STATEMENT OF

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OF THE

SENATE COMMITTEE ON BANKING,
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"THE ROLE OF BANKRUPTCY REFORM IN ADDRESSING TOO-BIG-TO-FAIL"

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Thank you for inviting me to testify on the role of bankruptcy reform in addressing too-big-to-fail ("TBTF"). I am the head of the Financial Institutions Group at Davis Polk & Wardwell LLP.[1] I am also the Co-Chair of the Failure Resolution Task Force of the Financial Regulatory Reform Initiative of the Bipartisan Policy Center. I have written a number of articles and participated in a number of debates on the nature of the TBTF problem and how to solve it.[2] Like most U.S. and foreign regulators, financial industry groups, think tanks, rating agencies and other stakeholders,[3] I believe that the most promising solution to the TBTF problem for most of the U.S. and foreign banking organizations that have been designated by the Financial Stability Board ("FSB") as global systemically important banking groups ("G-SIBs") is the single-point-of-entry ("SPoE") recapitalization within resolution or bankruptcy strategy.

During the past few years, I have spent a significant portion of my time working on resolution plans for a number of U.S. and foreign banking organizations under Section 165(d) of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-

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[1] My practice focuses on providing bank regulatory advice to the largest and most systemic U.S. and foreign banking organizations, as well as to a wide range of U.S. regional, mid-size and community banks. This focus includes advice on mergers and acquisitions, capital markets and other transactions when the target or issuer is a banking organization. I am the editor of REGULATION OF FOREIGN BANKS & AFFILIATES IN THE UNITED STATES (Thomson Reuters: 8th ed. 2014), the leading treatise in the area.

[2] *See, e.g.*, Randall D. Guynn, *Framing the TBTF Problem: The Path to a Solution*, in ACROSS THE DIVIDE: NEW PERSPECTIVES ON THE FINANCIAL CRISIS (Hoover Institution and Brookings Institution: Martin Neil Baily and John B. Taylor, eds., 2014); John F. Bovenzi, Randall D. Guynn and Thomas H. Jackson, *Too Big to Fail: The Path to a Solution*, A Report of the Failure Resolution Task Force of the Financial Regulatory Reform Initiative of the Bipartisan Policy Center ("BPC Report"); Randall D. Guynn, *Resolution Planning in the United States*, in THE BANK RECOVERY AND RESOLUTION DIRECTIVE—EUROPE'S SOLUTION FOR "TOO BIG TO FAIL"? (De Gruyter: Andreas Dombret and Patrick Kenadjian, eds., 2013); Randall D. Guynn, *Are Bailouts Inevitable?*, 29 YALE JOURNAL ON REGULATION 121 (2012); Debate Between Dean Paul Mahoney of the University of Virginia School of Law and Randall D. Guynn, *Are Bailouts Inevitable?* (available at: http://volokh.com/2011/03/04/uva-debate-are-bailouts-inevitable-under-dodd-frank/).

[3] Guynn, *Framing the TBTF Problem*, *supra* note 2, at 282-286.

Frank Act"). I have also represented a number of financial industry trade organizations, including The Clearing House Association, the Securities Industry and Financial Markets Association, the Global Financial Markets Association and the Financial Services Forum on issues related to recovery and resolution planning, including the ISDA Resolution Stay Protocol (the "ISDA Protocol")[4] and the FSB's proposal on total loss-absorbing capacity ("TLAC").[5] I am here today, however, in my individual capacity and not on behalf of any client, although I expect to be asked by clients to help them evaluate the various proposals for bankruptcy reform.

Congress is currently considering two bankruptcy reform proposals that are designed to address the TBTF problem. Both are based on the pioneering work of the Hoover Institution on a proposed new Chapter 14 of the Bankruptcy Code.[6] The House passed H.R. 5421, the Financial Institutions Bankruptcy Act ("FIBA"), last year, and is considering a nearly identical version of it this year. Two years ago, Senators Cornyn and Toomey introduced S. 1861, the Taxpayer Protection and Responsible Resolution Act ("TPRRA"). This year, they have introduced a substantially revised version of TPRRA. Both the Senate and House bills are modeled on the SPoE portion of what the Hoover Institution calls Chapter 14 2.0.[7] That portion of the revised version of the original

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[4] International Swaps and Derivatives Association, Inc., *ISDA 2014 Resolution Stay Protocol* (Nov. 4, 2014).

[5] Financial Stability Board, *Adequacy of loss-absorbing capacity of global systemically important banks in resolution*, Consultative Document (Nov. 10, 2014).

[6] *See, e.g.*, BANKRUPTCY NOT BAILOUT: A SPECIAL CHAPTER 14 (Hoover Institution: Kenneth E. Scott and John B. Taylor, eds., 2012); MAKING FAILURE FEASIBLE: HOW BANKRUPTCY REFORM CAN END "TOO-BIG-TO-FAIL" (Hoover Institution: Kenneth E. Scott, Thomas H. Jackson and John B. Taylor, eds., 2015).

[7] Thomas H. Jackson, *Building on Bankruptcy: A Revised Chapter 14 Proposal for the Recapitalization, Reorganization, or Liquidation of Large Financial Institutions*, in MAKING FAILURE
(….continued)

Chapter 14 proposal is designed specifically to facilitate an SPoE strategy (or what Professor Jackson calls the one-entity or two-entity recapitalization approach) under the Bankruptcy Code.[8]

This statement first discusses the nature of the TBTF problem. It then describes the SPoE strategy, including how it works, how it inevitably results in a substantial shrinkage of the failed banking group and why it is a viable solution to the TBTF problem. It then discusses the changes made since the 2008 global financial crisis to make U.S. banking groups more resilient against failure. Next, it describes the major structural changes that have been made by the U.S. G-SIBs so that they are safe to fail.[9] Finally, it discusses how bankruptcy reform can improve the ability of the Bankruptcy Code to address too-big-to-fail.

1. Nature of the TBTF Problem

The TBTF problem arises if policymakers do not believe they can allow certain large, systemically important banking groups to fail and impose losses on their private sector investors without risking the sort of contagious runs by short-term creditors or a disruption in critical operations that can destabilize the financial system.[10] Faced with a

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FEASIBLE, *supra* note 6, at 23; David A. Skeel, Jr., *Financing Systemically Important Financial Institutions,* in MAKING FAILURE FEASIBLE, *supra* note 6, at 62; John B. Taylor, *Preface*, in MAKING FAILURE FEASIBLE, *supra* note 6, at xii; William F. Kroener III, *Revised Chapter 14 2.0 and Living Will Requirements under the Dodd-Frank Act*, in MAKING FAILURE FEASIBLE, *supra* note 6, at 247.

[8] *See supra* note 7.

[9] *Cf* Thomas Huertas, SAFE TO FAIL: HOW RESOLUTION WILL REVOLUTIONISE BANKING (Palgrave Macmillan: 2014).

[10] Douglas Diamond and Philip Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, 91 JOURNAL OF POLITICAL ECONOMY 401 (1983); Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, Remarks at The Clearing House 2014 Annual Conference, New York, New York, at 2 (Nov. 20, 2014).

dilemma between taxpayer-funded bailouts and a potential collapse of the financial system, policymakers tend to choose bailouts as the lesser of two evils.[11] If there were no viable solution to that dilemma, bailouts would almost certainly be inevitable.[12] Thomas Huertas provides a good discussion of why TBTF is a problem and why it should be solved in *Safe to Fail: How Resolution Will Revolutionise Banking*.[13]

2. The Single-Point-of-Entry Strategy

But there is a viable solution if certain conditions are satisfied. It is called the SPoE resolution strategy. That strategy was originally developed by the FDIC under Title II of the Dodd-Frank Act.[14] It was subsequently endorsed by the Bank of England as the most promising strategy for dealing with failed G-SIBs without the need for taxpayer-funded bailouts and without causing the sort of contagion that can destabilize the financial system.[15] The European Union added language to its Bank Recovery and Resolution Directive authorizing resolution authorities at both the member state and union levels to resolve European banking and other financial organizations using the

[11] BPC Report *supra* note 2, at 1; Guynn, *Are Bailouts Inevitable?*, *supra* note 2, at 127-129.

