Reconsidering Safe Harbors for Repurchase Agreements

Hon. Christopher S. Sontchi, Moderator
U.S. Bankruptcy Court (D. Del.); Wilmington

Prof. Stephen J. Lubben
Seton Hall University Law School; Newark, N.J.

M. Stephanie Wickouski
Bryan Cave LLP; New York

AMERICAN BANKRUPTCY INSTITUTE

DISCOVER

search
search.abi.org

NEW Online Tool Researches ALL ABI Resources

Online Research for $295 per Year, NOT per Minute!*

With ABI's New Search:

- **One search gives you access to content across ALL ABI online resources -- *Journal*, educational materials, circuit court opinions, *Law Review* and more**
- **Search more than 2 million keywords across more than 100,000 documents**
- **FREE for all ABI members**

One Search and You're Done!
search.abi.org

*Cost of ABI membership

66 Canal Center Plaza • Suite 600 • Alexandria, VA 22314-1583 • phone: 703.739.0800 • abi.org

Join our networks to expand yours:

© 2015 American Bankruptcy Institute All Rights Reserved.

SAFE HARBORS FOR REPURCHASE AGREEMENTS

Presented by:
Stephanie Wickouski
stephanie.wickouski@bryancave.com

BRYAN CAVE
A Broader Perspective™

What is a Repurchase Agreement?

- A “repo” is a form of short-term borrowing for securities dealers
- Securities are transferred (sold) by dealers to investors, and then transferred back (repurchased) at a later time
- Many repo’s are on an overnight basis

2

Repurchase Agreements

- Contract to buy = repo; contract to sell = reverse repo
- Repos are classified as money-market instruments
- Repos are used to raise short-term capital
- There are over $1.7 trillion in repo agreements in the market

3

BRYAN CAVE

Why do safe harbors matter?

- While repurchase agreements are associated with only a small fraction of bankruptcy cases, the financial impact is large
- The purpose of the safe harbors is to promote the stability of the financial markets

4

BRYAN CAVE

Why do safe harbors matter?

- Some commentators believe that the safe harbors, and in particular the expansion of the safe harbors beyond Treasury securities, exacerbated the 2008 financial crisis, and that the inclusion of mortgage backed securities, in fact, could destabilize the financial markets.

BRYAN CAVE

Repurchase Agreement Section 101 (47)

- . . . an agreement, including related terms, which provides for the transfer of one or more certificates of deposit, mortgage related securities (as defined in section 3 of the Securities Exchange Act of 1934), mortgage loans, interests in mortgage related securities, or mortgage loans, eligible bankers' acceptances, qualified foreign government securities (defined as a security that is a direct obligation of, or that is fully guaranteed by, the central government of a member of the Organization for Economic Cooperation and Development), or securities that are direct obligations of, or that are fully guaranteed by, the United States or any agency of the United States against the transfer of funds by the transferee of such certificates of deposit, eligible bankers' acceptances, securities, mortgage loans, or interests, with a simultaneous agreement to transfer [the same] at a date certain, not later than 1 year after such transfer, or on demand against the transfer of funds

BRYAN CAVE

Securities Contract: Section 741(7)(A)

"Securities contract" is defined to include:

… a contract for the purchase, sale or loan of a security, a certificate of deposit, a mortgage loan, any interest in a mortgage loan, a group or index of securities, certificates of deposit, or mortgage loans or interests therein … or option on any of the foregoing, including an option to purchase or sell any such security, certificate of deposit, mortgage loan, interest, group or index, or option, and including any repurchase or reverse repurchase transaction on any such security, certificate of deposit, mortgage loan, interest, group or index, or option (whether or not such repurchase or reverse repurchase transaction is a "repurchase agreement" as defined in section 101) …

7

BRYAN CAVE

Safe Harbors: Statutory Provisions

- Section 555 provides:

The exercise of a contractual right of a stockbroker, financial institution, financial participant, or securities clearing agency to cause the liquidation, termination, or acceleration of a securities contract, as defined in section 741 of this title, because of a condition of the kind specified in section 363(e)(1) of this title shall not be stayed, avoided, or otherwise limited by operation of any provision of this title….

8

BRYAN CAVE

Repurchase Agreement Protections Under Section 559

§ 559 Contractual right to liquidate, terminate, or accelerate a repurchase agreement

- The exercise of a contractual right of a repo participant or financial participant to cause the liquidation, termination or acceleration of a repurchase agreement because of a condition of the kind specified in section 365(e)(1) of this title shall not be stayed, avoided, or otherwise limited by operation of any provision of this title or by order of a court or administrative agency in, any proceeding under this title, unless, where the debtor is a stockbroker or securities clearing agency, such order is authorized under the provisions of the Securities Investor Protection Act of 1970 or any statute administered by the Securities and Exchange Commission.

9 BRYAN CAVE

Repurchase Agreement Protections Under Section 559

- If a repo participant or financial participant liquidates one or more repurchase agreements with a debtor and under the terms of one or more such agreements has agreed to deliver assets subject to repurchase agreements to the debtor, then:
  - any excess of the market prices received on liquidation of such assets
  - (or if any such assets are not disposed of on the date of liquidation of such repurchase agreements, at the prices available at the time of liquidation of such repurchase agreements from a generally recognized source or the most recent closing bid quotation from such a source)
  - over the sum of the stated repurchase prices
  - and all expenses in connection with the liquidation of such repurchase agreements
  - shall be deemed property of the estate, subject to the available rights of setoff

10 BRYAN CAVE

Repurchase Agreement Protections Under Section 559

- As used in this section, the term "contractual right" includes a right set forth in a rule or bylaw of a derivatives clearing organization (as defined in the Commodity Exchange Act), a multilateral clearing organization (as defined in the Federal Deposit Insurance Corporation Improvement Act of 1991), a national securities exchange, a national securities association, a securities clearing agency, a contract market designated under the Commodity Exchange Act, a derivatives transaction execution facility registered under the Commodity Exchange Act, or a board of trade (as defined in the Commodity Exchange Act) or in a resolution of the governing board thereof and a right, whether or not evidenced in writing, arising under common law, under law merchant or by reason of normal business practice.

11

BRYAN CAVE

1984 Amendments

Section 559 was added in 1984 to include repurchase agreements within the safe harbors for commodities and securities contracts.

12

BRYAN CAVE

2005 Amendments

In 2005, Congress:

- added "financial participants" to the list of protected parties in Sections 555 and 559
- Included mortgage related securities in definition of repurchase agreements
- Broadened Section 555 to include termination or acceleration of a securities contract

13

BRYAN CAVE

Safe Harbor Reform: Pros and Cons

- The expansion of the safe harbor in 2005 to include financial participants has drawn criticism.
- Some commentators believe that the inclusion of mortgage loans and mortgage related transactions is not necessary to protect the liquidity of investments or to protect financing of government issued securities.
- Proponents of the status quo argue that the financial markets are interrelated and the protections support the domestic real estate market.

14

BRYAN CAVE

AMERICAN BANKRUPTCY INSTITUTE

COMMISSION TO STUDY THE REFORM OF CHAPTER 11

2012~2014

FINAL REPORT AND RECOMMENDATIONS

SPONSORED BY THE ANTHONY H.N. SCHNELLING ENDOWMENT FUND

D.J. Baker
Donald S. Bernstein
William A. Brandt, Jr.
Jack Butler
Babette A. Ceccotti
Hon. Arthur J. Gonzalez
Steven M. Hedberg
Robert J. Keach, Co-Chair
Prof. Kenneth N. Klee
Richard B. Levin
Harvey R. Miller
James E. Millstein
Harold S. Novikoff
James P. Seery, Jr.
Sheila T. Smith
James H.M. Sprayregen
Albert Togut, Co-Chair
Clifford J. White III
Bettina M. Whyte
Deborah D. Williamson
Geoffrey L. Berman
James T. Markus

Reporter: Prof. Michelle M. Harner

2. Treatment of Repurchase Agreements Under Safe Harbors

Recommended Principles:

- The safe harbor for repurchase agreements should be narrowed as a means to foster financial stability, reduce interconnectedness, and exclude disguised financing arrangements.
  - o As a preferred option, the safe harbors for repurchase agreements should be limited to the kinds of agreements included in the pre-BAPCPA definitions of "repurchase agreement" in section 101(47) and "securities contract" in section 741(7) of the Bankruptcy Code.
  - o Alternatively, at a minimum, the safe harbors for repurchase agreements should be amended to exclude repurchase agreements that are, in essence, committed financing arrangements for mortgage loan portfolios. Specifically, the definitions of "repurchase agreement" in section 101(47) and "securities contract" in section 741(7) should be amended to exclude repurchase agreement facilities that have the economic attributes of traditional mortgage warehouse facilities, which typically are more akin to committed secured financing arrangements than true repurchase agreements.

Treatment of Repurchase Agreements Under Safe Harbors: Background

Sections 555 and 559 of the Bankruptcy Code allow certain parties, including financial institutions and financial participants, to liquidate, terminate, or accelerate a securities contract or repurchase agreement without relief from the automatic stay of section 362 or concern for the prohibition on enforcement of *ipso facto* clauses in section 365(e) of the Bankruptcy Code.[367] In addition, the automatic stay generally does not apply to setoffs and the exercise of other remedies by the nondebtor party under a repurchase agreement.[368] Section 559 was added to the Bankruptcy Code in 1984 to treat repurchase agreements the same as commodities and securities contracts under the safe harbors, in large part to protect the financing of the national debt.[369]

367 11 U.S.C. §§ 555, 559.

368 *Id.* § 362(b)(7).

369 *See* 5 Collier on Bankruptcy ¶ 559.LH ("The effective functioning of the repo market can only be assured if repo investors will be protected against open-ended market loss arising from the insolvency of a dealer or other counterparty in the repo market. The repo market is as complex as it is crucial. It is built upon transactions that are highly interrelated. A collapse of one institution involved in repo transactions could start a chain reaction, putting at risk hundreds of billions of dollars and threatening the solvency of many additional institutions. Since the repo market is important to the health of the country's financial system, it is desirable that the Code be interpreted and implemented in a manner which protects that market without creating an unfair result for debtors. . . . The proposed amendments will take an important first step toward meeting the full objective of Public Law 97-222 by expressly providing that similar protections apply to the crucial portions of the repo market involving U.S. Government and agency obligations, certificates of deposit, and eligible bankers' acceptances. The structure of the proposed amendments is based upon the addition to the Code of new definitions of 'repo participant' and 'repurchase agreement' and the making of conforming changes in relevant provisions of the Code. The proposed amendments are intended to afford participants in the repo market the same treatment with respect to the stay and avoidance provisions of the Code that Public Law 97-222 explicitly provided stockbrokers, securities clearing agencies, commodity brokers and forward contract merchants in connection with securities contracts, commodity contracts and forward contracts.") (citations omitted).

In 2005, pursuant to the BAPCPA Amendments, Congress amended the scope of sections 555 and 559 by expanding the definitions of "securities contracts" and "repurchase agreements" and adding "financial participants" to the list of protected parties under these sections.[370] Specifically, Congress added mortgage loans and any interests in mortgage loans, including repurchase transactions, to the definition of securities contracts in section 741(7) of the Bankruptcy Code.[371] Similarly, it added mortgage-related securities, mortgage loans, and interests in mortgage-related securities or mortgage loans, to the definition of repurchase agreements in section 101(47) of the Bankruptcy Code.[372] It also defined financial participant as "an entity with at least $1 billion in notional or principal amount outstanding or $100 million in mark-to-market securities contracts, commodities contracts, swap agreements, repurchase agreements, or forward contracts, with the debtor at the time of filing or on any day during the fifteen-month period preceding filing."[373]

Some commentators have questioned whether the expanded definitions of securities contracts and repurchase agreements further the underlying policies of the safe harbors.[374] For example, a committed mortgage loan repurchase agreement facility can function similarly to a conventional secured mortgage warehouse facility, but arguably qualify for protections under the safe harbors. In a typical mortgage warehouse transaction, the loan originator obtains short-term financing from a lender through a credit facility or similar arrangement secured by a pledge of mortgages or other assets owned by the originator (often to provide short-term financing until the mortgages can be deposited into a securitization pool). The originator can transfer or sell the mortgages or assets and would typically use any proceeds to pay down the facility with the lender.[375] Such secured transactions do not, however, present the same contagion or market risks posed by true repurchase agreements and arguably fall outside the scope of the safe harbors.

Moreover, commentators robustly debate the ongoing utility of safe harbors for repurchase agreements covering mortgage loans and nonagency mortgage-backed securities. Some commentators argue that mortgage loan repurchase agreements should no longer be protected by the safe harbors.[376] These commentators have called for excluding mortgage interests and mortgage-related transactions from the definitions of repurchase agreements and securities agreements. They assert, among other things, that mortgages are illiquid assets and therefore fall outside the justification for safe harbor protection (*i.e.*, "preservation of the liquidity of investments").[377] Others support maintaining broad protection for repurchase agreements, including mortgage repurchase agreements, based on the interconnectedness of the markets and the increasing importance of repurchase agreements in both domestic and global

370 *See id.*
371 11 U.S.C. § 741(7).
372 *Id* § 101(47).
373 *Id* § 101(22A). *See also* Mooney, *supra* note 357, at 249.
374 *See, e.g.*, Calyon N.Y. Branch v. Am. Home Mortg. Corp. (*In re* Am. Home Mortg., Inc.), 379 B.R. 503 (Bankr. D. Del. 2008). *See also* Mooney, *supra* note 357, at 251–52.
375 These secured transactions are to be contrasted with repurchase agreements, which typically involve two agreements: first, the originator sells its mortgages or other assets to the lender in exchange for funds; second, the originator agrees to repurchase the mortgages or other assets for the original price plus a premium at a date certain (usually one year after the original sale).
376 *See, e.g.*, Edward R. Morrison et al., *Rolling Bank the Repo Safe Harbors*, 69 Bus. Law. 1015, 1019 (2014) (proposing to "scal[e] back the repo safe harbor to approximately the 1984 scope for 'repurchase agreements', namely, safe harboring only repos on U.S. Treasury and Agency securities backed by the government's full faith and credit, certificates of deposits, and bankers acceptances").
377 *Exploring Chapter 11 Reform: Corporate and Financial Institution Insolvencies; Treatment of Derivatives, Hearing Before the H. Subcomm. on Regulatory Reform, Commercial and Antitrust Law*, 113th Cong. 9 (2014) (statement of the Honorable Christopher S. Sontchi, U.S. Bankruptcy Judge for the District of Delaware). Judge Sontchi also explained: "The current safe harbors for repurchase agreements allow for 'runs' on financial institutions such as American Home Mortgage by counterparties/lenders which are not subject to the automatic stay and, thus, are free to terminate repos and other financial contracts en masse." *Id.* at 10.

investment portfolios.[378] With respect to repurchase agreements specifically, these supporters believe that the protections afforded to such contracts by the safe harbors reduce the cost of credit and support domestic real estate markets.[379] These supporters also suggest that any restrictions on investment in mortgage loans by financial institutions are best implemented through carefully considered prudential regulation rather than through the "blunt instrument" of a change to the Bankruptcy Code's safe harbors. Both sides rely on anecdotal evidence to support their respective positions.

Treatment of Repurchase Agreements Under Safe Harbors: Recommendations and Findings

Repurchase agreements as financial instruments provide liquidity and flexibility to market participants. They also represent a large component of the financial markets.[380] The Commissioners recognized the important role that repurchase agreements play in the markets, particularly those initiated on an overnight or short-term basis. Some of the Commissioners agreed with those commentators who distinguish mortgage loan repurchase agreements from other kinds of repurchase agreements structured around more liquid assets such as U.S. government and agency securities. The ability to liquidate the transferred assets immediately upon a default is a central and important feature of traditional repurchase agreements.

The Commissioners discussed the advantages and disadvantages of providing safe harbor protections to mortgage loan repurchase agreements and recognized the challenges to reducing these protections. Some of the Commissioners believed that the risks posed by removing mortgage loan repurchase agreements from the safe harbors were significantly outweighed by the potential benefits. These Commissioners were persuaded by the arguments that inclusion of these repurchase agreements encouraged runs on debtor originators and accelerated (rather than reduced) contagion.[381] The Commission voted to scale back the safe harbors for repurchase agreements to the pre-BAPCPA definitions of repurchase agreement and securities contract.[382]

---

378 *See* Steven L. Schwarcz & Ori Sharon, *The Bankruptcy-Law Safe Harbor for Derivatives: A Path-Dependence Analysis*, 71 Wash. & Lee L. Rev. 1715 (2014).

379 *See, e.g., Exploring Chapter 11 Reform: Corporate and Financial Institution Insolvencies; Treatment of Derivatives, Hearing Before the H. Subcomm. on Regulatory Reform, Commercial and Antitrust Law*, 113th Cong. 35 (2014) (statement of Seth Grosshandler, Partner at Cleary, Gottlieb, Steen & Hamilton LLP) ("In particular, the safe harbor for repurchase agreements on residential mortgage-backed securities and whole loan mortgages serves to reduce the cost of mortgage financing to homeowners.").

380 Data as of June 2014 suggest that the value of outstanding repurchase agreements in the United States is approximately $4 trillion. *See* Elizabeth Holmquist & Josh Gallin, *Repurchase Agreements in Financial Accounts of the United States*, June 30, 2014, *available at* http://www.federalreserve.gov/econresdata/notes/feds-notes/2014/repurchase-agreements-in-the-financial-accounts-of-the-united-states-20140630.html.

381 *See* Morrison, et al., *Rolling Back the Repo Safe Harbors*, *supra* note 376, at 1017 (discussing safe harbors for repurchase agreements and observing that "there is little evidence that they serve this purpose"). "Instead, considerable evidence shows that, when they matter most — in a financial crisis — the safe harbors exacerbate the crisis, weaken critical financial institutions, destabilize financial markets, and then prove costly to the real economy." *Id.* For a general discussion of these issues, see Schwarcz, *Derivatives and Collateral*, *supra* note 353, at *4–5 ("The purpose of the safe harbor is to help ensure that large derivatives dealers can enforce their remedies against a failed counterparty, thereby minimizing the dealer's losses and reducing its chances of collapse. There are however, at least three possible flaws in that logic. The first flaw is that if a dealer itself is a defaulting counterparty, the safe harbor enables the dealer's other counterparties to enforce their remedies, thereby hastening the dealer's collapse. This occurred, for example, in the case of [Lehman Brothers]. The second flaw is that there is 'little actual evidence to support' the claim that the collapse of a dealer might systemically disrupt the derivatives market. . . . [Lastly], the safe harbor itself appears to incentivize market concentration by enabling dealers and other parties to virtually ignore counterparty risk. . . . For this reason, creditors 'are not overly concerned with their debtor's financial stability, because they protect themselves with the debtor's collateral, rather than with their understanding of the firm itself.' ").

382 Between 1994 and 2006, the Bankruptcy Code had defined "***securities contract***" as follows:

> "securities contract" means contract for the purchase, sale, or loan of a security, including an option for the purchase or sale of a security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any option entered into on a national securities exchange relating to foreign currencies, or the guarantee of any settlement of cash or securities by or to a securities clearing agency; . . . .

Other Commissioners observed that markets are increasingly global and interconnected, and they found value in maintaining the same level of protection for all true repurchase agreements. Some of these Commissioners, however, also agreed that the safe harbors should not protect disguised mortgage warehouse arrangements. The Commissioners explored removing transactions that facilitate short-term financing through a pledge of the assets, rather than a true sale. In the course of these discussions, the Commissioners discussed specifically excluding committed mortgage loan repurchase agreement facilities that function as mortgage warehouse facilities from the definitions of repurchase agreements and securities contracts and the safe harbors under the Bankruptcy Code. The Commission voted in favor of this exclusion, subject to its preference for a more extensive reduction in the safe harbors for repurchase agreements, as described in the preceding paragraph.

