

Are U.S. SIFIs Still TBTF?

An Assessment of the New Resolution Regime for
Systemically-Important Financial Institutions



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Executive Summary

This paper examines a fundamental premise of financial-industry regulation: whether or not large financial-services firms are too big to fail. Assessing this in light of the new systemic-resolution process created in the Dodd-Frank Act (the “orderly liquidation authority” or OLA), the paper concludes that U.S. bank holding companies and other financial-services firms, regardless of size or the nature of their operations, can no longer be rescued at long-term cost to the federal government or otherwise supported in ways that undermine meaningful market discipline. The paper does not argue that OLA is complete, perfect or proven under stress. It does, however, detail key terms in the law, implementing regulation, government policy and other critical features to demonstrate that a large U.S. financial-services firm would not now be resolved in a fashion in any way comparable to the emergency transactions mustered during the financial crisis to support companies like AIG.

This conclusion results from analysis of statutory requirements and regulatory provisions that will force firms with potential systemic impact to reveal their inner workings, plan for the worst and ensure that they can be resolved under the Bankruptcy Code. Importantly, this analysis does not assess OLA in a “silo” that assumes that financial-services firms are as they were before the crisis or that many recent reforms have no effect. Instead, it takes account of provisions such as those that permit designation of nonbank financial companies as systemic institutions. If this were an imprimatur of too big to fail that afforded risk-free status, as some contend, then firms subject to potential designation would not be fighting so hard to reverse these provisions in the Dodd-Frank Act. Where relevant, new safeguards in U.S. law intended to prevent use of OLA and ensure ready use of bankruptcy are also described. Remaining issues in OLA are analyzed, along with work under way to address them.

OLA is analyzed as is and as it is being constructed, not in contrast to what some might see as a fully-realized, wholly-complete resolution regime. It is not suggested that OLA is perfect; rather, the paper argues that OLA is substantively different than prior policy and necessary since simple bankruptcy for systemic firms is not feasible. As is, OLA provides all the tools necessary to end too big to fail; as finalized, it will ensure failure at cost to shareholders and creditors without systemic disruption that puts ordinary customers or the broader economy in harm’s way. Bankruptcy will thus be an even more viable resolution method even for very large financial-services firms, meaning that OLA is rarely, if ever, deployed.

This analysis also describes how, in the event of unanticipated stress on a single firm or a trans-market or asset-class event, the new systemic-resolution framework can prevent chaos without providing a taxpayer safety net. OLA does so because, while bankruptcy resolution is to be the norm even for giant firms under acute stress, the law and implementing rules create a “bridge” option that gives regulators the time they would need in a crisis to ensure that losses are borne by creditors and shareholders, not innocent bystanders in the U.S. banking system, the broader financial market or the economy.

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Introduction

During the financial crisis of 2008, U.S. taxpayers took on hundreds of billions of dollars in direct and indirect support for troubled financial-services firms, with European regulators since then forced to marshal comparable amounts for banks in concert with rescue plans for their indebted sovereign nations. The scope of the crisis and the scale of these financial-industry supports have led to an array of sweeping reforms, many premised on the view that, despite new capital and prudential standards for the largest banking organizations, systemically-important financial institutions (SIFIs) remain too big to fail (TBTF). If these companies are in fact TBTF, then they might not only warrant these new rules, but perhaps also need still more to break them apart into smaller or less-complex firms. If, however, reforms include a meaningful cure to TBTF, then these additional rules are not only superfluous, but also likely so costly as to undermine the basic function of SIFIs as financial intermediaries. Such damaging regulation could hurt not just SIFI competitiveness, but also their ability to provide credit, keep markets liquid and provide other essential financial services. As a result, the question of whether SIFIs are still TBTF is a threshold one by which other regulatory and public-policy decisions must be judged.

This paper addresses the TBTF question with regard to large financial-services firms in the United States. Although the global regulators that comprise the Financial Stability Board (FSB) have finalized “key attributes” for effective SIFI resolution,¹ this policy statement leaves critical questions unanswered. Many nations frankly acknowledge that their SIFIs, especially when structured as large banks, may not only be TBTF, but also even too big to save due to the disproportionate share of national assets housed in a very few firms (the so-called “doom loop”). In contrast, the U.S. has not only tackled TBTF in theory, but also finalized a new statutory construct to ensure its end. Title II of the Dodd-Frank Act² creates an orderly-liquidation authority (OLA) to handle SIFI resolutions, with the brunt of new duties in this area assigned to the Federal Deposit Insurance Corporation (FDIC).