[12] Guynn, *Are Bailouts Inevitable?*, *supra* note 2, at 129. *See also* Thomas F. Huertas, *A Resolvable Bank*, in MAKING FAILURE FEASIBLE, *supra* note 6, at 129 ("A resolvable bank is one that is 'safe to fail': it can fail and be resolved without cost to the taxpayer and without significant disruption to the financial markets or the economy at large.").

[13] Huertas, *supra* note 7, chapter 1, at 4-20.

[14] Martin J. Gruenberg, Acting Chairman, FDIC, Remarks to the Federal Reserve Bank of Chicago Bank Structure Conference (May 10, 2012).

[15] FDIC and Bank of England, Joint Paper, *Resolving Globally Active, Systemically Important, Financial Institutions* (Dec. 10, 2012); Martin J. Gruenberg, Chairman, FDIC & Paul Tucker, Deputy Governor, Financial Stability, Bank of England, *Global Banks Need Global Solutions When They Fail*, FINANCIAL TIMES, Op. Ed. (Dec. 10, 2012; Bank of England, *The Bank of England's Approach to Resolution* (October 2014).

SPoE strategy.[16] The Failure Resolution Task Force at the Bipartisan Policy Center recognized that the SPoE strategy could be carried out under existing Chapter 11 of the Bankruptcy Code, but recommended that a new Chapter 14 be enacted to increase the legal certainty of SPoE under the Bankruptcy Code.[17]

a. How SPoE Works

Under the SPoE strategy, the top-tier parent of a U.S. banking group would be put into a special resolution proceeding under Title II of the Dodd-Frank Act or a Chapter 11 bankruptcy proceeding. The FDIC under Title II or the debtor-in-possession in a Chapter 11 proceeding would establish a new financial holding company ("FHC") called a bridge FHC (because it is a temporary bridge to an exit from the receivership or bankruptcy proceeding). All of the assets of the failed parent, including is ownership interests in its operating subsidiaries, would be transferred to the bridge FHC. This would be done in a bankruptcy proceeding, with court approval, pursuant to Section 363 of the Bankruptcy Code. All of the shares and long-term unsecured debt of the failed parent would remain behind in the receivership or bankruptcy proceeding. Only a limited amount of critical operating liabilities, such as those to the electric company or critical vendors as well as parent guarantees, would be assumed by the bridge FHC, making it essentially debt-free.

The parent or bridge FHC would recapitalize any operating subsidiaries that suffered losses by forgiving intercompany receivables or otherwise contributing assets to

[16] Directive 2014/15/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU, and Regulations (EU) No 1093/2010 and (EU) No 648/2012, of the European Parliament and of the Council.

[17] BPC Report, *supra* note 2, at 33-35.

the subsidiaries. It would do so because the franchise values of operating subsidiaries are almost always substantially greater than their liquidation values. Thus, recapitalizing the operating subsidiaries should maximize their value for the benefit of the failed parent's stakeholders.

At least in a bankruptcy proceeding the bridge FHC would be transferred to an independent trust, which would hold the interest in the bridge FHC for the benefit of the bankruptcy estate. The trustees of the trust would include experienced and highly regarded bankers, former regulators and others. The trust would enter into an agreement approved by the bankruptcy court that would spell out the duties of the trust to the bankruptcy estate. One key benefit of the trust would be to help gain public confidence in the stability of the bridge FHC.

Once the business transferred to the bridge FHC stabilizes, the FDIC or the trust would convert the bridge to an ordinary bank holding company ("New HoldCo") and sell all or a portion of the shares in New HoldCo to the public and distribute the net proceeds and any unsold shares to the receivership or bankruptcy estate. The net proceeds and any unsold shares would then be distributed to the failed parent's stakeholders in accordance with the priority of their claims.

A step-by-step illustration of how an SPoE strategy works is included in the BPC Report,[18] and attached to this Statement as Exhibit A.

b. Principal Strategy under Title I Resolution Plans

All but two of the U.S. G-SIBs recently disclosed in the public summaries of their 2015 resolution plans submitted under Section 165(d) of the Dodd-Frank Act that their

[18] BPC Report, *supra* note 2, at 23-32.

principal strategies for being resolved under the Bankruptcy Code is an SPoE strategy under existing Chapter 11 of the Bankruptcy Code.[19]

c. What Comes Out of the SPoE Hopper is Not What Goes in

As shown by the step-by-step illustration of the SPoE strategy in the BPC Report,[20] and attached to this Statement as Exhibit A, the SPoE strategy results in the resolution, not the resurrection of a failed banking group. The banking group that emerges from an SPoE strategy is always significantly smaller than it was before its top-tier parent failed. Under the stylized balance sheets used in the BPC Report, the banking group that emerged from the SPoE was half the size of the banking group just before its top-tier parent failed (total assets dropped from 100 to 50), as illustrated by Figures 1 and 7.[21] This is mainly a function of the fundamental nature of the SPoE process, as illustrated by Figure 2 in the BPC Report (where total assets dropped from 100 to 59, to reflect the hypothetical losses suffered by the group).[22] But it may also result from the sale of certain assets during the SPoE process if that would be consistent with maximizing the value of the firm and minimizing its losses for the benefit of the top-tier

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[19] See the FDIC's website, https://www.fdic.gov/regulations/reform/resplans/index.html, or the Federal Reserve's website, http://www.federalreserve.gov/bankinforeg/resolution-plans.htm. The firms that used the SPoE strategy as their principal strategy were Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase, Morgan Stanley and State Street. The firms that did not use the SPoE strategy as their principal strategy were the Bank of New York Mellon and Wells Fargo. The principal strategy used by those firms was a multiple-point-of-entry ("MPoE") strategy whereby the businesses of their flagship banks were transferred to bridge banks and then, over time, broken up and sold in an FDIC receivership and their material non-bank subsidiaries were sold to third parties as going concerns or wound down in their respective insolvency proceedings.

[20] BPC Report, *supra* note 2, at 23-32.

[21] *Id*. at 24, 30.

[22] *Id*. at 25.

parent's stakeholders left behind in the Title II receivership or bankruptcy proceeding, as illustrated by Figure 6 in the BPC Report.[23]

This shrinkage principle is illustrated by the public summaries of the 2015 Title I resolution plans recently filed by the U.S. G-SIBs.[24] According to the firms that used the SPoE strategy as their principal strategy,[25] the firm that emerged from the SPoE process was substantially smaller than the firm that entered the process. For example, Bank of America and JPMorgan Chase reported that their main bank subsidiaries would shrink by approximately 33% and their broker-dealer subsidiaries would shrink by 66-80%.[26] State Street reported that its flagship bank would shrink by 50% and it might sell its investment management businesses outside of insolvency proceedings as going concerns.[27] Citigroup, Goldman Sachs and Morgan Stanley all reported that they would cease to exist because they would sell their operations to third parties in public or private offerings or wind them down outside of any insolvency proceedings as part of the SPoE process.[28]

The shrinkage principle in the SPoE strategy, of course, is quite different from breaking up healthy banks for political reasons. Any shrinkage occurring as part of the SPoE strategy is simply a by-product of incurring losses and attempting to maximize the value of the enterprise and minimize its losses for the benefit of the failed parent's stakeholders.

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[23] *Id*. at 30.

[24] *See supra* note 19.

[25] *Id*.

[26] *Id*. (see public summaries for Bank of America and JPMorgan Chase).