3. Assumption of Financial Contracts

Recommended Principles:

- Under current law, several aspects of the safe harbors make it difficult for a trustee to exercise the traditional power under section 365 of the Bankruptcy Code to assume a derivative or other financial contract. For example, counterparties' ability to enforce *ipso facto* clauses and terminate contracts protected by the safe harbors often make assumption of a derivative or other financial contract impossible. Moreover, the safe harbors arguably allow counterparties to remove valuable assets from the estate, such as when the debtor is in the money on the contract in question, especially if damages paid upon termination do not compensate the estate fully for loss of the contract. Nevertheless, these challenges for the trustee need to be balanced against the volatile and systemic nature of the financial markets and the need to mitigate contagion in the larger economy.
- On balance and considering the proposed revisions to the safe harbors regarding the treatment of ordinary supply contracts, repurchase agreements, and walkaway clauses under these principles, the Commission does not believe further amendments to the safe harbors with respect to a trustee's ability to assume derivative and other financial contracts are necessary or advisable. In addition, the Commission is aware of ongoing efforts to provide financially distressed systemically important financial institutions (or their subsidiaries that are parties to such contracts) with some ability to transfer derivative and other financial contracts in certain circumstances in the event that such institutions become debtors under the Bankruptcy Code. The Commission has decided to take no action with respect to such institutions.

11 U.S.C. § 741(7) (effective Oct. 22, 1994 to Dec. 11, 2006). Between 2000 and 2004, the Bankruptcy Code had defined "***repurchase agreement***" as follows:

> "repurchase agreement" (which definition also applies to a reverse repurchase agreement) means an agreement, including related terms, which provides for the transfer of certificates of deposit, eligible bankers' acceptances, or securities that are direct obligations of, or that are fully guaranteed as to principal and interest by, the United States or any agency of the United States against the transfer of funds by the transferee of such certificates of deposit, eligible bankers' acceptances, or securities with a simultaneous agreement by such transferee to transfer to the transferor thereof certificates of deposit, eligible bankers' acceptances, or securities as described above, at a date certain not later than one year after such transfers or on demand, against the transfer of funds; . . . .

11 U.S.C. § 101 (effective Dec. 21, 2000 to Oct. 24, 2004).

ALDERSON REPORTING COMPANY

STEVEN MOSKEY

HJU085050

EXPLORING CHAPTER 11 REFORM: CORPORATE AND FINANCIAL INSTITUTION INSOLVENCIES; TREATMENT OF DERIVATIVES

Wednesday, March 26, 2014

House of Representatives

Subcommittee on Regulatory Reform, Commercial and Antitrust Law

Committee on the Judiciary

Washington, D.C.

The subcommittee met, pursuant to call, at 4:00 p.m., in Room 2141, Rayburn Office Building, Hon. Spencer Bachus [chairman of the subcommittee] presiding.

Present: Representatives Bachus, Marino, Holding, Collins, Johnson, and Jeffries.

Staff present: Daniel Flores, Majority Chief Counsel;

Anthony Grossi, Majority Counsel; Jaclyn Louis, Legislative Director for Rep. Marino; Jon Nabawi, Legislative Director for Rep. Holding; Jennifer Lackey, Legislative Director for Rep. Collins; Ashley Lewis, Majority Clerk; Susan Jensen, Minority Counsel; Norberto Salinas, Minority Counsel; and Slade Bond, Legislative Director for Rep. Johnson.

STATEMENT OF SETH GROSSHANDLER, ESQUIRE

Mr. Grosshandler. Thank you, Chairman Bachus. Thank you for having me here. You have my written testimony. I am not going to repeat what is in there. The only reference to the written testimony I want to make is to thank my colleagues Knox McIlwain and Timmy Coldorovo who put it together in such short order.

I was the co-chair with Judge Peck of the Lehman bankruptcy of the ABI Safe Harbors Committee that Judge Sontchi was on as well. And we started that a few years ago, and we were given by the ABI commissioners several pages of topics to cover. We could not get to them all. This is a very, very complicated topic, the safe harbors, the treatment of financial contracts in bankruptcy.

Part of that has to do with there are lots of different players involved, and you may have different answers depending on who the players are, so you have systemically important financial institutions. You have hedge funds. You have industrial companies. You have individuals on the debtor side. It may depend on who the creditor is. Is the creditor a securities clearing agency, like DTC, or is it a

non-dealer party? And there are different policy considerations depending on who you are talking about on the debtor and on the creditor side.

Although we had many disagreements among the committee members, there were several things we agreed on. First of all, really complicated. Could not get it all done in the time we had. And then, the safe harbors do derogate from the general principles of the Bankruptcy Code, and that needs to be justified, right? And the justification, and different people on the committee disagreed as to what was and was not justified under these standards. But I think that the basic standards were agreed to, which is the safe harbors, if they promote stability and liquidity, that those are things that might justify derogating from the usual rules of the Bankruptcy Code.

I think people generally agreed that the derivatives, creditors, and repo creditors, at least some of them, maybe not the whole loan repo creditors. I disagree with Judge Sontchi on that, but we can talk about that if you would like. But that some of the risk they face are different from other creditors under the Bankruptcy Code, and, therefore, at least some of the safe harbors were justified under those

standards.

The safe harbors also underpin very important markets. The derivatives market, the repo market, they might not cease to exist if you got rid of the safe harbors, but they would certainly shrink a lot, okay? And is that good or bad depends on a lot of things.

And one of the problems with just getting rid of the safe harbors is it is a very blunt instrument because it would basically mean everybody is not safe harbored as opposed to, for instance, regulatory change. So if you look at short-term funding transactions, like repos, the Federal Reserve Board is all over it, right, in terms of greater liquidity requirements, capital requirements, that sort of thing, to give a disincentive to over reliance on those kinds of transactions, whereas just getting rid of a safe harbor under the Bankruptcy Code, again, would be a very blunt instrument.

I think an interesting example is insurance insolvency, not the subject of this committee. It is State law. Insurance insolvency is governed by State law.

Little known to most people because why would they be focusing on this, but in the past 5 years, at least 10 States

have enacted new safe harbors for insurance company insolvency for derivatives and repos. We are up to about 20, 22 now. But the bulk of that has happened since the financial crisis. Why? It is the insurance companies, the users of those products that wanted the safe harbors to have access to those markets because Wall Street was unwilling to give them access or limited access because of the risk. So this is not only about protecting Wall Street, right? It is also end users like insurance companies who want the safe harbors.

All that being said, there are clearly issues with everybody liquidating all at once. You want to avoid that if you can. In Lehman, I think that that actually helped prevent more contagion. If all the creditors had been stayed from exercising their rights, there would have been a lot of problems. But the liquidations caused their own problems, of course.

So I think mechanisms that achieve continuity -- Chapter 14, the Federal Deposit Insurance Act, single point of entry -- all of these designed to avoid close out are very, very good things. The key to them working from a creditor perspective is that there is somebody who is creditworthy who

is able to continue the performance, and that is not only balance sheet creditworthiness. It is liquidity, liquidity to be able to perform.

And then the final thing I would say is to the extent that Congress believes that changes to the fundamental safe harbor provisions are necessary, need to be very careful. It is really complicated. There are a lot of international aspects to this. There are safe harbors around the world, capital implications for financial institutions.

And the final thing is on the committee we dealt with a number of issues, the really hard issues like the scope of the repo exemption. There was a lot of division. There were several other issues that we picked first because it was so-called low hanging fruit where there was actually a lot of agreement about changes that would make the safe harbors better for America. Thank you.

[The statement of Mr. Grosshandler follows:]

STATEMENT OF

SETH GROSSHANDLER

BEFORE

SUBCOMMITTEE ON REGULATORY REFORM, COMMERCIAL AND ANTITRUST LAW

COMMITTEE OF THE JUDICIARY

U.S. HOUSE OF REPRESENTATIVES

WASHINGTON, D.C.

MARCH 26, 2014

EXPLORING CHAPTER 11 REFORM: CORPORATE AND FINANCIAL INSTITUTION INSOLVENCIES; TREATMENT OF DERIVATIVES

Chairman Bachus, and members of the committee:

Thank you for inviting me to testify today. I am Seth Grosshandler, a partner at Cleary Gottlieb Steen & Hamilton LLP in New York City. I am co-chair of the Financial Contracts, Derivatives and Safe Harbors Advisory Committee to the American Bankruptcy Institute's Commission on the Reform of Chapter 11 and a member of the Legal Advisory Panel advising the Financial Stability Board on resolution questions. I represented the Securities Industry and Financial Markets Association in connection with the financial contract netting provisions of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (for bank insolvency) and the Bankruptcy Code amendments of 2005 and 2006. I previously testified with respect to the 2005 Bankruptcy Code amendments before the Subcommittee on Commercial and Administrative Law of the House Judiciary Committee in 1999.

A large portion of my practice is dedicated to working on resolution plans for large financial institutions required under Section 165(d) of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which has allowed me to spend considerable time thinking about the resolvability of financial institutions. I have also been actively engaged with both market participants and regulators in the development and implementation of innovative approaches to financial company insolvency, such as "bail-ins" and single-point-of-entry resolution strategies. I also dedicate a substantial part of my practice to cleared and uncleared over-the-counter derivatives and other financial contracts, ensuring that close-out and other rights are protected in the event of an insolvency. I appear before you today in my individual capacity. The views I express are entirely my own, and not those of Cleary Gottlieb Steen & Hamilton LLP or any client or organization with which I am affiliated.

This experience has led me to the conclusion that the Bankruptcy Code safe harbors[1] serve a vital role in promoting systemic stability and resilience, have significantly increased the availability to end-users of derivatives and repurchase agreements and the liquidity of these transactions and related assets, have reduced the cost of transactions to end-users and have decreased the cost of financing to issuers of assets. The safe harbors protect counterparties under a wide variety of financial contracts, including contracts for the purchase or sale of securities and commodities, derivatives contracts, such as swaps and forwards, and repurchase agreements on securities and mortgage loans (collectively, "Safe Harbored Contracts").[2] These contracts are used both by major financial market participants, such as dealers, banks, mutual funds, hedge funds and pension funds, and by businesses in the "real economy." The benefits of the safe harbors accrue not only to users of Safe Harbored Contracts, but to issuers of assets and borrowers under loans financed by Safe Harbored Contracts. In particular, the safe harbor for repurchase agreements on residential mortgage-backed securities and whole loan mortgages serves to reduce the cost of mortgage financing to homeowners.

The risks related to Safe Harbored Contracts, which are secured by (or reference) financial assets and commodities, the value of which can change rapidly, are fundamentally different from the risks related to other contracts; the protections afforded by the safe harbors are aimed at reducing the risks unique to Safe Harbored Contracts. These protections are especially important to central counterparties, who facilitate and reduce risk in markets for Safe Harbored Contracts by interposing themselves between parties to such contracts (acting as the "buyer" to the "seller," and the "seller" to the "buyer"). By protecting counterparties' rights to terminate their Safe

[1] *See* 11 U.S.C. §§ 362(b)(6), (7), (17), (27), 362(o), 546(e)-(j), 548(d)(2), 553(a)(2)(B)(ii), (a)(3)(c), (b)(1), 555, 556, 559, 560, 561, 562, 753 and 767 (2012).
[2] *See* 11 U.S.C. §§ 101(25) (forward contract), (38A) (master netting agreement), (47)(repurchase agreement), (53B) (swap agreement), 741 (securities contract), 761(4) (commodity contract) (2012).

Harbored Contracts, net amounts owing between the parties, and to exercise rights against related collateral, the Bankruptcy Code safe harbors serve as a firewall, ensuring that the failure of one party does not expose its counterparties to excessive, unquantifiable and therefore un-hedgeable risks. This firewall has been effective in allowing major market participants, such as Lehman Brothers, MF Global and Enron, to exit the market without causing cascades of failures throughout the financial system as a result of Safe Harbored Contracts. Of course, the Lehman bankruptcy did create risks in the financial system, but they, by and large, were not related to Safe Harbored Contracts, and the risks to counterparties and the financial system would have been far greater without the safe harbors.

One of the tangible effects of the safe harbors under "business as usual" conditions, that is, prior to a bankruptcy, is the increase of the liquidity of Safe Harbored Contracts, which reduces both the cost of these transactions and the costs to the issuers of the assets underlying the transactions—the securities or commodities being bought or sold, the mortgages and credit card receivables being financed, the risks being hedged. These benefits flow directly from the certainty provided to market participants that, in the event of the failure of their counterparty, they will be able to realize the value of their bargained-for security, crystalize their loss and hedge the risk related to their counterparty's failure.

It should be noted, however, that, in the context of systemically important financial institutions, immediate close-out may not be the ideal approach. While risks to the financial system would be far greater if counterparties could not immediately close out, the wide-spread and immediate liquidation of contracts and collateral following the failure of a major financial institution can negatively affect markets for less liquid assets. Indeed, this dynamic was present for certain parts of Lehman's book of Safe Harbored Contracts and increased losses to the

Lehman estate. Instead, an approach that provides for the continuity of Safe Harbored Contracts would be preferable in the case of a failed systemically important financial institution, as it would avoid immediate close-outs. I discuss possible approaches at the end of this testimony. However, the risks associated with counterparty contagion that the safe harbors mitigate are far more detrimental to the financial system than the effects of widespread close-outs. Therefore, even if mechanisms for promoting the continuity of Safe Harbored Contracts upon the failure of a systemically important financial institution cannot be achieved, the current safe harbors should be preserved.

Safe Harbors Reduce Systemic Risk by Protecting Against Contagion

Systemic risk can manifest itself in a variety of ways. One example is the risk that the failure of one financial institution could cause a chain reaction of failures in the financial system because of the high degree of interconnectedness within the system. Interconnectedness is inherent in financial markets and the business models of many financial market participants, especially dealers or "market makers." Because there are always at least two parties to any Safe Harbored Contract, major financial market participants are by definition interconnected to one another and, generally, to non-financial companies as well. Similarly, many of the Safe Harbored Contracts that market participants enter into are related or connected to other of their own Safe Harbored Contracts. For example, dealers and other major market participants generally seek to hedge market exposure. Thus, if they are exposed to a risk under one Safe Harbored Contract they will attempt to hedge that risk under a matching and offsetting Safe Harbored Contract (or on a portfolio basis), creating a web of interconnected financial contracts.

While interconnections can be reduced (and industry and regulators have indeed been taking steps to reduce interconnections), they cannot be eliminated. When considering how to address systemic risk, the question therefore becomes how the risks associated with such interconnections are handled during the insolvency of one of the parties to a transaction. While the safe harbors do not address all aspects of systemic risk, they have proven to be very effective in containing the risk of contagion by allowing counterparties to terminate volatile financial contracts with the debtor quickly, thus limiting their exposure to possibly catastrophic losses from the failure of the debtor. This is the very reason why Congress enacted the safe harbors in the first place.[3]

The effectiveness of the safe harbors in containing contagion was demonstrated during the bankruptcy of Lehman Brothers. None of Lehman Brothers' counterparties (many financial institutions among them) failed because of losses under Safe Harbored Contracts with Lehman.[4] Almost all counterparties exercised their safe harbored rights to terminate, net and exercise rights against collateral, with only approximately 3% of Lehman's derivatives book remaining outstanding after three months following its bankruptcy petition.[5] If these counterparties were not

---

[3] *See e.g.*, Bankruptcy Law and Repurchase Agreements: Hearing on H.R. 2852 and H.R. 3418 Before the Subcomm. on Monopolies and Commercial Law of the H. Comm. on the Judiciary, 98th Cong. 19 (1984) (statement of Hon. Walter E. Fauntroy) ("The great fear is that a chain reaction would result because of the complex interrelation of many transactions and firms, putting at risk hundreds of billions of dollars and threatening the solvency of many institutions."); H.R. REP. 97-420, at 1 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583, 583 (stating that the 1982 safe harbor amendments "are necessary to prevent the insolvency of one commodity or security firm from spreading to other firms and possible [sic] threatening the collapse of the affected market"); Bankruptcy Reform Act of 1978: Hearing on S. 2266 and H.R. 8200 Before the Subcomm. on Improvements in Judicial Machinery of the H. Comm. on the Judiciary, 95th Cong. 524 (1978) (statement of Stuart D. Root, Esq.) (stating that the absence of close-out rights for futures commission merchants would have "a potential domino effect"), *available at* http://www.archive.org/stream/bankruptcyreform1978unit/bankruptcyreform1978unit_djvu.txt.

[4] Kimberly Ann Summe, *Lessons Learned from the Lehman Bankruptcy, in* ENDING GOVERNMENT BAILOUTS AS WE KNOW THEM 59, 77 (2010), *available at* http://media.hoover.org/sites/default/files/documents/Ending_Government_Bailouts_as_We_Know_Them_59.pdf.

[5] *Id.* at 79.

protected by the safe harbors, these positions would have been indefinitely frozen, causing potentially catastrophic capital and liquidity implications for counterparties in addition to any losses under the contracts. While subsequent failures (and near-failures) occurred during the financial crisis, they had other causes—mainly losses caused by outsized exposures to the subprime mortgage market and the seizure of the inter-bank credit market. The effects of these dynamics were exacerbated by the political uncertainty caused by letting Lehman fail, while shoring up other institutions, which led to or exacerbated runs on not just broker-dealers, but on insured depository institutions (the first time runs had occurred since the Great Depression).

The effectiveness of the safe harbors in containing contagion was evident in the insolvencies of other financial companies, such as the failures of MF Global in 2011 and Enron in 2001. MF Global was a leading broker in a variety of U.S. and European commodities markets, but was able to exit the market safely and without disrupting financial markets.[6] Enron was a party to one out of every three gas transactions and one out of every five electricity transactions in the United States.[7] Despite this massive and unrivaled market presence, no other major financial institution failed as a result of Enron's bankruptcy.

Repealing or Substantially Narrowing the Safe Harbors Would Have Significant Negative Effects on Counterparties and Markets Related to Safe Harbored Contracts

The safe harbors are not a silver bullet against all systemic risk, but repealing them or substantially narrowing them would eliminate the most effective tool for addressing the risk of

[6] Jack Farchy, *MF Global's Demise Felt by Commodities Exchanges*, FT.COM (Nov. 1, 2011), http://www.ft.com/intl/cms/s/0/418fa2f2-046c-11e1-ac2a-00144feabdc0.html?siteedition=uk#axzz2wiK4MXNO.

[7] Committee on Governmental Affairs Members and Staff, Committee Staff Investigation of the Federal Energy Regulatory Commission's Oversight of Enron Corp. 19 (2002), *available at* http://fl1.findlaw.com/news.findlaw.com/hdocs/docs/enron/111202fercmemo.pdf.

contagion. This would decrease the resilience of financial markets and increase the risks to financial market participants, thereby increasing systemic risk.

Absent safe-harbor protection, counterparties would be subject to the Bankruptcy Code's automatic stay and assumption/rejection powers, which would subject Safe Harbored Contract counterparties to a variety of risks. Unlike other contracts, the value of Safe Harbored Contacts typically can change rapidly based on the fluctuating value of the underlying assets or collateral, prevailing market conditions and other factors. The inability of counterparties to terminate such contracts and foreclose on collateral exposes them to risks that cannot be hedged effectively. If the debtor is given the right to assume or reject Safe Harbored Contracts in bankruptcy, this effectively gives the debtor an indefinite option to perform or terminate the contract, making it impossible to effectively hedge the related risks in an adequate manner. It could also potentially give the debtor the right to "cherry pick" between contracts, exacerbating losses to creditors. Although the Bankruptcy Code provides protections to secured creditors, the mechanisms are not timely enough and are too cumbersome to obtain to effectively protect counterparties under volatile Safe Harbored Contracts, especially on a large scale, such as during the failure of a systemically important financial institution.

For example, a party who is owed 100 by the debtor at the time of the debtor's insolvency, and who has 105 in collateral, would be protected from risk if it could immediately terminate the contract, realize on 100 of the collateral and return the remaining 5 of collateral. However, if the counterparty is unable to terminate, and the value of the contract changes such that the debtor owes the counterparty 120 and additional collateral is not posted, the counterparty is exposed to a loss of 15. Similarly, if the value of the collateral were to decrease to 80, and the debtor did not post additional collateral, the counterparty would be exposed to a loss of 20. Further, the

increased loss for the counterparty would result in a larger claim against the estate, which would potentially reduce recoveries for other creditors of the estate.

