Senate Judiciary Committee
"Big Bank Bankruptcy: 10 Years After Lehman Brothers"
Questions for the Record
November 13, 2018
Senator Amy Klobuchar

<u>Questions for Professor Roe, Harvard Law School</u>

- Would creating a new "Chapter 14" bankruptcy process shift the risk associated with speculative investments away from banks and back to ordinary consumers - either through their investment in pension funds or by increasing the risk of a taxpayer bailout?
- During a financial crisis, banks and financial institutions will likely be stressed themselves and unable to provide financing to a failing bank in the process of reorganization. Without access to debtor-in-possession financing, is it reasonable to anticipate that creditors of a failing bank or systemically important financial institution are less likely to receive payment of their claims?

Senator Klobuchar, thanks for the opportunity to respond to your questions about chapter 14, as it has now evolved. You first asked whether a new "Chapter 14" (which I'm interpreting as chapter 14 as currently conceived in the draft bill some members of the Judiciary committee are considering) would shift risks associated with speculative investment away from banking complexes and back to ordinary consumers (either via their pension funds or as taxpayers).

If chapter 14 works as its strongest proponents hope and expect, then there would be no need for a taxpayer-financed bailout to stabilize the financial system. The bill contemplates a weekend proceeding during which a very large debt obligation of the banking complex would (de facto) rapidly turn into equity over a resolution weekend. The bank would reopen on Monday with much more safe equity than it had at the beginning of the weekend; the proponents' hope that financial markets would see the recapitalized bank, with much more equity, as sufficiently stable that they would continue to do business with the bank. The bank's counterparties, in the optimistic account, would not run.[1]

It's this hope, which I view as potentially viable but not assured, that leads me to be cautiously supportive of the effort as a potential incremental and modest improvement over the status quo, particularly if further improvements are made in the current draft.

A principal risk is that the weekend restructuring succeeds as a formal matter and the bank reopens on Monday, but then—here is the risk—the counterparties *nevertheless* run from the bank when it reopens on Monday. Or the weekend restructuring fails for another reason—I point to several possibilities in my November 13 written testimony. Some counterparties may on Monday morning simply not want to take any risk of future failure of the weakened banking complex; some may not understand that the recapitalization has result in a borderline but more or less stable bank; and then, once some parties run, the run can feed on itself, as is common when there's a bank run, with more parties refusing to do business with the restructured bank. If the bank fails anyway on Monday afternoon, then the regulators, particularly the FDIC, will find it more difficult to restructure the bank than if they had been in charge right from the beginning, on the Friday before the bank "failed" bankruptcy.

A more robust chapter 14 would address the possibility of bankruptcy "failure" and how the handoff to the FDIC could be accomplished in a way to minimize the chance of a systemic financial failure. In my view, such a handoff cannot be accomplished effectively without handling the likely ensuing run by the bank complex's qualified financial contract counterparties

[1] The bill itself specifies that no government funds can be paid to a covered financial corporation or to any of its creditors to satisfy the creditor's claim.

Technically, the bank itself will not go through bankruptcy. Its owner, the bank holding company, would.

(derivatives and repo are the main QFC's here) from closing out and draining the bank complex of liquidity. Somehow these runnable debts must be handled.

The runnable debt for failed banking complex comes primarily from deposits, repo, and the derivatives book. Much of the thinking in banking and policy circles is that the authorities would somehow provide liquidity to the banking complex (and the banking system overall), thereby either inducing the counterparties not to run or reducing the damage if they do run. But there's no formal, official liquidity source for this now and many see this absence as a defect in a bankruptcy process, because the needed private provision of liquidity to a systemically-important financial firm would be so large as to be impossible, but in some circles this liquidity provision, if done by the official sector,is seen as approaching or being a bailout.

I should expand on that last difficulty, because it is fundamental to the problem in current thinking about failed bank complex restructuring. The runnable debt problem is the main source of the restructuring problem and the difficulty in handling it is the elephant-in-the-room that too many do not want to face up to. *First*, there is considerable opposition to official provision of liquidity provision during a crisis, because of the view that such liquidity provision is (1) effectively a bail-out or (2) facilitates pre-failure moral hazard. And, *second*, there is *also* considerable opposition to cutting back on the safe harbors for repo and derivatives—which are the investments that will run and that create the demand for massive liquidity. But it is the bankruptcy safe harbor from normal bankruptcy practice (which freezes nearly all other debt of a failed firm in place for a time, thereby preventing a run) that enables these counterparties to run.