The FDIC has issued some rules to implement OLA and is working on more rules and the operational infrastructure needed for SIFI resolution. OLA has also not yet been “crash-tested” – that is, a SIFI has not faltered in a fashion that has yet led to OLA’s use. This has led some to argue that OLA may not prove up to the task of SIFI resolution, and others have said that, even though OLA is in theory robust, Congress would lose its nerve and override it in a crisis. This paper analyzes OLA based on its express provisions, not unknown eventualities against which no policy, including OLA, can be fairly assessed. If a SIFI fails and OLA falters – as bankruptcy resolutions sometimes do – then OLA would need to be revised or repealed; if Congress reverses it under stress, OLA is not the problem nor could any other seemingly more robust SIFI resolution plan be counted upon. To support these conclusions, this paper addresses the following questions:

- What is OLA in both law and rule?
- What else should policy-makers do to make OLA as robust as possible?
- How does OLA work in practice, taking into account the other reforms intended to end TBTF also mandated in the Dodd-Frank Act

¹ Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions* (Oct. 2011), available at http://www.financialstabilityboard.org/publications/r_111104cc.pdf.

² Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (2010), §§ 201-217.

Orderly-Liquidation Authority: What Does It Do to Whom?

As noted, Title II of the Dodd-Frank Act created OLA. The FDIC has been hard at work since the law was enacted in 2010 to build this resolution regime. It does so largely with full authority to define OLA's rules, although it is required by Dodd-Frank to coordinate with the Financial Stability Oversight Council (FSOC) created in Title I of Dodd-Frank³ to oversee the designation of SIFIs and work with the Federal Reserve Board (FRB) and other regulatory agencies to craft the prudential rules required for them.

It is not the intent of this paper exhaustively to survey all of OLA's provisions, the rules being implemented to create it or the broader U.S. SIFI regime, but rather to highlight key provisions and actions to permit judgment as to whether OLA does in fact meaningfully end TBTF in the United States. To do so, we pose key questions raised by OLA's critics and refer to the statute and FDIC regulations to address them. The Government Accountability Office (GAO) has recently surveyed OLA implementation⁴ and readers are referred to this report for tables on actions to date and those under way as of this writing.

How Does OLA Work?

As discussed in detail below, OLA can only be deployed after a stringent prior review by very senior government officials. Even if deployed, it is intended to be used in a fashion as comparable to bankruptcy as possible. The law also requires consideration of other SIFI resolution options, which both GAO and the FRB have considered. In 2011, the FRB issued a lengthy study evaluating both OLA and alternatives to it, refusing to endorse any alternatives on grounds that all pose significant unresolved questions.⁵

In OLA, the FDIC must put a failed or faltering SIFI into receivership, which forces losses as discussed in more detail below. It may, after declaring a receivership, deploy the following options:

- establishment of a “bridge” entity. In a bridge structure, the FDIC takes over the failed firm and, instead of continuing it more or less as before in hopes of recovery, restructures the firm through sale of assets or other actions designed to return as much of the firm as quickly as possible to private ownership. Under any circumstance, bridge entities have limited life spans under Dodd-Frank that force the FDIC to shutter a bridge or restructure it into a wholly private financial-services firm. The FDIC plans shortly to issue rules clarifying exactly how bridge entities would be established, reflecting the critical importance of this aspect of OLA for complex SIFIs that may fail due to sudden liquidity shocks that do not permit liquidation through an immediate receivership in the few hours prior to a systemic firm's potential failure;
- liquidation, leaving no surviving firm; or
- reorganization and/or sale of assets.

³ Dodd-Frank Act, § 111.

⁴ GAO, *Agencies Continue Rulemakings for Clarifying Specific Provisions of Orderly Liquidation Authority* (July 12, 2012), available at <http://www.gao.gov/assets/600/592318.pdf>.

⁵ FRB, *Study on the Resolutions of Financial Companies under the Bankruptcy Code* (July 2011), available at <http://www.federalreserve.gov/publications/other-reports/files/bankruptcy-financial-study-201107.pdf>.

Importantly, OLA does not allow for establishment of a conservatorship. This is sometimes used by the FDIC to handle failed insured depositories and it most significantly was deployed by the Federal Housing Finance Agency (FHFA) in 2008 when, in conjunction with the Treasury Department, it took over Fannie Mae and Freddie Mac. Almost four years later, these conservatorships remain little changed, demonstrating that this option is not a clear path to ending TBTF. Since it cannot be used in OLA, it is not a concern in this regard.

Under all of its OLA options, the FDIC is required to ensure that creditors get no less than they would in a Chapter 7 liquidation under the Bankruptcy Code. It is, however, allowed to treat creditors in dissimilar ways under certain, limited circumstances and/or to repudiate contracts or enforce them even if they would otherwise have been repudiated in bankruptcy. The ability to treat similarly-situated creditors differently is a major distinction between OLA and bankruptcy and one that, some contend, creates both undue uncertainty and the prospect for political decisions that favor particular parties in a SIFI failure. The FDIC is seeking to resolve these concerns in its OLA rulemakings, but it should be noted that the option to treat some creditors differently in OLA does not mean that firms are TBTF. Creditors, counterparties and others would experience losses above those prevented by a unilateral government takeover or similar SIFI resolution that prevents failure, meaning that – despite potential differentiation of claims – OLA is still far different than TBTF.