The inability to exercise close-out rights is particularly problematic where a counterparty has entered into back-to-back or related transactions. For example, a dealer or market maker generally will have entered into one or more offsetting transactions to eliminate its financial exposure and lock in a spread; the receipt of a payment under one contract offsets the obligation to make payments under the related contracts. A debtor's failure to post margin or make other payments required under the contract puts an immediate liquidity pressure on the counterparty. This liquidity pressure creates an immediate risk for counterparties, over and above any ultimate loss that may be realized on the contract. It is therefore critical for the non-defaulting party to close out contracts with the debtor, liquidate the collateral and use the proceeds to replace the position with a solvent, creditworthy counterparty. These risks do not exist nearly to the same extent for other creditors in bankruptcy. For example, the value of a loan secured by plant, property or equipment is not likely to change rapidly after the filing for bankruptcy.

These risks are particularly acute with respect to central counterparties, which interpose themselves between parties to Safe Harbored Contracts. Central counterparties reduce risk to the system and to clearing members by reducing net exposures and by maintaining collateral and other loss-absorbing mechanisms that prevent losses from being propagated through the financial system. Central counterparties therefore serve a role similar to that of the safe harbors—as a mechanism for containing contagion. But central counterparties can serve this risk-reducing function only if they can quickly close out Safe Harbored Contracts to contain and manage their own risk—otherwise, central counterparties become a vector for systemic risk.

One of the primary effects of the certainty and protections afforded by the safe harbors is to increase the liquidity of markets for Safe Harbored Contracts, which reduces the costs of both the safe harbored transactions and the costs to the issuers of the assets underlying such transactions. The history of the repurchase agreement market and the related safe harbor demonstrates well this dynamic. In the early 1980s, the securities dealers underwriting the issuances of U.S. Government debt (the so-called "primary dealers") financed their purchases of Treasuries by entering into repurchase agreements on the purchased securities with other market participants in reliance on the "securities contract" safe harbor. In 1982, the Lombard-Wall bankruptcy case threw a shadow over the safe-harbor protection for repurchase agreements by holding that they were to be treated as secured loans rather than purchases and sales of securities and were thus subject to the automatic stay.[8] The uncertainty that the case created had a substantial effect on the repurchase agreement market—the volume of repurchase agreement transactions dropped and the cost rose.[9] As a result, there was a measurable increase in the U.S. Treasury's borrowing costs and the cost of financing the U.S. debt. Concerned that the lack of a robust and liquid repurchase agreement market would impair the U.S. Government securities market, Congress created the safe harbor for repurchase agreements in 1984.[10]

---

[8] *Lombard-Wall Inc. v. Columbus Bank & Trust Co.*, No. 82 B11556 (Bankr. S.D.N.Y., Sept. 16, 1982) (bench decision). Courts in later decisions rule to the contrary. *See e.g.*, *In re Residential Resources*, 98 B.R. 2 (Bankr. D. Ariz. 1989).

[9] Bankruptcy Law and Repurchase Agreements: Hearing on H.R. 2852 and H.R. 3418 Before the Subcomm. on Monopolies and Commercial Law of the H. Comm. on the Judiciary, 98th Cong. 19 (1984) (statement of Hon. Walter E. Fauntroy) (acknowledging the "major impact" the ruling had on the repurchase agreement market and the resulting increase in repurchase agreement interest rates); Bankruptcy Law and Repurchase Agreements: Hearing on H.R. 2852 and H.R. 3418 Before the Subcomm. on Monopolies and Commercial Law of the H. Comm. on the Judiciary, 98th Cong. 48 (1984) (statement of Peter D. Sternlight, Executive Vice President of the Federal Reserve Bank of New York) (stating that, in the aftermath of the Lombard-Wall case, some repurchase agreement participants withdrew from the market and repurchase agreement financing costs were negatively affected).

[10] *Id.* at 18-19.

Lombard-Wall's effect on the repurchase agreement market demonstrates what would be the result for other Safe Harbored Contracts were their safe-harbor treatment eliminated or scaled back: the price of such transactions would increase, liquidity would decrease and the markets for such contracts would undoubtedly shrink. In my experience, financial market participants simply would not enter into certain Safe Harbored Contracts without the protection afforded by the safe harbors, meaning that markets for those contracts could virtually disappear. Because of the direct and dramatic effect that eliminating or substantially narrowing the safe harbors would have on markets for Safe Harbored Contracts, a decision to proceed with such revisions equates to a determination that these markets do not provide value to the financial system or the broader economy and thus can be curtailed or eliminated.

The benefits of the safe harbors are also evidenced by the fact that many states have very recently—since the financial crisis—incorporated safe-harbor protections into their laws governing the insolvency of insurance companies. Rather than being subject to the Bankruptcy Code or other federal insolvency law, insurance companies are subject to state "rehabilitation" regimes, many of which did not originally contain safe harbors for financial contracts. As of 2013, at least 21 states had added safe-harbor protections to their insurer insolvency laws, and most of these safe harbors have been added since 2008. My understanding is that the drive to enact these reforms came from the insurers themselves (rather than from the banks and dealers) in an effort to gain broader and more cost-effective access to markets for Safe Harbored Contracts, such as repurchase agreements and swaps.

Elimination of the safe harbors could also affect the funding profile and stability of financial companies, including systemically important financial institutions. In the absence of safe harbors, the preference of parties providing funding would likely be for very short-term

transactions in order to reduce the likelihood of being trapped in term transactions upon a counterparty's failure. Further, all counterparties—secured and unsecured, short term and long term—would be more likely to stop engaging in new transactions (i.e., to "run") at the first sign of weakness, making entities less stable and resilient. The safe harbors, therefore, provide counterparties the comfort necessary to engage in longer-term transactions and to continue to engage in transactions with a financial company notwithstanding signs of weakness.

Last but not least, the United States is not alone in providing safe-harbor protections for financial contracts. Since the financial crisis, numerous international bodies have considered the issue of systemic risk and financial company insolvency. The resounding consensus has been in favor of broad safe harbors for the termination of financial contracts, netting of amounts owing and realization on related collateral if such contracts cannot be transferred to a creditworthy successor within one or two days. This approach was enshrined in the Financial Stability Board's "Key Attributes of Effective Resolution Regimes for Financial Institutions," which was endorsed by the Group of Twenty Finance Ministers and Central Bank Governors (the G20) and serves as the global standard for financial company insolvency regimes in the developed world.[11] This approach was based on the financial contract safe harbors under the bank insolvency provisions of the Federal Deposit Insurance Act and the Orderly Liquidation Authority provisions of the Dodd-Frank Act, which served as models for the "Key Attributes." Both the Basel Committee on Banking Supervision and the International Monetary Fund, among others, support this approach.

Outside the sphere of financial company insolvency, there has been broad international support for safe harbors as effective means of protecting financial markets and cabining

[11] Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions (2011), *available at* https://www.financialstabilityboard.org/publications/r_111104cc.pdf.

contagion. According to data from the International Swaps and Derivatives Association, Inc., as of 2010, there were thirty-seven jurisdictions allowing a non-defaulting party the right to terminate and net obligations under derivatives contracts in the event of insolvency.[12] Any action by the United States to scale back on the safe harbors would be at odds with the international trend towards providing robust safe harbor protections. More importantly, it would put U.S. firms at a significant competitive disadvantage.

More Targeted Measures Should be Pursued

Some have criticized the safe harbors and argued for their repeal, citing among other things the creation of skewed incentives and potentials for distortions in asset markets. These criticisms are particularly prevalent in academic circles. To the extent any such criticisms are justified, and that they outweigh the safe harbors' unquestionable benefits to the stability of financial markets, such risks should be addressed directly, through targeted means, and not by the blunt instrument of repealing or narrowing of the safe harbors.

Take for example the criticism that the safe harbor for repurchase agreements has created an incentive for large financial institutions to rely excessively on short-term repurchase agreements rather than on other forms of funding.[13] The banking and securities regulators are uniquely positioned to address any such issues. In fact, regulators have already taken steps to reduce reliance on short-term funding through tougher capital and liquidity requirements,[14] and

[12] David Mengle, The Importance of Close-Out Netting, ISDA Research Note, No. 1 (2010), *available at* http://www.isda.org/researchnotes/pdf/Netting-ISDAResearchNotes-1-2010.pdf.

[13] Mark J. Roe, Statement to the Subcommittee on Regulatory Reform, Commercial and Antitrust Law of the Committee on the Judiciary of the House, The Bankruptcy Code and Financial Institution Insolvencies (Dec. 3, 2013), *available at* http://judiciary.house.gov/_files/hearings/113th/12032013_2/Roe%20Testimony.pdf.

[14] *See* Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and

plan further action.[15] These rules address specific concerns about the funding profile of major financial institutions without increasing risks to counterparties that would arise if the safe harbors were instead narrowed or eliminated.

Consider also the criticism that the wide-spread close-out that can occur upon the failure of a systemically important financial institution can have negative effects on markets for less liquid collateral. Rather than eliminating the transactions in question, by narrowing or eliminating safe-harbor protection, I would encourage the committee to explore mechanisms that provide for the continuity of such transactions and that avoid close-outs. A case in point is the Federal Deposit Insurance Act's treatment of Safe Harbored Contracts, which facilitates the transfer of a failed bank's portfolio of Safe Harbored Contracts to a creditworthy successor—a successor that is solvent from a capital perspective and that has the liquidity to meet its obligations. Similar concepts exist under the Securities Investor Protection Act, which facilitates the transfer of a failed broker-dealer's "customer" property and transactions to a successor broker-dealer, and Subchapter IV of Chapter 7 of the Bankruptcy Code and the Commodity Futures Trading Commission's Part 190 Rules thereunder, which similarly facilitate the transfer of a failed commodity broker's "customer" property and transactions to a successor commodity broker. Indeed, the recent "Chapter 14" bill proposed just such a mechanism in the context of special bankruptcy proceedings designed to allow financial institutions to restructure rather than

---

Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. 62,018 (Oct. 11, 2013), *available at* http://www.gpo.gov/fdsys/pkg/FR-2013-10-11/pdf/2013-21653.pdf; Liquidity Coverage Ratio, 78 Fed. Reg. 71,818 (Nov. 29, 2013) (Proposed Rule), *available at* http://www.gpo.gov/fdsys/pkg/FR-2013-11-29/pdf/2013-27082.pdf.

[15] *See* Daniel K. Tarullo, Speech at the Americans for Financial Reform and Economic Policy Institute Conference (Nov. 22, 2013) (indicating the need to address short-term wholesale funding through regulation and outlining possible regulatory approaches) , *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20131122a.htm.

liquidate.[16] Such approaches may ultimately prove the most effective at reducing the systemic risks associated with the failure of a major financial institution.

Finally, as noted at the beginning of my testimony, there are many aspects to systemic risks. Some have argued that because the Dodd-Frank Act and related regulatory efforts are aimed at reducing systemic risk, that there is no longer any justification for the safe harbors and that they should therefore be repealed. At best, this argument fails to distinguish among the various aspects of systemic risk. As I have described, the safe harbors are aimed at preventing failures from cascading throughout the financial system—one form of systemic risk. But as the 2008 financial crisis demonstrated, there are many other forms of systemic risk. The Dodd-Frank Act reforms are largely aimed at reducing other forms of systemic risk.[17] The fact that other aspects of systemic risk are being addressed through other regulatory means does not mean that the safe harbors are no longer justified or that they are no longer needed as a bulwark against cascading failures. To the contrary, the multiple aspects of systemic risk require that we deploy a variety of defenses.

Conclusion

In conclusion, the safe harbors should not be narrowed or repealed because they serve an important role in preventing the spread of financial contagion throughout financial markets. The certainty that these protections provide has created robust and liquid markets for Safe Harbored

[16] Taxpayer Protection and Responsible Resolution Act, S. 1861, 113th Cong. (2013).

[17] While the "single-counterparty credit limit" requirement of Section 165 of the Dodd-Frank Act is aimed at reducing interconnectedness, it would of course not eliminate it. The safe harbors would still be necessary to address counterparty contagion risk under the remaining interconnections. Further, while the Orderly Liquidation Authority provisions of the Dodd-Frank Act do address contagion risk, the Dodd-Frank Act provides that the Bankruptcy Code remains the preferred means of addressing financial company failures. Accordingly, it cannot be said to address contagion risk other than in the extreme cases in which it was designed to be used.

Contracts. This is not to say that the safe harbors cannot be improved upon. The Financial Contracts, Derivatives and Safe Harbors Advisory Committee, which I co-chaired with Judge James Peck, recommended to the American Bankruptcy Institute's Commission on the Reform of Chapter 11 a variety of potential improvements to the safe harbors. Other work is under way to develop mechanisms for providing continuity for financial contracts during the failure of a major financial institution and other improvements to the way the Bankruptcy Code addresses the failure of financial institutions. I encourage the subcommittee to consider these approaches when considering potential reforms to the Bankruptcy Code.

REFERENCES

Cases

- *Lombard-Wall Inc. v. Columbus Bank & Trust Co.*, No. 82 B 11556 (Bankr. S.D.N.Y., Sept. 16, 1982) (bench decision).

- *In re Residential Resources*, 98 B.R. 2 (Bankr. D. Ariz. 1989).

Statutes

- 11 U.S.C. §§ 101(25), (38A), (47), (53B), 362(b)(6), (7), (17), (27), 362(o), 546(e)-(j), 548(d)(2), 553(a)(2)(B)(ii), (a)(3)(c), (b)(1), 555, 556, 559, 560, 561, 562, 741,753, 761(4) and 767 (2012).

Legislative Materials

- Taxpayer Protection and Responsible Resolution Act, S. 1861, 113th Cong. (2013), *available at* https://www.govtrack.us/congress/bills/113/s1861/text.

- Bankruptcy Law and Repurchase Agreements: Hearing on H.R. 2852 and H.R. 3418 Before the Subcomm. on Monopolies and Commercial Law of the H. Comm. on the Judiciary, 98th Cong. 19 (1984), *available at* http://babel.hathitrust.org/cgi/pt?id=pur1.32754077953283#view=1up;seq=3.

- Bankruptcy Reform Act of 1978: Hearing on S. 2266 and H.R. 8200 Before the Subcomm. on Improvements in Judicial Machinery of the H. Comm. on the Judiciary, 95th Cong. 524 (1978), *available at* http://www.archive.org/stream/bankruptcyreform1978unit/bankruptcyreform1978unit_djvu.txt.

- H.R. REP. 97-420, at 1 (1982), reprinted in 1982 U.S.C.C.A.N. 583, 583.

Administrative Materials

- Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. 62,018 (Oct. 11, 2013), *available at* http://www.gpo.gov/fdsys/pkg/FR-2013-10-11/pdf/2013-21653.pdf.

- Liquidity Coverage Ratio, 78 Fed. Reg. 71,818 (Nov. 29, 2013) (Proposed Rule), *available at* http://www.gpo.gov/fdsys/pkg/FR-2013-11-29/pdf/2013-27082.pdf.

Other

- Jack Farchy, MF Global's Demise Felt by Commodities Exchanges, FT.COM (Nov. 1, 2011), http://www.ft.com/intl/cms/s/0/418fa2f2-046c-11e1-ac2a-00144feabdc0.html?siteedition=uk#axzz2wiK4MXNO.

- Financial Stability Board, Key Attributes of Effective Resolution Regimes for Financial Institutions (2011), *available at* https://www.financialstabilityboard.org/publications/r_111104cc.pdf.

- David Mengle, The Importance of Close-Out Netting, ISDA Research Note, No. 1 (2010), *available at* http://www.isda.org/researchnotes/pdf/Netting-ISDAResearchNotes-1-2010.pdf.

- Mark J. Roe, Statement to the Subcommittee on Regulatory Reform, Commercial and Antitrust Law of the Committee on the Judiciary of the House, The Bankruptcy Code and Financial Institution Insolvencies (Dec. 3, 2013), *available at* http://judiciary.house.gov/_files/hearings/113th/12032013_2/Roe%20Testimony.pdf.

- Kimberly Ann Summe, *Lessons Learned from the Lehman Bankruptcy, in* ENDING GOVERNMENT BAILOUTS AS WE KNOW THEM 59, 77 (2010), *available at* http://media.hoover.org/sites/default/files/documents/Ending_Government_Bailouts_as_We_Know_Them_59.pdf.

- Daniel K. Tarullo, Speech at the Americans for Financial Reform and Economic Policy Institute Conference (Nov. 22, 2013) (indicating the need to address short-term wholesale funding through regulation and outlining possible regulatory approaches) , *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20131122a.htm.

Rolling Back the Repo Safe Harbors

By Edward R. Morrison, Mark J. Roe**, and Christopher S. Sontchi****

Recent decades have seen substantial expansion in exemptions from the Bankruptcy Code's normal operation for repurchase agreements. These repos, which are equivalent to very short-term (often one-day) secured loans, are exempt from core bankruptcy rules such as the automatic stay that enjoins debt collection, rules against prebankruptcy fraudulent transfers, and rules against eve-of-bankruptcy preferential payment to favored creditors over other creditors. While these exemptions can be justified for United States Treasury securities and similarly liquid obligations backed by the full faith and credit of the United States government, they are not justified for mortgage-backed securities and other securities that could prove illiquid or unable to fetch their expected long-run value in a panic. The exemptions from baseline bankruptcy rules facilitate this kind of panic selling and, according to many expert observers, characterized and exacerbated the financial crisis of 2007–2009. The exemptions from normal bankruptcy rules should be limited to United States Treasury and similarly liquid securities, as they once were. The more recent expansion of these exemptions to mortgage-backed securities should be reversed.

Contents

* Charles Evans Gerber Professor of Law, Columbia Law School. Much of this paper was drafted while Professor Morrison was the Paul H. & Theo Leffmann Professor of Commercial Law at the University of Chicago Law School and received generous financial support from the SNR Denton Fund.

** David Berg Professor of Corporate Law, Harvard Law School.

*** United States Bankruptcy Judge for the District of Delaware. We thank Stephen Adams, Jim Baillie, Patrick Bolton, Felton Booker, Larry Brandman, Darrell Duffie, Mark Ellenberg, David Felsenthal, Gary Gorton, Seth Grosshandler, Howell Jackson, Stephen Lubben, Antoine Martin, Knox McIlwain, James Peck, Enrico Perotti, David Skeel, Joseph Sommer, Richard Squire, Kimberly Summe, Suresh Sundaresan, Daniel Tarullo, Bruce Tuckman, Shmuel Vasser, Eric Waxman, and conference participants at the Federal Reserve Bank of New York (Conference on the Risks of Wholesale Funding) and Harvard Law School for discussion and comments on this paper and earlier work on the scope of the repo safe harbors.

The authors are members of the Advisory Committee on Derivatives, Financial Contracts, and Safe Harbors of the American Bankruptcy Institute's Bankruptcy Commission to Study the Reform of Chapter 11.

Figures

Introduction

Special rules exempt an increasingly wide arc of creditors from the normal operation of bankruptcy. These so-called "safe harbors" exempt the bankrupt debtor's financial-contract counterparties from the basic rules that halt creditor collection efforts when the bankruptcy begins, that claw back preferential and fraudulent prebankruptcy transfers that harm creditors overall, and that facilitate orderly liquidation or reorganization. These safe harbors for financial contracts exist for one articulated purpose: to promote stability in financial markets.[1]

1. *See, e.g., Exploring Chapter 11 Reform: Corporate and Financial Institution Insolvencies; Treatment of Derivatives, Hearing Before the H. Subcomm. on Regulatory Reform, Commercial & Antitrust Law of the H. Comm. of the Judiciary*, 113th Cong. 6 (2014) (statement of Seth Grosshandler) [hereinafter Grosshandler Statement], *available at* http://goo.gl/QpTsgK ("safe harbors" have proven to be very effective in containing the risk of contagion by allowing counterparties to terminate volatile financial contracts with the debtor quickly, thus limiting their exposure to possibly catastrophic losses from the failure of the debtor. This is the very reason why Congress enacted the safe harbors in the first place.").

