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“Making a Financial Choice: More Capital or More Government Control”

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Witness Background Statement

Adam J. Levitin is a Professor of Law at the Georgetown University Law Center, in Washington, D.C., where he teaches courses in financial regulation, structured finance, contracts, bankruptcy, and commercial law. Among his publications is *Financial Restructuring: Business Bankruptcy in the Modern Commercial World* (Wolters Kluwer 2015).

Professor Levitin has previously served as the Bruce W. Nichols Visiting Professor of Law at Harvard Law School, as the Robert Zinman Scholar in Residence at the American Bankruptcy Institute, as Special Counsel to the Congressional Oversight Panel supervising the Troubled Asset Relief Program (TARP), and on the Consumer Financial Protection Bureau's Consumer Advisory Board.

Before joining the Georgetown faculty, Professor Levitin practiced in the Business Finance & Restructuring Department of Weil, Gotshal & Manges, LLP in New York, and served as law clerk to the Honorable Jane R. Roth on the United States Court of Appeals for the Third Circuit.

Professor Levitin holds a J.D. from Harvard Law School, an M.Phil and an A.M. from Columbia University, and an A.B. from Harvard College. In 2013 he was awarded the American Law Institute's Young Scholars Medal.

Professor Levitin has not received any federal grants or any compensation in connection with his testimony, and he is not testifying on behalf of any organization. The views expressed in his testimony are solely his own.

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CONTENTS

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Chairman Hensarling, Ranking Member Waters, Members of the Committee:

Good morning. Thank you for inviting me to testify at this hearing. My name is Adam Levitin. I am a Professor of Law at the Georgetown University, where I teach courses in financial regulation and bankruptcy, among other topics. I am here today solely as an academic who studies financial regulation and insolvency and am not testifying on behalf of any organization or regulated entity. I also have no financial interest implicated by the proposed legislation beyond that of an ordinary citizen.

Today's hearing is on the Financial CHOICE Act, which is billed as an alternative to the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Dodd-Frank Act is overall an excellent piece of legislation that represents a giant leap forward in financial regulation from where the United States stood at the time of the financial crisis. The Dodd-Frank Act is not perfect, however. It does not end too-big-to-fail, and it will not necessarily prevent future bailouts. The CHOICE Act, though, is the wrong solution to Dodd-Frank's shortcomings, and would seriously endanger the U.S.'s financial stability. Simply put, the CHOICE Act is a prescription for a financial crisis.

CHOICE Act represents a choice: a choice to prioritize laissez-faire ideology over careful and serious policy analysis and reasoning. And make no mistake: that laissez-faire ideology translates directly into a massive subsidy for the too-big-to-fail banks and for the bad actors in the financial services industry. However many times the lofty terms "choice" and "hope" and "liberty" and "freedom" and "accountability" are used in the bill's section headings, the CHOICE Act is nothing more than giant giveaway to the biggest banks and to outright fraudsters.

Take, for example, one relatively minor provision in the CHOICE Act, section 335, which would repeal the bipartisan Durbin Interchange Amendment to the Dodd-Frank Act.[1] The repeal of the Durbin Interchange Amendment would result in merchants paying an extra $8 billion a year in debit card swipe fees to the 110 largest banks. Much of that extra $8 billion in additional fees will get passed through to consumers in the form of higher prices and worse service. Put another way, section 335 of the CHOICE Act is an $8 billion annual tax on consumers and merchants that is then handed over to subsidize the 110 largest banks in the United States. How is consistent with ending too-big-to-fail? The CHOICE Act would actually *subsidize* too-big-to-fail megabanks.

And what about the 12,138 community banks and credit unions that are not affected by the Durbin Interchange Amendment's price caps? The CHOICE Act leaves them to compete on an uneven playing field against the megabanks.[2] The CHOICE Act would make it harder for community banks and credit unions to compete for deposit business by ensuring that the megabanks could use swipe fees to fund rewards programs to attract consumers and thus dominate the deposit market. (Don't think for a second that those rewards you get are "free"—there's no such thing as a free lunch in finance.) So there is a choice here: a choice to subsidize the megabanks at the expense of Main Street, consumers, community banks, and credit unions. This provision, in a nutshell, captures the hypocrisy of the CHOICE Act. The CHOICE Act is a choice of Wall Street over Main Street, a choice to favor megabanks over community banks, and a choice to favor predatory financial firms over consumers.

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[1] CHOICE Act § 335.

[2] James DiSalvo & Ryan Johnston, *How Dodd-Frank Affects Small Bank Costs,* Fed. Reserve Bank of Phila. Research Dept., 14 16-17Q1 2016 (finding that "evidence dos not support the claim that competitive forces have effective imposed the interchange ceiling on small banks").

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The CHOICE Act is a lengthy piece of legislation, and I do not attempt to critique it provision-by-provision in this testimony. Instead, my testimony focuses on the first three titles of the CHOICE Act, with occasional reference to provisions in other titles because the effect of these titles can only be understood when viewed together.

Title I gives highly capitalized banks the ability to opt-out of Basel III capital and liquidity requirements and the Dodd-Frank heightened prudential standards systemic risk regulatory system. While I believe there are serious problems with the proposed trade off of higher capital requirements for other types of prudential regulation, it is important to recognize that title I of the CHOICE Act cannot be sensibly analyzed in isolation from the CHOICE Act's other provisions. Not only does title I of the CHOICE Act remove regulators' ability to mitigate systemic risk from many of the largest banks, but title III of the CHOICE Act strips away effective consumer protections, giving unscrupulous financial institutions free rein to engage in predatory, but unsustainable lending practices, as happened in the run-up to the 2008 crisis. When a systemic crisis occurs, as it inevitably will under a CHOICE Act regime, title II of the CHOICE Act ensures that the result will be an unmanageable mess that will ultimately result in a messy bailout, as title I denies regulators key crisis response tools. The CHOICE Act throws fuel on the fire while taking away the fire department's hoses. In short, the CHOICE Act is a recipe for financial disaster.

I. A Simple Leverage Requirement Alone Is Inadequate to Ensure Financial Stability

The signature provision of the CHOICE Act is the replacement of a host of regulatory requirements designed to ensure against the failure of systemically important financial institutions with a simple, rather than a risk-weighted leverage requirement. That simple leverage requirement is a ratio of 10% "tangible equity" to "leverage exposure",[3] which is nothing more than the Basel III "Supplementary Leverage Ratio" (SLR).[4]

Specifically, the CHOICE Act would permit banks and credit unions with an SLR of at least 10% and a composite CAMELS rating of 1 or 2 to elect to be exempted from various regulatory requirements, including Basel III capital and liquidity standards, deposit concentration limits, and the "heightened prudential standards" applicable to larger financial institutions under section 165 of the Dodd-Frank Act, namely living wills, periodic credit exposure reports, credit exposure limits, short-term debt limits, internal risk committees, and (for non-banks) stress tests.

A. The CHOICE Act Actually Involves Two Choices, One of Which Is Reasonable, and the Other of Which Is Dangerous

Although the CHOICE Act is structured as a single opt-out provision, it is important to recognize that the CHOICE Act is actually proposing *two separate regulatory tradeoffs* because only the megabanks are subject to the Dodd-Frank heightened prudential standards:

[3] CHOICE Act §§ 101-102. It's ironic that the CHOICE Act section 335 proposes the repeal of the Durbin Interchange Amendment as an improper intervention in the market through price caps, yet imposing a similar type of fiat regulation in terms of financial institution capital requirements.

