Discussion on the Current State of Resolution Planning;
Remarks by
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Introduction

Thank you for inviting me to be with you at the annual convention of the American Bankers Association (ABA). As evidenced by the long list of guests who have joined your meetings in years past, the ABA provides an important forum to discuss the state of the banking industry, as well as the different issues facing financial institutions and the broader economy. Today I would like to share some perspectives on the state of resolution planning.

In many respects, achieving a credible and workable framework for resolving large and complex financial institutions (LCFI)[1] would be the pinnacle reform accomplishment in the wake of the 2008 financial crisis. Most banking organizations do not fall in the category of large and complex financial institutions; however, the policy implications of resolvability filter throughout the financial system. While the decision-making process in Washington on how to resolve LCFIs might have direct effects on only a small number of firms, the stakes of the outcome reach well beyond LCFIs. In other words, I believe it could be difficult for the financial system at large to reach a regulatory equilibrium until there is consensus that firms of all sizes are subject not only to appropriate supervision, but also to market discipline from equity holders, counterparties, and creditors.

Beginning in 2008, policymakers began calling for a legal framework to resolve LCFIs in an orderly way.[2] The massive and unprecedented assistance that the U.S. Government provided to firms in 2008 led the Congress to address the issue of resolvability when it debated, drafted, and enacted the Dodd-Frank Act (Dodd-Frank) of 2010. The Congress created two paths for resolution. The primary path is a bankruptcy process under Title I of the Act, and the other path is the use of a new Orderly Liquidation Authority (OLA) under Title II of the Act. Progress is being made to address resolvability. However, policymakers still need to consider and address a number of key issues.

Basic Tenets of Title I Resolution Planning

Title I of Dodd-Frank includes a number of provisions to further financial stability through capital regulation, enhanced prudential standards, stress testing, creation of the Financial Stability Oversight Council (FSOC), and resolution planning requirements. With respect to resolution planning, the Congress mandated that large bank holding companies and foreign banking organizations with branches or agencies in the U.S. submit resolution plans (or living wills) if their consolidated assets are greater

than or equal to $50 billion.[3] These living wills must report the “plan of such company for rapid and orderly resolution in the event of material financial distress or failure.”[4] The plans must include, among other items, a description of the ownership structure, assets, liabilities, and contractual obligations of each company as well as an identification of major counterparties.[5]

The statute requires the Federal Reserve and the FDIC (the Agencies) to review the resolution plans.[6] In the event that the Agencies jointly determine that a plan is not credible or would not facilitate an orderly bankruptcy process, the law requires the Agencies to notify the company of its plan’s deficiencies. Should such a notification occur, the company must resubmit its plan with revisions demonstrating that it can be resolved in an orderly way in a bankruptcy proceeding.[7] If the firm fails to resubmit a satisfactory plan, then the Agencies may impose enhanced supervisory measures[8] or order divestiture two years after the measures are imposed. [9]

Living Wills Considerations

As we now are moving beyond the nascent stages of the living wills process, it is important to evaluate how Title I will be used to achieve Dodd-Frank’s objective to make firms resolvable under bankruptcy. One potential challenge arises out of the statutory text. The threshold for determining whether a living will is credible or would facilitate an orderly bankruptcy is not well defined. Neither the statute nor the Agencies’ implementing regulation defines “credible.” Likewise, the statute does not provide specificity as to how the Agencies should determine whether a plan is credible or deficient. In response to comments received during the rulemaking process, the Agencies provided a definition of “rapid and orderly resolution.”[10] This definition requires that the liquidation or reorganization of the covered company can be accomplished within a “reasonable period of time and in a manner that substantially mitigates the risk that the failure of the covered company would have serious adverse effects on the financial stability of the U.S.”[11] However, what constitutes a “reasonable period of time” and what is required to satisfy the standard of “substantially mitigates” is not laid out clearly.

