

PANEL 3: BANKRUPTCY & RESTRUCTURING OF FINANCIAL INSTITUTIONS

Moderator: Barry E. Adler

Panelists: William A. Ackman, Marcia L. Goldstein,
Hon. Arthur J. Gonzalez, Michael H. Krimminger,
Edward R. Morrison

Barry Adler: Thank you all for being here. It is an honor for me to be on this panel and an honor to moderate it. Let me introduce our panel before we get started. William A. Ackman, the founder and CEO of Pershing Square Capital Management; Marsha Goldstein, a partner and chair of the business finance and restructuring department at Weil, Gotshal; the Honorable Arthur Gonzalez, a judge in the U.S. Bankruptcy Court for the Southern District of New York; and Ed Morrison, the Harvey Miller Professor of Law and Economics at Columbia Law School. Also on this panel is Mike Krimminger, and we're honored to have him here. Mike is a Special Advisor for Policy to the Chairman of the FDIC. I saved him for last because he is going to speak first, and I'll start him off with three questions.

What is a non-bank financial institution, and what is systemic risk? We hear both of those terms a lot. Also, does the former affect or cause the latter?

Michael Krimminger: Thank you. I have to do my usual disclaimer that I try to represent the views of the FDIC but don't take everything I say as necessarily representing the views of the FDIC or of my boss.

I would like to turn for a second from the questions you asked and just look at why we're here and why we're talking about some resolution authority that's different from the bankruptcy code for non-banks. To define what a non-bank financial firm is will depend on the final legislative language, but it's obviously not an insured depository institution because that's covered by the Federal Deposit Insurance Act. It's a financial institution effectively that's subject to heightened supervision under the provisions of either the House Bill or some future Senate Bill, so the actual parameters of that still remain to be defined.

As for what systemic risk is, I hate to quote Justice Potter Stewart but I'm tempted to. It really is a situation—you kind of know it when you see it—but it certainly is a situation where you are potentially facing the collapse of the financial system based upon the inability to deal with certain types of contracts or certain types of exposures or loss of credit intermediation; a loss of liquidity in the system. I think for purposes of proposal for resolution authority, one way of defining systemic risk is probably just to use the language of the statute, which is, to paraphrase because I don't have it in front of me, that the systemic risk which would require the appointment of a receiver under this proposed resolution authority would be a risk whereby there would be a conclusion by the regulators, that putting an institution into an insolvency proceeding under the Bankruptcy Code would create a systemic risk.

The default, or the recognized way in which virtually every institution will be resolved would be under the Bankruptcy Code. It would only be under that very rare circumstance where there is a conclusion that a normal bankruptcy resolution would create systemic risk that there would there be an exception.

Barry Adler: What legislation are you referring to?

Michael Krimminger: There was a bill passed by the House of Representatives in December 2009—the Wall Street Reform and Consumer Protection Act. Essentially it went through many iterations and it was designed to provide for financial reform. One of the points I would make in looking at this is that we have to look at the idea of a resolution authority for that rare case outside the Bankruptcy Code as being simply part of a whole package, and that whole package involves a number of things. It involves a creation of a Systemic Council to look across risk that might be percolating up through different types of entities, that perhaps a particular regulator was not addressing. I think there is a good case for that obviously, because we saw a risk that percolated up from non-bank financial firms, non-bank lenders, for the subprime market through their reliance upon securitization and the “originate to distribute model.” That Systemic Council would be designed to harmonize capital, leverage, and liquidity standards. You would need to have a resolution authority. In addition, you would need to have heightened consumer protections. As was

evident in this crisis, the failure to provide for consumer protection also led to risk coming up in the system because our experience has certainly been that any bank, or any nonbank that for that matter, engaging in activities that aren't appropriate for consumers are likely engaging in a lot of other activities that create risk for that institution, and potentially risk throughout the system.

I think the reason that we're here is that the fall of 2008 demonstrated in a lot of ways that we need new options if we are actually going to end "too big to fail." What we saw in the fall of 2008 obviously was an example where there's been discussion at times about constructive ambiguity—about whether the regulators would bail out a particular firm or not. The ambiguity was resolved, not necessarily in a constructive way, but there were things that had to be done because there weren't the tools that were necessary to actually deal with some of the problems.

Right now, I think in some ways we have maximum moral hazard, a more concentrated system, and we still lack some of the needed tools. That's one of the reasons why Congress is taking a look at a financial regulatory reform right now. One of the key things we need to do in order to squeeze out the moral hazard that is now in the system—and clearly it has been in the system for a long time—is that we need to end any bailouts.

As Chairman Bernanke said repeatedly, we need to end "too big to fail" and to do that we need to have a panoply of tools. I mentioned a Systemic Council, improved consumer regulation, improved macro prudential and micro prudential supervision as well. We need to bring non-banks into some level of supervision depending upon the risk they are presenting to the system. Particularly if they are the very largest institutions, they should be subjected to heightened standards so that we can reduce that systemic risk.

I do not have a lot of knowledge about the details of what the President is considering in the announcement yesterday, but one of the concepts is reducing the size, interconnectedness, and complexity of financial institutions which can be done in a variety of ways. One of things we've proposed is that if you have a resolution authority, you might need to have a resolution fund, and you might want to assess based upon the

higher risk activities that firms engage in. That in and of itself should make them operate more efficiently and effectively, and should reduce complexity and perhaps size as well.

One of the things that I want to dispel is that the legislation is creating some type of permanent bailout, or providing options for a government bailout. The whole purpose of what we've been advocating is that, as part of this elimination of "too big to fail," you need to eliminate the ability to provide firm specific equity injections, or firm specific support, for firm's that are in trouble. If a firm is in trouble and cannot survive then it should be closed and go through an insolvency proceeding, where shareholders and other creditors take losses to protect the taxpayer from taking losses in the future. If it needs liquidity, if there is liquidity support needed for the marketplace as a whole, then we have certainly supported things such as the Federal Reserve's 13.3 authority to provide system-wide liquidity support, as well as actions that the FDIC has taken, along with other regulators. We took, for example, our Temporary Liquidity Guarantee Program, which provided a certain level of liquidity support by providing FDIC guarantees of certain debt issued by banks and their holding companies as well.

Focusing on the resolution authority piece, we need to dispel the idea that some firms are simply too big or too interconnected to fail. We need to have a way to make sure that they do fail and that the shareholders absorb losses. In order to do that, we need to have an effective and credible resolution mechanism that provides for the orderly winddown of banking and other financial enterprises without imposing costs on the taxpayers. So the largest firms can be closed, we can impose losses on the shareholders and creditors, and sell the operations back to private firms. It needs to be quick, it needs to be decisive, and it needs to provide for continuity to prevent a systemic collapse; but only as a means to an eventual liquidation or selling off of the assets of that firm and recycling them back into the private sector. Certainly the resolution scheme as a process should be transparent to have an established claims priority where stockholders, not taxpayers, should be in the first-loss position with the obligation to minimize costs and maximize recoveries.

Most fundamentally, one of the things that can lead to potential systemic tie-ups is the loss of liquidity in the system,

which occurred in the fall of 2008. We need to be able to have a power under the new resolution law to create something that in the banking laws is called a “bridge bank”—it can be a bridge financial firm in this case, so that in the rare emergencies where bankruptcy can’t do the job, you can transfer operations and continue them in this bridge firm temporarily until the market could establish an equilibrium and until we can establish some continuity in the marketplace as a whole.

So that’s overall the function of what we’re trying to achieve in the discussions that we’ve had under our resolution authority. I would just note with regard to bankruptcy that it does a very effective job for the vast majority of insolvencies and we absolutely support the continuation of bankruptcy as doing that. But what we’ve seen is that similar to banks, many financial firms are dependant upon very short-term liquidity—and very short-term liquidity can dry up very quickly. The benefit we have in banks so that short-term liquidity in deposits doesn’t dry up so quickly is deposit insurance. Certainly I would not support the idea of having repo insurance or some other type of insurance for short-term financial market obligations—I don’t think anybody would. But since non-bank financial firms are subject to such quick liquidity ‘runs’, we need to have the ability to maintain continuity at those types of operations temporarily, and that would be through a sort of bridge-firm type of structure.

In this type of systemic crisis, we also need insolvency processes designed to help resolve claims, resolve the affairs of the firm in the public interest, rather than solely just in the creditor’s interest, and we need to make sure that this is designed for quick action and allows for immediate transfers over to the bridge bank without delay. Parties to financial markets contracts would be protected in the bridge bank if they’re transferred there; if not, they can terminate and net out their contracts just as they can today under current law. So there will be protection for the financial markets in that kind of structure as well. But that’s really the goal of the resolution structure.

