Copyright 2014 by John Crawford
Northwestern University Law Review

"SINGLE POINT OF ENTRY": THE PROMISE AND LIMITS OF THE LATEST CURE FOR BAILOUTS

John Crawford [*]

If the Holy Grail of financial reform is ending large financial firms' status as "too big to fail," most observers agree it remains elusive. The Dodd-Frank Act purported to solve the problem through the creation of a new mechanism for the resolution of failed financial behemoths called the Orderly Liquidation Authority (OLA).[1] As it was outlined in the statute, however, the OLA was widely deemed inadequate.[2] Now, pursuant to their Dodd-Frank authorities, regulators are poised to adopt a new resolution approach that has reanimated hopes for a credible solution to the too-big-to-fail problem. The approach combines a strategy of "single point of entry" (SPOE) resolution for systemically important financial institutions (SIFIs)[3]—involving the resolution of the SIFI's parent holding company while leaving its operating subsidiaries untouched—with a requirement that SIFIs issue a minimum amount of long-term debt.[4] This piece briefly describes the problem this proposed approach aims to solve and assesses its likely efficacy, focusing on the long-term debt requirement. The good news is that the long-term debt requirement will likely improve financial stability and reduce the probability of bailouts. We should nevertheless view with skepticism the claim that the long-term debt requirement and the SPOE approach provide a definitive solution to the too-big-to-fail problem.

---

[*] Associate Professor of Law, University of California, Hastings College of the Law. I am grateful to Abe Cable, Bill Dodge, Jared Ellias, Cathy Hwang, Mike Klausner, Stephen Lubben, Zachary Price, Morris Ratner, and participants at the UC Hastings Junior Faculty Workshop for helpful comments on early drafts of this essay.

[1] 12 U.S.C. § 5384 (2013) [http://perma.cc/S6EW-U4TC].

[2] *See, e.g.*, DAVID SKEEL, THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS (UNINTENDED) CONSEQUENCES 117–27 (2011).

[3] Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76614 (proposed Dec. 18, 2013) [hereinafter FDIC Proposed Rule] [http://perma.cc/WV58-LWFM]. The rule, which has not yet been finalized, does not supersede the FDIC's powers under OLA, but rather attempts to flesh out how it would employ those powers.

[4] The long-term debt proposal has been postponed, likely until 2015. Ryan Tracy, *Fed's Long-term Debt Rule May Slip to 2015*, MONEYBEAT (June 10, 2014, 6:25 PM), http://blogs.wsj.com/moneybeat/2014/06/10/feds-long-term-debt-rule-may-slip-to-2015 [http://perma.cc/MVR2-YYXD]. Authority for the rule arises from Dodd-Frank § 165, which empowers the Federal Reserve to prescribe enhanced prudential standards for SIFIs. 12 U.S.C. § 5365 (2013) [http://perma.cc/RF5F-NCXB].

I. THE PROBLEM

The dilemma financial regulators faced repeatedly in 2008 can be analogized to the problem of a fictional drought-stricken town whose fire department chief is anxious about private citizens setting off home fireworks throughout the summer.[5] Concerned about spotty enforcement of a prohibition on the fireworks, the chief announces that the department will deny its services to any citizen who sets his or her house ablaze with home fireworks.[6] When someone ignores the admonition and his house catches fire, the chief may face an unpalatable choice: either allow the fire to continue at risk of grave danger to the lives and property of innocent parties; or renege on the threat, thereby undermining the department's credibility, rewarding the rule breaker, and increasing others' incentive to flout department directives and take excessive risks going forward.

The fire chief *may* face such a nasty choice, but there is a third possibility: if sufficient firebreaks exist around the property in question, it should be possible to let the fire burn without running too great a risk that it will spread.

The analogy to financial crises and the goals of reform is straightforward. Drought conditions correspond to a fragile market, where creditors fear for the solvency of the entire system. When a SIFI falters, bailing it out is like dousing the amateur pyrotechnician's home and is objectionable for the same reasons: it wastes public resources, protects those who took excessive risk from the consequences of their actions, and removes the incentives of others to curb their risk-taking going forward.[7] On the other hand, allowing the institution to fail may cause losses to propagate through the financial system and the real economy,[8] thus harming innocent bystanders. The collateral damage from a SIFI's failure can be as terrifying as an uncontrolled fire.

