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# **“Living Wills”: The Legal Regime for Constructing Resolution Plans for Certain Financial Institutions**

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## Summary

One of the chief objectives of the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA) is to promote financial stability within the United States, without the need for emergency governmental assistance to troubled firms. To achieve this goal, the DFA establishes a heightened regulatory regime for certain, generally large “covered financial institutions.” A pillar of this heightened regulatory regime is that each covered financial institution must submit “credible” plans to the Board of Governors of the Federal Reserve System (FRB) and the Federal Deposit Insurance Corporation (FDIC) detailing how the firm could be quickly resolved in an orderly fashion under the U.S. Bankruptcy Code or other applicable insolvency regime “in the event of a material financial distress or failure.” These resolution plans are commonly referred to as “living wills.”

Over 130 institutions have filed at least one resolution plan with regulators. Each of the 11 largest financial firms in the U.S., which each hold more than \$250 billion in nonbank assets, has filed at least two resolution plans. However, all 11 of these companies’ plans, in spite of the fact that some of them span tens of thousands of pages, have fallen short of the minimum requirements of the DFA’s living wills regime in the discretionary view of the FRB and FDIC. The 11 firms’ next living wills are due July 2015. If any of these plans is determined to be insufficient, then the FRB and FDIC have expressed their intent “to use their [enforcement] authority under [DFA] section 165(d),” which eventually could include the power to require an institution “to divest certain assets or operations ... to facilitate an orderly resolution....”

This report reviews the legal structure of the DFA’s living will requirements, pursuant to both DFA Section 165(d) and the regulations and guidance issued jointly by the FRB and FDIC, and explains the August 2014 joint announcement of the FRB and FDIC regarding the inadequacies of the 2013 living wills filed by the 11 largest, most complex financial institutions in the country. This report also examines some of the steps that these institutions might voluntarily take, which, in the view of the FRB and FDIC, would improve their resolvability, including strategic divestiture; legal reorganization; amendment of default trigger provisions of qualified financial contracts; and increasing their long-term, unsecured debt as a proportion of their assets.

In addition to voluntary measures, there are bills in the 113<sup>th</sup> Congress that would change how financial institutions are regulated to promote the financial stability of the United States. For example, H.R. 46 and S. 20, the Financial Takeover Repeal Act of 2013, would repeal the DFA in its entirety, including the provisions designed to promote financial stability. H.R. 5421, the Financial Institution Bankruptcy Act of 2014, and a similar bill, S. 1861, the Taxpayer Protection and Responsible Resolution Act, would make changes to the Bankruptcy Code to facilitate the resolution of financial institutions. H.R. 1450/S. 685, the Too Big to Fail, Too Big to Exist Act, would require the Secretary of the Treasury to identify all financial institutions it considers to be “too big to fail,” and to “break up [these] entities ... so that their failure would no longer cause a catastrophic effect on the United States or global economy without taxpayer bailout.” And H.R. 613, the Systemic Risk Mitigation Act, would among other things, require every bank holding company with \$50 billion or more in consolidated assets to hold long-term, subordinated debt of the value of at least 15% of its total consolidated assets. Proponents argue that this could help promote the long-term viability of the firm and, if the firm actually fails, help absorb some of its losses.

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## Introduction

One of the chief objectives of the Dodd-Frank Wall Street Reform and Consumer Protection Act (DFA)<sup>1</sup> is to promote financial stability within the United States,<sup>2</sup> without the need for emergency governmental assistance to troubled firms like that provided by the Troubled Asset Relief Program (TARP) in 2008.<sup>3</sup> In fact, the first two titles of the DFA are devoted specifically to that policy objective.

Title I establishes the Financial Stability Oversight Council (FSOC)—a council of financial regulators<sup>4</sup> authorized “to identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected [financial institutions]” and generally “to respond to emerging threats to the stability of the United States financial system.”<sup>5</sup> Title I also establishes a heightened regulatory regime for domestic bank holding companies with \$50 billion or more in consolidated assets, certain foreign banks and foreign bank holding companies with \$50 billion or more in total consolidated assets,<sup>6</sup> and certain nonbank financial institutions that are designated by a 2/3 vote of the FSOC as potentially systemically significant. These “covered financial institutions” are subject to, among other things, heightened capital requirements and more restrictive leverage ratios than their smaller, less complex peers.

Additionally, a pillar of this heightened regulatory regime is that each covered financial institution must submit “credible” plans to the Board of Governors of the Federal Reserve System (FRB) and the Federal Deposit Insurance Corporation (FDIC) detailing how the firm could be

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<sup>1</sup> P.L. 111-203.

<sup>2</sup> The preamble to the DFA states: “To promote financial stability of the United States by improving accountability and transparency in the financial system, to end ‘too big to fail,’ to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.”

<sup>3</sup> TARP was implemented pursuant to the Emergency Economic Stabilization Act of 2008, P.L. 110-343. For more information on TARP, see CRS Report R41427, *Troubled Asset Relief Program (TARP): Implementation and Status*, by Baird Webel.

<sup>4</sup> The voting members of the FSOC are: the Secretary of the Treasury; the Chairman of the Board of Governors of the Federal Reserve System (FRB); the Chairperson of the Federal Deposit Insurance Corporation (FDIC); the Comptroller of the Currency; the Director of the Bureau of Consumer Financial Protection (CFPB); the Chairman of the Securities and Exchange Commission (SEC); the Chairperson of the Commodity Futures Trading Commission (CFTC); the Director of the Federal Housing Finance Agency (FHFA); the Chairman of the National Credit Union Administrations (NCUA), and a presidential appointee with expertise in insurance. There also are five nonvoting members of FSOC. For more information on the FSOC, see CRS Report R42083, *Financial Stability Oversight Council: A Framework to Mitigate Systemic Risk*, by Edward V. Murphy.

<sup>5</sup> 12 U.S.C. §5322(a).

<sup>6</sup> The DFA provides the FRB the flexibility to establish heightened prudential standards that account for the distinctions between the three classes of covered financial institution, including considerations regarding the prudential standards to which foreign-based covered institutions are subject in their home countries. 12 U.S.C. §5365(b)(2). See also Enhanced Prudential Standards for Bank Holding Companies and Foreign Bank Holding Companies, 79 Fed. Reg. 17,240, 17,263-64 (Mar. 27, 2014) (“In applying section 165 to a foreign-based bank holding company, the [DFA] directs the [FRB] to give due regard to the principle of national treatment and equality of competitive opportunity, and to take into account the extent to which the foreign banking organization is subject, on a consolidated basis, to home country standards that are comparable to those applied to financial companies in the United States. Section 165 also directs the [FRB] to take into account differences among nonbank financial companies, bank holding companies, and foreign banking organizations based on a number of factors.”).

quickly resolved in an orderly fashion under the U.S. Bankruptcy Code<sup>7</sup> or other applicable insolvency regime<sup>8</sup> "in the event of a material financial distress or failure." These resolution plans are commonly referred to as "living wills." If a covered financial institution fails to submit a "credible" resolution plan in the discretionary view of both the FRB and FDIC, then the company could be subject to enforcement actions, including the compelled divestiture of certain business lines and assets, as a means to foster its resolvability. The DFA does not explicitly define what it means to be "credible," thus providing the FRB and FDIC considerable discretion to implement the living wills regime.

Relatedly, Title II of the DFA<sup>9</sup> establishes a special insolvency regime that could be used if it were determined that the failure or financial distress of a bank or nonbank financial institution<sup>10</sup> poses a systemic threat to the U.S. financial system in spite of the heightened regulatory regime established by DFA, Title I and related financial laws and regulations. The Title II insolvency regime, called Orderly Liquidation Authority (OLA), would be administered by the FDIC.<sup>11</sup> Under OLA, the FDIC generally would have to liquidate the failed firm within five years,<sup>12</sup> and, although public funds could be used initially, the cost of the resolution ultimately is intended to be paid for through the assets of the failed company or, if necessary, post-hoc assessments on surviving covered financial institutions.<sup>13</sup>

A financial firm generally can only be subject to OLA if:

- 2/3 of the FRB and either 2/3 of the Board of Directors of the FDIC, 2/3 of the Securities and Exchange Commission,<sup>14</sup> or the Director of the Federal Insurance Office<sup>15</sup> vote to recommend the appointment to OLA based on a series of statutory standards, including an evaluation of the impact that the company's failure would have on financial stability;<sup>16</sup> and

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<sup>7</sup> U.S. Code, Title 11.

<sup>8</sup> E.g., the FDIC's conservatorship/receivership insolvency regime for FDIC-insured depository institutions; state insolvency regimes for insurance companies; and the insolvency regime established by the Securities Investor Protection Act for broker-dealers.

<sup>9</sup> 12 U.S.C. §§5381-93.

<sup>10</sup> A financial institution does not have to be a covered financial institution subject to heightened regulation by the FRB in order to be placed in this special insolvency regime. 12 U.S.C. §§5381, 5383.

<sup>11</sup> 12 U.S.C. §5383(a)(1)(A).

<sup>12</sup> 12 U.S.C. §5382(d).

<sup>13</sup> 12 U.S.C. §§5384(d), 5390(n)(9), 5390(o), 5394(b). Any assessments charged against surviving covered financial institutions would be risk-based, "with financial companies having greater assets and risk being assessed at a higher rate." 12 U.S.C. §5390(o)(2).

<sup>14</sup> The SEC would be involved in the recommendation for financial firms whose largest domestic subsidiary is a broker or dealer. 12 U.S.C. §5383(a)(1)(B).

<sup>15</sup> The Director of the Federal Insurance Office, in consultation with the FDIC, would be involved in the recommendation for financial firms whose largest domestic subsidiary is an insurance company. 12 U.S.C. §5383(a)(1)(C).

<sup>16</sup> The written recommendation must provide, among other things, assessments of: whether the company is in "default or in danger of default"; why the company could not be effectively resolved under the Bankruptcy Code or through other "private sector alternatives"; and "the effect that the default of the financial company would have on financial stability in the United States." 12 U.S.C. §5383(a)(2).

- the Secretary of the Treasury determines, among other things, that the institution is “in default or in danger of default,”<sup>17</sup> that “the failure of the financial company and its resolution under otherwise applicable Federal or State law would have *serious adverse effects on financial stability* in the United States,” and “*no viable private sector alternative is available....*”<sup>18</sup>

In other words, OLA is statutorily structured as a fallback alternative to the normally applicable insolvency regimes, such as the U.S. Bankruptcy Code, and is to be triggered only under extraordinary circumstances.

The living wills regime theoretically could play a crucial role in avoiding the need to employ OLA or some other extraordinary governmental action. This living wills regime requires large, complex, or otherwise systemically significant financial firms, in coordination with federal regulators, to design detailed roadmaps for utilizing—and to modify corporate, contractual, and other legal structures to make it easier to utilize—normal resolution regimes if these firms become insolvent or in danger of default.

Covered financial institutions’ initial living wills were required to be submitted in several waves, beginning in July 2012. Over 130 institutions have filed at least one resolution plan with regulators.<sup>19</sup> Each of the 11 largest financial firms in the United States, which each hold more than \$250 billion in nonbank assets, has filed at least two resolution plans.<sup>20</sup> **Table 1** sheds some light on the size, make-up, and complexity of these 11 financial institutions. As is discussed in greater detail below, all 11 of these companies’ plans, in spite of the fact that some of them span tens of thousands of pages,<sup>21</sup> have fallen short of the minimum requirements of DFA Section

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<sup>17</sup> The terms “default or danger of default” means:

- (A) a case has been, or likely will promptly be, commenced with respect to the financial company under the Bankruptcy Code;
- (B) the financial company has incurred, or is likely to incur, losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the company to avoid such depletion;
- (C) the assets of the financial company are, or are likely to be, less than its obligations to creditors and others; or
- (D) the financial company is, or is likely to be, unable to pay its obligations (other than those subject to a bona fide dispute) in the normal course of business.

12 U.S.C. §5383(c)(4).

<sup>18</sup> 12 U.S.C. §5383(b) (emphasis added). Judicial review of a determination by the Secretary to subject an institution to OLA is limited to whether the company meets the definition of “financial institution” and whether it is in “default or danger of default,” on an arbitrary and capricious standard—a high standard of review in which a reviewing court likely will accord significant deference to the Secretary’s determination. 12 U.S.C. §5382(a). The courts also could hear challenges based on the Constitution.

<sup>19</sup> *Resolution Plans*, Bd. of Gov. of the Fed. Reserve Sys., available at <http://www.federalreserve.gov/bankinforeg/resolution-plans.htm>. This includes the three nonbank financial institutions designated by FSOC for heightened regulation by the FRB—American International Group, Inc. (AIG), General Electric Capital Corporation, Inc. (GE Capital), and Prudential Financial, Inc.

<sup>20</sup> *Wall Street Reform: Assessing and Enhancing the Financial Regulatory System, Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 113<sup>th</sup> Cong. (2014) (written statement of the Hon. Martin J. Gruenberg at p. 5).

<sup>21</sup> *The Semiannual Monetary Policy Report to the Congress: Hearing Before the Senate Committee on Banking, Housing and Urban Development*, 113<sup>th</sup> Cong. (2014) (oral testimony of Janet L. Yellen, Chairman of the Bd. of Gov. of the Fed. Reserve Sys.).

