Insight

Bankruptcy and Too Big to Fail

DOUGLAS HOLTZ-EAKIN | DECEMBER 1, 2014

Today the House of Representatives will consider a measure which would continue the financial reform debate which began in 2009. In particular, the proposal would create (what they hope is) a credible bankruptcy regime alongside the current “Orderly Liquidation Authority” created as part of Dodd-Frank. The idea is simple: large complicated financial firms — those often categorized as “too big to fail” — need a predictable way to unwind and liquidate when they get into trouble lest they force policymakers to bail them out. Dodd-Frank took one approach to this problem, based on the premise that traditional bankruptcy (which applies to all other firms) was not sufficient, and created a government agency-directed process. Whatever the merits of this approach, “ politics will hover in the background” (as AEI’s Peter Wallison put it).

A better approach is one based on the time-tested system of bankruptcy: a system uniquely designed to handle competing claims on assets and liabilities when a firm becomes insolvent. Does the bankruptcy code need changes to handle large interconnected financial firms? Most definitely. Which is why proposals that build on the bankruptcy code deserve consideration and serious debate. As Stanford’s John Taylor put it in testimony last year, “reform[s] of the bankruptcy code designed to handle the big interconnected firms would alleviate too-big-to-fail [sic] and the problems it creates.”