[27] *Id*. (see pubic summary for State Street).

[28] *Id*. (see public summaries of Citigroup, Goldman Sachs and Morgan Stanley).

d. SPoE is a Viable Solution

The SPoE strategy is a viable solution to the TBTF problem if three essential conditions are satisfied.

(1) Sufficient Usable TLAC

First, the failed parent must have enough TLAC (i.e., combined equity and long-term unsecured debt) for the business that is transferred to the bridge FHC to be fully recapitalized after suffering losses in a sufficiently severe adverse economic scenario and the TLAC must be usable. By usable, I mean the group's losses can be imposed on the parent's private sector TLAC investors without fostering runs by the group's short-term creditors, which in turn can foster contagion throughout the financial system.[29] The key to being able to do so is separating the TLAC and other capital structure liabilities from short-term unsecured debt and other operating liabilities, and making the capital structure liabilities subordinate to the operating liabilities (or conversely making the operating liabilities senior to the capital structure liabilities).[30] As a result, both shareholders and

[29] Huertas, *supra* note 12, at 129.

[30] *Id.*, at 29-30. I believe that I was the first person to suggest this sort of separation and subordination of capital structure liabilities to operating liabilities in connection with the Financial Stability Board's Private Sector Bail-in Initiative, of which I was a member. That concept is now embedded in the FSB's TLAC proposal. *See* FSB, *supra* note 5. It was developed in response to what I found to be a persuasive criticism of the FDIC's discretion to discriminate among similarly situated creditors in Section 210(b)(4) of Title II of the Dodd-Frank Act, as long as the disfavored creditors receive at least as much as they would have received in a liquidation under Chapter 7 of the Bankruptcy Code (the "no creditor worse off than in liquidation" or "NCWOL" principle). Kenneth E. Scott, *A Guide to the Resolution of Failed Financial Institutions: Dodd-Frank Title II and Proposed Chapter 14*, in BANKRUPTCY NOT BAILOUT, *supra* note 6, at 11-12, 17 ("For my purposes, a bailout occurs when some favored claimants on a failed financial firm are given more than what they would receive in an ordinary bankruptcy, at the expense of others."). When I tried to analyze why the FDIC needed the power to discriminate among similarly situated creditors, it seemed to me that the only legitimate reason was to be able to treat short-term unsecured creditors as if they were senior to long-term unsecured creditors during a financial panic in order to stem runs and contagion. A rule of separation and subordination seemed superior to a discretionary power to achieve the same end since the discretionary power arguably resulted in an unexpected transfer of value from one group of creditors to another without compensation, meaning it could give rise to moral hazard since the favored creditors would not internalize the costs of their unexpected favored position. In contrast, (….continued)

long-term unsecured debt investors are expected to bear losses, a result that would be fundamentally different from the 2008 global financial crisis when long-term bondholders were generally insulated from losses and only shareholders bore losses.

The easiest way for U.S. bank holding companies to make TLAC usable is to make it structurally subordinate to the group's short-term unsecured debt.[31] This can be achieved by moving any short-term unsecured debt from the parent to its operating subsidiaries. The TLAC investors will then absorb all losses incurred by the group before any of the short-term unsecured creditors suffers any losses. Because the TLAC would act as a shield against losses by the short-term creditors, imposing losses on TLAC investors should reduce the incentive of the group's short-term unsecured creditors to run. To the extent this subordination framework makes short-term unsecured debt less risky, the market will force short-term unsecured creditors to internalize the costs of their preferred position (and thereby eliminate any moral hazard) by decreasing the returns they would otherwise be able to demand on short-term unsecured debt.

(2) Sufficient Liquidity

Second, the business transferred to the bridge FHC must have access to a sufficient amount of liquidity in a Title II or bankruptcy proceeding for the business to be stabilized after it has been transferred to the largely debt-free bridge FHC. If the business does not have sufficient liquidity, it may be forced to sell illiquid assets at fire-sale prices,

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with a clear non-discretionary rule of separation and subordination in place, the market would force short-term unsecured creditors to internalize the costs of their preferred status by reducing the amount of interest or other return they could demand. At the same time, it would allow long-term unsecured debt holders to demand a return that was sufficient to compensate them for the increased risk they would bear.

[31] Other less practical ways are to amend outstanding long-term senior unsecured debt to make it contractually subordinate to short-term unsecured debt or to persuade Congress to enact a statutory priority scheme that makes long-term unsecured debt subordinate to short-term unsecured debt.

which can cause an otherwise solvent bridge FHC to become insolvent.[32] A well-capitalized bridge FHC should be able to obtain secured liquidity from the market under normal market conditions.[33] But if the market for secured liquidity is dysfunctional, as it typically is during a financial crisis, the FDIC has the power to supplement the amount of secured liquidity available from the market in a Title II proceeding.[34]

There is no similar government source of back-up secured liquidity in a bankruptcy proceeding, and TPRRA would prohibit the Federal Reserve bank from making advances to a covered financial company or a bridge financial company for the purpose of providing court-approved debtor-in-possession financing.[35] A U.S. G-SIB that is required to show it can be resolved under the Bankruptcy Code without any access to secured liquidity from a government source will be forced to hold far more cash and other high quality liquid assets ("HQLAs") than otherwise in order to show it will have enough liquidity in a hypothetical, future bankruptcy proceeding. Such a requirement will reduce the amount of credit the U.S. G-SIBs can supply to the market.[36] It will also provide an incentive for U.S. G-SIBs to hoard liquidity during a financial crisis, when it is most needed by the market.[37]

To illustrate the impact of such a liquidity requirement on the supply of credit, consider how the money multiplier works. If all banks were subject to a 10% reserve

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[32] Diamond and Dybvig, *supra* note 10.

[33] Skeel, *supra* note 7, at 65-67.

[34] Dodd-Frank Act, §210(n) (Orderly liquidation fund).

[35] Skeel, *supra* note 7, at 63.

[36] Tarullo, *supra* note 10, at 5-6.

[37] *Id*. at 6, 18.

requirement ("RR"), it would mean that they are required to set aside $10 in cash for every $100 in loans they make. Since the potential money multiplier is 1/RR, it also means that every dollar of central bank money injected into the banking system by the Federal Reserve has the potential to multiply into 10 times the amount of money and credit throughout the banking system.[38] If the reserve requirement is increased to 20%, the amount of potential credit available to the system will shrink by 5 times the amount of central bank money (-500%) originally injected into the system. The point is not to say whether 10% or 20% is the correct reserve requirement, but to illustrate that there is a tradeoff between the amount of the reserve requirement and the amount of money and credit that can potentially be made available to the market. [39]

Liquidity requirements have the same effect on the supply of money and credit as reserve requirements.[40] If U.S. G-SIBs are required to hold twice as much cash and HQLAs as they would be required to hold if a government source of secured liquidity were available in a hypothetical, future bankruptcy proceeding, the potential amount of credit they can supply to the market will shrink in advance by approximately 5 times the amount of central bank money (-500%) originally injected into the system by the Federal Reserve. In other words, there is a serious tradeoff between the potential amount of credit the U.S. G-SIBs can provide to the market *now* and the benefits of prohibiting the Federal Reserve from using any of its lender-of-last-resort ("LOLR") facilities to provide liquidity to fully recapitalized bridge FHCs in a *future, hypothetical* bankruptcy

[38] *See, e.g.*, James R. Kearl, ECONOMICS AND PUBLIC POLICY: AN ANALYTICAL APPROACH 422-27, 792 (Pearson: 6th ed., 2011).

[39] *See, e.g.*, Tarullo, *supra* note 10, at 5-6.

