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"Simple Truths For a Complex Financial World"

Because I was requested only a day ago to testify, I can cover only the major points in my written testimony, and I thus will not touch on a score of other objections that might be raised to the latest version of the "Financial CHOICE Act of 2017." My goal is to keep it simple.

A. THE SYSTEMIC RISK MACRO ISSUES:

In my judgment, the key issues (and deficiencies) of this legislation are:

(1) The CHOICE Act's replacement of "Orderly Liquidation Authority" with a very modest revision of the Bankruptcy Code is the most important and questionable change mandated by the Act;

(2) Ranking second is the CHOICE Act's "off-ramp" provision, which will allow most banks to escape the substantive provisions of Dodd-Frank if they can meet a single metric (an admittedly ambitious leverage test);

(3) The elimination of the Volcker Rule, which bars banks from proprietary trading, will also increase systemic risk for the future;

(4) Less noticed but still very important is the CHOICE Act's elimination of the Treasury Department's Exchange Stabilization Fund, which was the only (if imperfect) means by which the Treasury was able to avert a major panic in money market funds during the 2008 crisis. We may not be so lucky next time in the absence of this fund;

(5) The CHOICE Act's repeal of "Financial Market Utilities" effectively means that clearinghouses (both for securities and derivatives) will go largely unregulated and cannot be saved from collapse if they become insolvent in a crisis. The failure of a clearinghouse would be more serious than the near failure of AIG;

(6) The repeal of the Financial Stability Oversight Council's ("FSOC") ability to classify a non-bank as a "systemically important financial institution" (or "SIFI") means that in the future institutions that might parallel the scale of AIG in 2008 will escape needed oversight; and

(7) By repealing (for the most part) Dodd-Frank's "risk retention rules," the CHOICE Act means that securitizers can return to a "originate to distribute" model, and that invites reckless behavior.

I. The Elimination of "Orderly Liquidation Authority" ("OLA")

Section 111 of the CHOICE Act repeals OLA in favor of a bankruptcy alternative. I do not doubt for a moment that a robust bankruptcy alternative to OLA could be desirable, at least as a supplementary option. But the U.S. financial sector has geared up for several years now—through "living wills" and other means—to adapt to, and prepare for, OLA, and this bill will pull the rug out from under that careful and deliberate planning. This is a leap without a parachute. Even worse, this substitution has three dramatically adverse consequences:

(a) Lack of Role for the Regulator. There is no meaningful role for any regulator (FDIC, Federal Reserve, or OCC) in this bankruptcy alternative. Bankruptcy can be initiated by the debtor or creditors, but regulators are rendered impotent and left to observe from the sidelines. This undercuts the value of "living wills" and other provisions, which are intended to arm and inform the regulator. Instead, an unprepared and uninformed bankruptcy judge, with no staff, will be asked to make the critical decisions. Thus, a regulator who sees that a bank is likely to fail can only wait (or perhaps criticize from afar). As a practical matter, this implies that necessary interventions will be delayed. A failing bank is likely to hide its condition and file for bankruptcy only at the last possible moment when it is totally out of funds (as

Lehman did). This will accentuate the impact on the financial system and increase the shock over that of an earlier resolution.

Further, there is a culture associated with the bankruptcy process; it is long, slow and sometimes interminable. Its principal virtue (for the Bar) is that it enables law firms to profit to a sometimes obscene degree.

(b) The Absence of Liquidity. OLA has a mechanism for supplying liquidity to a troubled bank: the FDIC provides funds at the same time it replaces the old management in a receivership. Many bank crises are essentially liquidity crises (particularly in the case of large banks), rather than true instances of insolvency (even Lehman can be debated in this regard). In contrast, bankruptcy does not offer any feasible means of providing liquidity (with the exception of debtor in possession financing). The draftsmen of the CHOICE Act apparently believe that, after a bankruptcy filing, the sound assets of the bank would be transferred to a "bridge company" (the "good bank") and the weak assets and liabilities would be left in the "bad bank." Then, the "good bank" could obtain financing in the private market without federal assistance. At best, this would take time, and, if a large bank shut down for even a few months because of a lack of liquidity, the impact could collapse the economy. At worst, this assumption that the "good bank" could obtain financing without a significant delay resembles a fairy tale.

