ESSAY

MAKING SENSE OF THE NEW FINANCIAL DEAL

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I. INTRODUCTION

A few years ago, a poet friend of mine wrote a poem called "The Game Changed," which concludes with a line about a "continuity in which everything is transition."[1] He was talking about 9/11 in particular, but the same thing is true anytime there is a fundamental social shift. We are in the middle of a fundamental shift. For all of us, and especially for those of you who have just graduated from law school, the game has changed.

You see this all around you. If you were applying for jobs last fall, you entered a law firm recruiting world that has been transformed. I was talking with a partner in a big city law firm the week before I gave the talk on which this Essay is based. She said she loves the new world. In the old days, she said, it was hard to get a young associate's attention; there was a general air of entitlement. But now they want to know how they can help, if there is anything they can do for you. This is not a bad attitude to have, but it reflects a deep uncertainty about the job situation.

We have just had a transformative election, just two years after another transformative election.[2] What does this mean? It may simply mean that transformative elections are not what they used to be. It probably also means that there will not be any more massive legislation anytime soon, and thus that we now have to play with the cards we have been dealt over the last two years. So this is a good time to ask where we are right now in the financial world.

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1. LAWRENCE JOSEPH, *The Game Changed*, *in* INTO IT: POEMS 63, 65 (2005).

2. I refer, of course, to the sweeping Republican victories in Congress and in state governors' elections in 2010, which came just two years after the election of Barack Obama, America's first black president, and a Democratic sweep in 2008.

To answer this question, I will begin by briefly reviewing the causes of the crisis. By now, this is a very familiar story, so I will keep this part of the discussion especially brief.

This will set the stage for our principal topic, the new financial reforms known as the Dodd-Frank Act.[3] Like it or not, the new law will shape the regulatory landscape for the next generation, so it is important to start thinking about it sooner rather than later. One of my main themes here will be that our financial world is just as prone to bailouts after Dodd-Frank as it was before, and that it would have made a lot more sense to focus on bankruptcy as the solution of choice for troubled financial institutions.

I will then discuss the CEOs and bonuses that have gotten so much attention in the press.[4] I will use this as a segue into a discussion about how Christians might think about issues like financial regulation that seem so far removed from the Gospel.

II. CAUSES OF THE CRISIS

The context for our discussion of the new regulatory regime is the financial crisis that began in 2007 and climaxed with the collapses of Fannie Mae, Freddie Mac, Lehman Brothers, Merrill Lynch, AIG, and others in the fall of 2008.[5]

When people first asked me what I thought the real causes of the 2007-2008 financial crisis were, I used to say: "I'm just a country law professor, not an economist, so I really am not qualified to opine on this." But I long ago stopped letting the limits of my expertise interfere with the opportunity to express an opinion—I am, after all, a law professor—and I now tend to give the following answer: "It's really quite simple," I say:

- We now know that the Panic was caused by the Bush administration's Ownership Society—the administration

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3. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376-2223 (codified as amended in scattered sections of U.S.C. titles: 2, 5, 7, 11, 12, 16, 18, 19, 20, 22, 25, 26, 28, 29, 30, 31, 41, 42, 44, 49, 112) [herinafter the "Dodd-Frank Act"].

4. *See, e.g.*, Edward Hadas, Martin Hutchinson & Antony Currie, *American Wages out of Balance*, N.Y. TIMES, Nov. 11, 2009, at B2.

5. These developments have been the focus of many good, popular-level books. Among the best are WILLIAM D. COHAN, HOUSE OF CARDS: A TALE OF HUBRIS AND WRETCHED EXCESS ON WALL STREET (2009); ANDREW ROSS SORKIN, TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM FROM CRISIS—AND THEMSELVES (2009); DAVID WESSEL, IN FED WE TRUST: BEN BERNANKE'S WAR ON THE GREAT PANIC (2009).

was so obsessed with expanding home ownership that no one paid any attention to whether the home buyers could actually afford the loans they took out to buy the homes.[6]

- Except that it was caused by Congressman Barney Frank's stubborn resistance to reforming Fannie Mae and Freddie Mac, the two giant, government-sponsored (and since September 2008, government-owned) entities that buy or guaranty a large percentage of the nation's home mortgages.[7]
- But the real reason for the mess was the Federal Reserve's monetary policy—the Federal Reserve kept interest rates so low, for so long, that they fueled the speculative bubble in the real estate markets.[8]
- Except that this would not have been such a problem if it were not for securitization—the exotic process by which mortgages were transferred to newly created entities, repackaged, and interests in the new entities sold to institutions and investors. Lenders who once might have held onto the mortgages they received from their borrowers immediately sold them and made more loans, without

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6. Raghuram Rajan offers an intriguing version of this thesis. Rajan argues that politicians (in the Clinton Administration as well as its successors in the Bush Administration) consciously or unconsciously pushed for "easy money" to deflect concerns about rising income inequality. "[I]f somehow the consumption of middle-class householders keeps up," he writes, "perhaps they will pay less attention to their stagnant monthly paychecks." RAGHURAM G. RAJAN, FAULT LINES: HOW HIDDEN FRACTURES STILL THREATEN THE WORLD ECONOMY 8-9 (2010).

7. Peter Wallison of the American Enterprise Institute was an early critic of Fannie Mae and Freddy Mac, arguing that they were highly politicized and could become an enormous problem if they threatened to fail. For a more recent retrospective, see PETER J. WALLISON & CHARLES W. CALOMIRIS, THE LAST TRILLION-DOLLAR COMMITMENT: THE DESTRUCTION OF FANNIE MAE AND FREDDIE MAC (2009). Wallison also sounded this theme in his dissent to the report of the Financial Crisis Inquiry Commission, as described in note 15 *infra*.

