CHAPTER 15

Single Point of Entry and the Bankruptcy Alternative

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Introduction

Viewed at a high level of abstraction, the Dodd-Frank Act has two main objectives. The first is to limit the risk of the banking system by more carefully regulating the key instruments and institutions of contemporary finance: the instruments being derivatives and other financial contracts and the institutions being the giant, systemically important financial firms like JP Morgan Chase, Citigroup, or AIG. The principal strategies for achieving the first objective are (1) requirements that most derivatives be cleared and traded on an exchange or similar platform and (2) the designation of systemically important financial institutions and the subjection of these institutions to, among other things, more stringent capital regulation.[1]

The Dodd-Frank Act's second objective is to limit the damage in the event one of these giant institutions nevertheless fails. To achieve the second objective, the Dodd-Frank Act gave bank regulators sweeping new authority to take over a struggling financial institution whose failure might pose systemic risk to the economy. Prior to the enactment of the Dodd-Frank Act, bank regulators had extensive resolution powers with commercial bank subsidiaries but did not have resolution authority over the bank holding company or nonbank affiliates, each of which was subject to the ordinary bankruptcy process.[2] Although bankruptcy remains the strategy of choice for resolving even the largest financial institutions,

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1. Each of these issues is discussed in detail in David Skeel, *The New Financial Deal: Understanding the Dodd-Frank Act and its (Unintended) Consequences* (Hoboken, NJ: John Wiley & Sons, 2011).

2. The Bankruptcy Code excludes commercial banks and insurance companies but not their holding company (11 USC Sec. 109[b]). Brokerages can file for Chapter 7, which provides for liquidation, but not Chapter 11, which governs reorganization (11 USC Sec. 109[d]).

the Dodd-Frank Act gives bank regulators an extensive new set of resolution tools.

This chapter focuses on the new resolution tools and, more generally, on the Dodd-Frank Act's second objective of containing systemic risk and more effectively resolving the failure of a systemically important financial institution. Housed in Title II of the Dodd-Frank Act—the Orderly Liquidation Authority, or OLA—the resolution rules were characterized by advocates as an extension of the powers the Federal Deposit Insurance Corporation has for resolving the financial distress of ordinary commercial banks. If the US Treasury, Federal Reserve, and FDIC agree, they are authorized to file a secret petition in a federal court in Washington, D.C. The court must approve the intervention so long as the troubled institution is engaged primarily in financial activities and is in default or in danger of default.[3] In most cases, the FDIC then takes over as receiver.[4] Title II instructs the FDIC to replace any managers who were "substantially responsible" for the financial institution's predicament, to impose losses on shareholders and creditors, and to liquidate (rather than reorganize) the troubled institution.[5] Although Title II contains an elaborate framework of rules, the rules provide only a sketchy picture of what a resolution might actually look like.

Over the past several years, the FDIC has attempted to fill in the picture with a remarkable new strategy it calls single point of entry.[6] In a single-point-of-entry resolution, bank regulators would put the financial institution's holding company into resolution, then transfer its assets, any short-term liabilities, and any secured obligations to a new bridge institution while leaving its stock and long-term unsecured debt (primarily bonds) behind in the old institution. The transfer would create a well-capitalized new institution and the FDIC would have access to large

3. Dodd-Frank Act, Sec. 202(a).

4. If the institution is primarily a brokerage, the Securities Investor Protection Corporation shares responsibility for customer accounts.

5. Dodd-Frank Act, Sec. 206 (shareholders recover last); Sec. 214 (liquidation).

6. The best current overview of single point of entry and the bankruptcy alternative is John F. Bovenzi, Randall D. Guynn, and Thomas H. Jackson, "Too Big To Fail: The Path to a Solution" (Washington, DC: Bipartisan Policy Center, May 2013). The FDIC has recently outlined the SPOE strategy in a call for comments. Federal Deposit Insurance Corporation, "Notice and Request for Comments, Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy," 77 Fed. Reg. 76614 (December 18, 2013).

amounts of liquidity from the US Treasury as needed for the holding company or subsidiaries. The FDIC would eventually distribute some or all of the equity of the new institution to the old long-term debt holders, while most likely wiping out the old stock.

The single-point-of-entry strategy is made possible by the unusual structure of large US financial institutions. Unlike their European counterparts, US financial institution groups generally have a top-level holding company whose capital structure includes substantial amounts of bonds and other long-term unsecured debt but relatively few derivatives and other short-term debt. Short-term debt and much of the group's operations are in subsidiaries. With bank holding companies especially, this structure is in large part a historical accident, caused by restrictions on banks' ability to branch across state lines and other regulatory obstacles. If it works, single point of entry will thus be a rare illustration of a happy unintended consequence.

Single point of entry has generated so much enthusiasm among regulators that the original working title of this chapter was "The Single-Point-of-Entry Silver Bullet." The title was only partly ironic. The single-point-of-entry approach does appear to be quite promising, and considerably more plausible than the process envisioned by the drafters of Title II. It would impose fewer demands on regulators than putting the entire holding company framework into resolution and could reduce the risk that foreign subsidiaries would face liquidity crises or other problems at the outset of the resolution, as they did when Lehman Brothers filed for bankruptcy in 2008. Although the virtues of single point of entry are real, the technique also has important vulnerabilities, and some of the claims made on its behalf are quite exaggerated. It does not end "too big to fail," for instance, as some advocates have claimed, and regulators may be reluctant to invoke it if multiple financial institutions face default at the same time or if resolution would expose particularly messy problems at one or more subsidiaries. It also reinforces problematic incentives for financial institutions to rely on short-term financing.

This chapter begins with a brief overview of concerns raised by the Lehman Brothers bankruptcy about the adequacy of our existing architecture for resolving the financial distress of systemically important financial institutions. The principal takeaway of the first section is that Title II as enacted left most of these issues unanswered. By contrast, the FDIC's single point of entry, which is introduced in the second section, can be seen as addressing nearly all of them. The third and fourth sections point out some of the limitations of single point of entry, first by highlighting potential pitfalls and distortions and then by explaining that single point of entry does not end the too-big-to-fail problem and would not reduce worrisome concentration in the financial services industry. The final section turns to bankruptcy, which remains the strategy of choice for resolving even systemically important financial institutions and considers how a single-point-of-entry-style strategy could be used in bankruptcy. Indeed, the strategy harkens back to the original procedure used to reorganize American railroads well over a century ago.

