

The Financial Crisis and “Too Big to Fail”

At the height of the financial crisis in 2008, the Bush administration believed that it was forced to choose between doing two unprecedented and undesirable things: propping up large failing financial companies at taxpayer risk on the one hand, or on the other permitting such companies to go through bankruptcy, with potentially catastrophic results for an already weak financial system.

Bush administration officials in most cases judged the risks associated with not acting to be unacceptably high. The Federal Reserve first provided direct aid under section 13(3) of the Federal Reserve Act to support and facilitate the acquisition of Bear Stearns. Bush administration officials then let Lehman Brothers fail, but that choice proved to be highly destabilizing because the abrupt cessation of the company’s operations, combined with its interconnectedness with other financial firms, caused a freezing up of financial markets in the United States and around the world. Because of these seriously damaging economic consequences, the Bush administration concluded that bankruptcy was not up to the task of dismantling a complex financial intermediary, and the Federal Reserve again used 13(3) to support AIG. At the urgent request of the Bush administration, Congress created the Troubled Asset Relief Program (TARP) to support a number of banks during the crisis. Bush administration officials also invoked the systemic risk exception in the Federal Deposit Insurance Act to allow the FDIC to create a loan guarantee program for banks.

That the government was forced to prop up troubled firms to avoid a systemic collapse clearly demonstrated that the regulators’ tool kit for managing the failure of large, interconnected financial firms, much of which was put in place when the financial system was significantly simpler, was inadequate. The provision of extraordinary government support blurred the line between liquidity support and solvency support and perpetuated the belief that some financial firms were “too big to fail” (TBTF).

Wall Street Reform Addresses the TBTF Problem at Its Roots

The Wall Street Reform and Consumer Protection Act addresses the TBTF problem at its roots by protecting the financial system without protecting the existence of any individual financial firm. It accomplishes this result through two basic means – first, by providing a set of tools to ensure that large, complex financial firms and the financial system in which they operate are more stable and transparent, and that regulators can supervise the financial system and its constituent parts more effectively; and second, by ensuring that a failing financial firm can fail in a fashion that minimizes risks to the financial system without any ultimate cost to taxpayers. As former Treasury Secretary Hank Paulson has made clear, if these tools had been in place before 2008, spillover effects of the crisis could have been managed with much less disruption in the economy and with no direct burden on the taxpayers.

Requiring companies to better manage risks and absorb losses, and giving regulators the necessary tools to supervise

The Wall Street Reform and Consumer Protection Act ensures that the largest, most interconnected firms are less likely to fail, not by preventing them from taking risks, but rather by making sure that they manage risks prudently and are capable of absorbing losses when they make mistakes. To that end, the law automatically places bank holding companies (BHCs) with assets of \$50 billion or more under enhanced prudential supervision by the Federal Reserve,¹ and empowers the new Financial Stability Oversight Council (FSOC) to designate nonbank financial companies for such supervision.² Enhanced supervision includes heightened capital, liquidity, and risk-management requirements; resolution plans, also known as “living wills,” which demonstrate how a company could be resolved in an orderly fashion under the bankruptcy code; and rigorous stress tests.³ These requirements will help companies to understand and manage their risk profiles more fully, and will allow regulators to target their attention more precisely on problem areas. The Wall Street Reform and Consumer Protection Act empowers regulators to address a financial firm’s size and activity mix in the event that these cause problems, but it does not assume that large size and certain activity combinations will always be problematic.⁴

The Wall Street Reform and Consumer Protection Act also strengthens the broader system within which financial firms operate by giving financial regulators a mandate and the necessary tools to address the health of the entire financial system, not just the safety and soundness of individual firms.⁵ The FSOC, backed by an Office of Financial Research,⁶ monitors the system for risks and can respond to identified threats not only by placing nonbank financial firms under Federal Reserve supervision, but also by providing for stricter regulation of systemically destabilizing activities and practices wherever they occur.⁷ This will allow regulators to address, for example, destabilizing situations that are created not by the action of one firm, but by the collective action of many firms. This authority, had it been in place before 2008, could have allowed regulators to prevent poor mortgage underwriting practices and the

¹ Section 165, codified at 12 USC 5365. A BHC that received financial assistance under TARP and that subsequently divests its bank cannot escape stricter regulation unless it appeals to the FSOC and 2/3 of that body, including the Treasury Secretary, affirmatively vote to grant that appeal. See Section 117, codified at 12 USC 5327.

