Ezra Bronstein:[1] In Defense of the "Better Bailout," A Heter-Iska Comparison

> Who is wise? One who can anticipate the future.[2]
>
> Who is wise? One who learns from experience.[3]

Overview

Academic calls for regulatory reform of the financial industry are always in vogue. Because of the complexity of the ever-evolving markets, market participants' powerful incentives to engage in regulatory arbitrage, the inevitable expertise gap that exists between the regulator and regulatees, and the regulator's budgetary constraints,[4] the regulatory regime is in perpetual need of an update to remain effective. However, as the country grapples with the crippling effects of the recent financial crisis and the public expresses their frustration with bailouts and the haphazard, knee jerk response by the federal government,[5] these calls for reform

[1] J.D. Candidate, 2012, The George Washington University Law School; B.A., 2006, Central Yeshivah Tomchei Temimim; Rabbinic Ordination, 2005, Machon L'Hora'a-Rabbinical College of Pretoria; Rabbinic Ordination, 2005, Machon Ariel.

[2] Rabbinic proverb. *See*, *e.g.*, SHLOMO YITZHAKI, KOHELET, 2:14 (interpreting *Ecclesiastes* 2:14 [lit. ("the wise man has eyes in his head") as referring to one who can anticipate the future).

[3] Talmudic proverb.

[4] *See*, *e.g.*, Saule T. Omarova, *Wall Street as Community of Fate: Toward Financial Industry Self-Regulation*, 159 U. Penn. L. Rev. 411, 416 (2011) (arguing that regulatory arbitrage in the financial markets is inevitable due to the nature and complexity of the industry); Mary L. Schapiro, Chairman, Sec. and Exch. Comm'n, Statement by SEC Chairman Concerning Agency Self-Funding (April 15, 2010), *available at* http://www.sec.gov/news/speech/2010/spch041510mls.htm (arguing that the SEC's dependence on yearly appropriations restrains the SEC from effectively regulating the increasingly complex and fast paced market); J. W. Verret, *Dr. Jones and the Raiders of Lost Capital: Hedge Fund Regulation, Part II, A Self Regulation Proposal*, 32 Del. Corp. L. 799, 817 (2007) (noting how some predict that regulatory solutions are outdated "almost instantly" due to the diverse activities and investment strategies utilized by the industry).

[5] *See*, *e.g.*, Jeffrey Manns, *Building Better Bailouts: The Case for a Long Term Approach*, 63 FLA. L. REV. 1350, 1379- 82 (2011) (discussing the costs of the "ad hocery" in the government's response to the financial crisis)

have reached a feverish pitch.[6] In particular, the recent academic literature is replete with reform suggestions running the gamut from mandatory pre-funded insurance pools to the abolition of, or limitations to, the authority of financial self regulatory organizations.[7] In response to the chorus clamoring for reform, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank).[8] Dodd-Frank is a sweeping bill that aims to promote the financial stability of the United States, although its ultimate impact remains to be seen.[9]

Professor Jeffery Manns argues that a fundamental gap in Dodd-Frank is its failure to equip financial regulators with a proactive way of addressing a future financial crisis and the inevitable bailouts which would follow such a crisis.[10] To fill this gap, Manns calls for the

[6] *See*, *e.g.*, Roger Lowenstein, *Occupy Wall Street: It's Not a Hippie Thing*, BLOOMBERG BUS. WEEK, *available at* http://www.businessweek.com/magazine/occupy-wall-street-its-not-a-hippie-thing-10272011_page_3.html (Oct. 27, 2011) (describing the overall message of the Occupy Wall Street demonstrators as a call for "more or better jobs, more equal distribution of income, less profit (or no profit) for banks, lower compensation for bankers" and a reduction in the influence that corporations wield in politics"). For a somewhat dated yet sophisticated argument, *see generally* LAWRENCE E. MITCHELL, CORPORATE IRRESPONSIBILITY (2001) (advocating for dramatic reforms in corporate law as a means of tempering the moral hazard inherent in the combination of a shareholder primacy approach to corporate governance with limited liability).

[7] *See*, *e.g.*, Jeffrey N. Gordon & Christopher Muller, *Confronting Financial Crisis: Dodd-Frank's Dangers and the Case for a Systemic Emergency Insurance Fund,* 28 Yale J. Reg. 151, 154 (2011) (advocating for a prefunded insurance fund into which all large financial institutions would pay premiums); Nan S. Ellis et al**,** *The NYSE Response to Specialist Misconduct: An Example of the Failure of Self-Regulation,* (2009), *available at* http://works.bepress.com/cgi/viewcontent.cgi?article=1000&context=nan_ellis (suggesting that "specialists scandal" at the (then) NYSE demonstrates the failure of the SRO model and argues that for direct SEC regulation); Danielle Brian, *POGO Letter to Congress Calling for Increased Oversight Over Financial Self Regulatory Organizations*, PROJECT ON GOVERNMENT OVERSIGHT (Feb 23, 2010), *available at* http://www.pogo.org/pogo-files/letters/financial-oversight/er-fra-20100223-2.html (placing partial blame for the recent string of SRO failures on the "incestuous" relationship between the SROs and market participants).

