AFR Americans for Financial Reform

November 13, 2018

Dear Senator,

On behalf of Americans for Financial Reform (AFR), we are writing to express our opposition to HR 1667, the "Financial Institution Bankruptcy Act" (FIBA).[1] We strongly support the Judiciary Committee's efforts to look into the issues surrounding the bankruptcy of Lehman Brothers and the potential failure of large financial institutions in the future. But we are concerned that legislation such as FIBA, while purporting to reduce the economic fallout from the bankruptcy of a giant financial institution, may actually give special benefits to large financial institutions and encourage the continuation of "too big to fail". FIBA and similar bills also do not address some of the key issues that made the bankruptcy of Lehman Brothers so protracted and disruptive.

The failure of Lehman Brothers contains many lessons for the future. These include the importance of careful pre-planning for bankruptcy, the need for aggressive supervision focused on reducing the internal complexity of major banks to ensure that their organization and practices do not create a barrier to orderly resolution, and the dangers to financial stability of the existing broad bankruptcy exemptions for complex financial products such as over-the-counter derivatives and certain forms of securitized lending,[2]

Another lesson from the aftermath of the Lehman bankruptcy was the importance of long term accountability for high-level executives in a failed financial firm. A Harvard study conducted after the failure of Bear Stearns and Lehman found that the five executives in these failed companies extracted some $2.4 billion bonus payments during the 2000-2008 period. None of this money was clawed back or returned to creditors.[3]

Some of these lessons were incorporated in the Dodd-Frank Act and some were not. For example, the Dodd-Frank Act makes no progress on reform of bankruptcy exemptions for complex financial products. However, it contains several very valuable provisions to better handle the future failure resolution of a major financial institution.

Title I of the Dodd-Frank Act requires that large banks produce detailed plans for their potential failure and resolution, and that regulators certify such plans would realistically permit the bank to go through a bankruptcy procedure under the Bankruptcy Code without creating significant economic disruption. Critically, if regulators find that the resolution plan is not realistic or credible, they are required to restructure or break up the bank. This resolution planning process has been used as leverage for requiring enhanced risk controls and some internal restructuring of large banking organizations. Given that Congress mandated that banks be restructured if needed

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[1] We understand that a new draft of the FIBA legislation may be circulated at today's Committee hearing. Since that draft has not yet been circulated, we focus here on HR 1667 which is the last publicly available version of the bill.
[2] Fleming, Michael J. and Sarkar, Asani, "The Failure Resolution of Lehman Brothers", Federal Reserve Bank of New York, Volume 20, Number 2, December, 2014. https://www.newyorkfed.org/research/epr/2014/1412flem.html; Roe, Mark J. and Adams, Stephen "Restructuring Failed Financial Firms in Bankruptcy: Selling Lehman's Derivatives Portfolio",Yale Journal on Regulation, Vol. 32, pp. 363-411, 2015. https://ssrn.com/abstract=2512490
[3] Bebchuk, Lucian A. and Cohen, Alma and Spamann, Holger, "The Wages of Failure: Executive Compensation at Bear Stearns and Lehman 2000-2008", Yale Journal on Regulation, Vol. 27, 2010, pp. 257-282; Harvard Law and Economics Discussion Paper No. 657; ECGI - Finance Working Paper No. 287. https://ssrn.com/abstract=1513522

to permit resolution under the existing bankruptcy code, it is ironic that there is now pressure to change the bankruptcy code to fit the banks.

As a backup strategy for bankruptcy, Title II of Dodd-Frank also provides tools for regulators and the Federal Government to take any systemically critical failing financial institution (not just a bank) into receivership and liquidate it. During this process the FDIC can use its receivership powers to restructure financial operations of the failing company, while a government credit line is available to avoid economic disruption. The Title II resolution process also empowers regulators to claw back past bonus payments to high-level executives at the failed financial institution, in order to minimize moral hazard and reduce incentives for mismanagement in the future. Other provisions of the Dodd-Frank Act – notably, Section 956 on incentive payments to bank executives – also require bonus payments to be held at risk in case of significant losses at a bank. Unfortunately this provision has not been implemented.