8. Early on, the Federal Reserve's policy of keeping interest rates low after the dot com bubble collapsed in 2000 was widely viewed as brilliant—as part of Alan Greenspan's magical touch. *See, e.g*, BOB WOODWARD, MAESTRO: GREENSPAN'S FED AND THE AMERICAN BOOM (2000). Most commentators now question the policy, and its continuation by Greenspan's successor, Ben Bernanke.

paying any attention to the credit-worthiness of their borrowers.[9]

- And yet the credit rating agencies could have blown the whistle before it was too late by refusing to give the new mortgage-backed securities the high ratings that enabled insurance companies, pensions and other institutions to buy them; but the credit rating agencies faced such serious conflicts of interest, and so poorly understood the securities they were rating, that they handed investment grade ratings to nearly every new securitization that was presented to them.[10]
- And there surely were too many corrupt mortgage brokers who nudged homeowners toward innapropriate or overpriced loans.
- But homeowners and investors were the ones who agreed to these loans. They were not all simply victims. Many people signed documents with misleading information or even bald lies, and many were hoping to make easy profits from real estate speculation.[11]
- And Wall Street compensation practices made everything worse, by encouraging the executives of the largest banks to

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9. Securitization and the further repackaging of mortgage-backed securities in Collateralized Debt Obligations (CDOs) and synthetic CDOs are a focus of Michael Lewis's engaging book on the crisis. MICHAEL LEWIS, THE BIG SHORT: INSIDE THE DOOMSDAY MACHINE (2010). The heroes of Lewis's story are a handful of oddball investors who recognized the looming disaster and placed large bets against the real estate market.

10. The credit rating agencies faced a conflict of interest because the mortgage-backed securities were presented for rating by the banks that had created them, and the same bank paid the cost of the rating. The inherent conflict in this system—known as issuer pays—was exacerbated after Fitch Ratings entered the market, which increased ratings competition. Because a bank that was unhappy with a proposed rating could take its business elsewhere, the rating agencies had strong incentives to give high ratings. This problem is described and modeled in Patrick Bolton et al., *The Credit Ratings Game*, (Nat'l Bureau of Econ. Research, Working Paper No. 14712, 2009), *available at* http://www.nber.org/papers/w14712.pdf. The Dodd-Frank Act does not eliminate the issuer pays framework, but it requires regulators to remove the references to SEC-approved rating agencies from a wide range of laws. *See* Dodd-Frank Act § 939.

11. Bill Cohan has written that "one of the dirty little secrets of the financial crisis is that one homeowner after another signed mortgage-loan documents that were filled with inaccurate information about his or her net worth, assets, salaries and ability to make monthly mortgage payments." William D. Cohan, *The Elizabeth Warren Fallacy*, N.Y. TIMES OPINIONATER, (Sept, 30, 2010, 9:00 PM), *available at* http://opinionator.blogs.nytimes.com/ 2010/09/30/the-elizabeth-warren-fallacy/.

push the banks towards high risk, high reward strategies—like creating and holding mortgage-backed securities.[12]

- And there might not have been a real estate bubble at all had it not been for a glut of savings in Asia, which Asian countries responded to by buying American treasury bonds, thus providing ever more liquidity for the real estate market.[13]

Conventional wisdom says that all of these factors contributed to the crisis. To be sure, conventional wisdom has hardly been an infallible guide. One of its most deeply ingrained "facts" attributes the market chaos in the fall of 2008—the Panic of 2008—to Lehman Brothers' bankruptcy filing on September 15, 2008. In my view, the claim that Lehman's bankruptcy was the catalyst of the crisis is almost completely mistaken.[14] Still, the general story about the reasons for the real estate bubble and its bursting is more or less accurate.[15]

In short, we had a very complicated problem, with mortgage related securities and the real estate market at its heart. How about the solution? This takes us to the new Dodd-Frank Act, which President Obama signed into law in July 2010.

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12. My colleagues Bill Bratton and Michael Wachter point to the sharp spike in the value of bank stocks during the 2000s as evidence of managers' increasing emphasis on shareholder value. William Bratton & Michael Wachter, *The Case Against Shareholder Empowerment*, 158 U. PENN. L. REV. 653, 718 & Fig. 2 (2010). The emphasis on stock price seems to have been encouraged, at least in part, by pervasive use of stock and stock options to compensate managers.

13. For a discussion of the role of Asian investment in, among other things, U.S. Treasury bonds, see Franklin Allen, Ana Babus, & Elena Carletti, *Financial Crises: Theory and Evidence*, ANN. REV. FIN. ECON. (2009), *available at* http://finance.wharton.upenn.edu/~allenf/download/Vita/Papers.htm.

14. For critiques of the Lehman Myth, see, Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy or Bailouts?*, 35 J. CORP. L. 469, 489-91 (2010); David Skeel, *Give Bankruptcy a Chance*, WEEKLY STANDARD, June 29, 2009.

15. My summary of the conventional wisdom tracks in many respects the dissent of three members of the Financial Crisis Inquiry Commission to the report filed by the majority. Like the dissenters, I believe that the majority report overemphasizes the culpability of bank executives and the failures of regulators, while the Peter Wallison dissent lays too much at the doorstep of Fannie Mae, Freddie Mac and housing policy. *See* FIN. CRISIS INQUIRY COMM'N, 112TH CONG., THE FIN. CRISIS INQUIRY REP. (Comm'n Print 2011), *available at* http://fcic.law.stanford.edu/report (last visited Apr. 26, 2011).