165(d) in the view of the FRB and FDIC.<sup>22</sup> These 11 firms' next living wills are due July 2015. If any of these plans is determined to be insufficient, then the FRB and FDIC have expressed their intent "to use their [enforcement] authority under section 165(d)," which eventually could include the power to require an institution "to divest certain assets or operations ... to facilitate an orderly resolution...."<sup>23</sup>

This report reviews the legal structure of the DFA's living will requirements, pursuant to both DFA Section 165(d) and the regulations and guidance issued jointly by the FRB and FDIC; explains the August 2014 joint announcement of the FRB and FDIC regarding the inadequacies of the 2013 living wills filed by the 11 largest, most complex financial institutions in the country; analyzes the steps that the FRB and FDIC have suggested that these companies could take to rectify the common shortcomings in resolution plans filed thus far; and discusses the enforcement tools the FRB and FDIC may utilize against firms that fail to submit "credible" resolution plans.

This report focuses on the legal aspects of the DFA living wills regime and how the FRB and FDIC are administering the regime. Policy issues, although raised at times, generally are outside its scope. In particular, this report takes no stance on whether or not the living wills regime, specifically, or DFA, Titles I and II, generally, actually promote financial stability, or whether the steps that the FRB and FDIC have recommended that covered financial institutions take to improve their resolvability would in fact do so.

It also should be noted that this report concentrates on the FRB's and FDIC's interpretation and implementation of the living wills regime because these two regulators are empowered to implement DFA Section 165(d) by law, as it currently exists. Congress, of course, has broad discretion to pass legislation modifying the existing regime. In fact, there are bills in the 113<sup>th</sup> Congress that would change how financial institutions are regulated to promote the financial stability of the United States. For example, H.R. 46 and S. 20, the Financial Takeover Repeal Act of 2013, would repeal the DFA in its entirety, including the provisions designed to promote financial stability in Titles I and II. On **December 2, 2014, the House of Representatives** approved H.R. 5421, the Financial Institution Bankruptcy Act of 2014, which would amend the Bankruptcy Code "in order to facilitate the resolution of an insolvent financial institution in bankruptcy." H.R. 5421 appears to be intended to eliminate the need for OLA. A similar bill, S. 1861, the Taxpayer Protection and Responsible Resolution Act, would make changes to the Bankruptcy Code to facilitate the resolution of financial institutions, while also explicitly repealing DFA Title II.

H.R. 1450/S. 685, the Too Big to Fail, Too Big to Exist Act, would require the Secretary of the Treasury to identify all financial institutions it considers to be "too big to fail," and within one year of such designation, "break up [these] entities ... so that their failure would no longer cause a catastrophic effect on the United States or global economy without taxpayer bailout." And as a final example, H.R. 613, the Systemic Risk Mitigation Act, would among other things, require every bank holding company with \$50 billion or more in consolidated assets to hold long-term, subordinated debt of the value of at least 15% of its total consolidated assets. As is discussed

<sup>22</sup> *Agencies Provide Feedback on Second Round Resolution Plans of "First-Wave" Filers*, Joint Press Release, Bd. of Gov. of the Fed. Reserve Sys., Fed. Deposit Ins. Corp., Aug. 5, 2014, available at <http://www.federalreserve.gov/newsevents/press/bcreg/20140805a.htm>.

<sup>23</sup> *Id.*



more fully below, increasing long-term, unsecured debt arguably could help promote the long-term viability of the firm and, if the firm actually fails, help absorb some of its losses.<sup>24</sup>

**Table I. Complexity at First-Wave Resolution Plan Filers**

Company	Total Assets* (U.S. Dollars; Billions)	Notional Derivatives* (U.S. Dollars; Billions)	Short Term Funding**	Countries with Operations
Bank of America	\$2,171	\$55,472	19.4%	>40
Bank of New York Mellon	\$401	\$1,321	19.0%	35
Barclays***	\$2,249	\$66,516	25.4%	36
Citigroup	\$1,910	\$61,753	20.8%	160
Credit Suisse****	\$1,005	\$58,353	21.2%	>50
Deutsche Bank^	\$2,280	\$75,420	18.0%	>70
Goldman Sachs	\$860	\$57,695	26.7%	>50
JPMorgan Chase	\$2,520	\$68,326	20.3%	>100
Morgan Stanley	\$827	\$44,135	26.1%	43
State Street Corp.	\$282	\$1,263	8.3%	29
UBS^^	\$1,108	\$29,437	9.3%	>50

**Source:** Table and notes pulled in its entirety with permission and with minor edits for CRS formatting from *Financial Stocks Weekly: Living Wills Become a New Pressure Point on Big Banks*, Keefe, Bruyette & Wood (KBW), at 2, Aug. 25, 2014, available at [http://op.bna.com/bar.nsf/id/jbar-9nblk8/\\$File/kbw.pdf](http://op.bna.com/bar.nsf/id/jbar-9nblk8/$File/kbw.pdf) (developed by KBW from company reports, SNL Financial, and KBW Research).

**Notes:**

\* Total assets and notional derivatives based on company disclosures which may differ in accounting convention between countries

\*\*Shown as a percentage of total liabilities. For U.S. banks, KBW defined short-term funding as fed funds and repurchase agreements, jumbo time deposits, short trading positions, commercial paper, and borrowings with less than one year until maturity.

\*\*\*Barclays disclosed the 36 countries which make up 90% of revenues. For short-term funding, KBW used select wholesale funding (repos, trading portfolio liabilities, <1 year wholesale debt).

\*\*\*\*For Credit Suisse, KBW showed short-term funding as repos, short positions, and short-term borrowings.

^Deutsche Bank data as of the fourth quarter of FY2013. Short-term funding equals wholesale funding (unsecured wholesale funding, asset-backed commercial paper, and capital markets issuance) with a maturity of less than one year, secured funding and shorts, and financing vehicles.

^^Short-term funding includes repos, trading account liabilities, certificates of deposit, commercial paper, other money market paper.

## DFA §165(d) – The “Living Wills” Regime

DFA Section 165(d) requires certain banks and bank holding companies with greater than \$50 billion in assets<sup>25</sup> and nonbank financial institutions designated by the FSOC for heightened

<sup>24</sup> See *infra* the “Increasing Long-Term, Unsecured Debt” section of this report.

<sup>25</sup> More specifically, U.S. bank holding companies, as well as foreign banks, foreign bank holding companies, and other foreign institutions that are treated as bank holding companies pursuant to the International Banking Act of 1978 (12 U.S.C. §3106(a)) with greater than \$50 billion in assets.



prudential regulation by the FRB (together, "covered financial institutions") to submit plans to the FRB and FDIC detailing how the companies would be resolved in an orderly and swift fashion under the Bankruptcy Code (or other applicable insolvency regime) if the companies failed or otherwise suffered significant financial trouble.<sup>26</sup> Pursuant to DFA Section 165(d), the plans must include information about how affiliated insured depository institutions are buffered from the activities of the nonbank subsidiaries of the company; detailed information regarding the company's obligations, liabilities, and assets; a list of the company's significant counterparties; a list of entities with rights to collateral backing the company's existing obligations; a list of any cross-guarantees linked to security agreements; detailed information regarding the company's ownership structure; and "any other information that the [FRB and FDIC] jointly require by rule or order."<sup>27</sup> Section 165(d) also requires each covered financial institution to provide periodic reports on "the nature and extent to which the company has credit exposure to other [covered financial institutions]" and other such institutions have with it.<sup>28</sup>

The FRB and FDIC are required to review the resolution plan submissions,<sup>29</sup> in a process that FRB Chairman Janet Yellen stated is "intended to be iterative."<sup>30</sup> If the FRB and FDIC *jointly* determine that a submitted resolution plan "is not credible or would not facilitate an orderly resolution of the company under [traditional insolvency regimes]," then the regulators must inform the relevant company of the plan's shortcomings and require the company to submit a modified plan within a specified time.<sup>31</sup>

The DFA does not explicitly define the term "credible." Thus, the FRB and FDIC have considerable discretion in determining whether a particular living will "is not credible or would facilitate an orderly resolution" of a covered financial institution given its unique business model, legal structure, assets, liabilities, etc.

If a covered company fails to submit a credible plan within the allotted timeframe, then the FRB and FDIC may jointly place limits on the company's operations and activities, or subject them to heightened liquidity, capital, or leverage standards until resolution plans that meet statutory requirements are submitted. Additionally, if a covered company fails to submit a credible resolution plan within two years of being subject to such heightened standards or restrictions, then the FRB and FDIC are authorized to compel the company to divest certain business lines and assets, as a means to foster its resolvability.<sup>32</sup>

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<sup>26</sup> 12 U.S.C. §5365(d)(1).

<sup>27</sup> 12 U.S.C. §5365(d)(1).

<sup>28</sup> 12 U.S.C. §5365(d)(2).

<sup>29</sup> 12 U.S.C. §5365(d)(3).

<sup>30</sup> *The Semiannual Monetary Policy Report to the Congress: Hearing Before the Senate Committee on Banking, Housing and Urban Development*, 113<sup>th</sup> Cong. (2014) (oral testimony of Janet L. Yellen, Chairman of the Bd. of Gov. of the Fed. Reserve Sys.). See also Michael McAuliff, *Elizabeth Warren Grills Fed Chair Janet Yellen on Too-Big-To-Fail Banks*, Huffington Post, July 15, 2014, available at [http://www.huffingtonpost.com/2014/07/15/too-big-to-fail\\_n\\_5588558.html](http://www.huffingtonpost.com/2014/07/15/too-big-to-fail_n_5588558.html).

<sup>31</sup> 12 U.S.C. §5365(d)(4).

<sup>32</sup> 12 U.S.C. §5365(d)(5).

## FRB and FDIC Joint Regulations

On November 1, 2011, the FRB and FDIC issued final regulations to implement DFA Section 165(d).<sup>33</sup> The regulations establish various economic conditions that resolution plans should assume;<sup>34</sup> establish the form that resolution plans should take;<sup>35</sup> specify the timeframes in which living wills must be filed;<sup>36</sup> and provide greater clarity as to what covered bank and nonbank financial institutions must include in their plans,<sup>37</sup> the process by which resolutions plans will be reviewed by the FRB and FDIC,<sup>38</sup> and how DFA Section 165(d) and the regulations will be enforced.<sup>39</sup>

### Assumptions

The regulations require that, in devising their resolution plans, covered financial institutions should take into account the same “baseline, adverse, and severely adverse economic conditions” that are established by the FRB for implementing the annual stress tests performed by the companies in accordance with DFA Section 165(i).<sup>40</sup> This requirement prevents covered financial institutions from developing living wills exclusively predicated on the potentially overly optimistic presumption that the rest of the market and the economy as whole will be functioning normally even while one or more covered financial institutions are being forced to liquidate because of financial trouble. The resolution plans also are prohibited from relying upon “the provision of extraordinary support by the United States or any other government to the covered company or its subsidiaries....”<sup>41</sup>

### Form

Pursuant to the regulations, the resolution plans must be separated into two distinct sections—one that will be made available to the public and a second that generally will be treated as confidential.<sup>42</sup> The public section of a living will should have an executive summary that provides an overview of the company’s business that includes such information as its consolidated financial statements, a list of its principal officers, descriptions of its resolution planning processes and related governing structure, and descriptions of its hedging and derivatives activities.<sup>43</sup> Whether or not the information in and materials used to create resolution plans will be

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<sup>33</sup> Resolution Plans Required, 76 Fed. Reg. 67,323 (Nov. 1, 2011) (to be codified at 12 C.F.R. Part 243 (FDIC) and 12 C.F.R. Part 381 (FRB)). The regulations at times make distinctions between domestic covered companies and foreign-based covered companies, i.e., covered companies that are not incorporated in the United States. 12 C.F.R. § \_\_\_.2(j). This report focuses on domestic covered companies.

<sup>34</sup> 12 C.F.R. § \_\_\_.4(a)(4).

<sup>35</sup> 12 C.F.R. § \_\_\_.8(c).

<sup>36</sup> 12 C.F.R. § \_\_\_.3.

<sup>37</sup> 12 C.F.R. § \_\_\_.4.

<sup>38</sup> 12 C.F.R. § \_\_\_.5.

<sup>39</sup> 12 C.F.R. §§ \_\_\_.6 and .9.

<sup>40</sup> 12 U.S.C. §5365(i)(1)(B). The stress tests are conducted by the financial institutions and overseen by regulators.

<sup>41</sup> 12 C.F.R. § \_\_\_.4(a)(4).

<sup>42</sup> 12 C.F.R. § \_\_\_.8(c).

