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Louis Massard

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A Review of The New Financial Deal by David Skeel

I. INTRODUCTION

In The New Financial Deal: Understanding the Dodd-Frank Act and Its (Unintended) Consequences, Professor David Skeel undertakes the harrowing task of both synthesizing and addressing the weaknesses of the Dodd-Frank Wall Street and Consumer Protection Act (Dodd-Frank). In clear, efficient, non-legal prose, Skeel provides a revisionist history of the events leading up to the financial crisis of 2008, a summary of the financial reforms of Dodd-Frank that emerged as a result, a critical view of these reforms, and proposals for addressing some of Dodd-Frank’s shortcomings.

On the whole, Skeel is critical of the Dodd-Frank reforms and is troubled by the destabilizing effects they may have on U.S. and global capital markets. The New Financial Deal synthesizes its criticism of Dodd-Frank into two prominent themes that emerge in the legislation: (1) a corporatist approach to bank regulation that allows the government to channel policy through partnership with large financial institutions; and (2) an erosion of rule-of-law principles by expanding the discretion of regulators in the event of financial crisis. These two developments, in Skeel’s view, greatly threaten the future of American finance.

However, Skeel’s outlook is not entirely gloomy. For instance, joining with a near unanimous chorus of academic voices, he finds the provisions regarding the clearing and exchange trading of derivatives to be an “unequivocal advance.” He also views the creation of the Consumer Financial Protection Bureau (CFPB or Bureau) as a positive and potentially prominent counterweight to the political leverage of the financial lobby. Yet, even these promising aspects of Dodd-Frank depend greatly on effective implementation.

3. SKEEL, supra note 1, at 14.
4. See id. at 14-15.
This review of *The New Financial Deal* both summarizes and analyzes some of Skeel’s views on Dodd-Frank and their implications for the future of bank regulation. Although Skeel accurately identifies several problems with the Dodd-Frank regime and introduces a very promising policy fix, his prediction for one of the regime’s key prongs—imposing more stringent capital requirements on systemically important financial institutions—has proven overly pessimistic.5

II. A NEW NARRATIVE OF THE FINANCIAL CRISIS AND THE “LEGISLATIVE GRINDER”

A. *Debunking the Lehman Myth*

Skeel provides his own account and interpretation of the events leading up to the financial crisis of 2008. Most notably, Skeel adamantly rejects what he describes as the “Lehman Myth” – the view that while the subprime crisis remained more or less manageable after the bailout of Bear Stearns, the Lehman Brothers’ bankruptcy filing on September 15, 2008, set into motion a wave of consequences that nearly brought down the U.S. and global economy.6 The Lehman Myth also convinced many that bankruptcy was not an adequate framework for handling the collapse of the largest financial institutions.7

Skeel dismisses views derived from the Lehman Myth as “almost completely wrong.”8 Specifically, he dismisses accounts by leading banking regulators that the Federal Reserve could not legally lend to Lehman since they had very little acceptable collateral.9 To Skeel, this argument is spurious in light of the fact that regulators “didn’t hesitate to stretch the law when they bailed out Bear Stearns and AIG.”10

To further debunk the Lehman Myth, Skeel examines key market indices to measure the true impact of Lehman’s bankruptcy filing.11 For instance, Skeel compares the daily market reactions

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5. See infra Part V.C.
6. SKEEL, supra note 1, at 20-21.
7. See id. at 21.
8. Id. at 22.
9. Id.
10. Id.
11. See id. at 23-26 (analyzing market data in reaction to the Lehman bankruptcy and the AIG bailout).
surrounding the news of Lehman’s bankruptcy filing and the AIG rescue package. Daily changes in those indexes — the S&P 500, the VIX, and the TED spread — were virtually identical, indicating that the reaction to the AIG news was equally forceful.

Addressing the second component of the Lehman Myth, Skeel attributes the perceived disorder of Lehman’s bankruptcy to the spoiled expectations of its leadership and observers that Lehman would either receive government assistance or be acquired. As an indicator of these expectations, Skeel points to the surprising lack of movement in the spreads for credit default protection against default by Lehman prior to the filing of its bankruptcy petition. Since government assistance was expected, Lehman was left largely unprepared for its bankruptcy filing on September 15, 2008. Estimates suggest that $50 to $75 billion of value dissipated from Lehman’s balance sheet as a result of its failure to plan for bankruptcy.

B. Legislative Background

Skeel expresses “no doubt that the one factor that contributed more directly to the thinking of the architects of Dodd-Frank than any other was the Lehman [M]yth.” On the other hand, Skeel contends that the backgrounds and personalities of Dodd-Frank’s two primary architects within the administration — Treasury Secretary Timothy Geithner and Director of the National Economic Council Lawrence Summers — weighed heavily in the Act’s formulation and in the legislative process.

In particular, the book suggests that two events in Geithner’s

12. SKEEL, supra note 1, at 23.
13. Short for the Chicago Board Options Exchange Market Volatility Index, the VIX measures market expectations for stock market volatility in the following thirty days. It is often referred to as the “fear index” or the “fear gauge.”
14. The TED spread measures the difference between interest rates on interbank loans and short-term U.S. government debt. It is a key indicator of perceived credit risk and of the health of the banking system.
15. SKEEL, supra note 1, at 23.
16. Id. at 28.
17. Id.
18. Id.
19. Id. at 39.
20. See id. at 43-44 (“[Geithner and Summers] won, leaving their stamp on financial regulation for the next generation.”).
career seem to have influenced his approach to financial crisis response: the Mexican currency crisis of 1994 and 1995, and the collapse of Long-Term Capital Management in 1998. In these two interventions, which were largely viewed as successes, Skeel argues that “Geithner seems to have learned . . . that bailouts are the best response when a large institution or country is in trouble.” Skeel portrays Geithner’s counterpart and mentor, Lawrence Summers, not only as an intransigent Washington elite with corporatist leanings, but also as one of the administration’s surprising advocates of the consumer protection agency that would eventually become the CFPB.

With these two personalities in place, The New Financial Deal recounts the U.S. Department of the Treasury’s (Treasury) March 2009 release of the outline that would eventually become the Dodd-Frank legislation. Among the greatest challenges proponents faced was the charge that the new resolution framework would institutionalize the bailouts of 2008.