The decision by the Agencies to preserve definitional flexibility could have implications on the overall effectiveness of Title I. The optimal outcome of the living wills process would result in each firm being resolvable under an orderly bankruptcy proceeding. Arguably, this outcome would obviate the need for a number of other current and future regulatory initiatives. Absent agreement by the Agencies that each firm is resolvable in an orderly bankruptcy, policymakers might exercise varying degrees of discretion and take one of three paths in the living wills process:

1. Policymakers could argue that the statutory text and clear intent of the law call for firms either to resubmit living wills that would result in an orderly bankruptcy or ultimately to face new regulatory restrictions and possible divestitures within a few years’ time;

2. Other policymakers could take a more incremental approach to Title I by arguing that because terms like “credible” and “orderly” are hard to define, supervisors should use information in the plans to require meaningful improvements from one year to the next; or

3. Policymakers could have a view that orderly resolution of LCFIs under traditional bankruptcy law is improbable given recent experiences in 2008 and therefore would not put the considerable weight of their authorities, efforts, and resources behind the process.

Depending on what course of action the Agencies pursue, the efficacy of the living wills process could be diluted substantially.

Basic Tenets of Title II

Title II of the Dodd-Frank Act sets forth provisions establishing OLA. It is important to note that Title II can be utilized only if a Title I bankruptcy process is “not appropriate” or would have serious adverse effects on U.S. financial stability.[12] Title I bankruptcy is the required resolution process absent these circumstances.

OLA applies to “covered financial companies,” including bank holding companies with assets greater than or equal to $50 billion and FSOC-designated nonbank financial companies subject to Federal Reserve supervision.[13] Additionally, a company must be subject to a statutory-based systemic risk determination as to whether the company is in danger of default, whether such a default would adversely affect the financial stability of the United States, and whether private sector or traditional bankruptcy law alternatives exist for addressing the failure of the company.[14]

In its operation, Title II borrows elements from the Federal Deposit Insurance Act (FDI Act) provisions that govern resolution procedures for insured depositories. Notably, the FDIC is afforded greater powers in certain key respects under Title II than under either current bankruptcy law or the more familiar bank resolution process. For example, the FDIC is not required to perform a least-cost resolution as under the FDI Act.[15] Additionally, it can draw upon funding from the Treasury Department’s Orderly Liquidation Fund to effectuate the resolution, which provides covered financial firms with access to government financing as opposed to other financial and non-financial firms that utilize private debtor-in-possession financing in the bankruptcy process.[16]

Title II Single Point of Entry Strategy

While not contemplated in Dodd-Frank, staff at the FDIC has formulated a strategy to execute a Title II resolution, known as “Single Point of Entry”[17] or SPE. The central tenant of the SPE strategy is that a resolution should take place at the holding company level only, leaving subsidiaries to continue operations. As described in FDIC staff testimony, the FDIC would organize a bridge financial company into which the FDIC would transfer assets from the receivership estate of the failed firm, including the failed holding company’s investments in and loans to subsidiaries. Equity, subordinated debt, and senior unsecured debt of the failed company likely would remain in the receivership

and be converted into claims. Losses would be apportioned according to statutory priority, and some of the remaining claims would be converted, in part, into equity that would serve to capitalize the new operations or into new debt instruments.[18]

In many respects, the SPE strategy could reduce many of the disruptions and complications of an insolvency scenario in which multiple legal entities are placed into bankruptcy or administration. In such a case, all failing operating subsidiaries would have to be resolved individually, which could entail the application of differing insolvency regimes for different subsidiaries, varying by host country for foreign subsidiaries and also potentially by business type (*e.g.*, broker-dealers, insured depository institutions).

SPE Strategy Considerations

Notwithstanding the conceptual advantages of the strategy, an SPE approach presents several issues that should be considered and analyzed. One issue relates to whether and how much long-term debt must be issued at the holding company level in order for an SPE strategy to be workable. Another relates to what effects the implementation of an SPE strategy might have on the competitive landscape in the various market segments in which the covered holding company's subsidiaries operate.

The Calibration of Long-Term Debt

The cornerstone of the SPE strategy is a holding company creditor-funded recapitalization of troubled operating subsidiaries. The approach would require sufficient long term unsecured debt issued at the holding company level to recapitalize the newly formed holding company following its exit from the receivership and bridge entities.[19] Key policymakers at the Federal Reserve have commented that the Board of Governors is considering a proposal that would require LCFIs to maintain a minimum amount of long-term unsecured debt at the holding company level.[20] The calibration of a debt requirement, both with respect to its size and how it is apportioned across and within organizations, is critically important to the SPE model. Further, a key premise upon which the effectiveness of a long-term debt requirement is based is that creditors of the holding company will monitor and discipline the entire organization.

