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The Resolution of Systematically Important Financial Institutions:
Lessons from Fannie and Freddie

Mark Calabria[1]

There was perhaps no issue of greater importance to the financial regulatory reforms of 2010 than the resolution, without taxpayer assistance, of large financial institutions. The rescue of firms such as AIG shocked the public conscience and provided the political force behind the passage of the Dodd-Frank Act. Such is reflected in the fact that Titles I and II of Dodd-Frank relate to the identification and resolution of large financial entities. How the tools established in Titles I and II are implemented are paramount to the success of Dodd-Frank. This paper attempts to gauge the likely success of these tools via the lens of similar tools created for the resolution of the housing government sponsored enterprises (GSEs), Fannie Mae and Freddie Mac.

An additional purpose of this paper is to provide some additional "legislative history" to the resolution mechanisms contained in the Housing and Economic Recovery Act of 2008 (HERA), which established a resolution framework for the GSEs similar to that ultimately created in Title II of Dodd-Frank. The intent is to inform current debates over the resolution of

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systemically important financial institutions by revisiting how such issues were debated and agreed upon in HERA.

Purposes of a Resolution Authority

To gauge the effectiveness of a resolution regime, it helps to have a clearly defined set of goals or purposes. In the area of bank resolution, there is considerable consensus as to those goals.[2] Many of these goals were explicated, debated, and examined by members of Congress and their staffs during the drafting of GSE reform.

Foremost among the purposes of a resolution regime, including a court-supervised bankruptcy, is to decide on the allocation of losses. In most circumstances, and definitely the case for a GSE resolution, the book value of liabilities will exceed the book value of assets. Given that book value can lag market value, the fair value of this difference can be quite substantial in a resolution. In the simplest terms, someone is not getting 100 cents on the dollar.

A resolution regime determines the process, the priorities, and even the "hair-cuts" imposed on creditors. Such a process was absent for the GSE before the passage of HERA. For instance prior to HERA, holders of agency mortgage-backed securities (MBS) had no guarantee that they would receive a higher priority in the resolution process than holders of unsecured GSE debt. In part this was due to the fact that the GSE did not organize their MBS pools as

[2] Generally see Phoebe White and Tanju Yorulmazer, 2014 "Bank Resolution Concepts, Trade-offs, and Changes in Practices", *Economic Policy Review*, Federal Reserve Bank of New York, Volume 20, Number 2 http://www.newyorkfed.org/research/epr/2014/1403whit.html

bankruptcy-remote trusts, as had been the case with private MBS pools. Specifying a chain of priorities can give market participants greater certainty as to their potential recovery in insolvency. Doing so also assists market participants in the pricing of different tranches of debt. As the largest cost in a corporate bankruptcy is generally the operation of a creditor committee, a resolution regime that specifies creditor priorities can substantially reduce administrative costs.

A resolution regime can also explicitly favor certain creditors over others. For instance the FDIC has generally treated foreign depositors differently than U.S. domestic depositors.[3] Of course the very structure of the FDIC treats depositors as a class separate from unsecured creditors. As witnessed in a variety of instances during the recent crisis, policymakers may also choose, *ex post*, to treat certain creditors more favorably than others without any statutory authority.

Administrative resolutions are occasionally claimed to be superior to a court-supervised bankruptcy due to concerns over potential contagion or panics.[4] During the financial crisis it was often claimed that firms could not be allowed to enter bankruptcy without causing a broader panic. The failure of Lehman Brothers is pointed to as evidence of this concern. While there is little debate over the ability of bankruptcy courts to resolve financial firms and allocate losses, the question is one of speed. The FDIC, for instance, allows insured depositors, and occasionally other creditors, to be paid immediately. While this is allowable under the bankruptcy code, it is not usual practice. Title II of Dodd-Frank is essentially a mechanism for quickly resolving non-bank financials in a manner similar to that for banks, with the exception that Title II appears on

