FIFTH REPORT PURSUANT TO SECTION 202(e) OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT PUB. L. NO. 111-203 (2010)

ADMINISTRATIVE OFFICE OF THE
UNITED STATES COURTS

WASHINGTON, D.C. 20544

JULY 2020

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I. Introduction

In response to the global economic turmoil that began in late 2007, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Act) introduced a broad array of regulatory reforms in the financial sector. This report focuses on the reforms in Title II of the Act, which are intended to mitigate risks posed by the failure of systemically important financial institutions. Title II directs the Administrative Office of the United States Courts (AOUSC) to study the resolution of these institutions and report on its findings. The AOUSC submitted its first four annual reports pursuant to 12 U.S.C. § 5382(e) on July 21, 2011 (First Report), July 17, 2012 (Second Report), July 19, 2013 (Third Report), and July 10, 2015 (Fourth Report). The AOUSC submits this report in compliance with the directive of section 5382(e).[1]

The report proceeds as follows:

- Part II provides an executive summary of the report's primary research, findings, and analysis.
- Part III describes the AOUSC's mandate under section 5382(e) of the Act and briefly summarizes the First, Second, Third, and Fourth Reports as well as the scope of this Fifth report.
- Part IV focuses on the key issue explored in this report: the growing presence of "nonbank lenders" in the U.S. residential mortgage market. We define "nonbank lenders" to mean U.S. lenders that lack the traditional features of banks and operate outside of the traditional banking system. There are risks associated with increased nonbank lending activity, including the unique vulnerability of nonbanks to liquidity crises and the potential negative consequences of sector failure on other financial institutions. There are also important benefits associated with increased nonbank lending activity, such as additional availability of loans to lower-income consumers. This section reviews these and other risks and benefits, as well as certain legal and regulatory developments that have contributed to nonbank lending sector growth. Finally, this section explores existing approaches to managing nonbank

1. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 202(e)(2), 124 Stat. 1376, 1449 (2010), codified under 12 U.S.C. § 5382(e)(2). The Act requires that the AOUSC summarize the results of its study in a report "[n]ot later than 1 year after the date of enactment of th[e] Act [and] in each successive year until the third year" and in every fifth year after date of enactment. The AOUSC appointed a Working Group to study the issues identified in section 5382(e). This Working Group is chaired by Judge Michelle M. Harner, United States Bankruptcy Court for the District of Maryland. Other members of the Working Group include: Judge Thomas L. Ludington, United States District Court for the Eastern District of Michigan; Judge Stuart M. Bernstein, United States Bankruptcy Court for the Southern District of New York; Judge Robert E. Grossman, United States Bankruptcy Court for the Eastern District of New York; Judge Brendan L. Shannon, United States Bankruptcy Court for the District of Delaware; Vito Genna, Bankruptcy Court Clerk for the Southern District of New York; and Professor Diane Lourdes Dick, Seattle University School of Law, as the academic representative. AOUSC and Federal Judicial Center staff provided support for the Working Group. A list of defined terms used in this report is set forth in Appendix A.

lender failures. Focusing on the use of the federal bankruptcy process to reorganize or liquidate a firm, the report presents three recent case studies that examine how chapter 11 of title 11 of the United States Code (the Bankruptcy Code) is meeting the restructuring needs of failed nonbank lenders, their stakeholders, and the financial system. The case studies suggest that the structure and flexibility of the Bankruptcy Code adapt well to many aspects of these cases. This section also identifies potential opportunities for enhancing the efficiency and effectiveness of the Bankruptcy Code with respect to these and other similar nontraditional financial intermediaries.

- Part V synthesizes the report's discussion and analysis regarding the growing presence of nonbank lenders in the U.S. financial system and the effectiveness of the Bankruptcy Code in facilitating the orderly liquidation or reorganization of these firms.

II. Executive Summary

Historically, financial intermediation in the U.S. capital markets was provided by depository banks that accepted deposits from customers and extended the investment capital to borrowers in the form of loans. Then and now, traditional banks broker the flow of funds between savers and borrowers, reducing both the information costs naturally faced by households and businesses in a position to lend funds, on the one hand, and the liquidity constraints faced by those seeking to borrow, on the other. But history has also shown that, for all these important benefits, traditional financial intermediation is inherently fragile in its exposure to "runs." For this reason, governments around the world attempt to minimize systemic risk by issuing guarantees on financial intermediary liabilities and by offering contingent liquidity through a central bank acting as a lender of last resort. Then, partly to manage the moral hazard risks associated with these interventions, an extensive network of laws and regulations provides for enhanced supervision and monitoring of banking institutions.

While the traditional model continues, financial intermediation is increasingly provided through what some describe as an alternative, parallel, "shadow" banking sector involving entities and activities outside of the regular banking system. As explained more fully below, there is no one-size-fits-all definition of the term "shadow banking," as the concept encompasses many different categories of nontraditional financial intermediaries. It includes, among other things, the focus of this report: the "nonbank lenders" that originate or service residential mortgages and other consumer and business loans. These nonbank lenders do so even though they lack the traditional features of banks, such as accepting and holding customer deposits, and are not covered by traditional governmental protections, such as liquidity backstops. Compounding the lack of consensus on what, exactly, constitutes "shadow banking," there is also some controversy surrounding the term itself. Some commentators believe that the term has pejorative associations, and that it obscures the positive influence these nontraditional financial intermediaries have had on the cost and availability of liquidity, maturity, and credit enhancement. Unfortunately, other labels have led to confusion.

Although the U.S. regulatory environment has changed over the years, the nonbank lending sector has largely avoided many of the administrative costs and regulatory burdens imposed on traditional banks. As a result, nonbank lending has grown substantially. On the one hand, there are many noteworthy benefits, such as increased availability of loans to lower-income individuals who may be turned away by traditional banking institutions. But there are also significant risks associated with increased nonbank lending. Because they are often thinly capitalized and lack access to important backstops, nonbank lenders are uniquely vulnerable to economic shocks and liquidity crises.

In recent months, the issue has been heightened by the coronavirus (COVID-19) public health crisis, as the ensuing economic effects will lead to severe challenges for the residential lending market in the months and years to come. It is increasingly important to consider whether and to what extent adequate systems are in place to facilitate the orderly liquidation or reorganization of financially distressed nonbank lenders. Because nonbank lenders are not covered by language in the Bankruptcy Code that renders "banks" ineligible for bankruptcy protection, firms large and small have used the federal bankruptcy process to reorganize or liquidate. A detailed analysis of three recent nonbank lender bankruptcies suggests that the Bankruptcy Code has been generally effective in facilitating the orderly liquidation and reorganization of these firms. In each of the three cases, the debtor was able to advance a confirmable plan and exit bankruptcy within a reasonable period, minimizing disruptions and preserving value. Nevertheless, no process is perfect and the case studies offer insights and perspectives on potential enhancements to the bankruptcy scheme for distressed nonbank lenders and similar financial entities. This report provides that analysis below, as well as commentary that may further assist policy makers.

III. AOUSC Reports Under Title II

Title II of the Act mandates various studies to consider the implications and alternatives of the insolvency scheme created for covered financial companies under the Act.[2] This report relates to the study mandated by 12 U.S.C. § 5382(e), "Study of Bankruptcy and Orderly Liquidation Process for Financial Companies."

Section 5382(e) requires the AOUSC to study the following three issues:

1. the effectiveness of chapter 7 or chapter 11 of the Bankruptcy Code in facilitating the orderly liquidation or reorganization of financial companies;
2. ways to maximize the efficiency and effectiveness of the Court [Title II defines "Court" to mean "the United States District Court for the District of Columbia, unless context otherwise requires"]; and
3. ways to make the orderly liquidation process under the Bankruptcy Code for financial companies more effective.

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2. 12 U.S.C. § 5382(e)–(g); Pub. L. No. 111-203, § 217, 124 Stat. at 1519–20.

Section 5382(e) further requires the AOUSC to submit a report summarizing the results of the study "[n]ot later than 1 year after July 21, 2010"—that is July 21, 2011.[3] It also requires the AOUSC to file two subsequent annual reports in July 2012 and 2013, and then a report "every fifth year after that date."[4]

The Act implemented a series of changes in the regulation of financial institutions, financial products, and various market participants that were designed to promote financial stability and more adequately address the financial distress of large, complex financial institutions. The provisions most relevant to the AOUSC's reports under section 202(e) of the Act are Title I of the Act, Financial Stability, which creates the Financial Stability Oversight Council (FSOC); and Title II of the Act, Orderly Liquidation Authority (OLA), which creates a regulatory process for the Federal Deposit Insurance Corporation (FDIC) to act as receiver and liquidate certain covered financial companies, as defined by the Act and implementing regulations.[5]

The First, Second, Third, and Fourth Reports systematically and objectively evaluated the resolution of distressed financial institutions and compared processes under the Bankruptcy Code to procedures under the OLA. This section briefly describes the substance of the First, Second, Third, and Fourth Reports and the scope of this Fifth Report.

The core contribution of the First Report is its systematic and thorough analysis of the key provisions of the Bankruptcy Code that likely would affect the reorganization or liquidation of a financial institution, with comparison to key OLA provisions. Relying on interviews with a range of stakeholders and case studies, the report explains the potential advantages and disadvantages of each resolution scheme in the context of large, complex financial institutions. It preliminarily concludes that the Bankruptcy Code generally functions well to address corporate distress, including that of bank holding companies and nonbank financial institutions.

The Second Report compared the relative efficiency and effectiveness of the claims resolution process under the Bankruptcy Code with that under the OLA. Notably, the OLA claims resolution procedure adopts certain aspects of the bankruptcy claims resolution procedure (e.g., requiring creditors to file proofs of claim and allowing the FDIC, as receiver, to object to claims). One critical OLA procedure, however, is contrary to the centralized claims resolution procedure fostered by the Bankruptcy Code (i.e., the ex post judicial review process whereby a creditor's claim is deemed rejected unless the FDIC allows the claim within the 180-day review period). The report suggests that the flexibility and concurrent court supervision inherent in the bankruptcy claims resolution procedure may allow that process to adapt more easily to the variety of distressed companies that require a claims resolution scheme.

3. 12 U.S.C. § 5382(e)(2).

4. *Id.*

5. *Id.* §§ 5321, 5383.

The Third Report considered one of the Bankruptcy Code's provisions for the treatment of stakeholders' claims and interests under a plan of reorganization: the best interests test of section 1129(a)(7) of the Bankruptcy Code, which sets the minimum distribution that stakeholders are entitled to receive under a chapter 11 plan.[6] Certain provisions in the OLA, including a protection for creditors known as "minimum recovery," are similar to the best interests test. Specifically, the OLA requires that creditors receive at least as much in a resolution under OLA as they would otherwise receive in a hypothetical chapter 7 bankruptcy. The challenge in applying this provision compared to the best interests test is that unlike the similarity in priority and distribution schemes between chapter 11 and chapter 7, the OLA priority and distribution schemes do not align as well with the relevant provisions of the Bankruptcy Code.

The Fourth Report focused on section 363(b) of the Bankruptcy Code,[7] which permits a chapter 7 or chapter 11 debtor to sell all or substantially all of its assets outside of the ordinary course of business—i.e., as a going concern sale—after notice and hearing. It evaluated this provision and a proposal by the American Bankruptcy Institute Commission to Study the Reform of Chapter 11 to amend the Bankruptcy Code, as well as the going concern/restructuring models underlying the OLA and similar proposals submitted to Congress for incorporation into the Bankruptcy Code. Each of the sale-based models presents a potential opportunity to preserve value, but they also raise issues concerning, for example, due process, fair and equitable treatment of similarly situated creditors, and the impact of additional indebtedness incurred prior to a sale on value realization and allocation.

This Fifth Report focuses on the unique restructuring needs of "nonbank lenders," which we define to mean U.S. lenders that lack the traditional features of banks and operate outside of the traditional banking system. It explores the risks and benefits associated with increased nonbank lending activity, as well as certain legal and regulatory developments that have shaped nonbank lending in recent years. Additionally, the report analyzes existing approaches to managing nonbank lender failures, focusing on the use of the federal bankruptcy process to reorganize or liquidate firms. Examining three recent case studies, the report considers how the federal bankruptcy process is meeting the restructuring needs of failed nonbank lenders, their stakeholders, and the financial system. Finally, the report presents potential opportunities to enhance the efficiency and effectiveness of the Bankruptcy Code with respect to these unique financial company debtors. The following section describes the AOUSC Working Group's research and analysis concerning the rise of nonbank lending in the United States and the ways in which the Bankruptcy Code facilitates the liquidation and reorganization of firms engaged in this and other forms of nontraditional financial intermediation.

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6. 11 U.S.C. § 1129(a)(7).
7. *Id.* § 363(b).

IV. The Growth of Nonbanks in the Financial Markets

This report examines the growing presence of nonbank lending institutions in the financial markets and considers how these institutions fit within traditional legal and regulatory schemes, including the U.S. bankruptcy laws. The growth of the nonbank lending market has received some attention from academics and other analysts and commentators, particularly in the wake of the FSOC's recent decision to remove the nonbank financial firm, Prudential Financial, from the list of systemically important financial institutions. As Treasury Secretary Steven T. Mnuchin explained, "The Council's decision [to de-designate Prudential] follows extensive engagement with the company and a detailed analysis showing that there is not a significant risk that the company could pose a threat to financial stability."[8] This decision was met with criticism from industry watchdogs, who argued that regulators had overlooked the critical role nonbanks play in the financial markets and that the decision would encourage the expansion of an unregulated "shadow banking" system.[9]

The topic of nonbank lending also provides a lens through which to reconsider some of the issues identified in the prior reports and update the analysis to account for changes in the legal and regulatory infrastructure. Indeed, the past five years have seen several notable developments and initiatives.

The U.S. House of Representatives passed legislation in 2017 that would have repealed Title II of the Act in favor of amendments to the Bankruptcy Code.[10] Proponents argued that a modified bankruptcy process would better meet the needs of distressed financial institutions, rendering the OLA in Title II unnecessary. In response to the legislation, President Trump directed the U.S. Treasury to conduct a review of the OLA and provide recommendations.[11] The U.S. Treasury published its findings in early 2018, recommending that bankruptcy serve as the primary option for distressed financial institutions, with the

8. *See* Press Release, Fin. Stability Oversight Council, Financial Stability Oversight Council Announces Rescission of Nonbank Financial Company Designation (Oct. 17, 2018), *available at* https://home.treasury.gov/news/press-releases/sm525.

9. *See, e.g.*, Jeremy C. Kress, *The Last SIFI: The Unwise and Illegal Deregulation of Prudential Financial*, 71 Stan. L. Rev. Online 171 (2018) (arguing that the decision is, among other things, a threat to financial stability).

10. On the Financial CHOICE Act, see Eric J. Spitler, *The Long Game: The Decade-Long Effort to Dismantle the Dodd-Frank Act*, 24 N.C. Banking Inst. 1, 47–50 (2020). The Financial CHOICE Act, H.R. 5983, 114th Cong. (2016), was first introduced in 2016 and passed the House Financial Services Committee on a partisan vote of thirty to twenty-six, but was never considered by the full House of Representatives. An amended version was introduced as H.R. 10 in the 115th Congress, which the House passed by a vote of 233 to 186 in 2017. Both bills included many provisions in addition to those provisions that would have repealed Title II of the Act.

11. Memorandum from President Donald J. Trump on Orderly Liquidation Authority for the Secretary of the Treasury (Apr. 21, 2017), *available at* https://www.govinfo.gov/content/pkg/DCPD-201700266/pdf/DCPD-201700266.pdf.

OLA preserved as a last resort.[12] In addition, the report recommended the adoption of certain amendments to both Title II and the Bankruptcy Code that would streamline the bankruptcy process and ensure a single-point-of-entry restructuring approach. Congress continues to explore these and other law reform proposals. In late 2018, the Senate Judiciary Committee held a hearing on a proposed law that would add a new chapter 14 to the Bankruptcy Code to address the unique needs of struggling financial institutions.[13] The proposed legislation reflects many of the U.S. Treasury report's recommendations, including the single-point-of-entry approach.

On the regulatory front, the Board of Governors of the Federal Reserve System (FRS) in 2016 issued final regulations mandating that systemically vital firms maintain, at the holding company level, a certain amount of "total loss absorbing capacity" (TLAC).[14] TLAC may be comprised of equity, subordinated debt, and long-term senior debt. The requirement, which further solidifies regulators' longstanding preference for the single-point-of-entry approach, ensures that losses can be allocated to the holding company's debt and equity investors while the operating subsidiary remains intact. The board has also adjusted its approach to implementing the Act's stress test and comprehensive capital analysis and review, shifting in recent years to a biannual testing interval for all but the largest banks.[15]

Although we have chosen to focus this report on the growth of nonbanks in the financial markets, each of the legal and regulatory developments described above could warrant an in-depth analysis and a separate report. As identified at Appendix B, academics, working groups, and other commentators have already provided significant scholarship and commentary on these and related issues.[16]

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12. U.S. Dep't of the Treasury, Report to the President of the United States Pursuant to the Presidential Memorandum Issued April 21, 2017, Orderly Liquidation Authority and Bankruptcy Reform 2 (2018), *available at* https://home.treasury.gov/sites/default/files/2018-02/OLA_REPORT.pdf.

13. *Big Bank Bankruptcy: 10 Years After Lehman Brothers*, 403 Corp. Couns. Int'l Adviser NL 2 (Dec. 2018) (reprinting witness statements).

14. Press Release, Bd. of Governors of the Fed. Reserve Sys., Federal Reserve Board Adopts Final Rule to Strengthen the Ability of Government Authorities to Resolve in Orderly Way Largest Domestic and Foreign Banks Operating in the United States (Dec. 15, 2016), *available at* https://www.federalreserve.gov/newsevents/press/bcreg/20161215a.htm.

15. *See, e.g.*, Lalita Clozel, *Big Banks Ace First Round of Federal Reserve's Stress Tests*, Wall St. J., June 21, 2019.

16. Appendix B provides a sampling of the literature available on these topics. It is not an exhaustive list of the available resources.

A. Introduction to Nonbank Lending

1. Overview of "Shadow Banking" and "Nonbank Lending"

Financial intermediaries play an important role in the capital markets, in the United States and around the world.[17] By aggregating investment capital and making it available to others in the form of loans, or by arranging the sale of a company's stocks and bonds to investors, a financial intermediary serves as a middleman among diverse parties in order to facilitate transactions.[18] In the U.S. financial markets, traditional financial intermediaries include depository or investment banks, hedge funds, mutual funds, and insurance companies.

For instance, a traditional bank brokers the flow of funds between savers and borrowers. Federal and state statutes and regulations generally provide that only "banks" may accept deposits,[19] which are typically made in the form of checking, savings, and money market deposit accounts and certificates of deposit.[20] By aggregating deposits and extending capital to borrowers in the form of loans, banks help to reduce both the information costs naturally faced by households and businesses in a position to lend funds, on the one hand, and the liquidity constraints faced by those seeking to borrow, on the other. Moreover, by engaging in securitizations and other structured finance transactions, banks and other financial intermediaries help parties manage their exposure to specific risks, such as those relating to credit, maturity, and liquidity.