It is a dangerous situation that we have opposition *both* to cutting back the cause of the run (the bankruptcy exceptions that disable bankruptcy from stopping the counterparties from exiting the failed financial firm for a week or two) *and* to the official provision of liquidity. For reasons that I will not go into further here, I'd strongly urge that there be a cutback on the instantaneous runnability of mortgage-based securities (MBS) repo and enable the authorities to restructure a failed banking complex's derivatives book by selling it off, product-line by product-line, which current law and practice (including the new chapter 14) bars. Cutting back these safe harbors in an effective way will lower the failed banking complex's demand for liquidity by reducing the extent and severity of any run; even if it doesn't lower it to the level that will allow for private financing, it should lower it to the level that public liquidity provision will be much more modest than what would now be needed with the full safe harbors in place, which form the foundation for runs of MBS repo (as we experienced in 2008-2009) and the collapse and dysfunctional close-out of a major dealer's derivatives book (as we experienced in 2008-2009).

Thus, somehow, if the bankruptcy fails, something will need to be done to handle the running repos and derivatives book. In my view, more thought and action should be given to narrowing the safe harbors that prevent some of that debt from being frozen in place until the financial firm is restructuring. This is particularly important for repos based on housing mortgages, which are historically volatile; for repo based on U.S. Treasuries, narrowing the bankruptcy exemptions (and thereby allowing them to run) is less important, because Treasuries are less susceptible to panic selling and sharp but temporary value declines. It's also vitally important that the derivatives book not be closed out willy-nilly (as happened after the Lehman failure). The authorities would need a short-period (a week? 10 days?) to restructure the failed bank complex's derivatives portfolio, including the authority to sell the portfolio off on a product-line basis (something that current bankruptcy law and derivatives contract practice bars for QFC's but not for generally for other assets of the failed firm).

Again, the scenarios I described in the last paragraphs are in play if the chapter 14 recapitalization fails; but we should hope for the best result (for which there will be no major liquidity need) and plan for the worst. Chapter 14 may fail.

Two additional but secondary comments are relevant to your query. First, the currently circulating form of chapter 14 anticipates that the bankruptcy judge find that the QFC's (the potentially speculative investments in derivatives and, possibly MBS repo) will be paid by the bridge entity that will take them over during the recapitalization weekend. These obligations are usually secured and, hence, a large fraction of that finding will be easy for the judge. But derivatives contracts are, even in normal times, often under-secured by just a sliver, and the security might deteriorate in value during a crisis. For the judge to make this finding that the QFC's will be paid, the proponents of the weekend recapitalization may have to move value from somewhere else in the complex to support the unsecured portion of the QFC's. While these amounts are unlikely to be large, this is the wrong direction to take. It'd be best not to further assure that these risks be covered and the QFCs assuredly repaid but to reduce the level of the riskiest of these (mortgage-backed repos and the fragile derivatives book if closed out rapidly).

The other secondary comment on the risk placement assessment concerns the composition of debtholders owning the debt that would be turned into equity. Pension funds are likely to own some of that debt. These investments will lose value in a bank restructuring. There is a view that as long as the pension fund understood the risks, diversified its investments well, and was paid a good interest rate for making the investment, the result is fair enough. I have sympathy for that perspective. But regardless of my analytic sympathies, in a crisis many citizens will perceive that ordinary people are paying more for the crisis while Wall Street speculators are paying less. This will make the political support for a restructuring weaker and could unleash other negative political forces; some of this happened in 2009 financial crisis.

Three responses to the risk-sharing concern are in order, two of which are not on the policy agenda, but in my view should be. First, the recapitalization will be politically fairer (and, hence, financially more stable) if senior management at the bank complex has a noticeable portion of their wealth tied up in the debt securities that lose value in the weekend restructuring. There is some fine analysis that's been done that this kind of ownership aligns senior management's incentives better with the financial well-being of the American economy. Your question leads me to offer an *additional* reason to encourage, or require, management being tied to the debt that gets converted in the chapter 14 process: it's not just incentives, as has been analyzed elsewhere, but also political fairness. Without a sense that the restructuring was fairly accomplished, it will be less stable. Regulators are less likely to trigger a chapter 14 even when needed for financial stability otherwise, if they believe it would not be politically stable.[2]

My understanding is that efforts were made toward such an incentive-oriented managerial ownership, but then abandoned.