III. THE DODD-FRANK ACT

Contrary to rumors that the Dodd-Frank Act is an incoherent mess, the Wall Street reform portion of its 2,319 pages (a mere 800 or so if the margins are squeezed and the type face shrunk) has two very clear objectives. The first is to limit the risk of the shadow banking system by more carefully regulating the key *instruments* and *institutions* of contemporary finance. By "instruments," I mean derivatives[16] and other financial innovations; and by "institutions," the giant, systemically important financial firms like Citigroup or AIG.[17] The second objective is to limit the damage in the event one of these giant institutions fails. The Dodd-Frank Act thus has two simple goals—limiting risk before the fact and trying to minimize damage if a giant financial institution nevertheless falters.[18]

The Dodd-Frank Act also has a recurring theme: partnership between the government and the largest banks. This partnership, in which the government locks arms with a small group of dominant institutions, looks a lot like the European style of regulation that is known as corporatism.[19]

As a historical matter, the new government-big bank partnership is a little surprising. Traditionally, American debates over how to regulate our major financial institutions have pitted one group, who contend that the biggest institutions should be broken up if they begin to dominate American finance, against another, who believe that giant institutions are inevitable and that the government should simply make sure it has the tools to control them.

In the 1930s, Louis Brandeis was the leader of the small-is-beautiful view, while Columbia University professors Rex Tugwell and Adolf Berle advocated the big-is-okay strategy.[20] Both were important Franklin D.

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16. A derivative is simply a contract whose value is based on an interest rate, currency price or nearly anything else, or on the occurrence of a specified event such as a default on a company's debt. *See, e.g.*, BLACK'S LAW DICTIONARY 475 (8th ed. 2004) ("A financial instrument whose value depends on or is derived from the performance of a secondary source such as an underlying bond, currency, or commodity.").

17. This characterization and many of the details of this section are drawn from DAVID SKEEL, THE NEW FINANCIAL DEAL: UNDERSTANDING THE DODD-FRANK ACT AND ITS UNINTENDED CONSEQUENCES (2011).

18. *Id.* at 4.

19. European style corporatism is analyzed in detail in FRANKIN ALLEN & DOUGLAS GALE, COMPARING FINANCIAL SYSTEMS (2000).

20. The debates within Roosevelt's "Brains Trust" feature in many accounts of the New Deal. One of the classic treatments is ARTHUR M. SCHLEISINGER, THE COMING OF THE NEW

Roosevelt advisors, and both helped to shape the New Deal corporate and financial legislation.[21] But the Brandeisian view largely won out with reforms like the Glass-Steagall Act that separated commercial and investment banking from the 1930s until 1999.[22]

What was odd about the discussions within the Obama administration that laid the groundwork for the Dodd-Frank Act was that there really was only one side presented, and it was the exact opposite side from the one that emerged in the New Deal. The key administration officials—most importantly, Treasury Secretary Timothy Geithner—all hailed from the big-is-okay side of the traditional divide. There was no strong voice within the administration for the view that perhaps the giant banks should be broken up, or at least scaled back.[24]

Dodd-Frank simply gave regulators more tools to do what they did the first time around. Under Dodd-Frank, the largest financial institutions will be designated as systemically important and subject to special oversight.[25] By singling these institutions out for special treatment, the Act guarantees their continued dominance of the financial services industry. This will make it impossible for smaller financial institutions to compete, and it is likely to stifle innovation in the financial services industry.

I have been talking about the way Dodd-Frank regulates the *institutions* of contemporary finance, and have been very critical. I will be at least as critical when we get to the new Dodd-Frank resolution rules for dealing with financial distress. But before we turn to resolution and then bankruptcy, I should note that I am much more encouraged by Dodd-Frank's regulation of the *instruments* of contemporary finance—derivatives

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DEAL 1933-35 (1958). For a description of the competing perspectives within the administration, see, *id.* at 18-19.

21. *Id.* at 182-84.

22. *See, e.g.*, *id.* at 443 (describing Glass-Steagall).

24. The principal advocate for a more aggressive, Brandesian stance was former Federal Reserve Chairman Paul Volcker. Although he was an important advisor during Barack Obama's presidential campaign, he was excluded from the inner circle during the period when the legislation was devised and promoted. Volcker's implicit banishment is described in detail in John Cassidy, *The Volcker Rule*, NEW YORKER, July 26, 2010. For discussion of Secretary Geithner's propensity for bailouts, see, e.g., Joe Becker & Gretchen Morgenson, *Geithner, as Member and Overseer, Forged Ties to Finance Club*, N.Y. TIMES, Apr. 27, 2009.

25. The treatment of the largest financial institutions is set forth in Title I of the Dodd-Frank Act. As discussed below, the new Financial Stability Oversight Council is authorized to designate nonbank financial institutions as systemically important, while bank holding companies automatically qualify if they have at least $50 billion in assets.

and other financial innovations. Prior to Dodd-Frank, derivatives were almost entirely unregulated, in no small part due to legislation in 2000 that prohibited the CFTC and SEC from regulating most over-the-counter derivatives.[26] This caused a lot of trouble during the crisis because regulators had no idea how much exposure Bear Stearns, Lehman, and AIG had, and were terrified as to what would happen if all these derivatives contracts were terminated at the same time.[27] Dodd-Frank will require that most of them be subject to clearing house arrangements in which a clearing house guarantees the performance of both sides of the contract; it will also require that they be traded on exchanges.[28] There are many uncertainties about how this will work, and a number of potential pitfalls. If one or a small number of clearing houses establishes a dominant share of the market, the clearing houses themselves could be a major source of systemic risk, as many commentators have already warned.[29] But overall, the new derivatives regulation is a vast improvement over what we had before.