Barry Adler: Mike, you mentioned the moral hazard problem but at the same time suggested that the goal was not to subsidize these firms when they fell. If there is no subsidy, then there is no moral hazard problem, so is there really going

to be no subsidy? That is, if by your account only liquidity is going to be provided, but no out-of-the-money claims are going to get paid (because if there were no subsidy, that would have to be the case), then how would this work as quickly as you need it to work? So if CitiGroup and Chase collapse on the same day and they enter into this resolution arrangement that's outlined in the bill, according to the story you just told what will happen is the FDIC or a governmental agency will come and provide liquidity but not pay creditors who don't deserve to get paid? How will the resolution authority know which creditors deserve to get paid in order to do that quickly and without subsidizing by paying in full claims that we're out-of-the-money under an absolute priority regime, such as what happened to AIG?

Michael Krimminger: Well, let's not be under a misapprehension that we did not have moral hazard when we relied on the bankruptcy code to resolve these problems. We have a moral hazard because when the Bankruptcy Code was the only option it was not going to be used for the largest firms, so they were going to be bailed out by the government.

But what we're talking about now is trying to make sure that we don't have a government bailout to support the shareholders, subordinated debt, and other types of creditors. If you are trying to protect against a systemic collapse, that by definition means that there are going to be some creditors who are going to come out better than other creditors. For example, if I am trying to make sure that the repo markets don't collapse, and let's say a hypothetical institution is very much a provider of liquidity and a key functionary in the repo market, then I may have to do some rolling-over of the repos that may require—even for those small amount of claims that may be uncollateralized—providing some additional liquidity to make sure the repos can roll over so that we don't have a systemic collapse.

What we can't be, though, is faced with a Hobson's choice, as we were in the fall 2008, with either going to a process where there could be, if there was not funding provided by someone, going into a bankruptcy there would be a freeze up of the ability to continue closing a settlement on these contracts. In that situation, you would have dumping of collateral on the market because there would be no liquidity, and you

could have a market collapse. If you are faced with that choice or you are faced with the choice of doing some kind of bailout using whatever interpretations of statutes that may have been necessary to prevent that type of systemic collapse, you are going to take whatever efforts necessary as a policy-maker.

I'd like to think that the United States has a certain amount of moral rectitude but we have proven that we are not going to sit there and let the system collapse as a result of trying to make sure that we're morally correct. The policy-makers are going to make the judgment of providing a bailout. We need a mechanism though that if you have to pay some sort of support for some types of claimants, that you're not providing support for the shareholders and other types of claimants that aren't necessary to protect the system from collapse. Is that an easy judgment to make overnight? No, it's not. But, just as we have done with bridge banks in the past, sometimes you've got to make transfers over to the bridge bank for short term, but then you can also take some actions to make sure that creditors that are left behind in the receivership, that they will suffer the haircuts that you need to make sure you impose. We're trying to impose the maximum number of haircuts, but it is not perfect.

Barry Adler: Ed, can you comment on what Mike talked about and also give your view on how the current Bankruptcy system as is or as amended might be structured to deal with these problems.

Edward Morrison: Okay, let me try to provide some context for what Michael described. You can view the administration's proposal and the House bill as one response to a problem, but there are of course other responses. One alternative is amending the Bankruptcy Code. Another is doing nothing: leave existing law as is. Before discussing these alternatives, let's talk a little bit about the problem.

The problem, in a nutshell, is that existing bankruptcy law has some important limits. Arguably, it doesn't do enough to deal with the problems faced by the kinds of institutions that are currently outside the insolvency authority of the FDIC. Firms like Lehman and AIG are eligible for bankruptcy protection, yet the bankruptcy laws are inadequate for dealing with their kinds of problems. Bankruptcy is good for dealing with the problems of a particular business but not the problems of

an entire economy, and when you have businesses like Lehman and AIG failing, their problems are problems of both their particular businesses and of the economy as a whole.

Part of the problem has something to do with what we call the “safe harbors,” which offer special protection to qualified financial contracts, including repos, swaps, and just about any other financial derivative that you can think of. These safe harbors tell us that when a firm like Lehman fails, counterparties to the protected financial contracts are free to ignore the bankruptcy filing. They are free to terminate and net-out their contracts with Lehman and then seize collateral to the extent that they are owed cash and can seize the collateral through self-help. So, the safe harbors ensure that a Lehman or an AIG or any business with a meaningful derivatives portfolio is subject to a feeding frenzy when it enters into bankruptcy.

Why have this special exception for financial contracts? It was thought to be a system risk exception: by having this kind of treatment for financial contracts, we protect our economy. When a Lehman fails, the J.P. Morgans and the Goldman Sachs of the world can extricate themselves from their relationship with Lehman and not be pulled down with Lehman. If the J.P. Morgans and the Goldman Sachs were subject to an automatic stay—and therefore barred from terminating their contracts with Lehman and seizing collateral—they would be stuck waiting weeks or months for Lehman to decide whether it wants to continue or terminate its financial contracts. The J.P. Morgans and Goldman Sachs of the world would be forced to hedge open positions and could potentially suffer massive losses. In this way, Lehman’s failure could infect its counterparties, generating widespread, systemic distress. Congress envisioned the safe-harbors as a way to stem the infection. Lehman’s distress may cause it to implode, but Goldman and J.P. Morgan can walk away with their collateral, relatively unscathed by Lehman’s failure.

This story—that, without the safe harbors, Lehman’s failure could infect other institutions and generate widespread distress—is one theory of how markets collapse, but it’s not the only vision. What we saw in October of 2008 was a different way that systemic collapse can occur.

The safe harbors assume that parties like Goldman and J.P. Morgan can extricate themselves from relationships with

failing institutions and then move on safely. But there are two things that can happen when a Lehman or other major market player fails in a world with safe harbors. One is an obvious knock-on effect: the safe harbors protect derivatives counterparties, not holders of ordinary bonds or commercial paper. So when a Lehman fails, it will default on its commercial paper and you may see mutual funds break the buck. That itself can destroy confidence in the financial system and promote systemic distress. Safe harbors can't do anything about this.

But there is something even more fundamental that the safe harbors can't do: They can't deal with the problem of liquidity. When a Lehman fails, counterparties will exercise their rights, as permitted by the safe harbors, to terminate their relationships and seize collateral. But what does that mean? That means they're terminating thousands of positions simultaneously and selling off massive amounts of collateral simultaneously. Here is an example. When Lehman filed for bankruptcy, it was party to about 1.5 million qualified financial contracts with 8,000 counterparties. About 80% of those 1.5 million transactions were terminated in the two week period after Lehman's filing. And that was considered slow.

Think about it: as a major financial institution fails, millions of transactions are being terminated by the counterparties, and treasuries and other types of liquid collateral are being seized out of margin accounts and sold. And everybody's rehedging in order to replace the contracts that have been terminated. When you have mass collateral sales and rehedging, you will see collateral prices drop precipitously and the cost of hedging rise precipitously. This creates an infection, spreading the failure of one major market player to other players throughout the financial system. Institutions holding the same collateral will find their balance sheets declining in value because tons of collateral are being dumped on the market. At the same time, everyone will find it harder to hedge.

It's this kind of problem that we actually saw happen when Lehman failed. It's exactly this same kind of problem that prompted the Federal Reserve to intervene when Long Term Capital Management failed in the late 1990's; the Fed intervened to orchestrate a private sector bailout of LTCM, the hedge fund, because it feared exactly what we saw when Leh-

man failed: a systemic meltdown, notwithstanding the Bankruptcy Code's safe harbors.

My goal here is to illustrate the point that bankruptcy just can't deal with the kinds of problems that arise when the Lehmans and AIGs of the world fail. I'm not saying anything about the Lehman bankruptcy process. It may have been a well-orchestrated, smooth-functioning event. You had the sale to Barclays within a week (perhaps at too low a price—that's being litigated now). But regardless of how smoothly the Lehman bankruptcy functioned, there was a major effect on the marketplace. It's thought to have caused massive gyrations in prices in the marketplace, and to have prompted federal intervention subsequently.

Back in the late '90s, during the LTCM bailout, the Fed recognized the defects in our bankruptcy laws. Yet we did nothing about it. We saw the defects in again in Fall 2008. Maybe now we should do something about it.

