

CAMBRIDGE WINTER CENTER
for Financial Institutions Policy



The Killer G's

Resolution Authority, Financial Stabilization,
and Taxpayer Bailouts

Research Note

April 23, 2010

THE KILLER G'S

Resolution Authority, Financial Stabilization, and Taxpayer Bailouts

By Raj Date¹

1.0 Introduction

More than three years after the U.S. mortgage market began its long, painful decline, the Senate Banking Committee last month passed a reform bill that, by its terms, purports to provide a sweeping overhaul of the nation's financial market regulation (the "Senate Bill" or the "Bill").² As early as next week, the full Senate will consider the legislation.

Like the bill passed by the House of Representatives in December³, and like the Administration's original legislative proposal last June⁴, the Senate Bill is in part intended to end the "too big to fail" problem.

That is, it is intended to sidestep the dilemma otherwise presented by the imminent failure of a large financial firm: the choice between (a) sudden bankruptcy, with its damaging ripple-effects on the broader economy; or (b) a taxpayer-funded bailout, with its attendant moral hazard and fundamental unfairness.

To date, policy-makers appear conflicted about whether the Bill succeeds or fails on this measure.⁵ This research note informs that question, by (1) describing a taxonomy of too big to fail bailouts as manifested during this financial crisis; (2) evaluating whether the Senate Bill, if it had been in place several years ago, would have prevented any or all of those taxpayer-funded rescues; and (3) highlighting an important caveat for policy-makers.

¹ Raj Date is the Chairman and Executive Director of the Cambridge Winter Center for Financial Institutions Policy. He is a former McKinsey & Company consultant, bank senior executive, and Wall Street managing director. The Cambridge Winter Center is a non-profit, non-partisan think tank focused on fostering a rational, fact-based dialogue on U.S. financial services policy. Cambridge Winter does not engage in lobbying activities, nor does it accept fees or other compensation for its services, including the publication of this report.

² Restoring American Financial Stability Act of 2010, S. 3217, 111 Cong., 2nd Sess. (2010) ("Senate Bill" or "Bill").

³ Wall Street Reform and Consumer Protection Act of 2009, H.R. 4173, 111 Cong. 2nd Sess. (2009) ("House Bill").

⁴ U.S. Department of the Treasury, Financial Regulatory Reform: A New Foundation, *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf (June 17, 2009) ("Treasury White Paper").

⁵ This is something of an understatement. The Bill's sponsor, Banking Committee Chairman Chris Dodd, has argued that the Bill "will end bailouts, ensuring that failing firms can be shut down without relying on taxpayer bailouts or threatening the stability of our economy." Opening Statement of Sen. Chris Dodd, Financial Reform: Full Committee Markup (March 23, 2010). Senate Minority Leader Mitch McConnell, by contrast, has argued that the Bill "would provide endless protection for the biggest banks on Wall Street." Press Release, "Financial Reform Must Not Lead to More Taxpayer-Funded Bailouts" (April 13, 2010).

2.0 Executive Summary

The term “bailout”, as applied to the most recent crisis, refers to three distinct kinds of taxpayer-funded support for private enterprises: “blank check” capital infusions and asset guarantees that supported all of a firm’s stakeholders, like the original TARP’s \$10 billion capital infusion into Goldman Sachs; “deathbed conversions” of non-banks into regulated bank holding companies, like the hurried transformation of GMAC; and “last resort liquidity” programs to alleviate the broad-based funding crunch, like the FDIC’s guarantee of more than \$50 billion of GE Capital’s unsecured debt.

The too big to fail problem manifests itself in all three categories of bailouts. As currently drafted, the Senate Bill dramatically reduces the problem posed by the first two, and makes some progress with respect to the third.

The “blank check” bailout is, in large measure, eliminated by the plain terms of the Bill’s resolution authority. Crucially, systemically important firms’ shareholders, creditors, and managers cannot wind up better off under the Bill’s resolution authority than they would have under a regular-way bankruptcy liquidation. Neither the pre-existence nor size of a resolution fund alters this fundamental point.

Moreover, because the Bill contemplates heightened prudential standards for even

shadow banks that are systemically important, the prospect of moral hazard-inducing “deathbed conversions” is diminished.

The Bill could be stronger with respect to “last resort liquidity”, particularly if policy-makers are concerned about generally available liquidity facilities that disproportionately benefit the largest firms. The Bill might, for example, provide a fast-track legislative check on the Fed’s emergency lending discretion, or inflict greater shareholder pain on a systemically important firm that avails itself of Fed- or FDIC-supplied emergency liquidity support.

The Senate Bill, then, takes a broadly sound approach to ending the too big to fail problem, with a few areas for tactical improvement. Policy-makers should recognize, though, that the power of the Bill’s approach could be eroded by systematic regulatory capture or inattention, particularly at the Federal Reserve.

3.0 A Bailout Taxonomy

In the most comprehensive understanding, a taxpayer-funded “bailout” includes any instance of government support to private enterprises, provided after the onset of the private firms’ financial distress. The massive government response to the financial crisis took myriad forms⁶, but government bailouts fit into three basic categories: the blank check; the deathbed conversion; and last resort liquidity. (*Figure 1*).

⁶ See Office of the Special Inspector General for the Troubled Asset Relief Program, Quarterly Report to Congress, pages 51-100 (overview of TARP and related programs), available at http://www.sig tarp.gov/reports/congress/2010/January2010_Quarterly_Report_to_Congress.pdf (January 30, 2010) (“SIGTARP 1Q10 Report”).

3.1 Blank Checks

The most striking category of bailout, and the one most reviled in the broad policy discourse, is the “blank check” -- that is, using taxpayer funds to directly invest subsidized capital into private firms, or to oth-

erwise directly buffer firms from loss through subsidized asset guarantees.

