

Systemically Important Financial Institutions: Dodd-Frank Resolution Plans ("Living Wills") and Orderly Liquidation Authority

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***Dodd-Frank Wall Street Reform and
Consumer Protection Act ("Act")
July 21, 2010***

For an excellent overview of the Act, see Davis Polk & Wardwell LLP, *Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (July 21, 2010), available at <http://www.davispolk.com>

I. Systemic Risk Regulation (Title I of Act): Financial Stability Oversight Council (FSOC)

- Membership, etc.
- Designation of systemically important nonbank financial companies; October 2011 Rules Proposal
- Systemically important bank holding companies (together with designated companies, “systemically important financial institutions” or SIFIs)
- Federal Reserve registration and regulation, enhanced prudential standards, “living wills,” stress tests, remediation and mitigatory actions

Resolution Plans: “Living Wills”

- SIFIs must prepare and maintain extensive rapid orderly resolution plans—so-called “living wills” (LWs)
- SIFIs must submit LWs annually to FSOC, Federal Reserve Board (FRB), and Federal Deposit Insurance Corporation (FDIC)
- Staggered annual filings beginning July 1, 2012 through Dec. 31, 2013
- If FRB and FDIC determine LW is inadequate, may impose additional regulation or restructuring

Resolution Plans: "Living Wills" (Cont'd)

- LWs must include strategic analysis for rapid and orderly resolution under Bankruptcy
- Focus on core businesses, critical operations, mapping of legal entities
- ID of funding, liquidity needs, interconnections and interdependencies, and management information systems
- Plan to fund critical operations during resolution

Resolution Plans: "Living Wills" (Cont'd)

- LWs must provide regulators with understanding of firm's structure, complexity, and international operations
- LWs will assist regulators to ensure safe and sound operations of SIFIs
- LWs will assist in planning for orderly liquidation procedures under Title II of Act

Resolution Plans: "Living Wills" (Cont'd)

- LWs will be given a two-step review
- First step: FRB and FDIC determine whether LW is informationally complete
- Second step: FRB and FDIC assess credibility of the plan
- Review to focus on potential impediments to rapid and orderly resolution (e.g., complexity of organizational structure, international operations, ISDA qualified financial contracts, liquidity/funding needs, exit strategies)

Resolution Plans: "Living Wills" (Cont'd)

Coverage of Insured Depository Institutions:

- LW requirements similar to those for SIFIs, and same timing for implementation
- Purpose: Facilitate FDIC resolution of insured institution independently of parent and non-bank affiliates

Resolution Plans: "Living Wills" (Cont'd)

Currently, regulators are:

- Meeting monthly with SIFIs for guidance on LW submissions
- Increasing staff and infrastructure to manage process
- Developing policies and procedures for reviews of LWs
- Managing international coordination to minimize variances between cross-border plan requirements

Resolution Plans: “Living Wills” (Cont’d)

LW Criticism/Skepticism:

- Risk management tools (e.g., valuation of assets, stress testing, scenario planning, war games, adjustments for unthinkable events (“black swans”)) may prove to be insufficient, given the difficulty in identifying and predicting risk
- Effectiveness will require enhanced quality of regulatory supervision
- LWs are a disclosure requirement and cannot solve the “too big to fail” problem

Resolution Plans: "Living Wills" (Cont'd)

LW Criticism/Skepticism (Cont'd):

- Cross-border insolvency issues remain
- Enormous costs of LWs may outweigh the benefits
- Confidential information supplied by SIFIs may expose them to substantial risks and providing less information could undermine effectiveness of LWs
- LWs cannot solve problems of systemic, market-wide problems

Resolution Plans: "Living Wills" (Cont'd)

LW Criticism/Skepticism (Cont'd):

- LWs may encourage overconfidence and false sense of security
- LWs involve contingency planning in a vacuum as the circumstances of future financial distress cannot be predicted with certainty

II. Orderly Liquidation Authority (Title II of Act): Key Elements

- Applicability and Appointment
- Authority for Immediate and Decisive Action
- Continuity—Bridge Financial Companies
- Access to Liquidity
- Prohibition of Taxpayer Bailouts

Orderly Liquidation Authority (Cont'd)

Applicability and Appointment:

- Presumption that Bankruptcy Code, not OLA applies
- “Financial company” defined
- Determinations by Treasury Secretary necessary for “covered financial company,” including:
 - “in default or in danger of default”
 - failure would have serious adverse effects
- Treasury Secretary with 2/3 of FRB and 2/3 of FDIC Board, in consultation with President

Orderly Liquidation Authority (Cont'd)

Applicability and Appointment:

- Exceptions for broker-dealers and insurance companies
- Judicial review of determination and court approval of appointment of FDIC as receiver

Selected OLA Rules

- OLA rules replace Bankruptcy Code rules
- Effect of FDIC appointment as receiver
- FDIC Powers
 - Federal Deposit Insurance Act model
 - Resolution powers
 - Claims
 - “Super” powers

Selected OLA Rules (cont'd)

- FDIC Powers (cont'd)
 - *Ipsa facto* clauses
 - Contract repudiation
 - QFCs
 - Security interests/avoidance powers
 - Setoff
 - Stays
 - Rulemaking

Selected OLA Rules (cont'd)

- Unsecured creditor priority claims
- Receivership time limits
- Customer property protections

Immediate and Decisive Action

- Immediate authority to operate business, resolve claims, pay creditors, transfer assets and liabilities.
- One-day stay on derivatives netting to allow transfers for value
- Differences in Bankruptcy Code based on speed of execution, value retention, and mitigation of systemic risks; otherwise generally parallel to Bankruptcy Code

Continuity – Bridge Financial Company

- Transfer of assets to bridge financial company maximizes value and mitigates systemic risks; maintains critical operations
- Temporary FDIC–chartered financial company
- Broad authority to operate and transfer assets and liabilities
- Broad funding options, including Orderly Liquidation Fund and DIP financing
- Flexible resolution options: merger, charter conversion, stock sale, purchase and assumption

Access to Liquidity

- As 2008 demonstrated, immediate liquidity is critical to preserve valuable operations, for value preservation, and to stem systemic risk
- Orderly Liquidation Fund available—BUT all funding must be repaid
- Cannot be used to preserve insolvent companies or to avoid closure and resolution

Prohibition of Taxpayer Bail-Outs

- Statutory bar on taxpayer loss—12 U.S.C. § 5394
- Unsecured creditors must bear losses
- Full repayment of OLF from creditors or industry
- Shareholders receive nothing until all claims are satisfied
- FDIC to ensure that senior management and board members responsible for failure are not retained.

Will the OLA be effective?

- OLA rules may provide some additional certainty, at least at the time of a crisis, but maybe not *ex ante*
- Would the OLA rules have affected the results in the Lehman, Bear, or other financial collapses?
- Would Chapter 11 be a better alternative (perhaps with a few tweaks)?
- Is the FDIC equipped for its new receivership responsibilities?
- Is the Federal Reserve equipped for its new regulatory responsibilities?

Will the OLA be effective (Cont'd)?

- The big question: Is it really possible to prohibit bailouts in the face of a true economic crisis?

Dodd-Frank Selected Bibliography

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- Adam Feibelman, *Living Wills and Pre-Commitment*, 1 Am. U. Bus. L. Rev. 93 (2011).