Yet there is little evidence that they serve this purpose. Instead, considerable evidence shows that, when they matter most—in a financial crisis—the safe harbors exacerbate the crisis, weaken critical financial institutions, destabilize financial markets, and then prove costly to the real economy. Worse, the best available evidence also shows that the safe harbors distort the capital structure decisions of financial firms by subsidizing runnable short-term financing at the expense of other, safer debt channels, including longer-term financing. When financial firms favor volatile short-term over more stable long-term debt, they (and markets generally) are more likely to experience a "run" in the event of a market shock, such as the downturn in housing prices during the most recent recession.

It is time for the Bankruptcy Code to get out of the business of regulating financial markets. Other institutions—the Federal Reserve and Treasury—are better suited for this task. The Bankruptcy Code should therefore be returned to about where it stood in 1984: safe harbors should exist only for agreements involving United States Treasury securities and several other, highly liquid assets (e.g., bank certificates of deposit, eligible bankers' acceptances, and agency securities[2] backed by the government's full faith and credit). Safe harbors for these repos can be justified on grounds that have nothing to do with systemic risk management and they are at base sufficiently liquid and likely to retain fundamental value in a crisis that they pose no real systemic risk.[3] For all other repos, such as mortgage-backed repos, the core rationale for safe harboring them—reducing systemic risk—lacks foundation. Their safe harbor should therefore be eliminated and they should be returned to ordinary bankruptcy practice.

Two of us have written on the scope of the safe harbor previously.[4] We focus here in this article on the safe harbors for repurchase agreements ("repos")—even though the protections for swaps and other financial contracts should be narrowed as well[5]—because the safe harbors for a wide array of repos are the most dangerous to financial stability. We are not the first to make this point.[6]

2. On agency securities and the safe harbors generally, see Shmuel Vasser, *Derivatives in Bankruptcy*, 60 Bus. Law. 1507, 1511–13 (2005). Bankers' acceptances are not in modern times an important category, although the category persists in the statute.

3. The U.S. Treasury repo market has become a principal means of financing the market for United States government securities. Tobias Adrian et al., Federal Reserve Bank of New York Staff Report—Repo and Securities Lending 1, 17 (2013), *available at* http://www.newyorkfed.org/research/staff_reports/sr529.pdf.

4. Franklin R. Edwards & Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment?*, 22 Yale J. on Reg. 91, 101 (2005); Mark J. Roe, *The Derivatives Market's Payments Priorities as Financial Crisis Accelerator*, 63 Stan. L. Rev. 539 (2011).

5. Much of the prior scholarship advocates narrowing the safe harbors generally, but does not focus on the specific case for narrowing the repo safe harbors. *See, e.g.*, Edwards & Morrison, *supra* note 4; Stephen J. Lubben, *Repeal the Safe Harbors*, 18 Am. Bankr. Inst. L. Rev. 319 (2010); Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. Cin. L. Rev. 1019, 1036 (2007); Roe, *supra* note 4; Michael Simkovic, *Secret Liens and the Financial Crisis of 2008*, 83 Am. Bankr. L.J. 253 (2009); *see also* Charles W. Mooney, Jr., *The Bankruptcy Code's Safe Harbors for Settlement Payments and Securities: When Is Safe Too Safe?*, 49 Tex. Int'l L.J. 243 (2013).

6. *See generally* sources cited at *supra* notes 4 and 5. Our proposal resembles reforms advocated by legal scholars and economists. *See, e.g.*, Thomas Jackson & David Skeel, *Transaction Consistency and*

In this paper we aggregate and evaluate the existing evidence, sharpen arguments made by prior scholars (including ourselves) and regulators, and examine the counter-arguments that proponents of the safe harbors commonly make.

The fundamental problem is this: The repo safe harbors exacerbated the financial crisis of 2007–2009 by encouraging the use of short-term repo financing by major American financial firms. The bulk of repo volume is overnight and the vast majority has a maturity of less than three months. This expansion of repo led that market to use securities that could not, and did not, retain their value in the crisis, thereby worsening the crisis and weakening financial firms and markets. The broad expansion of short-term repo, particularly repos of mortgage-backed securities, made major American financial firms more sensitive to financial shocks, more sensitive to disruption in the housing market, and more likely to propagate those shocks through the financial system via rapid close-outs, such as those that induced massive government backing of the financial system in 2007–2009. That government backing included a guarantee of the money market industry after the Reserve Primary Fund broke the buck in the wake of Lehman's failure, the rescue of AIG after the Lehman failure, the bailout of government-sponsored enterprises—Fannie Mae and Freddie Mac—that issue widely repo'ed securities, and the Federal Reserve's Primary Dealer Credit Facility—sized in the tens of billions of dollars—to support the repo market. This wide and deep governmental support makes clear that, although it is often mistakenly thought (particularly by industry representatives) that the safe harbors *mitigate* systemic risk, the reality is that the safe harbors both (1) make too many core financial institutions more fragile, by facilitating their reliance on short-term debt that is unstable in a crisis and (2) shift the epicenter of systemic risk to other sectors of the financial market, particularly after the government buttresses the safe-harbored market.

Today, proponents of the current safe harbors sometimes argue that regulators are bringing systemic risks under control, thanks to various federal and international regulatory changes. But if systemic risks are being brought under control, what then remains of the original rationale for the safe harbors? Either systemic risk still matters in bankruptcy, or it does not. If systemic risk is relevant (as we

the New Finance in Bankruptcy, 112 COLUM. L. REV. 152, 179 (2012) ("In our view, each of these costs would be well addressed by our proposal to exempt repos that are collateralized by cash or cash-like securities from the automatic stay."); Darrell Duffie & David A. Skeel, *A Dialogue on the Costs and Benefits of Automatic Stays for Derivatives and Repurchase Agreements*, *in* BANKRUPTCY NOT BAILOUT: A SPECIAL CHAPTER 14, at 133 (Kenneth E. Scott & John B. Taylor eds., 2012) (same); Gary Gorton & Andrew Metrick, *Regulating the Shadow Banking System*, 2 BROOKINGS PAPERS ON ECON. ACTIVITY, Fall 2010, at 269, 287 (proposing that banks and similar financial institutions benefit from the repo safe harbor only with respect to repos on Treasuries and other assets approved by regulators).

Our proposal is also compatible with other potential reforms for limiting the systemic risk potential of repo markets. *See, e.g.*, Viral V. Acharya & T. Sabri Öncü, *The Repurchase Agreement (Repo) Market*, *in* REGULATING WALL STREET: THE DODD-FRANK ACT AND THE NEW ARCHITECTURE OF GLOBAL FINANCE 319 (Viral V. Acharya, Thomas F. Cooley, Matthew P. Richardson & Ingo Walter eds., 2010) (advocating an FDIC-like "repo resolution authority" to regulate repo markets); Enrico Perotti & Javier Suarez, *A Pigovian Approach to Liquidity Regulation*, 7 INT'L J. CENT. BANKING 3 (2011) (advocating a tax on short-term funding such as repos).

conclude it may be), the evidence indicates that the safe harbors exacerbated systemic disturbance during the financial crisis. If systemic risk is not relevant (as proponents of the safe harbors sometimes assert), then bankruptcy should return to first principles, without the deep carve-outs (beyond U.S. Treasury securities) from the automatic stay, preference law, fraudulent conveyance law, and the limitation on *ipso facto* clauses.[7]

Hence, we recommend scaling back the repo safe harbor to approximately the 1984 scope for "repurchase agreements,"[8] namely, safe harboring only repos on U.S. Treasury and agency securities backed by the government's full faith and credit, certificates of deposits, and bankers' acceptances. This proposal is consonant with recommendations from leading economists and legal scholars[9] and federal regulators.[10] The Bankruptcy Code's safe harbors for other financial contracts should be narrowed as well, to ensure that the other safe harbors do not provide end-runs around the narrowed scope of the repo safe harbors.[11] Equally important, the Bankruptcy Code's rules governing adequate protection, setoff rights, and assumption and rejection of executory contracts should be modified to protect contracting parties better in general and to better protect financial contract counterparties in particular. The latter often face substantially greater costs from the bankruptcy process than other creditors and nonfinancial counterparties. Indeed, these costs are a driver of demand for safe-harbored financial contracts.[12] Reducing these costs will reduce the demand for financial instruments that short-circuit the Bankruptcy Code.

Although we address only the Bankruptcy Code in this article, its logic would support comparably narrowing the safe harbors in other federal statutes—e.g., the Federal Deposit Insurance Act and the Dodd-Frank Act.[13]

---

7. On the connection between repo safe harbors and collateral fire sales, see generally Brian Begalle, Antoine Martin, James McAndrews & Susan McLaughlin, Federal Reserve Bank of New York Staff Report—The Risk of Fire Sales in the Tri-Party Repo Market (2013), *available at* http://www.newyorkfed.org/research/staff_reports/sr616.html; Gaetano Antinolfi et al., *Repos, Fire Sales, and Bankruptcy Policy* (Fed. Reserve Bank of Chi., Working Paper No. 2012-15, 2012), *available at* http://ssrn.com/abstract=2189583; Sebastian Infante, *Repo Collateral Fire Sales: The Effects of Exemption from the Automatic Stay* (Fed. Reserve Bd. Fin. & Econ. Discussion Series No. 2013-83, 2013), *available at* http://www.federalreserve.gov/pubs/feds/2013/201383/201383pap.pdf.

8. The 1984 Code safe-harbored securities transactions between securities dealers and similar entities. Mortgage-backed securities were not as widespread in the marketplace at that time.

9. *See, e.g.*, Duffie & Skeel, *supra* note 5; Jackson & Skeel, *supra* note 5; sources cited at *supra* note 4.

10. *See* Thomas M. Hoenig & Charles S. Morris, Restructuring the Banking System to Improve Safety and Soundness 16 (2011), *available at* http://goo.gl/pUmTqC ("[T]he bankruptcy law for repurchase agreement collateral should be rolled back to the pre-2005 rules. This change would eliminate mortgage-related assets from being exempt from the automatic stay in bankruptcy when a borrower defaults on its repurchase obligation."). Thomas Hoenig was then-President of the Federal Reserve Bank of Kansas City and is now Vice Chairman of the Federal Deposit Insurance Corporation.

11. We do not here address the safe harbors for swaps and other derivatives transactions.

12. *See* Jun Kyung Auh & Suresh Sundaresan, *Bankruptcy Code, Optimal Liability Structure, and Secured Short-Term Debt* (Columbia Bus. Sch. Research Paper No. 13-8, 2013), *available at* http://ssrn.com/abstract=2217669.

13. Banking statutes govern the resolution of banks, but the Bankruptcy Code is the initial legal structure to resolve bank holding companies, most bank affiliates, insurance holding companies, and many nonbank financial institutions.

I. Background

A repurchase agreement ("repo") is a type of short-term financing that is economically equivalent to a secured loan. In *Bevill, Bresler & Schulman Asset Management Corp. v. Spencer S&L Ass'n* (*In re Bevill, Bresler & Schulman Asset Management Corp.*), the Third Circuit succinctly described repos as follows:

> A standard repurchase agreement, commonly called a "repo," consists of a two-part transaction. The first part is the transfer of specified securities by one party, the dealer, to another party, the purchaser, in exchange for cash. The second part consists of a contemporaneous agreement by the dealer to repurchase the securities at the original price, plus an agreed upon additional amount on a specified future date. A "reverse repo" is the identical transaction viewed from the perspective of the dealer who purchases securities with an agreement to resell.[14]

A repo is economically equivalent to a secured loan because the dealer receives funds immediately and promises to repay those funds, plus a premium (i.e., interest), at a future date. The transaction is secured by the securities. Courts[15] and commentators[16] are well aware of this economic equivalence.

Many market participants utilize the repo market, most notably the Federal Reserve, which uses the repo market to implement monetary policy, principally via repos on Treasury securities and agency debt.[17] Sophisticated institutional investors use it to safely meet short and long-term liquidity needs, corporations and money market funds use it for cash management, and broker-dealers use it to finance their securities inventory and other investments. (This is sometimes called "shadow banking."[18]) As of 2010, U.S. Treasury and agency securities (including agency mortgage-backed securities and securities not backed by the full faith and credit of the United States) made up about 75 percent of collateral used in repo transactions.[19] The U.S. Treasury repo market is a critical component not only of the U.S. capital markets, but also of global capital markets. It has become a principal means of financing the market for U.S. government securities.

The repo market has expanded from its U.S. Treasury securities base to include other types of financial investments, such as mortgage-backed securities

14. 878 F.2d 742, 743 (3d Cir. 1989).

15. *E.g.*, Granite Partners, L.P. v. Bear, Stearns & Co., 17 F. Supp. 2d 275, 301 (S.D.N.Y. 1998) ("any attempt to determine whether a repo or reverse repo transaction is more like a secured loan than a purchase and sale by weighing economic factors on a finely tuned balance scale would be an essentially formalistic and ultimately unproductive exercise" (quoting *In re* Bevill, Bresler & Schulman Asset Mgmt. Corp., 67 B.R. 557, 597 (D.N.J. 1986))).

16. *E.g.*, Vasser, *supra* note 2, at 1513 ("A repo is essentially a current sale and a forward contract. Economically, however, it is hard to distinguish a repo from a secured loan where the underlying securities serve as collateral, since the repurchase price includes interest on the imputed loan created by the repo.").

17. *Open Market Operations: Transaction Data*, Fed. Res. Bank of N.Y., http://www.newyorkfed.org/markets/omo_transaction_data.html (last visited Aug. 10, 2014).

18. *See, e.g.*, Gorton & Metrick, *supra* note 5; Enrico Perotti, *The Roots of Shadow Banking*, *in* Shadow Banking Within and Across National Borders (Stijn Claessens, Douglas Evanoff, Luc Laeven & George Kaufman eds., forthcoming 2014).

19. Payments Risk Comm., Fed. Reserve Bank of N.Y., Task Force Report on Tri-Party Repo Infrastructure 3 (2010), *available at* http://www.newyorkfed.org/prc/files/report_100517.pdf.

and mortgage loans.[20] This expansion in the repo market has coincided with expansion in the Bankruptcy Code's safe harbors for repos. The safe harbor for "securities contracts" first appeared in the Bankruptcy Code in 1982.[21] Two years later, in 1984, Congress added the safe harbor for "repurchase agreements."[22] "Repurchase agreements" were defined (in section 101(47)) as agreements that provided for the transfer of one or more of the following instruments: (1) certificates of deposit; (2) eligible bankers' acceptances; and (3) securities that are direct obligations of, or that are fully guaranteed as to principal and interest by, the United States or any agency of the United States.

In 2005, Congress expanded the range of safe-harbored repos by amending the definition of "repurchase agreement" to include transfers of the following additional instruments[23]:

- mortgage loans;
- mortgage-related securities (as defined in section 3 of the Securities Exchange Act of 1934);
- interests in mortgage-related securities or mortgage loans; and
- qualified foreign government securities (defined as securities that are direct obligations of, or that are fully guaranteed by, the central government of a member of the Organization for Economic Cooperation and Development).[24]

Congress also expanded the definition of "securities contract" in section 741(7) to include a

> contract for the purchase, sale, or loan of a security, a certificate of deposit, a mortgage loan, any interest in a mortgage loan, a group or index of [the foregoing], . . . or option on any of the foregoing, . . . and including any repurchase or reverse repurchase transaction on any such security, certificate of deposit, mortgage loan, interest, group or index, or option (whether or not such repurchase or reverse repurchase transaction is a "repurchase agreement," as defined in section 101).[25]

20. Kenneth D. Gardade, *The Evolution of Repo Contracting Conventions in the 1980's*, FED. RES. BANK OF N.Y. POL'Y REV., May 2006, 27, 27–28 (2006); *see also In re* Bevill, Bresler & Schulman Asset Mgmt. Corp., 878 F.2d 742, 745–46 (3d Cir. 1989); 5 COLLIER ON BANKRUPTCY ¶¶ 559.04, 559.LH (Alan N. Resnick & Henry J. Sommer eds., 15th ed. 2007).

21. Pub. L. No. 97-222, § 8, 96 Stat. 235, 237 (1982).

22. Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, § 391, 98 Stat. 333, 364–65. The Senate Report addressing the 1984 amendments noted that the "Lombard-Wall proceedings and their extensive press coverage have had an adverse impact on the financial markets and undermined the primary purpose of Public Law 97-222 [which introduced the "securities contract" safe harbor] because the repo market is subject to the same ripple effects as other securities markets." S. REP. NO. 98–65, at 47 (1983) (citation omitted).

23. The 2005 expansion is discussed in detail in Edward R. Morrison & Joerg Riegel, *Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges*, 13 AM. BANKR. INST. L. REV. 641 (2005).

24. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 907, 119 Stat. 23, 171–72 (codified as amended at 11 U.S.C. § 101(47) (2012)).

25. *Id.* § 907, 119 Stat. at 173–74 (codified as amended at 11 U.S.C. § 741(7) (2012)); Financial Netting Improvements Act of 2006, Pub. L. No. 109-390, § 5, 120 Stat. 2692, 2695–98 (codified as amended at 11 U.S.C. § 101(25)(a) (2012)).

Although the securities contract safe harbor is available to a narrower set of market participants—a "stockbroker, financial institution, financial participant, or securities clearing agency"[26]—than the repo safe harbor, virtually all systemically important financial institutions are eligible for protection as "financial institutions" or "financial participants."[27]

The safe harbors for repurchase agreements exempt favored creditors from the operation of normal bankruptcy practice, such as the automatic stay (stopping collection efforts outside of the bankruptcy court), avoidance recovery (of preferential and fraudulent prebankruptcy transfers from the debtor to the favored creditor), and the limitation on the creditor's right to immediately and fully setoff and net monies it owes the debtor against sums the debtor owes it. The relevant Bankruptcy Code provisions are:

- Sections 555 and 559, which protect the safe-harbored creditors' contractual rights to liquidate, terminate, and accelerate repurchase agreements—rights that are normally suspended in bankruptcy;
- Sections 362(b)(7) and 362(o), which protect repo counterparties' setoff rights and their rights to realize against margin or other collateral posted by the debtor (exercise of these rights is normally barred by the automatic stay); and
- Sections 546(f) and 548(d), which shield repo counterparties from preferential or fraudulent transfer actions seeking to recover margin, settlement, or other payments made in connection with the repo agreements.[28]

Together, these provisions permit counterparties to exercise nearly all out-of-bankruptcy contractual rights, notwithstanding the baseline automatic stay and avoidance powers of the bankruptcy court. As Collier explains, "[m]ost repurchase agreements afford a non-defaulting party the right to 'close-out' or 'liquidate' the agreement upon the other party's default."[29] Inside bankruptcy, other creditors cannot exercise these contractual rights to terminate their contracts with the bankrupt debtor; safe-harbored creditors can. They are effectively exempt from bankruptcy.

Furthermore, virtually all repos contain *ipso facto* clauses, as do many loans and executory contracts. These clauses give the favored party the right to declare a default, terminate the contract, and accelerate any obligations owed by the debtor if

26. 11 U.S.C. § 546(e) (2012).

27. A "financial participant," for example, includes an entity that entered into protected financial transactions (swaps, repos, forwards, etc.) worth at least $1 billion in notional value (or $100 million in mark-to-market value) at some point during the fifteen months preceding the bankruptcy filing date. *Id.* § 101(22A).

28. For the baseline bankruptcy rules, see generally *id.* § 362(a)(7) (setoffs); *id.* § 362(d) (automatic stay); *id.* §§ 365, 541(c)(1) (debtor's contract right is property of the estate); *id.* § 365(e)(1) (providing for unenforceability of *ipso facto* clauses that make the debtor's bankruptcy a default under its contract); *id.* § 547 (requiring return of preferences); *id.* § 548 (fraudulent conveyance liability for mismatched consideration).

29. 5 COLLIER ON BANKRUPTCY, *supra* note 20, ¶ 559.04.

it files for bankruptcy, becomes insolvent, or fails to maintain itself as financially sound.[30] Clauses like these are typically nullified in bankruptcy because otherwise neither a reorganization nor even an effective liquidation is normally possible. Not so for safe-harbored financial contracts like repos. With respect to these contracts, *ipso facto* clauses are fully enforceable.