Despite all these important benefits, traditional financial intermediation is inherently fragile in its exposure to "runs." The traditional bank's liabilities (customer deposits) tend to be short-term and highly liquid, while its assets (mortgage loans) tend to be longer-term and illiquid. The prototypical bank run occurs when many depositors attempt to withdraw their capital at the same time, usually because they believe the bank is at risk of failing. In the extreme—such as during the Great Depression—a contagion of bank runs can lead to systemic disruption.

Governments around the world attempt to minimize systemic risk by issuing guarantees on financial intermediary liabilities and by offering banks contingent liquidity through a central bank acting as a lender of last resort. To this end, Congress in 1933 established the FDIC as an independent agency to protect depositors (with the full faith and credit of the United States) against the loss of deposits that may occur when an insured bank fails.[21]

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17. *See* Robert G. King & Ross Levine, *Finance and Growth: Schumpeter Might be Right*, 108 Q. J. ECON. 717 (1993) (exploring the view that a robust capital market and functioning intermediaries are important elements of a strong economy).

18. On the history of financial intermediation, see Nicola Cetorelli et al., *The Evolution of Banks and Financial Intermediation: Framing the Analysis*, 18 FED. RES. BANK N.Y. ECON. POL'Y REV. 1, 3–4 (July 2012).

19. *See, e.g.*, 12 U.S.C. § 24 (providing that the acceptance of deposits is a fundamental power of banks); N.Y. Banking Law 96 (providing that only banks may hold and accept consumer deposits).

20. *See generally* 12 U.S.C. § 1813(*l*) (defining, for the purposes of the FDIA, "deposit").

21. *See* Federal Deposit Insurance Act of 1933, 12 U.S.C. §§ 1811–1831.

Moreover, to provide contingent liquidity, the FRS has the authority to make advances to member banks during periods of systemic distress.[22]

Although these policies have addressed key vulnerabilities in the traditional banking system, they are not a panacea. For example, commentators generally recognize that the provision of liability guarantees and liquidity backstops could lead to moral hazard issues in the form of excessive risk taking, leverage, and maturity transformation.[23] The moral hazard risk, in turn, is the theoretical basis for enhanced supervision and regulation of banking institutions.

Traditional financial intermediation, with credit intermediated through banks[24] and protection against runs, dominated the U.S. financial landscape well into the 1990s.[25] But over time, increased specialization in the provision of credit has transformed financial intermediation from a process involving a single institution to one involving several. Specialization has the benefit of reducing the total cost of intermediation. However, some commentators observe that the competitive drive to reduce costs has also fueled institutional evolution and structural innovations to reduce or eliminate costs associated with supervision and regulation—a phenomenon that is generally known as regulatory arbitrage.[26]

In the world of financial intermediation, regulatory arbitrage and other competitive market pressures[27] have led to the development of what some describe as an alternative, parallel, "shadow banking"[28] sector. As explained below, there is no one-size-fits-all

22. *See* 12 U.S.C. § 347b(a). For a thoughtful critique of lender-of-last-resort policies and practices, see Kathryn Judge, *The First Year: The Role of a Modern Lender of Last Resort*, 116 Colum. L. Rev. 843 (2016).

23. *See, e.g.*, Charles Goodhart, *Balancing Lender of Last Resort Assistance with Avoidance of Moral Hazard*, *in* Frank Heinemann et al., Monetary Policy, Financial Crises, and the Macroeconomy (2017).

24. By "traditional bank," we mean depository institutions, including commercial banks, thrifts, credit unions, industrial loan companies, and federal savings banks. And, unless the context suggests otherwise, we use the term "bank" to refer to traditional banks. *See* Zoltan Pozsar et al., Fed. Reserve Bank of N.Y., Staff Report No. 458, Shadow Banking (2010), 1 n2 (adopting a similar convention).

25. Many analysts pinpoint the 1990s as the time when the U.S. financial landscape began to shift. *See, e.g.*, Zsuzsa R. Huszar & Wei Yu, *Mortgage Lending Regulatory Arbitrage: A Cross-Sectional Analysis of Nonbank Lenders*, 41 J. of Real Est. Res. 219, 219 (2019) ("Since the early 1990s…the market has changed dramatically as less-regulated nonbank lenders have gradually become the primary lenders, especially for risky subprime mortgages").

26. For a comprehensive discussion of regulatory arbitrage in various contexts, see Victor Fleischer, *Regulatory Arbitrage*, 89 Tex. L. Rev. 227 (2010).

27. Professor Kathryn Judge acknowledges the role of regulatory arbitrage in the growth of shadow banking. However, she notes "there are also indicia that the system has grown in part to satisfy demands that the banking system cannot address," such as strong demands for money claims. Kathryn Judge, *Information Gaps and Shadow Banking*, 103 Va. L. Rev. 411, 438 (2017).

28. Economist Paul McCulley is widely acknowledged to have coined the term in 2007 to describe "the whole alphabet soup of levered up non-bank investment conduits, vehicles, and structures." Paul McCulley, Pimco, Teton Reflections: Pimco Global Central Bank Focus 2 (2007), *available at* https://www.pimco.com/en-us/insights/economic-and-market-commentary/global-central-bank-focus/teton-reflections.

definition of the term "shadow banking," as the concept encompasses many different types of entities and transactions with varying levels of risk to the broader financial system. This report uses the term to reference financial intermediation provided by entities that have not traditionally served as financial intermediaries.[29] An example of such intermediation is a trust designated as a special purpose entity to own and hold the rights to loan receivables. Investors then purchase trust certificates to gain exposure to the pool of loan assets.[30] While most of these entities would not qualify as systemically important financial institutions, they have the potential to impact systemically important financial institutions when they fail.

Although the regulatory environment has changed over the years, the shadow banking sector has largely avoided many of the administrative costs and regulatory burdens imposed on traditional banking institutions. These costs include FDIC premiums, strict capital requirements, and regulatory restrictions on investment portfolios.[31] The following section develops, for the purposes of this report, a working definition of "shadow banking," and distinguishes this broader concept from the narrower idea of alternative or "non-bank" lending.

a. Key definitions in this report.

Despite its widespread use by market participants and analysts, there is no universal definition of the term "shadow banking." Rather, several main categories of definitions emerge in the literature. One common definitional strand reflects a primary concern with regulatory arbitrage and its attendant consequences. For instance, a World Bank report defines shadow banking as "a set of activities, markets, contracts, and institutions that operate partially (or fully) outside the traditional commercial banking sector and as such, are either lightly regulated or not regulated at all."[32] In a similar way, the Financial Stability Board (FSB) defines shadow banking as "credit intermediation involving entities and activities outside of the regular banking system,"[33] where "prudential regulatory standards

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29. The FSB defines "shadow banking" as "the system of credit intermediation that involves entities and activities outside the regular banking system." Fin. Stability Bd., Shadow Banking: Strengthening Oversight and Regulation 3 (2011), *available at* https://www.fsb.org/wp-content/uploads/r_111027a.pdf.

30. Special purpose vehicles are trusts that are formed to own the rights to the loan receivables. Investors purchase securities or trust certificates. *See* Bryan Noeth & Rajdeep Sengupta, *Is Shadow Banking Really Banking?*, 2011 The Reg'l Econ. 8.

31. Although we focus on the U.S. market, many other reports analyze the rise of shadow banking from a comparative and/or international perspective. *See, e.g.*, Helen Huang, *Chinese Shadow Banking and Its Impact on the U.S. Economy*, 37 Rev. Banking & Fin. L. 2 (2017).

32. Swati Ghosh, Ines Gonzalez del Mazo & İnci Ötker-Robe, *Chasing the Shadows: How Significant Is Shadow Banking in Emerging Markets?*, 2012 Economic Premise No. 88, at 3, *available at* https://openknowledge.worldbank.org/handle/10986/17088.

33. Fin. Stability Bd., Shadow Banking: Scoping the Issues (2011), *available at* http://www.financialstabilityboard.org/2011/04/shadow-banking-scoping-the-issues/.

and supervisory oversight are either not applied or are applied to a materially lesser degree than is the case for regular banks engaged in similar activities."[34]

Definitions of this sort clearly emphasize the role of nontraditional financial intermediaries, but do not necessarily exclude traditional banks. Modern capital markets are incredibly complex[35] and, even where financial intermediation is provided by new market participants, traditional banks may still be part of the overall chain of financial intermediation.[36] For instance, traditional banks may provide lines of credit and other services to nontraditional financial intermediaries and may even be related through their corporate structures.[37] The FSB's definition of shadow banking is intended to be broad enough to account for the growing interconnectedness of traditional banking and more cutting-edge methods of financial intermediation.[38] At first blush this approach may seem overly broad in that it can potentially include any entity, market, or activity along the financial intermediation chain. However, the focus is narrowed by the FSB's emphasis on activities that implicate four key risk factors: maturity transformation, liquidity transformation, imperfect credit risk transfer, and leverage.[39] These are the kinds of activities commonly associated with greater systemic risk.

Another common approach to defining shadow banking attempts to zero in on the fundamental economic risks associated with such activities. Under this approach, the term is understood to include all financial intermediation liabilities other than those that are explicitly insured, guaranteed, or consolidated onto the balance sheet of an institution with access to lender of last resort support.[40] The Federal Reserve Bank of New York has used the term "shadow bank" to describe financial intermediaries that are "involved in the traditional bank activities of credit, maturity, or liquidity transformation, but without

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34. Fin. Stability Bd., *supra* note 29, at 3.

35. For a thorough exposition, see Dan Awrey, *Complexity, Innovation and the Regulation of Modern Financial Markets*, 2 Harv. Bus. L. Rev. 235 (2012).

36. Fin. Stability Bd., *supra* note 29, at 1–5.

37. *Id*.

38. *Id*. Academic commentators place a similar emphasis on the interconnectedness of banks and nonbanks. In remarks delivered at the Inaugural Symposium of the *Review of Banking and Financial Law*, Professor Steven Schwarcz urged policy makers and commentators to focus "not only the provision of financial products and services by shadow banks, but also the financial markets used to provide those products and services." Steven L. Schwarcz, *Regulating Shadow Banking: Inaugural Address for the Inaugural Symposium of the Review of Banking & Financial Law*, 31 Rev. Banking & Fin. L. 619, 622 (2012). *See also* Eric F. Gerding, The Shadow Banking System and Its Legal Origins (Jan. 24, 2012) (unpublished manuscript), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1990816 (describing the shadow banking sector as an interconnected web of financial and non-financial institutions).

39. Fin. Stability Bd., *supra* note 29, at 4.

40. An influential report defines "shadow banking" to include "all credit intermediation activities that are implicitly enhanced, indirectly enhanced, or unenhanced by official guarantees established on an ex ante basis." Tobias Adrian & Adam B. Ashcraft, Fed. Res. Bank of N.Y. Shadow Banking: A Review of the Literature, Staff Report No. 580, at 3 (2012), *available at* http://www.nyfedeconomists.org/research/staff_reports/sr580.pdf.

actually being chartered as banks and without having a meaningful access to a lender of last resort and an explicit insurance of their liabilities by the federal government."[41]

Compounding the lack of consensus on what, exactly, constitutes "shadow banking," there is also some controversy surrounding the term itself. Some commentators believe that the term has pejorative associations[42] and that it obscures the positive influence these nontraditional financial intermediaries have had on the cost and availability of liquidity, maturity, and credit enhancement.[43]

For this reason, some commentators prefer to refer to the activities of nontraditional financial intermediaries as "non-bank financial intermediation."[44] Unfortunately, this label can lead to confusion, as the term "nonbank" is also used to refer to entities that engage in a specific form of nontraditional financial intermediation: originating and/or servicing loans even though they lack the traditional features of banks, such as accepting and holding customer deposits. This nontraditional financing activity—which is the primary focus of this report—is frequently called "independent" or "nonbank" lending.

In this report, we use the term "shadow banking" to refer broadly to financial intermediation involving entities and activities outside of the regular banking system, at the same time acknowledging the role of traditional financial institutions in these activities. Then, because our report focuses specifically on the growing presence of nonbank lending institutions in the financial markets, we use the term "nonbank lenders" to refer to U.S. lenders—such as Quicken Loans Inc. and Freedom Mortgage Corporation—that lack the traditional features of banks and operate outside of the traditional banking system. With these working definitions in place, we turn now to a description of the typical nonbank lender's capital structure.

b. The typical nonbank lender's capital structure.

The typical nonbank lender is organized under state business entity laws as a for-profit registered organization, such as a corporation or limited liability company, to engage in the business of originating loans through retail, wholesale, joint venture, or preferred partner channels.[45] The retail channel consists of loans originated directly through the nonbank's branch offices, while the wholesale channel consists of loans that are sourced by independent brokers. Finally, the joint venture and preferred partnership channels include

41. Pozsar, *supra* note 24, at 15.

42. One commentator called it "an imprecise, overly ominous term." Nicole Gelinas, *Finance's Lengthening Shadow*, City J., Autumn 2018.

43. For a discussion of the benefits associated with nonbank lending, in particular, see *infra* Part IV.A.3.a.

44. *See, e.g.*, Fin. Stability Bd., Global Monitoring Report on Non-Bank Financial Intermediation 2019 (2020), *available at* https://www.fsb.org/wp-content/uploads/P190120.pdf.

45. Lending channels are explained in Kathleen C. Engel & Patricia A. McCoy, The Subprime Virus: Reckless Credit, Regulatory Failure, and Next Steps 27–28 (2011).

partnerships and strategic associations with other companies; for instance, many nonbank mortgage lenders develop affiliate relationships with homebuilders.

Nonbank lenders primarily derive income from the subsequent sale of the mortgage loans they originate. However, with so many mortgage loans available for purchase on the secondary market, investors are positioned to be selective. Accordingly, they frequently demand insurance to protect against borrower default, and they generally prefer smooth returns. In the residential lending market, loans to low-to-moderate-income borrowers are often insured by the Federal Housing Administration (FHA),[46] while loans to U.S. military veterans may be guaranteed by the Department of Veterans Affairs.[47] These and other newly originated mortgage loans are then sold to or securitized[48] through government owned or supported credit agencies, such as the Government National Mortgage Association (Ginnie Mae), the Federal National Mortgage Association (Fannie Mae), and the Federal Home Loan Mortgage Corporation (Freddie Mac), with such agencies guarantying principal and interest. Sales of this sort are made pursuant to standardized contracts and guidelines that require the loans to meet detailed eligibility criteria. A small portion of loans are sold to private loan aggregators or directly to investors.

Many nonbank lenders also generate revenue by servicing a portfolio of loans and collecting fees for the direct or indirect provision of services. Servicing operations typically include the invoicing and collection of monthly mortgage payments from individual borrowers and the subsequent disbursement of those funds to the owners of the mortgages and to any applicable escrow account managers. In the event of a borrower default, a loan servicer may also exercise remedies (such as foreclosure) against the borrower. As compensation for these and other services, the servicer is entitled to retain a portion of the borrower's monthly payment.

In part because they have not historically operated under any prescribed capital standards, nonbank lenders tend to be thinly capitalized.[49] Capitalization risks are compounded by lack of access to liquidity provided to traditional banks. As the name implies, nonbank lenders are not recognized as "banks" under applicable statutes and regulations, and therefore may not collect and use customer deposits to finance the loans they originate. Instead, they

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46. *See* 12 U.S.C. §§ 1701 to 1715z.

47. *See* 38 U.S.C. § 3702.

48. Securitization is the process of purchasing and bundling multiple loans into marketable mortgage-backed securities. This important form of financial intermediation facilitates the flow of funds in the residential lending market and smooths out risks by allowing investors to diversify their exposure. For a fascinating historical and political account of securitization, see Sarah L. Quinn, American Bonds: How Credit Markets Shaped a Nation (2019).

49. Citing research by the CSBS, a recent report by the FSOC observed that "in general, the largest nonbank servicers have limited liquidity, often just enough cash and securities held for sale to cover a few months of operating and interest expenses. Nonbank liquidity levels are significantly below those maintained by banks." Fin. Stability Oversight Council, 2019 Annual Report 43 (2019), *available at* https://home.treasury.gov/system/files/261/FSOC2019AnnualReport.pdf.

customarily finance their activities with revolving credit facilities provided by commercial banks, finance companies, and other capital market participants.[50]

These so-called mortgage warehouse lending facilities are often structured as repurchase agreements rather than secured loans. The nonbank lender sells newly originated loans to the counterparty to finance originations, and then repurchases the loans when it is ready to permanently sell them to a government owned or supported credit agency or other investor or aggregator. Credit facilities of this sort are structured to ensure that they qualify for certain "safe harbor" protections of the Bankruptcy Code that insulate nondebtor parties to certain financial contracts from the consequences that would otherwise flow from a counterparty's bankruptcy.[51] Financial arrangements that qualify for safe harbor protections are exempt from the automatic stay of collection and enforcement proceedings. Instead, counterparties are permitted to exercise their contractual rights to, among other things, terminate the contract, set off mutual claims, and liquidate and collect any collateral they may hold.[52] It is important to note, however, that provisions establishing servicing rights are generally considered to be severable from the repurchase agreement.[53] And, when analyzed separately, an agreement providing for servicing rights does not fall within the categories of agreements that are entitled to safe harbor protections; rather it is considered an asset of the estate, subject to the normal protections afforded by the automatic stay.[54]

Whether they are banks or nonbanks, mortgage lenders bear considerable risks. Pursuant to their purchase and/or servicing agreements, mortgage lenders are typically required to advance funds to investors in the event that the mortgage borrowers fail to make payments of principal and interest or fail to maintain sufficient escrow balances for taxes and insurance.[55] Mortgage servicers must also advance funds on behalf of investors for expenses, such as those associated with the exercise of remedies against a borrower and for property preservation. Although advances associated with defaulted mortgage loans are often reimbursed by a guarantor or insurer, there is typically a delay in the mortgage lender's receipt of reimbursement, and in some circumstances, the guarantor or insurer may ultimately shift the losses back to the mortgage lender. For instance, a guarantor or insurer may exercise contractual remedies against a mortgage lender for losses associated with

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50. For an overview, see Thomas LaMalfa, *The Inside Line on Warehouse Lending*, MORTGAGE BANKING, Nov. 1990, at 51.

51. *See, e.g.*, 11 U.S.C. §§ 555, 556, 559–562.

52. *See supra* note 51 and statutory sources cited therein; *see also* 11 U.S.C. § 362(a) (imposing an automatic stay upon the commencement of a bankruptcy case).

53. *See, e.g.*, Calyon New York Branch v. Am. Home Mortg. Corp. (*In re* Am. Home Mortg. Inc.), 379 B.R. 503 (Bankr. D. Del. 2008).

54. *Id*.

55. These obligations are discussed in Joe Light, *Mortgage Firms Teeter Near Crisis That Regulators Saw Coming*, BLOOMBERG (Apr. 3, 2020), https://www.bloomberg.com/news/articles/2020-04-03/mortgage-servicers-teeter-near-crisis-that-regulators-saw-coming.

loans originated and underwritten based upon materially inaccurate information, or where the mortgage lender has otherwise breached its representations or warranties.[56]

Like all mortgage lenders, nonbank lenders are susceptible to interest rate risks. One example of this risk occurs when a mortgage lender agrees to issue a loan to a borrower and enters into a so-called interest rate lock commitment with the borrower. As the name implies, an agreement of this sort fixes the interest rate that will apply to the loan. The lender bears the risk of market rate changes from the time that it enters into the agreement until the time that it sells the mortgage. Lenders typically manage these risks through interest rate hedging arrangements; in the case of nonbank lenders, such arrangements are often provided in conjunction with a warehouse lending facility. The following section explores the size and scope of both the shadow banking industry generally and the nonbank lending market specifically.