In buttressing his advocacy for bankruptcy reforms as a way to improve the Dodd-Frank framework, Skeel attempts to explain how and why a bankruptcy-based resolution alternative was ultimately set aside. In Skeel’s view, the administration’s resistance to bankruptcy-centered reforms was largely due to the persistence of the Lehman Myth and the Treasury’s (and Geithner’s) “strong preference for regulatory rescues and an equally strong aversion to bankruptcy.” Skeel suggests that Congress didn’t earnestly consider a bankruptcy alternative because committee jurisdiction would have forced Representative Barney Frank and Senator Christopher Dodd to relinquish their control over the reform process. In other words, since bankruptcy legislation is the province of the Senate Judiciary Committee, the Senate Banking and House Financial Services Committees would have lost their control over the reform process.

Therefore, with bankruptcy off the table as a serious alternative, lawmakers and the administration assuaged critics by making the resolution proposal look less like a framework for bailouts. Subsequent

21. Skeel, supra note 1, at 45.
22. Id. at 114.
23. Id. at 53.
24. Id.
25. Id.
drafts of the legislation introduced the requirement that all financial companies placed into receivership would be liquidated. Other provisions were also added to ensure that the costs of resolution would be borne by the financial services industry through assessments or by disposition of the troubled firm’s own assets.

In the end, Skeel points to one event for giving Dodd-Frank “irresistible momentum”: the April 19, 2010 announcement by the Securities and Exchange Commission (SEC) that it would sue Goldman Sachs for failing to inform investors in a complex transaction that its fund manager had taken positions against some of the transaction’s component securities. Within a matter of weeks of this announcement, the Dodd Bill passed in the Senate and was set to be reconciled with the Frank Bill in the House.

III. VIEWS OF DODD-FRANK’S FINANCIAL REFORMS

The bulk of The New Financial Deal is an examination of the major components of Dodd-Frank and the implications of these components. Grouped into the major areas of reform, each chapter provides a brief sketch of Dodd-Frank’s prominent features before proceeding to an analytical discussion.

A. Banking Reform

Skeel frames much of his criticism of Dodd-Frank by contrasting two competing approaches to managing the risk of the largest financial firms. One approach, which he calls the Brandeisian tradition, advocates breakup and dispersion of the most dominant firms to encourage competition. The other approach, the corporatist tradition, relies heavily on a partnership between large banks and government. The New Financial Deal argues that the corporatist tradition not only prevailed in the passage of Dodd-Frank, but that even

27. § 5394(b)-(c); SKEEL, supra note 1, at 54.
28. SKEEL, supra note 1, at 56.
29. Id.
30. Id.
31. Id. at 10.
32. Id. at 11.
the Brandiesian concessions within Dodd-Frank will serve to solidify the partnership between Washington and Wall Street.

Skeel begins his summary of the new banking regulation framework with a discussion of the Financial Stability Oversight Council (FSOC or the Council), a new regulatory body that, along with the Federal Reserve, will oversee any commercial bank holding company with over $50 billion in assets and any nonbank it designates as "systemically important."\textsuperscript{33} Such a designation for a nonbank financial institution requires a two-thirds vote of the Council's members.\textsuperscript{34} A court may overturn this designation only if it is deemed "arbitrary and capricious."\textsuperscript{35}

Ultimately, when a firm is designated as "systemically important," the Federal Reserve will impose more stringent capital requirements in order to limit the risk of its failure.\textsuperscript{36} Also, under what is termed the Volcker Rule,\textsuperscript{37} commercial banks and their affiliates are prohibited from engaging in proprietary trading and from holding an ownership interest in a private equity or hedge fund. In his analysis of these two new provisions, Skeel maintains that the partnership between the government and dominant financial institutions "will be the defining feature of the new financial order."\textsuperscript{38}

1. Elevated Capital Standards

\textit{The New Financial Deal} notes that Dodd-Frank's focus on higher capital requirements represents a near-consensus of academic opinion on how to rein in systemic risk in the financial system.\textsuperscript{39} However, Skeel raises two concerns with this approach. First, capital requirements are difficult to calibrate effectively given the complexity of banks' balance sheets.\textsuperscript{40} As an example, Skeel points to the

\begin{itemize}
\item \textsuperscript{33} \textit{Id.} at 78.
\item \textsuperscript{34} The Council is comprised of heads of the Federal Reserve, the SEC, the new Consumer Financial Protection Bureau and the new Federal Insurance Office. \textit{Skeel, supra} note 1, at 79.
\item \textsuperscript{36} \textit{Skeel, supra} note 1, at 79.
\item \textsuperscript{37} \textit{Id.}
\item \textsuperscript{38} \textit{Id.}
\item \textsuperscript{39} \textit{Id.} at 82.
\item \textsuperscript{40} \textit{Id.}
\end{itemize}
breakdown of the "state-of-the-art" Basel II capital adequacy standards as "an object lesson that the general enthusiasm for higher capital requirements is misplaced if the requirements cannot be implemented effectively." Second, Skeel worries that Dodd-Frank "provides only limited instructions to the Federal Reserve for fulfilling its charge to impose higher capital requirements on systemically important institutions." As such, he predicts that since these capital requirements will be negotiated out of the public spotlight, giant banks will likely be able to lobby effectively to erode them.

2. The Volcker Rule: Proprietary Trading, Hedge Funds, and Private Equity

The inclusion of the Volcker Rule, one of the most significant tools for the regulation of systemically important institutions, arose as a result of populist pressure. As noted above, the Volcker Rule prohibits commercial banks from engaging in proprietary trading and restricts their ability to own or sponsor hedge funds and private equity funds. By Dodd-Frank's definition, the Volcker Rule applies not only to commercial banks, but also to any corporate entity that includes a commercial bank as an affiliate.

Although the reach of the Volcker Rule appears quite expansive, Skeel argues that it is likely to be watered down for two primary reasons. First, the book notes that the exclusions built into the Volcker Rule – such as those permitting the trading of Treasury bills, market making, hedging, and transactions made for customers – permits a great degree of manipulation. For instance, Skeel predicts that proprietary trading units will simply migrate to desks that trade for company clients. As such, proprietary trading units will continue conducting the same business as before, but under the guise of client transactions.

