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IS DODD-FRANK'S FAILURE RESOLUTION REGIME FAILING?

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P R O C E E D I N G S

MR. KLEIN: Good morning. I'm Aaron Klein, a fellow here at Brookings and the policy director on the Center for Markets and Regulations. It's my pleasure to welcome you here today to have a conversation. It's incredibly topical with legislation pending on the House floor this week looking at this very topic, which is how is Dodd-Frank's failure resolution regime going?

A couple brief introductory remarks about how we got here today, substantively, and a little bit physically.

Substantively, it's a little bit perplexing. Is part of Dodd-Frank meant to deal with the "to fail" component of "too big to fail." You know, "too big to fail" is kind of one word now. It's actually one acronym or #TBTF. But it's really two separate concepts. Can a financial institution be too large? Or can you have one that's simply -- whose failure cannot be handled in a way that does not trigger a broader panic? Title II or the Orderly Liquidation Authority in Dodd-Frank was an attempt to deal with that "to fail" question. Hold aside too big.

When it was originally written, it was among the least controversial and most bipartisan components of Dodd-Frank. It passed the Senate by a vote of 93 to 5 and its principle author was Senator Shelby, the ranking member of the Banking Committee at the time who joined with Chairman Dodd in proposing this amendment. It's hard to imagine at this moment 93 senators agreeing on much within Dodd-Frank. But at the time they did on Title II. Its implementation by the FDIC, who was granted this broad new authority, is somewhat novel. Words you may hear today, like single point of entry, the resolution regime in which the FDIC adopted to come up with how to handle its new authority never appear in the entire text of Dodd-Frank. The FDIC is a bipartisan board, worked on this idea, and also moved it forward in a bipartisan manner. Yet again, it's become highly controversial.

For more information on exactly what it is, there's a primer put on your packet, and past the primer are four blog posts that have come out on Brookings and really explain how we got here today.

At the Center on Markets and Regulation, Martin Baily and I lead a series on financial regulation, and we are joined by two of our three outside commentators, David Skeel and Hester Peirce. Mike Calhoun is the third. And they're free to comment and write about anything that they choose within the subject area, and both of them have come out and put out pieces on how to handle failing financial firms under Dodd-Frank.

Similarly, Rodgin Cohen as an external author read and contributed and wrote his own piece. And Chairman Bernanke not only wrote a piece on the Brookings blog dealing with this point but actually lived it when he had to deal with the failures of systemically integrated financial firms before such authority existed.

So we thought, you know, Brookings, one of our goals is to have a diverse set of opinions. We collected a diverse set of opinions on our website and said why don't we bring them together for a live conversation? And for that, I turn to our partner in this, David Wessel. David is the senior fellow and director of the Hutchins Center. He joined Brookings after 30 years and a distinguished career at the Wall Street Journal where we've read David frequently. We still listen to him on NPR and we're pleased and joyful to be able to see him here live today.

So, David?

MR. WESSEL: Thank you very much. And welcome to you all on the 83rd anniversary of the signing of the Security and Exchange Act of 1934. I figured in this crowd people might find that a milestone.

I'm really pleased to be here to discuss, I mean, as Aaron said so well, basically, we're 10 years after the onset of the great financial crisis, the global financial crisis, it seems like only yesterday to some of us, huh? And one of the things when you look back about what happened was the extraordinary incapacity, the lack of authority for the Federal Reserve, the Treasury, the FDIC to deal with the failures or imminent failures of Bear Stearns, of Lehman Brothers, of AIG, and the extraordinary lengths they went to to try and save the financial system by protecting us from the fallout from the collapse of those entities, decisions that remain controversial today. And also during the crisis there were a number of efforts made to save, prop up, subsidize, whatever your verb of choice is, Citibank and Bank of America and other banks that ran into trouble. And the Orderly Liquidation Authority, Title II of Dodd-Frank and the Title I of Dodd-Frank, which deals with the bankruptcy statutes, were really attempts to resolve, to better equip our authorities to deal with this in the future.

So I think the fact that we haven't ever tried these things, yet now the House this week is likely to vote to repeal and replace them, and the president has issued an executive order suggesting that the existence of Orderly Liquidation Authority may encourage excessive risk-taking by creditors, makes this a very live issue. And we have a particularly good panel here to discuss it.

On the far end is Hester Peirce, who is from the Mercatus Center at George Mason University. She is -- you'll notice a trend here in the minute -- a lawyer.

To my immediate right is Rodge Cohen from Sullivan and Cromwell, who among other things represents a number of big banks. And I should disclose that he and his firm are generous contributors to the Economic Studies program at Brookings. He's the vice chairman of our Economic Studies Council.

On my left, of course, is Ben Bernanke, who had to deal with the collapse of financial institutions, and like me is not a lawyer.

And finally, David Skeel, who is a professor at the University of Pennsylvania Law School and has written a lot about this, among other things, including Christianity. And I'm interested in hearing what you think about the Christian application of Orderly Liquidation Authority and single point of entry. We'll get to that later.

So I basically asked each of the panelists to start with their answer to a relatively straightforward question. The House of Representatives is about to pass a bill that would repeal the Orderly Liquidation Authority and replace it with something else. The president has indicated some skepticism about this. There are a number of other people who think this is about the dumbest thing that the Congress of the United States could do, and that's a very high bar these days.

So I want to ask each of the panelists to basically start with, okay, should we get rid of Orderly Liquidation Authority, should we keep it, or should we modify it?

And David, why don't I start with you?

MR. SKEEL: Sure. So when I'm asked whether we should get rid of Title II of the Dodd-Frank Act, the Orderly Liquidation Authority, I can't help but think of the famous statement Bill Clinton made about abortion 25 years ago when he was running for president. He said that abortion should be safe, legal, and rare. I feel very similarly about Title II. I think it should be safe and legal. I don't think it should be repealed, but my hope would be that it would never be used.

MR. WESSEL: And would you change it?

MR. SKEEL: I would change it a little bit. I mean, one of the things -- one of my hobby horses with Title II and events like this is there's a real miss between -- a mismatch between what Title II says and what we're now talking about doing with it. What Title II says is if a large financial institution is taken over by regulators, it will be liquidated. It will be shut down. And Barbara Boxer made a really big deal about this, that there is a "thou shalt liquidate" requirement. Nobody is talking about liquidation anymore. The single point of entry strategy, there is a way you can characterize it as a liquidation, but it really is a reorganization. It's the way we've reorganized institutions for 150 years in this country. And so I would just change that. I would tweak that. There's some tweaks I would make to particular provisions. I really like several of the suggestions Rodge is going to make so I won't take those words out of his mouth, but he has some very, very nice ideas for tightening up the funding mechanism and reducing it a little bit, and making it a more transparent, more rule of law type procedure. But generally I would change the liquidation and stop pretending that we're going to liquidate the institutions and go from there.

MR. WESSEL: And the reason you think we can use it rarely is because you think in most cases we can use Title I, which is essentially let the bankruptcy court deal with it?

MR. SKEEL: Absolutely. And that's a very important point. We'll be talking for the next hour and a half about Title II, whether it should be repealed, but we'll also at least implicitly be talking about some changes to the bankruptcy code that are also part of the choice act that would make bankruptcy more workable for a large financial institution, and basically, would put in place the same approach, the same single point of entry kind of approach that we're talking about using under Title II. My vision or my desire would be for bankruptcy to be the strategy of first resort and in all but truly extraordinary circumstances, circumstances where we have multiple big banks going down, bankruptcy would be the way you would deal with the financial distress and Title II would only be there as a backstop.

MR. WESSEL: Ben, you have written that it would be imprudent and expose the economy to excessive risk and damnation if we got rid of Title II. Why?

MR. BERNANKE: Damnation is quite a theme.

MR. COHEN: That's a religious theme here.

MR. SKEEL: We've got this religious theme going.

MR. BERNANKE: (Inaudible) bankruptcy is like religious without sin; right?

MR. WESSEL: I kind of paraphrased what you wrote. Let me just say that there's three chairs in the front that are marked reserved, but whoever they're for isn't here, so you're welcome to take them. And if anybody else has a chair next to them that's empty, raise your hand. There's one down here. I promise not to call on you, cold call on you if you take a seat.