<sup>43</sup> 12 C.F.R. § \_\_\_.8(c).

treated as confidential<sup>44</sup> is determined by the FRB's Rules Regarding Availability of Information,<sup>45</sup> the FDIC's Disclosure of Information Rules,<sup>46</sup> and the Freedom of Information Act (FOIA).<sup>47</sup> In accordance with those rules, covered companies may apply to regulators to have certain information in their living wills to be treated as confidential.<sup>48</sup>

Thus far, the full living will submissions for many covered financial institutions are thousands, if not tens of thousands, of pages long.<sup>49</sup> The public sections of resolution plans, which are the only portions that have not been treated as confidential, typically are between 15 and 35 pages long.<sup>50</sup>

## Information

The regulations detail the information<sup>51</sup> that living wills should include, with emphasis not just on the covered parent company, but also its "material entities," "critical operations," and "core business lines."<sup>52</sup> In addition to an executive summary, living wills should provide:

- a "strategic analysis" of—
  - the assumptions the covered company used to develop the plan;
  - a "[r]ange of specific actions to be taken by the covered company to facilitate a rapid and orderly resolution ...";
  - the company's financial needs and available resources in both normal times and times of severe stress;
  - steps that the company would take to limit the impact on the U.S. financial system upon the collapse of a Material Entity, Core Business Line, or Critical Operation;

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<sup>44</sup> 12 C.F.R. § \_\_.8(d).

<sup>45</sup> 12 C.F.R. Part 261.

<sup>46</sup> 12 C.F.R. Part 309.

<sup>47</sup> 5 U.S.C. §552(b). For more information on FOIA and other federal nondisclosure laws, see CRS Report R41406, *The Freedom of Information Act and Nondisclosure Provisions in Other Federal Laws*, by Gina Stevens.

<sup>48</sup> 12 C.F.R. § \_\_.8(d).

<sup>49</sup> *The Semiannual Monetary Policy Report to the Congress: Hearing Before the Senate Committee on Banking, Housing and Urban Development*, 113<sup>th</sup> Cong. (2014) (oral testimony of Janet L. Yellen, Chairman of the Bd. of Gov. of the Fed. Reserve Sys.).

<sup>50</sup> *Resolution Plans*, Bd. of Gov. of the Fed. Reserve Sys., available at <http://www.federalreserve.gov/bankinforeg/resolution-plans.htm>.

<sup>51</sup> Under the regulations, covered companies that have at least 85% of total consolidated assets held by federal insured depositories and less than \$100 billion in nonbank assets are allowed to include less information in their living wills than other covered companies. 12 C.F.R. §§ \_\_.4(a)(3). The FRB and FDIC are authorized to exempt covered companies from including various pieces of generally required information in their resolution plans. 12 C.F.R. § \_\_.4(k).

<sup>52</sup> "Material entity" is defined as "a subsidiary or foreign office of the covered company that is significant to the activities of a critical operation or core business line...." 12 C.F.R. §§ \_\_.2(l). "Critical operations" are defined as "those operations of the covered company ... the failure or discontinuance of which, in the view of the covered company or as jointly directed by the [FRB and FDIC], would pose a threat to the financial stability of the United States." 12 C.F.R. § \_\_.2(g). "Core business lines" are defined as "those business lines of the covered company ... that, in the view of the covered company, upon failure would result in a material loss of revenue, profit, or franchise value." 12 C.F.R. § \_\_.2(d).

- time frames in which the company would be able to implement the various components of its resolution plan; and
- the current fair market value of its Critical Operations, Core Business Lines, and other important assets.<sup>53</sup>
- an account of how resolution planning is woven into the covered company's corporate structure, including a list of the senior management responsible for supervising the company's resolution planning;<sup>54</sup>
- a description of the steps the company has taken to strengthen its resolution plan since its last filing;<sup>55</sup>
- a detailed accounting and mapping of the company's legal organization, including the "location, jurisdiction of incorporation, licensing, and key management associated with each material legal entity";<sup>56</sup>
- a detailed accounting of the company's consolidated and unconsolidated balance sheets, liabilities, pledged collateral, important hedging activities, significant counterparties and how the failure of those counterparties likely would impact the covered company, and important off-balance-sheet exposures;<sup>57</sup> and
- any additional information regarding "interconnections and interdependencies ... that, if disrupted, would materially affect the funding or operations of the covered company."<sup>58</sup>

## Filing Deadlines, Regulatory Review, and Enforcement

The regulations establish a staggered schedule for the approximately 130 covered financial institutions' initial living will submissions. Covered institutions with more than \$250 billion of consolidated nonbank assets were required to file their initial plans by July 1, 2012.<sup>59</sup> There were 11 of these "first-wave filers."<sup>60</sup> Four covered institutions holding between \$100 and \$250 billion in nonbank assets were required to submit their first living wills one year later—July 1, 2013.<sup>61</sup> The remaining approximately 115 covered institutions had until December 31, 2013, to make their initial submissions.<sup>62</sup>

Covered financial institutions must submit a living will at least once every year, generally by the anniversary date of their initial submission.<sup>63</sup> However, the FRB and FDIC may jointly require

<sup>53</sup> 12 C.F.R. § \_\_.4(c). These terms are defined in *supra* n. 52.

<sup>54</sup> 12 C.F.R. § \_\_.4(d)(1).

<sup>55</sup> 12 C.F.R. § \_\_.4(d)(2).

<sup>56</sup> 12 C.F.R. § \_\_.4(e)(1).

<sup>57</sup> 12 C.F.R. §§ \_\_.4(e)(2)-(12).

<sup>58</sup> 12 C.F.R. § \_\_.4(g).

<sup>59</sup> 12 C.F.R. § \_\_.3(a)(1)(i).

<sup>60</sup> See *Resolution Plans*, Bd. of Gov. of the Fed. Reserve Sys., available at <http://www.federalreserve.gov/bankinforeg/resolution-plans.htm>.

<sup>61</sup> 12 C.F.R. § \_\_.3(a)(1)(ii).

<sup>62</sup> 12 C.F.R. § \_\_.3(a)(1)(iii).

<sup>63</sup> 12 C.F.R. § \_\_.3(a)(3).

plans be submitted more frequently<sup>64</sup> and, with proper notice, may require a plan to be submitted earlier than the regular due date<sup>65</sup> or may provide an extension for submission.<sup>66</sup> The regulators may compel covered institutions to provide updates on specified aspects of filed resolution plans, as well.<sup>67</sup> Covered companies also generally must provide the FRB and FDIC notice and an explanation of “any event, occurrence, change in conditions or circumstances, or other change that results in, or could reasonably be foreseen to have, a material effect on the [company’s] resolution plan ... ,” within 45 days of such occurrence.<sup>68</sup>

Within 60 days of receiving a living will, the FRB and FDIC are to inform each covered institution if its submission is “informationally incomplete” and what information is needed to enable regulators to effectively review the plan.<sup>69</sup> Upon such notification, the covered company generally will have 30 days to submit all necessary information.<sup>70</sup>

The regulations also provide that covered institutions that are notified by the FRB and FDIC that their living wills are not “credible” generally will have 90 days to submit a modified plan that details the changes that were made to rectify the deficiencies cited by the regulators, as well as explanations for why the company thinks the revised plan actually would “facilitate an orderly resolution of the covered company under the Bankruptcy Code.”<sup>71</sup> If the FRB and FDIC impose heightened capital, liquidity, or leverage requirements or limits on activities or operations on a covered company for submitting a revised resolution plan that does not fit within the regulators’ deadline or does not adequately address the noted deficiencies, those heightened standards or limitations will remain in effect until a living will has been submitted that the regulators consider credible.<sup>72</sup>

The regulations reiterate that a failure to submit a credible plan within two years of the regulators’ determination to impose heightened standards or activity restrictions could lead to the FRB and FDIC forcing the company to “divest[] of such assets and operations [as are] necessary to facilitate an orderly resolution.”<sup>73</sup>

Further, in consultation with the FDIC, the FRB may exercise any of the enforcement powers provided under 12 U.S.C. §1818 against a covered financial institution that fails to comply with the living wills regime.<sup>74</sup> Section 1818’s broad and flexible enforcement powers include the

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<sup>64</sup> 12 C.F.R. § \_\_.3(c)(1).

<sup>65</sup> 12 C.F.R. § \_\_.3(a)(4). The regulators must provide at least 180 days’ notice.

<sup>66</sup> 12 C.F.R. § \_\_.3(c)(2).

<sup>67</sup> 12 C.F.R. § \_\_.3(b)(1).

<sup>68</sup> 12 C.F.R. § \_\_.3(b)(2).

<sup>69</sup> 12 C.F.R. § \_\_.5(a).

<sup>70</sup> 12 C.F.R. § \_\_.5(a).

<sup>71</sup> 12 C.F.R. § \_\_.5(c).

<sup>72</sup> 12 C.F.R. § \_\_.6(b).

<sup>73</sup> 12 C.F.R. § \_\_.6(c). To the extent that any heightened standard or activity restriction, or compulsory divestiture “is likely to have a significant impact on a functionally regulated subsidiary or depository institution subsidiary of the covered company,” then the FRB generally must consult with that subsidiary’s primary federal regulator. 12 C.F.R. § \_\_.7.

<sup>74</sup> 12 C.F.R. § \_\_.9.

authority to issue cease and desist orders, issue prompt corrective actions, and assess civil money penalties.<sup>75</sup>

The DFA does not establish an appeals process specifically for the living wills regime. Disagreements regarding the enforcement of the living wills regime between a covered financial institution and the FRB and FDIC, like with other enforcement-related contentions, more often than not will be resolved informally through the iterative supervisory process.<sup>76</sup> However, if matters cannot be settled informally, a covered financial institution could avail itself of the formal hearing and judicial review process that generally applies to depository institutions, bank holding companies, and certain foreign banks and foreign bank holding companies.<sup>77</sup>

## Initial Submission of Plans by “First-Wave Filers” and Regulatory Response

The 11 first-wave filers submitted their initial living wills to the FRB and FDIC by the July 1, 2012, deadline. The 11 companies are Bank of America, Bank of New York Mellon, Barclays, Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, JPMorgan Chase, Morgan Stanley, State Street Corp., and UBS. The regulators did not make any official determinations regarding whether or not particular first-wave plans were “informationally incomplete” or not “credible.” Instead, the regulators publicly responded in April 2013 by issuing a joint guidance document “to provide further clarification, guidance and direction” for how the 11 covered companies should develop their 2013 plans.<sup>78</sup> The regulators also provided the companies an additional three months to submit their 2013 plans, by adjusting the deadline from July 1 to October 1, 2013.<sup>79</sup>

The guidance stipulates that the executive summaries should include “concise descriptions of the key elements” of the firm’s general resolution strategy.<sup>80</sup> The strategic analysis portion of the

<sup>75</sup> 12 U.S.C. §1818.

<sup>76</sup> See, generally, *Examining the Settlement Practices of U.S. Financial Regulators Before the House Comm. on Fin. Serv.*, 112<sup>th</sup> Cong. (2012) (written statement of Scott G. Alvarez, Gen. Counsel, FRB p. 2).

<sup>77</sup> 12 U.S.C. §1818(h); 12 C.F.R. §\_\_\_,9 (FRB)). See also 12 U.S.C. §5362 (subjecting nonbank financial institutions supervised by the FRB to 12 U.S.C. §§1818(b)-(n)).

<sup>78</sup> Guidance for 2013 §165(d) Annual Resolution Plan Submissions by Domestic Covered Companies that Submitted Initial Resolutions Plans in 2012, at I.A., Bd. of Gov. of the Fed. Reserve Sys., Fed. Deposit Ins. Corp., Apr. 15, 2013, available at <http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20130415c2.pdf> (hereinafter, 2013 Resolution Plan Guidance). The FRB and FDIC actually issued two different guidance documents—one for domestic and the other for foreign first-wave filers. Agencies Provide Additional Instructions for Submission of Some Resolution Plans, Joint Press Release, Bd. of Gov. of the Fed. Reserve Sys., Fed. Deposit Ins. Corp., Apr. 15, 2013, available at <http://www.federalreserve.gov/newsevents/press/bcreg/20130415c.htm>. The two guidance documents are largely the same, with a few exceptions. The guidance for foreign-based institutions allows institutions to supply a “supplemental analysis” of expected home-governmental support, both ordinary and extraordinary. Guidance for 2013 §165(d) Annual Resolution Plan Submissions Foreign-Based Covered Companies that Submitted Initial Resolution Plans in 2012, II.C.1, Bd. of Gov. of the Fed. Reserve Sys., Fed. Deposit Ins. Corp., Apr. 15, 2013, available at <http://www.federalreserve.gov/newsevents/press/bcreg/20130415c.htm> (hereinafter, 2013 Foreign-Based Resolution Plan Guidance). It also states that covered foreign-based institutions’ living wills should focus on their “Critical Operations ... that are conducted in whole or material part in the United States,” as well as the interconnectedness between their Critical Operations (both U.S. and foreign) and U.S.-based branches, subsidiaries, and agencies. 2013 Foreign-Based Guidance at I.D.

<sup>79</sup> 2013 Resolution Plan Guidance at I.B.

