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Chairman Bachus, ranking member Cohen, and members of the committee:

I'm Mark Roe, a law professor at Harvard Law School, where I teach corporate law and bankruptcy law, and do research in the same subjects. I appreciate the opportunity to be here to provide you with my views on the adequacy of the Bankruptcy Code in dealing with failing financial firms. I will focus my testimony on the exemptions from bankruptcy for derivatives and short-term financing—the so-called bankruptcy safe harbors.

The safe harbors are too wide. They exempt much short-term financing and risky investing from the normal operation of American bankruptcy law. By treating short-term financial debt and derivatives trading much better than regular lenders and ordinary suppliers to the bankrupt, the safe harbors make an effective resolution in a bankruptcy without regulatory support difficult, and for some financial firms, impossible.

Worse yet, they undermine market discipline in the pre-bankruptcy market, making the financial system and the American economy riskier than it needs to be and more prone to suffer major failures. The safe harbor exemptions from normal bankruptcy rules subsidize short-term loans over stronger, more stable longer-term financing for financial institutions.

Five years ago, the bankruptcy filing of Lehman Brothers, the major investment bank, propelled the financial crisis forward. Its bankruptcy was chaotic, as derivatives counterparties closed out their positions, dumped collateral on the markets, and helped to push mortgage-backed securities into an asset-price spiral that threatened the solvency of other major financial institutions. In short order the venerable Primary Reserve Fund, which owned Lehman debt, failed, leading the Federal Reserve to conclude that it had to guarantee the entire money market industry. AIG was on the verge of failure, with catastrophic consequences to its counterparties around the world, and the government bailed out AIG.

The country suffered from a deep financial crisis and sank into a major economic setback from which it is still slowly recovering.

If a Lehman-class bankruptcy occurred today, the Bankruptcy Code would do no better in 2013 than it did in 2008. The close-outs would be chaotic, with great potential damage to the financial system and the American economy.

We have exempted a wide range of securities and transactions from the normal operation of bankruptcy law. This is not a long-standing exemption, but one that has grown and expanded over recent decades, with a major expansion as recently as 2005. Even today, after the financial crisis, if a counterparty to a bankrupt financial institution has a favored investment, it can fully opt out of the failed financial institution's bankruptcy process—despite the fact that bankruptcy is an institution that has served this country well. Bankruptcy could help to stabilize the firm and the surrounding financial market, but for financial firms with a heavy dose of these bankruptcy-exempt obligations, it cannot. Opting out of bankruptcy is often good for those opting out but destabilizes the debtor and its other business partners.

The potential for chaotic close-outs and an unstable bankruptcy is only the first reason to rethink the safe harbors. The safe harbors also subsidize short-term debt at the expense of more stable longer-term debt. When we favor one form of debt over other debt, we get more of the subsidized debt and less of the rest. That's what we've done. And, third, the safe harbors sap market discipline. We want to harness market incentives to discipline the financial system. The safe harbors do the opposite. They tell counterparties that they can pay less attention, or none, to the credit quality of their counterparties and to the extent of their own exposure. We destroy market discipline where we need it. Fourth, the safe harbors can be best used by America's largest financial institutions. The safe harbors give the bigger money center institutions an artificial competitive advantage over regional and mid-sized institutions. Narrowing the overly-wide safe harbor exemptions will facilitate a more competitive financial market in which regional and mid-sized institutions can participate more effectively.

Each of these four problems would justify a sharp cutback in the safe harbors. Together the policy path is clear and compelling. The only questions should be when, how, and to what extent.

Thus far, our governmental reaction to the financial crisis has been to shore up financial regulation, with greater capital requirements, with activity restrictions, and with administrative controls like living wills and the single point of entry structure. These efforts have much that is admirable. But if a major financial failure gets by the regulators, we still cannot count on the bankruptcy system to catch the ball. Indeed, we should expect a miss as big as bankruptcy's miss for Lehman.

First, we should want redundancy in complex systems. If one stabilizer fails in a complex system, we want another mechanism to take over, to avoid catastrophic failure. Engineers know that, and likewise financial regulators and now Congress should turn to improving bankruptcy by stabilizing and narrowing its safe harbors.

Second, bankruptcy is the first line of defense by statute and regulatory preference. Financial regulators say they'll play the Dodd-Frank Title II card only if bankruptcy fails. But regulators cannot allow bankruptcy to go for even a day to see if it works, and then decide whether or not bankruptcy is getting the systemic risks under control. Under today's bankruptcy rules, as soon as a financial institution with major safe harbored financing files for bankruptcy, the exemption from the automatic stay for the safe harbored transactions will lead the financial firm's counterparties to rip apart the bankrupt's portfolio.[1] There will be no putting Humpty Dumpty back together.

Third, Title II may not work. It hasn't been tried.

