WHO IS TOO BIG TO FAIL: DOES TITLE II OF THE DODD-FRANK ACT ENSHRINE TAXPAYER-FUNDED BAILOUTS?

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT AND INVESTIGATIONS

OF THE

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WHO IS TOO BIG TO FAIL: DOES TITLE II OF THE DODD-FRANK ACT ENSHRINE TAXPAYER-FUNDED BAILOUTS?

Wednesday, May 15, 2013

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON OVERSIGHT
AND INVESTIGATIONS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Patrick T. McHenry [chairman of the subcommittee] presiding.

Members present: Representatives McHenry, Fitzpatrick, Duffy, Hultgren, Ross, Wagner, Barr; Green, Cleaver, Delaney, Sinema, Beatty, and Heck.

Ex officio present: Representative Hensarling.

Also present: Representative Sherman.

Chairman MCHENRY. The Oversight and Investigations Subcommittee of the Financial Services Committee will come to order. We are pleased to begin a hearing entitled, "Who Is Too Big To Fail: Does Title II of the Dodd-Frank Act Enshrine Taxpayer-Funded Bailouts?"

We have a distinguished panel composed of 4 witnesses. Three of them are currently here, and one is en route.

Without objection, the Chair is authorized to declare a recess of the committee at any time, and the Chair would like to announce that the intention is to adjourn this subcommittee by noon today. We have one witness who has to depart by 11:45, and that witness is Professor Skeel, who has to catch a flight.

So, with that, I recognize myself for 5 minutes for an opening statement.

Two-and-a-half years ago, when the Dodd-Frank Act was signed into law, President Obama declared that too-big-to-fail had ended. Today, there seems to be much debate as to whether that is true. Across the ideological spectrum, elected officials, members of the media, Federal Reserve Presidents, and even the Chairman of the Federal Reserve have acknowledged that this problem still persists.

Just this past week, Chairman Bernanke, in his speech to the Federal Reserve Bank of Chicago, said, "I think that too-big-to-fail is a very big issue and we will not have completed the goals of financial regulatory reform unless we have adequately addressed this issue."

The Administration's Attorney General Eric Holder highlighted the problem from the perspective of prosecuting Federal crime. Testifying in front of the Senate he said, "I am concerned the size of some of these institutions has become so large that it does become difficult for us to prosecute them when we are hit with indications that if you do prosecute, it will have a negative impact on the national economy, perhaps even the world economy."

The fact is that Dodd-Frank did not end too-big-to-fail but instead enshrined it. Title II of Dodd-Frank, which created the Orderly Liquidation Authority (OLA), made government guarantees for Systemically Important Financial Institutions (SIFI) explicit. The Orderly Liquidation Authority is less than orderly. Liquidity is provided by the government, but it does have enormous authorities within it. And it is this explicit guarantee that not only provides an unfair advantage to the biggest and most powerful companies and institutions, but in doing so has the potential to seriously distort our marketplace.

However, relatively little has been done in terms of the halls of Congress and policymakers here in regard to the actual process that takes place within the Orderly Liquidation Authority (OLA). The competitive advantages that OLA provides to large, troubled institutions are real, and whether these advantages will be applied to save large, troubled financial institutions while harming otherwise healthy competitors remains to be seen, as well.

OLA imposes a bank restructuring process in lieu of bankruptcy that is intended to allow troubled financial institutions to continue operating while undergoing recapitalization. The general idea is that the parent company suffers equity in debt write-downs while the operating subsidiary remains solvent and proceeds with business as usual. The FDIC calls this the single point of entry process.

While this process provides attractive benefits such as avoiding a loss of franchise value that often results from a run on a failed bank, the benefits of continuity come with an extraordinarily great price and a price to the taxpayers and to those who bank with other institutions, potentially, as well.

Protecting the franchise value requires a bailout. While the government provides liquidity to a bridge holding company while exempting it from taxes and potentially exempting it from capital requirements or other regulatory requirements, the cost of these subsidies is ultimately backed by attacks on banks and thereby attacks on those that utilize banking services, which, as we know, is clearly passed on to customers in my district and across the country.

The FDIC and Treasury—their discretion to provide these advantages is paired with the political value of saving a Systemically Important Financial Institution. When faced with a failed institution, and an open wallet from the Treasury backed by a bank tax, what do we expect the regulators to do? To advantage these corporations, these new entities, or disadvantage them?

These are the questions that we have today. As reflected in the continued lower cost of borrowing available to Systemically Important Financial Institutions, this bailout perpetuates too-big-to-fail and the moral hazard associated with it.

I recognize that our witnesses have a variety of opinions on this matter, and we look forward to their talking through this process to policymakers here so that we can more deeply understand the Orderly Liquidation Authority, what that bridge holding company looks like, and the terms under which they will operate, potentially operate, and what the letter of the law actually says.

So, I look forward to your testimony. And I look forward to Members' questions and getting to a deeper understanding of the Orderly Liquidation Authority within Dodd-Frank.

With that, I now recognize the ranking member, Mr. Green, for 5 minutes. Oh, the ranking member wishes Mr. Sherman to be recognized first on his side.

Mr. Sherman is recognized for 3 minutes.

Mr. SHERMAN. I thank the ranking member.

Chairman MCHENRY. I'm sorry. Recognizing that you are not a member of the subcommittee, we have to ask unanimous consent for you to make a statement, since we allow subcommittee members to speak first, but hearing no objection, we will recognize you for 3 minutes for an opening statement.

Mr. SHERMAN. I thank both the ranking member and my colleagues.

TARP stood for Troubled Asset Recovery Program. We put a big light on it, we stopped it for a while, and in the end they didn't dare buy a single toxic asset, a single bad bond from the big banks. Instead, they bought preferred stock, and that is why we are getting most of our money back, but it was still a bailout.

The Orderly Liquidation Authority in Dodd-Frank has some problems, but compare it the first four drafts of the bill, which I described and it was quoted by a few on the other side as TARP on steroids because it provided permanent unlimited bailout authority. The current bill limits the amount of cash the taxpayers put out to the value of the assets securing that cash, and while that does provide some advantages, it certainly is a pale shadow of what was intended by those who started that legislation.

Ultimately, though, you don't need legislation to get a bailout. They didn't have one in 2008. They were credibly able to tell the country that if we didn't bail them out, they would take us down with them, and as long as there are institutions that can credibly make that claim, we have seen once that Congress is willing to pass whatever statute eventually they propose. So what we need to do is make sure that no private entity can make the claim that they can pull down the entire economy. We ought to break up those who are too-big-to-fail, and as I think the chairman pointed out, too big to jail, no institution should be so large that its creditors believe that they will be bailed out and its executives believe that they are immune from the criminal laws that affect us all.

So, I look forward to ending the—not just changing the statute but changing the economic reality that we were confronted with in 2008, and that I hope we are not confronted with again.

I again thank the chairman, and I yield back.

Chairman MCHENRY. The gentleman yields back. I now recognize the vice chairman of the subcommittee, Mr. Fitzpatrick, for 2 minutes.

Mr. FITZPATRICK. Thank you, Mr. Chairman, for holding this important hearing. The Orderly Liquidation Authority, or the OLA, provides an alternative to bankruptcy that will most likely arise when a financial institution's failure threatens the broader economy. The FDIC has decided to implement the OLA through the single point of entry approach, or SPOE. The SPOE approach is an attempt to reduce the complexity associated with resolving massive and enormously complex financial institutions. SPOE calls for the equity and debt issued at the holding company level to be written down during the OLA process as a means to convert a failed financial institution into a new and stable financial institution, thereby imposing losses on the former owners and unsecured creditors of the firm.

Due to the complexity of Systemically Important Financial Institutions, the drafters of Dodd-Frank provided a great deal of discretion to the FDIC and Treasury in how and whether to recapitalize or liquidate a firm that is resolved under the OLA. Ultimately, the vast discretion embeds a permanent level of uncertainty.

Central to this point is the funding authority provided to the FDIC through the Orderly Liquidation Fund, or the OLF. When a troubled financial institution enters the OLA process, the FDIC is authorized to provide funding up to 90 percent of total consolidated assets in the financial institution. The FDIC alternatively could provide 0 percent and instead maximize capital via the write-down of debt. The difference between 90 percent of a trillion dollars and 0 percent of a trillion dollars is enormous. How can creditors of Systemically Important Financial Institutions accurately evaluate risk when the FDIC holds so much discretion? This is only one component of the vast discretion provided to the FDIC and to the Treasury.

I look forward to the testimony of our witnesses, and I yield back the balance of my time.

Chairman MCHENRY. I thank the vice chairman, and we will now recognize the ranking member of the subcommittee, Mr. Green, for 5 minutes.

Mr. GREEN. Thank you, Mr. Chairman. I thank you, and I want to especially thank the staff, if I may take a moment to do so, for the outstanding work that they have done in compiling information for us for this hearing.

I think this hearing will provide us an opportunity to get some answers to many questions that are being posed with reference to Dodd-Frank, but I would like to take a moment and deal with the issue that the hearing is designed to address: Does Title II of Dodd-Frank Enshrine Taxpayer-Funded Bailouts? Stated another way, does Title II of Dodd-Frank—which is the law—enshrine—which is to legalize, memorialize, perpetuate—a taxpayer-funded bailout? As you know, bailouts are monies that go to these institutions to keep them afloat. That is the way the public views this and that is the way I interpret what we are talking about today, the proposition that is before us.

And the question is to be answered in the following manner, pursuant to some of the material that the staff has given to us, and I am proud of this material. We have Section 214 styled "The Prohibition on Taxpayer Funding," which reads, "Section 214(a) provides that no taxpayer funds may be used to prevent the liquidation of any financial company under this title. Section 214(b) requires that all funds expended in the liquidation of a covered financial company be recovered from the disposition of assets or through assessments on the financial sector. Section 214(c) provides that the taxpayer shall bear no losses from the exercise of any authority under Title II."

Now, that is pretty explicit in terms of taxpayers bailing out an institution. I would also add, and I am pleased that my friend Mr. Sherman is here, he was very vocal about Section 13(3) and pursuant to his request, and I thank him for making these requests, we were able to prevent Section 13(3) funds from being utilized to bail out these institutions in the future. So we had this big debate about how we were going to bail out companies, and we decided we wouldn't, and then the debate became, how will the taxpayer dollars be used if they are used, and we thought that they shouldn't be used at all. That was the argument that was made in what is called an ex ante fashion, meaning that we would use funds from the industry to cover any losses the same way we use industry funds for premiums for FDIC. If you like the way FDIC functions, you should like the way Dodd-Frank and the Orderly Liquidation Authority function because FDIC funds are used, these are premiums, and these premiums are an ex ante premium. That means they are paid before an event occurs.

Because we had a good many persons who—and by the way, these were not persons, for the most part, on my side of the aisle—felt that we ought to have an ex post process, meaning that the funds, if they are to be collected from the industry, would be collected after the event occurs, and that was made a part of the bill, the ex post process.

Given that we now have this process of collecting after the fact, we also have this language that protects taxpayer funds. We can't use 13(3) funds. Taxpayers, while some of the funds may be used, they are not given to the FDIC. It is a loan, and the loan can carry with it an interest rate such that taxpayers will never be on the hook for a company going out of business.

Finally, on this point, and I will make it quickly, in my opinion, too-big-to-fail is the right size to regulate. That is what Dodd-Frank does. It regulates too-big-to-fail, but it also provides a means by which too-big-to-fail can be eliminated. There is an Orderly Liquidation Authority, and this Orderly Liquidation Authority has the means by which large mega companies, the AIGs of the world, can be wound down and not have an impact on the broader economy. That is what Dodd-Frank is enshrined to do, that is what the law says, and in my opinion, we have an opportunity to regulate and manage these too-big-to-fail institutions.

Thank you, Mr. Chairman. I yield back.

Chairman MCHENRY. I thank the ranking member, and it is healthy to have a debate, and that is good. So, with that, we will now recognize Mrs. Wagner of Missouri for 2 minutes.

Mrs. WAGNER. Thank you very much, Mr. Chairman. After our country went through the financial crisis of 2008, there was broad agreement on two very important issues: first, that hardworking American taxpayers should never again be forced to foot the bill for the failure of a financial institution; and second, that government policy should not favor one particular institution or class of institutions at the expense of the rest of the market.

Unfortunately, it appears that the so-called Orderly Liquidation Authority included in Dodd-Frank violates both of these principles. At best, the new resolution authority is, as former Democratic Senator Ted Kaufman recently put it, a "paper tiger that will fall apart the minute it is tested in a real life financial crisis."

And at worst, the OLA is a mechanism which makes taxpayer bailouts the official law of the land, and at the same time undermines basic principles of our free market economy. Either way, I hope today's hearing will make clear that Dodd-Frank and the OLA did not end too-big-to-fail and in many ways have actually made the problem worse.

I look forward to hearing from our witnesses on this very important topic.

Chairman MCHENRY. I thank the Members. With no other Members seeking recognition for opening statements, we will now move to the panel's oral presentation of their written testimony. Without objection, all of the witnesses' written statements will be made a part of the record.

On your table, there is a light. All four of you are savvy to hearings on Capitol Hill, and you know the process: green means go; yellow means hurry up; and red means stop. So with that, let me introduce our distinguished panel today.

We have Professor David A. Skeel, who is the Samuel Arsht Professor of Corporate Law at the University of Pennsylvania Law School. Among a number of his scholarly publications, he authored a book entitled, "The New Financial Deal: Understanding the Dodd-Frank Act and Its Unintended Consequences."

Professor John B. Taylor is the Mary and Robert Raymond Professor of Economics at Stanford University. He has also authored a number of scholarly publications, including a well-regarded book entitled, "First Principles: Five Keys to Restoring America's Prosperity." For Fed watchers, he is the originator of the Taylor rule, inventively entitled the "Taylor Rule," which is important.

We have Mr. Josh Rosner, the managing director at Graham Fischer & Company. He recently co-authored a book entitled, "Reckless Endangerment," which the Economist Magazine recognized as one of its 2011 books of the year and a "must read." The "must read" part was my addition to the Economist's recommendations. I think others will note the Economist's recommendations more than mine.

Mr. Michael Krimminger is a partner at the law firm of Cleary Gottlieb. He recently joined the firm in 2012 after a long and distinguished career serving government with the Federal Deposit Insurance Corporation, where he most recently was the General Counsel.

Each of you will be recognized for 5 minutes, and as I mentioned, your written statements will be included in the record, so you can summarize. We will begin with Professor Skeel.

STATEMENT OF DAVID A. SKEEL, JR., S. SAMUEL ARSHT PROFESSOR OF CORPORATE LAW, UNIVERSITY OF PENNSYLVANIA LAW SCHOOL

Mr. SKEEL. Thank you all for the opportunity to testify on this important issue. It is a great honor to appear before you all today.

What I would like to do in my brief opening remarks is two things: first, I will describe several very problematic features of Title II as it is written, as it is on the statute books; and second, I will focus for a minute or two on the single point of entry strategy that the FDIC has developed over the past year or so for implementing Title II.

I will argue that Title II needs serious amendments and also that the too-big-to-fail issue is not solved, not resolved by a long shot by Title II and should be addressed in other ways such as by changes to the bankruptcy laws.

I should perhaps start by noting that it is quite possible that regulators would simply bail out another giant financial institution that threatened to fail rather than ever invoke the rules in Title II. Although the Dodd-Frank Act tries to make bailouts more difficult, as has already been alluded to several times, it certainly hasn't at all eliminated the possibility of a bailout. With the six biggest institutions in particular, there is a very good chance that regulators would never turn to Title II, particularly if more than one of them were in trouble at the same time.

If regulators did invoke Title II, they would probably transfer some or all of the assets and liabilities of the holding company, the top corporation in the enterprise, to a newly created bridge financial institution. Title II authorizes the FDIC to create a bridge institution like this and permits the FDIC to keep it going for up to 5 years. For this 5-year or up to 5-year period, the bridge institution has major competitive advantages as compared to other financial institutions.

One benefit is access to copious amounts of funding from the United States Treasury, potentially at below market rates. Bridge institutions also are given a sweeping exemption from taxes. While the bridge is in existence, it is not required to pay any taxes on the value of its franchise, property, or income. This tax-free status gives the bridge institution an enormous advantage over other financial institutions. In my view, there is simply no justification for this special treatment.

For more than a year, the FDIC has been developing a strategy it refers to as a single point of entry strategy for invoking and using Title II. After establishing a new bridge institution, the FDIC would transfer all of the holding company's assets and all of its short-term liabilities to a new bridge institution, leaving its long-term debt, primarily its bonds, and its stock, behind in the old institution.

Although I think this is a very clever strategy for resolving a large bank's financial distress, it seems to me to raise three very important concerns. First, the single point of entry strategy assumes that all the derivatives contracts and other short-term obligations of the troubled financial institution will be bailed out. This will encourage the big banks to use even more of the derivatives and other complex financial contracts that caused so much trouble 5 years ago.

Second, although Title II explicitly requires that its provisions be used for liquidation, single point of entry is essentially a reorganization. It thus stands in tension with the explicit requirements of Title II.

Finally, the single point of entry strategy won't end too-big-to-fail at all. It will essentially rescue the troubled financial institution and is designed to ensure that the institution retains just as dominant a position after a financial crisis as before it.

Let me suggest three implications of these comments about the likely effect of Dodd-Frank's resolution rules. First, I think it is very, very important to amend Title II to fix these problems, particularly the exemption from taxes that the bridge institution has.

Second, Title II is not a solution to the too-big-to-fail problem. The largest financial institutions have, as they had, a dominant position in American finance in no small part due to the too-big-to-fail subsidy they enjoy when they borrow money. I think it is very important to do something directly about the too-big-to-fail problem.

Finally, I believe it is important to recognize that bankruptcy is a very effective alternative to Title II for addressing the financial distress of large financial institutions. John Taylor and I are both involved in a project at the Hoover Institution that tries to suggest some ways to make bankruptcy even better.

[The prepared statement of Professor Skeel can be found on page 66 of the appendix.]

Chairman MCHENRY. Thank you for your testimony.

We will now recognize Dr. Taylor.