² Section 113, codified at 12 USC 5323.

³ Section 165, codified at 12 USC 5365.

⁴ The law allows regulators to require a company to downsize or to limit certain activities if necessary to prevent grave threats to the financial system, or if the company fails to produce a credible living will in a timely manner. See Section 121, codified at 12 USC 5331, and Section 165(d)(5), codified at 12 USC 5365(d)(5), respectively. An often-overlooked component of the Volcker Rule prevents the largest financial firms from growing through acquisitions of other firms after they reach certain limits, although it does not prevent their organic growth or prevent them from acquiring a failing firm. See Section 622, codified at 12 USC 1852.

⁵ See generally title I, subtitle A, codified at 12 USC Sections 5321 through 5333; see also Section 604, codified within various banking laws, which requires regulators to consider the impact on financial stability as a factor when acting upon applications for structural changes and activity expansions.

⁶ Title I, subtitle B, codified at 12 USC 5341-5346.

⁷ Section 120, codified at 12 USC 5330. This authority does not empower the FSOC to regulate systemically destabilizing activities directly, but rather allows the FSOC to provide for stricter regulation by making recommendations to the relevant primary regulator(s), which must either implement the recommendation or explain the failure to act to the FSOC. If a company engaged in a systemically destabilizing activity did not have a primary regulator, the FSOC could designate it for enhanced prudential supervision by the Federal Reserve in order to bring it within the scope of Section 120.

shedding of all associated risk through securitization. In addition, the Volcker Rule prohibits banking entities from making proprietary bets that could result in losses that, if severe and widespread enough, could cause the failure of one or more banking entities and create systemic problems.⁸

Some have claimed that the new supervisory tools discussed above are not workable because they leave too much to the regulators, and because many key provisions, such as the Volcker Rule, do not draw bright lines. These critics should ask themselves two questions. First, would it be appropriate for Congress to write detailed rules that address many complex considerations and that need the capacity to evolve as facts and circumstances change? The answer to that clearly is “no.” Second, is there any precedent for statutory provisions that involve general concepts that must be fleshed out by regulators or courts over time? The answer to that clearly is “yes,” as demonstrated by provisions such as securities disclosures based on “materiality,” antitrust laws, and OSHA’s recognition of “functionally equivalent” standards. All these provisions involve facts-and-circumstances tests that nonetheless have resulted in clear sets of expectations on the part of the regulated.

Others have claimed that the Wall Street Reform and Consumer Protection Act caused the largest financial firms to get bigger. This confuses correlation with causation and ignores the likely effects of the law. Some firms got bigger before the law was enacted because they acquired other large firms that were on the brink of failure. These mergers were done at the urging and with the cooperation of Bush administration officials, who felt that, given the tools available at the time, these mergers reduced taxpayer exposure. That result was compelled precisely because we did not have something like Wall Street reform in place to guard against weakness but also to allow the weak to fail. The requirements in the Wall Street Reform and Consumer Protection Act’s new supervisory regime should result in firms naturally rationalizing their structure and perhaps downsizing, although it is not realistic to expect these changes overnight.

Providing a clear path to failure while protecting the financial system and taxpayers

In spite of the aforementioned tools designed to minimize the odds of failure, a financial firm still could fail. In that event, the Wall Street Reform and Consumer Protection Act provides the government with a clear, definitive path to ensure that the insolvent financial firm fails instead of being put on taxpayer-financed life support. The law recognizes that bankruptcy will remain the failure mechanism for the vast majority of nonbank financial firms and bank holding companies.⁹ To address the rare situations in which the operations of a nonbank financial company or bank holding company are too complex or important to go through bankruptcy without significantly disrupting the entire financial system, the Wall Street Reform and Consumer Protection Act provides a new Orderly Liquidation Authority as an alternative path to failure.¹⁰ Having such an alternative ensures that the government never again will face the

⁸ Section 619, codified at 12 USC 1851.

