Senator Reed Introduces Study Bill to Assess Systemic Risk Impact of "Bankruptcy-for-Banks" Reforms

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"Bankruptcy for banks" (or, more properly, bank holding companies) is the focus of the Bankruptcy Fairness Act of 2016, introduced by Senator Reed earlier this month.[1] The bill would require regulators to assess and report on the systemic risk impact of potential changes to the Bankruptcy Code ("the Code") that could facilitate the resolution of financial companies in bankruptcy. The bill would require some big picture thinking from the regulators, mandating that they assess different bankruptcy rules and systems, looking not only at the viability of these mechanisms in restructuring a single failed entity, but also at the likelihood that such changes would raise or reduce moral hazard and systemic risk.

The bill would enact few changes to the Code itself at this stage. Its proposed studies, however, add an important new dimension to the debate over bankruptcy reform, as the bill's structure implies that current reform efforts could distort pre-bankruptcy incentives and generate systemic risk, or at least that the potential for this outcome needs deeper consideration. Other recent legislative proposals have centered on amending the Code to handle the mechanics of resolving financial companies that have already failed. One such bill, the Financial Institution Bankruptcy Act ("FIBA"), passed the House in April of this year.[2]

This memorandum reviews the highlights of Senator Reed's bill and identifies where the bill's approach to bankruptcy reform diverges from that of FIBA's "subchapter V" and various "chapter 14" proposals introduced in Congress in recent years.

<u>Studies on the Code</u>

The core provisions of the bill call for two sets of studies on bankruptcy procedure and the Bankruptcy Code to be issued with recommendations and updated periodically.

One study, to be conducted by the federal judiciary, focuses on identifying the expertise needed for judges to oversee financial company bankruptcies and on flagging provisions in the Code and in bankruptcy procedure that complicate the Code-based resolution of financial companies.[3]

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[1] Bankruptcy Fairness Act of 2016, S. 3505, 114th Cong. (2016) [hereinafter "Bankruptcy Fairness Act"].
[2] Financial Institution Bankruptcy Act of 2016, H.R. 2947, 114th Cong. (as referred to the Senate Apr. 13, 2016) [hereinafter "FIBA"].
[3] Bankruptcy Fairness Act, § 3(a).

The second study, to be conducted by the Office of Financial Research ("OFR") and updated every two years, calls for an in-depth assessment of core policies embodied in the Bankruptcy Code as they affect financial companies.[4] The bill divides the required study into four parts, with each part focusing on key issues that have arisen in the debate on Bankruptcy Code reform since the 2008 financial crisis and that the bill implicitly indicates have not yet been well-addressed. The remainder of this memo summarizes the bill's focus on these four issues: the treatment of qualified financial contracts (such as repurchase agreements and derivatives), the possibility of breaking up master netting agreements if other restructuring efforts fail, the feasibility of the "single point of entry" resolution strategy, and the availability of financing for a bankrupt financial company.

1. Treatment of Financial Contracts

The role of the Bankruptcy Code's safe harbors for financial contracts in the financial crisis has been a major topic in debates on bankruptcy reform since 2008. The safe harbors allow favored financial contracts—like repurchase agreements ("repos") collateralized with U.S. Treasury securities or mortgage-backed securities ("MBS"), as well as derivatives contracts—to be exempt from the Bankruptcy Code's stay on immediate collection by creditors, which is designed to hold an otherwise viable enterprise together during bankruptcy. The stay also exempts financial contract creditors from most fraudulent conveyance liability. Senator Reed's bill would direct the OFR to study whether amendments to the current treatment of financial contracts might reduce losses in troubled financial companies and lessen risks to financial stability.

The bill requires more than an up or down (safe harbor or no safe harbor) analytic, which is common in discussions on Code reform. Instead, it adds nuance by calling for specific consideration of the extent to which different financial contracts should be safe harbored and whether different termination timelines are appropriate.[5] For example, the bill distinguishes between Treasury and MBS repos, presumably reflecting the price stability of and robust market for Treasuries relative to MBS.[6] It also designates securities lending agreements, interest rate swaps, and foreign exchange forwards for separate attention and analysis on the question of whether a full safe harbor is necessary and merited.[7]

With regard to termination timelines, the proposal directs the OFR to consider the effect of permitting termination at various points between the filing of the petition and either the contract's original maturity date or the date on which the debtor can no longer afford to provide adequate protection by posting variation margin.[8] Essentially, the bill asks whether all of the typically safe harbored contracts pose the same systemic risks and,