STATEMENT OF JOHN B. TAYLOR, MARY AND ROBERT RAYMOND PROFESSOR, STANFORD UNIVERSITY, AND GEORGE P. SCHULTZ SENIOR FELLOW IN ECONOMICS, STANFORD'S HOOVER INSTITUTION

Mr. TAYLOR. Thank you, Mr. Chairman, and Ranking Member Green for inviting me to testify on this important topic of bailouts, too-big-to-fail, and Title II of Dodd-Frank.

In my view, too-big-to-fail, and the concern about bailouts is very much alive even with Title II of Dodd-Frank. I know there is disagreement about that. The Chairman of the Federal Reserve says that expectations of bailouts aren't there because of Title II. A couple of his colleagues take different viewpoints. Jeff Lacker of the Richmond Fed says we haven't dealt with the too-big-to-fail problem. Charlie Rosner at the Philadelphia Fed says in particular, Title II resolution is likely to be biased toward bailouts.

When you look at OLA and how it might operate in practice, it seems to me there are serious reasons for concern. The FDIC will have an enormous amount of discretion about how to implement its difficult task of resolving a large financial institution. It is hard to specify what exactly they will do. There is a great deal of uncertainty about that, and a great deal of concern about transparency.

My sense is given this, and given the heat of a crisis, it is quite likely the top policymakers will go right around Title II. They may have to change the law to do so. That is quite possible. So that will involve the same kind of bailouts we saw in 2008. It is not enough of an alternative to bailouts, if you like.

But even if Title II is used, it seems to me the bailout problem is still there. There will be every incentive for the FDIC to provide additional funds to some creditors, additional funds over and above what they would get under a normal bankruptcy or in the marketplace. This is, by definition, to me a bailout. It really doesn't matter whether the funds come directly from the taxpayers or they come indirectly from the taxpayers through an assessment of financial institutions and higher prices to consumers of financial institutions, or for that matter, it doesn't matter if it comes from other creditors less favored. Money is taken away from the less favored to the more favored creditors. All the problems of lower interest rates that the large firms might get, the problem is the moral hazard exists with this form of a bailout. Yes, there is removal of the protection of the shareholders, but the protection of large important creditors is still there, and the determination of that will be through discretion, not through the law.

I think there are some other problems with Title II. David Skeel mentioned some of these. But more basically, under a bankruptcy, the new firm would be motivated by profit and loss considerations, the decisions to be made as we are familiar in our economy. Under Title II, the new firm, for as long as 5 years, is going to be run by the government, so all the concerns that this committee, in particular, would have about the pressures put on government agencies for favors, for example, for different kinds of treatment, will most likely exist for this kind of a firm.

In addition, as David said, there are very particular advantages. The lower borrowing cost because of the access to the Treasury, the exemption from taxes, and the lower capital requirements are enormous advantages this firm will have, and you can understand why the FDIC would like to nurse this firm for a while with those special advantages. But the truth is, they are so huge, and for a 5-year period, the firm will most likely have those unfair advantages, and I could see very well the government agencies would want to take account of that.

So I think a better approach is to reform the Bankruptcy Code. There is a lot of work done on that. David Skeel mentioned that. The idea is to have even a large financial firm go through an orderly bankruptcy without spillovers, according to the rule of law, without all the discretion that the current Title II entails. I think it is possible. I write about this in detail in my testimony. I will be happy to answer any questions you may have about it.

Thank you, Mr. Chairman.

[The prepared statement of Dr. Taylor may be found on page 70 of the appendix.]

Chairman MCHENRY. Thank you, Dr. Taylor.

I now recognize Mr. Rosner.

STATEMENT OF JOSHUA ROSNER, MANAGING DIRECTOR, GRAHAM FISHER & CO.

Mr. ROSNER. Chairman McHenry, Ranking Member Green, and members of the subcommittee, thank you for inviting me to testify on this important subject.

I should express my concern that the criticisms of Title II will be used as an argument for repeal of a flawed rule before a workable replacement or fix is created. That is not my intent. Before addressing Title II, I want to highlight the key problem with Title I. Congressional intent was to ensure all too-big-to-fail firms would be unwound through bankruptcy. If the Fed adhered to the intent of Title I, then Title II would be unnecessary.

Instead, Title I and Title II create a special class of GSE-like companies that benefit from implied government guarantee. Title II's liquidation authority was designed to protect from the disorderly failure of firms that cannot be resolved under bankruptcy. Because of the explicit and implicit subsidies it offers, the industry prefers it to bankruptcy. While a traditional liquidation would result in replacement of management, under the FDIC's proposed regime, key management of failed operating subsidiaries could continue to manage the newly recapitalized firm. It remains unclear what if any benefit will accrue to the public from OLA. By contrast, the measurable benefits will flow to those creditors that benefit from disparate treatment and bonuses will be paid to retain highly paid employees deemed essential to keeping the enterprise functioning.

The FDIC's approach requires an enormous amount of taxpayer subsidized debtor-in-possession financing from Treasury. It supports an "all animals are created equal but some animals are more equal than others" banking system. These companies are far too large. Markets simply can't fund them in bankruptcy.

Under Section 210(n)(5), bridge funding from Treasury is priced at Treasury rates plus the spread for average corporate bond yields, but Dodd-Frank does not state which corporate index should be used. If the FDIC indexes to a Triple A corporate average, funding may by at rates the market confers on only the healthiest institution. That subsidy has value not just in failure.

Additionally, the government has the authority to leave behind as much debt as it wants, another subsidy. Potential needs of the largest companies could reach to close to $100 billion, straining even Treasury's ability to access funds. This is the easiest way to understand that these companies are far too large. Markets simply can't fund them in bankruptcy.

Under the FDIC's approach, a failing firm's operating subsidiaries remain open and operating while the holding company would be subject to OLA. Thus, subsidiary creditors face greatly diminished chances of loss. After all, the FDIC has declared that these subsidiary banks and broker dealers will probably never face insolvency. Counterparties will be less prudent if they think creditors of the holding company are on the hook.

If the government stands behind the holding company, market monitoring will go down, leading to further problems. Why would creditors choose to do business with companies that face normal market discipline in bankruptcy when they could deal with the company that offers subsidized pricing and assurances from the FDIC that it would never fail? The FDIC's approach also create incentives for management and creditors to starve the holding company of funding and to instead raise capital at the operating company, weakening the holding company's ability to act as a source of strength.

It is very problematic if the same institution has the possibility of going through two different insolvency regimes, depending on the whim of regulators. Returns to creditors are different under each regime and are somewhat unknowable in the Title II regime, making it difficult for creditors to make investment decisions. More disturbing is the FDIC's decision to justify dissimilar treatment of similarly situated creditors under the guise of protecting critical functions. As market participants become concerned about the potential failure of a too-big-to-fail firm, they will exacerbate problems and increase systemic risk by selling their holdings into an increasingly illiquid market. It paradoxically provides benefits to any claimant that can convince regulators of its systemic importance.

As a restructure regime, Title II levies no cost of failure and provides no clear process to move assets from weak hands to strong hands. The proper approach to ending the too-big-to-fail problem would be to consider fairness, which is at the core of the too-big-to-fail problem. It is essential that large firms be subject to the same insolvency regime that smaller firms are: the Bankruptcy Code. Making these firms small and simple enough to fail through standard bankruptcy is clearly the best path forward. It would eliminate the Orwellian approach to equality, reduce risk of capital market flight, and support the FDIC's mission as deposit insurer to the narrow banking system.

There is obviously far more detail in my written testimony, and I would hope that you would take the time to read that. Thank you.

[The prepared statement of Mr. Rosner can be found on page 57 of the appendix.]

Chairman MCHENRY. Thank you, Mr. Rosner.

And finally, I recognize Mr. Krimminger.

STATEMENT OF MICHAEL H. KRIMMINGER, PARTNER, CLEARY GOTTLIEB

Mr. KRIMMINGER. Chairman McHenry, Ranking Member Green, and members of the subcommittee, thank you for the opportunity to testify today.

Too-big-to-fail did not begin with the recent financial crisis or with Dodd-Frank. It has been the long-term expectation by the market that some institutions are so critical to the functioning of the financial system that the government will act to prevent their insolvency. Over many years, this has distorted market pricing for debt and equity and limited the incentives that should be provided by market discipline. Unfortunately, the recent financial crisis proved the expectation of too-big-to-fail to be true.

Why? Because faced with the massive disruptions in the market in the fall of 2008, regulators had no other option than the Bankruptcy Code to resolve the largest non-bank financial companies. After the turmoil following the Lehman bankruptcy, this was not viewed as a reasonable choice, and as a result, the regulators had to take several difficult steps to prevent greater chaos.

To be succinct in response to the question posed for today's hearing, Title II of Dodd-Frank does not enshrine too-big-to-fail. Title II simply provides an alternative to the Bankruptcy Code to ensure that the tools are available in a crisis to close the largest financial companies and to impose the losses on their shareholders and creditors while mitigating the potential for more widespread dislocations in the financial system and economy.

Any consideration of Title II has to examine why it was created. In a properly functioning market economy, there will be winners and losers, and some firms will become insolvent and should fail. Actions that prevent them from failing ultimately distort market mechanisms, including the market incentive to monitor the actions of similarly situated firms.

Title II is a reaction to the fact that in 2008, the regulators did not have an adequate legal framework to close and resolve the largest companies. This was the reason that Title II was created, to address limitations of the then-current Bankruptcy Code. Title II is simply an adaptation of the rules the FDIC has long used to resolve banks. It is important to note also that the authorities in Title II are now the international standard because regulators everywhere recognize the need for tools adapted from those previously used by the FDIC. The G20 heads of state and the Financial Stability Board have endorsed them, and countries are putting those tools into place.

Let me be clear, however, that bankruptcy has a long and honored history under U.S. law. For the vast majority of the business bankruptcies in the United States, the current system has worked very well. In extraordinary circumstances, the limitations of normal bankruptcy can impair its ability to resolve the most complex financial companies. Improvements can and should be made to the bankruptcy process to make it more effective for such insolvency.

I have long recommended several improvements such as better capabilities to continue businesses under first day orders, changes to address financial contracts, and the ability to act immediately under broader mandates for designated trustees or debtors in possession. The recommendations made yesterday by the Bipartisan Policy Center and others offer valuable additional suggestions.

However, Title II does provide a critical backup resolution structure for extraordinary cases, and I think we need both. While Title II is a vital foundation, it is not sufficient to end too-big-to-fail. The expectation of a government bailout will end only when the market fully incorporates into its pricing and other interactions an expectation that in the next crisis, the largest institutions will be closed and resolved. While Title II provides the legal framework, more must be done. We must continue ongoing efforts to achieve even a greater international coordination and we must continue the ongoing resolution planning.

The FDIC has done an admirable job of explaining its plans, but the job is not complete, because questions and doubts remain. To complete the job, the FDIC must be much more explicit about how it will conduct any Title II process. I understand it will shortly be issuing a policy statement about that process. I will say that this statement needs to lay out very clearly the expected process under Title II and the limitations of its discretion.

Too-big-to-fail should be eliminated because of its distortion of market discipline and market practices and ultimately its negative consequences for the real economy. However, too-big-to-fail is not created or enshrined by the Dodd-Frank Act. We need to support market discipline by ensuring that we have insolvency procedures that are effective for all scenarios. Market discipline, if allowed to act, can prevent failures by incentivizing action by management and creditors alike.

Thank you, and I would be pleased to answer any questions.

[The prepared statement of Mr. Krimminger can be found on page 43 of the appendix.]

Chairman MCHENRY. I thank the witnesses.

Under Section 210 of the Dodd-Frank Act, the FDIC is authorized to borrow from the Treasury, "all purchases and sales by the Secretary of such obligations under this paragraph shall be treated as public debt transactions of the United States."

It is clear that the Orderly Liquidation Authority authorizes the FDIC to tap the Treasury, the Treasury to tap the public markets, and the taxpayers are on the hook for that debt that the Treasury lets, just as they are today for Treasury auctions in our current market.

Now, I bring this up, Professor Skeel, to understand this process, what dollar percentage cap within the Act is provided as a limitation on what the FDIC can loan a bridge corporation?

Mr. SKEEL. The Act has two different dollar limitations, and limitations almost isn't the right word because they are not very limiting. At the time a Title II resolution starts, the FDIC can borrow up to 10 percent of the consolidated asset value of the institution, which if you take JPMorgan Chase as your example, that is 10 percent of $2 trillion in consolidated assets, more or less. That is $200 billion at the start of the case.

Chairman MCHENRY. And then, thereafter?

Mr. SKEEL. And then, thereafter, after 30 days the FDIC can borrow up to 90 percent of the fair value of the assets. So if the asset—

Chairman MCHENRY. So 90 percent.

Mr. SKEEL. —is in that same range, we would be talking about $1.8 trillion.

Chairman MCHENRY. Okay. So Dr. Taylor, Mr. Rosner, can you put that in context for this last crisis? Perhaps, let's walk through the scenario. If you had multiple firms going through the Orderly Liquidation Authority, had it been in place in 2008, what would that look like?

Mr. ROSNER. I think it is fair to say that Title I and Title II were created under the premise of single institutions failing. I think if we ended up with the contagion and multiple large institutions failing at the same time, unfortunately we would likely see the Treasury, the Fed back up here before all of you arguing as to the reasons that we are going down the same path and need to do another TARP-like bailout.

Chairman MCHENRY. That is not a great answer. Dr. Taylor?

Mr. TAYLOR. I think your question really was addressing within Title II. There is the concern about going around it as well, but even within it, of course, that is a huge subsidy. The access to the Treasury borrowing is lower interest rates; also, the rate at which the FDIC would be able to translate that into its own loans is pretty much discretionary at this point as well.

Chairman MCHENRY. You have a bridge company, it is funded, getting liquidity support from the Treasury, lending enormous sums to this company. You have the FDIC that is in charge of managing this government bank, let's call it, so you have ongoing operations managed by the FDIC, while at the same time the FDIC and the Treasury are making decisions on how to value the assets, and is there enormous discretion there, Professor Skeel?

Mr. SKEEL. Absolutely.

Chairman MCHENRY. So you have enormous discretion on valuing those assets. Describe this conflict within the FDIC and Treasury on making a wise decision for taxpayer dollars while at the same time making wise decisions to get a firm back on a healthy basis making a nice profit.

Mr. SKEEL. Obviously, the FDIC has an incentive to make valuation decisions that support its goal of preserving this giant financial institution, so there is a direct conflict of interest, and the FDIC has almost complete discretion. It is very, very difficult to challenge its decisions

Chairman MCHENRY. So that discretion, Mr. Rosner, in terms of valuation, is there any check within the Act on that?

Mr. ROSNER. No, there isn't a check. First of all, I think it is also worth pointing out that there is no obligation or mechanism within Title II to price the credit risk that is being taken on, and I think that is an important part of a subsidy as well, but beyond that, I think the point that was made is really important to emphasize, which is the conflict, the internal and inherent conflict between the role as balancing the public interest with the interest of creditors—let's not think about it as the institution—as creditors of that institution, are really unbridgeable

Chairman MCHENRY. So unbridgeable, why?

Mr. ROSNER. Because at the end of the day, there is a political reality where they are going to have to show, just as we have seen claimed over and over since the crisis, that they have made all of the taxpayers' money back, and if that comes at the cost of unfair disadvantaging of certain creditors, that is an internal conflict which really needs to be addressed.

Chairman MCHENRY. I thank the witnesses. We will now recognize the ranking member for 5 minutes. I am sorry. The ranking member is asking me to recognize Mr. Cleaver. Mr. Cleaver is recognized for 5 minutes.

Mr. CLEAVER. Thank you, Mr. Chairman.

Dr. Taylor, would you agree that unless it is curtailed, too-big-to-fail will continue to place the taxpayers in a position of blackmail? You might want to substitute a word for "blackmail," it probably won't rhyme, but you get the premise of my question?

Mr. TAYLOR. I am not sure I do. I think the concern of too-big-to-fail and the bailout tendency is multifold. Part of it is the distortions it creates in the market and it encourages risk-taking. It leads to the crisis we are trying to avoid. That is probably the biggest concern I would have.

In terms of the taxpayers, absolutely. Using taxpayers' money like this is inexcusable, but I think the too-big-to-fail problem goes beyond that, because if, for example, through an assessment, you charge a broad group of financial institutions, they are going to charge higher prices on their customer, so it is going to be paid elsewhere. Or if the bailout of certain creditors occurs at the expense of other creditors, that is also a problem because it is going against the direction of the rule of law which we have in the country. So there is a whole set of ramifications that I am concerned about here.

Mr. CLEAVER. You mention rule of law. I was sitting right here when Secretary Paulson was sitting right there telling us that we have to take some action, that President Bush had sent him over to tell us the situation that we were in, and then I was really unhappy later when I read his comment that he did not have the authority to do what he did, and so my question is, in an economic crisis, do you think that we will discard again the rule of law? Mr. Rosner?

Mr. ROSNER. The answer, unfortunately, I think is yes, if we continue down the path that we are heading down. The thing that I found interesting is there does seem to be unanimity of view among the Members that too-big-to-fail is an intolerable situation for us to accept, which really says two things: one, we either have to make these companies small enough and manageable enough that they can be treated like every other corporation; or two, they have to have sufficient amounts of capital, real capital to be able to avoid that crisis. Those are the outcomes. Those are the opportunities. And I don't think Title I or Title II address those, and I think that really is the task before you.

Mr. CLEAVER. Yes, Mr. Krimminger?

Mr. KRIMMINGER. I thought I would note one thing. One of the things I would note about the criticisms of Title II as well, as I think as I noted in my testimony, is you have to look at the realistic alternatives we have had in the past. I don't think it is realistic to go back and discard Title II and have the Bankruptcy Code that was in existence in the past and expect to the situation to be different than it was in the past.

We certainly need to make improvements to the Bankruptcy Code. I think everyone, and I believe even including the FDIC, certainly when I was there, would have been wholeheartedly in support of making Title II a less-likely-to-be-used alternative, but to eliminate the alternative, even with an improved Bankruptcy Code, I think is in some ways potentially sending the message that in the next crisis, they are much more likely to come back and sit at these desks and ask for more money in the future.

Mr. CLEAVER. Do you believe that the economies of scale in banks and other certain businesses are worth preserving as long as they are regulated in proportion to their impact on the economy?

