CHAPTER 13

Framing the TBTF Problem

The Path to a Solution

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This essay will first discuss the development, status, and momentum of the single-point-of-entry (SPOE) strategy for solving the "too-big-to-fail" (TBTF) problem.[1] It will then describe the resiliency of the SPOE strategy in the face of criticism of the strategy itself or the statute under which it is implemented. It will next describe the nature of the problem it is trying to solve and the key to a solution. Then it will describe the statute under which the strategy has been developed. It will then describe the basic elements of the SPOE strategy. Finally, it will discuss how the strategy can be implemented under the Bankruptcy Code and what amend-

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1. For a good description of the TBTF problem and why it arises, see "Too Big to Fail: The Path to a Solution," a report of the Failure Resolution Task Force of the Financial Regulatory Reform Initiative of the Bipartisan Policy Center, May 2013, pp. 18–20. Several people have questioned whether the TBTF problem is really only—or even primarily—a question of size, rather than some combination of size, complexity, interconnectedness, maturity mismatches between assets and liabilities, or some other factors that make it likely that the failure of one or more of a particular type of financial institution is likely to trigger the sort of contagious panic throughout the financial system that can destabilize or even bring down the financial system, at least under certain severely adverse economic conditions when some sort of unexpected common shock occurs. Being persuaded by the latter view, I tried to redefine the problem as the too-systemic-to-fail (TSTF) problem in a previous publication: Randall D. Guynn, "Are Bailouts Inevitable?" Yale Journal on Regulation 29, no. 2 (Winter 2012), pp. 121–22. That and similar efforts by others proved to be futile, and it is clear that the TBTF label is here to stay. As a result, I have used that more common term throughout this essay even though I do not believe size is the only—or even the predominant—factor defining the TBTF problem.

ments might be useful to make it more likely to be successful under the Bankruptcy Code under the broadest range of economic scenarios.

Development, status, and momentum of the SPOE strategy

The SPOE strategy has taken the world by storm as the most promising solution to the TBTF problem since the strategy was first publicly announced by then-acting FDIC Chairman Martin Gruenberg in May 2012.[2] The speed with which it has been endorsed—or at least acknowledged—as a promising solution to the TBTF problem by a wide range of key US regulators, financial industry groups, think tanks, rating agencies, and other stakeholders has been nothing short of phenomenal.[3] Federal Reserve Board governors and other senior Federal Reserve officials have endorsed or praised it as innovative, promising, or even a "visionary breakthrough idea";[4] former FDIC Chairman Sheila Bair has called it a "viable

2. Martin J. Gruenberg, acting chairman, FDIC, remarks to the Federal Reserve Bank of Chicago Bank Structure Conference, May 10, 2012.

3. In addition, Paul Tucker, then deputy governor for financial stability at the Bank of England and chairman of the Resolution Steering Committee of the Financial Stability Board, said, "US authorities have the technology—via Title II of Dodd-Frank" and the bank holding company structure to use the SPOE strategy to resolve a US G-SIB today. "I don't mean it would be completely smooth right now; it would be smoother in a year or so as more progress is made. But in extremis, it could be done now." Paul Tucker, "Solving too big to fail: where do things stand on resolution?" speech given at the Institute of International Finance 2013 annual membership meeting, Washington, D.C., October 12, 2013, p. 2.

4. Daniel K. Tarullo, member of the Board of Governors of the Federal Reserve System, "Toward Building a More Effective Resolution Regime: Progress and Challenges," remarks at the Federal Reserve Board and Federal Reserve Bank of Richmond Conference, "Planning for the Orderly Resolution of a Globally Systemically Important Bank," Washington, D.C.. October 18, 2013, p. 8 (SPOE offers the "best potential for the orderly resolution of a systemic financial firm under Title II"); testimony of Janet Yellen, *Hearing on the Nomination of Janet L. Yellen, of California, to be Chairman of the Board of Governors of the Federal Reserve System, before the Senate Committee on Banking, Housing, & Urban Affairs,* 113th Cong., November 14, 2013 (calling SPOE "very promising"); Jerome Powell, member of the Board of Governors of the Federal Reserve System, "Ending 'Too Big to Fail,'" remarks at the Institute of International Bankers 2013 Washington Conference, Washington, D.C., March 4, 2013, p. 6 (calling SPOE strategy an "innovative" mind changer, a "classic simplifier, making theoretically possible something that seemed impossibly complex"); William C. Dudley, president of the Federal Reserve Bank

strategy";[5] Moody's Investors Service cited it as the reason for eliminating "all uplift from US government support in the ratings for bank holding company [BHC] debt,"[6] which had previously existed for certain large US BHCs because Moody's had assumed they would be bailed out rather than being allowed to fail; various trade associations and think tanks have concluded that it would be a viable solution to the TBTF problem, if properly implemented;[7] University of Rochester Professor Thomas Jackson, one of the leading bankruptcy scholars in the country and the principal author of the original Chapter 14 proposal,[8] called the SPOE strategy a breakthrough and suggested how the proposed new Chapter 14 might be revised to facilitate the successful use of the SPOE strategy under the Bankruptcy Code;[9] and a bill that would enact a version of the proposed Chapter 14 to facilitate a SPOE strategy under the Bankruptcy Code has been proposed by senators John Cornyn (R-TX) and Pat Toomey (R-PA).[10]

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of New York, "Ending Too Big to Fail," Remarks at the Global Economic Policy Forum, New York City, November 7, 2013, p. 4 ("I very much endorse the FDIC's single point of entry framework for resolution. I think it is the best plan for implementing Title II . . ."); Thomas C. Baxter, executive vice president and general counsel of the Federal Reserve Bank of New York, "Resolving the Unresolvable: The Alternative Pathways to Ending Too Big to Fail," Remarks at the International Insolvency Institute, 13th Annual Conference, Columbia University Law School, New York City, June 17, 2013, p. 4 (calling SPOE a "visionary breakthrough idea").

