb losses in the event the bank encounters financial distress. Shielded by Bail-In capital (as opposed to a bailout), even a foundering bank may be able to meet its obligations on systemically important assets such has short-term securities and derivatives treated as cash in the capital market.

On the topic of loss-absorbing capital, the experience of the United States is more complicated. As noted above, Title II of Dodd-Frank contains the OLA for the restructuring or liquidation of SIFIs that, per regulators, cannot be safely resolved in bankruptcy court. (The process is described in greater detail below.) Pursuant to Dodd-Frank, the FDIC has issued OLA regulations called the Single Point of Entry (SPOE) Strategy. The premise of SPOE is simple, and reflects the policy underlying Chameleon Equity and Bail-In. Under SPOE, among the entities that make up a SIFI—typically a bank holding company and subsidiaries—only the bank holding company would be subject to the orderly liquidation process; the subsidiaries, as operating companies, would continue unaffected by their parent's resolution, even its demise.

For the SPOE strategy to work, two conditions must hold. First, any subsidiary with systemically significant obligations must itself be sufficiently capitalized to avoid failure. Second, the holding company must be financed only through the issuance of expendable obligations—that is, not with systemically significant obligations. If these conditions are satisfied, the SPOE strategy operates essentially in the same way as Chameleon Equity or Bail-In: Each bank issues a significant amount of low-priority capital, beyond common equity, as a supplemental cushion for high-priority, systemically significant obligations. Under Chameleon Equity or Bail-In, capital is raised through the issuance of expendable obligations that fill low-priority tranches as part of a single entity's capital structure. Under SPOE, a holding company issues expendable obligations to raise capital that is then contributed to subsidiaries, which are permitted to issue systemically significant obligations.

It follows that the SPOE depends on requirements that the banks structure and finance themselves appropriately. The Living Will provisions of Title I establish an ideal platform for the imposition of these requirements, customized as they must be for each individual bank. Because Living Wills are not public documents, it is uncertain whether the plans produced by the banks have been required to meet these criteria.[41] But there is evidence that the banks have been so required. Last year, for instance, PricewaterhouseCoopers reported that most domestic SIFIs now have SPOE strategies for resolution of financial distress (a shift from the bridge-bank approach).[42]

We view the enhancement of loss-absorbing capital of the SIFIs since Dodd-Frank as real progress. Moreover, we do not oppose the CHOICE Act's off-ramp as a path to some regulatory relief (the details of which are beyond the scope of the current discussion). However, the off-ramp should not undermine the Living Will requirement, which allows regulators to ensure that a SIFI's capital structure is sufficiently robust to earn such regulatory relief.

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[41] The Living Will process has not been a smooth one, with regulators continuing to call for a reduction in organizational complexity and other evidence of viability. See Key Points from the US G-SIBs' Resolution Plan Progress Reports, *Harvard Law School Forum on Corporate Governance and Financial Regulation* (October 29, 2016). Because, as noted, the details of the plans are not public, it is not possible to evaluate them directly or say more than offered here.

[42] See *Regulatory Brief of PwC* (July, 2015). The bridge-bank approach encompasses a transfer of solvent operating subsidiaries from a failed holding company to a well-financed bridge entity that will hold the operating companies until they can be sold in due course, freed from the exigencies of their parent's crisis. Although the processes differ somewhat, and although, in principle, SPOE accomplishes a bank's transformation more simply than the bridge-bank approach, the intended result of the latter approach is the same as that of SPOE or, for that matter, of bankruptcy, OLA, or Bail-In, each of which is designed to salvage viable operations from the collapse of the affiliate's financial structure. The adoption of the SPOE approach by most companies is significant not so much in the structure chosen but in the signal that regulators have been able to impose their chosen discipline, presumably including the isolation of systemically important debt, away from the bank's insolvency risk.

Bankruptcy not Bailout

A successful Living Will could quickly resolve a failed firm's affairs, freeing all but its impaired obligations (which would be transformed or eliminated) to trade at solvency values. This result would limit the scope of a firm's failure and reduce the extent to which a firm's insolvency could spread through the financial system. The orderly transformation of lower-priority obligations can restore the higher-priority claims to in-the-money status, which can cabin the contagion.