Mr. KRIMMINGER. I think it is always very difficult to come up with a metric, if you will, or an analysis that it concludes at what size institutions should be. So, certainly there are economies of scale. Certainly, there is a need for a global financial system and financial institutions that can provide credit for that financial system. Certainly, there is regulation, additional regulation in Title I, and I think you have to look at Title I, Title II, and other parts of the Dodd-Frank Act as a combined whole and what effect they will have. Are there changes that may be necessary at times? Yes. But Title I and Title II, I think, are designed to kind of work in tandem, and that is part of the issue.

Mr. CLEAVER. We still have banks behaving badly, and I think something needs to be done about it. I appreciate the hearing, but

I think we need to tweak Title II if it is not strong enough and tough enough. I think the American people would support that.

I think that my time has run out, Mr. Chairman.

Chairman MCHENRY. I thank the gentleman, and I would certainly like to work with him on a process that will actually work, and I think this hearing is bringing to light that the current process doesn't. So I am encouraged by your comments, and I appreciate that.

We will now recognize Mr. Ross of Florida for 5 minutes.

Mr. ROSS. Thank you, Mr. Chairman. It is interesting that three of our witnesses talked about an amendment to the Bankruptcy Code, and one says that the Bankruptcy Code would not have helped.

In my experience in my practice, which has been very limited in bankruptcy, at least allowed for due process, notice to creditors, notice to debtors, and in fact put them on notice that they may only receive pennies on the dollar of what may be owed them, and yet underneath Title II it appears as though we are creating a situation where those creditors, even those shareholders have no risk if a bridge holding company takes over.

Is that your understanding, Mr. Skeel?

Mr. SKEEL. That is absolutely my understanding. And as I said earlier, the creditors that are most guaranteed to be protected are the fancy financial contracts, the derivatives that caused problems in 2008.

Mr. ROSS. With the obvious competitive advantage that a bridge holding company has, you also have a situation that is so contrary to market forces that says where you have increased risk, you may have increased return, and so if I am a shareholder in a company that is now part of a bridge holding company, my risk is almost eliminated; is that not true?

Mr. SKEEL. Absolutely, for up to 5 years. As long as that bridge company is going, it is a protected entity.

Mr. ROSS. And Mr. Krimminger, let me ask you this: Under Title II, is there any due process for these companies?

Mr. KRIMMINGER. Absolutely, there is due process.

Mr. ROSS. And what would that be? Obviously, it is not a full due process as the law allowed under the Bankruptcy Code.

Mr. KRIMMINGER. There is due process. In fact, the Bankruptcy Code provides for ex ante due process and a hearing before a judge. Part of the reason Title II has an ex post, in other words, you have a right to file suit against the FDIC for making errors or doing something to with your credit that is inappropriate after the fact, is because of the need for speed and financial insolvency.

And let me, if I may, just clarify one thing. I may have been misinterpreted. I absolutely believe that improvements to the Bankruptcy Code should be done and will be very helpful.

Mr. ROSS. And I think they should be, too, because not only are we talking about financial institutions. There are some financial institutions that are too-big-to-fail under some people's interpretation, but what about non-financial institutions? If we are allowing now for this process to go through that totally ignores our bankruptcy, what about Wal-Mart? What is to prevent them from having some regulatory reform system in place to keep them from going for bankruptcy? My point is that we are taking traditional due process methods and not allowing companies that have created a high risk, poor performance and allowing them to succeed to a market disadvantage.

Dr. Taylor, you talked about three of the disadvantages, one of which is the lack of having to be liable for taxes at every level. Do we know what the cost of that is?

Mr. TAYLOR. I don't think it has been estimated, unfortunately. Maybe that is something you could request.

Mr. ROSS. I think I will. Quite frankly, I think that the cost of tax exemption will probably outweigh the benefits, if any at all, in saving these companies.

Now, let me ask you this: The risk-based assessment, the last step in the event that we have to now repay FDIC, and we go to the good players, and we assess them their share, if you will, what happens if you have a mutual company, a savings and loan insurance company, that now has to be assessed. It has done everything right. Are they able to recapture the cost of this assessment in their rate-making process with their consumers? Does anybody have a comment on that?

Mr. TAYLOR. Most likely, absolutely. They will be able to capture it partly by passing it on to their customers, whether they are regulated or not, quite frankly. Economics says that kind of—

Mr. ROSS. So if I am a consumer who has a AAA rated, mutual insurance company that is now being assessed, I am going to have to pay for somebody who has been a bad actor. This reminds me of a situation where we have created the ultimate hangover cure in Title II, and every morning, these SIFIs, these Systemically Important Financial Institutions that are performing badly can take this hangover cure and go on and continue to perform, and yet they do so at the risk and at the cost of those who are not the drinkers in this situation.

Lastly, one of the three, and I am going to—give me a second, here, Dr. Taylor. You talked about the competitive advantages, including capital requirements. So if my State of Florida has certain capital requirements for an insurance company, those would be totally disregarded by the bridge holding company under Title II, is that correct?

Mr. TAYLOR. No.

Mr. KRIMMINGER. I would just say it would not because certainly under Title II, the insurance company—frankly, insurance companies are not really eligible for Title II until it has already gone through a—

Mr. ROSS. But the process is there, and I only have a second. The process is there that if they have been deemed Systemically Important Financial Institutions as an insurance company, they can have lesser capital requirements in conflict with State regulation.

Mr. KRIMMINGER. No, that is not true, but we can talk later, sir.

Mr. TAYLOR. The example of the insurance companies, there are many other examples you could use for which the capital requirements could be lower, as in Title II at this point.

Mr. ROSS. And I will follow up. Thank you, Mr. Chairman. I yield back.

Chairman McHENRY. The gentlelady from Ohio, Mrs. Beatty, is recognized for 5 minutes.

Mrs. BEATTY. Thank you so much, Chairman McHenry, and Ranking Member Green. And to our guests here testifying today, as you know, this is one of three hearings that we have had, and I am certainly looking forward to hearing your comment. This has been an ongoing discussion that we have been having in learning a lot of new terminology, hangover, from what I am drinking, to SIFI and all of the other things we are talking today. So I certainly welcome this healthy debate on the issue.

But first, I think it is clear that size and scope and scale and interconnectedness of the largest financial institutions prevent the elimination of all possible fallout resulting from a failure. But in Dodd-Frank Title II, it provides a new mechanism, I think, and I am interested later to hear your comments on that for government to resolve the most complex forms without creating new systemic failures associated with bank loans or across default provisions or acute asset value decline.

But as I look through your testimony, I guess one of the questions I would like to ask that we haven't quite touched on this morning is what is happening at an international level. And I think I want to address this question to you, Mr. Krimminger.

Can you tell us if what we are doing here today, if they have had any better results, for example, in China, with using Title II in their complex and in their monetary system?

Mr. KRIMMINGER. Certainly. I think Title II, as I said before, provides a statutory framework that I think has facilitated a lot more cooperation. One of the steps that has been undertaken over the last few years as a result of the crisis was that many other countries recognize that the old, if you will, liquidation process for banks as well as other types of financial companies was not very effective. Part of the problem, particularly in Europe, is that effectively they have always bailed out all of their banks because their only option was essentially a liquidation rather than the continuity that you even get under the Federal Deposit Insurance Act with the insured banks in the United States.

So one of the things that has gone on internationally is there has been a great expansion of cooperation, a great expansion of moving towards more similar types of legal infrastructures, as I noted in my testimony, and the heads of the state of the G-20, the Financial Stability Board and others, the types of authority that Dodd-Frank gives has really effectively become the international standard for the most complex financial companies.

One of the things we have to make sure we push against is the continuing desire in some countries to go to a bailout-type process. The problem is if you have nothing but a bankruptcy, or an old-fashioned bankruptcy liquidation process, or a bailout, these countries have always opted for a bailout. So the FDIC and other U.S. regulators are doing a lot to work more cooperatively with other international regulators to make sure that a plan is put in place, because planning and the ability to plan in advance is, I think, a major advantage provided by having this type of insolvency framework.

Mrs. BEATTY. Okay, thank you. Others, please?

Mr. ROSNER. Dodd-Frank provides no mechanism to deal with the international resolution process, and the Fed has recognized that and has made proposals on that basis for an intermediate holding structure for foreign banks operating in the United States. I think it is a little bit disturbing for us to fail to accept the reality that different countries have different legal regimes, and those cannot be handled through cooperation among regulators, or bridged I should say, by cooperation among regulators. That is something that is left and intended to be left to law, and each jurisdiction has its own.

We currently have memoranda of understanding between various jurisdictions. Those are largely unworkable when push comes to shove, especially because of the legal barriers imposed upon regulators. So I think this is an issue that needs to be addressed affirmatively by legislators, not outsourced to policymakers. It needs to be done before, not during or after a crisis.

Mr. KRIMMINGER. If I might comment on that, it is somewhat odd to assert as a defect of Title II that it doesn't deal with all of the international law issues when other countries have the ability to adopt their own laws. But what it does do, and what has occurred is a great deal more pre-planning. You have to have planning if you are going to have an effective resolution. And yes, I agree that paper documents don't do it. But you have to have planning if you are going to have any progress in the future. And to ignore the planning is to basically set yourself up for failure the next time.

Chairman MCHENRY. The gentlelady's time has expired. I am going to yield myself 5 minutes. Professor Skeel, I just want to follow up on a comment, a suggestion I made in my opening statement, which is since the FDIC can loan up to 90 percent of total consolidated assets to a bridge holding company, presumably it could loan 0 percent. Is that correct?

Mr. SKEEL. It can loan as little or as much as it wants up to that 90 percent, which is as much as $1.8 trillion.

Chairman MCHENRY. What are the ramifications or problems with that scenario?

Mr. SKEEL. It reinforces the things that we have been talking about. It creates an enormous amount of uncertainty. It gives the FDIC complete discretion as to what it does with Title II, and there really is no check on that.

Chairman MCHENRY. Dr. Taylor, given this wide latitude in funding authority, could the FDIC use it to change the degree to which they require creditors to suffer losses due to write-downs of their debts?

Mr. TAYLOR. Absolutely. It has the power to do what it needs to do, or what it wants to do to favor certain creditors maybe because there are concerns about systemic issues with those creditors, or there may be other reasons we don't know, but it has the power to do it. And it could do that even without this by hurting, if you like, other creditors who are not so favored compared to the bankrupt rules. So it definitely has that power. It is one of the uncertain things here you can't plan for. It is really not a rule of law as would exist under the Bankruptcy Code where you have priorities or specific ways you handle various kinds of creditors.

Chairman MCHENRY. Mr. Rosner?

Mr. ROSNER. Yes. I think that problem is probably the biggest issue to contend with, the ability to hand the FDIC the authority to treat similarly situated creditors differently at their whim under the guise of protecting the ability of potential counterparties to continue to serve in supporting essential functions of the institution. And so, they do have far too much discretion. It is absolute discretion, and by the way, the ability to fund can conceivably take what is a failed firm into being the most profitable firm overnight if we pump in enough taxpayer dollars.

Chairman MCHENRY. Mr. Rosner, if a bridge holding company borrowed at lower interest rates than its competitors while also avoiding all taxes, how significant would those combined advantages be?

Mr. ROSNER. Starve competition, increase the scope and scale and size of that utility, provide opportunities for that utility to justify to neighboring jurisdictions its ability and capability to operate in those markets. And it would ultimately just reinforce the oligopolistic market power of that institution and the small group of institutions that are similar.

Chairman MCHENRY. Professor Skeel?

Mr. SKEEL. I just want to follow on to that. I agree completely, and I would like to make a comment about the comparisons that have been made to the way financial institutions are regulated in Europe. I think it is important to keep in mind that the approach to financial institutions in Europe is completely different than the U.S. approach. Too-big-to-fail is a long-standing tradition in European regulation, and so the idea that we would be replicating what they are doing is not an idea that I think we should be sympathetic to. We have a very different perspective on the importance of competition in this country.

Chairman MCHENRY. I yield back the balance of my time.

I recognize the gentleman from California, Mr. Sherman, for 5 minutes.

Mr. SHERMAN. Let me start by asking Mr. Krimminger to also respond to the latest, the last question.

Mr. KRIMMINGER. I don't think anyone is suggesting we should adopt the European model for our financial regulation. This point was simply being made, was that the authorities to dissolve companies in Title II are being adopted in Europe, not the other way around. So I think that everyone has recognized that you simply can't have only a liquidation under bankruptcy as the only alternative under the existing Bankruptcy Code. We agree that we need to make improvements to it, but we need to look at the alternatives to make sure that you can deal with the potential systemic unwinding of the financial institution. That is why, frankly, under Title II there is some discretion, just as there has been for many, many years under the Federal Deposit Insurance Act, to provide for some additional payments to creditors that are essential to keep the company operating.

Bankruptcy also has first-day orders. In fact, one of the recommendations by many with regard to bankruptcy improvement has been to expand the ability to make sure that you can keep the essential functions operating beyond the traditional way of looking at first-day orders. So this is not a huge departure in terms of the tools that are available from the Bankruptcy Code. I think the departure that people are concerned about apparently is that there is the ability to act quickly with ex post judicial review instead of an ex ante judicial oversight.

Mr. SHERMAN. Thank you. We sometimes speak a different language than those who favor bailouts, should deal with translation. They believe that you have checks and balances if several different executive department officers have to sign off on the same thing, that you don't need Congress to have checks and balances on enormous power. And they also believe that it is not a bailout if the shareholders lose their money, even if the creditors are fully bailed out. And I disagree with that simply because the key in financial services is your cost of capital. And if you can assure creditors that they will be bailed out, you will have a lower cost of capital.

Mr. Taylor, for the record, if you could expand on in a written response how Title II provides for an almost crony capitalism as to which creditors get paid and which don't, because I am familiar with regular bankruptcy; you are either a secured creditor or you are an unsecured creditor. All of the unsecured creditors are equal. Apparently in this world, some animals are more equal than others. So if you could provide us with a written response there, certainly what worries me is that the key to being a successful business ought to be a successful business, not covering yourself by being well-connected and well-respected in Washington, D.C.

We have been focusing on what happens if there is a great catastrophe, a great storm, but the effect of this too-big-to-fail affects us even now on a relatively calm day, because the giant banks are getting bigger, and my concern is not so much for the banks. It is for the borrowers. We had Jamie Dimon sitting there saying he couldn't find small businesses in America to loan to, so he sent his money to London, where it got eaten by the whale. And the really big banks would rather make a billion dollar bet than a million dollar loan.

One controversy that has swirled is how much do the big banks benefit from this belief that when you lend the money, you are not just relying on their balance sheet; you have Uncle Sam's safety net? I have heard estimates of 80 basis points, 60 basis points. I would like to go down the list. Take the second or third largest banking institution in America, how many basis points do they save on their borrowed capital?

Mr. SKEEL. As John Taylor has noted, there is a lot of controversy about this, but I have heard anywhere from 70 or 80 basis points to higher. I have heard up to 2 percent in some of the estimates. There are a lot of numbers that are swirling around, but it is clear that the benefit is very, very large.

Mr. SHERMAN. Mr. Taylor, do you have an opinion?

Mr. TAYLOR. I think there are 80 basis points, that is what translates into $83 billion, is based on a study which I have looked at. I think it makes sense. They are looking at how different types of government policies affect credit ratings, which in turn, affect interest rates. I think that is a good number.

Mr. SHERMAN. Mr. Rosner?

Mr. ROSNER. Yes, I would agree. The NY study is actually fairly robust. I would also point out that any subsidy that advantages these institutions relative to the seven other firms in our country is anticompetitive and too much, and I would request or suggest that you turn to page 8 of my testimony, in which I refute many of the claims made about scale and benefit that we receive as a result of large global financial institutions.

Mr. SHERMAN. Mr. Krimminger?

Mr. KRIMMINGER. I am not sure that I have a number I would give. I think the key thing is to make sure that these large institutions are all subject to insolvency processes that will have the market discipline act and operate.

Mr. SHERMAN. My time has expired. I yield back.

Chairman MCHENRY. The gentlelady from Missouri, Mrs. Wagner, is recognized for 5 minutes.

Mrs. WAGNER. Thank you, Mr. Chairman. Professor Skeel, in your opinion, does Title II of Dodd-Frank do anything to limit the maturities of loans that the FDIC provides to the bridge company? In other words, could the FDIC just continuously provide short-term loans at favorable rates to the bridge company?

Mr. SKEEL. Sure. The FDIC can essentially cherry pick the rate it wants by picking obligations of the maturity that has an attractive interest rate. So, there is very, very little limitation on them.

Mrs. WAGNER. So while a private corporation would have to worry about renegotiating its credit line every 6 months or so, a company under OLA would have guaranteed access to favorable loans backed by the taxpayer?

Mr. SKEEL. Absolutely.

Mrs. WAGNER. I direct this both to Professor Skeel and Dr. Taylor. Would you say that one of the biggest risks financial institutions face, which is liquidity risk, would be largely eliminated for a financial institution that enters OLA?

Mr. TAYLOR. Once it is in the bridge form, yes, basically it can provide as much credit as it needs. That was put in the Act on purpose, I am sure, but it creates, if you take care of the liquidity problem, then you can do a lot of other things at the same time. So, it is a huge advantage.

Mrs. WAGNER. Professor Skeel?

Mr. SKEEL. Yes, all of those numbers we have been talking about are available to eliminate any hint of a liquidity problem.

Mrs. WAGNER. Dr. Taylor, what kind of advantages would this confer upon the company under OLA versus private financial institutions that don't have access to cheap, taxpayer-backed loans?

Mr. TAYLOR. One thing it could do which is actually kind of perverse is since it doesn't have to worry about liquidity, it doesn't have to worry about accessing the private market liquidity, you can take actions actually which are more risky than otherwise and be covered by that, and therefore that gives us a direct advantage. That would be one example.

Mrs. WAGNER. Professor Skeel, a little over a year ago, Martin Gruenberg as the Acting Chairman of the FDIC, gave a speech regarding OLA and talked about the need to, as you put it, craft a resolution, undergo a market test of viability, and appoint a temporary new board of directors, and a CEO from the private sector. When you were talking about an institution with potentially trillions of dollars in assets, wouldn't these steps to running a bridge holding company potentially take years?

Mr. SKEEL. Potentially, they could. And I worry more about this, about how we are going to decide who is going to be managing these giant bridge institutions the further we get away from 2008. If it happened right now, everybody has been focusing on it for 2 years. It is possible you could come up with some folks to run these companies. The further away we get, the more worried I am, and it is a huge question mark even now.

