Financial Scholars Oppose Eliminating “Orderly Liquidation Authority” As Crisis-Avoidance Restructuring Backstop

May 23, 2017

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Dear Chairman Crapo, Chairman Hensarling, Ranking Member Brown, Ranking Member Waters, Chairman Grassley, Chairman Goodlatte, Ranking Member Feinstein, and Ranking Member Conyers:

The Financial CHOICE Act of 2017, H.R. 10, would replace the “Orderly Liquidation Authority” (“OLA”), Title II of Dodd-Frank, with a new bankruptcy
procedure, the Financial Institution Bankruptcy Act (“FIBA”), as the exclusive means for addressing the failure of systemically important financial institutions (“SIFIs”).

Although a bankruptcy mechanism usefully expands the channels for resolution of a failing financial firm, bankruptcy institutions alone cannot manage a full-blown financial crisis. Crisis management will need regulatory authorities. Moreover, bankruptcy is untried in such a setting and it is not attuned to managing systemic risk. This difference in function, and the baseline uncertainty of success, could fan financial panic rather than stabilize the financial system, if there is no regulatory backup and support. Repealing OLA would leave bankruptcy courts with the entire responsibility in a crisis for handling restructurings in ways that they have never done before. While FIBA, particularly if made more robust than the current version, would be a valuable addition to the panoply of crisis tools, the economy and the financial system will still need OLA to make FIBA work. At a minimum, an OLA backstop will be needed to avoid a financial crisis — in case a major firm uses FIBA but FIBA fails. Moreover, OLA will be necessary to address multiple failed financial firms in an economy-wide financial crisis.

To repeal OLA and its supporting provisions would be a dangerous error.

The undersigned, for whom financial regulation or bankruptcy or both are significant parts of our research and teaching, all oppose substitution of FIBA for OLA and its supporting provisions. We identify key factors that support this conclusion in the following discussion. Although signatories differ on the weight of the identified factors, including some who view a particular factor as not relevant, there is unanimity in the conclusion that elimination of Orderly Liquidation Authority would be a grave mistake.

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FIBA’s limits in a crisis. For FIBA to function properly, it needs institutional supports that only OLA and its related rules now provide, making FIBA inadequate as the sole resolution mechanism available in a crisis.

H.R. 10 contemplates that a failed SIFI would land in a bankruptcy court and be resolved and stabilized within 48 hours. The tight time limit arises from FIBA’s “stay” period for financial contracts — the “stay” temporarily stops the financial contract counterparties from running on the financial institution by demanding repayment en masse. Such a run could destroy a financial firm and FIBA gives a necessary 48-hour respite from that run. Under present law the FDIC will have extensive familiarity with the SIFI through the “living wills” process aimed at preparing a SIFI for resolution. In anticipation of a filing under bankruptcy, the

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1 FIBA has passed the House as a stand-alone measure. This letter is written to oppose substituting FIBA for OLA, not to critique FIBA as a stand-alone addition (although we note several potential improvements at the end of this letter).
2 Bankruptcy generally “stays” creditors from collecting during the bankruptcy. Qualified financial contracts are not now subject to the stay, but under FIBA they would be subject to a 48-hour stay.
congressionally-preferred resolution option, or OLA, the FDIC will build a structure of advance planning to make a tight timetable doable. But H.R. 10 would strip away the FDIC’s involvement in the “living wills” process and its mandate to engage the resolution process. Thus a bankruptcy judge will be seeing the SIFI for the first time and will have no help from the regulator (the FDIC) with relevant experience in addressing a failing financial firm. The court could well succeed on its own; but it might not.

We do not doubt that bankruptcy could provide substantial advantages, in many settings, over purely regulatory restructurings, and FIBA (especially if strengthened) offers advantages over the current bankruptcy provisions. Bankruptcy can routinize restructuring, particularly for bank holding companies that may fail for firm-specific reasons not embedded in a broader crisis. But it cannot be a panacea for a crisis, as we outline next. Hence, OLA’s regulatory backup must be maintained and OLA’s supports for making FIBA functional must be retained.

We raise four limits of bankruptcy courts that require the FDIC and other regulators to be involved in managing a crisis-level financial event: international coordination, planning, coordinated response, and liquidity provision.

**International coordination.** The only precedent for a SIFI bankruptcy was that of Lehman Brothers, whose failure triggered or exacerbated a world-wide financial panic in significant part because of the lack of international coordination. Under Dodd-Frank’s OLA, the FDIC will have prior understandings with foreign regulators. This gives the FDIC the capacity to manage the resolution of a U.S.-based global SIFI without generating global financial contagion. These prior understandings also bring the benefits of international coordination, which will be needed for the many complex aspects of the failure of a massive global financial firm.