5. Mike Konczal, "Sheila Bair: Dodd-Frank really did end taxpayer bailouts," *Washington Post,* May 18, 2013.

6. Moody's Investors Service, "Rating Action: Moody's concludes review of eight large US banks," November 14, 2013, p. 1.

7. See, e.g., The Clearing House, "Ending 'Too-Big-to-Fail': Title II of the Dodd-Frank Act and the Approach of 'Single Point of Entry' Private Sector Recapitalization of a Failed Financial Company," Banking Brief White Paper Series, January 2013; The Clearing House, "Report on the Orderly Liquidation Authority Resolution Symposium and Simulation," January 2013; Bipartisan Policy Center report, "Too Big to Fail," p. 2.

8. Thomas H. Jackson, "Bankruptcy Code Chapter 14: A Proposal," in *Bankruptcy Not Bailout: A Special Chapter 14,* eds. Kenneth E. Scott and John B. Taylor (Stanford: Hoover Institution Press, 2012), p. 14.

9. See Bipartisan Policy Center report, "Too Big to Fail." Jackson made the comment during the process of researching the BPC report, which he co-authored. See especially pp. 82–89. Among his many contributions to the BPC report were suggestions about how the original Chapter 14 proposal could be revised to facilitate a SPOE strategy under the Bankruptcy Code. See pp. 11–14.

10. Taxpayer Protection and Responsible Resolution Act of 2013, S. 1861, 113th Cong., 2013.

The speed with which SPOE has been accepted outside the United States has been no less astonishing. Shortly after the first public elaboration of the strategy by the Federal Deposit Insurance Corporation (FDIC), the Bank of England signaled its agreement.[11] Indeed, the Bank of England had already been discussing bail-in within resolution[12] as a possible solution to the TBTF problem. Those discussions had grown out of proposals to use contingent convertible securities, bail-in bonds, or even statutory bail-in as recovery tools to recapitalize a troubled firm before any insolvency or resolution proceedings need to be invoked.[13] The Bank

11. Martin J. Gruenberg, chairman of the FDIC, remarks at the Volcker Alliance Program, Washington, D.C., October 13, 2013, p. 9.

12. The Financial Stability Board subsequently defined "bail-in within resolution" as "restructuring mechanisms to recapitalise a firm in resolution or effectively capitalise a bridge institution, under specified conditions, through the write-down, conversion or exchange of debt instruments and other senior or subordinated unsecured liabilities of the firm in resolution into, or for, equity or other instruments in that firm, the parent company of that firm or a newly formed bridge institution, as appropriate to legal frameworks and market capacity." Financial Stability Board, "Thematic Review on Resolution Regimes," Peer Review Report, April 11, 2013, p. 2.

13. The most visible early advocates of bail-in as a recovery tool were Wilson Ervin, Credit Suisse special adviser to the chairman; Thomas F. Huertas, then UK Financial Services Authority director; and the Institute of International Finance (IIF). See, e.g., Wilson Ervin and Paul Calello, "From bail-out to bail-in," *The Economist,* January 28, 2010; Thomas F. Huertas, "The Road to Better Resolution: From Bail Out to Bail In," LSE Financial Markets Group Paper Series, Special Paper 195, December 2010; IIF, "Preserving value in failing firms," September 9, 2010. See also Lisa Curran and Jaap Willeumier, "Report of the International Bar Association in Connection with Legal Issues Arising in Relation to Proposals for Bank 'Bail-in' Measures," November 29, 2010, submitted on behalf of the Financial Crisis Task Force of the Legal Practice Division. The idea that bail-in could be used as a resolution strategy under Title II of Dodd-Frank was first publicly suggested by the author during the question and answer period after a debate ("Resolving large and complex financial institutions: Making it work," organized by the IIF and hosted by the Federal Reserve Bank of New York on January 31, 2011) as to whether bail-in, as a recovery tool, was a superior method of resolving failing firms than orderly liquidation proceedings under Title II of the Dodd-Frank Act. The idea had been jointly developed with Davis Polk bankruptcy partner Donald Bernstein and former FDIC general counsel John Douglas after a meeting with the U.S. Treasury on November 9, 2009 in which bail-in as a recovery tool had been discussed. See also "Are Bailouts Inevitable?" a debate between Paul Mahoney, dean of the University of Virginia School of Law, and

of England subsequently published a joint paper with the FDIC endorsing the SPOE strategy.[14] Paul Tucker, then deputy governor for financial stability at the Bank of England and chairman of the Resolution Steering Committee of the Financial Stability Board, co-authored an Op-Ed in the *Financial Times* with then-acting FDIC Chairman Martin Gruenberg on the promise of the SPOE strategy in providing a viable solution to the TBTF problem.[15] Germany and Switzerland subsequently endorsed the strategy as their preferred method of resolving systemically important