As noted, the FDIC has issued many of the rules needed to clarify OLA, provide market certainty in advance of a possible SIFI failure and establish a credible process ready to deploy under even acute cross-border market strain. Although the FDIC readily acknowledges that it has remaining work to do to craft the full OLA framework (with key outstanding issues discussed below), matters already addressed in rules include:

- key terms and conditions;
- claims priority, including with regard to administrative expenses and unsecured creditors;
- the process for administering claims against a failed SIFI;
- recovery of prior compensation to a SIFI officer or director;
- the distribution of assets of a non-insurance company subsidiary of an insurer and the treatment of mutual insurance holding companies; and
- (in a pending proposal) the treatment of intra-group guarantees.

Is OLA All There Is?

Just as it is not the intent of this paper exhaustively to catalog OLA, so it cannot provide an in-depth assessment of the systemic-regulatory framework designed in Dodd-Frank to ensure that OLA is used as little as possible. Many of the most important aspects of this systemic framework remain in proposed form or have only recently been finalized in the rules referenced below. However, they do establish a substantial and – for designated firms – costly new framework designed to prevent a repeat of the 2008 crisis. Even as these reforms are being implemented, however, large U.S. banks sometimes considered SIFIs have made significant strides. For example, the nineteen largest bank-holding companies (BHCs) doing business in the U.S. have raised their most important capital bulwark (common-equity Tier 1) by \$339 billion between 2009 and 2011.⁶

Many critical SIFI-regulatory requirements are in Title I of the Dodd-Frank Act. These include:

- **SIFI Designation:** Dodd-Frank includes a system for designating nonbank financial companies as SIFIs. Any BHC with assets above \$50 billion is subject to extensive systemic rules (see below), and these are also to apply to designated nonbank financial companies placed under the Federal Reserve’s supervision. Some have suggested that SIFI designation affords TBTF protection, but this is not the case since, as demonstrated throughout this paper, OLA need not be used to resolve a designated firm (including a BHC) nor does it confer undue protection should it need to be deployed. Market forces are demonstrating that designation does not constitute a declaration of TBTF status (with resulting funding-cost advantages and insulation from market discipline), as nonbanks fearing designation are seeking to repeal this aspect of the Dodd-Frank Act even as they fight potential FSOC designation.
- **Early Remediation:** Title I of the Act also requires the Federal Reserve to issue rules that subject large BHCs and SIFIs to sanctions of increasing severity as the firm’s risk profile increases. The Federal Reserve has proposed very stringent standards⁷ that go well beyond the “prompt corrective action” required for insured depositories. To be sure, regulators in the past have not always acted promptly to correct bank problems, but Dodd-Frank gives the FRB far less discretion to overlook problems at a SIFI. To the extent the FRB intervenes, as required, the prospects for a systemic SIFI failure correspondingly decrease and, should one occur, the potential for systemic impact diminishes.
- **Systemic Surcharges:** Dodd-Frank also requires much tougher prudential rules for large BHCs and SIFIs. The FRB has proposed tough systemic standards for BHCs⁸ including higher capital, liquidity, stress-test, governance and single-counterparty exposure limits. Many of these proposals go so far as to pose an array of potential unintended adverse consequences, but they surely signal a stringent systemic regulatory regime that will dramatically redefine covered firms.

⁶ FRB, *Comprehensive Capital Analysis and Review: Methodology and Results for Stress Scenario Projections* (Mar. 13, 2012), available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20120313a1.pdf>.

⁷ FRB, *Proposed Rule on Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies*, 77 Fed. Reg. 594 (Jan. 5, 2012), available at <http://www.gpo.gov/fdsys/pkg/FR-2012-01-05/pdf/2011-33364.pdf>.

⁸ *Id.*

Is OLA a Bail-Out?

This is the most critical question raised by the new resolution regime: if OLA still permits bail-outs, then TBTF is untrammelled; if OLA does not in fact allow for taxpayer losses, then TBTF rescue is meaningfully addressed even if aspects of the new resolution regime remain incomplete. Section 214 of the Dodd-Frank Act expressly bars use of OLA as a bail-out. However, the following issues have caused some to question OLA:

- **Taxpayer Risk:** This is suggested because Dodd-Frank pays for any U. S. Government (USG) resolution costs through an after-the-fact assessment on the financial industry, not through a prefunded resolution kitty akin to the FDIC's Deposit Insurance Fund (DIF). However, this post-hoc mechanism can only be changed by law, meaning that it ensures industry – not taxpayer – payment for any short-term SIFI-resolution costs. If Congress loses its nerve, then it is Congress, not OLA, that determines TBTF and any such decision then cannot be deemed a failure of OLA nor could any other resolution approach be deemed any more robust. On a total-cost basis, taxpayers in OLA bear no risk of loss.
- **Treasury Discretion:** Some have suggested that Treasury could use OLA to seize troubled firms and protect them from market forces. As discussed below, OLA can replace bankruptcy only under a stringent process involving the most senior regulators, Treasury and the President. Any decision to exercise OLA after this process can be submitted to the court and may be appealed. This process, combined with the criteria dictating use of OLA, protects firms from arbitrary seizure.
- **Counterparty/Creditor Protection:** OLA is structured to match bankruptcy to the greatest extent possible, with the Dodd-Frank Act requiring the FDIC to structure OLA in this fashion and large BHCs and designated SIFIs told to develop “living wills” that plan for orderly resolution under the Bankruptcy Code.⁹ Reflecting the law's bankruptcy focus, studies are under way as to how to “haircut” secured creditors so that their total recoveries most closely match those likely in bankruptcy¹⁰ and the FDIC is working on plans (see below) to handle holding-company resolution in a manner comparable to recapitalization in bankruptcy.

⁹ FDIC, FRB, *Final Rule on Resolution Plans Required*, 76 Fed. Reg. 67323 (Nov. 1, 2011), available at <http://www.gpo.gov/fdsys/pkg/FR-2011-11-01/pdf/2011-27377.pdf>.

¹⁰ FSOC, *Report to the Congress on Secured Creditor Haircuts* (July 2011), available at <http://www.treasury.gov/initiatives/Documents/report%20to%20congress%20on%20secured%20creditor%20haircuts.pdf>.

When Can OLA Be Deployed?

As noted above, OLA would be susceptible to TBTF assertions if it could be deployed in an arbitrary fashion either to protect companies from market forces or to limit creditor rights. OLA seeks to prevent this in two ways:

- **Safeguards Against Deployment:** Dodd-Frank establishes a stringent process for use. Under it, the Treasury Secretary must consult with the President before the FDIC can be appointed receiver under OLA. Treasury can only appoint the FDIC as receiver if various regulators recommend it through two-third majority of their boards. Treasury must also conclude that the target firm is eligible (see below), in default or in danger of default that the firm's failure is a potential source of systemic risk and that bankruptcy would be more destabilizing than invoking OLA. A firm subject to OLA after this process can seek to reverse it through an emergency appeal to the courts and, even if this is denied, subsequently appeal it. The court has established a limited procedure to hear these appeals and consider Treasury OLA requests in a manner designed to address emergency financial crises without sacrificing a firm's rights.¹¹ Congress requires court approval of a Treasury OLA petition and this appeals and reversal process imposes a constraint on all of the officials required to consent before OLA can be deployed.
- **Creditor/Counterparty Risk:** The law also requires that creditors and others at risk in a SIFI failure receive no less under OLA than would have been received in Chapter 7 liquidation under the Bankruptcy Code. Calculating this amount is difficult (see below), but it affords a vital protection because creditors and similar parties cannot be intentionally disadvantaged by government action.

What Types of Financial Services Firms Come Under OLA?

Because OLA is set for SIFIs, Dodd-Frank limits its use to financial companies. Defining "financial companies" is not entirely straightforward, leading to a recent FRB re-proposal on ways to do so for nonbank financial companies.¹² However, OLA clearly cannot be used for firms principally engaged in non-financial activities – thus preventing a repeat of the financial-crisis experience in which the Troubled Asset Relief Program (TARP) designed for financial-services companies was used to support automobile manufacturers. In addition, for firms usually understood to be financial entities – BHCs, securities broker-dealers, futures commodity merchants (FCMs) and insurance companies – the law defines the inter-relationship between OLA for parent companies and other affiliates and otherwise-applicable resolution regimes for regulated subsidiaries (e.g., insured depositories that fall solely under the FDIC's usual process for handling a failed bank).

Importantly, a financial company need not be a BHC with assets over \$50 billion (subject to significant systemic standards under Dodd-Frank) or a nonbank financial company designated by the FSOC to be handled through OLA. Under stress, the process described above could be deployed by Treasury after a

¹¹ District Court for the District of Columbia, LCvR. 85. (July 6, 2011), *available at* http://www.dcd.uscourts.gov/dcd/sites/dcd/files/2011_LCvR_85_Dodd-Frank_Amended.pdf.

¹² FRB, *Proposed Rule on Definition of Predominantly Engaged in Financial Services*, 77 Fed. Reg. 21494 (Apr. 20, 2012), *available at* <http://www.gpo.gov/fdsys/pkg/FR-2012-04-10/pdf/2012-8515.pdf>.

stringent decision process that generally involves two-thirds majority votes of the FRB and the directors of the FDIC to bring an otherwise-undesignated financial firm, the failure of which could prove systemic, under OLA. This presents a potential asymmetry in rule – designated firms and large BHCs are subject to extensive, costly rules designed to limit systemic risk, but could still be exposed to it and/or forced to bear the cost of reimbursing taxpayers if OLA is deployed for an undesignated financial-services firm. This may be unfair, but it does not confer TBTF status on designated firms because OLA still requires the bankruptcy-style process described above and does not distinguish designees from other firms for which OLA could be deployed under stress.