MR. BERNANKE: Okay. So it is about less than 10 years ago that Lehman's failure was the critical moment in the acceleration of the global financial crisis. We were facing a global panic and the uncertainty and fear generated by the Lehman collapse obviously was a major factor in making this crisis going from one of the worst in history to, in my view, the worst financial panic in American history. And you know, the government, the Fed, the Treasury, the FDIC, worked to do what they could to deal with the situation, but evidently we didn't have the tools to address the financial impact of Lehman's failure. And it's quite evident that the bankruptcy procedures are not adequate. First, bankruptcy almost by definition is aimed at protecting creditors and making sure that all those who have claims on the firm are served in the appropriate order, et cetera. But there's no real element in the bankruptcy process for serving financial stability and looking at the impact of a financial collapse on the rest of the financial system. Moreover, the bankruptcy system has no need for speed. You know, some of the Lehman claims are still being resolved or have recently been resolved now almost a decade later, whereas, obviously, in the kind of situation we faced in September 2008, you need weekend-type of speed.

So the deal that Dodd-Frank included was that the Fed and the Treasury and the FDIC would give up a number of the tools that we use in various ad hoc ways in exchange for creating an orderly, systematic procedure to be used to protect the financial system in the event of a collapse or near collapse of a major financial firm in the contingency of there being a major financial crisis which was identified as a crisis by the Fed, the FDIC, and the Treasury, in consultation with the president.

I think that was a good deal, one that I was supportive of. Again, I think I was glad to get the Fed out of that line of fire. But now, for no reason that I can see, there is this desire to eliminate this critical backstop authority. In my view, while I agree, you know, that Title I and bankruptcy should be the normal course of events, particularly in a situation where you have an individual firm that is in great stress but the rest of the system is at least in reasonable condition, but under circumstances like we had in 2008, I really don't see that as being realistic.

In my blog I made three points -- there are many others I could make -- but the first is that the Fed and the FDIC have done an enormous amount of preparatory work. There is a whole division in the FDIC which has been planning, you know, firm by firm, for how the process would work doing all this work in advance. And I have to say that the antagonism towards Title II is puzzling to me because the FDIC has been resolving banks along these lines for many, many years and has that expertise. It would be a very similar conceptual approach, but they've done a lot of work, and I can't imagine that a court or a panel of judges would be able to replicate all this preparatory work that has been done by the agencies for each major firm.

Secondly, again, the key goal of Title II, in the event that it is used, is to protect the broader financial system and the economy. Judges, I mean, even if they're mandating attention to broader financial stability, they won't have the information about what's happening in the money market funds, for example, or other parts of the system that were relevant to the decisions that we made in trying to deal with Lehman and other failing institutions.

And finally, I think very importantly, every other major jurisdiction and all of our big institutions are multinational. And Citibank has branches in something like 110 countries. Every one of our international partners has a similar resolution mechanism to Title II and there's a tremendous amount of consultation between the agencies like the Fed and the Treasury and the FDIC and their foreign counterparts planning and working together for the event where a multinational firm fails. A U.S. court does not have the ability or the remit to work with, I don't know, Swiss courts in advance of a failure, so that essential coordination would not be there. And without that coordination, what our partners would just do is just ring fence, you know, all of the deposits or assets of American firms and their countries and the whole process would break down.

So I think that it's just completely infeasible in a financial crisis to safely unwind a major firm. Now, one could say, well, then maybe we should just break them all up and that's a different strategy. That's not the one we've chosen. I think that this Title II strategy will work, but given that we haven't chosen that strategy, I think we have to make sure we have a way to safely unwind the firm. And if you want to avoid bailouts, you've got to eliminate the incentive for a bailout. When the government is in a situation where it's do an unpopular bailout or let the economy crash, the incentives are pretty strong to do the bailout. So the best way to avoid a bailout is to have a process in place that gives you a reasonable chance of successfully unwinding without the tremendous side effects that we saw in 2008.

MR. WESSEL: Thank you.

So Rodge, you'd make some changes to the statute?

MR. COHEN: I would. But could I take just a moment, David, because I think the case for has been very well articulated not surprisingly already. Could I just mention four arguments against and try and anticipate and deal with them and then go to the revisions which are closely related?

First argument is that Title II is some sort of radical legislative departure. I would disagree. I think, in fact, it is a logical extension. Congress has previously decided that you need special resolution regimes for financial institutions. So banks, insurers, and broker-dealers are not regulated under or resolved under the bankruptcy code. And if you look interestingly enough at the legislative history of SIPC for broker-dealers, Congress quite well articulated why you needed a special regime. The bankruptcy code just did not work.

Another element of this departure purportedly is the orderly liquidation fund. And we've got to go to that because that is in many ways the elephant in the room. But we are now 104 years since Congress recognized that we needed a government lender of last resort in large part because banks are assigned the role in society of maturity transformation. And so they do run into potential liquidity problems just by the very nature of their business. So that's one set of arguments.

The second is that it somehow, and Aaron mentioned this in his introductory remarks, that somehow Title II would perpetuate "too big to fail." I think as Chairman Bernanke pointed out, actually it will inter "too big to fail" because if you don't have a legitimate, rational regime which is widely respected, then the government will be faced with a "too big to fail" problem.

Third, you can ask about what is the risk of the orderly liquidation fund. And Title II, I think, makes a legitimate effort to deal with that. There's a borrowing base. There is a high priority of the FDIC's claims. And the largest members of the banking industry are on the hook if somehow the assets of the field institution are insufficient. Now, as David mentioned, I think that could be strengthened. I think the borrowing base could be readily reduced and I believe that the time periods for repayment, which are quite long, could also be reduced which would help, I think, reduce what is already a minimal risk down to close to zero.

And fourth, there is a concern which is a legitimate concern about the protection of the rule of law. You have just an administrative agency, not the courts, and we believe that could be dealt with by having the bankruptcy estate -- not the ongoing financial institution but the bankruptcy estate -- administered under the bankruptcy code. So you split. The FDIC does what it should be doing, which is dealing with the financial institution and the state by a properly situated judge.

And just if I could, very lastly, the other -- it's not really an argument. It's, at best, a rationalization, is that boy, we could really reduce the deficit by ending Title II. And the Congressional Budget Office is the first to admit there is very little risk of loss. That isn't the issue at all. It has to do with the arcane methodology of budget scoring. And I would suggest for the reasons already articulated that it would be unconscionable to sacrifice -- I'm going to continue with the religious theme here -- sacrifice Title II's protections for the system on the altar of artificial budget scoring.

MR. WESSEL: Why don't you tell us a little bit about how you would change -- what one or two changes would you make to the statute? And then we'll hit -- I want to hit some of the points you raised.

MR. COHEN: I think the changes would be, number one, to change the five-year repayment period to either six months or a year, both for the institution itself and if you ever have to assess the large banks. I would reduce the borrowing base from 90 percent by applying the discounts under sections 23A of the Federal Reserve Bank.

MR. WESSEL: So what you're talking about is, so the law says if they take over some big financial institution and it turns out that their liabilities are greater than their assets, the question is, where does the money come from? The law provides that the FDIC can get some money from the Treasury if it needs it. Right? And then they're supposed to get paid back. And if the institution doesn't have enough money to pay it back, then they go to the banking system and get it. And you're saying tighten that a little bit so the money comes back more quickly.

MR. COHEN: In both cases. But also, reduce the borrowing base. So instead of being able to lend up to 90 percent of the failed institution's assets, it would be roughly about 70 percent or 65 percent.

MR. WESSEL: Okay. Hester?

MS. PEIRCE: I think there's a reason that I'm here at the end.

MR. WESSEL: No, it's not that.

MR. COHEN: Save the best for last.

MS. PEIRCE: I agree with all of these gentlemen that financial stability is very important. I think the question is, is OLA the way to get there? And I would argue that it's not the panacea that we've sort of come to hope that it would be. You can't just push a button and make a crisis go away. And I know that's not what these people are saying but that sort of has become the popular understanding of OLA is this magic way to just ease the pain, make the pain go away during a crisis. Crises will be painful and OLA is going to be very difficult to administer. You're asking the FDIC probably to administer -- to run not one firm but multiple firms through this at the same time. The FDIC does, as Chairman Bernanke has some history with resolving banks, but it's typically done that by selling a bank to another bank, which with these large financial institutions is probably unlikely and that is not the strategy that they've laid out. So it will be a very difficult job for the FDIC to do. I would argue they haven't even done such a good job in bank resolutions. We saw just recently there was a bank resolved with a billion dollar hit to the Deposit Insurance Fund. And certainly, that can't all be blamed on the FDIC, on their resolution activities, but it does just illustrate how difficult this task could be.

