

Written Testimony of David A. Skeel, Jr.

Before the Subcommittee on Oversight and Investigations
Committee on Financial Services
United States House of Representatives
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Thank you for the opportunity to testify on the question of “Who is Too Big to Fail: Does Title II of the Dodd-Frank Act Enshrine Taxpayer-Funded Bailouts?” My name is David Skeel, and I am the S. Samuel Arsht Professor of Corporate Law at the University of Pennsylvania Law School. It is a great honor to appear before you today.

Perhaps the biggest question about the Dodd-Frank Act since the moment it was enacted in July 2010 has been whether it could or did end “Too Big to Fail.” Although the administration and the giant financial institutions themselves have insisted that Too Big to Fail has ended, a growing number of observers are concerned that the Too Big to Fail problem has not been solved at all. Those who hold this view include at least one member of the Board of Governors of the Federal Reserve, Daniel Tarullo, as well as others at the Fed. Governor Tarullo has given several speeches raising the alarm about Too Big to Fail, and has suggested that Congress should act to impose limits on the size of the largest financial institutions.

Our particular focus in this hearing is on the implications of Title II of the Dodd-Frank Act—also known as the Orderly Liquidation Authority, OLA, or the Dodd-Frank resolution rules—for Too Big to Fail. The largest financial institutions have pointed to Title II as evidence that the Too Big to Fail issue has been solved, and some Americans may be under the impression that it has been. But in my view, Title II does not end Too Big to Fail at all. To the contrary, it perpetuates these problems in several important respects.

After very briefly describing how Title II works, I’ll divide my remarks into two parts. In the first part, I will describe several problematic features of Title II as it is drafted. In the second, I’ll focus on the “Single Point of Entry” strategy the Federal Deposit Insurance Corporation (FDIC) has developed over the past year or so for implementing Title II. The single point of entry approach is designed to preserve a systemically important financial institution that threatens to default. Even if the strategy were actually used, it would not end the Too Big to Fail problem. I will conclude by arguing that Title II should be amended, and that the Too Big to Fail issue should be addressed in other ways, such as bankruptcy.

The Basic Mechanics of Title II

Resolution under Dodd-Frank begins when “the three keys turn”—Treasury proposes to take over a systemically important financial company that is in or near default, and the Fed and

FDIC concur by a two thirds vote.¹ If the company does not agree to the intervention, resolution is commenced by the filing of a petition in the federal district court in Washington, DC. The court has 24 hours to consider the petition.² The only grounds for rejecting the petition are that the company in question is not a financial company, or that it is neither in default nor in danger of default.³ The FDIC has nearly unfettered discretion to sell the company or any of its parts, either directly or after transferring the assets to a bridge financial company.

The resolution rules include a variety of provisions that are designed to counter complaints that the new framework would institutionalize bailouts. One provision explicitly requires that the financial institution's managers be removed if they were responsible for the financial distress, that shareholders be wiped out, and creditors take losses.⁴ The framework also instructs regulators to liquidate the institution rather than reorganizing it.⁵ Although these provisions sound like harsh medicine, the FDIC also is given ample discretion to sidestep them.

Title II's Contributions to Too Big to Fail

I should perhaps start by noting that it is quite possible that regulators would simply bail out a giant financial institution that threatened to fail, rather than invoking the resolution rules in Title II. Although the Dodd-Frank Act tries to make bailouts more difficult, it certainly hasn't eliminated the possibility of a bailout.⁶ With the six largest institutions in particular, there is a very good chance that regulators would never invoke Title II, particularly if more than one of the institutions were at risk.

If regulators did invoke Title II, they would probably transfer some or all of the assets and liabilities of the holding company to a newly created bridge financial institution. Title II authorizes the FDIC to create a bridge institution, and permits the FDIC to keep it in place for up to five years.⁷ During this five year period, the bridge institution has major competitive advantages as compared to other financial institutions. One benefit (available to the FDIC whether or not it sets up a bridge institution) is access to copious amounts of funding from the United States Treasury. Although there are some constraints on this funding, the Treasury and the FDIC can structure the funding in ways that give the bridge institution low cost funding.

Bridge institutions also are given a sweeping exemption from taxes. While the bridge institution is in existence, it is not required to pay any taxes on the value of its franchise, property

¹ Dodd-Frank Act § 203. The discussion in this section is drawn from Thomas H. Jackson & David A. Skeel, Jr., *Dynamic Resolution of Large Financial Institutions*, 2 HARV. BUS. L. REV. 435, 439-40 (2012), available at <http://ssrn.com/abstract=2247599>. I give a much fuller overview and analysis of Title II and the Dodd-Frank Act as a whole in David Skeel, *The New Financial Deal: Understanding the Dodd-Frank Act and its (Unintended) Consequences* (Wiley, 2011).