[8] Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[9] *See*, SUMMARY OF THE DODD-FRANK WALL STREET REFORM AND CONSUMER PROTECTION ACT, DavisPolk.com (July 21, 2010), http://www.davispolk.com/files/Publication/7084f9fe-6580-413b-b870-b7c025ed2ecf/Presentation/PublicationAttachment/1d4495c7-0be0-4e9a-ba77-f786fb90464a/070910_Financial_Reform_Summary.pdf (providing a summary of Dodd-Frank and noting that Dodd-Frank requires 243 rulemakings and 67 studies).

[10] Manns, *supra* note 5, at 1382.

creation of an independent agency, the Federal Government Investment Corporation (FGIC).[11] In the event of a future financial crisis, the FGIC would serve as an investor of last resort and would institutionalize the bailout process and condition government intervention on the recipient's concessions to affect structural changes aimed at forcing the failing institution to share long term risks and returns with taxpayers.[12] By coercing the recipient to internalize risk while providing the taxpayers with the long term returns, the FGIC would allow the government to proactively address a future crisis while minimizing the moral hazard problems inherent in the recent batch of bailouts.[13]

This Note attempts to support Manns's premise that an institutionalized approach to confronting moral hazard and risk that flows to, and from, a necessary yet unattractive financial product may generate a workable solution by drawing a functional comparison between the FGIC and a time-proven Jewish Business Law mechanism known as the Heter Iska.

The Heter Iska

Jewish Law (Halakha)[14] forbids the charging, or paying, of interest (Heb. "Ribis")[15] in business transactions between Jews.[16] In order to encourage lending, Halakhic scholars have

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[11] *Id*. at 1383-88.

[12] *Id*. at 1388-92.

[13] *Id*.

[14] The terms "Jewish Law" and "Halakha" are used interchangeably.

[15] The definition of Ribis as "interest" is imprecise as it is both over-inclusive and under-inclusive. For more on the scope of the Ribis laws, *see*, *e.g.*, J. Stern, *"Ribis: A Halachic Anthology"*, IV J. Halacha Contemp. Soc'y 46, 46- 66 (Fall 1982) (exploring the parameters of the Ribis laws); ENCYCLOPEDIA JUDAICA, *Usury* (1996 corrected edition bt Keter Publishing House Jerusalem Ltd., Israel); Steven H. Resnicoff, *A Commercial Conundrum: Does Prudence Permit the Jewish 'Permissible Venture'?*, 20 Seton Hall Law Review 77 (1989), *available at* http://www.jlaw.com/Articles/venture.html. In this Note, Ribis is referred to as "interest" for lack of a better term.

debated, for hundreds of year, how to structure a transaction in a way that mimics the essential characteristics of an interest bearing loan yet remains Halakhicly permissible.[17] Although there are several variations of the preferable structure, the "Heter Iska" partnership has evolved from these scholars' suggestions.[18] Essential, the Heter Iska is a complicated legal mechanism that restructures a loan into a partnership investment with a pre-determined rate of expected profit.[19] The terms of the Heter Iska are such that the contributing partner (*i.e.*, the lender) is practically guaranteed the return of the principal with "interest."

To illustrate, a typical Heter Iska agreement includes the following provisions:[20] First, the lender is considered to have entered into a partnership agreement (or joint venture) with the borrower. Second, as a partnership, half, or in some versions all, of the transferred money is legally defined as having been invested in the partnership rather than as having been loaned to

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[16] As an aid to understanding the Jewish Law context of this section, it is useful to have a general understanding of the history and structure of Jewish Law. For the following overview, *see* Michael J. Broyde & Steven H. Resnicoff, *Jewish Law and Modern Business Structures: The Corporate Paradigm*, 43 Wayne L. Rev. 1685, 1685 n.1 (1997):

> Jewish law or Halakhah, is used . . . [to] denote the entire subject matter of the Jewish legal system, including public, private, and ritual law. . . . The Pentateuch (the five books of Moses, referred to collectively as the Torah) is the elemental document of Jewish law, and according to Jewish legal theory, was revealed to Moses at Mount Sinai. The Prophets and Writings, the other two parts of the Hebrew Bible, were written over the next 700 years, and the Jewish canon was closed around the year 200 before the Common Era (B.C.E.). . . . The period from the close of the canon until 250 of the Common Era (C.E.) is referred to as the era of the Tannaim, the redactors of Jewish law…The next five centuries constitute the epoch in which the two Talmuds (Babylonian and Jerusalem) were written and edited by scholars called Amoraim ("those who recount" Jewish law) and Savoraim ("those who ponder" Jewish law). . . . The Babylonian Talmud is of greater legal significance than the Jerusalem Talmud and is a more complete work. . . . From the period of the mid- fourteenth century until the early seventeenth century, Jewish law underwent a period of codification, which led to the acceptance of the law code format of Rabbi Joseph Karo [1488-1575], called the Shulhan Arukh, which serves as the basis for modern Jewish law. . . .