[3] See Christopher Curtis, 2000, “The status of foreign deposits under the federal depositor-preference law,” *University of Pennsylvania Journal of International Economic Law* 21, Summer, 237-271.
[4] Federal Deposit Insurance Corporation. 2011. “The Orderly Liquidation of Lehman Brothers Holdings Inc. under the Dodd-Frank Act”, *FDIC Quarterly* Volume 5 #2.
https://www.fdic.gov/bank/analytical/quarterly/2011_vol52.html

its surface only to allow for liquidation. It also allows for the protection of certain creditors to forestall a panic. Accordingly, an administrative resolution regime is presented as an avenue for containing financial market contagion.

Whether an administrative resolution is quicker than a court-supervised bankruptcy is an empirical question. Both an administrative agency and court face similar tasks, such as judging the validity of claims. For most, if not all, of these tasks there is no "special sauce" that agencies have which courts lack. While the data is sparse, with important limitations, what data that does exist, suggest that FDIC receiverships are no faster than the typical Chapter 11 proceeding.[5] Both have a median time to resolution of 28 months. Since the FDIC is generally the largest creditor in the resolution of a depository, having the FDIC manage the failure of a depository may indeed offer some cost savings. In the case where the FDIC is not the largest creditor, for instance with an insurance company, it is far from obvious that the FDIC is cost effective.

A related, but separate, issue to contagion is the importance of maintaining "critical facilities." A rationale for deposit insurance is protecting the payments system. Given the important role of certain banks in the tri-party repo market, one could also imagine assistance being provided for those entities. If the resolution process for an entity administering critical facilities is uncertain, the ability of those facilities to access credit and basic services may indeed be hindered. Thus, both the bankruptcy code and FDIC administrative proceedings allow continued operation of the troubled entities during the resolution process. The central role of the GSEs in the U.S. mortgage market also demanded that a continuing operation of core facilities be possible should a GSE become insolvent.

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[5] Mark Calabria. 2010. *Failing Banks: Bankruptcy or Receivership?* Cato-At-Liberty. http://www.cato.org/blog/failing-banks-bankruptcy-or-receivership

All of the preceding rationales for a resolution framework were debated, either at the staff or member level, during the drafting of GSE reform. The included legislative history[6] is intended to shed some light on the substance and conclusion of those debates. The following is also meant to illustrate that regulators were not simply left helpless and without appropriate "tools" by Congress.

Comparing Bank and GSE Resolution

The resolution framework for the GSEs is explicitly modeled on the Federal Deposit Insurance Act, as is the orderly resolution authority established in Title II of Dodd-Frank. There are a number of important differences between GSEs and depositories that require some modifications to the traditional FDIC approach.

There are also a number of differences in the GSEs model that make resolution relatively simpler than similarly sized bank (bear in mind that by level of assets, Freddie Mac is close in size to Citibank).[7] One difference that has vexed policymakers is the issue of cross-border resolution. Given the many foreign subsidiaries of large U.S. banks and the difference in national resolution regimes, handling the failure of a large internationally active entity remains an important public policy issue. Fortunately that is not an issue with Fannie Mae or Freddie

[6] Of course one person's faulty recollection of events, sometimes a decade previous, does not officially constitute "legislative history" in any legal sense. The recollections provided here are meant to inform on-going and future debates as to the resolution of large financial companies.

[7] For a fuller comparison, see Larry Wall, W. Scott Frame and Robert Eisenbeis. 2004. "Resolving Large Financial Intermediaries: Banks Versus Housing Enterprises," Federal Reserve Bank of Atlanta Working Paper No. 2004-23a; and David Carpenter and M. Maureen Murphy. 2008. "Financial Institution Insolvency: Federal Authority over Fannie Mae, Freddie Mac, and Depository Institutions," CRS Report for Congress. Congressional Research Service. September 10.

Mac. Neither have foreign subsidiaries. There is no need to for Washington (or New York) to coordinate with London (or elsewhere) in the resolution of a GSEs.