Mrs. WAGNER. The FDIC really has no experience winding down a large, internationally connected complex institution?

Mr. SKEEL. No. That is a very important point, and if I may, let me throw in an additional cause for concern. We have been talking about what the FDIC does with its bank resolutions, what it has done for a long time. It is very important to keep in mind the normal FDIC bank resolution looks nothing like the institutions we are talking about.

Mrs. WAGNER. Right.

Mr. SKEEL. The small mom-and-pop institution, all of its liabilities are deposits. This is a completely different creature and this is uncharted territory.

Mrs. WAGNER. Absolutely. Mr. Rosner, if OLA were implemented prior to 2008, is it reasonable to assume that multiple firms would have undergone the OLA process as a result of the financial crisis?

Mr. ROSNER. It is reasonable to expect that they would try because of congressional legislative mandate. Is it reasonable that it would succeed? No.

Mrs. WAGNER. So, if multiple institutions are undergoing the OLA process at the same time, is it reasonable to assume that the FDIC would find itself, as we have just discussed with Professor Skeel, quickly overwhelmed?

Mr. ROSNER. I think the answer is, absolutely. And in fact, during the crisis we had managements that needed to be replaced and there was not an available pool of talent within the industry to bring enough management in, so we often found management left in place under greater supervision, which is neither an equitable outcome, nor is that the proper resolution to have the people who created failure continue to run an institution in failure.

Mrs. WAGNER. My time is short here, but if the FDIC proves itself—as we just discussed—incapable of running a bridge holding company into the ground after exercising discretion over its assets, could this potentially, I assume, cause irreversible harm to the broader economy?

Mr. ROSNER. I don't think there is any question, and I think you raise an important point, which is if in failure, or if we find OLA results in failure, what are the remedies at that point?

Mrs. WAGNER. Right. Thank you, I appreciate it. I believe I have run out of time.

Chairman MCHENRY. We will now recognize the gentleman from Maryland, Mr. Delaney.

Mr. DELANEY. Before I ask my questions, I want to say that I actually think the FDIC did a very nice job through the financial crisis. We had a situation where 19 of the 20 largest financial institutions in the United States, 19 of 20, either failed or required massive investment by the U.S. Government. The only one that didn't was Berkshire Hathaway, and we, within a relatively short period of time, completely recapitalized the banking system and the financial system continued to function. So it is not clear to me why there is a sense that the FDIC would not manage this process well. Does anyone have data that suggests that the FDIC did a bad job managing this process?

Mr. ROSNER. I don't think the question is, did the FDIC do a bad job. As you said, 19 of 20 either failed or required capital investments.

Mr. DELANEY. Yes.

Mr. ROSNER. And that in itself, is inequitable, that we ended up backstopping, supporting, saving, keeping in place management of companies that otherwise would neither have been able to fund or exist to the disadvantage of the other banks within our banking system.

Mr. KRIMMINGER. If I may just respond, of course, one of the reasons we now have have Title II is to have an alternative to a bailout that occurred in TARP, and I think that we also—again, I have a theme here, what are our alternatives to having a process where the FDIC can help take over these institutions and make the shareholders and creditors bear the losses. In bankruptcy, in Chapter 11 we often ignore the fact that the debtor in possession, which is typically the old management, is operating the company in reorganization. So there is always going to be a challenge with getting the right-skilled people to take over these companies.

Mr. DELANEY. Exactly, and that is why I wanted to just put this in context because I think it is a great discussion, and an appropriate discussion of that inequality that occurred as it relates to the response to the financial crisis, because I certainly believe there was significant inequality. But perfect is the enemy of the good, and we had to save the financial system because the consequences, in my judgment, would have been worse.

And my point was, as it relates to the FDIC, I don't see anything in their behavior that would indicate that they are not in a position to manage this process well, because in fact, when tested, their deposit insurance fund did not in fact, need a significant—I am going to move on to my next question—bailout, and I think again, in the context of things, they operated prudently. And this is a roadmap for handling it, one which did not exist before. So if you look at their past behavior, when they didn't actually have a roadmap, and assume that with a roadmap I would actually judge that they would do better, but what I do worry about, which is what my question is, that the ability to provide funding to these financial institutions fails for one of three reasons: fraud; credit risks; or liquidity risk. And these large institutions have an advantage as it relates to liquidity, because they have liquidity built in to the extent they were to fail. And while it is very clear that equity and management and those kind of things get wiped out, stabilizing the institutions does help its creditors, and the equity of these institutions is 10 percent of the balance sheet; 90 percent of the balance sheet is creditors, so having in place a mechanism to stabilize the institution with liquidity, while the liquidation occurs, one would argue is good for its creditors because it allows an institution to actually liquidate its assets in an orderly way where you typically get better prices than if you have to liquidate assets in a non-orderly way where you get worse prices. So the question is, do you think this mechanism will in fact over time—and I apologize if you testified on this before—provide an advantage to how these institutions borrow in the unsecured debt markets?

I will open that up to Mr. Skeel and Dr. Taylor.

Mr. SKEEL. I certainly do think it will provide an advantage, particularly with short-term debt. The proposal that the FDIC is putting forward, the single point of entry proposal, would, if it were ever used, write down bond debt, so I think there may be some negative effect on the price with respect to bond debt. But with short-term unsecured debt in particular, I think there is going to be a significant increase in the attractiveness of this debt. The cost is going to go down a lot, and there is still a general too-big-to-fail subsidy that is going to reduce credit costs as well.

Mr. TAYLOR. I think a lot of the things you would like to have orderly, et cetera, could be achieved with the Bankruptcy Code in the right format. And don't forget that the Bankruptcy Code avoids all of this rule of law violation, all of these special things we are doing for favored creditors here. It has a procedure to handle that and it can be modified so that you do have the orderly kind of process if you want to.

Mr. DELANEY. Thank you. Mr. Krimminger?

Mr. KRIMMINGER. I will just note that I think the idea that, yes, there could maybe be a subsidy to creditors in some ways if they are carried over to the bridge bank, we have to put that, again, in consideration of the alternatives.

Mr. DELANEY. Right.

Mr. KRIMMINGER. Right now, everybody has been saying that the banks have uplift based upon the expectation of too-big-to-fail. If you remove an alternative way of resolving these institutions, whether in the extraordinary case where the Bankruptcy Code won't work, and again, I think we need to make it where the Bankruptcy Code can be more successful, removing that alternative way is simply going to emphasize that too-big-to-fail may still be the case in a crisis.

Mr. DELANEY. I agree with you; it is better than the alternative. I just think we should be observing how much these spread differentials in fact occur.

Mr. ROSNER. Can I just make one point?

Mr. DELANEY. Please.

Mr. ROSNER. We are also forgetting a key issue here, which is we are creating incentive through this structure for the institution to issue debt at the OPCO level, rather than at the HOLDCO level, and creditors who prefer to invest in the operating company level, rather than the holding company level because of the difference in treatment.

Mr. DELANEY. I am not sure that is a problem. I am going to take back my time, because the problem was HOLDCO debt, not OPCO debt, generally speaking.

Chairman MCHENRY. The gentleman's time has expired. I would love to engage more deeply on this question, because where those unsecured creditors are going into a crisis may be significantly different under the Orderly Liquidation Authority and their rights are very unclear, and that is—I have a question about that when we get to the second round, which I am hopeful we can, and I would love to engage with you about that.

With that, I will recognize Mr. Hultgren for 5 minutes.

Mr. HULTGREN. Thank you, Mr. Chairman. And thank you all for being here. I want to follow up briefly on Representative Sherman, who was questioning a couple of minutes ago. I think he had to step out maybe to another meeting, but to follow up a little bit on some of his points that he had started discussing, I was looking at a speech that Richard Foster, President and CEO of the Federal Reserve Bank of Dallas, had made back in January where he referenced some numbers given by Andrew Haldane and gave estimates of the current implicit too-big-to-fail global subsidy to roughly $300 billion per year for the 29 global institutions identified by the Financial Stability Board as systemically important. To put that $300 billion estimate annual subsidy in perspective, all of the U.S. BCs summed together reported 2011 earnings of $108 billion.

I wondered if I could ask Professor Skeel, and also Professor Taylor, to the extent Dodd-Frank and Title II truly eliminate bailouts, shouldn't this be reflected in increased borrowing costs to the institutions covered by the title?

Mr. SKEEL. It should, and the Haldane speech—which I would commend anybody to read; it is a terrific paper—very, very strongly suggests to the contrary that we are going in the opposite direction, that the too-big-to-fail subsidy has gotten bigger since the crisis, not smaller.

Mr. TAYLOR. And the IMF study we discussed a few minutes ago finds that the basis points have increased since the crisis.

Mr. HULTGREN. I wonder if you could just elaborate a little bit more. To the extent the borrowing cost advantage persists, does this imply that the expectation for bailouts persist as well?

Mr. SKEEL. Absolutely, and the trend line is not good. To refer to something else that is in that Haldane talk, the top three U.S. banks in 1990 had 10 percent of industry assets. They now have 40 percent of industry assets. So we are very much going in the wrong direction.

Mr. ROSNER. I think it is also demonstrable. If you look at the rating agencies' response to the Brown-Vitter bill as introduced, it was that if it were enacted, it would eliminate the upsweep support of the government that they include in their ratings of these companies.

Mr. HULTGREN. Following a little bit further on that with Professor Skeel and Professor Taylor, what other factors do you see that contribute to the borrowing cost advantage enjoyed by bigger institutions, and any other factors besides an implicit guarantee that affect the creditworthiness and borrowing costs of banking institutions?

Mr. SKEEL. We have talked about a lot of the factors, the likelihood that creditors will be bailed out, the likelihood that the institution wouldn't be allowed to fail. Also in that is an assumption that the capital requirements that everybody is talking about as the solution to too-big-to-fail won't work. Historically, capital requirements have not worked. They haven't predicted crises. They haven't avoided crises, and I think the market is pretty confident they are not going to work this time either.

Mr. TAYLOR. I think it is hard to control for all of the different factors that affect the spreads, and these studies tried to do that. But there could be other differences with large banks. Mr. Rosner says he doesn't find particular advantages of larger banks, but there may be some advantages besides the Federal support which provides a different rate. So it is important to take that into account and if you are going to have a good debate about these issues, consider the other sides. But when you look carefully, it seems to me that the expected Federal Government support, if you like, the expectations of bailouts, is a big factor in this favorable rate.

Mr. HULTGREN. But any specifics? Besides the backstop, what other implicit benefits?

Mr. ROSNER. I should make sure it is understood that I wasn't saying there were no benefits. I was suggesting that the social benefits, the systemic benefits of these global institutions are overstated and not substantial.

Mr. SKEEL. Just to throw one more benefit in, the big institutions were given enormous tax breaks during the period of the crisis, as well. And these were ad hoc tax breaks, where the IRS changed its rule on things like net operating losses for the benefit of the institutions. So there is an assumption that the government is going to be behind them helping them out in the event of a crisis.

Mr. HULTGREN. My time is winding down, so I am not going to really have a chance to ask another question, but I would love to follow up. There has been some allusion to needed changes in the Bankruptcy Code, dealing specifically with this, so I would love to hear any suggestions you might have on that, of what we should be looking at or working on with other committees, Judiciary and other committees, to be able to address that, and to also make sure that this never happens again.

Thank you so much. I yield back.

Chairman MCHENRY. Mr. Heck is recognized for 5 minutes.

Mr. HECK. Thank you, Mr. Chairman. For those of you who said that having access to the Orderly Liquidation Fund yields some kind of funding or competitive advantage, that is clearly implying that there is an incentive to do so. So my question is, is there evidence to suggest that banks have engaged in merger talk to reach that magic $50 billion threshold to take advantage of this? Is there evidence that banks are lobbying any of us to lower the $50 billion threshold so that they could achieve this status? Is there any evidence that non-banks are lobbying FSOC to be designated as SIFIs so they could take advantage of what you are suggesting is competitive and funding advantage?

Mr. ROSNER. Can I turn the question around a little bit?

Mr. HECK. No.

Mr. KRIMMINGER. I would be happy to answer it, briefly. I think it is very clear—

Mr. HECK. I was teasing him. He is welcome to turn it around.

Mr. KRIMMINGER. I would be happy to say that I think by and large, companies have not been willing to be over that $50 billion threshold. Certainly, Title II of Dodd-Frank does not apply to any company over the $50 billion threshold. Of course, it applies to the very largest where bankruptcy would potentially create systemic risk, and it is trying to address that systemic risk. So companies certainly would not want it to be over $50 billion because they would not want to undergo the additional supervisory oversight by the Federal Reserve and other preparation of living wills and things like that.

Mr. HECK. So are the funding advantages and the competitive advantages neutralized or negated by this additional requirement?

Mr. KRIMMINGER. I certainly don't think that the institutions perceived there being a funding advantage, particularly at that $50 billion threshold cutoff.

Mr. SKEEL. It seems to me that the issue isn't the $50 billion threshold. It is the $800 billion, $1 trillion threshold. So in my view, the reason why people don't want to be over the $50 billion is because they are not the beneficiaries. The beneficiaries are JPMorgan and Citigroup and Goldman and Morgan Stanley, and those banks, and so if you get just over the $50 billion threshold, you get the disadvantages of being singled out without the advantages of being singled out.

Mr. HECK. So at what dollar level does the advantage kick in?

Mr. SKEEL. I couldn't put a precise dollar level, but when you get into the top 10 banks or so in the country—

Mr. HECK. It is not clear to me how that changes the spirit of my question, though. Then why aren't multiple regional banks talking with one another to achieve this holy grail of the funding advantage and competitive advantage of—

Mr. ROSNER. I do think that we have institutions that have sought to be what I call aspirational too-big-to-fail institutions that have grown in precisely that manner with—

Mr. HECK. Can you name names?

Mr. ROSNER. I think that is one of the drivers we have seen with PNC over the years, and previously with SunTrust and with regions at times. So I think there is this class of aspirational too-big-to-fails, but where I was going before was if we do not see the Orderly Liquidation Authority as a benefit, or the DIF funding as a subsidy, then why don't we just open that DIF funding to every single institution in this country in case of trouble? Allow everyone to access low-cost Treasury capital when they are in trouble. It is absurd. It is an absurd suggestion, and the fact that we all recognize it is an absurd suggestion demonstrates or points to the inequity of that financing in the first place.

Mr. HECK. I am glad you made a reference to DIF. I would like to move on if I may, sir. As you define bailouts, would the traditional FDIC resolution process to wind down a depository institution qualify as a bailout?

Mr. ROSNER. No, because it is actually a liquidation rather than a restructuring. And in fact, it seems that the institutions have sought to make themselves intentionally more complex even within the banks by moving their derivative books which had historically in many cases been outside the banks into the banks to increase the complexity and the difficulty of resolving a bank.

Mr. KRIMMINGER. Having a little bit of experience with the FDIC, I think it is—you can't make that distinction, frankly, between the FDIC process and banks being a liquidation and this being a reorganization. What happens in a bank is that you sell it to another bank. You put it into a bridge and then sell it to another bank. Here, you don't want to put it into a bridge and sell it to another large institution because then you just treble the size of the large institution, potentially. So you really can't draw that distinction. I think the FDIC certainly has a lot of experience in dealing with those bank resolutions, but certainly I think under the Dodd-Frank Title II provision, we want to make sure that the Bankruptcy Code can be effective up to the largest possible size. I don't think, frankly, banks have been moving their derivatives portfolios into the bank to increase their magic complexity, but there is funding because you have a deposit base that is insured. That is why people like to have that solidity of the deposit base. You can debate whether that is the appropriate step or not, but that is the reason, not—

Mr. ROSNER. I think there are multiple reasons. I don't think they are mutually exclusive.

Chairman MCHENRY. The gentleman's time has expired. I will now recognize Mr. Barr of Kentucky for 5 minutes.

Mr. BARR. Thank you, Mr. Chairman, and thanks to the witnesses for your testimony this morning. Professor Skeel, I was particularly impressed with the arguments that you made that OLA does, in fact, afford a competitive advantage to failed financial firms that access the Title II provisions. I would like all of the witnesses to maybe comment and amplify on those thoughts, and in particular, how the tax exemption, the funding advantage, the capital advantage, for a bridge company, how would that contribute to the perception or reality of an implicit government guarantee contribute to moral hazard, and in your comments in answering that question, I would like for you to address the arguments made by those who defend Title II, that Title II doesn't somehow enshrine too-big-to-fail because it imposes losses on shareholders, because it imposes losses to creditors, because management has changed; in other words, that Title II does impose consequences on failed institutions.

Mr. SKEEL. Okay, a couple of quick comments on that. I do think that the bridge institution would be a specially protected non-market driven institution. It has all of these benefits we have been talking about, the tax benefits. It is also the case that the FDIC would not let it back out into the world until it was healthy and there was no way it was going to fail. So I think there is this limbo state in which it would have enormous advantages.

With respect to the claim that taxpayers will never pay anything, I don't think that is accurate for two reasons. One is, we have talked about a number of ways in which taxpayers will pay, even though in theory they are not paying. Taxpayers are paying if the interest rate on loans that the bridge institution has is a below-market interest rate. Taxpayers are paying because of the tax exemption that the bridge institution has. So there is that set of issues. The other set of issues is that even if some of the costs of resolution were ultimately recovered from the industry down the road after 5 years or whatever, that is a tax of sorts, as John Taylor has said. Effectively what we are doing is taxing a particular industry to support the resolution of the failed institution.

Mr. TAYLOR. I would just agree with that, but it is a different—under a bankruptcy, the shareholders get wiped out, so there is not an issue there. The issue is about other creditors. And in Title II, it is hard to see how it wouldn't happen. You would be giving special favors to certain creditors and charging the assessment fund for that, if not the Treasury directly, or also just charging other creditors for that, and that has all of the elements of a bailout, all of the dangers that we are worried about of a bailout, too much risk-taking, the moral hazard, the uncertainty, the lack of rule of law, and those are the concerns. That is why we keep coming back to some notion of a Bankruptcy Code trying to do this, but also, it is fair. It deals with Wal-Mart, and other firms as well.

Mr. BARR. I am mindful of my time, so if I could just move on to a second question. Many of you testified that an enhanced bankruptcy procedure perhaps amending Chapter 14 is preferable to a Title II OLA. What about the criticism of those who say that a bankruptcy process is too slow, particularly in a 2008 financial meltdown scenario? What is the response to those criticisms, and also speak to access to debtor and possession financing in a liquidity crisis?