II. Principles for Policymakers

These departures from basic bankruptcy rules need justification. Financial contracts should receive safe harbor treatment only when benefits exceed costs. Proponents of the current safe harbors typically point to two related benefits: (1) improving the liquidity of collateral and reducing financing costs and (2) reducing systemic risk.[31] Neither justification, however, can support the broad departures from normal bankruptcy practice.

A. Benefits

1. Liquidity and Financing Costs

The safe harbors undoubtedly improve the liquidity of repurchase agreements and the underlying collateral. Because counterparties can terminate repos and liquidate collateral, regardless of any bankruptcy filing by the debtor, the safe harbors allow counterparties to avoid bankruptcy-specific costs of distress, such as inadequate protection of collateral values, deviations from absolute priority, and cherry-picking of executory contracts by the debtor (assuming in-the-money contracts and rejecting out-of-the-money contracts with the same counterparty). These costs are thought to be non-trivial and to exceed the costs associated with terminating repos and liquidating collateral outside bankruptcy.[32] Because the safe harbors allow counterparties to avoid these costs, the collateral is more "liquid" in the sense that it can be sold at a price close to its fundamental value. The more liquid the collateral, the lower the costs of default to counterparties. And lower costs of default translate into better terms of trade for debtors: Debtors receive a higher purchase price for securities (a smaller "haircut") when these securities can be liquidated at lower cost.[33]

30. *Id.* ¶¶ 559.04, 559.LH.

31. *See, e.g.*, Grosshandler, *supra* note 1. These purported benefits to the American economy are not fully distinct. They overlap.

32. In the model of Auh & Sundaresan, *supra* note 12, these bankruptcy-specific costs drive the demand for safe-harbored repos. In the absence of these costs, the safe harbors for repos would have no effects on liquidity.

33. Grosshandler, *supra* note 1, at 4 ("One of the tangible effects of the safe harbors under 'business as usual' conditions, that is, prior to a bankruptcy, is the increase of the liquidity of Safe Harbored Contracts, which reduces both the cost of these transactions and the costs to the issuers of the assets underlying the transactions—the securities or commodities being bought or sold, the mortgages and credit card receivables being financed, the risks being hedged. These benefits flow directly from the certainty provided to market participants that, in the event of the failure of their counterparty, they will be able to realize the value of their bargained-for security, crystalize their loss and hedge the risk related to their counterparty's failure.").

2. Shadow Banking

The safe harbors played an important role in the growth of shadow banking.[34] Corporate cash managers, as well as pension and mutual funds, investment banks, and other institutional investors with large cash reserves want immediate access to this cash, but would also like to earn a return on the cash until it is needed. Safe-harbored repos provide the solution: They function like demand deposits, but without the government guarantee. The cash provider earns a small return on its cash, the investment is safe because the repo's duration is generally very short (often overnight), and the underlying collateral can be liquidated without interference from the Bankruptcy Code.[35]

3. Systemic Risk

Because they improve the liquidity of collateral, the safe harbors are thought to mitigate systemic risk. In the event of a debtor's default, counterparties can quickly terminate contracts with the debtor, liquidate collateral to cover any losses, and re-hedge by entering new contracts with new debtors. In this way, the debtor's distress will have no knock-on effects on the counterparties. In the absence of the safe harbors, counterparties would incur larger losses due to the various bankruptcy-specific costs, and these losses might trigger distress at the counterparties themselves.[36] Additionally, the safe harbors may increase the supply of credit to institutions suffering liquidity crises, potentially allowing them to avoid collapse. A distressed institution typically faces a "debt overhang" problem: It cannot readily attract new loans because creditors worry that if they lend, some of the value of that loan will support the prior distressed debt and not the new loan. By reducing costs of default and by making the new lender's recovery more certain, the safe harbors ease the debt overhang problem and thereby allow distressed institutions to attract new investment and potentially avoid default.

B. Costs

The costs of the safe harbors are mirror-images of the benefits.

34. *See generally* Gorton & Metrick, *supra* note 5, at 276–79.

35. A transactionally complex implication: Repos are often used to hedge derivative positions and to short securities. *Id.* at 278–79. Because repo collateral can be "rehypothecated," repos provide an important vehicle for shorting securities, which can improve market efficiency. While this market is a useful one for its participants, it is unclear whether the safe harbors are vital for it.

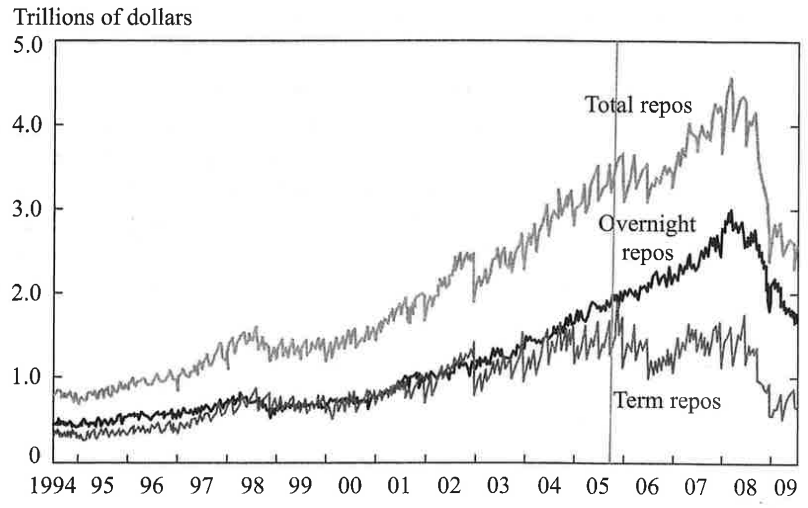
36. To ease discussion, we use the terms "borrower," "lender," and "collateral" in place of "seller," "purchaser," and "purchased securities," notwithstanding that repos are structured formally as purchases and sales of assets, and not as secured loans. This vocabulary of collateral, borrower, and lender is conventional in the industry.

1. Liquidity and Financing Costs

Liquidity does not come for free. The safe harbors enhance liquidity in repo markets by reducing liquidity in other markets, especially markets for traditional, long-term lending. Because safe harbor benefits are available for some kinds of financing (repos, which are largely short-term credit facilities) but not others (traditional, longer-term lending and other shorter-term markets), the Bankruptcy Code is implicitly subsidizing some markets at the expense of others.[37] Liquidity is shifted from one market to another. In the process, the safe harbors artificially distort the capital structure of financial institutions toward less stable, run-prone financing. Even worse, the costs of this risk-shifting are borne by the public, the U.S. Treasury, and the American taxpayer via increased financial instability.

Figure 1:

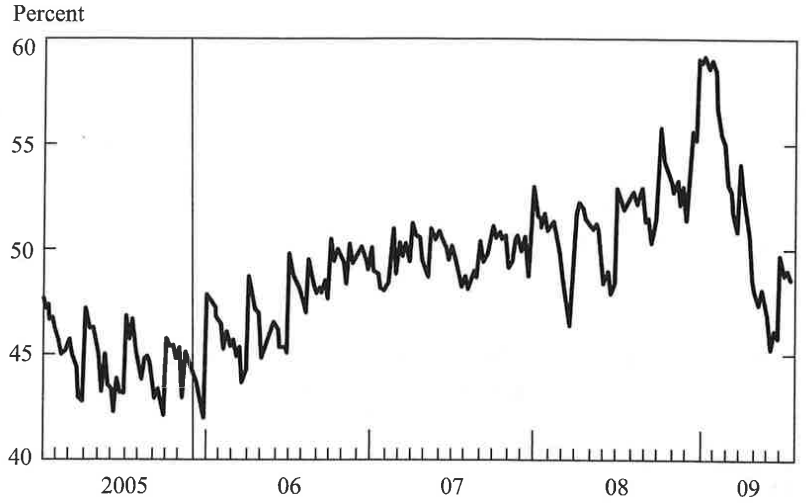
Overnight Repos as a Percentage of Total Primary Dealer Repo Financing, January 5, 2005–July 22, 2009[38]



37. In the event of financial failure, non-safe-harbored creditors (oftentimes longer-term creditors) will be less likely to be paid immediately, while safe-harbored creditors (oftentimes shorter-term creditors) are permitted to immediately liquidate collateral—this thereby contributes to a market preference for safe-harbored debt over non-safe-harbored funding, all else equal.

38. This figure comes from Tobias Adrian, Christopher R. Burke & James J. McAndrews, *The Federal Reserve's Primary Dealer Credit Facility*, FED. RES. BANK OF N.Y.: CURRENT ISSUES IN ECON. & FIN., Aug. 2009, at 1, 2 (2009) (Figure 1 in original). We added the vertical line for October 2005, to identify the years before and after the repo safe harbors were expanded.

Figure 2:
Prevalence of Less Liquid Collateral in Primary Dealers' Repo Transactions, January 5, 2005–July 22, 2009[39]



Mortgage loan repurchase agreements, for example, substitute for warehouse loans. The former are safe harbored from normal bankruptcy rules, the latter are not. The former are thereby favored financially and made more liquid, but the latter are disfavored and made relatively less liquid. We see no principled reasons to favor the favored and disfavor the disfavored. One Federal Reserve report describes this problem and illustrates the sharp increase in overnight repo financing and illiquid collateral in the run-up to the financial crisis:

> [C]onditions in 2008 [became] particularly precarious [due to] the resort to less liquid collateral in repo agreements. . . . Originally focused on the highest quality collateral—Treasury and Agency debt—repo transactions by 2008 were making use of below-investment-grade corporate debt and equities and even whole loans and trust receipts. This shift toward less liquid collateral increased the risks attending a crisis in the market since, in the event of a crisis, selling off these securities would likely take time and occur at a significant loss.[40]

Figures 1 and 2 illustrate the rapid growth of short-term (overnight) financing via repo during the years after October 2005, when the Bankruptcy Code's repo safe harbors expanded substantially. Figure 1 shows that, in terms of dollar volume, short-term repos increased sharply after 2005, while longer-term repos stayed relatively constant. Figure 2 is more important: It shows that repos involv-

39. *Id.* at 4 (Figure 3 in original). We added the vertical line for October 2005, to identify the years before and after the repo safe harbors were expanded.
40. *Id.* at 3–4.

ing illiquid collateral, such as mortgages and mortgage-backed securities, accounted for an increasing share of primary dealer repos. By 2008, they accounted for nearly 60 percent of all primary dealer repos. Although these figures cannot prove causal relationships, they provide suggestive evidence that the safe harbors facilitated the over-reliance of financial institutions on short-term financing with relatively illiquid collateral.

The safe harbors, in other words, plausibly encourage less stable financing for our largest and most important financial institutions, thereby making it more likely that a stressed institution will need to liquidate in a costly way. Those who might be prepared to lend long term to an important financial institution would, all else equal, be induced by the safe harbors to lend short term (via repo) and roll over that repo on a regular basis. They are then incentivized to decline to rollover (to run) in the event of a financial crisis or in the event of financial difficulty with the borrower. This broad safe harboring policy is unwise. It weakens American financial structures and institutions.[41]

To be sure, the foregoing argument assumes that the safe harbors merely "move" liquidity around, favoring some markets (repos) and not others (longer-term financing). The net "liquidity effect" of the safe harbors might not be zero. The safe harbors could have a net positive effect, increasing liquidity overall and lowering the cost of capital of institutions that rely on repo financing. This is plausible if the safe harbors allow counterparties to avoid substantial costs associated with the bankruptcy process, such as administrative expenses and inadequate protection of collateral values, which are deadweight costs, and violations of absolute priority (such as inappropriate distribution to shareholders). Because they avoid these costs, repo counterparties offer more liquidity on better terms to borrowers. This argument, however, implies that *every creditor* should be free to contract around the Bankruptcy Code. Every creditor should enjoy the safe harbors. We take no position on the longstanding academic debate[42] over whether a wide array of creditors should be free to contract around bankruptcy. But if the safe harbors increase social welfare because they increase liquidity overall (and not just for the benefited creditors at the expense of other creditors), then the safe harbors should apply to all secured debt, not just financial contracts.

But one should be uncertain whether there is a net liquidity gain for the economy or, indeed, for a particular debtor. The "net liquidity effect" of the safe harbors could well be *negative* if they make it more difficult to reorganize a debtor that used safe-harbored repos or if they disrupt an economy-wide market. When a debtor files for bankruptcy, most counterparties are stayed from terminating

41. Some of this disfavoring of long-term finance over short-term finance arises from how baseline bankruptcy rules treat the time value of money. Appropriate compensation for the time value of any delay to both sets of creditors, prioritized at the underlying priority level of the principal amount, would even up the bankruptcy value of safe-harbored and non-safe-harbored investments. (Because the safe-harbored investors can close out immediately, they are less concerned with the time value of any delay in realization than are non-safe-harbored investors.) This possibility should be an issue for further analysis.

42. *See, e.g.*, Robert K. Rasmussen, *Debtor's Choice: A Menu Approach to Corporate Bankruptcy*, 71 TEX. L. REV. 51 (1992); Alan Schwartz, *A Contract Approach to Business Bankruptcy*, 107 YALE L.J. 1807 (1998).

their agreements with the debtor and/or engaging in self-help remedies against estate assets that serve as their collateral. These baseline bankruptcy rules do not apply to repo counterparties. These safe-harbored counterparties can, and will, rapidly close out their positions, selling their collateralized assets into the marketplace at whatever price they can get. If there is widespread selling, there can be a rapid destruction of collateral value as counterparties, unimpeded by the automatic stay, terminate and enforce their rights in debtor assets that serve as collateral. In other words, the safe harbors may have both redistributive effects (favoring repos at the expense of other financing) and deadweight costs (causing value destruction in the event of default). If the safe harbors facilitate widespread selling of the underlying collateral, and if the collateral does not maintain its fundamental value, then owners of that collateral will have reason not to sell that collateral, waiting for its value to recover. This process, which seems to have been at work in the financial crisis, dries up liquidity.

Hence, in principle, the net liquidity effect of the safe harbors could be positive, negative, or zero.

2. Shadow Banking

Safe-harbored repos allow financial institutions to offer the equivalent of demand deposits. Outside of a crisis, shadow banking expands the ability of banks to fund risky, illiquid investments such as mortgages. In a crisis, shadow banking exposes financial institutions to destructive runs. Although safe-harbored repos replicate demand deposits, they lack the FDIC guarantee that applies to true demand deposits. The "on demand" feature of safe-harbored repos is both their virtue and their vice, as the next subsection discusses in greater detail.

3. Systemic Risk

The safe harbors have long been justified on the ground that they mitigate systemic risk by reducing contagion.[43] Three reasons show why this common assertion is false.

a. Raising Systemic Risk by Encouraging Short-term Finance

The additional credit that the safe harbors facilitate allows a systemically important financial institution to become larger, more leveraged with more easily runnable debt, and—as a result—more systemically important and more dangerous both before and after it becomes distressed. Repo use, for example, expanded greatly during the run-up to the financial crisis, growing faster than financial debt grew overall in the American economy.[44] Many observers view the safe harbors as necessary for this expansion.

43. Steven L. Schwarcz & Ori Sharon, *The Bankruptcy-Law Safe Harbor for Derivatives: A Path Dependence Analysis*, 71 WASH. & LEE L. REV. (forthcoming 2014), *available at* http://ssrn.com/abstract=2351025 (describing the justification at page 14).

44. Total financial sector debt was reported in 2010 to have been twenty times larger than it was in 1981. The repo market overall was fifty times greater than its 1981 size. Much of the greater growth

This growth in short-term finance[45] rendered American financial institutions more fragile than they would have been without the safe harbors. Worse, when these institutions suffered distress, repo counterparties could refuse to renew the contracts or demand additional collateral before agreeing to renew the contracts, and they did. This "rollover risk," when realized, drained liquidity from these institutions and thereby exacerbated financial stress instead of relieving it.

Opponents of reform often emphasize that the safe harbors increase the supply of credit to an institution suffering a liquidity crisis. They point to J.P. Morgan's willingness to continue supplying liquidity to Lehman as it foundered. But Lehman's acute need for liquidity was itself a product of the safe harbors, which encouraged it to rely on short-term financing and to have large safe-harbored obligations before the crisis. When Lehman foundered, it needed to replace this financing. Put differently, one of the most lauded purported benefits of the safe harbors—increasing the supply of liquidity to failing institutions—is a feature that only partially mitigates a problem that the safe harbors themselves create, namely, capital structures that overly rely on short-term, run-prone financing. Thus, even a core safe harbor benefit—facilitating crisis financing—comes packaged with serious negatives—facilitating runs, encouraging interconnectedness via repo, expanded run-prone, short-term financing, and excessive leverage.

b. Raising Systemic Risk by Facilitating Runs

Second, by permitting counterparties to "run" on failing institutions, as stated in the prior paragraph, the safe harbors accelerate failure and exacerbate the risk of systemic collapse.[46] This is a lesson of the Lehman Brothers bankruptcy: during the days preceding and following the filing, counterparties refused to roll over repos (or demanded larger haircuts) and terminated other financial contracts en masse, effectively draining Lehman of liquidity.[47] Had Lehman not become so

in repos was during the 2000–2007 run-up to the financial crisis. Fed. Reserve Bd., Federal Reserve Statistical Release Z.1: Flow of Funds Accounts of the United States 9 (Sept. 17, 2010), *available at* http://www.federalreserve.gov/releases/zl/20100917/zl.pdf; *Statistical Supplement to the Federal Reserve Bulletin*, FED. RES. BD., www.federalreserve.gov/pubs/supplement/default.htm (last updated May 30, 2014) (Table 1.43 of the bulletin); *U.S. Government Securities Dealers—Positions and Financing, Statistical Supplement to the Federal Reserve System*, FED. RES. ARCHIVAL SYS. FOR ECON. RESEARCH, http://www.fraser.stlouisfed.org/publications/frd/page/314888 (last visited Apr. 4, 2014).

45. Overnight repos rose from being one-half of primary dealer repo financing in early 2005 to about 70 percent of primary dealer repo financing in 2008–2009. Adrian et al., *supra* note 38, at 3 (Chart 2). We understand that the overnight share of repos has persistently been above 50 percent of the overall repo market.

46. The role of the Bankruptcy Code's safe harbors in facilitating "runs" has been explored in many studies by economists, regulators, and legal scholars. Recent examples include Gaetano Antinolfi et al., *Repos, Fire Sales, and Bankruptcy Policy* (Fed. Reserve Bank of Chi., Working Paper No. 2012-15, 2012), *available at* http://ssrn.com/abstract=2189583; Auh & Sundaresan, *supra* note 12.

47. *See, e.g.*, ADAM COPELAND, ANTOINE MARTIN & MICHAEL WALKER, FEDERAL RESERVE BANK OF NEW YORK STAFF REPORT—REPO RUNS: EVIDENCE FROM THE TRI-PARTY REPO MARKET 26–27 (2012), *available at* http://www.newyorkfed.org/research/staff_reports/sr506.html (documenting a collapse in tri-party repo collateral posted by Lehman during the week before its bankruptcy); Michael J. Fleming & Asani Sarkar, *The Failure Resolution of Lehman Brothers*, 20 FED. RES. BANK OF N.Y. ECON. POL'Y REV (forthcoming 2014) (describing how the run of the counterparties for Lehman's reverse repo assets, which were a large part of Lehman's holdings, left Lehman cash-constrained); Kimberly Anne Summe, *Lessons*

dependent on safe-harbored repos—more than one-third of its liabilities were said to be in repo—it might have been better positioned to weather the crisis long enough for a more stable solution to emerge. Opponents of narrowing, who point to the Lehman close-outs as a success, ignore that the safe harbors put Lehman in the fragile position it occupied. Opponents also ignore the knock-on failures in the money market and elsewhere—failures that were every bit as serious as those that the contagion rationale for safe harbors is supposed to prevent.

c. Raising Systemic Risk by Depressing Collateral Values During a Crisis

By facilitating runs on systemically important financial institutions, the safe harbors induce the institutions' counterparties to terminate all financial contracts en masse, via cross-default clauses, and liquidate the supporting collateral en masse. En masse liquidation of collateral other than the safest (i.e., United States government obligations) typically leads to low-price fire-sale close-outs, further weakening the target institution and temporarily depressing the market value of comparable collateral held by other institutions. These two effects—fire sales and depressed collateral values generally—spread the distress at the failing institution to other, initially healthier institutions. Recent empirical work confirms the importance of these fire-sale externalities.[48]

The safe harbors, in other words, facilitate contagion.[49] Part of the reason they facilitate contagion is that they are built on old-school contagion concepts: If X defaults on obligations to Y, Y may suffer large losses that force it to default on its own obligations to Z, which may in turn default on its obligations to its counterparties, and so on throughout the financial system. This is the "dominos" theory of systemic risk. But systemic risk can arise from other channels: If X defaults on obligations to Y, Y will liquidate collateral posted by X. If X defaults on many obligations to many parties, all of these counterparties will liquidate the same type of

Learned from the Lehman Bankruptcy, in BANKRUPTCY NOT BAILOUTS: A SPECIAL CHAPTER 14, at 79 (Kenneth E. Scott & John B. Taylor eds., 2010) (reporting that 80 percent of Lehman's derivative portfolio was terminated within the first five weeks after the bankruptcy filing).