<sup>80</sup> 2013 Resolution Plan Guidance at I.C.1.

livings wills should consist of a more detailed narrative that is bolstered and substantiated by data and other information in appendixes.<sup>81</sup> Where relevant, the narrative should provide citations to specific provisions of appendixes. Each narrative also must at a minimum address five important obstacles to resolvability that the FRB and FDIC have identified.<sup>82</sup> These five obstacles are

1. contending with several, potentially competing, resolution regimes;
2. the impact of the covered financial institution's actions or inactions on self-interested ring fencing by administrators of foreign resolution regimes and the company's counterparties;
3. reliance on third parties and affiliates for the provision of important services and operations, and the potential for matters outside of the covered financial institution's control to disrupt those services and operations;
4. disruptions caused by the actions of the covered institution's counterparties, such as a counterparty's unilateral ability to increase margin requirements, close-out, liquidate, or net derivative contracts upon the covered financial institution's default; and
5. the illiquidity of the covered company's Material Entities and its impact on their ability to maintain Critical Operations.<sup>83</sup>

The guidance further elaborates on the assumptions that covered companies are and are not permitted to make in the development of their living wills. In addition to not being permitted to assume financial assistance from the United States or a foreign government, for instance, the guidance states that covered companies also should not assume they will be able to acquire unsecured financing just before default, such as debtor-in-possession financing as part of a Chapter 11 bankruptcy plan.<sup>84</sup>

## 2013 Resolution Plans by the 11 First-Wave Filers

In light of the guidance, each of the 11 first-wave filers submitted its second living will by the October 1, 2013, deadline. Some of these documents span more than 10,000 pages.<sup>85</sup> In spite of their girth, however, on August 5, 2014, the FDIC and FRB publicly announced that each of these living wills failed to establish sufficient plans for the companies' resolutions.<sup>86</sup> The regulatory agencies noted that some improvements were made from the firms' original submissions in 2012, but that each of the plans submitted in 2013 had various deficiencies, which were specified in individualized letters delivered to each company.<sup>87</sup> Although each firm had unique issues, the

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<sup>81</sup> *2013 Resolution Plan Guidance* at I.C.2.

<sup>82</sup> *2013 Resolution Plan Guidance* at I.C.2.

<sup>83</sup> *2013 Resolution Plan Guidance* at II.A.

<sup>84</sup> *2013 Resolution Plan Guidance* at II.C.2.

<sup>85</sup> *The Semiannual Monetary Policy Report to the Congress: Hearing Before the Senate Committee on Banking, Housing and Urban Development*, 113<sup>th</sup> Cong. (2014) (oral testimony of Janet L. Yellen, Chairman of the Bd. of Gov. of the Fed. Reserve Sys.).

<sup>86</sup> *Agencies Provide Feedback on Second Round Resolution Plans of "First-Wave" Filers*, Bd. of Gov. of the Fed. Reserve Sys., Fed. Deposit Ins. Corp., Joint Press Release, Aug. 5, 2014, available at <http://www.federalreserve.gov/newsevents/press/bcreg/20140805a.htm>.

<sup>87</sup> These letters have not been made public.



FRB and FDIC noted that problems with the 2013 living wills had two common characteristics. The resolution plans:

(i) [made] assumptions that the agencies regard as unrealistic or inadequately supported, such as assumptions about the likely behavior of customers, counterparties, investors, central clearing facilities, and regulators, and (ii) the[y] fail[ed] to make, or even to identify, the kinds of changes in firm structure and practices that would be necessary to enhance the prospects for orderly resolution.<sup>88</sup>

The agencies are requiring the companies to take a number of steps to get their living wills into compliance with DFA Section 165(d). These actions include

- simplifying the companies' business structures and legal organizations;
- modifying derivatives, commodities, and other "qualified financial contracts" (QFCs)<sup>89</sup> to provide a temporary stay from a counterparty's rights to terminate the contracts when a covered financial institution enters an insolvency proceeding;
- strengthening internal operations, including the ability to produce documents and other necessary information for implementing a resolution in a timely manner; and
- establishing the ability to maintain necessary operations during a resolution.<sup>90</sup>

As a result of shortcomings in the resolution plans, the FDIC went so far as to issue an official determination that all 11 of the 2013 plans are "not credible and do not facilitate an orderly resolution under the U.S. Bankruptcy Code." Had the FRB voted to make the same determination, the regulators would have established the predicate condition for exercising their Section 165(d) enforcement powers. Instead, the FRB "determined that the 11 banking organizations must take immediate action to improve their resolvability and reflect those improvements in their 2015 plans."<sup>91</sup>

All of the companies are expected to submit living wills that the FRB and FDIC consider "credible" by July 1, 2015. If any fail to file adequate plans by then, the FRB's and FDIC's joint statement on August 5 indicates that the regulators intend to exercise their authority under Section

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<sup>88</sup> *Agencies Provide Feedback on Second Round Resolution Plans of "First-Wave" Filers*, Bd. of Gov. of the Fed. Reserve Sys., Fed. Deposit Ins. Corp., Joint Press Release, Aug. 5, 2014, available at <http://www.federalreserve.gov/newsevents/press/bcreg/20140805a.htm>.

<sup>89</sup> See the *Amending Default Trigger Provisions in Qualified Financial Contracts* section of this report below. The term "qualified financial contract" is defined in the Federal Deposit Insurance Act (FDI Act), 12 U.S.C. §1821(e)(8)(D) for the purpose of the conservatorship/receivership resolution regime for insured depository institutions and under OLA, 12 U.S.C. 5390(c)(8)(D). The term is not explicitly defined in the Bankruptcy Code; however, certain individual contracts (e.g., securities contract, repurchase agreement, forward contract, swap agreement, commodity contract) that constitute "qualified financial contracts" under the FDI Act and OLA are defined in the Bankruptcy Code, with some differences that are not relevant for the purposes of this report. See, e.g., 11 U.S.C. §§ 101(25), 101(38A), 101(47), 101(53B), 741(7), 761(4). This report refers to the relevant terms under all three legal regimes as "qualified financial contracts" or QFCs.

<sup>90</sup> *Agencies Provide Feedback on Second Round Resolution Plans of "First-Wave" Filers*, Bd. of Gov. of the Fed. Reserve Sys., Fed. Deposit Ins. Corp., Joint Press Release, Aug. 5, 2014, available at <http://www.federalreserve.gov/newsevents/press/bcreg/20140805a.htm>.

<sup>91</sup> *Id.*

165(d) to “impose more stringent capital, leverage, or liquidity requirements, or restrictions on the growth, activities, or operations of the company” until robust resolution plans are submitted. As previously mentioned, if a covered company fails to rectify its living will within two years of the regulators imposing “more stringent” standards, the FRB and FDIC would have the power to compel the companies to divest certain business lines and assets.<sup>92</sup> This divestiture power is in addition to the FRB’s general enforcement tools under 12 U.S.C. Section 1818.<sup>93</sup>

## Initial Submissions for Covered Financial Institutions with Less than \$250 Billion in Nonbank Assets and Regulatory Response

After reviewing the initial resolution plans of the covered financial institutions that were not among the first-wave filers, which were due on July 1, 2012, the FRB and FDIC did not publicly indicate that any of the resolution plans were out of compliance with the Dodd-Frank Act, at least to a degree that would warrant exercising Section 165(d) enforcement powers. The regulators, however, provided each of these firms “with guidance, clarification and direction for their second resolution plans.”<sup>94</sup>

In a joint press release, the regulators indicated that they had established three different standards of resolution plans of varying degrees of sophistication. The regulators informed each covered financial institution as to the standard with which it must comply based on their determination of the firm’s complexity and the extent of its operations within the United States.

More than 30 firms with less than \$250 billion in nonbank assets, but which have relatively complex operations, must submit full resolution plans akin to those of the first-wave filers. An intermediate group of approximately 25 covered financial institutions will be allowed to submit “tailored plans” using a model template that the regulators issued publicly along with the joint press release.<sup>95</sup> The model template establishes a series of statements to be answered and provides a consistent order by which information may be presented.<sup>96</sup> The remaining covered financial institutions, which the FRB and FDIC have determined have only limited domestic operations, may meet their Section 165(d) responsibilities by building off of their original filings and submitting living wills that discuss “material changes to their initial plans as well as actions taken to strengthen the effectiveness of their initial plans.”<sup>97</sup>

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<sup>92</sup> *Id.*

<sup>93</sup> Section 1818’s broad and flexible enforcement powers include the authority to issue cease and desist orders, issue prompt corrective actions, and assess civil money penalties. 12 U.S.C. §1818.

<sup>94</sup> *Agencies Provide Additional Guidance for Certain Resolution Plans*, Joint Press Release, Bd. of Gov. of the Fed. Reserve Sys. and Fed. Deposit Ins., Aug. 15, 2014, available at <http://www.federalreserve.gov/newsevents/press/bcreg/20140815a.htm>.

<sup>95</sup> *Id.*

<sup>96</sup> *2014 Model Template for §165(d) Tailored Resolution Plans*, Bd. of Gov. of the Fed. Reserve Sys. and Fed. Deposit Ins., available at <http://www.federalreserve.gov/bankinforeg/resolution-plans/2014-model-template.pdf>.

<sup>97</sup> *Agencies Provide Additional Guidance for Certain Resolution Plans*, Joint Press Release, Bd. of Gov. of the Fed. Reserve Sys., Fed. Deposit Ins., Aug. 15, 2014, available at <http://www.federalreserve.gov/newsevents/press/bcreg/20140815a.htm>. It appears that many of these institutions are U.S. branches and agencies of foreign banking organizations. See *id.* and *Resolution Plans*, Bd. of Gov. of the Fed. Reserve Sys., available at (continued...)

## Steps 11 First-Wave Filers Could Take to Enhance Resolvability, as Recommended by the FRB and FDIC

In light of the fact that the FRB and FDIC have indicated that the 11 first-wave filers' living wills are lacking, this report examines some of the steps that these institutions might voluntarily take, which, in the discretionary views of the FRB and FDIC, would improve their resolvability. Although this report focuses on the legal issues associated with living wills, it should be noted that implementing the changes discussed below could result in increased administrative, regulatory, and market costs. Due to the fact that some of these steps would help address the common deficiencies noted by the regulators and because some of the first-wave filers are such dominant players in certain markets, some of these steps, if implemented, could lead to industry-wide changes. Consequently, some of the changes designed to eliminate risks to the U.S. financial system that policy makers explicitly chose to limit to the largest, most complex financial firms in the country, have the potential to indirectly impact smaller companies, including community banks.

### Strategic Divestiture

One notable way that the FRB and FDIC have indicated covered financial institutions could improve their resolvability would be to engage in strategic divestiture to simplify operations. This approach would seem to be what some policy makers and commentators have described as "breaking up the big banks."<sup>98</sup> While it would seem that the divestiture of significant portions of an institution's business so as to dramatically reduce its overall size could increase resolvability, size is only one of many factors that might affect a firm's resolvability. Other potential strategies include divestiture of foreign assets or particular products that are not adequately hedged or that carry concentrated risk exposure, as are discussed below.

### Divestiture of Foreign Assets and Entities

One potential strategy could be to sell off smaller, nonessential entities that are organized and operating in foreign countries.<sup>99</sup> Focusing on this type of divestiture would not only reduce the institution's size and complexity, but would have the added benefit of reducing the institution's geographical footprint and potentially the number of foreign insolvency regimes with jurisdiction over aspects of the covered financial company. As is indicated in **Table 1**, each of the 11 first-

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(...continued)

<http://www.federalreserve.gov/bankinforeg/resolution-plans.htm>.

<sup>98</sup> See, e.g., Michael McAuliff, *Elizabeth Warren Grills Fed Chair Janet Yellen on Too-Big-To-Fail Banks*, Huffington Post, July 15, 2014, available at [http://www.huffingtonpost.com/2014/07/15/too-big-to-fail\\_n\\_5588558.html](http://www.huffingtonpost.com/2014/07/15/too-big-to-fail_n_5588558.html); Simon Johnson, *Break Up the Big Banks*, N.Y. Times, Jan. 12, 2014, available at <http://www.nytimes.com/roomfordebate/2014/01/12/are-big-banks-out-of-control/break-up-the-big-banks>; Mike Konczal, *Sen. Sherrod Brown explains why he wants to break up the big banks*, Wash. Post, Mar. 9, 2013, available at <http://www.washingtonpost.com/blogs/wonkblog/wp/2013/03/09/sen-sherrod-brown-explains-why-he-wants-to-break-up-the-big-banks/>.