[4] The numerator in the CHOICE Act's ratio is tangible equity—Common Equity Tier 1 plus additional Tier 1 capital (and Trust Preferred Securities for smaller banks), while the denominator is the "total leverage exposure" as defined in 12 C.F.R. § 3.10(c)(4)(ii). This is just the "Supplemental Leverage Ratio" of 12 C.F.R. § 3.10(c)(4).

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(1) For community banks, the CHOICE Act would allow the use of the 10% SLR in lieu of the Basel III capital and liquidity standards. This means that community banks could use a simple leverage ratio instead of a risk-weighted leverage ratio.

(2) For megabanks, the CHOICE Act would allow the use of the 10% SLR in lieu of the Basel III capital and liquidity standards *and the Dodd-Frank heightened prudential standards.*

Recognizing that there are these two separate tradeoffs within the CHOICE Act is key to seeing the CHOICE Act's problems. The first trade, that of a simple leverage ratio for risk-weighted leverage ratios and only for community banks, has much to commend it, although I believe it could be better designed. A simple leverage ratio has much to commend it over a risk-weighted leverage ratio because it can be less gameable and distortionary if designed well. (Unfortunately, the CHOICE Act's leverage ratio is not well-designed, as discussed below.) Likewise, the use of a leverage ratio like the SLR that includes off-balance sheet exposures, is a better measure than one that only looks to on-balance sheet exposures, given the frequent reality of implicit recourse in the financial system.

But the second trade, that of a simple leverage ratio for risk-weighted leverage ratios *and* relief from the Dodd-Frank heightened pleading standards is hugely problematic and is an unnecessary and dangerous giveaway to the megabanks. Ounce for ounce, the best approach to safety and soundness is requiring more equity. But it does not follow that the best regulatory approach is *only* a simple equity requirement. An effective financial regulatory system incorporates a strong capital requirement with a comprehensive range of other safety-and-soundness tools. Thus, other proposals for higher leverage requirements, such as the Brown-Vitter bill in the Senate[5] and FDIC Vice-Chairman Hoenig's regulatory relief plan, would maintain additional regulatory safeguards against excessively risky business practices. Strong capital requirements are a necessary, but not sufficient condition for ensuring systemic financial stability.

B. The CHOICE Act's Two-Tracked Approach to Financial Stability Courts Disaster

For both community banks and megabanks, the CHOICE Act sets up a two-tracked approach to financial regulation: a track of financial institutions subject to a Basel III and a paired-down Dodd-Frank Act and a track of financial institutions that opt out of Basel III and the Dodd-Frank Act altogether. This is a remarkably bad idea that courts disaster not just for the opt-outs, but for those institutions that remain subject to the manqué Dodd-Frank regime. If an opt-out institution fails, the effect will not just be borne by its shareholders. Instead, it may well drag down financial institutions that have *not* opted out of the Dodd-Frank regulatory regime and are relying on ex-ante regulation for safety-and-soundness, not on higher capital levels.

In other words, the CHOICE Act does not prevent systemic externalities. Instead, it relies on nothing other than blind ideological faith on opt-out institutions not failing. If history has taught us anything it is that there are lots of ways for a financial institution to fail. Either all financial institutions need to be under the Dodd-Frank regulatory regime or they all need to have higher capital levels. The CHOICE Act's pick-your-own-adventure approach, however, could result in the worst of both worlds.

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[5] Terminating Bailouts for Taxpayer Fairness Act of 2013, S.798 (113th Congress).

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C. Shareholder Discipline Is Ineffective and Often Counterproductive for Managing Risks at Financial Institutions

The CHOICE Act relies on shareholder discipline rather than on regulators to ensure that the financial institutions that opt out of Dodd-Frank do not take on excessive risks. While I share some of the CHOICE Act's sponsors' skepticism of the effectiveness of financial regulators,[6] relying on markets alone to discipline risk-taking is unrealistic. Financial institutions, particularly large, complex ones, have opaque balance sheets that make it hard for the market to know what a financial institution is up to until it is too late. Market discipline for financial institutions is often after-the-fact.

Market discipline can also push banks to take on excessive risks because shareholders often prioritize short-term gain over long-term value. Thus, during the housing bubble, Countrywide Financial, one of the most aggressive players in the mortgage market, was the market's darling from 2001 until mid-2007, far outperforming other S&P 500 banks.[7] In contrast, JPMorgan Chase was more conservative than many of the other large banks, and its stock underperformed that of other S&P 500 banks during the same period.[8] The market rewarded the risky, and ultimately disastrous strategy. So much for market discipline reliably preventing excessive risk-taking.

There should be no more cautionary words in this regard than those of then-Citigroup CEO Charles E. Prince regarding why Citigroup continued to be long on the housing market despite Prince's doubts, "When the music stops, in terms of liquidity, things will be complicated. . . . But as long as the music is playing, you've got to get up and dance. We're still dancing."[9] Not long afterwards Citigroup was bailed out.

Market discipline has a role to play in financial regulation, but market discipline alone will result in financial instability. Indeed, market discipline is likely to push firms that opt out of Basel III capital requirements to pursue *greater* risks. Firms that opt out of Basel III under the CHOICE Act will be less highly leveraged than those that remain under Basel III. Opt-out firms will have to compete for capital with firms that are subject to Basel III. Less leveraged firms have lower returns on equity, all else being equal. Therefore, in order to compete for capital with more leveraged firms, a less leveraged firm has to assume greater risks in order to equal the more leveraged firms' return on equity. Put another way, market discipline on share prices is likely to encourage excessive risk-taking at firms that opt-out of Basel III.

D. The CHOICE Act Does Not Address Illiquidity, Which Is the Immediate Cause of Financial Crises

A major shortcoming of the CHOICE Act's opt-out option for all banks is that it only addresses solvency, not liquidity. If the policy goal is to prevent taxpayers from bearing the cost of the failure of systemically important financial institutions, then ensuring that these institutions are unlikely to fail is a good place to begin. A strong equity cushion is the best guard against *insolvency*, but the problem for systemically important financial institutions is not typically insolvency, but *illiquidity*. (Illiquidity ultimately begets insolvency, but it is illiquidity that results in the firm's failure.) While an equity cushion will help reduce ultimate losses from an insolvency, it will not prevent the

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[6] *See* Adam J. Levitin, *Safe Banking: Finance and Democracy*, 83 U. CHIC. L. REV. 357 (2016).

[7] William W. Bratton & Michael Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 716-723 (2010).

[8] *Id.* at 720-21.

[9] Stephen Kotkin, *A Bear Saw Around the Corner*, N.Y. TIMES, Jan. 4, 2009, at BU2 (reviewing and quoting from JAMES GRANT, MR. MARKET MISCALCULATES: THE BUBBLE YEARS AND BEYOND (2008)).

market disruption and spillover effects from a firm being illiquid, particularly when paired with the unworkable financial institution bankruptcy system envisioned by the CHOICE Act (discussed below) and the disabling of regulators' emergency response tools (also discussed below). A simple equity requirement does nothing to prevent against illiquidity. Unfortunately, nothing in the CHOICE Act addresses the illiquidity risk, which is the real regulatory problem.