2. Size and Scope of the Market

As noted in Part IV.A.1.a above, there are no universally accepted definitions of the terms "shadow banking" and "nonbank lending." Moreover, because so many of the parties and transactions involved lack regulatory oversight, attempts to quantify them necessarily rely on estimates and assumptions. Naturally, this creates a methodological problem in attempting to describe and assess the role of nontraditional participants in the financial markets.

We can, however, examine and use various data sources to qualitatively understand the size and scope of shadow banking and nonbank lending. And the numbers paint a clear picture of a shifting financial landscape. According to a recent report, the shadow banking sector (defined in that report to include those "non-banks" that are likely to introduce bank-like financial stability risks and/or engage in regulatory arbitrage) provides financial intermediation for approximately 13.6 percent of global financial assets.[57] With respect to the U.S. financial markets, financial intermediation data suggest that the provision of maturity and credit transformation by shadow banking entities has grown from 5.4% of the transformation total in 1960 to 43.4% as of the third quarter of 2019.[58] Over the same time period, traditional financial intermediation has fallen from 94.9% to 56.6% of the transformation total.[59]

Meanwhile, nonbank lending has grown substantially in the U.S., particularly in the residential mortgage market. Nonbank lenders originated only nine percent of new mortgages

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56. These so-called "repo demands" have received considerable attention in recent years. *See, e.g.*, Nick Timiraos, *Buyback of Loans is Forced on BofA*, Wall St. J. (May 23, 2012), *available for a fee at* https://www.wsj.com/articles/SB10001424052702304065704577422540136789210.

57. Fin. Stability Bd., *supra* note 44, at 4.

58. A more detailed discussion of historical bank and nonbank financial intermediation data evidencing the growth of the shadow banking sector in the U.S. financial markets is provided in Appendix C, prepared by Dr. William T. Rule, Senior Economist at the AOUSC.

59. *Id*.

in 2009.[60] By 2016, they originated approximately half of all mortgage loans.[61] More recent statistics published by the FDIC suggest that nonbanks have eclipsed traditional banks in various measures of market share, both in terms of mortgage loan origination and servicing.[62] Reflecting on the interconnectedness of traditional banks and nonbank lenders in the modern economy, a recent FDIC report notes that "[b]ank lending to nonbank financial institutions has expanded seven-fold since 2010 and [today] exceeds $400 billion."[63] In light of this explosive growth, the following section considers the risks and benefits of increased nonbank lending activity.

3. Risks and Benefits of Nonbank Lending Sector Growth

Risks associated with increased nonbank lending activity include, among other things, the potential negative consequences of sector failure on other financial institutions, particularly given the unique vulnerability of nonbanks to liquidity crises. On the other hand, a noteworthy benefit of increased nonbank lending activity is the increased availability of loans to lower-income individuals who may be turned away by traditional banks. The following sections explore these and other risks and benefits of nonbank lending sector growth.

a. Risks associated with increased nonbank lending activity.

As Part IV.A.1.b explained, nonbank lenders tend to be thinly capitalized, making them uniquely vulnerable to liquidity crises. An example of this appears in the residential lending market, where mortgage lenders are often required to advance funds to security holders to compensate them for losses associated with defaulted mortgage loans. Although the mortgage lender may be reimbursed by a guarantor or insurer, there is typically a delay in the mortgage lender's receipt of reimbursement. Some losses may be shifted back to the mortgage lender, such as those stemming from its own failure to adhere to industry guidelines. Meanwhile, nonbank lenders tend to rely on revolving credit facilities, such as warehouse lines of credit, to finance new originations. These lines of credit may be reduced or even terminated, effectively ending the nonbank lender's operations. In times of financial market distress, multiple credit line reductions or terminations have the potential to cause a widespread credit market freeze.

More broadly, nonbank lending may increase market complexity and risk by decentralizing financial activity, leading to "market fragmentation, interconnectedness, and opacity,

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60. *Mortgage Lending: Concerns Over Nonbank Lenders*, 51 No. 23 Mortgage & Real Est. Executives Rep. NL 7 (2019).

61. You Suk Kim et al., *Liquidity Crises in the Mortgage Market*, 2018 Brookings Papers on Econ. Activity 347, 350–51, *available at* https://www.brookings.edu/wp-content/uploads/2018/03/KimEtAl_Text.pdf.

62. Fed. Deposit Ins. Corp., *Bank and Nonbank Lending Over the Past 70 Years*, 13 FDIC Q. no. 4 31, 34 (2019).

63. Fed. Deposit Ins. Corp., 2019 Risk Review 34 (2019), *available at* https://www.fdic.gov/bank/analytical/risk-review/full.pdf.

which make it difficult for market participants to effectively process information."[64] In a 2015 speech, Stanley Fischer, then-Vice Chairman of the Board of Governors of the FRS, summarized the concern as follows: "With the growth of nonbank lending, intermediation chains have lengthened, often involving both banks and other nonbank financial institutions."[65] As a result, risks are able to quietly accumulate over time, leading to panic and overcorrection when those risks are suddenly revealed.[66] In other words, as several commentators recently observed, "the activities of some non-bank entities can create bank-like risks to financial stability."[67] Some commentators further suggest that, without protection against runs, these risks pose an even greater threat.[68]

b. Benefits associated with increased nonbank lending activity.

At the same time, there are important benefits associated with increased nonbank lending activity. For one thing, nonbank lending has the potential to increase economic efficiency. This is primarily achieved through a feature known as "disintermediation." In traditional financial intermediation, the intermediary acts as a middleman, profiting from the interest rate differential between what is paid on deposits and what is charged to borrowers. According to disintermediation, the elimination of a middleman in a nonbank lending structure reduces costs to borrowers.[69] And during periods of tight margins and increased regulatory burdens, nonbank lenders may be nimble and agile enough to enter markets that traditional banks either will not or cannot enter.

Nonbank lenders also tend to succeed in leveraging digital technology to interact with prospective borrowers, allowing them access to markets that are underserved by traditional banks.[70] In the residential lending market, mortgages originated by nonbanks tend to be lower credit quality than those originated by banks,[71] with credit extended to borrowers who "are more likely to have lower incomes and wealth, are less likely to hold Bachelor's

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64. Schwarcz, *supra* note 38, at 628 (citing Dan Awrey, *Complexity, Innovation and the Regulation of Modern Financial Markets*, 2 HARV. BUS. L. REV. 235 (2012)).

65. *The Importance of the Nonbank Financial Sector*, BK. COMPL. GD. 6298014 (C.C.H.), 2015 WL 6298014 (2019).

66. Schwarcz, *supra* note 38, at 629.

67. Peter J. Green, Jeremy C. Jennings-Mares, & Lewis Lee, *Out of the Shadows and Into the Light*, 14 NO. 05 2013 WGL DERIVATIVES: FINANCIAL PRODUCTS REPORT, *1, Jan. 2013.

68. Concerns of this sort are examined in JC Reindl, *Quicken Loans may need temporary emergency funding amid coronavirus pandemic*, DETROIT FREE PRESS, Mar. 24, 2020.

69. For instance, when special purpose entities (SPEs) are used in nonbank lending, they do not typically charge higher rates of interest. *See* Comm. on Bankr. and Corp. Reorganization of the Ass'n of the Bar of the City of N.Y., *New Developments in Structured Finance*, 56 BUS. LAW. 95, 132 (2000).

70. This benefit is emphasized in a recent white paper published by an influential trade group. *See* MORTGAGE BANKERS ASS'N, THE RISING ROLE OF THE INDEPENDENT MORTGAGE BANK—BENEFITS AND POLICY IMPLICATIONS (2019), *available at* http://mba-pa.informz.net/mba-pa/data/images/IMB22219.pdf.

71. *Servicing: Freddie Mac Financing Nonbanks*, 51 NO. 8 MORTGAGE & REAL EST. EXECUTIVES REP. NL 4 (2018).

degrees, and are more likely to be non-white."[72] Although there is certainly a risk of predatory lending, some data suggest that nonbank lending activity serves to enhance consumer welfare and economic parity by increasing the financial products available to a wider range of consumers.[73] This, in turn, may contribute to economic growth.

More broadly, nonbank lending has the potential to distribute losses among many smaller market participants rather than among a handful of large institutions. As Professor Steven Schwarcz observed, decentralization of this sort may ultimately "mitigate the 'too big to fail' problems."[74] In other words, as nonbank lending activity increases, we may find that, at least in specific branches of the financial market, there is no one financial institution that is so large and interconnected that its failure would wreak havoc across the entire economy. However, as the following section explores, there may still be opportunities to enhance the regulatory structure.

B. Overview of the Regulatory Background

1. Key Changes in the Regulatory Environment

Federal and state statutes and regulations generally provide that only "banks" may accept deposits. Under these federal and state laws, any person accepting and holding deposits for future withdrawal by the depositor is engaged in the activity of banking and becomes subject to a host of regulatory requirements.[75] A complex network of banking rules imposes, among other things, licensing requirements, capital ratios, disclosure obligations, and restrictions on certain lending and collection activities.[76] These and other laws and regulations are designed to ensure the safety and soundness of the financial system and protect borrowers and communities from aggressive and predatory lending.[77]

To the extent these and other requirements fail to reach nonbank lenders, opportunities are created for regulatory arbitrage by such lenders. That nonbank lenders have traditionally been subject to little or no regulatory oversight of their own further compounds matters. For many decades, no dedicated federal agency was authorized to supervise nonbank lenders, leaving the market subject to "fragmented jurisdiction" by a handful of agencies that

72. *Id*.

73. However, some studies reach the opposite conclusion. For a review of literature focused on the so-called fintech sector, see Vincent Di Lorenzo, *Fintech Lending: A Study of Expectations Versus Market Outcomes*, 38 Rev. Banking & Fin. L. 725 (2019).

74. Schwarcz, *supra* note 38, at 628.

75. *See* John L. Douglas, *New Wine Into Old Bottles: Fintech Meets the Bank Regulatory World*, 20 N.C. Banking Inst. 17, 23–24 (2016) (making this point via a prototypical set of state banking laws).

76. For a list of banking regulations, see *Regulations*, Bd. of Governors of the Fed. Res. Sys., https://www.federalreserve.gov/supervisionreg/reglisting.htm.

77. The principal goals of financial regulation are: "(a) safety and soundness of financial institutions, (b) mitigation of systemic risk, (c) fairness and efficiency of markets, and (d) the protection of customers and investors." Group of Thirty, The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace 21–22 (2008).

possessed limited power to act. For instance, the Federal Trade Commission has always possessed the power to prosecute nonbanks, but the agency does not have the authority or the means to engage in regular ongoing supervision.[78] General supervisory authority, to the extent it existed at all, was typically vested in state regulators. And, while the Conference of State Bank Supervisors (CSBS) is, at the time of this writing, working to establish a set of uniform regulatory standards for the nonbanks that its members oversee, such efforts are in an early stage of development.[79]

Of course, the legal and regulatory environment shifted in both dramatic and subtle ways following the financial crisis of 2007–08. As part of the Act, Congress established the Consumer Financial Protection Bureau (CFPB) to investigate predatory conduct in the consumer finance market, within the traditional banking and burgeoning nonbank lending sectors. In July 2013, the CFPB issued a final procedural rule[80] detailing the agency's authority to regulate certain nonbank entities engaged in consumer finance transactions.[81] CFPB regulatory oversight extends to nonbanks that are engaged in mortgage-related services, including loan origination, servicing, and modification.[82] Additionally, the CFPB has the power to supervise nonbanks that are "engaging, or ha[ve] engaged, in conduct that poses risks to consumers with regard to the offering or provision of consumer financial products or services."[83] The creation of the CFPB has, at least to some degree, reduced regulatory arbitrage. As Professors William Bratton and Adam Levitin recently observed, "mortgage lenders and servicers must now play by the same set of rules."[84] New substantive rules impacting the residential lending sector include, among other things, a requirement that all lenders—including nonbank lenders—take certain steps to verify the borrower's ability to satisfy its obligations.[85]

Meanwhile, broader policy shifts have also had an impact on nonbank lenders to the extent such reforms have generated "greater transparency, less leverage, and more stable forms of liquidity transformation."[86] Initiatives such as the Large Institution Supervision Coordinating Committee (LISCC) are said to reflect a new "macroprudential perspective

78. *See* David H. Carpenter, Cong. Research Serv., R42572, The Dodd-Frank Wall Street Reform and Consumer Protection Act, Title X: The Consumer Financial Protection Bureau 3 (2013).

79. *See Vision 2020*, Conference of State Bank Supervisors, https://www.csbs.org/vision2020.

80. Procedural Rule to Establish Supervisory Authority over Certain Nonbank Covered Persons Based on Risk Determination, 78 Fed. Reg. 40352 (2013), codified at 12 C.F.R. pt. 1091.

81. For a discussion of the CFPB's role in monitoring nonbanking entities, see David Reiss, *Consumer Protection Out of the Shadows of Shadow Banking: The Role of the Consumer Financial Protection Bureau*, 7 Brook. J. Corp. Fin. & Com. L. 131 (2012).

82. 12 U.S.C. § 5514(a)(1)(A)–(E).

83. *Id*. at § 5514(a)(1)(C).

84. William W. Bratton & Adam J. Levitin, *A Tale of Two Markets: Regulation and Innovation in Post-Crisis Mortgage and Structured Finance Markets*, 2020 U. Ill L. Rev. 47, 62.

85. 15 U.S.C. § 1639c(a)(1).

86. *The Importance of the Nonbank Financial Sector*, Bk. Compl. Gd. 6298014 (C.C.H.), 2015 WL 6298014 (2019).

to supervision and regulation," pursuant to which regulators engage with complex financial institutions "not…as standalone entities, but…with consideration of how their actions could affect other firms and activities in a highly connected financial system."[87] In a similar way, accounting standards and prudential regulations now mandate that banks identify their direct and indirect links to nonbanks. These and other initiatives take into account the growing interconnectedness of traditional banking and more cutting-edge financial activities.

Finally, the Act established the FSOC to provide for more centralized systemic risk oversight. The FSOC has, over the years, designated certain nonbank entities as systemically important financial institutions, rendering them subject to enhanced supervision by the FSB.[88] And in a recent report, the FSOC identified nonbank residential mortgage lending as a potential source of instability in the U.S. financial system.[89]

But despite these important reforms and initiatives aimed at reducing opportunities for regulatory arbitrage, recent market data show that banks have further scaled back their presence in the residential lending market, while nonbanks have gained a larger share.[90] This development may relate to the continued regulatory gap between the traditional banking sector and the nonbank lending sector, notwithstanding the formation of the CFPB, LISCC, and FSOC and the enactment of new substantive rules that apply equally across the residential lending market. In fact, some argue that the gap has grown even wider in the wake of the financial crisis of 2007–08.[91] These commentators cite factors such as the lack of any official requirement for nonbanks to hold the same capital cushions and adhere to the same prudential standards as traditional banking institutions. The following section explores these and other facets of the existing regulatory scheme.

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87. *Id.*

88. *See, e.g.*, Fin. Oversight Stability Council, Basis of the Financial Stability Oversight Council's Final Determination Regarding American International Group, Inc. 1 (2013); Fin. Oversight Stability Council, Basis for the Financial Stability Oversight Council's Final Determination Regarding General Electric Capital Corporation, Inc. 1 (2013); Fin. Oversight Stability Council, Basis for the Financial Stability Oversight Council's Final Determination Regarding Prudential Financial, Inc. 1 (2013). But one commentator argued that it is "exceedingly difficult to designate a shadow bank as systemically important but easy to undo a designation," reflecting an overall "bias against strong regulation of shadow banks." Gregg Gelzinis, *A Stronger Regulatory Framework for Shadow Banks*, Ctr. for Am. Progress (July 18, 2019), https://www.americanprogress.org/issues/economy/reports/2019/07/18/471436/fact-sheet-stronger-regulatory-framework-shadow-banks/.

89. Fin. Stability Oversight Council, *supra* note 49, at 121.

90. *See supra* notes 60 through 62 and sources cited therein.

91. *See, e.g.*, Gary Bechtel, *BankThink: Nonbanks Need to Get Serious About Self-Regulation*, Amer. Banker (Dec. 14, 2018), https://www.americanbanker.com/opinion/nonbanks-need-to-get-serious-about-self-regulation ("Nonbank lending has existed for decades, but the burgeoning alternative lending space came into prominence in large part thanks to two sweeping pieces of financial regulation: the Dodd-Frank Act and Basel III capital reforms").

2. Nonbanks in the Existing Regulatory Scheme

As the previous section explains, recent regulatory changes have attempted to reduce opportunities for regulatory arbitrage by nonbank lenders. However, many commentators continue to assert that these reforms have not completely closed the regulatory gap between the traditional banking sector and the nonbank lending sector. This lingering gap may be the result of other reforms tightening credit conditions and increasing capital requirements for traditional banks, thereby restricting bank lending to the most creditworthy borrowers in the years following the financial crisis of 2007–08. And, because nonbanks fall beyond the scope of these regulations, they have arguably received a distinct competitive advantage.

The Basel III reforms,[92] which are an internationally agreed-upon set of measures developed by the Basel Committee on Banking Supervision and implemented in the United States via rules finalized in 2013, expanded existing bank risk management standards by instituting a number of new capital and liquidity measures. Specifically, Basel III raised both the quality and quantity of capital that banks are required to hold, increasing bank liquidity while decreasing bank leverage. It accomplished this by imposing new minimum leverage ratios that account for the risk levels associated with various asset classes, and that prioritize the common equity component of so-called tier one capital. Under Basel III, the largest banks are also subject to ratios that consider potential losses derived from off-balance sheet transactions. The overall effect of these reforms is that banks are required to hold more capital.

As implemented in the United States, Basel III also placed significant restrictions on the amount of mortgage servicing rights banks could retain. Mortgage servicing rights were subject to a regulatory cap equal to ten percent of common equity tier one capital; investments in mortgage servicing rights in excess of this cap would subject the bank to deductions from regulatory capital. Restrictions of this sort are intended to factor in the risks inherent in otherwise profitable servicing rights: when a borrower defaults, even if the associated losses may be insured or guaranteed, mortgage servicers are required to advance the amount of the anticipated payments to the investors and then seek reimbursement. To the extent there is a wave of borrower defaults, a mortgage servicer may be rendered insolvent by the obligation to advance funds.

Notwithstanding these risks, some banks complained that such a strict regulatory standard would have the effect of squeezing banks out of the mortgage servicing market altogether.[93] In response to these critiques, the rule was recently modified, raising the cap to 25%. At the same time, however, regulators phased in a previously adopted standard subjecting mortgage servicing rights to higher risk-weighting. The net result of the regulatory

92. Basel Comm. on Banking Supervision, Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems (2010), *available at* https://www.bis.org/publ/bcbs189_dec2010.pdf.

