CHAPTER 16

We Need Chapter 14—*And* We Need Title II

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A number of thoughtful commentators have proposed that Congress amend the Bankruptcy Code to add a new chapter—generally referred to as Chapter 14—that would apply in the event of the failure of a systemically important financial institution (SIFI). Chapter 14 would remedy a number of perceived inadequacies in the current version of the Bankruptcy Code as it would apply to the failure of a SIFI, including speed of the process, role of the regulators, close-out of derivatives, and possibly liquidity facilities. Some of the proponents of a Chapter 14, or their allies in Congress, say that upon, or in connection with, the adoption of Chapter 14, the Orderly Liquidation Authority (OLA) of Title II of Dodd-Frank should be repealed. Improving the Bankruptcy Code with a new Chapter 14 is a good idea. Repealing Title II, whether or not Chapter 14 is enacted, is a bad idea.

It is worth starting with some basic principles. A sensible and effective resolution process for large financial institutions—in bankruptcy or otherwise—ought to include at least the following particularly important elements in order to prevent adverse systemic consequences and to end "too big to fail" (TBTF):

- Assuring that liquidity is available—and, if it comes from the public sector, assuring that it is fully secured and at a penalty rate. Note that fully secured liquidity is not the same as capital—capital, which can absorb losses, should come only from the private sector and is key to preventing contagion.
- Dealing with qualified financial contracts like derivatives.
- Making sure the authority responsible for overseeing the resolution proceedings has the expertise and resources to move quickly and fairly.
- Providing for the continuation of critical services for customers and clients so as to minimize the adverse impact of the failure on

the economy as a whole, consistent with the public interest and the legitimate interests of creditors.
- Making sure that losses are imposed on stockholders, creditors, and responsible management of the failed institution, and are not borne by taxpayers.

In most important respects, Title II addresses these issues, and it does so in a way that is consistent with the Financial Stability Board (FSB) Key Attributes, which is important for international credibility. These alone are pretty good reasons not to repeal Title II. So is the fact—as shown by the list of ways in which the proponents of Chapter 14 say it would improve the bankruptcy process—that a large part of what Chapter 14 would do is address these exact issues, often in ways that are similar to the ways that Title II addresses them.

But no matter what Chapter 14 eventually looks like, when and if enacted, it would be a bad idea to repeal Title II because Title II provides the government with a set of tools that may work better than bankruptcy in the next crisis.

What is particularly important about Title II in this regard is the Title II single point of entry (SPOE) approach developed by the Federal Deposit Insurance Corporation (FDIC). Under the SPOE approach, in the event of a SIFI failure, the operating subsidiaries of the institution—the bank, the broker-dealer, the insurance company, as the case may be—will remain open and operating, providing essential services to customers and clients and to the market as a whole. Meanwhile, the loss will be imposed, as it should be, on the stockholders and long-term unsecured creditors of the holding company and on responsible management. This is accomplished under the FDIC SPOE plan by having a holding company convert holding company advances to the subsidiary into equity or by "downstreaming" other holding company assets, thereby recapitalizing the subsidiary and keeping it solvent and operating, even though the holding company fails and is resolved through an FDIC-administered bridge holding company. While there is more to be done by the regulators to implement the SPOE plan—particularly, requiring holding companies to have sufficient loss-absorbing capital (equity and long-term unsecured debt) as well as assets that can recapitalize the bank and other operating subsidiaries in the event of failure, and issuing a clear "presumptive path" telling the market how the regulators expect to implement Title II—the basic plan is clear and it will work.

And, of critical importance, a Title II SPOE resolution will assure foreign governments that the operating subsidiaries of the failed SIFI, particularly the ones that are important to the economy of the host country, will remain open and provide services locally and internationally. With sufficient assurance, foreign governments will have no incentive to "ring-fence" or take other actions that would threaten global flows and world-wide economic activity. Given the uncertainty about what will work best in the circumstances we may face, it makes no sense to take away a very important tool like Title II—a tool that ends TBTF by making the shareholders and creditors of the failed institution bear the losses of the enterprise, assuring the dismissal of responsible management, and protecting taxpayers from any risk of loss.