The Lehman challenge

It would be difficult to identify an aspect of the Lehman Brothers default in 2008 that is not subject to at least some controversy and debate. This includes, of course, the accepted wisdom that Lehman's bankruptcy triggered the market chaos of 2008.[7] Even those who interpret the significance of Lehman's collapse in diametrically opposed ways tend to agree, however, on many of the shortcomings Lehman exposed in the existing architecture for handling the financial distress of a systemically important financial institution. (By architecture, I mean both the formal options in place for handling financial distress and regulators' use of those options.) In this section, I briefly describe five challenges Lehman posed for the current architecture and show how the Dodd-Frank Act addressed several of these challenges but left most of them unresolved. In the next section, I will turn to the FDIC's innovative single-point-of-entry strategy and will explain how it theoretically could address many or all of the issues left open by the Dodd-Frank Act.

Five issues from Lehman

The first issue posed by Lehman was what tools are necessary for regulators to adequately address the financial distress of a systemically important institution. As of fall 2008, the Federal Reserve had the authority to make emergency loans under section 13(3) of the Federal Reserve Act so long as the loans were fully collateralized, but it and other bank regulators did not otherwise have direct authority to resolve the financial distress of a bank holding company or nonbank financial institution.

7. For criticism of the accepted wisdom, see, e.g., Kenneth Ayotte and David A. Skeel Jr., "Bankruptcy or Bailouts?" *Journal of Corporation Law* 35 (2010): 469.

After Lehman defaulted and the failure to bail out Lehman was widely criticized, Treasury Secretary Henry Paulson and Fed Chairman Ben Bernanke both asserted that the restrictions prevented them from providing rescue funding. Because Lehman did not have adequate collateral, the reasoning went, the Federal Reserve could not make an emergency loan and therefore was forced to let Lehman default.[8] Although their claim that the Fed could not have made an emergency loan seems implausible, especially given the creativity the Fed used in its other rescue operations during the crisis, Lehman did highlight the limitations of bank regulators' authority in the event a systemically important financial institution failed. Bankruptcy was available, but bank regulators have limited authority in bankruptcy and did not have other resolution options.

A second issue raised by Lehman concerns the predictability of regulators' intervention in the event of a crisis. Prior to the crisis, some commentators advocated an intervention strategy known as "constructive ambiguity."[9] In a system characterized by constructive ambiguity, regulators do not signal in advance whether they will provide rescue financing in the event a systemically important financial institution or other entity falls into financial distress. The uncertainty theoretically could create an equilibrium in which the managers and creditors of a large financial institution don't count on a bailout, which removes the moral hazard created by the expectation of a bailout, but regulators can provide a bailout if this proves to be necessary to prevent systemic harm.[10] The events of 2008, especially Lehman's collapse, cast serious doubt on the efficacy of constructive ambiguity. Although regulators insisted that large financial institutions should not expect to be bailed out, Lehman CEO Richard Fuld believed, almost up to the moment of Lehman's default, that rescue financing would be available if necessary. Similarly, faced with uncertainty as to whether they would be bailed out, AIG's managers spent considerable

8. For the retrospective of another Treasury official, see Philip Swagel, "Why Lehman Wasn't Rescued," *New York Times,* September 13, 2013, http://economix.blogs.nytimes.com/2013/09/13/why-lehman-wasnt-rescued/?_r=0.

9. See, e.g., *Statement of E. Gerald Corrigan Before the United States Senate Committee on Banking, Housing, and Urban Affairs,* Washington DC, February 4, 2010.

10. For a critical assessment of constructive ambiguity after the crisis, see Jeffrey M. Lacker, "Reflections on Economics, Policy, and the Financial Crisis," speech before the Federal Bank of Richmond, September 24, 2010, http://www.richmondfed.org/press_room/speeches/president_jeff_lacker/2010/lacker_speech_20100924.cfm.

energy in the weeks before the government stepped in preparing a report that was designed to persuade regulators that a failure to bail out AIG could be disastrous.

One very destructive consequence of Lehman's assumption it would be bailed out was that Lehman made almost no efforts to prepare for the possibility of bankruptcy. Lehman has speculated that up to $75 billion of value was destroyed due to the absence of pre-bankruptcy planning.[11] Whatever the precise costs, the failure of constructive ambiguity suggests the need to devise clearer signals whether and how regulators are likely to intervene. As with the prompt corrective rules that apply to ordinary banks, the ideal framework would provide clarity as to when regulators will intervene and how they will resolve financial distress. It also would encourage the parties to prepare for the possibility of financial distress.

A third issue raised by Lehman relates to the trade-off between speed, on the one hand, and information and rule-of-law virtues, on the other, when a financial institution's distress is resolved very quickly. Ordinary bank resolution offers speed and regulators generally are well informed, but it sacrifices rule-of-law virtues, since regulators have nearly complete discretion in resolving a bank.[12] Ordinary bankruptcy better honors the rule of law and is designed to produce considerable information, but it is more time-consuming than bank regulation. The Lehman case was an odd hybrid of the two approaches. Although the case has remained in bankruptcy for five more years, Lehman sold its core brokerage operations to Barclays four days after it filed for bankruptcy. The speed came at the cost, however, of information and rule-of-law virtues. In approving the sale motion, the bankruptcy judge emphasized that the process had been rushed, with little time to digest the relevant information, and made clear that the case should not be viewed as precedential for future transactions.[13] Lehman hewed more closely to rule-of-law virtues than

11. See, e.g., Jeffrey McCracken, "Lehman's Chaotic Bankruptcy Filing Destroyed Billions in Value," *Wall Street Journal*, December 29, 2008, http://online.wsj.com/news/articles/SB123050916770038267.