[40] Indeed, reserve requirements are a type of liquidity regulation. *Id.* at 18, note 18.

proceeding. Assuming that the Federal Reserve would provide such liquidity in accordance with the classic rules laid down by Walter Bagehot[41]—i.e., only on a fully secured basis to solvent bridge FHCs at appropriate above-market interest rates—it would seem as if the risk of loss to the Federal Reserve and the risk of creating any moral hazard would be essentially zero. It therefore seems as if the tradeoff strongly favors the availability of a properly structured LOLR facility to serve as a back-up source of secured liquidity in a bankruptcy proceeding.[42]

For the reasons described in the BPC Report, it is important for policymakers to distinguish between capital and liquidity.[43] Government programs like the Troubled Asset Relief Program ("TARP") provided equity capital to both viable and troubled financial firms. TARP bailed out the private sector investors of otherwise insolvent firms by protecting them against losses without requiring those investors to compensate the government for providing such protection. In contrast, traditional LOLR facilities provide only temporary fully secured liquidity at above-market interest rates to solvent firms with sufficient capital. If properly structured, such facilities expose the government to no risk of loss and require borrowers to adequately compensate it for the small amount of liquidity risk it assumes.[44] Thus, it is fair and appropriate to label government injections

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[41] Walter Bagehot, LOMBARD STREET: A DESCRIPTION OF THE MONEY MARKET (1873).

[42] *See* David A. Skeel, Jr., *supra* note 7, at 65, 74-75, 81-85. Indeed, Professor Skeel argues that Congress should amend Section 13(3) of the Federal Reserve Act to expressly authorize the Federal Reserve to provide secured liquidity to bridge financial companies and their operating subsidiaries in order to facilitate an SPoE strategy under the Bankruptcy Code. *Id.* at 65.

[43] BPC Report, *supra* note 2, at 19.

[44] Tarullo, *supra* note 10, at 9. Paul Tucker, *The lender of last resort and modern central banking principles and reconstruction*, BIS Papers No. 79 (Sept. 2014).

of capital such as those made under the Capital Purchase Program of TARP as bailouts,[45] but it is wrong to label properly structured LOLR facilities as bailouts.

(3) Mitigation of QFC Cross-Defaults

Third, and related to the second, a material amount of the qualified financial contracts ("QFCs") at the group's operating subsidiary level must not contain cross-defaults to the parent's failure. Alternatively, any such cross-defaults must be overridden contractually, for example, as provided by the ISDA Protocol or a similar contractual arrangement or by regulation or statute. Otherwise, such cross-defaults would allow the QFCs to be terminated and drain liquidity out of the group even if the operating subsidiaries have been recapitalized and are performing on those QFCs. In addition, collateral securing the QFCs would be dumped on the market, putting downward pressure on asset values. Such a potential drainage of liquidity would require U.S. G-SIBs to carry even more cash and HQLAs in order to be sure they would have enough liquidity in a hypothetical, future bankruptcy proceeding, putting further pressure on their ability to supply credit to the market and increasing their incentive to hoard liquidity during a financial crisis.[46]

3. U.S. Banking Groups Are More Resilient

U.S. banking groups have taken substantial actions to make themselves more resilient against failure since the 2008 global financial crisis. For example, as shown in Exhibit B, the largest, most systemic banking groups have nearly twice as much capital as they had on the eve of the 2008 financial crisis. They are also projected to have more

[45] *See* Davis Polk, A GUIDE TO THE LAWS, REGULATIONS AND CONTRACTS OF THE FINANCIAL CRISIS, chapter 3 (Margaret Tahyar, ed., September 2009).

[46] Tarullo, *supra* note 10, at 6, 18.

capital in a stressed environment than they had actual capital in 2008. This makes them more resilient against insolvency. They also have significantly more liquid balance sheets, making them more resilient against runs, as illustrated in Exhibit C. They have three times (3X) the amount of HQLAs compared to 2008, and five times (5X) the amount of cash. They have also reduced their reliance on short-term wholesale funding, as shown in Exhibit D. U.S. regulatory standards increase with the size and complexity of U.S. and foreign banking organizations, as shown in Exhibit E.

4. U.S. G-SIBs Are Safe to Fail Under the Bankruptcy Code

The U.S. G-SIBs have made major structural changes so that they will be safe to fail under the Bankruptcy Code.[47]

a. More Usable TLAC

The most important structural change that almost no one has heard of relates to usable TLAC, as illustrated on Exhibit F. The U.S. G-SIBs had, on average, nominal TLAC equal to approximately 17% of their risk-weighted assets ("RWAs") in 2008. Unfortunately, only tangible common equity turned out to be loss-absorbing without risking contagion because of how the TLAC was structured, and tangible common equity amounted to only 5% of RWAs. Losses could not legally be imposed on long-term senior unsecured debt without causing contagion because it ranked equally with short-term senior unsecured debt issued at the parent level. There was no provision in the Bankruptcy Code that allowed bankruptcy courts to discriminate among similarly situated creditors unless it would maximize the value of the enterprise for the benefit of the

[47] *Cf.* Huertas, *supra* note 9.

disfavored creditors.[48] Although losses could theoretically have been imposed on subordinated debt, preferred equity and trust preferred securities without causing contagion, the market was confused about the relative priority among those instruments and long-term senior unsecured debt so policymakers worried about causing contagion if such securities were allowed to suffer any losses.

Today the U.S. G-SIBs have, on average, nominal TLAC equal to approximately 25% of RWAs, as illustrated by Exhibit F. More importantly, they have restructured their TLAC so that it is all usable to absorb losses without causing contagion.[49] This means that they have five times (5X) the amount of usable TLAC (which consists of both equity and long-term unsecured debt) compared to what they had during the 2008 global financial crisis. They have achieved this result by moving virtually all of the short-term unsecured debt that used to be issued by their top-tier parent companies to their operating subsidiaries. Long-term senior unsecured debt can now be left behind in an FDIC receivership or bankruptcy proceeding of the parent without imposing losses on the group's short-term unsecured debt. This amount of TLAC should be enough to recapitalize the business transferred to a bridge FHC at full Basel III capital levels under conditions twice as severe as the 2008 global financial crisis.

Both the market and the regulators expect this structural change to make U.S. G-SIBs more resolvable under the Bankruptcy Code, as shown on Exhibit G. For example, Fitch and Moody's have eliminated any uplift on the ratings of U.S. G-SIBs based on an

[48] *See, e.g.,* Douglas G. Baird, ELEMENTS OF BANKRUPTCY 225-26 (5th ed. 2010). In contrast, the FDIC has the discretion to treat similarly situated creditors differently under Section 210(b)(4) of the Dodd-Frank Act as long as the disfavored creditors receive at least as much as they would have received in a liquidation under Chapter 7 of the Bankruptcy Code.

[49] *See* Huertas, *supra* note 12, at 129.

expectation of government support because government bailouts are no longer expected.[50] Standard & Poor's has indicated that it may eliminate any uplift based on an expectation of government support.[51] The spreads on long-term unsecured debt of U.S. G-SIBs are now higher than the spreads on long-term unsecured debt issued by other U.S. banks.[52]

b. Increased Liquidity

As noted above, the U.S. G-SIBs have substantially more cash and HQLAs than in 2008. Several of them have increased their cash and HQLAs in order to show they would have enough liquidity to carry out an SPoE resolution strategy under Chapter 11, assuming no access to secured liquidity from any government LOLR facility. This new liquidity requirement may have already started to result in a higher effective liquidity requirement than either the Basel III liquidity coverage ratio or net stable funding ratio. It raises serious public policy questions whether this new liquidity requirement is justified in light of the negative impact it may already be having on the potential amount of credit that the U.S. G-SIBs are able to provide to the U.S. economy.[53]

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[50] Government Accounting Office, *Large Bank Holding Companies: Expectations of Government Support*, at 25-26 (July 2014). Moody's Investors Service, Rating Action: *Moody's concludes review of eight large US banks* (Nov. 14, 2013).