There are at least four alternative approaches to the problem. One is to do nothing: leave the Code as is and add nothing new to deal with the Lehmans and AIGs of the world. Yes, existing law has defects, but the defects aren't all that bad. The federal government can always intervene, as it did when Bear Stearns, AIG, and Fannie and Freddie found trouble. Indeed, even Lehman's bankruptcy didn't have to happen. The federal government could have intervened and recapitalized the investment bank. There are statements from Geithner and Bernanke that the Federal Reserve felt constrained in its ability to intervene in Lehman's case, but there's some evidence to show that may not be completely accurate. There may have been effective ways to intervene and prevent the meltdown.

Indeed, a virtue of current law is that it forces the government to intervene in a very public way when a major institution craters. Think of Chrysler and GM. There was a sense among government officials that a collapse of these auto makers would create a systemic meltdown. Although the companies did file for bankruptcy, the federal government managed the bankruptcy process deftly. It was able to intervene with few constraints imposed by the bankruptcy court. Through its DIP lending powers, the federal government forced Chrysler to separate its salvageable and non-salvageable parts and sell off the salvageable. Much the same process is contemplated by the

financial reform bill in the House, which would separate a non-bank institution into its salvageable and non-salvageable parts. The House bill would transfer the salvageable parts to a bridge or to a purchaser, maybe J.P. Morgan, and the non-salvageable parts would be left behind and liquidated. That's basically what happened in Chrysler's bankruptcy, and it also happened at GM's. Maybe that's the template for what would be done in a world where we don't do anything to change existing law. Put differently, through existing law, the government can use bankruptcy to salvage non-bank institutions in much the same way that it salvaged Chrysler and GM.

The counter argument is that, with Chrysler and GM, we saw the problem coming a mile away. It was very clear at least a half year ahead of time that Chrysler was going down the tubes; there was lots of time to plan. Also, the failure of Chrysler and GM was not one that led to a massive loss of confidence in our economy. By contrast, it was widely feared that if an institution like Citibank or J.P. Morgan failed, we could see widespread loss of confidence in our banking system. We actually saw that happening for a little while. We saw Treasury interest rates fall to zero in Fall 2008. There was a flight to quality when Lehman failed and AIG was rescued, because nobody wanted to hold anything other than government money. So doing nothing might not be the best approach.

Another approach, proposed by the Republicans in the House last summer, is to modify the Bankruptcy Code to make it more amenable to the failure of a systemically important institution. That would involve the creation of a systemic oversight board of the sort that Michael mentioned. It would also require Bankruptcy Code amendments to, oddly enough, get rid of the safe harbors. Keep in mind that the safe harbors were designed to deal with systemic risk, but new proposals suggest that they may actually exacerbate the systemic meltdowns.

Now, I have a feeling that the safe harbors are a red herring—that they don't really matter much when it comes to systemic risk. They may help in reducing the probability of a meltdown far in the future, but they do nothing when you have a clear and present danger of collapse. They're not going to help. Only infusion of new capital into the system is going help—the kind of infusions we saw when government intervened with Chrysler and when it bailed out AIG. That's

the only thing that's going to work. This means that proposals to modify the Bankruptcy Code are little better than proposals to leave existing law as is: both proposals will require government intervention when systemically important institutions fail.

So we might want to consider a different proposal, perhaps one that doesn't force the government to wait for a firm to go into bankruptcy and then intervene. We might consider a policy that allows the government to intervene when it wants to and implement an "early rescue" when it makes sense to. That's what is being proposed by the Obama administration, the House bill, and the draft Dodd bill. The basic flavor of this proposal is that it gives to the federal government all the powers that are now possessed by bankruptcy courts. The FDIC can liquidate an investment bank through a receivership. It can also conduct the equivalent of a Section 363 going-concern sale. It can take the failing institution, separate it into its good and bad parts—the systemically important part is the good part—transfer that to a purchaser or transfer it to a bridge bank. The government could even impose a conservatorship—it's basically a reorganization, with old equityholder kicked out and the government running the show. It's what we are doing with Fannie and Freddie right now. So that's what the Obama plan does and you can say that the primary virtues of that are two things: speed and clear expectations.

When the FDIC is in control, things move very fast—you turn around a bank overnight. Yes, Lehman moved fast; that took a week. But as fast as that process was, it left considerable damage to the market in its wake. Chrysler was considered light speed; 30 days. But 30 days would be death if there is a financial meltdown. The FDIC's speed comes from limited judicial review of its decision making. Its decision to put a firm into a receivership is subject to review, but other decisions are subject to little, if any, review.

Michael Krimminger: Caveat time, but we can talk about that later.

Edward Morrison: Maybe I'm being extreme, but I think there's case law to show that there is very light judicial review of most FDIC decisions, in contrast to bankruptcy court decisions.

There are also clear expectations; it is clear ahead of time in the Obama plan that you have a regulator ex-ante who is telling everybody, "This firm is in good or bad condition. Here is what the firm must do to be in good condition." Everyone knows who is going to be the receiver at the end of the day, and this receiver can line up a buyer long before this institution is put into receivership.

The benefits are speed and clear expectations. The downside is that there is a lack of transparency: what is the FDIC actually doing? How is it deciding who should get priority among the creditors? How does it decide who's systemically important? And when it separates the good and bad bank, what are the priorities among creditors? In other words, the downside is a lack of transparency.

In sum, one option is to do nothing, another is to amend the Bankruptcy Code, and another is the House Bill. There's still another option: link the Bankruptcy Code to the House bill. Under this approach, everything in the House Bill would remain the same except that the Bankruptcy Code would determine creditor priorities during liquidation of the non-salvageable parts of the bank (the "rump" that is left behind after the salvageable parts are transferred to a buyer). Once the federal government has identified the assets and debts that are not considered systemically important, these assets and debts would be transferred to the bankruptcy courts, which would apply ordinary rules to determine payoffs. We might even require that the payoffs exceed some "liquidation baseline," to ensure that every creditor in the rump receives at least what it would have received if the government had not intervened and the firm had been liquidated instead of rescued.

So we could think of the final option as being one that tries to achieve a happy medium. But don't get me wrong, I fully sign on to Michael's position that the Bankruptcy Code is not an adequate mechanism for resolving the distress of systemically important institutions, at least not right now.

Barry Adler: Thanks Ed, and that perfectly leads into my next question, which is for Judge Gonzalez. Can the Bankruptcy Code actually work pretty much as Mike suggests a resolution authority might? And my suggestion to you, Judge, is that that's exactly what happened in Chrysler. The government came along, not to provide liquidity, but to rescue an

industry. It came along with a bunch of money, decided who was going to get paid and who wasn't, separated the firm into a good part and a bad part, leaving you—and you're probably still dealing with—the bad part, and sent the good assets on their way without the encumbrance of the taint of the bad assets. And this was accomplished with a subsidy that permitted you to approve it all. Is this a fair characterization in your view of what happened in Chrysler?

Arthur Gonzalez: It's fair, but it doesn't emphasize the openness of the process which I think is what's missing with what I've heard as proposals, which will lead to a great deal of uncertainty and concern about the closed manner of how these things are going on. Chrysler ultimately did play itself out. The parties that began it accomplished what they wanted to accomplish in the separation of the assets. It was a very open process. It was dealt with in thirty days, but there was a lot done in thirty days. I don't envision any of these proposals performing in any better way, and probably because of the lack of this adversarial context you would have in these government-run proposals as you describe them, I see them being bogged down. I see people being completely confused as to who is going to take what, who is going to make an arbitrary decision, and then what's going to happen. So I think the system needs to be fixed in the bankruptcy context to address the concerns you raised, but I still would rather see it in that form as opposed to a government agency running these kinds of liquidations.

Marcia Goldstein: I agree with Judge Gonzalez. The thought that we would put so much power and control in a resolution authority, where decisions could be made without transparency and without the opportunity for an adversarial process, to me just doesn't sit well.

Barry Adler: Isn't this what the FDIC already does with banks?

Marcia Goldstein: It does it with banks, and I represent the holding company of Washington Mutual. I think tremendous amount of value was lost in the takeover, or turnover, of that bank to J.P. Morgan. I'm not suggesting the FDIC doesn't do a good job generally speaking, but the bank was trying at that time to sell itself, and I think the competitive process did

not occur. It was a middle-of-the-night takeover and the bank was in effect handed to an institution that could have been involved in the competitive process, but instead had been lined up and standing on the sidelines. Maybe that was the best way to go, and maybe that's not the example for all financial institutions when the FDIC intercedes.

