At the heart of the Dodd-Frank law is a two-pronged approach to the too-big-to-fail problem. The first section of the legislation, Title I, stipulates that all firms must be able to go bankrupt without causing large-scale damage to the broader financial system or the real economy. Regulators are instructed, in no uncertain terms, to make sure that all large financial firms are structured in such a way that bankruptcy, using the standard rules and procedures of the court system, can happen without repeating the catastrophic post-Lehman cascade.

In Title II of Dodd-Frank, Congress created a back-up authority through which the Federal Deposit Insurance Corporation (FDIC) can take over and manage a failing financial firm and impose appropriate losses on shareholders and some creditors without creating widespread systemic damage or a global panic. The good news is that, over the past half-decade, the FDIC has made some progress formulating the design of a workable Title II.

The bad news is that there has been almost no progress in terms of ensuring that large financial firms actually can go bankrupt. In a hearing this week before a part of the Senate Banking Committee, there was complete agreement across the political spectrum on this point. The disagreement concerns what must be done to finish this important piece of Dodd-Frank business.

The Republican proposal is to modify the bankruptcy code, creating special provisions for large, complex financial institutions. There are three problems with this approach.

First, all companies in the US should be able to fail under the same rules. Privileged treatment for anyone perpetuates the perception that it is safer to lend to some large financial firms – and further strengthens their unfair advantage.

Second, it is fanciful to believe that the private sector would want to get involved in providing funding to a huge financial firm under court supervision, particularly during

a systemic crisis. The definition of such a crisis is precisely that moment when private-sector loans are not readily available. And a large loan – in the tens of billions of dollars – provided by the US Treasury to a bankruptcy court judge is unlikely to be politically acceptable or economically sensible.

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Finally – and most fatally – the bankruptcy of any large US financial firm today would induce a scramble for assets by regulators around the world. Some foreign regulators – such as the Bank of England – have agreed not to act preemptively in a resolution process run by the FDIC. But such agreements do not apply to a court-run bankruptcy process; authorities everywhere would move to protect local creditors and taxpayers by seizing assets in their jurisdiction.

The only reasonable alternative is to make large, complex financial institutions smaller and less complex so that it is possible for them to fail under standard bankruptcy rules. This is the intent of Dodd-Frank.

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