<sup>99</sup> *Financial Stocks Weekly: Living Wills Become a New Pressure Point on Big Banks*, Keefe, Bruyette & Wood (KBW), at 4, Aug. 25, 2014, available at [http://op.bna.com/bar.nsf/id/jbar-9nblk8/\\$File/kbw.pdf](http://op.bna.com/bar.nsf/id/jbar-9nblk8/$File/kbw.pdf).

wave filers is spread over at least 29 different countries, with two operating in more than 100. If these covered financial institutions failed, they likely would have assets in each of those countries that could be subject to insolvency regimes specific to those countries. As previously mentioned, contending with multiple insolvency regimes is also one of the five obstacles that the FRB and FDIC specifically have told the 11 first-wave filers should address in their resolution plans.<sup>100</sup> FDIC Vice-Chairman Thomas M. Hoenig has explained:

Countries have their own laws, courts, and regulatory environment. Contracts enforceable in one country might not be so in another. Depositor preference, wholesale funding arrangements, derivatives, and repurchase agreements often are treated differently among countries when a firm enters bankruptcy.<sup>101</sup>

Reducing the number of countries of operation and the extent of operations within countries could help improve a covered financial institution's resolvability by, for example, reducing the coordination burdens of multiple insolvency regimes cooperating on the proper allocation of assets and treatment of creditors and, relatedly, the incentive of administrators of those regimes from engaging in self-interested "ring-fencing" of the failed institution's assets. Ring-fencing, in this context,<sup>102</sup> refers to an insolvency regime administrator freezing the transfer of assets<sup>103</sup> held by an affiliate of a failed institution that are located within the jurisdiction of the administrator so that those assets may be used to pay off domestic creditors, potentially at the expense of creditors located in other jurisdictions. Ring-fencing can lead to an inefficient allocation of the failed firm's assets, inconsistent treatment among creditor classes, and cutting the flow of cross-border funds that may be needed to maintain certain Critical Operations.<sup>104</sup>

The FDIC in recent years has been active in entering memoranda of understanding (MOU) with administrators of these cross-border insolvency regimes establishing ground rules regarding how the administrators of the cross-border insolvency regimes will interact and coordinate with each other if a multinational financial institution went into default.<sup>105</sup> While the FDIC's actions are potentially beneficial, it may be difficult to reach agreements with every relevant country. Even to the extent that MOU are entered into, they generally are not legally enforceable, and thus

<sup>100</sup> See *supra* notes 82-83 and surrounding text.

<sup>101</sup> Thomas M. Hoenig, *A Credible Case for Resolving Through Bankruptcy*, Remarks Presented to the George Washington University Law School Conference on Financial Stability After Dodd-Frank: Have We Ended Too Big to Fail?, Nov. 5, 2014, available at [https://www.fdic.gov/news/news/speeches/spnov0514.html?source=govdelivery&utm\\_medium=email&utm\\_source=govdelivery](https://www.fdic.gov/news/news/speeches/spnov0514.html?source=govdelivery&utm_medium=email&utm_source=govdelivery).

<sup>102</sup> For an understanding of various definitions of the term "ring-fencing," see Steven L. Schwarcz, *Ring-Fencing*, 70 So. Cal. L. Rev. 69 (2013).

<sup>103</sup> This likely would be accomplished through the imposition of a "stay." Stays are discussed in the *infra* "Amending Default Trigger Provisions in Qualified Financial Contracts" section of this report.

<sup>104</sup> Thomas M. Hoenig, FDIC Vice-Chairman, *A Credible Case for Resolving Through Bankruptcy*, Remarks Presented to the George Washington University Law School Conference on Financial Stability After Dodd-Frank: Have We Ended Too Big to Fail?, Nov. 5, 2014, available at [https://www.fdic.gov/news/news/speeches/spnov0514.html?source=govdelivery&utm\\_medium=email&utm\\_source=govdelivery](https://www.fdic.gov/news/news/speeches/spnov0514.html?source=govdelivery&utm_medium=email&utm_source=govdelivery); Daniel K. Tarullo, Member of the FRB, *Regulation of Foreign Banking Organizations*, Remarks Presented at the Yale School of Management Leaders Forum, at pp. 8-9, Nov. 28, 2012, available at <http://www.federalreserve.gov/newsevents/speech/tarullo20121128a.pdf>.

<sup>105</sup> *Improving Cross Border Resolution to Better Protect Taxpayers and the Economy, Hearing Before the Subcomm. on Nat'l Sec. and Internat'l Trade and Fin. of the S. Comm. on Housing and Urban Dev.*, 113<sup>th</sup> Cong. (2013) (written testimony of Jim Wigand, Dir. of the Office of Complex Fin. Inst., Fed. Deposit Ins. Corp., at pp. 10-14), available at [http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing\\_ID=52cb066d-1043-485b-b9e9-07c8684a3d36&Witness\\_ID=6f0037bb-73bb-4278-93ab-f926f0bd7e0d](http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Testimony&Hearing_ID=52cb066d-1043-485b-b9e9-07c8684a3d36&Witness_ID=6f0037bb-73bb-4278-93ab-f926f0bd7e0d).

essentially rely on voluntary cooperation, which might be lacking in the midst of financial tumult.<sup>106</sup>

## Divestiture Based on Risk

Another possible focus could be the divestiture of particular products or economic sectors that are viewed as insufficiently hedged or carry unusually concentrated risk exposure. For example, in the run-up to the "Great Recession," American International Group (AIG) was on one-side of a significant portion of the overall market for certain credit default swap derivative products linked to mortgage assets, through which AIG essentially was insuring the performance of mortgage-backed securities.<sup>107</sup> When the mortgage market crashed, AIG faced large margin calls and payouts on these mortgage-related derivatives products, which, according to the Financial Crisis Inquiry Commission, played a major role in the company's near collapse and its need for extraordinary assistance from the Federal Reserve.<sup>108</sup> In theory, going through the process of developing a living will could alert a covered financial institution's internal risk managers, as well as regulators, to significant concentrations akin to AIG's mortgage-related credit default swaps. This, in turn, could provide an impetus to divest the products to reduce concentration exposures to more reasonable, less risky levels in the view of internal risk managers or regulators.

## Legal Reorganization

Where divestiture is not a viable or an attractive option, a covered financial institution might focus on reorganizing or restructuring to reduce its complexity or interconnectedness.

## Domestic Reorganization

One type of restructuring that FDIC Chairman Gruenberg has highlighted is to align business areas with legal organizations. This could mean transferring the legal interests in interconnected business lines to a single subsidiary to serve as an intermediate holding company.<sup>109</sup> The goal of the Chairman's suggestion is to improve resolvability by, for example, creating a more transparent and rational organization. It also could ease the company's ability to maintain necessary operations during the resolution process. When assessing a legal restructuring strategy, covered financial institutions might place a particular focus on aligning certain Material Entities

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<sup>106</sup> It should be noted that by encouraging and in some cases requiring covered financial institutions to take steps to move assets and subsidiaries into the U.S. and to take other steps to improve a multinational covered financial institution's resolvability in the U.S., the FRB and FDIC could be viewed as engaging in U.S.-centric ring fencing, particularly in the eyes of foreign regulators. See Daniel K. Tarullo, Member of the FRB, *Regulation of Foreign Banking Organizations*, Remarks Presented at the Yale School of Management Leaders Forum, at pp. 10-11, Nov. 28, 2012, available at <http://www.federalreserve.gov/newsevents/speech/tarullo20121128a.pdf> (noting the various policies that U.S. and various foreign regulators had begun contemplating "to fortify the resources of internationally active banks within their geographic boundaries.").

<sup>107</sup> *The Financial Crisis Inquiry Report*, Nat'l Com. on the Causes of the Fin. and Econ. Crisis in the U.S., at pp. 50, 132-42, Feb. 25, 2011, available at <http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf>.

<sup>108</sup> CRS Report R42953, *Government Assistance for AIG: Summary and Cost*, by Baird Webel.

<sup>109</sup> *Wall Street Reform: Assessing and Enhancing the Financial Regulatory System*, Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs, 113<sup>th</sup> Cong. (2014) (written statement of the Hon. Martin J. Gruenberg at p. 6), available at [http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing\\_ID=b15fe832-df18-47d7-8c7d-1367e5770086](http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=b15fe832-df18-47d7-8c7d-1367e5770086).



and Core Operations within distinct legal structures to help buffer them from financial losses originating in other parts of the conglomerate. Taking these steps also likely would increase directors', management's, and the regulators' understanding of the covered financial institution's legal structure and help reduce its complexity and interconnectedness.

To further address the regulators' concerns, the covered financial company could have policies in place intended to ensure that each intermediate holding company is sufficiently capitalized to absorb some potential losses by the subsidiaries in the intermediate holding company. Companies could take additional steps to implement policies by which the intermediate holding company would formally serve as a "source of strength"<sup>110</sup> for its subsidiaries and which generally would prohibit other portions of the covered financial institution from guaranteeing the liabilities of entities within the intermediate holding company structure.<sup>111</sup> Contracts with counterparties and affiliates could memorialize these policies. This could help avoid the need for the parent holding company to serve as a source of strength for its dozens or, in some instances, hundreds of subsidiaries, which do not conduct Core Operations and are not Material Entities.<sup>112</sup>

The creation of incorporation and contractual barriers within each intermediate holding company arguably could help reduce the likelihood that financial distress within the intermediate holding company and its subsidiaries would spread into other parts of the covered financial institution, and vice-versa. This potentially could reduce the likelihood that the financial stress would pose material risk to the whole covered financial institution.<sup>113</sup>

For example, virtually all of AIG's credit default swaps that were linked to mortgage-backed securities were issued by one subsidiary, AIG Financial Products (AIG FP). According to the Financial Crisis Inquiry Commission, AIG FP's ability to issue those credit default swaps was aided by the fact that the AIG parent holding company guaranteed their performance.<sup>114</sup> Had AIG FP been organized within an intermediate holding company and prohibited from entering credit default swaps that were guaranteed by the parent holding company, counterparties may have been more reticent to purchase credit default swaps from AIG FP. This in turn might have reduced AIG FP's exposure and concentration in the market while simultaneously diminishing the risk to AIG (the parent holding company) when the credit default swaps went sour.

## Foreign Reorganization

In a slightly different context that shares many parallels with the living wills regime, the FRB issued final regulations<sup>115</sup> requiring certain foreign banking organizations<sup>116</sup> to establish one or

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<sup>110</sup> 12 U.S.C. §1831o-1; 12 C.F.R. §225.4(a)(1). See also *Failure to Act as Source of Strength to Subsidiary Banks*, Bd. of Gov. of the Fed. Reserve Sys. Policy Statement, April 24, 1987, available at <http://www.kc.frb.org/publicat/banking/membership/bhc/FailuretoActAsSourceofStrengthtoSubsidiaryBanks.pdf>.

<sup>111</sup> An exception would have to be made for depository institution subsidiaries for which the parent holding company generally is required by law to serve as a source of strength. *Id.*

<sup>112</sup> See, e.g., JPMorgan Chase & Co., Sec. and Exch. Comm'n Form 10-k, Exhibit 21, filed Feb. 20, 2014, available at <https://www.sec.gov/Archives/edgar/data/19617/000001961714000289/corp10k2013exhibit21.htm>; Bank of America, Corp., Sec. and Exch. Comm'n Form 10-k, Exhibit 21, filed Feb. 25, 2014, available at <https://www.sec.gov/Archives/edgar/data/70858/000007085814000012/bac-12312013x10kex21.htm>.

<sup>113</sup> Steven L. Schwarcz, *Ring-Fencing*, 70 So. Cal. L. Rev. 69, 77 (2013).

<sup>114</sup> *The Financial Crisis Inquiry Report*, Nat'l Com. on the Causes of the Fin. and Econ. Crisis in the U.S., at pp. 139-40, Feb. 25, 2011, available at <http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf>.

<sup>115</sup> Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. (continued...)

more U.S.-based intermediate holding companies. These intermediate holding companies must hold virtually all<sup>117</sup> of the ownership interests of the conglomerate's U.S.-based financial subsidiaries. Some of the policy justifications for these regulations were to reduce the risk of a firm's cross-border activities to the financial stability of the U.S., help eliminate a "fractured organizational structure that can reduce the effectiveness of attempts ... to manage [] risks," and improve the resolvability of U.S.-based subsidiaries within U.S. resolution regimes.<sup>118</sup> Similarly, the FRB noted that, to the extent that unusual circumstances prevent a foreign banking organization from transferring all ownership rights of its U.S.-based subsidiaries to the intermediate holding company, then "the [FRB] expects to require passivity commitments or other supervisory agreements to limit the exposure to and transactions between the U.S. intermediate holding company and the U.S. subsidiary that remains outside of the U.S. intermediate holding company."<sup>119</sup>

It appears that some foreign covered financial institutions are indeed taking some of these reorganization steps. UBS, for example, announced on September 29, 2014, that it was restructuring by creating a parent holding company as a beginning step in a plan to eventually separate much of its banking activities into a distinct banking subsidiary and to establish a U.S.-based intermediate holding company through which it would conduct most of its U.S.-based activities.<sup>120</sup> The company explained the purpose for the restructuring in this way:

the establishment of a holding company is a significant step in a series of envisaged changes to UBS's legal structure that are intended to substantially improve its resolvability in response to evolving industry-wide "too-big-to-fail" requirements. ... After the setup of the holding company, further anticipated changes extending into 2016 include the establishment of a banking subsidiary in Switzerland (by mid-2015) and a US Intermediate Holding Company (by mid-2016).<sup>121</sup>

Legally restructuring in the ways described above likely would result in costs to covered financial institutions. There would be administrative and legal costs associated with reorganizing the firm, transferring ownership rights, establishing board and risk management oversight of the intermediate holding company, and potentially in the amendment and redrafting of contracts. Transferring capital from other portions of the covered financial institution to the intermediate holding company could impact compliance with minimum capital standards in effect in the U.S.

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(...continued)

17,240 (Mar. 27, 2014) (to be codified at 12 C.F.R. pt. 252), available at <http://www.gpo.gov/fdsys/pkg/FR-2014-03-27/pdf/2014-05699.pdf>.

<sup>116</sup> The regulations apply to foreign banking organizations that have \$50 billion or more in consolidated assets and \$50 billion or more of total U.S. assets. 79 Fed. Reg. 17,420, 17,324 (Mar. 27, 2014) (to be codified at 12 C.F.R. §252.142).

