Big Bank Bankruptcy: 10 Years after Lehman Brothers

Comments on S1841, A bill "To amend title 11 . . . to provide for the liquidation, reorganization or recapitalization of a covered financial corporation, and for other purposes."

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Thank you Chairman Grassley, Ranking Member Feinstein, and members of the Committee for the opportunity to offer my views on financial bankruptcy in general, and on S1841, a bill to establish a narrow bankruptcy channel for failed financial firms, in particular.

I strongly support a robust bankruptcy channel for failed financial firms as an alternative or addition to existing regulatory channels. The current bill's value is in its potential to facilitate a *rapid weekend recapitalization* of a failed financial institution, by (in effect) turning specified debt into equity quickly. It provides a bankruptcy channel for the regulator's "single point of entry" (SPOE) approach, which seeks to achieve a same weekend recapitalization. While the restructuring could occur under regulatory authority, bankruptcy can provide an alternate channel with some not insignificant technical advantages. Because the effort has a good chance of succeeding in recapitalizing a failed financial firm (although it has a significant chance of failing), I support the effort, with qualifications — some large, some not.

The bill that I read last week substantially improves over the earlier version that passed the House. The current bill, unlike prior versions, provides for a regulatory mechanism to commence the bankruptcy for certain systemically-vital firms. It also defines eligibility in terms of existing regulatory standards, which should help anchor these other needed regulatory structures. (More on that below.) It tightens several provisions, including the provision releasing bankers from liability for filing to restructure — the prior release section had been overly broadly drafted. Several important further steps are needed to make this bill a good first step forward to a viable chapter 14 bankruptcy; I believe these are attainable. But several other important steps that are highly desirable and that would provide a much more robust chapter 14 or better alternative are not on the policy agenda, although they should be. I outline these below.

The potential "show-stopper" limit to unqualified support for the bill — and that neither attainable local improvements nor an expanded policy agenda can cure — is that, although the bill is a narrow bankruptcy measure, it could mistakenly be thought to fully substitute for even the best of the regulatory efforts embedded in title I and title II of Dodd-Frank. The "chapter 14" proposal can assist but not replace these regulatory efforts. Hence, it is important to assess whether passage of chapter 14 would materially increase the chances of cutting back or repealing a regulatory-led restructuring. I do not see that as likely now. But if it were likely on could become likely I would be wary about passing this form of chapter 14 and its modest advance. I proceed on the basis that this is not a substantial risk.

Those are the headline points. Next I'll discuss and extend them.

The Bill's value

The bill's value is in facilitating a rapid recapitalization of a failed financial institution by turning specified debt into equity over a weekend. If it works as planned (no guarantees), the institution could reopen at the end of the recapitalization weekend without facing a run. The Dodd-Frank single-point-of-entry restructuring mechanism is similar; the chapter 14 mechanism would assist and complement the title II process by (1) providing part of the needed institutional channel, (2) possibly lowering the decibel level (and panic potential) by having the process work through a bankruptcy court, and (3) resolving some technical issues (on voidable transfers) that the Dodd-Frank title II's SPOE structure has not. It could, if effective in turning pre-positioned debt into equity quickly, approximately double the funds able to absorb losses, compared to current loss-absorbing equity levels, if a major financial institution fails.

In the run up to bankruptcy, the strong units in the financial firm could transfer value to the weaker, but systemically vital units. These transfers, however, could be called back under bankruptcy clawback rules that require equal treatment of most creditors in the 90 days running up to a bankruptcy. The bill would exempt a bank complex's internal transfers from this bankruptcy rule. The bill thereby increases the potential viability of the Fed's source-of-strength doctrine (which focuses on inducing a holding company to use its resources to stabilize its bank) and increases the validity of pre-bankruptcy transfers to systemically vital units by exempting such transfers from normal bankruptcy scrutiny, even if they short-change other creditors of the holding company, including other subsidiaries that are not as critically important to financial stability. The provision, however, has some serious defects as now structured — these are discussed below — but the general concept is wise and needed, and the defects can be handled.

