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The Orderly Liquidation Authority: Reform Proposals

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The Orderly Liquidation Authority (OLA) was created by Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203; Dodd-Frank) to allow the Federal Deposit Insurance Corporation (FDIC) to resolve certain failing financial institutions whose collapse could threaten the stability of the financial system. Although OLA has never been used, it has become the subject of a number of reform proposals. This Insight briefly describes the OLA and two prominent examples of such proposals.

Overview

A failed company (banks and insurance companies are notable exceptions) will generally go through a bankruptcy—a judicial process that often imposes losses on the company's shareholders and creditors. However, in the case of large, complex financial institutions, some observers argue the bankruptcy process could potentially destabilize the financial system and result in devastating economic outcomes, citing Lehman Brothers' 2008 bankruptcy as an example. Thus, the government may feel compelled to provide assistance to (or "bailout") such an institution to prevent bankruptcy. Expectations of government support are problematic because they expose taxpayers to potential losses and cause market distortions.

One Dodd-Frank measure taken to eliminate expectations of government support of individual institutions was the creation of OLA, an administrative resolution regime that grants the FDIC the authority to resolve a nondepository financial institution. OLA is similar to the FDIC's existing authority to resolve a depository institution outside of traditional bankruptcy. It is intended to be a backup option used only if the Treasury and designated financial regulators determine that the first-choice option of bankruptcy would destabilize the financial system.

Title II requires an institution's equity and debt holders to bear the losses resulting from a failure first, not the government and taxpayers. To facilitate the process, if needed, the FDIC can draw funds from the Orderly Liquidation Fund (OLF; also established by Title II) at the Treasury. If the OLF is used, subsequent to the resolution, the FDIC is required to assess sufficient fees on large financial firms to offset any costs. The OLF is not "prefunded" so there could be temporary losses for the government and taxpayers until the funds are recovered from the large financial firms.

Proposed Reforms

OLA is a contentious issue and policy perspectives range from supporting OLA to proposing a full repeal of OLA in conjunction with amending the bankruptcy code.

Proponents of OLA assert that it offers an alternative means of avoiding systemic financial distress resulting from a financial institution failure without relying on ad hoc government intervention and funding. They argue a resolution process carried out by technical experts is likely to be less disruptive to the financial system than a process overseen by a bankruptcy judge who may be unfamiliar or inexperienced with such institutions.

Critics of OLA argue that the resolution of a depository—even a large one—is substantially different from the resolution of a complex financial institution and voice doubts that OLA is the right mechanism to smoothly resolve such an institution. Critics also assert that OLA gives policymakers too much discretionary power, which could result in higher costs to the government and preferential treatment of favored creditors during the resolution, thus perpetuating market distortions.

Among critics of OLA, there is disagreement on what is the best approach, as demonstrated by the Financial CHOICE Act and the February 2018 Treasury OLA report. The Financial CHOICE Act (H.R. 10), which passed the House in June 2017, would, among other things, repeal OLA and amend existing bankruptcy code chapters to provide an alternative approach to resolving a failing nonbank financial company. Supporters of H.R. 10 argue that the amended bankruptcy chapters would provide a better mechanism to resolve financial companies, protect taxpayers, and promote market discipline.

In February 2018, the Treasury Department issued a report in response to an April 2017 memorandum in which the President directed the Treasury Department to consider whether OLA or an improved bankruptcy process would be a better method for the resolution of financial companies and to propose recommendations for reform. The report recommended an enhanced bankruptcy regime for financial companies and reforms to OLA. The report stated that "existing provisions of the bankruptcy code were not designed with the resolution of a large, complex financial corporation in mind." Echoing the arguments made by supporters of H.R. 10, the report recommended creating a new chapter of the Bankruptcy Code specifically for distressed financial companies that preserve the advantages of the existing bankruptcy process and create tailored features that address the unique challenges posed by large interconnected financial companies.

Unlike the approach proposed by H.R. 10, the report, however, also identified challenges the new bankruptcy process could encounter, such as accessing sufficient liquidity to facilitate the resolution and developing sufficient judicial expertise. To address these concerns, the Treasury report recommended retaining OLA with reforms including, among other things:

eliminating FDIC's authority to treat similarly situated creditors differently on an ad hoc basis,

using private-sector borrowing instead of direct lending from the Treasury Department to fund the OLF,

limiting the duration of OLF funding and using assessments on financial institutions as soon as possible to recoup losses on unpaid OLF loans, and

reforming certain judicial review provisions related to the Treasury petitioning for an order authorizing the appointment of a receiver to resolve a failing financial institution.

In response to the Treasury report, some Members of Congress have expressed disappointment in certain aspects of the report's recommendations, including that Treasury did not recommend the repeal of OLA.

Federal Budgetary Impact

As mentioned above, OLA is designed to prevent taxpayer losses by assessing fees on financial institutions after the fact to recoup losses. However, due largely to scoring conventions, The Congressional Budget Office (CBO) estimates in its May 2017 score of H.R. 10 that eliminating the OLF would reduce the deficit by an estimated $14.5 billion. The CBO estimate is for a 10-year window, and the agency forecast said that, if used, OLF funds would not necessarily be recouped within that timeframe.