I do think a bank is different because the FDIC is protecting depositors. I want to step back from that and suggest something that might be considered a bit of heresy here. What I heard—in terms of why the Bankruptcy Code doesn't work and why we want to have a resolution authority—did not address the bailout, because you still need liquidity in these institutions, even if it's just for the good institutions, or the good side of the bank or financial institution. So I think that we're not free from the prospect of a bailout. We need to have a way to provide liquidity, even if it's a federal debtor-in-possession financing. I think that was handled well by the government, in terms of General Motors and Chrysler.

I would like to talk a little bit about AIG, since I was involved in the crisis that led to the "bailout"—the \$85 billion bailout on day one. I do think that the safe harbors in the Bankruptcy Code have proven to be a cause rather than a help in terms of systemic risk. I think that the safe harbors as they applied in the Lehman cases, as Ed described, created a global run on a bank to the point that it led to a global infection in terms of valuation of collateral. And if you think about that, consider what happened to AIG. It suddenly became the subject of billions of dollars of collateral calls, because of the valuation of collateral. If we would have had an opportunity to step back from that, and allow the situation to stabilize, that situation may have come out very differently. One theory was that had the Fed just stepped in and stood behind the collateral, instead of actually having to put up funds for the bailout, perhaps there would have been some stability created in terms of collateral value.

Barry Adler: How would it have stood behind it without putting up the funds?

Marcia Goldstein: The government could have put up a guarantee, which arguably equates to a funding. But perhaps the guarantee would never have been called upon if there had been some stability created. Also, let me talk about why AIG

didn't file for bankruptcy. The bankruptcy alternative was considered versus whether to take the \$85 billion.

Barry Adler: Well that didn't seem hard.
[Laughter.]

Marcia Goldstein: Well actually that is hard. In hindsight it was the right decision given all the factors, and given what AIG's options were. Clearly things occurred after that, for example, the restructuring of the bailout loan, which created a great improvement in the circumstances of AIG, which supported the initial decision.

But why didn't AIG file for bankruptcy? One, it wouldn't have had protection because of the safe harbor, in terms of the financial products business. Two, the downgrades coming from the rating agencies may be the villain here. It would have led to a massive domino effect in terms of takeover of the insurance businesses globally. In contrast, we did the restructuring of SCA, now called Syncora—totally out of court, with the full cooperation of the New York insurance regulator. We were able to deal with all the counterparties. We were in communication with the insurance regulator every day. It's hard to do that globally with an entity of the size and complexity of AIG. If there were a provision in the Bankruptcy Code, in the automatic stay, which provided for a temporary automatic stay—some period of time, 45 days, 60 days, with respect to the safe harbor—perhaps we could have had a stabilization and time to go organize all the insurance regulators, and assure them that these insurance companies were in good financial condition. The run on the insurance companies that occurred later, and later was stabilized, occurred because of the taint of the AIG name, basically done more by the press than anybody else. Given time, talking to the insurance regulators, organizing them, and establishing that those businesses wouldn't be harmed, could have enabled the filing of a bankruptcy petition. Bankruptcy judges enter orders that govern the management of a company's cash all the time. We would have had agreements with the regulators not to do anything to impair the capital at those entities, creating stability. Had there been takeovers of all of those insurance companies, we would have had a Main Street systemic risk, where potentially the owners of those policies couldn't borrow on them.

AIG also owned a number of other businesses: AGF, very similar to CIT, a huge provider of financings to small companies; ILFC, a provider of financing in the aircraft industry. Those are perfect examples of companies that could be successfully reorganized in Chapter 11—but couldn't be. Why? Because we couldn't even exercise what I would consider normal restructuring tools to deal with the debt at those companies; because if you successfully exchange debt for equity, you get from the rating agencies an SD, a selected default, which is a downgrade. Had that occurred, we risked the insurance company domino effect. So while we could have probably accomplished some deleveraging at the AIG subs and improved their debt profile, the lenders all knew we couldn't. . . so we couldn't and it cost more money from the parent and the federal funds that were already there. So I think that my villain in the AIG scenario is not the government—the FDIC had nothing to do with it—my villain perhaps is the working of the rating agencies. We have to have some way to deal with that for a company like AIG.

For a company like AIG, even if we had some temporary period, perhaps under the bankruptcy code, in which we could go to the insurance regulators, we might also need a temporary respite from an insurance regulator who can take over an insurance company. Today, an action by a governmental authority to take over an insurance company is an exception to the automatic stay under the Bankruptcy Code. So what would have helped AIG would have been a complete standstill for a short period of time. I think that would have saved money. Of course there is a lot written about the AIG bailout as to whether it was really a bailout of AIG or a much more systemic bailout.

Michael Krimminger: Like Goldman Sachs.

Barry Adler: Marcia, you mentioned the importance of trying to save the sound operating companies or subsidiaries of AIG. But on the question of systemic risk, AIG was deeply insolvent. The speculative part of the firm couldn't have paid all its obligations, couldn't have met all its insurance obligations, all its derivative contracts, could it have? I mean you could have waited as long as you wanted but unless someone subsidized you, those were going to fail.

Marcia Goldstein: It was the drop in collateral value that impacted AIG's liquidity and solvency. I think if you had been able to use Chapter 11 we would have not had a run on insurance companies; we would have had a bankruptcy that affected mostly the financial products business. We would have also re-organized some of their finance subs, ILFC and AGF, in that process.

Barry Adler: The bubble burst.

Marcia Goldstein: The bubble burst, but we might have been able to effectuate a bankruptcy at that level without impairing the insurance company values.

Barry Adler: Not the insurance companies, but AIG's.

Marcia Goldstein: Well, we had competing regulatory authorities—

Barry Adler: But the counterparties on the derivatives with AIG still would have suffered.

Marcia Goldstein: Yes, I'm not suggesting they would have come out whole. They could have suffered, but that might have been another alternative, and maybe the bailout could have been a lot smaller.

Barry Adler: Got it. Okay, I am going to turn this over to William Ackman.

William Ackman: Ok, so let me just excuse myself by saying that I am not a lawyer, but I am an active participant in the capital markets so I will call myself a capitalist. We do actually purchase and sell derivative contracts so I'll give a slightly different perspective.

Let's talk about financial institutions that don't have big derivative portfolios. My general view of the world is that a lot of tax payer money was wasted, thrown out the window in the last 24 months, and it could have been avoided. I think the best example of that is when the world started to fall apart, among other financial institutions, CIT was determined to be systemically important. The government put \$2.3 billion in preferred stock in CIT, and then about a year later decided that CIT was no longer systemically important, and did the right thing and said they are not going to put up any capital. The management complained, the shareholders complained,

the bondholders complained, and the government stayed tough. And what happened?

What happened is the creditors got together and they negotiated a deal, unsecured debt converted into equity—about \$10 billion worth. The company did a pre-pack, filed, it emerged 30 days later—it's listed on the New York Stock Exchange as a viable enterprise and no additional taxpayer money was invested. That to me is what should happen.

In fact I think the bankruptcy code is a bit like the Constitution—I think they got it right the first time and it's really some of the amendments they've gotten wrong. I really agree with Marcia on this and others on the panel that the qualified financial contract exemption is a huge mistake—and this is from someone who actually buys derivative contracts! I think that it doesn't create any meaningful market value. You've got to be careful who you contract with, and I think that derivative contracts should be treated like any other secured or unsecured creditors depending on how your particular contracts are written.

What's interesting is that Lehman, as an example, didn't require any incremental capital. It wouldn't have required any government support in order to have emerged successfully if it had simply done a CIT-like restructuring. Despite the disastrous handling of the Lehman situation, even with this exemption and all these contracts being terminated at the absolute bottom of the market, the unsecured creditors of Lehman are still going to make a meaningful recovery. What that means is that if the bondholders had gotten together and negotiated a transaction without the overnight failure of the institution, they could have ended up in a much better position than they ended up now, without any need for taxpayer money.

If you look at Fannie and Freddie, they have plenty of capital. They have way more capital than they need. The problem is too much of that capital is in the form of debt and not enough of it is in the form of equity. Instead of the U.S. government putting \$400 billion into Fannie and Freddie, what should simply happen is that the government decides it is no longer going to support Fannie and Freddy. The bondholders sit down and negotiate a transaction in which a meaningful percentage of the unsecured debt of Fannie is converted into

equity and so we have a solvent institution. And that's a really good approach. It's capitalism and it doesn't require any subsidy from the taxpayers. It's fair, it respects the hierarchy of claims, and it eliminates moral hazard. We don't have the problem of the government deciding what the compensation should be for the management of various financial institutions. We're back in business. And if Citibank tomorrow—I think there's something like \$400 billion in holding company debt—if \$200 billion of that converted into equity, I think the shareholders could probably negotiate something where they make a recovery better than where the stock trades today, interestingly enough. And you would have a strong financial institution. What I would do is make it so that they could not pay any dividends or buy back any stock and you make them overcapitalize.