You know, during a crisis, short-term creditors want to get paid back and they're looking to get paid back. And if they think that the government will pay them back, that could be one use of the OLA. And that leads to my second point, which is that the OLA is ambiguous enough. It's not transparent, and so it is a way for the government to craft a bailout without telling people that it's a bailout. Certain creditors are likely to get bailed out through the OLA. And yes, the OLA does have a mechanism for repayment, but you heard the numbers. The numbers are big. Even under Rodge's modified version it would be possible to borrow up to 70 percent of the company's assets. And if you're talking about a JPMorgan, that's a huge percentage -- that's a huge dollar figure. So even the idea that during a financial crisis you would be able to get other firms to pay that amount back in six months or even five years. I think it's very unlikely that regulators would have the fortitude to force that to happen.

The other concern I have about OLA is just by its mere existence it adds a tremendous amount of uncertainty. It can be used under a very ambiguous trigger. It can be used for any financial company, not just a SIFI. If can be any financial company. And they can be run through without any input from the creditors. When the regulators decide it's going to go into OLA, the creditors don't have any ability to object. And the company doesn't have any ability to object, so it's this very uncertain thing. And it adds a huge measure of uncertainty when people are deciding whether and how they want to lend to other institutions.

It also creates a laziness because it does lead us to believe that the government can swoop in through OLA, dump a lot of money into a firm and solve the problem, so that means that people aren't thinking ahead of time. And by people I mean both regulators and market participants aren't thinking ahead of time how can we take protective steps? How can we be careful to address and protect our own interests ahead of time which then protects the rest of the financial system?

So I'm going to bring it from the theological to a much lower level and say that OLA reminds me of an automatic flush toilet. Once you know those things are out there you stop doing the normal things that your mother taught you to do and it really does lead us to be much less careful in what we do. I would argue that a better approach is to work on reforming the bankruptcy code and making it more workable. And as David Skeel mentioned, you can do a lot of what they're trying to do through OLA through the bankruptcy code. If you work on a single point of entry approach, for example.

Another advantage that we have now is because Dodd-Frank required living wills and required a lot more thinking about what each individual institution would have to do to resolve itself, that will serve regulators and institutions better when they run into problems. But we really want to make sure there's an incentive for institutions to think that there is no backstop for them, that they have got to get into bankruptcy before it's too late. And there was a haze of uncertainty in the last crisis and we saw what that led to.

MR. WESSEL: So, and I think the question that rises is, I think there's universal agreement that we would like to ever avoid being in a circumstance where we have to use OLA. But you don't seem to think that there's any wisdom in saying, okay, if everything else fails, we want to have some system of rules so we don't have to use the ad hoc approach. I mean, the analogy that is sometimes used is, yes, we want to have fire resistant office buildings. We want to have sprinklers -- although I don't see any in here. We want to have building codes. But we don't want to say, okay, we don't need a fire department because someday we know everything will go wrong and we'll have a fire. What would you do? Aren't you worried at all about insuring the system, the stability of the system in case we get hit with a shock like 2008?

MS. PEIRCE: Well, certainly I worry about those things. I think we all worry about them, but OLA is an ad hoc bailout mechanism. It's designed so that regulators can do what they want behind the curtain without a lot of input, without any input from a judge. And so I would argue that OLA is just another way. It's another mechanism for regulators to be able to come in and do whatever they think is wise at the moment.

MR. WESSEL: Does that sound like such a bad idea, giving regulators --

MR. BERNANKE: That's not true. Hold on. There's a whole lot of rules set up and a whole lot of procedures and they show the exact sequencing of events, the prioritizations. A lot of that has been done in advance and put in the form of rules.

I have another factual question. Rodge, maybe you can help me. It's not 90 percent of assets; it's 10 percent of assets.

MR. COHEN: Well, 10 percent at first and then it goes up to 90.

MR. WESSEL: Ten percent pre-invocation and then 90?

MR. BERNANKE: Yeah, well, that's over time. So it's not 90 percent of JPMorgan's assets.

MR. COHEN: Not immediately. No.

MR. WESSEL: It's 90 percent of what's left after they've collapsed?

MR. COHEN: Basically.

MR. WESSEL: After they've been taken over.

MS. PEIRCE: Which could still be quite large.

MR. WESSEL: So it seems to me when I listen to Jeb Hensarling, the chairman of the House Financial Services Committee, who I hope someday will come here and talk about this on our stage, one of the points he makes is -- goes something like this. The problem with Title II and OLA is it's too focused on curing a disease. And I would like to prevent the disease. And the argument is that the mere -- and Hester has made this as well -- the mere existence of some mechanism to deal with a collapse like this creates moral hazard, leads people to take more risks than they otherwise would. So the only way to prevent a crisis is to basically deny yourself the ability to deal with one. I don't think exactly that's how he put it.

Now, Ben, you said, basically, if you don't have some rule for doing the last resort thing, then your expectation is, well, the political system will just do it otherwise. Is that basically what your point is?

MR. BERNANKE: That's right. And there's a couple other problems with that argument. I mean, the first one is that the individual firms, there's an externality problem. Individual firms might worry about their own well-being, but they're not going to say, oh, gee, if I do X, I might slightly increase the chance of a global financial crisis. They don't take that into account in their decision making. So there needs to be some kind of external, you know, it's just like if I'm smoking in bed, do I take into account the fact that the whole town is wood and that my fire might spread? I'm not doing that. I'm worried only about my own well-being. So there's an externality there that firms are not taking into account.

The other thing is that the OLA would involve liquidation of the equity, replacement of the management and board, losses in the senior debt in the holding company, and ultimately, to the extent there is sort of an industry-wide conscience, assessments on the whole industry. So I think, you know, the idea that people say, oh, OLA is there, therefore, I can do whatever I want, take whatever risks I want, it just doesn't -- I mean, there's a lot of effort already being put into the law to address the moral hazard problem. And you made the analogy to fire departments. You know, we have fire codes and we do all we can to make people take these things into account, but in the end, if the town is burning, you probably ought to send a fire truck.

MR. WESSEL: David, do you worry about this moral hazard problem, the notion that by creating a system for dealing with the collapse of financial institutions you will necessarily lead people to be more trusting, take more risks with these big financial institutions?

MR. SKEEL: Well, it's always a risk that you're going to create moral hazard if you create an escape. I personally think the moral hazard risk here is pretty low. I mean, OLA is not attractive if you're a CEO of a big bank. I mean, it's not a place you want to end up. Bankruptcy is not a place you want to end up if you're a CEO of a big bank. So I really don't see the moral hazard issue as being that serious. I guess I would say that serious.

I also at this point don't see the bailout risk as being that serious. When Title II was first put in place, when Dodd-Frank was first put in place, I do think it entrenched, or it looked like it was going to entrench "too big to fail" because what it says is you have to liquidate one of these giant financial institutions if you take them over. Everybody knew that the Fed and the FDIC were not going to liquidate Citi Group or Bank of America. And so what would happen under the original set of rules is if there was a crisis they would be bailed out. I mean, it seemed pretty clear. And so the argument that Title II is entrenching a bailout made some sense initially. But then single point of entry came along. And single point of entry, it's not a liquidation, but it is, in my view, a very clever -- a very clever strategy for recapitalizing a troubled bank. And it, to me, doesn't really look like a bailout.

MR. WESSEL: Just for people who don't know, explain a little bit in layman's terms what single point of entry is.

MR. SKEEL: Sure. So single point of entry, the strategy is that rather with a big bank holding company and all the subsidiaries, the broker-dealer, the commercial bank, what people assumed in 2010 would happen was that if a big bank was in trouble, all of those entities would be taken over and put into resolution. So you put the holding company into resolution. You'd put the -- well, you can't do the commercial bank under OLA, but the FDIC would do it under banking law. You'd put a broker-dealer into resolution. Single point of entry simplifies all of that. It is a very different strategy. With single point of entry, you only put the holding company into resolution. You put the holding company into resolution. You set up a bridge institution. You immediately transfer all of the assets, all of the short-term liabilities, and you can transfer secured debt to that bridge institution. You leave the stock behind. You leave the long-term debt, which is primarily bonds behind. And over a course of a couple of days you've completely recapitalized the entity. And it's more complicated that than. You may have to downstream liquidity to one of the subsidiaries that's in trouble, but the idea is you do everything at the holding company level.