Skeel's second concern relates to the "de minimis" exception to the Volcker Rule which allows a bank to own up to three percent of an
otherwise prohibited hedge fund or private equity fund so long as that interest does not exceed three percent of the bank’s core capital. Specifically, he believes that this exception effectively preserves the status quo since “most banks will be able to fit within the [three] percent limitation without any significant shedding of assets.”

In sum, since these Brandeisian concessions rely so heavily on the discretion of regulators, they are unlikely to force any meaningful downsizing in the largest financial institutions. On the contrary, the discretion in afforded implementation and enforcement of these provisions will in fact solidify a partnership between systemically important financial institutions and regulators – a partnership in which government will promote its political objectives. Pointing to the Obama administration’s inclusion of energy efficiency incentives in the terms of the Chrysler bankruptcy, Skeel concludes that “Dodd-Frank not only invites [the] mixing of political and economic objectives; it positively encourages it . . . .”

B. Derivatives Reform

Recognizing the negative connotation recently attached to the phrase “financial innovation,” The New Financial Deal is careful to explain how derivatives differ from other financial instruments. After summarizing the new exchange trading and clearing requirement, the book provides an on-the-fly history of derivatives regulation – from the establishment of the Chicago Board of Trade through the Commodities Futures Modernization Act of 2000 (CFMA). For Skeel, the CFMA had two major consequences: (1) it secured a huge source of profits for dealer banks; and (2) it exacerbated the crisis by virtue of the opacity of the derivatives market.

48. SKEEL, supra note 1, at 88.
49. Id.
50. While Fiat was initially given a twenty percent stake in Chrysler, the deal terms allowed Fiat to increase its ownership stake in Chrysler by fifteen percent for free provided, among other things, that it helped Chrysler produce a more fuel-efficient car and market it outside of the United States. In January 2012, Fiat officially fulfilled this requirement and increased its ownership stake accordingly. Jeff Bennett & Gilles Castonguay, Fiat Increases Ownership in Chrysler to 58.5%, WALL ST. J., Jan. 5, 2012, http://online.wsj.com/article/SB10001424052970203513604577141651251660594.html.
51. SKEEL, supra note 1, at 93.
52. Id. at 65-66.
Skeel portrays the derivatives reform component of Dodd-Frank as "sweeping . . . yet uncontroversial." The new framework will honor the existing regulatory jurisdiction of the Commodities Futures Trading Commission (CFTC) and the SEC. The SEC will regulate trading of security-based swaps, and the CFTC will regulate trading of all other categories of swaps. The new framework now divides derivatives market participants into two categories: swap dealers and major swap participants. Beyond these designations, the new regime’s requirements are fairly straightforward. When regulators order a swap to be cleared, it must be cleared by a clearinghouse and traded on an exchange.

Although the general requirements appear somewhat uncomplicated, Skeel aptly points out some of the concerns and dilemmas that the new framework engenders. For instance, since dealer banks earn substantial fees from individually tailored contracts, they stand to gain by persuading regulators that exchange trading and clearing is not necessary for certain types of new derivatives. Dealer banks are also capable of limiting migration to exchanges and clearinghouses by creating derivatives that are highly complex and difficult to standardize.

Furthermore, the concentration of risk in the derivatives market will simply shift depending on how the market for clearinghouses develops. Whereas the emergence of a few dominant clearinghouses creates an enormous concentration of risk, a market of many dispersed clearinghouses could encourage a race to the bottom, similar to the oversight failures experienced in the credit rating market.

Ultimately, Skeel believes that “a large majority of derivatives will find their way to clearinghouses and exchanges within a few years.”

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53. Id. at 66.
54. Id. at 68.
55. Id. at 69.
57. Designated by Dodd-Frank as a “swap execution facility.” Id.
58. SKEEL, supra note 1, at 69-70.
59. Id. at 70.
60. Id. at 69.
years" and that a concentrated market of clearinghouses is a more likely and preferable scenario. The New Financial Deal suggests that like many of the provisions of Dodd-Frank, prospects for the success of the new derivatives framework “comes down to the regulators.” If too few derivatives products are corralled into the exchange/clearing framework or if dangerous incentives develop in the clearinghouse industry, one of the more promising contributions of Dodd-Frank will be substantially undermined.

C. The Consumer Financial Protection Bureau

The New Financial Deal portrays the creation of the Consumer Financial Protection Bureau as a story of “unexpected triumph.” Before summarizing the new Bureau’s charge, Skeel delves into the Bureau’s unlikely roots: the writings of the leading consumer finance scholar, Elizabeth Warren. Though the Bureau’s launch was somewhat precarious, Skeel is hopeful that it will become a “meaningful counterweight” to the influence of systemically important banks.

Defying widespread predictions that the CFPB would not survive the legislative process, the Bureau emerged with “more clout and independence than anyone imagined possible.” Although it is a bureau within the Federal Reserve, the CFPB operates independently. The President, with consent of the Senate, appoints its director for a five-year term. The CFPB director is a voting member of the FSOC. The CFPB is charged with overseeing markets for consumer financial products and services, such as mortgages, credit cards, and payday lending. Within these realms, the Bureau’s powers are broad and formidable. A rule promulgated by the Bureau may be set aside by other regulators only by a two-thirds vote of the FSOC and a

61. Id. at 70.
62. Id. at 71.
63. Id. at 75.
64. SKEEL, supra note 1, at 99.
65. Id. at 102.
66. Id.
67. Id. at 99.
68. Id. at 101.
69. Id. at 100.
70. SKEEL, supra note 1, at 101.
determination that the rule presents systemic risk concerns.\textsuperscript{71}

The author stresses that the long-term success of the CFPB “will depend heavily on whether it quickly establishes itself as a significant regulatory player.”\textsuperscript{72} Using the mixed history of success by the SEC as an example, Skeel suggests that the enthusiasm that Warren brings to the Bureau may not last.\textsuperscript{73} At very least, the Bureau will confront its first significant roadblock in 2014 when funding guaranteed by Dodd-Frank ceases.\textsuperscript{74}

Skeel also echoes some common concerns regarding the CFPB: that the CFPB’s oversight could both stunt innovation and decrease the availability of consumer credit.\textsuperscript{75} Nevertheless, Skeel maintains that although it is impossible to know whether these concerns will actually materialize, more stringent oversight of the consumer credit market is necessary.\textsuperscript{76} Most importantly, he argues that the CFPB “runs counter to Dodd-Frank’s endorsement of the biggest financial institutions . . . .”\textsuperscript{77} As an appreciably stronger advocate of consumer rights, the CFPB will be able to rein in the abusive credit practices of large banks.