Barry Adler: Why isn't that happening?

William Ackman: It's not happening because Bill Gross the Bond Manager has too much influence with the Treasury and the bondholder lobby has too much power. What we've been doing is we've been taking taxpayer money and we've been infusing it into Fannie and Freddie and Citi and others and that money has been going out the door to pay interest to bondholders. So, the farmer, the guy driving the pickup-truck, the kind of guy that can win an election in Massachusetts—that guy is putting up money and that money is going to subsidize owners of bonds. It's completely un-American. It's totally unfair. It's absurd and someone should be screaming about it.

You know all these systemically important institutions were supposed to be set up with holding company structures, and the systemically important institution was supposed to be the subsidiary, and if the institution got into trouble, you should be able to file the holding company preserve the segregated nature of the subsidiary.

I am of the view where I disagree with Marcia, I think AIG should have filed for bankruptcy (the holding company). AIG financial products had a bunch of people who bought \$450 billion worth of derivatives—it filed. What they shouldn't have done is kept putting up more and more collateral. They should have filed and then you get a bunch of unsecured credit, you sit down and negotiate with them. And, I have a pretty front seat view of this because I actually bought some

AIG stock when the thing blew up and tried—I'm what they call an activist investor—I tried to see if I could negotiate something with some of the derivative counterparties. I called up UBS, I got the relevant people on the phone, and they were willing to negotiate a haircut on their contract with AIG. I ended up giving up and selling my stock because as I watched what was taking place, I thought that there was no real prospect for that happening.

So I actually think that AIG would be a much better off institution had they filed and reorganized in a sensible manner, and so what if the counterparties for AIG financial products couldn't. If they terminated their contracts, so fine, they've got an unsecured claim in AIG financial products. All the real value of AIG is in the insurance subsidiaries—they're segregated—the policy holders are safe. To prevent a run on the bank, that is where I might say, number one, the insurance department should come out and say they are completely segregated. Yes the companies have similar names, but if people are concerned about that, that's where I would have the government step in and provide a guarantee saying don't worry policy holders, we're going to make sure that the problems of the parent company aren't going to affect the subsidiary. And so I just think that we've gotten away from classic capitalism.

Barry Adler: I'm going to ask you the same question that I asked Marcia. Maybe I'm just wrong, but the concern was over the problems of the parent company—

William Ackman: They should have let the parent company go. Who cares about the parent company? This is the containing the systemic risk point.

Marcia Goldstein: The parent company was the guarantor on all those hedges and all those contracts and *that* should have been subject of some regulation. If you're going to have a regulatory scheme that affects a financial institution like an AIG, that owns significant insurance assets but also wants to dabble in financial products, the parent company should not have been allowed to guarantee those claims—because then Bill is 100% right: we would had the ability to file the financial products business and resolve those claims separately and we would have been able to make an unqualified statement that this was of no import with respect to the insurance business.

Also we have the complexity of the regulators globally, and nothing I heard in terms of the resolution authority gave me comfort that we would be able to coordinate a global collapse. The problem with AIG is, we might have been to work with the New York regulator because we've done so in other situations, but we had no ability to predict how you're going to deal with the regulators in China, Japan, Europe. This was truly a global problem.

William Ackman: My point is, who cares about the AIG holding company? So what: it owns an aircraft company, it owns a financial products company, and it owns stock in a bunch of important subsidiaries. So it's a shareholder, those are the assets of the entity, you file the entity—big deal. And you do the same thing at Lehman: you file the parent company, you convert debt into equity until we have a solvent institution, and we don't invest taxpayer money.

If there's a role for the government, it's to provide temporary guarantees to instill confidence. If you look at the AIG financial products subsidiary, they had about \$450 billion of contracts. Three hundred billion were so called regulatory arbitrage contracts where the financial products subsidiary was guaranteed a bunch of loans for European banks so they wouldn't have to hold a lot of collateral against them. I don't think they'll make any payments on any of those \$300 billion worth of contracts. But on a mark-to-market basis they had to write a huge check because of all the stress going on in the world, and money went out to these banks, and they got paid for insurance—it's almost like you collect on your homeowners insurance even though there never was a fire; a complete disastrous waste of money and resources. They would have lost a little bit of money on subprime—\$30-40 billion maybe—and that's little in the context of what has been wasted, and what has been lost, and the destruction of a great institution.

Barry Adler: So you two at either end of our panel, Marcia and Bill, are denying the premise of systemic risk, at least with respect to AIG's collapse. Is that correct?

Marcia Goldstein: I said that had we had certain changes to the bankruptcy code we would have felt more comfortable letting the parent go. We were concerned with collapse of the

insurance businesses which would have caused a tremendous loss of value.

William Ackman: If I got to play God here is what I would have done: the problem we had is that Bear Sterns was saved, and then moral hazard was set between equity and debt. So the market was told, "Don't worry if you are an unsecured creditor, or if you're a CDS counterpart or another investment bank, you don't have to worry because we're going to flush the shareholders, we're going to give 2 bucks, maybe 10, something like that and the bondholders are going to be safe." That was the first mistake. What they should have done when Bear was on the brink of collapse was pull all the creditors in the room and say "This is what's going to happen. We are going to file this entity, unless we can come to a compromise—if we can't, we will file the holding company, and we're going to convert debt to equity until we have a solvent enterprise." And even in Bear Sterns there is enough capital in the holding company alone for there to be a solvent enterprise. Once that took place, the whole world is going look at every other financial institution to decide who is on the brink, and they're going to negotiate debt for equity conversions until we have a a solvent world. This whole holding company subsidiary debt equity hierarchy of claims all makes sense, and we completely violated it. I'm not sure why—whether ignorance, or politics, but I just think it was a disaster.

Barry Adler: Ignorance or politics as if those are separate?

Michael Krimminger: I think that it's important to make sure that we're talking about the same thing and talking about it from the same context as well. Our proposal, which is not always perfectly reflected in legislation adopted by the House or the Senate, is that you squeeze out any opportunities for the government to provide any kind of guarantees to individual firms. If the firm can't survive based on liquidity support then the firm fails and is put into an insolvency process in which the bondholders, the shareholders, and the creditors take the loss.

Any kind of liquidity assistance that would be needed in this bridge firm would not be funded by the government. It would be funded by the industry. We propose an *ex ante* fund—a resolution fund that's paid by assessments on the industry to make sure that it's not going to be coming from tax-

payer funds. If there is any shortfall, we take the money, shall I say, out of the hide of the shareholders, bondholders, and up the priority scheme, and ultimately that will be paid by the industry on the back-end as well.

As far as the issue of transparency, I think is a little bit of a misperception as well. Even in the FDIC receivership for banks, there is a full right of anyone who feels they are not treated fairly in their claim to go to court, challenge that claim and it's de novo review. There is no deference at all to any decision by the FDIC on the claim. In transparency, one of the things we think is important, and I agree with Judge Gonzalez, is that you have a very clear layout of the priorities of claimants. What we propose is a very clear layout of priority of claimants—one that people can challenge and that there would be regulations that specify what is going to happen in any of these receiverships. So I think the idea that there is not transparency in FDIC receiverships is not truly accurate.

As far as the bailout, liquidity support is very different from AIG, it's very different from TARP, it's very different from the bailouts that occurred in the fall of 2008. They occurred because there were really only two options as I pointed out before: bankruptcy, which would create quite a bit of concern and a dry-up of liquidity after the Lehman bankruptcy—I don't necessarily think that the Lehman bankruptcy filing itself created a loss of liquidity but I think it's fair to say that it contributed to the loss of liquidity in the system. After that, I don't think the regulators were comfortable taking that as the other option besides the bailout, so they engaged in a lot of bailout activity. We want to end that kind of bailout activity. An important issue is to make sure that parties do take haircuts whenever you can make them take a haircut and not expose the system to overarching risk of loss or collapse. That is really the only time that anything other than a haircut on creditors should apply. And again, our view is that bankruptcy should be the rule for virtually any kind of institution, including financial institutions. Except for the very rare case in the middle of a catastrophic collapse, there needs to be some short-term liquidity then make sure that shareholders and others take the loss and there should not be guarantees of particular firms' obligations across the board.

One last point is the issue about the temporary stay and the idea of having federal guarantees. I am very concerned

about the idea of federal guarantees, in part because of what did occur. Looking at the options of going into bankruptcy with the holding company, or doing some type of guarantee, the regulators did agree to provide ring-fencing for certain firms or holding companies. This was done in order to provide a guarantee that gave a backstop to help with market stabilization, if you will, of asset values to a degree, but certainly a stabilization of those firms more specifically. That's what we would certainly like to get away from; we want to get away from those firm-specific guarantees.