[51] GAO, *supra* note 50.

[52] *Id.* at 50-52.

[53] Tarullo, *supra* note 10, at 5-6, 18.

c. Mitigation of QFC Cross-Defaults

Five of the eight U.S. G-SIBs[54] are among the 18 G-SIBs[55] that agreed to adhere to the new ISDA Resolution Stay Protocol. As summarized in the slide attached as Exhibit H, the ISDA Protocol overrides cross-defaults in ISDA financial contracts among the 18 adhering G-SIBs based on a parent's or other affiliate's bankruptcy or entry into resolution. The adhering U.S. G-SIBs have also supported regulations to expand the principles of the ISDA Protocol to more counterparties and financial contracts. No similar mechanism existed during the 2008 financial crisis. According to the Financial Stability Board, "[w]ith the adoption of the [ISDA] protocol by the top 18 dealer G-SIBs in November, over 90% of their OTC bilateral trading activity will be covered by stays of either a contractual or statutory nature."[56] The FDIC and the Federal Reserve described the ISDA Protocol as "an important step toward mitigating the financial stability risks associated with the early termination of bilateral, OTC derivatives contracts triggered by the failure of a global banking firm with significant cross-border derivatives activities."[57]

d. Other Actions

The U.S. G-SIBs have also made a number of other structural changes and taken a number of other actions to make themselves more resolvable under the Bankruptcy Code. These include restructuring and other actions to ensure the continuity of shared services

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[54] The adhering U.S. G-SIBs are Bank of America, Citigroup, Goldman Sachs, JPMorgan Chase and Morgan Stanley. *See* ISDA Press Release (Oct. 11, 2014).

[55] The adhering non-U.S. G-SIBs are Bank of Tokyo-Mitsubishi UFJ, Barclays, BNP Paribas, Crédit Agricole, Credit Suisse, Deutsche Bank, HSBC, Mizuho Financial Group, Nomura, Royal Bank of Scotland, Société Générale, Sumitomo Mitsui Financial Group, and UBS. *Id*.

[56] Financial Stability Board, Press Release (October 11, 2014).

[57] Federal Reserve and FDIC, Joint Press Release (October 11, 2014).

throughout the resolution process, improving operational capabilities, and preserving access to financial market utilities. In addition, the U.S. regulatory agencies have taken significant actions to improve coordination with foreign regulators.[58]

e. Regulator Recognition

The regulators have noticed how much progress the U.S. G-SIBs have made in making themselves safe to fail under the Bankruptcy Code. FDIC Chairman Martin Gruenberg has described the progress as transformational and impressive, and perhaps underappreciated. See Exhibit I for a representative set of quotes from selected regulators.

5. Role of Bankruptcy Reform in Addressing Too-Big-to-Fail

While I believe that the actions taken above should make SPoE feasible under the existing Bankruptcy Code, bankruptcy reform would enhance the ability of the Bankruptcy Code to address too-big-to-fail by making four key additions:

- Clarifying that bank holding companies can recapitalize their operating subsidiaries prior to the commencement of bankruptcy proceedings.
- Clarifying that Section 363 of the Bankruptcy Code can be used to transfer the recapitalized operating subsidiaries to a new holding company using a bridge company structure.
- Adding provisions that permit a short stay of close-outs and allow the assumption and preservation of qualified financial contracts, and

[58] *See* Statement of Donald S. Bernstein Before the Subcommittee on Regulatory Reform, Commercial and Antitrust Law of the House Committee on the Judiciary at 6-7 (July 9, 2015).

overriding ipso facto (bankruptcy) defaults or cross-defaults that might impede the resolution process.

- Providing for some form of fully secured liquidity resource that would offer financing to help stabilize the recapitalized firm and prevent fire sales until access to market liquidity returns.[59]

The first two of these features would increase the certainty of application of current law to actions that must be taken in connection with an SPoE strategy in bankruptcy.[60]

The third of these features currently is being addressed by contractual workarounds like the ISDA Protocol, but it would be far better if the Bankruptcy Code were amended to include a provision similar to Section 210(c)(16) of the Dodd-Frank Act that provides for the override of cross-defaults under QFCs in an SPoE resolution under the Bankruptcy Code.[61]

The last of these features is currently being addressed by the substantially increased liquidity reserves on the balance sheets of most of the U.S. G-SIBs, though once they have been recapitalized in an SPoE resolution, there is no reason why traditional, secured LOLR facilities should not be available to non-bankrupt, fully capitalized, going concern subsidiaries of the firms.[62] The availability of such liquidity, if

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[59] *Id*. at 8-9.

[60] *Id.* at 9.

[61] *Id.*

[62] Skeel, *supra* note 7, at 65 (arguing that Congress should amend Section 13(3) of the Federal Reserve Act to expressly permit the Federal Reserve to make secured liquidity available to a bridge financial company and its operating subsidiaries to facilitate an SPoE resolution under the Bankruptcy Code).

properly structured, would involve no risk of loss to taxpayers and would help to mitigate any panic run on subsidiary liquidity after the holding company commences its bankruptcy proceedings.[63]

Although TPRRA includes most of these features, it contains a provision that would prohibit the Federal Reserve from providing liquidity to a bridge FHC for the purpose of providing court-approved debtor-in-possession financing under the Bankruptcy Code. I believe this provision should be deleted.[64] My view is consistent with the position recently taken by the National Bankruptcy Conference ("NBC"), which essentially made the same observation and recommendation.[65] In addition, if TPRRA fails to allow the Federal Reserve to provide secured liquidity to a bridge FHC under the Bankruptcy Code, the U.S. G-SIBs may be forced to hold more cash and HQLAs than otherwise. This will sharply reduce the amount of credit they can make available to the market and give them a powerful incentive to hoard liquidity during a financial crisis, when it is most needed by the market.[66] Finally, the absence of a government LOLR

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[63] Bernstein, *supra* note 58, at 9.

[64] Professor Skeel would go a step further and argue that Congress should amend Section 13(3) of the Federal Reserve Act to expressly authorize the Federal Reserve to provide secured liquidity to a bridge financial company and its operating subsidiaries to facilitate an SPoE resolution under the Bankruptcy Code. Skeel, *supra* note 7, at 65. While I agree with Professor Skeel's view, I believe that it would be worth enacting TPRRA even if it does not contain such an express authorization.

[65] Letter dated June 18, 2015 from the National Bankruptcy Conference to the Honorable Tom Marino, Chairman of the House Subcommittee on Regulatory Reform, Commercial and Antitrust Law, the Honorable Hank Johnson, the Ranking Member of that Committee, the Honorable Chuck Grassley, the Chairman of the Senate Committee on the Judiciary, and the Honorable Patrick J. Leahy, Ranking Member of that Committee ("NBC Letter"), at 7.

[66] Tarullo, *supra* note 10, at 5-6, 18.

facility in a bankruptcy proceeding will increase the range of circumstances under which Title II can be lawfully invoked.[67]

TPRRA would also repeal Title II of the Dodd-Frank Act. Largely for the reasons stated by the NBC,[68] I believe this would be inadvisable. While I would prefer that a new Chapter 14 be added to the Bankruptcy Code to minimize the circumstances under which Title II can be lawfully invoked to the bare minimum,[69] I believe that there is value in preserving Title II for several reasons. First, it may be necessary to have a provision like Title II to be able to have a government source of back-up secured liquidity in the event of a liquidity famine in the market during a future financial crisis. Second, there may be certain unforeseeable emergency circumstances that would justify a compromise with the rule of law in favor of allowing the FDIC to exercise the broad range of discretion granted by Title II, which a bankruptcy court does not have under the Bankruptcy Code. Third, foreign jurisdictions do not have a tradition of recapitalizations or reorganizations under their insolvency laws. As a result, foreign regulators associate insolvency laws with liquidations, not recapitalizations or reorganizations. To provide for recapitalizations or reorganizations of financial firms, these foreign jurisdictions have created special resolution regimes ("SRR") run by administrative agencies rather than courts. These SRRs are substantially similar to Title II of the Dodd-Frank Act and the bank resolution

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[67] Under Section 203(b)(2) of the Dodd-Frank Act, Title II can only be lawfully invoked if the resolution of a covered financial company under the Bankruptcy Code would have serious adverse effects on financial stability in the United States. The resolution of such a company under the Bankruptcy Code is more likely to have serious adverse effects on U.S. financial stability if the Federal Reserve is prohibited from providing secured liquidity to solvent entities at appropriate above-market interest rates to facilitate resolution under the Bankruptcy Code.

