

# Meeting the Liquidity Challenge in Resolution: the US Approach

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# Two Pronged Strategy



1. Improve prudential supervision and create new policies to reduce the probability the any G-SIB will fail
  - No one believes that we could or should make G-SIBs fail- safe and so need a plan to resolve in an orderly way
2. Provide resolution authorities with tools to ensure every G-SIB is safe to fail without exacerbating systemic risk and with losses allocated solely to shareholders & creditors

# Mandated by G-20 in 2009



- ✓ Arose from consensus that authorities faced an impossible choice in the GFC
  - Either provide enormous bailouts (which amounted to ca 25% of world GDP) or
  - Attempt to resolve a a G-SIB and risk causing intolerable spillovers for the financial system & real economy
    - Lehman Brothers was the exception that proved the rule
- ✓ Concluded Too-Big-To-Fail was too expensive – financially and politically– to continue
  - But understood without introduction of appropriate resolution tools, this conclusion would be unconvincing

# Snapshot (12/07) Revealed Formidable Legal Complexity that Would Impede an Orderly Resolution

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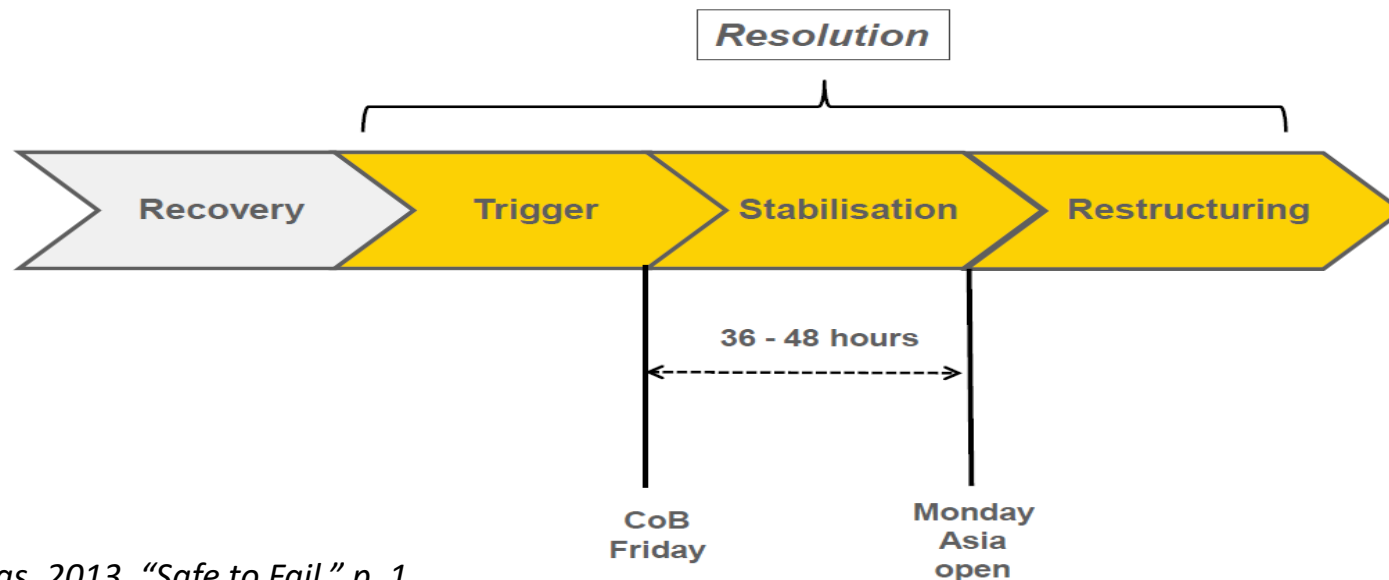
- ✓ The number of majority-owned subsidiaries indicates the minimum number of legal entities that would need to be dealt with (median 923, high 2,435)
- ✓ The % of foreign subsidiaries indicates that (at least) two authorities would need to be involved in a resolution (median 53%, high 95%)
- ✓ The % of non-bank subsidiaries indicates the possibility that other functional regulatory authorities would need to be involved (95%)

# Enormous Challenge: Need for Speed


How to develop a credible way to resolve any G-SIB through recapitalization, sale or wind-down without

1. Destabilizing financial system and real economy or
2. Tax-payer funded bailouts

Must be accomplished over a weekend and so planning essential



*The U.S. Congress addressed resolution policy  
under Titles I & II of the Dodd-Frank Act*