12. For an analysis of the benefits and shortcomings of administrative resolution and bankruptcy, see Thomas H. Jackson and David A. Skeel Jr., "Dynamic Resolution of Financial Institutions," *Harvard Business Law Review* 2 (2012): 435.

13. See, e.g., Emily Chasan, "Judge Approves Lehman, Barclays Pact," *Reuters,* September 21, 2008, http://www.reuters.com/article/2008/09/21/us-lehman-barclays-idUSN1932554220080921. (Article quotes Judge James Peck as

the bailouts of Bear Stearns and AIG did, but Lehman—like the two bailouts—raised the question whether the rule of law can be honored more fully without sacrificing the need for speed.

The fourth concern that emerged from Lehman is the susceptibility of derivatives and short-term credit to run, creating a risk that value will be destroyed due to premature liquidation, as well as concerns about larger systemic consequences. With Lehman, the principal concerns related to its repo financing and J.P. Morgan's grabbing of collateral as uncertainties about Lehman grew.[14] Although Lehman's derivatives portfolio was unwound without major incident, a run on AIG's credit default swaps—and AIG's inability to halt the run even temporarily—was a major factor in AIG's collapse.[15] These incidents raised the question whether the risk that short-term credit will run, and that these runs will have destructive effects, can be contained in the event a systemically important financial institution threatens to collapse.

The final issue arises from the global reach of systemically important financial institutions like Lehman. Some of the most destructive consequences of Lehman's failure came outside the United States. Due to their loss of immediate access to funds in Lehman's cash management system, several Asian subsidiaries failed. Several hedge funds failed after Lehman's London subsidiary was placed in administration. The worldwide ripple effects of Lehman's default underscored the fact that an effective resolution strategy needs to consider not only the domestic effects of financial institution distress but the potential for worldwide consequences. The question here is how best to minimize the global disruption caused by the default of a systemically important financial institution.

The regulatory response in Dodd-Frank

How well does Dodd-Frank address these issues? To answer this question, I will briefly describe Dodd-Frank's strategy for resolving financial distress, highlighting a handful of provisions of particular relevance. I then will consider how fully this strategy addresses the Lehman questions.

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saying, "It can never be deemed precedent for future cases. It's hard for me to imagine a similar emergency.")

14. These concerns are discussed in David A. Skeel Jr. and Thomas H. Jackson, "Transaction Consistency and the New Finance in Bankruptcy," *Columbia Law Review* 112 (2012): 152, 163–66.

15. Ibid., 165–66.

Dodd-Frank's core strategy for resolving troubled financial institutions is to funnel them into formal bankruptcy or resolution proceedings.[16] The principal mechanisms for achieving this are two key financing provisions. The first restricts the Federal Reserve's section 13(3) power—its power to make emergency loans—by prohibiting the Fed from providing rescue funding to a single financial institution.[17] In theory, this restriction will sharply constrain regulators' capacity to bail out troubled financial institutions as they did with Bear Stearns and AIG. If regulators invoke the resolution rules, by contrast, they have access to large amounts of funding from the US Treasury. As receiver of a troubled financial institution, the FDIC is entitled to borrow up to 10 percent of the institution's pre-resolution book value and 90 percent of the fair value of its assets once it has been placed in resolution.[18]

Although the financing provisions reflect a preference for resolution rather than bailouts, the legislation signals that resolution should be used only if the other major alternative—bankruptcy—is likely to be unavailing. When a systemically important financial institution prepares a living will ("resolution plan" is the term used), as Dodd-Frank now requires it to do, the living will must explain how a bankruptcy would unfold, rather than resolution under Dodd-Frank.[19] Similarly, Dodd-Frank ostensibly precludes regulators from invoking the resolution rules unless they first determine that alternatives such as bankruptcy are not feasible or would create a risk of adverse systemic effects.[20]

The drafters of Dodd-Frank seem to have envisioned that regulators would look to bankruptcy as the option of choice, and then Dodd-Frank resolution if bankruptcy did not appear to be adequate. If regulators do

16. There is an interesting echo here of the funneling strategy used for ordinary corporations in the New Deal. In the Trust Indenture Act of 1939, Congress prohibited voting provisions that had previously been included in an increasing number of bond indentures to facilitate restructuring of bonds outside of bankruptcy. The provision was designed to force troubled companies to use bankruptcy instead. See, for example, Mark J. Roe, "The Voting Prohibition in Bond Workouts," *Yale Law Journal* 97 (1987): 232, 234, 251.

17. Dodd-Frank Act, Sec. 1101(a).

18. Dodd-Frank Act, Sec. 210(n).

19. Dodd-Frank Act, Sec. 165(d)(4). (This section requires the Federal Reserve and FDIC to assess whether the living will is credible and would facilitate an orderly resolution under the bankruptcy laws.)

20. One of the systemic risk findings bank regulators must make before initiating a resolution is "an evaluation of why a case under the Bankruptcy Code is not appropriate for the financial company." Dodd-Frank Act Sec. 203(a)(2)(F).

put the institution into receivership under the resolution rules, they will have access to copious funding. Under the other resolution provisions, they also would have extensive flexibility in deciding how to resolve the financial distress, subject only to the proviso that the resolution rules require that the institution be liquidated.[21]

Also of particular note for assessing how fully the Dodd-Frank framework addresses the questions raised by Lehman is Dodd-Frank's new requirement that most derivatives be cleared and presented to an exchange.[22] Under the new rules, a clearinghouse will guarantee the performance of both parties to a cleared derivative, entering into agreements with both the buyer and the seller, thus shifting counterparty risk to the clearinghouse. It remains to be seen how much of the derivatives markets will be cleared, but already roughly 65 percent of interest rate swaps and 40 percent of all credit derivatives are migrating to the clearinghouses.[23]

Under the Dodd-Frank resolution rules, derivatives and other financial contracts are subject to a one-plus day stay after the receivership of a systemically important financial institution begins.[24] Counterparties are prohibited from terminating their contracts during this period and cross-default provisions—provisions that make the receivership of one entity an event of default for contracts with an affiliate—are invalidated. Regulators are required to continue making margin payments on the derivatives, and they must either assume or reject all of the contracts with any given counterparty—they cannot keep some and terminate others.