Thus, my first "simple lesson" for a complex world is that successful reorganizations require the provision of at least short-term liquidity, and the CHOICE Act provides none. To keep a company operating and meeting its payroll requires that funds be provided at the outset.

(c) Lack of Accountability Provisions. Dodd-Frank contains multiple provisions to hold the officers and directors of a failed bank accountable. The CHOICE Act has none. This may be based on the premise that, if strict accountability provisions were authorized, no bank's management would ever file for bankruptcy, even if they knew they were hopelessly insolvent. Nonetheless, I am confident that the vast majority of Americans want accountability provisions that apply to reckless behavior by bank officers and directors that results in insolvency. By analogy, the CHOICE Act would absolve a Bernie

Madoff (if he were running a bank) in order to encourage him to file bankruptcy. That is insufficient; more is needed.

(d) Bottom Line. Although I recognize that a robust bankruptcy code provision could supply a useful alternative to OLA, it is rash to remove the safety net that OLA affords without a proven alternative. The British Financial Conduct Authority has already publically warned that if OLA is eliminated, it will have substantially less confidence in the safety and soundness of U.S. banks. More generally, bankruptcy is primarily concerned with the protection of creditors; OLA is primarily concerned with the protection of the economy and the American public from a devastating systemic risk crisis. The CHOICE Act subordinates this latter goal (saving the economy) to the former (providing full value to creditors). That is a wrong CHOICE.

II. The Off Ramp.

The CHOICE Act creates an "off-ramp" that permits financial institutions to escape Dodd-Frank's capital and liquidity requirements (and its activity restrictions) if they can satisfy a simple leverage ratio. Admittedly, that leverage ratio is demanding (10%—or well above the Basel III standard). Not all banks will be able to meet this standard, and, I concede, there are some virtues associated with a simpler standard.

But there are also two major problems associated with this "off ramp" strategy:

First, banks will be incentivized by it to shift towards a riskier portfolio of assets. That is, at any leverage ratio, banks can hold conservative assets (a portfolio of U.S. Treasury securities, for example) or risky securities (the junior tranche of a portfolio of real estate backed, sub-prime mortgage investments). In contrast, Basel III focuses on a risk-weighted leverage ratio.

Second, the CHOICE Act invites gaming by banks—in particular because the Act measures its leverage ratio only on the last day of each quarter. Those with a memory that goes back before 2008 will remember that Lehman engaged on the last day of each quarter in elaborate, multi-billion dollar derivative transactions in order to manipulate its leverage ratio as of the last of each quarter (and then returned to its normal, more leveraged state the next day). If Congress does not learn from this history, it is destined to repeat it.

At this point, let me advance my second "simple truth": Banks can change their portfolios virtually overnight. They can move from safe assets to risky assets, or vice versa, and they will predictably play a game of regulatory arbitrage if they can escape Dodd-Frank by modifying a single metric.

Bottom Line: No single metric—leverage, capital, risky activities—is sufficient to preserve the safety and soundness of banks that are "too big to fail."

III. The Volcker Rule

Title IX of the CHOICE Act (and Section 901) repeals the Volcker Rule, which prohibits banks from engaging in proprietary trading or owning or sponsoring hedge funds. This is an amazing about face, which will shock the banks that have now largely disengaged from these activities. No justification is provided for this radical shift. If the banks are "too big to fail" (and many are) and if we do not wish them to be bailed out on insolvency by taxpayers, the only practical alternative is to regulate banks so that they do not fail. Risk-taking must be limited. The Volcker Rule is a reasonable means to this end. Further, because large banks have access to the Federal Reserve's discount windows, it is particularly unacceptable that they should be allowed to gamble with funds borrowed from the U.S. Treasury (and taxpayers).

IV. Restrictions on the Exchange Stabilization Fund

Section 133 of the CHOICE Act places strict limitations on the Treasury's Exchange Stabilization Fund so that it cannot lend to, or guarantee, the obligations of a nongovernment entity. In my judgment, the most plausible scenario for a financial panic in the future is that a money market fund will "break the buck" and thereby create a panic that leads to hundreds of thousands of middle-income investors racing in panic to redeem their money market funds. This nearly happened in 2008 when the Reserve Fund did "break the buck." The crisis was averted when the Treasury used the Exchange Stabilization Fund to guarantee all money market funds. This is hardly an ideal solution, and the FSOC has suggested other solutions (which have been resisted successfully by the mutual fund industry). Still, use of the Exchange Stabilization Fund is a last resort solution that should not be denied to the Treasury. With little else adopted to avert a possible panic, it is foolish to abolish the Government's ability to utilize emergency solutions.