An earlier draft had open-ended language exempting the financial firm's board from liability for the actual filing for bankruptcy (which is sensible) *and* for acts done "in connection with" the filing, which was quite broad. In an aggressive lawyer's hands, that "in connection with" standard would support arguments that the provision would even exempt managerial liability for any wrong-doing that led to the financial firm's failure. The current bill tightens this provision to exempt liability only to private parties for the actual act of filing for bankruptcy; i.e., it's possible that the filing is needed for American financial stability, but a pure shareholder-orientation would sometimes militate to management and the board of directors waiting in the often-vain hope of a turnaround.

Moreover, and very importantly, the current bill substantially improves upon prior drafts by authorizing a regulatory filing, subject to standards. While regulators could often have the strength to induce a voluntary bankruptcy when a financial institution is out of compliance with basic bank regulation, their so doing may come at a cost and may not happen as quickly as needed. The bill handles this consideration. It is a vital improvement to the House-passed bill.[1]

The Bill's focus

The bill is limited to a specific bankruptcy process; **it will not establish a robust means for financial firm bankruptcy.** A robust bankruptcy process for too-big banks that fail is viable but not on the policy agenda; I will below briefly outline what a robust financial firm bankruptcy would entail.

Accordingly, **the bill's title** "to provide for the liquidation …" is misleading; there is no direct liquidation mechanism contemplated in the bill but only a recapitalization mechanism. Properly characterizing its limited scope is important in better assuring that future policymakers do not mistakenly think this bill's version of a chapter 14 would be sufficiently robust to replace titles I and II of Dodd-Frank. (Prior chapter 14 efforts, including those from the Hoover Institution, were considerably more robust.) A more accurate title would be the following: A bill "To amend title 11, United States Code, to provide *a narrow and limited, special-purpose recapitalization mechanism* ~~for the liquidation, reorganization, or~~ for a covered financial corporation, and for other purposes."[2]

[1] The regulatory authority to file is lodged with the Federal Reserve not the FDIC, and not jointly. There are competing considerations. While the Fed is the regulator most attuned to systemic financial stability, the FDIC is frequently the most involved in assessing how to restructure a failed financial firm and has the responsibility to manage a restructuring if one is needed.

[2] Similarly, the short title would be better said to be the "Taxpayer Protection and Narrow, Special-Purpose Resolution Act." To be sure here, the regulatory process contemplates some break up planning and after the bankruptcy process is completed, a break up might occur. But the bill does not contemplate the judge overseeing a failed firm's break-up and sale, in a way that has become common for nonfinancial firms.

The Bill's downsides, including a need to retitle the proposal

<u>The bill's major downside</u> is the risk that a bankruptcy option (even a weak one) leads policymakers to conclude that titles I and II of Dodd-Frank are thereby made superfluous or that a weak chapter 14 obviates astute prudential regulation. Since the two (chapter 14 and cutback of title II) were previously linked, this is a reasonable fear. Chapter 14 cannot work well without regulatory involvement — one, in approving (and the judge would need to hear this) that the convertible debt is of the right kind and, two, in coordinating with foreign regulators — something judges cannot do readily — for a global systemically important financial institution.[3] The current draft drops a useful anchor: entities eligible for chapter 14 are defined by reference to a Dodd-Frank provision.[4] Stronger anchors could be considered. (As noted, a title commensurate with the bill's limited purpose would help.)

The shape of more robust bankruptcy and related reform

The bill is an equity-enhancing measure. A stronger mechanism would recognize explicitly what is implicit in the bill, namely that **<u>that existing equity levels are insufficient</u>** and would remedy that shortfall more directly. Good studies indicated that the financial system would have needed equity levels of about 17% or so during the financial crisis to be stable. Equity levels have increased roughly from 4% (or even less) in 2008 to 8 or 9%. The rapid debt conversion over the chapter 14 bankruptcy weekend contemplates about another 8% or so of debt turning into equity, if that convertible debt is part of the failed firm's financial structure — either because current regulatory requirements here persist or because the firm's keep such debt as a matter of prudence.

[3] If foreign regulators mistrust American bankruptcy judges but trust our regulators, a court-driven process without the regulators could lead foreign regulators to immediately seize local assets — to ring-fence, in the new jargon — in ways that could make a domestic stable restructuring impossible.