On its face, such intervention has two features that particularly create moral hazard, and therefore particularly distort market-based decisions. First, it typically protects

all stakeholders, including those that affirmatively chose to bear the most risk in the capital structure -- that is, equity holders, preferred stockholders, subordinated debt investors, and unsecured creditors.⁷ By doing so, it dulls the incentives for such high-risk investors to perform *ex ante* due diligence on financial firms’ risk profiles. Second, in most cases, such investments have not required the replacement of boards of directors, CEOs, or senior executives. As a result, the decision-makers who led their firms into distress, in large part, remain in place.

“Blank check” investments were authorized under six

Figure 1

Three Categories of Bailouts

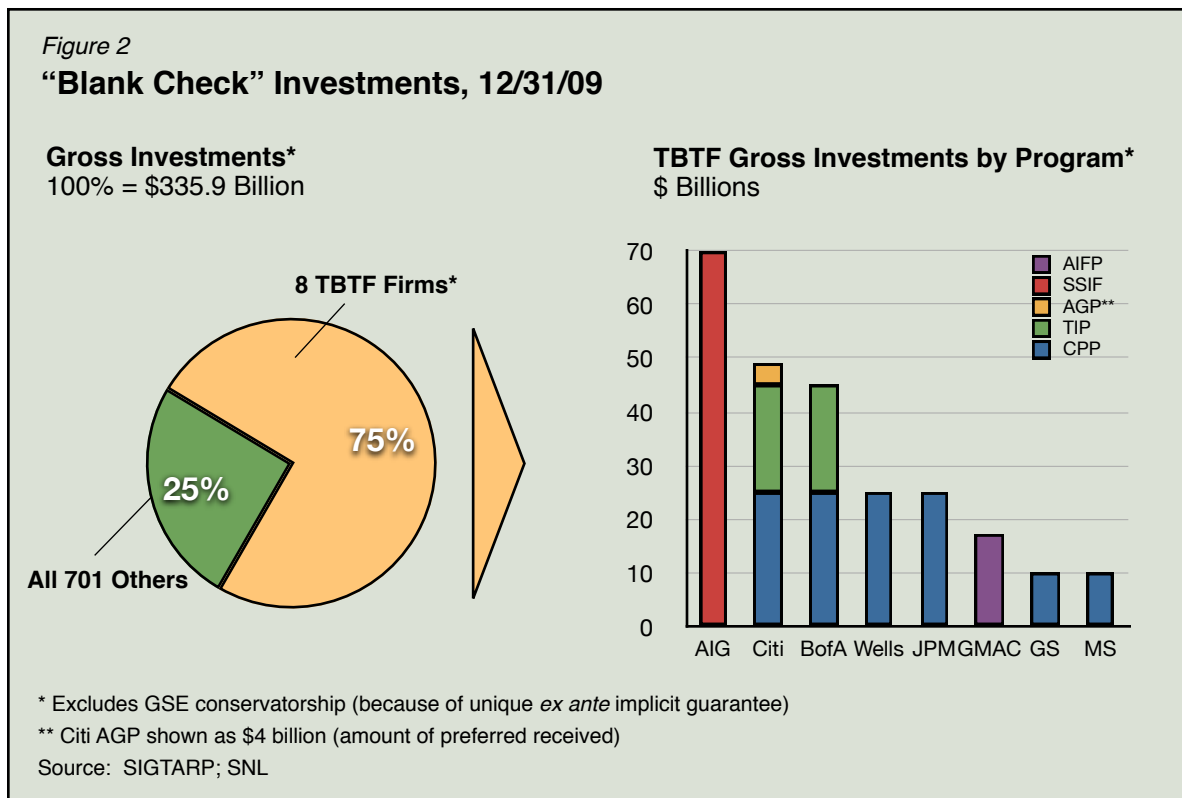
TYPE	DESCRIPTION	EXAMPLES
“Blank checks”	<ul style="list-style-type: none"> Capital infusions or asset guarantees Most or all stakeholders protected: senior debt, sub debt, preferred stock, and (frequently) common stock and management 	<ul style="list-style-type: none"> Capital Purchase Program (“CPP”) <ul style="list-style-type: none"> Banks & thrifts (e.g. SunTrust) Converted shadow banks (e.g. Goldman Sachs) Systemically Significant Failing Institutions (“SSFI”) <ul style="list-style-type: none"> AIG Targeted Investment Program (“TIP”) <ul style="list-style-type: none"> Citigroup, Bank of America Asset Guarantee Program (“AGP”): <ul style="list-style-type: none"> Citigroup Automotive Industry Financing Program (“AIFP”) <ul style="list-style-type: none"> GMAC GSE conservatorship <ul style="list-style-type: none"> Fannie Mae, Freddie Mac
“Deathbed conversions”	<ul style="list-style-type: none"> Convert “shadow bank” into bank to qualify for bank-specific bailouts <ul style="list-style-type: none"> Convert ILC to bank Convert parent company to bank holding company 	<ul style="list-style-type: none"> Large investment banks <ul style="list-style-type: none"> Goldman Sachs, Morgan Stanley Large finance companies <ul style="list-style-type: none"> GMAC, CIT, American Express, Discover
“Last resort liquidity”	<ul style="list-style-type: none"> Emergency taxpayer-backed funding <ul style="list-style-type: none"> Lending to financial institutions Guarantees of bank borrowing 	<ul style="list-style-type: none"> Federal Reserve <ul style="list-style-type: none"> Discount window Non-traditional expansion: CPFF, MMIFF, AMLF FDIC <ul style="list-style-type: none"> Expanded insurance cap Transaction Account Guarantee Debt Guarantee Program

Source: SIGTARP; Cambridge Winter Center analysis

⁷ Sometimes, that protection is not sufficient. Three banks (UCBH, Pacific Coast National Bancorp, and CIT) that received taxpayer capital infusions have failed anyway, essentially wiping out both private shareholders and the taxpayers’ investment. SIGTARP 1Q10 Report, *supra* note 6, at page 53.

different programs, the best known of which was the \$204.9 billion in preferred stock investments under the Capital Purchase Program (“CPP”) launched by then-Treasury Secretary Paulson in late 2008. Although the CPP was ostensibly available to a wide range of banks, the other five programs (GSE aid, TIP, SSFI, AGP, and AIFP)⁸ were explicitly targeted at only systemically important firms, on an *ad hoc* basis.