Regulators need credible firebreaks—a way to stop panic and losses from spreading—in order to escape the awful choice between a bailout and risking a financial wildfire. Of particular concern in building such firebreaks is a special class of creditor, namely depositors and those who hold deposit-like, short-term debt outside the traditional banking system.[9]

---

[5] The fire analogy for financial crises is, of course, well established. *See, e.g.*, Charles A.E. Goodhart & Enrico Perotti, *Preventive Macroprudential Policy*, VOX (Feb. 29, 2012), http://www.voxeu.org/article/preventive-macroprudential-policy [http://perma.cc/4JXW-HLTV].

[6] For purposes of the stylized example, assume perfect visibility into fire causes.

[7] The analogy, of course, is not perfect, for SIFIs may fail even if they are not engaged in activities deemed too risky ex ante. The ex post dilemma faced by regulators, however, remains structurally similar.

[8] For an account of loss propagation mechanisms in a financial crisis, see John Crawford, *Wargaming Financial Crises: The Problem of (In)Experience and Regulator Expertise*, REV. BANKING & FIN. L. (forthcoming 2014).

[9] A primary example of deposit-like debt outside the traditional banking system is the "repurchase agreement," or "repo," where a depositor (such as a money market fund) will lend a bank (such as a

Such debt creates the risk of a run on the issuing institution, with all its attendant pernicious effects.[10] Unlike traditional bond investors, who care *primarily* about risk-adjusted return, holders of deposit-like debt care *primarily* about two things: (i) immediate access to the cash due them when the debt matures (or on demand, as with bank deposits); and (ii) full recovery of the principal of their deposit or deposit-like loan. These may be termed, respectively, the "no delay" and "no haircut"[11] conditions for run prevention.[12]

When fear overwhelms greed in markets, the violation of one or both conditions for deposit-like debt issued by a SIFI can inspire a run on *other* similar institutions.[13] This "contagion by simile" is one of the key channels of loss propagation in a crisis. Preventing this dynamic requires meeting both the no delay and the no haircut conditions for deposit-like debt, either at the failed institution itself, or, by explicit guarantees, at other firms throughout the system subsequent to the failure. A strategy to meet these conditions constitutes an essential financial firebreak.

Until the establishment of the Federal Deposit Insurance Corporation (FDIC), the traditional banking system could not meet these conditions and was consequently extremely vulnerable to periodic systemic panics.[14] The FDIC largely ended panics in the traditional banking system. It meets the no delay condition through the extraordinary discretionary authority it has to resolve member banks: an FDIC receivership team may descend upon a failed bank at 5 P.M. on a Friday and complete a transfer (usually prearranged) of all bank accounts to a solvent bank by the following Monday morning.[15] This degree of speed—and the ability to avoid delay in

broker-dealer) cash with high-quality securities as collateral. The transaction is short-term (often overnight) but is routinely rolled over, thus functioning very much like a demand deposit. *See* GARY B. GORTON, SLAPPED BY THE INVISIBLE HAND: THE PANIC OF 2007 43–44 (2010).

[10] Allowing firms to issue such debt and then use the funds to make investments in the real economy is socially valuable, but creates a risk of financial instability. This problem was "solved" for traditional banking through a combination of extensive regulation and supervision, lender-of-last-resort functions, and deposit insurance. There is a persuasive argument that a similar regime should be applied to these non-traditional forms of deposit-like debt. *See* Morgan Ricks, *Regulating Money Creation After the Crisis,* 1 HARV. BUS. L. REV. 75, 103–22 (2011) [http://perma.cc/MD3T-GHXE]. Such a regime does not, however, appear to be in the offing.

[11] A haircut is a financial term for losses imposed on creditors. If a creditor lends a company $100 and suffers a five percent haircut when the firm goes bankrupt, the creditor will receive a distribution of $95.

[12] Ricks makes a similar point when he discusses the importance of liquidity and price protection for deposit-like creditors. *Id.* at 89–93.

[13] This was a common theme in late 2008. For example, in the ten days following Lehman Brothers' bankruptcy filing, Morgan Stanley cash holdings fell by almost half, representing a run of $85 billion. Darrell Duffie, *Liquidity and Stress Testing,* FED. RES. BANK N. Y.. http://www.newyorkfed.org/aboutthefed/liquidity_stress_612.pdf (last visited Nov. 23, 2014) [http://perma.cc/A669-Z8MF].

