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Supervising and Resolving Large Financial Institutions

Remarks by

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Proposals for the creation of a special resolution process for large financial firms have rightly assumed prominence in the wake of the financial crisis. Some events during the crisis have also focused attention on the difficult problems often created by the failure of a large, internationally active financial firm. In my remarks this afternoon I want to elaborate a bit on the relationship between resolution processes and an effective overall system of financial regulation and supervision in both the international and domestic spheres.¹

At the risk of some oversimplification, I would state that relationship as follows: First, an effective domestic resolution process is a necessary complement to supervision that would bring more market discipline into the decisionmaking of large financial firms, their counterparties, and investors. Second, the high legal and political hurdles to harmonized cross-border resolution processes suggest that, for the foreseeable future, the effectiveness of those processes will largely depend on supervisory requirements and cooperation undertaken before distress appears on the horizon. I would further suggest that the importance of proposed requirements that each large financial firm produce a so-called living will is that this device could better tie the supervisory and resolution processes together.

A Resolution Regime for Large, Interconnected Firms

During the financial crisis, serious distress at a large financial firm presented authorities in the United States and many other countries with only two realistic alternatives. First, they could try to contain systemic risk by stabilizing the firm through capital injections, extraordinary liquidity assistance, or both. Second, they could allow the firm to fail and enter generally applicable bankruptcy processes.

¹ The views expressed are my own and not necessarily those of other members of the Board of Governors.

Faced with the possibility of a cascading financial crisis, most governments selected the bailout option in most cases. Yet this option obviously risks imposing significant costs on the taxpayer and supports the notion that some firms are too-big-to-fail, with consequent negative effects on market discipline and competitive equality among financial institutions of different sizes. Indeed, too-big-to-fail perceptions undermine normal regulatory and supervisory requirements. However, as the Lehman Brothers experience demonstrated, permitting the disorderly failure of a large, interconnected firm can indeed unleash just the systemic consequences that motivated the bailouts.

The desirability of a third alternative is thus obvious--a special resolution process that would allow the government to wind down a systemically important firm in an orderly way. As compelling as the case for such a process is, the debate around resolution proposals has shown how challenging it is to craft a workable resolution regime for large, interconnected firms that will effectively advance the complementary--but at times competing--goals of financial stability and market discipline. Still, I think there are certain key features that are essential.

First, any new regime should be used only in those rare circumstances where a firm's failure would have serious adverse effects on financial stability. That is, the presumption should be that generally applicable bankruptcy law applies to non-bank financial firms. One way to help ensure that the regime is invoked only when necessary to protect the public's interest in systemic stability is to use a "multi-key" approach--that is, one that requires the approval of multiple agencies and a determination by each that the high standards governing the use of the special regime have been met. Once invoked,

however, the government should have broad authority to restructure or wind down the company in an orderly way. This authority should include--among other things--selling assets, liabilities, or business units of the firm, transferring the systemically significant operations of the firm to a new bridge entity that can continue these operations, and repudiating burdensome contracts of the firm, subject to appropriate compensation.

Second, there should be a clear expectation that the shareholders and creditors of the failing firm will bear losses to the fullest extent consistent with preserving financial stability. Shareholders of the firm ultimately are responsible for the organization's management (or, more likely, mismanagement) and are supposed to be in a first-loss position upon failure of the firm. Shareholders, therefore, should pay the price for the firm's failure and should not benefit from any rehabilitation of the firm through a government-managed resolution process. To promote market discipline on the part of the creditors of large, interconnected firms, unsecured creditors of the firm should also bear losses, although the extent of these losses and the manner in which they are applied likely would need to depend on the facts of the individual case.

Third, the ultimate cost of any government assistance provided in the course of the resolution process to prevent severe disruptions to the financial system should be borne by the firm or the financial services industry, not by taxpayers. The scope of financial institutions assessed for these purposes should be appropriately broad, reflective of the fact that a wide range of financial institutions likely would benefit, directly or indirectly, from actions that avoid or mitigate threats to financial stability. However, because the largest and most interconnected firms likely would benefit the most, it seems appropriate that these firms should bear a proportionally larger share of any costs that

cannot be recouped from the failing firm itself. To avoid pro-cyclical effects such assessments should be collected over an extended period.