48. Fernando Duarte & Thomas M. Eisenbach, *Fire-Sale Spillovers and Systemic Risk* (Fed. Reserve Bank of N.Y. Working Paper No. 645, 2014), *available at* http://ssrn.com/abstract=2340669.

49. Two Fed researchers state:

> There is an apparent puzzle at the heart of the 2007 credit crisis. The subprime mortgage sector is small relative to the financial system as a whole and the exposure was widely dispersed through securitization. Yet the crisis in the credit market has been potent. Traditionally, financial contagion has been viewed through the lens of defaults, where if A has borrowed from B and B has borrowed from C, then the default of A impacts B, which then impacts C, etc. However, in a modern market-based financial system, the channel of contagion is through price changes and the measured risks and marked-to-market capital of financial institutions. When balance sheets are marked to market, asset price changes show up immediately on balance sheets and elicit response from financial market participants. Even if exposures are dispersed widely throughout the financial system, the potential impact of a shock can be amplified many-fold through market price changes.

Tobias Adrian & Hyun Song Shin, *Liquidity and Financial Contagion*, FIN. STABILITY REV.—SPECIAL ISSUE ON LIQUIDITY, Feb. 2008, at 1, 1.

collateral that Y is liquidating. Not only will Y (and the other counterparties) fetch fire sale prices for the collateral, but any other institution (say, Z) holding that type of collateral will need to mark its balance sheet accordingly to reflect the new market prices. In this way, X's distress spreads to Z through the market for collateral, even though X does no business with Z. Because the safe harbors facilitate fire sales of collateral, they magnify this channel of contagion. One channel of contagion (dominos) is mitigated while another (the collateral channel) is exacerbated.

A growing battery of evidence highlights the importance of the collateral channel as a vector of contagion. We now know that there was a "run on repo" and other sources of short-term funding during the financial crisis[50]—the very harm that the safe harbors were constructed to avoid. There was panic selling across financial markets of mortgage-backed securities.[51] Several Federal Reserve Governors have pointed to this panic and run as critical to the financial crisis.[52] This panic selling, which was supported by overly wide safe harbors and could not have been as wide without them, may well have pushed prices of some of the underlying securities temporarily below their long-run value, making financial institutions appear to be insolvent or less solvent than they would otherwise have been.

The analytic misstep that one might make, and which safe harbor proponents appear to make, is to assume that the *local* benefit of the safe harbors to an *individual* market participant scales up to also be an *aggregate* benefit of the safe harbors to the *entire* repo market. It does not. If only one firm with one safe-harbored repo counterparty fails, then the counterparty can quickly liquidate the collateral and maintain the firm's own liquidity, because its sale will not disrupt the market overall. This can be a good, local result. But if many counterparties of major failed firms liquidate their repo collateral simultaneously, a result that the safe harbors

50. Gary B. Gorton & Andrew Metrick, *Securitized Banking and the Run on Repo*, 104 J. FIN. ECON. 425, 428 (2012); Arvind Krishnamurthy, Stefan Nagel & Dmitry Orlov, *Sizing Up Repo* (Nat'l Bureau of Econ. Research Working Paper No. 17768, 2012), *available at* http://www.nber.org/papers/w17768. To be sure, we do not think that a complex phenomenon such as the financial crisis grew solely from an overly wide ambit for the repo safe harbors. Rather our view is that a negative economic event occurred, could occur again, and the wide safe harbors played a supporting role. Without that support, we do not believe the crisis would have been averted. But if multiple reforms are undertaken, the financial system can be made safer. Narrowing the repo safe harbor is one of the appropriate reforms in a wider package.

51. The "deleveraging spiral" that led to en masse fire sales of mortgage-related securities is described by Federal Reserve economists in BEGALLE, MARTIN, MCANDREWS & MCLAUGHLIN, *supra* note 7, at 2.

52. Daniel K. Tarullo, Member, Bd. of Governors of the Fed. Reserve Sys., Shadow Banking and Systemic Risk Regulation, Remarks at the Americans for Financial Reform and Economic Policy Institute Conference (Nov. 22, 2013) [hereinafter Tarullo, Shadow Banking and Systemic Risk Regulation], *available at* http://federalreserve.gov/newsevents/speech/tarullo20131122a.htm; Jeremy C. Stein, Member, Bd. of Governors of the Fed. Reserve Sys., The Fire-Sales Problem and Securities Financing Transactions, Remarks at the Federal Reserve Bank of Chicago and International Monetary Fund Conference on Shadow Banking Within and Across National Borders (Nov. 7, 2013), *available at* http://www.federalreserve.gov/newsevents/speech/stein20131107a.pdf.

While presiding over one of the Fed's regional banks and serving as a voting member of the Federal Open Market Committee (FOMC), the current FDIC vice chair called for a repo rollback along the lines outlined here. *See* Hoenig & Morris, *supra* note 10, at 16–17. Other, academic analyses have concluded similarly. *See* Skeel & Jackson, *supra* note 5, at 177–79; Roe, *supra* note 4.

facilitate, then the liquidity benefit can be (and it seems was) reversed. The safe harbors encourage liquidity at low usage levels; they impede liquidity at large usage levels. Policymakers must guard against wishful thinking here, expecting that what works on the micro-level of a single failed firm with a small set of counterparties will work as well, or even in the same direction, when many firms are liquidating collateral underlying their safe-harbored repos.

C. Costs After Dodd-Frank

It could be argued that, if the safe harbors contribute to the too-big-to-fail problem, that problem is better addressed by Title I of Dodd-Frank and other statutes than by amending the Bankruptcy Code, which affects all debtors, regardless of whether they are too-big-to-fail. Title I of Dodd-Frank undoubtedly moderates the risk-taking of systemically important institutions and the associated regulatory monitoring of major financial firms further does so. Indeed, if there were widespread agreement that the Dodd-Frank Act has relegated systemic crises to history's dustbin, we would be less concerned about the safe harbors being an unjustified deviation from bankruptcy basics, as the damage from their deviation from basic bankruptcy principles might only be slight if there were no more systemic financial crises.

But systemic crises are unlikely to be a thing of the past, and regulation is unlikely to be perfect. Some financial institutions will become too-big-to-fail, despite regulators' best efforts, and some of those too-big-to-fail institutions will become distressed despite existing statutory and regulatory safeguards. Moreover, Dodd-Frank's orderly liquidation authority and its regulatory initiatives are untested and may fail. A strong way to moderate these risks is to reduce the scope of the safe harbors, which allow distressed institutions to become larger, more leveraged, and more threatening to market stability. Like engineers who seek redundancy and backup in complex systems, bankruptcy reformers should seek a Code that supports financial stability, not one that undercuts it.

Finally, this systemic risk counterargument to narrowing the repo safe harbor—that systemic risk is now handled, and handled well enough, by Dodd-Frank's Title I—undercuts, and perhaps destroys, the foundational justification for the safe harbors in the first place. Their foundational bankruptcy justification was to help control systemic risk. But the safe harbors should be *eliminated*—not narrowed—if systemic risk is now best addressed through the "front door" of Dodd-Frank and related regulation rather than the "back door" of the Bankruptcy Code. The primary justification for the safe harbors is their role in mitigating systemic risk. If that role has been assumed by other laws and regulations, the original foundation of the safe harbors has crumbled.

III. Narrowing the Repo Safe Harbors

The challenge for policymakers is clear. The repo safe harbors increase the risk and amplitude of crises, but also increase asset liquidity and the supply of credit outside of crises. The first effect must be balanced against the second. Various

proposals have been put forward to achieve this balance, but most rely heavily on a federal regulator to monitor the repo market, limit the kinds of collateral that are repo-ed, set position limits, and perhaps impose taxes that force counterparties to internalize the costs of repo-based financing to market stability.[53] Indeed, many proposals would leave the safe harbors intact but use Dodd-Frank and related authority to monitor and mitigate systemic risk.

We support proposals for greater regulatory oversight of repo markets. But it is unwise to rely exclusively on federal regulators to mitigate systemic risk. Regulators are imperfect, as the recent crisis illustrates. And the current safe harbors make regulation harder and more complex by fostering shadow banking. A better approach, we think, is to narrow the repo safe harbors in a simple way that is (i) predictable, (ii) does not depend on the fallible discretion of regulators, and (iii) provides a back-stop that protects the financial system when federal regulators make mistakes. We want redundancy in systemic risk protection.

A. Narrow the Repo Safe Harbors

Policymakers can strike the right balance—protecting markets but preserving the credit-enhancing effects of repo-based financing—by narrowing the safe harbors to protect only repos involving highly liquid securities backed by the full faith and credit of the U.S. government ("FFC securities"), including Treasuries and some agency securities (e.g., those guaranteed by Ginnie Mae). This category amounts to about half of the outstanding securities in the repo market, so it is not small. Repos on other collateral—such as private mortgage-backed securities, equities, bonds, and agency securities that lack the backing of the United States' full faith and credit—should not receive safe harbor treatment.[54]

The case for protecting repos on Treasuries and other FFC securities is straightforward. First, safe harbor protection is consistent with longstanding public policy fostering liquidity in the market for government securities. It is cheaper for the government to issue debt when the securities it issues can be readily repo-ed by investors.

Equally important, safe harbors for repos on FFC securities are unlikely to contribute to systemic risk. Recall that the safe harbors contribute to systemic risk by exposing failing institutions to runs and collateral fire sales. Although the potential for a run exists when a failing institution has entered safe-harbored

53. *See* the proposals listed at *supra* notes 4 and 5.

54. Here is a breakdown of the collateral backing the American repo market: U.S. Treasury securities (at 34.7% of the market) and full faith and credit obligations of U.S. agencies (5.9%) would remain safe harbored. Equities (at 4.5%), private mortgage-backed securities and collateralized mortgage obligations (at 3.9%), corporate bonds (at 3.5%), and a miscellaneous category (at 2.7%) would not be safe harbored. Of the government-sponsored mortgage-backed securities and collateralized mortgage obligations (at 45% of the entire repo market), approximately one-quarter were backed by the full faith and credit of the U.S. government (such as bonds guaranteed by Ginnie Mae), amounting to 11% of the total repo collateral; they would be safe harbored. Bonds guaranteed by Fannie Mae and Freddie Mac are not guaranteed by the full faith and credit of the United States. *See US Repo Market Factsheet*, SIFMA (June 27, 2012), *available at* http://www.sifma.org/research/item.aspx?id=8589939674.

repos, the risk of collateral fire sales is minimal when the collateral consists of FFC securities. These securities are nearly equivalent to cash, are widely traded, and—due to government backing—unlikely to lose their liquidity during crises. Indeed, this is a crucial distinction between repos on FFC securities and repos on any other asset: FFC securities tend to retain their liquidity in good times and bad.[55] For other assets, liquidity is endogenous: The current liquidity of the asset is no guide to its future liquidity and its capacity to be sold quickly at long-run value in a crisis.

Safe harbors for repos on FFC securities are, therefore, unlikely to increase the risk or amplitude of market crises. The opposite is true for repos on other assets. Even if the assets are liquid today, in a normal economy, they may become highly illiquid in a crisis, thereby exacerbating market crises via the collateral channel. The history of mortgage-backed securities offers a case in point, as asset-backed securities performed poorly during the financial crisis.[56]

A large class of Agency assets lacks FFC support but has implicit government backing, namely the mortgage securities backed by Fannie Mae and Freddie Mac, two government-sponsored entities. The empirical case for rolling back the safe harbor for repos of these agency-backed mortgage securities is closer than that for private mortgage-backed securities. During the financial crisis, these entities were put into a government-financed conservatorship and bailed out.[57] Recent work by Begalle, Martin, McAndrews, and McLaughlin shows that agency-backed securities are less likely to retain their long-run value than Treasuries, which suggests that they should not receive the same safe-harbor treatment as Treasuries.[58] The authors estimate the time needed to liquidate a typical large dealer's repo portfolio without affecting market price. Even during stable, non-crisis market conditions, Treasuries can be liquidated more quickly in much larger volume—nearly twice as much daily—than agency securities without affecting market prices. A typical large dealer would need more than three weeks to liquidate its portfolio of agency securities without a price impact—a time span similar to that for liquidating private securities without price impact. By contrast, the dealer could unload its Treasury portfolio in nine days. These comparisons are unfavorable to non-FFC agency securities during stable conditions. Worse yet, during a crisis, a flight-to-quality would widen the gap, as Treasuries become more desirable.[59]

55. Even U.S. Treasury securities could become illiquid, but that illiquidity is likely to arise only when the U.S. government is insolvent. Were that to occur, systemic risk would be a problem with or without the safe harbors. The nation would be facing an economic crisis of such severity that safe harboring Treasuries would be a minor issue.

56. COPELAND, MARTIN & WALKER, *supra* note 47, at 32.

57. *See* Press Release, U.S. Dep't of the Treasury, Statement by Secretary Henry M. Paulson, Jr. on Treasury and Federal Housing Finance Agency Action to Protect Financial Markets and Taxpayers (Sept. 7, 2008), *available at* http://www.treasury.gov/press-center/press-releases/Pages/hp1129.aspx (announcing conservatorship for Fannie and Freddie).

58. BEGALLE, MARTIN, MCANDREWS & MCLAUGHLIN, *supra* note 7, at 14–18.

59. *Id.* at 15–16 ("It is worth noting that these estimates are conservative. The assumption regarding the number of days to liquidate is for normal market conditions taking into account historical daily turnover in each asset class and is meant to avoid signaling effects. Under stressed market con-

Despite these projections, however, non-FFC agency securities did well during the recent crisis: neither their liquidity nor their pricing deteriorated substantially.[60] This surprisingly robust performance was likely a product of massive government support to both the repo markets (about 40 percent of which is agency-backed)[61] and the agencies themselves. Fannie and Freddie entered federal conservatorship and received about $187.4 billion in government support.[62]

Agency-backed securities were, in retrospect, de facto FFC securities during the crisis. Indeed, the robust in-crisis performance of Agency securities might suggest that the repo safe harbor could be extended to both de jure FFC securities (e.g., Treasuries) and de facto FFC securities (e.g., agency-backed MBS) without increasing the risk or amplitude of market crises.

We disagree with that view. A security enjoys de facto FFC status when market participants anticipate government backing. But expectations about government support to financial markets can be erroneous, particularly because government support depends in part on political calculations in the executive branch and the Congress; the recent experience during the crisis created an anti-bailout perspective among many there. Indeed, during the crisis itself, many expected that Lehman Brothers would be bailed out, perhaps including Lehman executives; yet it was allowed, indeed encouraged, to file for bankruptcy. Put bluntly, de facto FFC securities might not be bailed out in a future crisis: the negative reaction to the 2008–2009 bailouts has been substantial.

Additionally, having a repo safe harbor for de facto FFC securities can damage the financial system: The existence of a repo safe harbor facilitates having these securities repo'ed in many financially important areas of the financial system, some of which can be fragile financial interconnections that can only exist with repo safe harbors. But repo'ing securities that cannot maintain their value and liquidity without government support can create more underlying financial fragility that, in a crisis, calls forth government support that would not otherwise be needed. Accordingly, our policy analysis is to consider the appropriateness of a repo safe harbor if the securities and their guaranteeing agencies were not bailed out. Without a bailout, agency securities lacking the government's full faith and credit would likely have suffered serious illiquidity, similar to that of private mortgage-backed securities. Their widespread liquidation would have

ditions, liquidating most asset classes would take longer. One possible exception is Treasury securities, which tend to benefit from flight-to-quality episodes.").

60. COMM. ON THE GLOBAL FIN. SYS., THE ROLE OF MARGIN REQUIREMENTS AND HAIRCUTS IN PROCYCLICALITY 11 (Bank for Int'l Settlements CGFS Paper No. 36, 2010), *available at* www.bis.org/publ/cgfs36.pdf.

61. And one-quarter of the agency securities here do receive the full faith and credit of the United States (the quarter guaranteed by Ginnie Mae), but are mixed in with the data on agency-backed securities' performance during the crisis.

62. *See* OFFICE OF MGMT. & BUDGET, EXEC. OFFICE OF THE PRESIDENT, BUDGET OF THE UNITED STATES GOVERNMENT, FISCAL YEAR 2015, APPENDIX: GOVERNMENT-SPONSORED ENTERPRISES 1–3 (2014) (describing total expenditures to Fannie and Freddie as $116.1 billion and $71.3 billion, respectively), *available at* http://www.whitehouse.gov/sites/default/files/omb/budget/fy2015/assets/gov.pdf.

further degraded collateral prices in the economy, heightening the very systemic risks that the safe harbors were intended to avoid.

* * *

The foregoing discussion addresses repos of securities that are *currently liquid* but might be illiquid in a crisis. But today's safe harbors also protect repos of assets that are *currently illiquid*, even during normal market conditions. Thanks to the safe harbors, these repos allow distressed institutions to increase in size and leverage, as noted above. In the absence of safe harbor treatment, the institutions would be limited to ordinary secured debt financing to finance their growth. To be sure, this "ordinary" secured debt might also be very short-term financing. But even if it is just as short term as repo financing, this "ordinary" secured debt is subject to ordinary bankruptcy rules, such as the automatic stay, which prevent a value-destroying run on the debtor, fire sales of its collateral, and, if the financial stress leads to a system-wide crisis, the potential degradation of system-wide liquidity if the sales put excessive downward pressure on the collateral's price.

The repo safe harbors should therefore be limited to agreements collateralized by securities issued by the U.S. government or otherwise backed by the government's full faith and credit. Proposed basic statutory amendments are set out in the appendix. This rollback tracks the definition of "repurchase agreement" as originally enacted in 1984. Our conclusion rests on the available empirical evidence, the logic of the relationships, and the experience during the financial crisis.[63]

B. Substitution Effects and the Other Safe Harbors

If Congress rolls back the repo safe harbor as we recommend, markets will adjust. The price for repo'ing a mortgage-backed security, for example, will rise relative to other financing channels. We anticipate several kinds of responses, some positive, some benign, and some pernicious.

A positive, or at least benign, response is that financial institutions may reduce their reliance on repo-based financing and increase their use of less run-prone debt. In the absence of safe-harbor protection, repo lenders will demand higher haircuts because the underlying collateral is less liquid. Counterparties will, at the margin, more carefully assess with whom they deal and will seek more collateral. Repo-based financing will, therefore, be more expensive and less attractive. We may therefore see substitution toward more traditional secured debt financing. This might include short-term secured debt and longer-term debt. Longer-term debt should provide more stable financing.

63. We do not address considerations beyond those relating to financial stability and systemic risk. Other opponents of safe harbors may point to rapid close-outs as impeding reorganization of industrial firms, which they probably do. But because that process lacks the potential for knock-on effects to the entire economy, we are unsure of the correct policy. If the safe-harbored debts are a small part of an industrial firm's capital structure (in contrast to the one-third or more that it constituted for Lehman and other major financial firms), refinancing via section 364 debtor-in-possession prioritized financing should be possible.