E. The Use of a Simple Leverage Ratio Without Other Protections Incentivizes Risky Bank Behavior

The CHOICE Act gives banks the options of being subject to a simple leverage ratio instead of a risk-weighted leverage ratio. A simple leverage ratio has much to commend it relative to a risk-weighted leverage ratio. Risk-weightings are imprecise (risks do not come only in buckets of 20%, 50%, and 100%, but constitute a spectrum), politicized (e.g., lower risk-weighting for sovereign and mortgage assets), and gameable. A simple leverage ratio avoids all of those problems. On the other hand, a simple leverage ratio incentivizes banks to load on up riskier—and thus higher yielding—assets. This problem with a simple leverage ratio can be mitigated, but only if there are other regulatory tools, such as credit exposure limits and liquidity requirements. The CHOICE Act, unfortunately, would adopt a simple leverage ratio while eliminating the regulatory tools necessary to prevent banks from gaming the simple leverage ratio by seeking out high-risk assets.

F. The CHOICE Act's 10% Leverage Ratio Is Gameable

The CHOICE Act's measure of capital for the 10% leverage ratio is gameable, enabling firms to opt out of Dodd-Frank without really having a 10% leverage ratio on a regular basis. The CHOICE Act measures firms' leverage ratios on the last day of the quarter. This enables a strategy similar to the infamous Lehman Brothers Repo 105, in which assets are moved off-balance sheet just for the day of capital measurement. While the CHOICE Act's leverage exposure measure includes off-balance sheet exposures, I have little doubt that bank lawyers and accountants will find work-arounds through various capital relief trades. A better approach would be to require a running daily average of capital ratios.

G. There Is No Evidentiary Basis for the Choice of a 10% Leverage Ratio

Even if one were to believe that a simple equity ratio alone is the right regulatory approach, there is the subsidiary question of whether 10% is the right level. ***There is no basis whatsoever for a 10% number.*** The 10% number adopted by the CHOICE Act is apparently indirectly derived *solely* from research by Bank of England Chief Economist Andrew Haldane.[10] The problem is that the Haldane research does not in fact support a 10% simple leverage ratio, much less as a substitute for other regulatory supervision, and in fact no research supports a 10% leverage ratio. The CHOICE Act's 10% figure is just made up.

The Republican memorandum on the CHOICE Act credits the Haldane research for the proposition that no bank with a simple leverage ratio of over 10% failed or was bailed out in the last financial crisis.[11] This is a narrowly correct reading of a *graph* in Haldane's research, but Haldane does *not* draw the conclusion that a 10% level is the right level for a simple leverage ratio. Instead, his point was merely that simple leverage ratios are generally more effective than risk-weighted

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[10] House Committee on Financial Services, *The Financial Choice Act: Creating Hope and Opportunity for Investors, Consumers, and Entrepreneurs—A Republican Proposal to Reform the Financial Regulatory System*, June 23, 2016, 36-37 (citing Andrew Haldane, Address at the Federal Reserve Bank of Kansas City's 366th economic policy symposium: *The dog and the Frisbee* (Aug. 31, 2012), *available at* http://www.bis.org/review/r120905a.pdf).

[11] *Id.*

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leverage ratios at predicting bank failure.[12] He finds statistical significance regarding the use of simple leverage ratios, rather than risk-weighted ratios, as predictors of bank failure,[13] but nowhere does Haldane suggest that the simple leverage ratio should be 10%. Indeed, Haldane's data are incapable of supporting that conclusion. Haldane's research involved a sample of only 37 banks.[14] Only *one* of those banks had a leverage ratio of over 10%,[15] making it impossible for his data to support any statistically valid claim about a 10% level. Moreover, whether or not banks failed in 2008-2009 did not occur in a vacuum; but for the massive government intervention in those years surely more banks would have failed. And, Haldane's research does not control for the particular regulatory schemes applicable to those banks other than their capital levels. Haldane's research, then, supports the use of a simple leverage ratio, rather than a risk-weighted leverage ratio, but it says nothing about 10% being the proper threshold.

It is also important to note that Haldane does not argue that a simple leverage ratio alone is all that is needed. In the same research relied upon by the Republican memorandum, Haldane outlines five interlaced policy measures needed to achieve financial stability, including "strengthening supervisory discretion" and "regulating complexity explicitly."[16] Thus, Andrew Haldane's work does not support the idea of a leverage requirement of any sort *instead of* other regulation. There is no evidentiary basis for choosing a 10% leverage ratio. It is a number plucked out of the air.

H. The CHOICE Act Eliminates Protections Against Excessive Risk-Taking by Financial Institutions

Another reason the CHOICE Act's reliance on a 10% simple leverage ratio is inadequate is that the CHOICE Act eliminates key protections to ensure that capital adequacy is never put to the test in the first place. Among other provisions, the CHOICE Act:

- exempts nonbank financial institutions that make the capital election from virtually all federal prudential regulation;[17]
- repeals the Volcker Rule, which prohibits financial institutions from engaging in proprietary investments using depositor funds.[18] By repealing the Volcker Rule, the CHOICE Act is practically begging financial institutions to engage in high-risk speculative behavior;
- eliminates federal regulators' ability to prescribe risk management standards for critical financial market utilities such as clearinghouses.[19] The Dodd-Frank Act requires most types of swaps to be cleared through clearinghouses.[20] Mandated central clearing is preferable to bilateral clearing, it does have the effect of making clearinghouses unique nodes of concentrated risk in the financial system.[21] A well-managed clearinghouse should be able to manage such risk. Accordingly, the Dodd-Frank Act gave regulators the power to prescribe

[12] Andrew Haldane, Address at the Federal Reserve Bank of Kansas City's 366th economic policy symposium: *The dog and the Frisbee* (Aug. 31, 2012), *available at* http://www.bis.org/review/r120905a.pdf, at 10-11.
[13] *Id.* at 11.
[14] *Id.* at 10.
[15] *Id.* at 29, Chart 5.
[16] *Id.* at 14.
[17] CHOICE Act § 102(a)(8).
[18] CHOICE Act § 901.
[19] CHOICE Act § 251 (proposing repeal of Dodd-Frank Act title VIII).
[20] Dodd-Frank Act section 723.
[21] Adam J. Levitin, *The Tenuous Case for Derivatives Clearinghouses*, 101 GEO. L.J. 445 (2013).

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risk management standards for clearinghouses and similar utilities to ensure that they are well-managed. The tracking of risk and regulation reflects the Spiderman principle of financial regulation: with great risk goes great regulation. Unfortunately, the CHOICE Act keeps the clearinghouse requirement, but eliminates regulators' ability to ensure that clearinghouses are in fact well run. The result is an enormous government handout to the clearinghouses: the clearinghouses receive a legally blessed monopoly, but without any regulatory oversight;

- eliminates the risk retention requirement for securitizations of non-residential mortgage.[22] The risk retention requirement is an anti-moral hazard provision that recognizes the temptation of securitizers to use their informational advantage over investors to shift greater risks to investors than the investors realize;
- makes it difficult for U.S. regulators to coordinate with foreign financial regulators for the purpose of monitoring and mitigating threats to financial stability.[23]

The CHOICE Act also has numerous provisions that make it difficult for the SEC to pursue enforcement actions and achieve meaningful relief. These provisions reduce the SEC's deterrence ability and thereby embolden financial fraudsters whose malfeasance can reverberate throughout the financial system. Among other provisions, the CHOICE Act:

- requires the SEC to make additional findings before levying civil monetary penalties against issuers.[24] Thus, while the CHOICE Act increases financial fraud penalties with the one hand,[25] with the other it ensures that those penalties will rarely be imposed.
- repeals the SEC's authority to issue officer and director bans.[26] This means that even the worst fraudsters will continue to be able to participate in securities markets.
- eliminates automatic bad actor disqualification from securities law exemptions even for firms that have been *convicted of felonies*.[27] Apparently a convicted felon cannot be trusted with the right to vote, but can be trusted with pension funds and retirees' savings.