[17] One of the earliest mentions of a Heter Iska-like agreement is found in a Responsa attributed to Rabbi Israel Isserlein Ben Petachia (1390-1460). *See* ISRAEL ISSERLEIN BEN PETACHIA, TERUMAT HADESHEN, Responsa 302.

[18] Lit. "permissible venture." *See* Resnicoff, *supra* note 15.

[19] For an overview of the evolution of the Heter Iska, *see generally* sources cited *supra* note 14; ARI MARBURGER, BUSINESS HALACHA 109-128 (2008).

[20] *See infra* Exhibit A.

the borrower.[21] Third, profits and losses are shared equally between the partners (*i.e.*, the lender and borrower).[22] Fourth, before profits or losses are divided, the agreement requires the borrower to provide a precise accounting of how well, or poorly, the partnership has performed. Fifth, depending on whether the borrower claims the partnership suffered losses or enjoyed gains, the Heter Iska provides the only two acceptable means of validating the accuracy of the accounting.[23] To verify the extent of losses, the lender may require the borrower to produce two Halakhicaly acceptable witnesses. To verify the extent of gains, the lender may require the borrower to take a solemn oath.[24] Fifth, if the borrower cannot, or elects not to, provide the lender with the required accounting of profits or losses, the borrower agrees to repay the lender the principal, plus a pre-determined sum of profit on her investment (*i.e.*, the interest). In exchange for the receipt of this pre-determined profit payment, the lender agrees to waive the borrower's obligation to provide a proper accounting.

For a religious borrower, the two acceptable methods of verifying the partnership's profits or losses (*i.e*., through producing witnesses or taking of a solemn oath) are not particularly attractive. This is because, as a practical matter, it is unlikely that there are two acceptable witnesses who have direct knowledge of the business affairs.[25] Additionally, Halakha

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[21] Accordingly, in the Heter Iska there is no lender or borrower. Rather, there is passive investor and an actively managed partnership. In this note, the terms lender or borrower are used merely for clarity.

[22] Note: prior to the division of profits, the Heter Iska mandates that the lender pay a nominal "management fee" to the borrower. An alternative form of compensation would be to award the borrower a greater percentage of the profits. MARBURGER, *supra* note 19, at 114 & n.21.

[23] As will be explained below, for an observant Jew, these two options are impracticable.

[24] *See id.*, at 112 (citing authorities holding that the Heter Iska may not require witnesses to verify the extent of gains)

[25] Halakha severely limits the acceptability of witnesses. *See*, *e.g.*, MAIMONIDES, MISHNA TORAH*:* HILCHOT EIDUT 9:1 (disqualifying ten broad categories of people from testifying as witnesses).

strongly discourages the taking of an oath in all circumstances.[26] The borrower's remaining option is to repay the principal with the pre-determined rate of return. As expected, the vast majority of Heter-Iska borrowers choose to make the payment and the lender is repaid the principal with profit (*i.e.*, interest).

Stated differently, the Heter Iska creates a partnership structure that, for the contributing partner, is the functional equivalent of an interest bearing loan as she (the contributing partner) is practically guaranteed the return of the principal and a pre-determined profit payment.

However, notwithstanding the functional similarities to a traditional loan, a major distinction between a traditional loan and the Heter Iska is the degree of risk that the lender assumes. In a traditional loan, the lender assumes the risk of the buyer's unlawful default. In a Heter Iska agreement, however, because the lender is an investor, the lender assumes the risk of the "borrower" lawfully defaulting should the venture fail.[27] The possibility of a lawful default on the Heter Iska loan inevitably creates moral hazard. This is because a borrower, armed with the knowledge that the lender ultimately bears the cost of failure,[28] is more likely to engage in unsound business practices than she would in the case of a traditional loan. Because of the

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[26] *See* Exodus 20:7 (prohibiting the taking of God's name in vain).