A less attractive response is that counterparties may try to obtain safe-harbor protection for repos using the *derivatives* safe harbors. We have in this paper focused on the repo safe harbor, but comparable protection is available to counterparties to swaps, forwards, options, and other derivative contracts, including combinations of these contracts. If a mortgage-backed repo does not receive protection under the repo safe harbors, counterparties could construct a *synthetic* repo that has the same economics as a mortgage-backed repo but receives protection under the safe harbors for swap agreements.[64]

This possibility presents a statutory drafting problem: the drafters must close end-run "loopholes" by narrowing the derivatives safe harbors at the same time they narrow the repo safe harbors. That task is doable, but drafting is rarely perfect, and the ingenuity of financial market players and their lawyers is great.

An even less attractive response is that repo-based financing might migrate from smaller, systemically benign institutions to the biggest, systemically important financial institutions. That would tend to occur if the largest too-big-to-fail financial institutions continue to be too-big-to-fail, inducing non-safe-harbored repo investors in the mortgage-backed sector to protect themselves by migrating further to too-big-to-fail institutions. If that is the substitution effect, then rolling back the repo safe harbors will not have made the financial system much safer than before.[65]

Lastly, some of the currently existing short-term repo channels are set up in ways that can only handle short-term finance. These channels cannot and will not shift to being providers of long-term debt. This inelasticity may well mean that the market adjustments from rolling back the repo safe harbors will not be immediate. But a normal economic expectation would be that the costs of using this channel will rise, while the costs of other channels will fall, and over time markets will adjust away from the more expensive channel to the less expensive one.

While we cannot assuredly predict where the substitution will occur, and when it will happen, we can state that the current broad safe harbors did not work well during the financial crisis. They had encouraged the growth of investment channels that proved to be highly unstable and they failed to contain the crisis when it erupted. In our view, our financial system could not do much worse than have the weak, run-prone structures and incentives that we have now and that the broad safe harbors promoted and still promote. The downside

64. For a description of synthetic repos, see MOORAD CHOUDHRY, THE REPO HANDBOOK 192–95 (2002). One can conceptualize this as follows: A counterparty buys the security from the debtor under one contract and simultaneously enters a total return swap with the debtor under a separate and formally distinct contract. The total return swap requires the debtor to make periodic interest payments and requires the counterparty to pay any changes in the value of the securities. When the swap matures, the counterparty will sell the security back to the debtor. Through these three transactions, the parties replicate a repo. Each transaction—the two securities contracts and the swap—is safe harbored by the Code.

65. Another possibility is that, in the absence of safe-harbor protection, repo counterparties insist that their bank counterparties be well-capitalized, with capital levels even greater than those required by regulators. This would be a systemically positive effect.

of malign substitution from rollback is possible but seems limited, leaving the major issue, in our judgment, only the size and breadth of the improvement.

Moreover, we repeat the point we have made earlier: in general those drafting the Bankruptcy Code should leave monetary and financial policy to the institutions designated to do so. The mortgage-backed repo safe harbors are efforts at macro financial policy, not bankruptcy policy.[66]

C. Reduce Bankruptcy Costs for Financial Contract Counterparties

The demand for safe-harbored repos derives partly from inefficiencies in the Bankruptcy Code.[67] Without the safe harbors, it is said, counterparties would be exposed indefinitely to interest rate and spread risk, affecting their capital and liquidity, and would be unable to effectively hedge their risk.

These are important concerns, but they should not be overstated. In the absence of safe harbor treatment, repos are likely to be treated as secured loans, not executory contracts, by bankruptcy courts. If the status of repos as secured loans is unclear, the Code should be amended to make this clear. Like any secured loan, the repo contract should terminate upon the bankruptcy filing and the counterparty's secured claim set equal to the value of the underlying collateral on the filing date.[68] Counterparties should face the same risks and have the same protections as any secured lender in bankruptcy: The value of the collateral may vary over time and courts must adequately protect the secured party from deterioration in value.[69]

66. Bankruptcy policymakers should, however, be aware of how bankruptcy policy can tilt financing away from the stable long term to the less stable short term. Better attention to how interest is paid in bankruptcy, or not paid, on long-term undersecured debt and the adequacy of protection could strengthen long-term financing channels.

67. See, *e.g.*, Grosshandler, *supra* note 1, at 8 ("Absent safe-harbor protection, counterparties would be subject to the Bankruptcy Code's automatic stay and assumption/rejection powers, which would subject Safe Harbored Contract counterparties to a variety of risks. Unlike other contracts, the value of Safe Harbored Contacts typically can change rapidly based on the fluctuating value of the underlying assets or collateral, prevailing market conditions and other factors. The inability of counterparties to terminate such contracts and foreclose on collateral exposes them to risks that cannot be hedged effectively. If the debtor is given the right to assume or reject Safe Harbored Contracts in bankruptcy, this effectively gives the debtor an indefinite option to perform or terminate the contract, making it impossible to effectively hedge the related risks in an adequate manner. It could also potentially give the debtor the right to 'cherry pick' between contracts, exacerbating losses to creditors. Although the Bankruptcy Code provides protections to secured creditors, the mechanisms are not timely enough and are too cumbersome to obtain to effectively protect counterparties under volatile Safe Harbored Contracts, especially on a large scale, such as during the failure of a systemically important financial institution.").

68. *See* Skeel & Jackson, *supra* note 5, at 173–80. Indeed, the predecessor to the mortgage repo was the warehouse *secured* loan. *See supra* Part II.B.1.

69. In the unlikely event that a repo were treated as an executory contract, the counterparty would face similar challenges as those raised with a secured loan. For example, under section 365(d)(2) of the Code, the trustee in a Chapter 11 case has until confirmation of a plan to assume or reject an executory contract. But the statute also provides that "the court, on the request of any party to such contract or lease, may order the trustee to determine within a specified period of time whether to assume or reject such contract or lease." 11 U.S.C. § 365(d)(2) (2012).

True, some collateral, such as mortgage-backed securities, is more volatile than the collateral underlying some secured loans. Safe-harbor proponents indicate that this volatility justifies exemption from the normal workings of bankruptcy. But the very reason asserted for bankruptcy exemption—high volatility—is a reason that should make Congress and policymakers worry that the exemption unwisely subjects the financial system to greater risk. We have that concern, and policymakers should as well.

Some of the volatility problem comes from the likelihood that the adequacy of bankruptcy protection may be adequate in form but inadequate in financial reality. Interest rate shifts may change the value of the underlying collateral and interest is not necessarily available even to secured lenders.[70] A long stay might be costly to non-safe-harbored repo debt, as it can be for many secured creditors. This difficulty might warrant amendments to the Bankruptcy Code that better protects the counterparty's interest in the collateral, as valued on the filing date.[71] Additionally, in some cases the collateral will be assets that are unnecessary to an effective reorganization of the debtor, warranting a lift-stay order, particularly in cases of operating companies using repo.

Lastly, proponents of wide safe harbors worry about a counterparty needing liquidity that is tied up in a bankruptcy proceeding. Above we addressed such concerns: since all creditors have such worries, this is more a reason to safe harbor all debt from bankruptcy. But another market feature blunts the strength of this problem. A counterparty with an intense need for the cash—one that cannot wait out the bankruptcy process—has modern market alternatives. A wide and deep market of claims trading has arisen in recent years in bankruptcy.[72] A liquidity-constrained counterparty can sell the claim for cash to a financier that can wait out the bankruptcy process, in a way that was much harder to accomplish decades ago. We do not assert that the market for claims trading is perfect, but there is one and it blunts the force of the liquidity argument.

IV. Potential Critiques

Opponents of reform often make the following arguments in favor of retaining the status quo:

(1) The safe harbors prevented a systemic meltdown following the Lehman bankruptcy.[73]

70. *Id.* §§ 502, 506(b).

71. And the difficulty might justify revisiting whether adequate protection for an extended length stay should encompass the time value of money, prioritized at the level of the basic obligation.

72. *See, e.g.*, Victoria Ivashina, Benjamin Iverson & David C. Smith, *The Ownership and Trading of Debt Claims in Chapter 11 Restructurings* (Harvard Bus. Sch. Working Paper, 2013), *available at* http://www.ssrn.com/abstract=1573311; Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 Yale L.J. 648 (2010).

73. *See, e.g.*, Grosshandler, *supra* note 1, at 6–7 ("The effectiveness of the safe harbors in containing contagion was demonstrated during the bankruptcy of Lehman Brothers. None of Lehman Brothers' counterparties (many financial institutions among them) failed because of losses under Safe Harbored Contracts with Lehman. Almost all counterparties exercised their safe-harbored rights to

(2) Little would be gained by narrowing the repo safe harbors because the risk-taking activities of systemically important institutions are now constrained under recently enacted laws and regulations.[74]

(3) Our proposal will reduce the liquidity of mortgage-related securities and thereby undermine long-standing federal policy supporting the housing market.

(4) There is a worldwide demand for money-like obligations that monetary policymakers need to meet. Wide repo safe harbors facilitate meeting that demand.

We have addressed some of these issues obliquely above. We address each directly now.

A. Lessons from Lehman

Opponents of reform often argue that the safe harbors mitigated the market impact of Lehman's failure. In particular, the safe harbors prevented Lehman's failure from destabilizing its counterparties in the dealer market. There are two problems with this argument. First, it is a selective recounting of developments in financial markets after Lehman's collapse. Most obviously, it ignores the subsequent failure of AIG, the failure of the Reserve Fund, the needed guarantee of the entire money market, and the disarray and freezing of many financial channels. There was a major financial crisis and Lehman's collapse is generally thought to have deepened it.

The more important problem with the argument—that the safe harbors saved Lehman's dealer counterparties—is that it is probably incorrect.[75] Lehman and its counterparties required $28 billion in Fed assistance to stabilize the Lehman repo book when it filed, the Federal Reserve reports.[76] The safe harbors were,

terminate, net and exercise rights against collateral, with only approximately 3% of Lehman's derivatives book remaining outstanding after three months following its bankruptcy petition. If these counterparties were not protected by the safe harbors, these positions would have been indefinitely frozen, causing potentially catastrophic capital and liquidity implications for counterparties in addition to any losses under the contracts. While subsequent failures (and near-failures) occurred during the financial crisis, they had other causes—mainly losses caused by outsized exposures to the subprime mortgage market and the seizure of the inter-bank credit market. The effects of these dynamics were exacerbated by the political uncertainty caused by letting Lehman fail, while shoring up other institutions, which led to or exacerbated runs on not just broker-dealers, but on insured depository institutions (the first time runs had occurred since the Great Depression).").

74. *Id.* at 13–14 ("Take for example the criticism that the safe harbor for repurchase agreements has created an incentive for large financial institutions to rely excessively on short-term repurchase agreements rather than on other forms of funding. The banking and securities regulators are uniquely positioned to address any such issues. In fact, regulators have already taken steps to reduce reliance on short-term funding through tougher capital and liquidity requirements, and plan further action. These rules address specific concerns about the funding profile of major financial institutions without increasing risks to counterparties that would arise if the safe harbors were instead narrowed or eliminated.").

75. Adam Copeland, Antoine Martin & Michael Walker, Federal Reserve Bank of New York Staff Report: The Tri-Party Repo Market Before the 2010 Reforms 55–64 (2010), *available at* http://www.newyorkfed.org/research/staff_reports/sr477.pdf.

76. *Id.* at 56.

contrary to the opponents' recounting, insufficient to stabilize even Lehman's own repo book. And worse:

> [O]ther dealers [in the tri-party repo market] experienced stress during the following days [after Lehman filed]. . . . [S]tress in this market would [apparently] have been considerably worse, absent the exceptional policy responses that took place, including the presence of the [Fed's Primary Dealer Credit Facility].[77]

The Primary Dealer Credit Facility was a credit facility that the Federal Reserve created to backstop the tri-party repo market and illiquid collateral in that repo market (which we argue here should not benefit from the safe harbor).[78] The Lehman Bankruptcy Examiner's Report recounts the importance of the Fed's Primary Dealer Credit Facility in steadying repo markets around the time of Lehman's bankruptcy.[79] The Fed's facility was not in use just prior to the Lehman bankruptcy in mid-September; by October 1—two weeks after Lehman filed—the facility had seen repo dealers draw $148 billion on it.[80]

In other words, even the safe-harbored repo market needed massive government support and could not rely on the safe harbors to achieve stability. This result is hard to square with the view that the safe harbors prevented further failure after Lehman went down.

B. Post-Crisis Laws and Regulations

Our proposed reform—narrowing the repo safe harbors to approximately their 1984 extent—could be said to be "fighting yesterday's war." In a post-Dodd-Frank world, the costs of the safe harbors—especially their systemic risk effects—are now addressed and minimized by federal regulators. Indeed, any modification of the Bankruptcy Code's safe harbors would simply complicate and undermine the coordinated efforts of federal regulators and their counterparts around the world.

This is an important argument, and would be particularly powerful if we were advocating reforms designed to be primary tools in mitigating systemic risk. That is indeed a job that should be left in the hands of regulators. But we are not proposing that the Bankruptcy Code play a larger or different role in regulating systemic risk. We are instead arguing that the Code should *get out* of the business of regulating systemic risk. For over twenty years, Congress has added an expanding

77. *Id.* at 61.

78. On September 14, 2008, fear that a Lehman failure would "put other financial institutions at risk" led the Fed to expand the Primary Dealer Credit Facility. Adrian, Burke & McAndrews, *supra* note 38, at 3. "The facility proved to be a critical recourse for primary dealers at the time of the Lehman Brothers bankruptcy." *Id.* at 9.

79. *See* Report of the Examiner Anton R. Valukas at 1390–99, *In re* Lehman Brothers Holdings, Inc., Case No. 08-13555 (JMP) (Bankr. S.D.N.Y. Mar. 11, 2010), *available at* http://lehmanreport.jenner.com. The examiner describes Lehman's direct reliance on the facility, allowing it to pay counterparties. *Id.* at 1399.

80. Fed. Reserve Bd., Federal Reserve Statistical Release H.4.1: Factors Affecting Reserve Balances (Oct. 2, 2008), *available at* http://www.federalreserve.gov/releases/h41/20081002/ (showing outstanding loans of $147.7 billion through its Primary Dealer Credit Facility).

array of safe harbor provisions to the Bankruptcy Code with the stated intent of minimizing the risk of systemic distress. We think this is a mistake, especially with respect to repos, because the available evidence suggests that the safe harbors make systemic crises more likely and more severe.

More importantly, our proposal complements current efforts by federal regulators to limit the risk-taking of systemically important firms. Despite their best efforts, regulators may make mistakes and a systemically important institution may collapse (this is precisely why Congress adopted Title II of Dodd-Frank). The broad safe harbors we now have magnify the cost of regulatory error. They allow a failing institution to become more leveraged, more dependent on runnable short-term debt, and more likely to need a bailout when it collapses. Thus, our proposal—to narrow the repo safe harbors—helps reduce the cost of regulator error. Our proposal builds redundancy into the financial regulatory system.

The importance of this redundancy should not be overlooked. Regulators responsible for financial safety regret that they lack authority to handle broad aspects of systemic risk residing in the so-called "shadow banking" system.[81] If broad portions of the repo market move out of the banking system, as some believe safety regulation for banking might induce,[82] then the systemic costs of the Bankruptcy Code's subsidy to short-term repo financing could rise, to the discredit of the bankruptcy system. While riskier repo transactions declined in the wake of the financial crisis, they have climbed back up since[83] and Federal Reserve regulators continue in 2014 to worry that several Wall Street firms are seriously vulnerable to a repo run.[84] Narrowing the repo safe harbors to Treasuries helps to keep the shadow banking system, which is less susceptible now to direct regulation, from overly relying on mortgage-backed repos.

Moreover, Congress, via Dodd-Frank, expected bankruptcy to play an important role in resolving distress of systemically important financial institutions. The

81. Tarullo, *supra* note 46 (Federal Reserve governor concludes that "completion of this task [of promoting financial safety] will require a more comprehensive set of measures, . . . some of which must cover financial actors not subject to prudential regulatory oversight."). Moreover, "[w]e would do the American public a fundamental disservice were we to declare victory without tackling the structural weaknesses of short-term wholesale funding markets," Tarullo had previously concluded. Peter Eavis, *A New Fed Thought for 'Too Big to Fail' Banks: Shrink Them*, N.Y. TIMES DEALBOOK (May 3, 2013, 1:32 PM), http://dealbook.nytimes.com/2013/05/03/fed-governor-pushes-for-measure-aimed-at-strengthening-large-banks/.

82. *National Public Radio: New Rules Force Big Banks to Keep a Bigger Cushion* (Nat'l Pub. Radio broadcast Apr. 9, 2014) (analysis of Karen Shaw Petrou, Federal Financial Analytics), *available at* http://goo.gl/txkMbJ ("[I]f the big banks can't [operate in a market] because of these [new] rules, the business is going to go to non-banks.").

83. Rob Wile, *They're Back: Subprime MBS Are Reemerging in the Repo Market*, BUS. INSIDER (Feb. 3, 2012, 1:46 PM), http://www.businessinsider.com/theyre-back-subprime-mbs-are-reemerging-in-the-repo-market-2012-2.

84. *See* Eric Rosengren, Broker Dealer Finance and Financial Stability: Keynote Remarks at the Conference on the Risks of Wholesale Funding (Aug. 13, 2014), *available at* http://www.bostonfed.org/news/speeches/rosengren/2014/081314/081314text.pdf (Rosengren is the president of the Federal Reserve Bank of Boston); John Carney, *Wall Street's Reason to Fear the Repo*, WALL ST. J., June 22, 2014, at 6.

resolution planning process required in Dodd-Frank for financial institutions requires that the institutions plan for resolution under the Bankruptcy Code if they are eligible to file for bankruptcy. Title II of Dodd-Frank and many of its key regulatory interpreters expect bankruptcy to be the first line of resolution defense, with the expanded Dodd-Frank processes kicking in only if bankruptcy fails.[85]

C. Effects on the Housing Market

Our proposal would eliminate safe harbor protection for repos on mortgages and mortgage-backed securities. These assets will become less liquid, the supply of credit to the housing market could decline, and it could become harder for potential homeowners to obtain mortgages.

We offer no view here about the value of subsidizing mortgages. This is a matter for policymakers in other arenas to decide. But the American housing market was robust and mortgages were common before the repo safe harbor for mortgage-backed securities became explicitly available in 2005. The benefit to housing could not have been fundamental; the impact in facilitating the financial crisis was, however, substantial. If policymakers nevertheless decide that the safe-harbor benefit to liquidity of mortgage-backed securities is worth continuing, despite its impact in the financial crisis, then it should not move forward via a type of "off-budget" financing by which major risks from their being safe-harbored are borne by the U.S. Treasury, taxpayers, and the American economy but are not otherwise accounted for. If mortgage-backed securities are to get the benefit of the safe harbors, then they should be backed by the full faith and credit of the United States, a result that policymakers and experts have recommended anyway as superior to the current implicit guarantees of government-backed, but not government-guaranteed, entities and their securities.[86]

85. *See Implementation of the Dodd-Frank Act: Hearing Before the S. Comm. on Banking, Housing & Urban Affairs*, 112th Cong. 82–88 (2011) (statement of Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation), *available at* http://www.fdic.gov/news/news/speeches/chairman/spdec0611.html ("If the firms are successful in their resolution planning, then [Dodd-Frank's Orderly Liquidation Authority] would only be used in the rare instance where resolution under the Bankruptcy Code would have serious adverse effects on U.S. financial stability."); *The Bankruptcy Code and Financial Institution Insolvencies: Hearing Before the Subcomm. of Regulatory Reform, Commercial & Antitrust Law, H. Comm. of the Judiciary*, 113th Cong. 12 (2013) (statement of Jeffrey M. Lacker, President, Federal Reserve Bank of Richmond), *available at* http://goo.gl/9MybDd ("[T]he Dodd-Frank Act envisions bankruptcy without government support as the first and most preferable option in the case of a failing financial institution."); *see also Exploring Chapter 11 Reform: Corporate and Financial Institution Insolvencies; Treatment of Derivatives: Hearing Before the Subcomm. of Regulatory Reform, Commercial & Antitrust Law, H. Comm. of the Judiciary*, 113th Cong. 5 (2014) (statement of Thomas H. Jackson), *available at* http://goo.gl/6iVMPj (describing FDIC view that Dodd-Frank expects bankruptcy, not Orderly Liquidation Authority, to be the normal mode of resolution for distressed Systematically Important Financial Institutions).