Relatedly, the GSEs are relatively simple organizations when compared to similarly-sized financial companies. Their legal structures are not particularly complex. Questions as to the relationship between subsidiaries and a holding company are not relevant. Questions as to the relationship between affiliates, such as those raised under Sections 23A and 23B of the Federal Reserve Act, are not relevant. GSEs engage in a relatively small number of activities and ones that are transparent and easily understood. Their core business is not a mystery. As such, a GSE is far easier to reorganize or resolve than a comparably sized bank.

The GSEs also lack debt that could be described as "demandable." Almost all their debt issuance is relatively long-term, with only about half coming due within a year. Text book style bank runs simply are not an issue with the GSEs; although roll-over risk may be a concern.[8] About half of GSE debt is in the form of MBS, which offer the security of the underlying mortgages as collateral.

Contrary to popular perceptions, the FDIC generally avoids liquidating a failed bank. The preferred strategy is to sell the bank "whole" in a "purchase and assumption" transaction to another bank. Under such circumstances, there is no liquidation. The purchasing bank takes both the assets and liabilities of the failed bank, occasionally with some assistance from the FDIC. It was recognized that such a strategy would be both politically and administratively difficult for a failed GSE. Obviously the size of either Fannie Mae or Freddie Mac would make a direct purchase unlikely. And even if such a purchase could be arranged, Congress wanted

[8] For Fannie Mae's outstanding debt, due within one year, the effective term to re-pricing generally runs between 4 and 5 months. For Fannie Mae's longer term outstanding debt, the typical effective term to re-pricing is 60 months.

ultimate say over such a transaction. Accordingly HERA explicitly relies on a "bridge bank" structure under which an insolvent GSE continues its operations and the existing charter is retained. As with the FDIC, conservatorship was not viewed as a likely option for an insolvent entity. Conservatorship was largely perceived as a "holding tank" for an illiquid GSE. Conservatorship for a GSE was envisioned to last no more than six months, after which a GSE would be expected to either leave conservatorship or enter receivership.

The Road to GSE Resolution Authority

> **Chairman Richard Shelby**: "There is a perception by some people that some of the largest banks are too big to fail.…In that context, do we need to give the new proposed GSE regulator the same type of systemic risk powers that FDIC has?
>
> **Chairman Alan Greenspan**: "I would certainly think so, sir."
>
> Hearing before the Senate Committee on Banking, Housing and Urban Affairs, February 24, 2004

On June 9, 2003, Freddie Mac dismissed its three most senior executives, including its CEO.[9] It was later revealed that Freddie Mac had been engaged in manipulating its earnings; a finding applied to Fannie Mae almost a year later. Of additional concern is that its then regulator, the Office Of Federal Housing Enterprise Oversight (OFHEO), in its annual Report to Congress, also released in June 2003, praised Freddie Mac's audit and accounting functions as

[9] http://articles.baltimoresun.com/2003-06-10/news/0306100348_1_freddie-mac-weakness-chief-financial-officer

"independent and effective," as well as claiming that Freddie Mac's internal audit function "appropriately identifies and communicates control deficiencies to management and the Board of Directors."[10] Those observations on the part of OFHEO proved stunningly wide of the mark.

Public and congressional concerns as to the potential systemic risk of the GSEs were nothing new. What gave much needed energy to the debate was the sudden loss of confidence in their accounting and also in the competence of their regulator. The events of June 2003 and subsequent congressional hearings that fall led many in Congress to believe that no one was "watching the store"—not the management, not the board, and unfortunately not the regulator. What was needed, at a minimum, was a new regulator with enhanced powers. At no time during the 2003 to 2008 congressional debates was serious consideration given to eliminating the GSEs, which was seen as politically impossible. As a participant in those debates, I can attest that just imposing "bank-like" prudential standards on the GSEs was hard enough politically. Reform was almost exclusively focused on the powers of the regulator.