[4] Bankruptcy Fairness Act, § 5.
[5] Bankruptcy Fairness Act, §§ 5(b)(3)–(4).
[6] Bankruptcy Fairness Act, § 5(b)(3).
[7] Bankruptcy Fairness Act, § 5(b)(3).
[8] Bankruptcy Fairness Act, § 5(b)(4).

accordingly, whether tailored stay timelines should be considered. In contrast, neither the current Code nor FIBA distinguishes among financial contracts based on their "runnability" or any other systemic risk they pose. As it stands today, the Code exempts all of the safe harbored financial contracts from the stay entirely, and FIBA would enact an across-the-board 48-hour stay.[9]

Overall, the bill's proposed study of financial contracts seems to seek a foundational review of whether and how to reform core provisions of the Code to evaluate which changes would exacerbate pre-bankruptcy incentives that generate systemic risk and which changes would lower such risk. In other words, the bill appears to ask which rules would expand the use of systemically-sensitive markets and instruments and which rules would reduce it.

The bill also seems skeptical as to whether consideration of pre-bankruptcy incentives sufficiently informs recently proposed legislation in this area, such as FIBA, which is primarily geared toward equipping the Code to handle the bankruptcy of a financial company that is already in trouble.[10] In focusing instead on Code reforms that would target a major source of systemic risk and contributor to failure, Senator Reed's bill seeks to expand the terms of the current debate on Code reform.

2. Break Up of Master Netting Agreements

The bill would also direct the OFR to consider some policy options for handling the risks attendant on large, complex master netting agreements ("MNAs"). Under title II of the Dodd-Frank Act, the debtor financial company must assume, assume and assign, or reject all financial contracts with a particular counterparty.[11] This all-or-nothing restriction is intended to protect non-debtor counterparties from being stuck with all the unfavorable contracts from a portfolio, which would occur if the debtor could "cherry pick" by assuming some contracts and rejecting others. The bankrupt debtor, if authorized to do so, could assume the contracts it finds profitable and reject those it finds unprofitable. The other recently proposed amendments to the Bankruptcy Code have followed this lead, adopting an all-or-nothing approach.[12]

The Bankruptcy Fairness Act, however, directs the OFR to evaluate the possibility of dividing the financial contracts covered by a large MNA into groups based on product type and risk level and then disposing of the contracts in these bundles.[13] The division of an MNA appears to be designed to come into play if the transfer of the whole portfolio under title II or an amended Code fails. Breaking up MNAs along these lines could make it easier to sell off the large derivatives portfolios of systemically important

[9] *See* FIBA, § 3 (adding a 48-hour stay through proposed §§ 1187(a)(3) and 1188(a)).
[10] FIBA, § 3.
[11] 12 U.S.C. § 5390(c)(9).
[12] *See* FIBA, § 3 (requiring debtor all-or-none treatment for qualified financial contracts in proposed § 1188(a)).
[13] Bankruptcy Fairness Act, § 5(e).

financial institutions, without contract-by-contract close-outs, because a wider range of financial institutions would be able to assume each bundle. Improving the marketability of the bulk of a financial company's portfolio would, in turn, reduce both risks to overall financial stability and the likelihood of a federal government bail-out of a troubled financial institution. Presumably the bill's drafters had in mind the disruptive close-outs of Lehman's financial contracts under bankruptcy rules that allowed neither the transfer of an entire portfolio nor its division into product lines.

By introducing the idea of breaking up MNAs, the Bankruptcy Fairness Act could modulate policy discussions on how to handle financial contracts in bankruptcy, adding an alternative to the stark all-or-nothing proposition common in other reform proposals.

3. *Single Point of Entry Assessment*

The bill would require the OFR to evaluate the single-point-of-entry ("SPOE") strategy that has come to dominate the discussion of financial company resolution.[14] Various reform proposals, including the version of FIBA that passed the House, have focused solely or primarily on amending the Code to facilitate the use of this strategy in bankruptcy.[15] The Bankruptcy Fairness Act, however, appears to be critical of SPOE, either as a general strategy or to the extent that it has become the only substantial resolution mechanism in other proposed legislation.