I do think Hester is right that we've been a little -- those of us who were involved in talking about this process have been a little overoptimistic about the chances of success. I think they're high but

I don't think they're 100 percent. I do think they make a bailout a lot less likely. I think any time in the foreseeable future, if a big bank is in trouble, I see single point of entry as being the strategy of first resort.

MR. WESSEL: Rodge, Ben mentioned that one of the challenges here is that -- I think as Mervin King once said -- banks are global in life and national in death. Is that a deal with -- even with OLA, how do we deal with these sprawling, multinational global institutions with, you know, a variety, a kaleidoscope of regulations and all sorts of competing interests? So (a) is OLA well equipped for that; and (b) how big a challenge would that be even if we had OLA?

MR. COHEN: Well, I think that is an extraordinarily important question because if you look at what has been done, and an awful lot has been, not only OLA but as David mentioned, single point of entry is critical. Under Chairman Bernanke's leadership in really initiating it, we are at what's called TALC, total loss absorbency capacity, which provides, in effect, that the creditors knowingly of the holding company will have to really subordinate themselves and take equity. So a tremendous amount has been done. But the glaring omission here is international.

Now, I think Chairman Bernanke said it well. He elaborated on it in his blog that because international regulators know, trust, work with the U.S. regulators, there is a clearly improved chance under Title II that you will have an effective international resolution. They don't know, and they never will know the Bank of England or Banc de France is never going to know a bankruptcy judge by definition. There can't be any preparation. Personally, I don't think it's enough. I would strongly advocate a treaty, and you only need really four signators to make it effective -- US, UK, EU, Japan, and you're there. And it's actually -- it's not complicated. It's just probably one paragraph which is that each will recognize the resolution regime of the home country of the banking institution. Because I worry much about Merman King's statement that no matter how much trust there is, no matter what the relations are, there could be national interest at the end of the day.

MR. WESSEL: So my advice is not one paragraph. Just keep it to 144 characters.

Hester, we've been talking a lot about banks and investment banks but I know you've expressed some concern about the clearinghouses, institutions which have become much more important, in part, because of the post-crisis regulation. We've asked financial institutions to do a lot more of their trading of derivatives through clearinghouse so we don't have a variety of hard to understand bilateral transactions. So the clearinghouse has become very important.

How do clearinghouses fit into this Title II OLA conversation, and what do you think the risks are there?

MS. PEIRCE: So just before getting to that, on the international point, I think if you do create that kind of treaty that you've basically said that OLA is a first resort, not a last resort during a financial crisis because you've represented that that's what you will be using. So I think that that calls into question the rarity with which OLA will actually be invoked.

On the clearinghouse point, so clearinghouses are -- basically, they act as buyer to the seller and seller to the buyer in many kinds of transactions, including derivatives transactions which can be quite long-lasting. So these -- following Dodd-Frank, which mandated the clearing of standardized and liquid derivative, you saw a lot of derivatives going into clearinghouses and clearinghouses are quite bit. And so now people are starting to think what's going to happen if we have a failure of the clearinghouse? This could be a massive problem.

And although clearing houses have a fairly good historical record, there have been some problems in the past, and given the complexity of some of the products that are now being cleared, there's even more worry that there could be a problem in the future.

So some people have said, well, that's easy. We have OLA and that's what OLA is for. But it's not clear, one, that OLA could legally be used for clearinghouses. Folks have made that case. And second, it's not clear that it would even be particularly effective because you can only -- the borrowing limits are based on assets, and the assets of clearinghouses are actually not that high because they're really -- they're really holding other people's assets, not their own. They're not -- it's not their money; they're holding collateral that they get from others. So it's not clear that it would work.

And then the bigger issue, I think, is that FDIC has no experience in clearinghouses at all. And so to have them come in and try to do some kind of quick resolution job where it's so complicated. When there's a problem at a clearinghouse you really need to have the experts who are often drawn from the members themselves to figure out how to wind down a defaulting member's portfolio. And if you actually get -- there's a default waterfall at a clearinghouse, which means there's an order of priority that you go through when you have a problem. And when you get to the end of that waterfall, there's a real question of what to do next. And there's been a lot of discussion about what to do next. And for the FDIC to swoop in and say, all right, we're going to do margin haircutting now and we're going to figure this out, the FDIC just has no basis for determining how to do that.

MR. WESSEL: So the first two things one could solve by making clear that the OLA applies to clearinghouses. But I sense that you don't think that's a great alternative. So given that the clearinghouses are more important, and given that the failure of a clearinghouse would not be a good thing, what would you do?

MS. PEIRCE: Well, I think there have been, again, I think that there's been a lot of good interest in the issue, which I think is leading people to try to sit down members and regulators and clearinghouses to sit down and say, okay, what are we going to do when there's a problem? And to really consider whether the existing structure of clearinghouses is the right structure. And so my advice is let's think about it now before we have a problem. I don't have a brilliant answer. I would end the clearing mandate but that's probably even more controversial than getting rid of Title II.

MR. WESSEL: I think you're probably right about that.

MR. COHEN: I think Hester's focus on this is critical. I mean, it's time for the Financial Stability Board and fossil to step up to the plate and really deal with these issues which are glaring issues.

MR. WESSEL: The clearinghouse issues?

MR. COHEN: Yes.

MR. SKEEL: Can I just jump in and add one thing?

MR. WESSEL: Please. Yeah, please.

MR. SKEEL: Because I agree with all of this.

MR. WESSEL: Everybody can't agree with everything. You don't have to say "I agree" and then disagree. You can just by saying I disagree.

MR. SKEEL: So I disagree. I disagree that we should get rid of the clearing mandate. I think we should keep that in place. But some folks have suggested with clearinghouses what to do when they fail. And I agree that this is a really, really important issue. Some people have suggested, well, let's just use single point of entry the way we're going to use it for banks. I think that is a very bad idea. The beauty of single point of entry is that it worked with banks' traditional capital structure in this country which is banks, because of some of the eccentricities of our regulation have a lot of bond debt at the holding company level and that bond debt can be used to recapitalize the bank if it fails.

Clearinghouses don't have bond debt like that. They have a very different capital structure and it seems to me we really do need to think about the resolution. I think they probably should be resolved in Title II, but I'm not sure that the FDIC should be the resolution authority. I think the Fed probably with the assistance of the primary regulator should probably be the regulatory authority.

MR. BERNANKE: Two quick comments. Even if we agree that OLA may not be the right tool for clearinghouses, that's not an argument against using OLA for what it was intended, which is large financial firms. The second argument would be to the extent that OLA works well, I mean, the main risk to a clearinghouse is the failure of one of its members. To the extent that you're in a crisis situation, OLA helps to resolve the member. That's going to help the clearinghouse as well.

MR. WESSEL: So I want to just expand a little bit on a point that Rodge made. So as I understand it, under the current scoring, the Congressional Budget Office says if you get rid of chapter -- Title II OLA, you save money over 10 years.

MR. COHEN: Right; a number which has fluctuated substantially depending on the month.

MR. WESSEL: And the reason they say it would save money is: (a) they assume that there will be -- something will fail in the 10-year window; and (b) that whatever revenue is collected by this tax on the broader financial system will not be sufficient during the 10-year window to compensate for the losses even if it would be over time. Is that basically right?

MR. COHEN: Unfortunately, it is. And as I understand it, and I may be wrong, the example give is that the failure occurs in the last year. And so you have --

MR. WESSEL: Last year of the 10-year window?

MR. COHEN: Of the 10-year window. And then you don't get the revenues until afterwards. Therefore, it scores negatively even though by year 11 it's all paid off.