The second response is that the ongoing sense that we need some mechanism to turn debt into equity when it's most needed indicates that we *still* do not have sufficient equity in the financial system to be stable. Requiring large financial firms to have higher equity overall, instead of just on a contingent basis, has fallen off of the public agenda, but it should not have.

[2] This is not the place to fully design such an investment for the banking complex's senior management. However, in prior discussions of the issue, one objection raised has been that the debt holders would become the primary owners of the bank, after the weekend recapitalization. (They would lose value, but gain ownership.) This would appear to be illegitimate to many and potentially unwise operationally if senior management was integral to the failure. A design feature to avoid this would have the senior management investment here go to zero if there were a conversion, or be converted into nonvoting stock.

The third response is probably the most politically viable at this time, but is only a modest one. The regulators may need a mechanism to see that the convertible debt is widely distributed throughout the economy.

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Your second question concerns the potential need for debtor-in-possession financing during the chapter 14 proceeding. The short answer is that if the process works as well as its proponents expect, then DIP financing isn't a major issue. If it fails (see above, the early part of the answer to the last question), it's a very serious issue.

The reason why large-scale DIP financing may well not be needed is the following: The immediately runnable debt of a major bank complex consists primarily of deposits, repos, and derivatives. (Derivatives, while typically long-term contracts, usually provide that if there's an event of default, the bank's derivative counterparty can cash out immediately, i.e., can "run"). Deposits, particularly retail deposits, are usually thought unlikely run, due to FDIC deposit insurance. Chapter 14 would enjoin the repo and derivatives counterparties from running over the weekend. This stay dramatically reduces the banking complex's liquidity needs, but only for the reorganization weekend. Then, however, if chapter 14 works as its most vigorous proponents expect, when the bank reopens on Monday, the repo and derivatives counterparties will see a stable organization and not run en masse. That will make the banking complex's liquidity needs modest.

The difficulty with this scenario, as indicated in my answer to the prior question, is that it is a possible result and maybe even, if well-managed before the bankruptcy, a more-likely-than-not result, but it is not an assured result. If the counterparties run anyway, or if the restructuring fails for other reasons, the liquidity needs will be substantial. Moreover, parts of Dodd-Frank limit the regulators' authority to offer liquidity. Hence, a more robust bankruptcy agenda would examine whether the runnable nature of all of the QFC's, particularly those tied to the housing market but not those tied to U.S. Treasuries, should be reexamined and cut back.

Thank you again for the opportunity to elaborate on my prior oral and written person testimony.

---Mark J. Roe

Professor Mark J. Roe
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QUESTIONS FROM SENATOR BOOKER

1. In your testimony and in other research you have done, you state that the very broad exemptions from the bankruptcy stay that we grant to complex financial instruments such as repo contracts and derivatives increase moral hazard, financial instability, and systemic risk, and should be limited or in some cases eliminated. Other witnesses at the panel appeared to imply that this new bankruptcy proposal would make progress in reforming these exemptions by granting a 48 hour stay for Qualified Financial Contracts (QFCs). But in your testimony you appear to disagree and instead state that this bill “further boosts” the preferences granted to short-term QFCs.

    a. In your view, does this new bill represent a significant step forward in reforming bankruptcy stays for complex financial contracts, or is it instead a step backward? Please explain your views, and any contrast between your views and those of other witnesses.

2. During the hearing, several Senators implied or stated that the Chapter 14 bankruptcy bill would increase the ability to recover insider executive compensation and bonuses in a bankruptcy, in order to pay out to other non-insider creditors. However, unlike Dodd-Frank Orderly Liquidation Authority, the TPRRA does not appear to contain any new tools for clawing back insider bonuses or pay. The Chapter 14 procedure also appears to give the existing firm very substantial choice as to what liabilities would be transferred over to a new bridge company, with a very limited time span for the bankruptcy judge to question such transfers during the highly compressed and accelerated bankruptcy procedure envisioned in the TPRRA.

    a. Do you believe that this new bankruptcy bill would increase the ability to recover insider compensation and bonuses from a failed financial institution, leave that ability the same, or increase it? Please explain.

    b. In general, do you believe that the TPRRA/Chapter 14 process would tend to benefit insiders in the failing company more or less than current bankruptcy procedures do?