[27] This assumes the (unlikely) prospect of the borrower producing two qualifying witnesses. In the event of such a default, an issue that often arises is whether the lender can, nonetheless, enforce the repayment of the loan in secular courts. Although a complete analysis of the enforceability of a Heter Iska in a secular court is beyond the scope of this note, for our purposes it is sufficient to note that secular courts tend to view rabbinical courts as arbitration. *See* Kenneth H. Ryesky*, Secular Law Enforcement of the Heter 'Iska*, JEWISH LAW ARTICLES n.30 and accompanying text, http://www.jlaw.com/Articles/heter1.html(citing cases where secular courts treat rabbinical courts as arbitration). As with all arbitration agreements, a detailed Heter Iska that is understood, and signed, by the parties is likely to be upheld in a secular court. *Id. See also generally* Resnicoff, *supra* note 15.

[28] In the case of a borrower that is willing to take an oath or that can produce qualifying witnesses.

heightened risk in a Heter Iska, Heter Iska lenders scrutinize prospective borrowers, and the borrower's business plans, more diligently than they would with a traditional loan.[29]

Additionally, because the Heter Iska agreement is contractually based,[30] the Heter Iska document lends itself to modification through revisions of its terms.[31] Indeed, Heter Iska lenders are encouraged to protect their interests by inserting creative provisions that tend to minimize moral hazard.[32] One interesting example is the "preclusion" provision that requires borrowers to notify lenders within thirty days of an anticipated loss or shortfall. Additionally, the provision requires the borrower immediately repay the lender any remaining funds. Finally, the failure to notify the lender is construed to be an admission that the partnership is performing according to expectation. The preclusion provision, therefore, serves a dual purpose. One, it forces the borrower to internalize risk by making it increasingly difficult for to claim losses. Two, it precludes the lender from losing more than thirty days of "interest." While these suggestions do not eliminate a lender's risk, nonetheless, they are useful in keeping the interest of the borrower in-line with the interests of lender.

In sum, the Heter Iska is a tool born out of necessity and presents problems with moral hazard. Yet, for hundreds of years, inter-community Jewish business transactions are

[29] MARBURGER, *supra* note 19, at n.34 and accompanying text (citing SMA, KUNTRES HARRIBIS, KISTZUR 3.

[30] To be Halakhicly valid, the Heter Iska must be reduced to writing, understood by the parties, and signed. For a detailed analysis of the basis for these requirements, *see*, *e.g.*, MENACHEM MENDEL SCHNEERSON, TZEMACH TZEDEK-YORAH DEAH, Responsa 88. Additionally, as a practical matter, secular courts tend to regard Heter Iskas as arbitration agreements only when they are fully reduced to writing and signed by the parties. *See* sources cited *supra* note 25.

[31] Rabbinic scholars constantly adjust the Heter Iska to meet the needs of the evolving marketplace. An example of a major, and controversial, Heter Iska innovation is the "general Heter Iska" (Heter Iska Klali) for Jewish owned banks. *See generally*, YAAKOV BLAU, BRIS YEHUDA, Responsa 40.

[32] As a matter of Jewish Law, parties to a transaction with a creative Heter Iska should consult with a competent Halakhic authority before relying on any such document.

successfully negotiated and performed with the Heter Iska as a central loan document. Indeed, the Heter Iska is currently used by institutional and private investors worldwide.[33] The success of the Heter Iska is partially attributable to its lenders' no nonsense approach of directly confronting problems with moral hazard with tough provision that nudge the borrower's interests towards that of the lender's.

The Bottomless Bailout

Although the precise trigger for the current financial crisis is a matter of debate, there is widespread consensus that the out-of-control systemic risk[34] that plagues our financial system, and the failure of firms to internalize those risks, shoulders much of the blame.[35] Unfortunately,

[33] *See*, *e.g.*, ENCYCLOPEDIA JUDAICA, *supra* note 15 (noting how the Heter Iska from is used by institutional investors worldwide); *Bank Tailor Lending for Jewish Lenders*, http://www.business.rutgers.edu/media/coverage/bank-tailors-lending-jewish-community. *See also infra* Exhibit B (a copy of an original Heter Iska signed by the Israel Electric Company (IEC), Israel's main electric supplier, for purchasers of IEC's corporate bonds).

[34] For an in-depth treatment of the nature of systemic risk in the financial sector, *see*, *e.g.,* Steven L. Schwarcz, *Systemic Risk*, 97 GEO. L.J. 193 (2008); Kimberly D. Krawiec, *More Than Just "New Financial Bingo": A Risk-Based Approach to Understanding Derivatives*, 23 J. CORP. L. 1, 47 (1997) (defining systemic risk as "risk that a disturbance will impair the efficient functioning of the financial system and, at the extreme, cause its complete breakdown").