To be fair, the CHOICE Act arguably requires some degree of additional safety-and-soundness regulation by providing that the 10% simple leverage ratio alternative is available to banks only if they received a CAMELs rating of 1 or 2 as of their last examination before the election.[28] The high CAMELs rating requirement, however, applies only to depository institutions, not to non-banks, which do not have CAMELs ratings, and the CHOICE Act exempts non-banks from virtually all regulation by federal regulators.[29] Thus, a non-bank financial institution need only meet the 10% capital requirement, nothing more, to avoid the Dodd-Frank heightened prudential standards.

Moreover, the CAMELs rating requirement is a one-time requirement that applies only when the bank elects the alternative ratio. A bank's CAMELs rating could fall thereafter, but it would not be resubjected to the full battery of Dodd-Frank Act regulatory requirements. In short,

[22] CHOICE Act § 442.
[23] CHOICE Act § 671.
[24] CHOICE Act § 417.
[25] CHOICE Act §§ 801-811
[26] CHOICE Act § 418.
[27] CHOICE Act § 419.
[28] CAMELs is an acronym for Capital adequacy, Asset quality, Management, Earnings, and Liquidity.
[29] CHOICE Act § 102(a)(8).

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the CAMELs rating requirement does not do a lot of work. Under the CHOICE Act, there really is nothing but a cushion of 10% equity standing between a financial institution and failure, even if that failure has systemic consequences.

I. The CHOICE Act Eliminates Key Regulatory Tools for Responding to Crises

The CHOICE Act not only takes away regulators' tools for preventing crises, but it takes away their tools for responding to crises. The CHOICE Act repeals the FDIC's ability to create a widely available program to guaranty the obligations of solvent depositories and their holding companies during times of severe economic stress.[30] The CHOICE Act also renders the Federal Reserve's emergency lender-of-last-resort power under section 13(3) of the Federal Reserve Act effectively unusable by requiring the Federal Reserve Board and all federal banking regulators with jurisdiction over the borrower to certify that the borrower is not insolvent at the time of initial borrowing.[31] Making an affirmative determination of solvency is timely and costly and not something that federal regulators can do on a market-wide scale during a crisis. As a result, if there is a fire in the financial sector, the firemen will be without hoses.

J. The CHOICE Act Ensures that Regulators Will Be Ineffective with Their Remaining Tools by Subjecting Them to Political Harassment and Micromanagement

The CHOICE Act not only takes away key crisis prevention and crisis response tools from regulators, but it also effectively ensures that regulators will not be able to adequately use even the tools they have left. The CHOICE Act ensures regulatory ineffectiveness by creating a system that facilitates political harassment and micromanagement of regulators. To wit, the CHOICE Act includes:

- an unprecedented prohibition against any significant new financial regulations from taking effect unless both Houses of Congress approve within 70 days.[32] Given Congressional deadlock, this all but ensures that there will be no further financial regulation, period;

- the elimination of the long-standing Supreme Court precedent that requires courts to defer to the subject-matter experts in regulatory agencies when reviewing agency rulemakings.[33] The lack of judicial deference will encourage financial institutions to bring court challenges to all actions taken by financial regulators;

- an inappropriate cost-benefit analysis requirement for all financial regulatory rulemakings (without even subjecting the cost-benefit analysis requirement to cost-benefit analysis).[34] Formal cost-benefit analysis requirements are nothing more than a way to slow the regulatory process and enable court challenges to regulation;

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30 CHOICE Act § 241.

31 CHOICE Act § 707. I note that this provision is similar to that proposed in the Warren-Vitter bill in the Senate. While the provision has much to commend it in isolation, as it is in the Warren-Vitter bill, it is more problematic when combined with the other provisions of the CHOICE Act that incentivize banks to engage in riskier behavior in the first place.

32 CHOICE Act § 632.

33 CHOICE Act § 641. Apparently access to the courts is a good thing when it benefits businesses, but not when it benefits consumers. *Cf.* CHOICE Act § 338 (stripping CFPB of authority to limit binding mandatory arbitration).

34 CHOICE Act § 612. Regarding the appropriateness of cost-benefit analysis in financial regulation, *see* John C. Coates IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 YALE L.J. 882 (2015) (arguing that cost-benefit analysis is only appropriate when its benefits exceed its costs, which are unlikely in the financial regulatory area because of the highly speculative nature of regulations' impacts on the economy).

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- a requirement that regulators spend time constantly reviewing past rulemakings with an eye toward deregulation.[35]

The CHOICE Act would also put all financial regulators onto appropriations,[36] creating the possibility of undue political interference with regulation and giving Wall Street a second bite at the apple through backroom influence on the appropriations process. Altogether, then the various provisions of the CHOICE Act will guaranty ineffective regulators. The result will be free rein for Wall Street to engage in systemically risky behaviors.

K. The CHOICE Act Is About Helping Megabanks, Not Community Banks; There Are Better Ways to Help Community Banks

To the extent that the CHOICE Act's 10% leverage ratio alternative is in fact meant to help primarily community banks, I applaud the goal, but I would underscore that there are better and more direct ways to do so. The Basel III capital and liquidity rules are a poor fit for America's community banks, and I support targeted regulatory relief, including different regulatory capital requirements and a separate charter, for community banks, which already struggle to compete in a market where economies of scale are often key. Community banks' operations and risks are simply different from megabanks, and so too should their regulation be different.

The CHOICE Act, however, opens the door not just for regulatory relief for community banks, but also for megabanks. That is particularly dangerous because the regulatory safeguards such as the Volcker Act that the CHOICE Act would eliminate are especially important for megabanks. An easy fix (although probably not the optimal one) would be the restrict Title I of the CHOICE Act to community banks (reasonably defined as having under $10 billion or, perhaps even under $2 billion in consolidated assets).

It is hard to believe that the CHOICE Act is really about helping community banks. There's a telltale sign: the CHOICE Act would exempt firms with 10% leverage ratios from the Riegle-Neal Act limitation on a single bank acquiring by merger over 10% of the deposits in the United States.[37] That is an exemption that, by definition, can only benefit a megabank. Thus, the CHOICE Act not only disarms financial regulators, but it paves the road for megabanks to get even bigger and riskier.

Title I of the CHOICE Act, then, primes the pump for a financial disaster. Title III, discussed next, pours more fuel on the fire by gutting consumer financial protections. And Title II of the CHOICE Act creates a regime for resolving the mess that will flow from Titles I and III. Unfortunately, that resolution regime is totally unworkable and because it is unworkable, the result will be *ad hoc* bailouts.