# Title I



- ✓ Requires systemically important banks to prepare living wills that detail plan for rapid and orderly resolution under the bankruptcy code
- ✓ If FRB & FDIC determine plan is not credible, can impose *sanctions*
  - More stringent capital and liquidity requirements
  - Activity restrictions
  - Constraints on growth
  - Restructuring or divestment
- ✓ As a fall back, the authorities may use Title II

# Title II (misleadingly termed): Orderly Liquidation Authority

- ✓ Under extraordinary circumstances Secretary of Treasury may appoint FDIC as receiver upon recommendation of 2/3<sup>rds</sup> of FED Board and FDIC Board
  - Must make a case that resolution through bankruptcy courts would exacerbate domestic financial instability
  - If bank fails, FDIC will place it in receivership under FDIA, as usual
  - But if BHC fails, the FDIC will take over the BHC and transfer its assets to a "bridge institution", leaving bailinable debt behind
- ✓ Bridge institution
  - Solvent by design
  - Intended to be liquid because transparently solvent, but
    - If market is unwilling to fund, FDIC can draw on a line of credit at the Treasury—**Orderly Liquidation Fund** up to 90% of fair value of assets of bridge institution
    - If Treasury funding is not repaid, shortfall will be assessed on remaining SIFs



*But Title I not Title II is the presumed approach.*

*Why the insistence on bankruptcy?*



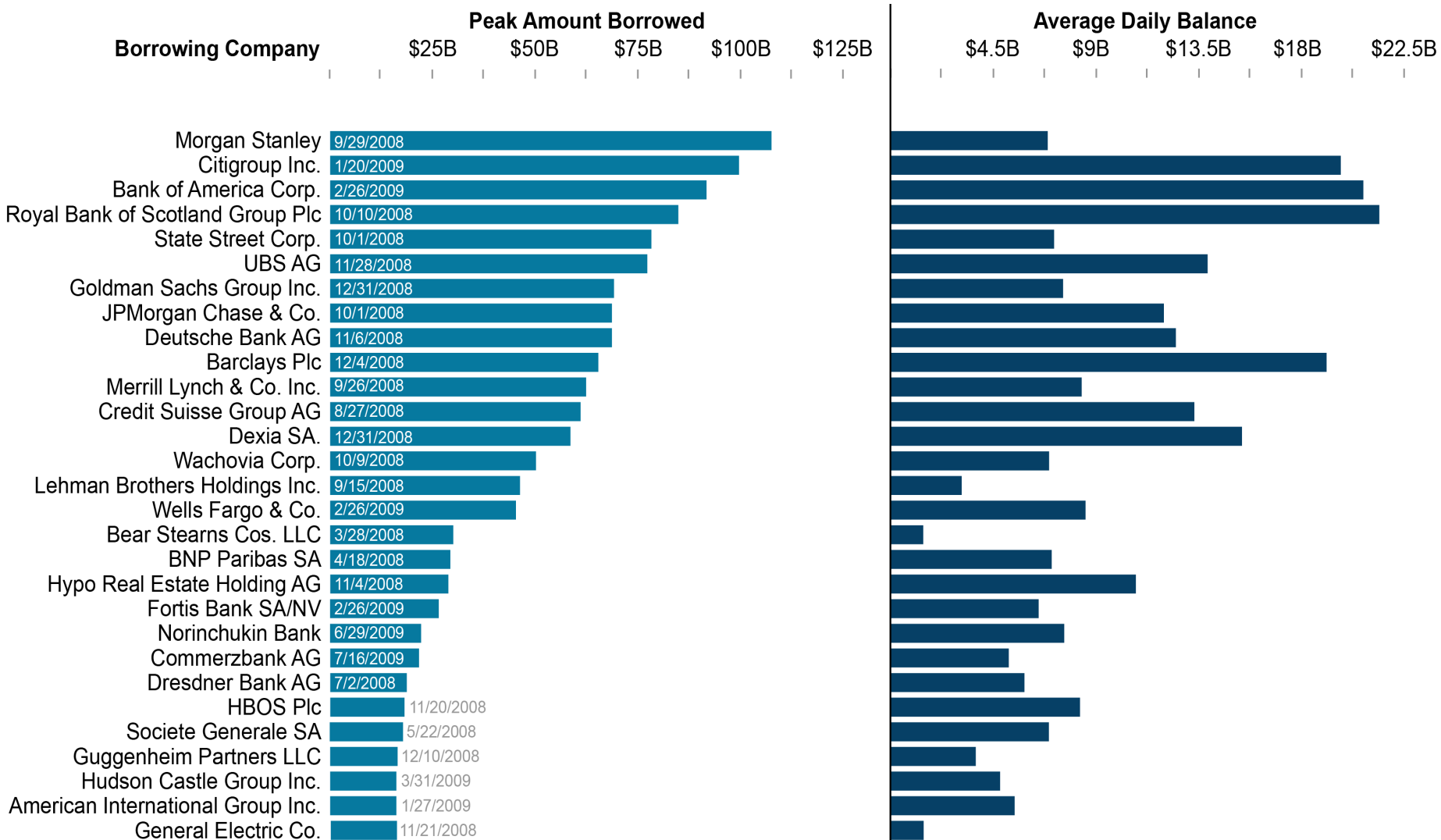
# At least three reasons



1. Conviction that an administrative resolution would inevitably become a way for regulatory agencies to subsidize large banks thus perpetuating 2B2F
  - ✓ Massive FDIC asset guarantees
  - ✓ Huge LLR operations by FED
    - Not authorized by Congress
    - Not visible to Congress
    - Included massive loans to institutions of questionable solvency
    - Included massive loans to foreign institutions

# The Fed Used Its LLR Capacity imaginatively to fund many of the largest banks in the world

## (Fed Loans 8/2007-4/2010)



Source: Bradley Keoun and Phil Kuntz, 2011, "Wall St. Aristocracy Got \$1.Trillion," Bloomberg.com, August 22.

# Preference for Bankruptcy (*cont'd*)

2. Belief that Title II perpetuated the notion of 2B2F
  - If too large or complex to go through bankruptcy, then too large and complex. Should be broken up.
  - Trump administration originally targeted Title II as the easiest part of DF to repeal
    - Could do so under a simple majority because of budgetary implications
    - In the end Treasury decided not to proceed
3. Strong preference for a rules-based approach with strong procedural safeguards
  - Dislike bureaucratic discretion
    - Probably overdone. Resolution authorities are bound by the principle that no creditor can be made worse off than they would be in bankruptcy