[14] *See, e.g.,* BEN S. BERNANKE, THE FEDERAL RESERVE AND THE FINANCIAL CRISIS 9–10 (2013) (identifying six banking panics between 1873 and 1914).

[15] *See, e.g.,* RICHARD SCOTT CARNELL ET AL., THE LAW OF FINANCIAL INSTITUTIONS 502 (5th ed.

depositors' access to their accounts—would be impossible under normal bankruptcy procedures. The FDIC can meet the no haircut condition by guaranteeing full payment of deposits under the insurance cap and through ad hoc insurance of deposits *over* the cap if a "systemic risk exception" is invoked.[16]

Traditional commercial banks were at the periphery of the 2008 financial crisis, however. The heart of the crisis involved large financial conglomerates that often did not even include deposit-taking institutions in their labyrinthine organizational charts, but which nevertheless issued billions of dollars of deposit-like debt.[17] Regulators scrambled to contain the fire, sometimes bailing out specific institutions and sometimes erecting ad hoc firebreaks such as vast emergency liquidity and guarantee programs.[18] These measures, however justified, enraged critics on both the left and right, propelling the post-crisis reform effort.

II. TWO STABS AT A SOLUTION

One of the chief aims of financial reform in the wake of the crisis was to provide regulators with a way to navigate between the Scylla of bailouts and the Charybdis of catastrophic collateral damage. The Dodd-Frank Act attempted to chart this course with the OLA, which, as noted, was widely acknowledged as inadequate to the task set for it. While it provided for the appointment of the FDIC as receiver of a failed SIFI and formally mirrored many features of the FDIC's receivership authority over commercial banks, it was considerably less likely than traditional bank resolution to meet the no delay condition for deposit-like debt.[19] This is because the legal and technical issues involved in a SIFI resolution, for example with respect to capital structure and cross-border jurisdiction, are orders of magnitude more complex than a traditional bank resolution.[20] More problematically, Dodd-

2013).

[16] 12 U.S.C. § 1823(c)(4)(G) (2013) [http://perma.cc/VK2S-AM7Z]. Note that during the crisis, the FDIC provided comprehensive guarantees above and beyond the traditional insurance cap to creditors of all commercial banks. *See, e.g.*, TIMOTHY F. GEITHNER, STRESS TEST: REFLECTIONS ON FINANCIAL CRISES 232–33 (2014). While the Dodd-Frank Act rescinded the FDIC's authority to provide this sort of "widely available debt guarantee program," the systemic risk exception can still be invoked for individual institutions that are being wound down in an FDIC receivership. 12 U.S.C. § 5613 (2013) [http://perma.cc/775S-6DL4].

[17] Lehman Brothers, for example, included no deposit-taking institution in its corporate family and so benefited neither from the FDIC's resolution powers nor from its insurance. It had borrowed many billions of dollars in the repo market, however. *See, e.g.*, Lehman Brothers Holdings Inc., Quarterly Report (Form 10-Q) (July 10, 2008) [hereinafter Lehman 10-Q] [http://perma.cc/GA44-Y79Z].

[18] For a comprehensive account of the government's crisis response measures, *see* DAVIS POLK & WARDWELL LLP, FINANCIAL CRISIS MANUAL (2009) [http://perma.cc/MP4T-AU3H].

[19] A good critique of the pre-SPOE version of the OLA can be found in Stephen J. Lubben, *Resolution, Orderly and Otherwise: B of A in OLA*, 81 U. CIN. L. REV 485 (2012) [http://perma.cc/66D8-TK74].

[20] *See id. passim*. It is worth noting that the "living wills" prescribed by Dodd-Frank were meant to

Frank included no effort to address the no haircut condition.[21] Providing a guarantee for a certain class of debt would likely have been seen as exacerbating, rather than solving, the too-big-to-fail problem. But in failing to construct credible firebreaks by protecting a particular class of creditors, the law failed to make credible its "no bailout" threat for *institutions*.