A U.S. bankruptcy court will lack deep prior relationships or the authority to reach understandings with foreign regulators in advance of a bankruptcy filing. This increases the likelihood that foreign regulators or foreign courts, at the behest of local interests, will seize assets within their jurisdiction. For a global SIFI, such seizures are likely to be the death-knell of a successful bankruptcy. To avoid such difficulties, and thereby to make FIBA viable, American regulators will need to help make foreign regulators comfortable with the bankruptcy process. But repealing OLA and its supports would undermine that objective because it would remove an essential American backstop in the event that a FIBA restructuring is unsuccessful. Barring the regulator from initiating the proceeding (as the current version of FIBA does) will further reduce the possibility of pre-filing coordination with foreign regulators in the days before a FIBA proceeding begins. That coordination, one expects, will be critical to contain a run on the foreign subsidiaries of the failing financial firm.

**Planning.** FIBA is designed to manage the failure of a financial firm that has been forced to plan for its own demise. Today, large bank holding companies and designated SIFIs must plan for their own resolution, in bankruptcy and otherwise, through the “living wills” process of section 165(d) of Dodd-Frank. Thus far, this planning has focused on having these financial firms build out a special capital structure that can be made to bear losses in a 48-hour bankruptcy period, with pre-
positioned liquidity to allow the complex to stabilize. This pre-planning makes the 48-hour bankruptcy potentially viable. Without the living will process, it would be virtually impossible for a court to restructure a complex financial firm within FIBA’s 48-hour time limits.

H.R. 10 would eliminate the regulators’ authority to designate additional financial firms as SIFIs. Thus the bill would eliminate these firms’ responsibility to create a “living will” resolution plan that would lead to a capital structure that a FIBA-enabled court could handle. Yet almost assuredly, some financial firms outside the existing SIFI-perimeter will grow to become systemically important without the unique Federal Reserve and FDIC-regulated capital structure, organizational structure, and liquidity that facilitate resolution. Bankruptcy courts could not use FIBA to satisfactorily resolve such firms without those features already in place. There is no escaping this reality. Without such advance planning, FIBA will fail. Thus without OLA, Congress and the financial regulators would be faced once again with the choice between a Lehman Brothers-type event or a bailout.

While resolution of a non-designated SIFI will be challenging, even for the regulators, OLA gives the regulator more tools than are available to the bankruptcy court. Although the specifics of OLA are also untried, regulators have resolved substantial failed banks. The regulators, unlike the bankruptcy courts, will be able to observe the growth of new financial firms and can “war-game” failure scenarios to increase the likelihood of success for a newly emergent SIFI.

The mechanisms that bring such new systemically important firms into the planning-for-bankruptcy orbit need to be preserved so that a financial institution bankruptcy could work. Yet H.R. 10’s substitution of bankruptcy for OLA and its associated planning would end this process and thereby undermine FIBA.

Coordinated response. Several of us familiar with bankruptcy are optimistic that a bankruptcy court with robust support from an upgraded, modified Bankruptcy Code could handle the restructuring and, if necessary, the dismantling of even a very large failed financial institution, if the bankruptcy courts obtained the needed panoply of tools. But a financial crisis that threatens the economy will involve multiple institutions failing or tottering simultaneously. Moreover, as noted previously, many of those firms could lack the capital structure, organizational structure, or prior liquidity provisioning that would facilitate a bankruptcy resolution. Even if some failed institutions could move through a robust bankruptcy process, the American economy will need a coordinated response, particularly if the entire financial system suffers a panic or lack of liquidity. Bankruptcy judges cannot provide that coordinated response. They cannot caucus and decide how to handle multiple bankruptcies in a way that best stabilizes the economy. Bankruptcy courts cannot provide that coordinating function; they have neither a mandate, nor the proper experience, nor the

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3 H.R. 10 provides an “off ramp” from the living wills process for large bank holding companies with a leverage ratio of 10:1 or less. Such a leverage ratio, requiring that 10% or more of the company’s total value be in equity, will generally reduce the risks of failure because more equity means a thicker loss-bearing cushion, but it does not guarantee against failure, since a simple ratio does not control the riskiness of assets nor ensure adequate liquidity. Moreover, because H.R. 10 would exempt off-ramp firms from resolution pre-planning, there would be another group of firms for which a FIBA proceeding would fail.
staff needed to design a plan to protect the financial system as a whole. Only the regulators can do that, and OLA and its supporting provisions are necessary for the regulatory effort.