93. *See, e.g.*, MidFirst Bank, Punitive Treatment of Mortgage Servicing Rights Under Basel III Needs to Be Revisited, *available at* https://www.banking.senate.gov/download/midfirst-bank-mortgage-servicing-rights-under-basel-iii-senate-banking-committee-rflp-june-2017pdf.

shifts, according to at least one commentator, is "higher capital requirements for some banks that have mortgage servicing rights portfolios."[94]

Some scholars link the growth in nonbank lending to Basel III and other similar regulatory changes. Recent finance literature suggests that, across the globe, heightened capital standards and increased supervisory activity have caused banks to retreat from the residential lending market, allowing nonbank lenders to assume greater market share.[95] And in the United States specifically, evidence suggests that implementation of Basel III's liquidity rules has given nonbank lenders a higher market share for mortgage loans, particularly those backed by Ginnie Mae.[96] Similar effects have been observed in the corporate debt market: a recent study found that banks increasingly sell their corporate loans—typically to nonbank entities—in order to comply with stricter capital requirements.[97]

Of course, market participants fill some of the regulatory void, imposing a host of capital and liquidity standards on nonbank lenders. For instance, the warehouse lending facilities that are the lifeblood of the nonbank lending sector are typically contingent on the nonbank's initial and ongoing compliance with financial covenants addressing net worth and liquidity. Failure to maintain the required ratios constitutes a default, entitling the lender to terminate the credit line. Similarly, mortgage lenders that sell to or service loans on behalf of government owned or supported credit agencies must agree to comply with terms, requirements, and conditions set forth in extensive and regularly updated guidelines.[98] These guidelines address virtually all areas of the business, with specific provisions focusing on capitalization, profitability, liquidity, and funding sources.[99] Requirements of this sort are continually refined.[100] Ginnie Mae recently tightened its liquidity and capital requirements, and has even considered implementing a stress testing regime for nonbank lenders.[101]

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94. Amanda Garnett, *New Capital Rule Changes Treatment of Mortgage Servicing Rights*, Fin. Insts. Blog (July 2, 2019), https://blogs.claconnect.com/financialinstitutions/new-capital-rule-changes-treatment-of-mortgage-servicing-rights/.

95. Greg Buchak et al., *Fintech, Regulatory Arbitrage, and the Rise of Shadow Banks*, 130 J. Fin. Econ. 453 (2018).

96. Pedro Gete & Michael Reher, Liquidity Regulations in Mortgage Markets. The Regulatory Premium Channel and the Rise of the Nonbanks (2018), https://sipa.columbia.edu/sites/default/files/Pedro%20Gete%20Paper%20Session%202.pdf.

97. Rustom Irani et al., *The Rise of Shadow Banking: Evidence from Capital Regulation* (2020), https://rirani.web.illinois.edu//IraniIyerMeisenzahlPeydro_CapitalShadowBanking.pdf.

98. *See* Motion of Fed. Home Loan Mortg. Corp. for Relief from the Automatic Stay Pursuant to 11 U.S.C. § 362(D) and Request for Emergency Hearing, *In re* Taylor, Bean & Whitaker Mortg. Corp., No. 09-07047 (Bankr. M.D. Fla. Aug. 25, 2009) (describing requirements of this sort).

99. *Id*. at 3.

100. *See, e.g.*, Seller/Servicer Guide, Freddie Mac, https://sf.freddiemac.com/tools-learning/sellerservicer-guide/overview.

101. Press Release, Ginnie Mae, Ginnie Mae Solicits Feedback on its Stress Testing Framework (July 23, 2019), *available at* https://www.ginniemae.gov/newsroom/Pages/PressReleaseDispPage.aspx?ParamID=172.

Nonetheless, a regulatory gap appears to continue, leading the authors of a recent Brookings report to warn that nonbank lenders are subject to relatively lax standards that leave them poorly equipped to handle financial shocks.[102] And if we learned anything from the financial crisis of 2007–08, it is that financial institutions have the potential to fail spectacularly, sending shockwaves through the economy. The following section considers whether and to what extent adequate systems are in place to facilitate the orderly liquidation or reorganization of financially distressed nonbank lenders.

3. Approaches to Managing Firm-Specific Nonbank Failures

Like all sectors of the economy, the residential lending market has its peaks and troughs. For most of the last decade, low interest rates and strong growth in home values buoyed the residential lending market, providing ample business for nonbank lenders. But in the last few years, as housing inventory has contracted and home sales have weakened in many parts of the country, purchase loan originations have declined. At the same time, the loan refinancing market has contracted during periods of rising interest rates.[103] Although the FRS has, at the time of this writing, made emergency rate cuts in response to the COVID-19 public health crisis,[104] the residential lending market will likely face severe challenges in the months and years to come. Borrowers who are struggling with income losses are likely to face difficulty making loan payments, while a federal moratorium on most foreclosures will hamstring mortgage lenders seeking to enforce remedies. And, since mortgage lenders are expected to advance payments to investors even when the borrower defaults, nonbanks with sizable servicing portfolios face even greater risks.[105] For these reasons, the Mortgage Bankers Association recently called upon the FRS to establish a temporary liquidity backstop for mortgage servicers.[106]

These market forces place considerable pressure on both bank and nonbank lenders. However, the concerns are only magnified when we consider that nonbanks tend to originate and service loans with higher credit risks. And even before the COVID-19 public health crisis, multiple sources of data suggested that nonbank mortgage lenders have been struggling financially, with nearly one-third of nonbank mortgage lenders losing money as

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102. Kim, *supra* note 61.

103. *See, e.g.*, Christina Rexrode, *Retreat of Smaller Lenders Adds to Pressure on Housing*, Wall St. J. (Nov. 22, 2018), *available for a fee at* https://www.wsj.com/articles/rising-rates-are-roiling-nonbank-mortgage-lenders-1542891600.

104. David Goldman, *Federal Reserve Cuts Rates to Zero to Support the Economy During the Coronavirus Pandemic*, CNN (Mar. 16, 2020), https://www.cnn.com/2020/03/15/economy/federal-reserve/index.html.

105. The issue is examined in Andrew Ackerman, *Mortgage Firms Brace for Wave of Missed Payments as Coronavirus Slams Homeowners*, Wall St. J. (Mar. 23, 2020), *available for a fee at* https://www.wsj.com/articles/mortgage-firms-brace-for-wave-of-missed-payments-as-coronavirus-slams-homeowners-11585017857.

106. Reindl, *supra* note 68.

of 2018.[107] Against these pressures, some nonbank lenders have already used the federal bankruptcy process to reorganize or liquidate. They have been able to do so because nonbank lenders are not covered by language in the Bankruptcy Code that renders "banks" ineligible for bankruptcy protection.[108]

One of the first high-profile nonbank lender bankruptcy cases occurred in 2007,[109] when New Century Financial Corporation, a prominent subprime mortgage lender, filed under chapter 11 of the Bankruptcy Code in the U.S. Bankruptcy Court for the District of Delaware.[110] In recent years, other nonbank lenders—large and small—have followed in New Century's footsteps. The following sections analyze three such cases: *In re* Taylor, Bean & Whitaker Mortgage Corp., *In re* Ditech Holding Corp., and *In re* Stearns Holdings, LLC. The case studies reveal how bankruptcy courts have had to grapple not only with the usual questions concerning due process and fair and equitable treatment of creditors, but also with novel questions that relate specifically to the debtor's status as a nonbank lender. For instance, what is the role of the bankruptcy court, federal agencies, the debtor's financial contract counterparties, and other stakeholders in ensuring that the nonbank's failure does not threaten financial stability? How can courts ensure that a nonbank lender's bankruptcy does not cause severe disruptions in the debtor's business operations or otherwise unduly burden other financial institutions or cause immediate and substantial harm to consumers? The following sections shed light on these and other important questions.

a. In re *Taylor, Bean & Whitaker Mortgage Corp.*

Headquartered in central Florida, Taylor, Bean & Whitaker Mortgage Corporation was, prior to its stunning collapse, the largest nonbank mortgage lender in the United States. The company employed thousands of people in offices around the country, engaging in a high-

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107. Sam Fleming & Joe Rennison, *US Non-bank Mortgage Lenders Come Under Scrutiny*, Fin. Times (Apr. 9, 2019), *available for a fee at* https://www.ft.com/content/d9329ee4-5549-11e9-91f9-b6515a54c5b1.

108. *See* 11 U.S.C. § 109(b), (d) (stating that banks are ineligible for bankruptcy). Instead, banks are subject to regulatory seizure. For an enlightening discussion, see Richard M. Hynes & Steven D. Walt, *Why Banks Are Not Allowed in Bankruptcy*, 67 Wash. & Lee L. Rev. 985 (2010). Of course, bank holding companies have effectively used federal bankruptcy process to liquidate or reorganize. This Working Group previously considered CIT Group Inc.'s chapter 11 case in Admin. Office of the U.S. Courts, Third Report Pursuant to Section 202(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, at Appendix B (2013), as well as Lehman Brothers Holdings Inc. and Washington Mutual, Inc. in Admin. Office of the U.S. Courts, Second Report Pursuant to Section 202(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (2012).

109. We do not focus on *New Century* in this Report because it predates the financial crisis of 2007–08. The Working Group has previously analyzed a number of financial company bankruptcies from this time period. *See supra* note 108 and sources cited therein.

110. Jonathan Stempel, *New Century Files for Chapter 11 Bankruptcy*, Reuters (Apr. 2, 2007), https://www.reuters.com/article/idUSN0242326420070402.

volume loan origination and servicing business.[111] In 2008, it originated approximately $30 billion in new mortgage loans,[112] funding commitments through several large warehouse lending facilities. In August 2009, the company and certain of its affiliates (collectively, Taylor Bean) filed voluntary petitions for relief under chapter 11 of the Bankruptcy Code in the U.S. Bankruptcy Court for the Middle District of Florida.[113] We have chosen to profile the case because it highlights the potential for serious conflicts regarding the ownership of mortgage assets, as well as the importance of protecting consumer mortgage payments and ensuring timely reconciliation of accounts during the pendency of a nonbank lender bankruptcy case.

Characterizing Taylor Bean's fall as "sudden and dramatic," newly retained managers explained in court filings that, just a few weeks prior to the bankruptcy, the company—along with its former chairman and majority owner—became the subject of federal scrutiny in relation to certain dealings with Colonial Bank (Colonial), Taylor Bean's warehouse lender. Specifically, in early 2009, Taylor Bean announced that it had arranged a much-needed $300 million equity investment in Colonial's holding company that would enable the commercial bank to receive federal Troubled Asset Relief Program funds.[114] Following the announcement, the stock price of Colonial's publicly traded parent soared. However, contrary to Taylor Bean's representations, it had not actually lined up any investors.[115] The equity transaction would later fall through, causing Colonial's stock price to fall.[116]

In early August 2009, Colonial was placed into receivership by the FDIC, where federal examiners discovered evidence suggesting a longstanding pattern of fraud and misrepresentation with respect to Taylor Bean's mortgage lending business.[117] When these allegations came to light, Freddie Mac and other government owned or supported credit agencies took immediate action, rescinding Taylor Bean's approvals to originate and service loans on their behalf and effectively "deal[ing] a death blow to [its] business operation."[118] The final nail in the coffin came when multiple states issued cease and desist orders, prohibiting the company from engaging in mortgage-related activities.

Although Taylor Bean filed under chapter 11 of the Bankruptcy Code, all signs pointed to a liquidation plan. In one of its earliest declarations to the court, the debtor characterized

111. Debtor's Emergency Motion for Entry of Interim and Final Orders Authorizing Use of Cash Collateral and Granting Replacement Liens at 2, *In re* Taylor, Bean & Whitaker Mortg. Corp., No. 09-07047 (Bankr. M.D. Fla. Aug. 24, 2009).

112. *Id*. at 5.

113. *See, e.g.*, Voluntary Petition of Taylor, Bean & Whitaker Mortg. Corp., *In re* Taylor, Bean & Whitaker Mortg. Corp., No. 09-07047 (Bankr. M.D. Fla. Aug. 24, 2009).

114. *Id*. at 7.

115. Press Release, SEC, SEC Charges Former Chairman of Major Mortgage Lender with $1.5 Billion Securities Fraud and Related TARP Scheme (June 16, 2010), *available at* https://www.sec.gov/news/press/2010/2010-102.htm.

116. *See id*.

117. *Id*.

118. Debtor's Emergency Motion, *supra* note 111, at 6–7.

its ongoing business operations during the pendency of the case as "primarily limited to conserving as much as possible the value of its servicing rights."[119] Despite allegations of fraud and mismanagement, no trustee was appointed in the bankruptcy case. Instead, the previous officers and directors resigned, and new, independent directors were appointed.

One of the earliest conflicts concerned the debtor's access to cash collateral. In first-day filings, the debtor asked the court to grant an emergency motion to use cash collateral,[120] which consisted of funds on deposit in various bank accounts and numerous accounts/notes receivable.[121] While requests of this sort are met with resistance in many cases, the matter is much thornier where the debtor's cash includes receipts from individual borrowers' mortgage payments.

Predictably, the motion drew multiple objections. One of Taylor Bean's creditors argued that the debtor had failed to inform anyone of the value of the collateral, both prior to and following the commencement of the bankruptcy case.[122] Hinting that there was more to the story than the typical conflict over the debtor's use of cash collateral, the creditor complained that "[t]he Debtor's motion does not identify where the bank accounts are located containing the alleged cash collateral, nor any identification of the source of cash in such accounts."[123] And, although the debtor designated some cash as "operating cash," the previous managers were "compromised by certain alleged improprieties," while the "existing 'management' could not possibly have assessed or analyzed the actual character and nature of funds that may be on deposit."[124]

The FDIC, as receiver for Colonial, objected on similar grounds and, with respect to bank accounts maintained by Colonial, reminded the court that, pursuant to the Federal Deposit Insurance Act (FDIA), "no court may take any action…to restrain or affect the exercise of powers or functions" of the agency when it is acting as a receiver for a failed institution.[125] But the FDIC's objection also highlighted severe disruptions in the debtor's business operations, which clearly had the potential to impact residential borrowers and other financial institutions.

Specifically, in the weeks following Colonial's suspension of the debtor's accounts, mortgage payments were received by Colonial and the debtor but not deposited into the appropriate accounts. The FDIC explained that it felt compelled to perform duties that are outside of the agency's normal jurisdiction in order to "protect[] the interests of the

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119. *Id*. at 16.

120. The court may authorize a debtor's use of cash collateral under 11 U.S.C. § 363(c)(2).

121. Debtor's Emergency Motion, *supra* note 111, at 16.

122. RBC Bank (USA) Successor by Merger to Fla. Choice Bank's Objection to Debtor's Emergency Motion at 3, *In re* Taylor, Bean & Whitaker Mortg. Corp., No. 09-07047 (Bankr. M.D. Fla. Aug. 27, 2009).

123. *Id*. at 4.

124. *Id*.

125. Limited Objection of FDIC, as Receiver for Colonial Bank, to Debtor's Motion for Orders Authorizing Use of Cash Collateral at 1–2, *In re* Taylor, Bean & Whitaker Mortg. Corp., No. 09-07047 (Bankr. M.D. Fla. Aug. 26, 2009) (citing 12 U.S.C. § 1821(j)).

investors in the mortgage loans and determin[e] what payments need to be made on their behalf."[126] For instance, "[n]otwithstanding the lack of jurisdiction," the agency "attempted to work with the Debtor to reach an agreement regarding the transition of mortgage servicing…to a successor servicer, as well as an interim solution for borrower payments that have accumulated in the pipeline."[127] Such steps were critical because, without prompt processing of borrower payments, timely payment of property insurance premiums and real estate taxes would not occur. But these early efforts were largely unsuccessful, allegedly because the debtor failed to "provide necessary assistance and information."[128] Then, once the debtor entered bankruptcy, the FDIC ceased all efforts to collect files and transfer servicing rights so as not to run afoul of the automatic stay.[129]

An objection filed by Freddie Mac painted what is perhaps the clearest picture of the immediate consequences of the nonbank lender's failure. The agency described the debtor's possession of certain funds belonging to Freddie Mac but not yet transferred to it. These funds—which included at least 4,220 checks that had been received by Colonial but not deposited into the appropriate accounts, as well as at least 30,000 unendorsed checks that had been sent by borrowers to Taylor Bean—constituted borrower principal and interest payments, taxes, and insurance escrow funds that should have been timely applied to the borrowers' obligations and released to the respective investors.[130] Meanwhile, at least 35,000 automated clearing house payments for borrowers' payments had not been debited as scheduled.[131]

The agency warned that the consequences of continued delay with respect to these borrower payments would be substantial: "loan remittances may not be correctly credited and loan pay-offs may not be properly applied in a manner discharging the loan. Borrower insurance policies will lapse for non-payment, and real property tax bills will go unpaid, resulting in increased tax liabilities and possible tax deed/foreclosure sales."[132] Like the FDIC, Freddie Mac detailed its efforts to work with the debtor: employees spent weeks at the debtor's premises attempting to collect payments and mortgage files and transfer servicing duties to interim servicers.[133] However, these and other efforts were largely unsuccessful. In the weeks prior to the bankruptcy filing, progress was slowed by the fact

126. *Id*. at 2.

127. *Id*.

128. *Id*.

129. Motion of FDIC, as Receiver for Colonial Bank, for Relief from the Automatic Stay Pursuant to 11 U.S.C. § 362(D) and Request for Emergency Hearing, No. 09-07047 (Bankr. M.D. Fla. Aug. 28, 2009).

130. Objection of Fed. Home Loan Mortg. Corp. to Debtor's Emergency Motion for Authority to Use Cash Collateral, *In re* Taylor, Bean & Whitaker Mortg. Corp. at 5–6, No. 09-07047 (Bankr. M.D. Fla. Aug. 25, 2009).

131. *Id*. at 8.

132. *Id*. at 7.

133. *Id*. at 5–6.

that the debtor had already terminated many of its employees; once the bankruptcy case was filed, Freddie Mac—like the FDIC—had to be mindful of the automatic stay.[134]

Concerned about the potential harm to individual borrowers, the FDIC[135] and Freddie Mac[136] each petitioned the court to lift the automatic stay so that they could collect records, payments, and other property relating to loans serviced by Taylor Bean. But other stakeholders opposed these efforts, with one large secured creditor asserting that, since neither the debtor nor any other party "can state with certainty who owns the Mortgage Loans," they should remain property of the estate until all of the various claims, interests, rights, and entitlements could be identified.[137] The debtor resisted the stay motions as well, even going so far as to file its own motion requesting that the court order the FDIC to turn over all of the funds in its possession relating to Taylor Bean's accounts at Colonial.[138]

Ultimately, the debtor reached settlements with these and other stakeholders. First, the debtor and the FDIC agreed that the debtor could retain access to records and funds in its possession, as well as gain access to information in the FDIC's possession, in order to reconcile borrower accounts.[139] Both parties agreed to work collaboratively to complete the account reconciliation process in an expedited manner, with the debtor also promising to deliver final and interim progress reports to the court. Taylor Bean reached a similar agreement with Freddie Mac, promising that it would cooperate fully with the agency to transfer servicing rights to designated third parties.[140] Regarding the use of cash in its possession, the debtor agreed that it would not use cash receipts from individual borrowers' mortgage payments, and would follow an agreed-upon budget.[141]

But this would not be the last skirmish. Within days of court approval of the settlements, another creditor filed a motion for an order authorizing Rule 2004 examinations of the

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134. *See* Motion of Fed. Home Loan Mortg. Corp. for Relief from the Automatic Stay Pursuant to 11 U.S.C. § 362(d) and Request for Emergency Hearing, *In re* Taylor, Bean & Whitaker Mortg. Corp., No. 09-07047 (Bankr. M.D. Fla. Aug. 25, 2009).