Taken together, “blank check” investments were made to 711 different firms. But those investments were dramatically concentrated on ten systemically important institutions: two government-sponsored enterprises (Fannie Mae and Freddie Mac); four banks (Bank of America, Citigroup, JP Morgan, Wells Fargo); two investment banks (Goldman Sachs, Morgan Stanley); one finance company (GMAC); and one insurance company (AIG). All of the GSE, TIP, SSFI, AGP, and AIFP investments made



⁸ The other five programs: the conservatorship of the housing GSEs Fannie Mae and Freddie Mac; the Targeted Investment Program (“TIP”); the Systemically Significant Failing Institutions (“SSFI”) program; the Asset Guarantee Program (“AGP”); and the Automotive Industry Financing Program (“AIFP”). Strictly speaking, another program, the Capital Assistance Program, would have provided capital to meet incremental needs as indicated by the 2009 “stress tests”, but no investments were made under that program. Eighteen of the 19 firms subject to the stress tests either were deemed to not require incremental capital, or raised that capital in the private markets. The last, GMAC, accessed the Automotive Industry Financing Program. See Press Release, U.S. Department of the Treasury, “Treasury Announcement Regarding the Capital Assistance Program” (November 9, 2009).

to financial companies were made to extremely large firms. Even the CPP, which was broadly available, was more than 58% focused on the largest firms. (Figure 2).

3.2 Deathbed Conversions

Many forms of taxpayer assistance, including the CPP, by statute could be extended only to regulated banks, but many troubled too-big-to-fail firms were actually lightly regulated “shadow banks.”⁹

In light of that, the banking regulators chose to convert systemically important distressed firms into banks, or otherwise liberalize last-resort lending facilities, so that giant shadow banks could qualify for both emergency funding and capital support.¹⁰ The beneficiaries of these conversions appear to have been, exclusively, extremely large investment banks (Goldman Sachs, Morgan Stanley) and finance

companies (CIT, GMAC, American Express, Discover).¹¹

The result was, for these shadow banks, the extraordinarily shrewd and successful culmination of a long-term regulatory arbitrage versus Federal Reserve supervision. Large Wall Street firms and finance companies had grown to dominate the use of the Utah ILC charter during the credit bubble, and thereby availed themselves of a loophole in Fed supervision that had originally had been intended for industrial companies. By doing so, the shadow banks evaded what otherwise would have been tighter leverage restrictions at their parent companies. (Figure 3).

When that excess leverage, and a reliance on non-bank wholesale-market funding, became predictably problematic during the credit crisis, they were allowed, through “deathbed conversions”, taxpayer assis-

⁹ Shadow banks can be properly understood as firms that take on illiquid, bank-like risks in their asset portfolios (like the credit risk and rate risk of residential mortgages), but fund those assets through relatively fragile wholesale-market non-deposit funding. See generally Raj Date and Michael Konczal, Out of the Shadows: Creating a 21st Century Glass-Steagall, Roosevelt Institute, available at http://www.cambridgewinter.org/Cambridge_Winter/Archives/Entries/2010/3/3_RESEARCH_NOTE_SHADOW_BANKING_files/out%20of%20the%20shadows%20030310.pdf (March 3, 2010).

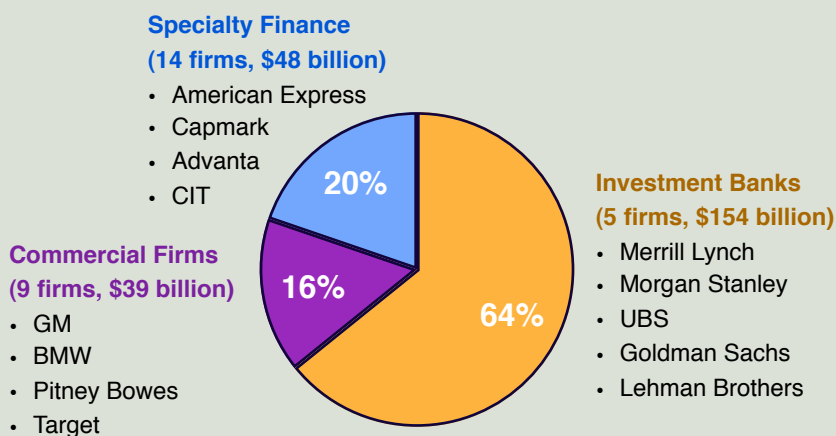
¹⁰ Conversions were typically executed by transforming an industrial loan company subsidiary (parent companies of which enjoy a loophole in the Federal Reserve’s bank holding company supervision) into a traditional commercial bank. Unlike the Treasury White Paper, the Senate Bill retains the ILC loophole, but provides that it be studied, and that a moratorium be imposed on new charters. Senate Bill, at section 603. See also Raj Date, ILCs and Shadow Banks, Cambridge Winter Center, available at http://www.cambridgewinter.org/Cambridge_Winter/Archives/Entries/2009/8/10_RESEARCH_NOTE_INDUSTRIAL_LOAN_COMPANIES_files/ILCs%20and%20shadows%20081009.pdf (August 10, 2009).

¹¹ See, e.g., Ari Levy and David Miltenberg, “Discover Wins Fed Approval to Become Bank”, Bloomberg, available at <http://www.bloomberg.com/apps/news?pid=20601087&sid=ajGN5jNMOHdY> (December 19, 2008).

Figure 3

Utah ILCs by Parent Company Type, 2Q08

Percent of ILC Assets



Source: FDIC; SNL; Cambridge Winter Center analysis

tance otherwise only available to banks that had been subject to more strict *ex ante* parent company supervision.