⁹ Section 202(c), codified at 12 USC 5382(c).

¹⁰ Title II, codified at 12 USC 5381 through 5394. The Orderly Liquidation Authority preserves existing federal and state insolvency regimes as the resolution mechanism for any insolvent part of the failing company that already is subject to them, including banks subject to resolution under the FDI Act, broker dealers that are SIPC members, and

choice that it did in 2008 between propping up a failing firm or letting it fail at the risk of unacceptable systemic consequences.

The Orderly Liquidation Authority has been the subject of substantial, and repeated, mischaracterizations by some who claim that it entrenches TBTF, when in fact it does exactly the opposite. Below is a detailed discussion of how Orderly Liquidation Authority would work in reality, based on the statutory framework and the FDIC's implementing rules.

The bar to use the Orderly Liquidation Authority is very high. The Federal Reserve, the appropriate federal agency for the largest subsidiary of the failing firm, and the Treasury Secretary, in consultation with the President, must conclude that the company is failing and that its failure would cause serious adverse effects in the financial system.¹¹ If that determination were made, the FDIC would be appointed as receiver,¹² and would have many of the same powers it has had for many years when it liquidates failed banks, and which no legitimate critic has ever accused of being used to provide a "bailout."

The FDIC as receiver would be required to liquidate the firm within five years.¹³ In the course of so doing, the FDIC would be required to fire culpable management and directors, and to ensure that shareholders and unsecured creditors bear losses consistent with their first and second loss positions, respectively, in the statutory list of payment priorities.¹⁴ The FDIC has authority to place some or all of the firm's assets in a bridge company, and the FDIC has indicated that it will use this authority.¹⁵ It may do this, however, solely for the purpose of preserving financial stability during the liquidation, and it may not take any action to resuscitate the failed firm.¹⁶ Use of the bridge authority will allow the FDIC to liquidate the firm's assets in a manner that does as little systemic harm as possible, and will occur in furtherance of, and be entirely consistent with, the statutory mandate that the firm be liquidated within a finite time.

In recognition that a failed firm's inability to honor any of its financial contracts could have cascading and far-reaching effects throughout the financial system, the Orderly Liquidation Authority empowers the FDIC to pay some financial contracts, in whole or in part, to prevent a financial meltdown. The FDIC is authorized to transfer qualified financial contracts to a solvent financial institution, subject to specific requirements regarding notice, timing, and preservation of counterparty contractual rights.¹⁷ Counterparties to qualified financial contracts that are not transferred would stand in line with other unsecured creditors under priority-of-payment rules. Those rules allow the FDIC to pay some unsecured creditors more than others similarly situated, or to pay some unsecured creditors more than the liquidation value they would have received in

insurance companies that would be resolved by their state insurance regulator. See the "covered broker dealer," "covered financial company," "covered subsidiary," and "financial company" definitions in Section 201, codified at 12 USC 5381. See also Section 203(e), codified at 12 USC 5383(e), and Section 205, codified at 12 USC 5385.

¹¹ Section 203(a)-(b), codified at 12 USC 5383(a)-(b).

¹² Section 202, codified at 12 USC 5382.

¹³ Section 202(d), codified at 12 USC 5382(d). The only purpose for which a receivership may be extended beyond five years is to allow for the completion of ongoing litigation.

¹⁴ Section 206, codified at 12 USC 5386.

¹⁵ Section 210(h), codified at 12 USC 5390(h).

¹⁶ See Section 206(1), codified at 12 USC 5386(1).