II. THE CHOICE ACT WOULD EFFECTIVELY ELIMINATE CONSUMER PROTECTION AGAINST SHARP FINANCIAL PRACTICES AND DISCRIMINATORY LENDING

Consumer spending drives the American economy, and consumer spending goes through the financial system. To the extent that pervasive problems emerge in the consumer finance space, they are likely to cause far-reaching economic problems. Accordingly, strong consumer financial protection is a key component of financial stability. The Dodd-Frank Act achieved a singular

[35] CHOICE Act §§ 615-616.
[36] CHOICE Act §§ 661-665.
[37] CHOICE Act § 102(a)(5) (exemption from section 18(c)(13) of the FDIC Act), 102(a)(9) (exemption from any federal law, rule, or regulation that would impose a deposit concentration limit).

success in this area with the creation of the CFPB, an effective, unconflicted regulator dedicated to consumer financial protection. The CFPB is the only federal financial regulator to finish all of its Dodd-Frank Act rulemakings on schedule, and in just a few years of existence it has already achieved over $11 billion in consumer relief, benefitting nearly 20 million consumers.[38] These results dwarf the relief achieved by nearly a dozen regulators over the course of the previous two decades. In short the CFPB has been a remarkably effective regulator.

A. The CHOICE Act Would Eliminate Effective Federal Consumer Financial Protection

The CHOICE Act would destroy the CFPB. It would do so in the most Orwellian fashion, creating a rebranded "Consumer Financial Opportunity Commission" that has little real ability to undertake any rulemaking or enforcement. Indeed, the proposed Consumer Financial Opportunity Commission would literally fulfill its name—it would ensure that consumers are financial opportunities for businesses engaged in sharp practices. And in such an unfettered market, the bad will drive out the good,[39] as consumers cannot readily distinguish good actors from bad ones. This is a market that no honest business should want.

The CHOICE Act destruction of the CFPB begins by changing the CFPB's structure from that of a single director to a commission. If that were the only change proposed, it would be an issue about which reasonable minds could disagree in good faith. I believe there are good reasons to have a single director, but there are credible arguments that can be made in favor of a commission structure. The problem is that the proposed change in leadership structure is not the only CFPB amendment proposed by the CHOICE Act. When the transformation to a commission structure is coupled with the complete neutering of the CFPB's rulemaking, supervision, and enforcement powers, intense political interference and micromanagement,[40] and provisions that will make it impossible for the CFPB to attract highly-qualified personnel, it is clear what is afoot: the CHOICE Act seeks to create an utterly ineffectual consumer financial services regulator so that bad actors will have free rein to take advantage of consumers, with the toothless agency serving as a beard against any constituent political pushback. In other words, the CHOICE Act will take consumer financial protection back to the pre-Dodd-Frank Act days when it did not exist in any meaningful way on the federal level.

B. Elimination of the "Abusive" Standard Will Allow for Sharp Practices that Do Not Meet the Narrow Definitions of "Unfair" and "Deceptive"

To see just how the CHOICE Act neuters the CFPB, consider what the CHOICE Act does with the Dodd-Frank Act prohibition on "abusive" acts and practices.[41] The "abusive" prohibition was one of the more controversial provisions of the Dodd-Frank Act. Critics have questioned what exactly falls within the scope of the abusive prohibition, which is not defined by statute. (The statute imposes restrictions on the CFPB's ability to make rules designating acts and practices as

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[38] CFPB, Consumer Financial Protection Bureau by the Numbers, July 21, 2015, *at* http://files.consumerfinance.gov/f/201507_cfpb_factsheet-by-the-numbers.pdf.

[39] George A. Akerloff, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970).

[40] The CHOICE Act would subject the CFPB to Congressional appropriations. Although I appreciate the impulse for there to be democratic accountability for regulatory agencies, the appropriations process is not simply about democratic accountability. It is an opportunity for horse-trading, logrolling, and backdoor policy changes. Subjecting the CFPB to appropriations simply ensures that consumer financial protection can be held hostage every budget cycle. That is likely to result in a one-way deregulatory ratchet. The whole reason the CFPB is not currently subject to appropriations is so it will not be dragged down by Congressional dysfunction and politics.

[41] Dodd-Frank Act § 1036.

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abusive,[42] but does not define "abusive" per se.) To date, the CFPB has not finalized any rulemakings under the abusive prohibition, and it has undertaken only a handful of enforcement actions that invoke the abusive standard. The prohibition on abusive acts and practices is a critical gap-filler for the traditional prohibition against unfair and deceptive acts and practices (UDAP). Too many things can fall between the cracks of "unfair" and "deceptive" as currently interpreted. Unfair requires a cost-benefit analysis that allows sharp practices to continue if they benefit *some* consumers even at the expense of others. Deceptive requires an actual misleading statement or omission. That is hardly the universe of sharp practices. For example, consider the following practices that might qualify as abusive, and that should, at the very least, give us pause:

- A lender lending to consumers whom the lender knows cannot repay in full and on-time (likely because the lender receives high rollover or upfront fees or has the ability to sell the loan to a third party);
- A lender whose business model anticipates default rates of over 50%;
- A loan broker steering consumers into higher cost loans when they qualify for lower cost ones because the high cost loan will result in greater compensation for the broker might both qualify as abusive.

There is a reasonable critique of the "abusive" power as drafted, namely that the statute should actually define "abusive", rather than limit what the CFPB can do in terms of rulemaking. The CHOICE Act, however, does not just restrict the CFPB's power under 12 U.S.C. § 1131 to undertake rulemakings designating certain acts and practices as "abusive." Nor does the CHOICE Act tighten the definition of "abusive." Instead, the CHOICE Act actually makes "abusive" acts and practices *legal* by also repealing 12 U.S.C. § 1136.[43] Apparently financial liberty includes the liberty to engage in abusive acts and practices.

C. The CHOICE Act Facilitates Discriminatory Lending

Financial liberty also apparently includes the right to engage in discriminatory lending. Among the most invidious provisions in the CHOICE Act are a trio that would shield discriminatory lenders from legal repercussions. The CHOICE Act would nullify the CFPB's indirect auto lending guidance and impose an onerous process for any future guidance.[44] The CHOICE Act would reduce the data collected under the Home Mortgage Disclosure Act, a key anti-discriminatory lending law.[45] And under the cynical heading of "Right to Lend," the CHOICE Act would prohibit data collection on small business lending, ensuring that regulators will lack the data necessary to conduct examinations for discriminatory small business lending.[46] The choice being made by the CHOICE Act is a choice to protect discriminatory lending.

D. The CHOICE Act Effectively Prevents Regulation of Payday Lending in <u>Any</u> State

The CHOICE Act showers love on payday lenders. Section 333 of the CHOICE Act allows states and Indian tribes to opt out of federal out of payday regulation. The opt-out can be renewed perpetually. There are other state opt-out provisions in federal consumer financial protection statutes, but those provisions are designed to allow for *greater* not *lesser* state consumer protection.[47]

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42 Dodd-Frank Act § 1031.
43 CHOICE Act § 337
44 CHOICE Act § 334.
45 CHOICE Act § 1171(c).
46 CHOICE Act § 1161.
47 *See, e.g.,* 12 U.S.C. § 3804.

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More critical, however, is that *lenders in states and Indian tribes that opt-out of federal regulations are still permitted to lend across state lines*. The result is to ensure that federal regulation of payday lenders ineffective even in states that want regulation. If the issue is states rights, states should be permitted to opt-out of the federal regulation, but lenders should *also* be limited to lending only in-state or within tribal territory. Indeed, if states rights are so important in financial regulation, then Congress should move to overturn the Supreme Court's *Marquette* decision that allowed national banks to export interest rates.[48]

E. The CHOICE Act Facilitates Risky Mortgage Lending

The CHOICE Act also eviscerates consumer protections in mortgage lending. In mortgage lending, the CHOICE Act raises the trigger threshold for what is considered a "high cost" mortgage loan,[49] and thus subject to additional regulatory protections. It also creates a portfolio lending safe harbor for the Dodd-Frank Act's "ability to repay" requirement.[50] While portfolio lending does not have the same moral hazard potential as securitization, it does not guaranty an alignment of lender and borrower interests, and even if it did, we know from experience that portfolio lenders can make lots of mistakes—Washington Mutual and Countrywide retained many of their option-ARMs in portfolio, and the entire S&L crisis was about portfolio lenders.