[4] A future Congress could alter both the chapter 14 definitional section and the substantive aspects of titles I and II, in the mistaken view that chapter 14 adequately substitutes for titles I and II. So the anchor is hardly unmovable.

That gets into the safety range (and is the reason I support, with qualifications, a strengthened bill). A better means to get there would have much or all of the higher equity level baked in from the beginning. But increased equity is not on the policy agenda now.[5] The sense that we need this chapter 14 structure suggests, however, that it should be.[6]

Hence, the justification here for the chapter 14 process is primarily that the much safer channel — enhanced equity — is not possible. Only in the absence of a higher equity possibility does the bill provide a measurable advance.

A bank that has failed because it is too big should be broken up rapidly. Bankruptcy courts have become very adept in recent decades in overseeing rapid sales of failed nonfinancial firms. The same could be achieved for failed financial firms. The bankruptcy judge would oversee a rapid sale, business-by-business (broker-dealer to Barclays, commercial bank to X, London subsidiary to Y). Presumably the regulators would pre-arrange such sales prior to the bankruptcy filing; similar pre-filing arrangements are made now in nonfinancial bankruptcies. Some of this may well be accomplished by the bridge institution after the bankruptcy is substantively

[5] Three rationales militate in favor of debt over equity: One, the business of banking is in large measure maturity transformation; equity fits badly here. Two, the tax costs of equity over debt are substantial and will undermine banking as compared to other financial channels. Three, when the government bails out a financial firm, it typically does not bail out its equity but bails out some or all of its debt. When the potential for bailout becomes real, the cost of debt to financial firms falls relative to equity.

The first justification is weak in this setting: We are speaking of substituting real equity for long-term debt with equity-like characteristics, not short-term deposits. The second is fixable if we wanted to even out the taxation of bank debt and bank equity. The third is illegitimate and threatens the financial stability of the United States.

Overall, policymakers who want to minimize the risk of any bailout using taxpayer funds should consider whether increased equity — which rarely is bailed out — is superior to the current effort to get more debt, but make that debt convertible to equity during a weekend.

[6] There is an independent reason to have this kind of convertible debt in the financial firm's capital structure. It could — like the canary-in-the-miner's-cage — provide an early warning system, if bondholders (or bond analysts) see bank problems before the bank or the regulators do. But there's reason to suspect that this benefit would be infrequent: banks are notoriously opaque and the incentives of these particular convertible bondholders are not — if they continue to hold their bonds as opposed to selling them — to uncover and announce problems that will seriously damage themselves via a resulting a chapter 14.

completed. But even better would be to include this as a potential tool for the bankruptcy court. It seems to be aspired to, however, in the bill's title, which alludes to the bill as providing a mechanism for liquidation of the bank. It would be wise to adapt the bill substantively to its aspirational title, by adding basic bankruptcy break up mechanisms adapted to breaking up a failed financial firm.[7]

<u>The proposed Chapter 14 may not succeed</u>. The mechanics of the recapitalization could succeed, but the financial firm could still fail. The bill contemplates that the failed financial firm would enter bankruptcy after the close of business on Friday, contemplates that it would recapitalize over the weekend, and contemplates that it then would reopen on Monday morning, sufficiently strong that its counterparties and large depositors would not run. But if the financial firm's counterparties are dubious about the quality of the institution and the restructuring, they may well continue to run from the firm when it reopens on Monday. If they do, the firm may still fail.

Title II is thought to be the back-up if bankruptcy fails. But if the run on the reopened financial firm continues and is severe on Monday or if the recapitalization fails over weekend, the process for hand-off to the regulators is weak. I.e., the regulatory restructuring also contemplates a weekend process, but chapter 14 "uses up" the weekend. If the run continues on Monday and is severe, title II could well be compromised as a back-up.

[7] This is not something that needs general study; the means to effectuate a chapter 14 break-up, by analogy and speeding up of the existing chapter 11 process, and attainable now, if the will exists to go there.

After the weekend recapitalization, the resulting entity might break up, or it might not. But the bankruptcy court would not be overseeing any such break up.