V. Financial Market Utilities

The Dodd-Frank Act requires most swaps to be cleared through clearinghouses. No one has challenged this reform because we all recall how the implosion of AIG's credit default swaps caused the 2008 crisis. But the creation of new clearinghouses creates a danger: one might fail. Such a clearinghouse failure would likely be even more catastrophic than the barely averted failure of AIG. Thus, it seems paradoxical that the provisions of Dodd-Frank allowing financial regulators to supervise clearinghouses (and other financial market utilities) would be repealed by the CHOICE Act. See Section 141. The result is to paint the financial system into a corner: requiring clearinghouses but making it easier for them to fail.

VI. Handcuffing the FSOC

The Financial Stability and Oversight Council ("FSOC") is downgraded by a number of CHOICE Act provisions, but none is more important than the eliminations of FSOC's ability to declare a non-bank to be a "systematically important financial institution." To date, FSOC has only used this power in a few cases, and the courts may resolve the propriety of its use of that power. This is an emergency power, and none of us can foresee what new and powerful financial institution will arise in the future. To deny FSOC that power assumes inaccurately that major changes in the financial environment will not occur in the future.

VII. Risk Retention Rules

Section 842 of the CHOICE Act would repeal Dodd-Frank's risk retention requirements (except in the case of residential mortgage securities). The simple truth that we all learned in 2008 was that the "originate to distribute" model is dangerous and encourages reckless behavior by originators who do not have to hold any percentage of their own product. The most feasible answer is to make them keep some "skin in the game." Residential mortgages are not unique; other financial assets can also be recklessly securitized, and the CHOICE Act will permit and encourage a return to such practices.

B. INVESTOR PROTECTION

The CHOICE Act does desirably increase penalty levels (see Sections 801-806), but this is more than offset by the following features:

1. The Defacto Elimination of Administrative Proceedings.

Section 823 of the CHOICE Act would enable a defendant charged civilly in a SEC administrative proceeding to require the SEC to move the proceedings to federal court. I suspect that the vast majority of such defendants would so opt—if only to slow the pace down. The SEC is severely resource constrained, and administrative proceedings permit the SEC to litigate at lower cost and more quickly. The slower the SEC must go, the more wrongdoers who escape sanctions. I do recognize that there are constitutional issues surrounding the SEC's use of administrative proceedings, but these issues do not involve questions of due process, but rather issues of executive power. They are best left to the Supreme Court to resolve in due course.

If a defendant did opt to stay in the administrative hearing, Section 831 raises the standard that the SEC must meet to "clear and convincing evidence." This is a standard usually reserved for issues involving loss of civil liberties, rather simply a monetary judgment. It adds another unnecessary obstacle to the SEC's ability to enforce the federal securities law.

2. Officer and Director Bars. Section 825 would also repeal the SEC's existing authority to bar individuals from serving as officers or directors of a public company. Although I agree that such a sanction should not be imposed indiscriminately (and might even justify a "clear and convincing" standard of proof), there is no reason to take this power away from the SEC. Can anyone doubt that a Bernie Madoff (if he escaped criminal liability) should be barred from so serving?

3. Fiduciary Duty. Section 841 of the CHOICE Act repeals the Department of Labor's fiduciary rule for brokers and other investment advisors. The SEC has shown for several years now that it is hopelessly stalemated on these issues and cannot strike a compromise between the "suitability rule" applicable to brokers and the tougher fiduciary rule applicable to investment advisers. Meanwhile, the industry has begun to respond to the DOL's rule, and major brokers are shifting from commissions to annual fees. In this light, repealing the DOL's rule and expecting the SEC to craft a substitute are ill-advised steps.

4. Enforcement Generally. The CHOICE Act adds a variety of new procedural rights and cost/benefit analyses that will hobble the SEC's enforcement program. I simply do not have the time or space to discuss all these, and I do not suggest that every one of these provisions is misguided, but the cumulative effect will be devastating.