Nevertheless, some impairment of a firm's obligations would remain unavoidable, so ultimately Living Wills are limited in their ability to stem contagion. Moreover, no plan is fool proof. A Living Will could fail to achieve its purposes if, for example, Bail-In capital proved insufficient or, for another, if not only a bank holding company—the intended single point of entry to the restructuring process—but also its operating subsidiaries, proved insolvent. However well designed, Living Wills must be backstopped.

As noted above, the backstop under Dodd-Frank had two parts: the bankruptcy process and Dodd-Frank's own Orderly Liquidation Authority. If a financial institution, such as a bank holding company or one of its subsidiaries, failed, the Act's presumption is that the institution would go through the ordinary bankruptcy process or other applicable insolvency law. However, upon the recommendation of the Federal Reserve Board (by a two-thirds vote) and a similar vote by the FDIC (or, in some cases, the Securities and Exchange Commission for broker-dealers or the director of the Federal Insurance Office for insurance companies), the secretary of the Treasury could determine that the financial institution should be subject to the OLA. Such financial institutions are designated Covered Financial Companies (CFCs). The secretary would have to establish a number of conditions, including that the CFC had defaulted on its obligations or was about to and that failure of the company under ordinary procedures, such as under the bankruptcy code, would seriously undermine the stability of the U.S. financial system.

Under Dodd-Frank, if the board of a CFC does not acquiesce to an orderly liquidation, the Treasury secretary may petition the U.S. District Court for the District of Columbia. If the District Court does not find that the secretary's petition is "arbitrary and capricious," the petition must be granted. All of this must take place within 24 hours of the petition being filed. Further appeals are possible. Once appointed as a receiver, the FDIC would have broad powers to manage the CFC's affairs, including the authority to transfer or sell assets and to satisfy claims. The FDIC is not able to use any funding, however, unless an orderly liquidation plan has been approved by the Treasury secretary.

The Dodd-Frank Act shapes the OLA on the receivership model of the FDIC (though specialized alternative provisions apply where the CFC is a broker-dealer or insurance company). Consistent with the FDIC's current and continuing role in resolving depository institutions, the FDIC would have the power to take over the assets of and operate the CFC. The FDIC's authority includes the power to transfer assets or liabilities to a third party or bridge financial company. It is worth noting here, as we did in our earlier paper,[43] that the essence of the Act's receivership model is also consistent with the bankruptcy process. In each case, a financially distressed firm becomes subject to the supervision of an administrator—the FDIC or a bankruptcy judge, respectively—and in each case, the administrator oversees the operation of the firm and the disposition of its assets.

There are differences, however, between bankruptcy and OLA in the way creditors are paid and in the procedures applied. Take, for instance, the order of payments to creditors, which generally

[43] See Acharya et al. Resolution Authority, cited in note 36.

follows state law priorities under the bankruptcy code. Under the Dodd-Frank Act, the FDIC would be able to cherry-pick among obligations (paying some out of priority order or treating obligations with similar priorities differently) under the proviso that no creditor gets less than what it would have received in a liquidation under the bankruptcy code, and subject to certain provisions for specified financial contracts.

Beyond priority, under the provisions of Title II of the Dodd-Frank Act, the OLA's rules do, in some cases, follow those prescribed by the bankruptcy code. For example, secured debt, contingent claims, preferential payments, and fraudulent conveyances are treated under the OLA largely as they would be treated under bankruptcy law. But not all provisions are the same under the FDIC receivership model and the bankruptcy code. For example, the settlement of qualified contracts is subject to a stay of up to one business day after the commencement of an FDIC receivership but not subject to the stay at all under the bankruptcy code. And setoffs, which are generally honored under the bankruptcy code, are subject to alteration under FDIC receivership.

There is the potential for a mismatch between the insolvency regimes, and even where the substantive rules are effectively identical, their implementation under the new law may be uncertain. In general, at least initially, there could be great uncertainty as to how the new statute would be interpreted, and uncertainty can be costly.

One wonders, moreover, whether the FDIC has the institutional capacity to deal with the dissolution of covered firms, which are, by definition, large and complex. The FDIC has been a receiver for banks and savings and loan associations, which are simpler by comparison, in that as the deposit insurer and holder of the depositors' claims by subrogation, the FDIC is the natural location for the firm's assets. This is not a reason to have the FDIC administer the insolvency of CFCs. By contrast to the OLA, the bankruptcy code, while imperfect and subject to some uncertainty, has well-established provisions tested by litigation. And the bankruptcy courts are experienced with the management of large cases—Enron, General Motors, and Lehman Brothers, among them.