This problem is potentially quite serious. It makes a very difficult task for the FDIC — a regulatory restructuring of systemically important financial institution — nearly impossible if it must start on Monday afternoon with a global but highly damaged institution that bankruptcy has failed to restructure in a stable way. Realistically, if the bankruptcy restructuring fails on Monday — i.e., if a run persists — there may be no way for the FDIC to recover effective capacity to restructure the failed entity unless the stay on closing out repos and derivatives is extended a few days, probably until the subsequent week-end. Such an extension would be, I understand, anathema to the financial industry. Yet, without it, policymakers should recognize that the chapter 14 bankruptcy process will be flying very, very high, with summersaults never before attempted but with no net below.

A quick list of other reasons — some unlikely but all realistically possible — are in play why the chapter 14 proceeding may fail: (1) there's a continuing constitutional cloud on the range of authority of the bankruptcy courts, because they are not Article III courts and, hence, lack the full judicial power of the United States; the appellate process contemplated in the bill is also geared to appellate panels of the constitutionally-limited Article I judges;[8] (2) the debt may turn out to have provisions that bar or impede the anticipated weekend recapitalization; (3) the chapter 14 process faces impediments in getting liquidity into the solvent but illiquid firm; the regulatory structure

[8] This Article I limitation on bankruptcy courts appears to be why the early Hoover Chapter 14 proposal lodged the process in Article III District Courts — lodging jurisdiction there though presents a different problem, in that district judges are not generally expert in bankruptcy.

The litigation nightmare for those seeking to quickly restructure the firm in bankruptcy is not simply whether the U.S. Supreme Court ultimately holds that the bankruptcy courts have the authority vested in them via chapter 14. It's that a credible challenge is made by those who do not wish a restructuring to succeed (because they will be paid more otherwise, or bailed out if the restructuring fails). It's that if there's a credible appeal, the uncertainty may make the otherwise safely restructured firm unviable in the interim.

provides more liquidity options — many commentators see this a serious debility;[9] (4) the weekend stay on closing out QFC's (repos and derivatives; qualified financial contracts) may turn out to have more porosity than expected; (5) the judge may not be able to make the requisite findings quickly enough in a way consistent with constitutional due process; (6) foreign regulators are said to distrust bankruptcy courts (perhaps in some jurisdictions especially if their bankruptcy courts do not function as well as ours) and may not cooperate.[10]

The bill's unwise boost to systemically sensitive qualified financial contracts: repos and derivatives. This chapter 14 bill further **boosts qualified financial contracts — repos and derivatives**. It is not designed to work well (or at all) unless the assuming entity can pay all or a large swath off and the judge makes related findings that these qualified financial contracts will be paid by the assuming entity. The business could have to reallocate value from other creditors and activities to assure that the repo and derivatives book is fully paid.[11]

Continually boosting the assurance of payment of repos on mortgage-backed securities, as we have done repeatedly over the years, has created a serious moral hazard problem. At some point we should stop doing so. It would be better *not* to have this boost in the bill. Bankruptcy normally stops immediate debt collection, so that the debtor can take a breath and reorganize. Repos and

[9] Liquidity drains here would come mostly from run-offs of deposits, repos, and derivatives close-outs. None are assured of draining off. All are possible. During the bankruptcy weekend, the bill contemplates an injunction on the repos and derivatives running off. After the bank reopens on Monday, that injunction is lifted, enabling a run.

Normal bankruptcy practice enjoins all creditors from running off during the pendency of the bankruptcy. Repos and derivatives are exempt from this normal bankruptcy practice. This facilitates the operation of the repo and derivatives markets, at the expense of some restructuring options.

[10] The need for foreign regulatory cooperation underscores the importance of continued U.S. regulatory involvement pre-bankruptcy via titles I and II, or similar provisions. First, the regulators are more likely to assure that the debt has the terms that can work in the chapter 14 proceeding; second, the U.S. regulators are better positioned than courts to coordinate, when needed, with foreign regulators.