86. *See* Nick Timiraos, *What Can Take the Place of Fannie and Freddie?*, Wall St. J. (Mar. 15, 2014, 5:00 AM EST), http://blogs.wsj.com/economics/2014/03/15/what-can-take-the-place-of-fannie-and-freddie/tab/print/. The academic, industry, and perhaps regulatory consensus proposal is reported to be to make the implied guarantee explicit, backed by the federal government's full faith and credit.

D. Liquidity in Money Markets

Repos are an important part of the money market[87] and the safe harbors are generally thought to play an important role in supporting the use of repos in money markets.[88] Our proposal would affect liquidity in money markets by reducing the range of assets subject to repo safe-harbor protection.[89] This might even lead to a "collateral shortage": Market participants may be unable to quickly access collateral that is subject to safe-harbor protection.[90]

These are important downsides of our proposal. Outside of a crisis, the safe harbors increase asset liquidity, promote liquidity in money markets, and expand access to credit. In a crisis, however, the safe harbors have opposite effects. A balance must be struck between (i) rules that foster the creation of money-like claims and (ii) rules that protect financial markets from destabilizing runs in systemically important institutions. This is obvious; there is an academic consensus that such a balance must be struck.[91] Although there are many ways to strike this balance, our proposal is a simple way to achieve it.

Our proposal will not prevent the financial system from creating money-like claims. First off, the Treasury market is itself broad and, in our view, should continue to have safe-harbor repos. Second, a repo rollback will shift creation of these claims from weakly capitalized financial entities to well-capitalized ones. The repo safe harbors are intrinsic to modern private money creation primarily because they protect counterparties of weakly capitalized, insolvency-prone financial entities. The safe harbors are unimportant if the entity seeking to create near-money is so well capitalized that its strength and survivability are unquestioned. Indeed, private money creation has a long history,[92] and for most of that history private money was created without repo safe harbors, which are a modern phenomenon, dating from the 1980s. Narrow safe harbors, such as those that we recommend, would provide private competitive incentives for some financial entities to move toward such ultra-safe structures, so that they could profit from issuing more near-money, which weakly capitalized financially entities could not. Regulators could analogously modulate safety-enhancing financial regulation with private money creation in mind.

* * *

87. Zoltan Pozsar, *Shadow Banking: The Money View* 5 (U.S. Treasury, Office of Fin. Research Working Paper No. 14-04, 2014), *available at* http://goo.gl/3obp6I.

88. *See, e.g.*, Gorton & Metrick, *supra* note 5, at 284 ("The rise of shadow banking was facilitated by a demand-driven expansion in the bankruptcy safe harbor for repos.").

89. Our proposal might reduce the extent to which repo'd assets are rehypothecated. We see this as a virtue, however, because it should reduce financial interconnectedness involving weakened securities—a problem during the financial crisis.

90. On collateral shortages, see Gorton & Metrick, *supra* note 5, at 289–90. *Cf.* Chrystin Ondersma, *Shadow Banking and Financial Distress: The Treatment of "Money-Claims" in Bankruptcy*, 2013 Colum. Bus. L. Rev. 79.

91. Perotti, *supra* note 18.

92. Gary Gorton, Misunderstanding Financial Crises: Why We Don't See Them Coming 10–25 (2012).

If our proposal has a large adverse effect on liquidity in money markets, and if federal regulators believe that the benefits of greater liquidity in these markets outweigh the potential systemic risks, regulators can expand the scope of the repo safe harbor in a simple way: The federal government can offer full faith and credit backing to a broader range of securities.

In other words, if there is a collateral shortage in money markets, or if regulatory authorities want more money-like channels with unimpeachable collateral to be built,[93] public authorities ought to push for appropriate private ordering or for government full faith and credit backing. To do otherwise is to ask bankruptcy to do what it cannot. If the collateral that provides the foundation to a money channel cannot retain its long-run value in a crisis, the legal framework has not created a solid money channel. Instead it has created a money channel that can operate during stable economic times but that in a financial crisis cracks, constricts, and collapses. It fails during a financial crisis because the foundational collateral does not retain its long-run value. But if important financial institutions rely on this shaky channel, then when it cracks, government authorities are pressed to conclude that they must support the channel to prevent its full collapse. Government authorities face the choice of propping up the channel and bailing out its participants, or allowing the real economy to suffer.[94]

Conclusion

The repo safe harbors are too wide and should be narrowed. The safe harbors should be limited to United States Treasury and similar securities with the government's full faith and credit backing them up. They should not encompass private mortgage-backed securities.

The safe harbors depart sharply from standard bankruptcy practice, effectively putting a large class of creditors outside the normal operation of the Code, by exempting them from the automatic stay, the bankruptcy court's avoidance powers, the normal scope of setoff, and the normal treatment of *ipso facto* clauses. These departures demand strong justification, but there is no strong justification for mortgage-backed repos. If the safe harbors truly supported systemic financial safety, they might well be justified. But the safe harbors do no such thing. They

93. The view that we need more near-money channels is not unanimous. Jeremy Stein, prior to joining the Federal Reserve, suggested that the greater problem may be the excessive manufacture of near-money obligations. Jeremy C. Stein, *Monetary Policy as Financial Stability Regulation*, 127 Q.J. Econ. 57 (2012).

94. Consider this description:

> Prior to the . . . crisis there was a credit boom . . . in housing. The mortgages were typically securitized into bonds that were used as collateral in repo. During the credit boom, over 1996–2007, . . . mortgage-backed securities grew by 1,691 percent. When house prices started to decline these mortgage-backed securities became questionable, leading to the financial crisis, when the short-term debt was not renewed, leading to almost a complete collapse in the volume of collateral. . . . The decline in house prices led lenders to question the value of the collateral in mortgage-backed bonds, as well as other securitizations.

Gary Gorton & Guillermo Ordoñez, *Collateral Crises*, 104 Am. Econ. Rev. 343, 346 (2014).

may well indeed do the opposite by encouraging short-term financing at the expense of stable long-term financing, by facilitating more runnable debt, and by facilitating runs—and especially destructive ones—when a financial firm weakens.

The departure from core bankruptcy principles—a recent one, beginning only a few decades ago and expanding substantially as recently as 2005 and 2006—is unjustified and should be ended.

APPENDIX: STATUTORY PROPOSAL

Amend section 101(47) to read approximately as it did in 1984:

> 101(47): "repurchase agreement" (which definition also applies to a reverse repurchase agreement) means an agreement, including related terms, which provides for the transfer of certificates of deposit, eligible bankers' acceptances, or securities that are direct obligations of, or that are fully guaranteed as to principal and interest by, the United States or any agency of the United States, if backed by the full faith and credit of the United States, against the transfer of funds by the transferee of such certificates of deposit, eligible bankers' acceptances, or securities with a simultaneous agreement by such transferee to transfer to the transferor thereof certificates of deposit, eligible bankers' acceptances, or securities as described above, at a date certain not later than one year after such transfers or on demand, against the transfer of funds;

Additionally, the definition of "securities contract" would need to be narrowed in order to prevent it from safe harboring repurchase agreements that fall outside the scope of the narrowed repo safe harbor. For example, a securities contract to purchase a security could be paired with a formally separate securities contract to sell that security back at a later time. That pairing could functionally substitute for a repo. Hence, section 741(7), which safe harbors certain securities transactions, should also be narrowed to eliminate transactions that are functionally equivalent to repos. Other conforming changes would likely be needed.

Legislative Update

By Hon. Christopher S. Sontchi[1]

Mortgages Should Be Removed from Repo Agreement Safe Harbors

Hon. Christopher S. Sontchi
U.S. Bankruptcy Court (D. Del.); Wilmington

Hon. Christopher Sontchi is a U.S. Bankruptcy Judge for the District of Delaware and a member of the Advisory Committee on Financial Contracts, Derivatives and Safe Harbors of the ABI Commission to Study the Reform of Chapter 11.

Since 2007, I have been presiding over the *American Home Mortgage* case.[2] At the time of its filing, American Home Mortgage was the 10th-largest home mortgage originator in the nation and was in the business of originating, securitizing, selling and servicing "Alt-A" home mortgage loans, a step above the now-infamous subprime market. As part of its origination and securitization business, the company was a party to numerous repurchase (or "repo") agreements involving billions of dollars. My experience in that case and other cases, coupled with my ongoing work in the area, has led me to conclude that Congress should scale back the scope of the safe harbors for repurchase agreements to exclude "mortgages" and "interests in mortgages" from the definition of repurchase agreements in § 101(47)(a)(i), as well as the definition of "securities contract" in § 741(7)(A). The effect would be to remove "mortgages" and "interests in mortgages" from the safe harbors of §§ 555 and 559 (and § 561 under chapter 15).

The current safe harbors for repurchase agreements allow for "runs" on financial institutions, such as American Home Mortgage, by counterparties/lenders, which are not subject to the automatic stay and, thus, are free to terminate repos and other financial contracts *en masse*. These *en masse* terminations drain a target institution of its liquidity, destroy its portfolio and accelerate its liquidation. The end result is that it is virtually impossible to reorganize companies with significant repo exposure such as American Home Mortgage.

It became quickly apparent to me during the *American Home Mortgage* case that mortgages simply do not fit into one of the primary purposes behind protecting repurchase agreements (*i.e.*, preservation of liquidity of investments). In fact, mortgages and interests in mortgages are not liquid assets, due in large part to the fact that mortgages are bundled into large groups and sold by the originators to investors or securitization trusts, as well as the unique nature of mortgages. Every mortgage is secured by a unique piece of real property and involves a buyer that has a unique credit profile and payment history. In order to address the uncertainty arising from the individual nature of mortgages, sales often include lengthy look-back periods where the buyer can return some mortgages in a portfolio to the seller if there is, for example, an early default, or if representations regarding the loans turn out to be inaccurate. In fact, it can take several months to complete the sale of a portfolio of mortgages. These are not U.S. government securities. The reality is that the counterparties to repurchase agreements (*i.e.*, the lenders) are not interested as much in preserving the liquidity of their investment in the mortgages originated by a debtor as they are in owning what would otherwise be property of the estate and the lender's collateral.

The business of originating mortgages requires access to a huge amount of capital. For example, when a new homeowner buys a house for $100,000 with 20 percent (or $20,000) down and borrows the remainder of the purchase price through a mortgage, the mortgage company must deliver $80,000 in cash at the closing of the sale. As of the end of 2013, there were approximately $9.9 trillion in home mortgage loans that were outstanding, every penny of which came from a mortgage lender.[3] In most cases, the mortgage lender providing the cash at closing obtained that money from a counterparty to a repurchase agreement or through a secured loan.

Traditionally, a mortgage lender would borrow the large amount of money necessary to originate mortgage loans through a warehouse secured line of credit or loan. At the closing of a mortgage loan, the cash necessary for the mortgage borrower to buy the property would come from the warehouse lender. The amount of the balance under the warehouse loan would increase by the amount of the mortgage loan, and the mortgage itself would automatically become the warehouse lender's collateral.

However, the mortgage would remain property of the mortgage lender. When the mortgage lender later sells the mortgage loan to another financial institution or a securitization trust, the cash received from the sale would be used to pay down the warehouse secured loan (plus interest) and the mortgage loan would automatically be removed from the warehouse lender's collateral pool. In the event of a bankruptcy by the mortgage lender, the mortgage loans that had been originated but not yet sold would become property of the bankruptcy estate, the automatic stay would prevent the warehouse lender from taking con-

1 This article is based on testimony that I recently submitted to the Subcommittee on Regulatory Reform, Commercial and Antitrust Law of the House of Representatives Committee on the Judiciary at a hearing on "Exploring Chapter 11 Reform: Corporate and Financial Institution Insolvencies; Treatment of Derivatives" in March. I am very grateful to Reps. Spencer Bachus (R-Ala.) and Hank Johnson (D-Ga.) for inviting me to testify at that hearing. The full testimony from the hearing is available at commission.abi.org.

2 Case No. 07-11047 (CSS).

3 Board of Governors of the Federal Reserve System, "Mortgage Debt Outstanding," March 6, 2014, *available at* www.federalreserve.gov/econresdata/releases/mortoutstand/current.htm.

trol of the mortgage loans, and the warehouse lender would have both a secured claim against the estate collateralized by the mortgage loans and be entitled to adequate protection.

In the late 1990s, master repurchase agreements began to replace warehouse secured loans. The prevalence of mortgage repos increased slowly until, as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), Congress expanded the definition of "repurchase agreement" to include mortgages.[4] Since 2005, the bulk of lending to mortgage originators has been through repurchase agreements. Mortgage repurchase agreements are virtually identical to warehouse secured loans except that under a repo, the mortgage belongs to the repo counterparty/lender rather than to the mortgage lender. This difference is of huge import.

The procedure for originating mortgage loans under a master repurchase agreement and a warehouse secured loan are virtually identical. The mortgage lender and the repo counterparty/lender would enter into a master repurchase agreement. At the closing of a mortgage loan, the cash necessary for the mortgage borrower to buy the property would come either directly from the repo counterparty or the mortgage lender. Simultaneously with the mortgage loan closing, the mortgage lender would sell the mortgage loan to the counterparty with an agreement that the mortgage lender would repurchase the mortgage loan within a specified period of time (usually between 30 and 90 days) for the original purchase price plus a fee. The mortgage lender would use the time of the repurchase agreement to arrange to sell the mortgage to a "permanent" investor or a securitization trust. At the time of the closing of the ultimate sale or securitization of the mortgage loan, the mortgage lender would repurchase the mortgage from the repo counterparty and flip it to the "permanent" buyer. As mortgage loans are sold to the repo counterparty, the balance of loans subject to the master repurchase agreement would increase, and as they were repurchased the balance would decrease.

Under a repurchase agreement, the mortgage loan is property of the repo counterparty. In the event of a default or bankruptcy by the mortgage lender, the repo counterparty has the right to declare a default and require the mortgage lender to immediately repurchase the mortgages (in secured creditor parlance, this would be the equivalent of calling the loan). In the event that the mortgage lender could not immediately repurchase the loan, the repo counterparty would obtain permanent ownership over the mortgage loans and be able to immediately sell them directly to permanent investors, securitization trusts or any other third party that is willing to buy the loans. Alternatively, the repo counterparty could maintain ownership over the mortgages. In any event, the mortgage loans would *not* be property of the estate and the automatic stay would *not* be applicable. The aforementioned structure and the safe harbor from the rules governing warehouse secured loans, such as the automatic stay, have been codified by the repo safe harbors.[5]

The ability of a repo counterparty/lender to be able to immediately sell the mortgage loans to a third party, and thus limit its exposure to the risks inherent in the mortgage itself (*i.e.*, liquidity), is asserted as one of the primary bases for the repo safe harbors. The argument is that without the liquidity that is supplied by the safe harbors, the cost of lending would increase, and in the event of a default, there could be a cascading series of defaults that might spread to the repo counterparty/lender, as well as parties to other agreements with the repo counterparty. So far, so good.

The assertion that the repo safe harbors are necessary to preserve liquidity does not apply to illiquid assets such as mortgages.

However, in my experience, the repo counterparty may not be interested in having the ability to preserve liquidity by selling the mortgages but rather would be likely to hold the loans for later disposition, especially in a crisis such as in 2007-09, where the value of a mortgage was artificially low. Indeed, as described above, mortgage loans are illiquid assets, and thus, the counterparty might have no choice but to hold the loans, even in the best of circumstances. The safe harbors allow the repo counterparty rather than the debtor to hold the mortgage and obtain the upside of any increase in value. In the event that the transaction is treated as a loan, the debtor would be able to retain ownership and control over the mortgage loans, subject to providing adequate protection, and preserve the upside for the estate as a whole. As applied to mortgages, the safe harbors allow for the repo counterparty/lender to grab what would otherwise be its collateral and prevent the mortgage lender/debtor from maximizing the value of those loans for the benefit of the bankruptcy estate.

This is contrary to the treatment of secured loans in bankruptcy and turns the Bankruptcy Code on its head. The economic reality is that a mortgage lender such as American Home Mortgage can be stripped of its assets in days or even hours, leaving no ongoing business and denying its creditors in general the value of its assets (*i.e.*, its mortgage loans).[6] While these safe harbors make sense in the context of assets that are actually liquid, such as U.S. Treasuries, they do not make sense in the context of an illiquid asset, such as mortgages.

Here's a real-world example. In the *American Home Mortgage* case, the debtor was a party to a master repurchase agreement with Calyon Bank. Immediately prior to the bankruptcy filing, Calyon Bank declared a default under the master repurchase agreement and took ownership of the mortgage loans. If a repo counterparty such as Calyon Bank takes ownership of the mortgages subject to the repurchase agreement, and the value of those mortgages is less than the outstanding principal balance of the loans, the counterparty (*i.e.*, Calyon Bank) can assert an unsecured claim for the deficit.[7]

I conducted a trial over two related issues: (1) At what time does the court value the mortgage loans for determining

4 Prior to 2005, mortgage repurchase agreements proceeded under the theory that they were protected by the safe harbors governing securities contracts. The number of repos under that theory were limited by the fact that there was a risk that courts might not agree that the safe harbors were applicable and that the transaction was, in fact, a loan.

5 *See* 11 U.S.C. §§ 101, 362(b)(7) and (o), 546(f), 548(d), 555, 559, 561 and 741.

6 Generally speaking, a debtor would not be able to force a lender under a warehouse secured loan or a repurchase agreement to continue funding future mortgages. 11 U.S.C. § 365(c)(2). However, at the very least, a debtor would still own its portfolio. In addition, forcing a debtor and a secured lender to deal with each other often results in continued lending.

7 11 U.S.C. § 562.

continued on page 63

Legislative Update: Mortgages Should Be Removed from Repo Safe Harbors

from page 11

whether there is a deficit and, thus, a claim, and (2) how does the court calculate the value of the loans? I ultimately issued an opinion on those issues, which was affirmed by the Third Circuit.[8] I raise the issue here, however, for a different reason. It became clear at the trial that Calyon Bank never intended to sell the mortgage loans in the foreseeable future. Rather, its strategy was to hold the mortgages until value rebounded, and in the interim its credit exposure was minimized because the mortgage borrowers (*i.e.*, the homeowners) were continuing to make principal and interest payments.

Calyon Bank's strategy to hold onto the loans made perfectly valid economic sense. The problem is that it should have been in the debtor's purview — not Calyon Bank's — to make the decision; the consideration should have been the benefit to the bankruptcy estate and the debtor's creditors as a whole, rather than just to Calyon Bank. As with virtually every other type of asset that serves as collateral for a secured loan, control rests with the debtor. However, secured creditors are not without protection, and they might be entitled to adequate protection.

The law governing the rights of secured creditors and the balance of those rights with other considerations are well developed. The repo safe harbors remove what would otherwise be considered a secured loan from the bankruptcy estate, depriving the debtor of any control over what would otherwise be its property and the lender's collateral. The asserted reason for exempting mortgages from the rules governing virtually every other type of collateral is that those protections are necessary to preserve liquidity in the system and, more particularly, for the repo counterparty's exposure. However, that asserted basis for extraordinary treatment is fallacious because mortgage loans are not liquid, especially in times when loan default is more likely, such as was the case in 2007-09. There is no reason to exempt mortgage loans and interests in mortgage loans from the ordinary and well-established rules governing secured lending.

The application of the safe harbors to mortgages and interests in mortgages is a complicated and controversial subject, and any amendment to the safe harbors should be carefully weighed. While there are a number of issues and arguments that should be considered in such an examination, I think one thing is clear: The assertion that the repo safe harbors are necessary to preserve liquidity does not apply to illiquid assets such as mortgages. They should be returned to whence they came and be subject to the normal, long-standing and well-developed law governing secured lending. abi

8 *In re American Home Mortgage Holdings Inc.*, 411 B.R. 181 (Bankr. D. Del. 2009), *aff'd*, 637 F.3d 246 (3d Cir. 2011).

Copyright 2014
American Bankruptcy Institute.
Please contact ABI at (703) 739-0800 for reprint permission.