Be wary of untested systems.

Fourth, the safe harbors encourage excessive risk-taking and short-term financing that put more of our big institutions at risk. When Bear Stearns failed, one-quarter of its liabilities were in short-term, often overnight debt that did not have to comply with basic bankruptcy rules. When Lehman failed, one-third of its liabilities were in short-term, bankruptcy exempt, safe harbored debts. Part of the reason they

[1] The automatic stay stops creditors from acting against the bankrupt until the court and the bankruptcy process can ascertain whether the firm is more valuable kept intact. If it is, the firm is continued and creditors are compensated later. Ipso facto provisions in bankruptcy law limit the impact of loan clauses that make the debtor's bankruptcy an irremediable default under the loan documentation.

were in short-term safe harbored debt is that the safe harbors subsidize short-term debt over longer-term, more stable financing.[2] This short-term debt has become a big part of the financial system. Evening up the legal status of short-term and long-term debt would shift some financing away from short-term, often overnight and unstable repo financing, to longer-term financing. Same for derivatives.

What to do?

First, the kind of collateral allowed for the short-term lending safe harbors should be narrowed: United States Treasury securities, yes; mortgage-backed securities, no.

Second, the automatic stay should be brought back in for derivatives, but in a limited way: long enough to package the failed firm's derivatives book and sell bundles off intact. The chaotic close-outs are said to have cost Lehman $50 billion or more in value.[3] A modest stay will make an alternative to chaotic close-out possible. Sophisticated derivatives industry leaders are now recognizing that the rapid close-out mechanisms are potentially destructive not just of the economy but of the derivatives players themselves.[4]

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[2] In financial markets, these short-term, typically safe-harbored loans, are made by one firm selling the collateral and agreeing to repurchase (or "repo" it) shortly thereafter, often the next day. The collateral is repurchased at a slightly higher amount than its sales price, with the difference constituting the loan's interest.

[3] The return of the automatic stay would need to be coordinated with other bankruptcy rules, such as by bringing back the long-standing bankruptcy bar on effectiveness in bankruptcy of ipso facto contract clauses—those contract terms that allow counterparties to cash out if their debtor goes bankrupt.

[4] Whittall (2013) reports that the derivatives industry was told in the keynote speech from one of their leaders at the International Swaps and Derivatives Annual General Meeting:

> Derivatives users should be prepared to make amendments to one of their most-treasured legal rights to help in the fight to end too-big-to-fail, attendees ….
>
> Wilson Ervin — vice-chairman in the group executive office at Credit Suisse and a leading architect of the so-called debt bail-in framework — argued in a keynote speech to ISDA delegates that modifying legal documentation that currently allows swaps counterparties to leapfrog other creditors of bankrupt firms was "essential".
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> To highlight the severity of the issue, Ervin cited the US$40bn in costs the Lehman Brothers administration had to swallow in order to comply with early termination requests from its swaps counterparties, hugely exacerbating the extent of the losses racked up by the bankrupt estate.
>
> The swaps termination costs dwarf the estimated US$25bn of losses from real estate and private equity holdings Lehman was harbouring on its balance sheet before it went under, and contributed substantially towards the estimated final bill of US$150bn to wind up the firm.

Related, the ipso facto clause ban as now constituted makes the regulators' single point of entry harder to work. This problem is now well-known in regulatory and derivatives circles. But there are other safe-harbor-induced technical problems.[5]

Third, the blanket preference safe harbor needs to be better targeted. Preference law has long served American bankruptcy well, by reducing the incentives for creditors to grab collateral and force repayment on the eve of bankruptcy, at the expense of other creditors. If John owes Jane $1 billion in normal debt and she holds a gun to John's head to force him to repay, she goes to jail for extortion and assault with a deadly weapon. And the $1 billion will be recovered from Jane in John's bankruptcy as a preference. It will be recoverable even if Jane exerts less pressure than with a gun. *But* if John owes Jane $1 billion in derivatives claims and she hold a gun to John's head to collect, then, while she will also go to jail for extortion, she will *not* have to return that $1 billion as a preference. The derivatives safe harbors will protect her from preference law. Exempting even blatant collateral and repayment grabs from basic preference law, and expecting that other legal institutions will remedy the situation, is one of many overly-wide aspects of the safe harbors that need correction.

The rapid collateral grab that AIG suffered as it sank in 2008 would likely have been preferential had the safe harbors not existed. AIG might have failed and been bailed out anyway. But maybe not in such dire circumstances. More options might have been available.

