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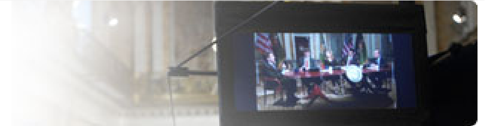

Remarks of Acting Assistant Secretary for Financial Institutions Amias Gerety before the Exchequer Club

9/17/2014

WASHINGTON - Thank you so much for the opportunity to talk with you today. I'm honored to be here and to join the tradition of thoughtful discussion of financial and economic policy for which the Exchequer Club is known.

This week marks the sixth anniversary of the demise of a very different storied institution, and I'd like to focus my remarks today on just how far we've come since then.

As we emerged from the depths of the crisis, President Obama and former Secretary Geithner had the foresight to think beyond the emergency measures that stabilized our economy. They knew that we had to fundamentally reform the financial system to both guard against future crises and make sure taxpayers would never again be put at risk for the failure of financial institutions.

As part of the team that brought Dodd-Frank into being, I will be the first to recognize that you all may have different views on the specific merits of the various reforms. However, it remains as true today as during the crisis that financial reform was necessary and overdue, and that Dodd-Frank addressed the central failings of an outdated financial system. The way I like to think about Dodd-Frank is that:

- It addresses the riskiness of the largest most complex firms – whether banks or nonbanks;
- It gives us a way to let any financial firm fail without jeopardizing the broader system, just as we have long done for banks through the FDIC;
- It transforms the derivatives markets via a transparent and comprehensive regulatory regime; and
- It created an agency focused on consumer financial products and services, so that banks, which have always been subject to regulation, are on a level playing field with payday lenders, mortgage originators, and others in how they treat their customers.

With each passing year, we have made increased and tangible progress first in containing the crisis - administering and eventually stepping away from emergency support measures - and concurrently, in implementing new reforms. Four years after the passage of Dodd-Frank, it may be tempting to let our collective attention wander, but from where I sit, it's apparent that we continue to move forward in a meaningful way.

Just over a year ago, Secretary Lew promised to "step on the accelerator" to implement Dodd-Frank, and he articulated several financial reform milestones that he hoped to achieve. We have hit every one of them. Building on what has already been put in place, this past year has been extremely productive. Our independent regulatory agencies have made substantial reform progress, including the following major milestones:

I'll go through these quickly – but this list speaks to the diligence with which the regulators have continued to push to complete implementation.

- Late last year we finalized the Volcker Rule – notable in part because five regulators completed at the same time a single joint rule, even though as many as three would have been possible under the law.

- The "ability to repay" rule and qualified mortgage standards became effective in January of this year. And late last year, regulators finalized a rule consolidating two separate mortgage disclosures into one simple form.

- The CFPB created the "Financial Aid Shopping Sheet' with the Department of Education, which has now been adopted by more than 2,000 colleges to help students make apples-to-apples comparisons of college costs.

- In early 2014, the Federal Reserve Board finalized rules establishing enhanced prudential standards for our largest banks and foreign banking organizations operating in the U.S.

- In April, the banking regulators finalized rules establishing Enhanced Supplementary Leverage Ratio standards, which strengthen the backstop capital requirement that goes along with the increases in risk-based requirements.

- In May, the Federal Reserve Board issued a proposed rule to implement Financial Sector Concentration Limits (from section 622 of the Dodd-Frank Act), setting a cap on growth by acquisition for the largest financial companies.

- This summer, the SEC adopted new reforms of money market mutual funds (MMFs), including a requirement for institutional prime funds to operate with a floating net asset value (NAV).

- The SEC also finalized rules addressing transparency and accountability for credit ratings agencies, and significantly revised its Regulation AB to improve disclosure, reporting and registration of asset-backed securities.

- And, finally, just in the past few weeks, the banking regulators finalized the Liquidity Coverage Ratio and have re-proposed rules for margin on uncleared swaps.

I'd like to focus in a bit more detail on a key piece of reform where we have seen real progress – facilitating the orderly resolution of a failing financial institution. As you know, Title II of the Dodd-Frank Act gave regulators the tools to wind down a firm whose failure would be a threat to financial stability. This authority did not exist during the depths of the crisis, so the

only option available at that time for a resolving a failing nonbank financial company, such as Lehman Brothers, was a bankruptcy process that had severe negative consequences for the broader financial system.

