Lawmakers and Regulators Continue Focus on Strategies for Resolving SIFIs

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The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 contains two sets of provisions for managing the insolvency of financial institutions. First, the legislation creates an Orderly Liquidation Authority (OLA), a comprehensive regime for resolving a financial institution whose failure is determined to potentially endanger the U.S. financial system. Second, certain financial institutions, including so-called "systemically important financial institutions" (SIFIs), are required to develop "living wills," which are plans for restructuring or winding down in accordance with the U.S. Bankruptcy Code. The plans are submitted annually and are subject to review by the FDIC and the Federal Reserve, which make credibility assessments. The preferred approach for dealing with an insolvent financial institution is through the bankruptcy process; the FDIC-administered OLA is to serve only as a fallback.

Over 100 financial institutions have prepared and submitted living wills to the FDIC and the Federal Reserve. The largest financial institutions submitted their first ones in 2012 and have submitted two additional versions since. Smaller financial institutions first began submitting their living wills in 2013. Some of the smaller financial institutions required to submit living wills have been allowed to submit more streamlined, "tailored" plans.

On August 5, 2014, the FDIC and the Federal Reserve concluded that the living wills submitted by 11 of the largest financial institutions (so-called "First Wave Filers") had shortcomings. These included problematic assumptions regarding the likely behavior of market participants in reaction to the firms' distress and the failure to make or identify necessary changes in structure and practice to improve prospects for orderly resolution. The agencies required actions in the following areas on or before July 1, 2015, so the firms would show progress on the identified shortcomings: (1) establishing less complex legal structures that would better align legal entities and business lines, (2) developing holding company structures to improve resolvability, (3) amending financial contracts to avoid early termination triggered by insolvency, (4) ensuring the continuity of shared services, and (5) demonstrating operational readiness for resolution, including the ability for timely production of reliable information.

However, the FDIC also stated its directors had determined that the 2013 plans submitted were not credible, implying that the plans would not facilitate an orderly resolution under the Bankruptcy Code. FDIC Vice Chairman Thomas Hoenig issued a separate statement in which he identified three categories of shortcomings: continued reliance on wholesale funding and an inadequate showing that liquidity would be available for restructuring, insufficient capital in view of leverage levels, and lack of clarity with respect to the ability to effectuate a cross-border flow of funds during a crisis, given uncertainties around actions regulators may take in different jurisdictions.

The regulators' statements underscore the significance and breadth of the task of planning an orderly wind-down or resolution of a large, global financial institution. The scale and depth of the required analysis may be inferred even from the high-level guidance that the agencies issued in April 2013. There, the agencies identified the following "obstacles" to rapid and orderly resolution: (1) multiple competing insolvencies under different bankruptcy regimes for various affiliates within a financial holding company (*e.g.*, simultaneous proceedings under the Securities Investor Protection Corporation (SIPC) for broker-dealers, the Federal Deposit Insurance Act (FDIA) for an insured depository institution, and foreign law for non-U.S. affiliates); (2) the potential that foreign supervisors and governments would take actions such as ring-fencing (protecting assets in one jurisdiction from transfer to another) that could exacerbate the financial institution's funding position; (3) the impact of operations and interconnectedness, raising the risk that third parties ranging from financial market utilities to IT vendors and other service providers may take adverse actions that significantly exacerbate the situation; (4) the risk that trading counterparties would seize collateral or take other actions to complicate, if not impede, resolution; and (5) the inability to obtain funding (including debtor-in-possession or "DIP" financing) to maintain critical operations. To make the exercise even more challenging, financial institutions must present their plans against baseline and stressed market scenarios, considering possibly idiosyncratic failure or failure under stressed market conditions. Finally, financial institutions may not assume any kind or level of extraordinary government assistance.

Accordingly, to develop a plan that regulators will find acceptable, financial institutions need to focus not just on planning for the nuts and bolts of bankruptcy filings; they also must develop detailed accounts of the impact of markets and the behavior of their counterparties and vendors on their balance sheet and operations. The nature of the assumptions made in connection with each aspect of operations, counterparty behavior (including financial market utilities), asset valuation and funding sources will be critical to the integrity of the proposed living will and subject to rigorous scrutiny by the regulators. Although the challenges are many, five sets of issues merit further comment: providing for liquidity and securing funding sources, managing self-help measures taken by counterparties, anticipating actions and proceedings in foreign jurisdictions, aligning legal entity structure with line of business, and operational ability to handle resolution.

Having enough liquidity to allow a financial institution to operate in an orderly fashion as it winds down is critical to managing distress and avoiding a spillover to the financial system. A significant focus in the living wills process is how financial firms will obtain and maintain liquidity, whether in the form of sufficient unencumbered assets or otherwise, to serve as the functional equivalent of DIP financing. In a typical situation, DIP financing is an operating loan made — usually by financial institutions — to an entity in bankruptcy. The OLA resolution scheme under Title II addresses liquidity provision through the creation of an orderly liquidation fund (OLF), with the expectation that any amounts disbursed will be recouped without taxpayer exposure. However, in the living wills process, financial institutions must design their liquidity provisions with no expectation of extraordinary government support.

One challenge is that financial counterparties typically are reluctant to provide funding to financial institutions approaching insolvency. As a result, financial holding companies must think carefully about the liquidity needs associated with each of the scenarios they present, and whether they adopt liquidation or restructuring strategies with respect to various affiliates as a result of the underlying analysis. A related, though antecedent, issue is outlining how the company will use liquidity in the 30-day "runway" period, and how it will determine whether resolution, as opposed to recovery, is required. Sometimes, because companies in crisis utilize their unencumbered assets to avoid formal insolvency proceedings, they may have few such remaining assets to support DIP financing if and when they file for bankruptcy. The living wills process requires firms to prepare for such contingencies. Accordingly, providing for sufficient DIP financing to fund resolution will require living wills to contemplate entry into formal insolvency proceedings long before reserves and other unencumbered assets are depleted, which in turn may require far greater vigilance in the early phases of troubled market dynamics.

