Stanley Fischer: Comments on the Resolution Framework for Banks and Bank Holding Companies in the United States

Speech by Mr Stanley Fischer, Vice Chair of the Board of Governors of the Federal Reserve System, at the Panel Discussion on Resolution Riksbank Macroprudential Conference, Stockholm, 22 June 2016.

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I'm grateful to the organizers for inviting me to participate in this conference. I would like briefly to describe the legal frameworks that exist for resolving banking organizations in the United States, the steps that the Federal Reserve and other U.S. regulators have taken to make global systemically important banking organizations (GSIBs) in the United States more resolvable, and a few of the criticisms of U.S. regulatory actions in this area, together with my responses to them.

U.S. law provides several legal frameworks for resolving failed financial firms. In the United States, a failed depository institution is resolved by the Federal Deposit Insurance Corporation (FDIC) using a framework created by the Federal Deposit Insurance Act. The FDIC has acted as receiver for several thousand failed banks since 1934, including 465 from 2008 through 2012. Most of these failed banks were relatively small community banks, and all were considerably smaller than the most systemically important firms active today.[1]

While the Federal Deposit Insurance Act creates a special resolution framework for failed *banks*, a failed U.S. *bank holding company* – that is, a corporate entity that controls one or more banks – would generally be resolved under the same provisions of the U.S. Bankruptcy Code as would apply to other corporate debtors, such as industrial firms, in a proceeding overseen by a federal judge. During the recent crisis, fears about the systemic consequences that would follow from the bankruptcies of systemically important financial firms motivated extraordinary government actions to prevent such firms from failing. Unfortunately, the fears proved well founded: The bankruptcy of Lehman Brothers Holdings – the largest bankruptcy filing in American history – significantly exacerbated the crisis.[2]

To increase the viability of the Bankruptcy Code as a framework for resolving failed financial firms without major systemic consequences, section 165(d) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act) requires large banking organizations to produce resolution plans, also known as living wills, demonstrating how they could be resolved under the Bankruptcy Code in an orderly fashion in the event of failure.

Although the Bankruptcy Code provides the default legal framework for the resolution of a failed bank holding company, Title II of the Dodd-Frank Act creates a backup resolution framework, called the orderly liquidation authority, to be used if the resolution of a failed financial company under the Bankruptcy Code would have serious adverse effects on U.S. financial stability. If that criterion and several others are met, Title II allows the Secretary of the Treasury to appoint the FDIC as receiver for the failed financial company as an

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1 The average (per bank) assets of the 465 banks resolved by the FDIC between 2008 and 2012 was roughly $1.5 billion, with a total of $680.3 billion. The largest depository institution ever resolved by the FDIC was Washington Mutual, which was resolved in 2008 and had total assets of $307 billion prior to failure.

2 Lehman's pre-bankruptcy total assets were $691 billion. The second-largest bankruptcy in American history was the bankruptcy of Washington Mutual, Inc., the savings and loan holding company that owned Washington Mutual; its pre-failure total assets were nearly $328 billion. Both Lehman and Washington Mutual filed for bankruptcy in September 2008.

alternative to a bankruptcy resolution overseen by a judge. The orderly liquidation authority has several features that could reduce the systemic effect of a financial company's failure relative to a bankruptcy resolution, including an orderly liquidation fund to provide government liquidity support for the failed firm and provisions to prevent the unwinding of the failed firm's derivatives and other qualified financial contracts while they are transferred to a solvent firm.

The Federal Reserve Board has recently proposed important new rules to increase the prospects for the orderly resolution of a GSIB with minimal effect on financial stability. Last October, the Board proposed a rule to subject the eight U.S. GSIBs to total loss-absorbing capacity (TLAC) and long-term debt requirements, building on the international TLAC standard established by the Financial Stability Board.[3] The proposal would require these systemically important firms to maintain outstanding a large quantity of long-term debt that could be used to absorb losses and recapitalize the firm in an orderly resolution under either the Bankruptcy Code or the orderly liquidation authority.[4]

The proposal would also apply internal TLAC and long-term debt requirements to the U.S. intermediate holding companies of foreign GSIBs in order to facilitate the recapitalization of a failed foreign GSIB's U.S. operations. Finally, the proposal would restrict the operations of GSIB holding companies (as distinct from their operating subsidiaries) so that those legal entities could go through a resolution proceeding without setting off short-term wholesale funding runs or otherwise jeopardizing financial stability.

In May of this year, the Board issued another proposal to make GSIBs more resolvable. This second proposed rule would impose restrictions on GSIBs' qualified financial contracts – including derivatives and repo agreements – to guard against the mass unwinding of those contracts during the resolution of a GSIB.[5] The proposed restrictions are a key step toward GSIB resolvability because the rapid unwinding of a GSIB's qualified financial contracts could destabilize the financial system by causing asset fire sales and toppling other firms.

Acting in conjunction with the FDIC, the Federal Reserve Board has also sought to increase GSIB resolvability through its review of the firms' living wills. In April this year, the Board and the FDIC announced the results of their review of the eight U.S. GSIBs' 2015 resolution plans, which evaluated the plans based on the firms' capital, liquidity, governance mechanisms, operational capabilities, legal entity rationalization, derivatives and trading activities, and responsiveness to prior agency feedback.[6]

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[3] Board of Governors of the Federal Reserve System (2015), "Federal Reserve Board Proposes New Rule to Strengthen the Ability of Largest Domestic and Foreign Banks Operating in the United States to Be Resolved without Extraordinary Government Support or Taxpayer Assistance," press release, October 30.