[11] This assurance of repayment reaches not just the secured portion of repos and derivatives, which typically would be paid, but also to any unsecured short-fall, thereby making any unsecured shortfall superior in payment potential than other unsecured creditors.

derivatives are fully exempt from the now from the normal bankruptcy practice. This is fine for repurchase agreements covering assets that do not lose their value in a sell-off, like U.S. Treasuries. It is unwise for securities based on the American housing market, which suffers a boom, bubble, and retreat intermittently, and which cannot retain its fundamental value in an extreme sell-off, such as in 2008. The bill's anticipated boost makes these MBS (mortgage-backed securities) overnight repos more attractive than other investments lacking the boosts; consequently, more money flows into these risky and unstable channels — as we saw in years running up to the 2008 crisis — than if the boosts were not available.[12]

Coverage. Further thinking is needed as to which firms can access chapter 14 and how to handle the pre-bankruptcy planning. The statute contemplates that a "financial company" under section 201(a) of Dodd-Frank can voluntarily file for chapter 14. That coverage is broad and includes companies that will not generally have had their convertible debt previously reviewed by the regulators, as I understand how the Dodd-Frank structure has evolved. Hence, for these firms, the bankruptcy judge would be at sea, without a regulatory guide to be better assured the right kind of debt, suitable for weekend recapitalization was in the failed financial firm's capital structure.

[12] Roughly half of the repo market has been on MBS debt and half on U.S. Treasuries, historically. It would be better to weaken the bankruptcy exemptions for MBS repo, to reduce its attractiveness as near-money, as we've seen that repo on mortgage-backed securities cannot hold its underlying value in a crisis. (Repo on U.S. Treasuries and most derivatives are not subject to this infirmity.)

The study provision in the bill does create the possibility of putting this issue on the Washington agenda. But we know enough about the 2008-2009 destructive-of-the-economy run-on-repo to act now.

The bill reflects a conundrum: by requiring findings that the repo counterparties will be made whole, the weekend restructuring is effectively inducing the judge to find that the conditions are absent for a repo run when the bank reopens on Monday. But to do so means that value could be moved from elsewhere in the weakened institution to support the failed firm's repo and derivatives book. That possibility (1) could weaken the stability of other parts of the institution and (2) facilitates the moral hazard problem, as players in this space know that they are more likely to be protected in a crisis than those in other financing channels.

The kinds of failed financial firms that would be most suitable for using chapter 14, at least initially,[13] are likely to be regional banks for which coordination with foreign regulators is not vital, and for which a simple but large recapitalization will stabilize the entity. But as more such institutions are exempted from title I, fewer institutions will have regulators having enough familiarity to indicate to the bankruptcy judge the appropriateness of their capital structure for the weekend restructuring. The judge may consequently be unable to act appropriately in the narrow time frame given. The substantive scope of which firms chapter 14 will cover needs more work and may need some sort of a hybrid, lower-key planning mechanism, so that regulators can assure that a structure susceptible to stable bankruptcy recapitalization is in place.[14] Bankruptcy planners and statute-drafters need to coordinate more with banking planners in structuring chapter 14.

Broader implications: Legitimacy and who will own the debt to convert?

A negative political dynamic could develop during a chapter 14 recapitalization. While the repos and derivatives (Wall Street players, in major part) are getting this boost (briefly outlined in the prior section), the loss-absorbing debt is, well, absorbing the losses. Who will own this loss-absorbing debt? Three major debt-holding channels to consider: (1) pension funds, (2) financial institutions, and/or (3) distressed debt investors. <u>**Each poses a problem to a financial restructuring's success and American financial stability, but does so in differing ways.**</u>

[13] While the following sentence's thought is crude, we must recognize that we are asking institutions — both bankruptcy judges under chapter 14 and the FDIC under title II — to undertake tasks at a scale that they have never before been asked to handle. Better mechanisms will arise over the long-run if the first failed institutions resolved under title II or chapter 14 are not globally important ones, but mid-sized ones from whose resolution the relevant players can learn and thereafter implement better measures that will succeed even better.

[14] I.e., perhaps a standard-setting entity can indicate that debt with characteristics 1, 2, and 3, and lacking characteristics A, B, and C should be suitable for chapter 14 recapitalization. Perhaps lawyers' opinions, given at the time of the debt issuance and then renewed in the chapter 14 proceeding could substitute for regulatory assurance of the debt's appropriateness. It is a lot to expect a bankruptcy judge to do due process in 48 hours — barely enough time to study the plan and the company, much less evaluate de novo the documents covering the loan agreement.