Mr. SKEEL. Just a couple of things very quickly on that. Bankruptcy can be used very, very quickly. One of the interesting things that a group of us are working on now is the idea of using bankruptcy to do a resolution somewhat similar to the one that the FDIC has in mind, where you sell the assets of the holding company immediately, and then you have a new institution that is subject to market forces out there. So it seems to me the idea that bankruptcy can't be used quickly is a misperception, and that you can do all of the things we have been talking about with Title II with a couple of tweaks to the Bankruptcy Code in bankruptcy, and if you did it in bankruptcy, you would have a new institution that would be fully subject to market pressures.

Chairman MCHENRY. I thank the gentleman.

Professor Skeel, as previously announced, your departure time has arrived, and we thank you for your testimony, and you are dismissed. We will continue with the remainder of the panel.

We will now recognize the ranking member, Mr. Green, for 5 minutes.

Mr. GREEN. Thank you, Mr. Chairman. We have now concluded that Dodd-Frank is not perfect. The current Bankruptcy Code is not perfect. But we can, it seems, make the Bankruptcy Code perfect, whereas we cannot make Dodd-Frank perfect.

So let me start by asking who among you would eliminate Dodd-Frank completely? If you would do so, would you kindly raise your hand? This way, I will be able to move quickly. Who would eliminate Dodd-Frank completely? Mr. Taylor, would you eliminate it completely?

Mr. Taylor, I hate to do this because time of the essence.

Mr. TAYLOR. There are some things in there I would not eliminate.

Mr. GREEN. Okay, so you would keep some portions of Dodd-Frank.

Mr. Rosner?

Mr. ROSNER. I would keep some portions of Dodd-Frank.

Mr. KRIMMINGER. I would keep some portions of it. We clearly need an alternative. Just very quickly, I know you have very little time, is that mainly the tweaks we need to do with the Bankruptcy Code, they are in all of the recommendations, actually make it more like Dodd-Frank in many ways to accomplish some of the goals. Bankruptcy needs cash because in a huge crisis, debtor-in-possession financing is not always available.

Mr. GREEN. You are going to segue into my next question, so let me just toss it to you. Dodd-Frank mimics the Bankruptcy Code as much as possible, but it has some additional things that the Bankruptcy Code doesn't have. Can you take just a quick moment and give us some thoughts on those different things, please?

Mr. KRIMMINGER. A couple of things. First of all, it does have liquidation funds we have talked about a lot. The Bankruptcy Code would need cash in order to be able to do a resolution. If you are trying to deal with systemic risk, you need to have some ability to deal with systemic risk and to say you want to eliminate any ability to make sure you can maintain operations which does involve preferencing some creditors, I think is not consistent with trying to deal with systemic risk. The Bankruptcy Code, itself, has some mechanisms to continue those things. They might need to be expanded. The ex ante, or the before decisions are made, a decision by a judge on each of the questions, is something that Dodd-Frank puts after the fact for lawsuits to challenge what the receiver has done, and the receiver would need to be able to act quickly. That is one of the things that Title II does, and it also provides for borrowing authority to transfer things to that bridge financial company.

Mr. GREEN. Thank you. I asked the question about Dodd-Frank, and mending it, because there are some people who want to end it. And there are some people who want to use your testimony to end Dodd-Frank and bring in a regime under bankruptcy.

Let's point to something else. There was talk about the industry being taxed after the fact once the liquidation has taken place. That taxing, as you have called it, isn't that similar to the premium paid by banks with the FDIC? Mr. Krimminger?

Mr. KRIMMINGER. It is. The difference, of course, is that the Deposit Insurance Fund is funded up front by risk-based premiums.

Mr. GREEN. Right.

Mr. KRIMMINGER. The Orderly Liquidation Fund is repaid. If all the cash that is paid, that is received through the bridge company could not be paid to Treasury, which I think is very unlikely, you would have to almost have the value of that company being zeroed out because Treasury takes off the top. The cash is risk-based, and it is paid ex ante, very much like the Deposit Insurance Fund.

Mr. GREEN. So it is similar, just that one is paid up front, and the other is paid after the fact, correct?

Mr. KRIMMINGER. That is correct, and the important difference, to respond to one of the questions earlier, this is only paid by those institutions that are over that $50 billion threshold or have been designated as 50 that is not paid by the thrift and savings and loans that are smaller.

Mr. GREEN. Mr. Krimminger, in your paper—by the way, I thought it was excellent, and I plan to post it on my Web site—you indicate that there is an additional thing that Dodd-Frank does that bankruptcy doesn't do. Bankruptcy deals with creditor claims, whereas Dodd-Frank also deals with protection of the public, and it looks at the impact on the economy. Can you please give me your thoughts on this, because it is important for us to note that in 2008, the crisis was so large that banks were not lending to each other, that a prepackaged bankruptcy was not possible because you didn't have the liquidity to take into that process. So with that in mind, would you kindly explain how this notion in Dodd-Frank of protecting the public becomes exceedingly important?

Mr. KRIMMINGER. The reason that Title II was created in the first place was because of making sure that in that rare extraordinary circumstance where you had a systemic crisis, you had an additional option that could impose losses upon the shareholders and the creditors as much as possible while making sure you could continue this operation of the institution that would deal with systemic risk. That is why you needed funding and that is why inevitably, just as you do in bank failures because of maximizing value, you do have some creditors who get more than others. To say that all creditors should get only the amount provided for under the priority system, in some ways is not even true under bankruptcy at times because you need to continue operations.

Mr. GREEN. One final quick question. How many of you would make the big banks smaller? There has been talk about doing it. Let's see now if you would do it. Would you raise, would you make the big banks, would you downsize them, break them up? If so, kindly raise your hand. Okay, we have one person, Mr. Rosner would. Mr. Taylor?

Mr. TAYLOR. You asked, would I like to get rid of this too-big-to-fail? I would like to deal with it that way.

Mr. GREEN. I understand, but the question I am asking is, would you break up the big banks?

Mr. TAYLOR. It would have those effects. That would have those incentives. When you ask the question that way, you missed, I think, the point that we have a problem that is—

Mr. GREEN. I understand the point, but when you make statements about breaking up the banks, I would like to know if this is what you would do.

Mr. ROSNER. When I say break up the banks—

Mr. GREEN. My time has expired, and I have gone over. So I have to yield back, Mr. Chairman.

Mr. ROSNER. Can I just respond?

Chairman MCHENRY. The gentleman is trying to answer the question.

Mr. ROSNER. So to clarify, if the Fed took seriously its obligations under Title I, which would be to use the living will process to figure out how institutions can fit through the Bankruptcy Code, Title II becomes unnecessary. Would I use that process to achieve those ends? Yes. Is that forcibly breaking them up? No. It is creating incentives to make sure that they are manageable through the bankruptcy process.

Mr. GREEN. And in effect, what you are doing, what you are acknowledging, is that Dodd-Frank provides a means by which this may be done.

Mr. ROSNER. No, what I am acknowledging is that there is a tool that creates a living will, which is a blueprint for how things could work, not how they will work.

Mr. GREEN. I didn't say how they will, but I do contend and I believe you agree that Dodd-Frank provides the means by which it may be done.

Chairman MCHENRY. I appreciate the dialogue and debate. We will now recognize Mr. Duffy for 5 minutes.

Mr. DUFFY. Thank you, Mr. Chairman. Mr. Taylor, I don't know if you wanted to further answer that question that was asked about your thoughts on breaking up big banks.

Mr. TAYLOR. I think I would like to. A lot of the concerns about too-big-to-fail and the anticipation of bailouts is that it does give advantages to certain institutions. And so that could make that larger. There is also the question about what capital should be. There is a real concern about capital, in my view, and so that would also have an impact on the size of the institutions. I think that is what you want to do. You want to level the playing field.

And also with respect to repealing or eliminating Dodd-Frank, the question really—there is the Office of Thrift Supervision which is eliminated, you have the central clearinghouses. So those are good reforms, but Title II itself, it seems to me, has real problems. And if you could replace it with modification of the Bankruptcy Code, I think that would be far preferable. If for political reasons, you have to keep it, and put in the Bankruptcy Code reforms, then I would be all for that. But Title II itself is problematic.

Mr. DUFFY. I think we have engaged in a really nice conversation today to try to find some solutions on how we can move forward to truly end too-big-to-fail, and I think you see a bipartisan approach to that effort. And I think we can all work together to improve the current legislation, and I think there is a willingness today, more so than there has been in the past, to try to find a system that is workable, and breathes certainty into the marketplace. But one of my concerns in regard to too-big-to-fail and SIFI is looking at Title I, and Title II, is the implicit Federal backstop for the operating subsidiaries. And my concern is that if you have this Federal backstop and you are designated an SIFI, what does that do to the borrowing costs of those various institutions? Does it create an actual benefit before they are thrown into Title II? If they are just operating as an SIFI, doesn't that automatically give them a borrowing advantage?

Mr. TAYLOR. Data certainly suggest that large institutions get this advantage and that it has increased since the financial crisis. So that is what the data show, and then when you go through and look at the details, you could see why that might be the case.

Mr. KRIMMINGER. If I could just say, I think that, clearly, it has been a long-term issue about too-big-to-fail and the uplift, if you would, provided for the largest institutions. I think in some ways it would be difficult to, but we need to separate out the uplift that might have increased the Federal filing requirements because we took what was an expectation of too-big-to-fail and made it reality. So the markets incorporated that concept as well.

As far as the operating subsidiaries, certainly it is important to make sure that Title II, whether it is used at the single point of entry at the holding company, or at different levels, is kept in mind. I try to remind people—and I reminded people when I was at the FDIC as well—that single point of entry could not be the way it would work out because you might have multiple entities within that holding company that simply can't go on. Multiple point of entry so that you close the subsidiaries has to be looked at as being a viable option as well so that you reduce that filling of the subsidy for the subsidiaries.

Mr. DUFFY. But wasn't it in your testimony that you admitted that there is a subsidy there to the operating subsidiaries?

Mr. KRIMMINGER. In the case of a subsidiary that doesn't fail, you don't close a company just because they happen to be a subsidiary of a failed company. If the subsidiary is operating in the best value for that subsidiary, and it is making money, to continue for it to make money, then that would be the rational thing to do in any type of insolvency process.

Mr. DUFFY. But if you are a creditor to that subsidiary, you are not going to be allowed to have that debt not met, right? The holding company is going to go to Treasury. They are going to access dollars from Treasury, and they are going to be able to meet—go find the creditor, and I am going to lend to a subsidiary. I have a Federal backstop. So I am going to be able to, if I am one of those subsidiaries, I don't have a benefit in borrowing.

Mr. KRIMMINGER. If that subsidiary is insolvent, it should be closed. That is why I am talking about the multiple—

Mr. DUFFY. What happens to the creditor if it is insolvent?

Mr. KRIMMINGER. If it is closed, then it goes through an insolvency process, and it would either go in through an insolvency process in bankruptcy, or it would go through an insolvency process under Title II, and the creditors—

Mr. DUFFY. I am saying if we are in Title II.

Mr. KRIMMINGER. Okay, but the holding company could be in a Title II resolution, a single point of entry, but there also could be a failure of a subsidiary. So that subsidiary under the statute could go right into bankruptcy or under Title II if it were systemic itself, and if it is systemic and it goes under Title II, the creditor is still going to take losses because you don't have the kind of single point of entry approach at that level of the entity.

Mr. DUFFY. Do you agree with that, Dr. Taylor?

Mr. TAYLOR. This is the question about whether there is the Federal backstop and how that is affecting rates?

Mr. DUFFY. Right. Yes.

Mr. TAYLOR. I will stand with what I said before. It is there and it is affecting rates and it has increased since Dodd-Frank was passed.

Mr. DUFFY. Mr. Rosner?

Mr. ROSNER. I agree. And again, it creates an incentive for creditors to choose to invest in the OPCO rather than the HOLDCO, further distorting the ability of the HOLDCO to be a source of strength to its operating subsidiaries.

Mr. DUFFY. I yield back.

Chairman MCHENRY. All right. The first round of questioning is now done.

I expressed at the beginning of the hearing that our intention was to adjourn by noon, but we have additional Members with a few extra questions, so I ask unanimous consent that we have 7 additional minutes per side, with 5 minutes going to Mr. Barr, and 2 minutes to me on our side. I will now recognize the ranking member for 7 minutes.

Mr. GREEN. Thank you, Mr. Chairman. And if there are other Members who would like to speak, if you will kindly let someone know, I will adjust my time.

Let's come back to Dodd-Frank versus bankruptcy, because this is what this has become about today. Let's ask this question. What is it that you find that you can do with bankruptcy that you cannot do with Dodd-Frank?

Mr. TAYLOR. The advantage of bankruptcy is it is part of our system for creditors. It has been around as part of the rule of law. It can work for all kinds of—

Mr. GREEN. I understand.

Mr. TAYLOR. And that is what you want to—

Mr. GREEN. Time is of the essence, and we have to move on.

Mr. TAYLOR. —make it available—

Mr. GREEN. Can you give me something that you can do under bankruptcy that you can't do under Dodd-Frank?

Mr. TAYLOR. Yes. That is the main thing. You have the rule of law applies and Dodd-Frank you don't.

Mr. GREEN. Dodd-Frank is not the rule of law?

Mr. TAYLOR. Dodd-Frank has tremendous discretion authority given to—

Mr. GREEN. I understand.

Mr. TAYLOR. —to the FDIC.

Mr. GREEN. But that is under the rule of law.

Mr. TAYLOR. And how they treat creditors—

Mr. GREEN. Let me go on to Mr. Krimminger.

Mr. Krimminger, can you tell me something about Dodd-Frank that allows it to do what we generally speak and want to do with bankruptcy, please?

Mr. KRIMMINGER. Essentially what Dodd-Frank does, as I said, it is really supposed to be an alternative, and I worked a long time, I worked with a number of people when I was at the FDIC, to try to make sure that Title II would not be viewed as being substantially or substantively different in the way it would treat creditors. Yes, there was more discretion, but the discretion is inherent to the ability to address a systemic risk.

I think if we go and say we have to eliminate the discretion, you are eliminating the ability to deal with a systemic risk in a crisis. So, clearly, Title II will allow you to do that. It is also simply not true to say that Title II does not or ignores the rule of law. Title II just has the rule of law after the decision is made initially and you can file suit for damages.

Under U.S. law, it has always been viewed as being an appropriate remedy to be able to file a suit for damages rather than having a judge make every decision in advance. That is the bankruptcy way, and bankruptcy should apply wherever possible.

Mr. GREEN. Let's talk for just a moment about bridge institutions. There seems to be this notion that a bridge institution is somehow going to come into existence, reap a lot of benefits, and a lot of money is going to be made. What is the purpose of the bridge institution, and talk about its longevity, please, Mr. Krimminger?

Mr. KRIMMINGER. The bridge institution is designed to be a very short-term entity. I think that much of the discussion today about the length of a bridge company being up to 5 years, that is also true under the Federal Deposit Insurance (FDI) Act, and the average length of time for a bridge institution under the FDI Act has been less than 6 months.

Now, it might be longer under a Title II situation, but remember, under the single point of entry approach the FDIC is talking about, you would be taking over the holding company, which is a very simple organization. There, the way they plan to do that would be to do a—that debt for equity swap, if you will, a creditor claim for equity swap for the debt within 6 to 9 months, because I will assure you, the FDIC does not want to run a mega institution for any extended period of time.

Mr. GREEN. Mr. Krimminger, in your paper you also talk about time being the enemy in a time of crisis. In 2008, it was a time of crisis and time was the enemy. Would you please elaborate on time being the enemy and juxtapose this to bankruptcy as an option?

Mr. KRIMMINGER. I think time is an enemy because you need to act very quickly. In 2008, on the weekends when things needed to be done, and it seemed to happen on far too frequent a basis, you had to make the decisions and come to a conclusion about how to deal with an institution by the Sunday night before the business opened in Asia, because once the market was open, it would be too late, and the illiquid institution would fall.

If you look at the Lehman bankruptcy, and again, I would like to see bankruptcy improve where it could deal with the situation much better, but if you look at the Lehman bankruptcy itself, it effectively allowed for a transfer of the broker-dealer, in that case by keeping the broker-dealer open with large funding from the Federal Reserve Bank of New York. We want to get to a situation where an institution can be closed, it can be resolved while losses are imposed rather than having funding for an extended period of time so that some creditors get out and complete their transactions.

I think the Lehman bankruptcy illustrated some of the issues of bankruptcy and illustrated some of the ways forward in how we can make improvements.

Mr. GREEN. We understand that banks don't go through bankruptcy, generally speaking. They go through a process with the FDIC. Is what we are attempting to do with Dodd-Frank, which by the way is in its infancy, it is still being developed, rules are still being promulgated. Is what we are trying to do with Dodd-Frank similar to what is being done with the FDIC and banks, generally speaking?

Mr. KRIMMINGER. It is based upon essentially the similar powers of the FDIC. I think, as I was saying here in my testimony earlier, that it has been internationally recognized that you need to have certain powers in extremis, if you will, to be able to take those actions, so it is really based upon the same models of authority to take action and then have a determination.

Mr. GREEN. Now, there were some points that you wanted to make earlier, and I remember you didn't get an opportunity to. If you made note of them, I would like for you to use some of this time to make those points.

Mr. KRIMMINGER. I would just note, as I was trying to make a lot—I just note in response to some of the questions earlier that clearly some of the improvements we are trying to make in the Bankruptcy Code, in order for the ability to act more quickly, the first day order issue, the ability to find an identifiable area of cash or debtor possession financing and others, the ability to deal with systemic risk; in fact, the creation through potentially a Section 343 sale under the Bankruptcy Code of a sale to an entity that would be similar to a bridge company is very much modeled upon what we are talking about in Title II.

So I think we just have to keep in mind that the changes we want to make should be appropriate for the types of entities we are talking about, and I don't think we want to have all those changes in the normal bankruptcy process anyway, so we need to make sure that the changes in the Bankruptcy Code make it more effective, but do not dramatically change the normal bankruptcy process.

Mr. GREEN. Is it possible for bankruptcy itself to have an adverse impact upon the economy in a time of crisis? For example, if AIG had gone through bankruptcy in a time of crisis, how would that have impacted the economy?