Liquidity. Similarly, liquidity can be crucial to stabilizing financial firms in a crisis. But the bankruptcy judge cannot provide liquidity to the system or to a tottering SIFI. And, if financial distress is widespread, private markets cannot provide that liquidity either. Under the Dodd-Frank Act, the only source of public liquidity support for a failing financial firm would be through an FDIC receivership. While other liquidity channels may be possible, this is the channel that is now assured and authorized. Thus the FDIC under OLA could use the financial firepower of public liquidity to stabilize the newly-resolved firm through a proceeding that would wipe out the firm’s shareholders. Public knowledge of the availability of this FDIC backstop would be essential to stabilizing the financial system and maintaining public confidence in the American financial structure, even if all the firms that failed were resolved through bankruptcy without actually needing such liquidity support.4

In sum, relying on FIBA as the sole resolution mechanism for enormous financial institutions with global reach is a reckless gamble with the stability of the U.S. financial system.

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OLA issues. We understand that two of the primary objections that have been voiced in Congress to OLA lie in (1) the view that government loans under OLA will amount to a “bailout,” even though the Act requires that the loans be backed by the assets of the firm, and that they be recovered in the resolution process or from the largest members of financial industry thereafter, and (2) the discretion that OLA gives the regulators to provide similarly situated creditors with different recoveries, as long as none gets less than its anticipated payout had the SIFI been liquidated. We understand these concerns, but disagree that repealing OLA is the appropriate way to address them. Rather, because these concerns are important but limited, the effort should go into handling these issues in OLA itself by adjusting and toughening the recovery rules, while preserving OLA’s critical advantages. For example, while we collectively take no position here on the appropriateness of the following two alternatives, we note that suggestions have been made to include penalty rates up-front in any lending under OLA and to delete the authorization for differential recovery. These local issues in OLA are best handled through local solutions, not by a baby-with-the-bath-water jettisoning of OLA.

4 Public liquidity disbursements must be recovered, under the statute, through the resolution process or, if there are any shortfalls, by assessing the largest players in the financial industry. This too will be well known. If these measures are seen as insufficient, the next paragraph points to how OLA might be strengthened in this regard.
Local weaknesses in FIBA. For completeness we note that the current version of FIBA and some general characteristics of American bankruptcy fall short of being as robust as they could be in facilitating resolution of a financial firm. We mention three.

First, the current version of FIBA gives the SIFI and its executives exclusive control over when to initiate a FIBA proceeding. Even if the SIFI is on a failure trajectory, executives have reason to wait, in hope, however small, of recovery or some private capital infusion. Yet during that period, the SIFI may lose whatever liquidity buffer it had, making it much harder for any bankruptcy restructuring to succeed and raising the stark choice between a bailout and a chaotic failure. Thus the regulators need authority to choose the timing of a FIBA proceeding. Otherwise, FIBA cannot readily accomplish its goals.

Second, FIBA is silent on how the SIFI would be restructured if the 48-hour period runs out without a successful resolution. FIBA is not a general vehicle for financial firm bankruptcies, but a mechanism to effectuate a particular kind of quick restructuring. This strategy is valuable if it succeeds. However, because it is untested, its success is not a sure thing, particularly for firms without an easily restructured capital and organizational structure. Indeed, FIBA’s success would be unlikely without pre-positioning easily-restructured debt and the further resolution planning that will be found only in firms that have been previously identified as SIFIs.

Third, American bankruptcy courts currently lack the full judicial power of the United States, which will add uncertainty to the bankruptcy process in a crisis. Bankruptcy courts’ authority to make a range of decisions, some of which may be implicated in a FIBA-style restructuring, has not been fully vetted and could well be contested by aggrieved parties in a crisis.

In sum, although FIBA’s usefulness as an alternate channel to OLA could be improved as indicated, FIBA is particularly unsuited to replace OLA for the issues mentioned earlier (international coordination, planning, liquidity, and economy-wide reaction), which are tasks beyond the capacity of the bankruptcy courts working alone without regulatory supports.

Conclusion. Bankruptcy cannot substitute for resolution via the Orderly Liquidation Authority administered by the FDIC. It can provide an additional, useful resolution channel. But bankruptcy is inherently unable to assuredly provide the broad response to, and necessary planning to confront, systemic risks that, unfortunately, if the past is any guide, we will need at some future time.

Repealing OLA and its supporting provisions and replacing it with FIBA would be a serious disservice to the stability of the American economy. For FIBA to function well, it needs OLA and its supports. While some of the undersigned emphasize the
issues outlined above in different ways, may express themselves separately, and reject particular factors, we are unanimous in the conclusion that bankruptcy cannot be an across-the-board substitute for OLA. Repealing the Orderly Liquidation Authority and its supporting provisions, we unanimously conclude, would subject the American economy to grave risks.

Respectfully yours,

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