Remaining OLA Issues

As the analysis above makes clear, the Dodd-Frank Act constructs a detailed framework for OLA designed to prevent bail-outs, a framework the FDIC has largely implemented in key respects. However, there are several outstanding uncertainties that will need to be resolved before OLA is complete and market participants can anticipate its impact should systemic risk force its use instead of the Bankruptcy Code. Remaining matters include:

Structure of Bridge Entities/SIFI Recapitalization

As noted, the bridge-entity powers provided under OLA are a critical difference from bankruptcy. Understanding how this would work is thus essential both for market participants and policy-makers. In May of 2012, Acting FDIC Chairman Gruenberg outlined how recapitalization through a bridge would work for financial holding companies that are deemed SIFIs and found to pose systemic risk when they are in danger of default.¹³ Mr. Gruenberg indicated that the FDIC plans to use both the receivership and bridge options described above to handle the most likely SIFI failures, cases in which a holding company controls an array of varying financial-services affiliates and subsidiaries in complex, often international structures difficult to parse without a legal-entity identifier (see below). Although bank failures are principally the result of solvency problems – that is, loan or other losses that eat through capital – complex SIFI losses would, Mr. Gruenberg says, most likely result from sudden liquidity shocks that cause failure for otherwise sound firms or expose solvency risk that could be cured over time. To address this under OLA, the FDIC plans to use receivership for a parent holding company – thus penalizing shareholders and top-tier management – and form a bridge financial company, to which the assets of the holding company, including the stock of the subsidiaries, would be transferred.

The use of a bridge company for the holding company would allow the FDIC as receiver to determine the most value-maximizing course of each action for the financial institution, instead of seeking an emergency over-arching acquisition that could exacerbate financial-system concentration and, over time, systemic risk. The FDIC anticipates that the bridge entities would generally honor derivative and other financial-market obligations and the receivership would have the equity in the bridge holding company (which houses all these bridged subsidiaries). However, prior shareholders and, perhaps, subordinated-debt holders of the parent company would see their interests liquidated in the receivership. To create the capital base for the bridge holding company, some of the debt of the failed parent company would be turned into equity for the bridge. If the bridge holding company still needed liquidity, the FDIC could

¹³ Acting FDIC Chairman Martin Gruenberg, *Remarks at Federal Reserve Bank of Chicago Bank Structure Conference* (May 10, 2012), available at <http://www.fdic.gov/news/news/speeches/chairman/spmay1012.html>.

provide it in the OLA framework from the Orderly Liquidation Fund. The FDIC could also guarantee some obligations of the bridge holding company, helping to stabilize it and secure additional liquidity.

This, the FDIC believes, accomplishes Dodd-Frank's requirement for loss to key counterparties and interested parties as well as OLA's goal of preventing systemic risk, while also providing an effective, rapid way to transition as much of the failed company as possible into new private hands. Importantly, even if the FDIC provided liquidity support or certain guarantees, any costs resulting from these supports would not, as discussed above, be borne by taxpayers.

Importantly, Mr. Gruenberg has indicated that this bridge framework will be clarified in rule and/or policy statements. These will be most useful in ensuring a complete understanding of these sometimes complex options and providing certainty to the markets about how OLA would be used in a systemic crisis.

Cross-Border Crises

Although global regulators have advanced the "key attributes" described above, actual resolution protocols and the data-sharing required to ensure orderly resolution remain incomplete for cross-border application. This results not only from the complexity of banking operations, but also importantly from the continued differences in banking structure in key financial markets. While some – e.g., the U.S. – plan for orderly liquidation with the express ban noted above on taxpayer support – others – e.g., the EU – are currently providing an array of direct and indirect sovereign supports to troubled banks. Unless or until these differences are resolved, the prospects for cross-border resolution protocols robust enough to function under stress are, at best, unclear. The recapitalization option noted above is in part to address these cross-border issues.

This is not to say, however, that orderly resolution in the U.S. and the resulting end to TBTF are endangered because of international TBTF uncertainty. Key actions in the U.S. – for example, the living wills noted above – are permitting advance planning by the FDIC and other regulators and giving them necessary information to handle cross-border failures or, if they determine that this is problematic, requiring a SIFI to restructure in advance of possible stress so that it is in fact resolvable despite its international operations. The U.S. is also in advanced discussions with the U.K. – where the majority of U.S. offshore banking assets are held – to harmonize resolution planning to ensure orderly liquidation for U.S./U.K. banking organizations.

