

Guide to Proposed Congressional Financial Regulation



Prepared by: Midge Decter, Ruth King, Herb London and Carol Taber
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What You Need to Know About Financial Regulation

It is safe to say that most Americans support the idea of common sense financial regulations that will help to avoid future meltdowns in our financial system. But as reported by *Investor's Business Daily*:

“The problem is, what the president and Congress have so far proposed doesn't fix the problem. Instead, it makes scapegoats of the financial industry for our government's own regulatory failings — the very ones that led to the financial meltdown.

As we've noted many times, the U.S. is uniquely driven by investment. It's why our financial markets have since World War II been second to none in both innovation and getting capital to sectors that need it most.

But in the past year and a half, despite the commitment of nearly \$20 trillion in taxpayer funds to prevent another crisis, lending has stalled or shrunk. This isn't Wall Street's fault, or the fault of derivatives. It's the fault of specific government policies ranging from failed bank oversight by the Fed to housing policies geared toward raising homeownership to the decision to bail out companies that made bad bets because they were "too big to fail."

Yes, Wall Street needs regulation — but regulation that will work without turning one of our most sophisticated industries into a wholly owned subsidiary of the U.S. government. That's exactly what current reform proposals would do....”

Specifically, the Dodd bill is a dangerous piece of legislation that allows the government unprecedented discretion to seize America's largest financial institutions and other companies, prop up bloated companies which are “too big to fail”, and provide unlimited bailouts for favored companies and creditor groups at the expense of millions of taxpayers. The Dodd bill will severely harm the long-term competitiveness of the U.S. financial system and economy.

What actually needs fixing?

Modernizing the regulatory system to take on the challenges facing finance in the 21st century is a necessary task. What the nation needs are firms that are sound and resilient. This requires smart, thoughtful and targeted fixes that address the specific problems that can turn minor market fluctuations into crises, not overwhelming and unnecessary government control of our large parts of the economy. Such fixes include narrow but important changes to the existing bankruptcy laws, as well as global, comprehensive margin and capital requirements that are uniform for similar types of risk, regardless of what kind of firm incurs the risk and regardless of where around the world the risks are incurred.

The Dodd Bill

Under the preposterous assumption that the entire U.S. financial system can be “insured” by the imposition of huge taxes and the redistribution of those taxes as bailout funds, the bill represents a dangerous threat to the U.S. economy and financial system.

The 1,300-page bill proposes massive changes to the U.S. financial regulatory framework. For a broadly defined variety of U.S. companies with “*financial*” operations, the bill replaces the Bankruptcy Code, a bedrock of U.S. commercial law, with a new resolution scheme in which the FDIC is granted a stunningly large amount of power and discretion. The bill also gives the government the power to charge random and unlimited assessments (aka taxes) on a very wide range of U.S. corporations to create a bailout fund, and to use that money to arbitrarily pay whatever creditor groups that the government sees fit, regardless of contractual priorities.

The Dodd bill sets these rules eight months *before* the bipartisan Financial Crisis Inquiry Commission, tasked *by Congress* to understand the causes of the financial crisis, is scheduled to submit a report on its findings. The Dodd bill is a political rush job rather than sound policymaking. At the very least, the Commission’s report should be disseminated and analyzed before a sweeping overhaul is shaped.

A Government Takeover

The Dodd bill gives the FDIC unprecedented power to seize a broad range of U.S. “*financial companies*”, including firms that might not be considered conventional financial institutions, such as General Electric or the financial arm of a retailer. The FDIC can exercise this power if the agency and the Treasury Secretary believe that a company is “in danger of default” (following a determination by a judicial panel that has only 24 hours to hear and decide on a petition). Once the company has been seized, the FDIC will take control of the company as well as the entire resolution process. The FDIC effectively serves as the firm’s management *and* resolution judge *and* stakeholder, with minimal standards for judicial review.