The new rules relating to SPOE and long-term debt requirements aim to address the shortcomings of the original law and have generated a good deal of excitement in the process.[22] First, the FDIC's proposed SPOE strategy for resolving SIFIs could, if successful, satisfy the no delay condition for preventing contagion. The strategy takes advantage of a quirk in the organizational structure of U.S. SIFIs: they are conglomerates with a holding company at the top and a dizzying array of operating subsidiaries beneath.[23] The holding company tends not to engage in operations; it issues equity and long-term debt and invests most of the funds in its operating subsidiaries.[24] The operating subsidiaries, in turn, tend to fund themselves not only with equity and longer-term debt from their parent but also with deposit-like debt from third parties. It is the deposit-like debt from third parties that is of particular concern from a systemic viewpoint. The SPOE strategy would involve the liquidation of the holding company *only*; the subsidiaries would be transferred untouched, with no hiccup in operations, to a newly created "bridge" holding company.[25] The subsidiaries would be recapitalized by having their debts to the parent forgiven and perhaps by having parent assets (such as cash) transferred to them (in exchange, for example, for new equity shares issued by the subsidiary).[26] Under this arrangement, holders of the subsidiaries' deposit-like debt would have immediate access to their cash as the claims mature, just as if the SIFI had not failed.

In contrast, the shareholders of the original parent would likely be wiped out, and the long-term creditors would receive equity in the new bridge holding company in exchange for their debt claims against the old holding company.[27] It is important to note that these long-term creditors

---

address this issue, but have been a disappointment. Peter Eavis, *Federal Reserve and F.D.I.C. Fault Big Banks' 'Living Wills,'* DEALBOOK (Aug. 5, 2014, 8:35 PM), http://dealbook.nytimes.com/2014/08/05/federal-reserve-and-f-d-i-c-fault-big-banks-living-wills [http://perma.cc/8T4E-MWPR].

21 *See* Ricks, *supra* note 10, at 126.

22 *See, e.g.*, Joint Comment Letter from John Court, et al. to Robert E. Feldman, Exec. Sec'y, FDIC 7–10 (Feb. 18, 2014) [hereinafter Joint Comment Letter] (quoting optimistic comments by, among others, Federal Reserve Board Chair Janet Yellen, Federal Reserve Board Governors Jerome Powell and Daniel Tarullo, Federal Reserve Bank of New York President William Dudley, and former FDIC Chair Sheila Bair) [http://perma.cc/U3S9-64QV].

23 *See* FDIC Proposed Rule, *supra* note 3, at 76615.

24 *Id.*

25 *Id.* at 76615–17.

26 *Id.* at 76617.

27 *Id.* at 76617–19.

would be quite different from deposit-like creditors; they would be investing primarily for risk-adjusted return rather than for liquidity and the assurance of full recovery, and they (and those similarly positioned at other institutions) would not be able to run. There are several trenchant critiques of the practical obstacles to making the SPOE strategy work.[28] No one doubts, however, that it is much more promising than the original law, and there is optimism that the kinks can be worked out.[29] In short, by shifting focus from the tangled web of myriad subsidiaries to the single parent atop the SIFI structure, the "approach is a classic simplifier, making theoretically possible something that [had previously] seemed impossibly complex."[30]

For the SPOE strategy to succeed in creating financial firebreaks around a faltering SIFI, however, the no haircut condition for deposit-like debt must *also* be met. To this end, the Federal Reserve plans to issue a proposed rule requiring SIFIs to maintain extra loss-absorbing capacity at the holding company level beyond the heightened capital requirements already applied to SIFIs.[31] This will—as the FDIC confidently asserts throughout its proposed SPOE rule—ensure that the holding company has enough equity and long-term debt to absorb *all* the losses of the consolidated SIFI.[32] The systemically important, deposit-like debt of the subsidiaries will not suffer any loss as long as the holding company has enough loss-absorbing capacity.

III. BANK CAPITAL: LONG-TERM DEBT VS. EQUITY

The key measure of a bank or bank holding company's ability to absorb losses is its capital. Capital in this context refers to equity and equity-like instruments. Banks can (already) count *limited* amounts of subordinated long-term debt as capital for certain purposes. While equity

[28] *See, e.g.*, Stephen J. Lubben, *OLA After Single Point of Entry: Has Anything Changed?*, *in* AN UNFINISHED MISSION: MAKING WALL STREET WORK FOR US 13 (Mike Konczal & Marcus Stanley ed., 2013) [http://perma.cc/7WUP-3FJJ]; David A. Skeel Jr., *Single Point of Entry and the Bankruptcy Alternative*, *in* ACROSS THE GREAT DIVIDE: NEW PERSPECTIVES ON THE FINANCIAL CRISIS (Martin Neil Baily & John B. Taylor eds., 2014).