3.3 Last Resort Liquidity

Both the Federal Reserve and the FDIC, under current law, have emergency powers to provide for liquidity during a financial crisis. The principle behind those powers is straightforward: by providing a last-resort source of funding, government-backed entities can prevent the catastrophic propagation of panic-driven de-leveraging in the

financial system, and attendant real economy disruptions.¹²

Both the Fed and the FDIC aggressively used this authority during the crisis. The Fed's response had three major components: providing short-term liquidity to regulated banks through its traditional vehicles, like the discount window; directly lending to borrowers and to lenders in the shadow banking markets; and purchasing government and GSE securities in large quantities.¹³

For its part, the FDIC both expanded the limits of traditional deposit insurance (e.g. through the Transaction Account Guarantee program) and implemented non-traditional liquidity backstops -- the most significant being the Debt Guarantee Program, which had extended FDIC guarantees to some \$309 billion in unsecured debt outstanding at year-end 2009.

In principle, these liquidity programs were generally available to financial institutions.

¹² See Chairman Ben S. Bernanke, The Crisis and the Policy Response, Speech at the London School of Economics, available at <http://www.federalreserve.gov/newsevents/speech/bernanke20090113a.htm> (Jan. 13, 2009).

¹³ Federal Reserve, The Federal Reserve's Response to the Crisis, available at http://www.federalreserve.gov/monetarypolicy/bst_crisisresponse.htm (Feb. 5, 2010).

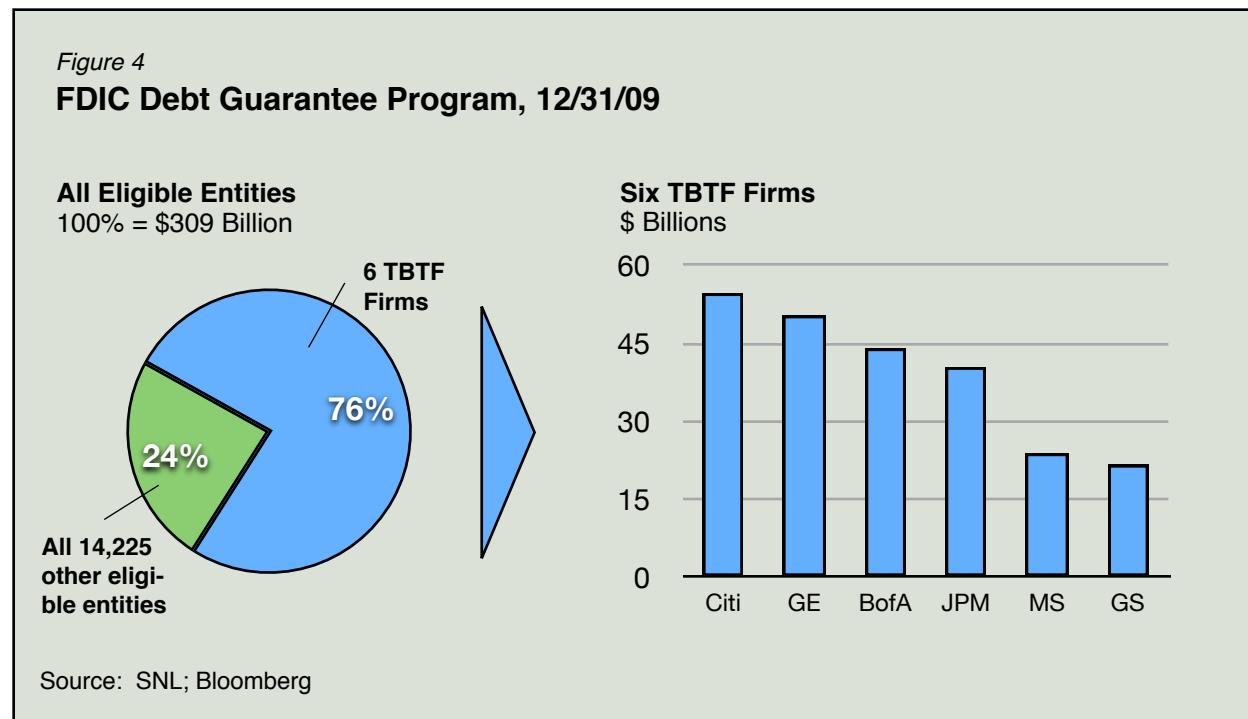
For example, 86% of depositories chose to participate in the FDIC's Transaction Account Guarantee program, and almost 55% of eligible institutions opted in to the Debt Guarantee Program.¹⁴

In practical terms, though, some programs were disproportionately valuable to systemically important firms. The Debt Guarantee Program, for example, proved most valuable to those firms that had disproportionately large non-deposit funding bases. Indeed, although there are more than 7,000 FDIC-insured banking organizations, and more than 14,000 legal entities eligible

for the program, fully 76% of Debt Guarantee Program volumes were issued by just six firms. (Figure 4).

4.0 Evaluating the Senate Bill

With this bailout taxonomy in place, the Senate Bill can be evaluated through specific examples from each category of taxpayer rescue. Considering the "Killer G's" -- Goldman Sachs, GMAC, and GE Capital -- can be especially instructive.¹⁵ Their business models are quite different from each other, but they share crucial common features: each was a shadow bank that ex-



¹⁴ See FDIC, Temporary Liquidity Guarantee Program, Final Rule, 73 Fed. Reg. 72244-72273 (Nov. 26, 2008) ("TLGP Final Rule") FDIC, Quarterly Banking Profile, Fourth Quarter 2009, page 19 (Feb. 1, 2010).

¹⁵ Two other "G's" -- the housing GSEs -- prove less useful as examples, given their uniquely bizarre *ex ante* implicit taxpayer backing. The core difficulty with the GSEs was not so much their taxpayer rescue, which was inevitable, but rather their fundamental structure and mission. See generally Raj Date, The Giants Fall: Eliminating Fannie Mae and Freddie Mac, Roosevelt Institute, available at http://www.cambridgewinter.org/Cambridge_Winter/Archives/Entries/2010/3/3_RESEARCH_NOTE_GSE_reform_files/giants%20fall%20030310.pdf (March 3, 2010).

exploited a regulatory loophole to avoid bank holding company supervision; each took on substantial credit or liquidity risk during the bubble; each faced the possibility of catastrophic capital or liquidity shortfalls; and each was deemed too big to fail and rescued by taxpayers.