Mr. KRIMMINGER. I don't want to really speak to AIG particularly, being as it is an open company at this point, but certainly I think that if you had the rapid deleveraging of a company that is involved very much in the derivatives markets, that could be very destabilizing in the marketplace. And one of the great things about the ability to terminate net contracts in bankruptcy or under the FDI Act after a one-day stay is that it allows people to have liquidity in their market contracts. One of the bad things is that if you have that ability to immediately terminate those contracts and dump them on an already illiquid market, you run the risk of having much more illiquidity in the market and it freezes up the markets.

Mr. GREEN. Thank you. My time has expired.

Thank you, Mr. Chairman.

Chairman MCHENRY. With that, we will now recognize Mr. Barr for 7 minutes, with my colleague understanding that I would certainly appreciate a few minutes at the end. Two minutes at the end would be great.

Mr. BARR. Absolutely, Mr. Chairman. Thank you.

Chairman MCHENRY. Thank you.

Mr. BARR. I would be interested in Dr. Taylor's and Mr. Rosner's responses to the comments, the testimony that Mr. Krimminger just made with respect to the perceived or real deficiencies of bankruptcy, and please speak to the liquidity issue and the timing questions?

Mr. TAYLOR. I will just make a couple of points. There is no reason, and I document it in my written testimony, that you couldn't be just as quick with a bankruptcy as what is being contemplated with the FDIC's new single point of entry. In fact, I describe how that could work with an example. It could be done over the weekend, if you like. The process could be very quickly.

We also have ways that we can have experts more involved with the bankruptcy judges than they are now. There is a wide range of things in terms of the reform side that could make this very smooth.

And I would say even now when we think about what the FDIC might do, we don't know. They are talking about issuing a paper. They are talking about issuing some procedures. That is very important to do, but that will still just be their procedures. That is not part of the rule of law. That could be changed on a dime. So it is quite different. All that discretion is still there.

So I think those two things are the most important, I would say, in response to what Dr. Krimminger said.

Mr. BARR. Mr. Rosner?

Mr. ROSNER. I would agree. I would add, which is also in response to Mr. Green's question, the same thing. The question is almost more importantly asked, what does the Bankruptcy Code offer that Dodd-Frank doesn't, and to that end, the answer is clarity, certainty, due process. Those are the key features that you want codified in law and in judicial process and review rather than leaving it in the arbitrary hands of even the most well-intentioned and well-meaning regulators.

Mr. BARR. A question for all of the witnesses generally on the issue of too-big-to-fail systemic risk, I have heard the argument made that size or largeness is not in and of itself systemic risk, that the real question, the real problem is overleverage, the real problem is liquidity risk, that is the more fundamental problem in a crisis situation. And in fact, I have also heard the argument—and I think there is a persuasive element to it—that large institutions that are highly diversified have the capacity, unlike non-diversified smaller institutions, to absorb losses. As we kind of grapple with policymakers with the issue of too-big-to-fail, could you all kind of comment on that, and as we approach the problem, how should we take that into account when we hear proposals to break up banks?

Mr. ROSNER. Look, I am sympathetic to the view that if we are sitting here having discussions over a Title II authority as treating institutions differently because they pose systemic risk, we do have to stop, step back, and ask why we have all chosen to live with a gun at our head rather than figure out how to manage that so it doesn't pose a threat, and I think that is really the starting point. And I think leverage is a key issue there. I think capital is a key issue there. I think clarity of structure, the ability to put through bankruptcy and an international structure that would allow for management of those operating subs in insolvency or some sort of a ring fencing of those makes sense. I would start there rather than by codifying too-big-to-fail through Title II.

Mr. BARR. I want to yield time back to my chairman, but if Mr. Krimminger would like to follow up on that, and then I will yield back to the chairman.

Mr. KRIMMINGER. Just briefly, I think that the diversification of assets and operations can certainly do a lot. I think fundamentally, if you are looking to make sure an institution of whatever size doesn't fail, it is a question of risk management. I think the largest institutions as well as the smaller institutions today have made a lot of strides in the last few years in actually looking at ways to better manage their risk, and I think the living will process has actually paid some dividends because there has been some significant changes in the way the operation has been done in reaction to those efforts.

Mr. ROSNER. Non-public, non-transparent, and frankly not visible to the market outcome supposedly of Title I.

Chairman MCHENRY. Will my colleague yield?

Mr. BARR. I will. Thank you, Mr. Chairman.

Chairman MCHENRY. Thank you, Mr. Barr.

My question, Mr. Krimminger is, within the Act, within the Dodd-Frank Act, Title II authority, liquidation authority as we are discussing today, does the FDIC have discretion about the order of creditors?

Mr. KRIMMINGER. The FDIC has authority under the Act subject to its own regulations to provide additional funding or additional payments to some creditors if they are essential to the operation of the receivership of the bridge.

Chairman MCHENRY. Okay. But there is discretion for the FDIC in that process?

Mr. KRIMMINGER. There is a statutory requirement, and the FDIC put in place a regulation that said that their board of directors had to approve any particular payments to a particular creditor, but again, that is to deal with systemic risk.

Chairman MCHENRY. How many members are on the FDIC board?

Mr. KRIMMINGER. Five.

Chairman MCHENRY. And how many votes does it take in order to make that determination?

Mr. KRIMMINGER. It requires, under that regulation, a supermajority, so I think it would end up being four.

Chairman MCHENRY. Four. So four individuals are given discretion, just like in the crisis, they took the discretion to reach out and insure a set of assets that they had never previously, in the FDIC's history, insured.

Mr. Rosner, to this point, this question of discretion, does that increase uncertainty or decrease uncertainty?

Mr. ROSNER. In absolute terms and relative terms, it increases uncertainty. It will have impact not only as an institution approaches failure, but definitionally has impact as we see in the cost of funds advantage long before we get there.

Chairman MCHENRY. Dr. Taylor, you talk about discretion with monetary policy and the challenges there. So, if you are an unsecured creditor, unsecured debt within an institution, does this process give you greater certainty than where you would be in a bankruptcy process?

Mr. TAYLOR. The bankruptcy will be much clearer. Here, the discretion creates uncertainty. There is no question about it.

Again, we don't know, even now, what the FDIC's policy is. A paper may help, but it will still have the discretion to change it when they want to.

Chairman MCHENRY. Okay.

Mr. TAYLOR. I think it is tremendous uncertainty, which is one of my biggest concerns about that whole too-big-to-fail process.

Chairman MCHENRY. Thank you, and thank you for your testimony. I appreciate your answers to the variety of questions posed today. We have a few takeaways accordingly: that the Orderly Liquidation Authority leads to greater uncertainty; that greater uncertainty is not helpful to the marketplace, not helpful to our nature of the rule of law and a regulatory policy that is clear to the marketplace.

Likewise, the functioning of this would—if an institution went into an orderly liquidation, it could result in an enormous bank tax, which would be put on other institutions, surviving institutions, and thereby their consumers. And finally, the overall question about taxpayers being on the hook. I think that is pretty well resolved now that we better understand what the Orderly Liquidation Authority actually means.

Thank you so much for your testimony, and thank you for being so forthcoming.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

This hearing is now adjourned.

[Whereupon, at 12:15 p.m., the hearing was adjourned.]

A P P E N D I X

May 15, 2013

Rep. Peter King Statement for the Record

Oversight and Investigations Subcommittee Hearing: "Who is Too Big to Fail: Does Title II of the Dodd-Frank Act Enshrine Taxpayer-Funded Bailouts?" – May 15, 2013

I want to thank Chairman McHenry for holding today's hearing. This is an issue that is of particular importance to New York, since many of our nation's largest financial institutions are headquartered or have significant operations in the state.

The 2008 financial crisis is something we can all agree we want to avoid repeating, and I appreciate today's hearing for investigating how the Dodd-Frank Act handles a failing bank under Title II and the "Orderly Liquidation Authority." I hope to gain insight into whether OLA would have applied to multiple firms had it been in existence prior to 2008, and whether it would have slowed the recovery of the finance industry. During the crisis, would multiple firms have had to undergo the orderly liquidation process? Would the FDIC have been able to handle multiple significant financial institutions in receivership? And could some of those firms still have been in receivership today, since under Dodd-Frank the FDIC is able to maintain the failed institution in a bridge holding company for up to five years.

I have concerns about whether this would result in a more entrenched government role in our financial sector, and if it would give a firm in receivership (which made poor management choices) a temporary advantage over its competitors. The health of New York's economy is strongly tied to the health of the U.S. financial industry. I look forward to gaining a better understanding of the impact of Title II of Dodd-Frank and exploring other options for addressing a failing significant financial institution.

STATEMENT

OF

MICHAEL H. KRIMMINGER

on

"Who is Too Big to Fail:

Does Title II of the Dodd-Frank Act Enshrine Taxpayer Funded Bail-outs?"

OVERSIGHT AND INVESTIGATIONS SUBCOMMITTEE

FINANCIAL SERVICES COMMITTEE

U.S. HOUSE OF REPRESENTATIVES

May 15, 2013

Washington, D.C.

Chairman McHenry, Ranking Member Green, and members of the Subcommittee, thank you for the opportunity to testify today. The topic for today's hearing is "Who is Too Big to Fail: Does Title II of the Dodd-Frank Act Enshrine Taxpayer Funded Bail-outs?"

Too Big to Fail did not begin with the recent financial crisis or with Dodd-Frank. It is the product of the long-time expectation by the market that some institutions are so critical to the functioning of the financial system and economy that the government will act to prevent their insolvency and resolution. This expectation over many years has distorted market pricing for debt and equity, and limited the incentives that should be provided by market discipline. The recent financial crisis transformed the expectation of a bail-out into a proven reality in 2008 because the regulators had no option other than bankruptcy to resolve the largest non-bank financial companies and, as a result, had to take several difficult steps to prevent greater chaos.

To be succinct in response to the question posed for today's hearing, Title II of Dodd-Frank does not enshrine Too Big to Fail. Title II provides an alternative to the Bankruptcy Code to ensure that the tools are available in a crisis to close the largest financial companies and to impose the losses on their shareholders and creditors, while mitigating the potential for more widespread dislocations in the financial system and economy. These tools are based on those long used by the Federal Deposit Insurance Corporation to resolve failed insured banks. I think it beyond dispute that we our statutory framework in 2008 did not have all of the tools necessary. Title II provides that statutory framework.

Any consideration of Title II has to examine why it was created and the alternatives. In a properly functioning market economy there will be winners and losers, and some firms will become insolvent and should fail. Actions that prevent firms from failing ultimately distort market mechanisms, including the market's incentive to monitor the actions of similarly situated firms. Title II was a reaction to the fact that in 2008 the regulators did not have the legal authority to close the largest financial holding companies, impose losses on their shareholders and creditors, and resolve them. In 2008, the only alternative was the Bankruptcy Code and no one wanted to replicate the experience of the Lehman Brothers' bankruptcy.

One explanation for the market reaction to the Lehman failure was that it shocked investors because, following Bear Stearns, they had assumed Lehman was too big to fail and its creditors would garner government support. Others feel that the bankruptcy process itself had a destabilizing effect on markets and investor confidence. While the underlying causes of the market disruption that followed the Lehman failure will likely be debated for years to come, both explanations pointed to the need for a new resolutions process for systemically important non-bank financial institutions.

It was clear in the United States and internationally that some alternative to impose shareholder and creditor discipline through an insolvency process without the consequences of widespread economic dislocation was necessary. Title II was designed to provide that alternative in the rare cases where the Bankruptcy Code could not meet those needs.

I served with the Federal Deposit Insurance Corporation for more than twenty-one years, and represented the FDIC on the Financial Stability Board's Resolutions Steering Group after the financial crisis began in 2008. During this time, it became obvious to virtually everyone in the international arena that you could not close a complex financial company operating internationally under then-existing U.S. or foreign laws without creating havoc in national and international markets with potentially devastating consequences for the citizens of those countries. In the absence of the essential legal tools, such as those in Title II, other countries like the United States opted for bail-outs in 2008 because the consequences of a disorderly collapse were too dire.

The universality of the recognition that certain statutory tools are essential to resolve a complex financial company is reflected in the Key Attributes of Effective Resolution Regimes for Financial Institutions adopted by the G-20 heads of state in 2011. The Key Attributes incorporate virtually all of the powers contained in Title II, which itself was based on the long-standing authority used by the FDIC to resolved failed banks. The Financial Stability Board is now regularly evaluating the progress of member countries in implementing those authorities. The insolvency tools included in Title II are now being incorporated into law in the European Union, the United Kingdom and other jurisdictions because those tools are basic building blocks to resolve large, complex financial companies. It is no exaggeration to say that Title II is, in fact, the international standard.

The Role of Bankruptcy

Bankruptcy has a long and honored history under U.S. law. For the vast majority of the business bankruptcies in the United States, the current system has worked very well. In fact, the U.S. bankruptcy process is aptly considered a strength of our commercial and economic system. Many thousands of businesses have been successfully reorganized or liquidated under the Bankruptcy Code. The bankruptcy process has even been an effective tool for restructuring large commercial companies, such as General Motors and Chrysler.

However, experience has shown that an alternative is necessary as a back-up for dealing with the resolution of some financial institutions during periods of financial crisis. During those rare cases where the Bankruptcy Code could create a potential for wider systemic consequences, we need an alternative to address several key issues. In a crisis, immediate action may be necessary that is more difficult under the current Bankruptcy Code. It is essential that someone have the power to act immediately after failure to take over the business, preserve critical financial operations, establish an operating institution – such as a so-called bridge institution, and provide continuity for those critical operations. During the uncertainty of a market crisis threatening a spiral of market dislocations, a response to an insolvency that can stabilize the failed operations quickly allows the markets, both domestic and international, to make investment, pricing and liquidity decisions with greater certainty and reduce the likelihood of market disruptions.

In addition, it is important to have features in the applicable insolvency law – such as bridge financial companies and the ability to transfer financial contracts without immediate termination – that are essential to the continuity of the business of a large, complex financial company. Continuity is critical in order to maximize value for the creditors of large financial companies and to avoid potential systemic consequences. Both the Bankruptcy Code's automatic stay and the immediate termination of financial contracts can make this more difficult. The option of a bridge financial institution, such as available in bank receiverships, allows the receiver to transfer assets and contracts from the failed firm to the bridge institution in order to retain franchise value and to avoid dumping financial contracts on the markets. The Bankruptcy Code also allows counterparties to certain financial contracts to terminate the contracts and retain net collateral immediately after initiation of the bankruptcy. While this protection can be important to protect financial markets in normal times, it can create a rapid unraveling of the failed company, and broader problems for the financial markets, during the failure of larger financial companies. The bridge financial institution also can maintain other systemically significant functions such as payments processing, securities lending, and the continuity of ongoing government securities or other transactions.

An effective insolvency process for complex financial companies that can be subject to market runs may also require a ready source of liquidity. The Bankruptcy Code currently lacks access to such a source and, during a crisis, it has so far proven difficult to arrange adequate financing under the existing "debtor-in-possession" framework. This is particularly crucial because in virtually all cases large financial companies fail because they lack sufficient liquidity. While work to improve the availability of debtor-in-possession financing should be pursued, this remains a significant challenge in financial bankruptcies.

Finally, a resolution of the most complex financial firms requires pre-planning. An essential element in this advance planning is consideration of what steps are necessary to protect the public interest. The bankruptcy process focuses on resolving creditor claims and not protection of the broader public interest. For almost all insolvencies, this is the appropriate focus, but in extraordinary cases it may be necessary to consider the consequences for the broader economy.

An essential element in the FDIC's process for resolving failed insured banks is extensive pre-planning of the resolution and the ability to develop expertise in quickly implementing a resolution that preserves critical financial operations once the bank is closed. As a useful comparison, without the ability to pre-plan for the closure of an insured bank, the FDIC could not achieve success in giving insured depositors virtually immediate access to their deposits. This factor, so critical to preserving liquidity for even the smallest failed bank, is self-evidently indispensable to avoid broader market and economic disarray in the resolution of the largest financial firms in a crisis.

The Bankruptcy Code can be improved and provide a much more effective tool to address the insolvency of large financial companies. There are certain discrete improvements that can be made to substantially improve the ability of the Bankruptcy Code to address the failure of financial companies. However, in my view, we will always need the tools in Title II for some insolvencies because of the foregoing inherent limitations of the Bankruptcy Code.

The Title II Process

In examining whether Title II enshrines Too Big to Fail, it is worth recognizing that the powers provided to the FDIC are drawn from those used for many for decades to manage receiverships of failed banks – and include many parallels to those in the Bankruptcy Code. In fact, the provisions in Title II specifically follow the Bankruptcy Code wherever possible with the differences focused on those provisions essential to address the missing elements noted previously. The reason is simply that since Title II is a back-up option for those extraordinary circumstances where bankruptcy appears likely to lead to systemic consequences, it should mimic bankruptcy except in those areas needed to address systemic risks. As a result, Title II is structured so that the market evaluation of debt or equity issued by a company potentially subject to Title II should not differ in substance from their evaluation in a bankruptcy scenario. Of course, because Title II will rarely be invoked, it is critically important for both markets and non-U.S. regulators that the FDIC provide as much transparency as possible – in advance – about its preferred course of action for this type of resolution. I understand that the FDIC is preparing a statement of policy to better describe this process. To be helpful, this statement must be sufficiently detailed to provide market participants with clear direction on the expected steps and the parameters for action. Application of Title II is not an area for vague and uncertain standards.

The Orderly Liquidation Authority includes the elements that are needed to deal with a rapidly changing environment surrounding a large, complex financial company. This new process is only initiated in extraordinary circumstances, under specific standards, by a process requiring the recommendation of a super majority of the Board of Governors and the FDIC Board, or alternatively the Securities and Exchange Commission or Director of the Federal Insurance Office in the case of a broker and dealer or insurance company, respectively. It is designed to be a rarely used option and only as a last resort.

Once the FDIC is appointed as receiver, it can move immediately to transfer operations to other financial companies or to a bridge financial company to preserve value and mitigate systemic consequences. This allows the immediate authority to act decisively that is essential to respond to the vagaries of a rapidly changing financial environment. The FDIC would have the authority to sell or transfer operations to a buyer or newly created bridge financial company so that synergistic value and critical operations can be maintained. While there are important due process rights to which creditors are entitled, those rights are fully protected by the ability to sue the FDIC as receiver for damages after the fact – Title II preserves this important protection by providing for jurisdiction in the federal courts for claims against the receiver.