For example, the bill directs the OFR to assess obstacles to capitalizing, funding, and transferring the assets of a financial company to a bridge company in the 48-hour window envisioned for SPOE under FIBA and similar proposals.[16] As part of this assessment, the bill focuses attention on the risk that a financial company reborn through SPOE might still be an unattractive credit risk or investment opportunity for other financial market participants, given its predecessor's recent trouble.[17]

The bill also focuses on the risks to financial stability that could arise from the failed resolution of a systemically important financial institution ("SIFI") through the SPOE strategy. On this issue, the bill calls for a study of how the negative effects of a failed SPOE resolution might be mitigated both in a world with title II and in a world without it.[18] Presumably the study would evaluate what steps could be taken if an SPOE resolution failed. Overall, the Bankruptcy Fairness Act's skepticism of the SPOE strategy

[14] Bankruptcy Fairness Act, § 5(c).
[15] FIBA, § 3. The single-point-of-entry strategy aims to have loss-absorbing financial instruments, including unsecured long-term debt, positioned at the financial holding company to take the loss in the event of a failure and support the subsidiaries' debt, including its qualified financial contracts. On December 15, 2016, the Board of Governors of the Federal Reserve System finalized a rule requiring top-tier bank holding companies to maintain such "total loss-absorbing capacity."
[16] Bankruptcy Fairness Act, §§ 5(c)(2)–(3), (7) and (10); FIBA, § 3; Taxpayer Protection and Responsible Resolution Act, S. 1840, 114th Cong. § 3 (2015) (adding proposed § 1407(a)(3), which would terminate the temporary stay after 48 hours).
[17] Bankruptcy Fairness Act, § 5(c)(8).
[18] Bankruptcy Fairness Act, § 5(c)(4).

adds a divergent perspective to the congressional and regulatory discussion of bankruptcy reform, which has tended to look to SPOE as the only mechanism needed for resolution.

4. *Financing*

Funding and liquidity for a financial company in bankruptcy is another critical issue that remains unresolved in the bankruptcy-for-banks policy debate. A financial company could need a significant amount of financing during resolution. Title II of Dodd-Frank authorizes the Federal Deposit Insurance Corporation ("FDIC") to obtain financing from the U.S. Treasury to aid in the resolution of a SIFI under that title.[19] Public funding is not clearly available to a financial company in bankruptcy, however, and the size of funding, particularly during a crisis, might be larger than is common in private markets. FIBA makes no provision for financing a bankrupt financial company during its resolution under an amended Bankruptcy Code. Drawing attention back to the financing issue, Senator Reed's bill would require regulators to study how much financing a financial company in bankruptcy would need over a two-year period, whether private financing would be available to a bankrupt financial company, and what amendments to the Code would be necessary to give a bankrupt financial company easier access to private credit.[20]

<u>Regulator Involvement and Appointment of Judges</u>

In addition to the Bankruptcy Code studies, the bill would enact a set of specific changes to bankruptcy procedure to facilitate the resolution of financial companies under the Code. First, the bill would give regulators explicit standing to raise and be heard on any issue in a bankruptcy case in which the debtor is a financial company,[21] although it would not give regulators power to file an involuntary petition as some earlier proposals have done.[22] Second, the bill would provide for the Board of Governors of the Federal Reserve System and the FDIC to nominate five prospective trustees for the financial company debtor, with the United States trustee to appoint a nominee from this list.[23] Finally, to help ensure that the judge overseeing the bankruptcy of a financial company has the requisite expertise, the bill requires the Supreme Court to issue a rule providing for the appointment of a bankruptcy or district court judge knowledgeable about financial company resolution to oversee the case.[24]

[19] 12 U.S.C. § 5390(n).
[20] Bankruptcy Fairness Act, § 5(d).
[21] Bankruptcy Fairness Act, § 4(2).
[22] When FIBA was introduced in the House, it gave the Board of Governors of the Federal Reserve System authority to file an involuntary petition, although this provision was deleted before the bill passed the House in April 2016.
[23] Bankruptcy Fairness Act, § 4(4).
[24] Bankruptcy Fairness Act, § 3(b).

The Harvard Law School Bankruptcy Roundtable brings together corporate bankruptcy practitioners with bankruptcy scholars in an online venue to discuss critical issues in corporate bankruptcy. The Roundtable is an initiative of the Harvard Law School Bankruptcy and Corporate Restructuring Project. For inquiries and comments, please contact us at bankruptcyproject@law.harvard.edu.