Even worse, creditor rights are stripped by provisions that enable the FDIC to favor one class of creditor over another solely at the agency’s discretion. And, the bill allows the FDIC to determine that “*parties having responsibility for the condition of the financial company bear losses consistent with their responsibility.*” This is an invitation for open-ended attacks against anyone associated with a troubled financial company. These vague and punitive standards give the government unprecedented discretion over vast cross-sections of the U.S. economy.

The bill replaces decades of carefully developed bankruptcy law and precedent, eliminating fundamental protections of the rights of corporate stakeholders. For instance, under current law, companies cannot be forced involuntarily into bankruptcy unless they are generally not paying their undisputed debts as they are due. Purported insolvency alone is insufficient to force a company involuntarily into bankruptcy. And yet the Dodd bill sets a recklessly low bar by establishing a standard that the firm must only be “*in danger of default*”. This dramatically shifts the balance of power from corporate management to the government, creating greater market uncertainty for all corporate stakeholders. In addition, U.S. bankruptcy law has a strict absolute priority rule that ensures that if creditors bargain for particular treatment (e.g., senior or subordinated status) when making an investment, that treatment will be respected when

recoveries are distributed through a bankruptcy process. The Dodd bill tosses this fundamental and critical right into the garbage by allowing the FDIC to give disproportionate recoveries to creditors with similar claims. A recent example was the auto industry takeover in 2009, described below.

Furthermore, a company in bankruptcy cannot transfer assets of the firm without getting explicit approval from a bankruptcy judge. Again, this is a critical and fundamental right for creditors. When a lender makes a loan to a corporate entity, the loan contract (and the law) normally prevents the company from randomly removing important assets from the entity. The primary protection a lender has against a violation of these contractual provisions is to declare a default. But when a company is in a bankruptcy, it has already defaulted, and thus the normal contractual protection disappears. As a result, the rule of law provides a basic level of protection by ensuring that companies in Chapter 11 don't play games with corporate assets. The Dodd bill gives the FDIC nearly unfettered discretion to transfer assets out of the seized corporation without corresponding protections for creditors. The government did this in the auto industry takeover.

This is just the tip of the iceberg on differences between the Bankruptcy Code and the government takeover proposed in the Dodd bill. The dynamic is made worse by the fact that the FDIC lacks the knowledge and expertise to manage complex financial institutions (or the financial operations of industrial companies) or to deal with complicated derivatives contracts which played such an integral role in the recent crisis. The FDIC's commercial banking mandate is simple and unsophisticated – seize a commercial bank, transfer insured deposits and certain assets to another commercial bank, sell any remaining detritus, and use the Deposit Insurance Fund to compensate insured depositors. Much of this entire process occurs over a short period, normally just a few days. This model is vastly different than the FDIC's new mandate in the Dodd bill. By definition, the companies seized by the FDIC would not have viable private market alternatives. So the FDIC will actually have to run the company for an extended period of time (probably years), a role it very rarely assumes even with regular banks which do not contain the immense complexity of modern multi-faceted financial institutions. And since the FDIC process will employ the use of "*bridge companies*", it is likely that the FDIC will create new entities from parts of the seized company that are not liquidated, but run as going concerns.

Bailout Fund

The Dodd bill enables the FDIC to charge *unlimited* assessments (aka taxes) on a wide range of U.S. financial companies (not just investment banks or other firms vilified by politicians) in order to finance a bailout fund. The taxes may be incurred by relatively well-managed firms that don't cause systemic risk and will never see a dollar of benefit from the bailout fund. And if politicians think this is purely a "corporate" tax, they are sorely mistaken. The fees will ultimately be paid by the millions of customers or investors of these financial institutions and, hence, represents a hidden tax on the average taxpayer. For example, if the tax is imposed on a large well-run financial institution, the parties who bear the cost are either its customers or its shareholders (which consist of pension plans, endowments, and mutual funds, with millions of taxpayers as beneficiaries or owners), or both.