MR. WESSEL: Okay. Ben, it seems to me that one of the themes that runs through the discussion of Title II, and actually other parts of the Choice Act, the House's Bill to change Dodd-Frank is we gave the regulators, the Fed and the rest of them, too much discretion. And we constrained it some in

Dodd-Frank and other places we gave them more discretion. And we would like to find a way to basically limit as much as possible the discretion that the technocrats and the regulators have; that in a democracy, Congress should set the rules, and if we're in a situation where the regulators don't have the power, well, they can always come back to Congress and get whatever resolved. But we, in Congress, want to be involved in that decision. I guess I wonder, do you agree with that assessment? And if you do, is there some resolution to this tension between discretion and statute that we can get the balance so that members of Congress are more comfortable with it?

MR. BERNANKE: Well, sure. I mean, so you can't rule out discretion in all circumstances. I mean, you tell the military we want to, you know, protect the country against invasion. It's not really probably a good idea for it to lay out every possible tactical move that could be taken under all possible circumstances. There's got to be some discretion among the experts who are in the field, but those experts are accountable. They need to be, first of all, have a clear set of goals. They need to be transparent about what they're doing and what their plans are. They need to report regularly and get feedback from the legislators. So I think that's what OLA actually does which was, I mean, because -- I think it's in some sense an oversight, a historical accident, the fact that the Fed was founded at a time when the only major financial institutions were banks and therefore, its lending powers, et cetera, applied only to banks. The FDIC was founded at a time when basically all short-term, you know, liquid assets were bank deposits and therefore, it only applies to bank deposits.

Then the financial system grew and created all these other kinds of institutions which were outside of the traditional structure of banking. Europe didn't have any of the problems we did with the Lehman-type situation because the ECB can lend to any kind of institution without it because it was created much more recently.

So anyway, the point is that what we lacked in 2008 was the legal structure to do things in an orderly, systematic, and predictable and transparent way using ad hock methods which were not sufficient because again, our system was built 100 years ago and was not -- it was not created to deal with the kinds of firms and markets that we had in 2008. What the OLA is an attempt to do, and let me just say that I am totally open to suggestions to improve it, to improve Title I and so on, absolutely. But what it is meant to do is to create a systematic framework that allows this to be done in a way with clear goals and transparency and predictability and at the same time to give the regulators, the Treasury, the president the tools necessary to achieve the objectives, and therefore, to avoid ad hoc interventions.

And I guess I'm just puzzled by arguments which say OLA is not perfect; therefore, we should get rid of it. I mean, it's certainly -- and it's not perfect but it is a significant improvement over what we had in 2008. And again, I would reiterate that it was part of the explicit bargain and the Fed would not contest the restrictions on 13.3. That the Treasury would not contest the restrictions on the Exchange Stabilization Fund. The FDIC would not contest the restrictions on its bond guarantee authorities. In exchange for that there would be put in place a transparent structure to allow us to do this in an orderly way.

MR. WESSEL: Just a definition, 13.3 is the section of the Federal Reserve Act which gives the Fed the power to lend to almost anybody in the usual and exigent circumstances, which were used during the crisis.

MR. BERNANKE: Right, and which has been cut back.

MR. WESSEL: Right. The Exchange Stabilization Fund is a fund that was created a long time ago that the Treasury used to backstop the money market funds. And during the crisis, the Federal Deposit Insurance Corporation, encouraged by the other financial regulators agreed to guarantee the new data of all the banks. All those things are substantially limited in Dodd-Frank.

MS. PEIRCE: Although I would argue section 13.3, the limits are -- they're not -- I mean, the limit is it has to be a broad-based program but you could easily design a broad-based program that worked very well for one company and not for anyone else. So 13.3 is definitely still available.

MR. BERNANKE: No, but it requires the Treasury approval. It requires tougher collateral requirements. So it certainly has been, I mean, you can argue about how much but it certainly has --

MR. WESSEL: Right. And the Choice Act would tighten it further by limiting the circumstances, changing the definition of what unusual and exigent is to add some clauses and to require that nine of the 12 Federal Reserve Bank presidents also acquiesce.

Hester, I wonder if you would respond basically to Ben's point which is, okay, it's not perfect. It's better than what we had before, and that the alternative is, okay, you don't like this, then really the choice is let's break up the bank so that we don't have banks that are systemically important.

MS. PEIRCE: I think that the choice -- at the time that OLA was put in place, revising bankruptcy was an option that was considered but for committee jurisdiction reasons the emphasis was put on creating OLA instead. In terms of it's a deal with the regulators that they gave up certain powers in order to get OLA, my guess is that Congress doesn't feel bound by any deal that it's caught with regulators. Congress is ultimately responsible for writing the laws and I think that ultimately they're responsible to the people for what they decide to do.

So the argument that I think is strongest against OLA is that its very existence does contribute to this uncertainty and it contributes to this belief that there will be a bailout. And that belief, the moral hazard is not only for the company itself but for its short-term creditors. I mean, I think that that's, you know, short-term creditors are thinking, great, we're just going to get forwarded over to this new company and we're going to get -- we don't have to worry at all. And so they're not going to be any form of discipline on the companies that they're lending to because they'll be willing to lend in any circumstance. So I worry about that issue.

So it's the fact that OLA itself adds to the instability of the system. I don't think it actually solves --

MR. WESSEL: So would you prefer that they passed a law breaking up the big banks so we never have to deal with one of these things?

MS. PEIRCE: You know, I don't think that having a size limit on banks is the answer. I think that the answer is to have -- and I think the smoker in the bed analogy, if the guy smokes in bed and he burns down the building, he's the one who's going to suffer the most. Right? So he has the most incentive not to smoke in bed because he's going to be dead. So I think the externality arguments are real but I think they've been a little bit overemphasized. If people were really watching their own houses, and watching the counterparties they deal with we'd have a stronger financial system.

There have been steps taken that I think have been good steps. We have very complex financial institutions. Having a living will to better understand, going through and understanding what all your subsidiaries are and how you might resolve them, those are all helpful things. And then taking a look at whether we're subsidizing bigness. That's fair, too. I think we should think about different ways that we might be subsidizing bigness and try to get rid of those subsidies. But in terms of deciding how to affirmatively break up banks, that's a hard thing for government to do effectively. I would want to see what the plan was for actually doing that.

MR. WESSEL: David, so a lot of the discussion seems to be why can't we just use the bankruptcy courts all the time? Why don't we just have chapter whatever. I don't know what chapter -- 14. Chapter 14 in the bankruptcy statutes it says, here's how we'll deal with the big financial institution collapsing and do away with all these things. So you've written a lot about bankruptcy. Is that practical?

MR. SKEEL: So I think bankruptcy can get us almost all the way there, and so I really do think bankruptcy should be the strategy of first resort. I don't think it can get us all the way there. And my concern is that if you only had a bankruptcy option, you really are bringing bailouts back into the picture.

MR. WESSEL: In other words, they won't be able to tolerate the bankruptcy, which might be a little more uncertain than Hester suggests. And as a result, they'll do something like just pay off the creditors so the institution doesn't have to go into bankruptcy?

MR. SKEEL: That's right. That's right. AT least with the very biggest banks, I just don't think regulators would trust bankruptcy enough to let the bankruptcy process handle them. So my hope would be that with almost any financial institution we have, bankruptcy would be trusted, particularly if this subchapter five as it's currently called or chapter 14 is put in place to make single point of entry work more effectively in bankruptcy, but I still think that with the two or three biggest banks, regulators aren't going to leave them to bankruptcy. And I think you do need the Title II backstop.

MR. WESSEL: Do you agree with that?

MR. COHEN: I would very much agree. Sorry, but I do. I would, however, think that this -- when the question gets phrased as either or, we're making a mistake. Why not have an improved bankruptcy code as well as OLA? The one thing that is for sure is that a crisis is unpredictable. By definition it is. So why not have as much flexibility and optionality as one can have to deal with that crisis in terms of the legal structure for resolving an institution? I would make one suggestion, one more revision, and this is on the bankruptcy side. One of the criticisms which I and others have levied is there isn't the expertise. So whether it's subchapter five or chapter 14, I would suggest that there should be a mandate for appointing ideally the Federal Reserve as a special master in the bankruptcy proceedings. Now, the special master can't make any decisions but it's the bankruptcy judge that has somebody that it can really rely on.

MR. WESSEL: You mean if a financial institution goes into Title I bankruptcy?

MR. COHEN: And it's above a certain size or certain complexity.

