

Testimony on the Financial Institution Bankruptcy Act

John B. Taylor*

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* Mary and Robert Raymond Professor of Economics at Stanford University, George P. Shultz Senior Fellow in Economics at Stanford University's Hoover Institution, and former Under Secretary of the Treasury for International Affairs. This testimony builds on previous testimonies before committees of the U.S. Senate and the House of Representatives including Taylor (2009, 2013, and 2015). It is based on the work of members of the Resolution Project at Stanford University's Hoover Institution published in Scott, Shultz and Taylor (2010), Scott and Taylor (2012), and Scott, Jackson and Taylor (2015).

Chair Marino, Ranking Member Cicilline, and members of the Subcommittee on Regulatory Reform, Commercial and Antitrust Law, thank you for inviting me to testify at this hearing on the Financial Institution Bankruptcy Act (FIBA) of 2017.

Bankruptcy reform designed to handle large financial firms is an essential element of a pro-growth economic program. A reform that makes failure feasible under clear rules without disruptive spillovers would prevent bailouts, diminish excessive risk-taking, and remove uncertainty associated with an inherently ad hoc bailout process. It would also reduce the likelihood and severity of financial crises, and thereby lead to stronger economic growth.

In the years since the global financial crisis, my colleagues and I at the Resolution Project at Stanford University's Hoover Institution have focused on finding the best way to proceed with bankruptcy reform for large financial firms. We came up with a reform that has been dubbed "Chapter 14" because there is currently no Chapter 14 in the Bankruptcy Code. The Financial Institution Bankruptcy Act of 2017, FIBA, which adds a new Subchapter V to Chapter 11, is an excellent "Chapter 14 type" reform.

Under current law, a failing firm can be reorganized under a Chapter 11 proceeding in which losses are calculated according to prescribed and open procedures, known in advance. If the failed firm's liabilities exceed its assets, then the shareholders are wiped out. The remaining difference between liabilities and assets is then allocated among creditors in the order of priority stipulated by the law, which is also known in advance. The creditors' debts are written down and, sometimes, converted into equity in the reorganized firm. In the end, the firm continues in business with either the old or new managers. Chapter 11 ensures that creditors bear losses and this reduces moral hazard and excessive risk-taking.

These are all important advantages of the Chapter 11 bankruptcy process which has served the American economy well. But large complex financial institutions present special circumstances which require adding provisions to that process. The existing Chapter 11 bankruptcy process is likely to be too slow for the fast moving markets that these types of firms deal in, and it is difficult with this process to prevent runs in a failing firm and thus prevent a crisis. Moreover, traditional bankruptcy judges might not have the needed expertise.

Resolution Under FIBA

Bankruptcy under FIBA would operate faster—over a weekend—and with as much precision as the existing Chapter 11. It would leave all operating subsidiaries outside of bankruptcy entirely. It would do this by moving the original financial firm’s operations to a new bridge company that is not in bankruptcy. This bridge company would be recapitalized by leaving behind long-term unsecured debt—called the “capital structure debt.” The firm’s long-term unsecured debt would bear the losses due to the firm’s insolvency and any other costs associated with bankruptcy. If the amount of long-term debt and subordinated debt were sufficient, short-term lenders would not have an incentive to run, and the expectation of an orderly bankruptcy will reduce uncertainty about runs.

The goal of these provisions is to let a failing financial firm go into bankruptcy in a predictable, rules-based manner without causing disruptive spillovers in the economy while permitting people to continue to use its financial services without running. The 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.

The primary federal regulator of the firm could file a bankruptcy petition. This would expedite the process, especially in cases where management, fearing a loss of equity or employment, has incentives to put off a filing.

Unlike reorganization under existing Chapter 11, FIBA proceedings would be overseen by judges designated by the Chief Justice of the United States to be available to hear cases under the new Subchapter V of Chapter 11. The bankruptcy would involve only a single proceeding, unlike current law where a parent company must go through one proceeding and insurance and brokerage subsidiaries through another, adding considerable complexity.