[35] *See generally*, FINANCIAL CRISIS INQUIRY COMMISION, FINAL REPORT ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS IN THE UNITED STATES, at xxii (Jan. 2011), *available at* http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf. *See also*, *e.g.*, Ormarova, supra note 3, at (attributing the near collapse of the global credit and capital markets to Wall Street's lack of community of fate mentality, the "unbridled pursuit of economic profit," and the general incompetence of the industry's regulators); Olufunmilayo B. Arewa, *Risky Business and Credit Failure*, 104 Nw. U. L. Rev. Collquy 398, 399 (2010) (noting that the problems with systemic risk in the recent crisis illustrated the gaps in industry risk models and internal risk management structures).

In particular, arguably, one catalyst for the economic downturn was the securitization of sub-prime mortgages, the resulting liquidity, and the yield drawn from their subsequent sale. The return on these mortgage backed securities maximized the investments of the various banks that participated in the sub-prime business. Fannie Mae and Freddie Mac's special status as Government Sponsored Enterprises, coupled with traditional concepts of limited liability and the risk-spreading qualities of securitization, helped to create a delusional sense of security for shareholders. As private-label banks joined in the game, the stakes grew even greater. Banks reaped the benefit of easy liquidity offered by securitization, while the buyers of these mortgages were stuck with "toxic" mortgages. The cycle of irresponsible lending, securitization, and large profit margins continued until the cycle's inevitable bust. The end result was the collapse of the housing market and a general economic recession. *See*, *e.g.*, ROGER LOWENSTEIN, THE END OF WALL STREET 1-39 (2010) (describing the role of the secondary mortgage market in the collapse of the recent batch of bailouts did little to minimize this problem.[36] Indeed, a strong argument can be made that the bailouts aggravated the moral hazard that encouraged the risky behavior in the first place.[37] For distressed banks, the ready availability of taxpayer-sponsored bailout funds on terms far below market rates solidified the perception that banks need not internalize the brunt of bad risks that they assumed.[38] To make matters worse, because the salient qualification to be a fitting candidate for a bailout seemed to be "too big to fail," the bailouts have the perverse effect of implicitly encouraging banks to grow even riskier and bigger so as to guarantee that they be eligible for a bailout during the next crisis.[39]

On July 21, 2010, President Obama signed into law the Dodd-Frank Act.[40] The stated objectives of Dodd-Frank include: "[t]o promote the financial stability of the United States . . . to

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the housing market and economy). *See also generally*, Aron M. Zuckerman, *Note: Securitization Reform: A Coasean Cost Analysis*, 1 Harv. Bus. L. Rev. 303 (2011) (analyzing securitization reform proposals through an examination of the underlying economic justification for securitization). For an alternative view on the causes for the economic recession, *see* Lynn Stout, *Derivatives and the Legal Origin of the 2008 Credit Crisis*, 1 Harv. Bus. L. Rev. 1 (2011) (blaming the credit crisis on legal changes to laws governing the trading of over the counter derivates).

36 *See generally* Manns, *supra* note 5, at 1370-77 (discussing the shortcomings of the TARP bailout).

37 *See*, *e.g.*, *id*. at 1380 ("The myriad of specially tailored bailouts raised the moral hazards for future bailouts, as companies may have greater incentives to magnify risk-taking to ensure that a debacle in their economic sector will capture the government's attention.").

38 One would imagine that, with the leverage that comes by virtue of being the liquidity provider of last resort, the government would make bailout funds contingent on the recipient affecting structural reforms intended to minimize the need of further bailouts. At a minimum, the government would insist on terms that have some bearing to the prevailing market rates for similar funds. Unfortunately, that is not the case. Rather, with a few isolated exceptions, the government has doled out tremendous sums of money to problematic institutions on terms far below what the market would dictate and without having implemented significant structural reforms. *See*, *e.g.*, *id.*, at 1375-76 (comparing the federal government's bailout of Goldman Sachs with Berkshire Hathaway's five billion dollar investment in Goldman Sachs, concluding that Berkshire Hathaway's investment [theoretically] yielded more than double the rate of return of the government's bailout, even though it assumed the same level of risk.)

39 *See*, *e.g.*, *id*. at 1383; Caroline Salas Gage, *Fed's Fisher Says Regulators Should Break Up 'Behemoth' Banks*, BLOOMBERG (Nov. 15, 2011), http://www.bloomberg.com/news/2011-11-15/fed-s-fisher-regulators-should-break-up-behemoth-banks.html (noting how "sustaining too-big-to-fail-ism and maintaining the cocoon of protection of systemically important financial institution is *counterproductive*, expensive and socially questionable" [emphasis added]).