¹⁷ Section 210(c)(8)-(12), codified at 12 USC 5390(c)(8)-(12).

bankruptcy, but the FDIC may make such payments only for the purpose of minimizing receivership losses or enabling the continuation of functions essential to the receivership.¹⁸ The FDIC's implementing rule, however, provides that such payments cannot be made to shareholders, subordinated debt holders, and longer-term debt holders.¹⁹

To continue functions essential to the receivership and to pay creditor claims while the liquidation is in progress, the FDIC likely will need access to temporary funding. For this reason, the Treasury Department is authorized to lend to the FDIC, but not until the FDIC has presented a plan acceptable to Treasury regarding how the FDIC actually will use the money.²⁰ The FDIC is authorized to use such borrowed funds solely for the purpose of taking actions that stabilize the financial system and explicitly is prohibited from taking any equity interest in the failing firm.²¹ There are two statutory limits on the amount that Treasury can lend to the FDIC. First, Treasury can lend only up to a percentage of the failing company's assets.²² While this is a legal maximum, the actual amount of Treasury lending to the FDIC would be substantially lower than this, because Treasury's transactions with the FDIC are public debt transactions and thus are limited by the debt ceiling.²³ In contrast, some of the extraordinary assistance provided to financial institutions in 2008, such as the Federal Reserve's lending under 13(3), was not subject to specific amount limits or the debt ceiling. In combination, the safeguards in the Orderly Liquidation Authority's funding mechanism definitively show that there is no basis to claims that the Orderly Liquidation Authority could be used to lend trillions of dollars to, or to save, a failing firm.

Claims that taxpayers will bear the cost of an Orderly Liquidation similarly are not based on the statute, which explicitly rules out the possibility that taxpayers ultimately will lose money.²⁴ First, the FDIC and the United States are the first creditors in line for repayment from the proceeds of the sale of the firm's assets.²⁵ Second, if the proceeds of the liquidation are insufficient to repay the government, then the FDIC is required to claw back any payments it

¹⁸ Sections 210(b)(4), (d)(4), and (h)(5)(E), codified at 12 USC 5390(b)(4), (d)(4), and (h)(5)(E), respectively.

¹⁹ See the FDIC's rule implementing the Orderly Liquidation Authority at 12 CFR part 380, particularly § 380.27; see also the Federal Register notice explaining that final rule, at 76 FR 41626 (July 15, 2011).

²⁰ Sections 204(d) and 210(n)(9), codified at 12 USC 5384(d) and 12 USC 5390(n)(9), respectively.

²¹ Sections 204(d), 206(1), and 206(6), codified at 12 USC 5384(d), 12 USC 5386(1), and 12 USC 5386(6), respectively.

²² Section 210(n)(6), codified at 12 USC 5390(n)(6), provides that, during the first 30 days of the receivership, the aggregate amount of outstanding debt that the FDIC issues or incurs in connection with an orderly liquidation cannot exceed 10% of the company's total consolidated assets based on the most recent financial statements available (unless the FDIC already has determined the fair value of the company's total consolidated assets that are available for repayment); after the first 30 days, or such earlier time as the FDIC determines the fair value of the company's total consolidated assets that are available for repayment, the amount of outstanding debt that the FDIC issues or incurs cannot exceed 90% of the fair value of the company's total consolidated assets that are available for repayment.

²³ Section 210(n)(5)(E), codified at 12 USC 5390(n)(5)(E).

²⁴ Section 214, codified at 12 USC 5394, specifically prohibits taxpayer funds from being used to prevent a liquidation, requires that all taxpayer funds expended during a liquidation be recovered from the assets of the failed firm or through industry assessments, and provides that taxpayers shall not suffer losses from the exercise of the Orderly Liquidation Authority.

²⁵ See Section 210(b)(1)(A)-(B), codified at 12 USC 5390(b)(1)(A)-(B), section 204(d), and 12 CFR part 380.

previously made to creditors beyond the liquidation value of their claims.²⁶ Finally, if those sources in combination were inadequate to repay the full amount of the temporary funding, then the FDIC would be mandated to impose risk-based assessments on financial firms with total consolidated assets of \$50 billion or more to recover the remaining shortfall.²⁷ The statute thus unequivocally requires that the temporary funding Treasury provides be fully repaid, and no further congressional action is needed to ensure that result.