Arthur Gonzalez: I still come back to the point: why can't it be done in a bankruptcy court? We have the priority system there; it can play itself out. If the government wants to provide DIP loans for any bridge period, it can do that. Under the Code, it can act as quickly as anyone else in a much more open forum. So I don't understand necessarily why this should be run, even the exceptional case, by a government entity. I think it's much better to have the government entity on the outside, with its regulations, making whatever it needs available for liquidity. In that methodology, you wouldn't necessarily be bailing out equity; you wouldn't be bailing out creditors so much, you would just be maintaining the short term liquidity that is necessary from a system-wide standpoint, if that's the choice of the government. I don't understand the need to create a whole separate enterprise to deal with this.

Michael Krimminger: I co-chaired an international working group looking at some of the lessons from the crisis. One of the lessons that we drew from representatives of countries, the G-20 and others, was that we needed a way to have a more coordinated harmonization of national laws, so that we could improve the ability to coordinate these types of insolvencies and try to deal with some of the currently total unpredictability of the actions of laws in various countries. Despite the fact that we have a globalized financial system, we have a very nationalized legal infrastructure for dealing with firms in distress. What we saw in the fall of 2008 was that, with the uncertainty involved and the lack of tools, there was a complete resort to national solutions, which had some issues in a number of different insolvencies, including Lehman because of some issues between the UK and the U.S. and some other jurisdictions. But the reason, I would argue, bankruptcy may not be the best

tool in these rare cases is the need for quick, decisive action, where there needs to be an ability for someone to challenge a claim later, but not stop the ability to take the action to make transfers and sell assets immediately upon the insolvency.

Also, with a federal entity being involved in this process, you have the ability to put in place regulations, do a lot more pre-planning with foreign regulators, as far as how you will deal with a future insolvency. There's a lot of discussion right now about wind down planning, about trying to see what structures could be achieved internationally, to make sure that if there's a crisis for a particular bank, or a bank holding company, or financial firm, that there would be a way of working and coordinating these things. This process makes the firm think about resiliency planning in a way they hadn't thought about it before—how could you actually break up if you had to. That type of planning can better be done through a regulatory process. But I think, fundamentally, it's the ability to achieve immediate decisive action with funding from the resolution fund. Also the bankruptcy process, as I said, is wonderful for most insolvencies, but we're talking about that incredibly rare case where there simply is a need to provide additional funding, and that funding should be into a system that has the public interest, the systemic stability at heart, rather than just mediating and liquidating and litigating creditor claims.

Arthur Gonzalez: You can have a transparent claims process, but the way you describe it, you don't have a transparent transfer process. You're talking about the ability to make transfers, which would not be transparent, and there's no look back at that; it's over.

Michael Krimminger: There's transparency in the sense that people can challenge what has been done later. But that's why I'd emphasize the bankruptcy process is what should apply in everything except the very rare case. That's our goal, as well. But, in that very rare case, there's a need for speed to make those transfers without litigation of that issue before you make the transfer, because you really don't have even a day or two to do that in these cases.

Edward Morrison: I'd say that what's being proposed by the House and by President Obama is not reinventing the wheel. I admit that it might look that way. If you look at the

House bill, you'll see a set of provisions dealing with preferences, fraudulent conveyances, and other matters that are virtually identical to the Code. But instead of reinventing the wheel, the bill is shifting authority from bankruptcy judges to the Fed and FDIC. You could say that all we're doing is changing the primary decision-maker. Instead of a judge, we have the FDIC. To be sure, there is a downside to this change: the FDIC is judge, prosecutor, and defendant all at once.

But there are very important benefits that outweigh this downside. One is the speed of the process. You're right that there is very minimal review, at least *ex-ante* review, of any of the transfer decisions. That's the virtue of the FDIC process and that's why it can happen overnight. So speed is very valuable.

Suppose we have a systemic risk regulator who identifies systemically important institutions, imposes restrictions on leverage, restrictions on capital requirements, on trading. You live in a world where the federal government is monitoring firms and taking steps to constrain their activities. If you live in that world, which kinds of firms will end up failing and threatening our economy? Well, only those kinds of firms where the government and the rest of the public had no idea that they were as risky as they were. Their failure is a complete surprise, or the people inside that firm were hiding stuff, fraudulently, and we still are surprised. But in a world where we're surprised, and markets are surprised, that's where you have to act very, very quickly. So speed can be very, very important. The second part is the global process. You need a global solution to most of these problems, and the hope is that putting the authority in the executive branch creates a greater hope for international cooperation than putting the authority in the judicial system. That's just a claim.

But then one final interesting issue—and I'm not sure how it gets resolved—is how do you start the process? How do you commence the case? If you have the FDIC resolution authority, it's started whenever the FDIC feels like it's time to pull the trigger. We could have a situation where the government's gun shy and it takes too long to intervene, or we might have a trigger happy government. But any regulation is going to have those two kinds of problems.

If the FDIC doesn't have authority to commence a case, well how does it start? You might worry that fraudulent insiders are going to delay the case until it's really too late to take the right intervention. You could give the government power to bring an involuntary bankruptcy filing, but, frankly, an involuntary filing could be a bad thing. Just commencing a case sends a bad signal to the market at just the time when it's not appropriate to send that kind of signal.

I also want to make one point about what Mr. Ackman said. I get the impression, Mr. Ackman, that you sense that although we experienced a moment of systemic meltdown in fall of 2008, it was a moment that we created by bailing out Bear Sterns and Fannie and Freddie and thereby creating an expectation of government largesse, which deterred creditors from making the kinds of haircuts or offering the kind of cooperation that they might otherwise. I'm not sure, is that right? We lived in an environment with correlated portfolios due to a massive decline in housing prices that affected lots of banks. We also had a lot of overleveraged banks. And so you ask, if you have a series of firms that are suffering distress and are going to demand massive haircuts—Bear Stearns, Lehman, Fannie, Freddie, AIG, and it goes on—how many haircuts can counterparties suffer before they too are infected and become distressed? If you imagine a world where the portfolios of the institutions are highly correlated, as they are in fact in the real world, the failure of one institution will infect others. That's really what we're calling systemic meltdown: many institutions failing at exactly the same time.

William Ackman: What I would say is that one of the great solutions to an over-leveraged world is a world in which there is just debt for equity conversion until we readdress the leverage problem. It wouldn't bother me at all. All that happens when you have debt for equity conversion is a change in ownership of the institution from one investor to another. It's a change where the equity investor chose the capital structure they had with the amount of financial leverage they had, they were the beneficiary of the 40-to-1 leverage when prices were going up, so they have to suffer the consequences when prices are going down. The people who lent them money understood what the risk was and have to bear the consequences associated with that. The fear is that if we don't save the bond own-

ers then some insurance company might fail and that puts half their capital in financial institution bonds, and that is a very imprudent thing to do. What do you do with that insurance company? You convert their debt into equity until they are solvent and then the system delevers very quickly and it doesn't require taxpayer support.

Edward Morrison: I guess it's a speed of adjustment question. How quickly does the system adjust when Citibank has to write down a lot of its assets, including the claims it has on other institutions? Write-downs will deplete the bank's capital reserves dramatically. It won't lend as much going forward.

William Ackman: I think its counterparties become more solvent when they convert debt into equity, instead of the other way around. My point is I don't think we are better off now with the U.S. government effectively guaranteeing five trillion of Fanny and Freddie obligations and having \$180 billion in receivables with AIG and that company basically immolating. I think the system is better off when the people who bore the risk are responsible for their actions and there is a transfer of ownership to, first, the junior creditors, then the senior creditors, then to the secured creditors, until we have solvent institutions.

How do you get banks to start lending? There are financial institutions where it's questionable whether they are solvent based on their capital structures. If you convert sufficient debt into equity where they were so clearly overly-capitalized, the only way they could get a return on capital is to increase assets; which would force them to make loans, which would solve one of the problems we have in this economy, which is small and medium sized businesses access to capital. The problem we have is that putting equity into an insolvent institution, all you're doing is subsidizing a bondholder, and even the management would be better off. If you own options today in a bank of questionable solvency, you aren't motivated to stay with that financial institution because you don't think your compensation is going to be worth anything, so you leave and you go elsewhere. All the best people leave—you have a brain drain, and gradually the institution deteriorates. Whoever thought of this whole bankruptcy thing and the hierarchy of claims, they were smart and the further we have gotten away from that, the worse the consequences. If you think about this

from a political point of view, not only are the citizenry going to be a lot happier when the bondholder that took the risk suffers the consequences, but the management is going to be better off, and the only people who would suffer are the people today that earned an excess return on bank holding company bonds and are receiving treasury-like risk because of subsidies from the government, and I have no sympathy for those people at all.