    - Innate preference of lawyers for legal procedures

*Understandably, enthusiasm for bankruptcy  
not shared by authorities abroad*

A thick, horizontal yellow brushstroke with a textured, painterly appearance, spanning the width of the slide.

In their view, Lehman Brothers demonstrated how destabilizing the US bankruptcy process could be

*But the U.S. authorities must find a way to  
make bankruptcy work*



# FDIC (with Bank of England) has devised a Single Point of Entry (SPOE) strategy

- ✓ Aim to recapitalize and continue operating subsidiaries, without resolution proceedings
  - Critical functions would continue without interruption
  - Going-concern value would be preserved
  - Losses would be imposed on shareholders and private creditors without need for a government bailout
  - Thus, moral hazard would be minimized
- ✓ To facilitate SPOE strategy need
  - **Clean top-level holding company** – no operating functions
  - Sufficient capital and liquidity resources at OpCos to sustain during resolution
  - Prevention of automatic close-out losses during resolution
  - Cooperation with, or at least acceptance by, non-US regulators

# Advantages of SPOE Strategy

- ✓ Any plausible strategy must deal with cross-border issues
  - Harmonization of insolvency procedures unattainable and the US is awkwardly placed to advocate a universalist approach
  - Domestic depositor preference law
  - Tradition of NY State Authorities in ring-fencing branches
- ✓ Resolution Authority must coordinate with different national authorities, which have different objectives, powers, resources & traditions
- ✓ SPOE attempts to finesse these problems by ensuring material subsidiaries remain solvent
  - Reduces burden of cross-border coordination
  - Reduces urgency of radical simplification of legal structures
- ✓ FDIC will apply under Title II; Living Wills plan to use in bankruptcy



# SPOE Reorganization Separates Financial Restructuring from Operational Restructuring

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- ✓ Chapter 11 proceedings are commenced for the top level BHC only (which can be accomplished quickly)
  - Transfer of recapitalized subs to new debt-free BHC owned by a trust for the benefit of the bankruptcy estate, leaving bailinable debt behind
- ✓ Operating subsidiaries are recapitalized (and provided with liquidity) prior to Chapter 11 proceedings
  - OpCos continue in business outside of bankruptcy proceedings
  - Going-concern value of OpCos preserved until orderly disposition including possible sale, IPO or wind-down
  - Systemic risk is minimized
- ✓ Losses absorbed by shareholders and subordinated creditors of BHC
  - But will benefit from preservation of going concern value of OpCos by New HoldCo for bankruptcy estate