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Randall D. Guynn, head of the Financial Institutions Group, Davis Polk & Wardwell, February 28, 2011. The debate, on whether allowing large, complex financial firms to fail under the Bankruptcy Code in all circumstances (Mahoney) or invoking Title II of Dodd-Frank to resolve them using a bail-in-within-resolution strategy during financial emergencies (Guynn) was more likely to end bailouts, is available at http://www.youtube.com/watch?v=yiOvMR5rvMY. The bail-in-within-resolution idea germinated into a joint comment letter submitted to the FDIC on May 23, 2011, by the Securities Industry and Financial Markets Association (SIFMA) and The Clearing House Association (TCH), urging the FDIC to develop a recapitalization-within-resolution strategy for resolving firms under Title II of Dodd-Frank. The FDIC described the comment letter as "an example of the value generated by constructive dialogue between the private financial markets and the federal government on topics such as this one." See "Certain Orderly Liquidation Authority Provisions under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Final Rule)," 76 Fed. Reg. 41626, 41634–41635 (July 15, 2011). See also Financial Stability Board, "Key Attributes of Effective Resolution Regimes for Financial Institutions," October 2011 (endorsing "bail-in-within resolution" as a preferred resolution strategy). The FDIC developed the SPOE strategy in the process of adapting the recapitalization (bail-in) within resolution model to the U.S. bank holding company structure. James Wigand, director of the FDIC's Office of Complex Financial Institutions, first described it publicly in January 2012. "Resolution Strategy Overview," presentation of James Wigand, director of the Office of Complex Financial Institutions, to the FDIC's Systemic Resolution Advisory Committee (January 25, 2012). Gregory Baer of JPMorgan Chase (JPMC) subsequently illustrated the strategy using JPMC's balance sheet at December 31, 2012. Gregory Baer, managing director and general counsel for corporate law and global regulatory affairs, JP Morgan Chase & Co., "Orderly Liquidation of a Failed SIFI," presentation at the "Harvard Symposium on Building the Financial System of the 21st Century: An Agenda for Europe and the United States," March 24, 2012.

14. FDIC and Bank of England, "Resolving Globally Active, Systemically Important, Financial Institutions," joint paper, December 10, 2012.

15. Martin J. Gruenberg and Paul Tucker, "Global Banks Need Global Solutions When They Fail," Op-Ed, *Financial Times,* December 10, 2012.

banking groups with global operations (G-SIBs).[16] The UK government proposed legislation that would authorize the use of a SPOE strategy.[17] And the European Union added language in its proposed Bank Recovery and Resolution Directive (BRRD) authorizing resolution authorities at both the member state and union levels to resolve European banking and other financial organizations using the SPOE strategy.[18]

In short, in less than two years after the strategy was first announced by the FDIC, it has gained such wide acceptance and momentum, at least among government officials and other thought leaders throughout the United States and around the world, that it is fair to say that the SPOE strategy is the leading strategy for solving the TBTF problem for G-SIBs with centralized structures and a sufficient amount of combined capital, long-term unsecured debt, and other loss-absorbing resources at the top-tier parent.[19]

16. See, e.g., FINMA (Swiss Financial Market Supervisory Authority) Position Paper, "Resolution of Globally Systemically Important Banks," August 7, 2013; and Martin J. Gruenberg, remarks at the Volcker Alliance Program, pp. 9–10.

17. Financial Services (Banking Reform) Act 2013, Schedule 2, pp. 121–123 (adding a "bail-in" tool and amending the "bridge-bank" tool contained in the UK Banking Act 2009).

18. Council of the European Union, Proposal for a Directive of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms (final compromise text), document 17958/13, December 18, 2013; see also Freshfields Bruckhaus Deringer, "European Bank Recovery and Resolution Directive," January 2014.

19. It is generally acknowledged, however, that SPOE is not the best solution for all banking or other financial groups. A multiple-point-of-entry (MPOE) strategy may be more promising for G-SIBs with decentralized or "archipelago" structures where loss-absorbing resources are generally pre-positioned at operating subsidiaries instead of being concentrated at a top-tier parent company. See Institute of International Finance, "Making Resolution Robust—Completing the Legal and Institutional Frameworks for Effective Cross-Border Resolution of Financial Companies," June 2012, pp. 19, 54. Nor is it necessarily the most efficient strategy for resolving smaller US banking groups in which depository institution subsidiaries account for the vast majority of the group's assets, short-term deposits and other short-term liabilities account for the vast majority of liabilities, and cross-border operations are not material. More traditional strategies such as putting the depository institution subsidiaries into one or more FDIC receiverships under Section 11 of the Federal Deposit Insurance Act and selling their assets and liabilities to a healthy third party through a purchase and assumption agreement, with or without loss-sharing, or transferring their businesses to a bridge bank to be sold in pieces over time may be more efficient and just as effective.

Resiliency of the SPOE strategy

The SPOE strategy, or at least Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the law under which the strategy was developed, has not been without its detractors. For example, the Hoover Institution originally proposed a new Chapter 14 of the Bankruptcy Code as a substitute for Title II, not as a supplement to it.[20] The principal criticism against Title II was that it gave the FDIC too much discretion to resolve a systemically important financial institution (SIFI) without meaningful judicial review and was therefore unpredictable, inconsistent with traditional notions of due process and the rule of law, and possibly unconstitutional.[21] Others have warned that once the market understands that the long-term unsecured debt holders at the top-tier parent will bear the first losses of the group under a SPOE strategy after the group has suffered losses that render it critically undercapitalized or illiquid, investors will shift from holding long-term unsecured debt at the top-tier parent to holding short-term unsecured debt at the operating subsidiary level.[22] Still others have argued that the orderly liquidation fund (OLF), which Title II permits the FDIC to use to provide liquidity to a bridge financial company, is a form of taxpayer-funded bailout.[23] Finally, others have suggested that the FDIC's SPOE strategy may be inconsistent with its statutory duty to liquidate a financial company that is put into a Title II receivership[24] because the strategy is more like a corporate reorganization that preserves the going concern value of the group's operating subsidiaries than a traditional liquidation as contemplated by the statute.[25]

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20. Kenneth E. Scott, "A Guide to Resolution of Failed Financial Institutions: Dodd-Frank Title II and Proposed Chapter 14," in *Bankruptcy Not Bailout*.