Treatment of Broker-Dealers

OLA may be deployed for SIFIs with broker-dealer subsidiaries covered by the Securities Investor Protection Corporation (SIPC), the investor-protection scheme designed to reimburse broker-dealer customers under limited circumstances. These can be so limited and investor expectations under SIPC so high that broker-dealer resolutions in recent years (e.g., the Madoff case) have been problematic, leading some to consider statutory changes to SIPC to make it more akin to bank deposit insurance.¹⁴

¹⁴ *The Securities Investor Protection Corporation: Past, Present, and Future: Hearing Before the Subcommittee on Capital Markets and Government Sponsored Enterprises of the House Committee on Financial Services*, 112th Cong. (Mar 7, 2012), available at <http://financialservices.house.gov/calendar/eventsingle.aspx?EventID=282666>.

Dodd-Frank requires the FDIC to work with the Securities and Exchange Commission (SEC) to promulgate rules to clarify how OLA would be exercised in the event of a broker-dealer insolvency. These rules and, perhaps, broader changes to SIPC must be in place before it is clear how a broker-dealer subsidiary of a SIFI, including a large banking organization, would be handled under OLA. A joint FDIC/SEC rulemaking is noted by the FDIC as an outstanding OLA matter to be addressed at a future date. Even in the absence of these rules, however, OLA clearly bars TBTF protection for counterparties of a broker-dealer beyond that provided under SIPC or a similar safety net for a parent of a broker-dealer.

FCMs

FCMs could also come under OLA, although there now is no resolution protocol for FCMs akin to those applicable to insured depositories, some insurance companies and SIPC-covered broker-dealers. The FDIC has planned to issue rules in this area, but also to coordinate its actions with the Commodity Futures Trading Commission (CFTC). In the wake of recent failures (e.g., MF Global), the CFTC is beginning to contemplate a new FCM resolution regime that would better protect individual investors without resulting in TBTF.

In August of 2012, CFTC Commissioner Bart Chilton proposed a “Futures Investor and Customer Protection Fund.” The construct is modeled on the SIPC, not FDIC, and thus poses a series of questions that must be addressed in concert with the SIPC ones noted above.¹⁵ It would require statutory action and thus has an uncertain future that cannot be known in the near term. Again, though, absence of a specific FCM-coverage scheme creates uncertainty for affected investors, but does not afford TBTF protection for FCMs, affiliated companies or parent entities.

Qualified Financial Contracts (QFCs)

The FDIC also has plans to mandate new QFC record-keeping requirements that would help it monitor these commitments at SIFIs. QFCs are an array of derivatives and similar financial obligations that are not subject to the automatic stay in bankruptcy, but are protected under the Bankruptcy Code, FDIC resolution protocols for insured depositories and other resolution protocols on the grounds that treating QFCs in an undifferentiated manner from other contracts could wreak havoc in financial markets. Conversely, automatic protection for QFC counterparties could lead to moral hazard, as counterparties would have little reason to reduce risk to troubled firms because they could be secure regardless of the firm’s fate. Under OLA, QFCs are subject to a one-day stay, following which the FDIC can repudiate the QFC or transfer it to a bridge entity.

Various alternatives to OLA address the QFC issue.¹⁶ These variations on OLA could better reconcile the complexities of ensuring orderly markets without creating moral hazard. However, as the FRB study cited above concluded, no option yet has resolved this issue in definitive fashion, especially taking other concerns – e.g., cross-border resolution – into account. Thus, OLA may be seen as a near-term solution

¹⁵ CFTC Commissioner Bart Chilton, *Statement on the Futures Investor and Customer Protection Act (FICPA) Proposal* (Aug. 9, 2012), available at <http://cftc.gov/PressRoom/SpeechesTestimony/chiltonstatement080912>.

¹⁶ Ken Scott, Stanford Law School, *A Guide to the Resolution of Failed Financial Institutions: Dodd-Frank Title II and Proposed Chapter 14* (Feb. 29, 2012), available at <http://media.hoover.org/sites/default/files/documents/guide-to-resolution-project-20120302.pdf>.

to QFCs that does not permit TBTF even if it does not fully answer all questions in this complex area. Reflecting this continued uncertainty, regulators are taking immediate action to force SIFIs to plan for QFC claims under various resolution regimes.¹⁷

Bankruptcy-Equivalence Test

As discussed above, OLA is to ensure that creditors and other counterparties receive at least what would be likely under a Chapter 7 bankruptcy proceeding (i.e., liquidation). Doing so is, however, complicated by the need for the FDIC very quickly to value a failed SIFI under Chapter 7. The FDIC is working on a minimum-recovery protocol to be proposed shortly in regulatory form to address this important issue.