4.1 Resolution Authority vs. Blank Checks

The Senate Bill succeeds in minimizing the probability of blank check bailouts, principally through the creation of a resolution authority for systemically important firms.¹⁶

4.1.1 The problem with bankruptcy

Systemically important financial firms, like Goldman Sachs, operate with dramatically higher leverage, in both percentage and nominal terms, than non-financial companies. At the end of 2007, for example, Goldman held more than \$29 of tangible assets for every \$1 of tangible equity. It had nearly \$1.1 trillion in liabilities.

Roughly half of that amount -- some \$530 billion -- were payables or short-term liabilities, like repo and commercial paper funding. Off-balance sheet liabilities, like open derivatives positions, add to these amounts.

As asset values deteriorate, as they did over the course of 2008, creditors of such a hyper-leveraged firm naturally grow quite anxious about the safety of their principal. They become progressively more conservative about the pricing, volumes, and terms

under which they are willing to refinance or “roll” their debt. Faced with constricting sources of debt, leveraged firms are forced to shed assets. Such selling causes realized losses, and broadly declining asset prices, which together cause further, quite rational, credit tightening by lenders. The result is a vicious cycle that resembles, in effect, a traditional bank run.¹⁷

Absent taxpayer intervention, and under current law, such a run on funding could conceivably have pushed Goldman into bankruptcy. As the Lehman bankruptcy illustrated, this is deeply problematic in the case of a systemically important financial firm.

First, as Goldman spiraled towards bankruptcy, it would turn to increasingly desperate asset sales. Given the firm’s size (more than 50% larger than Lehman), that would markedly amplify an already pro-cyclical plunge in asset prices.

Second, in a Goldman bankruptcy, its sheer number of creditors and counter-parties would have meant that financial institutions broadly would become even more skeptical about each other’s solvency, because the full nature of any given firm’s exposure to Goldman would not be immediately evident. The length and complexity associated with bankruptcy litigation would tend to prolong that uncertainty; uncertainty about a large number of financial institutions’ insolvency would have the predictable

¹⁶ Senate Bill, *supra* note 2, sections 201-11.

¹⁷ See Gary B. Gorton, Slapped in the Face by the Invisible Hand: Banking and the Panic of 2007, Federal Reserve Bank of Atlanta, 2009 Financial Markets Conference, pages 14-15 (May 9, 2009).

impact of grinding capital markets functions to a halt.

Third, financial firms' franchise value tends to decay quickly as talent and clients migrate to competitors, even within business units that might remain profitable throughout a crisis (like, say, Goldman's market-leading equity capital markets and M&A platforms). This means that stakeholders would end up with dramatically less than they would in a more orderly wind-down.

4.1.2 Resolution authority

Taken together, the reasons why a Goldman bankruptcy would be systemically inefficient are similar in kind to many of the reasons FDIC-insured banks are subject to resolution, instead of bankruptcy.¹⁸

Not surprisingly, then, the Senate Bill establishes an "Orderly Liquidation Authority" for systemically risky firms that, in broad terms, resembles the FDIC's resolution authority for insured depositories: clear priority of claims; expedited decision-making; access to working capital; flexibility to favor some creditors within a class to minimize aggregate losses; potential use of

"bridge bank" vehicles; the single-minded goal of liquidation. In other words, for systemically important financial firms, the Senate Bill extends the FDIC's resolution mechanism from banks to bank holding companies and shadow banks.¹⁹

One crucial distinction, though, is its scope. Whereas the FDIC subjects all insolvent depositories to potential receivership, the Senate Bill contemplates that the vast majority of non-bank financial firms would still be subject to the bankruptcy code. Only a small subset of bank holding companies or finance companies -- those in "default or danger of default", and whose regular-way bankruptcy "would have serious adverse effects on financial stability in the United States" -- would be subjected to the Bill's resolution authority.²⁰

That determination also appears subject to significant procedural hurdles. For Goldman to be put into liquidation, two-thirds of the SEC's board, two-thirds of the Fed's board, the Secretary of the Treasury (in consultation with the President), and a majority of a special three judge panel of the Bankruptcy Court would all have to agree.²¹

¹⁸ One of the implicit logical premises of the last decades' deregulatory impulse, culminating with 1999's Gramm-Leach-Bliley Act, was that shadow banks could be allowed to fail with no systemic collateral damage, precisely because they lacked a significant amount of insured deposits. While perhaps a plausible theory at the time, the last few years have demonstrated that premise to be tragically inaccurate. See Date and Konczal, *supra* note 9, at pages 66-68.

¹⁹ Senate Bill, *supra* note 2, at section 201(7), (11) (defining "covered financial company" and "financial company" for purposes of the title on orderly liquidation authority).

²⁰ *Id.* at section 203(b)(1), (2).

²¹ *Id.* at sections 202(a), (b) (describing "Orderly Liquidation Authority Panel" of Bankruptcy Court judges); 203(a)(1)(B) (describing SEC and Fed recommendations); 203(b) (describing Secretary of the Treasury's required determination). Note that in the case of firms in which banks, as opposed to broker dealers, are the primary subsidiaries, the FDIC's two-thirds vote is required instead of the SEC's. *Id.* at section 202(a)(1)(A).

Assuming that capital market conditions had continued to deteriorate in the absence of government intervention in September 2008, given Goldman's size and systemic centrality, it seems likely this determination of serious risk to financial stability would have been made.

This means that no taxpayer funds could have been used as capital infusions (as they were in a \$10 billion CPP investment to Goldman under TARP). Receivership by the FDIC, and the firm's liquidation, would have been the only course allowed under the Bill.