MR. WESSEL: Then the Fed comes in as a special master. Boy, you must be glad you're not there anymore.

MR. SKEEL: Can I add one thing to Rodge's suggestion? And I think this is a very, very important piece that's missing from the current legislation is I think regulators, I think the Fed at least ought to be able to file the bankruptcy petition. And there's been discussion of that in the past that is not in the current legislation. It's not in the Choice Act version of bankruptcy reform. And I think the more that you give regulators a role in the bankruptcy process, I think more willing, the more comfortable they're going to be with the bankruptcy process. I also think the more comfortable foreign regulators are going to be with the bankruptcy process.

MR. WESSEL: I'm going to open it up to the audience but I want to make sure -- there's a hundred things in Dodd-Frank we can talk about but on Title II OLA, is there anything you want to raise that I didn't before we go to the audience?

Okay, let's take a few -- I think I'll take questions in groups of three so that we can then give more people a chance to be heard. Please wait for a mic, tell us who you are, and try to keep it short and remember that questions end with a question mark. So there's two right in the aisle here.

MR. HAMRICK: Hello, I'm Hunter Hamrick. I'm with -- I'm a finance associate at National Journal.

So I really enjoyed the conversations about OLA, and why not? But I kind of wanted to know, given the current congressional climate, do you think actual changes to OLA will be passed in Congress? And if you do, what kind of changes do you think would be passed?

MR. WESSEL: Okay. Can you pass the mic behind you?

SPEAKER: Yes, (inaudible) Foundation.

I would like to ask about the moral hazard of the regulators themselves. We heard about risk-weighted capital requirement. The market though, okay, risks have been weighted. We hear about living will. Oh, there's someone thinking about it. We hear about stress test, that's taken care of. And now we hear about Orderly Liquidation Authority. Why is that word “orderly” there when we probably know it’s not going to be that way?

MR. WESSEL: We’ll posit that.

There’s another gentleman on the aisle there in the blue shirt.

MR. SMITH: I’m Carl Smith. I’m a chief economist in the Niskanen Center.

So this is for Hester. I think my sort of thought here is do you not accept that the public choice problem is so large that we basically can’t leave this to the bankruptcy system? I mean, that seems implicit in what everybody else on the stage is saying, but you seem to be saying like, no, this will be okay. The evidence from the past seems to be that the public choice problem is just too big. Do you have like any sort of like --

MR. WESSEL: What do you mean by the public choice problem for people who aren’t frequenting the Niskanen Center?

MR. SMITH: So essentially we might have an ideal set of rules that we want to set up but that legislators will not abide by those rules because they understand the consequences for them and their careers are so bad that they’re going to change rules and break them and make them essentially like we had last time, ad hoc systems.

MR. WESSEL: Okay. Right. Heather, do you want to start with that -- Hester, do you want to start with that?

MS. PEIRCE: Yeah, I think that that’s -- a big part of the reason why I worry about OLA is I think it allows the regulators in the time of crisis to do whatever they want. So it’s a mechanism for ad hoc which certainly plays into all of those public choice concerns that certain creditors will be favored over others.

And so the better approach is to use a system that we’ve been using for a long time in bankruptcy, and people know what to expect and it’s actually much harder to game a bankruptcy system than it is this new --

MS. WESSEL: You don’t assign much weight to Ben’s argument and the one implicitness question is if we’re in a situation where bankruptcy isn’t going to work, the political economy prediction that’s being made is Congress is going to swoop in and bail them out.

MS. PEIRCE: And that's fine. And that's what Congress is for. I mean, Congress can make -- in that moment can make a determination, yeah, we want to do a rescue. I might -- if I were in Congress, I might vote against it but that's fine if that's what they decide to do. I mean, that was what happened with TARP. Congress decided to swoop in and do something with TARP and that same thing could be done.

MR. WESSEL: It was a little slower than swoop.

Anybody want to make a political forecast on what happens to OLA and the Choice Act?

MR. SKEEL: I will since I don't live in Washington. And my predictions on Congress are nearly as good as my Supreme Court predictions which are not very good, unfortunately.

I think currently the Choice Act has repeal of Title II which we've been talking about, coupled with these bankruptcy changes that would make bankruptcy more able to do a single point of entry resolution. In my view, as long as repeal of Title II is part of the package it just won't pass. I can't imagine a single democrat voting for it. So I think if somehow there's a deal to remove the repeal of Title II, I think the bankruptcy part really could pass, but without that I don't think it will.

MR. BERNANKE: But there is this aspect of reconciliation which is that the Title II funding could be --

MR. SKEEL: That's true. That is true. Yeah, that is true.

MR. BERNANKE: -- extracted and voted on by a straight majority even though as Rodge points out it's really kind of a -- it's not a true budgetary cost in an economic sense.

MR. WESSEL: I predict if there is a compromise they will do something to make community and regional banks happier. That's the one thing that everybody in Congress seems willing to do.

Martin? Why don't you wait for the mic? Martin Baily from Brookings.

MR. BAILY: So Hester raised a question of could the FDIC really manage multiple large institutions at once and do it in a way that avoids the problems that came up before. And I was on a panel somewhat like this with Paul Kupiec who spent years at the FDIC and he said you'd be crazy to think that the FDIC can handle multiple large bank failures in a way that avoids the kind of crisis we had last time. So what makes you confident that this can actually happen?

MR. SKEEL: Is that to me?

MR. BERNANKE: He's looking straight at you.

MR. SKEEL: You know, I've had a number of meetings with people there and people doing the planning and, of course, with Marty Grunberg and other people on the commission, and I'm very impressed with the amount of progress they've made. I think it's much greater than is perceived and understood by the public. I think it's also -- I want to add that I think that this preparatory work they're doing is valuable in that, for example, working with the living wills, there's been a lot of work trying to make the firms more resolvable ex ante, that is to try to make sure that their legal structures are such that they correspond to business lines, for example. But again, your argument is relevant to the question about OLA versus breaking up the banks, you know, which is the better strategy? It's not relevant to the question of OLA or no OLA. I just can't get my mind around the idea that OLA, you know, we saw what happens without OLA. We saw it. It's 2008. We don't want that again. We want some new thing. OLA may not be perfect. It certainly may not be successful if you have multiple firms as you point out in a complex situation, global firms, all those things are real problems they need to keep addressing. But I'm absolutely confident that it would have been a better strategy, a better framework than the kinds of ad hoc, you know, and politically fraught approaches that the government was forced to use in the last crisis. And so I guess everything should be compared to, you know, what's the alternative? And if 2008 is the alternative, I don't think, you know, we really want to go there again.

MR. WESSEL: Rodge, I think one of the things I hear sometimes from members of Congress is, well, there must be something wrong with this because the big banks like it. So (a) do the big banks, if you can generalize, like this? And how do you answer people who say they must be hiding something from us if they think it's a good system?

MR. COHEN: Well, this again question approaches theology. And if you believe that big banks are inherently evil, I mean, it's sort of an ethic that you're born in damnation and you're going to live in damnation all your life, then --

MR. WESSEL: What does that make you as a lawyer for the bank? I have to think about that.

MR. BERNANKE: He represents damnation.

MR. COHEN: An enabler, I guess. But seriously, no, the large banks, I think generally, approve of Title II. I hope I'm not damning Title II by saying that, because they do believe it provides a better system for a resolution, not if, but when we need it. And it's not -- nobody is going to say Title II is perfect. I again would agree with Hester, it is not a panacea but it is a lot better than just leaving this to even an improved bankruptcy code. And you know, the large banks have all seen -- it's a question of why they like it. They have all seen their ratings cut because there's no longer an uplift --

MR. WESSEL: The credit rating agencies of their debt.

MR. COHEN: Right.

MR. WESSEL: Which previously assumed if they get in trouble the government will come in.

MR. COHEN: Right. And so they had a so-called uplift which was worth one rating grade. That's all gone. So it is not because they're financing more cheaply; it's because they have as much as anybody, an inherent interest in the stability of the system.

MR. WESSEL: So it won't be orderly but it'll be more orderly than the alternative?

MR. TRACY: Hi, Ryan Tracy with the Wall Street Journal. If I could do the journalist trick and try a two-parter. One to Chairman Bernanke. To suggest an alternative that some bring up to OLA or what, the answer embedded in the Choice Act is OLA -- take away OLA but have more capital in the banks. And that's what Tom Mahonig talks about, too. So I'm curious what you all think of that alternative.