The taxes are assessed not only on financial institutions, but on *any creditor* who receives payment or credit from a financial institution that has been seized by the FDIC. (This is eerily

reminiscent of TARP, in which the government saw fit to bully any recipient of TARP dollars.) In addition, there are no consistent or certain standards for calculating the size of the tax that any particular firm may face, creating tremendous uncertainty for financial firms that operate in the U.S.

The taxes will be used by the government pre-crisis to create an initial \$50 billion bailout fund. After that fund is depleted, the FDIC has the power to raise unlimited additional dollars. And these assessment fees can be used to pay creditors of the failing firms as the FDIC sees fit, regardless of their contractual priority. This is why we call it a bailout fund. It can be used to preserve large institutions that would otherwise be broken up or go out of business, or it can be used to give disproportionate recoveries to creditors the government thinks are systemically important. In fact, this exact type of bailout occurred in the recent crisis when the government used tens of billions of taxpayer dollars to pay off AIG's creditors including Goldman Sachs, Morgan Stanley, et al.

The bill also gives the FDIC the power to provide unlimited guarantees during a time of systemic crisis. And the Fed still retains emergency lending powers to the marketplace which will certainly be tapped by solvent and struggling companies alike. The opportunity for payments by the government to financial institutions is even broader than prior to the crisis.

Institutionalizing “Too Big To Fail”

By allowing the government to seize financial institutions and then use taxpayer funds to keep big companies alive, or pay off creditors that the government favors or deems systemically important, the Dodd bill institutionalizes corporate bailouts and enshrines the concept of “too big to fail”. And the moment a company becomes subject to the FDIC liquidation authority, creditors will jockey for position to receive these government handouts. The Dodd bill also sends the message that if you are a creditor to one of these financial institutions, you will potentially be subject to unlimited taxes.

With such broad government control and discretion, just think about the myriad ways that the scheme distorts the structure of the U.S. financial industry as well as primary and secondary markets for credit to financial institutions. The Dodd bill creates special companies that are subject to special rules which have access to special dollars. With so many opportunities for gamesmanship and arbitrage who knows the extent to which the U.S. financial system will be reordered?

What is more knowable is that the Dodd bill represents a massive wealth redistribution scheme that forces well-managed businesses to pay incalculable and unlimited taxes to competitors who take dangerous and excessive risks. At the same time, in practice, the policies do nothing to discourage “too big to fail”. If anything, the presence of slush funds, endless assessments, unlimited FDIC guarantees and Fed emergency lending powers create the potential that the largest, most complicated firms will become even larger and more complex as these firms petition for bailout dollars. Ultimately this legislation has the potential to turn America's largest financial institutions into GSE's.

Sanctioning Inequities

The Dodd bill is also an invitation to corrupt government behavior. With such expansive power by the government to randomly tax businesses and to apportion different recoveries to creditors who hold the *exact same claim*, it is almost inevitable that the government will behave corruptly and favor political constituents.

Investors experienced this kind of corruption first-hand in the Chrysler and GM bailouts, in which the biggest donor base of the Democrats – the labor unions – received an approximately \$15 billion gift from the government (i.e., taxpayers) in the form of higher recoveries on union members' unsecured claims as compared to the dramatically lower recoveries for *pari passu* unsecured claims or even higher priority secured claims. The government argued that because the government infusions of cash were required to save the companies from liquidation, it could give any creditor constituency any extra recovery it desired. Absent from the government's argument was a critical reality – the cash infusions were from the taxpayers, and the recipients of the extra \$15 billion gift were the labor unions which were the largest political donors of the Democratic party which was running the government.

The Dodd bill seeks to codify this inequitable treatment by giving government the explicit legal power to bestow different recoveries upon creditors who hold the exact same claim. The investment community has already seen that the government is willing to manipulate existing rules in order to reach a desired outcome. It is difficult to imagine how much more egregious the behavior may be if the government has the legal authority to break contracts, transfer assets around without regard to creditor's rights, and deliver disproportionately higher payments to its political donors and friends.