21. See, e.g., Kenneth E. Scott, "Dodd-Frank: Resolution or Expropriation?" in *Bankruptcy Not Bailout;* and David A. Skeel Jr., *The New Financial Deal: Understanding the Dodd-Frank Act and its (Unintended) Consequences* (Hoboken, NJ: John Wiley & Sons, 2011).

22. Tarullo, "Toward Building a More Effective Resolution Regime," pp. 11–12.

23. Peter J. Wallison, "Too big to ignore: The future of bailouts and Dodd-Frank after the 2012 election," American Enterprise Institute, October 24, 2012, pp. 3–4.

24. Dodd-Frank Act, Sect. 214(a).

25. See, e.g., comments of Paul Volcker and Simon Johnson at the FDIC's meeting on December 11, 2013, with its Systemic Resolution Advisory Committee, https://fdic.primetime.mediaplatform.com/#/channel/1384300429544/Advisory+Committee+on+Systemic+Resolution

Rather than defeat SPOE, these criticisms have tended to reveal the fundamental resiliency of the strategy by showing how easy it is to make refinements to address these criticisms. For example, in order to address the criticism that Title II provides the FDIC with too much discretion and is therefore unpredictable and inconsistent with the rule of law, the Bipartisan Policy Center (BPC) report urged the FDIC to "announce a strong presumption in favor of using SPOE recapitalization to resolve all G-SIFIs."[26] The FDIC subsequently issued a proposed notice that went a long way toward making such a public statement,[27] although it did not include as strong a public commitment to use its SPOE strategy as would be necessary to entirely address these predictability and rule-of-law concerns. The fundamental point, however, is that these concerns could be fully addressed with a strong enough public commitment, such as in a statement of policy or regulation or by a statutory mandate.

In response to the criticism that the FDIC's discretion to discriminate among similarly situated creditors under Title II could result in a subsidy of favored creditors by disfavored creditors if the differential treatment is unexpected because the market will misprice the risk,[28] the BPC report recommended that the FDIC "confirm that it will not use its general discretion to discriminate among similarly situated creditors."[29] Such discretion is not needed for financial stability reasons in a SPOE resolution of a US G-SIB. The only legitimate reason for using that discretion for financial stability reasons would be to favor short-term unsecured debt over long-term unsecured debt to deter runs by the holders of short-term debt, since contagious runs can destabilize the financial system. But US

26. BPC report, "Too Big to Fail," p. 8.

27. "Notice and Request for Comments, Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy," 78 Fed. Reg. 76614 (Dec. 18, 2013) (SPOE notice).

28. Professor Scott had rightly defined such an unexpected transfer of wealth as a bailout of the favored creditors by the disfavored creditors. See Scott, "A Guide to Resolution," *Bankruptcy Not Bailout,* pp. 9–10.

29. BPC report, "Too Big to Fail," p. 8. The BPC report probably should have included an exception for differential treatment that would maximize the recovery of all creditors, such as the differential treatment in favor of critical vendors permitted under the Bankruptcy Code. See Douglas G. Baird, *The Elements of Bankruptcy, 5th ed.* (New York: Foundation Press, 2010), pp. 225–26, in which he describes the availability under Chapter 11 of so-called critical vendor orders and other immediate payments to certain unsecured creditors where such payments are "in the interests of the estate as a whole."

G-SIBs typically have substantial amounts of long-term unsecured debt at the top-tier parent levels and almost no short-term unsecured debt at those levels; virtually all of their short-term unsecured debt is located at the operating subsidiary level. Because parent unsecured debt is structurally subordinate to unsecured debt at the operating subsidiary level, the long-term unsecured debt at the parent level is already subordinate to the short-term unsecured debt at the operating subsidiary level, so there is no reason for the FDIC to preserve any of its disparate treatment discretion. Moreover, if the long-term unsecured debt that will be used to absorb first losses is structurally subordinate to the short-term debt at the operating subsidiary level, the market will price the two types of debt efficiently and eliminate any subsidy that might otherwise arise.

The FDIC confirmed in its proposed notice that it has severely limited its own discretion to discriminate among similarly situated creditors,[30] although it did not make the sort of categorical limitation as would be necessary to entirely address this subsidy risk. The fundamental point, however, is that this subsidy risk could be fully addressed with a strong enough limitation on this power, such as in a statement of policy or regulation or by statutory amendment.

The concern that a SPOE strategy would create an incentive for investors to shift out of long-term unsecured debt at the parent level and into short-term unsecured debt at the subsidiary level is addressed in two ways. First, if this dynamic started to occur, the price (rate) the parent would have to pay to investors for long-term unsecured debt would rise, making it relatively more attractive to investors. At the same time, the price (rate) the subsidiaries would be required to pay to investors for short-term unsecured debt would drop, making it relatively less attractive to investors. Presumably, the market would settle upon an efficient risk-adjusted price for the long-term unsecured debt at the parent level and an efficient risk-adjusted price for the short-term debt at the subsidiary level. This market dynamic would reduce much of the incentive for investors to shift out of long-term unsecured debt at the parent level and into short-term debt at the subsidiary level. The same analysis would apply to long-term unsecured debt at both levels.

Second, just in case the market does not result in enough long-term unsecured debt at the parent level, the Federal Reserve has indicated that it intends to issue a regulation requiring US G-SIBs to maintain enough

30. 78 Fed. Reg. 76622.

combined equity, long-term unsecured debt, and other loss-absorbing resources to ensure that the SPOE strategy would be feasible under severely adverse economic circumstances.[31] This regulatory mandate will obligate US G-SIBs to raise additional long-term unsecured debt at the top-tier parent level if investors shifted too much unsecured debt from the parent to its operating subsidiaries.