# If successful, SPOE reorganization has several benefits

1. All OpCo obligations are paid in full when due
2. Systematically critical operations of OpCos, like clearing and settlement continue without interruption
3. Shared services among affiliates continue without interruption
4. Financial contract books are preserved, minimizing closed-out netting and fire-sale losses
5. Foreign OpCos remain open and operating, enhancing likelihood of international cooperation
6. Losses are absorbed by private sector stakeholders

# Success Depends on



- ✓ Sufficient financial resources at BHC to recapitalize and provide adequate liquidity for OpCos
- ✓ Tripwires that will ensure bankruptcy occurs while BHC still has sufficient resources to recapitalize and provide liquidity for operating companies
  - These requirements are stated as Guidance for 2017 Resolution Plans which
    - Address positioning of resources and
    - Triggers for recapitalization

**To Succeed, Must Have Sufficient Bailinable  
Capital to Insure Recapitalization  
Over the Resolution Weekend**




# **Total Loss Absorbing Capital (TLAC) Designed Primarily to Meet the Need for Ready Recapitalization**

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Debt TLAC (bailinable debt)  
intended to provide additional  
buffer against loss for taxpayers

# Transformation of Gone Concern Capital into Going Concern Capital



- ✓ TLAC is Total Loss-Absorbing Capacity: Tier 1 regulatory capital + eligible long-term debt (LTD)
- ✓ TLAC is issued by a Clean Holding Company
  - By insuring that the BHC has no operating function, it should be possible to do a rapid financial restructuring
  - Provide a ready, reliable source of funds to recapitalize material entities
  - Protect taxpayers against any exposure to loss