40 *Supra* note 8.

end “too big to fail”, to protect the American taxpayer by ending bailouts . . . .” To further these goals, Dodd-Frank placed significant restrictions on banks’ availability to engage in risky practices. For example, Section 619 of the Act implements the so-called “Volcker Rule” that severely limits investments by banking entities in private funds of all types. Additionally, Dodd-Frank established the Financial Stability Oversight Counsel (FSOC). In addition to monitoring risks to the financial industry[41] and other responsibilities, the FSOC is granted the authority to determine whether a non-bank financial company will be subject to the supervision of the Board of Governors of the Federal Reserve System.[42] Dodd-Frank also created a new federal receivership process (the “Orderly Liquidation Authority” or OLA) and empowers the FDIC to unwind a distressed “covered financial company”[43] without forcing it into bankruptcy.[44] Supporters of Dodd-Frank claim that these grants of extraordinary regulatory power, amongst a host of other reforms,[45] will provide regulators with the tools to end the phenomena of too-big-to-fail financial institutions and should eliminate the necessity for future bailouts.[46]

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[41] *See generally*, FINANCIAL CRISIS INQUIRY COMMISION *supra* note 35.

[42] Dodd-Frank Act § 120. The FSOC reaches this determination by considering if the non-bank financial institution may pose risks to the U.S. financial system as a result of its activities or in the event of its material financial distress. *Id*.

[43] A “covered financial institutions” is an institution that poses a significant risk to the financial stability of the United States. *Id.* § 203.

[44] *Id*. at §§ 201–217.

[45] For example, *id.* §171 instructs banking regulators to raise capital requirements for banks and systemically important financial institutions to ensure that "financial institutions hold sufficient capital to absorb losses during future periods of financial distress."

[46] Sheila C. Bair, Chairman, Fed. Deposit Ins. Corp., Statement on Systemically Important Institutions and the Issue of "Too Big to Fail" before the Financial Crisis Inquiry Commission (Sept. 2, 2010), *available at* http://fdic.gov/news/news/speeches/chairman/spsep0210.html.

Manns's FGIC and the Better Bailout

As with all ambitious regulatory initiatives, only time will tell Dodd-Frank's ultimate impact.[47] However, critics argue that, while its enactment was important, Dodd-Frank is "seriously flawed" as it is overly optimistic in dealing with too-big-to-fail and future bailouts.[48]

In particular, Professor Jeffrey Manns points out[49] that the success of the Dodd-Frank reforms hinges on the presumed efficacy of ex ante reforms to mitigate systemic risk and to, thereby, create an environment where bailouts of the financial sector are no longer the government's responsibility.[50] Manns argues that these reforms, therefore, fall short in several respects. First, they fail to acknowledge that federal bailouts of the financial sector may be inevitable in a financial crisis.[51] Second, because of Dodd-Frank's failure to concede that future bailouts may be unavoidable, it does not tackle the moral hazard problems amply illustrated during the recent bailout debacle.[52]

To fill the regulatory gap, Manns calls for the creation of an independent agency, the Federal Government Investment Corporation (FGIC). In the event that Dodd-Frank's ex ante reforms fails to prevent a systemically important financial institution (SIFI) from collapsing, the

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[47] *See*, *e.g.*, *supra* note 9; Dakin Campell, *Fed 'Punted' on Capital, Liquidity Limits in Dodd-Frank Plan*, BLOOMBERG (Dec. 21, 2011), http://www.bloomberg.com/news/2011-12-21/fed-punted-on-capital-liquidity-limits-in-dodd-frank-plan.html.

[48] Edward F. Greene, *Dodd-Frank and the Future of Financial Regulation*, 2 Harv. Bus. L. Rev. Online 79, 79 (2011), http://www.hblr.org/2011/10/greene-symposium-dfa/.

[49] Manns, *supra* note 5, at 1382-83.

[50] *See, e.g.*, Sheila C. Bair, *supra* note 46.

[51] *See* Manns, *supra* note 5, at 1382-83.

[52] *Id*.

FGIC would serve as an *investor of last resort*.[53] The FGIC would institutionalize the bailout process by conditioning government intervention on the recipient's agreement to affect structural changes aimed at forcing the failing institution to share long term risks and *returns* with taxpayers.[54] As an institutional investor with an eye on long term returns, the structural reforms imposed by FGIC can be deeper and more meaningful than the reforms currently mandated by Dodd-Frank.[55] Furthermore, by coercing the bailout recipient to internalize risk, the FGIC will minimize the moral hazards associated with bailouts.[56] The FGIC, therefore, provides a depoliticized way of proactively dealing with distressed SIFIs, minimizes moral hazard, and allows taxpayers to enjoy the profits generated by their tax-dollars.[57]

The Heter Iska and the FGIC

As noted, the Heter Iska is a financial tool born out of necessity and is morally hazardous. Yet, by directly confronting problems these problems, the Heter Iska has proven to be workable solution for millions of observant Jews. Similarly, bailouts of distressed SIFIs are, for all practical purposes, a necessary form of government intervention.[58] Unfortunately, the current bailout process is associated with moral hazards of epic proportions. Manns's investor-oriented approach to bailouts acknowledges the inevitability of bailouts yet directly confronts the moral

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[53] In contrast with the current role of the federal government as the liquidity provider of last resort and merely concerned with breaking even. *Id*. at 1384-88.