In response to the argument that the OLF is a form of bailout if it is used to provide capital or other financial assistance to the bridge financial company, the FDIC has responded by publicly stating that it will only use the OLF to provide liquidity to a bridge financial company on a fully secured basis. It has also stated that it will never use the OLF to provide capital to a covered company in receivership or a bridge financial company. The BPC report recommended that the FDIC go a step further and confirm that it will only use the OLF to provide liquidity to a bridge financial company in a manner that complies with the classic principles for central bank lender-of-last-resort facilities—that the liquidity would only be available to bridge financial companies and operating subsidiaries that are both solvent and sufficiently capitalized, on a fully secured basis at above-market rates.[32] The BPC report argued that if the OLF is only used to provide temporary fully secured liquidity in accordance with these classic principles, it would not amount to a bailout because taxpayers would not face any material prospect of losses and would be fully compensated for any risk assumed.[33]

Finally, the argument that the FDIC's SPOE strategy is inconsistent with its statutory duty to liquidate any US G-SIB put into a Title II receivership—because it is more like a value-maximizing reorganization under the Bankruptcy Code than a traditional liquidation as contemplated by the statute—is incorrect. The duty to liquidate does not imply a duty to minimize value. Indeed, Title II imposes a statutory duty on the FDIC to carry out a Title II receivership in a manner that maximizes the return on the covered company's assets and minimizes its losses.[34] It is also required to minimize moral hazard and mitigate any risk to financial stability.[35]

31. Tarullo, "Toward Building a More Effective Resolution Regime," pp. 11–12.

32. BPC report, "Too Big to Fail," p. 9. See also Walter Bagehot, *Lombard Street: A Description of the Money Market* (London: Henry S. King & Co., 1873), establishing classic central bank lender-of-last-resort principles.

33. Ibid., p. 32.

34. Dodd-Frank, Sect. 210(a)(9)(E).

35. Ibid., Sect. 204(a)

Moreover, the duty to liquidate only applies to the financial company that is actually put into a Title II receivership.[36] Under the SPOE strategy, only the parent would be put into such a receivership. There is nothing in the letter or spirit of Title II that requires a US G-SIB's operating subsidiaries to be put into a Title II receivership if the parent is put into such a receivership. As a result, the FDIC's SPOE strategy is clearly consistent with its duties to liquidate the covered company, maximize the value of the covered company's assets, minimize its losses, minimize moral hazard, and mitigate any risk to financial stability.

Nature of the TBTF problem

What is the TBTF problem?

The TBTF problem is essentially the Hobson's choice between a taxpayer-funded bailout, on the one hand, and the destabilization or collapse of the financial system, on the other. It arises when the failure of one or more financial institutions creates a contagious panic characterized by fire-sale liquidations and value-destroying reorganizations that can severely destabilize or even cause a collapse of the financial system.[37] All indications from history suggest that when public policymakers, and even the public, are faced with the choice between bailout and collapse or destabilization, they typically choose bailouts rather than risk a collapse of the system.

Why does it arise?

The TBTF problem arises because banks and other non-bank financial institutions engage in the socially useful activity of maturity transformation—the process by which financial institutions fund themselves with short-term borrowing and use those funds to make loans or investments in other illiquid assets. Engaging in maturity transformation renders financial institutions vulnerable to liquidity runs during a financial crisis. If concern about the solvency or liquidity of one of these institutions forces it to sell its illiquid (but valuable) assets at fire-sale prices, that concern can turn into a contagious panic throughout the financial system that causes otherwise solvent financial institutions to become insolvent. It could be said that the TBTF problem would be resolved by doing away with maturity transformation. Most people, however, believe that maturity

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36. Dodd-Frank, Sect. 214(a).
37. BPC Report, "Too Big to Fail," pp. 18–19.

transformation is a valuable social good—having money and credit from banks is a positive thing. Without maturity transformation the modern economy would grind to a halt. The question is really not whether to ban maturity transformation or to allow it without any limitations, but rather what the right balance is in terms of capital and liquidity requirements on the maturity transformation process.[38]

Key to a solution

The key to solving the TBTF problem without taxpayer-funded bailouts is a high-speed recapitalization of the failed financial group that imposes losses on shareholders and other stakeholders but avoids unnecessary value destruction and preserves the group's going-concern value.[39]

This sort of strategy needs certain characteristics. It has to be predictable and viable, so that the market will know how to price the risks. There must be a sharp distinction between capital and liquidity. Losses should be borne by the holders of capital structure liabilities—the equity holders, the long-term debt holders—not avoided by taxpayer or public injections of capital. The group needs to have enough loss-absorbing resources—including long-term debt on the right side of the parent's balance sheet and enough assets on the left side of its balance sheet—to recapitalize subsidiaries to the extent necessary. Long-term debt must be legally or structurally subordinate to short-term debt, which is vulnerable to runs in a financial crisis. This subordination must be clear in advance of a crisis. Finally, the recapitalized business must have access to a temporary secured liquidity facility from the public or private sector that is sufficiently large to make the process work.[40]

Orderly Liquidation Authority of Title II of Dodd-Frank

The Orderly Liquidation Authority (OLA) established under Title II of the Dodd-Frank Act was designed to provide an *ex post* solution to the TBTF problem if *ex ante* requirements like enhanced capital, liquidity, and other enhanced prudential regulations did not prevent failure. The best way of looking at Title II is as a last-resort option for reorganizing, liquidating, or otherwise resolving (to use the FDIC's terminology)

38. BPC Report, pp. 16–18.
39. Ibid., p. 3.
40. Ibid., pp. 3–4.

a SIFI without destabilizing the financial system and without resorting to a taxpayer-funded bailout. OLA was designed to supplement the Bankruptcy Code, which remains the preferred law to govern most financial institution insolvencies or failures. OLA remains a last-resort option because its administrative system is considered less transparent, more discretionary, and less well-understood than the judicially administered bankruptcy process.