The Wall Street Reform and Consumer Protection Act affirms the value of liquidity support but ensures that it cannot turn into solvency support

Although the Wall Street Reform and Consumer Protection Act ends the need for solvency support, it recognizes that liquidity support may be entirely justified to enable healthy financial firms to withstand periods of systemic stress. The law therefore preserves liquidity tools but includes safeguards to ensure that they do not become a backdoor through which to provide solvency support. The Wall Street Reform and Consumer Protection Act amended section 13(3) of the Federal Reserve Act so that the Fed now may provide emergency liquidity only to solvent firms, and only through facilities that have broad-based eligibility.²⁸ The law also ensures that the FDIC can establish a loan guarantee program only for solvent banking entities, which must pay a guarantee fee and are subject to backup assessments to ensure that the program pays for itself and there is no cost to taxpayers.²⁹ The law also removes authority for the FDIC to provide open bank assistance to failing banks.³⁰

The clearer distinction that the Wall Street Reform and Consumer Protection Act draws between solvency support and liquidity support would, if in effect in 2008, likely have eliminated the need for a program such as TARP, which blurred that distinction. Some have argued that, under the Wall Street reform law, the banking agencies and Treasury nonetheless would rescue a failing firm, but, as former FDIC Chairman Sheila Bair recently has pointed out, they would be breaking the law if they did so. Similarly, Adair Turner, head of the United Kingdom's Financial Services Authority, has acknowledged that US law no longer permits taxpayer funds to be used to provide support on an entity-specific basis.³¹

Empirical Evidence Suggests that the Wall Street Reform Act Ends TBTF

The markets have affirmed that being subject to enhanced prudential supervision is not a guarantee of being TBTF in several important ways. Enhanced prudential supervision seems to

²⁶ Section 210(o)(1)(D)(i), codified at 12 USC 5390(o)(1)(D)(i). The FDIC is required to establish rules, in consultation with the Treasury Secretary, regarding how to carry out the assessment authority in section 210(o), including the creditor claw backs discussed here and the industry assessments discussed below.

²⁷ Section 210(o)(1)(D)(ii), codified at 12 USC 5390(o)(1)(D)(ii). These assessments would be determined using a risk matrix, developed by the FDIC in consultation with the FSOC, that takes into account, among other factors, the risks an assessed firm presents to the system and whether the firm or any of its subsidiaries pays into other insolvency regimes, such as the DIF, SIPC, or the state insurance guaranty system.

²⁸ Section 1101, which amends 12 USC 343. The Wall Street Reform and Consumer Protection Act did not amend the Federal Reserve's "discount window" authority, which was before the crisis, and remains, a lender-of-last resort authority under which the Fed charges above-market rates for fully collateralized loans to solvent banks.

²⁹ Section 1105, codified at 12 USC 5612.

³⁰ Section 1106, which amends 12 USC 1823(c)(4)(G).

³¹ See Adair Turner speech, entitled "Reforming finance, are we being radical enough?," dated February 18, 2011.

be the gift that no one wants. In multiple congressional hearings, Democratic members of Congress have asked the regulators how many nonbank firms have asked to be designated for heightened supervision; the answer consistently has been “none,” and in fact some such firms actively have sought to avoid designation.³² In addition, the rating agencies have downgraded many large financial companies, in part on the theory that extraordinary government support of the kind provided during and in the wake of the 2008 crisis is no longer likely.³³ At least one large bank CEO has indicated that, when one takes into consideration the mix of assets and liabilities, funding costs for his firm are comparable to those of other financial firms, and are higher than those of nonfinancial companies.³⁴ This same CEO has indicated clearly that he thinks the Wall Street Reform and Consumer Protection Act provides the tools to end TBTF.³⁵ In the wake of the crisis, we witnessed the market turn against Bank of America, which saw its costs in the bond market increase more than its similarly-sized competitors in response to its deteriorated condition. All of the above-mentioned factors indicate that, because of the passage of the financial reform law, the long-assumed “funding advantage” of the largest financial firms is a thing of the past.