In order to evaluate such a reform, it is essential to examine in detail how it would work in practice to resolve a large complex financial institution. Fortunately, Emily Kapur (2015) has done just that by examining how such a process would have worked in the case of Lehman Brothers in 2008. In an important contribution she has demonstrated how a new solvent holding company could have been created over the weekend and opened for business on Monday. She uses actual balance sheet and financial data that has been made public through Lehman's court proceedings. Attached to my testimony below is a useful summary she has prepared which goes through the Lehman case assuming that a "Chapter 14 type" bankruptcy reform was in place in 2008.

Current law requires that resolution plans—living wills—be submitted by large complex financial firms to show how they can be resolved under bankruptcy in cases of distress or failure in a rapid and orderly resolution without systemic spillovers. But for the reasons I discussed earlier, it is very difficult at this time to bring one of these large firms through a conventional Chapter 11 bankruptcy. A FIBA reform would greatly facilitate the resolutions plans' ability to meet the statutory requirements, because it would leave all operating subsidiaries outside of

bankruptcy as these subsidiaries are moved to the new firm that is not in bankruptcy.

Bankruptcy reform would thus help greatly in the resolution planning process required under current law, as explained by Kroener (2015).

Comparisons with Title II of the Dodd-Frank Act

FIBA has advantages over the resolution process under Title II of the Dodd-Frank Act, and for this reason it would likely be used in practice even if Title II remained in force. In the years since Title II was passed the focus of the FDIC has been on how to resolve and reorganize the failing firm into an ongoing concern. To achieve this end, the FDIC would transfer part of a failing firm's balance sheet and its operations to a new bridge institution. To do so, the FDIC would likely exercise considerable discretion in comparison with bankruptcy proceedings through which firms are resolved and reorganized using the rules of the bankruptcy laws. There is thus uncertainty about how the reorganization process would operate, and this policy uncertainty could lead to further instability.

Moreover, bailouts would like occur under Title II. As the FDIC exercised its discretion to form a bridge bank, it would likely give some creditors more funds than they would have expected or been entitled to under bankruptcy law. They might wish to hold some creditors harmless, or nearly harmless, in order to prevent a perceived contagion of the firm's failure to other parts of the financial system. This action would violate the priority rules that underlie everyday decisions about borrowing and lending. Under the reasonable 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. Discipline is imposed on the firm by its creditors, 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. The expectation of bailouts of creditors weakens the incentives for them to monitor their loans and thereby provide this constraint on risk taking. 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.

There is yet another advantage of FIBA over Title II resolution. Under a FIBA 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.

Moreover, FIBA allows private parties to decide who will run the firm. If they decide that the old management will do a bad job, they will fire them. If they decide that the old management would do the job well, then they will keep them, recognizing that they have already lost out because the equity holders have been wiped out.

The resolution of a firm under Title II through a government-administered bridge company could give the new firm advantages over its competitors in comparison with a bankruptcy resolution. The Treasury is authorized to fund the FDIC which can fund the bridge firm, creating a subsidy, and under Title II the bridge firm can be given lower capital

requirements and forgiven tax liabilities. One can understand that a government agency in charge of resolutions would want to use such legal provisions to nurse the bridge firm with special advantages before letting it compete on a level playing field. But with a large amount of discretion and strong incentives to make the resolved firm a success, there is a concern that the advantages granted by a government agency could become excessive and prolonged.

Additional Liquidity and International Considerations

There is also the issue of liquidity to consider if FIBA were to replace Title II, in which case there would be no Orderly Liquidation Fund. If the firm faced the need for additional liquidity, it might need lender of last lender support. However, Section 13(3) of the Federal Reserve Act would be available in such circumstances, and it could be used even with the additional restrictions (such as the need for a broad-based facility). Indeed, with the expectation of having to go through losses and write-downs imposed by the bankruptcy, the additional expectations of possible new loans afterwards would cause little moral hazard.

International arrangements would also have to be addressed if FIBA were to replace Title II. For example, current European resolution authorities contemplate a parallel authority abroad. If Title II were repealed and there were no parallel authority in the U.S., then a way to cooperate internationally would have to be created.