It is very important to recognize that Title II is not available for use unless certain determinations are made. The two most important ones are, first, that procedures under the Bankruptcy Code would be unable to reorganize, recapitalize, liquidate, or otherwise resolve the SIFI without destabilizing the financial system or resorting to a taxpayer funded bailout; and, second, that OLA would more successfully achieve that goal.[41] If either of those conditions is not satisfied, OLA cannot be legally invoked.

OLA was modeled on the bank insolvency provisions of the Federal Deposit Insurance Act,[42] but it was actually harmonized in many respects with the rules that define creditors' rights in the Bankruptcy Code. Such harmonization is necessary because a holding company would be resolved under either the Bankruptcy Code or the OLA, and it would be highly undesirable to suddenly change any material rules that define creditors' rights upon making a determination that OLA would be used.

OLA can only be legally invoked if an institution is found to be a "financial company"[43] and certain financial distress findings are made. One key finding relates to whether the financial institution is in default or in danger of default. This can be based on a finding either that an institution is balance-sheet insolvent or that it is facing a liquidity run, such

41. Dodd-Frank Act, Sect. 203(b)(2), (5).

42. The bank insolvency provisions are principally contained in Sections 11 and 13 of the Federal Deposit Insurance Act.

43. It is important to note that OLA can be invoked for *any* financial company that is not a bank or other excluded company if the financial distress and other conditions are satisfied. OLA is *not* limited to bank holding companies with assets of $50 billion or greater or non-bank financial companies that have been designated as systemically important or subject to the enhanced prudential supervision of the Federal Reserve. Thus, for example, it could be invoked for bank holding companies with less than $50 billion in assets if their resolution under the Bankruptcy Code would result in serious adverse effects to financial stability such as if several of them failed at the same time. That being said, the conditions for legally invoking OLA are most likely to be satisfied only with respect to systemically important financial groups under the most extreme economic conditions.

that it is unable or unlikely to pay debts as they come due in the ordinary course of business.[44]

Two other key findings, discussed above, are that reorganization or liquidation of the company under the Bankruptcy Code would result in serious adverse effects on financial stability in the United States—whether alone or with other financial companies that fail at the same time—and that the use of OLA would avoid or mitigate those effects.

In addition, OLA can be invoked through the use of the so-called three keys process. The treasury secretary, in consultation with the president, must make the financial distress findings listed above (danger of default, serious adverse effects on the financial stability of the United States, and an avoidance or mitigation effect of using OLA). Action must then be recommended by two-thirds of the FDIC Board of Directors and two-thirds of the Federal Reserve Board. For broker-dealers, the approval requirement is two-thirds of the Securities and Exchange Commission and two-thirds of the Federal Reserve Board, with the consultation of the FDIC. For insurance companies, the director of the Federal Insurance Office and two-thirds of the Federal Reserve Board must agree to invoke OLA, with the consultation of the FDIC.

These determinations are subject to judicial review only of the "default" and "financial company" determinations. This judicial review will be triggered only if the board of directors of the company refuses to consent to the FDIC's receivership. If there is no consent, confidential court review takes place within twenty-four hours and applies an arbitrary and capricious standard of review to the two determinations. The board is insulated from liability for consenting.[45]

Special rules apply under OLA for broker-dealers and for insurance companies. For broker-dealers, Securities Investor Protection Act-like provisions apply for the protection of customer securities.[46] For insurance companies, state insurance law insolvency codes apply in place of the substantive provisions of OLA.[47] The FDIC may only be appointed receiver if the state insurance commissioner refuses to take action. Problems may arise in application of these insurance rules because state insurance insolvency codes are typically not very comprehensive—many

44. Dodd-Frank Act, Sect. 203(b)(1), (c)(4).
45. Ibid., Sect. 202(a)(1)(A), (e).
46. Ibid., Sect. 205.
47. Ibid., Sect. 203(e).

are not much more than general grants of discretion to state insurance commissioners. Since the FDIC is directed to apply those rules in receivership of an insurance company, it could have even more open-ended discretion to resolve insurance companies than other non-bank financial companies.

SPOE Strategy

G-SIFIs (including G-SIBs) are often discussed as if they are legal entities or institutions. Instead, they are legal groups. The classic structure of a US G-SIB is a holding company at the top, a bank subsidiary, a broker-dealer, perhaps a foreign broker-dealer, and a series of other foreign and domestic operations.

Under SPOE, after being appointed as receiver, the FDIC transfers all the assets of the failed financial company in receivership, including its operating subsidiaries, to a newly formed bridge financial company. The FDIC leaves the failed company's equity and long-term debt behind in the receivership, resulting in the business transferred to the bridge being recapitalized.

The company then uses assets available at the bridge financial company level, including the forgiveness or contribution of intercompany receivables, to recapitalize the operating subsidiaries and keep them out of insolvency proceedings. The claimants left behind in the receivership are entitled to the residual value of the bridge financial company and any assets left behind in the receivership, to be distributed to them in satisfaction of their claims in accordance with the priority of their claims.