The first category: **<u>pension funds</u>**. If ordinary people's pension funds hold much of the recapitalizing debt, then chapter 14 will likely seem unfair to many voters: financial interests will do well, while pensioners' pension funds are hit. While hard-edged analysts will say, correctly in my view, that the pension funds were paid to take that investment risk, the issue will not end there. While I am sympathetic to the concept that a well-managed pension fund will be diversified and compensated ex ante for taking these risks, the fact that these ideas are already in the air now suggests that the fairness concern can have systemic implications.[15] It makes it possible that the chapter 14 proceeding could succeed mechanically and then fail politically.

Consider the media and public opinion dynamic that would ensue if the public sees ordinary people — pensioners — as paying to bail out the big bank and its repo and derivatives counterparties. Particularly given the mysterious aspects in popular thinking of hot money repos and risk-trading derivatives overall, the public may well see this as ordinary citizen-outsiders bailing out insider-Wall-Street bankers' risky bets. This would, if pensions were major holders of the debt, degrade the legitimacy of the process. Perhaps fatally.[16]

A strongly viable resolution process not only needs to be financially stable but must also be politically stable.

[15] My impression is that pension funds take on investments that are individually riskier than convertible financial firm debt. And the financially correct way to assess risk-taking here is on a portfolio-wide basis. An appropriately diversified portfolio reduces many risks of holding financial firm debt subject to chapter 14 or title II SPOE loss-bearing. But investment integrity is not the core issue here; it's whether the structure will be politically resilient when called upon.

[16] This kind of legitimacy problem based on holders of the debt to be turned into equity arose in recent European bank restructurings. The current regulatory focus on the so-called single-point-of-entry restructuring has this potential for backlash as well; hence, the chapter 14 does not add risk here, but faces the same potential setback.

I understand that proposals have arisen to have a registry of owners in this convertible debt in Europe, facilitating assessments that the holders are well-diversified and own only small pieces of the convertible debt. Presumably a similar mechanism might be usable here — bank assurance under the TLAC rules that the holdings are in sufficiently small lots compared to the assets of the holder, so that the legitimacy issue is likely to be small.

Something like this was in play in 2008 and 2009. Ordinary people lost their houses in mortgage foreclosures; bigger financial institutions got access to the government's primary dealer facility and TARP money. This unleashed a political backlash. Even if the interest charged on TARP or liquidity facilities is high, the backlash can be real. The same could happen if the debt that takes the hit under chapter 14 is debt that directly funds people's well-being. A break-up mechanism and an absence of a boost to the qualified financial contracts are both better for financial safety and lack these potential legitimacy weaknesses.

Alternatively, and also perniciously, this legitimacy mismatch could lead to a political cry to save the pension funds by bailing out the failed entity fully and not allowing the loss-placing process to move forward.

A second debt-holder category: **<u>other major financial institutions</u>**. But if other systemically-important, debt-holding financial institutions take the hit, the financial crisis may spread instead of being contained. (Banks and other highly-leveraged financial institutions would be poor holders here; mutual funds and some insurers would be better loss-absorbing holders.) Legitimacy may not be a problem; contagion would be.

A third category: **<u>distressed debt funds</u>**. Activist distressed funds are common in nonfinancial bankruptcies. If they are major holders of the converting debt, the legitimacy problem will be absent, and the contagion problem would generally be absent as well. But a different, insidious problem would be in play: many distressed funds make money by aggressive actions during a restructuring. If there is a soft spot in the chapter 14 process (e.g., constitutional jurisdiction of the bankruptcy courts, appropriateness of the decisionmaking under statute, fidelity to the terms of the converting debt), distressed debt investors should be expected to exploit the wedge and hammer open the restructuring in an effort either to avoid their debt being hit or to increase the chance of a direct bailout of the failed systemically-vital institution and, indirectly, of the distressed investor's debt. Here, the bankruptcy process needs to be resilient to the most opportunistic behavior possible.