[68] NBC Letter, *supra* note 65, at 3-5.

[69] *See supra* note 67.

provisions in the Federal Deposit Insurance Act. As a result, many foreign regulators have an almost impossible time understanding or accepting that an SPoE strategy can be executed effectively under the Bankruptcy Code. It is therefore useful to preserve Title II to foster cross-border confidence and cooperation in the U.S. resolution process. Such confidence and cooperation would almost certainly be undermined if Title II were repealed.

Conclusion

While the U.S. G-SIBs have made substantial progress showing that an SPoE strategy can be executed under existing Chapter 11, bankruptcy reform has the potential to increase the legal certainty of that outcome. Indeed, I believe that the proposed TPRRA would increase the ability of the Bankruptcy Code to address too-big-to-fail with two modifications. First, the provisions prohibiting the Federal Reserve from providing advances to bridge financial companies in a bankruptcy proceeding for the purpose of providing it with debtor-in-possession financing should be deleted. Second, while it is desirable for TPRRA to reduce the circumstances under which Title II of the Dodd-Frank Act can be lawfully invoked to the bare minimum, it should not entirely repeal Title II.

EXHIBITS TO STATEMENT OF

RANDALL D. GUYNN

HEAD OF THE FINANCIAL INSTITUTIONS GROUP
DAVIS POLK & WARDWELL LLP

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER PROTECTION

OF THE

SENATE COMMITTEE ON BANKING,
HOUSING, AND URBAN AFFAIRS

"THE ROLE OF BANKRUPTCY REFORM
IN ADDRESSING TOO-BIG-TO-FAIL"

JULY 29, 2015

Exhibit A Step-by-Step Illustration of How SPoE Works (from BPC Report)........ A-1

Exhibit B Increased Capital B-1

Exhibit C Increased Liquidity: More Cash and HQLAs..C-1

Exhibit D Increased Liquidity: Reduced Reliance on Short-Term Wholesale Funding.. D-1

Exhibit E U.S Regulatory Standards E-1

Exhibit F Increased Usable TLAC F-1

Exhibit G Increased Usable TLAC: Reaction of Markets and Regulators G-1

Exhibit H ISDA Resolution Stay Protocol.. H-1

Exhibit I Recognized Progress in Improving Resolvability.....................................I-1

Exhibit A

Step-by-Step Illustration of How SPoE Works
(from BPC Report)

The OLF is an unusual creation. As a result, the application of the ordinary governmental budgetary scoring has not produced logical results. For example, in implementing the government-wide sequester, the Office of Management and Budget (OMB) determined that there were $77 million in "savings" by implementing the sequester on the OLF. This makes no sense, given that the OLF has never been used and its use is not contemplated absent the failure and resolution of a SIFI under OLA. Another example is the Congressional Budget Office's (CBO) decision to score the repeal of OLA as providing "savings" to the government. The logic behind CBO's score has to do with the temporal sequencing of events over a ten-year time horizon. Specifically, CBO's practice is to assume a small but non-zero probability of use in each year, with repayment coming after the end of the ten-year period. Thus, if there is a failure in years nine or ten of the ten-year window, the government has to provide funding for OLF immediately but is not repaid until after year ten, which is outside the budget window.

In reality, if the OLF is used properly to provide only temporary, fully secured liquidity to recapitalized entities and not to provide capital to insolvent entities, it should not cost the taxpayers (or other financial institutions) anything. Both the Administration and some in Congress have used budgetary scoring rules in ways that are not consistent with what should occur. Both sides should debate these issues on their merits and not use artificial scoring results in ways that are not consistent with what taxpayers will actually experience.

SINGLE-POINT-OF-ENTRY (SPOE) RECAPITALIZATION STRATEGY

The FDIC has the authority to develop strategies for implementing its power under OLA whenever the conditions for invoking OLA are satisfied. FDIC Chairman Gruenberg recently announced that the FDIC's preferred strategy for resolving the largest and most complex financial groups under OLA is the SPOE recapitalization strategy. The key elements of the strategy can be executed over a weekend or even overnight. It imposes ***all losses*** on the parent company's ***shareholders and long-term unsecured debt holders***, as well as any other holders of comparable capital structure liabilities of the parent, and ***not on taxpayers***. If the parent has sufficient loss-absorbing resources in its capital structure and sufficient access to liquidity, this strategy ensures that all short-term obligations and other similar operating liabilities of the group, including demand deposits, are satisfied in a timely manner.

The FDIC has issued a joint paper with the Bank of England advocating the SPOE recapitalization strategy for resolving G-SIFIs. FDIC Chairman Gruenberg and Bank of England Deputy Governor for Financial Stability Paul Tucker also jointly published an editorial in the *Financial Times* lauding the SPOE recapitalization strategy for resolving G-SIFIs without a taxpayer-funded bailout.

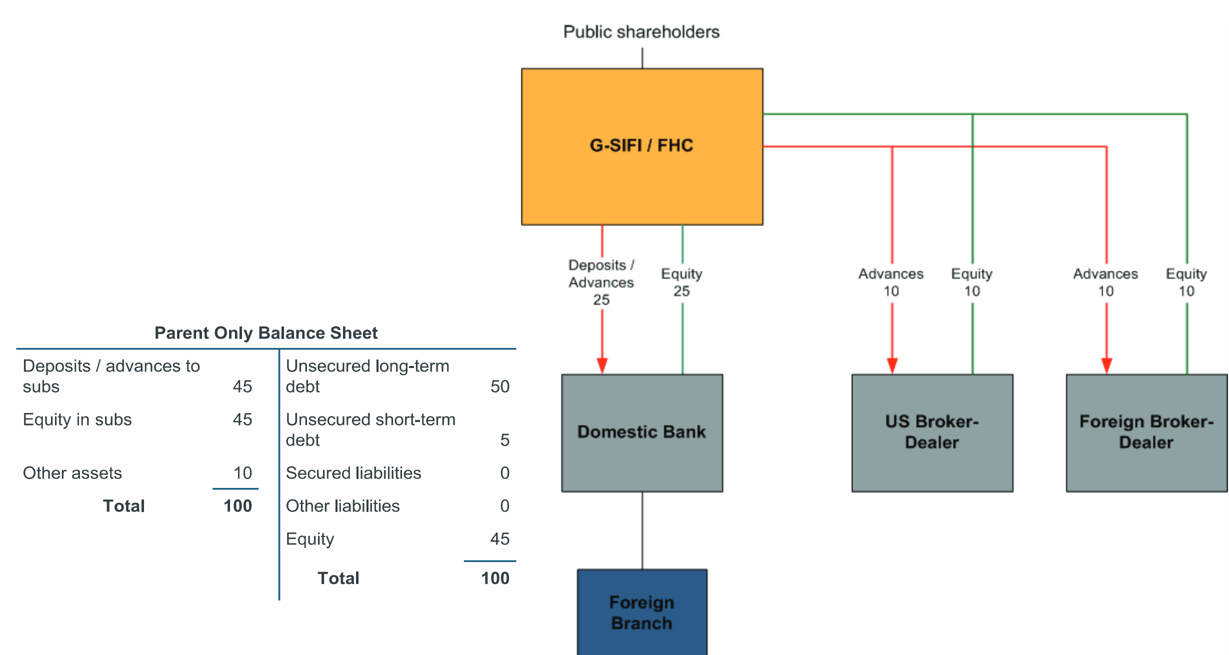
The FDIC has indicated that it intends to propose a policy statement or regulation describing how it will use its authority under OLA to resolve a covered financial company using the SPOE recapitalization strategy.