This Orderly Liquidation Authority, or OLA, is a new backup emergency authority for use by regulators in cases where the traditional resolution of a financial institution under the Bankruptcy Code could pose a threat to financial stability in the United States. OLA allows for the orderly resolution of a firm without cost to U.S. taxpayers. Using it would result in the firm's shareholders losing their investment, creditors taking necessary losses, and culpable management being removed.

Fortunately, we have not had to use this authority yet; but that is all the more reason to work tirelessly to make sure that it will be ready if we need it. And that important work is well underway.

Let's take a moment to walk through the government's strategic approach to the failure of a large complex financial firm. I will point out our achievements to date and highlight four important areas where our work continues to remove barriers to a successful resolution that would protect the financial system while letting a firm itself fail.

Planning

First, while not actually part of Title II orderly liquidation, a conversation on resolution must begin with planning – namely, resolution planning through the living wills process. As you know, under the Dodd-Frank framework, bankruptcy remains the preferred option for the resolution of a financial company. In order to achieve this objective, Title I of Dodd-Frank requires bank holding companies with total consolidated assets of $50 billion or more and nonbank financial companies designated by the Financial Stability Oversight Council to submit resolution plans, or living wills, to the Federal Reserve Board and the FDIC. The living wills must describe the firm's strategy for rapid and orderly resolution in the event of material financial distress or failure.

Last month, the Federal Reserve Board and the FDIC completed reviews of the second round of resolution plans submitted to the agencies in October 2013 by 11 bank holding companies. In completing their review, the FDIC and the Federal Reserve noted certain shortcomings in the resolution plans that the firms must address in order to improve their resolvability in bankruptcy. Both agencies indicated the expectation that firms make significant progress in addressing the identified issues in their 2015 resolution plans. Both the Fed and FDIC have indicated that their staffs will work with each of the firms to discuss required improvements in their resolution plans and their efforts, both proposed and in progress, to facilitate the firms' preferred resolution strategy. The agencies are also working with the firms to explore ways to enhance public transparency of future plan submissions.

Turning to OLA more broadly, the first piece of the puzzle was to develop an overarching strategy to resolve a large, complex financial institution. In meeting this challenge, the FDIC has come up with an innovative approach known as the Single Point of Entry. Let me briefly outline the fundamentals of the Single Point of Entry strategy.

Conceptually, bankruptcy is still a good starting point as it generally allocates losses – first to shareholders and then to unsecured creditors, in some cases by giving creditors equity holdings in a new company that takes over the assets of the bankrupt firm. But it is only a starting point, because for banks and other large, complex financial institutions – the trick is not just to allocate losses, but also to minimize disruption to the financial system and the broader economy in the process.

Under the Single Point of Entry strategy, the FDIC would effectively pre-determine who will take losses and pre-position the capacity to take those losses before the failure occurs. It would do so by organizing a bridge financial company into which it would transfer assets from the failed firm primarily consisting of the failed firm's investments in and loans to subsidiaries. Losses would be borne in accordance with the priority of a claims "waterfall" among equity holders and unsecured creditors whose equity, subordinated debt and a substantial portion of senior unsecured debt would remain with the failed firm. One way you could think about this is that the Single Point of Entry strategy facilitates something like a pre-pack bankruptcy, where determining who takes losses is done ahead of time, and with a financing mechanism to ensure a smooth unwind process as subsidiaries remain open and operating.

That is the roadmap for how the Single Point of Entry strategy is expected to work. I want to specifically highlight three other key areas where work continues in order to ensure regulators will be able to carry out a successful resolution: recapitalization of subsidiaries, funding, and derivatives.

Recapitalization of Subsidiaries

In order to facilitate the Single Point of Entry strategy, there must be enough loss absorbing capacity at the holding company at the time of failure, so that losses can be absorbed and any subsidiaries transferred to a bridge financial company can continue operating. This loss absorbing capacity could be achieved through a combination of equity and holding company debt.

The Basel III regulatory capital requirements provide a good baseline for equity capital, but if that capital reserve is exhausted, additional instruments will be needed in order to recapitalize the bridge financial company. For this reason, the Federal Reserve Board is working with the FDIC to develop a rule to require sufficient amounts of long term unsecured debt to be held at the holding company. This requirement will be in addition to current capital standards already in place.

Along the same lines, U.S. agencies are also working with their international counterparts via the Financial Stability Board to develop a proposal requiring the largest, most complex global banking firms (or G-SIBs) to maintain a minimum amount of total loss absorbing capacity above the levels set forth in Basel III. The details are still under discussion, but we expect considerable progress on these issues in the near term.