During the 108th and 109th congressional sessions, Senator Richard Shelby (R-AL) chaired the Senate Banking Committee and led efforts to reform the regulatory structure of the GSEs. The author served on Chairman Shelby's staff during that time. Senator Shelby's instructions to staff were to create a GSE regulator that was as "bank-like" as possible. While the 2003 Shelby bill was based upon a bill in the House of Representatives (H.R. 2575) introduced by Representative Richard Baker (R-LA), it was felt that the receivership provisions of the Baker bill (section 134) did not sufficiently mirror the existing framework for depository institutions.

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[10] OFHEO, *Report to Congress*, June 2003, pages 36-37.

The 2004 Shelby bill was considered by the Banking Committee on April 1, 2004, using Senator Hagel's bill (S. 1508) as the base text for the mark-up. Essentially the entire text of S. 1508, as introduced, was struck and replaced by a Chairman's "mark" drafted by Chairman Shelby's staff. S.1508 was reported out of Committee with receivership provisions that more closely mirrored the Federal Deposit Insurance Act. These provisions were later modified and included in the 2005 Senate consideration of GSE reform, where the base text was S.190, marked-up by the Banking Committee on July 28, 2005.

In crafting the conservator and receivership provisions that eventually comprised Section 1145 of HERA, the Committee staff, under the direction of Chairman Shelby, quite literally "marked-up" Sections 11 and 13 of the Federal Deposit Insurance Act (FDIA). Every line of those sections was examined and debated over to consider whether they would be appropriate for GSEs. The presumption was that FDIA powers would apply to a GSE resolution, unless there was a compelling reason otherwise. By that time the Committee also had little faith in the ability of the GSE regulator. It was anticipated that OFHEO or any successor organization would not implement regulations surrounding a GSE conservator or receivership before they were needed. The authorities contained in statute would have to suffice on their own. It was also intended that the existing body of law, including court decisions, surrounding the FDIC's exercise of its conservator and receivership powers be incorporated into that governing the GSEs.

It was recognized that doing so would give the new GSE regulator considerable—some would say extraordinary—power. This was intentional. By placing the GSEs within the body of law governing bank receivership the Committee intended to create additional certainty over how a GSE would be resolved in the case of insolvency. It was also the understanding and intent of the drafters that such powers would be used. The receivership provisions contained in HERA were never intended to be a “dead letter.” They were meant to be used.

The Banking Committee considered the approach of placing the GSEs within the bankruptcy code. Contributing to the uncertainty of how a failed GSE would be handled is that prior to 2008, the GSEs were understood by many to be exempt from the bankruptcy code, although such is not explicit. In the absence of either explicit court or administrative powers, the failure of a GSE could well force a congressional rescue and at a minimum would entail significant uncertainty. During the Committee mark-up of S.1508 in 2004, Senator John Sununu (R-NH) offered amendments that would have allowed the regulator to file a bankruptcy petition in the case of GSE insolvency. The Sununu amendments also clarified that a GSE would not be treated as a “governmental unit” for the purposes of a bankruptcy. The Sununu amendments were withdrawn and never voted upon. The primary concern was that by including these amendments jurisdiction over the proposed legislation might be extended to the Senate Committee on the Judiciary, which has jurisdiction over the bankruptcy code. Given the existing complexity of reform, involving negotiations with another committee were viewed as an unsurmountable obstacle to reform. These provisions were not rejected because any perceived inadequacies in the bankruptcy process.

The conservator and receivership provisions in HERA were largely taken from the 2005 Shelby bill (S.190 as amended in Committee). Little debate in 2008 occurred around these provisions, despite the change in control of the Senate from Republicans to Democrats. The following are a number of specific issues debated within the Senate Banking Committee in the years leading up to the passage of HERA.