It also may be worth noting that I favor the new Consumer Financial Protection Bureau ("Consumer Bureau" or "Bureau"). The new Consumer Bureau got off to a shaky start. Afraid that Elizabeth Warren, who first proposed the new regulator,[30] could not be confirmed as director by the Senate, President Obama circumvented the normal approval process by naming her as an advisor to him and as a special assistant to Treasury Secretary Geithner.[31] While this has called the legitimacy of the Bureau's activities into question during the initial start-up period, the case for giving consumers a designated champion is compelling. Most importantly, the Federal Reserve, which previously had the principal responsibility for

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26. *See, e.g.*, GIOVANNI P. PREZIOSO, THE COMMODITY FUTURES MODERNIZATION ACT OF 2000 3 (2002); Noah L. Wynkoop, Note: *The Unregulables? The Perilous Confluence of Hedge Funds and Credit Derivatives*, 76 FORDHAM L. REV. 3095, 3099 (2008).

27. *See, e.g.*, COHAN, *supra* note 5, at 24 (describing regulators' uncertainty as Bear Stearns collapsed).

28. The clearing house and exchange requirements are set forth in Dodd-Frank Act § 723.

29. *See, e.g.*, Craig Pirrong, *The Clearinghouse Cure*, 31 REGULATION 44 (2008-09).

30. Warren called for a new consumer regulator in Elizabeth Warren, *Unsafe at Any Rate*, 5 DEMOCRACY: A JOURNAL OF IDEAS, (Summer 2007), at 8, and again in Oren Bar-Gill & Elizabeth Warren, *Making Credit Safer*, 157 U. PENN. L. REV. 1 (2008).

31. Katie Benner, *The Elizabeth Warren End Run*, CNNMONEY.COM (Sept. 16, 2010 12:03 PM), http://finance.fortune.cnn.com/2010/09/16/the-elizabeth-warren-end-run/.

protecting consumers, has a serious conflict of interest.[32] One of the Federal Reserve's foremost tasks is assuring the stability of the banking system.[33] Because practices that harm consumers can be beneficial for banks, the Federal Reserve cannot be expected to vigorously promote consumers' interests at all times.[34] And during the real estate bubble, it did not.[35]

This brings us to the new Dodd-Frank resolution rules.[36] The guiding premise of the resolution rules is that the best strategy for dealing with the failure of a large financial institution is to give the Federal Deposit Insurance Corporation (FDIC) the same powers it has when an ordinary bank falls into distress. When a commercial bank fails, the FDIC arranges a sale of some or all of its assets and liabilities to another bank, closes the bank on a Friday afternoon, and has everything ready to open again first thing Monday morning.[37] The advocates of Dodd-Frank argued that this works really well with ordinary banks, so it is a great template for handling systemically important financial institutions.[38]

The problem with this assumption is that none of the benefits of FDIC resolution apply when it comes to the largest financial institutions. FDIC

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32. BD. OF GOVERNORS OF THE FED. RESERVE SYS., THE FEDERAL RESERVE SYSTEM: PURPOSES & FUNCTIONS 75 (9th ed. 2005), *available at* http://www.federalreserve.gov/pf/pdf/pf_6.pdf.

33. STAFF OF JOINT ECON. COMM., 105TH CONG., REP. ON THE IMPORTANCE OF THE FEDERAL RESERVE (Comm. Print 1997), *available at* http://www.house.gov/jec/fed/fed/fed-impt.pdf (last visited Apr. 26, 2011).

34 *See, e.g.*, Bar-Gill & Warren, *supra* note 30, at 94 (describing Congressional criticism of the Fed's failure to promulgate rules protecting consumers). The Office of the Comptroller of the Currency faced very similar conflicts of interest. *Id.* at 91 (describing OCC intervention on behalf of banks challenging California credit card legislation enacted to protect consumers), 93 (concluding that the "OCC's inaction may also be attributable, at least in part, to its direct financial stake in keeping its bank clients happy").

35. Another problem stemmed from the multitude of different bank regulators. In practice, lenders have a choice as to which regulator will be their primary overseer, and many used this to bargain for lax oversight. The Office of Thrift Supervision, which regulates savings and loans and will be abolished by the Dodd-Frank Act, was notorious in this regard. *See, e.g.*, KATHLEEN C. ENGEL & PATRICIA A. MCCOY, THE SUBPRIME VIRUS: RECKLESS CREDIT, REGULATORY FAILURE, AND NEXT STEPS (2011).

36. The resolution rules come in Title II of the legislation, Dodd-Frank § 201.

37. For a helpful overview of the FDIC's resolution strategies, and the relative frequency of each, see Richard M. Hynes & Steven D. Walt, *Why Banks Are Not Allowed in Bankruptcy* (2009) (unpublished manuscript) (on file with author).