Senator Booker, thanks for the opportunity to respond to your written questions. In your first question, you asked about how the broad exemptions for repos and derivatives interact with the currently-proposed chapter 14 process. In particular, you ask whether the currently-discussed bill will significantly reform how bankruptcy treats repos and derivatives, and whether any reform here for chapter 14 is a step backward or forward.

The currently-discussed version would not significantly reform the QFC exemptions. This is unfortunate, because systemic safety could be significantly improved by reforming several targeted areas of the favorable treatment of QFC's (the qualified financial contracts—primarily derivatives and repos—that have been accorded much more favorable bankruptcy treatment than other debt). This absence to QFC reform is one major reason why I consider the current chapter 14 proposal an incremental proposal and not a robust one—one that if done well can improve somewhat on the status quo, but not one that will dramatically reduce the chance of a financial crisis or dramatically reduce the costs of one.

While banking industry proponents of the QFC exemptions may see the bill's 48-hour stay on QFC's running as a major change, as some of the testimony indicated, it is not a major change, for several reasons. First, the industry has *already* agreed for some time that a 48-hour stay is necessary to make any bank complex restructuring viable via the so-called ISDA protocols. The proposed chapter 14 provision would just replicate this already-existing contractual stay, formalizing in bankruptcy a very limited statutory 48-hour stay on QFC's closing out and "running"—which, to repeat, the QFC industry *has already* agreed to. The proposed bill improves upon the existing contractual stay because it would eliminate some residual porosity in the ISDA protocol (such as whether all relevant parties have signed the protocol, whether the protocol applies to a particular transaction, and the possibility that the ISDA protocol has embedded in it drafting lacunae, some of which the statutory stay closes). This greater certainty of application is valuable, but it does not conceptually differ from what the industry has already agreed is necessary.

Second, the stay is planned to apply over a weekend. Generally speaking, QFC counterparties do not close out transactions over a weekend.[3]

Third, the chapter 14 stay is designed to facilitate a restructuring that will better assure these repo and derivatives counterparties that they will be repaid. The convertible debt takes the "hit" first. It's hard to see why the QFC parties should complain that they are offering a big "give-up" when the bill is in large measure *structured to better assure them of being paid.*

A more robust chapter 14 would deal more effectively with the impact of QFC runs on the financial stability of the United States. In particular, a longer stay on mortgage-based repo would reduce the deep, pernicious, and—even at this late date a decade after the financial crisis—persistent moral hazard and systemic risk problems associated with MBS repo; the longer stay would also facilitate a sound restructuring when needed. A short stay on closing out the derivatives book (along with some other needed fixes) would, in a robust bankruptcy structure, allow the authorities and the judge to engineer a stable sale of the derivatives book along product lines (interest rate swaps to X, commodities futures to Y).

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Your second question focuses on executive compensation and how it would fare in the chapter 14 bill under consideration.

The interaction of executive compensation with chapter 14 and Dodd-Frank is not one that I have studied closely, with the exception of one provision in the proposed chapter 14 bill.

[3] While counterparties might run if they can when the banking complex fails, for many the contractual default that would allow them to run is the actual filing for bankruptcy---which is denominated an event of default under their agreements. If the bank, or an affiliate of the bank, had not filed for bankruptcy on Friday after the close of the business, many of the QFC counterparties would not have a contractual basis to run.

In earlier drafts, chapter 14 lifted executives of liability for filing for chapter 14. But the provision was broadly drafted, extending to all acts "in connection with" the filing. That broad phrasing had the potential to encompass (in an aggressive lawyer's hands) executive wrong-doing that led to the bankruptcy filing. In the last draft of the chapter 14 bill that I reviewed, this provision seemed to have been carefully redrafted to only encompass the act of filing and acts in immediate preparation for filing. It improves over the prior versions.

The bill is now generally silent on other matters of executive compensation—neither barring other recoveries under other legal structures nor adding measures to recover from the insiders.[4] Bankruptcy, however, provides for management removal (generally "for cause" and similar derelictions) via appointment of a trustee. It also allows the bankrupt debtor to recover pre-bankruptcy payments made while the debtor was insolvent, if not made for fair consideration.