For these reasons, as we observed in our earlier paper,[44] any inadequacy of the current bankruptcy code to deal with SIFIs does not imply that the code should be scrapped and replaced by FDIC-like powers of the OLA. The FDIC generally deals with specific and narrowly defined institutions. The bankruptcy code, and years of practice under it, is broader in its design and reach.

So we applaud the decision under the Financial CHOICE Act to replace the OLA with what the **House Report** describes as “a new subchapter of the bankruptcy code tailored to address the failure of a large, complex financial institution.” The new bankruptcy chapter, based on noted bankruptcy scholar Tom Jackson’s proposal for a new Chapter 14 for SIFIs,[45] would provide a specialized forum and an expedited process to resolve SIFI insolvency all otherwise under the auspices of the well-evolved rules of the bankruptcy code.

We further agree with the CHOICE Act’s elimination of Dodd-Frank’s industrywide fund assessment, essentially a tax, to pay any shortfall in repayment of federal funds advanced to a SIFI undergoing OLA resolution. In our earlier paper,[46] we observed (in language quoted by the CHOICE Act Report) that such an *ex post* fund assessment would essentially require prudent financial companies to pay for the sins of the others. This would be bad enough even from merely an *ex post* perspective once a crisis had begun, as the costs to the financial system could be substantial, and would weigh against the ability of the system to provide credit. Ironically, an illiquid financial system is the very evil the Dodd-Frank Act is intended to avoid. But

[44] See Acharya et al. Resolution Authority, cited in note 36.
[45] See Kenneth E. Scott and John B. Taylor, Editors, *Bankruptcy* Not *Bailout: A Special Chapter 14* (Hoover Institution Press, 2012).
[46] See Acharya et al. Resolution Authority, cited in note 36.

it gets worse, as we said. Dodd-Frank's plan for successful financial institutions to pay the creditors of failed institutions may not be a bailout at the expense of the general taxpayer but would lead to an identical free rider problem.[47]

Having proposed the elimination of assessment as a means for taxpayers to recover improvidently advanced capital, the CHOICE Act goes on strictly to limit the use of federal funds as loans for SIFIs undergoing bankruptcy. In a section of the House Report titled "Bankruptcy not Bailout," the Report describes what its drafters see as too-permissive rules for the use of federal funds under Dodd-Frank. The report then describes the CHOICE Act's restriction on the use under section 13(3) of the Federal Reserve Act "to those instances that meet the specific criteria of Bagehot's Dictum, named after the noted British financial journalist Walter Bagehot, which stipulates that a central bank should lend freely in a financial crisis, but only to solvent borrowers, against good collateral, and at penalty rates." It is here that we part company with the CHOICE Act's drafters.

In our earlier policy paper's assessment of Dodd-Frank,[48] we observed that the lending rules under Dodd-Frank were, in our opinion, *too* strict, or more precisely, insufficiently broad. We observed that, ideally, in the event of a systemic liquidity crisis, during which private funds have become scarce, federal funds could be made available as a source of capital to financial institutions in bankruptcy—that is, as a debtor-in-possession (DIP) lender much in the same way the Treasury served as a DIP lender in the Chrysler and General Motors cases. That is, we said, one could advantageously strip away the process portions of the Orderly

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[47] Proposals for an *ex ante* tax on the banking industry to fund liquidity in times of crisis would alleviate the problem of specially burdening financial institutions at the time they are most vulnerable, and such a tax may be preferable to a general taxpayer provision of a liquidity fund, but such an *ex ante* tax would not address the moral hazard problem described here and further addressed below.

[48] See Acharya et al. Resolution Authority, cited in note 36.

Liquidation Authority and leave its only truly unique element, an Orderly Liquidation Fund.

Further, we said, there would be an additional benefit to segregating the federal government's capacity to lend in times of crisis from the OLA. As an entity devoted to the management of systemic financial crisis, rather than a mere liquidation facilitator, the Orderly Liquidation Fund, perhaps renamed the Systemic Risk Avoidance Fund, could, at prescribed times of pending systemic illiquidity, lend not only to failed firms but also to struggling ones, perhaps to prevent their failure.[49] Put another way, a federal fund focused on liquidity rather than liquidation might prevent a crisis rather than attempt to rescue the financial system after a crisis has occurred, when problems are more expensive to address.[50]

We were not, and are not, unmindful of the moral hazard created by the potential availability of federal funds. Thus, we continue to stress, the importance of regulation and oversight, including the oversight that the CHOICE Act seeks to diminish.