\section*{D. \textit{A New Resolution Framework for Systemically Important Financial Institutions}}

1. Spotlight on the FDIC

The extension of the FDIC’s resolution framework to systemically important financial institutions has been promoted as the solution for ending bailouts. However, before beginning a detailed discussion of the new resolution framework for large financial institutions, Skeel questions many of its underlying justifications. Specifically, he inquires whether the FDIC really occupies the same role in this new regime and if its framework was actually as effective as it was portrayed.

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\item \textsuperscript{71} \textit{Id.}
\item \textsuperscript{72} \textit{Id.} at 111.
\item \textsuperscript{73} \textit{Id.}
\item \textsuperscript{74} \textit{Id.} at 112.
\item \textsuperscript{75} \textit{Id.} at 113.
\item \textsuperscript{76} SKEEL, supra note 1, at 113
\item \textsuperscript{77} \textit{Id.} at 114.
\end{itemize}
\end{flushleft}
Skeel explains that for much of the FDIC's eighty-year history, very few banks failed and the agency had little to do.\textsuperscript{78} The first real challenge came in the 1980s during the savings and loan crisis. Although the FDIC had little to do with the regulation of savings and loan institutions, the crisis drew attention to a regulatory flaw that led to the enactment of two laws\textsuperscript{79} that bolstered the FDIC's resolution powers. This post-1991 resolution framework gave the FDIC the authority to close a bank unilaterally – a power it did not previously have.\textsuperscript{80}

Furthermore, Skeel argues that the FDIC resolution framework is not well suited for what it is asked to do. In particular, the FDIC resolution practice has been tailored to the profile of deposit-taking commercial banks.\textsuperscript{81} While the FDIC's handling of ordinary bank failures has varied, it has "struggled mightily in nearly all of its larger cases."\textsuperscript{82} As examples, Skeel points to the FDIC's delay in closing IndyMac and its failed attempt to resolve Wachovia.\textsuperscript{83} In his view, "[t]he new resolution regime . . . . extends FDIC oversight to precisely the kinds of financial institutions the FDIC has been least effective in handling."\textsuperscript{84}

2. The New Resolution Authority

Before assessing the prospects for the new resolution regime, also termed the "orderly liquidation authority," Skeel provides a summary of the new regime's key features. First, as mentioned above, a resolution begins when, after consultation with the President, the Treasury recommends a takeover and both the Federal Reserve Board

\textsuperscript{78} Id. at 119.
\textsuperscript{80} FIRREA, 12 U.S.C. § 1821(c)(10).
\textsuperscript{81} See Skeel, supra note 1, at 125.
\textsuperscript{82} Id.
\textsuperscript{83} Id.
\textsuperscript{84} Id. at 126.
and the FDIC concur by a two-thirds vote. Though designed primarily to wind down systemically important institutions, the resolution framework permits regulators to take over any financial institution whose failure they believe would have a destabilizing effect.

Challenging a decision to step in will be very difficult. If managers of the troubled financial institution do not consent to a resolution, regulators can simply file a petition in federal court claiming that the financial institution in question is in default or in imminent danger of default. The court is given twenty-four hours to make its ruling, and it may only reject the petition if it finds it is “arbitrary and capricious.” As receiver, the FDIC is permitted to sell the institution or any of its parts. With the exception of the contracts that the FDIC chooses to honor, creditors of the financial institution will ordinarily take losses. The goal is to liquidate the company in an orderly manner.

To assess whether this new resolution framework will in fact end taxpayer bailouts, Skeel lays out four key objectives that he finds critical for any insolvency framework: (1) that it be initiated in a timely fashion; (2) that it limit the damaging effect of financial distress on third parties; (3) that shareholders and creditors not be paid in full if the company is insolvent; and (4) that the regime protect as much of the value of the company’s assets as possible. Ultimately, Skeel finds that the Dodd-Frank resolution framework fails to achieve three of these four key objectives.

3. Timeliness

First, The New Financial Deal argues that despite the considerable discretion afforded to bank regulators, they will nevertheless seek to postpone a resolution as much as possible. Instead, Skeel predicts that the Federal Reserve will more likely respond by fashioning a broad-based lending program meant to prop up the
troubled institution. Furthermore, "even if regulators wanted to intervene in a timely fashion, the complexity of the nation's largest financial institutions is sufficiently great that they are not likely to know until late in a company's decline that the time has come." At the same time, bank managers, the individuals with the best information regarding a company's true condition, have every incentive to delay intervention or seek a bailout. Since neither regulators nor managers will be eager to invoke the new resolution framework, timely intervention appears unlikely.

4. Controlling Systemic Risk

With reservations, Skeel believes that controlling systemic risk "is indeed the one thing Dodd-Frank may do tolerably well." Underlying Dodd-Frank's approach to controlling systemic risk is a special set of rules for qualified financial contracts and the FDIC's enormous power of the purse.

First, ipso facto clauses in derivatives contracts - those dictating that initiation of insolvency proceeding constitute an event of default - are unenforceable for one business day under the new Dodd-Frank regime. For both individual and master agreements with counterparties of the troubled institution, the FDIC must either repudiate all of the contracts or none of them. Also, to fund its intervention, the FDIC may have the Treasury issue debt obligations up to an amount equal to ten percent of the value of the company's pre-resolution assets. This borrowing is entitled to priority, and any costs not covered in the resolution proceeding will be paid from an Orderly

91. Between March and November 2008, the Federal Reserve exercised its authority under section 13(3) of the Federal Reserve Act (12 U.S.C. § 343) to create six new lending facilities to promote overall market liquidity. To refocus the Federal Reserve's section 13(3) authority, Dodd-Frank explicitly prohibits lending programs that are intended to "aid a failing financial company." 12 U.S.C. § 343(a)(6) (Supp. IV 2010).
92. SKEEL, supra note 1, at 140.
93. Id. at 140-41.
94. Id. at 142.
95. Id.
96. Id.
97. Id. at 142.
98. SKEEL, supra note 1, at 144.
Liquidation Fund, funded by assessments imposed on other systemically important institutions.\textsuperscript{99} Ultimately, Skeel concludes that the new framework still leaves open the possibility of bailouts outside the resolution process that would carry the same negative effects.