By the terms of the Senate Bill, in other words, a blank check bailout to Goldman in 2008 would have been impossible.

4.1.3 Removing moral hazard

The mere existence of a special resolution regime for certain large firms, and not others, could in theory create its own difficulties. Orderly liquidation almost certainly preserves more franchise value than an uncontrolled de-leveraging followed by bankruptcy. Absent counter-measures, that would create a perverse preference by creditors to lend to the largest and most

systemically risky firms, like Goldman, as opposed to smaller rivals.

In light of that risk, the Senate Bill crafts a strikingly punitive resolution regime. The Bill requires that the FDIC, as receiver, act "not for the purpose of preserving the covered financial company"; ensure that shareholders are paid only after all other claims are paid; require that unsecured creditors bear losses; and terminate "management responsible for the failed condition".²²

Crucially, the Bill also sets out a cap on the amount that a creditor can receive from the resolution of a systemically important firm. No creditor can receive more than it would have received in a regular-way chapter 7 bankruptcy liquidation.²³ Creditors cannot be better off because of the existence of the resolution authority. Thus, the Bill effectively severs the potential feedback loop from the existence of a special resolution regime to moral hazard among creditors.

4.1.4 Industry funding

The Bill provides that the FDIC, in its capacity as receiver, be able to access an "Orderly Liquidation Fund" to cover expenses associated with liquidating systemi-

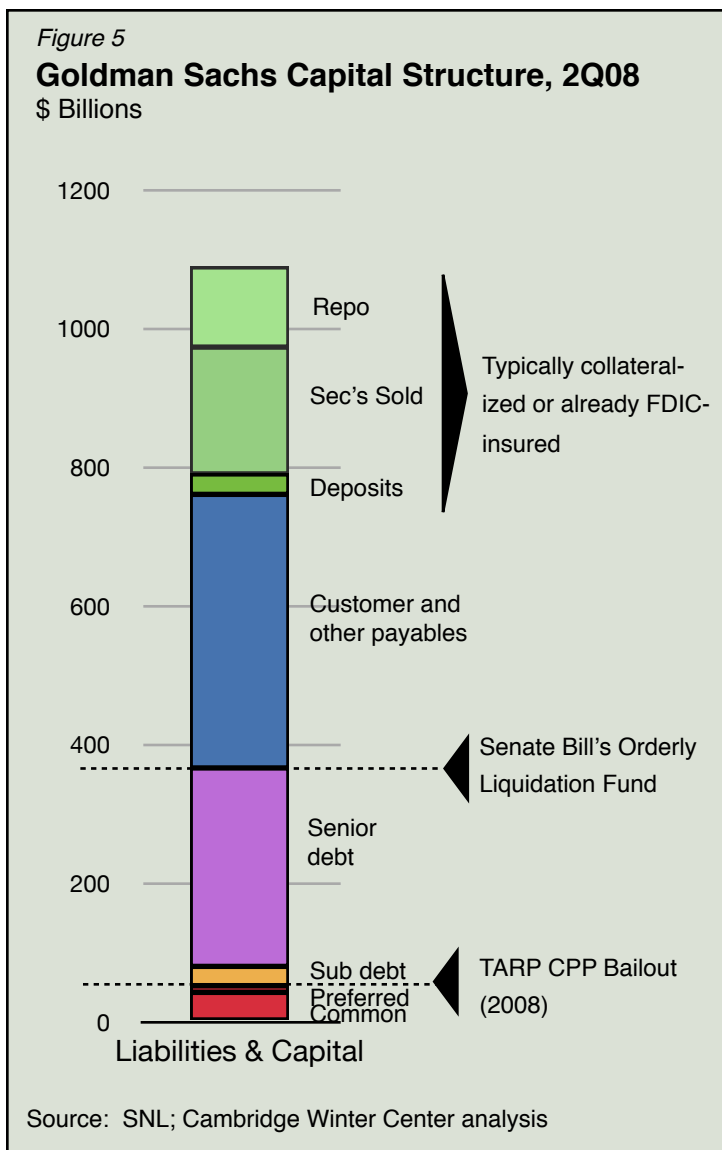
²² *Id.* at section 206.

²³ *Id.* at section 210(d)(2). Note that this maximum recovery also serves as a minimum recovery in those instances that the FDIC wishes to use its discretion to pay certain creditors more than similarly situated creditors, to minimize aggregate losses. In other words, the FDIC can preferentially pay a creditor, but only if similarly situated creditors are at least receiving what they would have received in a chapter 7 bankruptcy. *Id.* at section 210(b)(4)(B).

cally risky firms. The fund is built through risk-based assessments on the largest financial firms, over a five to 10 year period. To the extent that the costs of orderly liquidation exceed the amount of the fund, the Bill provides for a taxpayer line of credit, and for subsequent industry assessments for fund replenishment.²⁴

As currently defined, the fund is not, as it has been occasionally characterized, a “bailout fund” for shareholders and creditors. To the contrary, the Bill appears to quite unequivocally require that the FDIC’s expenses and amounts owed to the taxpayer are repaid before senior creditors, subordinated creditors, preferred shareholders, or equity holders.²⁵ Investors become a buffer for the fund. This is the *opposite* of the blank check bailouts of 2008, in which, for example, \$10 billion in taxpayer funds were explicitly subordinated to Goldman’s creditors. (Figure 5).

Notably, the critical features of such a fund are that they are industry-funded, and that they be backed by a taxpayer line of credit (which, if used, is repaid through industry assessments). With those in place, it is not functionally relevant whether the fund is created before resolution authority is invoked, or after. Nor does the size of a pre-funded amount appear necessarily relevant for the resolution authority’s credibility or effectiveness. The FDIC’s insurance fund, for example, remains negative, but deposi-



tor confidence does not appear to have been impaired by that fact.

Instead, the principal consideration for the timing of industry assessments should hinge on whether they might be made counter-cyclical. That is, ideally, risk-based assessments should not hit financial firms at precisely the time that their capital

²⁴ *Id.* at section 210(n), (o).