The Role of the U.S. Treasury

A crucial question during GSE reform was where to house the new regulator. The Bush administration initially proposed to model the new regulator on the Office of the Comptroller (OCC) and place it within the Department of the Treasury. A bill (H.R. 2803) was introduced in the House by Representative Ed Royce (R-CA) in July 2003 that followed this suggestion. By the time the Senate began its deliberations and in response to congressional objections, the Bush administration softened its preferences for Treasury control, only stipulating certain conditions that should apply and expressing some preference for those conditions.[11]

Regardless of the preferences of the Bush administration, momentum in Congress quickly built against a policy or supervisory role for the Treasury Department. Generally Democrats did not trust the Bush Treasury, fearing a too aggressive regulator, while Republicans feared that housing the regulator within the Treasury would "harden" the implied guarantee, as market participants might perceive such as bringing the GSEs ever closer to having their debt viewed as equivalent to treasuries.

The Treasury, or its related agencies (Office of the Comptroller of the Currency), are often given important roles in the supervision and resolution of depositories. The OCC, as the primary regulator of national banks, can appoint the FDIC as receiver of a national bank. The Treasury Department also has a critical role to play when the systemic risk exceptions to the least-cost resolution requirements of Section 13G of the Federal Deposit Insurance Act are invoked. Congress specifically and intentionally gave FHFA sole authority over a GSE conservatorship or receivership. Only FHFA can decide when a GSE enters or leaves. No other

[11] See Statement of John W. Snow, Secretary, U.S. Department of the Treasury, before the United States Senate, Committee on Banking, Housing and Urban Affairs, October 16, 2003.

entity has legal authority to appoint FHFA as conservator or receiver. Nor is there any systemic risk exception contained in HERA.

The sole authority granted to the Treasury under the GSE provisions of HERA is in the exercise of its rights as a creditor, should it provide assistance to the GSEs. While a creditor can, of course, negotiate certain provisions as a condition of providing credit, under no circumstances can those conditions supersede other provisions of law. The Treasury has no authority to assume the powers of a conservator via its rights as a creditor. The Treasury can no more, as a creditor, bind FHFA's authorities, than could a holder of bank debt bind the powers of FDIC. Moreover, FHFA, as an independent regulator, has no authority to delegate its powers as a conservator/receiver to the Treasury or any other government agency.

The role of the Treasury was viewed under HERA as that of a creditor. The Treasury was directed to consider issues of priority and protection of the taxpayer. In addition, such assistance was intended to be temporary, as is the nature of credit, rather than perpetual, as is the nature of equity. Put simply Treasury assistance to the GSEs was envisioned to take the form of a senior debt, something like debtor-in-possession financing. Such assistance was not intended to keep the GSEs out of receivership or to transfer losses from creditors to the taxpayer.

Avoiding "Takings" Claims

Ours is a Litigious Society. The design of any resolution framework must take such into consideration. Such was explicitly examined during the construction of a resolution framework for the GSEs. In order to obtain federal deposit insurance, bank owners agree to accept the terms of the bank charter and the legal framework surrounding those terms. As such, their ownership in a bank can have considerable value. That value can be lost in a resolution. In fact one of the objectives of a resolution may well be to impose losses on equity.

The FDIC has authority to invoke a receivership when a depository institution still has some positive book value. Committee staff were concerned that if FHFA could invoke a receivership while a GSE still had a positive book value, then shareholders could make a "takings" claim.[12] For this reason, a mandatory receivership is not invoked until a GSE has a book value of zero or less. Furthermore, shareholders would also receive any excess value obtained from the performance of a failed GSE's assets. HERA establishes a "good bank/bad bank" or bridge bank model to allow a failed GSE to be quickly reorganized. In such reorganization, shareholders are left with the "bad" bank, but could receive any excess value should assets end up being worth more than liabilities.