5. Consistent Haircuts

*The New Financial Deal* maintains that any effective insolvency regime must honor the absolute priority rule, a core bankruptcy principle that guarantees that the claims of certain creditors must be satisfied in full before other creditors receive payments.\textsuperscript{100} Although Dodd-Frank incorporates promising elements of bankruptcy law and explicitly announces its intention to force shareholder and creditor haircuts, Skeel fears that the enormous discretion afforded to the FDIC will allow it to evade these requirements fairly easily.\textsuperscript{101} For Skeel, the wide discretion given to the FDIC greatly erodes the rule of law principles that define an effective insolvency regime.

6. Preservation of Enterprise Value and Liquidation

Finally, Skeel assesses how well-equipped Dodd-Frank's resolution regime is to protect the value of insolvent financial institutions. First, Skeel points out that the FDIC's common strategy for closing small and medium sized banks -- finding a buyer to assume the banks' assets -- is more difficult, if not impossible, in the context of the largest banks and nonbank financial institutions.\textsuperscript{102} He reminds us that a successful assumption by a large financial institution will likely "make a financial giant even bigger."\textsuperscript{103}

Furthermore, Skeel argues that by confining the FDIC's resolution options to liquidation, the FDIC is ill-equipped to preserve a troubled company's value and that this will undermine competition in the financial services industry.\textsuperscript{104} In a market of few or no potential

\textsuperscript{99.} Id. at 145.  
\textsuperscript{100.} Id. at 144-45.  
\textsuperscript{101.} Id. at 148.  
\textsuperscript{102.} Id. at 148-49.  
\textsuperscript{103.} Id. at 149.  
\textsuperscript{104.} SKEEL, supra note 1, at 150.
buyers, restructuring may be highly preferable to a receivership approach.

IV. SKEEL’S RECOMMENDATIONS

Though Skeel describes the Dodd-Frank resolution framework as “a mess,” he is hopeful that it can be salvaged. Recognizing that there is likely no possibility of reversing the key elements of the new regulatory regime, Skeel is confident that small adjustments can be made to remedy some of its flaws. In particular, he argues that “the most serious problems can be fixed through simple adjustments to the ordinary bankruptcy laws to encourage troubled companies to initiate voluntary proceedings in the event of a crisis.”

In formulating these adjustments, Skeel emphasizes the importance of reducing the role of regulators in the new regime, engaging the “superior knowledge” of private parties, and reinforcing predictable, rule-based principles.

A. Staying Derivatives in Bankruptcy Proceedings

Skeel’s first proposed reform would eliminate the special treatment that is afforded to derivatives and other financial instruments in bankruptcy. Beyond enjoying a largely self-regulated derivatives market for many years, derivatives creditors have also been exempt from key bankruptcy rules such as the prohibition on enforcement of ipso facto clauses, the provisions for preferences and fraudulent conveyances, and most importantly, the automatic stay.

For context and support, Skeel looks back to how the fear of fallout in the derivatives market fueled enormous systemic risk concerns. Namely, regulators from across the board feared that the termination of hundreds of thousands of derivatives contracts upon the bankruptcy filing of an institution like AIG would itself spark a

105. Id. at 152.
106. Id. at 155-56.
107. Id. at 152.
108. Id. at 158.
109. Id.
110. SKEEL, supra note 1, at 158-59.
111. Id. at 160-61.
systemic crisis. As a solution, Skeel believes that “[t]reating derivatives the same way as other contracts would give the managers of troubled financial institutions much greater incentives to make adequate preparation for insolvency proceedings, and to use bankruptcy rather than the Dodd-Frank resolution regime.”

Furthermore, in the market for derivatives and repo lending, which is extremely volatile, bank counterparties are much less inclined to limit their exposure to a troubled institution if they know they would be permitted to grab collateral at the first sign of distress. Repos and derivatives have become increasingly popular specifically because of this preferential treatment in bankruptcy. Skeel argues that subjecting derivatives and repos to these core bankruptcy principles would reduce the bias towards these types of volatile financing instruments and encourage derivatives creditors to more closely monitor and to disperse their exposure to a faltering institution. Moreover, as the new clearing requirement for derivatives takes hold and clearinghouses serve as backstops for a bank’s performance, the special treatment of derivatives and repos in bankruptcy will become unnecessary.

Skeel insists that the most dramatic changes would emerge for the managers of systemically important financial institutions. For managers, bankruptcy would become a much more attractive option as the institution approaches insolvency. The temporary safe haven of the automatic stay as well as the ability to recover preferential conveyances would allow managers to resist the onerous margin call requirements that pushed AIG to the brink in 2008. If bankruptcy were a more attractive option, the managers of a faltering financial institution would be ensured a role in the institution’s future and would be more inclined to plan for bankruptcy.

Nevertheless, Skeel responds to two natural concerns that arise in connection with highly volatile markets such as derivatives. The first concern is that for derivative counterparties with sizeable hedging positions, the prospect of having to enter into replacement contracts – in

112. Id. at 160.
113. Id. at 158.
114. Id. at 161.
115. Id. at 162.
116. SKEEL, supra note 1, at 162.
117. Id.
118. See id. at 163.
the event of the imposition of a stay – appears unrealistic.\textsuperscript{119} The second concern is that the volatility of derivatives contracts is such that their value can change drastically in a short period of time.\textsuperscript{120} In other words, holding up the resolution of these extremely short-term and volatile contracts could have disastrous consequences. To address these concerns, Skeel suggests that creditors can generally diminish these risks by demanding adequate collateral and taking several smaller derivatives positions with several banks rather than a larger position with a single institution.\textsuperscript{121} He also advocates limiting the duration of the automatic stay to three days, a period slightly longer than the one-plus business day permitted\textsuperscript{122} in the Dodd-Frank resolution framework.\textsuperscript{123}

Ultimately, Skeel is confident that “if the special treatment of derivatives were reversed, the Dodd-Frank resolution regime would rarely, if ever, be necessary.”\textsuperscript{124} By making bankruptcy a more viable option for systemically important financial firms, Skeel believes that procedural fairness, transparency, and rule of law principles can be restored to our insolvency laws.