[54] *Id*.

[55] *Id.* at 1391-92.

[56] *Id*. at 1389-92.

[57] *Id.* at n.22 and accompanying text.

[58] Rodrigo Quintanilla,*The U.S. Government Says Support For Banks Will Be Different "Next Time"--But Will It?*, STANDARD & POOR'S, *available at* http://www.politico.com/pdf/PPM223_7-12-11_-_the_us_government_says_support_for_banks_will_be_different_nexttime_but_will_it_071211.pdf (July 12, 2011)

hazard with common sense suggestions borrowed from the private sector. This allows the FGIC to be a workable solution for the American public as the Heter Iska is for the Halakhicly observant individual.

Conclusion

Dodd-Frank's attempt to control systemic risk and eliminate the potential for future bailouts by imposing additional restrictions on the financial industry has been subject to withering criticism. A common critique of Dodd-Frank is its failure to address the possibility of future bailouts. Manns's FGIC proposal supplies a novel, yet common sense, solution to this regulatory gap. This Note attempts support the viability of a central premise in Manns's suggestion by drawing an analogy between the FGIC and the Heter Iska. Admittedly, any comparison between a private sector solution for a problem that affects several million people and a federal initiative aimed at systemically important financial institutions is necessarily imperfect. Nonetheless, the problems facing the American financial industry are sufficiently grave that it is worthwhile to draw an imperfect analogy if only to provide volume to a strong reform proposal.

Exhibit A. Sample Heter Iska

AGREEMENT CONCERNING INTEREST ON LOANS

INTRODUCTION

Jewish Religious Law strictly prohibits the paying or receiving of interest on loans made between Jews. However; monies are advanced in the course of a business transaction, an agreement may be entered into, whereby the provider and receiver of these funds are considered equal partners. This partnership is based upon the stipulation that, upon request, every loss must be proved by two trustworthy witnesses, and all profits verified by oath. All consequent profits or losses are then equally shared. However, in order to avoid these very stringent requirements, the provider of the funds, under this "Shtar Iska", agrees to waive his share of the profits in lieu of receiving a fixed percentage of the money advanced. This percentage is then considered profit, rather than interest on a loan. This agreement becomes effective when the receiver of the funds executes a form as set forth below.

THE AGREEMENT

I, the undersigned, have received from [Lender], the sum of [$____________], payable on [date loan is due], for the purpose of transacting business in connection with the real property located at [Address of property], in which profits and losses are to be equally shared. However, [Lender] has agreed that in lieu of such sharing of profits and losses, which would require substantiation of all losses by two trustworthy witnesses, and verification of all profits by oath, [Lender] shall accept my payment of an annual percentage interest rate of [twelve (12%)] percent, and waive all other profits which may be earned by the advanced funds. We have received a token payment of $1.00 from [lender], for our efforts in connection with this undertaking.

If this Iska agreement ever comes before a civil court it is the intent of the parties that the court construes this agreement as an ordinary loan agreement and enforces it as such.

SIGNED this ________ day of September, 2011

____

[Borrower’s name]

<u>Exhibit B: Heter Iska signed by Israel Electric Company</u>

10-OCT-2005 11:05 From:ZARCHNOT V-TARIFIM 972 4 8182688 To:Israel Electric Co P.1/1

בס״ד

שטר היתר עיסקא

על פי החלטות הנהלת חברת החשמל לישראל בע״מ (להלן: ״החברה״) אנו הח״מ מודיעים ומתחייבים בזה בשם החברה שכל עניני הכספים שיש בהם חשש ריבית מכל סוג איסור שהוא אשר תעסוק החברה בין מה שתיתן לאחרים ובין מה שתקבל מאחרים, בין בכסף בין בשוה כסף כולל הקדמת מעות והמתנת מעות, חיובים והתחייבויות, ערבויות ונאמנות, יהיה ביד המקבל בתורת עיסקא כתיקון חז״ל, ויהיה חלקו של המקבל מחצית מן הרווח ובהפסד ח״ו ישא המקבל שליש ונותן שני שליש, ובחלק הפיקדון יהיה על המקבל אחריות בגין רשלנות, גניבה ואבידה כשומר שכר. עוד הוסכם שאם יתבצעו בין הצדדים עסקים שאין בתנאי היתר זה כדי לבטל מהם איסור ריבית אזי תנאי ההתעסקות בעסקים אלו יהיו בתורת פיקדון כולו ביד המקבל ויהיה על המקבל אחריות בגין רשלנות, גניבה ואבידה כשומר שכר, ורווח יהא לנותן שבעים וחמישה אחוז ולמקבל עשרים וחמישה אחוז.