An opponent of Title II might say that a properly drafted and comprehensive Chapter 14 could also result in the operating subsidiaries of the SIFI remaining open and operating. It is true that a single point of entry approach is not necessarily exclusive to Title II. It may well be possible to achieve a SPOE result, in whole or in part, for certain institutions, depending on their structure and financial condition, under existing Chapter 11 of the Bankruptcy Code and under Chapter 14, depending on what it ultimately contains.

But the fact that you could get to some form of SPOE through bankruptcy does not mean Title II is not needed. In fact, for various reasons, Title II is likely to work better than bankruptcy in certain circumstances.

Most importantly, under Title II foreign regulators can reach agreements with US regulators now, in advance of the next crisis, outlining how each will act if the cross-border resolution of a SIFI is required. The joint FDIC-Bank of England paper[1] issued in December 2012 was a step in this direction. And the FDIC announced in 2012 that it had entered into a bilateral resolution memorandum of understanding with at least four jurisdictions—including the United Kingdom—and had many others in discussion or planned.

It is obviously not feasible for the foreign regulators to develop these kinds of agreements with bankruptcy judges. Without at all suggesting that Chapter 11 and Chapter 14 are not useful tools or that suitable resolution plans cannot be developed under those provisions, one can

1. Federal Deposit Insurance Corporation and Bank of England, "Resolving Globally Active, Systemically Important, Financial Institutions," Joint White Paper, December 10, 2012.

easily imagine why a plan of action, constructed well before the crisis and agreed-upon by regulators who know and have worked with each other in the crisis management groups or otherwise, would facilitate the rapid cross-border resolution of a SIFI once a crisis hits in a way that cannot be replicated when the US decision-maker is an unknown bankruptcy judge.

Since Title II has these desirable characteristics, there would have to be extremely persuasive reasons to repeal it. The reasons in support of repeal are not, however, persuasive.

The most common arguments for the repeal of Title II are that it gives the regulators too much discretion; that it puts taxpayers at risk; and that its very existence has immediate adverse economic impacts. A full response is beyond the scope of this note, but a few quick points show that these arguments are unpersuasive.

The "too much discretion" argument focuses particularly on the contention that Title II provides insufficient clarity about the order of priority of claims because it allows the FDIC under certain circumstances to pay some creditors more than others, which, it is said, would not be permissible in bankruptcy. Putting aside whether this argument fairly describes the supposed clarity of the bankruptcy process, there are three responses:

- First, Dodd-Frank contains a "no worse off than under Chapter 7 of the Bankruptcy Code" provision to protect creditors, so no matter what the FDIC does, the bankruptcy rules provide a floor for all creditors.
- Second, the range of discretion that the FDIC would have in a Title II resolution is fundamentally the same as the range of discretion it has had for many years in resolving failed banks, without evidence of the kind of abuse imagined by opponents of Title II.
- Third, Title II can be used in place of bankruptcy only if resolution under the Bankruptcy Code would result in severe adverse effects on US financial stability. In other words, the FDIC gets to use its discretion only when the alternative would be worse for the country.

The argument that taxpayers are put at financial risk by Title II is based on the provision that allows the FDIC, with the approval of the secretary of the treasury, to draw on the orderly liquidation fund to provide interim liquidity to a holding company that the FDIC has taken over. But Title II requires that OLA advances be fully secured by a first priority lien on the assets of the failed institution; and if these prove to be insufficient to repay the government in full, Title II requires that any shortfall be paid by other large financial institutions. Dodd-Frank categorically provides that "taxpayers shall bear no losses from the exercise of any authority" granted by Title II. One would have to believe that the regulators and the Treasury Department would knowingly violate the express requirements of the law to believe that taxpayers will lose money if OLA is invoked. That is an unfair and unjustified insult to dedicated and hard-working government employees who are charged with administering Dodd-Frank.