Concluding Remarks

In this testimony I showed why a reform of the bankruptcy law along the lines of “The Financial Institution Bankruptcy Act of 2017 (FIBA) is essential. Such a reform—which makes

failure feasible even for large and complex financial institutions— plays a key role in addressing the problems of excess risk taking, uncertainty, and too-big-to-fail.

Moreover, FIBA has advantages over Title II of the Dodd Frank Act, and would be a preferable resolution process even if Title II remained. Under FIBA the procedures to determine asset values, liabilities, sales of some lines of business, write-downs of claims, and recapitalization would be based on the rule of law and the strict priority rules of bankruptcy would govern. Thus, the resolution regime under bankruptcy would ensure that any failing institution would be resolved through the same known set of processes. One of the biggest problems in the 2008 panic was a lack of predictability, with the government applying widely varying policies.

If FIBA were enacted without Title II of Dodd Frank, some consideration should be given to liquidity and international issues. Liquidity needs of the new firm created in the bankruptcy process could likely be addressed through Section 13(3) of the Federal Reserve Act, and certain international protocols would have to be created.

Thank you. I would be happy to answer your questions.

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A Lehman Brothers Scenario under Chapter 14

Emily Kapur

Stanford University

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Lehman Brothers, like most of its peers, had a holding company at the top, called Lehman Brothers Holdings Inc., which owned thousands of subsidiaries. These included its New York based broker-dealer Lehman Brothers Inc., or LBI, and its London based broker-dealer Lehman Brothers International Europe, or LBIE. Lehman was involved in many businesses including securities trading, over-the-counter derivatives, prime brokerage, and even commercial banking. But it was Lehman's real-estate-related activities that got it into trouble. Researchers have estimated that Lehman's losses totaled between \$15 and \$65 billion, or up to \$45 billion more than Lehman's \$20 billion book equity as of September 15, 2008.

Lehman's problems mounted for months but came to a head in early September 2008. At that point, markets still perceived Lehman to be solvent, but thought its assets were worth only \$2 billion more than its liabilities. Internally, Lehman was preparing to announce third quarter losses that would be \$2 billion more than markets had predicted. Thus, there was every reason to expect this announcement to eliminate markets' perceptions that Lehman was solvent. Sure enough, once Lehman announced its third-quarter losses and conceded that its efforts to raise additional capital had failed, creditors and counterparties ran. The firm lost \$30 billion of liquidity over a week as repurchase agreement lenders pulled funding, prime brokerage clients withdrew accounts, and derivatives counterparties and clearing banks demanded additional

collateral. Entirely out of cash with which to continue operations, on September 15, 2008 Lehman Brothers filed the largest Chapter 11 case in U.S. history.

Importantly, Lehman owed about \$100 billion in subordinated and long-term debt upon its demise, far more than any estimate of the extent to which real-estate losses exceeded equity. This combined with the fact that its liquidity problems were foreseeable make Lehman's the type of case that Chapter 14 would be best structured to address.

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

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

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

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

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

In the end, then, the bankruptcy proceeding makes clear to markets that, even after recognizing its real estate losses, the company headed by New Holdings—call it New Lehman—is exceedingly well capitalized for a financial firm, with a leverage ratio of 10 to 20% depending

on the extent of the write-downs. By the time markets open in Asia on Monday morning, LBI and LBIE can continue to provide key financial services and there is no reason for creditors to run. Furthermore, because the proceeding was undertaken in a timely manner, New Lehman can withstand a moderate drain on liquidity as markets adjust to its new structure.

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

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

In the end, if Lehman went through Chapter 14, shareholders and subordinated debt holders would make out the same as in Lehman's Chapter 11 case—getting nothing—and everyone else would do better, reducing the overall losses by hundreds of billions of dollars. Consequently, risks of systemic effects would be minimized both because the quick proceeding would allow the firm to continue operating and because all parties would expect lower losses. Nonetheless, unlike in a bailout, a substantial proportion of creditors would come away from the

process convinced that the possibility of sustaining losses was a real one. And the procedure would demonstrate that even a Lehman Brothers-type firm is not too big to fail.

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