And then also, with respect to the rating agencies, I wanted to bring up, Hester mentioned short-term creditors. The rating agencies have given the subsidiaries of the large bank holding companies some uplift because of OLA. They say that they expect that the creditors of these subsidiaries in single point of entry would survive. And so I'm just curious whether the supporters of OLA would disagree with that or is that sort of a subsidy that we just have to accept in this new system?

MR. WESSEL: Is there another question? There's one way in the back there.

SPEAKER: My name is (inaudible). No relevant affiliation.

What I'm wondering is the way we're talking about this now it seems as if there's like this binary state. The bank is failing, the bank isn't failing. When I think back at the crisis, if you take the big banks, there was like a year and a half over which they went from like super well capitalized to still by statute Super Bowl capitalized but everyone thinks they're failing. And my question is you point out that -- I guess this is for Chairman Bernanke. You point out that the OLA isn't so attractive for the bank shareholders but my question -- the question is whether regulators have the fortitude to use this in a way that's timely and not too late. And the reason I ask that is throughout the crisis, I go back and read the FOMC minutes and you see that the Federal Reserve Board and other regulators are kind of pushing for accounting rule changes that delay the recognition of losses because there's the idea that banks -- if banks are forced to take losses early and sell off their assets, that exacerbates the crisis. And it's kind of analogous in the sense that had banks been required to take losses sooner that are simply recapitalized earlier and the fortitude question is important because even a month after Lehman failed, Citi Group is trading at $80 billion. So one might ask why didn't, you know, the Federal Reserve or any other regulator go to Citi Group and say let's look at your accounting in a conservative way and you can do a deeply discounted rights issue and recapitalize privately.

MR. WESSEL: Okay. I think there was at least 15 questions in that.

Why don't we start with the question about, Rodge, the short-term credit? Is it factually correct? And why would the short-term credit agencies be uplifting the subsidiaries?

MR. COHEN: I actually, and you know, you can debate the issue, but I would actually argue that the improved credit ratings for the short-term debt at the large banks is 100 percent or close to it a function not of OLA but of TALC because in effect --

MR. WESSEL: Total loss absorbing capital.

MR. COHEN: Capital. Or capacity, yeah. And in effect, you have, for a short-term creditor of a bank, you now have not 10, 11, or 12 percent, you have 22 percent capital supporting them because all that TALC eligible debt gets converted in an insolvency. So there's now a huge capital base under the short-term debtholders.

MR. WESSEL: Does anybody have a view? The Choice Act basically says if you agree to hold a lot more capital, a leverage ratio of 10 percent, there's a so-called off-ramp. Does anybody have a view on whether that's a good idea or not?

MR. STEEL: I do. I think it's a very good idea. I think the idea that if you have lots of capital you should get regulatory relief. You should be rewarded for it is an excellent idea and that's one part of the Choice Act I would very much like to see passed.

MR. BERNANKE: I disagree with that. So in principle, yes. If you have a lot more capital. But the specifics in the Choice Act are only the leverage ratio. It drops stress testing. It drops risk weighting, all those things. And my argument would be that you need different perspectives on capital. So in particular, if you have only a leverage ratio, it would be a big increase in capital. If the current banks raise the capital to meet that leverage ratio with their existing assets, that would be a meaningful increase in capital and that would be positive.

But they would have strong incentives to change the mix of assets they hold. So they would hold much riskier assets. They would not be engaged in safe assets. Like, they would withdraw absolutely from repo markets and other markets where they have to hold treasuries and other low-risk assets. So I think you say you have more capital. Relative to what? So while I agree with the principle, that more capital makes banks safer in general and that should affect the kinds of regulation they face, a leverage ratio alone is important but it needs other indicators of capital.

MR. WESSEL: Okay. And as I understand the way that orderly liquidation and Title II work, there is kind of a binary switch. At some point, the FDIC, the Fed, the Treasury, I think the consultation with the president have to decide to flip the switch and say --

MR. BERNANKE: Well, it's binary but the questioner's point was right. Back in the '80s, Congress put in prompt corrective action and other rules to force the FDIC to recognize losses more quickly. And that is an issue but I would have to say that you're much more likely as a regulator to want to recognize losses and resolve a situation when you have some tools to do so as opposed to a situation where you know that, you know, forcing a firm into bankruptcy is going to be highly disruptive because you don't have the liquidation authority.

MR. WESSEL: Aaron?

MR. COHEN: Could I just support, just for one second, what Chairman Bernanke was saying in the following respect? I think there are flaws in either too much capital or too little capital. Clearly, in 2008, there was too little capital. But one of the chairman's former colleagues, Jeremy Stein, did a study and it is fascinating to see, if you go back through American history, certain periods of very high capital requirements also had very high bank failures. And I think it was exactly because of what Chairman Bernanke said. When you have these very high capital ratios, it requires higher risks in the assets to get returns.

MR. WESSEL: Aaron? Aaron Klein?

MR. KLEIN: I want to turn for a second because OLA was set up to deal with both as been discussed, the kind of growth after Gramm-Leach-Bliley of commercial banks being emerged with investment banks and broker-dealers in extending the authority, and also to deal with any firm-designated systemically important financial institution (SIFI). To date, the only private firms that are SIFIs are insurance companies. We've not talked about --

MR. WESSEL: Other than the banks.

MR. KLEIN: The banks are just over a certain size threshold.

MR. WESSEL: I see.

MR. KLEIN: The SIFI designation only currently has been applied to insurance companies, and the resolution of an insurance company is actually kind of the opposite of a resolution of a bank. In a bank you need to act very fast. With this creditor runoff and insurance companies it's actually the other way. Liabilities are much longer tailed. In addition, insurance companies have a state-based system of 50 different state-based insurance funds. So I want to kind of get the panel's thoughts on does OLA work for insurers? Is it sufficient? Has there been enough preparatory work done in that space? And if not, you know, what is the right framework here? Because currently that's a large amount of the remit of OLA is to large insurance companies.

MR. WESSEL: There's one insurance company; right?

MR. KLEIN: There's AIG, Prudential --

MR. WESSEL: And MetLife.

MR. KLEIN: MetLife is currently not a SIFI pending court appeal.

MR. WESSEL: Right. Okay. Does anybody have a view on that?

MS. PEIRCE: Well, given that the work of the FSOC on insurance seems to suggest that they completely misunderstand how insurance works and how a run in insurance would work, I think that probably there hasn't been enough preparation work done. I think in AIG -- in AIG's case, for example, during the crisis, a number of the insurance companies actually did have pretty severe problems, and I think you could have seen each one of those resolved at the state level instead of trying to federalize all that. So I think it could be done better at the state level.

MR. WESSEL: Do you want insurance companies? Are you for insurance or against it?

MR. BERNANKE: Am I for or against it? I think I would partly respond by saying that the biggest gap that OLA addresses, again, is strictly a quirk of history. So every argument that's been made against OLA could be made against 1913 style (inaudible) last resort. You know, discount window lending against deposit insurance. So it's just a quirk of history that our system is set up to provide these kinds of tools for banks but not for other institutions. So the most important example is holding companies which most people would be, what? Bank holding companies are separate companies which are not banks but they're over maybe a bunch of different banks or banks and broker-dealers or even insurance companies. And it was those holding companies that were not eligible for bank-type resolution. And when I think about OLA, that's what I think about is the big holding companies that have broker-dealers in other institutions below them. Insurance, I mean, I think, you know, the Fed has been struggling with, you know, the fact that Dodd-Frank is very much a bank centric kind of approach in terms of its regulation and its capital and so on. In some ways it's not inappropriate for insurance. And I haven't been there for a few years so I'm not up to date on all the developments, but I do know they're trying to think hard. And there were some changes even. One of the very few changes to Dodd Frank was the one that lowered the capital requirement for insurance companies relative to banks. I think they are working to try to, you know, adapt the structure. But it is a little bit of an awkward fit to insurance.