²⁵ *Id.* at section 210(b)(1). Note, however, that unlike in the House Bill, counter-parties in qualified financial contracts and secured creditors would not suffer haircuts that would support the fund’s repayment.

bases, and therefore their lending capacity, are already under pressure. Through that lens, pre-funding, which is the approach of the Bill, appears preferable because it is more clearly counter-cyclical, now that bank earnings have begun to rebound.

4.1.5 Regulatory & legislative forbearance

The Senate Bill, then, creates a resolution authority that does substantially eliminate the blank check bailouts that marked the fall of 2008.

Ironically, the principal weakness of the Bill in this respect is that its tough treatment of stakeholders may, over time, make regulators (Fed governors, FDIC directors, SEC commissioners) loathe to force a politically powerful, nearly iconic firm like Goldman into receivership before it actually defaults on its obligations, and before massive market disruption has already begun to take place.

A credible resolution authority would be superior to the bankruptcy of a large firm; but the receivership of a firm like Goldman would still be both disruptive and painful in both the financial system and the real economy.²⁶ Regulators will, presumably, have some notion of the magnitude of that

pain, and might conceivably exercise discretion to avoid it, in favor of forbearance. Regulatory forbearance sometimes allows firms to work their way out of trouble; as frequently, it just delays and amplifies troubled firms' eventual failure.

Legislative forbearance is also, perhaps inevitably, a danger. In the face of a politically important firm's receivership, a suddenly weak-kneed legislature might override the Senate Bill's provisions. After all, it was bipartisan legislative action -- at the behest of a Republican White House, and through a Democrat-controlled Congress -- that enabled the Goldman bailout in this crisis.²⁷

4.2 Shadow Bank Supervision vs. Deathbed Conversions

The Senate Bill takes a different, but still effective, approach to the second category of bailout: the deathbed conversion of failing systemically important shadow banks into regulated bank holding companies.

GMAC is a useful example. That firm, which was jointly owned by the private equity giant Cerberus Capital Management and General Motors, was a lightly regulated shadow bank with a major presence in con-

²⁶ Among other problems, a U.S.-based resolution authority, at present, would not precisely dovetail with the treatment of international affiliates. Harmonization of resolution schemes may be slow to develop, or may not develop at all.

²⁷ Emergency Economic Stabilization Act of 2008 (EESA), Pub. L. 110-343 (2008). Similarly, the bailout of the housing GSEs relied on congressional action, as requested by the Bush Administration, during 2008. Housing and Economic Recovery Act of 2008 (HERA), Pub. L. 110-289 (2008).

sumer auto finance, auto dealer finance, and -- disastrously -- non-traditional and subprime mortgage. Faced in 2008 with climbing credit losses, falling capital, and a looming liquidity crisis, GMAC asked for expedited conversion of its Utah ILC charter into a commercial bank, and a parent company conversion into a Fed-regulated bank holding company. Citing "unusual and exigent circumstances," and with only one dissenting vote, the Fed agreed.²⁸

A series of taxpayer rescues ensued, enabled by GMAC's newfound status as a bank holding company. For GMAC, and particularly for its creditors, this was the best possible outcome. It had been permitted to operate without bank holding company supervision and restrictions for years, but nevertheless ultimately enjoyed a safety net otherwise reserved for better-regulated firms. This regulatory coup by GMAC, unfortunately, is profoundly market-distorting. Shadow banks rely only on market discipline to control their risk appetite; they, definitionally, do not have significant bank-like prudential regulation. By allowing deathbed conversions and bail-

outs, this market discipline -- already apparently in short supply -- is eroded further.

The Senate Bill would have prevented this arbitrage by requiring that a systemically important non-bank like GMAC be subject to prudential regulation by the Fed, and, indeed, be subject to enhanced prudential standards by virtue of its size and centrality. Thus, although the bank holding company conversion itself might still have been possible under the Bill²⁹, the regulatory arbitrage and market distortions created by it would have been substantially mitigated.

4.3 Accountability vs. Last Resort Liquidity

The Senate Bill is weaker with respect to the third type of government assistance: the provision of last-resort liquidity.

GE Capital is the most instructive example in this category. The firm, a major subsidiary of the giant industrial conglomerate General Electric, is one of the largest U.S. shadow banks, and had more than \$620 billion in assets at the end of 2007. Because of GE's high-quality credit rating, GE

²⁸ Federal Reserve, Order Approving Formation of Bank Holding Companies, *available at* <http://www.federalreserve.gov/newsevents/press/orders/orders20081224a1.pdf> (Dec. 24, 2008). The dissenting vote was from Governor Duke, the only former commercial banker, and therefore the only Governor who would have had direct experience with GMAC's activities in the primary credit market. *Id.* at note 29.

²⁹ To be clear, the Bill does prevent a narrow class of deathbed conversions. If, for example, an OCC-regulated national bank has been subject to a cease-and-desist order, the Bill prevents its conversion to a state bank charter to escape its federal regulator. The Bill also prevents conversions in the opposite direction. Importantly, though, this prohibition would not have affected the significant bank holding company conversions during the crisis (e.g. Goldman Sachs, Morgan Stanley, GMAC). See Senate Bill, *supra* note 2, at section 612.

Capital was able to satisfy most of its immense borrowing needs, during the bubble, in the capital markets. As the crisis developed, and capital market conditions tightened, GE leaned heavily on both Fed and FDIC emergency liquidity programs.

4.3.1 FDIC liquidity programs

Only a small fraction of GE Capital's funding (some \$24 billion in the middle of 2008) came through FDIC-insured deposits. Despite that, the structure of the FDIC's Debt Guaranty Program enabled GE Capital to issue well more than that (more than \$50 billion) in unsecured debt that was, in effect, taxpayer-guaranteed. In essence, the program was structured³⁰ in a way that almost uniquely favored a shadow bank like GE -- one with a relatively small depository, but with immense unsecured debt that had been issued by the depository's affiliates. (Figure 6).