<sup>117</sup> The regulations make exceptions for U.S.-based subsidiaries or U.S. bank branches established for the purpose of holding debt previously contracted in good faith, as well as companies formed pursuant to Bank Holding Company Act Section 2(h)(2) (12 U.S.C. §1841(h)(2)).

<sup>118</sup> Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17,420, 17,278-79 (Mar. 27, 2014).

<sup>119</sup> Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17,420, 17,275 (Mar. 27, 2014).

<sup>120</sup> *UBS publishes prospectus of its share-for-share exchange offer to establish a group holding company*, UBS Group AG, UBS Press Release, Sept. 29, 2014, available at [https://www.ubs.com/global/en/about\\_ubs/media/emea/releases/news\\_display\\_media\\_emea.html/en/2014/09/29/prospectus.html](https://www.ubs.com/global/en/about_ubs/media/emea/releases/news_display_media_emea.html/en/2014/09/29/prospectus.html).

<sup>121</sup> *Id.*



or other regulatory jurisdictions and may result in negative tax consequences.<sup>122</sup> The borrowing costs of intermediate holding companies or other subsidiaries that are subject to contractual or other legal barriers to receiving financial support from the parent also might be higher than they would if there was an explicit guarantee by the parent.<sup>123</sup> There also is the possibility that, even if contracts between intermediate holding companies and their counterparties explicitly state that the parent covered financial institution does not guarantee the performance of specific contracts or the financial stability of certain subsidiaries, counterparties might presume the parent would choose to do so in practice to avoid legal and reputational harms of default.<sup>124</sup> Similarly, the market forces that arguably would make the reorganizations described above beneficial may break down if market participants believe that emergency governmental assistance would be provided if a covered financial institution's subsidiaries defaulted and the parent was unable to cover the losses.<sup>125</sup>

## Amending Default Trigger Provisions in Qualified Financial Contracts

Another step that the FDIC and FRB are promoting to help improve covered financial institutions' resolvability is for covered financial institutions to voluntarily modify the standard terms in derivatives, securities, commodities, and other financial contracts to give covered financial institutions and administrators of insolvency regimes greater control over the netting, close-out, and settlement of such contracts upon the covered financial institution triggering a default provision.<sup>126</sup> One possible change could be to contractually provide for a brief "stay" on a counterparty's ability to enforce its rights under the contract, akin to the FDIC's power as receiver under OLA<sup>127</sup> and as a conservator or receiver for insured depository institutions under the Federal Deposit Insurance Act (FDI Act).<sup>128</sup> The special but disparate treatment of derivatives, securities, and other financial contracts under the Bankruptcy Code, on the one hand, and the FDI Act and OLA, on the other, are discussed in detail below.

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<sup>122</sup> Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17,240, 17,270 (Mar. 27, 2014).

<sup>123</sup> *Id.* at 17,279.

<sup>124</sup> *Id.* As an analogy, securities issued by Fannie Mae and Freddie Mac were required by law to explicitly state that they were not backed by the full faith and credit of the United States (12 U.S.C. §1719(d) (Freddie Mac); 12 U.S.C. §1455(h)(2) (Fannie Mae)), but when the two mortgage giants were in danger of default, the U.S. government, utilizing statutory authorities enacted as part of the Housing and Economic Recovery Act of 2008 (P.L. 110-289), provided hundreds of billions of dollars of governmental support to avoid defaults on those securities. For additional information on the U.S. government's investments in Fannie Mae and Freddie Mac, see CRS Report R42760, *Fannie Mae's and Freddie Mac's Financial Status: Frequently Asked Questions*, by N. Eric Weiss.

<sup>125</sup> See CRS Report R42150, *Systemically Important or "Too Big to Fail" Financial Institutions*, by Marc Labonte, p. 12.

<sup>126</sup> *Agencies Provide Feedback on Second Round Resolution Plans of "First-Wave" Filers*, Bd. of Gov. of the Fed. Reserve Sys., Fed. Deposit Ins. Corp., Joint Press Release, Aug. 5, 2014, available at <http://www.federalreserve.gov/newsevents/press/bcreg/20140805a.htm>.

<sup>127</sup> 12 U.S.C. §5390(c)(8).

<sup>128</sup> 12 U.S.C. §1821(e)(8). The statutory provisions governing the applicability of qualified financial contracts (QFCs) under OLA were modeled after, and largely follow, those of the FDI Act. Although there are some differences between the two laws as they apply to QFCs, most notable in that conservatorships are not permissible under OLA while conservatorships are permissible under the FDI Act, the laws are equivalent for the purposes of this report, unless noted otherwise.

Modifying the standard terms of these contracts potentially could improve the resolvability of covered financial institutions. First, it would ensure that the contracts are treated the same in a standard bankruptcy process as they are in the special insolvency regimes administered by the FDIC, which would mean that the impact on parties to these contracts would more likely be the same regardless of which insolvency regime a covered financial institution is subject. It also could increase the likelihood that cross-border financial contracts would be treated uniformly by insolvency regimes in other countries, although complete uniformity would likely require statutory and regulatory changes, as well. As is discussed more fully below, it appears that a significant number of global financial institutions are voluntarily taking steps to modify many of these contracts to provide a temporary stay from counterparties' ability to exercise default trigger rights when a financial institution enters bankruptcy or another insolvency regime.

Separately from the issue of modifying these financial contracts, FDIC Vice Chairman Thomas M. Hoenig has suggested that some covered financial institutions should reduce their overall exposure to these contracts.<sup>129</sup> **Table 1** illustrates that most of the 11 first-wave filers have notional derivatives exposures exponentially larger than their total consolidated assets.

## Overview of the Treatment of Qualified Financial Contracts Under the Bankruptcy Code

A "stay" is a power by which creditors are, at least temporarily, barred from pursuing their claims against a defaulting entity. As one commentator explains:

Stays permit the resolution authority [the time to] collect and validate claims, to determine the best way to dispose of assets in an orderly, non-fire-sale manner, and to treat all like-priority creditors equally. Stays prevent creditor runs and keep contracts in force—the counter party is bound by the contract; claims on the insolvent firm remain pending; and collateral may usually not be liquidated. This facilitates the coordination of creditor claims.<sup>130</sup>

The U.S. Bankruptcy Code establishes a general stay automatically upon petitioning for bankruptcy.<sup>131</sup> However, the Code provides a number of exceptions to the automatic stay, including for certain "qualified financial contracts (QFCs)" i.e., securities contracts, commodity contracts, forward contracts, repurchase agreements, swap agreements, and netting arrangements.<sup>132</sup> It is especially common for financial institutions to be parties to QFCs, making special protections provided for them all the more important in case of a financial institution's insolvency.

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<sup>129</sup> See, e.g., *Statement of Thomas M. Hoenig, Vice Chairman, FDIC on the Credibility of the 2013 Living Wills Submitted by First Wave Filers*, Aug. 5, 2014, available at <https://www.fdic.gov/news/news/speeches/spaug0514a.html>; *Financial Stocks Weekly: Living Wills Become a New Pressure Point on Big Banks*, Keefe, Bruyette & Wood (KBW), at 2, Aug. 25, 2014, available at [http://op.bna.com/bar.nsf/id/jbar-9nblk8/\\$File/kbw.pdf](http://op.bna.com/bar.nsf/id/jbar-9nblk8/$File/kbw.pdf).

<sup>130</sup> Robert R. Bliss and George G. Kaufman, *U.S. Corporate and Bank Insolvency: An Economic Comparison and Evaluation*, Fed. Reserve Bank of Chicago (2006), available at [https://www.chicagofed.org/digital\\_assets/publications/working\\_papers/2006/wp2006\\_01.pdf](https://www.chicagofed.org/digital_assets/publications/working_papers/2006/wp2006_01.pdf).

<sup>131</sup> 11 U.S.C. §362(a). See *supra* n. 89 for a discussion of the definitions of "qualified financial contracts" under the Bankruptcy Code, FDI Act, and OLA.

<sup>132</sup> 11 U.S.C. §362(b).

Additionally, the Bankruptcy Code provides trustees, who administer bankruptcy liquidations, the authority to avoid (i.e., claw-back or reverse) certain transfers (subject to certain limitations<sup>133</sup>) made by debtors shortly before a bankruptcy petition is filed.<sup>134</sup> The purpose of this avoidance power is to facilitate the equitable distribution of the bankruptcy estate's assets among credit classes and to limit the "race to the courthouse" problem.<sup>135</sup> However, most QFCs are exempt from this general avoidance power.<sup>136</sup>

These so-called "safe-harbor protections" for QFCs were established, in part, to suppress the negative repercussions of a financial institution's bankruptcy on global financial markets—in other words to reduce systemic risk.<sup>137</sup> These safe harbors provide counterparties with the power to terminate or liquidate the collateral<sup>138</sup> held against the contracts and net or setoff each party's positions subsequent to a troubled firm filing a bankruptcy petition.<sup>139</sup> These legal constructs are explained by two prominent economists this way:

Close-out and netting consist of two separate but related rights, often combined in a single contract: 1) the right of a counterparty to unilaterally terminate contracts under specified conditions (close-out), and 2) the right to offset amounts due at termination of individual contracts between the same counterparties when determining the final obligation [(netting)].<sup>140</sup>

Almost all QFCs have close-out and netting provisions that are triggered by an act of default, including the institution filing for bankruptcy, even if the contract itself is still performing. Some scholars argue that these provisions have the potential to exacerbate the financial condition of ailing firms and to deplete their assets.<sup>141</sup> For example, debtors of the Lehman Brothers

<sup>133</sup> See, e.g., 11 U.S.C. §§546, 547, 555, 556, 559, 560, 561.

<sup>134</sup> 11 U.S.C. §547(b). These conditions are: (1) the transfer was made "to or for the benefit of a creditor"; (2) the transfer was for a debt owed before the transfer; (3) the transfer "was made while the debtor was insolvent"; (4) the transfer occurred "on or within 90 days" of the petition or within one year if the transfer was made to an "insider"; and (5) the creditor received more from the transfer than it would have through bankruptcy proceedings. The term "insider" is defined at 11 U.S.C. §101(31).

<sup>135</sup> Collier on Bankruptcy p. 5-547.01 (16<sup>th</sup> ed. rev.).

<sup>136</sup> 11 U.S.C. §§546(e)-(j).

<sup>137</sup> GuyLaine Charles, *OTC Derivative Contracts in Bankruptcy: The Lehman Experience*, NY Bus. L.J. Vol. 13, No. 1, p. 14 (Spring 2009) (hereinafter "*OTC Derivative Contracts in Bankruptcy*").

<sup>138</sup> Counterparties typically hold the collateral underlying these contracts, which usually consists of liquid assets such as securities or cash. Robert R. Bliss and George G. Kaufman, *Derivatives and Systemic Risk: Netting, Collateral, and Closeout*, Fed. Reserve Bank of Chicago, p. 7 (2005), available at [https://www.chicagofed.org/digital\\_assets/publications/working\\_papers/2005/wp2005\\_03.pdf](https://www.chicagofed.org/digital_assets/publications/working_papers/2005/wp2005_03.pdf) (hereinafter "*Derivatives and Systemic Risk*").

<sup>139</sup> *OTC Derivative Contracts in Bankruptcy* at 15.

<sup>140</sup> *Derivatives and Systemic Risk* at 4.