In addition to reactions here in the United States, policymakers in other countries, who similarly are attempting to end the need to rescue failing firms, are looking at the same sets of issues that Wall Street Reform addresses and taking similar actions. The Basel III accord among the G20 countries affirms the importance of higher capital, lower leverage, and improved liquidity coverage, and holds the largest, internationally-active banking entities to higher standards in these areas. The Financial Stability Board has proposed a resolution framework that its member countries should enact, which closely tracks Orderly Liquidation Authority and starts to address the cross-border issues that no country can solve in isolation. In Great Britain, the ring-fencing proposal advocated by the Vickers Commission is designed to prevent commercial banks from taking risks that threaten their safety, which is similar in intent to the Volcker Rule. More generally, policymakers in other countries, including Adair Turner, have spoken favorably about US financial reform efforts.³⁶

³² See Rep. Frank’s questioning of the government panel at a hearing held by the Oversight & Investigation subcommittee of the House Committee on Financial Services on April 14, 2011; see also Rep. Maloney’s questioning of the government panel at a hearing held by the Financial Institutions and Consumer Credit subcommittee of the House Committee on Financial Services on June 14, 2011. In addition, many large BHCs have sought, through their comments on regulatory proposals, to minimize the consequences of automatically being subject to enhanced prudential standards.

³³ See, e.g., the Moody’s rating action dated September 21, 2011. Moody’s recognized that some forms of government support could remain, but opined that Wall Street Reform decreased the probability of the extraordinary support of the type extended during the crisis and increased the likelihood that the government might allow a large financial institution to fail because the contagion of such a failure could be contained. Some forms of ongoing “government support” for banking entities of all sizes include deposit insurance and discount window access, but neither of those mechanisms can be used to save a failing firm. The discount window exists to provide backup liquidity to solvent banks, and deposit insurance exists to enable a bank to fail without precipitating runs or creating other systemic disruptions.

³⁴ See Jamie Dimon’s testimony before the House Committee on Financial Services on June 19, 2012.

³⁵ Id.

³⁶ See Adair Turner speech, entitled “Reforming finance, are we being radical enough?,” dated February 18, 2011. See also Adair Turner interview with Prospect Magazine, dated December 14, 2011.

The Republicans’ “modified bankruptcy” alternative during financial reform missed the mark badly

As the Lehman Brothers failure amply demonstrated, existing bankruptcy laws are inadequate for unwinding a complex financial intermediary without causing significant contagion within the broader financial system. During development of the Wall Street Reform and Consumer Protection Act, Republicans on the House Committee on Financial Services repeatedly offered a “modified bankruptcy” proposal intended to end TBTF.³⁷ As even a Republican witness at a 2011 hearing on TBTF indicated, any regime for unwinding a financial intermediary needs two things, speed and liquidity, that current bankruptcy laws lack.³⁸ The bankruptcy modifications that the Republicans proposed for financial institutions would have exacerbated, not mitigated, the problems inherent in existing bankruptcy laws with respect to those critical elements, and, had they been in effect in 2008, likely would have made the Lehman bankruptcy more disruptive, not less so.