B. International Solutions

For large financial institutions with an international presence, insolvency proceedings are governed by the varying rules of each country.\textsuperscript{125} Citing the messy nature of insolvency proceedings and the global span of the recent crisis, Skeel criticizes how little Dodd-Frank has contributed in this area.\textsuperscript{126} Dodd-Frank addresses the international aspects of financial regulation by encouraging cooperation with foreign regulators, banning brokers and derivatives traders from trading in the United States if their country’s regulation threatens the stability of U.S.

\textsuperscript{119} Id. at 164.
\textsuperscript{120} Id. at 164-65.
\textsuperscript{121} Id. at 165.
\textsuperscript{122} For example, ispo facto clauses are stayed from the moment the receivership commences until 5:00 PM the following business day. 12 U.S.C. § 5390(c)(10)(B) (Supp. IV 2010).
\textsuperscript{123} SKEEL, supra note 1, at 166.
\textsuperscript{124} Id. at 163.
\textsuperscript{125} Id. at 176.
\textsuperscript{126} Id.
markets, and requiring a living will for rapid and orderly resolution in
the event of an institution’s failure.  

First, Skeel notes that beyond general pleas encouraging
cooperation with foreign regulators, Dodd-Frank authorizes the Public
Company Accounting Oversight Board to exchange information with
foreign regulators in the event of an international bank’s insolvency.  
While the book notes that these provisions can “hardly be described as a
dynamic new strategy,” they do much in facilitating communication
with regulators in foreign proceedings. Skeel also recognizes that
while the threat of banning brokers indicates a desire to protect the
United States from financial instability, the threat’s real objective is to
address the risk that derivatives operations will move offshore. Skeel
senses a “whiff of desperation” in this strategy and doubts that U.S.
regulators will actually follow through with this threat. Lastly, Skeel
considers the living will requirement to be the “one genuine advance” in the field of cross-border financial regulation. Implying that it is more
of a procedural disclosure obligation, Skeel is hopeful that the living
will requirement will encourage managers and directors to simplify their
capital structures. In turn, these simplified institutions would be
easier for regulators to monitor.

Conceding that sovereignty interests make a truly
comprehensive international insolvency framework impossible, Skeel
suggests that a “gradual, partial convergence of regulation around the
world is quite possible and might help.” To achieve this, Skeel
recommends that an explicit treaty of even limited signatories could
clear up some of the most significant issues that arise in cross-border
insolvencies, namely cash management and settlement problems. Since much of the world’s financial activity is concentrated in a handful
of countries, even a limited treaty could be remarkably beneficial.

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127. Id.
128. Id. at 177.
129. SKEEL, supra note 1, at 184.
130. Id.
131. Id.
132. Id. at 185.
133. Id.
134. Id. at 185-86.
135. SKEEL, supra note 1, at 186.
136. Id. at 187.
V. Assessing Skeel’s Arguments

Since this review benefits from roughly a year of developments since the book’s publication, it also benefits from the ability to evaluate Skeel’s predictions. First, The New Financial Deal’s primary policy proposal – to remove special treatment for derivatives creditors in bankruptcy – is remarkably persuasive and appears to have gained traction in policy circles. The book has also proven remarkably poignant in its emphasis on the point that much of Dodd-Frank’s success will depend on how effectively regulators lay out and enforce new rules. However, Skeel’s gloomy prediction for Dodd-Frank’s new capital adequacy regime has proven largely untrue.

A. Treatment of Derivatives Contracts in Bankruptcy

Stated differently, Skeel’s most prominent policy recommendation is somewhat elusive: the potential harm of the Dodd-Frank resolution regime can be mitigated by making a different alternative more attractive. Nevertheless, Skeel’s proposal appeals to common sense and is compelling in light of the inherent systemic risks of derivatives markets.

First, removal of the special treatment of derivatives would treat like transactions similarly and would place creditors in an even position in the event of default. Since repo agreements are essentially a form of short-term secured lending, creditors in these agreements should be treated no differently than other secured creditors in bankruptcy. These special exemptions essentially elevate the status of certain forms of financing in bankruptcy without a convincing reason to do so.

Furthermore, in addition to diminishing the incentive for creditors to monitor a troubled financial institution, the derivatives safe harbor provision also exacerbates systemic risk by permitting runs on the institution’s assets. In truth, the systemic risk concerns surrounding special treatment of derivatives in bankruptcy should have been considered much sooner and with much more sincerity. When the Federal Reserve intervened in response to the collapse of Long-Term Capital Management in 1998, officials feared that a rush of more than seventy-five counterparties to terminate hundreds of billions of dollars
of derivatives contracts would have tipped off a systemic shock.\textsuperscript{137} The removal of the derivatives safe harbor would permit firms to resist collateral grabs both before and after the filing of a bankruptcy petition.

Notwithstanding staunch opposition from influential interest groups such as the International Swap and Derivatives Association,\textsuperscript{138} Skeel’s proposal appears to be gaining traction among policymakers and insolvency experts.\textsuperscript{139} The proposal was examined at length in a July 2011 Federal Reserve report on the efficacy of the Bankruptcy Code for the resolution of financial companies.\textsuperscript{140} Though the study maintains a neutral viewpoint, it states that the proposal to remove the derivatives safe harbor “form[s] a foundation for consideration and exploration” of further legislative reform.\textsuperscript{141}

Perhaps the strongest sign of support for Skeel’s proposal has come from the FDIC itself. In a December 2011 interview, FDIC General Counsel, Michael H. Krimminger, voiced his support for making “improvements to the Bankruptcy Code to make it much more likely we would never have to use the last option of a Title II resolution.”\textsuperscript{142} Krimminger envisions that such improvements to the Bankruptcy Code should provide for at least a brief delay in terminating and netting of derivatives contracts.\textsuperscript{143} Echoing Skeel’s arguments, Krimminger believes that if the derivatives safe harbor were modified,
troubled firms "would likely be able to retain value for those valuable contracts and sell them in the marketplace as part of the franchise sale of the operations of the entity that’s gone into bankruptcy . . . This will recoup more value for creditors and help stabilize the market."\textsuperscript{144}

Ultimately, since the FDIC would nevertheless retain the ability to pull the firm’s bankruptcy petition and place it into resolution,\textsuperscript{145} implementation of Skeel’s proposal would not hamper the FDIC’s efforts to exercise its orderly liquidation authority. If lawmakers really intend to leave Chapter 11 open as an option for a distressed financial institution, they should afford its managers the necessary tools, and indeed the opportunity, to restructure the firm in a more transparent manner.