MR. SKEEL: Can I just add one quick thing quickly? Mostly just to double-down on your question. The kinds of things we've been talking about -- single point of entry, they're not an obvious fit for insurance companies and so there is a question there. And the Choice Act currently would remove the ability to designate nonbank financial institutions as systemically important. I personally think that would be a mistake despite the poor fit because we don't know what the next systemically important financial institution is going to be. It might be some other category all together. It does seem that we want regulators to have the ability to identify them and to look at them more closely. So I don't think any of this is an argument for removing the designation authority.

MR. WESSEL: I think you had a question here and I overlooked you and I apologize.

SPEAKER: Hi, (inaudible) with American Banker.

So a lot of the points you made on OLA are very interesting. Overall though I was wondering, it seemed like one of the arguments for appealing OLA is the idea that it's "too big to fail." And in Dodd-Frank it's supposed to be a backstop. But we all seem to be talking about it as in how it would work and how likely it is to work. So have we gotten to the point where we consider that bankruptcy won't work for one of these large financial institutions?

MR. WESSEL: Okay. Is there -- can we take a couple more? The gentleman there in the aisle and one over there standing against the wall. The guy in the pink shirt against the wall. Raise your hand madly so we can find you.

MR. GIBSON: Hi, Campbell Gibson.

My question is sort of a follow-on on that and it's sort of to the chairman and Rodge's points on the international aspect of OLA process and our work with international jurisdictions or national regulators. How would -- we saw in the Lehman bankruptcy how poorly the meshing of U.S. bankruptcy law and international bankruptcy law worked for resolving a large complex institution. How would any changes to domestic bankruptcy law facilitate the resolution of a large public firm?

MR. WESSEL: Thank you.

MR. COURT: Yeah, my question would be I guess for --

MR. WESSEL: Tell us who you are.

MR. COURT: Oh, John Court with The Clearing House.

My question would be for Rodge and Hester. Hester, you say one of the problems with OLA is that there's no market discipline. For short-term creditors, you know, they're protected. They'll get moved over to the bridge. But can you talk a little bit about whether the market discipline imposed through TALC would sort of make up for that? I mean, the TALC requirements are that institutions have basically five percent leverage issued in unsecured long-term debt. And that debt is going to roll every few years so they're always going back to the market. So JPMorgan, for example, has to have $150 billion of outstanding unsecured long-term debt and they're constantly rolling it. So the fixed income analysts are constantly assessing JPMorgan's viability. And that debt is the first line of defense after equity; right? It's subordinated to all other creditors. So is that a powerful market discipline?

MR. WESSEL: Okay. Thank you.

So David, the first one, I think we've touched on this, but does OLA essentially mean that some institutions are too big or too complicated to resolve in bankruptcy? The answer is?

MR. SKEEL: So I'm going to change the question from the way you framed it to the way I heard it which is are we saying -- are we saying that bankruptcy won't work? And my answer to that is no. I think bankruptcy will work. I actually think bankruptcy would have worked during the crisis if it had been given a chance before Lehman. But I also think that there's some institutions that regulators just aren't going to leave to bankruptcy. And so I think there does need to be a backstop. But I don't think -- I don't think saying there needs to be a backstop also commits you to -- commits one to the position that bankruptcy doesn't work. I think it would work. I just think there needs to be -- there needs to be a nuclear option if we're in a --

MR. WESSEL: I guess, Heather, your point is if you have it, you'll use it?

MS. PEIRCE: Yeah. Because it's an easier way for the government to dump money into a company that's having trouble, and that's what the government's inclination is during a crisis. Understandably. You know, you want to stop the pain from happening so you just want to throw money into a situation. And that sort of ties to why I think the market discipline, the TALC is helpful for that purpose but I think we're losing the benefit of having some discipline coming from short-term creditors as well. They should be watching on the spot as well. So I think you get some extra discipline from that but you lose some. You know, to go back to the bank capital question, I think having higher capital, higher leverage ratios is a way to insert discipline back into the system.

MR. WESSEL: Rodge, do you want to take the TALC question?

MR. COHEN: I think by definition, again, TALC does create a substantial amount of market discipline. If you are -- first of all, there's a lot more available capital as we discussed. But also, if you are now a creditor at the holding company level, you're taking a very different risk than you were prior to the TALC regulations coming in. You are at total risk. Unlike a typical chapter 11 bankruptcy where, you know, over time even unsecured creditors achieve substantial returns, there's no certainty here of any returns. So I think there is real discipline.

If I could just return very quickly to a point Aaron made. It's always easy in retrospect, but one of the, I think, criteria which was missing from the designation for FSOC is what percentage of assets and revenues are outside of the regulated financial institution? After all, that was the AIG problem, not so much the insurer.

MR. WESSEL: And Ben, I think you spoke on this before, but as we look back in history, are there reasons to believe that the bankruptcy system could work more effectively than it has? Could the bankruptcy system deal with globally sprawling institutions? Is there some advantage to having judges and some kind of preunderstood priority for creditors?

MR. BERNANKE: Well, it's important to point out that America has made this choice. We don't put banks in bankruptcy. We have a lender of last resort and we have the FDIC. And we haven't -- even for small banks we don't do this generally. So it's an accident that we don't have a lender of last resort for other kinds of financial firms. That's what 13.3 essentially did -- the Emergency Lending Authority did during the crisis. And bankruptcy by its nature, again, just in terms of what the mandate is, the mandate is to protect the rank ordering of the creditors, which is an important thing. And I would say that creditors -- in fact, there is a provision that in Title II creditors cannot be worse off than they would be in Title I. So creditors are protected in Title II. But the focus is different. Instead of focusing strictly on the disposition of the assets, it's also -- the OLA is about trying to protect the overall system.

In terms of the international, I guess I would just make the point that a couple of things about MLA make it more likely to be successful internationally than a bankruptcy. The first is that it's just going to be a lot more coordination. The regulators get together and talk about how they're going to actually operate. They do dry funs and exercises and the like. And indeed, the rules that are being set up by the Financial Stability Board and other international bodies are actually taking into account the coordination among different countries.

The other is the SPOE, the single point of entry is actually a big bonus for international coordination because by down streaming capital from the holding company, putting the holding company into a bridge, it means that the London subsidiary is sound and the British authorities don't have to get panicked about it because it's going to be okay and the losses are going to occur only at the U.S. holding company. So, while it's not perfect again, you can't make the perfect enemy of the good but it is certainly a much more likely possibility of resolving international organization with the SPOE approach than it would be through any kind of sort of standard, put the whole company in liquidation approach.

MR. WESSEL: And David, finally, I don't think you -- I asked you to respond to Ben's point that the problem with bankruptcy is that it's about adjudicating claims among creditors, not protecting the financial stability of the system. Do you agree with that? Is that fixable?

MR. SKEEL: As a generalization, I do agree with it, that the focus is on that institution and the parties to that institution. I think with many failures that would be exactly what you want, is to focus on that institution. I also think that the reality is that when there are potential systemic implications, bankruptcy judges are aware of that and they respond to that. So people talk about how long the Lehman bankruptcy had taken, the fact that we're still dealing with Lehman claims now. Well, the real Lehman case took place in four days and I think that was because of -- the sale of the major assets took place four and a half days after Lehman filed for bankruptcy and that was because an awareness of the systemic implications. So Chairman Bernanke has said a number of times that you don't -- these systems aren't perfect. I don't think bankruptcy is perfect either but I think we shouldn't overstate the inability to take systemic considerations into account in bankruptcy. I do think that is a difference. I think that is a limitation of bankruptcy. But it's only a partial limitation. And bankruptcy judges are fully aware of the systemic implications.

MR. COHEN: David, could I just --

MR. WESSEL: Please.

MR. COHEN: Again, this Lehman point is an important one, and David is absolutely right. In four days the major asset was sold to Barclays. That would never, ever again happen. When Barclays found out it had lots of liabilities, or JPMorgan for Bear Stearns, nobody will do it again, and therefore, that's just one other argument in my view for having the flexibility and optionality.

MR. WESSEL: Why would nobody do it again?

MR. COHEN: Because the government was more than willing to come in and say we don't care whether you rescued it or not. If Lehman did something wrong or Bear did something wrong or Countrywide did something wrong, that's on your watch because you bought it.

MR. WESSEL: Okay. I think our time is up. I want to thank the panel and thank all of you for coming. And ask you, please, to take the papers and coffee cups at your feet and put them in the garbage.

(Applause)

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