The most important argument against Title II is that, despite what Title II was designed to do and what it says it does, Title II actually preserves "too big to fail." Because of Title II, the argument runs, creditors of large financial institutions do not believe they are at risk; instead, they believe they will be protected—"bailed out"—by the government in the event of a failure. Therefore, it is said, creditors do not provide market discipline for SIFIs, as shown by their willingness to lend to SIFIs at lower rates than they offer to smaller institutions.

The problem with this argument is that the facts undermine it. As the September 2013 Treasury paper[2] on the financial crisis shows, "senior unsecured borrowing costs for large bank holding companies have risen more than for small, regional bank holding companies." Specifically, Fifth Third, KeyCorp, PNC, and SunTrust all have lower spreads over Treasury yields than do Bank of America, Citigroup, Goldman, J.P. Morgan, and Morgan Stanley.

In addition, and just as telling, the Treasury paper shows that spreads vary widely among the largest six financial institutions. This is completely inconsistent with the notion that creditors of these institutions expect to be bailed out. If they did, all of the large institutions would have the same or very similar spreads, and they would be very small—neither of which is true post-Dodd-Frank. So there is ample evidence that long-term unsecured creditors of large bank holding companies understand they are at risk—and will not be bailed out by the government—in the event of a failure and the use of Title II.

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2. Anthony Reyes, "The Financial Crisis Five Years Later: Response, Reform, and Progress," US Department of the Treasury, September 2013.

The ratings agencies, always slow post-crisis to change their views, have caught up to the reality that holding company creditors are at risk under the FDIC's Title II SPOE plan. In mid-November 2013, Moody's eliminated the ratings "uplift" based on assumed government support for the eight large bank holding companies, noting that Title II SPOE "is designed to allow regulators to restore the solvency of a distressed entity without using public funds." Moody's went on (emphasis added), "As envisioned by US regulators, *the [SPOE] approach would impose losses on US bank holding company creditors* to recapitalize and preserve the operations of the group's systemically important subsidiaries in a stress scenario. As a result, *the holding company creditors are unlikely to receive government support, signaling a higher risk of default*."

And some key policymakers outside the United States understand the point. Paul Tucker of the Bank of England is reported to have said recently that US regulators are "basically equipped to resolve" US SIFIs and that a US government bailout would not be needed.

For all these reasons, which are summarized here only at a very high level, Title II is a useful and important tool. It is a tool which can only be invoked with approval of independent banking regulators and highest executive branch officials, and only if a financial institution's failure and resolution under the Bankruptcy Code would result in severe adverse effects on US financial stability. If Title II is invoked, US taxpayers will not bear the cost, which will be imposed, as it should be, on stockholders, creditors, and responsible senior management of the institution's holding company.

Improving the bankruptcy process for dealing with the failure of a large financial institution is highly desirable. Indeed, no set of institutions has a greater stake in making sure that the bankruptcy process works as effectively as possible for the failure of large financial institutions than large financial institutions themselves. The reason is simple. Large financial institutions are required by Title I of Dodd-Frank to submit resolution plans (living wills in common parlance). These plans must be based on the assumption that the Orderly Liquidation Authority granted to the FDIC by Title II of Dodd-Frank is not available and that the institution is resolved under the Bankruptcy Code. The more effectively the bankruptcy system can handle the failure of a SIFI, the more likely it is that that the living wills of SIFIs will be deemed satisfactory. And satisfactory resolution plans are plainly a good thing—good for the country, good for the regulators, and good for the institutions themselves. So improving the bankruptcy process through some form of Chapter 14 is a good idea.

But when and if Congress adopts a Chapter 14, it should reject any attempt to take Title II authority away from the regulators who may someday need it. The country needs to have more tools in the toolbox when a large financial institution fails, not fewer.