38. *See, e.g.*, *Written Testimony Before the Subcomm. on Commercial & Admin. Law of the H. Comm. On the Judiciary*, 111th Cong. (2009) (testimony of Michael S. Barr), *available at* http://judiciary.house.gov/hearings/pdf/Barr091022.pdf.

resolution is an opaque process that offers no real opportunity to second-guess the FDIC's decisions as to who gets what.[39] It has none of the transparency and rule of law virtues of bankruptcy. This may be justified with the small and medium-sized banks that the FDIC ordinarily handles. The vast majority of the liabilities of these banks are insured deposits.[40] Not only is it important that consumers have access to those deposits at all times, but, because of the deposit guarantee, the government is by far the largest creditor, so it is the government's money that is at stake.

None of this holds true with a large bank holding company, much less with an insurance company, like AIG, or investment bank, like Lehman Brothers. In addition, the FDIC strategy of quick, secret sales is much less effective with large institutions.[41] With a big institution, there often will not be any plausible buyers. If regulators do manage to find a buyer, on the other hand, the sale is likely to make a dominant institution even more dominant. Just look at the size of JP Morgan Chase—over two trillion dollars in assets after its acquisitions of Bear Stearns and Washington Mutual.[42]

The resolution rules give bank regulators the power to take over any systemically important financial institutions that are in trouble (even if the institutions have not been designated as systemically important).[43] Lawmakers added a few bankruptcy provisions—such as the power to retrieve preferences and fraudulent conveyances—to make it look a little more like bankruptcy, but it really is not bankruptcy at all.[44] The FDIC still can pick and choose the creditors it wants to pay, which means that any resolution is likely to end up looking a lot like a bailout.

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39. This argument is made in more detail in SKEEL, *supra* note 17, at 123.

40. For specific details, see Hynes & Walt, *supra* note 36, at 32-33.

41. The FDIC's resolution of IndyMac, the giant S&L that failed in 2008, is a good illustration. The resolution is estimated to have resulted in an eight to nine billion dollar loss, which is widely viewed as much more costly than a more efficient resolution would have been. *See, e.g.*, Binyamin Applebaum, *FDIC Agrees to Sell IndyMac to Investor Group*, WASH. POST, Jan. 2, 2009.

42. *See generally* Roger C. Lowenstein & Jamie Dimon, *America's Least Hated Banker*, N.Y. TIMES MAG., Dec. 1, 2010 (profiling JP Morgan Chase head Jamie Dimon and describing the bank's expansion in the crisis).

43. The rules for initiating a resolution are set forth in Dodd-Frank Act § 203.

44. *See, e.g.*, Dodd-Frank § 210(a)(11).

IV. WHY NOT BANKRUPTCY?

In my own little involvement in the debates over the financial reforms, I made no secret of my belief that bankruptcy is almost always the best strategy for resolution of the financial distress of a large financial institution.[45] Bankruptcy is not perfect, of course, but I do think Chapter 11 is a surprisingly effective response to the failure of a large financial institution. It could be even better with a few small changes to the bankruptcy rules. (I also think bankruptcy may be a good solution to the sovereign debt problems in Greece and Europe, and to California's debt crisis; but I will save that for other work.)[46]

So why did bankruptcy not figure more prominently in the thinking on the new financial reforms? One reason is that the same people who masterminded the 2008 bailouts were also the architects of the financial reforms. Treasury Secretary Geithner in particular has long been a defender of bailouts, as discussed earlier, and has never seriously considered bankruptcy as an alternative.[47]

The second reason is the bankruptcy phobia that seemed to afflict lawmakers and regulators during the recent financial crisis.[48] Although corporate reorganization has been used to restructure troubled firms for well over a century—since the railroad failures of the late 1800s—and it has proven remarkably adaptable to changing conditions, many people still seem to imagine that bankruptcy is a synonym for death or, in the epithet that was repeatedly invoked by advocates of bailouts, "disorderly failure."[49] There was reluctance in some quarters to consider bankruptcy-oriented solutions during the crisis.[50]

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45. *See, e.g.*, Francis X. Diebold & David A. Skeel, Jr., *Geithner is Overreaching on Regulatory Power*, WALL ST. J., Mar. 27, 2009; David Skeel, *Give Bankruptcy a Chance*, WEEKLY STANDARD, June 29, 2009.

46. For an argument that Congress should enact bankruptcy rules for states, see David Skeel, *Give States a Way to Go Bankrupt*, WEEKLY STANDARD, Nov. 29, 2010, at 22. Europe appears to be edging toward the adoption of at least a few bankruptcy-like strategies for dealing with debt crises. *See, e.g.*, Charles Forelle, David Gauthier-Villars, Brian Blackstone & David Enrich, *As Ireland Flails, Europe Lurches Across the Rubicon*, WALL ST. J., Dec. 28, 2010, at A1 (discussing the Deauville pact to impose losses on bondholders of European Union countries that become insolvent in 2013 or later).

47. *See supra* note 24 and accompanying text.

48. I have written about this phenomenon elsewhere. *See* David A. Skeel, Jr., *Bankruptcy Phobia*, 82 TEMPLE L. REV. 333 (2009).

49. The relevant history is discussed in DAVID A. SKEEL, JR., DEBT'S DOMINION (2001).

50. *See, e.g.*, Skeel, *supra* note 48.