Under the Senate Bill, the FDIC would maintain broad discretion on the pricing and terms of such a guarantee program³¹, but it would be subject to additional checks on its ability to implement the program in a crisis. First, it would require approval of two-thirds of both the new Financial Stability Oversight Council and the Federal Reserve Board, plus the agreement of the Secretary of the Treasury.³² Second, the

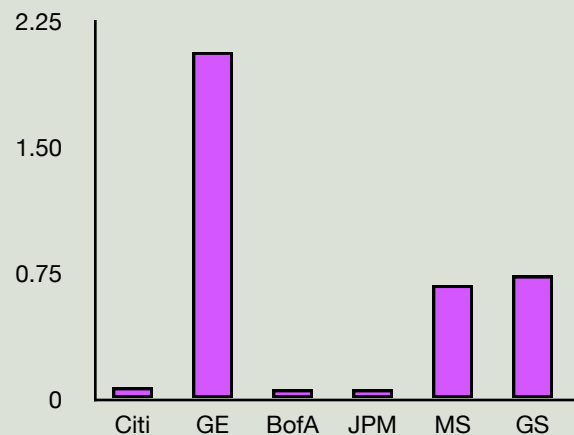
Bill provides for a legislative check, by creating the possibility of a fast-track joint resolution by Congress disapproving the program's implementation. In other words, the Bill creates the default presumption of Congress's approval, but creates a streamlined means to express disapproval.³³

The existence of those checks on the FDIC's discretion, though, would not likely have dictated a different outcome in the case of GE Capital. Given the severity of the post-Lehman liquidity squeeze, and the arguably unsurpassed economic and political impor-

Figure 6

Debt Guarantee to Pre-Crisis Deposits

Ratio: 4Q09 Debt Guarantees to 2Q08 Deposits



Source: FDIC; SNL; Cambridge Winter Center analysis

³⁰ The FDIC structured the Debt Guaranty Program so that (1) non-bank affiliates of depositories could issue debt; and (2) the amount of issuance was proportional to the amount of unsecured debt that the firm had outstanding, as opposed to the amount of its FDIC-insured deposits. See TLGP Final Rule, *supra* note 14.

³¹ Senate Bill, *supra* note 2, at section 1155(b).

³² *Id.* at section 1154.

³³ *Id.* at section 1155(d).

tance of GE, it is difficult to imagine that the Council, the Fed, or the Congress would have prevented the FDIC from coming to GE Capital's assistance.

4.3.2 Federal Reserve lending

The Bill is even less restrictive with respect to the Fed's discretion, as the GE Capital example also illustrates.

As one of the most substantial U.S. borrowers in the global capital markets, GE Capital benefitted substantially from the myriad emergency Federal Reserve lending programs in late 2008. For example, GE was, before the crisis, the single largest U.S. issuer of commercial paper. The Fed directly and indirectly supported that market through an alphabet-soup of programs -- CPFF, AMLF, and the MMIFF chief among them.³⁴

The Senate Bill creates some new constraints on the Fed's emergency lending authority, but none so substantial that it would have particularly impacted GE's ability to benefit during the crisis. Indeed, the Fed-related provisions appear to lack the fast-track legislative check that, in theory, could constrain the FDIC.

To its credit, the Bill does create a number of *post hoc* audit and disclosure requirements regarding Fed emergency liquidity

programs and their deployment.³⁵ It also makes clear that emergency lending should (1) be broadly available, (2) not subject the taxpayer to loss, and (3) not support failing firms.³⁶ But the CPFF, AMLF, and MMIFF all would appear to have met those criteria -- at least in their design. So, again, it is unlikely that the Bill, if it had been in place at the time, would have somehow prevented GE Capital's disproportionate use of emergency liquidity.

The near certainty that GE would receive emergency liquidity assistance, even with the Bill in place, would ordinarily create (or sustain) moral hazard among GE management, and the resultant tendency to operate with greater liquidity risk than would otherwise be prudent.

This is not a fatal flaw. The Bill would, after all, appear to require GE Capital to meet enhanced prudential requirements, including more stringent liquidity requirements, precisely because of its systemic importance.³⁷ But the relative lack of constraints on emergency liquidity in the Bill puts greater pressure on the efficacy of that prudential regulation.

³⁴ See, e.g., Rachel Layne and Scott Lanman, "GE to Sell CP to Fed to Help Unlock Credit Markets", Bloomberg, available at <http://www.bloomberg.com/apps/news?pid=20601009&sid=aDJKIbQuQxFc> (October 24, 2008).

³⁵ Senate Bill, *supra* note 2, at section 1151(6).

³⁶ *Id.* at sections 1151(2), (4), (5), (6).

³⁷ See *id.* at section 165(b)(1)(A)(iii) (enhanced prudential standards for systemically important non-banks shall include liquidity requirements).

5.0 Implications, and a Caveat

The Senate Bill represents a major improvement over current law with respect to the problem of “too big to fail” bailouts.

The Bill would dramatically reduce the prospect of “blank check” rescues, and mitigate the distortions produced by the “deathbed conversions” of shadow banks. Even the emergency liquidity provisions, which surely could be tightened further, are an improvement over current practice.

Still, policy-makers should be mindful of the Bill’s key vulnerability -- the threat of gradual regulatory capture or inattentiveness, particularly at the Federal Reserve.

- The Bill’s resolution authority can avoid disruptive uncontrolled collapses of giant firms -- *but only if regulators* have the courage to invoke it;
- Enhanced prudential regulation on large shadow banks can mitigate the moral hazard associated with deathbed conversions -- *but only if regulators* impose and enforce tough standards on them;
- Constrained yet powerful emergency liquidity facilities can be a prudent way to alleviate the impact of systemic shocks -- *but only if regulators* develop rigorous liquidity stress tests to mitigate the resultant moral hazard.

The Senate Bill creates a far more robust architecture for the financial system; but it may well rely too heavily on the discretion and talent of regulatory bodies that have proven themselves all too fallible.