135. *See* Motion of FDIC, *supra* note 129.

136. *See* Motion of Fed. Home Loan Mortg. Corp., *supra* note 134.

137. Bank of America's Response to the FDIC's Motion for Relief from the Automatic Stay at 8–9, *In re* Taylor, Bean & Whitaker Mortg. Corp., No. 09-07047 (Bankr. M.D. Fla. Sept. 10, 2009).

138. Emergency Motion for Turnover, Approval of Procedures for the Maintenance and Use of Borrower Payments, and Immediate Resolution of Related Issues, *In re* Taylor, Bean & Whitaker Mortg. Corp., No. 09-07047 (Bankr. M.D. Fla. Aug. 31, 2009).

139. Notice of Filing Stipulation Between Debtor Taylor, Bean & Whitaker Mortg. Corp. and FDIC, as Receiver For Colonial Bank, *In re* Taylor, Bean & Whitaker Mortg. Corp., No. 09-07047 (Bankr. M.D. Fla. Sept. 14, 2009).

140. Stipulation of Settlement by and Between Fed. Home Loan Mortg. Corp. and the Debtor Regarding Stay Relief and Transfer of Loan Servicing, *In re* Taylor, Bean & Whitaker Mortg. Corp., No. 09-07047 (Bankr. M.D. Fla. Sept. 20, 2009).

141. Order Authorizing Interim Use of Cash Collateral, *In re* Taylor, Bean & Whitaker Mortg. Corp., No. 09-07047 (Bankr. M.D. Fla. Sept. 9, 2009).

debtor and other third parties, including the FDIC and Freddie Mac.[142] In an objection that emphasized the importance of "triage" in complex bankruptcy cases, the unsecured creditors committee urged restraint, noting that "reconciliations that will benefit all parties in interest are already underway and the type of discovery requested…would materially and prejudicially interfere with the existing reconciliations."[143] No examiner was ever appointed, and the debtor filed its final reconciliation report in July 2010.[144] The court confirmed the debtor's plan in July 2011, establishing a trust to pursue avoidance actions and other claims of the estate on behalf of Taylor Bean's creditors.[145]

b. In re *Ditech Holding Corp.*

In February 2019, the nationwide nonbank lender Ditech Holding Corp., along with certain of its affiliates (collectively, Ditech), commenced its second chapter 11 bankruptcy in the U.S. Bankruptcy Court for the Southern District of New York.[146] The company, which originated and serviced residential mortgage loans, had completed a prepackaged bankruptcy reorganization just one year earlier. In first-day filings, the debtor explained that it intended to actively market and attempt to sell substantially all of its assets, but that it would continue to fully operate its business during the pendency of the case in order to preserve the option of a reorganization transaction.[147] With operations spanning a broad spectrum of the residential mortgage market, the company's portfolio included an emphasis on so-called reverse mortgage loans marketed to senior citizens.

We have chosen to profile this case because it reveals the unique concerns that arise when consumer creditors hold substantial claims against a nonbank lender debtor and attempt to participate in the proceedings individually and collectively to protect their interests. Indeed, one of the most complicated issues in the case concerned the representation and ultimate plan treatment of the debtor's consumer mortgage borrowers, many of whom held claims and defenses against the debtor arising out of its alleged misconduct in originating and/or servicing mortgage loans.

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142. Deutsche Bank, AG's Motion for an Order Authorizing 2004 Examinations of Taylor, Bean & Whitaker Mortg. Corp. and Certain Third Parties Pursuant to Bankr. Rule 2004 and Section 105(a), *In re* Taylor, Bean & Whitaker Mortg. Corp., No. 09-07047 (Bankr. M.D. Fla. Sept. 16, 2009).

143. Joinder of the Official Comm. of Unsecured Creditors to the Objections of FDIC and Freddie Mac, *In re* Taylor, Bean & Whitaker Mortg. Corp., No. 09-07047 (Bankr. M.D. Fla. Oct. 15, 2009).

144. Final Reconciliation Report, *In re* Taylor, Bean & Whitaker Mortg. Corp., No. 09-07047 (Bankr. M.D. Fla. July 1, 2010).

145. Order Confirming Chapter 11 Plan, *In re* Taylor, Bean & Whitaker Mortg. Corp., No. 09-07047 (Bankr. M.D. Fla. July 21, 2011).

146. *See, e.g.*, Voluntary Petition of Ditech Holding Corp., *In re* Ditech Holding Corp., No. 19-10412 (Bankr. S.D.N.Y. Feb. 25, 2019).

147. Declaration of Gerald A. Lombardo at 4–6, *In re* Ditech Holding Corp., No. 19-10412 (Bankr. S.D.N.Y. Feb. 25, 2019).

Within a few days of the debtor's filing, the U.S. Trustee formed an official committee of unsecured creditors to represent these and other claimants.[148] Weeks later, as it became apparent that consumer borrowers would be the largest class of unsecured creditors and would play a significant role in the case, the U.S. Trustee appointed two additional consumer creditors to the committee.[149] In April 2019, advocates from the Bluhm Legal Clinic at Northwestern Pritzker School of Law filed a letter on behalf of three consumers with potential claims and defenses against Ditech, requesting the appointment of a special committee to represent the interests of all similarly situated mortgage borrowers.[150] Stressing the importance of adequate representation in the case, the advocates reminded the court that many of the debtor's borrowers are "elderly, disabled, and lack the financial means to obtain representation."[151] The initial request was joined by an attorney claiming that he and several other law firms collectively represented approximately eight hundred of the debtor's consumer borrowers.[152] He argued that the unsecured creditors committee could not possibly provide adequate representation for this unique constituency: "non-consumer creditors will rely on income generated by loans to existing and new consumer creditors who need relief from abusive loans. This creates an irreconcilable conflict."[153]

In response to these requests, the U.S. Trustee promptly appointed an official committee to represent all consumer creditors in the case.[154] But the debtor and several other stakeholders soon objected, urging the court to either disband the committee or impose a strict cap on the committee's fees and expenses.[155] The court declined to do either, leaving the committee intact and authorizing it to exercise the full range of powers granted to statutory committees.[156] Then, demonstrating the diversity and complexity of the consumer creditor class, consumers victimized by a reverse-mortgage fraud scheme continued to intervene in the case as an *ad hoc* group.[157]

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148. Notice of Appointment of Official Comm. of Unsecured Creditors, *In re* Ditech Holding Corp., No. 19-10412 (Bankr. S.D.N.Y. Feb. 27, 2019).

149. Motion to Disband Comm. at 3, *In re* Ditech Holding Corp., No. 19-10412 (Bankr. S.D.N.Y. May 8, 2019).

150. Letter, *In re* Ditech Holding Corp., No. 19-10412 (Bankr. S.D.N.Y. Apr. 19, 2019).

151. *Id*. at 2.

152. Letter, *In re* Ditech Holding Corp., No. 19-10412 (Bankr. S.D.N.Y. Apr. 23, 2019).

153. *Id*.

154. Notice of Appointment of Official Comm. of Consumer Creditors, *In re* Ditech Holding Corp., No. 19-10412 (Bankr. S.D.N.Y. Apr. 22, 2019).

155. The committee's history is described in Motion to Disband Comm, *supra* note 149.

156. Order Denying Debtors' Motion to (I) Disband the Official Comm. of Consumer Creditors Appointed by the U.S. Trustee or, Alternatively, (II) Limit the Scope of Such Comm. and Cap its Fees and Expenses, *In re* Ditech Holding Corp., No. 19-10412 (Bankr. S.D.N.Y. Sept. 12, 2019).

157. *See, e.g.*, The Diamond Victims' Joinder in the Objection of the Official Comm. of Consumer Creditors to the Debtors' Amended Joint Chapter 11 Plan and Sale of the Debtors' Forward and Reverse Businesses, *In re* Ditech Holding Corp., No. 19-10412 (Bankr. S.D.N.Y. July 18, 2019).

Meanwhile, the debtor proposed to sell, pursuant to a chapter 11 plan, substantially all of its assets "free and clear" of consumer creditor claims and defenses.[158] The consumer creditors committee complained that the sale would therefore seemingly release claims arising out of such actions as the debtor "overstating and failing to correct borrower accounts, improperly servicing borrower accounts in contravention of applicable regulations and statutes, demanding payments barred by confirmed plans or the discharge injunction in borrowers' prior chapter 13 cases, improperly applying funds paid by borrowers, and wrongfully foreclosing on borrowers' properties,"[159] in essence "preclud[ing] consumer creditors from asserting their fundamental rights to seek to correct overstated accounts, defend themselves against wrongful foreclosures, and/or exercise recoupment and set-off rights."[160]

The committee raised section 363(o) of the Bankruptcy Code, which was enacted in response to a "wave of bankruptcy filings by mortgage companies that had engaged in predatory lending practices and…where the mortgage companies were able to sell their assets free and clear of all consumer claims."[161] That section provides that, to the extent a debtor sells an interest in a consumer credit transaction pursuant to section 363, then the purchaser remains subject to consumer claims to the same extent as if the purchase had occurred outside of bankruptcy. The provision, the committee argued, explicitly protects claims by consumer borrowers against Ditech, and ought to apply even where the debtor proposes to sell the assets pursuant to a confirmed plan as opposed to a pre-confirmation sale.[162]

In a widely publicized decision[163] that held that the plan could not be confirmed primarily because it failed the best interests test,[164] the bankruptcy court disagreed with the committee that section 363(o) applies to sales conducted pursuant to a chapter 11 plan. However, notwithstanding the inapplicability of section 363(o), the court explained that consumer creditors would retain many of the claims they sought to protect. For one thing, "[t]he doctrine of recoupment is a creature of non-bankruptcy law, and a defense—sometimes asserted affirmatively—that does not give rise to a claim or debt that is dischargeable in bankruptcy, or a right to demand payment."[165] In other words, claims and defenses of this sort would survive with or without explicit, protective language in the plan or Bankruptcy

158. *In re* Ditech Holding Corp., 606 B.R. 544 (Bankr. S.D.N.Y. 2019).

159. Objection of the Official Comm. of Consumer Creditors to the Debtors' Amended Joint Chapter 11 Plan and Sale of the Debtors' Forward and Reverse Businesses at 1, *In re* Ditech Holding Corp., No. 19-10412 (Bankr. S.D.N.Y. July 18, 2019).

160. *Id*. at 3.

161. *Id*. at 2.

162. *Id*. at 2–5. *See also In re* New 118th Inc., 398 B.R. 791, 794 (Bankr. S.D.N.Y. 2009) ("A trustee may sell property prior to confirmation, 11 U.S.C. § 363, or through a plan.").

163. *See, e.g.,* Joao F. Magalhaes*, The SDNY's Exposition of the Code's Asset-Sale Provisions,* 2020 Am. Bankr. Inst. J. 40 (analyzing the "sweeping decision").

164. 11 U.S.C. § 1129(a)(7).

165. *In re* Ditech Holding Corp., 606 B.R. 544, 600 (Bankr. S.D.N.Y. 2019).

Code. Meanwhile, as to setoff rights, the court acknowledged that the parties had already reached an agreement that the plan would not affect common-law setoff rights preserved by section 553 of the Bankruptcy Code.[166]

Following the court's decision, the parties resumed negotiations and ultimately reached an agreement regarding certain monetary and nonmonetary protections for consumer borrowers.[167] Such protections included a provision explicitly preserving borrowers' rights to "raise issues associated with their accounts and to pursue remedies to correct those accounts if they are misstated or invalid," as well as the establishment of "a cash reserve to maximize the likelihood that any other claims that would have been protected under section 363(o) outside the chapter 11 plan context—but which would otherwise not be covered by the language allowing consumer borrowers to correct their loan accounts—would be satisfied in full."[168] The court ultimately confirmed the plan in September 2019, paving the way for the company to finalize the sale transaction.

As a final note, one remarkable aspect of the case was that it featured a high level of involvement by consumer borrowers, many of whom appeared *pro se*. Although it is a fundamental principle of bankruptcy law that all parties in interest should have an opportunity to participate in the proceedings, it can be difficult for consumers to understand the precise contours of the bankruptcy court's jurisdiction. As a result, some filings by consumer borrowers in *Ditech* reflect attempts to challenge foreclosure actions and otherwise use the bankruptcy forum to litigate claims arising out of the debtor's origination or servicing of a mortgage loan.[169] We discuss this phenomenon in more detail in Part IV.C.

c. In re *Stearns Holdings, LLC*

In July 2019, Stearns Holdings, LLC, the parent company to nonbank lender Stearns Lending, along with certain of its affiliates (collectively, Stearns), filed voluntary petitions for relief under chapter 11 in the U.S. Bankruptcy Court for the Southern District of New York.[170] At the time, Stearns was the 20th largest mortgage lender in the U.S.[171] The

166. *Id*. at 597. Section 553(a) provides, subject to certain exceptions, that the Bankruptcy Code "does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case."

167. Statement of the Official Comm. of Consumer Creditors in Support of the Debtors' Third Amended Joint Chapter 11 Plan, *In re* Ditech Holding Corp., No. 19-10412 (Bankr. S.D.N.Y. Sept. 18, 2019).

168. *Id*. at 4.

169. *See, e.g.*, Debtors' Objection to Motion to Discharge Borrower, *In re* Ditech Holding Corp., No. 19-10412 (Bankr. S.D.N.Y. Sept. 30, 2019).

170. *See, e.g.*, Voluntary Petition of Stearns Holdings, LLC, *In re* Stearns Holdings, LLC, No. 19-12226 (Bankr. S.D.N.Y. July 9, 2019).

171. Declaration of Stephen Smith, President and Chief Fin. Officer of Stearns Lending, LLC in Support of Chapter 11 Petitions and First Day Pleadings at 3, *In re* Stearns Holdings, LLC, No. 19-12226 (Bankr. S.D.N.Y. July 9, 2019).

company focused almost exclusively on mortgage originations, having previously sold its mortgage servicing business. We have chosen to profile this case because it demonstrates how the bankruptcy process encourages the consensual allocation of losses between a nonbank lender's equity owners and creditors.

In first-day filings, an officer of the debtor explained that 70% of the company's equity interests were owned by funds managed by Blackstone Group, a private equity firm (Blackstone), with the balance of interests owned by the nonbank's founder and a handful of other individuals.[172] In addition to the typical warehouse financing facilities, Stearns also had $183 million of outstanding capital market debt in the form of senior notes secured by substantially all of the debtor's assets.[173] Approximately 67% of the outstanding note indebtedness—which was scheduled to mature in August 2020—was held by various funds affiliated with Pacific Investment Management Company LLC (PIMCO).[174]

In the years leading up to the bankruptcy filing, the company faced increased financial strain caused by a variety of market forces. And, while the company took steps to reduce costs and streamline its operations, its warehouse lenders grew increasingly concerned about the company's financial position. Their concerns were only exacerbated by the fast-approaching maturity date for the senior secured notes, as well as a requirement that the company use proceeds from the sale of its servicing business to pay down the notes rather than fund working capital and shore up liquidity.[175]

In 2018, after failing to find a new lender to refinance the senior secured notes, Stearns attempted an out-of-court restructuring with PIMCO. But the parties could not agree on terms.[176] Stearns had hoped that PIMCO would agree to extend the maturity date and relax the tender requirement, but PIMCO, sharing warehouse lenders' concerns about the debtor's liquidity and refusing to subject its investment to unnecessary risk, stood firm in its insistence that the company honor its contractual promise to use sale proceeds to pay down the notes. It also refused to extend the maturity date unless Blackstone made an additional capital contribution of $50 million.[177] Following the failed negotiations, Stearns enlisted the help of an investment advisory firm to explore its strategic alternatives, including a sale of the company, but these efforts were also unsuccessful.[178] Meanwhile, Stearns' warehouse lenders "began reducing advance rates, increasing required collateral accounts and increasing liquidity covenants, further contracting available working capital necessary to operate the business."[179] Eventually, two of the warehouse lenders refused to make additional advances and the debtor filed for bankruptcy.

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172. *Id*. at 5.
173. *Id*. at 6–7.
174. *Id*. at 7.
175. *Id*. at 8–9.
176. *Id*. at 9–10.
177. *Id*. at 8–13.
178. *Id*. at 9–11.
179. *Id*. at 11.

Along with its voluntary petitions, Stearns filed a request to use cash collateral and borrow $35 million on a post-petition, senior secured superpriority basis from Blackstone. Additionally, because Stearns intended to preserve its business as a going concern, it arranged post-petition warehouse financing, seeking and obtaining an order from the court that not only authorized the borrowing, but also modified the automatic stay so that the warehouse lenders would have, during the pendency of the case, the customary rights and remedies associated with a repurchase facility of this sort.[180] The debtor also sought and obtained an order authorizing it to provide assurances of future performance to Fannie Mae, Freddie Mac, and Ginnie Mae, and modifying and lifting the automatic stay to the extent necessary to enforce the company's obligations and commitments to these credit agencies.[181]

The company also filed a draft proposed plan sponsored by Blackstone. The plan, which essentially sought to give PIMCO the economic equivalent of the liquidation process it allegedly demanded outside of bankruptcy, contemplated a cash-only auction of sponsorship rights to a reorganization plan that would retire PIMCO's secured debt position.[182] The debtor proposed a thirty-day auction period, with Blackstone's $60 million offer serving as the stalking horse bid.

No creditors committee was appointed in the case, but PIMCO waged its own battle against the debtor's proposal. The firm alleged that Stearns' request to use cash collateral and enter into the proposed debtor-in-possession financing would "den[y] the Noteholders access to their bargained-for collateral through excessive priming liens and a complete disregard of adequate protection," putting "Blackstone in a preferred position of control."[183] PIMCO also alleged that, through the proposed plan, the debtor and Blackstone "have engineered a plot to deliver assets to Blackstone at a discounted price."[184] Indeed, the firm suggested that the company was worth far more than the $60 million stalking horse bid.[185] Finally, PIMCO emphasized its strong preference for an orderly wind-down, complaining that the debtor's proposed auction process was commercially unreasonable: in PIMCO's view, the compressed timeline, coupled with unduly burdensome procedures and

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180. *See, e.g.*, Final Order (A) Authorizing Debtors to Enter Into Repurchase Agreement Facilities and Related Documents; (B) Authorizing Debtors to Sell And Repurchase Mortgage Loans in the Ordinary Course of Business; (C) Granting Backup Liens and Superpriority Administrative Expense Claims; (D) Modifying the Automatic Stay; and (E) Granting Related Relief, *In re* Stearns Holdings, LLC, No. 19-12226 (Bankr. S.D.N.Y. July 31, 2019).