In the final step, the old bridge company becomes a new financial holding company, fully in the private sector. It no longer has access to the OLF secured liquidity, but instead receives liquidity exclusively from the private sector. The BPC report contains a graphical step-by-step description of the SPOE strategy.[48]

The overarching benefit of the SPOE method is that only the holding company is put into a receivership and the operating subsidiaries remain going concerns. This is important for several reasons. If the SIFI in question has cross-border operations, including foreign branches, the transfer of any assets of the branches is generally unenforceable or prohibited

48. BPC report, "Too Big to Fail," pp. 23–31.

without the consent of foreign counterparties, foreign regulators, or foreign courts. SPOE avoids the need for those consents. SPOE reduces or eliminates the incentive to ring-fence foreign operations and reduces the need to rely on cooperation from foreign authorities.

Another benefit is that, by taking advantage of the structural subordination of long-term unsecured debt (most of which is held by US financial groups at the parent holding company level) to short-term unsecured debt and derivatives contracts (most of which is held at the operating subsidiary level), the SPOE strategy reduces or eliminates the incentive of short-term creditors to run and the right of derivatives counterparties to terminate. This in turn reduces or eliminates the likelihood of contagious panic throughout the financial system. The statute overrides cross-defaults based on the failure of the parent company in financial contracts at the operating subsidiary level, except for foreign contracts that are outside the territorial reach of the statute.

Meanwhile, the OLF ensures that the bridge financial company will have access to sufficient secured liquidity to preserve going-concern value and prevent value destruction of valuable but illiquid assets.

SPOE strategy and the Bankruptcy Code

Prerequisites

Whether it is possible to execute a SPOE recapitalization under the Bankruptcy Code was once an open question. It is now understood to be possible. Such a recapitalization would require the same prerequisites as under OLA: sufficient loss-absorbing resources at the parent company level in the form of equity, long-term unsecured debt, and assets available to recapitalize operating subsidiaries, and structural subordination of long-term debt at the parent level to short-term debt at the operating subsidiary level. It also requires a few extra prerequisites. For instance, a shell company may need to be established in advance to serve as the bridge financial company. Bankruptcy judges may need to be educated about this in advance, so that no difficulties arise in the execution of the strategy.[49] A new Chapter 14 of the Bankruptcy Code, which could clarify these issues, would be a valuable addition to the statute.

49. The living will process under Title I of Dodd-Frank is designed to, among other things, have contingency plans to identify and begin to implement items such as this.

Mechanics

After filing for bankruptcy, the debtor transfers all of its assets, including its operating subsidiaries, to a debt-free bridge financial company under Section 363 of the Bankruptcy Code, to be held by a private trustee for the benefit of the bankruptcy estate. The bankruptcy court should be willing to approve this transfer because the assets are not being transferred away from the bankruptcy estate, but instead are held for its benefit.

The debtor leaves its equity and long-term debt behind in its bankruptcy estate, resulting in the business transferred to the bridge being recapitalized. Assets available at the parent or bridge financial company level, including intercompany receivables, are used to recapitalize the operating subsidiaries and keep them out of insolvency proceedings.

The claimants left behind in the bankruptcy estate are entitled to the residual value of the bridge financial company and any assets left behind in the bankruptcy estate, to be distributed to them in satisfaction of their claims in accordance with the priority of their claims.

Key benefits

By keeping the operating subsidiaries out of insolvency proceedings, the SPOE strategy avoids the most significant impediments that otherwise apply to the resolution of a SIFI with cross-border operations. It reduces or eliminates the incentive to ring-fence foreign operations and reduces the need to rely on cooperation from foreign authorities.

By taking advantage of the structural subordination of long-term unsecured debt (most of which is held by US financial groups at the parent holding company level) to short-term unsecured debt (most of which is held at the operating subsidiary level), the SPOE strategy reduces the incentive of short-term creditors to run and cause contagious panic throughout the financial system.

Missing benefits

The major drawback to SPOE under the Bankruptcy Code, as opposed to under OLA, is that there is no provision analogous to the OLF that ensures that the bridge financial company would have access to sufficient liquidity, even on a fully secured basis, to preserve going-concern value and prevent value destruction of valuable but illiquid assets. In the severely adverse scenario under which SPOE recapitalization is likely, private sector DIP (debtor-in-possession) financing may not be available to the parent company or its non-bank subsidiaries in sufficient amounts.

Unless the relevant SIFIs have access to sufficient liquidity resources in addition to loss-absorbing resources, this would leave few clear sources of liquidity. The Fed's discount window can provide secured liquidity to the subsidiary bank, but Section 23A of the Federal Reserve Act limits the bank's ability to provide secured liquidity to non-bank affiliates. Section 13(3) of the Federal Reserve Act could be invoked to provide such liquidity in extreme circumstances. But such liquidity must be part of a program or facility with broad-based eligibility, which creates uncertainty as to its use.

Another issue is that the Bankruptcy Code does not have a provision analogous to OLA's provision that overrides cross-defaults in financial contracts at the operating subsidiary level based on the failure of the parent company.

If Congress and the public find that using the Bankruptcy Code would be superior to Title II (because it is rule-based, better-understood, more transparent, and more predictable), then finding some way to provide a secure liquidity facility to facilitate a SPOE recapitalization under bankruptcy would make the Bankruptcy Code more effective and useful in a greater range of circumstances.

Proposal for secured liquidity provision under Chapter 14

A new Chapter 14 would be more effective in limiting the need for OLA under severely adverse economic circumstances when ordinary financial markets break down if it contained a provision that authorized the Federal Reserve to provide secured liquidity to a bridge financial company. This would be a genuine liquidity facility, and not a bailout, if three conditions were met:

- The liquidity would only be available if the bridge financial company and its operating subsidiaries were well capitalized because of an effective SPOE recapitalization.
- The liquidity is fully secured.
- The liquidity is provided at above-market rates.[50]

A bridge holding company and its operating subsidiaries that are fully recapitalized should be able to pledge or sell, subject to a repurchase agreement, illiquid assets to the private sector if three conditions are satisfied:

50. Bagehot, *Lombard Street*.

(1) the private sector is confident that they are sufficiently recapitalized; (2) ordinary financial markets are not dysfunctional; and (3) private sector institutions are not prohibited from providing the necessary amount of secured liquidity by the proposed new limits on counterparty credit exposures.