The FIBA does not improve on Dodd-Frank and in a number of ways would actually make the situation worse. The legislation rests on the assumption that the bankruptcy of a large, complex financial institution could be addressed over a very brief time period by a bankruptcy judge who is empowered to wipe out the firm's long-term debt and replace it with equity capital. The conversion of debt to equity would permit a newly recapitalized company to emerge from bankruptcy in just a 48 hour period. While this process in some ways replicates the FDIC's "single point of entry" (SPOE) resolution strategy, it assumes the most optimistic possible version of such a resolution. In our view, it is excessively optimistic to assume that this kind of very-short term pre-packaged bankruptcy would work in all or even most cases for large, complex, financial firms with significant liquidity needs. The lack of realism of this scenario is increased even further by FIBA provisions that will make third party funding harder to obtain.[4]

In contrast, Dodd-Frank encourages regulators to require firms to plan for multiple bankruptcy options under the Title I resolution planning process. The Title II liquidation process for a large bank also grants regulators numerous backstop powers to ensure the proper restructuring of a large bank and the adequate financing of critical economic functions. It is true that the FIBA does not directly amend or interfere with these Dodd-Frank powers, which is positive. But in practice the addition of a new Chapter 11 bankruptcy provision which assumes that a large institution bankruptcy could be handled in a very rapid and relatively simple way will weaken the ability of regulators to require robust resolution planning under Dodd-Frank Title I.

Under Section 165(d)(4) of the Dodd-Frank Act, regulatory powers to require bank restructuring and advance provision for bankruptcy are based on the assessment of whether bank resolution planning would "facilitate an orderly resolution of the company under Title 11". In our view, placing a new chapter into Title 11 which assumes a large financial firm could effectively emerge from bankruptcy in just 48 hours based on nothing beyond conversion of debt to equity would lower the bar regarding the level of preparation expected for banks to prepare for recovery or resolution. The practical effect would be to weaken the ability of regulators to demand more

[4] See discussion of FIBA provisions regarding encumbered assets and qualified financial contracts on pp. 16-17 of Professor Bruce Grosgahl's testimony before the House Judiciary Committee on March 23, 2017. https://judiciary.house.gov/wp-content/uploads/2017/03/Grohsgal-Testimony.pdf

thorough planning or restructuring of the bank to handle the unexpected difficulties of a large financial institution bankruptcy.

This is not the only issue with current versions of FIBA. The legislation makes no real progress on eliminating or reforming the current unjustifiable bankruptcy exemptions for short-term financial contracts such as derivatives – despite the fact that those exemptions materially contributed to issues with the Lehman Brothers bankruptcy. Since the counterparties to these complex short-term contracts are generally other large and sophisticated financial institutions, FIBA would benefit these Wall Street insiders at the expense of pension funds and other Main Street investors who hold the longer-term debt that would be wiped out under the bankruptcy process contemplated in FIBA. The FIBA legislation contains no requirement to warn such investors that the debt contracts they hold would be particularly vulnerable to being wiped out under the unusual bankruptcy process contemplated in FIBA.

Making matters worse, FIBA also provides a broad exemption from liability for financial institution directors for any actions taken in contemplation of bankruptcy. This further advantages insiders who may be able to work out mutually beneficial deals with key personnel at a financial institution prior to bankruptcy, and contributes to the already existing issues with moral hazard that became clear in the aftermath of the Lehman bankruptcy.

It might be possible to design thoughtful reforms to the bankruptcy code that make progress in limiting the harm created by “too big to fail” financial institutions. But the Financial Institution Bankruptcy Act is not that reform. In our view, the Judiciary Committee should instead focus on reforms that take a more realistic perspective on the complexities of bankruptcy for a large, complex financial institution, address current unjustified bankruptcy exemptions for short-term financial contracts, and do not unduly advantage Wall Street insiders at the expense of Main Street creditors. In addition, Congress should act to mandate higher capital levels for banks than are currently set by regulators, in order to protect the solvency of major banks.

Thank you for your attention. For more information please contact AFR’s Policy Director, Marcus Stanley, at marcus@ourfinancialsecurity.org or 202-466-3672.

Sincerely,

Americans for Financial Reform