The prior three possibilities are reasons why having more robust equity would be much better in a financial crisis: the equity would reside in risk-absorbing institutions that are set up to take major hits to parts of their portfolios. Moreover, a bankruptcy structure that the public sees as unfair will be one that the authorities will be reluctant to invoke (and affects the regulator's willingness and effectiveness in using the single-point-of-entry mechanism as well), is one that may not succeed even if invoked, and is one that can have seriously damaging collateral effects, political and otherwise. Perhaps the distribution of the convertible debt holdings can be managed so that this legitimacy fear and backlash does not arise; perhaps the sentiment that the holders are being paid to take the risk of financial firm failure will dominate; but the better solutions are not to boost the repo and derivatives portfolios (and particularly for MBS repo, avoiding the boost has significant and direct system stability benefits), to foster a true break-up if the failed firm is just too big, and to lessen the reliance on debt conversion by focusing more on equity enhancement.

Avoidable transfers. Bankruptcy law in general bars the debtor from favoring one creditor over another in the months leading up to a bankruptcy. Favored creditors generally have to return to the debtor what they received preferentially. In the run up to a bankruptcy, the holding company may stream value into its systemically more precarious subsidiaries. Such value transfers could be later attacked in bankruptcy as preferential payments (particularly if the holding company was obliged to make similar transfers to other subsidiaries but did not). The bill insulates these downstream transfers from later attack as preferences that must be returned. (It also insulates postfiling transfers that are otherwise more tightly controlled by the bankruptcy judge.) This insulation will better allow an unstable banking enterprise to downstream value to the systemically most important subsidiaries. It also facilitates finality.

But the bill's provision here looks to be overly broad. The bill seems to seek to limit this safe harbor to *internal* transfers, by requiring that the receiving institution be an affiliate of the holding. But the ownership required (20%) for the recipient to be internal seems too low. Majority-owned, or even 80%-owned, seems more appropriate level for internal transfers. The better rule would be to exempt only those transfer that go to firms largely owned by the financial institution.[17]

Moreover, the transfers once made, cannot be recovered. The assumption behind the exemption is that the transfers will be made *to* the systemically most sensitive affiliates; but it exempts *all* transfers, both before and during the bankruptcy, and as a matter of logic could have perverse effects. If transfers were made to systemically *un*important affiliates *at the expense of* the systemically-important ones, those transfers also could *not* be recovered. This is a serious issue.

Conclusion

The bill's recapitalization measure is a modest but useful addition to extant restructuring tools; I support (with the qualifications mentioned) the effort. In general, a *robust* chapter 14 will be a useful restructuring channel to add to what we have. The bill is not as robust as would be desirable.

[17] The bill's 20% threshold corresponds to the Bankruptcy Code's definition of an affiliate. Symmetry would call for the same threshold. However, here the risk is to be sure that the protected transfers are going to systemically important targets and not largely exiting the failing financial firm as could happen with the low 20% ownership threshold. Some utility-type institutions are jointly owned by financial firms, each of which owns a small portion of the equity; they are appropriately included in the exemption. But as written the exemption could include an ordinary firm in which the financial entity happened to own 20% of its stock. Drafting to limit to jointly owned financial utilities would be wiser.

While a robust step forward here should not be the enemy of this modest step forward, a better chapter 14 process is appropriate.

The process could be made more robust, to better use the tools of bankruptcy: by adding stronger bankruptcy-based measures to break up a too-big bank that has failed (in ways that are common for nonfinancial firms now); by allowing a stay on the most pernicious types of qualified contracts that's long enough to facilitate the restructuring of the failed firm (and long enough to nicely turn the restructuring over to the regulators if bankruptcy fails to stabilize the firm). More modest improvements would deal with the overly-broad preference exemption, the appropriate scope of coverage (so that covered firms are better assured of having appropriately recapitalizable debt and regulators able to so advise a bankruptcy judge), and the overly-broad title to the bill.

A wider perspective: the chapter 14 effort (like the related and intertwined regulatory single-point-of-entry effort) implicitly recognizes that safe, loss-absorbing equity is still too low in the financial system; there are more direct ways to address this shortfall than by seeking a process to turn a very large debt obligation into equity during a bankruptcy weekend. Lastly, and quite importantly, we need to guard against the potential that a weak and limited bankruptcy process becomes a cudgel that could be used against astute prudential regulation.

Thank you.