# How much TLAC is enough?

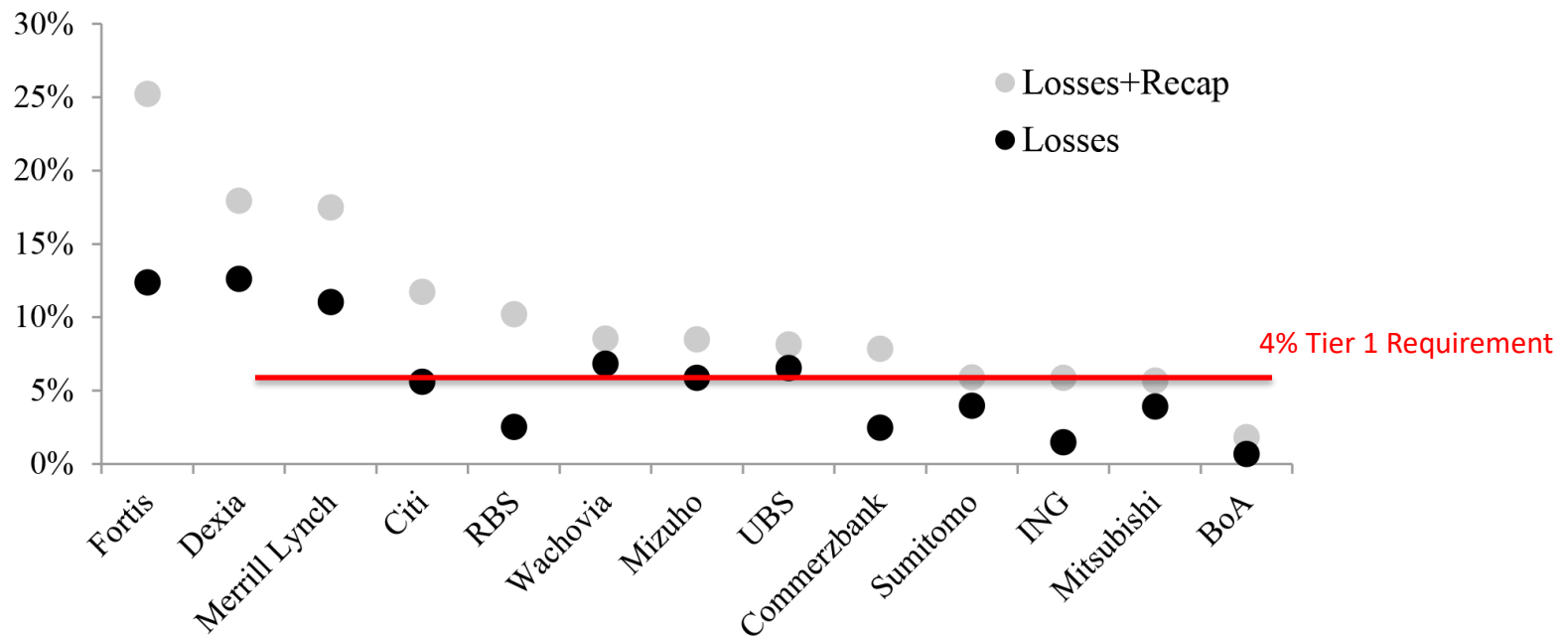


- ✓ FSB undertook quantitative impact study
- ✓ Attempted a crude cost/benefit analysis
- ✓ And examined how much TLAC would have been necessary to absorb the biggest loss of a G-SIB in the crisis

# Large Bank Losses During the Crisis Relative to RWA

## Losses and recapitalisation (risk-weighted assets)

TCI (with regulatory adj.) and total recapitalisation, percentage of RWA



Notes: risk-weighted assets are based on the first year a bank had losses. If TCI with regulatory adjustments is not available, unadjusted TCI is used.



# Measures to Assure Sufficiency of Capital & Liquidity

- ✓ During business as usual (BAU), must position internal capital and liquidity to anticipate a stress scenario
  - Resolution Capital Adequacy and Positioning (RCAP)
    - Must be sufficient to meet capital requirements for OpCos throughout resolution and meet prepositioning requirements for foreign OpCos imposed by local regulators
  - Resolution Liquidity Adequacy and Positioning (RLAP)
    - Must model daily contractual mismatches between inflows and outflows, daily movements of cash and collateral for inter-affiliate transactions and daily stressed liquidity flows as well as trapped liquidity due to actions taken by clients, counterparties, key financial market utilities and foreign supervisors

# Triggers provide clarity about when BHC must apply for bankruptcy



- ✓ Provides substance to astonishingly vague FSB standard for when to initiate resolution: “when a firm is no longer viable or likely to be no longer viable and has no reasonable prospect of becoming so”.
- ✓ Triggers based on available capital & liquidity relative to projected needs of OpCos during resolution

# US G-SIBs must develop triggers

- ✓ Based on available capital & liquidity relative to projected needs of OpCos during resolution
- ✓ Triggers are designed to activate while BHC resources are sufficient to cover projected OpCo capital and liquidity needs in resolution
  - Projections are made for each OpCo to determine adequacy of preposition capital and liquidity
  - Updated daily during financial distress
  - Any projected short-fall at OpCo level must be covered by BHC