Crucial to the ability to preserve value and prevent systemic consequences, as noted previously, is having statutory authority to continue the financial company's systemically important operations. Naturally, as noted above, a precondition to doing this is to prevent the immediate termination of market-based contracts once the receiver is appointed, while providing for the continuation of those contracts in a purchasing company or in a bridge financial company.

Equally vital is the ability to address the fundamental reason the financial company failed in the first place – the evaporation of liquidity. Title II does this by providing a source of temporary liquidity funding if private market funding is not available that the FDIC may obtain from the Treasury Department in order to lend to the failed company. This temporary government funding cannot be used as a taxpayer bailout in disguise, because the statute flatly prohibits the use of this funding as a means to shift losses of the failed institution to taxpayers.

In addition, Title II expressly precludes any use of this liquidity source in order to prevent the closing and resolution of any entity.

Title II includes important safeguards to ensure that taxpayers never sustain losses from such funding. First, any money that the Treasury makes available must be repaid from the sale of the failed company's assets before any other creditors recover a dime. This alone should be more than adequate to ensure repayment of any loans made by the FDIC in nearly all circumstances. Second, the amount of money that Treasury can provide is capped at less than the value of the company's assets – further supporting repayment by the sale of those assets. Third, no money can be made available without a specific plan and repayment schedule for full repayment between the Secretary of the Treasury and the FDIC based on the resources available to repay the amounts requested. Fourth, in the highly unlikely event that the assets of the failed company prove inadequate to fully repay the temporary funding, the FDIC can "clawback" certain monies from creditors. Finally, in the even more unlikely event that the proceeds from the assets and the clawback payments are insufficient to fully repay the amounts outstanding, the FDIC must recover the balance due through risk-based assessments on the large, complex financial institutions subject to special Board of Governors' oversight.

Another key element in Title II is the ability, coupled with the living wills requirement in Title I and the additional supervisory authorities granted to the Board of Governors, to undertake advance planning. Advance planning is particularly critical to develop the framework for resolution of the cross-border operations of a large, complex company. Past experience leads to the conclusion that U.S. and foreign regulators are unlikely to cooperate in a way that will achieve a cooperative resolution of a cross-border financial company. The failed cooperation involving Lehman Brothers, the sub-optimal resolution of Fortis Bank between the Netherlands and Belgium, and the problematic issues created by the collapse of several Icelandic banks are simply recent examples. The Financial Stability Board, during and after my service, has recognized these problems – as have all national regulators. They have also recognized that, in a world without an international insolvency process, cooperation in a crisis by national supervisory and resolution authorities must be based on common statutory powers, extensive pre-crisis information sharing and planning cooperation, and by a sober appreciation that cooperation in a crisis can only be reliable when each countries' domestic interests are promoted by doing so. These foundational elements revolve around regular and detailed pre-planning both to test approaches and to test confidence. Title II is the first U.S. law to provide the basis for this pre-planning by creating the statutory framework to resolve banks and complex non-bank financial companies. In this way, the authorities in Title II – along with the planning requirements in Title I – are essential to improved international cooperation.

The FDIC has been engaged in an ongoing domestic and international planning process for some time, but much remains to be done. The largest financial companies, and the largest insured banks now prepare living wills under regulations required by Title I of the Dodd-Frank Act. The requirement of a detailed, *credible* resolution plan for each financial company with assets greater than $50 billion is a major undertaking and the financial companies themselves have devoted enormous resources to meeting the requirements. The FDIC and the Board of Governors, as well as individual Federal Reserve Banks, have likewise focused significant resources on evaluating these plans and working with the companies to improve them. This is a critical step forward. After all, the court-appointed trustee overseeing the liquidation of Lehman Brothers Inc. found that the lack of a disaster plan "contributed to the chaos" of the Lehman bankruptcy, the loss of billions of dollars in value, and the liquidation of its U.S. broker-dealer.

When a large, complex financial institution gets into trouble, time is the enemy. The larger, more complex, and more interconnected a financial company is, the longer it takes to assemble a full and accurate picture of its operations and develop a resolution strategy. By requiring detailed resolution plans in advance, the Dodd-Frank Act gives the FDIC and the Board of Governors information that will allow for extensive advance planning both by regulators and by the companies themselves.

Today, the FDIC is working with other regulators and the financial services industry to actively evaluate how to resolve the most complex financial companies. The FDIC's "single point of entry" approach offers significant advantages in addressing a number of the major challenges in the resolution of the largest financial companies. This work is an important step forward, but it must continue to be strengthened and deepened. The FDIC must convince the marketplace that its plans will, in fact, allow it to resolve a systemically important financial institution without creating widespread financial and economic disruptions. Only if the marketplace, and the public, are convinced that a Title II resolution is realistic will market discipline operate more effectively on financial companies of all sizes. This is the real question. The FDIC has done an admirable job of explaining its plans and how its process will work. But, the job it not complete because questions and doubts remain. To complete the job will require a much more explicit and detailed public statement of how the resolution will be conducted.

Today, market participants generally understand the fact that Title II does not allow the FDIC, or any other regulator, to simply keep a financial company open and bail-out its shareholders. What they question is whether the Title II process will be invoked or whether the laws will be changed to allow another bailout in the next crisis.

Where Do We Go From Here?

While Title II is a vital foundation, it is not sufficient to end Too Big to Fail. The expectation of a government bail-out will end only when the market fully incorporates into its pricing and other interactions an expectation that in the next crisis the largest institutions will be closed and resolved. While Title II provides a legal framework for the resolution of a large, complex financial company, more must be done. We must continue ongoing efforts to achieve greater international coordination and we must continue the ongoing resolution planning that the large U.S. financial companies and the FDIC and Board of Governors are pursuing.

The history of the recent crisis is replete with examples of missed opportunities to sell or recapitalize troubled institutions before they failed. The market cannot operate effectively unless bailout is kept off the table by providing a statutory framework for a resolution that imposes the costs on shareholders and creditors. Bailout is now off the table by legislative decision. It must remain off the table. Removing Title II might be read many market observers as simply signaling that the next crisis is more likely to return to past practice and bailout the largest financial companies. We need to support market discipline by ensuring that we have insolvency procedures that are effective for all scenarios. Market discipline, if allowed to act, can prevent failures by incentivizing action by management and creditors alike. We need a Title II process to help market discipline make its mark.

Conclusion

Too Big to Fail should be eliminated because of its distortion of market discipline and market practices, and ultimately its negative consequences for the real economy. However, Too Big to Fail was not created or enshrined by the Dodd-Frank Act. Too Big to Fail simply reflects the expectation that the government will step in to prevent the insolvency of the largest financial companies. In 2008, this expectation became a proven reality. Title II of the Dodd-Frank Act directly prohibits such a bailout. In fact, the statutory insolvency tools provided by Title II helps support other insolvency tools by serving as a back-up to ensure that market discipline will be effective even in the extraordinary cases. However, the elimination of Too Big to Fail is a work in progress. Much work remains to be done.

GRAHAMFISHER

Statement of Joshua Rosner

Managing Director, Graham Fisher & Co.

before the

House Committee on Financial Services

Subcommittee on Oversight and Investigations

"Who is Too Big to Fail: Does Title II of the Dodd-Frank Act Enshrine Taxpayer Funded Bailouts?"

May 14, 2013

Chairman McHenry, Ranking Member Green and Members of the Subcommittee:

Thank you for inviting me to testify on the important topic of Title II's effectiveness in ending "Too Big to Fail". Before I begin my discussion of the limitations and failures of Title II, I should express my concern that my criticism will be used as an argument for repeal of a flawed rule before a workable replacement or fix is created. That is not my intent.

Recent passage, in this body, of bills that eliminate unworkable Dodd Frank rules, without first proffering the replacements necessary to correct failures has resulted in a renewed and inappropriate deregulatory push. This type of response must be avoided if Congress choses to accept the reality that Title II does not address the "too big to fail" problem or its implications for future taxpayer funded bailouts. It is also important to recognize many of the failures of Title II result less from the legislation than from the failure of regulators to promulgate rules, and to vigorously pursue goals on Title I, that are consistent with congressional intent.

Before addressing specific key failures of Title II, it is important to highlight some of the problems that exist with Title I and its implementation. The clear intention of Title I was to legislate a process under which all too-big-to-fail firms would be small enough and simple enough to be unwound through a standard bankruptcy regime. Recognizing the impossibility of achieving such an end without forcing designated firms to alter their structures, the official sector is writing off the effectiveness of Title I. To do so without ever really having tried to fully implement it is a clear violation of legislative intent.

Today, the effect of Title I and Title II of Dodd-Frank is to re-create a class of special public companies that, because of their ties to the government, receive the benefit of a GSE-like "implied government guarantee". For background, for the better part of the first decade of this millennium, market participants were increasingly convinced the GSEs (Fannie and Freddie) could become unstable. Nevertheless domestic and foreign bondholders and foreign central banks viewed the companies as low credit risks. It was assumed that if they got into trouble they would be bailed out with taxpayer dollars and without significant losses being forced upon bondholders. As a result, the GSEs had a significantly lower cost of capital than their non-"special" and fully private competitors. They also benefit from a government-imposed monopoly on the best credits in the mortgage sector, leaving the subprime world to private lenders.

No matter how frequently Treasury, the Fed, the White House or Congress said that the government did not stand behind the obligations of the GSEs, the markets did not accept that view. When push came to shove in September 2008, the GSEs were taken over by the government, placing taxpayers on the hook for any potential GSE losses. GSE creditors walked away from the accident and even equity holders, who had always been paid to take the first loss, were not wiped out.

So, are we expected to believe that today's TBTF institutions are not provided a lower cost of capital, by the markets and rating agencies, based on the understanding that the government will always stand ready to fund their losses? Moreover, from where in history can we draw comfort that when a macro crisis hits, regulators and policymakers will assess to other TBTF institutions the realized losses rather than arguing that that might lead to a contagion risk?

As witnessed in this crisis, a withdrawal of liquidity from one systemically risky institution can lead to both a withdrawal of liquidity to its peers and also a contagious decline in asset values leaving all undercapitalized at the same time. Nearly three years after its passage, Dodd-Frank, and especially Title II, have done almost nothing to mitigate the TBTF problem. In fact, Title II operates under the completely implausible and economically unsound notion that in a crisis, TBTF firms will be taxed to fund losses at other failing TBTF firms.

If there is a positive to the GSE model and the "implied government guarantee" it is for the Washington political class. TBTF companies will provide all legislators, regardless of their political affiliation, with a constant stream of lobbying dollars in return for help in stymieing regulators. Washington welcomes the lobbying and campaign dollars spent by TBTF banks to convince officials that their derivatives books were never at risk and their credit trends are stronger. One of the ironies of Dodd-Frank is that is discourages banks from making mortgage loans, but encourages derivatives trading and investment banking activities. The ongoing failure to proactively create a banking system where all firms are small and simple enough to be managed through the bankruptcy process is a testament to Washington's love affair with the campaign financing provided by large financial firms. There is still a massive lobbying dollar hole left by the withdrawal of the largess that accompanied the collapse of Fannie and Freddie.

Title I – Congressional Intent Ignored

Title I, specifically mandates firms designated as "systemically important" create, and submit to the Federal Reserve, "living wills" that detail how they can be resolved through the Bankruptcy Code. If legislators and regulators followed through on this mandate and ensured that these firms could be resolved under the Bankruptcy Code, as intended by law, a special liquidation authority under Title II would be entirely unnecessary.

I should also point out that Dodd-Frank has no method to deal with cross-border insolvencies. The Federal Reserve Board knows this, and this is why they have proposed the intermediate holding company structure for foreign banks operating in the US. Only with the subsidy of the Treasury funding through the "Orderly Liquidation Fund" (OLF) does an international resolution have hope of success. While various jurisdictions have entered into memorandums of understanding those are unworkable and would likely fail in crisis given the various jurisdictional prohibitions on backstops and support.

Because various cross-border legal regimes exist, the management of these problems should not wait to be dealt with in the next crisis nor should they be left to unelected officials within the regulatory community. There are some examples of cooperation in cross-border resolution during insolvencies, including the MF Global collapse but these examples are not evidence against the significant and unavoidable conflicts. Governments must abide by applicable local insolvency laws, regardless of problems that may result in other countries in which a multi-national company operates. Title I should be proactively and specifically implemented to manage the shrinking of these firms to reduce the complexity of insolvencies so they create no future risks to taxpayers.

We absolutely need to eliminate the problems posed by the anti-competitive, market distorting, highly complex, highly interconnected and highly correlated too-big-to-fail firms. Title II is seriously flawed in that it provides significant benefits to designated firms, benefits that exist even prior to the point at which the "Orderly Liquidation Authority" (OLA) is invoked.

Title II – Undermining any Resolution to Too Big to Fail

Section 165(d) of Title I could work if Title II didn't exist – the problem is that the very existence of the FDIC's single point of entry approach in Title II obviates any need to require that "systemically important" companies become smaller or less complex. That is a key reason why these systemically risky banks support Title II – it purports to fix the problem that 165(d) was intended to fix. In reality it is little more than a new form of bailout.

Title II is supposed to define an OLA, a backup plan if a firm cannot be resolved under bankruptcy. Congress could have named it "Orderly Restructuring Authority" but chose not to. It, therefore, is clear that intended it to be a very distasteful, unpleasant exercise that results in resolution, not reform, of failed firms. Because of the explicit and implicit subsidies, created by its design, the industry prefers it to bankruptcy.

Those who argue that Title II provides no subsidy should be asked to answer they question of why it should not be available to all companies. The answer is clear; allowing every company access to government financed dip financing is absurd and would eliminate the need for prudence by banks and investors. Based on the possibility they would have access to the Treasury's OLF if it became insolvent value accrues even to healthy firms that are designated as "systemically important". The fact that this financing is available to only a few firms is unfair.

As a result, Title II authority must be eliminated if we are to give Title I the chance to work. The financial crisis made clear that the resolution of large financial firms under bankruptcy would have been disorderly. This is not because of flaws in the bankruptcy process; it is due to certain parts of the financial institution – most notably the trillion-dollar derivatives books – that create interconnectivity among the largest financial institutions.

Title II - Uncertainty and Subsidy

While a true liquidation would result in the replacement of management, in the FDIC's proposed regime, key management of failed operating subsidiaries would be able to continue to manage the newly recapitalized firm. Although the FDIC claims they would replace personnel there is no requirement to do so. Their decisions will be arbitrary and driven by both the perceptions of regulators and market realities. The risk remains that, even in instances in which it is clear that management should be replaced there may be a lack of a deep bench of available industry management. This was the reality during the past crisis. Artificial enrichment of personnel responsible for corporate failure is only one of the major problems with Title II.

The FDIC recognized that a "liquidation" authority would be deleterious to financial markets in a moment of crisis. Restructuring a firm, not liquidating a firm, is the proven way to preserve an institution's value. So the FDIC revised the Orderly Liquidation Authority to fund a corporate restructuring through a single point of entry method. Bankruptcy has and should continue to be the preferred means to restructure the assets of failed firms. Instead, OLA is effectively a cram down that requires a huge amount of debtor-in-possession (DIP) financing from the Treasury.

This financing is a taxpayer-funded and anti-competitive subsidy. It supports the continuation of a banking system in which "All animals are equal but some animals are more equal than others". This is perhaps the easiest way to understand that these companies are far too large; the system simply can't fund them in bankruptcy.

Furthermore, it is easy to imagine non-"systemically important" firms innovating to provide services and functions better than "systemically important" financial institutions. Evidence of this can be found in the development of standalone investment banking partnerships, monoline mortgage originators (such as

Household International, Beneficial Mortgage and Quicken Loans), monoline credit card lenders (American Express and Capital One) and asset managers.

Unfortunately, innovation has been stifled by the protections and benefits afforded to our largest bank holding companies. The barriers to entry provided by Title II will only serve to further reduce competition. Specifically, under the FDIC's single entry method, all operating subsidiaries (which include some very large banks and broker dealers) would remain open and operating while the top tier holding company would be subjected to an OLA resolution. Effectively, this means that creditors of these subsidiaries face greatly diminished chances of losses in a bankruptcy because the FDIC has declared that these subsidiary banks and broker dealers will probably never face insolvency proceedings. Why would potential creditors choose to do business with a company that faces normal market discipline and bankruptcy when they could deal with a company that can offer subsidized pricing and assurances from the FDIC that it would probably never fail? Taking it a step further, how could any smaller firm enter a market that a "systemically important" firm is in? The "systemically important" firm will have an artificially low cost of capital because the FDIC has signaled that it will likely not face bankruptcy. This feature promises to stifle innovation in financial services to only the things that behemoth companies choose to provide. It's un-American, and it's happening because of Title II and other unwarranted benefits we provide to overly influential firms.

Because of the FDIC's "single point of entry" and the fact that it will aggregate losses to the holding company while seeking to preserve the operating companies, the ability of the holding company to remain a source of strength to the subsidiaries, including the bank, will be imperiled. It creates incentives for management and creditors to starve the holding companies of needed funding and to, instead, raise capital at the operating company level. This will further weaken the ability of the holding company to act as a source of strength.

Regulatory capital requirements are intended to ensure that there are adequate levels of capital to prevent insolvency, but without requiring significant amounts of stable capital to serve as a buffer in case of insolvency, investors will become increasingly uncomfortable buying the debt of the holding company. The Federal Reserve has yet to issue rules defining the amount of 'buffer' capital that will be required but it appears likely it will require far less than the 20-30% of equity and unsecured debt relative to assets that should be required.

Moreover, it appears, from comments made by several members of the Board of Governors, that they will support the use of contingent capital instead of long-term debt. Contingent capital, such as "Trups" and "CoCos" are neither contingent nor capital. Equity is equity and there is no substitute. As long as the Federal Reserve retains any "13.3" emergency powers, one must expect that when a TBTF institution is imperiled or required to convert their contingent debt to contingent equity, the "too big to fail" institution will hold legislators and regulators hostage to the notion that such a conversion would cause a market panic and lead counterparties to pull secured lines and withdrawing liquidity. This is not a hypothetical argument but is a reality we suffered in the crisis.