F. The CHOICE Act Will Produce a Brain-Drain at the CFPB

The CHOICE Act not only attacks the CFPB's substantive powers, but it also aims to create a calamitous brain drain at the CFPB. The CFPB has assembled an amazing talent pool, equaled by few, if any government agencies. Part of the attraction of working at the CFPB is its mission-driven culture, but part is undeniably that the CFPB offers more competitive pay. The alternative employment for many CFPB employees is with the private sector financial institutions the CFPB regulates. If the CFPB had to pay regular GS pay scale, as proposed by the CHOICE Act,[51] it would not be able to attract top-flight talent.

Likewise, a key part of the CFPB, as an evidence-driven agency, is its research unit. The CHOICE Act would effectively destroy the CFPB's research unit's ability to get data and thus to attract talented researchers. Section 324 of the CHOICE Act requires that the CFPB (or CFOC) make public all data, studies, and other analysis on which its research papers are based.[52] It bears underscoring that CFPB research papers are not policy positions, but studies by economists and other scholars who work for the CFPB.[53] Those researchers come to the CFPB with the express understanding that they will have to commit a certain percentage of their time to working in support of CFPB regulatory activities, but that they will also have a certain percentage of their time available to purpose research of their choosing, as well as access to the agency's data. This is an incredible draw that enables the CFPB to compete with elite academic institutions for top-flight researchers.

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[48] *Marquette National Bank v. First of Omaha Service Corp.*, 439 U.S. 299 (1978).

[49] CHOICE Act § 1101-1103.

[50] CHOICE Act § 1116.

[51] CHOICE Act § 325. It is a mark of the CHOICE Act's sponsors' animus toward the CFPB that the CFPB is singled out among federal financial regulators for a reduction in pay scale.

[52] CHOICE Act § 324.

[53] The official studies the CFPB has put out, such as those required by Congress under section 1028 of Dodd-Frank regarding arbitration, have been scrupulously non-interpretive, but simple presentations of statistical information.

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Many data sources that the CFPB has cannot be publicly disclosed as a matter of contract, and the CHOICE Act would make others prohibitively expensive to disclose.[54] Requiring publication of these data sources means that the CFPB will not be able to publish research papers, and that will create a serious brain drain (and adverse selection) in the CFPB's research unit. The result will be an ineffectual CFPB—just what Wall Street wants.

G. The CHOICE Act Prioritizes Bank Profits Over Fairness to Consumers

Most telling, though, about what really is motivating the CHOICE Act is section 332(b), which provides that the CFPB (or, to be precise, the rebranded Consumer Financial Opportunity Commission) must consider "the impact of such rule on the financial safety or soundness of an insured depository institution".[55] "Financial safety or soundness" means profitability—an unprofitable institution is not safe or sound. In other words, the CFPB needs to consider how important an unfair or deceptive practice is to the profitability of an insured depository as part of a rulemaking. The only reason to undertake an unfair or deceptive act or practice, however, is because it is profitable. Thus, if a depository is only profitable because of an unfair or deceptive act or practice, the CFPB will have a difficult time making a rule that can withstand court challenge. This is the equivalent of saying that it is legal to rob people…as long as doing so is critical to your livelihood. The CHOICE Act cannot credibly claim to promote consumer protection when it is giving out free licenses to fleece consumers.

In sum, the CHOICE Act replace a single director with a commission to ensure regulatory dysfunction, mandates a cost-benefit analysis that makes no sense in this context,[56] legalizes "abusive" practices, it ensures that payday lenders can operate without regulation, reduces the effectiveness of protections against predatory mortgage loans,[57] effectively prevents the CFPB from policing discriminatory lending, protects all kinds of otherwise illegal acts if they are profitable, and it deprives consumers of their right to a day in court by allowing businesses to forcing them into private arbitration.[58] This is not consumer protection, but consumer abuse.

III. THE CHOICE ACT'S FINANCIAL INSTITUTION BANKRUPTCY PROPOSAL IS UNWORKABLE, PRIORITIZES WALL STREET OVER MAIN STREET, AND WOULD RESULT IN MORE BAILOUTS

To fully understand the problems created by Title I of the CHOICE Act, it is necessary to understand how they would be resolved. Title I of the CHOICE Act would eliminate a key set of prudential regulations for certain financial institutions. Title III would effectively eliminate consumer financial protection. Combined these titles and other assorted provisions of the

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[54] CHOICE Act § 331. The consumer notification provisions seem to be motivated by a completely unfounded belief that the CFPB has information about individual consumers' spending choices, as opposed to aggregated spending data. If the CFPB—or any government agency—regularly collected information about individual consumer's individual purchases, I would be gravely concerned. But the CFPB's critics simply do not understand the nature of the data the CFPB collects, and have substituted paranoia for facts in this regard. *See* Adam J. Levitin, *The CFPB's Data Collection Is To Be Applauded*, AM. BANKER, Aug. 18, 2015. *See also* Hearing Before the Senate Judiciary Committee, Subcommittee on The Constitution, "The Administrative State v. The Constitution: Dodd-Frank at Five Years," July 23, 2015 (oral testimony and written questions for the record of Prof. Adam J. Levitin).

[55] CHOICE Act § 332(b). My read is that the statute intends this provision to apply to a generic depository institution, rather than to an actual, specific depository institution, but the drafting is unclear in this regard.

[56] *See* Coates, *supra* note 34.

[57] CHOICE Act § 1101-1103, 1116.

[58] CHOICE Act § 338.

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CHOICE Act guaranty financial crises. Unfortunately the CHOICE Act also strips regulators of key crisis management tools and instead, in title II, naively provides for financial institution resolution to be handled by the bankruptcy courts without any government assistance. The result will be spectacularly messy.

Specifically, the CHOICE Act would replace title II of the Dodd-Frank Act (the Orderly Liquidation Authority title) with a new subchapter V to chapter 11 of the Bankruptcy Code designed for "covered financial corporations"—essentially large financial holding corporations and bank holding corporations. The proposed subchapter V institutes a "good bank/bad bank" structure through bankruptcy: the good assets of the failed institution, along with its "non-capital structure" debt would be transferred to a newly created bridge company (the "good bank"). The bad assets and the capital structure debt would remain with the debtor firm (the "bad bank"). If everything works right, then after the transfer, the good bank should have clearly positive equity value, whereas the bad bank is likely insolvent. The equity of the good bank would then be sold, with the proceeds going to satisfy the claims of the creditors of the bad bank.