[29] Joint Comment Letter, *supra* note 22, at 7–10.

[30] Jerome Powell, Governor, Fed. Reserve, Ending "Too Big to Fail," Remarks at the Institute of International Bankers 2013 Washington Conference (Mar. 4, 2013) [http://perma.cc/L66V-XD7R].

[31] *See* Tracy, *supra* note 4.

[32] *See, e.g.*, FDIC Proposed Rule, *supra* note 3, at 76617 ("The bridge financial company would have a strong balance sheet with assets significantly greater than liabilities since unsecured debt obligations would be left as claims in the receivership while all assets will be transferred."). The Proposed Rule does clarify that in the case of insufficient loss-absorbing capacity at the parent level, key subsidiaries would be put into resolution and the subsidiaries' deposit-like creditors would be subject to haircuts. *Id.* at 76623. If the bailout-or-wildfire choice arises, then, the implicit *formal* requirement of the law is to let it burn. Some critics, however, believe that the FDIC's authority to provide liquidity to a firm in SPOE resolution creates the possibility of a backdoor bailout. Any such lending would have to be fully secured, *id.* at 76616; it may, however, be possible to meet the letter but not the spirit of the law by making a few optimistic assumptions about the subsidiaries' value.

claimants (i.e., shareholders) cannot withdraw *any* funds from a faltering firm, long-term creditors cannot withdraw their principal until the debt matures. If a SIFI issues long-term debt on a staggered basis, it can ensure that not too much of it will mature at any one time. Both long-term debt and equity, then, are sources of funding that cannot flee *en masse* in a crisis.

A long-term debt requirement for SIFIs is laudable in part because it could help break a logjam on what many view as the most important matter of unfinished business in post-crisis financial reform: increasing bank capital levels. While required capital levels for SIFIs have risen since the crisis, critics believe they remain too low.[33] Indeed, the mere fact of a proposed new long-term debt requirement constitutes an implicit admission by regulators that current capital levels remain too low to absorb all losses in a crisis. In the face of intense resistance from banks, however, efforts to impose significantly higher *equity* requirements have fizzled.[34] The need to coordinate with international regulatory counterparts exacerbates this political problem.[35] Banks' resistance to higher equity requirements, however, has not appeared to extend to the long-term debt requirement.[36] The long-term debt requirement could thus help break the gridlock and force SIFIs to fund themselves to a much greater degree from sources that are not systemically vulnerable. In this respect, it should greatly increase the resiliency of the financial system.

It is, of course, important to emphasize that long-term debt is a good substitute for equity from a systemic perspective only if the SPOE approach works as advertised in preserving market confidence and meeting the no delay condition. If the SPOE approach does work, then it should not matter from a systemic standpoint whether those absorbing losses in a resolution

---

[33] *See, e.g.*, ANAT ADMATI & MARTIN HELLWIG, THE BANKERS' NEW CLOTHES: WHAT'S WRONG WITH BANKING AND WHAT TO DO ABOUT IT *passim* (2013).

[34] The most notable U.S. effort in this regard was an amendment sponsored by Senators Sherrod Brown and David Vitter in 2013 that passed the Senate but failed in the House. *See* Shahien Nasiripour & Michael McAuliff, *With the Lights On, 99 Senators Voted Against Wall Street. The Lights Went Off and They All Fled*, HUFFINGTON POST (Dec. 17, 2013, 8:30 PM), http://www.huffingtonpost.com/2013/12/17/budget-deal-2013-megabanks_n_4462305.html [http://perma.cc/65ZQ-EBAU].

[35] *See, e.g.*, Binyamin Appelbaum, *When She Talks, Banks Shudder*, N.Y. TIMES (Aug. 9, 2014), http://www.nytimes.com/2014/08/10/business/when-she-talks-banks-shudder.html (summarizing a speech by Federal Reserve Vice Chairman Stanley Fischer, in part: "If other countries aren't willing to impose stricter capital requirements on their own banks—and they don't appear to be—then unilateral increases would hurt the American banking industry and the broader economy.") [http://perma.cc/5VRG-T3HP]. The risk of regulatory and jurisdictional arbitrage and of cross-border spillovers in financial instability make harmonized regulation on this point very important.