\textbf{B. Will Washington Answer the Call?}

Skeel is correct in his view that Dodd-Frank left many of the more meaningful reforms to be decided in the regulatory rulemaking process out of public view. In other words, in negotiating some of the Act’s more technical points, regulators may fail in certain respects to make Dodd-Frank the robust regulatory regime intended by Congress.

In no context has this proven more accurate than in the implementation of the Volcker Rule. The proposed form of the Volcker Rule released for notice and comment in October 2011\textsuperscript{146} occupied nearly three hundred pages and was accompanied by more than 1,300 questions about 400 topics.\textsuperscript{147} Given the length of proposed rule, the long list of questions, reports of persistent infighting among regulators,\textsuperscript{148} and the extension to the comment period,\textsuperscript{149} some

\textsuperscript{144} Id.
\textsuperscript{145} 12 U.S.C. § 5384 (Supp. IV 2010).
\textsuperscript{149} Cheyenne Hopkins, Regulators Extend Comment Period on Volcker Rule Proposal,
observers doubt that regulators will be able to meet their July 2012 deadline. Initially envisioned as a relatively straightforward and simple reform measure, the Volcker Rule is now so lengthy and complex that former FDIC chief Shiela Bair has urged regulators to “think hard about starting over again[.]”

More substantively, regulators essentially affirm Skeel’s concern with “the malleability of the term proprietary trading.” In the Volcker proposal, regulators concede that it is difficult to define certain permitted activities because it “often involves subtle distinctions that are difficult both to describe comprehensively within regulation and to evaluate in practice.” Specifically, the proposal admits that “[a]lthough the purpose and function of [market making activities and proprietary trading] are markedly different . . . clearly distinguishing these activities may be difficult in practice.” Likewise, industry participants complain that the lack of definitional bright lines will make it difficult, if not impossible, for banks to comply. This lack of clarity will also likely mean that regulators will have to enforce the Volcker Rule’s restriction on proprietary trading after transactions have been completed. Others, such as banking and securities law expert,


151. Paul Volcker initially outlined the proposal for the rule in a three-page letter to President Obama in 2009. See Steward, supra note 147.

152. Hopkins, supra note 149.

153. SKEEL, supra note 1, at 88.


155. Id. at 53.


Kimberley Krawiec, worry that the “disturbingly vague” definitions contained in the proposal will allow banks to sidestep the rule.158 Like Skeel, Krawiec predicts that banks will be able to effectively disguise their proprietary trading volumes as trades executed for clients.159

While Wall Street trading will face new restrictions under Dodd-Frank, it will not likely be restricted to the extent envisioned by Congress in the Volcker Rule. Given how slowly the rule-drafting process has progressed and the fundamental difficulties regulators have confronted in defining key terms, the Volcker Rule will likely be watered down significantly.

C. Committed to Enhanced Capital Requirements

Lastly, in the time that has passed since the publication of The New Financial Deal, Skeel’s bleak prognosis for Dodd-Frank’s new capital adequacy regime has proven largely untrue. While he is understandably skeptical in his belief that regulators may not follow through on some of Dodd-Frank’s directives, he is positively dismissive of their ability to implement effective capital adequacy rules:

Perhaps the Fed will impose stringent capital requirements that fully offset the advantages of financial institutions that are perceived as too big to fail. But this seems unlikely . . . . [These institutions can] argue that higher capital requirements will dampen [their] willingness to lend . . . . The likelihood that they will emerge with favored status surely is a major reason that the largest banks didn’t squawk much as Dodd-Frank’s capital requirements and resolution regime were put in place.160

As this passage demonstrates, Skeel focuses intently on the attendant benefits of being designated a systemically important financial

159. Id.
160. SKEEL, supra note 1, at 83.
institution under Dodd-Frank. Yet, despite the significant costs associated with such a designation, The New Financial Deal largely ignores the possibility that financial institutions would want to avoid it.

Overall, given the prominence of enhanced capital requirements as a regulatory tool and the notable progress on efforts to implement them, it is unconvincing to suggest that regulators will readily retreat from them. Furthermore, preliminary estimates regarding the costs of these measures indicate that they could be significant enough to erode much of the funding advantages that the largest financial institutions enjoy today.

1. Prominence and Progress

Enhanced capital requirements have been among the most prominent strategies for reining in systemic risk since the beginning of the debate surrounding financial reform. This proposal was included in the original Treasury White Paper\(^\text{161}\) and in the Squam Lake Working Papers\(^\text{162}\) outlining measures to strengthen regulation of financial markets. Rather than retreating in the face of opposition from large banks, federal regulators have instead proposed aggressive plans for a capital surcharge on the largest financial institutions.\(^\text{163}\) These proposals have, in turn, galvanized industry opposition in the form of new lobbying efforts and the commission of a comprehensive study concerning the harmful effects of higher capital buffers.\(^\text{164}\)

Intent on cementing these strict capital surcharges, U.S. regulators have also been strongly encouraged by their international counterparts. Certainly due to the passage of time since The New Financial Deal was published, the book makes no mention of Basel III,
the new global regulatory standard on bank capital adequacy.\textsuperscript{165} Through the course of Basel III negotiations, a global regulatory consensus has emerged in favor of imposing capital surcharges on the largest and most interconnected financial institutions.\textsuperscript{166} As such, in November 2011 global regulators agreed to impose capital surcharges ranging from 1 to 2.5 percent of risk-weighted assets on twenty-nine of world’s largest financial firms.\textsuperscript{167} In December 2011, the Federal Reserve responded with new proposed capital surcharge rules that correspond to those set forth by the Basel Committee.\textsuperscript{168} Indeed, the Federal Reserve’s decision to accept the Basel capital adequacy framework has been deemed “a defeat for giant U.S. banks.”\textsuperscript{169}