Barry Adler: One editorial comment. This is gratifying to me, because I have talked about what is now called living wills for fifteen years, which would accomplish what you are saying without the threat of crisis. It would be done quickly, if not automatically, and that is something that Michael also referenced, so maybe that is something else that we could talk about.

Michael Krimminger: I think, surprisingly perhaps, we fully agree with the idea that with debt for equity conversions bondholders should suffer the losses, and the taxpayers should not be bearing any losses fundamentally. That is what we want to make sure ends up moving forward. All we may disagree on, and I'm not sure if we disagree on this, is that it may take time for the debt for equity swap, and something may need to be done in the interim. If the firm can't survive while it is negotiating the debt for equity swap without the system-wide liquidity support that might be necessary at a certain time, then close the firm, and you basically have debt becoming equity because they get wiped out.

William Ackman: Let me be clear. I think, of all the government entities involved in the financial crisis, that the FDIC has done by far the best job in how they have handled things, largely because I think they have acted in the most commercial manner, so I agree with what you said. I wish it had applied more globally to other institutions—not just 300 smaller banks, but also to the large ones as well.

Michael Krimminger: One clarification I want to make to what Ed was saying earlier is that we have never asked for, and never want to have, the sole authority to appoint us as receiver for any nonbank, or even any systemic bank. We have always said that needs to be done at least by what we refer to as the three keys, which means the Federal Reserve, us, and the Trea-

sury, in consultation with the President, or through some council with all of the regulators. We don't want that to be something we can do, so it would not be something we can simply assert.

AUDIENCE QUESTION: It seems that, even though the market is stabilizing, and banks seem back in the business of making money, that the FDIC seems almost on a roll in terms of taking over bank after bank, and I don't know if there is going to be any end to it. Though the economic situation seems to be stabilizing with respect to the banks, why is it that the FDIC banks don't seem to be a part of that recovery process?

Michael Krimminger: Well, there is one thing to remember. We have had a crisis that built up with a huge bubble—I wouldn't even call it underwriting that occurred in many cases – with badly underwritten loans that are still on a lot of banks' balance sheets. There is a lot of risk still on the balance sheets. There has been a lot of recovery, the market has been stabilizing. Unfortunately, banks tend to be lagging indicators of crisis, so after the crisis ends things tend to come home to roost on banks' balance sheets. There were some extraordinary actions taken for the largest banks, and they didn't close, but the small and medium sized banks are the ones that are closing and they are being subjected to the harsh realities of having made bad judgments.

What happened, of course, is that the larger banks tended to be the ones who originated, along with nonbanks – which were at least half the market — many subprime and other bad mortgages. What you saw with the medium sized and smaller banks is they tended to get in on the boom by investing in loans which were commercial real estate loans and development loans, and those loans take a little bit longer to go bad, but they are now going bad, so, unfortunately, there will be a substantial number of bank failures this year. But there is improvement in the market, and we are hoping the economy will continue to improve—and if the economy does so, then the number of bank failures will drop off much more quickly. There are still some bad assets to work off the banks' balance sheets.

William Ackman: While we have someone from the FDIC here, there are a couple of ideas I wanted to throw your way to prevent this from happening in the future. Why aren't deposit insurance premiums based on the risk of the institution? Is there real differentiation between one price?

Michael Krimminger: It is. We only had that authority starting in 2005, and in 2006 we got the regulations in place, so for a long time, we didn't have the ability to make much differentiation in risk. In fact, two weeks ago we put out a proposed rule which is going to put out an additional risk factor—executive compensation—so we are asking for comment. You can find it on our website, and we would appreciate comments from everyone because what we are trying to do is make it as detailed a risk-based premium system as possible. It is risk-based now, but we want to make it more reflective of actual risk.

William Ackman: Alright, if the concern is “too big to fail” institutions, why don't the capital requirements increase meaningfully once a bank gets above a significant scale, so that banks can make the decision, “Am I getting a sufficient economies-of-scale by virtue of being at this size to justify having to carry around the weight of more capital, or do I separate into two banks so I stay within the lower capital requirements?”

Michael Krimminger: Well, we would support that. In fact, one of the things that we hope would be accomplished by the Systemic Council that's been proposed in the House bill and is included also in the Dodd bill, in the Senate bill, is the ability for that council to basically say that, if a particular regulator is not imposing capital standards stringent enough on particular firms that could pose systemic risk to the system, the regulator must impose more stringent capital standards. We'd like to see not only higher capital standards but an resolution fund assessment for this firm that would be based upon the riskier activities. One of the risky activities could be simply mind-numbing complexity, which we've seen occasionally, as well as a level of inter-connectedness that creates additional systemic risk. So if you can pay the higher capital standards, and the higher assessments, and still operate efficiently for your shareholders, perhaps that's fine. But part of the debate that's ongoing right now, as the President's announcement yesterday illustrated, is whether that's still fine, whether there

should be some real limits on the types of activities that some firms should be engaging in and certainly our Chairman has advocated in the past, that you should move some things like proprietary trading or more risky activities outside of insured banks because you shouldn't be funding it with deposit insurance.

Barry Adler: Because high premiums do not prevent moral hazard. You can just keep cycling without regulation.

William Ackman: This sounds simple and silly, but I think it's true. If AIG's holding company had a totally different name from AIG subsidiaries—you know in Japan, it's just AIG, so people didn't know who they had their policy from—but if you had an entity, the holding company were required to have a completely distinct name, not be advertised along with the subsidiaries, but really was a segregation and rig fencing of the systemically important part, I just think we wouldn't have a lot of the fears about the runs because of the problems of the holding company.

Michael Krimminger: I would really like is the world which I learned about when I was in law school – where subsidiaries were really walled off in a clear way. I think one of the things we've learned in the crisis is that the walls tend to be very porous—both before a crisis and during a crisis—so it's difficult to do that, but we need to make sure that there's a clear separation of the types of activities that someone's engaging in with different subsidiaries. We obviously have an interest in making sure insured banks are protected from more risky activities.

AUDIENCE QUESTION: My question is for Marcia and for Bill specifically. Marcia touched on rating agencies doing automatic downgrades when a company goes through a debt-for-debt or debt-for-equity, sort of dilutive restructuring exchange. My question for Bill is: in your view, from seeing the markets on a daily basis, is there really an economic justification for such an automatic downgrade? What do you see when you see companies coming out of an out-of-court restructuring process with a more healthy capital structure, and does that justify those kinds of rating agency actions?

And my question for Marcia is: in your view, what would be the effect of the rating agencies' more rationally looking at

the prospective health of the company's balance sheet versus the fact there historically has now been some old news that presumably people already know.

Marcia Goldstein: I think the SD rating is a silly rating because when you do a debt-for-equity exchange you're de-levering and you're improving the balance sheet. You're doing exactly what you should be doing to enhance the debt that remains on the balance sheet. For the most part, from a company's standpoint, it would not care and just go ahead with the debt restructuring because the rating is not going to have an impact. Some of the creditors, in their lending groups, depending on who they are and what the impact of the SD rating would do to their books, do care, but, it may not be a big deal.

For an AIG, it is a big deal, because that's starts the ripple, with the insurance regulators. And so this juxtaposition of the rating agency, with this SD rating, with the insurance regulator having the ability, and perhaps in Japan, or wherever there may not be an understanding of what's going on here, suddenly using that downgrade as the basis to takeover the insurance businesses, creates a bad effect which impairs the ability to do effective debt restructurings, which require less capital because you're de-levering. So I think the current approach of rating agencies is a big problem that needs to be fixed. Certainly for institutions impacted by collateral calls and insurance regulators, these are huge impacts that impair a company's ability to effectively restructure.

William Ackman: And on the rating agencies, interestingly, President Obama talked yesterday about how banks, were largely responsible for the credit crisis. I would argue that the rating agencies were more responsible for the credit crisis than the banks themselves. Had the rating agencies not overrated structured securities, the banks could never have sold them to people who were looking for low-risk places to put capital., I get that banks certainly had their share of responsibility, but we're taxing the banks, we're trying to recover everything from the banks, when we should be recovering whatever we can from the rating agencies first, frankly. The rating agencies generally downgrade a company after it files for bankruptcy, that's kind of their strategy.