If we map this framework onto the questions raised by Lehman, Dodd-Frank clearly responds to the first of the five issues. Under the new resolution rules, regulators have sweeping authority to intervene if a systemically important financial institution totters, with almost no judicial second-guessing of a decision to intervene. Although regulators are required to make a list of findings, their petition can only be rejected if the institution in question is not a financial company or is not in default or in danger of default.[25] The resolution rules give the FDIC enormous

21. Dodd-Frank Act, Sec. 214.

22. The new derivatives requirements are set forth in Title VII of the Dodd-Frank Act. For an overview, see Skeel, *The New Financial Deal,* 59–75.

23. See Financial Stability Board, "OTC Derivatives Market Reforms: Sixth Progress Report on Implementation," September 2, 2013, 27.

24. Dodd-Frank Act, Sec. 210(c)(8)(F).

25. For extensive discussion of the petition requirements and limited judicial oversight, see Kenneth E. Scott, "Dodd-Frank: Resolution or Expropriation?" in

discretion as receiver. No longer need regulators worry that they lack sufficient authority to intervene.

Although Dodd-Frank clearly addresses the first of the five issues, on each of the others the framework as enacted is at best incomplete. The framework does not increase the mystery as to whether and how regulators will intervene, but neither does it remove the uncertainty. Although struggling financial institutions are funneled to bankruptcy or resolution, the funnel is quite leaky. As discussed in more detail below, regulators still can bail out the financial institution, despite the restrictions on the Fed's emergency lending powers. And the top managers of the institution have strong incentives to resist Dodd-Frank resolution, since they are likely to be ousted.

With the third issue, Dodd-Frank appears at first to have made significant strides in incorporating rule-of-law virtues into an administrative resolution process. The resolution rules include a priority scheme that instructs regulators to impose losses on shareholders and junior creditors; promises that every creditor will be given at least the liquidation value of its claim and that excess payments can be clawed back; and borrows preference, fraudulent conveyance, and setoff provisions from the bankruptcy laws.[26] These provisions give the OLA a patina of regularity. But the rule-of-law protections are more illusory than real. The FDIC can ignore the priorities if it deems an alternative approach necessary to financial stability; and the promise of liquidation value has little content, since the FDIC can take the position that there would be little or no value available to any creditors if it had not intervened. Considerable uncertainty remains under the Dodd-Frank framework as enacted.

In one very important respect, the risk of runs on short term funding—the fourth issue—has been reduced by the Dodd-Frank Act. Counterparties of derivatives that are now cleared have much less incentive to run in the event the other party threatens to collapse. Even here, however, the solution is incomplete. Many derivatives are likely to remain uncleared—especially those that cannot easily be standardized.[27] The

Bankruptcy Not *Bailout: A Special Chapter 14,* eds. Kenneth E. Scott and John B. Taylor (Stanford CA: Hoover Institution Press 2012), 199.

26. For a more detailed discussion, see Skeel, *The New Financial Deal,* 142–48.

27. As of September 2013, roughly 65 percent of US interest rate swaps and 40 percent of credit derivatives were being cleared, as noted earlier, but the percentages are much lower with commodity-based and other derivatives. See Financial Stability Board, "OTC Derivatives Market Reforms," 27.

counterparties to these derivatives still have reason to run in a crisis. Moreover, the Dodd-Frank Act did almost nothing to address the fragility of the short term repo market, which figured prominently in the Lehman and Bear Stearns collapses.

Finally, Dodd-Frank did not address the international dimensions of a systemically important financial institution's collapse. Presumably, regulators have taken these concerns into account in implementing Dodd-Frank's living will requirement. Other than with living wills, almost the only references in Dodd-Frank to the global dimensions of a financial institution default are a handful of exhortations of US regulators to coordinate with their foreign counterparts.

As this brief overview makes clear, the Dodd-Frank framework as enacted leaves many of the most important issues raised by Lehman unaddressed or, at the least, under-addressed.

The single-point-of-entry strategy

In the discussion thus far, I have referred on occasion to the Dodd-Frank framework "as enacted." I have used this language to distinguish the bare statutory rules from the quite remarkable strategy for implementing the resolution rules that the FDIC has developed and promoted over the past several years. In this section, I briefly describe the single-point-of-entry approach. I then map the strategy against the question we considered in the previous part. A signal selling point of the new strategy is that it far more effectively answers nearly all of the Lehman questions than does the framework as enacted.

The new approach is called single point of entry because the holding company atop a financial institution's corporate structure would be put into receivership but most or all of the affiliated entities would not.[28] The restructuring would occur primarily at the holding company level, with liquidity down-streamed to affiliates as necessary. In a single-point-of-entry resolution, the FDIC would transfer all of the holding company's assets, any short-term unsecured debt, and any secured debt to a newly created bridge institution. The holding company's stock and long-term unsecured debt would be left behind, leaving the bridge institution with a more sustainable capital structure. At some point thereafter, the FDIC

28. Bovenzi, Guynn, and Jackson, "Too Big To Fail: The Path to a Solution," 26–27.

would (probably) wipe out the old stock and would convert at least some of the long-term debt to stock in the bridge entity. If one or more subsidiaries were facing a solvency issue, the holding company could inject capital by converting obligations owed by the subsidiary to the bridge entity into stock or by contributing other holding company assets (including receivables from other subsidiaries) to the needy subsidiary.[29]

Much more than the Dodd-Frank Act as enacted, which seems to contemplate a wind-down of the troubled institution, single point of entry addresses the issues posed by Lehman. The approach is far from foolproof, and I will consider some of its limitations in the next two sections. But single point of entry is considerably more promising than the structure envisioned by the rules as enacted.

Start with the second issue, the uncertainty whether and how regulators will intervene. With a well-defined single-point-of-entry strategy in place, it is at least possible that regulators would invoke the resolution rules if a systemically important financial institution threatened to fail. The uncertainty would not be dispelled altogether, but it is more plausible that regulators would use Title II to effect a single-point-of-entry restructuring than it is that they would take over a giant financial institution and wind it down.