181. Final Order (I) Authorizing the Debtors to Continue Origination of Mortgage Loans in the Ordinary Course and Granting Related Relief and (II) Modifying the Automatic Stay on a Limited Basis to Facilitate the Debtors' Ongoing Operations, *In re* Stearns Holdings, LLC, No. 19-12226 (Bankr. S.D.N.Y. July 31, 2019).

182. Joint Chapter 11 Plan of Reorganization, *In re* Stearns Holdings, LLC, No. 19-12226 (Bankr. S.D.N.Y. July 9, 2019).

183. Objection of Pac. Investment Management Company LLC at 2, *In re* Stearns Holdings, LLC, No. 19-12226 (Bankr. S.D.N.Y. July 10, 2019).

184. *Id*.

185. *Id*. at 7.

requirements, would make it difficult to attract serious bidders, while the refusal to allow credit bidding would hamstring its own ability to participate.[186]

The debtor insisted that the proposed auction procedures were both reasonable and necessary, reminding the court that the goal of bringing all possible suitors to the table must be balanced against the need to move quickly so as to preserve key relationships—including, in particular, its critical relationships with the government owned or supported credit agencies.[187]

Notwithstanding these early conflicts, the parties would soon find a way to allow the restructuring to proceed without the costs and delays of protracted litigation.[188] Under the terms of a settlement approved by the court in September 2019, the debtor and Blackstone agreed to pay PIMCO's professional fees and cancel the proposed auction, instead advancing a plan that would distribute to the noteholders $65 million cash, replacement notes with a face amount of up to $15 million, and a small equity stake entitling them to share in any upside. At the time, the total value of the proposed distributions was estimated to be a 41% recovery for the noteholders.[189] In exchange, PIMCO agreed to support the debtor's amended plan proposal and waive not only its unsecured claims, but also its right to make a section 1111(b) election. The court confirmed the plan in October 2019, paving the way for the company to exit bankruptcy.[190]

C. Potential Takeaways from the Case Studies

The case studies discussed in Part IV.B.3 suggest that the Bankruptcy Code has been generally effective in facilitating the orderly liquidation and reorganization of nonbank lenders, and would likely be effective in meeting the needs of most other failed nontraditional financial intermediaries. In each of the three cases, the debtor was able to advance a confirmable plan and exit bankruptcy within a reasonable period, minimizing disruptions and preserving value. In *Stearns Holdings*, the parties were able to resolve major conflicts and agree to a fair, rules-based allocation of losses between the firm's equity owners and creditors in less than two months. It seems that the inherent flexibility of chapter 11 of the Bankruptcy Code, when coupled with the strong restructuring expertise of the bankruptcy bench and

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186. Objection of Pacific Inv. Mgmt. Co. to the Debtors' Motion for an Order (A) Approving the Plan Sponsor Selection Procedures; (B) Establishing Notice Procedures; and (C) Granting Related Relief, *In re* Stearns Holdings, LLC, No. 19-12226 (Bankr. S.D.N.Y. July 17, 2019).

187. Debtors' Reply to Objection of Pacific Inv. Mgmt. Co., *In re* Stearns Holdings, LLC, No. 19-12226 (Bankr. S.D.N.Y. July 22, 2019).

188. Debtors' Motion for Order (I) Authorizing Entry Into the Restructuring Support Agreement; and (II) Granting Related Relief, *In re* Stearns Holdings, LLC, No. 19-12226 (Bankr. S.D.N.Y. Sept. 11, 2019).

189. Amended Disclosure Statement with Respect to the Amended Joint Chapter 11 Plan at 3, *In re* Stearns Holdings, LLC, No. 19-12226 (Bankr. S.D.N.Y. Sept. 11, 2019).

190. Findings of Fact, Conclusions of Law, and Order Confirming the Amended Joint Chapter 11 Plan of Reorganization, *In re* Stearns Holdings, LLC, No. 19-12226 (Bankr. S.D.N.Y. Oct. 24, 2019).

bar, affords these uniquely situated debtors a highly responsive and agile legal regime that takes into account broader concerns relating to financial stability.

One advantage may be that bankruptcy naturally reflects the interconnectedness of the theoretical framework. This is because the Bankruptcy Code grants powerful substantive and procedural rights to creditors and other contractual counterparties to ensure the fair and equitable allocation of economic burdens. In the case of nonbank lenders, these large stakeholders often include traditional banks and government owned or supported credit agencies, which play a key role in the bankruptcy case. Indeed, *Stearns Holdings* also reveals the strong role that traditional financial intermediaries—such as banks extending warehouse credit facilities and other capital market creditors—play in monitoring nonbank lenders for signs of potential distress and helping to nudge these firms into bankruptcy when there is still time to pursue an orderly liquidation or reorganization process.

At the same time, chapter 11's broad party-in-interest standing provision allows other interested parties to intervene individually or in *ad hoc* groups,[191] while provisions authorizing the formation of statutory committees[192] afford claimants effective and efficient collective representation. In *Ditech*, widely dispersed and fragmented groups, such as the debtor's consumer mortgage borrowers and its reverse-mortgage fraud scheme claimants, had a strong economic interest in the outcome of the case and were able to participate meaningfully and effectively on an individual and *ad hoc* committee basis, as well as through a special statutory committee.

But the case studies also highlight several important considerations.[193] For one thing, *Taylor Bean* and *Ditech* highlight the unique concerns that arise with respect to servicing rights. Although such rights are often valuable assets of the estate, their current treatment under the Bankruptcy Code may not fully consider the risks of disruptions in the debtor's business operations. Notably, any delay or misappropriation by the debtor with respect to borrower records or payments has the potential to cause immediate and substantial harm to hundreds or even thousands of borrowers. Of course, the bankruptcy court has the power to implement appropriate checks and balances during the pendency of the case, such as the reconciliation and reporting process implemented in *Taylor Bean*. However, in that case, the judicial solution was the product of expensive and time-consuming stay litigation. Perhaps that solution might provide a template for case protocols or even statutory guidance for future nonbank bankruptcy cases.

The Bankruptcy Code itself suggests another tool that might be useful in nonbank bankruptcy cases, namely the appointment of a consumer creditor ombudsman to monitor the quality of the debtor's loan servicing and represent the interests of consumer creditors

191. 11 U.S.C. § 1109.

192. *Id*. at § 1102.

193. Neither the AOUSC nor the Judicial Conference of the United States has taken a position on any proposed legislative changes to the Bankruptcy Code, the Act, or any other relevant statute. It is, of course, for Congress to decide whether any legislative changes are necessary to facilitate the orderly liquidation and reorganization of nonbank lenders.

in the case.[194] This approach might help address the potential for loan servicing quality issues in any given case and provide a more streamlined approach to representing the interests of consumer creditors in the bankruptcy case. An advocate of this sort might eliminate the need for an additional statutory committee and foster a sounding board for consumer borrowers. In *Ditech*, some filings by consumer borrowers reflect attempts to challenge foreclosure actions and otherwise use the bankruptcy forum to litigate claims arising out of the debtor's origination or servicing activities. There are at least two potential risks associated with this activity: first, the consumer who attempts to litigate issues of this sort through the bankruptcy docket may neglect to timely file her claims and/or raise defenses in the proper forum (typically state court); and second, a flurry of irrelevant or misdirected filings has the potential to disrupt the bankruptcy proceedings and further strain the estate's limited resources. An ombudsman might help address these and related issues by providing consumer guidance, consultation, and assistance regarding the impact of a mortgage lender's bankruptcy on their rights and obligations.

One further consideration is whether more structure would streamline proposed transactions in nonbank bankruptcy cases. Although the bankruptcy process—as opposed to a regulatory or administrative resolution—appears to effectively manage nonbank lender distress, it can occasionally afford too much leeway, leading to intense conflicts and a lack of consistency, certainty, and uniformity. In *Taylor Bean* and *Ditech*, the parties engaged in extensive negotiations and litigation to determine how the debtor should go about selling certain mortgage loan pools and servicing rights, including whether such assets would be sold free and clear of claims and defenses. In contrast, the FDIC, in its capacity as receiver for failed institutions, typically conducts sales of this sort pursuant to a clearly defined sealed bid sale process, using standard forms of transaction documents that are readily available for review.[195] A more structured bankruptcy auction process, modeling more closely the forms and processes used by the FDIC, might benefit all parties involved in a nonbank bankruptcy case. In addition, clarifying the role of section 363(o) of the Bankruptcy Code in cases involving assets sales under a confirmed plan might assist the process.

In the meantime, existing bankruptcy laws appear to be accommodating these nonbank bankruptcies, providing a scheme that minimizes disruption, preserves value, and treats all parties as fairly as possible. More broadly, these findings suggest that the existing bankruptcy system is well-equipped to address a wide range of shadow banking entity failures, with laws and procedures already in place to effectively manage potential impacts on the broader financial markets.

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194. See 11 U.S.C. § 333, which provides for the appointment of a patient care ombudsman in health care business bankruptcies, and *id*. at § 332, which provides for the appointment of a consumer privacy ombudsman to the extent a debtor's estate includes certain personally identifiable information.

195. *Loan Sales Announcements & FAQs*, Fed. Deposit Ins. Corp., https://www.fdic.gov/buying/loan/.

V. Conclusion

Nonbank lenders present unique challenges for policy makers. As firms and regulators work to identify risks and weigh the costs and benefits of expanded supervision, the bankruptcy courts are already responding to and managing the consequences of nonbank failures. Thanks, in large part, to the inherent flexibility of chapter 11 of the Bankruptcy Code, the existing bankruptcy laws appear to provide a scheme that minimizes disruption, preserves the most value, and treats all parties as fairly as possible. Moreover, recent case studies offer important lessons on key disputes in, and identify opportunities for enhancing, the resolution or reorganization of nonbank lenders under the Bankruptcy Code. Although the report is focused on nonbank lending, the findings suggest that the existing bankruptcy system is well-equipped to address a wide range of nontraditional financial intermediaries.

Appendix A: List of Defined Terms Used in Report

Defined Acronyms and Abbreviations

Act	Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010
AOUSC	Administrative Office of the United States Courts
Bankruptcy Code	Title 11 of the United States Code
CFPB	Consumer Financial Protection Bureau
CSBS	Conference of State Bank Supervisors
Fannie Mae	Federal National Mortgage Association
FDIA	Federal Deposit Insurance Act
FDIC	Federal Deposit Insurance Corporation
FHA	Federal Housing Administration
Freddie Mac	Federal Home Loan Mortgage Corporation
FRS	Federal Reserve System
FSB	Financial Stability Board
FSOC	Financial Stability Oversight Council
Ginnie Mae	Government National Mortgage Association
LISCC	Large Institution Supervision Coordinating Committee
OLA	Orderly Liquidation Authority
TLAC	Total Loss Absorbing Capacity

Other Defined Key Terms

COVID-19: the abbreviated version of the official name given by the World Health Organization in February 2020 to the disease causing the 2019 novel coronavirus pandemic.

Nonbank lenders: generally refers to U.S. lenders that lack the traditional features of banks and operate outside of the traditional banking system.

Regulatory arbitrage: generally refers to institutional evolution and structural innovations to reduce or eliminate costs associated with supervision and regulation.

Shadow banking: refers broadly to financial intermediation involving entities and activities outside of the regular banking system.

Systemically important financial institutions: generally refers to nonbank institutions that the FSOC determines to be "systemically important" and banks with more than $50 billion in assets.

Traditional banks: refers to depository institutions, including commercial banks, thrifts, credit unions, industrial loan companies, and federal savings banks.

Appendix B: Annotated Bibliography

1. U.S. Treasury, Orderly Liquidation Authority and Bankruptcy Reform (2018), https://home.treasury.gov/sites/default/files/2018-02/OLA_REPORT.pdf.

This report concludes that bankruptcy should be the resolution method of first resort and recommends modest changes to OLA and a new chapter 14 of the Bankruptcy Code for financial institutions. Together the two resolution methods would reduce the need for taxpayer bailouts, strengthen market discipline of the largest financial institutions, and reduce the likelihood of ring-fencing requirements and interference by non-U.S. authorities, while preserving a predictable, impartial adjudication of claims between creditors in bankruptcy.

Recommended OLA statutory and regulatory modifications were aimed at eliminating opportunities for *ad hoc* disparate treatment of similarly situated creditors, tightening the terms of Orderly Liquidation Funding (OLF) (i.e., limiting duration of advances to OLF; preference for loan guarantees over direct loans and providing premium interest rates for direct loans; lending only on a secured basis; expedition of OLF industry-wide backstop assessment); and strengthening judicial review of the decision to invoke OLA. Other modifications would provide for adjudication of claims against the receivership by the bankruptcy court; clarify the statutory tests for determining when a financial company is in "default or in danger of default"; and repeal the tax-exempt status of bridge companies.

Chapter 14 recommendations include that: no asset threshold define which companies are eligible for chapter 14; the definition of "covered financial corporation" under chapter 14 be consistent with the definition of "financial company" in Title II and the FDIC implementing regulations; statutory standing be provided to domestic regulators to be heard in any chapter 14 bankruptcy case; courts be given the authority to grant standing to foreign regulators; consideration be given to requiring that courts give deference to Federal Reserve determinations as to the financial stability implications of transfers to bridge companies; the Chief Justice designate a set of bankruptcy judges to preside over chapter 14 cases and the applicable Chief Judge of the Court of Appeals assign judges to cases (with consideration of the alternative approach of designating district court judges); and the definition of "capital structure debt" include all secured debt for borrowed money other than qualified financial contracts (QFCs) (as provide in recent House and Senate bills), but also include a secured lender's unsecured deficiency claim for an under-secured debt (as in the Hoover Institution's proposal).

2. Exec. Order No. 13,772, 82 Fed. Reg. 9965, Core Principles for Regulating the United States Financial System (Feb. 3, 2017), https://www.whitehouse.gov/presidential-actions/presidential-executive-order-core-principles-regulating-united-states-financial-system/.

This Executive Order sets forth seven Core Principles to guide reform on the U.S. financial regulatory system, including to: "(a) empower Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth; (b) prevent taxpayer-funded bailouts; (c) foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazard and information asymmetry; (d) enable American companies to be competitive with foreign firms in domestic and foreign markets; (e) advance American interests in international financial regulatory negotiations and meetings; (f) make regulation efficient, effective, and appropriately tailored; and (g) restore public accountability within Federal financial regulatory agencies and rationalize the Federal financial regulatory framework."

3. Memorandum from President Donald Trump to the Sec'y of the Treasury Dep't, Orderly Liquidation Authority (Apr. 21, 2017), https://www.govinfo.gov/content/pkg/DCPD-201700266/pdf/DCPD-201700266.pdf.

This Presidential Memorandum directed the Secretary of the U.S. Treasury to examine the OLA to propose recommendations for reforms guided by the Core Principles in Executive Order 13772 and to examine whether a new chapter of the Bankruptcy Code for financial companies was warranted.

4. The Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174 (2018), https://www.congress.gov/bill/115th-congress/senate-bill/2155.

With bipartisan support, the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 (EGRRCPA) repealed or altered many of the Act's provisions. Specifically, it:

a. raised the threshold at which bank holding companies are subject to enhanced prudential standards and enhanced supervision by the Federal Reserve Board (FRB) from $50 billion to $250 billion in total consolidated assets and gave the FRB the authority to impose enhanced supervision on a case-by-case basis for bank holding companies with between $100 billion and $250 billion in consolidated assets;
b. raised the threshold at which the FSOC may designate a nonbank financial institution as a systemically important financial institution (SIFI), and thus subject it to enhanced prudential standards and enhanced supervision;
c. eliminated the supervisory stress tests for bank holding companies with less than $100 billion in total consolidated assets and made the supervisory stress tests for

bank holding companies with more than $100 billion but less than $250 billion in total consolidated assets periodic rather than annual;

d. required company-run stress tests by bank holding companies with $250 billion in total consolidated assets and SIFIs periodically rather than semi-annually; and

e. raised the asset threshold for required company-run stress tests for all financial institutions from $10 billion to $100 billion and made the requirement periodic rather than annual.

The EGRRCPA also provided regulatory relief to community banks, defined as those having less than $10 billion in assets by (a) exempting them from the Volcker Rule (§ 619 of the Act) and its proprietary trading prohibitions; and (b) simplifying their capital compliance requirements, defining "well capitalized" by reference to the "Community Bank Leverage Ratio" (CBLR), rather than the more demanding Basel III capital requirements. In addition, the EGRRCPA amended the Truth in Lending Act to allow a depository institution or credit union with assets of less than $10 billion to forgo certain ability-to-pay requirements regarding residential mortgage loans and to exempt mortgage loan applications in rural communities involving property valued at less than $400,000 from an independent appraisal under certain circumstances.

5. Financial CHOICE Act, H.R. 10, 115th Cong. (2017), https://www.congress.gov/bill/115th-congress/house-bill/10.

As passed by the House on June 8, 2017, the Financial CHOICE Act would repeal provisions of the Act and other laws, and nullify any rule issued or revised pursuant to a repealed provision. Among other things, it would:

a. repeal the orderly liquidation authority of the FDIC;
b. replace the OLA with a new subchapter V under chapter 11 of the Bankruptcy Code;
c. eliminate the FSOC's authority to designate nonbank financial institutions and financial market utilities as "systemically important" and repeal previous designations;
d. repeal FDIC authority to provide emergency guarantees and narrow the Fed's emergency lending authority;
e. reduce the frequency of living will submissions to every two years and eliminate FDIC's role in the process;
f. overhaul the stress test regime for banking organizations by extending the Comprehensive Capital Analysis and Review (CCAR) cycle to every two years and eliminating the Act's stress tests for banking organizations that are not holding companies;
g. revoke the Volcker Rule; and

h. exempt financial institutions with a simple leverage ratio of 10% or high from a number of regulatory provisions, including certain "enhanced prudential standards" established by the Act.

Appendices B and C of the U.S. Treasury, Orderly Liquidation Authority and Bankruptcy Reform (2018) provide a useful summary of the subchapter V provisions. Notably, these provisions would:

a. permit voluntary filings by covered financial corporations;
b. define covered financial corporations as bank holding companies of any size and nonbank holding companies engaged in activities that are financial in nature with assets of $50 billion or greater;
c. define "financial in nature" by reference to section 4(k) of the Bank Holding Company Act of 1956, such that covered financial corporations do not include broker-dealers, commodity brokers, insurance companies, and depository institutions;
d. institute a 48-hour stay of QFC counterparties to facilitate transfers to a bridge company;
e. permit transfer to a bridge company upon judicial determination by a preponderance of the evidence that transfer is "necessary to prevent serious adverse effects on financial stability in the United States" and provide for the appointment of a special trustee to distribute the assets;
f. define "capital debt structure" to include all unsecured debt for borrowed money other than QFCs but to exclude secured lenders' unsecured deficiency claims for under-secured debts;
g. permit conversion to chapter 7 under specified circumstances; and
h. permit specified federal financial regulatory agencies to appear and be heard.

The Chief Justice of the United States would designate a set of bankruptcy judges to hear the cases and the Chief Judge for the applicable court of appeals would randomly assign one such judge to any specific case.

6. Financial Institution Bankruptcy Act of 2017, H.R. 1667, 115th Cong. (2017), https://www.congress.gov/bill/115th-congress/house-bill/1667.