[36] This is likely because of the tax advantage of debt: interest payments are deductible, while dividend payments are not. ADMATI & HELLWIG, *supra* note 33, *passim*, argue persuasively that regulators should lean against the anti-equity bias created by this disparate tax treatment. Whether for good reasons or bad, however, significantly higher equity requirements appear unlikely in the foreseeable future.

are equity claimants or long-term creditors.[37] What matters for stability is avoiding haircuts for the deposit-like third-party creditors of the SIFI subsidiaries, and this depends not on the particular *mix* of equity and long-term debt at the parent level but rather on their sufficiency in combination to absorb all the SIFI's losses. To the degree there are lingering concerns over SPOE's mechanics, however, it would be better to take steps to avoid SIFI resolution in the first place, as even a SIFI with sufficient loss-absorbing capital could touch off a panic if a botched resolution delayed its deposit-like creditors' access to their cash. The most straightforward way to avoid resolution would be to minimize the risk of SIFI insolvency. A firm is insolvent when its liabilities (including long-term debt) exceed its assets—in other words, when its losses outstrip its equity buffer. If our goal is to avoid resolution in the first place, then more equity, by making insolvency less likely, is preferable to more long-term debt.

On the other hand, long-term debt has advantages that go beyond lower levels of bank resistance. For example, it is easier to measure and less subject to gaming than equity[38] and can provide better information about downside risks.[39] In any event, the decisive factor that should provide real (if qualified) comfort to financial reformers is that a long-term debt requirement will increase the stability of SIFI funding in a way that would likely be politically infeasible were equity our only recourse.

IV. REALITY CHECK

If our concern is ending the too-big-to-fail problem, however, the key question is whether the required loss-absorbing capacity at the parent company will, in fact, be enough.[40] While we await the proposed rule from

---

[37] *See* Joseph H. Sommer, *Why Bail-In? And How!*, 20 ECON. POL'Y REV. (forthcoming 2014) (manuscript at 28–29) [http://perma.cc/3VQ9-7R3X]. While the strongest form of capital, common equity, can absorb losses before any creditors suffer haircuts, long-term debt in a SPOE regime would be able to absorb losses before *systemically important* creditors suffered haircuts.

[38] *See id.* (manuscript at 28). The loss-absorbing capacity of debt at any given point from the issuer's perspective is simply the remaining principal and accrued interest. Equity, on the other hand, measures the difference between a firm's assets and liabilities and an accurate measure of it requires an accurate measure of asset values. This can be much trickier and a few excessively optimistic assumptions can make a weak institution appear strong. *See infra* note 43.

[39] Equity cannot provide downside information as effectively as debt because a small chance of large gains may lead to a high share price even in the face of significant default risk.

[40] David Skeel observes that a holistic approach to assessing SPOE's effectiveness must look to its timely invocation by regulators, *prior* to the point where a SIFI's losses outstrip its loss-absorbing capacity. *See* Skeel, *supra* note 28 (manuscript at 11). If regulators put a SIFI into resolution "on time" in this sense, then there should always be sufficient loss-absorbing capacity. So why worry about the size of the buffer? There is, for a variety of reasons, a regulatory bias toward delay in these situations. There is hope that the problem will resolve itself, fear of unintended consequences from action, and concern that proactive steps will shift blame to regulators for bad outcomes that would have occurred regardless of their actions. When one adds to all this the difficulty of measuring assets accurately in a volatile market, it is perhaps not surprising that regulators do not always act before the firm's solvency is in question.

the Federal Reserve, there are reasons to be skeptical. The Financial Stability Board (FSB) recently proposed a requirement for SIFIs to maintain total loss-absorbing capacity – in equity and long-term debt – of between 16 and 20 percent of risk-weighted assets.[41] Would a ratio in this general range be adequate? It is worth observing that a few months prior to its demise, Lehman Brothers reported a ratio of total capital-to-risk-weighted assets of 16.1 percent.[42] In the Lehman case, of course, the problem of mismeasurement looms at least as large as the problem of insufficiency, but mismeasurement can be difficult to detect in a bubble.[43] A sufficiently large loss-absorbing buffer probably constitutes our best (though hardly only) protection against the risk of mismeasurement.[44]

Despite the measurement problem, the Lehman case remains instructive and implies that capital levels would have to rise to implausibly high levels to solve the too-big-to-fail problem once and for all. Consider that Lehman's reported total assets in May 2008 came to approximately $639 billion;[45] estimates of total creditor losses in the wake of Lehman Brothers' bankruptcy have run as high as $200 billion (31 percent of total assets).[46] It is also worth noting that prior to the establishment of the FDIC, bank capital levels typically exceeded 25 percent of total assets,[47] but this failed to stop crippling panics from striking every decade or two.[48] Indeed,