<sup>141</sup> Kenneth Ayotte and David A. Skeel, *Bankruptcy or Bailouts?*, 35 J. Corp. 469, 495 (2010). But see Kimberly Anne Summe, *Lessons Learned from the Lehman Bankruptcy*, at 77-92 (2010), available at [http://media.hoover.org/sites/default/files/documents/Ending\\_Government\\_Bailouts\\_as\\_We\\_Know\\_Them\\_59.pdf](http://media.hoover.org/sites/default/files/documents/Ending_Government_Bailouts_as_We_Know_Them_59.pdf) ("The application of the automatic stay, while appearing to preserve the value of the 'assets' of the failing firm, may be illusory as it relates to derivatives since derivative transactions and the collateral associated with those transactions are not really assets in the traditional sense, and the preservation of value may rapidly change, particularly in a distressed market. Moreover, the legal certainty afforded to the termination of these contracts... should not be discounted. Highly liquid derivative transactions ... were terminated by many of Lehman Brothers' counterparties after the investment bank's failure, allowing those counterparties to reduce potential losses by entering into replacement transactions. The loss of an ability to hedge one's trading book because of the application of a stay would result in significant losses for qualified financial contract counterparties, causing a catastrophic decline in the activities of the financial markets.").

bankruptcy estate estimated that, just prior to the bankruptcy petition being filed, they were a party to around 930,000 QFCs. Of those nearly 1 million contracts, approximately 733,000 were terminated within about three months of Lehman Brothers filing its bankruptcy petition.<sup>142</sup> It appears that, in the vast majority of the QFCs that were terminated, the non-Lehman counterparties were “in the money”—that is, Lehman owed money to the counterparty.<sup>143</sup> Those counterparties that held collateral against their QFCs were able to terminate the contracts and keep the collateral as settlement of their claims.<sup>144</sup> QFCs that were not collateralized could be closed-out and overall positions could be netted. The counterparties were then able to seek a claim as unsecured creditors of the bankruptcy estate.<sup>145</sup> Harvey Miller, the lead attorney for the Lehman Brother bankruptcy, testified before a Subcommittee of the House Judiciary Committee, that Lehman’s counterparties’ unilateral authority to terminate, close-out, and net QFCs “caused a massive destructive value for Lehman.”<sup>146</sup>

## Overview of the Treatment of Qualified Financial Contracts Under the FDIC’s Receivership Regimes

Whereas the general rule for a corporate liquidation under the Bankruptcy Code is the implementation of the automatic stay to provide time to ensure that similarly situated creditors are treated equally, the FDIC as receiver is more likely to further the statutory objectives of the FDI Act and OLA by maintaining much of the company’s operations. For example, when acting as a receiver under the FDI Act, the FDIC generally will ensure that consumers continue to have access to FDIC-insured consumer deposits in order to achieve its primary goal of protecting

<sup>142</sup> Notice of Debtors’ Motion For an Order Pursuant to Sections 105 and 365 of the Bankruptcy Code to Establish Procedures for the Settlement or Assumption and Assignment of Prepetition Derivatives Contracts, U.S. Bankr. Ct. S.D.N.Y. Case No. 08-13555, Docket No. 1498. Counterparties to many of these 700,000+ contracts seem to have at least attempted to terminate the contracts within a few days of Lehman Brother’s bankruptcy filing. *Lehman Risk Reduction Trading Session and Protocol Agreement*, Int’l Swaps and Derivatives Assoc., Inc. Press Release, Sept. 14, 2008, available at <http://www.isda.org/press/press091408lehman.html>. However, problems appear to have arisen in the close-out and netting process, which led the International Swaps and Derivatives Association (ISDA), a major trade association representing derivatives participants, to develop a Lehman derivatives “Protocol Agreement” to help rectify these problems. ISDA 2008 Lehman CDS Protocol, available at <http://www.isda.org/2008lehmancdsprot/2008lehmancdsprot.html>. The disruptions in the settlement process likely alleviated the strain that settling 700,000 contracts within hours of one another could have had on the derivatives market, as dozens of counterparties sought replacement contracts/counterparties, and on the Lehman Brothers bankruptcy estate, as collateral was seized outside of the automatic stay’s protection. Nevertheless, the process arguably exacerbated the seismic repercussions of Lehman’s failure on U.S. and global markets. *The Financial Crisis Inquiry Report*, Nat’l Com. on the Causes of the Fin. and Econ. Crisis in the U.S., p. 343, Feb. 25, 2011, available at <http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf>.

<sup>143</sup> Kimberly Anne Summe, *Lessons Learned from the Lehman Bankruptcy*, at 78 (2010), available at [http://media.hoover.org/sites/default/files/documents/Ending\\_Government\\_Bailouts\\_as\\_We\\_Know\\_Them\\_59.pdf](http://media.hoover.org/sites/default/files/documents/Ending_Government_Bailouts_as_We_Know_Them_59.pdf). In response to a motion by the Lehman Brothers bankruptcy estate, the bankruptcy court ultimately approved the assignment to third parties of the QFCs that were not terminated by Lehman’s counterparties, without those counterparties’ permissions because “the estate might best realize the value of those transactions through assignment.” *Id.*

<sup>144</sup> Ayotte and Skeel at 494-95.

<sup>145</sup> *Id.*

<sup>146</sup> *Too Big to Fail: The Role for Bankruptcy and Antitrust Law in Financial Regulation Reform*, Subcommittee on Commercial and Administrative Law of the House Committee on the Judiciary, 111<sup>th</sup> Cong. (2009) (statement of Harvey R. Miller, Senior Partner, Weil, Gotshal & Manges LLP at 9), available at [http://judiciary.house.gov/\\_files/hearings/pdf/Miller091022.pdf](http://judiciary.house.gov/_files/hearings/pdf/Miller091022.pdf).

insured deposits “at the least possible cost to the Deposit Insurance Fund.”<sup>147</sup> Although it has never exercised the authorities before, the FDIC has indicated that maintaining a failed firm’s Critical Operations would be a major strategy of resolution under OLA as a means to promote financial stability, which is the overarching purpose of OLA.<sup>148</sup> To reach these ends, the FDIC is empowered with greater flexibility to manage the QFCs of a troubled depository under the FDI Act or a nondepository financial institution under OLA than is available under the Bankruptcy Code.<sup>149</sup>

Notably, the FDIC, as receiver, is empowered with the authorities of the failed firm’s directors, management, and shareholders. The FDIC also under certain circumstances may transfer, repudiate, and avoid the QFCs of a troubled depository or nondepository financial institution. It may employ those powers during the imposition of a temporary stay in which counterparties are prohibited from exercising their rights to terminate QFCs, liquidate collateral, and net their overall positions with the failed firm solely because the FDIC has been appointed its conservator or receiver. Such a stay would remain in place until the counterparties are notified of a transfer of the QFC or until 5:00 p.m. of the business day after the appointment of the receiver.<sup>150</sup> Only after

<sup>147</sup> 12 U.S.C. §1823(c)(4). See also Fed. Deposit Ins. Corp. Resolution Handbook, Ch. 2, p. 16, available at <https://www.fdic.gov/bank/historical/reshandbook/ch2procs.pdf>; Robert R. Bliss and George G. Kaufman, *U.S. Corporate and Bank Insolvency Regimes: A Comparison and Evaluation*, 2 Va. L. & Bus. Rev. 143, 158-59 (2007).

<sup>148</sup> 12 U.S.C. §5384(a). See also Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76,614, 76,615 (Dec. 18, 2013), available at [https://www.fdic.gov/news/board/2013/2013-12-10\\_notice\\_dis-b\\_fr.pdf](https://www.fdic.gov/news/board/2013/2013-12-10_notice_dis-b_fr.pdf); Martin J. Gruenberg, Acting Chairman of the Fed. Deposit Ins. Corp., Remarks to the Fed. Res. Bank of Chicago Bank Structure Conf.; Chicago, IL, May 10, 2012 (“... the most promising resolution strategy from our point view will be to place the parent company into receivership and to pass its assets, principally investments in its subsidiaries, to a newly created bridge holding company. This will allow subsidiaries that are equity solvent and contribute to the franchise value of the firm to remain open and avoid the disruption that would likely accompany their closings. Because these subsidiaries will remain open and operating as going-concern counterparties, we expect that qualified financial contracts will continue to function normally as the termination, netting and liquidation will be minimal. In short, we believe that this resolution strategy will preserve the franchise value of the firm and mitigate systemic consequences. This responds to the goal of financial stability.”).

<sup>149</sup> The FDIC has a number of tools, referred to as “superpowers,” to deal with insolvent depository institutions that stem from long-standing judicial decisions, many of which were later enacted into law through the FDI Act and then OLA. For a fuller description of these “superpowers,” see Erin Burrows and F. John Podvin, Jr., *Revising the FDIC’s “Superpowers”: Contract Repudiation and D’Oench Duhme*, 127 Bank. L. J. 395 (May 2010). The superpowers include the power to reorganize the institution, replace its senior management, sell its assets, as well as avoid, repudiate, and avoid certain claims, with little judicial oversight. These powers, in some respects, exceed the authority provided to bankruptcy administrators. See, e.g., Thomas C. Baxter, Jr., Joyce M. Hansen, and Joseph H. Sommer, *Two Cheers for Territoriality: An Essay on International Bank Insolvency Law*, 78 Am. Bankr. L. J. 57, 72 (2004); Robert W. Norcross, Jr., *The Bank Insolvency Game: FDIC Superpowers, the D’Oench Doctrine, and Federal Common Law*, 103 Banking L. J. 316, 328 (1986); Fred Galves, *Might Does Not Make Right: The Call for Reform of the Federal Government’s D’Oench, Duhme and 12 U.S.C. 1823(e) Superpowers in Failed Bank Litigation*, 80 Minn. L. Rev. 1323 (1996); Robert W. Norcross, Jr., *The Bank Insolvency Game: FDIC Superpowers, the D’Oench Doctrine, and Federal Common Law*, 103 Banking L. J. 316, n.137 (1986). The FDIC’s “superpowers” tend to be broader when pertaining to non-QFCs. Contrast, for example, the FDIC’s general avoidance power, 12 U.S.C. §1821(d)(17) (FDI Act); 12 U.S.C. §5390(a)(11) (OLA) to its avoidance power for QFCs, 12 U.S.C. §1821(e)(8)(C) (FDI Act); 12 U.S.C. §5390(c)(8)(C) (OLA). A “qualified financial contract” in the context of an FDIC administered conservatorship or receivership of an insured depository institution is defined as “any securities contract, commodity contract, forward contract, repurchase agreement, swap agreement, and any similar agreement that the ... [FDIC] determines by regulation, resolution, or order to be a qualified financial contract...” 12 U.S.C. §§1821(e)(1) and (8)(F); 12 U.S.C. §5390(c)(8)(D). Although there are distinctions between the relevant definitions of financial contracts under the OLA receivership and the FDI Act conservatorship/receivership regimes and the U.S. Bankruptcy Code, those distinctions are not relevant for the purposes of this report. Kimberly Anne Summe, *Lessons Learned from the Lehman Bankruptcy*, at 72 (2010), available at [http://media.hoover.org/sites/default/files/documents/Ending\\_Government\\_Bailouts\\_as\\_We\\_Know\\_Them\\_59.pdf](http://media.hoover.org/sites/default/files/documents/Ending_Government_Bailouts_as_We_Know_Them_59.pdf).

<sup>150</sup> 12 U.S.C. §1821(e)(10)(B)(i) (FDI Act); 12 U.S.C. §5390(c)(10)(B)(i) (OLA). This means that the FDIC often has (continued...)



this temporary stay are counterparties free to exercise rights to net, terminate, or liquidate under such contracts.<sup>151</sup>

During this stay, the FDIC is permitted to transfer QFCs to other financial institutions as long as certain notice requirements are met. In exercising this authority, the FDIC must either transfer all QFCs with a particular party and its affiliates to a single financial institution, or it may not transfer any of them.<sup>152</sup>

The FDIC, as receiver under the FDI Act and OLA, also may repudiate certain contracts if allowing performance would be “burdensome” and “disaffirmance or repudiation ... will promote the orderly administration of the institution’s affairs.”<sup>153</sup> The FDIC may only repudiate QFCs, however, if it repudiates all QFCs with a particular counterparty and its affiliates.<sup>154</sup> In other words, the FDIC must either repudiate all QFCs with a particular party and its affiliates, or it may not repudiate any of them.

Finally, in contrast to QFCs being completely exempt from the avoidance power under the Bankruptcy Code,<sup>155</sup> the FDIC as conservator or receiver may avoid (i.e., reverse or claw-back) property transferred pursuant to a QFC when the transfer was performed with the “actual intent to hinder, delay, or defraud” the FDIC, or the failed company or its creditors.<sup>156</sup>

## Analysis of Strategy to Amend the Default Trigger Provisions in Qualified Financial Contracts

The temporary stay for QFCs under both the FDI Act and OLA gives the FDIC a brief period of time to determine how to most effectively and economically exercise its transfer, avoidance, and repudiation powers and to assess whether requisite legal conditions for employing those powers exist. For example, the FDIC might choose to transfer performing QFCs to different financial institutions to obviate the unnecessary and inefficient process of a counterparty terminating the QFC with the failed firm and then seeking to re-establish virtually the same contract in the private market with a different financial institution to stand in the shoes of the failed firm.

This temporary stay is in stark contrast to the blanket exception from the automatic stay for netting, terminating, and liquidating QFCs under the Bankruptcy Code. Modifying QFCs to provide covered financial institutions in default or their insolvency regime administrators with the

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(...continued)

approximately three days to make decisions because it frequently is appointed receiver on a Friday. Under the FDI Act, counterparties to QFCs whose rights would be triggered by the appointment of a *conservator* or by the financial condition that results in the appointment of a conservator, *may not* exercise such rights. 12 U.S.C. §1821(e)(10)(B)(ii). However, counterparties are free to exercise rights under QFCs triggered by the default *of the contracts* (as opposed to the insolvency of the depository institution) when a depository is in *conservatorship*. 12 U.S.C. §1821(e)(8)(E). There are no equivalent provisions in OLA because, as previously mentioned, the OLA does not establish a conservatorship regime.

<sup>151</sup> 12 U.S.C. §1821(e)(8)(A) (FDI Act); 12 U.S.C. §5390(c)(8)(A) (OLA).

<sup>152</sup> 12 U.S.C. §§1821(e)(8)(F), (e)(9), and (e)(10) (FDI Act); 12 U.S.C. §5390(c)(8)(F), (c)(9), and (c)(10) (OLA).

<sup>153</sup> 12 U.S.C. §1821(e)(1) (FDI Act); 12 U.S.C. §5390(c)(1) (OLA).

<sup>154</sup> 12 U.S.C. §1821(e)(11) (FDI Act); 12 U.S.C. §5390(c)(11) (OLA).

<sup>155</sup> For a discussion of the avoidance powers in bankruptcy, see *supra* notes 133-136 and surrounding text.