The FDIC will probably continue to use its pre-existing tools for resolving SIFIs on the less complex, more domestic and smaller end of the continuum between D-SIFIs with $50 billion in assets and G-SIFIs with over $1 trillion in assets. This means that it would probably continue to use its tool of choice under the FDI Act – ***purchase-and-assumption transactions*** – to resolve any bank subsidiary of a domestic or D-SIFI's parent holding company. This tool involves the sale of a failed bank to one or more healthier third-party banks through an auction process, with or without loss-sharing supported by the industry-funded Deposit Insurance Fund. Moreover, as long as the consolidated operations of the parent holding companies of D-SIBs are essentially domestic in nature, the FDIC will probably also allow their parents to be reorganized or liquidated under the Bankruptcy Code rather than invoking OLA to resolve them.

The SPOE recapitalization strategy is one way to resolve SIFIs, including G-SIFIs, without creating contagious panic or resorting to taxpayer-funded bailouts. As a result, it is a viable solution to the too-big-to-fail problem if properly implemented. The FDIC's decision to use SPOE is a significant, positive step toward ending the too-big-to-fail problem.

Figures 1, 2 and 3 illustrate the before and after scenarios of the first step in a SPOE recapitalization of a stylized U.S. G-SIFI.

Figure 1. SPOE: Group Structure Before Recapitalization



Parent Only Balance Sheet

Assets		Liabilities	
Deposits / advances to subs	45	Unsecured long-term debt	50
Equity in subs	45	Unsecured short-term debt	5
Other assets	10	Secured liabilities	0
Total	**100**	Other liabilities	0
		Equity	45
		Total	**100**

Figure 2. SPOE: Hypothetical Losses

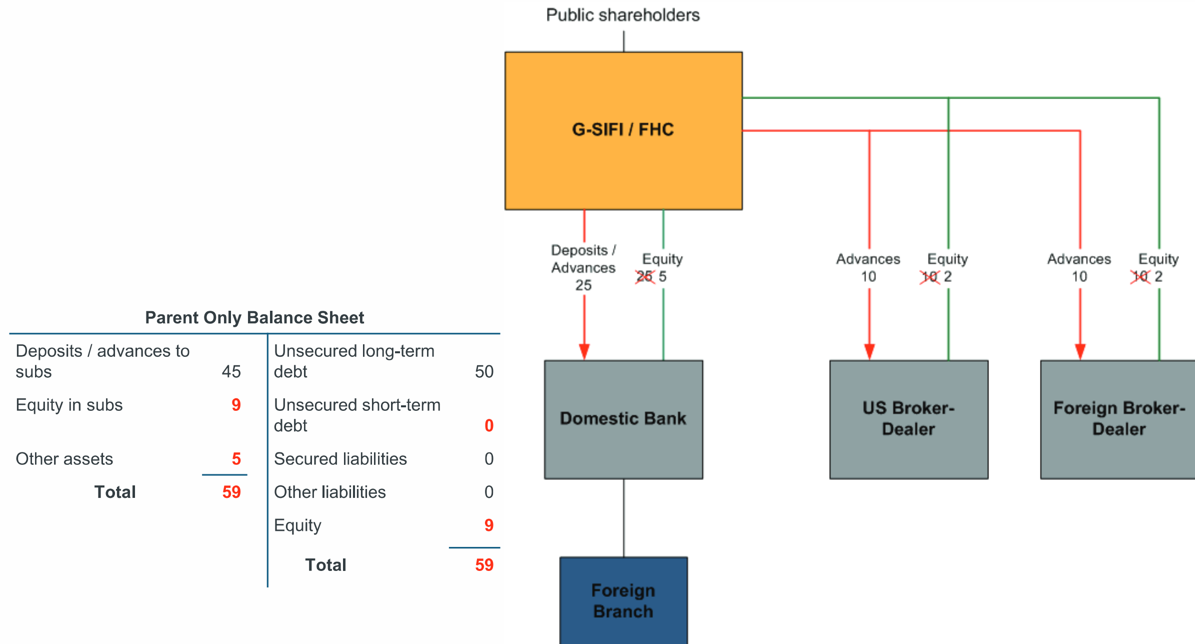
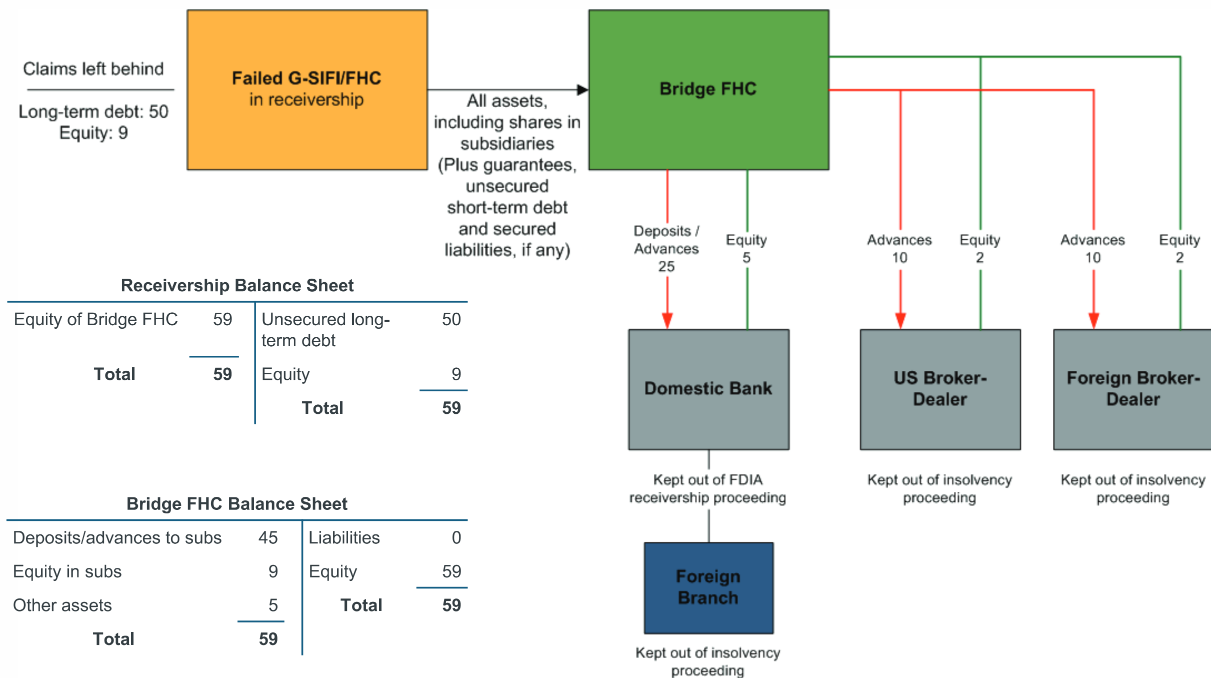