In addition, unless there are clear prohibitions against banks investing in each other's "contingent capital notes", the use of contingent capital will increase systemic risk by engendering precisely the entanglement and interconnectedness that defines systemic risk. We have witnessed the problem of interconnectedness in this last crisis in at least two situations; banks and insurers investing in each other's trust preferred securities (TRUPS) and becoming exposed to not only declines in the equity value of their TRUPS but also to losses on their investments in other banks' TRUPS. We have also seen the damage caused by regional banks outsized exposure to GSE preferreds. Lastly, unless market participants saw through the contingent capital notion and considered it to carry an "implied government guarantee", the cost of issuance of the notes would be at a prohibitively high rates. Given the failures in the "CoCo" and "Trups" markets during the crisis this is an inappropriate and unstable form of funding.

Furthermore, rules promulgated by the FDIC create further distortions of capital markets and of existing debt contracts by allowing regulated entities, under the guise of protecting critical functions, to justify dissimilar treatment of similarly situated creditors. Given the interconnectedness of these firms it is likely that, to stave off the risk of contagion at the time a large firm approaches insolvency, they would choose to favor other large and correlated firms over less "systemically important" firms.

As market participants become concerned about the potential failure of a "systemically important" firm they will likely exacerbate the firm's troubles and increase systemic risk by selling their holdings into an increasingly illiquid market to avoid the potential that they are treated unfairly relative to other, similarly situated, creditors. It paradoxically provides benefits to any company or claimant that can convince regulators of its systemic importance.

Uncertainty among creditors about which regime, Title II or the Bankruptcy Code, will be used to address the failing of a "systemically important" firm as it approaches insolvency, will only serve to increase the role of regulators. It is very problematic, for creditors, if the same institution has the possibility of going into two different insolvency regimes, depending on the whim of regulators. Returns to creditors are different under each regime (and somewhat unknowable in the Title II regime), making it difficult for creditors to make investment decisions. All institutions must be required to fail through the same legal process; otherwise institutions that go through the special Title II process will always be deemed "too big to fail".

From the perspective of market participants, the regulatory discretion in Title II will make it difficult for creditors to hold any claims against the institution at the moment that market participants believe it's in distress. This too will create a self-fulfilling downward spiral where creditors will quickly sell their positions (if they can sell them at all) at very deep discounts, dramatically raising the cost of capital of the institution and ensuring a quicker-than-normal demise.

These uncertainties will extend beyond the largest and designated firms. If investors believe that a large and complex non-designated firm is at risk of failure there would be a natural basis for concern that regulators could decide that a heretofore non-designated firm must be designated so on an emergency basis. The result would be increasing capital flight at precisely the time regulators would need to be able to operate in a stable environment.

Each of these distortions will compound. Because counterparties will be less prudent if they think creditors of the holding company are on the hook, and the government stands behind the holding company market monitoring will go down leading to further distortions in capital market functioning.

Perhaps the greatest impact of using Title II as a restructuring regime, rather than as an intended orderly liquidation regime is that there will be no cost of failure and no clear process to move assets from weaker hands to stronger and better-managed hands.

Simply stated, Title II creates further subsidies for a handful of firms that will be costly to taxpayers and bestow further advantages to systemically important financial institutions (SIFIs) relative to non-SIFI firms. I expect that based on the precedent from 2008, in a future crisis, a CEO from a large banking company that has been very aggressive in taking on badly managed risks will call his friends and former colleagues at the Federal Reserve Board and Treasury to get access to cheap OLF financing. The company will be bigger and more complicated than it was in 2008 because 165(d) will have been long since forgotten. He may have funding options, but none on terms as favorable as the OLF. They will band together to spin a tale of looming systemic crisis, and will force a reluctant FDIC to join them in approving the use of OLA. The OLF will be cheap and will provide great benefit – only the non-systemically holding company creditors will take losses, and the company will emerge from OLA much as it entered, to do it all again. We can't allow this to happen – OLA rewards companies for becoming "systemically important" and overly influential, it hurts smaller companies, and stifles innovation. The government created it and the government can and should take it away.

Under 210(n)5 of the Dodd-Frank Act, the bridge borrows from the FDIC, and the FDIC borrows from Treasury at treasuries plus a spread over treasuries for average corporate bond yields. Nowhere in Dodd-Frank does it state which index should be used for determining these bond yield. As a result, if the FDIC chooses to index to a "AAA" corporate average, funding may be at rates that the market confers on only the healthiest institutions. How does one begin to value an option to obtain funding, at any price, when all other funds providers have abandoned an institution? It is far larger than the spread between junk and whichever index the FDIC uses because without it the firm is dead. This subsidy has value all the time (not just upon failure), because "systemically important firms" and their creditors understand that, in good times, you get to play fast and loose in search of returns, without fear of the Treasury, as the fund provider of last resort, abandoning you.

Adding to these subsidies, but less often considered, is that the government has the authority to leave behind as much debt as it wants, potentially engendering a massive debt crisis. The funding needs for some of these firms could reasonably be expected to be in the 10s of billions of dollars, with the need at larger companies being close to 100 billion dollars. At the high end of this range it can begin to strain even the Treasury's ability to access funds, this is the basis of the preference for guarantees over cash borrowing. Moreover, if they overdo it, they are able to turn the worst capitalized bank in the world into the best. This could be pretty destabilizing and inflict great damage to relatively healthy companies that should have the ability to compete on a level playing field.

The proper approach to ending the too-big-to-fail problem would be to consider fairness, which is at the core of the TBTF problem. It is essential that large firms be subject to the same insolvency regime that smaller firms are: the Bankruptcy Code. Making these firms small enough and simple enough to fail, through standard bankruptcy is clearly the best path forward. Not only would such an approach reinforce market discipline and eliminate the Orwellian approach to equality, it would reduce the risks of capital market uncertainty, reduce risk of capital market flight in times of crisis and would support the FDIC's intended mission as deposit insurer to the narrow banking sector.

Finally, it can be expected that those arguing against a more proactive reduction in risk and size of TBTF institutions will revert to an argument that strikes a natural chord in every American's heart: 'Doing so would put our institutions at a disadvantage among international competitors.' Level playing fields are a worthy goal, but this is not a relevant argument. Instead, this tired bromide must be resoundingly dismissed on several counts:

- Those countries with the largest banks as a percentage of GDP (Iceland, Ireland, Switzerland) demonstrated that a concentration of banking power can cause significant sovereign risk and tilt global economic playing fields away from that country.

- The likely breakups of ING, Lloyds and KBC suggest that it is we who seek to support an unleveled playing field where we subsidize our TBTF banks while other nations recognize the policy failures of moral hazard. If we continue down this path we will likely be at risk of violating international fair trade regimes.

- When the "unleveled playing field" argument is cited, in the name of protecting big banks from governmentally- subsidized international competition, keep in mind this reasoning supports the disadvantaging of 7,000+ community banks relative to our largest banks.

- There is no longer any evidence that, beyond a cost of capital advantage that comes with implied government support, there are sustainable and tangible economies of scale arising from being the largest firm. The financial supermarket concept has been proven a failure. The only ones who benefit are top-level executives. The notion that you need large banks to finance global companies is false. For centuries, syndicates of banks have financed trade and finance quite effectively. More banks involved in providing credit helps to better understand and diversify risk.

- We must demand that our legislators no longer allow unelected officials at the Federal Reserve to sign international accords created by the TBTF banks through supra-national bodies like the Basel Committee. This accord should be subject to the advice and consent of the Senate.

- Are we to believe that if we did not have such large and globally dominant firms, US borrowers might be paying more that the 29% interest that several of the TBTF firms now charge to their credit card customers? Perhaps we should think about what, if any advantages American consumers have received as a result of our financial institutions being such a large part of our economy.

- Since when did we accept a national strategy of following rather than leading? When we do what is right, others follow. As example, consider the bank secrecy havens – they made money for a bit. Now, even the Swiss and the Cayman authorities are coming around to our view.

- We are already at a disadvantage given that the largest foreign banks operate in the US with very little Tier 1 capital, yet most large foreign banks have not built a bricks and mortar presence here. Nobody screams about their undercapitalization nor has that undercapitalization caused deposits to migrate to foreign banks.

By getting out of the TBTF game, we will have a more robust and economically competitive economy where no players have a governmentally-conferred advantage or subsidy. Such a leveled playing field will begin the process of reinstating credible markets and attracting stable foreign capital. Let other nations pursue misguided policies of protecting uneconomic and anti-competitive businesses. Such an approach will allow our taxpayers to avoid having to be part of the next banking bailout crisis. The fact remains that most of the companies and functions that claim to be "systemically important" really are not. They simply claim to be because the government supports those claims and rewards them mightily as a result.

Written Testimony of David A. Skeel, Jr.

Before the Subcommittee on Oversight and Investigations
Committee on Financial Services
United States House of Representatives
May 15, 2013

Thank you for the opportunity to testify on the question of "Who is Too Big to Fail: Does Title II of the Dodd-Frank Act Enshrine Taxpayer-Funded Bailouts?" My name is David Skeel, and I am the S. Samuel Arsht Professor of Corporate Law at the University of Pennsylvania Law School. It is a great honor to appear before you today.

Perhaps the biggest question about the Dodd-Frank Act since the moment it was enacted in July 2010 has been whether it could or did end "Too Big to Fail." Although the administration and the giant financial institutions themselves have insisted that Too Big to Fail has ended, a growing number of observers are concerned that the Too Big to Fail problem has not been solved at all. Those who hold this view include at least one member of the Board of Governors of the Federal Reserve, Daniel Tarullo, as well as others at the Fed. Governor Tarullo has given several speeches raising the alarm about Too Big to Fail, and has suggested that Congress should act to impose limits on the size of the largest financial institutions.

Our particular focus in this hearing is on the implications of Title II of the Dodd-Frank Act—also known as the Orderly Liquidation Authority, OLA, or the Dodd-Frank resolution rules—for Too Big to Fail. The largest financial institutions have pointed to Title II as evidence that the Too Big to Fail issue has been solved, and some Americans may be under the impression that it has been. But in my view, Title II does not end Too Big to Fail at all. To the contrary, it perpetuates these problems in several important respects.

After very briefly describing how Title II works, I'll divide my remarks into two parts. In the first part, I will describe several problematic features of Title II as it is drafted. In the second, I'll focus on the "Single Point of Entry" strategy the Federal Deposit Insurance Corporation (FDIC) has developed over the past year or so for implementing Title II. The single point of entry approach is designed to preserve a systemically important financial institution that threatens to default. Even if the strategy were actually used, it would not end the Two Big to Fail problem. I will conclude by arguing that Title II should be amended, and that the Too Big to Fail issue should be addressed in other ways, such as bankruptcy.

The Basic Mechanics of Title II

Resolution under Dodd-Frank begins when "the three keys turn"—Treasury proposes to take over a systemically important financial company that is in or near default, and the Fed and

FDIC concur by a two thirds vote.[1] If the company does not agree to the intervention, resolution is commenced by the filing of a petition in the federal district court in Washington, DC. The court has 24 hours to consider the petition.[2] The only grounds for rejecting the petition are that the company in question is not a financial company, or that it is neither in default nor in danger of default.[3] The FDIC has nearly unfettered discretion to sell the company or any of its parts, either directly or after transferring the assets to a bridge financial company.

The resolution rules include a variety of provisions that are designed to counter complaints that the new framework would institutionalize bailouts. One provision explicitly requires that the financial institution's managers be removed if they were responsible for the financial distress, that shareholders be wiped out, and creditors take losses.[4] The framework also instructs regulators to liquidate the institution rather than reorganizing it.[5] Although these provisions sound like harsh medicine, the FDIC also is given ample discretion to sidestep them.

Title II's Contributions to Too Big to Fail

I should perhaps start by noting that it is quite possible that regulators would simply bail out a giant financial institution that threatened to fail, rather than invoking the resolution rules in Title II. Although the Dodd-Frank Act tries to make bailouts more difficult, it certainly hasn't eliminated the possibility of a bailout.[6] With the six largest institutions in particular, there is a very good chance that regulators would never invoke Title II, particularly if more than one of the institutions were at risk.

If regulators did invoke Title II, they would probably transfer some or all of the assets and liabilities of the holding company to a newly created bridge financial institution. Title II authorizes the FDIC to create a bridge institution, and permits the FDIC to keep it in place for up to five years.[7] During this five year period, the bridge institution has major competitive advantages as compared to other financial institutions. One benefit (available to the FDIC whether or not it sets up a bridge institution) is access to copious amounts of funding from the United States Treasury. Although there are some constraints on this funding, the Treasury and the FDIC can structure the funding in ways that give the bridge institution low cost funding.

Bridge institutions also are given a sweeping exemption from taxes. While the bridge institution is in existence, it is not required to pay any taxes on the value of its franchise, property

[1] Dodd-Frank Act § 203. The discussion in this section is drawn from Thomas H. Jackson & David A. Skeel, Jr., *Dynamic Resolution of Large Financial Institutions*, 2 HARV. BUS. L. REV. 435, 439-40 (2012), available at http://ssrn.com/abstract=2247599. I give a much fuller overview and analysis of Title II and the Dodd-Frank Act as a whole in David Skeel, *The New Financial Deal: Understanding the Dodd-Frank Act and its (Unintended) Consequences* (Wiley, 2011).
[2] Dodd-Frank Act § 202.
[3] *Id.*
[4] Dodd-Frank Act § 206.
[5] Dodd-Frank Act § 214.
[6] The Dodd-Frank Act prohibits the Federal Reserve from making extraordinary loans to individual institutions, for instance, but it would not preclude support framed in more general terms.
[7] Dodd-Frank Act § 210(h)(12).

or income.[8] This tax free status gives the bridge institution an enormous advantage over other financial institutions. In my view, there is simply no justification for this special treatment.

Notice that these features not only give the bridge institution a competitive advantage over other financial institutions. They also are at odds with the frequent claim that Title II will not impose any costs on taxpayers.

The FDIC's "Single Point of Entry" Strategy

For more than a year, the FDIC has been developing a strategy for implementing the resolution rules that it refers to as a "single point of entry" approach. Under single point of entry, the FDIC would intervene with the holding company of a troubled financial institution, and it would seek to leave most or all of the troubled company's subsidiaries intact. After establishing a new bridge financial institution, the FDIC would transfer all of the holding company's assets and short-term liabilities to the new bridge institution, leaving its longterm debt—primarily, bonds—behind in the old institution. Some or all of the stock of the new bridge institution would eventually be distributed to the long-term creditors of the old institution.

Although I think this is a very clever strategy for resolving a large bank's financial distress, it seems to me to raise three very important concerns. First, the single point of entry strategy assumes that all of the derivatives contracts and other short term obligations of a troubled financial institution will be bailed out. These complicated financial instruments were one of the major problems during the 2008 crisis, yet the single point of entry strategy proposes to continue to fully protect them. This will encourage the big banks to use even more of the derivatives and other complex financial contracts that caused so much trouble five years ago.

Second, although Title II explicitly requires that its provisions be used for liquidation, single point of entry is essentially a reorganization. It thus stands in tension with the explicit requirements of Title II.

Finally, the single point of entry strategy won't end too big to fail at all. It will essentially rescue the troubled financial institution, and is designed to ensure that a giant financial institution retains just as dominant a position after a financial crisis as before it.

Defenders of Title II insist that no taxpayer money will be used in connection with the resolution of a giant financial institution. But this is highly misleading. It is based on the fact that Title II authorizes bank regulators to impose a surcharge on other big banks to recoup the costs of the resolution process if they are not repaid as part of the process. First of all, this surcharge is essentially a tax imposed on one particular group of taxpayers, the banking industry. In addition, as I have already noted, the resolution process imposes costs that are not taken into account in this calculation, such as the cost of exempting the bridge institution from taxes.

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[8] Dodd-Frank Act § 210(h)(10) states that: "Notwithstanding any other provision of Federal or State law, a bridge financial company, its franchise, property, and income shall be exempt from all taxation now or hereafter imposed by the United States, by any territory, dependency, or possession thereof, or by any State, county, municipality, or local taxing authority."

Implications

Let me suggest three implications of these comments about the likely effect of Dodd-Frank's resolution rules. First, I believe it is very important to amend Title II to fix some of these problems. I do not think that Title II needs to be repealed. But I do think it should be amended to address problems such as the unjustifiable tax advantages given to bridge financial institutions.

Second, Title II is not a solution to the Too Big to Fail problem. The largest financial institutions have a dominant position in American finance. Among other benefits, they are able to borrow money much more cheaply than other financial institutions, because their cost of credit is artificially reduced by the Too Big to Fail subsidy. The small and medium sized banks that are most likely to lend to small and medium sized industries are at a particular disadvantage. None of the proposed solutions to this problem, including the Brown-Vitter proposal, is ideal. But I think the problem needs to be addressed, in order to level the playing field in the financial services industry.

Finally, I believe that it is important to recognize that bankruptcy is a very effective alternative to Title II for addressing the financial distress of large financial institutions. In its living will requirements and in other areas, the Dodd-Frank Act itself suggests that bankruptcy should be the resolution strategy of choice wherever possible. It is interesting to note, in this regard, that the single point of entry strategy can be replicated in bankruptcy, through a prompt sale to a newly created entity. The bankruptcy alternative would not have any of the anti-competitive characteristics that are found in Title II. The new entity would pay taxes like everyone else, for instance, and it would compete in the market on the same terms as other financial institutions.

A working group at the Hoover Institution of which I am a part has proposed a new Chapter 14, which consists of a handful of amendments to the Bankruptcy Code that we believe would make it even more effective as a mechanism for handling the default of a large financial institution.[9] I believe that one of the best things Congress could do is to enact these proposed changes, which would reduce the need to resort to Title II in the next crisis.

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[9] The Chapter 14 proposal is set forth and analyzed in *Bankruptcy* Not *Bailout: A Special Chapter 14* (Kenneth E. Scott & John B. Taylor, eds., 2012).

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

John B. Taylor[1]

Testimony Before The
Oversight and Investigations Subcommittee
Committee on Financial Services
U.S. House of Representatives
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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]

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[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.

[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.
>
> 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
>
> The proceedings should be overseen by a specialized panel of Article III judges and special masters with financial expertise.
>
> 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.

The strict priority rules of bankruptcy should govern.

The new chapter should provide special treatment for derivatives, stays and preferential transfers.

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.

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[11] Technically this is accomplished according to the bankruptcy law through a Section 363 sale.

[12] Taylor (2002)

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