Underlying much of the global push toward more stringent capital requirements is the contention that the social benefit of reducing the risk of financial crisis far outweighs any temporary impairment to economic growth. On the whole, regulators have dismissed arguments that elevated capital requirements will decrease the availability of credit and crimp the ability of banks to aid growth. As Skeel admits, several studies have found that higher capital standards have a very limited effect on the cost or availability of credit.\textsuperscript{170} In a macroeconomic

\begin{footnotesize}
\begin{enumerate}
\item \textsuperscript{165} BASEL COMM. ON BANKING SUPERVISION, BANK FOR INT’L SETTLEMENTS, BASEL III: A GLOBAL REGULATORY FRAMEWORK FOR MORE RESILIENT BANKS AND BAKING SYSTEMS (2010), available at http://www.bis.org/publ/bcbsl89.pdf.
\item \textsuperscript{168} Enhanced Prudential Standards and Early Remediation Requirement for Covered Companies, 77 Fed. Reg. 594 (Jan. 5, 2012); see also Shahien Nasiripour, \textit{Fed Proposes New Bank Capital Rules}, \textit{FIN. TIMES}, Dec. 21, 2011, http://www.ft.com/intl/cms/s/0/107db944-2b3e-11e1-9fd0-00144feabcdc0.html#axzz1m67bZor3 (noting that the proposed rules were an “expected move that mirrors proposals by [the Basel Committee].”).
\item \textsuperscript{170} See DOUGLAS J. ELLIOTT, \textit{A FURTHER EXPLORATION OF BANK CAPITAL REQUIREMENTS: EFFECTS OF COMPETITION FROM OTHER FINANCIAL SECTORS AND EFFECTS OF SIZE OF BANK OR BORROWER AND OF LOAN TYPE 2} (2010), available at http://www.brookings.edu/papers/2010/orchestra/media/664e1ad0493e4c77b1178a60f4296773.pdf ("[C]apital levels could be raised quite substantially without a large effect on bank loan pricing or availability"); JOSE M. BERROSPIDE & ROCHELLE M. EDGE, \textit{FED. RESERVE BD., THE EFFECTS OF BANK CAPITAL ON LENDING: WHAT...
context, a recent joint study by the Basel Committee on Banking Supervision and the Financial Stability Board estimated that imposing an additional one percent capital surcharge on the thirty largest banks over eight years would only cut economic growth by about .01% a year.\(^7\) One commentator suggests that the leveling effect of these capital surcharges could even encourage competition and boost economic growth.\(^1\)

In a June 2011 speech, Federal Reserve Board Governor Daniel Tarullo referred to capital regulation as “the [most supple and] dynamic tool we have to keep pace with the shifting sources of risk taken by financial firms.”\(^17\) Not only have enhanced capital standards been a fundamental prong in the financial reform agenda, their efficacy is supported by substantial empirical evidence. Although U.S. regulators will certainly face a significant challenge in handling the convergence of U.S. and international regulations, support for a capital surcharge on systemically important financial institutions has reached a critical mass.

2. The Cost of Being “Systemically Important”

Without doubt, the funding and borrowing cost advantages that come from being viewed as too big to fail are significant, and Skeel cites figures indicating that these advantages have only increased since the crisis.\(^17\) While these enhanced capital requirements aim to reduce systemic risk in the global financial system,\(^17\) the Federal Reserve has


\(^17\) Specifically, Dodd-Frank directs regulators to “develop capital requirements... that address the risks that the activities of such institutions pose, not only to the institution engaging in the activity, but to other public and private stakeholders in the event of adverse performance, disruption, or failure of the institution or the activity.” 12 U.S.C. § 5371
been explicit in its desire to use them to "offset any implicit subsidy [that banks enjoy] as a result of market perception of implicit government support." Since the publication of *The New Financial Deal*, the costs that systemically important banks will incur as a result of these capital surcharges have become increasingly clear.

For instance, Glenn Schorr, of Nomura Securities, quantified the potential impact of the new capital surcharges on J.P. Morgan and Bank of America. He concludes that the capital surcharge for J.P. Morgan and Bank of America – as compared to other institutions not designated as systemically-important – will equal roughly $11.1 and $12.5 billion, respectively.

It is predicted that these additional requirements will also carry some negative impact on return on equity. The widely publicized study by The Clearinghouse Association, the nation’s oldest banking trade group, estimates that the “cumulative impact of the Basel III minimum capital requirement and [systemic institution] surcharges would decrease bank return on equity by up to 4.9 percentage points.” Such an impact would decrease investor appetite for bank equity and reduce the size of banks’ balance sheets.

In sum, while Skeel’s doubts regarding the ability of regulators to fulfill Dodd-Frank’s directives on certain issues are merited, efforts to strengthen capital requirements have remained a priority for reform and have progressed significantly through the creation of new international standards. These new standards will not only be

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(Supp. IV 2010).


178. *Id.*


180. *See The Changing Role of the FDIC: Hearing Before the Subcomm. on TARP, Fin. Servs., and Bailouts of Pub. and Private Programs of the H. Comm. on Oversight and Gov’t Reform*, 112th Cong. 11 (2011), available at http://oversight.house.gov/images/stories/Testimony/Bair_Testimony.pdf (statement of Sheila C. Bair, Chairman, Fed. Deposit Ins. Corp.) (“The single most important element of a strong and stable banking system is its capital base . . . . Supervisory processes will always lag innovation and risk-taking to some extent, and restrictions on activities can be difficult to define and enforce. Hard and fast objective capital standards . . . . are easier for supervisors to enforce, and provide an additional cushion of loss absorbency when mistakes are made . . . .”).
sufficiently robust to offset some of the competitive advantages that larger banks currently enjoy, they will do so by forcing them to embrace a more conservative balance sheet. To suggest, as Skeel does, that the financial lobby will overrun policymakers on the issue of new capital requirements is excessively pessimistic.

VI. CONCLUSION

In conclusion, The New Financial Deal provides both a thoughtful overview and critique of Dodd-Frank and suggests different ways in which the legislation could be improved. As a bankruptcy scholar, Skeel understandably adopts a bankruptcy-centric approach to financial regulatory reform that is as creative as it is persuasive. Although Skeel is overly pessimistic concerning the ability of regulators to effectively implement one of Dodd-Frank’s most critical reforms, he has written a remarkably engaging study of Dodd-Frank and the future of financial services regulation in the United States.

LOUIS MASSARD