---

[41] FIN. STABILITY BD., ADEQUACY OF LOSS-ABSORBING CAPACITY OF GLOBAL SYSTEMICALLY IMPORTANT BANKS IN RESOLUTION (2014) [HTTP://PERMA.CC/VJ8E-36XM]. It is important to note that with special capital surcharges, the required total loss-absorbing capacity under the FSB's approach could rise as high as 25 percent of risk-weighted assets for the largest SIFIs. *Id.* at 13. It is widely expected that the Federal Reserve's proposed rule will closely track the FSB's approach.

[42] Lehman 10-Q, *supra* note 17, at 102.

[43] Firms and banks always have some discretion in valuing their assets, whether it be business loans for commercial banks or infrequently traded securities for broker-dealers. A few optimistic assumptions about, for example, losses given default on certain loans, can have a significant impact on the magnitude of reported assets.

[44] While the measurement problem may be partially mitigated by measuring capital against total assets rather than risk-weighted assets, it would not be eliminated. *See* Matt Levine, *Relatively Simple Basel Leverage Rules Still Pretty Complicated*, DEALBREAKER (June 26, 2013, 5:03 PM), http://dealbreaker.com/2013/06/relatively-simple-basel-leverage-rules-still-pretty-complicated [http://perma.cc/85YC-EJCN].

[45] Lehman 10-Q, *supra* note 17, at 4. Its reported risk-weighted assets were $217 billion. *Id.* at 102. Note that a new rule for SIFIs, to take effect in 2018, prescribes a ratio of capital to *total* assets (the leverage ratio) of just 5 percent at the parent level and 6 percent for deposit-taking subsidiaries. Joint Press Release, Bd. Of Governors of the Fed. Reserve Sys., FDIC, & Office of the Comptroller of the Currency, Agencies Adopt Enhanced Supplementary Leverage Ratio Final Rule and Issue Supplementary Leverage Ratio Notice of Proposed Rulemaking (Apr. 8, 2014) [http://perma.cc/BD6G-43AZ].

[46] Michael Fleming & Asani Sarkar, *The Failure Resolution of Lehman Brothers*, LIBERTY STREET ECON. (Apr. 3, 2014), http://libertystreeteconomics.newyorkfed.org/2014/04/the-failure-resolution-of-lehman-brothers-.html [http://perma.cc/4WHH-WK9D]. As the authors note, of course, some of these losses are attributable to the direct and indirect costs of bankruptcy. *Id.*

[47] *See, e.g.*, ADMATI & HELLWIG, *supra* note 33, at 30–31.

[48] *See* note 14 and accompanying text.

the history of banking prior to federal deposit insurance should inspire skepticism that capital requirements, as important as they are, can serve as a prophylactic panacea for panics.

We should not make the perfect the enemy of the good: SPOE is a tremendous improvement over the original OLA, and the long-term debt requirement holds the promise of strengthening SIFI balance sheets significantly and helping us resolve SIFIs without bailouts or systemic aftershocks. But we should not permit optimism about the potential of the new resolution approach to blind us to lingering weaknesses in the financial system,[49] or to blunt continuing efforts to heighten its resiliency.

---

[49] In addition to the risk that a SIFI's losses will outstrip its loss-absorbing capacity, or that implementing SPOE will hit a snag, it is worth noting that crises are not just about SIFIs. For example, a run on the money market industry after a $63 billion fund "broke the buck" in September 2008 led to the Treasury guaranteeing the entire multi-trillion-dollar industry. Press Release, U.S. Dept. of the Treasury, Treasury Announces Temporary Guarantee Program for Money Market Funds (Sept. 29, 2008) [http://perma.cc/3BCG-6AW9]. Recent money market reforms have failed to persuade critics that the vulnerabilities have been addressed. *See, e.g.*, Jill E. Fisch, *Long-awaited Money Market Regulatory Reform Falls Short*, REGBLOG (Aug. 4, 2014), http://www.regblog.org/2014/08/04-fisch-long-awaited-money-market-regulatory-reform-falls-short.html [http://perma.cc/34LY-UT3P].