International Efforts on Resolution Issues

The looming or actual failure of a large, internationally active financial firm inevitably complicates the already challenging process of resolution. Mismatches in the amount and maturities of assets and liabilities held by the firm in the various countries in which it operates can lead host governments to take special action to protect the interests of depositors and creditors. Different insolvency regimes apply to separately incorporated subsidiaries across the world. Some of those regimes may be substantively inconsistent with one another, or may not account for the special characteristics of a large international firm.

A natural response, which one can find peppered through various law journals over the years, is to propose an international treaty that would establish and harmonize appropriate insolvency regimes throughout the world. Just to state the proposition is to see the enormous hurdles to its realization. The task of harmonizing divergent legal regimes, and reconciling the principles underlying many of these regimes, would be challenge enough. But an effective international regime would also likely require agreement on how to share the losses and possible special assistance associated with a global firm's insolvency.

Despite the good and thorough work being undertaken in both the Basel Committee on Banking Supervision (Basel Committee) and the Financial Stability Board, we must acknowledge that satisfyingly clean and comprehensive solutions to the

international difficulties occasioned by such insolvencies are not within sight.² It would certainly be useful if jurisdictions could at least broadly synchronize both standard bankruptcy and any special resolution procedures applicable to a failing financial firm. But even this significant advance would not settle many of the nettlesome problems raised by a cross-border insolvency.

It thus seems reasonably clear that effective management of these problems will, at least for the foreseeable future, require regulatory coordination and supervisory cooperation *before* a large firm's failure becomes a real possibility. In one sense, this observation reinforces the importance of the international agenda for strengthening capital and liquidity standards. It also counsels continued attention to efforts to ensure that globally active institutions are subject to effective consolidated supervision, and that information-sharing arrangements among home and host country supervisors are well designed and implemented. To this end, the key supervisors and central banks for each of the largest global banks will begin to meet regularly to discuss crisis planning, with particular attention to contingency liquidity planning.

The crisis demonstrated that issues around cross-border liquidity support are difficult. Liquidity pressures may arise in unexpected places; time for coordination will be short; and failures in one jurisdiction likely will spread quickly to other jurisdictions. The Basel Committee and the Committee of European Banking Supervisors are working on definitions of liquid assets, common stress testing metrics and structural balance sheet

² See Basel Committee on Banking Supervision, Cross-border Bank Resolution Group (2009), *Report and Recommendations of the Cross-border Bank Resolution Group* (Basel: Basel Committee, September), available at <http://www.bis.org/publ/bcbs162.pdf?noframes=1> and Financial Stability Forum (2009), *FSF Principles for Cross-Border Cooperation on Crisis Management* (Basel: FSF, April 2), available at http://www.financialstabilityboard.org/publications/r_0904c.pdf. (The Financial Stability Forum subsequently was renamed the Financial Stability Board.)

measures. We are actively discussing the appropriate division of responsibility between home and host authorities to provide liquidity support and the related issue of how to approach cross-border branch operations. Some have called into question the traditional assumption that home country authorities will be willing and able to support all of the worldwide operations of a banking group headquartered in its jurisdiction. What approach to substitute remains unclear, however, beyond the obvious need for broad international consistency and careful calibration with other prudential requirements.

One of the key issues identified by the Basel Committee's Cross-border Bank Resolution Group is the complexity and interconnectedness of the largest organizations. Often the complexity is motivated by tax or regulatory factors, rather than a clear business purpose. Given the way these firms are structured and their linkages to key systems and other institutions, resolution of such an organization will carry significant risk of spillovers to other key markets, payments systems, or systemically important institutions. The Cross-border Bank Resolution Group consequently recommended developing initiatives that would result in simpler, less connected structures.

Living Wills and Improved Management Information Systems

This point leads us to one much-discussed idea, that of firm-specific resolution plans--sometimes referred to more colorfully, though not wholly accurately, as living wills. In one variant of the idea, each internationally active bank would be required to develop, and potentially to execute, its own resolution plan--literally to plan for its own demise. Such a requirement could doubtless be helpful to some degree, but it has notable limitations.