Treatment of Favored Creditors

A resolution mechanism can explicitly prefer some creditors over others, regardless of what place in line those creditors have contracted for. A variety of entities are significant holders of GSE debt. Insured depositories have large holdings of GSE debt, as do other financial market participants, such as insurance companies and pension funds. Of particular importance are the large holdings of GSE debt by foreign governments, especially foreign banks. Some of these central banks, such as the Chinese and Russian, have unique and critical relationships with the United States. These central banks are also large purchasers of U.S. Treasury debt. The Banking Committee was not unaware of these relationships. In fact concerns were repeatedly

[12] The fifth amendment's requirement that not private property not be taken by government without compensation could potentially arise when a public company is acquired by the government while there is some probably that shareholders equity still have a positive value, see generally Richard A. Epstein (1985). *Takings: Private Property and the Power of Eminent Domain*. Cambridge: Harvard University Press

voiced that if left to the Treasury, credit losses on GSE debt holders by foreign central banks would transferred to the American taxpayer. This was viewed as an unacceptable outcome. The lack of an explicit creditor preference for foreign agencies is not due to Congress having overlooked the issue, but rather to Congress having rejected such a preference.

Conservatorship versus Receivership

As a rough approximation, about 90 percent of the energy and thinking of Congress in relation to resolution were devoted to receivership as opposed to conservatorship. Similar to bank conditions under the FDIC, it was assumed that conservatorship would rarely be used and if it was used, it would be brief. As it clear under HERA, any reorganization or wind-down would occur under a receivership, which itself had explicit time limits, albeit measured in years. The receivership framework created in HERA was established both because the existing conservatorship framework was inadequate but also because conservatorship itself was believed inadequate. The limbo currently being experienced by the GSEs was never intended by Congress and is quite contrary to the framework established in HERA.

The Path Not Taken

The preceding demonstrates that most, if not all, the rationales asserted commonly for the rescue of large financial entities were contemplated and addressed in regards to the GSEs in HERA. The tools to resolve a failed GSE, without cost to the taxpayer, were created and in place by September 2008. Those tools closely mirror both the Federal Deposit Insurance Act and those created in Title II of Dodd-Frank. Yet, those tools where not used.

As the FHFA and Treasury only offer vague generalities at the commencement of the conservatorships of Fannie Mae and Freddie Mac, one can only parse their statements and actions for the actual intent. Certainly the primary objective of Treasury and FHFA was to guarantee that GSE creditors did not take losses, despite clear statutory intent otherwise. As Dodd-Frank's Title II is presented as a way to impose losses on creditors, this issue is of paramount importance if Dodd-Frank is to have any credibility.

There are at least three reasons that the Treasury and FHFA may have wanted to protect GSE creditors. The first is foreign policy concerns. Foreign governmental entities, including central banks, are large holders of GSE debt. Despite Congress having contemplated and rejected treating foreign governmental entities as favored creditors, the Treasury, in particular, may have felt that allowing a default on GSE debt would be viewed internationally as the equivalent of a default by the U.S. government. As many large holders of GSE debt were also holders of U.S. Treasury debt, that concern was likely foremost on the minds of policymakers. Although a GSE default could well have triggered a "flight to quality" driving down the yield on U.S. Treasuries.

The GSEs were not alone in receiving an implied guarantee, even if they represented an extreme version of such. As their failure came at a time of particular stress in the U.S. financial markets, Treasury officials may have felt that imposing losses on GSE creditors would have called into question any implied guarantee among other troubled institutions. If Fannie Mae and Freddie Mac were allowed to fail, then would not the same be possible for Citibank or Bank of America? If the Treasury desired to maintain an implied guarantee behind the largest banks, then protecting Fannie Mae and Freddie Mac would have been necessary.