A primary consideration is how to establish the level of long-term debt that will be required. Given some of the historical shortcomings of an ex-ante risk-weighted approach, the ex-post framework for recapitalizing failed entities might not be served well by basing debt requirements solely on a risk-weighted asset basis. A long-term debt requirement could be implemented using both total assets and risk-weighted assets.

In addition to the amount of debt required, the use of the debt is important to the SPE strategy. Without sufficient intra-company debt to recapitalize a failed subsidiary, the desired orderliness of a Title II SPE approach might not be achievable. In order to effectuate an SPE resolution, policymakers might need to consider requiring that the debt be apportioned, or pre-positioned, in a particular way among subsidiaries. Such a requirement could lead further down a path in which traditional business operational and

funding decisions are no longer the primary domain of management and boards of directors, but instead are left to the prescription of the regulatory community.

Competitive Landscape

One of the central advantages of the SPE strategy is that it would provide for the continuing operation and viability of operating subsidiaries by focusing the resolution at the holding company level. However, this approach could also impact the competitive landscape. For example, creditors of these subsidiaries could perceive that they would not take a loss upon distress at an LCFI and therefore would require a lower return on transactions or investments. Similarly, clients and counterparties might transact with LCFI subsidiaries based on where they perceive greater safety and stability because of government policy to prevent operational disruption and distress. To be clear, in the event sufficient debt is not required, the market equilibrium could shift in favor of LCFI subsidiaries. The converse could be true if too much debt is required at LCFIs. To remedy this competitive dynamic would require either: (1) market participants transacting under the assumption that all firms would be subject to the normal bankruptcy process, or (2) regulators calibrating the long-term debt requirement at LCFIs with sufficient accuracy to eliminate non-market advantages and incentives at their operating subsidiaries.

Conclusion

There seems to be universal agreement that large and complex financial institutions should be resolvable in an orderly way. Without question, a great deal of effort from the official sector, private enterprise, academia, and the legal community has been spent addressing impediments and complications of differing resolution frameworks. Notwithstanding progress made to date, there remain serious issues to consider and challenges to overcome before reaching the consensus policy objective. With respect to Title I, the Congress afforded the Agencies significant authorities to address resolvability of LCFIs. The Agencies must arrive at a view on how to carry out their joint duties and responsibilities under the law. Under Title II, the Agencies not only must work through issues such as the debt requirement and potential competitive dynamics, but also must deal with other issues like the uncertainty around legal authority of foreign law contracts in a resolution.[21] The Federal Reserve and the FDIC have been granted significant authorities in the resolution process. The way in which the Agencies choose to exercise their respective and joint powers will have a considerable bearing on the outcome of resolvability. The obstacles to resolution will not solve themselves, and thus it will take continued vigilance and effort to achieve the mission.

Thank you.

[1] Throughout these remarks, the term LCFI is used to mean those firms both that must file resolution plans under Section 165(d) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Pub. L. 111-203) (July 21, 2010) (codified at 12 U.S.C. § 5365(d)) and that might be considered eligible to be resolved under Title II of Dodd-Frank.

[2] *See, e.g.,* Henry M. Paulson, Secretary of the Treasury, to the U.S. Chamber of Commerce (March 26, 2008) *available at* http://www.treasury.gov/press-center/press-releases/Pages/hp887.aspx; Timothy F. Geithner, President and CEO of the Federal Reserve Bank of New York, to the Economic Club of New York (June 9, 2008) *available at* http://www.newyorkfed.org/newsevents/speeches/2008/tfg080609.html; Sheila C. Bair, Chairman of the FDIC, to the Johns Hopkins Carey School of Business Leaders and Legends Lecture Series (November 20, 2008) *available at* http://www.fdic.gov/news/news/speeches/archives/2008/chairman/spnov2008.html.