Funding

Just as sufficient amounts of loss absorbing capacity may be critical to a successful resolution, so too is the bridge financial company's continued access to liquidity. If a resolution proceeding is invoked, the Dodd-Frank Act provides the tools to ensure that the bridge financial company will have access to needed funding. The FDIC's Single Point of Entry strategy and potential requirements for sufficient loss-absorbing capacity are intended to stabilize the subsidiaries transferred to the bridge and restore confidence. However, historical experience teaches us that we may need "overwhelming force" to demonstrate that the bridge financial company is indeed viable.

So while, ideally, the bridge will have immediate access to private sector sources of liquidity, if private financing is not available, then Title II provides a mechanism called the Orderly Liquidation Fund, or OLF. Through the OLF, the FDIC can borrow funds from the U.S. Treasury and use those funds to make direct loans to the bridge company or guarantee the bridge company's obligations such that it can secure adequate financing. This fund can be an important tool to stabilize the bridge and limit disruptions to financial markets without taxpayers bearing any related losses.

The OLF is housed within the Treasury Department, managed by the FDIC, and cannot be used or funded until the FDIC is appointed as receiver under OLA. The FDIC intends to use the OLF to provide temporary liquidity – not capital. Additionally, the FDIC intends to require that any borrowings from the OLF be fully secured.

If the assets of the failed company are not sufficient to pay in full the amounts borrowed from the U.S. Treasury, the FDIC must ultimately assess the financial industry for repayment, thereby ensuring that taxpayers will bear none of the losses from OLA.

Derivatives

Major financial institutions now work globally, and for resolution of these firms to work, cross-border coordination must be a part of our resolution planning. One fundamental development in this area has been the international effort to develop a proposal to prevent the disorderly early termination of derivatives and other contracts during the cross-border resolution of a global financial institution.

To understand why this can be problematic, it's important to understand that derivatives are usually long term contracts designed to transfer risk between two parties, and the pricing of these transactions reflects a range of financial and economic outcomes. The decision to terminate based on an exogenous event, while perhaps individually rational, destroys value for the individual counterparty, the failing firm and other stakeholders. A mass close-out of derivatives could impede efforts to stabilize and resolve the firm and further disrupt broader markets amid a period of intense uncertainty.

OLA contains a one business day stay and a transfer provision that allows the FDIC time to work through these contracts and – under the strategy laid out in Single Point of Entry – to continue to make good on these contracts through the bridge financial company. But this stay operates only under U.S. law, and may not apply to contracts governed by foreign law. This would mean that counterparties to foreign subsidiaries may have contractual rights allowing them to accelerate or terminate qualified financial contracts once the U.S. parent is placed in OLA thus complicating the goals of an orderly resolution.

U.S. agencies, foreign regulators, financial firms, and other financial market actors have been working with the International Swaps and Derivatives Association, known as ISDA, to develop a protocol amending the ISDA Master Agreement for derivatives contracts. A new Protocol would help prevent the disorderly termination of cross-border derivatives contracts based on resolution-based defaults and potentially remove a large hurdle to effective cross-border resolution. The Financial Stability Board will be reporting on the progress of the ISDA Protocol efforts later this fall.

Supporting Financial Stability and Economic Growth

There is a commonly held belief that there is an inherent tradeoff between financial stability and economic growth. The arguments around this tradeoff need to accommodate the example of the crisis we just lived through – in 2008 we learned what an unstable financial system can do to economic growth.

Our financial system is safer and stronger because of the actions taken to respond to the crisis and the reforms that have been put in place since then; banks have added over $500 billion of capital over the last five years to cushion against unexpected losses, support lending to consumers and businesses, and reduce overall leverage in the banking system.

Concurrent with that, lending continues to grow, and asset quality continues to improve, and the banking sector has generally shifted to more stable funding (aggregate deposits continue to grow) and stronger liquidity buffers. Since the crisis, unemployment has declined dramatically and GDP growth continues to improve.

Of course, Treasury and the rest of the regulatory community have made a continual effort to monitor the effects and the impact of new reforms as they have been developed, and will continue to do so through implementation and beyond.

As we finish the job that Dodd-Frank set out for us, we continue to deepen our understanding of how the financial sector can and should evolve to meet the needs of our dynamic economy. The conversation on how best to do that will continue; and we look forward to engaging with those in this room and others as we pursue policies that support that goal.

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