On the third issue, too—the tension between speed and rule-of-law virtues—single point of entry is more promising than the rules as enacted. By fully protecting one group of unsecured creditors (derivatives and other short-term debt) while restructuring another (long-term debt), the single-point-of-entry strategy alters ordinary priorities. But if the FDIC commits to using single point of entry, the treatment is known in advance and in this sense honors rule-of-law virtues. While codification of these principles would be clearer still, single point of entry could couple a relatively clear set of rules with the speed of administrative resolution.[30]

Fourth, because single point of entry promises that the financial institution's derivatives and other short-term debt will be fully protected,

29. Ibid., 27. If one or more subsidiaries continued to face a liquidity crisis after being recapitalized, the bridge entity theoretically could make a secured loan to the needy subsidiary and re-pledge the collateral received from the subsidiary to the FDIC in return for a matching secured loan from the FDIC's orderly liquidation fund (which is borrowed from the US Treasury).

30. Thus far, the FDIC unfortunately has continued to insist on retaining the discretion to alter claimants' treatment on an ad hoc basis in the event of a resolution. See FDIC, "Notice and Request for Comments."

it diminishes the likelihood of runs in the event a financial institution threatens to default. The risk of runs will not disappear altogether; repo lenders may still refuse to roll over their repo loans, for instance. But single point of entry reduces the downside consequences of failure for a financial institution's short-term creditors and as a result should reduce the risk of runs.

Finally, if the single-point-of-entry plan works as intended, it addresses the global consequences of a failure by limiting the consequences of default to the US holding company. Foreign subsidiaries theoretically will be insulated from the failure and will continue to operate on normal terms. So long as the crisis is limited to the US holding company, or to the holding company and one or more US subsidiaries, the effects of a financial institution's default outside the United States will be much less serious than with Lehman.[31]

In the next two sections of this chapter I will explore some of the problems with, and concerns about, the single-point-of-entry strategy. But it should by now be evident that single point of entry is a far more promising approach to financial institution failure than the Dodd-Frank resolution rules as enacted.

What could go wrong?

The single greatest threat to single point of entry is simply that regulators won't take the weapon out of its holster when a troubled financial institution stumbles. In the past, regulators have rarely if ever intervened in a timely fashion. The prompt corrective action rules enacted after the savings and loan crisis of the 1980s were designed to respond to precisely this problem. Even these rules, which instruct the FDIC to intervene before a bank becomes insolvent, do not always assure a timely regulatory response. The decision when to intervene under Dodd-Frank is entirely discretionary. Because it is a plausible mechanism for resolving the financial distress of a systemically important financial institution, single point of entry will make regulators more comfortable intervening. But

31. US and UK regulators have attempted to signal their confidence in the likely effectiveness of this approach through a joint statement endorsing the general framework. See Martin J. Gruenberg (chairman, FDIC) and Paul Tucker (deputy governor, financial stability, Bank of England), "Global Banks Need Global Solutions When They Fail," *Financial Times,* Op-Ed, December 10, 2012.

regulators will still be tempted to delay. The longer the time lag between the last crisis and the next one, the greater the temptation may be. The Fed and FDIC have scaled up significantly in the wake of the crisis and enactment of Dodd-Frank and might well intervene if a large financial institution were to stumble in the near future. But the state of readiness will inevitably erode with time.

Regulators' natural reluctance to intervene will be still greater if there is a potentially messy crisis at a major subsidiary. Single point of entry is designed for financial distress that can be resolved with the financial equivalent of arthroscopic surgery—a narrowly targeted intervention. Although the FDIC has considered ways of down-streaming capital and liquidity to troubled subsidiaries, capital and liquidity alone may not be enough to solve the problems. If this is the case, regulators may be particularly hesitant to invoke their resolution powers. If they do attempt to stanch the crisis through a single-point-of-entry restructuring, the restructuring could fail or it could leave the troubled institution in government hands for years, rather than the much shorter period the FDIC contemplates.

The risk of subsidiary-level complications could be particularly acute if there are problems with a non-US subsidiary. Although British regulators have endorsed the single-point-of-entry approach, as noted earlier, they worry about whether US regulators will act as vigorously to recapitalize a troubled UK subsidiary as with a troubled US subsidiary.[32] Uncertainties abound for US regulators as well. Although they can be confident that the United Kingdom will welcome direct injections of capital, US regulators would not have any control over the restructuring or liquidation of a non-US subsidiary.

JP Morgan Chase poses another version of the messy subsidiary problem. J.P. Morgan, a subsidiary of JPMorgan Chase, and Bank of New York Mellon handle the vast majority of tri-party repo transactions in the United States. Although tri-party repo is not nearly as important a profit center for J.P. Morgan as it is for Bank of New York, a J.P. Morgan failure could entangle a large portion of the tri-party repo market.[33] Although regulators theoretically could use single point of entry to resolve

32. The general issue is discussed in Thomas F. Huertas, "Safe to Fail," LSE Financial Markets Group Paper, Series 21 (May 2013).

33. For related reasons, Darrell Duffie has argued that tri-party repo clearing services should operate through a regulated utility. See Darrell Duffie, "Replumbing Our Financial System: Uneven Progress," *International Journal of Central Banking,* January 2013: 251, 253.

a J.P. Morgan default without interfering with tri-party repo clearing, they might be very reluctant to take the risk. As a practical matter, J.P. Morgan's centrality to the tri-party repo market could function as a poison pill that will prevent regulators from invoking the Dodd-Frank resolution rules.

Thus far, I have focused on the problems that could arise if a single financial institution fell into distress. Historically, financial crises have often engulfed multiple banks rather than just one. The 2008 crisis was of course a vivid illustration, bringing the collapse of two investment banks and bailouts of other struggling banks as well. It is quite unlikely that regulators would seriously consider attempting single-point-of-entry resolutions of more than one systemically important institution at the same time. Even after their post-Dodd-Frank expansion, regulators probably do not have the capacity to handle multiple resolutions simultaneously; and their capacity is likely to erode as memories of the last crisis recede. Moreover, broader crisis conditions make it much less likely that systemically important financial institutions can be restructured and released from FDIC oversight quickly to resume normal operations in the marketplace.