[3] 12 U.S.C. § 5365(d). The discussion in these remarks centers on the resolution planning requirement in Section 165(d) of Dodd-Frank and its implementing regulation codified at 12 CFR 381 *et seq.* applicable to covered BHCs, foreign banking organizations with U.S. branches or agencies, and FSOC-designated nonbank financial companies. The discussion does not address the FDIC's resolution planning requirements applicable to covered insured depository institutions with assets greater than or equal to $50 billion codified at 12 CFR 360.10 *et seq.* (CIDI Rule).

[4] 12 U.S.C. § 5365(d)(1).

[5] *Id.*

[6] 12 U.S.C. § 5365(d)(3).

[7] 12 U.S.C. § 5365(d)(4).

[8] Section 165(d) states that the Agencies: "may jointly impose more stringent capital, leverage, or liquidity requirements, or restrictions on the growth, activities, or operations of the company, or any subsidiary thereof, until such time as the company resubmits a plan that remedies the deficiencies."12 U.S.C. § 5365(d)(5)(A).

[9] 12 U.S.C. § 5365(d)(5)(B).

[10] *See* 12 CFR § 381.2(o).

[11] 12 CFR § 381.2(o).

[12] *See* 12 U.S.C. § 5383(a)(2)(F); 12 U.S.C. § 5383(b)(2).

[13] *See* 12 U.S.C. §§ 5381(a)(8), 5381(a)(11). In addition to BHCs with assets greater than or equal to $50 billion and FSOC-designated nonbank entities, the statute also

deems companies and their subsidiaries that are predominantly engaged in activities that the Federal Reserve has determined are "financial in nature or incidental thereto" under Section 4(k) of the Bank Holding Company Act of 1956 (12 U.S.C. § 1843(k)) to be financial companies for the purpose of Title II eligibility. The FDIC has promulgated a Final Rule providing additional clarity as to this category of eligible firms. *See* Federal Deposit Insurance Corporation, "Definition of 'Predominantly Engaged in Activities That Are Financial in Nature or Incidental Thereto,'" Final Rule. 78 FR 34712 (June 10, 2013).

[14] *See* 12 U.S.C. §§ 5383(a), 5383(b).

[15] *See* 12 U.S.C. § 1823(c)(4). Under Title II, the FDIC is required, to the greatest extent practicable, to maximize returns and minimize losses in the disposition of assets. *See* 12 U.S.C. § 5390(a)(9)(E).

[16] *See* 12 U.S.C. § 5390(n).

[17] *See* James R. Wigand, Director of the Office of Complex Financial Institutions, Federal Deposit Insurance Corporation, Testimony Before the Subcommittee on National Security and International Trade and Finance, U.S. Senate Committee on Banking, Housing, and Urban Affairs (May 15, 2013) *available at* http://www.fdic.gov/news/news/speeches/spmay1513_2.pdf; Federal Deposit Insurance Corporation and the Bank of England, *Resolving Globally Active, Systemically Important, Financial Institutions* (December 10, 2012) *available at* http://www.fdic.gov/about/srac/2012/gsifi.pdf.

[18] Wigand, *supra* note 17 at 8.

[19] *See* Daniel K. Tarullo, Governor of the Board of Governors of the Federal Reserve System, "Dodd-Frank Implementation" Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (July 11, 2013) *available at* http://www.federalreserve.gov/newsevents/testimony/tarullo20130711a.htm ("[s]uccessful execution by the FDIC of its preferred SPE approach in OLA depends on the availability of a sufficient combined amount of equity and loss-absorbing debt at the parent holding company of the failed firm. Accordingly, in consultation with the FDIC, the Federal Reserve is working on a regulatory proposal that requires the largest, most complex U.S. banking firms to maintain a minimum amount of outstanding long-term unsecured debt on top of their regulatory capital requirements.").

[20] *See id*. *See also* Jerome H. Powell, Governor of the Board of Governors of the Federal Reserve System, "Ending Too Big to Fail" (March 4, 2013) *available at* http://www.federalreserve.gov/newsevents/speech/powell20130304a.htm; Daniel K. Tarullo, Governor of the Board of Governors of the Federal Reserve System, "Industry Structure and Systemic Risk Regulation" (December 4, 2012) *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20121204a.htm.

[21] *See* Daniel K. Tarullo, Governor of the Board of Governors of the Federal Reserve System, "Planning for the Orderly Resolution of a Systemically Important Bank"

(October 18, 2013) *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20131018a.htm.

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