These provisions can allow the bankruptcy court to replace senior management "for cause" and to recover some improperly paid pre-bankruptcy pay, if the compensation paid was more than the consideration received. The chapter 14 structure, however, will have the core bank not run through the bankruptcy (rather, the bank holding company will be run through the process), with much of the holding company's operating subsidiaries transferred to a trust over the restructuring weekend. The judge's range of authority to use the bankruptcy removal process (generally by appointing a trustee to replace the pre-bankruptcy management) is not eliminated

[4] The bill exempts from bankruptcy's normal avoidance powers transfers to 20%-owned entities of the debtor in bankruptcy. The avoidance powers sometimes could allow for recovery of excess "unfair" compensation in the period before bankruptcy. It does not seem now that executive compensation would be channeled through 20% owned entities, but if it were, the bill's exemptions would disallow recovery under normal bankruptcy procedures. (This section of the bill needs, in my view, further thinking for different reasons: it's designed to facilitate value movement to the systemically most vital part of the banking complex, but assuring that the transfers will not be subject to bankruptcy clawback powers. But it also exempts from clawback misdirected transfers *from* the systemically vital units.

in chapter 14, but chapter 14's structure attenuates the judge's reach because the relevant entities are not directly under the bankruptcy court's jurisdiction. And appointment of a trustee is generally considered an extraordinary remedy under the Bankruptcy Code.

Moreover, there are two managerial removal processes in title II—one from the manager's position in the failed firm and one banning the executive from the financial services industry. The latter does not, as far as I can tell, require that the executives be officers of a firm going through title II; as such this ban could be effectuated for firms going through chapter 14. Nevertheless, those who want to more assuredly replicate the Dodd-Frank title II compensation clawbacks and removal procedure (which requires that the FDIC not retain management responsible for the financial firm's failure) would want further judicial power and reach here by adding a section implementing the specific standard set forth in title II.

The Dodd-Frank statutory process for removal and recovery is not, however, as I have heard some state, automatic. Firstly, title II requires the turning of several "keys" and one should not be certain that the keys to start a title II proceeding will be turned and, if turned, will turn fast enough. If they're not turned, the entity ends up in chapter 11 (or chapter 14). Secondly, title II does *not* automatically remove executives and automatically recover compensation, as I have heard some imply or state. The formal standards for removal and recovery in title II are in fact not trivial and are easy to dispute. I call your attention to a student memo that further outlines the title II removal process, describing title II's subordination of managerial compensation claims and the mechanisms for the regulators to recoup compensation paid to executives substantially responsible for the financial firm's failure. The removal process is more, as best I can tell, one of developing norms and presumptions embedded in the living will process of title I of Dodd-Frank;

the norms in bankruptcy are the opposite: bankruptcy has no presumptive removal of the bankrupt debtor's senior management.

In terms of aligning executive compensation here with the well-being of the American economy, executives could be compensated in part via a subordinated debt security that loses its value in chapter 14. But these kinds of structures are not specifically provided for in the current draft.[5]

On this issue of clawbacks, I offer a suggestion. The recapitalization will be perceived to be politically fairer (and, hence, more politically stable) if senior management at the bank complex has a noticeable portion of their wealth tied up in the junior debt securities that are turned into (less valuable) equity over the weekend. If these senior management investments are "baked into" the structure, then there's no need (on this money) for a clawback authority: the bankers' lose value when the banking complex restructures.

Moreover, such losses to senior management would be automatic if they were achieved through management holding this junior debt. There would not be a need for a regulator to make potentially disputable findings (as required by title II) or a judge or other parties to invoke general recovery doctrines that also could be disputed. The automatic nature of the loss would have benefits beyond ease of application in rapid and complex restructuring proceeding. Incorporating these kinds of subordinated, loss-bearing, junior debt compensation would align senior management's incentives better with the financial well-being of the American economy. My understanding is that efforts were made toward such an incentive-oriented managerial

[5] My understanding is that regulators proposed requiring senior executives to hold such junior debt, but these regulations have not been finalized and have stalled. One possibility for the Committee to consider is requiring that for a covered corporation to have access to chapter 14 that it will have complied with any such junior debt holding requirement for senior management, if promulgated.

ownership, but then abandoned; while the text of a bankruptcy bill may not be the best place to handle this kind of initiative, I would urge that this be part of the broader policy agenda.

Again, thank you for the opportunity to add to my prior oral and written testimony.

---Mark J. Roe