Passed by the House on April 5, 2017, this bill amends the Bankruptcy Code to allow certain large financial institutions to elect a new "subchapter V" bankruptcy process specific to such institutions. Under the new process, a debtor institution may request the bankruptcy court to order the transfer of the debtor's assets to a newly formed bridge company. The court may order the transfer only if it determines, by a preponderance of the evidence, that "transfer is necessary to prevent serious adverse effects on financial stability in the United States." The bill imposes a temporary stay on actions to terminate or modify contracts

with institutions that file under the subchapter. Regulatory agencies, including the SEC and FDIC, have standing to be heard in the cases. Under specified situations, cases may be converted to chapter 7. The bill amends the Federal Judicial Code to require the Chief Justice of the United States to designate at least ten bankruptcy judges to hear the cases. Earlier bills include: Financial Institution Bankruptcy Act of 2016, H.R. 2947, 114th Cong. (2016) and Financial Institution Bankruptcy Act of 2014, H.R. 5421, 113th Cong. (2014). Appendices B and C of the U.S. Treasury, Orderly Liquidation Authority and Bankruptcy Reform (2018) provide a useful summary.

7. Taxpayer Protection and Responsible Resolution Act, S. 1841, 114th Cong. (2015), https://www.congress.gov/bill/114th-congress/senate-bill/1841.

Introduced in the Senate, this bill amends the Bankruptcy Code to add "Chapter 14 - Liquidation, Reorganization, or Recapitalization of a Covered Financial Corporation" and provides that no funds appropriated to the federal government may be paid to a covered financial corporation or to any of its creditors to satisfy a claim in a case under chapter 14. The bill's bankruptcy provisions are substantially similar to those in the 2017 House bills. However, this bill does not include asset restriction for non-holding companies in its definition of "covered financial corporation." Also, the 2013 version of the bill would permit the filing of an involuntary petition by the FRB (Taxpayer Protection and Responsible Resolution Act, S. 1861, 113th Cong.). Appendices B and C of the U.S. Treasury, Orderly Liquidation Authority and Bankruptcy Reform (2018) provide a useful summary of the chapter 14 provisions in this bill.

8. Kenneth E. Scott & John B. Taylor, eds., Bankruptcy Not Bailout: A Special Chapter 14 (Hoover 2012), https://www.hoover.org/research/bankruptcy-not-bailout-special-chapter-14.

This book proposes a new chapter 14 to be added to the Bankruptcy Code. It discusses the shortcomings of the current Bankruptcy Code as well as those of the OLA.

9. Kenneth E. Scott, *A Guide to the Resolution of Failed Financial Institutions*, *in* Kenneth E. Scott & John B. Taylor, eds., Bankruptcy Not Bailout: A Special Chapter 14 (Hoover 2012), https://www.hoover.org/sites/default/files/research/docs/scott_taylor_bankruptcy_not_bailout_ch01.pdf.

This chapter outlines the differences between the OLA and the new chapter 14 proposed within the book. Four central concepts are covered within this section: (1) financial institutions that are covered; (2) commencement of proceedings; (3) the resolution procedure; and (4) systemic risk. This is not an exhaustive list of differences between the Act and chapter 14, but it is a list of what distinctions are perceived as the most important to the Resolution Project. The conclusion lays out the possible policy choices that may be

made including repealing the OLA, enacting an alternative resolution process similar to that of chapter 14, or leaving Title II of the Act as is.

10. Thomas H. Jackson, *Bankruptcy Code Chapter 14*, *in* Kenneth E. Scott & John B. Taylor, eds., Bankruptcy Not Bailout: A Special Chapter 14 (Hoover 2012), https://www.hoover.org/sites/default/files/research/docs/scott_taylor_bankruptcy_not_bailout_ch02.pdf.

This chapter proposes a new chapter 14 of the Bankruptcy Code to improve the current system of handling the failures of large financial institutions. This chapter discusses the Bankruptcy Code provisions the new chapter 14 would change or replace, addresses the perceived issues in the provisions it would change or replace, and lays out the ways in which the new chapter 14 provisions would better address these issues.

11. William F. Kroener III, *Comment on Orderly Liquidation Under Title II of Dodd-Frank and Chapter 14*, *in* Kenneth E. Scott & John B. Taylor, eds., Bankruptcy Not Bailout: A Special Chapter 14 (Hoover 2012), https://www.hoover.org/sites/default/files/research/docs/scott_taylor_bankruptcy_not_bailout_ch03.pdf.

This chapter argues that the new chapter 14 would provide a better bankruptcy alternative than the OLA. Mr. Kroener contends that the FDIC's counterfactual presentation on how the FDIC would have conducted the orderly liquidation of Lehman overstates how much creditors are expected to receive in the Lehman Bankruptcy. Under the proposed chapter 14, creditors could be better protected and the "too big to fail" concerns could be avoided in the event of a SIFI failure. This is because chapter 14 allows for continued management participation, promotes more extensive creditor involvement, and removes FDIC discretion to choose which creditors prevail during a liquidation.

12. Kimberly Anne Summe, *An Examination of Lehman Brothers' Derivatives Portfolio Postbankruptcy*, *in* Kenneth E. Scott & John B. Taylor, eds., Bankruptcy Not Bailout: A Special Chapter 14 (Hoover 2012), https://www.hoover.org/sites/default/files/research/docs/scott_taylor_bankruptcy_not_bailout_ch04.pdf.

This chapter analyzes how the Lehman Brothers' bankruptcy unfolded and explores whether the bankruptcy would have occurred differently if the OLA had been in place in September of 2008. It concludes, as a practical matter, that there likely would not have been a significant difference because the treatment of derivatives post-bankruptcy has not significantly changed under the Act.

13. Darrell Duffie & David Skeel, *A Dialogue on the Costs and Benefits of Automatic Stays for Derivatives and Repurchase Agreements*, *in* Kenneth E. Scott & John B. Taylor, eds., Bankruptcy Not Bailout: A Special Chapter 14 (Hoover 2012), https://www.hoover.org/sites/default/files/research/docs/scott_taylor_bankruptcy_not_bailout_ch05.pdf.

This chapter provides a cost-benefit analysis of automatic stays in bankruptcy proceedings for QFCs in the context of SIFIs. Professors Duffie and Skeel provide their views on whether automatic stays should be applied to different types of QFCs (repos, uncleared derivatives, cleared OTC derivatives) within the context of the proposed chapter 14 and the OLA.

14. Kenneth E. Scott & Thomas H. Jackson, *The Going-Concern Value of a Failed SIFI*, *in* Kenneth E. Scott & John B. Taylor, eds., Bankruptcy Not Bailout: A Special Chapter 14 (Hoover 2012), https://www.hoover.org/sites/default/files/research/docs/scott_taylor_bankruptcy_not_bailout_ch06.pdf.

The FDIC claims that the OLA is a superior alternative to the Bankruptcy Code for handling the resolution of large financial institutions in distress. According to the FDIC, the OLA achieves the goal of maintaining a firm's going-concern value better than the procedures under the existing Bankruptcy Code. This chapter seeks to analyze whether the new chapter 14 would better address the failures of large financial institutions and maintain these firms' going-concern values than would the procedures under Title II.

15. Kenneth E. Scott*, Dodd-Frank: Resolution or Expropriation?, in* Kenneth E. Scott & John B. Taylor, eds., Bankruptcy Not Bailout: A Special Chapter 14 (Hoover 2012), https://www.hoover.org/sites/default/files/research/docs/scott_taylor_bankruptcy_not_bailout_ch07.pdf.

This chapter discusses the constitutional issues that arise under the OLA. It argues that the procedure does not provide financial institutions adequate due process rights. Consequentially, without adequate safeguards, the administrative authority has too much power.

16. Kevin M. Warsh, *Regulatory Reform*, *in* Kenneth E. Scott & John B. Taylor, eds., Bankruptcy Not Bailout: A Special Chapter 14 (Hoover 2012), https://www.hoover.org/sites/default/files/research/docs/scott_taylor_bankruptcy_not_bailout_ch08.pdf.

This chapter argues that regulatory discipline alone is not enough to prevent the failure of large financial institutions—capital standards and market discipline must also be revived (the other two "pillars" of prudential supervision). Furthermore, remodeling the current Bankruptcy Code to include chapter 14 and other reforms may better mitigate the "too big to fail" problem within the financial system and allow for more prudential supervision.

17. Andrew Crockett, *A Macroeconomic Perspective*, *in* KENNETH E. SCOTT & JOHN B. TAYLOR, EDS., BANKRUPTCY NOT BAILOUT: A SPECIAL CHAPTER 14 (Hoover 2012), https://www.hoover.org/sites/default/files/research/docs/scott_taylor_bankruptcy_not_bailout_ch09.pdf.

Allowing companies to be "too big to fail" leads to undesirable risk taking by these institutions. To protect against such risk taking and bad business judgment in general, institutions must face a credible threat of failure if they engage in such activities. This chapter discusses how to solve the "too big to fail" problem within the financial system.

18. THOMAS JACKSON, KENNETH E. SCOTT & JOHN B. TAYLOR, EDS., MAKING FAILURE FEASIBLE (Hoover 2015), https://www.hoover.org/research/making-failure-feasible.

This book builds upon the 2012 book proposing that a new chapter 14 be added to the Bankruptcy Code to deal with the reorganization or liquidation of the nation's large financial institutions. The contributors expand on their proposal to improve the prospect that these financial institutions, particularly with prebankruptcy planning, could be successfully reorganized or liquidated and, in doing so, make resolution planning pursuant to Title I of the Act more fruitful and reliance on administrative proceedings pursuant to the OLA largely unnecessary.

19. Kenneth E. Scott, *The Context for Bankruptcy Resolutions*, *in* THOMAS JACKSON, KENNETH E. SCOTT & JOHN B. TAYLOR, EDS., MAKING FAILURE FEASIBLE (Hoover 2015), https://www.hoover.org/sites/default/files/research/docs/makingfailurefeasible-ch1.pdf.

This chapter provides an overview of the problems associated with the OLA and the existing Bankruptcy Code and explains how the revised chapter 14 proposal addresses these issues. Specific topics explored include capital debt, liquidity, due process, international coordination, and the problem of systemic risk.

20. Thomas H. Jackson, *Building on Bankruptcy: A Revised Chapter 14 Proposal for the Recapitalization, Reorganization, or Liquidation of Large Financial Institutions*, *in* THOMAS JACKSON, KENNETH E. SCOTT & JOHN B. TAYLOR, EDS., MAKING FAILURE FEASIBLE (Hoover 2015), https://www.hoover.org/sites/default/files/research/docs/makingfailurefeasible-ch2.pdf.

This chapter introduces the Resolution Project Working Group's revised chapter 14 proposal (Chapter 14 2.0). Chapter 14 2.0 is similar to the original proposed chapter 14 (Chapter 14 1.0) in that it provides for conventional reorganization of operating companies, but it differs in that it allows for the facilitation of a two-entity recapitalization of a holding company. The first part of this chapter outlines the resolution procedure under Chapter 14 1.0 and the appendix discusses how Chapter 14 2.0 further amends the Bankruptcy Code.

21. David A. Skeel Jr., *Financing Systemically Important Financial Institutions in Bankruptcy*, *in* THOMAS JACKSON, KENNETH E. SCOTT & JOHN B. TAYLOR, EDS., MAKING FAILURE FEASIBLE (Hoover 2015), https://www.hoover.org/sites/default/files/research/docs/makingfailurefeasible-ch3.pdf.

This chapter tackles the issue of financing a SIFI in bankruptcy. It discusses different financing options for SIFIs including Title II's single-point-of-entry resolution, Chapter 11 of the Bankruptcy Code, and the "quick sale" approach under Chapter 14 2.0. It argues that the "pessimism about a SIFI's ability to borrow sufficient funds—sufficiently quickly—to finance a resolution in Chapter 11 is substantially overstated." Professor Skeel contends that this pessimism is overstated because the structure of large banks has changed since the financial crisis and the enactment of the Act. He further argues that the quick sale resolutions would require less new liquidity. This chapter proceeds by first discussing the financing options available to a SIFI if it were to file for bankruptcy at the time this book was written. It then goes on to analyze whether prearranged financing would allow a SIFI to increase its liquidity upon bankruptcy. Finally, it examines whether there is a need for additional government financing.

22. Darrell Duffie, *Resolution of Failing Central Counterparties*, *in* THOMAS JACKSON, KENNETH E. SCOTT & JOHN B. TAYLOR, EDS., MAKING FAILURE FEASIBLE (Hoover 2015), https://www.hoover.org/sites/default/files/research/docs/makingfailurefeasible-ch4.pdf.

This chapter explores alternative "insolvency and failure resolution regimes" for central counter parties (CCPs). It concludes with a discussion of certain steps that should take place in an administrative CCP failure resolution process.

23. Simon Gleeson, *The Consequences of Chapter 14 for International Recognition of US Bank Resolution Action*, *in* THOMAS JACKSON, KENNETH E. SCOTT & JOHN B. TAYLOR, EDS., MAKING FAILURE FEASIBLE (Hoover 2015), https://www.hoover.org/sites/default/files/research/docs/makingfailurefeasible-ch5.pdf.

This chapter considers the issues that arise under the OLA in the international context and argues that replacing the OLA with chapter 14 may lead to increased enforceability of cross-border resolutions.

24. Thomas F. Huertas, *A Resolvable Bank*, *in* THOMAS JACKSON, KENNETH E. SCOTT & JOHN B. TAYLOR, EDS., MAKING FAILURE FEASIBLE (Hoover 2015), https://www.hoover.org/sites/default/files/research/docs/makingfailurefeasible-ch6.pdf.

This chapter discusses what is necessary for the creation of a resolvable bank. A resolvable bank is one that does not need a taxpayer funded bailout upon failure and does not lead to systemic disruption of the economy or financial industry. In order to analyze resolvable

banks, this chapter explores various different types of resolvable banks, including a single unit bank, a bank subsidiary with branches, a unit bank with a parent holding company, the parent company, and a parent holding company with domestic and foreign subsidiaries.

25. Emily Kapur, *The Next Lehman Bankruptcy*, *in* Thomas Jackson, Kenneth E. Scott & John B. Taylor, eds., Making Failure Feasible (Hoover 2015), https://www.hoover.org/sites/default/files/research/docs/makingfailurefeasible-ch7.pdf.

This chapter provides a theoretical analysis of how chapter 14 could prevent bank runs that are usually a result of chapter 11 bankruptcy proceedings. It also analyzes how chapter 14 may address the problem of moral hazard often created by bailouts. The rest of the chapter attempts to answer whether the Lehman Brothers' failure would have turned out differently if the company went through chapter 14 rather than chapter 11 bankruptcy.

26. William F. Kroener III, *Revised Chapter 14 2.0 and Living Will Requirements Under the Dodd-Frank Act*, *in* Thomas Jackson, Kenneth E. Scott & John B. Taylor, eds., Making Failure Feasible (Hoover 2015), https://www.hoover.org/sites/default/files/research/docs/makingfailurefeasible-ch8.pdf.

This chapter argues that Chapter 14 2.0 would allow financial companies to meet the living will requirement under Title I of the Act. It contends that Chapter 14 2.0 would "improve pre-failure resolution planning" and thus better facilitate the satisfaction of the living will requirement under Title I of the Act.

27. Jacopo Carmassi & Richard Herring*, The Cross-Border Challenge in Resolving Global Systemically Important Banks*, *in* Thomas Jackson, Kenneth E. Scott & John B. Taylor, eds., Making Failure Feasible (Hoover 2015), https://www.hoover.org/sites/default/files/research/docs/makingfailurefeasible-ch9.pdf.

This chapter analyzes the specific issues faced by global systematically important banks (G-SIBs) in the context of cross-border resolutions. It discusses the scope of the problem as highlighted by the financial crisis. It also provides data on the "organizational complexity and the international legal structure" of existing G-SIBs and how this complexity affects orderly resolution. Additionally, this chapter explores why international cooperation is necessary for an orderly resolution and how the lack of such cooperation would impact cross-border resolutions.

28. *CHOICE Act 2.0 Passes the House: What is the 'CHOICE'?*, Sherman & Sterling (July 20, 2017), https://www.shearman.com/perspectives/2017/07/choice-act-2-passes-the-house-what-is-the-choice.

This article provides a useful summary of the Financial CHOICE Act, H.R. 10, 115th Cong. (2017–2018), as passed by the House.

29. Bruce Grohsgal, *Case in Brief Against "Chapter 14"*, Am. Bank. Inst. J. (May 2014), http://blogs.harvard.edu/bankruptcyroundtable/files/2014/05/ABI-feature6-May-2014.pdf.

The author argues that Chapter 14, as proposed by the Hoover Institute and S. 1841, to replace the OLA does not reconcile the Act's purposes of mitigating systemic risk and minimizing moral hazard with the Bankruptcy Code's contrasting aims of reorganizing troubled companies, preserving going concerns, and maximizing payments to creditors. The Act already encourages failing financial institutions to file bankruptcy, which has proved to be an adequate tool, and the need for Title II receivership as a last resort continues.

30. Randall D. Guynn, *Are Bailouts Inevitable?*, 29 Yale J. on Reg. 121 (2012), https://digitalcommons.law.yale.edu/yjreg/vol29/iss1/5/.

This essay examines solutions focused on reducing the likelihood of SIFI failure and reducing social costs, should one occur, and analyzes why liquidation of SIFIs under the Bankruptcy Code, particularly one with significant cross-border operations, could result in disorderly liquidation (i.e., "fire-sale liquidations" or "value-destroying reorganizations"). It establishes an economic model for testing when a proposed solution is credible and applies that test to the proposed chapter 14 to the Bankruptcy Code, concluding it does not go far enough, and to the FDIC's combined existing and new resolution powers under the Act, concluding this combined resolution authority, if properly used, provides a credible solution to recapitalize the systemically important and viable parts of a failed institution and liquidate the rest without cost to taxpayers.

31. Thomas H. Jackson & David A. Skeel, Jr., *Dynamic Resolutions of Large Financial Institutions*, 2 Harv. Bus. L. Rev. 435 (2012), https://www.hblr.org/wp-content/uploads/sites/18/2012/11/HLB202_Dynamic-Resolution.pdf.

This article considers alternatives for the resolution of systemically important financial institutions, including the OLA, bankruptcy, a European-style bail-in process, and coerced mergers. It concludes that four changes to Bankruptcy/OLA framework would make it more effective: (1) removing the liquidation mandate from the OLA, (2) requiring financial institutions and regulators to follow the living will provision; (3) establishing a strong presumption that regulators would not remove a financial institution from the bankruptcy process; and (4) eliminating the special treatment of derivatives and other QFCs in

bankruptcy. It also endorses adopting the Hoover Institute's chapter 14 proposal, which authorizes regulators to file involuntary cases; resolves some, although not all, issues related to debtor-in-possession funding; and requires that cases be heard by an Article III District Court Judge.

32. Thomas W. Joo, *Lehman 10 Years Later: The Dodd-Frank Rollback*, 50 Loy. U. Chi. L.J. 561 (2019), https://research.luc.edu/media/lucedu/law/students/publications/llj/pdfs/vol50/issue-3/12_Joo_(561-597).pdf.