GSE securities were also held across the U.S. financial markets. At the time of the crisis, GSE securities held by depositories was well over 150 percent of Tier 1 capital levels for the banking system as a whole. About 3 percent of insured depositories held GSE securities at levels in excess of 500 percent of their Tier 1 capital.[13] GSE securities were also broadly used as collateral in the repo market. Allowing even minor haircuts on GSE debt could have contributed to the failure of hundreds of (mostly small) banks.[14] The GSEs also held large derivative positions with a small number of commercial and investment banks. To some extent the rescue of Fannie Mae and Freddie Mac was a rescue of the banking system. While most of these holdings were known, in some cases publicly, the Treasury may have felt that allowing losses, even small ones, on such a large number of institutions would undermine confidence in U.S. financial markets.

Lessons for the Future of Too-Big-To-Fail

There are perhaps no companies considered more "too big to fail" than Fannie Mae and Freddie Mac. Recognizing the harm a disorderly failure of a GSE could cause, Congress established in law in the summer of 2008 a resolution mechanism that would allow an insolvent GSE to fail without cost to the taxpayer and in an orderly manner. Despite those tools being in place, they were not used. That failure raises the distinct possibility that even though Dodd-Frank creates similar tools for other large complex financial organizations those tools will simply be ignored. How can policymakers increase the likelihood that such tools will be used?

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[13] Federal Deposit Insurance Corporation. 2004. *An Update on Emerging Issues in Banking: Assessing the Banking Industry's Exposure to an Implicit Government Guarantee of GSEs*, Federal Deposit Insurance Corporation. https://www.fdic.gov/bank/analytical/fyi/2004/030104fyi.html

[14] Tara Rice and Jonathan Rose. 2012. "When Good Investments Go Bad: The Contraction in Community Bank Lending After the 2008 GSE Takeover" Board of Governors of the Federal Reserve System IFDP 1045.

Both Dodd-Frank and HERA leave regulators with considerable discretion. As long as regulators have such discretion, the choice of personnel also becomes one of policy. One avenue for reducing "too big to fail" is to appoint regulators individuals who place a larger weight on ending bailouts than does the public, something along the lines of Kenneth Rogoff's "conservative banker," except for rescues rather than monetary policy.[15] The appointment of Thomas Hoenig to Vice-Chairman of the FDIC can be viewed in such a light. His selection was a conscious strategy by the Senate Republican leader along these very lines.

Congress may also choose to limit the discretion of regulators. In a few instances, Dodd-Frank attempts to limit regulatory discretion, such as the Federal Reserve's use of its Section 13-3 authorities. In establishing a mandatory receivership mechanism for the GSEs, HERA also attempted to limit regulatory discretion. What HERA missed was that regulators would simply ignore those limitations. This is perhaps the hardest question in ending bailouts. Regulators rarely suffer when they violate legal restrictions on their ability to assist failing firms. For instance FDIC's broad guarantee of bank debt during the crisis lacked any basis in law, but no one at the FDIC has paid any penalty for doing so. The general public lacks any standing to sue regulators for statutory violations. Until a better solution is found, efforts must be made to change the culture of bank regulators. Instead of a "whatever it takes" mentality, regulators should be encouraged to embrace a "whatever the law directs" mentality.[16] Regulators should also not simply assume that if they lack tools which they would like to have that somehow Congress simply forgot to give them such tools. In many instances Congress did indeed debate giving regulators certain tools and then decided not to. A number of regulators have expressed

[15] Kenneth Rogoff. 1985. "The Optimal Degree of Commitment to an Intermediate Monetary Target," *The Quarterly Journal of Economics* Vol. 100, No. 4 November, pp. 1169-1189

[16] For an up close picture of "whatever it takes" see David Wessel, *In FED We Trust: Ben Bernanke's War on the Great Panic*, Crown Business 2010.

dismay at being "second guessed" post-crisis, especially by Congress.[17] Such regulators may well keep in mind that Congress doesn't usually enjoy being "second guessed" by regulators on what powers said regulators were given.

The regulatory culture around financial rescues is also driven by how those rescues are portrayed. A number of commentators, including some regulators, have argued that if Lehman Brothers had been given assistance, much of the financial crisis would have been avoided. Doing so, however, would send a signal to market participants that regulators are comfortable with rescues. Regardless of one's views on the effectiveness of rescues, the need to avoid the appearance of "victory laps" should be obvious. A better solution would be for rescues to be accompanied by the resignation of the responsible regulators along with the responsible management (or not to engage in rescues at all).