[4] Under the proposal, a U.S. GSIB would be required to hold at a minimum (i) a long-term debt amount of the greater of 6 percent plus its GSIB surcharge of risk-weighted assets and 4.5 percent of total leverage exposure and (ii) a TLAC amount of the greater of 18 percent of risk-weighted assets and 9.5 percent of total leverage exposure. See Board of Governors of the Federal Reserve System (2015), "Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations; Regulatory Capital Deduction for Investments in Certain Unsecured Debt of Systemically Important U.S. Bank Holding Companies," notice of proposed rulemaking (Docket No. R-1523), *Federal Register,* vol. 80 (November 30), pp. 74931–32. The GSIB has to satisfy both constraints. TLAC encompasses both equity capital and eligible long-term debt.

[5] See Board of Governors of the Federal Reserve System (2016), "Federal Reserve Board Proposes Rule to Support U.S. Financial Stability by Enhancing the Resolvability of Very Large and Complex Financial Firms," press release, May 3.

[6] See Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation (2016), "Agencies Announce Determinations and Provide Feedback on Resolution Plans of Eight Systemically Important, Domestic Banking Institutions," joint press release, April 13.

The agencies found that five of the GSIBs' plans fell short of the Dodd-Frank Act's standard and required those firms to fix the deficiencies in their plans by October of this year or potentially face more stringent prudential requirements. The agencies also identified less-severe shortcomings in the plans of all eight GSIBs, which the GSIBs are expected to address in their next round of resolution plan submissions, due in July 2017. The deficiencies and shortcomings identified by the agencies touched on most of the categories I have just listed, especially liquidity, governance mechanisms, operational capabilities, and legal entity rationalization.

I want to end by briefly addressing several criticisms that have been made of the Dodd-Frank Act's orderly liquidation authority and the Board's TLAC proposal. One criticism is that there is no need for the backup orderly liquidation authority because the Bankruptcy Code provides an adequate framework for the resolution of any financial company. As Title II of the Dodd-Frank Act recognizes, however, the Bankruptcy Code may not be adequate to minimize the systemic impact of the resolution of a systemically important financial firm. The Bankruptcy Code does not direct the judge to take financial stability into account in making decisions, and it does not provide other important stabilizing features of the orderly liquidation authority, such as government liquidity support and stay-and-transfer treatment for qualified financial contracts.

A related line of criticism holds that the orderly liquidation authority enshrines "too big to fail" and provides for taxpayer bailouts of systemically important firms through the orderly liquidation fund. However, under the Board's proposed TLAC rule, a failed GSIB would be recapitalized by its private-sector long-term creditors (whose debt claims would be converted into equity), not by the government. The orderly liquidation fund would be used only to provide liquidity support, not to inject capital, and in the unlikely event that the fund does incur losses, the Dodd-Frank Act provides that these losses would be covered by assessments on major financial companies and would not be passed on to taxpayers. I also note that credit rating agencies have recognized public-sector efforts to end the too-big-to-fail phenomenon. The rating agencies no longer assume that the U.S. government will take extraordinary actions to prevent the failure of systemically important U.S. financial firms.

Finally, one criticism that has been leveled at our TLAC proposal is that imposing long-term debt requirements on GSIBs will lead those firms to increase their leverage and thereby raise their probability of failure, and that they should instead be required to hold higher levels of equity capital. I agree that equity capital plays a key role in preventing financial firm failures, and we have raised equity capital requirements for banking organizations – especially GSIBs – substantially since the crisis. But to protect financial stability, we must reduce not only the probability that a GSIB will fail, but also the damage that its failure could do if it were to occur. At the point of failure, a banking firm's equity capital is likely to be zero or negative, so to improve GSIB resolvability, our proposal requires GSIBs to have a thick tranche of gone-concern loss-absorbing capacity to ensure that resolution authorities will have the necessary raw material to manufacture fresh equity and recapitalize and stabilize the firm.[7] That is the role played by the proposal's long-term debt requirements. And we expect that firms would generally come into compliance with the proposed requirements by replacing existing ineligible liabilities with eligible long-term debt rather than by increasing their leverage. At any rate, even if a firm were to come into compliance in part by increasing the size of its balance sheet, it would remain subject to our robust equity capital requirements and leverage limits, which are designed to ensure a very low probability of failure. Finally, the existence of a thick

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7 See Board of Governors (2015), "Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements," in note 5. Under the proposal, a U.S. GSIB would be subject to external long-term debt requirements of 6 percent of risk-weighted assets plus the amount of the risk-based capital surcharge applicable to the GSIB under the Board's GSIB surcharge rule and 4.5 percent of total leverage exposure.

tranche of loss-absorbing long-term debt should reduce a GSIB's probability of failure by reducing its short-term creditors' incentives to run at the first sign of distress.

In short, we and other U.S. regulators are working hard to address the too-big-to-fail problem by improving the prospects for the orderly resolution of a GSIB in the United States. The Dodd-Frank Act gave us tools to reduce the probability of failure of our largest and most complex banking firms and to significantly reduce the damage that the failure of such a firm would do to the U.S. financial system and the broader economy. We have made a lot of progress toward accomplishing these goals, leaving the U.S. banking system fundamentally safer and stronger, and our work in this area will continue.

Thank you.