The final reason—the most depressing, but I suspect the most important—was the arcane realities of congressional committee jurisdiction. The financial reforms were handled by Senator Christopher Dodd, who oversaw the Senate banking committee, and Congressman Barney Frank, the then-chair of financial services in the House. If lawmakers had included a significant bankruptcy component in the reforms, Dodd and Frank would have been forced to cede a significant portion of their control to the Judiciary Committee. The importance of this fact was brought home for me by an email I got during the debates from a top staffer for an important Senator. "We feel strongly that bankruptcy can and would work for most financial institutions," she wrote, "but have stumbled onto the difficult challenge of the . . . jurisdiction issues between Judiciary and Banking."[51] There was no way Dodd or Frank were going to let go of their baby.

So it turned out that the deck was stacked against bankruptcy.[52] What emerged instead was a regulatory framework that relies on a partnership between the government and the largest banks, and is likely to require bailouts if any of the banks runs into trouble.

V. WHAT ABOUT THOSE CEOS?

The one piece of the puzzle I have not yet discussed is the role of the CEOs of the big financial institutions. Nearly everyone agrees that they were a key part of the problem.[53] In the new afterward to the paperback edition of *Too Big to Fail*, a popular book about the recent crisis, Andrew Ross Sorkin concludes by quoting an op-ed by Elizabeth Warren:

> This generation of Wall Street CEOs could be the ones to forfeit America's trust. When the history of the Great Recession is written, they can be singled out as the bonus babies who were so shortsighted that they put the economy at

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51. Email from Senate Staffer to David Skeel and two others (Feb. 2, 2010). The email says "Bankruptcy" rather than "Banking;" this is a typo.

52. I think a few small amendments to the Bankruptcy Code would significantly increase the likelihood that it, rather than the new resolution rules, would generally be the strategy of choice for resolving the financial distress of large financial institutions in the coming decades. The most important of these changes would reverse the special treatment that derivatives currently receive in bankruptcy. *See, e.g.*, David Skeel & Thomas Jackson, *Transaction Consistency and the New Finance in Bankruptcy*, COLUM. L. REV. (forthcoming 2012).

53. As briefly noted earlier. *See supra* note 12 and accompanying text.

> risk and contributed to the destruction of their own companies. Or they can acknowledge how Americans' trust has been lost and take the first steps to earn it back.[54]

Although these sentiments are widely shared, the bank executives have not been poster children for the crisis to nearly the extent that the CEOs of the scandal-prone companies of 2001 and 2002 were. After Enron collapsed, everyone knew exactly what Ken Lay looked like. But most people cannot identify people like Jimmy Cayne of Bear Stearns or Richard Fuld of Lehman Brothers.

Why are the bank CEOs so much more anonymous? The most obvious reason, in my view, is that these CEOs do not seem to have committed fraud, or at least blatant fraud of the kind committed by Enron and WorldCom. The problems were more complicated—and frankly, harder to understand—because they stemmed from a variety of legal and structural factors, in addition to the outside pressures I discussed at the beginning of this Essay.

Two structural factors stand out. The first is a dramatic shift in the investment banking industry in the past thirty years. In the old days, investment banks were partnerships, which meant that each partner was potentially liable for all of the debts of the partnership.[55] They were very cautious as a result, and made their money by underwriting—that is, selling—a company's stock or bonds and providing various kinds of advice. Over the past several decades, thanks to computers and the insights of new financial theory, those old businesses became less lucrative and it became much more profitable for the banks to trade for their own accounts—to buy or sell derivatives, mortgage back securities, or nearly anything else. This is the "proprietary trading" that has now been banned in commercial banks by the "Volcker Rule" enacted as part of the Dodd-Frank Act.[56] To raise the

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[54]. ANDREW ROSS SORKIN, TOO BIG TO FAIL: THE INSIDE STORY OF HOW WALL STREET AND WASHINGTON FOUGHT TO SAVE THE FINANCIAL SYSTEM—AND THEMSELVES 555 (2010) (internal quotes omitted)

55. The transformation I discuss in this paragraph is ably documented in ALAN D. MORRISON & WILLIAM J. WILHELM, JR., INVESTMENT BANKING: INSTITUTIONS, POLITICS, AND LAW 267-80 (2007).

56. The Volcker Rule, which was championed by former Federal Reserve Chairman Paul Volcker, was enacted in Dodd-Frank Act § 619. As enacted, the ban is narrower than the version advocates originally proposed. Rather than prohibiting commercial banks from holding stakes in hedge funds and equity funds, for instance, it limits the stakes to three percent. 12 U.S.C. § 1851(d)(4)(B)(ii)(I). In addition, it remains to be seen whether

huge amount of money they need to engage in this trading, nearly every investment bank has converted into a corporation so that it could sell its own stock to investors.[57]

The other factor was that the tax laws create an incentive to pay executives in stock rather than in cash. Under a provision put in place in 1993, and which was designed to *reduce* executive compensation, a corporation cannot deduct any cash salary to an executive that exceeds one million dollars per year, but stock and stock options were exempt from this limitation.[58]

Together, these factors created very large incentives for the CEOs of the big banks to take risks and to generate big returns for their stockholders.[59] And the limited liability the CEOs have as executives of a corporation, rather than a partnership, removed the most important structural incentive investment bankers once had to be cautious.

What has Dodd-Frank done to address this? The main thing the new financial reforms do is try to make it harder for CEOs and their banks to take risks by requiring more capital—that is, a bigger buffer on the bank's balance sheet; limiting the amount of leverage, or debt; and inviting regulators to limit banks' use of short term debt.[60] These provisions may not help much unless regulators really crack down, which they have not often done well in the past.[61]

Some experts think we need to take much more ambitious steps to rein in bank CEOs. Bill Cohan, the author of *House of Cards*, the book about Bear Stearns, proposed in the *New York Times* that the top 100 executives in each of the big banks should be required to commit their entire net worth to a bond that would default if their bank failed. If their bank failed, they would

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regulators will be able to prevent banks from disguising their proprietary trading as market making or trades for clients, both of which are permitted.