But sufficient private sector liquidity may not be available if any of these conditions are not satisfied, especially if the market is dysfunctional. Therefore, unless the relevant SIFIs have access to sufficient liquidity resources, the only reliable source of secured liquidity under those circumstances may be the government—likely the Federal Reserve Board.

If sufficient secured liquidity is not available, even a well-capitalized bridge financial company will be forced to sell illiquid assets at fire-sale prices, causing it to become insolvent. These fire sales are likely to be contagious throughout the system to other financial institutions engaged in maturity transformation, thereby threatening a collapse of the system. This would mean Chapter 14 would not be a useful alternative to bailouts in severely adverse economic scenarios when ordinary financial markets are dysfunctional. If OLA is not repealed, this state of affairs will justify invoking Title II to give access to the OLF; if OLA *is* repealed, the lack of secured liquidity under the Bankruptcy Code could result in irresistible pressure for capital injections—bailouts—to prevent the financial system from collapsing.

Several objections have been leveled against such a secured liquidity provision. First, although the vast majority of people who have considered whether a government-provided secured liquidity facilities are a form of bailout have concluded that they are not,[51] at least one commentator has argued that they are simply another form of bailout.[52] From this perspective, enacting the secured liquidity provision would be authorizing one type of bailout to avoid another, and the only real solution is to completely eliminate the availability of government assistance.

A more political objection is that, if such a liquidity source were included in Chapter 14, it would undermine the narrative that Title II and OLF are really just institutionalized government bailouts; a secured

51. See, e.g., Joint Economic Committee of the Senate and House of Representatives, "Lender of Last Resort in the Modern Financial System," November 29, 2012; BPC Report, "Too Big to Fail," pp. 46–53.

52. Stephen J. Lubben, "Why Federal Reserve Support is Really a Bailout," *New York Times,* December 9, 2013.

liquidity provision under Chapter 14 would serve a similar role to the OLF under OLA.

Finally, it could be argued that the Federal Reserve is justified to provide discount window secured liquidity to insured banks and the uninsured branches of foreign banks but not to uninsured but recapitalized bridge financial companies or to their uninsured non-bank operating facilities, such as broker-dealers, that are also engaged in maturity transformation.

I agree with those who argue that a government-provided secured liquidity facility that satisfies Bagehot's classic conditions—borrower must be solvent, the liquidity must be fully secured, and the credit must be provided at above-market interest rates—is not a form of bailout.[53] Such facilities protect governments against loss and compensate them for the risks they take. It is noteworthy that such reliable free-market economists as Milton Friedman have never considered the Federal Reserve's discount window to be a form of bailout or to be inconsistent with free market principles or the goals of minimizing moral hazard and maximizing market discipline. This is because the discount window is only available when the free market is dysfunctional. The borrower must be solvent and liquidity must be fully secured and priced at an above-market rate. A bailout involves capital injections or loss- or uncompensated risk-shifting from private sector to government; if the discount window conditions are satisfied, there is no loss- or uncompensated risk-shifting to the government.

A secured liquidity provision in Chapter 14 of the sort recommended by the BPC would be subject to the same conditions as the current discount window.[54] All losses would be borne by the group's shareholders and debt holders, with no material risk of loss to the Federal Reserve if it sets proper haircuts for collateral, and the Federal Reserve would be compensated for the risk it would take.

If such a secure liquidity facility is not available and a SPOE recapitalization under the Bankruptcy Code takes place, even a well-capitalized bridge financial company may be forced to sell illiquid assets at fire sale prices, causing it to become insolvent, unless it otherwise has access to sufficient liquidity. This would mean that a Bankruptcy Code SPOE would not be a useful alternative to either bailout or a potential destabilization or collapse of the financial system. If that were the case, then the TBTF problem will not have been solved—at least not with the Bankruptcy

53. See, e.g., Joint Economic Committee, "Lender of Last Resort."

54. BPC Report, "Too Big to Fail," p. 12.

Code. This would just lead to Title II being invoked in a greater number of circumstances.

Bankruptcy Code and Title II

The Bankruptcy Code and Title II should coexist. The Bankruptcy Code should be made as effective as it possibly can be in order to reduce the need to use Title II to the smallest possible number of circumstances. But Title II must be preserved for those extreme circumstances where the discretion afforded by its administrative process, and the secured liquidity available through the OLF, are absolutely needed.

Conclusion

In conclusion, the FDIC's SPOE strategy has taken the world by storm. It is now widely considered to be the dominant strategy for solving the TBTF problem for G-SIBs with centralized structures, like US bank holding company groups. The TBTF problem arises primarily because large, interconnected banking groups are engaged in the socially beneficial activity of maturity transformation. The key to a solution to the TBTF problem without taxpayer-funded bailouts is a high-speed recapitalization of the failed financial group that maximizes value. OLA can be invoked only if the resolution of a particular financial company under the Bankruptcy Code would result in severe adverse effects to financial stability in the United States and if OLA would avoid or mitigate those adverse effects. The SPOE strategy would avoid or mitigate such effects if they arise. The SPOE strategy can be implemented under the existing Bankruptcy Code, although a new Chapter 14 could increase the likelihood of its success, particularly if it were coupled with a secured liquidity facility from the government that would be able to provide such liquidity under the most severe economic conditions.