This article describes the changes that the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 (EGRRCPA) made to the Act, and analyzes EGRRCPA's direct and indirect effects on the deregulation of large banks, community banks, mortgage lending standards, and consumer protection in the industry. It argues that EGRRCPA ignores the risk factors associated with the 2007–2008 financial crisis and is better explained as part of a larger deregulatory agenda that aims to make the financial sector, and industry generally, less accountable to customers and to society at large.

33. Marc Labonte et al., Cong. Res. Serv., The Financial CHOICE Act in the 115th Congress: Selected Policy Issues (2017), https://fas.org/sgp/crs/misc/R44839.pdf.

This report analyzes policy issues related to the Financial CHOICE Act (H.R. 10), as passed by the House in June 2017 and as incorporated in two FY 2018 appropriations bills (H.R. 3280 and H.R. 3354).

34. Stephen J. Lubben, *Resolution, Orderly and Otherwise: B of A in OLA*, 81 U. Cin. L. Rev. 485, 51619 (2013), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2037915.

Using the legal and financial structure of Bank of America (BoA) as a model, Professor Lubben critiques the adequacy of the OLA, the existing Bankruptcy Code, and the proposed chapter 14 for resolving SIFIs. His analysis assumes the OLA will be invoked and explores its limitations, noting that other insolvency regimes would be invoked to resolve some of BoA's subsidiaries and OLA is incomplete in its preemption of those regimes; that OLA applies only domestically; that OLA could decrease the time the FDIC has to prepare for insolvency proceedings due to premature disclosure of the debtor's plans; and that OLA could cause financial contagion among similar institutions. He concludes that relative to the proposed chapter 14, the OLA procedures offer more realistic funding mechanisms and speed (although with limited due process); that the relative expertise of a district judge (chapter 14) and the FDIC (OLA) is a draw; and that neither OLA nor chapter 14 does much to solve the international component, although bankruptcy is somewhat more "global."

35. Stephen J. Lubben, *What's Wrong with the Chapter 14 Proposal*, N.Y. Times (Apr. 10, 2013), https://dealbook.nytimes.com/2013/04/10/whats-wrong-with-the-chapter-14-proposal/.

Professor Lubben identifies significant problems with the Hoover Institute's proposed chapter 14, including (1) replacing experienced bankruptcy judges with federal district court judges; (2) assuming that private debtor-in-possession financing will be available; (3) subordinating DIP financers' claims to the extent financing is used to "overpay" creditors, which discourages financing and penalizes the provision of too much stability; and (4) failing to address the need for speed.

36. Stephen J. Lubben & Arthur E. Wilmarth, Jr., *Too Big and Unable to Fail*, 69 Florida L. Rev. 1205 (2017), http://www.floridalawreview.com/wp-content/uploads/2-Lubben_Wilmarth.pdf.

This article expresses significant doubt about the ability of the financial regulatory scheme to meet its explicit goal of enabling a SIFI to fail without requiring a government bailout. The "single point of entry" (SPOE) resolution strategy, which focuses all resolution efforts on a SIFI's parent holding company, is unlikely to work as intended during a global crisis that involves multiple failing SIFIs operating thousands of subsidiaries across dozens of national boundaries. The FRB's TLAC rule creates an opaque way to impose the costs of resolving failed SIFIs on ordinary citizens, because most TLAC debtholders are likely to be retail investors in brokerage accounts, mutual funds, and pension funds. Recommended regulatory reforms include requiring SIFIs to provide detailed disclosures when selling TLAC debt to investors and strengthening the TLAC rule by requiring either a prefunded Orderly Liquidation Fund or a self-funded resolution fund held by each holding company. Proposed Bankruptcy Code revisions for large financial companies should not tie the use of bankruptcy to SPOE and should not lock financial institutions into any one resolution mechanism. Revisions should include provisions addressing the specific challenges of financial institution insolvency (e.g., providing regulators standing and ability to institute involuntary bankruptcies, statutory ability to conduct short notice § 363 sales to bridge companies, and a short stay on financial claims covered by safe harbors). Because private DIP financing will not always be available, the Bankruptcy Code should be revised to work in tandem with OLA.

37. Memorandum from Arnold & Porter, Passage of the Economic Growth Act Modifies the Dodd-Frank Act and Provides Other Financial Regulatory Relief (June 1, 2018), https://www.arnoldporter.com/en/perspectives/publications/2018/06/passage-of-the-economic-growth-act-modifies.

This memorandum provides a comprehensive summary of The Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018.

38. Memorandum from Cleary Gottlieb, Treasury Recommends Retaining Orderly Liquidation Authority (Feb. 28, 2018), https://www.clearygottlieb.com/-/media/files/alert-memos-2018/treasury-recommends-retaining-orderly-liquidation-authority.pdf.

This memorandum provides a useful summary of the report on the OLA that was issued by the U.S. Treasury Department on February 21, 2018.

Appendix C: Additional Background on Recent Reporting on Financial Intermediation Data and the Growth of the Shadow Banking Sector

As we acknowledge in the body of the report, no universally accepted definition of "shadow banking" exists. Typical of the many measures employed in the literature, however, is the approach taken by Adrian, Ashcraft, and Cetorelli[196] who analyze the liabilities of financial business in the context of four major categories: traditional maturity transformation, traditional credit transformation, shadow maturity transformation, and shadow credit transformation. Their measures are compiled from the Financial Accounts of the United States.[197]

Total traditional transformation has grown from $748 billion in 1960 to $51 trillion in the third quarter of 2019. Over the same time period, total shadow transformation has grown from $40 billion to just under $39 trillion. Within traditional transformation, maturity transformation has grown from $331 billion to $19 trillion while credit transformation has grown from $388 billion to $32 trillion. Shadow maturity transformation has grown from $6.5 billion to $7.9 trillion while shadow credit transformation has grown from $34 billion to $31 trillion. See **Figure 1** and **Table 1**.

196. Tobias Adrian, Adam B. Ashcraft & Nicola Cetorelli, *Shadow Bank Monitoring* (Federal Reserve Bank of New York Staff Report No. 638, Sept. 2013) available at https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr638.pdf.

197. Both **Figures 1** and **2** and **Table 1** are based on data taken from the Board of Governors of the Federal Reserve System, Federal Reserve Statistical Release z.1, Financial Accounts of the United States published quarterly. The release can be downloaded from https://www.federalreserve.gov/releases/z1/20191212/z1.pdf and the data from https://www.federalreserve.gov/releases/z1/20191212/z1_csv_files.zip. Most of the series are taken from Table L.108 except as noted. Traditional maturity transformation includes bank deposits (lines 31 and 32) and interbank liabilities (line 30). Traditional credit transformation includes bank and bank holding company term debt (line 40 plus Table L.213 lines 4 and 9) and reserves of pension funds (Table L.227 line 1 minus line 4) and life insurance companies (line 45). Shadow maturity transformation includes money market mutual funds line (33), repos (line 34), open market paper (line 36), and security broker-dealer credit (Table L.130 line 29) and payables (table L.130 line 30). Shadow credit transformation includes GSEs (line 37), nonbank term debt (line 38 minus Table L.213 lines 4 and 9), mutual fund shares (line 43), REIT mortgage debt (line 42) and "other" loans (line 41).

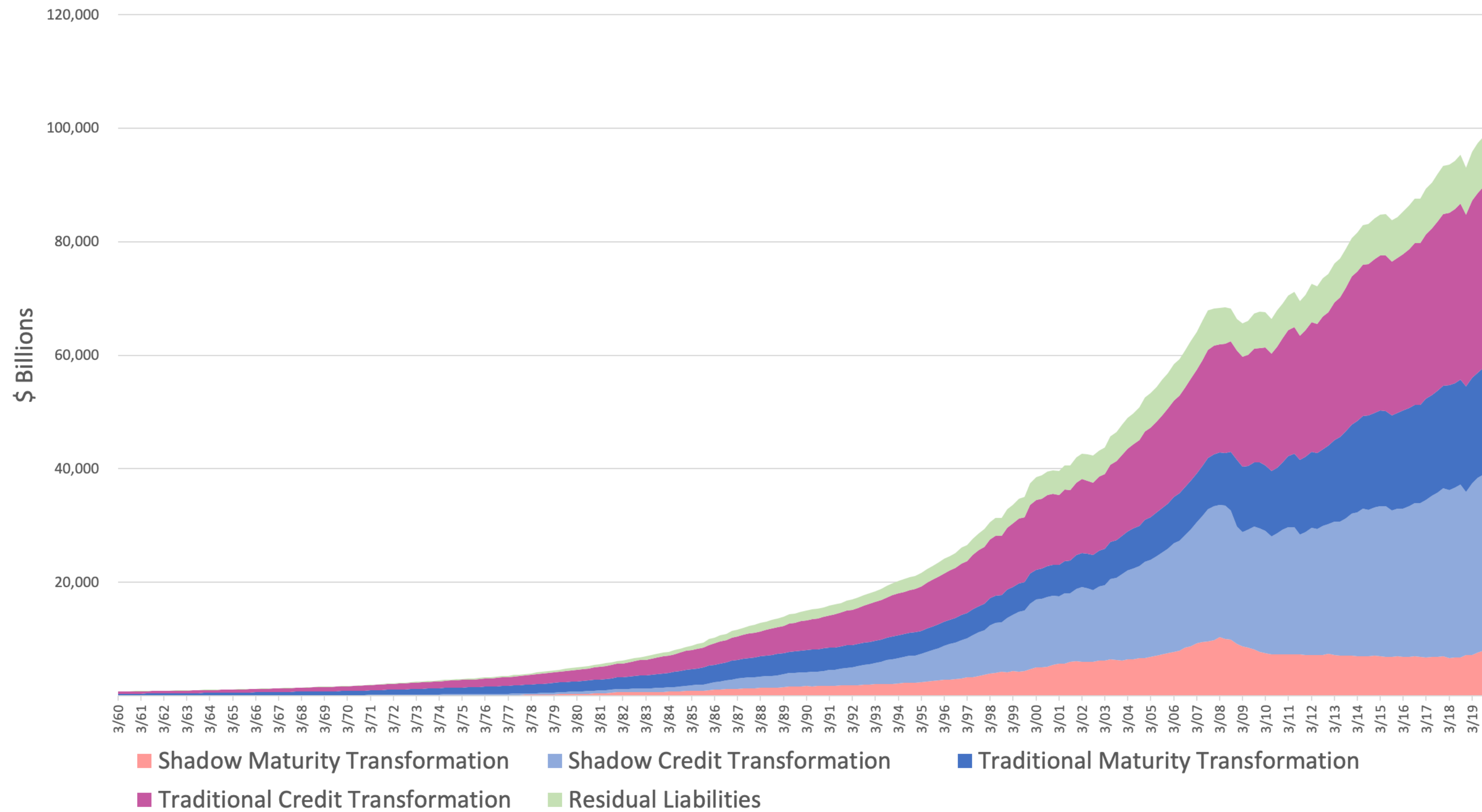

Figure 1: Traditional and Shadow Credit and Maturity Transformation. Broader Definition after Adrian, Ashcraft and Cetorelli (2013).

Date	Shadow Maturity Transformation	Shadow Credit Transformation	Total Shadow Transformation	Traditional Maturity Transformation	Traditional Credit Transformation	Total Traditional Transformation
9/30/1960	6.5	33.9	40.4	345.6	402.3	747.9
9/30/1970	52.3	116.8	169.2	721.7	867.6	1,589.2
9/30/1980	396.8	456.6	853.4	1,856.1	2,139.3	3,995.4
9/30/1990	1,731.1	2,555.8	4,287.0	3,881.2	5,441.7	9,322.9
9/30/2000	5,160.9	12,314.6	17,475.5	5,374.3	12,516.7	17,891.0
9/30/2001	5,964.4	12,103.3	18,067.7	5,778.7	12,451.9	18,230.7
9/30/2002	6,014.9	12,607.3	18,622.2	6,225.3	12,734.9	18,960.2
9/30/2003	6,278.9	14,549.8	20,828.7	6,632.3	13,842.5	20,474.9
9/30/2004	6,650.1	16,167.1	22,817.3	7,143.2	15,086.8	22,230.1
9/30/2005	7,350.0	17,886.2	25,236.2	7,831.5	16,370.0	24,201.5
9/30/2006	8,532.4	19,806.8	28,339.2	8,446.1	17,481.6	25,927.6
9/30/2007	9,627.8	23,232.6	32,860.4	9,024.6	19,025.0	28,049.7
9/30/2008	9,920.6	22,746.1	32,666.7	10,313.4	19,433.1	29,746.5
9/30/2009	8,157.9	21,618.9	29,776.8	11,397.9	20,019.7	31,417.6
9/30/2010	7,314.4	21,332.4	28,646.7	11,538.0	21,302.0	32,840.0
9/30/2011	7,280.9	21,179.1	28,460.0	13,154.7	21,867.7	35,022.5
9/30/2012	7,250.5	22,684.1	29,934.6	13,527.9	23,300.4	36,828.3
9/30/2013	7,050.9	24,213.7	31,264.6	15,356.1	25,217.8	40,573.9
9/30/2014	6,944.8	25,868.7	32,813.5	16,563.3	26,715.0	43,278.3
9/30/2015	6,919.1	25,686.9	32,605.9	16,759.6	27,132.9	43,892.5
9/30/2016	6,964.1	27,027.3	33,991.3	17,309.6	28,436.6	45,746.2
9/30/2017	6,878.2	28,975.9	35,854.1	17,942.8	29,822.6	47,765.3
9/30/2018	6,808.8	30,449.7	37,258.5	18,413.2	31,041.3	49,454.6
9/30/2019	7,944.3	30,971.2	38,915.5	18,872.4	31,882.5	50,754.8

Table 1: Traditional and Shadow Maturity and Credit Transformation. Annual Data as of September 30 ($ Billions).

Compositionally, shadow transformation has grown from 5.1% of the transformation total in 1960 to 43.4% as of the third quarter of 2019. Over the same time period, traditional transformation has fallen from 94.9% to 56.6% of the transformation total. In 1960, traditional maturity transformation accounted for 43.8% of the total, while traditional credit transformation accounted for 51%. By contrast, shadow maturity and credit transformation accounted for just 0.8% and 4.3% of the total, respectively. By 2019 traditional maturity and credit transformation respectively accounted for 21% and 35.6% of total transformation while shadow maturity and credit transformation accounted for 8.9% and 34.5% of the total. See **Figure 2**.

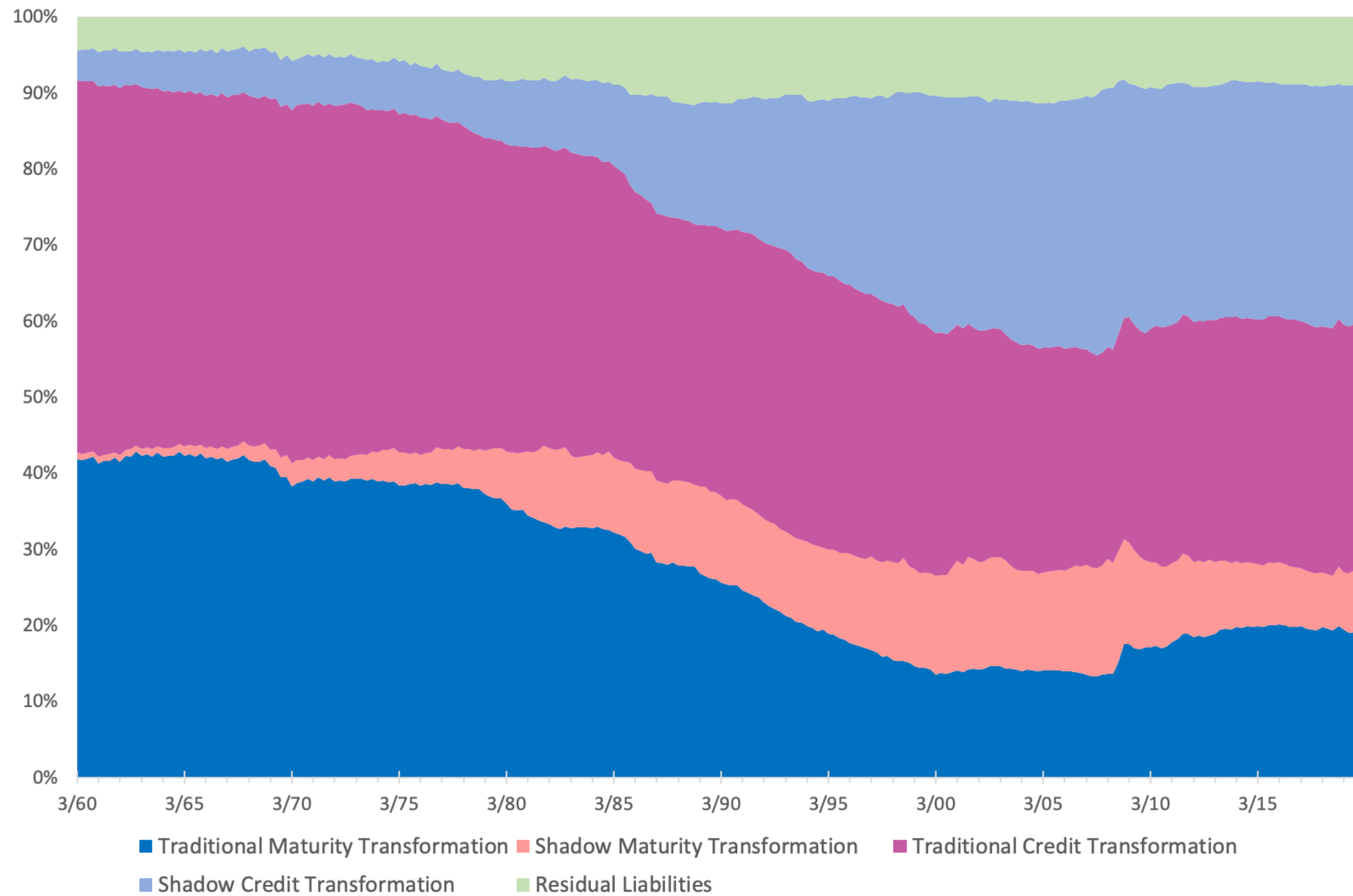

Figure 2: Composition of Total Financial Sector Liabilities. Traditional and Shadow Maturity and Credit Transformation. Quarterly Data 1960Q1–2019Q3.

The growth rates for the shadow banking segments have been extraordinary. Over the period from 1960 to present, shadow maturity transformation has grown at a compound annual rate of 12.8% and shadow credit transformation has grown at the rate of 12.3%. By way of comparison, traditional maturity transformation has grown at the rate of 7.1% and traditional credit transformation at 7.8%. Compounded over the period, the differences are quite large. Whereas traditional transformation in 2019 was 68 times its 1960 level, shadow transformation was 964 times its 1960 level.

Growth in shadow maturity and credit transformation was fairly uniform from 1960 to the mid-2000s. Shadow credit transformation peaked in 2007 followed by a peak in shadow maturity transformation in 2008. From its 2007 peak, shadow credit transformation declined each year until it resumed growth in 2012. Shadow maturity transformation trended down from its 2008 peak through 2018. However, from 2018 to 2019 it jumped 17%.

Traditional credit and maturity transformation has trended up over the entire period from 2000 through 2019 with the exception of a 1% decline in the latter from 2009 to 2010.

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