## 4 New Measures Address Positioning of Resources & Triggers for Bankruptcy & Recapitalization

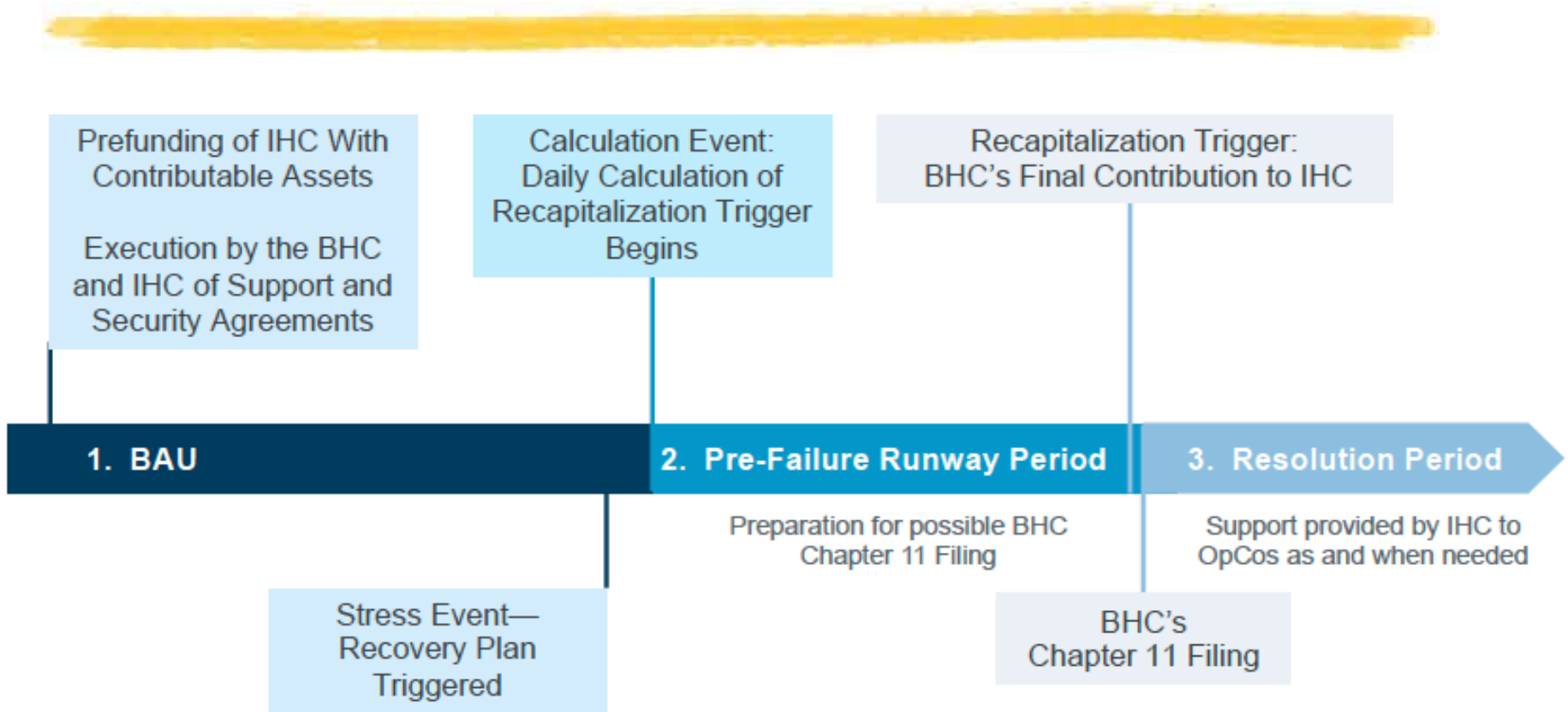
### BAU Positioning of Resources for an SPOE Resolution

1. RCAP = Resolution Capital Adequacy and Positioning
2. RLAP = Resolution Liquidity Adequacy and Positioning

### Projecting Actual Needs of OpCos to Make SPOE Resolution Feasible in time of distress

3. RCEN = Resolution Capital Execution Need
4. RLEN = Resolution Liquidity Execution Need

# Bankruptcy Resolution Timeline



# To Be Viable a BHC Must Have Sufficient Resources to Meet RLEN & RCEN Shortfall of all OpCos

- ✓ An OpCo's RCEN is measured against its internal TLAC to project its capital needs:
  - $RCEN \text{ Shortfall} = RCEN - TLAC$
- ✓ An OpCo's RLEN is measured against its remaining HQLAs to estimate its projected needs:
  - $RLEN \text{ Shortfall} = RLEN - HQLA$
- ✓ An OpCos resources needs are determined by the whichever shortfall is greater

# Must monitor capital and liquidity needs under conditions of stress

- ✓ Under stress, must make real-time projections of capital and liquidity needs to ensure resolution feasible
  - RCEN
  - RLEN
  - Triggers set to go off when projected resolution capital or liquidity needs are approaching the amount of the firm's capital and liquidity resources
  - Bankruptcy trigger:  $[\text{Available Financial Resources} / \text{Aggregate Resources Needs}] \rightarrow 1$
- ✓ Boards have a fiduciary duty to apply for bankruptcy before this trigger is breached

# But Framework Remains Untested

## Will it work?

- ✓ Will process be initiated before necessary liquidity and bailinable capital exhausted?
- ✓ Can back-up liquidity be provided to stabilize bridge institution?
  - -Need likely to exceed capacity of market to provide DIP financing
  - OLF is not intended to support bankruptcy
  - Fed is restricted in discount window lending to any individual institution
- ✓ Will host countries abstain from ring-fencing?
  - Massive efforts to facilitate international cooperation, but no sovereign is likely to give up the option to ring fence.
  - “Prepositioning” capital and liquidity
  - US IHC requirement
- ✓ Will authorities keep up the pressure until all G-SIBs can be credibly resolved without exacerbating financial instability and without taxpayer assistance?



For a more complete explanation of bankruptcy under Title I, see Wharton Financial Institutions Center, *Resolution Under Bankruptcy* available at <https://fic.wharton.upenn.edu/resolution-under-bankruptcy/>