Erosion of U.S. Financial Markets and Economy

The new FDIC resolution authority, combined with the bailout fund, could increasingly destabilize the U.S. financial markets and economy. As in the "Too Big To Fail" section above, these policies will distort the way our largest institutions access financial markets, likely creating even larger and more complicated financial institutions and eventually putting the entire financial system under the government's thumb.

Once market participants begin to realize the tremendous uncertainty that these policies create – whether it is incalculable and unlimited taxes or the random, disparate treatment of corporate stakeholders – there will be a severe chilling effect on investment, growth and job creation in the U.S. No business can voluntarily allow itself to be subject to completely unpredictable taxes and tax rates. No investor can provide credit without being able to accurately calculate his potential downside within a reasonable degree of certainty. This bill will threaten the position of the U.S. as the global center of finance.

A Prescription for Regulatory Change.

Markets have not existed in a state of nature. There have been rules related to capital and margin requirements for decades, keeping risk-taking within bounds. Financial institutions that take gigantic risky trading positions without adequate capital and that pile on excessive amounts of leverage are relatively new phenomena, basically only in the last ten to twenty years. During the recent crisis, major financial institutions were leveraged 30:1 or 40:1. A system comprised of such shaky institutions can fall like dominos at light speed as losses of only a few percent make

these companies insolvent and susceptible to runs on their liquidity. Compare this to more traditional leverage ratios of 15:1 or 10:1 or lower which allow companies to absorb losses and volatile market reverberations. What the nation needs are firms that are sound and resilient. This requires global, comprehensive margin and capital requirements that are uniform for similar types of risk, regardless of what kind of firm incurs the risk and regardless of where around the world the risks are incurred.

With respect to resolving authority, the Bankruptcy Code is entirely capable of handling large complex financial institutions. The Dodd bill's numerous overreaching mechanisms, such as the FDIC liquidation process and the bailout funds, are unnecessary and unhelpful. The problems with our financial system in recent decades are not due to the absence of government authority to seize financial firms.

The bankruptcies of Washington Mutual (\$300+ billion), Lehman (\$600+ billion), Drexel Burnham, Enron, Worldcom, and others, have been handled through the bankruptcy process without systemic risk. The bankruptcy process allows a company to sort out financial and strategic issues, prepare a plan of reorganization or liquidate, and allocate recoveries to creditors according to contractual priorities and a body of law that has been refined by decades of insolvency disputes.

One of the primary reasons why the Lehman failure had such a volatile impact on financial markets was that the firm's immense derivatives book (over a million bilateral trades) froze, generating a cascading effect directly on its counterparties and indirectly on multiple other firms that had large leveraged derivatives trading or investing activities. In addition, collateral grabs by counterparties and other creditors around the time of the bankruptcy created a partial run on the institution, which left it with a larger-than-anticipated financial hole.

Had Lehman and other financial institutions been able and required to continue receiving and paying daily mark-to-market payments related to bilateral derivatives even with most of its entities in bankruptcy, the derivatives books could have been unwound quickly, but without the systemic disruption of an instant unwind. In addition, a more orderly unwind would prevent counterparties from using provisions in their derivatives contracts to assert egregiously large claims.