With each of the concerns I have discussed—regulators' general reluctance to intervene, the messy subsidiary problem, and simultaneous failures—single point of entry may not work at all, either because regulators are unwilling to use it or because the resolution process may not function as intended. Several collateral consequences of the single-point-of-entry strategy also warrant mention. First, bank regulators recognize that they will need to impose mandatory bondholding requirements, lest banks shift to other, protected forms of financing, leaving insufficient bond funding to facilitate a single-point-of-entry restructuring.[34] In addition, because

34. See Federal Reserve Governor Daniel K. Tarullo, "Toward Building a More Effective Resolution Regime—Progress and Challenges," Speech at the Federal Reserve Board and Federal Reserve Bank of Richmond Conference, "Planning for the Orderly Resolution of a Global Systemically Important Bank" (October 18, 2013). (Tarullo states that an important "way to enhance the credibility of the FDIC's approach is to require adequate loss-absorbing capacity within large financial firms"); Federal Reserve Governor Daniel K. Tarullo, *Dodd-Frank Implementation: Testimony Before the Committee on Banking, Housing, and Urban Affairs,* US Senate, July 11, 2013. (Tarullo states that "in consultation with the FDIC, the Federal Reserve is working on a regulatory proposal that requires the largest, most complex US banking firms to maintain a minimum amount of outstanding long-term unsecured debt on top of their regulatory capital requirement.")

the FDIC has not specified how or when it will determine the magnitude of the haircuts to bondholders in the event of a single-point-of-entry restructuring, bondholders may put even more pressure on regulators to avoid a default than they did in 2008. The uncertainty as to how bondholder haircuts will be determined is not likely to prevent single point of entry from working, but it is a potential problem that the FDIC would do well to fix by providing more guidance about the process it plans to use.

The second concern is the implications to the derivatives market of a commitment to single point of entry. By committing to fully protect derivatives in the event of a resolution, single point of entry diminishes the monitoring incentives of derivatives counterparties, who will often be the first to recognize that a systemically important financial institution is in financial distress; and it strengthens incentives to use derivatives and other short-term financing. Given the problems with these financial contracts in 2008, the added incentive to use fragile forms of financing could have dangerous unintended consequences. To be sure, the risks are mitigated somewhat by the increased clearing and exchange trading of derivatives. But a substantial percentage of derivatives still is not cleared; and with cleared derivatives, the protection may have a dampening effort on the clearinghouses' monitoring incentives.

Is "too big to fail" over?

When President Obama signed the Dodd-Frank Act in July 2010, he proclaimed that it would end the too-big-to-fail problem. "Because of this law," the president said, "the American people will never again be asked to foot the bill for Wall Street's mistakes. There will be no more taxpayer-funded bailouts. Period."[35] Although these words can perhaps be construed as the hyperbole that attends the enactment of once-in-a-generation legislation, other enthusiasts have continued to make similar claims. In a recent book and in public appearances, Sheila Bair, the former head of the FDIC, also has expressed optimism that Dodd-Frank has ended taxpayer bailouts and the too-big-to-fail problem.[36]

35. See, e.g., Annalyn Censky, "Obama on new law: 'No more taxpayer bailouts,'" *CNN Money*, July 21, 2010, http://money.cnn.com/2010/07/21/news/economy/obama_signs_wall_street_reform_bill/.

36. Sheila Bair, "Why taxpayers may now be off the hook when a big bank fails," *Fortune*, April 11, 2013.

The basis for this claim is two key parts of the Dodd-Frank Act. The first is the provision in the law that limits the ability of the Federal Reserve to make the kind of extraordinary bailout loans that it gave Bear Stearns and AIG during the crisis in 2008.[37] Under the new provision, which amends the Fed's emergency lending powers under section 13(3) of the Federal Reserve Act, the Fed cannot make an extraordinary loan to a single institution. Only industry-wide programs are permitted. The second part of the answer is Dodd-Frank's resolution rules, as supplemented by the single-point-of entry resolution strategy. These provisions may have reduced the likelihood of bailouts in some circumstances. But by no stretch of the imagination can they be said to have eliminated bailouts or the too-big-to-fail problem.

The most obvious limitation of the restrictions on the Federal Reserve is that they can only work if the Federal Reserve adheres both to the spirit and to the letter of the restriction on its section 13(3) powers, which is highly unlikely in a crisis. The Fed still has the power to make emergency loans to an entire industry, and if the Fed really only wanted to bail out one institution, it isn't hard to create a program that purports to be for the entire industry but really has one institution in mind. In fact, if the Fed wanted to, it could simply ignore the law and make a loan directly to one bank, because no one would be in a position to bring suit against it. Still another option is for regulators to go to Congress to ask for a new source of bailout funding, as they did with the TARP (Troubled Asset Relief Program) legislation in 2008. If there is a will, bank regulators will have ways to bail out systemically important financial institutions in the next crisis, as they did in the last.

Suppose, however, that this time really is different and regulators take their chances with Dodd-Frank's resolution rules rather than bailing out the troubled institution. Even here, it would not be accurate to say that bailouts will be avoided and too-big-to-fail and related concerns will be fully addressed. The generous financing provisions provided by Title II, which allow the FDIC to borrow up to 10 percent of the financial institution's pre-resolution book value and 90 percent of its fair value in resolution,[38] have several important leaks. One potential leak is hidden in a provision governing the interest rate to be paid for the financing. Title II instructs regulators to base the interest rate on the average interest rate for

37. Dodd-Frank Act, Sec. 1101(a).
38. Dodd-Frank Act, Sec. 210(n)(6).

a basket of corporate bonds.[39] The corporate bond rate may well be less than the appropriate rate for the resolution of a troubled financial institution (even one that has been recapitalized through a transfer of assets and liabilities to a bridge) and it will almost certainly be less than the penalty rate of interest called for in traditional lender-of-last-resort lending. Moreover, regulators can ensure an even lower interest rate through strategic selection of the term or category of bonds they use as a bench mark. The implicit costs of below-market lending will of course be costs that are borne by taxpayers.