Living Wills

As discussed throughout this paper, advance planning for resolution has been deemed essential by the Dodd-Frank Act, FSB and U.S. regulators. It is an important element of the FSB's "key attributes," but only the U.K. and U.S. have taken clear steps to require robust resolution and recovery plans from SIFIs. These include the FRB/FDIC rules noted above for SIFIs and new FDIC living will requirements for large insured depositories.¹⁸ The first round of SIFI resolution plans was filed by nine large banking organizations in July of 2012, and additional plans are due in coming years from all BHCs with assets over \$50 billion, including certain foreign banking organizations and, when designated, any nonbank SIFIs.

The U.S. SIFI rules cited above require covered firms to file an array of highly-proprietary information with the FRB and FDIC, stress test key assumptions, describe contingency plans to ensure recovery and lay out plans for resolution under the Bankruptcy Code should it be needed. The law mandates this focus on bankruptcy, not OLA, for two important purposes: first, to facilitate use of bankruptcy to prevent any expectation of benefit under OLA and second, to make it easier for the FDIC to anticipate potential bankruptcy recoveries to meet OLA's requirement for creditor/counterparty protection equivalent to Chapter 7 to the greatest degree possible. Living wills do not resolve the questions to be addressed in pending rules for SIFIs with broker-dealers, FCMs or insurance subsidiaries, but they lay out plans to handle resolution to ensure orderly resolution regardless of these exogenous uncertainties. Public disclosures are also required of the summary assumptions and plans in these filed living wills, giving market participants insight into both how the plans are structured and the rigor with which the regulators have judged them. Should regulators not approve of a SIFI's resolution plan, Dodd-Frank gives them sweeping authority to require structural changes – e.g., divestiture of problematic activities – to force reorganization into a form the agencies deem more amenable to quick resolution under bankruptcy.

Despite these stringent requirements, some critics have suggested that firms are not filing meaningful living wills, that the FRB and FDIC lack the expertise to judge them and/or that all this planning simply cannot account for stress occurring when market forces affect financial-services firms in general, not one firm subject to idiosyncratic problems. Given the formative stage of these living wills, the FRB and

¹⁷ Bank for International Settlements, Basel Committee on Banking Supervision, *Supervisory Guidance for Managing Risks Associated with the Settlement of Foreign Exchange Transactions – Consultative Document* (Aug. 2012), available at <http://www.bis.org/publ/bcbs229.pdf>.

¹⁸ FDIC, FRB, *Final Rule on Resolution Plans Required*, 76 Fed. Reg. 67323 (Nov. 1, 2011), available at <http://www.gpo.gov/fdsys/pkg/FR-2011-11-01/pdf/2011-27377.pdf>.

FDIC have promised to review them in what has been described as an “iterative” fashion – that is, to discuss concerns with filing institutions and seek to resolve them, not initially to sanction firms filing deficient plans. It is thus premature to judge U.S. living wills and regulatory determination to ensure OLA’s effective deployment. It is not, however, too early to note the stringency of these rules, the complex plans filed to date, the scrutiny over them now under way and the power of law and rule given the FRB and FDIC to regulate SIFIs to ensure orderly resolution under bankruptcy. Importantly, these regulators are also using living wills to refine their own resolution plans.

Financial-Market Infrastructure

Often overlooked in the discussion of systemic risk is the role played by firms that provide the infrastructure for financial markets – most importantly, the payment, settlement and clearing services used to handle banking transactions, derivatives deals and securities trades. These firms, called “financial market utilities” (FMUs) in the Dodd-Frank Act¹⁹ are as important to preventing systemic risk as plumbing is to ensuring an orderly household, but their seemingly prosaic nature is often overlooked in discussions of TBTF.

It has not, however, been overlooked by global and U.S. regulators. The FRB has issued final standards establishing risk-management requirements for FMUs²⁰ and the global Committee on Payment and Settlement Systems (CPSS), in conjunction with the International Organization of Securities Commissions (IOSCO), has issued a new global regulatory framework for them.²¹ The FRB’s standards do not address FMU resolution, but draft standards from the CPSS and IOSCO do so.²² Once these are finalized, the FRB plans to act on them, adding another important plank to U.S. financial standards that prevents TBTF concerns for FMUs and provides an essential safeguard for financial markets.

Legal-Entity Identifier (LEI)

G-20 summits have identified establishment of a legal-entity identifier as an important safeguard against systemic risk, leading to an array of efforts under the FSB to finalize global protocols for the LEI.²³ These identifiers are set for launch in March of 2013, although it is still unclear how they will be structured or the degree to which they will be truly comparable across national borders. The U.S. has, however, taken the first steps on its own to establish an LEI for use by the CFTC with regard to commodity-swap reporting.²⁴

Although incomplete, work to establish LEIs does address several critical resolution questions. With these identifiers or similar standards set within national regimes, banks can readily identify their ultimate

¹⁹ Dodd-Frank Act, §§ 802-814.

²⁰ FRB, *Final Rule on Financial Market Utilities*, 77 Fed. Reg. 45907 (Aug. 2, 2012), available at <http://www.gpo.gov/fdsys/pkg/FR-2012-08-02/pdf/2012-18762.pdf>.