A difficult policy question is how to handle foreign governments as creditors.[18] Congress did examine the issue of foreign governments as large holders of GSE debt. Congress made the choice not to treat such creditors as favored. But Treasury Secretary Hank Paulson apparently did not agree with Congress and during the crisis assured Chinese officials that their holdings would be protected, despite not having any legal authority to make such assurances. Given that the role of sovereign wealth funds as investors in many large U.S. financials, the significance of foreign policy considerations is not limited to Fannie Mae and Freddie Mac. Should Congress accept that the Treasury (and White House) will occasionally treat some foreign investments as "favored" despite statutory provisions otherwise? Should such creditors

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[17] See Timothy Geithner, *Stress Test: Reflections on Financial Crises*, Crown 2014.

[18] See William Patalon III, "Foreign Bondholders – and not the U.S. Mortgage Market – Drove the Fannie/Freddie Bailout," *Morning Money*, September 11, 2008. http://moneymorning.com/2008/09/11/fnm/

be given an express preference? If they were, hair-cuts would have to be imposed upon other creditors, while also forcing these favored foreign creditors to receive lower yields.

Conclusion

Dodd-Frank's efforts to create an orderly resolution framework closely mirror similar attempts at ending the "too-big-to-fail" status of the housing enterprises, Fannie Mae and Freddie Mac. Title II's orderly liquidation authority mirrors the receivership provisions created for the GSEs in HERA. These provisions were operational by September of 2008, yet were not used. Several of the reasons they were not used are applicable to Dodd-Frank's Title II, suggesting that its tools will also be ignored by policymakers and the comfortable and familiar route of taxpayer rescue will again be taken.

The neglect of HERA's tools and the likely similar neglect of Dodd-Frank's suggest a much deeper reform of our financial regulatory system is in order. The regulatory culture of "whatever it takes" must be abandoned. A respect for the rule of law and obedience to the letter of the law must be instilled in our regulatory culture. More important, the incentives facing regulators must be dramatically changed. If we hope to end "too-big-to-fail" and to curtail moral hazard more generally, significant penalties must be created for rescues as well as deviations from statute. A very difficult question is that lack of standing for any party to litigate to enforce statutory prohibitions against rescues.

Of course all of these objectives are more difficult to obtain under a regulatory environment that lacks transparency. While Dodd-Frank has made modest advances in forcing financial regulators to become more transparent, it falls short in relation to future regulatory actions. A policy audit of the Federal Reserve would be a useful starting place. Any exercise of the Federal Reserve's Section 13(-3) powers should be subjected to an immediate independent audit.

Policymakers must also review regulatory decisions that create systemic risk. For instance, despite a the lack of a explicit guarantee and statutory language to the contrary, bank regulators have treated, for regulatory purposes, the debt of Fannie Mae and Freddie Mac as "risk free." But it should be obvious that such debt is not risk free. As a Banking Committee staffer in 2004, I queried senior FDIC staff on this issue and received little more than a shrug. The fact is that a rescue of GSE creditors was made more likely because bank regulators treated it as such. Similar issues have arisen in the euro area with the regulatory treatment of sovereign debt. It is reckless enough when legislators choose to treat risky debt as risk free, it is puzzling when prudential regulators choose to do so.

My experience attempting to avoid a taxpayer assisted rescue of Fannie Mae and Freddie Mac leaves me pessimistic as to avoiding bailouts for other large financial institutions. My skepticism of Dodd-Frank's resolution powers derives from the experience of having tried such tactics for the GSEs and watching them fail. To guarantee the success of Dodd-Frank's efforts to end taxpayer-assisted rescues, we must learn from the failure of similar efforts for the GSEs.