ואפילו אם יוזכר לשון הלוואה או ריבית או ריבית דריבית הרי הכל יהיה כאמור לעיל או בתורת עיסקא או בתורת כולו פיקדון.

המקבל בין בתורת עיסקא ובין בתורת פקדון יעסוק בדמי העסקא בכל עסקיו המותרים היותר טובים לטובת העיסקא, בין בנכסי דניידי בין דלא ניידי, בין בעסקיו הקיימים ובין בעסקיו שמכאן ולהבא, ותמורת המעות יקנה לנותן חלק בכל נכסיו ועסקיו, לפי שומת נציגי החברה, הכל בקניין באופן היותר מועיל ע״פ דין תורה ותיקון חז״ל.

על המקבל להוכיח שנהג ועסק בנאמנות בדמי העיסקא כנ״ל כתקנת מהר״ם, ולא יהיה נאמן על הקרן אלא בעדות כשרה ונאמנה כדין תורה, ולא יהיה נאמן על הרווח אלא בשבועת חמורה.

אמנם הוסכם והותנה שאם יתן המקבל לנותן עבור חלקו ברווח כפי שיוסכם ביניהם ו/או כפי שיקבע מומן לזמן בכללי החברה המוצאים כדין ו/או בכל דין המחייב במדינת ישראל - יהא המקבל פטור מחובת ההוכחה ומותר הרווח יהא לו לבדו.

עוד הוסכם שזמן פרעון הרווחים יחשב בכל יום העסקים האחרון של החודש העברי. ועל המקבל להמציא לנותן הודעה בכתב על רווחיו ו/או הפסדיו בעיסקאות הנ״ל לנותן לא יאוחר משבוע ימים מהמועד הנ״ל ובאם לא הודיע כאמור אזי הרי זה הודאה גמורה בביה״ד ברווח ומחייבת בתשלומי הרווחים כפי שהוסכם בין הצדדים, ושוב לא יוכל המקבל לטעון שהעיסקא הפסידה או לא הרוויחה עד המועד הנ״ל כתקנת החכ״א, כן הוסכם כי על המקבל לשלם לנותן מיידית עם מתן ההודעה כנ״ל את החלק בהלוואה ואת החלק שלטענתו של המקבל לא נפסד מהפקדון, לפני שביה״ד ידון בטענתו על הפסד או אי הרווח כנ״ל.

כל זה החלטנו בהנהלת החברה באופן מחייב, ויש תוקף ועדיפות להחלטה זו כאחת מתקנות החברה המחייבות, ואין רשות למי שהוא לפעול בשם החברה ולקבל התחייבות באופן שיש איסור ריבית כי אם עפ״י תנאי הת״ע כנ״ל.

בפרוש הותנה שכל עניני הכספים של החברה יהיו על דרך של עיסקא כאמור לעיל אף אם לא נכתב בפרוש באופן פרטי.

אחרי שעפ״י החלטה זו לא תעסוק החברה בכל עניני הכספים שלה באופן שיש בהם איסור ריבית, הרי ברור הוא כי כל המתעסק עם החברה עפ״י תקנותיה הוא מתעסק, ובכלל זה גם תקנה זו הנ״ל.

וכדי לתת תוקף ופרסום נוסף לתקנה הוחלט כי תקנה זו תפורסם במשרדי החברה.

וכל זאת נעשה בהודאה גמורה בקניין סודר בבי״ד חשוב דלא כאסמכתא ודלא כטופסי שטרא והכל נעשה בקניין המועיל ביותר.

היום יום שני ו׳ מנחם אב תשנ״ט

ולראיה באנו על החתום בשם החברה

חברת החשמל לישראל בע״מ

______________ חותמת החברה

______________ התליכות

אנו החתומים מטה בית דין צדק פה בני ברק מאשרים בזה כי שטר עיסקא הנ״ל סודר ונעשה בפנינו ע״פ הרשאה שיש לחותמים הנ״ל בשם הנהלת חברת החשמל בע״מ בקא״ס במדל״ב כתיקון חז״ל ושטר זה הינו בר תוקף.

היום יום שני ו׳ מנחם אב תשנ״ט

נאם ______________ נאם ______________ נאם ______________

אם יש איזה פרט בנוסח שטר היתר עיסקא זה שאינו מועיל להתיר איסור ריבית אינו מתבטל תקפו אלא יחול בלעדיו באופן היותר מועיל על פי היתר העיסקא.

____
חברת החשמל בע״מ

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שטר זה נערך ע״י מכון כלכלה עפ״י ההלכה שע״י ביהמ״ד להלכה בהתישבות החקלאית