Fourth, the Code's netting is overly-broad. It is perfectly appropriate for the counterparty to be able to net all of its transactions—both winners and losers—in the same product (say, foreign exchange, or interest rate swaps, or weather derivatives) with the same counterparty and then pay (or be paid) a single amount to (or from) the bankruptcy debtor, as long as the two parties contracted for this kind of offset. This does allow the counterparty to come out better than if the debtor could cherry-pick and take

[5] For example, if the holding company redeems some of its long-term debt, under creditor pressure, and in advance of its failure, the redemption would under normal bankruptcy law be recoverable as a preference. But that redemption can be made to be safe harbored and beyond recovery in the holding company's bankruptcy. Regulators should wish to have a bankruptcy legal team do a bankruptcy forensic review to help make bankruptcy work under the regulators' plans.

the contracts it's ahead on while rejecting those that it's behind on. But the Code now safe harbors much more: obligations in otherwise unrelated derivatives businesses can be netted. This not only allows the counterparty to do even better than others, but, more importantly, this wide netting (1) makes it harder to sell a single business line of the debtor in its bankruptcy, because the wide netting expands any sale from being a sale of one product line to another firm in the same product line to being a sale of the bankrupt's entire derivatives business to a single buyer. But the market may better be served by selling the segmented businesses, one-by-one. Furthermore, (2) the wide netting rules encourage financial supermarkets that become too-big-to-fail financial institutions, because they can take advantage of cross-product netting better than single-product line financial firms can. Upstarts in a single product line cannot compete as easily because they cannot get the subsidy from cross-product netting. Eliminating cross-product netting should be on the agenda to give the little guy and regional banks—the financial upstart—a fighting chance to compete.

Fifth, while the safe harbors need narrowing, so that we do not continue to subsidize these transactions at the expense of ordinary financing, not all of the evening up that needs to be considered is in narrowing the safe harbors. The safe harbors allow favored creditors to escape from poorly structured parts of the Bankruptcy Code that apply to all creditors. These poorly structured parts should be fixed up.

Here is one aspect of basic Code rules that could be changed overall, although it is tricky: A major advantage of short-term, safe harbored financing is that the counterparty does not need to worry about bankruptcy's baseline rules, which would not assuredly pay the stayed creditor interest, and which usually would not. But interest is the life blood for a financial creditor. The safe harbored creditor, however, can cash out and get the time value of its investment, because it can reinvest its funds. The non–safe harbored counterparty can find itself providing a no-interest loan to the debtor. Rethinking, and reconstructing, the interest payment rules to non–safe harbored creditors could bring the attractiveness of stable financing more in line with safe harbored financing. (Reconstruction will be tricky because of the impact on other creditors, but this could be done fairly and efficiently. One possibility: for financial

firms, the obligation to pay interest shall continue after any bankruptcy filing, at the prebankruptcy contract rate, with a standard rate used for noncontract creditors.)

Overall, when Bear Stearns failed it owed about a quarter of its value in short-term repo, which was about eight times its equity. Yet, as recently as 1989, it had only 6% of its value, not 25%, exposed to short-term repo.[6] The safe harbors may have played a role in its unstable financing choices.

Safer finance is possible. Were the safe harbors better targeted, American finance would be safer and the potential call for bailouts less likely to happen.

Other bankruptcy rules fit badly with the derivatives and short-term repo market, and the Code should accommodate the derivatives and repo markets, but do so without endangering American financial markets. For example, basic bankruptcy rules give the debtor a nearly unlimited right to assume or reject its prebankruptcy contracts. Derivatives counterparties, who are selling protection from volatility, can then be slammed by the bankrupt debtor who waits, sees if the pricing has become good for the debtor and then assumes the contract, or, if the pricing is bad for the debtor, rejects the contract. Returning to the baseline bankruptcy rule is inappropriate, unfair, and destructive of the entire derivatives market. But our current safe harbors reverse the situation, allowing the counterparty to choose—a result that is no better. A middle ground is possible.

Sixth, we want bankruptcy judges prepositioned to deal with major financial institutions. Bankruptcy law should require each Circuit Court to designate a judge who is on-call for such efforts. That judge presumably would already have the needed bankruptcy and financial expertise, would keep acquiring more, and would follow financial developments so that he or she would be ready to roll if a non-bank systemically important financial institution filed for bankruptcy. We may wish to confront the problem of Article III vs. Article I authority for this class of judges.

[6] Bear Stearns 10-K's; Roe (2011: 563).

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Overall, we should want bankruptcy to support financial safety better than it does now. Bankruptcy should be capable of resolving a systemically important nonbank financial institution even if it has major safe harbored financing. As of today, it cannot. Because it cannot, bailouts are more likely than otherwise and the costs to the American economy would be higher than they would otherwise be. Bankruptcy should not subsidize the riskiest forms of financing and investment, facilitating riskier, larger, and less stable financial institutions. Today it does. Bankruptcy should promote market discipline. Today it undermines market discipline, making our major financial institutions weaker than they otherwise would be.

We can fix these problems and we should.

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