² Dodd-Frank Act § 202.

³ *Id.*

⁴ Dodd-Frank Act § 206.

⁵ Dodd-Frank Act § 214.

⁶ The Dodd-Frank Act prohibits the Federal Reserve from making extraordinary loans to individual institutions, for instance, but it would not preclude support framed in more general terms.

⁷ Dodd-Frank Act § 210(h)(12).

or income.⁸ This tax free status gives the bridge institution an enormous advantage over other financial institutions. In my view, there is simply no justification for this special treatment.

Notice that these features not only give the bridge institution a competitive advantage over other financial institutions. They also are at odds with the frequent claim that Title II will not impose any costs on taxpayers.

The FDIC's "Single Point of Entry" Strategy

For more than a year, the FDIC has been developing a strategy for implementing the resolution rules that it refers to as a "single point of entry" approach. Under single point of entry, the FDIC would intervene with the holding company of a troubled financial institution, and it would seek to leave most or all of the troubled company's subsidiaries intact. After establishing a new bridge financial institution, the FDIC would transfer all of the holding company's assets and short-term liabilities to the new bridge institution, leaving its longterm debt—primarily, bonds—behind in the old institution. Some or all of the stock of the new bridge institution would eventually be distributed to the long-term creditors of the old institution.

Although I think this is a very clever strategy for resolving a large bank's financial distress, it seems to me to raise three very important concerns. First, the single point of entry strategy assumes that all of the derivatives contracts and other short term obligations of a troubled financial institution will be bailed out. These complicated financial instruments were one of the major problems during the 2008 crisis, yet the single point of entry strategy proposes to continue to fully protect them. This will encourage the big banks to use even more of the derivatives and other complex financial contracts that caused so much trouble five years ago.

Second, although Title II explicitly requires that its provisions be used for liquidation, single point of entry is essentially a reorganization. It thus stands in tension with the explicit requirements of Title II.

Finally, the single point of entry strategy won't end too big to fail at all. It will essentially rescue the troubled financial institution, and is designed to ensure that a giant financial institution retains just as dominant a position after a financial crisis as before it.

Defenders of Title II insist that no taxpayer money will be used in connection with the resolution of a giant financial institution. But this is highly misleading. It is based on the fact that Title II authorizes bank regulators to impose a surcharge on other big banks to recoup the costs of the resolution process if they are not repaid as part of the process. First of all, this surcharge is essentially a tax imposed on one particular group of taxpayers, the banking industry. In addition, as I have already noted, the resolution process imposes costs that are not taken into account in this calculation, such as the cost of exempting the bridge institution from taxes.

⁸ Dodd-Frank Act § 210(h)(10) states that: "Notwithstanding any other provision of Federal or State law, a bridge financial company, its franchise, property, and income shall be exempt from all taxation now or hereafter imposed by the United States, by any territory, dependency, or possession thereof, or by any State, county, municipality, or local taxing authority."

Implications

Let me suggest three implications of these comments about the likely effect of Dodd-Frank's resolution rules. First, I believe it is very important to amend Title II to fix some of these problems. I do not think that Title II needs to be repealed. But I do think it should be amended to address problems such as the unjustifiable tax advantages given to bridge financial institutions.

Second, Title II is not a solution to the Too Big to Fail problem. The largest financial institutions have a dominant position in American finance. Among other benefits, they are able to borrow money much more cheaply than other financial institutions, because their cost of credit is artificially reduced by the Too Big to Fail subsidy. The small and medium sized banks that are most likely to lend to small and medium sized industries are at a particular disadvantage. None of the proposed solutions to this problem, including the Brown-Vitter proposal, is ideal. But I think the problem needs to be addressed, in order to level the playing field in the financial services industry.

Finally, I believe that it is important to recognize that bankruptcy is a very effective alternative to Title II for addressing the financial distress of large financial institutions. In its living will requirements and in other areas, the Dodd-Frank Act itself suggests that bankruptcy should be the resolution strategy of choice wherever possible. It is interesting to note, in this regard, that the single point of entry strategy can be replicated in bankruptcy, through a prompt sale to a newly created entity. The bankruptcy alternative would not have any of the anti-competitive characteristics that are found in Title II. The new entity would pay taxes like everyone else, for instance, and it would compete in the market on the same terms as other financial institutions.

A working group at the Hoover Institution of which I am a part has proposed a new Chapter 14, which consists of a handful of amendments to the Bankruptcy Code that we believe would make it even more effective as a mechanism for handling the default of a large financial institution.⁹ I believe that one of the best things Congress could do is to enact these proposed changes, which would reduce the need to resort to Title II in the next crisis.

⁹ The Chapter 14 proposal is set forth and analyzed in *Bankruptcy Not Bailout: A Special Chapter 14* (Kenneth E. Scott & John B. Taylor, eds., 2012).