A. Bankruptcy Is Not Designed to Handle Systemic Risk Issues, and the Pressures of Systemic Risk Concerns Will Warp the Rule of Law

As an initial matter, it's worthwhile noting that this structure is basically a codification of the structure used in the *GM* and *Chrysler* bankruptcies.[59] The adoption of this structure is rather surprising given the criticism of the GM and Chrysler bankruptcies by Chairman Hensarling when he was serving on the Congressional Oversight Panel for the Troubled Asset Relief Program.[60]

One of the complaints about the GM and Chrysler were their supposed failure to follow bankruptcy rules of priority. While this criticism is incorrect (the absolute priority rule applies only in a cramdown confirmation, and only to unsecured claimants and equity interests), it underscores a more fundamental point: the bankruptcy system is not designed for dealing with systemic financial crises. When a non-Article III judge with no expertise in the particular debtor firm or in financial markets generally is presented with a situation in which he is told that he has to immediately approve a transaction or else the US economy will collapse, that judge is put in an untenable position and is likely to approve the transaction, whether or not it complies with the law. The rule of law virtues of the bankruptcy system will inevitably become warped when the system is dragooned to handle systemic risks that trump any law. Put differently, it is bad for bankruptcy courts to deal with systemic risk, and it is bad for systemic risk to have bankruptcy courts managing the resolution process.

B. The CHOICE Act's Bankruptcy Alternative Will Not Work Because There Is No Liquidity Source for the Bridge Company

First and foremost among the problems with the CHOICE Act's turn to bankruptcy is that the CHOICE Act provides no financing mechanism for the bridge company. *It is impossible to conduct a liquidation or a reorganization without financing.* This is not a matter of opinion. It is something every first-year bankruptcy associate knows. Because there is no provision for reliable financing in subchapter V, it cannot work. Period.

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59 *See* Jeffrey McCracken et al. *U.S. Threatens Bankruptcy for GM, Chrysler*, WALL ST. J. Mar. 31, 2009 (describing use of bankruptcy for implementing good bank/bad bank plan).

60 CONGRESSIONAL OVERSIGHT PANEL, SEPTEMBER OVERSIGHT REPORT, USE OF TARP FUNDS IN THE SUPPORT AND REORGANIZATION OF THE DOMESTIC AUTOMOTIVE INDUSTRY, Sept. 9, 2009, at 148, 160 (additional views of Rep. Jeb Hensarling).

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The bridge company will need liquidity to operate from the very moment it comes into existence. It will need to be able to pay to keep the lights on, retain employees, maintain insurance coverage, pay taxes, etc. The bridge company must have the financial wherewithal to be able to assume the contractual assets of the bad bank. The bridge company is prohibited from assuming any of the bad bank's assets unless it can show that it is likely to be able to perform on any contracts it assumes.[61] Thus, unless the bridge company can obtain financing, the entire structure of the proposed subtitle V bankruptcy proceeding cannot work.

Where will financing for the bridge company's operations come from? It cannot come from the sale of the bridge company's equity, because the proceeds of that equity sale are earmarked by statute for the creditors of the bad bank.[62] Retained earnings represented another possible source of financing, but they will take too long to accumulate in sufficient volume to finance operations.

Thus, the only way the bridge company can get funding is going to be obtaining a loan from someone, and it will need that funding on day 1 of the bankruptcy. Who is going to make that loan? Perhaps the buyer of the good bank, but that assumes that there is a buyer is waiting in the wings, who just wants to use the bankruptcy process as a way to scoop of the good assets, without the bad ones. That will not be the case in messier situations, and even when there is a stalking horse, few potential buyers will want to extend credit unless they are assured that their purchase bid will be successful.

This leaves the private lending market as a financing source. It is *absurd* to think that private capital markets will be able to underwrite multi-billion dollar loans to a newly established firm with an uncertain equity value on little or no notice at a time when credit markets are in turmoil. In order to operate as a going-concern, a large financial firm needs substantial liquidity. JPMorgan Chase, for example, has around $500 billion in high quality liquid assets that cover peak short-term cash outflows.[63] It is hard to imagine private capital markets coming up with much more than *one one-hundredth* of that within the time necessary.

Many of the assets assumed by the bridge will not be high quality liquid assets, particularly because of the all/or nothing requirement regarding assumption of Qualified Financial Contracts (QFCs)— swaps, derivatives, securities and options contracts, forward and futures contracts, and master netting agreements.[64] Moreover, outflows are likely to be high given the uncertainty of the bridge company's financial strength; the bridge company will be fighting a run. Even if the bridge company does not have immediate liquidity needs of hundreds of billions, counterparties will run if that funding is not there to provide reassurance. Thus, it's quite reasonable to assume that the bridge company would need a credit facility of tens or even hundreds of billions of dollars to assuage counterparties, and possibly much, much more.

Who is going to make a $50 or $100 billion loan on almost no notice at a time when credit markets are in turmoil?[65] Even in good conditions, with plenty of notice, a loan of that size would be difficult, if not impossible to arrange. Consider: the largest private syndicated loan in history was $75 billion, raised in November 2015 for AB InBev's takeover bid for SABMiller, and that syndicate

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[61] CHOICE Act § 232 (proposed section 1185(a)(6)).

[62] CHOICE Act § 232 (proposed section 1186).

[63] JPMorgan Chase, *Firm Overview*, Feb. 23, 2016, *at* https://www.jpmorganchase.com/corporate/investor-relations/document/firm_overview_investor_day_2016.pdf.

[64] CHOICE Act § 232 (proposed section 1188(c)(1)).

[65] *Bankruptcy Financing Proves Elusive,* N.Y. TIMES, Oct. 13, 2008, *at* http://dealbook.nytimes.com/2008/10/13/bankruptcy-financing-proves-elusive/ (noting the difficulty obtaining DIP financing in 208 when credit markets were frozen).

took *weeks* to assemble for a solvent firm.[66] The largest private debtor-in-possession financing ever assembled was a mere $9 billion loan for Energy Futures Holdings in 2014.[67] It's not reasonable to believe that private markets could produce immediate financing for the bridge company of much beyond $5-$10 billion during a crisis, and that is unlikely to be sufficient. Government financing is not an option—the CHOICE Act closes the door on such a possibility.[68]

The bottom line is this: it is not credible to suggest that a financial institution bankruptcy process can work without standby government financing. I recognize that such government involvement is ideologically anathema to many members, but government is capable for bearing certain risks that the private market cannot, and the risk of a need for a massive and immediate liquidity injection into a firm is such a risk. Even if the proposed bankruptcy process were modified to include a standby government financing provision for the bridge company, however, there are still enormous problems.

C. The CHOICE Act's 48-Hour Stay for Qualified Financial Contracts Will Result in Runs and Make It Harder to Sell the Equity of the Bridge Company

The CHOICE Act contemplates a stay of only 48 hours for QFCs.[69] This short stay creates a number of problems. First, it increases the likelihood of a run on the debtor and the bridge company as soon as 48 hours passes. The bridge company will not be able to consummate a sale of its assets within 48 hours of the filing, which will mean that there is some degree of uncertainty about whether it will ultimately be able to honor its contractual obligations. Faced with this uncertainty (not to mention the bridge company's problems obtaining financing), QFC counterparties are likely to accelerate, terminate, and liquidate their contracts, and once that begins, it will inevitably turn into a run, as no counterparty wants to be the last one left when faced with a firm with uncertain repayment ability.

That means that the bridge company has only 48 hours to decide which QFCs it wishes to assume and which to reject. This is not a realistic timeframe for evaluating which QFCs are valuable and which are not. Consider that a JPMorgan Chase has some $70 trillion in derivative exposures. It is not possible to sort through those contracts responsibly in 48 hours, particularly when all hell is breaking loose and key managers are spending their time shopping their resumes with other employers.