<sup>156</sup> 12 U.S.C. §1821(e)(8)(C) (FDI Act); 12 U.S.C. §5390(c)(8)(C) (OLA).

same powers as the FDIC as receiver under OLA or the FDI Act arguably could reduce the financial strain on an insolvent covered financial institution, as well as its many counterparties.<sup>157</sup>

On the other hand, providing the FDIC with the discretion on whether to transfer or repudiate QFCs arguably could increase uncertainty in financial markets because it may be difficult to predict how the FDIC will exercise that discretion.<sup>158</sup> This uncertainty could incentivize a covered financial institution's counterparties to exercise default trigger rights prior to the FDIC stepping in (or the company filing a petition for bankruptcy), thus hastening and exacerbating the covered financial institution's financial duress. If the FDI Act and OLA were amended so as to treat QFCs under those regimes the same as they are under the Bankruptcy Code, there is a strong likelihood that counterparties to a failed firm would decide whether or not to terminate, close-out, and net QFCs based on whether or not they would be "in the money."

In October 2014, 18 of the world's largest financial institutions, working through the International Swaps and Derivatives Association, Inc. (ISDA) announced an agreement in principal to voluntarily amend a significant portion of the industry's over-the-counter (i.e., those that are negotiated privately between parties rather than being traded on public exchanges) swaps contracts to allow for a temporary stay from counterparties' ability to terminate, liquidate, and accelerate the contracts when one of the other participating financial institutions enters a resolution process.<sup>159</sup> The agreement, called the ISDA Resolution Stay Protocol,

essentially enables adhering counterparties to opt into certain overseas resolution regimes via a change to their derivatives contracts. While many existing national resolution frameworks impose stays on early termination rights following the start of resolution proceedings, these stays might only apply to domestic counterparties trading under domestic law agreements, and so might not capture cross-border trades.<sup>160</sup>

Approximately 90% of the over-the-counter derivatives market will be covered by the ISDA Resolution Stay Protocol when it is implemented by the initial 18 companies, but that market share is expected to increase as additional institutions join.<sup>161</sup> The 18 firms also agreed to work with their regulators as they implement similar temporary stays through regulations in the United States and other jurisdictions. The companies expect to finalize the terms of the Protocol in November, which will go into effect at the beginning of 2015. The initial participating financial institutions include the domestically based Bank of America Merrill Lynch, Citigroup, Goldman Sachs, JP Morgan Chase, and Morgan Stanley.<sup>162</sup> The FDIC and FRB expressed their support of the ISDA Resolution Stay Protocol in a joint press release.<sup>163</sup>

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<sup>157</sup> It also might reduce the potential chaos of closing out and terminating hundreds of thousands of contracts in a short period of time.

<sup>158</sup> Thomas J. Fitzpatrick IV and James B. Thomson, *How Well Does Bankruptcy Work When Large Financial Firms Fail? Some Lesson from Lehman Brothers*, Fed. Reserve Bank of Cleveland Economic Commentary, Oct. 26, 2011, available at <http://www.clevelandfed.org/research/commentary/2011/2011-23.cfm>. Another potential source of uncertainty could be whether the U.S. or another government would provide some form of emergency assistance to the failed firm, like the U.S. did in 2010 with A.I.G., Citigroup, Fannie Mae and Freddie Mac, among others. *Id.*

<sup>159</sup> *Major Banks Agree to Sign ISDA Resolution Stay Protocol*, Int'l Swaps and Derivatives Assoc., Inc. Press Release, Oct. 11, 2014, available at <http://www2.isda.org/news/major-banks-agree-to-sign-isda-resolution-stay-protocol>.

<sup>160</sup> *Id.*

<sup>161</sup> *Id.*

<sup>162</sup> *Id.*

<sup>163</sup> *Federal Reserve Board and FDIC Welcome ISDA Announcement*, Bd. of Gov. of the Fed. Reserve Sys., Fed. (continued...)



## Increasing Long-Term, Unsecured Debt

Another step that representatives of the FDIC and FRB have indicated would be beneficial to the resolution of a covered financial institution is for these institutions to increase their long-term, unsecured debt as a proportion of their risk-weighted assets.<sup>164</sup> This policy also is being proposed by the Basel Committee on Banking Supervision<sup>165</sup> and the Financial Stability Board<sup>166</sup> to apply globally to systemically important financial institutions.

There has been a significant amount of focus on the role that minimum capital requirements can have on reducing the likelihood that covered financial companies will fail.<sup>167</sup> Capital requirements are not intended to completely eliminate a financial institution's risk of default.<sup>168</sup> In order to effectively serve as financial intermediaries for their customers and to keep financial markets functioning, financial institutions typically fund their loans and other assets through liabilities (e.g., customer deposits). As a result, there always will be some risk that the capital held by a financial institution will not be enough to cover its losses.<sup>169</sup>

According to the FDIC and FRB, long-term unsecured debt has several benefits over secured and short-term unsecured debt in an insolvency proceeding. First, holders of long-term, unsecured debt are more likely to be willing to accept haircuts and otherwise restructure their claims in a resolution. Secured creditors in an insolvency proceeding generally are protected up to the value of the collateral underlying their claim against the insolvent company.<sup>170</sup> Thus, they have little incentive to voluntarily take a haircut or accept less than the value of the underlying collateral.

Second, it is often the case that long-term debt better aligns the market interests of the covered financial institution with debt holders, as compared with short-term and secured debt. Secured debt holders, because they are generally protected up to the full value of the underlying collateral,

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Deposit Ins. Corp., Joint Press Release, Oct. 11, 2014, available at <https://www.fdic.gov/news/news/press/2014/pr14083.html>.

<sup>164</sup> *Wall Street Reform: Assessing and Enhancing the Financial Regulatory System, Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 113<sup>th</sup> Cong. (2014) (written statement of the Hon. Martin J. Gruenberg at p. 8; written statement of the Hon. Daniel K. Tarullo at pp. 9-10), available at [http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing\\_ID=b15fc832-df18-47d7-8c7d-1367e5770086](http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=b15fc832-df18-47d7-8c7d-1367e5770086).

<sup>165</sup> *Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement*, Basel Comm. on Bank. Super., July 2013, available at <http://www.bis.org/publ/bcbs255.pdf>.

<sup>166</sup> *2013 update of group of global systemically important banks (G-SIBs)*, Fin. Stability Bd., Nov. 11, 2013, available at [http://www.financialstabilityboard.org/publications/r\\_131111.pdf](http://www.financialstabilityboard.org/publications/r_131111.pdf).

<sup>167</sup> *Wall Street Reform: Assessing and Enhancing the Financial Regulatory System, Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 113<sup>th</sup> Cong. (2014) (written statement of the Hon. Daniel K. Tarullo at p. 9), available at [http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing\\_ID=b15fc832-df18-47d7-8c7d-1367e5770086](http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=b15fc832-df18-47d7-8c7d-1367e5770086).

<sup>168</sup> *Wall Street Reform: Assessing and Enhancing the Financial Regulatory System, Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 113<sup>th</sup> Cong. (2014) (written statement of the Hon. Daniel K. Tarullo at pp. 9-10), available at [http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing\\_ID=b15fc832-df18-47d7-8c7d-1367e5770086](http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=b15fc832-df18-47d7-8c7d-1367e5770086).

<sup>169</sup> CRS Report R42150, *Systemically Important or "Too Big to Fail" Financial Institutions*, by Marc Labonte, at 5.

<sup>170</sup> *Wall Street Reform: Assessing and Enhancing the Financial Regulatory System, Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 113<sup>th</sup> Cong. (2014) (written statement of the Hon. Martin J. Gruenberg at p. 8; written statement of the Hon. Daniel K. Tarullo at pp. 9-10), available at [http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing\\_ID=b15fc832-df18-47d7-8c7d-1367e5770086](http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=b15fc832-df18-47d7-8c7d-1367e5770086).

generally do not have a strong incentive to ensure that covered financial institutions are managed for long-term stability.<sup>171</sup> Similarly, short-term debt holders of a covered financial institution are more likely to only be concerned about the financial strength of covered financial institutions through the life of the debt. On the other hand, long-term, unsecured debt holders are more likely to have an interest in the long-term stability of the covered financial institution because they generally are going to be low priority claimants in a resolution proceeding. Consequently, if a covered financial institution fails, the long-term, unsecured creditors likely will be absorbing its losses.<sup>172</sup> As a result, part of the consideration into whether or not to extend long-term, unsecured credit to a covered financial institution is the company's long-term viability. If a covered financial institution's long-term financial health is questioned, it likely will have difficulty obtaining long-term unsecured credit at a reasonable cost. Additionally, short-term debt could be hard to rollover in a stressed environment. A firm that is heavily reliant upon short-term debt may be less stable during a market downturn than one that relies more on long-term debt.<sup>173</sup> (**Table 1** lists the short-term funding as a percentage of total liabilities of the 11 first-wave filers.)

FRB Governor Daniel K. Tarullo has explained it this way:

While minimum capital requirements are designed to cover losses up to a certain statistical probability, in the even less likely event that the equity of a financial firm is wiped out, successful resolution without taxpayer assistance would be most effectively accomplished if a firm has sufficient long-term unsecured debt to absorb additional losses and to recapitalize the business transferred to a bridge operating company. The presence of a substantial tranche of long-term debt that is subject to bail-in during a resolution and is structurally subordinated to the firm's other creditors should reduce run risk by clarifying the position of those other creditors in an orderly liquidation process. ... [L]ongterm debt also should have the benefit of improving market discipline, since the holders of that debt would know they faced the prospect of loss should the firm enter resolution.<sup>174</sup>

<sup>171</sup> *Wall Street Reform: Assessing and Enhancing the Financial Regulatory System, Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 113<sup>th</sup> Cong. (2014) (written statement of the Hon. Daniel K. Tarullo at pp. 9-10), available at [http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing\\_ID=b15fc832-df18-47d7-8c7d-1367e5770086](http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=b15fc832-df18-47d7-8c7d-1367e5770086).

<sup>172</sup> *Id.*

<sup>173</sup> Relatedly, some at the FDIC and FRB also believe that some financial institutions should reduce their reliance on short-term wholesale funding in order to promote financial stability. See, e.g., *Statement of Thomas M. Hoenig, Vice Chairman, FDIC on the Credibility of the 2013 Living Wills Submitted by First Wave Filers*, Aug. 5, 2014, available at <https://www.fdic.gov/news/news/speeches/spaug0514a.html>; *Wall Street Reform: Assessing and Enhancing the Financial Regulatory System, Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 113<sup>th</sup> Cong. (2014) (written statement of the Hon. Daniel K. Tarullo at p. 7), available at [http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing\\_ID=b15fc832-df18-47d7-8c7d-1367e5770086](http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=b15fc832-df18-47d7-8c7d-1367e5770086). The FRB, FDIC, and the Office of the Comptroller of the Currency (OCC) are imposing liquidity rules pursuant to authorities distinct from the DFA's living wills regime. See Regulatory Capital Rules: Regulatory Capital, Revisions to the Supplementary Leverage Ratio, 79 Fed. Reg. 57,725 (Sept. 26, 2014) (to be codified at 12 C.F.R. Part 3 (OCC), 12 C.F.R. Part 217 (FRB), and 12 C.F.R. Part 324 (FDIC)).

<sup>174</sup> *Wall Street Reform: Assessing and Enhancing the Financial Regulatory System, Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 113<sup>th</sup> Cong. (2014) (written statement of the Hon. Daniel K. Tarullo at pp. 9-10), available at [http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing\\_ID=b15fc832-df18-47d7-8c7d-1367e5770086](http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=b15fc832-df18-47d7-8c7d-1367e5770086).

In fact, both FDIC Chairman Gruenberg and FRB Governor Tarullo have acknowledged that the agencies are considering imposing a minimum level of long-term, unsecured debt that must be held by covered financial institution parent holding companies.<sup>175</sup>

It should be noted, however, that long-term, unsecured debt generally is more expensive than short-term, secured debt.<sup>176</sup> Additionally, many of the policy justifications for holding long-term, unsecured debt that are discussed above could prove illusory if creditors of the covered financial institution believe that it will receive emergency governmental assistance if it becomes insolvent or in danger of default.<sup>177</sup>

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<sup>175</sup> *Wall Street Reform: Assessing and Enhancing the Financial Regulatory System, Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 113<sup>th</sup> Cong. (2014) (written statement of the Hon. Martin J. Gruenberg at p. 8; written statement of the Hon. Daniel K. Tarullo at pp. 9-10), available at [http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing\\_ID=b15fc832-df18-47d7-8c7d-1367e5770086](http://www.banking.senate.gov/public/index.cfm?FuseAction=Hearings.Hearing&Hearing_ID=b15fc832-df18-47d7-8c7d-1367e5770086). Such a standard could be imposed pursuant to statutory authority distinct from DFA Section 165(d). See, e.g., 12 U.S.C. §5365.

<sup>176</sup> CRS Report R43345, *Shadow Banking: Background and Policy Issues*, by Edward V. Murphy, pp. 10-11.

<sup>177</sup> See CRS Report R42150, *Systemically Important or "Too Big to Fail" Financial Institutions*, by Marc Labonte, p. 12.