A second leak comes with the tax status of the bridge institution. The bridge institution is exempt from nearly all taxes while it remains in Title II.[40] The longer the Title II process takes, the greater the magnitude of this tax break. Although the FDIC envisions a comparatively short resolution process, there is no guaranty that this will be the case. The FDIC can keep the bridge institution in place for up to five years. The cost to taxpayers could therefore be considerable.

The final leak arises in the event the bridge institution is not able to repay its loans in full. Under these conditions, Title II requires bank regulators to make an assessment on other systemically important institutions to cover the shortfall.[41] Because the assessment is directed to other financial institutions, Title II advocates can claim that under no circumstances will taxpayers be responsible for the difference. But the costs of any assessment are likely to be passed on to the financial institutions' customers. As a result, although the costs are not a tax on taxpayers, they may have a somewhat similar effect.

In addition to the potential for a partial bailout even within Title II, the FDIC's single-point-of-entry strategy has another, related limitation: it is not designed to reduce concentration in the banking industry. The principal objective of single point of entry is to quickly restructure and recapitalize a troubled bank. If it works as intended, the troubled financial

39. Dodd-Frank Act, Sec. 210(n)(5)(C) (interest rate based on difference between Treasury bill rate and interest rate for corporate securities of comparable term).

40. Dodd-Frank Act, Sec. 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."

41. Dodd-Frank Act, Sec. 210(o).

institution will emerge from the restructuring nearly as large and dominant as it was before the crisis. If it is one of the six dominant bank holding companies before the crisis, it will almost certainly retain that status after its single-point-of-entry resolution.

This last point is not necessarily a criticism of the single-point-of-entry approach so much as a corrective to suggestions that single point of entry is a comprehensive solution to "too big to fail" and related problems. If the banking industry is too concentrated, as many believe, single point of entry is not the solution. Other correctives are necessary.

The bankruptcy alternative

Although the exact genealogy of the single-point-of-entry strategy is unclear,[42] it bears a striking resemblance to the transactions that were used to bail out and restructure Chrysler and General Motors in 2009. In each case, the company filed for bankruptcy at the behest of the US government and promptly transferred nearly all of its assets and many (but not all) of its liabilities to a newly created entity. The claims that were transferred, such as employee health care obligations and the companies' trade debt, were paid in full, while many of the creditors left behind received only a fraction of what they were owed. To finance the transactions, the US Treasury made substantial loans to each company.[43]

Whether the car bailouts honored or abused the bankruptcy process is the subject of an extensive debate that we need not enter into here. The important point for my purposes is that bankruptcy can be used in this fashion if the transactions are structured properly. Indeed, a bankruptcy "sale" to an entity set up by the debtor itself—the bankruptcy equivalent of what hipsters call a "selfie"—is precisely the form that the railroad reorganizations of the late nineteenth century, the precursors of Chapter 11, took. This suggests that the single-point-of-entry strategy for resolving systemically important financial institutions could potentially be employed in bankruptcy. In the discussion that follows, I briefly describe a handful of reforms that would need to be made for the strategy to be effective,

42. Randy Guynn appears to deserve considerable credit as author of a SIFMA (Securities Industry and Financial Markets Association) memo and a law review article that contain some of the earliest outlines of the approach. See Randall D. Guynn, "Are Bailouts Inevitable?" *Yale Journal on Regulation* 121 (2012):29.

43. For more detailed discussion, see Mark J. Roe and David Skeel, "Assessing the Chrysler Bankruptcy," *Michigan Law Review* 108 (2010): 727.

focusing in most detail on the two biggest concerns: the timing of the initial sale and the funding.[44]

In order to facilitate the transfer of any derivatives and short-term debt to the newly created entity, the Bankruptcy Code would need to be amended to alter the special status of derivatives.[45] Under current law, the stay that prevents creditors from terminating their contracts and seizing or selling collateral and the bankruptcy rules that invalidate provisions that deem bankruptcy to be an event of default do not apply to derivatives. At the least, derivatives would need to be subject to at least a one- or two-day stay to facilitate the transfer to a new entity. As noted earlier, Dodd-Frank's resolution rules provide a one-plus day stay.

Second, and more importantly (given that the holding company itself is unlikely to have significant amounts of derivatives), the bankruptcy laws would need to invalidate so-called cross-default provisions—that is, provisions in contracts that have been entered into by the debtor's affiliates that make the debtor's bankruptcy a default under the affiliate contract. The invalidation of cross-defaults is somewhat trickier because a US law to this effect would bind US counterparties but not counterparties in another country such as the UK. This issue would need to be addressed either in the standard ISDA (International Swaps and Derivatives Association) contract or through a treaty or other arrangement with the United Kingdom. US and European regulators are at work on this issue as it applies to Dodd-Frank resolution.[46] Including bankruptcy in any solution

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44. For an excellent new analysis of the bankruptcy alternative, see Thomas H. Jackson, "Resolving Financial Institutions: A Proposed Bankruptcy Code Alternative," *Banking Perspective,* March 2014.

45. For much fuller discussions of these issues, see Skeel and Jackson, "Transaction Consistency"; and Darrell Duffie and David A. Skeel, "A Dialogue on the Costs and Benefits of Automatic Stays for Derivatives and Repurchase Agreements," University of Pennsylvania Institute for Law and Economic Research paper 12–02. See also Mark J. Roe, "The Derivatives Market's Payments Priorities as Financial Crisis Accelerator," *Stanford Law Review* 63 (2011): 539; and Stephen J. Lubben, "Repeal the Safe Harbors," *American Bankruptcy Institute Law Review* 18 (2010): 319.