57. One of the last to convert was Goldman Sachs. For a laudatory account of Goldman's conversion from a Goldman insider, see LISA ENDLICH, GOLDMAN SACHS: A CULTURE OF SUCCESS (2000).

58. I.R.C. § 163 (2010).

59. To the extent the banks were too big and interconnected to fail, their creditors didn't have adequate incentives to rein them in.

60. *See* Dodd-Frank Act § 165 (heightening capital requirements for systemically important firms) and § 165(g) (authorizing limits on short-term debt).

61. The one curb on compensation that tries to curb risk taking is a provision that gives regulators the power to disallow any provision in executives' contracts that they think is problematic. Dodd-Frank Act § 956. But it's far from clear exactly what this will mean in practice.

fail.[62] I am not sure whether he was being altogether serious, but experts from Alan Greenspan to a number of scholars have proposed that executives or all shareholders of a bank be liable for some of its debts if the bank fails.[63] The goal is to go back to the old days when bankers were more cautious. None of these ideas seem very realistic to me,[64] but they do put their finger on a real problem—a problem that I will return to in just a minute.

VI. A CHRISTIAN PERSPECTIVE ON THE NEW FINANCIAL DEAL?

How should a Christian—those of us who look to Jesus Christ as our Savior—think about these issues? I would like to think I have been trying to answer that question already, and that everything I have said thus far has reflected thinking from a Christian perspective. I am reminded of C.S. Lewis's statement many years ago, which I believe to be still true, that: "What we want is not more little books about Christianity, but more little books by Christians on other subjects—with their Christianity *latent*."[65] But let me be more explicit about faith and finance and make five basic points.

The first is that we always need to be careful about how much we expect from secular law. Law is essential in a fallen world, but it cannot save us and can be used to oppress. It is important to be modest about our aspirations for law.[66] This is true with social issues like abortion and gambling, and it is true with economic issues like credit and banking.

Second, with this caveat in mind, the most useful contribution that legal reform can make is often to fix rules that have the unintended consequence of encouraging people to misbehave. The implicit governmental subsidy enjoyed by banks that are "too big to fail" has this kind of effect, since it invites risk-taking, as does the tax treatment of executive compensation

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62. William D. Cohan, *Make Wall Street Risk It All*, N.Y. TIMES, Oct. 8, 2010.

63. For an especially interesting proposal along these lines, see Peter Conti-Brown, *Solving the Problem of Bailouts: A Theory of Elective Shareholder Liability*, 64 STAN. L. REV. (forthcoming 2012).

64. Other scholars have proposed new forms of executive compensation that might discourage excessive risk-taking. *See, e.g.*, Jeffrey N. Gordon, *Executive Compensation and Corporate Governance in Financial Firms: The Case for Convertible Equity-Based Pay* (2010) (unpublished manuscript), *available* at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1633906. Some of these proposals are more realistic than eliminating limited liability, but it would, in my view, be a mistake to impose them by law.

65. C.S. LEWIS, *Christian Apologetics*, in GOD IN THE DOCK: ESSAYS ON THEOLOGY AND ETHICS 89, 93 (1970).

66. This theme is developed in much more detail in David A. Skeel, Jr. & William J. Stuntz, *Christianity and the Modest Rule of Law*, 8 U. PA. J. CONST. L. 809 (2006).

described earlier. The Dodd-Frank Act does take aim at the first of these distortions, although the efficacy of its solutions is far from clear, as we have seen.[67]

Third, I believe that the income inequality that we hear so much about—the enormous gap between the income at the highest level and income at lower levels—is a genuine issue with obvious Christian implications. The real estate bubble disguised the gap between those in the executive suites and ordinary Americans by encouraging Americans to buy and live beyond their means.[68] And we are now suffering the hangover from this. I do not think the solution is trying to micromanage executives' salaries. (Unfortunately, the new financial reforms may invite some of this).[69] It is more likely to involve rethinking some of the policies that fueled the bubble—including the special tax advantages we give to mortgages—and renewing our emphasis on the obligations that come with material wealth.

A century ago, Walter Rauschenbusch, who was the leader of a movement known as the social gospel, compared corporate managers to the stewards in Jesus's parables. "In the parables of the talents and pounds," Rauschenbusch wrote, Jesus "evidently meant to define all human ability and opportunity as a trust."[70] "His description of the head servant who is made confident by the continued absence of his master," Rauschenbusch continues, "is meant to show the temptation which besets all in authority to forget the responsibility that goes with power."[71] I personally am not a big

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67. As noted earlier, the Dodd-Frank Act instructs regulators to impose higher capital requirements and limit a bank's short-term debt. The former would force the bank (and its executives and shareholders) to bear more of the costs of risk-taking, and the later would limit the risk of a sudden failure. Both are only as effective as the regulators and regulation that ultimately implement them.

68. For an insightful analysis of this point, see RAJAN, *supra* note 6.

69. As noted earlier, Dodd-Frank Act § 956(b) authorizes regulators to disallow provisions in the compensation contracts of executives of systemically important institutions that the regulators believe will increase risk taking.