Most obviously, it is very difficult to predict in advance of a crisis which parts of the firm will be under greatest stress, what geographical regions may be affected most severely, and what the condition in various markets and economies will be, as well as the stability of counterparties and similarly situated institutions. Furthermore, governments may be understandably reluctant to rely too much upon a wind-down plan developed by an internationally active financial firm that so mismanaged itself that it is on the brink of failure, placing other institutions at peril. Finally, management of an institution can be expected to seek to preserve as much value for shareholders as possible in its planning, whereas the supervisors' objective in a crisis is to achieve an orderly resolution, which will often entail winding down or restructuring the insolvent firm in ways that effectively wipe out shareholder interests.

The living will requirement could be broadened so as to make it into a potentially very useful supervisory tool for healthy firms, as well as a resource in the event that resolution became necessary. Under this approach, the firm would, in addition to developing a resolution plan, be required to draw up a contingency plan to rescue itself short of failure, identify obstacles to an orderly resolution, and quickly produce the information needed for the supervisor to orchestrate an orderly resolution. These plans will need to evolve as the organization's business and economic conditions evolve and will need to become a regular part of normal supervisory processes.

A living will of this type could remove some of the uncertainty around a possible resolution. It would force firms and their supervisors to review contingency plans regularly. As part of their ongoing oversight, supervisors could target the areas where a firm's planning falls short of best practice. Indeed, by focusing on the legal, contractual,

and business relationships among the firm's subsidiaries, this requirement could yield significant benefits for prudential supervision in normal times, quite apart from its benefits in a stressed environment.

Central to the success of a living will as a supervisory tool is the quality of information it would make available in a crisis. Some of the information would be relatively static. A firm would have to inventory all its legal entities, along with the legal regimes applicable to each one, and map its business lines into legal entities. A firm also would have to document interaffiliate guarantees, funding, hedging, and provision of information technology and other key services. This information would be needed to deal with any crisis, no matter what its specific form.

Supervisory discussions will be essential to determine the scope and nature of the rapidly changing information that would be needed under each firm's living will. It can be expected to include matters such as credit exposures, funding, unpledged collateral and available lines of credit, cash flows, earnings, capital, and so forth--all coded by identifiers such as business line, legal entity, counterparty, and legal jurisdiction to allow for the ready retrieval of critical information needed depending on the nature, location, and type of stress. Much of this information can change monthly, daily, or even intraday.

Once the centrality of accurate, comprehensive information is understood, it becomes apparent that a very significant upgrade of management information systems (MIS) may be the only way for the firm to satisfy living will requirements. Improved MIS are also needed for ongoing risk management at the institution. One of the lessons of the recent crisis is that many firms had inadequate information systems to measure and manage their risks. Improvements in automated MIS capacity will likely involve

considerable expense. Again, though, the result will be improvements in risk management that will help avoid a crisis at the firm, as well as to manage such a crisis successfully should it nonetheless occur.

Supervisory demands for improved MIS could have another benefit. Just as a homeowner has an incentive to shed belongings to reduce the expense of moving, so a financial firm may have a powerful incentive to simplify its organizational structure and rationalize relationships among its corporate entities in order to reduce the cost of developing comprehensive MIS that enables an organization to retrieve information in multiple formats across jurisdictions, business lines, and legal entities. Simpler structures can also be encouraged by re-emphasizing existing supervisory guidance requiring banking organizations to measure and manage their risks not only on the global, consolidated level, but also on a legal entity basis. Together, the information requirements of living wills and the need to measure and manage risks at the legal entity level can help create the right incentives for firms to simplify their structures without necessarily requiring a supervisor to delve into the details of a banking group's structure.

Conclusion

All the work on resolution, both domestically and internationally, is important and necessary. But we must be realistic about what it can accomplish. In light of what has happened over the past 18 months, it is imperative that governments convince markets that they can and will put large financial firms into a resolution process rather than bail out its creditors and shareholders. Yet no one can guarantee that future resolutions of systemically important firms will proceed smoothly or predictably. Resolution mechanisms must be understood not as silver bullets, but as critical pieces of a broader

agenda directed at the too-big-to-fail problem. Measures such as strengthening capital standards and bringing all systemically important firms within the perimeter of regulation are other essential elements of that agenda.