Against all this, the drafters of the CHOICE Act argue that eliminating even the possibility of a bailout will discipline SIFIs and render them responsible citizens. This basis for reform is misguided, in our view, for at least five reasons:

[49] As we observed in our earlier work, id., the Dodd-Frank Act does allow the FDIC, in consultation with the Treasury secretary and by two-thirds vote of the FDIC and Board of Governors, to create a systemwide program to guarantee obligations of solvent depository institutions and holding companies for a fee that offsets projected losses and expenses. However, as we noted, in addition to these procedural hurdles, the creation of such a program requires a determination that a liquidity crisis is underway, and so any relief may come too late. The details of how a federal liquidity fund could be optimally designed and implemented is beyond our current scope.

[50] See Viral V. Acharya and Matthew Richardson, Implications of the Dodd-Frank Act, 4 *Annual Review of Financial Economics* 1 (2012).

- Managers of corporations, including financial institutions, are not always faithful agents of their principals and, motivated by private gain, might take unjustified risks with corporate funds.
- Even if managers were entirely faithful agents to their investors, SIFIs would take on more than the socially optimal level of risk because, by their nature, the *systemic* costs of risk are *externalized*.
- Whatever their intent, humans commit errors and managers of SIFIs have the capacity to err spectacularly, as we've seen, with the world's economy at stake.
- No matter how strident the anti-bailout rhetoric of the House Report, the CHOICE Act cannot bind a future Congress confronted with a financial meltdown. So, given the opportunity to invest unwisely, one might expect SIFIs to do so in anticipation of the CHOICE Act's repeal and a bailout should things go wrong.
- Even if none of this were true, a worldwide liquidity crisis could occur even without SIFI misbehavior, and so a prohibition on federal rescue would be overly restrictive.

For these reasons, we disagree with the CHOICE Act's attempt to play chicken with SIFIs, which remain too-big-to-fail with or without a safety net. The Bagehot Dictum's limitation on funding to "good collateral" could be dangerously restrictive in a financial crisis. This implies that this provision of the CHOICE Act is either counterproductive or, because it is subject to later repeal, essentially meaningless. Neither of these possibilities is an endorsement.

Summary and Conclusion

There is much to like—but also much to worry about—in the CHOICE Act. With respect to financial stability and the too-big-to-fail issue, the CHOICE Act's stated intentions are encouraging, but the proposals suffer from two main conceptual flaws.

First, the drafters seem unable to recognize the fact that not only regulators, but market actors as well, can be mistaken about financial risks. It is true that in the lead-up to our most recent crisis, regulators misjudged the enormous increase in leveraged exposure to housing risk. But it is equally true that junk bonds reached their narrowest spread in recorded history in June 2007, and the market willingly lent to Greece at the same rate as it lent to Germany. In fact, in many cases, narrow market spreads were used to explain to regulators that they had nothing to worry about. It is therefore equally dangerous to put one's faith entirely in market discipline, as it is to put it entirely with regulators.

Second, in its zeal to address moral hazard, the CHOICE Act forgets the lessons from the 1930s. It is a dangerous idea that the only option in a systemic crisis is simply to let firms fail, regardless of the consequences. The CHOICE Act's elimination of a rescue option would likely be ineffective, in any case, inasmuch as a future Congress would have both the power, and good reason, to restore the option of federal relief.

The goal of financial regulation is to strike the right balance between market discipline and regulation, and to be realistic about the limits of each.

We think that the off-ramp is a potentially good idea, but it should not relieve firms from the obligation to undergo stress tests or to write credible Living Wills. If regulated entities perceive other forms of enhanced supervisions as overly burdensome, these could perhaps be reduced in exchange for more capital.

We approve the idea of replacing the OLA with a new subchapter of the bankruptcy code and of eliminating the industrywide fund assessment. The bankruptcy chapter should, however, allow for DIP financing by the federal government as part of a more general authority to address *systemic* liquidity concerns. The moral hazard of potential relief should be policed through regulatory requirements, including Living Wills. Continuation of such regulation would also make the new chapter more credible.