46. The FDIC, the Bank of England, the German Federal Financial Supervisory Authority, and the Swiss Financial Market Supervisory Authority recently sent a letter to ISDA calling for ISDA to include a "short-term suspension of early termination rights" in its contracts. See FDIC Press Release, "Federal Deposit Insurance Corporation, Bank of England, German Federal Financial Supervisory Authority and Swiss Financial Market Supervisory Authority Call for Uniform Derivatives

that emerges would facilitate the use of quick sales in bankruptcy as an alternative to single point of entry under Title II.

The third adjustment that would be needed is a provision assuring that any licenses that are transferred in the initial sale would continue to be valid, so that the company did not risk a disruption in its ability to do business as a result of the sale.

This brings us to the two most difficult issues with achieving a quick sale in bankruptcy: the need for speed and the need for liquidity funding. Although bankruptcy courts routinely oversee prompt sales of debtors' assets under Section 363, the transfer of a systemically important financial institution's assets would need to be much faster than the ordinary thirty- or sixty-day auction period used in bankruptcy, given the fragility of bank assets and liabilities. Timing is less of an issue with single point of entry under Title II because, with the exception of an extremely limited, secret, initial hearing, the Dodd-Frank Act gives bank regulators discretion to transfer a financial institution's assets as quickly as they choose. Bankruptcy's rule-of-law protections make a quick sale more difficult. The most obvious solution to the timing issue is to provide for a much quicker sale than is usually the case, with notice given to regulators and a group of the largest creditors. Under one current proposal, the notice and sale would take place within twenty-four hours of the bankruptcy filing.[47]

The other major issue is funding. As discussed earlier, Title II makes huge amounts of funding available from the US Treasury for a Dodd-Frank resolution. Although the financing provisions of US bankruptcy law are extremely generous by international standards, they rely on financing by private lenders.[48] There are serious questions whether private

Contracts Language," November 5, 2013. Relatedly, the EU has included a provision in the final compromise language of its proposed Recovery and Resolution Directive that would override cross-default provisions in ISDA contracts with European counterparties. Council of the European Union, "Proposal for a Directive establishing a framework for the recovery and resolution of credit institutions and investment firms," December 18, 2013 (includes as Article 60a "Exclusion of certain contractual terms in early intervention and resolution").

47. The Hoover Institution working group that developed the proposed new Chapter 14 is currently developing a quick sale procedure along the lines discussed in this chapter. The quick sale provisions would be included as part of Chapter 14 or could be adopted separately. A stand-alone version of the quick sale procedure was introduced by Senators John Cornyn and Pat Toomey in December 2013 as S. 1861.

48. The rules for debtor-in-possession financing are set forth in 11 USC Sec. 364.

financing could be raised quickly enough in the midst of a systemically important financial institution's distress to satisfy its liquidity needs. Most commentators who have followed the bank resolution discussions believe that it could not be. Although I generally share this view, it may be useful to begin by considering some of the arguments in favor of private funding. Perhaps the most important is that the new entity created for the purposes of a quick sale will be extremely well-capitalized. It will have left its long-term debt behind, with the expectation that much or all of the debt will be converted into equity in the new entity. It is possible that this cleansing of its capital structure would enable the new entity to very quickly arrange funding from private lenders.[49]

It is also worth noting that, if there were a system-wide liquidity crisis affecting multiple financial institutions, the Federal Reserve might implement an emergency lending program under its section 13(3) powers, as revised by the Dodd-Frank Act. A new entity created for the purposes of a quick bankruptcy sale presumably would have access to this funding.

If one were to conclude that an additional form of funding is necessary due to the uncertainty of private-market funding, what form should that funding take? One obvious alternative would be to replicate the funding terms of Dodd-Frank. A troubled financial institution could be given access to Treasury funding in the same or similar amounts. The principal concern with this approach is that it seems to put too much funding at the new entity's disposal. In theory, this need not have distortive effects, but it is impossible to avoid the suspicion that it would. In my view, these concerns counsel in favor of a more carefully calibrated approach, such as limited access to the Federal Reserve's discount window. If the new entity were temporarily permitted to borrow on a fully collateralized basis, as ordinary banks do, the danger of excessively generous access to liquidity would be reduced.

One important benefit of a quick sale in bankruptcy, as compared to single point of entry under Dodd-Frank, is that the new entity would be outside of bankruptcy from the moment the sale was completed. Indeed, if lawmakers wished, they could move the process outside of bankruptcy altogether by enacting legislation authorizing a restructuring of the existing financial institution along the lines I have discussed, as a bail-in

49. It also would be possible to develop more ambitious forms of private funding, such as pre-committed lines of credit, or a public-private facility in which private loans were supported with government guarantees.

arrangement that did not require the pretense of a sale. Because the new entity would not be subject to bankruptcy, it would be subject to normal market forces from the beginning. Unlike with single point of entry under Dodd-Frank, regulators would not be in a position to prolong the period in which the institution is a ward of regulators. There would be no risk of an ongoing state of limbo, as has been the case with the government-sponsored enterprises Fannie Mae and Freddie Mac.

Conclusion

Single point of entry is one of the most important innovations to emerge in the implementation of the Dodd-Frank Act. In this chapter, I have described how single point of entry has addressed many of the issues that were raised by the Lehman case and which were curiously neglected by the Dodd-Frank Act itself. I have also pointed out that some of the claims surrounding single point of entry, such as the claim that it has eliminated the too-big-to-fail problem, are exaggerated. Even when coupled with the single-point-of-entry strategy, the Dodd-Frank Act does not prevent bailouts; and single point of entry is not a plausible strategy under all circumstances. It is unlikely to be attempted if more than one systemically important financial institution were to fall into financial distress, for instance, and may not work with an institution that has one or more significant and troubled foreign subsidiaries. Single point of entry is quite promising, but it is important to be realistic about its limitations.

The chapter concluded by discussing how a similar strategy could be achieved in bankruptcy. The bankruptcy alternative is subject to similar concerns as single point of entry and needs to address concerns about speed and access to liquidity. Addressing these concerns would further buttress bankruptcy as the resolution forum of choice in all but the most extreme cases of bank holding company and nonbank financial institution distress.