²¹ Bank for International Settlements, CPSS, *Principles for Financial Market Infrastructures* (Apr. 16, 2012), available at <http://www.bis.org/publ/cpss101a.pdf>.

²² Bank for International Settlements, CPSS, *Recovery and Resolution of Financial Market Infrastructures* (July 31, 2012), available at <http://www.bis.org/publ/cpss103.htm>.

²³ FSB, *Progress Note on the Global LEI Initiative* (Aug. 23, 2012), available at http://www.financialstabilityboard.org/publications/r_120823.pdf.

²⁴ CFTC, *Announcement on Website to Register for CFTC Interim Compliant Identifiers* (Aug. 21, 2012), available at <http://cftc.gov/PressRoom/PressReleases/pr6331-12>.

counterparty through a sometimes complex maze of legal affiliates and indirect linkages. This has significant overall prudential value, but also facilitates resolution in several respects.

First, LEIs make it possible for regulators like the FDIC to spot very large exposure counterparties in resolution plans that can be reduced as part of the regulatory response to any living-will concerns. Secondly, LEIs facilitate regulatory understanding of the full scope of a firm's operations across business lines and/or borders, cutting through corporate charts (often organized by business line, not legal charter) to show clearly how a SIFI is structured and where intra-group exposures may be problematic.

Data/Process Uncertainties

It remains difficult to judge OLA because research and data on SIFI resolution is incomplete. Reflecting this, the Administrative Office of the U.S. Courts (AOUS) and the Federal Judicial Center have begun a new tracking system for financial bankruptcies, but its ability to support an end to TBTF through ready use of bankruptcy is unknown.

What Happens When a SIFI Falter?

Finally, this paper assesses what would happen under OLA were a SIFI to stumble with potential systemic consequence. As noted, there are numerous outstanding questions, most importantly what would happen if a SIFI has extensive cross-border operations, the procedures for handling holding companies and how QFCs will be addressed. There are also different ways in which a SIFI could experience acute stress that affects whether and how OLA is deployed. In the wake of the 2008 crisis, systemic risk is often attributed to bank recklessness and/or regulatory obliviousness, causes that then lead to recommendations for punitive resolution regimes. However, as history has frequently demonstrated, systemic risk can arise from causes beyond the control of an individual institution or those so extreme in nature that even the best-laid rules can be overwhelmed. These systemic risks can be described as:

- **Liquidity Risk:** This can occur when a firm (e.g., Lehman Brothers) fails to match its assets to its liabilities, leaving it unable to fund day-to-day operations despite holdings of sizeable assets that, given time, can be liquidated for more than sufficient value to honor claims. These crises can sometimes be attributed to risk-management lapses of startling proportions at a single institution. However, liquidity risk also can occur widely across financial markets, capturing prudent firms, when short-term funding crises are caused by failure of a major counterparty or provider of critical payment, settlement or clearing services. In such a case, a SIFI can be caught short – unable to honor its overnight calls – even though, given time, it has ample resources with which to make whole its creditors and counterparties. Contingency planning can cushion the blow of these external liquidity strains, but not always cure them, especially when operational risk causes a major trans-market crisis.
- **Operational Risk:** This results when idiosyncratic incidents like trading fraud threaten market confidence in a single institution, again cases in which risk-management problems specific to a single firm are at fault. However, operational risk also comes from broader threats (terrorism, natural disasters, cyber-crime) that incapacitate vital market functions. Again, firms are solvent, but temporarily under such acute stress that they may not be able to meet

their obligations. And, again, contingency planning is an essential risk preventative, but not a fail-safe cure.

The FDIC has begun a series of exercises in which it takes a sample situation and/or institution(s) and maps out how a systemic incident would be handled to minimize use of OLA and prevent systemic risk. These exercises rightly are not made public (although over time the FDIC is expected to issue transparent descriptions of its general procedures to buttress market confidence in policies and to ensure that counterparties, creditors and others take prudent steps to exert market discipline on troubled SIFIs). The FDIC has, however, published a case study of how it could handle a Lehman-style failure under OLA,²⁵ providing useful insights into its procedures. Also of note with regard to judging OLA to date is a 2011 exercise in which *The Economist* gathered a group of former senior policy-makers (e.g., an ex-Secretary of the Treasury) to “game” a SIFI failure.²⁶ This group concluded that recapitalization would work well under stress for SIFIs without affording a target firm TBTF protection.

²⁵ FDIC, *The Orderly Liquidation of Lehman Brothers Holdings, Inc. under the Dodd-Frank Act* (Apr. 2011), available at http://www.fdic.gov/bank/analytical/quarterly/2011_vol5_2/lehman.pdf.

²⁶ The Economist, *Fright Simulator: How to Deal with a Collapsing Bank under the Dodd-Frank Rules* (Nov. 12, 2011), available at <http://www.economist.com/node/21538164>.