Second, closely related to the issue of funding is managing counterparties during a period of distress. Various legal contracts with counterparties can complicate the winding-down process by affording them the right to seize collateral or to terminate contracts. Moreover, cross-default provisions and parent guarantees can magnify the impact of the failure of a particular affiliate across the entire holding company structure, including potential impact on efforts to transfer assets and liabilities during a restructuring to a bridge bank. Living wills are expected to focus on issues surrounding counterparty rights and collateral management (including netting and valuation). Regulators and industry associations have been pressing for progress on these issues, more generally, to assist resolution planning. On October 11, 2014, for example, the International Swaps and Derivatives Association (ISDA) announced in a press release a Resolution Stay Protocol that imposes short-term stays on counterparties exercising remedies in the event of a counterparty insolvency that, in theory, would avoid termination of certain short-term financing instruments. Such stays would preserve a financial institution's liquidity position and avoid a short-term run as it resolved its affairs.

Third, since the "First Wave Filers" are global financial institutions, they also must account for how the resolution efforts will affect, or be affected by, the circumstances of their foreign affiliates. The challenge here is that the bankruptcy laws of different countries are not the same and regulators may not all react to distressed financial firms with a consistent policy. Thus, firms will need to not only consider the impact of different laws on their efforts to resolve, but also anticipate the impact of potential actions such as ring-fencing. Such actions may result in constraints on deployment of liquidity by the financial firm and disruption of basic operating services, such as data management and trade execution. Firms must plan for contingencies with respect to the operational interdependencies of their global affiliates. Again, the regulators have sought to address structural issues in this area. Certain foreign banking organizations (FBOs), for example, are obligated to create an intermediate holding company structure based in the United States, which will be designed to facilitate resolution. 12 C.F.R. pt. 252, subpt. O (2015).

Fourth, continuing on the issue of structure, firms will have to further demonstrate alignment of legal entity with business lines. Frequently, financial firms conduct similar activity across multiple legal entities, such that a single transaction might involve several affiliates (for example, in the case of derivatives and risk-hedging transactions). Managing a bankruptcy where positions on individual transactions, for example, implicate multiple entities can become very complicated. Thus, firms and regulators will need to balance the business and efficiency rationale of housing activity in multiple entities against the incremental complexity it might create for orderly resolution.

Finally, operational continuity is critical to orderly resolution. Complex financial firms benefit from operational synergies through shared services, for example. In resolution, should some affiliates be disposed in bankruptcy, to maintain essential operational continuity, it is important that the shared services contracts contemplate continued service to the various entities. Moreover, rapid and efficient bankruptcy proceedings require that systems be configured to provide up-to-date information regarding the financial positions, exposures and general condition of the firm and all its affiliates. Accurate and timely internal reporting of data thus becomes critical to resolution planning. This requires attention to controls, so as to optimize timely input of data and information, and system integration, which consists of timely and accurate reporting and recordkeeping of the consolidated entity and its subsidiaries.

The foregoing measures, whether by regulators or financial institutions in their living wills, may assist in resolving financial institutions under the Bankruptcy Code. However, one challenge is that the Bankruptcy Code's focus on protection of creditor rights and process, designed to afford all interested parties with advance notice and an opportunity to be heard, can impede the ability of a troubled financial institution to effectuate a resolution with the speed necessary to preserve value and protect private interests while simultaneously minimizing systemic risk and protecting the public. Accordingly, a bill has been introduced in Congress that, if adopted, would amend the Bankruptcy Code through creation of a new subchapter for large financial institutions (Subchapter 5). Like the OLA and the FDIA, Subchapter 5 provides for the prompt transfer of a large financial institution's assets to a newly created "bridge company." Again, under this approach, a single holding company would file bankruptcy — a "single-point-of-entry" — with the assets of such company, *i.e.*, the stock in its operating subsidiaries, transferred to the bridge company. The bridge company must assume protected accounts and secured debt related to any transferred collateral, but unsecured claims and equity would be left behind in the bankruptcy estate. The equity in the new bridge company would be placed into a trust to be disposed at the discretion of a plan trustee with the proceeds distributed to unpaid, unassumed creditors in the order of their priority.

Unlike the OLA, however, a Subchapter 5 proceeding would not be effectuated with the FDIC as receiver, nor would there be an OLF. Rather, the process would be overseen, on a highly expedited basis, by an experienced bankruptcy judge selected from among a predetermined group designated to serve in this role. And consistent with the OLA, the FDIA and the ISDA's Resolution Stay Protocol, parties to short-term funding sources like repurchase agreements and securities contracts could not immediately terminate their obligations if they are assumed by a bridge company — which, under Subchapter 5, must occur within 24 hours of the commencement of a formal insolvency proceeding for the SIFI.

The proposed legislation may modify the Bankruptcy Code to further mitigate the risks to the financial system of financial institution insolvency and enhance the resolvability of financial institutions that do become insolvent. However, it does not address some important issues, such as funding and the complexities attendant to differing requirements that may be imposed on cross-border enterprises subject to multiple legal regimes. Moreover, Subchapter 5 does not provide for the resolution of a U.S. branch of an FBO. This is significant given most FBOs' very prevalent use of the U.S. branch structure. Accordingly, holding company structures may not necessarily result in a more streamlined "single-point-of-entry" insolvency process for FBOs. Until lawmakers and regulators across the globe coordinate on such matters, the risk of disjointed insolvency proceedings, which itself could contribute to financial system instability, will remain.