Barry Adler: They can notice that when there's bankruptcy filing there's something wrong—they're really talented people.

[Laughter]

William Ackman: Really what should happen, before a company is converting debt into equity, well before that point in time, the company's credit should be downgraded very significantly and then actually when the debt gets converted into equity—so now the debt is in a better position in the company—the rating should be going up. So they've got it a little bit wrong. They're terrible at what they do; they're a big cause of the credit crisis. I have no economic position on the rating agencies, I might even have some friends who work there, I hope not, but they've done more damage, and there should be more focus on the damage they've done and I wouldn't rely on them for their credit advice.

AUDIENCE QUESTION: The CIT example is an interesting example, but I feel like it's removed from the context of kind of the panic and the insanity of what was going on back in the fall of 2008. I mean Professor Morrison mentioned before, that Treasury Yields, I think, basically went to zero. People were actually paying the government to hold their money. And so, I guess that leaves me the question that well, maybe it could have worked, but what if it did. What if people didn't sit around rationally and work it out. The consequences, given the interconnectedness of all these institutions were so catastrophic, at some point maybe you just couldn't take that risk. I'm just not sure what the source of your confidence is, that all this would have worked out just fine and rationally.

William Ackman: The answer is that you could certainly have done it first, right? That you could certainly have gone around converting debt into equity, and if that didn't work, then fine, write a five trillion dollar check from the taxpayers. But, it's certainly worth a try. And, I think, had that happened—you know, Bear Stearns is going down, the equity stock is two dollars a share, and you negotiate a deal. Bear Stearns could have survived as an institution and could have continued to employ the people it employed, if all you did was took holding company debt and converted a lot of it into eq-

uity. The equity holders would have lost something close to what they lost in the purchase by J.P. Morgan, and the unsecured creditors would have actually had a chance to recover a meaningful amount of their investment had the institution done well over time. The same thing is true for Fannie and Freddie. And then the message that was sent by that, if the government is going to save every counterparty, then it's going to cause the riskiest counterparties to go run around in order to try to generate profits and enter into a lot of contracts right before they fail. That's really what happened to Lehman.

AUDIENCE QUESTION: I have a question. You very briefly mentioned the Chrysler bankruptcy and I just wanted to see what your views of that are, because to my view that was a very extreme example of unprecedented interference by the executive branch. Or in the more general context, I'm just wondering what effect that has on the general view of actors in the market place?

Arthur Gonzalez: As far the influence of the government upon the lenders from TARP, I think as a judge who presided over it, there's no record of that, number one. Number two, I think of we observed the actions of the banks who received the TARP funding, they are the least intimidated group I've ever seen in my entire life.

[Laughter]

They do what's in the interest of their institutions. The government gave them billions of dollars, they didn't open the credit market. The government complained, they still didn't open the credit market. They improved their balance sheets because that's what they thought their fiduciary obligations are and were. As far as other actions they've taken, they've continued to pay salaries in what they deemed is what's in their interest in spite of the actions of the government and complaints. So I never bought into that and there is no record of it. But even as a citizen I never bought into this idea that the government intimidated the bondholders to accept the Chrysler deal. I think the action of the government in Chrysler was a political decision. It's not a bankruptcy decision. Once the government comes in as the funder of the transaction, they're the funder of the transaction and I rule on the bankruptcy issues that come before me. I don't make political judgments of whether they should have done it,

shouldn't have done, is it good for capitalism, is it good for the markets—that is really not something that I believe should have been ever brought before me, and so, and I think others can comment on that.

William Ackman: I'll give a slightly different point of view. But I actually ultimately come to the same places as the judge, which is that absolutely there was enormous pressure brought to bear onto the hedge funds and others. President Obama made public statements which effectively threatened people who didn't go along with the deal. But I think what happened was that the Bush Administration did not want, at the end of a difficult administration, the capstone to be the failures of the bankruptcies of Chrysler and GM. So they punted Chrysler and GM into the Obama Administration by providing unsecured, unsecured credit that gave them the ability to survive until February/March, at which point it became an Obama problem. And then what the Obama administration did is they re-characterized those unsecured loans as DIP loans, effectively. And I think the unsecured creditors ended up with about what they would have recovered had it filed under the Bush Administration, had the government money come in as a DIP loan and had they been junior claimants. So I actually think what ultimately happened, and to the Judge's credit, and maybe to President Obama's credit, is what should have happened economically. It happened in an unusual fashion because of politics, but I do think the outcome is right. I do think it's dangerous to the extent that the government intervenes and affects priorities of claims in bankruptcies, and two similar claimants get different outcomes. But I do think the laws of rough justice applied here, and what should have happened ultimately happened.

Barry Adler: You're not saying that the payments were the same as if the government never intervened, are you? You don't think the payments of the UAW would have occurred in the private market, do you?

William Ackman: No, I'm saying that if Chrysler had simply filed without any DIP financing from anyone in the Bush Administration, the unsecured, the bondholders would have gotten less.

Barry Adler: Chrysler unsecured creditors got nothing, except the UAW, but not from the bankruptcy, this is a more complicated issue—

William Ackman: No, no the bondholders have made a recovery.

Arthur Gonzalez: The secured—

William Ackman: Yes, so my point is the secured bondholders got a recovery that was similar to the one they would have gotten had the government money come in as a DIP loan, as opposed to. . .

Barry Adler: That's right, that's not what you said earlier.

William Ackman: Okay I apologize.

AUDIENCE QUESTION: Can you address the effect of mark-to-market valuations on the asset valuations and the way in which they affect the rating agency devaluation, the acceleration of the illiquidity, the inability to trade. Why isn't that a focus?

Michael Krimminger: I don't want to get into all the intricacies of mark-to-market accounting, trust me, but certainly I think the bigger factor there is really just the lack of any kind of confidence by anybody in any kind of valuation. So whether you would do it under mark-to-market or not, there was a view by the market place that they were too uncertain about the value of any types of mortgage-related collateral, of mortgage-related assets, and any CDO or other types of structured investment vehicle that appeared to possibly have any exposures to these types of assets. So I think a huge contributor was that there was simply a complete pulling back, and I think that was reflected in the fact that virtually all funding seemed to go to Treasuries because they were all looking for a safe haven. I think that was just a lack of confidence in any type of other funding. Many argue to this day about what parts of a firm's balance sheet should be marked-to-market or how different firms treat their balance sheets for accounting depending upon their goals for particular assets. But I think that the fundamentally a lack of confidence of anybody in evaluation was simply the biggest issue, much more than mark-to-market accounting.

William Ackman: Just one quick thought on what I think I understand your question is—the impact of mark-to-market accounting on causing, and contributing to the credit crisis. Interestingly, I think mark-to-market accounting is one of the best means to prevent such a crisis in the future. What was unique about the current credit crisis—the institutions that created the systemic problem were given an exemption from having to post collateral on mark-to-market contracts. If you think about the institutions that have caused the credit crisis—the AAA rated institutions, ironically—it's the AIGs, the Fannies, the Freddie's, the MBIA's, the bond insurers, the mortgage insurers. The AAA institutions under the terms of the CDS contracts weren't required to post collateral. And so, the CEO of AIG has this division that was just printing money. They would collect premiums every month and never had to put up any capital. So they were earning infinite return on capital and it looked like the greatest business in the world, allowing management to do whatever they wanted.

Goldman Sachs, on the other hand, manages risk so that all their traders get paid based on a mark-to-market, including the mark-to-market of their counter parties. So if you've got a Goldman Sachs trader who had an oil contract with some energy company, and that energy company's credit worthiness was deteriorating as their CDS contract is widening, the trader's P&L would go down by the loss in value of that contract. The trader is incentivized to hedge that risk by buying a CDS contract. So let's say they have exposure to Enron, see that Enron is deteriorating—the trader is incentivized to buy the contract. If you were a AAA institution that's not required to post, there's no one disciplining you or warning you that there was a problem coming.

So I'm a big believer in mark to market accounting. You know, the hedge funds did not cause the credit crisis. And part of the reason why they didn't cause the credit crisis is that the investors were very close. The investors suffer the consequences, and also they weren't allowed to take risk they couldn't afford to; they weren't allowed to sell insurance on which they could not pay because hedge funds were required to post collateral with all the various counter parties.

So as long as there's a discipline requiring all the parties in the system to post collateral with each other, mark-to-market is actually a very good mechanism to keep everyone hon-

est. It's kind of the canary in the coal mine on upcoming problems. It's when there's an exemption. . .

Barry Adler: Alright then, I want to thank everyone on the panel and in the audience.