Thus, from a bankruptcy perspective what actually needs to be fixed is the way over-the-counter derivatives books are treated. Important fixes to the Bankruptcy Code would allow derivatives books to continue in existence for a limited time as long as daily two-way mark-to-market payments continue. This may require a very brief stay on derivatives terminations to allow for a more orderly unwind of dealers' books. Counterparties would have to make payments to the debtor, and the debtor would have to make payments. If the debtor needs liquidity it could borrow privately, or the government could form a facility, like traditional debtor-in-possession bankruptcy financing, that is senior secured and provides adequate protection to existing secured lenders, to provide liquidity for daily mark-to-market payments. Such a government facility would be as protected as possible against loss and its uses would be highly restricted and not deployed for random, discretionary political purposes. The facility would be proscribed by Congress at the time of the crisis to ensure such limitations, unlike the Dodd bill which places

unlimited borrowing capacity in the hands of a few unelected officials today. This is the type of minimalist government intervention that may be appropriate in case of crisis. Instead, the Dodd bill provisions for massive bailout funds today (that can be raised on the backs of selected taxpayers of the government's choosing) and massive new government infrastructure and intrusiveness, which is just the type of unnecessary largesse that will be damaging to the economy.

These fixes need to occur simultaneous with changes in the way derivatives are traded. Derivatives should be traded on exchanges or clearing houses wherever possible, with every party posting adequate margin, and bilateral derivatives should carry higher margin and capital requirements than exchange-traded derivatives. In addition, all parties should be required to post variation margin based on two-way daily marks-to-market. There cannot be exceptions for parties, such as dealers, who may build up large uncollateralized obligations in the absence of two-way daily mark-to-market provisions.

End-user exemptions for derivatives trading should not be permitted. Such exceptions are unwarranted loopholes which will enable much of the same risky behavior as before, with much the same systemic risks. Initiating large derivatives positions under the rubric of "hedging" enables firms to take mismatched positions in commodities or output requirements versus derivatives, and the marks-to-market that are needed to limit counterparty risk can lead to large cash outflows that can eviscerate their liquidity and financial condition. Such positions need to be margined properly. Also, in the case of financial institutions, what constitutes a "hedge" versus a pure risk position is ethereal at best, and will just facilitate big risky trades that continue the pre-crash ability of companies to seek private gain at public taxpayer risk if the trades go wrong.

Conclusions

- The Dodd bill requires real debate. If our leaders are serious about ending bailouts and addressing firms that cause systemic events, the legislation must be substantially reworked.
- The bill creates mechanisms to bail out creditors of systemically important companies who would otherwise not get paid if the government (i.e., taxpayers) did not provide these funds.
- It is disingenuous for politicians to argue that these funds are paid by big companies and not the average taxpayer.
- The creation of a fund or the existence of government assessment powers and government guarantees signals to the market that there will be cash and/or credit waiting to be showered on the systemically important creditors of the seized systemically important institutions.
- The unlimited assessment and guarantee powers are in the hands of a few unelected officials. Congress is abdicating its authority to limit the extension of bailout funds in future crises.

- The structural elements of the Dodd bill unfairly favor large institutions that are perceived to be systemically important. And it will concentrate even greater power in a handful of financial institutions that will be firmly under the government's thumb (ie, quasi-GSE's).
- The discretion given to the government to treat similarly situated creditors differently and to randomly transfer assets and liabilities of the seized companies without adequate judicial review, practically ensures bad behavior and political favoritism.
- Global standards for more prudent capital and margin requirements are needed. Ensuring the soundness of individual firms will ensure the soundness of the system.
- Instead of an entirely new and dangerous resolution scheme that unnecessarily gives massive power and discretion to a few federal officials, the country needs thoughtful fixes to the bankruptcy code. For decades, the code has facilitated the fair and successful reorganization and liquidation of distressed firms, under a system managed by court supervision and a well-developed body of reliable law.
- The government needs to make regulators accountable for their failures in regulating financial markets. Not reward the same government officials who encouraged or were oblivious to the recent financial crisis.
- Uncertainty among creditors will make the U.S. financial system more prone to volatile shocks. Capital and investment will go where it is welcome and subject to fair, understandable law and practice. Investors, innovators and job-providers will not flock to America just because of America's history as the land of opportunity if America's rulers demonstrate a lack of respect for law, fairness, predictability and providing attractive incentives for investment.