The Republican alternative would have slowed the bankruptcy process down and potentially frozen the claims of many creditors, both of which would precipitate runs on the failing firm and exacerbate damaging effects within the financial system. The Republican plan generally would have required a pre-bankruptcy consultation process that would have delayed commencement of bankruptcy by at least ten days.³⁹ The apparent intent of this was to avoid the need for bankruptcy by encouraging creditor forbearance, or alternatively to pave the way for a more orderly bankruptcy proceeding. The more likely effect, however, would be to alert creditors of the firm’s failing state and encourage them to pull their funds during the consultation period, which would make a destabilizing failure more certain. The Republican alternative also would have allowed the bankruptcy court, upon the motion of the debtor, to subject counterparties to qualified financial contracts to an automatic stay on their contractual rights. Many of these creditors currently enjoy a statutory exemption from the automatic stay, in recognition of the interconnected nature of financial contracts and the importance of their fulfillment or prompt liquidation to keeping financial markets running. Merely the threat of these contracts being subject to the stay would incentivize a run on the failing firm, and, if the authority actually were exercised, financial intermediation could grind to a halt with serious systemic consequences.

³⁷ Reps. Capito, Bachus, Neugebauer, Biggert, Hensarling, and Garrett offered an amendment in the nature of a substitute, which included the modified bankruptcy language among other provisions, during a markup to title I of the House bill in November 2009. Modified bankruptcy language appeared again in a more comprehensive amendment in the nature of a substitute that these same Republicans offered during floor consideration of the House bill in December 2009. Reps. Capito and Smith (of Texas) offered bankruptcy modifications as an alternative to title II of the Wall Street Reform Act during the conference committee proceedings on June 17, 2010.

³⁸ See the written and oral testimony of Stephen Lubben at a hearing held by the Financial Institutions and Consumer Credit subcommittee of the House Committee on Financial Services on June 14, 2011. Although Professor Lubben was not uniformly supportive of the Orderly Liquidation Authority, he did commend its speed and liquidity features and opine that they were an improvement over existing bankruptcy.

³⁹ The proposal would have allowed the institution, its functional regulator, and a Market Stability and Capital Adequacy Board, in consultation with any agency charged with administering an insolvency regime for any component of the firm, to certify that an immediate filing is necessary “in the interest of justice.” It is unclear, however, how quickly this determination could be made, or whether it would allow an immediate filing for the purpose of avoiding systemic problems.

The Republicans' "modified bankruptcy" also would have provided no alternative to existing private debtor in possession (DIP) financing and specifically would have prohibited any federal funding to facilitate a modified bankruptcy, which would severely constrain liquidity options instead of improving them. DIP financing, which is used to sustain a firm's activities during its liquidation or restructuring under current bankruptcy law, is critical to a successful bankruptcy – without it, the firm's operations are effectively shut down immediately, without regard to the value of the firm or the importance of its operations to the financial system. DIP financing was not readily available during the financial crisis, however, and similarly would not be available in the future if a complex financial institution failed during a period of economic stress and illiquid markets.⁴⁰ It is unlikely that DIP financing could be arranged even in good times in a sufficient amount and within a sufficiently short time to facilitate a controlled bankruptcy that does not have broader systemic effects.⁴¹

Although the Republican proposal likely would have exacerbated the systemically destabilizing aspects of a bankruptcy involving a large, complex financial intermediary, it did not recognize, let alone explicitly protect taxpayers from, these destabilizing spillover effects.

Conclusion

The Wall Street Reform and Consumer Protection Act clearly establishes a framework that allows large financial firms to fail while preventing catastrophic harm to the broader economy. It effectively ends "too big to fail" and specifically outlaws future taxpayer bailouts of a failing financial institution.

The financial crisis of 2008 devastated our economy and resulted in massive losses of jobs and household wealth. It would have been irresponsible for Congress not to have addressed the root causes of the crisis and end the TBTF problem that was so central to it. As the foregoing analysis shows, the Wall Street Reform and Consumer Protection Act accomplishes both goals by combining tools to prevent financial firms from failing with tools that allow a financial company to fail without causing collateral damage to the system if a failure nonetheless occurs. Arguments to the contrary ignore the provisions and structure of the financial reform law, the practical evidence regarding the law's impact, or both.

⁴⁰ Professor Lubben's written testimony at the June 14, 2011 subcommittee hearing, referenced above, acknowledged these points.

⁴¹ Again, Professor Lubben concurred with this assessment in his written testimony at the June 14, 2011, hearing.