70. WALTER RAUSCHENBUSCH, CHRISTIANITY AND THE SOCIAL CRISIS IN THE 21ST CENTURY 308 (Paul Rauschenbusch ed., 2007). In the parable of the talents, which is recounted in *Matthew* 25, a master gives ten, five and one talents to three of his servants. While the recipients of ten and five talents each double the master's money by investing it, the third servant buries his single talent in the ground. The master chastises him for failing to put his master's money to profitable use. The parable of the "pounds" is a similar parable in *Luke* 19. In the parable of the pounds—or minas—a nobleman gives ten minas to each of ten slaves for trading.

71. RAUSCHENBUSCH, *supra* note 70, at 308. In the parable of the head servant, the head servant abuses the master's servants, and when the master finally sends his son, thinking the son will be respected, kills the son. *Matthew* 21:33-46.

fan of the social gospel, which tended to focus so heavily on transformative social change that its proponents neglected Christ's teachings about our personal sinfulness and need for redemption. But I do think Rauschenbusch is right that these parables can tell us something about the proper role of executives. Here, as throughout the Bible, Scripture repeatedly warns about the importance of economic morality.

Rauschenbush's own conclusion was that many of the giant corporations of his era should be taken over by the government and nationalized. "It is probably only a question of time," he wrote, "when the private management of public necessities will be felt to be impossible and antiquated, and the community will begin to experiment seriously with the transportation of people and goods, and with the public supply of light and heat and cold."[72] This solution seems to me to trade one problem for another, responding to the excessive power of the giant corporations of his era by giving excessive power to the government to run business. I fear that, by singling out the largest banks for special treatment, the Dodd-Frank Act could carry us a little too far in this direction. This leads to my fourth point, which is closely related to arguments I have made throughout this Essay. I think Congress would have done far more to make the biggest banks and their executives more accountable—and more responsible—if it had taken serious steps to downsize them, and had looked to bankruptcy as the strategy of choice if they fail.

My fifth point concerns the moral consequences of the crisis and the legislative response. Regulators are widely—and in my view accurately—seen as having bailed out Wall Street in 2008, while providing little genuine relief for the millions of homeowners whose houses were or are worth less than they owe under their mortgages as a result of the bursting of the real estate bubble.[73] While the treatment of the largest financial institutions seems far removed from the moral decisions each of us face in our individual lives, I believe there is an important connection between the two. Let me give a simple illustration. A friend recently told me about friends of his who are wrestling with the question whether to repay their mortgage. Although they can afford to pay, it would be a struggle, and the house is seriously underwater. A strategic default—that is, simply handing the keys to the bank or whoever holds the mortgage and walking away—would be much simpler, and would save a great deal of money. Why should they struggle to make good on their obligations, the friends asked, when the giant banks were not held responsible for theirs? This is only anecdotal

72. RAUSCHENBUSCH, *supra* note 70.

73. *See* Skeel, *supra* note 46.

evidence, of course, but experimental evidence seems to confirm the cultural cost of the recent bailouts, suggesting that the bailouts may have made homeowners less hesitant to default on their own home loans.[74]

The Dodd-Frank Act may actually make this problem worse. True, the legislation purports to hold the largest financial institutions responsible in the future by preventing new bailouts and requiring that these institutions be liquidated if they fall into distress. But almost no one believes that the legislation will forestall future bailouts. The claim that it will is not credible, and could reinforce Americans' skepticism about the fairness of financial regulation. When we calculate the costs of the crisis, and consider whether the Dodd-Frank Act should be amended, we need to keep these moral costs prominently in view.

VII. CONCLUSION

Let me conclude by briefly answering the same question we have been considering—how might a Christian think about these issues—in one last way.

In the wake of the crisis and reforms, I cannot help but think of the famous statement made by Rahm Emanuel, the former Obama adviser who is now mayor of Chicago. He said, "A crisis is a terrible thing to waste."[75] What he meant, I think, is that a crisis is a great opportunity to pass major legislation that would never get through Congress during ordinary times. I believe that crisis is a great opportunity for Christians too, particularly those of us who are lawyers, law professors, and law students, but in a very different way. One of the greatest periods in the history of the church came during the plagues that afflicted Rome during the first several centuries after Christ. Everyone who could flee to the countryside to try to escape the pestilence did flee. But the Christians stayed behind, and ministered to those in need.[76] They were not like everyone else. In a very real way, Christians were the body of Christ.[77]

Our circumstances are obviously not as dire as Rome during the plagues, but this period too is an opportunity for Christians to be different. We can

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74. A fascinating new study by my colleague Tess Wilkinson-Ryan finds that 24.8% of the subjects in her experimental survey reported that they would default at a higher value—that is, while their house was less under water—if their bank had been bailed out than if it had not been. Tess Wilkinson-Ryan, Breaching the Mortgage Contract: The Moral Psychology of Strategic Default 22 (2011) (unpublished manuscript) (on file with author).

75. Jack Rosenthal, *A Terrible Thing to Waste*, N.Y. TIMES MAG., Aug. 2, 2009.

76. PETER R. S. MILWARD, APOSTLES AND MARTYRS 115 (1997).

77. *See 1 Corinthians* 12:12-27.

be available for those who are struggling to find a job or unsure how they will ever pay off their student loans. If we are struggling ourselves, we can use our struggles as a way to minister to others. As I think about these issues and the recent crisis more generally, I am reminded of an old hymn called, "They Will Know We Are Christians by Our Love." In the past several decades, those of us who call ourselves Christians have not always distinguished ourselves in public life by our love. In my view, there could not be a better time for us to bring the words of the old hymn back to life.