Further complicating things is that the CHOICE Act requires that the bridge company assume all or none of the QFCs with a given counterparty.[70] The result will be that the bridge company will have to either assume bad QFCs in order to assume good ones or will have to reject good QFCs in order to avoid bad ones. Either way the bridge company will end up in a substantially weaker financial position. This will reduce the value of the bridge company's equity and thus the return for the creditors of the failed firm whose debts are not assumed.[71]

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[66] Alasdair Reilly & Tessa Walsh, *AB InBev backs SABMiller buy with record $75 billion loan,* REUTERS, Nov. 13, 2015, *at* http://www.reuters.com/article/us-abinbev-loans-idUSKCN0T019E20151113.

[67] Billy Cheung, *Energy Future Holdings lining up $9 billion bankruptcy financing*, REUTERS, Mar. 27, 2014, *at* http://www.reuters.com/article/us-energy-future-hd-loans-idUSBREA2Q13020140327.

[68] CHOICE Act § 707.

[69] CHOICE Act § 232 (proposed section 1187(a)(3).)

[70] I note that the CHOICE Act leaves open the question of whether corporate affiliates count as a single counterparty or not.

[71] This all-or-nothing approach undermines the whole good bank/bad bank structure contemplated by subchapter V because the bridge company will not truly be a "good bank," as it will have to assume plenty of bad assets as well as good ones.

D. The CHOICE Act Makes No Provision for Resolution of Cross-Border Assets

Large financial firms often operate internationally and have cross-border assets. Nothing in title II of the CHOICE Act even addresses the problem of assets outside of the United States, which may be a critical component of a financial firm's value. Chapter 15 of the Bankruptcy Code provides a mechanism for international cooperation between U.S. and foreign insolvency proceedings, but Chapter 15 is not designed to move on the same time table as subchapter V, and it is unclear how a foreign regulatory actions, rather than judicial actions would interface with a U.S. legal proceeding. If foreign regulators ring-fence the debtor firm's foreign affiliates (as they are likely to do), substantial value could be lost to foreign creditors. The lack of attention to international restructuring problems is a glaring omission in the CHOICE Act.

E. The CHOICE Act Has a "Wall Street First" Priority Scheme

The CHOICE Act also creates a priority scheme that deviates significantly from traditional bankruptcy law priorities and ensures that Wall Street creditors get paid, while Main Street creditors get "bupkes":

- Only certain types of liabilities can be assumed by the bridge company (and thus paid 100 cents on the dollar). QFCs are eligible for assumption by the bridge company.[72] In contrast, regular bond debt, deposit liabilities, and debts owed to suppliers, employees, retirees, and judgment creditors cannot be assumed by the bridge company and will be paid pennies on the dollar, if anything. Thus the CHOICE Act makes sure that Wall Street gets repaid, while Main Street does not.[73]

- When secured debts are assumed by the bridge company, they must be paid 100 cents on the dollar, even if the debts are underwater.[74] This is a complete deviation from the standard bankruptcy rule that secured creditors are guarantied a recovery only of the value of their collateral, not of the face amount of their debt.[75] The result is a huge boondoggle for secured creditors—Wall Street, not Main Street.

F. The CHOICE Act Encourages Moral Hazard and Preferential Transfers to Insider Creditors

Beyond the fundamental viability problems and skewed priority scheme, there are a number of other flaws with the proposed bankruptcy subchapter. These flaws are not fatal to the operation of the proposed system, but are consistent with the overarching theme in the CHOICE Act of interfering with regulators' ability to head off financial crises and enabling "head I win, tails you lose" behavior by financial institutions under the guise of "liberty".

- The CHOICE Act places the decision to file for bankruptcy solely in the hands of the debtor firm.[76] There is no involuntary bankruptcy allowed under subchapter V.[77] The management of an insolvent firm has little incentive to file for bankruptcy, however, and every incentive to "gamble on resurrection," when it is insolvent and playing with creditors'

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[72] CHOICE Act § 232 (proposed section 1185).

[73] Ironically, a similar problem exists with the FDIC's proposed Single-Point of Entry (SPOE) approach under title II of the Dodd-Frank Act.

[74] CHOICE Act § 232 (proposed section 1185(c)(3)(A)(i)).

[75] 11 U.S.C. §§ 506(a), 725, 1129(b)(2)(A).

[76] CHOICE Act § 232 (proposed section

[77] CHOICE Act § 232 (proposed section

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money. Thus, subchapter V might never be used, or it might only be used once it is too late and the systemic risk has metastasized.

- The CHOICE Act absolves directors of any liability for actions taken in contemplation of or in connection with" a bankruptcy petition or asset transfer to the bridge company.[78] While this provision might be intended to encourage directors to use subchapter V, it also creates a moral hazard because directors will not have liability for their pre-bankruptcy actions.

- The CHOICE Act prohibits actions to avoid transfers made "in contemplation or connection with" a subchapter V filing.[79] This means that debtors have free rein to engage in preferential transfers on the eve of bankruptcy. It also facilitates "gold parachute" payments to officers and directors if made in connection with the transfer to a bridge company.

G. Because the CHOICE Act's Bankruptcy Route Is Unworkable, Ad Hoc Bailouts Will Inevitably Happen in Response to Crises

What happens in a world in which Congress has mandated an unworkable bankruptcy process for dealing with the failure of large financial institutions? One of three things:

- The bankruptcy process will be abused as in *GM* and *Chrysler* to achieve the financial stability end sought by whatever administration is in office;

- There will be a questionably illegal bailout, with lots of finger-wagging after the fact, as occurred with the use of the Exchange Stabilization Fund to aid Mexico in 1994;

- Congress will rapidly pass bailout legislation, much as it did with the Emergency Economic Stabilization Act in 2008.

None of these are desirable outcomes. Nobody likes bailouts. But realistically they are inevitable when things get bad enough because no one wants to deal with the political consequences of a true economic meltdown.[80] The realistic goal is not avoiding bailouts altogether, but finding a predictable legal framework for them that puts as much of the cost as possible on the beneficiaries of the bailout. Insisting on bankruptcy as a bailout alternative is ideologically-driven self-deception. We will end up with bailouts and worse ones that if we had a formalized (if flawed) process like title II of Dodd-Frank.

CONCLUSION

The CHOICE Act is an amalgam of bad choices. It encourages risky behavior by banks and condones sharp and discriminatory practices. It takes away key tools from regulators and ensures that they will be ineffective using their remaining tools because of political harassment and micromanagement. The inevitable result will be another financial crisis, but this time crisis resolution will be handled by a bankruptcy system that is simply incapable of performing the task assigned to it. The result will be chaos and a hastily pieced-together bailout … and serious economic and political fallout ensuing.

There are sensible reforms to be made to the Dodd-Frank Act, but those sensible reforms are not to be found in the CHOICE Act. Instead, the CHOICE Act is a full course meal of

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78 CHOICE Act § 232 (proposed section 1183(c)).
79 CHOICE Act § 232 (proposed section 1191).
80 Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435, 439-40 (2011).

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extreme, anti-regulatory ideology and bad choices. Blind faith in "free" markets should not trump sensible regulation. Unfettered financial markets are inherently unstable and foster unfair, deceptive, and abusive practices, precisely because such practices are profitable (at least in the short term). The stability of the U.S. economy—of consumers' savings and of consumers' and businesses' ability to get funding—is simply too important to stake on an ideological gamble like the CHOICE Act.

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