Figure 3. SPOE Step 1: Recapitalizing Business Transferred to Bridge FHC

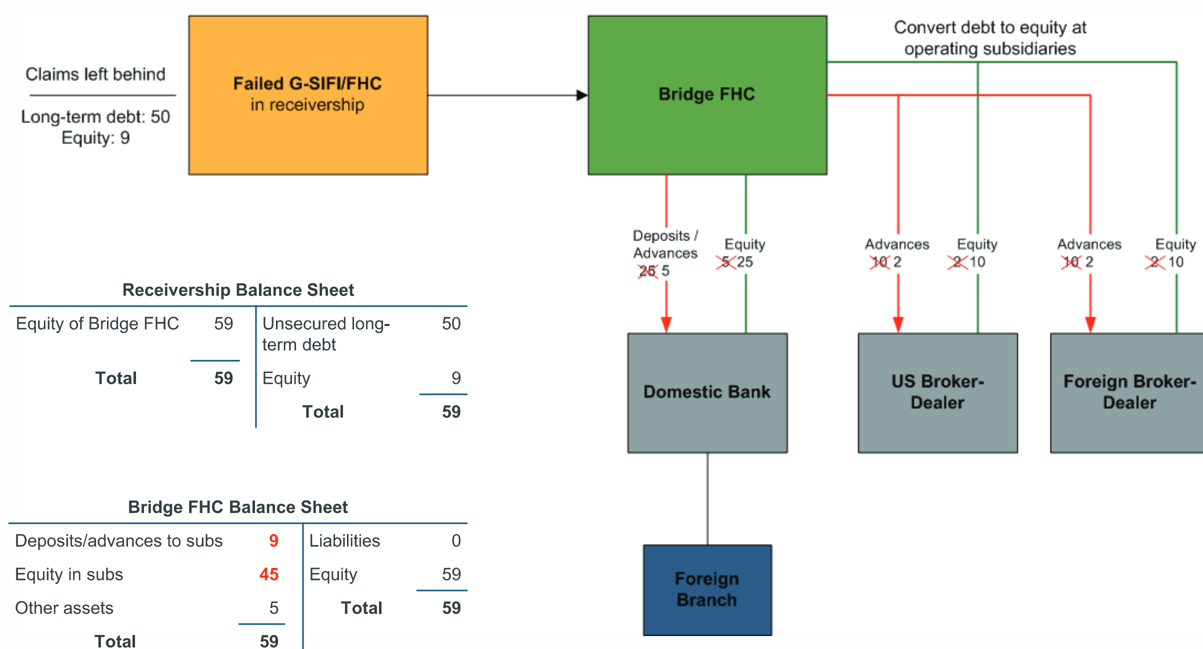


Under the SPOE recapitalization approach, a parent holding company that failed would be put into an FDIC receivership under OLA, which is similar to a proceeding under the Bankruptcy Code. Rather than immediately selling the firm or its assets to a third party, however, all of the firm's assets, including its ownership interests in and intercompany loans to its bank, broker-dealer and other operating subsidiaries, would be transferred to a newly established holding company called a ***bridge holding company*** (or bridge) over a weekend or even overnight.

The equity, long-term unsecured debt and other similar capital structure liabilities of the failed holding company would be left behind in the receivership. Any short-term unsecured debt, secured liabilities, financial contracts, guarantees of a subsidiary's financial contracts or other operating liabilities at the parent company level would be transferred to the bridge, if necessary to prevent contagion. It is rare, however, for secured liabilities or financial contracts to be booked at holding companies. Moreover, the holding company parents of G-SIFIs increasingly have very little, if any, commercial paper or other short-term debt at the holding company level, and the FDIC has the discretionary authority to make long-term debt legally subordinate to short-term debt. Finally, OLA contains a provision that overrides the early termination rights of counterparties on financial contracts booked at operating subsidiaries if those rights arise solely because of a failure of a parent holding company or an affiliate, as long as a creditworthy bridge financial company or third party assumes any parent or affiliate guarantees of those contracts within one business day after the parent's failure.

The FDIC is required to remove any directors and senior management responsible for the firm's failure, but it is free to include any other directors and senior management on the new bridge company's board of directors and senior management team.

Figure 4. SPOE Step 2: Recapitalizing Operating Subsidiaries



Receivership Balance Sheet

Equity of Bridge FHC	59	Unsecured long-term debt	50
Total	**59**	Equity	9
		Total	**59**

Bridge FHC Balance Sheet

Deposits/advances to subs	9	Liabilities	0
Equity in subs	45	Equity	59
Other assets	5	**Total**	**59**
Total	**59**		

The business transferred to the bridge would be recapitalized as a result of leaving behind the long-term unsecured debt in the receivership. The FDIC would cause the bridge to recapitalize the operating subsidiaries by contributing its unconsolidated assets to any operating subsidiaries that need to be recapitalized. See Figure 4. One of the most common holding company assets is intercompany loans from the holding company to its operating subsidiaries. If there are enough such assets, the FDIC could cause the bridge to recapitalize the operating subsidiaries by forgiving such intercompany loans. For example, Figure 4 shows the bridge holding company forgiving $20 of the U.S. bank subsidiary's obligations on intercompany advances and deposits, resulting in an increase in the bank's capital of $20. If a subsidiary did not have enough intercompany debt for the bridge to forgive, the bridge could, subject to any regulatory requirements or limitations, contribute receivables from other subsidiaries to the troubled subsidiary since receivables would be assets on the bridge company's unconsolidated balance sheet. For example, if the U.S. bank subsidiary in Figure 4 did not have enough intercompany debt for the bridge to forgive, and the U.S. broker-dealer did not need additional capital, the bridge could contribute any receivables from the U.S. broker-dealer to the U.S. bank. This is because the receivable is an asset on the bridge's balance sheet and the bank would not be paying any purchase price for the contribution or assuming any liabilities in connection with the contribution.

In this manner, the FDIC could effectively cause any losses incurred at the operating subsidiary level to be pushed up to the failed holding company's receivership. The operating companies would therefore be recapitalized and kept out of insolvency proceedings without the use of any taxpayer money. The FDIC also might choose to cause the failed holding company to recapitalize the operating subsidiaries after the FDIC has been appointed receiver but before any assets are transferred to the bridge.

The bridge holding company with its recapitalized business and its recapitalized operating subsidiaries would open for business at the normal opening time on the day after resolution weekend or resolution night.

If the bridge holding company or any of its operating subsidiaries were unable to obtain enough liquidity from the market to fund their operations despite being recapitalized, the FDIC would use the OLF to provide them with temporary, fully secured liquidity at modestly above-market rates until the market stabilized. Once the market stabilized, the bridge and its operating subsidiaries should be able to obtain liquidity from the private sector and pay back the FDIC. Without such a temporary fully secured liquidity facility, the bank and other operating subsidiaries of the holding company would not be able continue to serve customers and clients, and the going concern value of the recapitalized group could be destroyed. If the group were forced to sell its otherwise valuable but illiquid assets for cash at fire-sale prices, it could destroy the franchise value of the otherwise well-capitalized bridge and foster the very sort of contagious panic that needs to be avoided to solve the too-big-to-fail problem.

From the point of view of averting contagion, certain features of a SPOE recap are critical. Specifically, the operating subsidiaries of the bridge holding company would be kept out of

receivership or insolvency proceedings and would open for business at the normal opening time on the day after resolution weekend or resolution night. All holders of any operating liabilities of the failed SIFI parent and its operating subsidiaries, including any depositors, would be paid in full in the ordinary course of business. The holding company's long-term, unsecured debt and other capital structure liabilities would be structurally subordinated to any debt at the operating subsidiary level, including any short-term, unsecured debt and comparable operating liabilities. In addition, to calm depositors and other short-term creditors and provide the markets with comfort regarding the safety and soundness of the recapitalized group, the OLF would be available to provide temporary, fully secured liquidity at modestly above-market rates to the bridge holding company and, indirectly, its operating subsidiaries until the group's liquidity stabilized. The going concern value of the recapitalized group would thus be preserved, and valuable but illiquid assets would not have to be sold for cash at fire-sale prices.

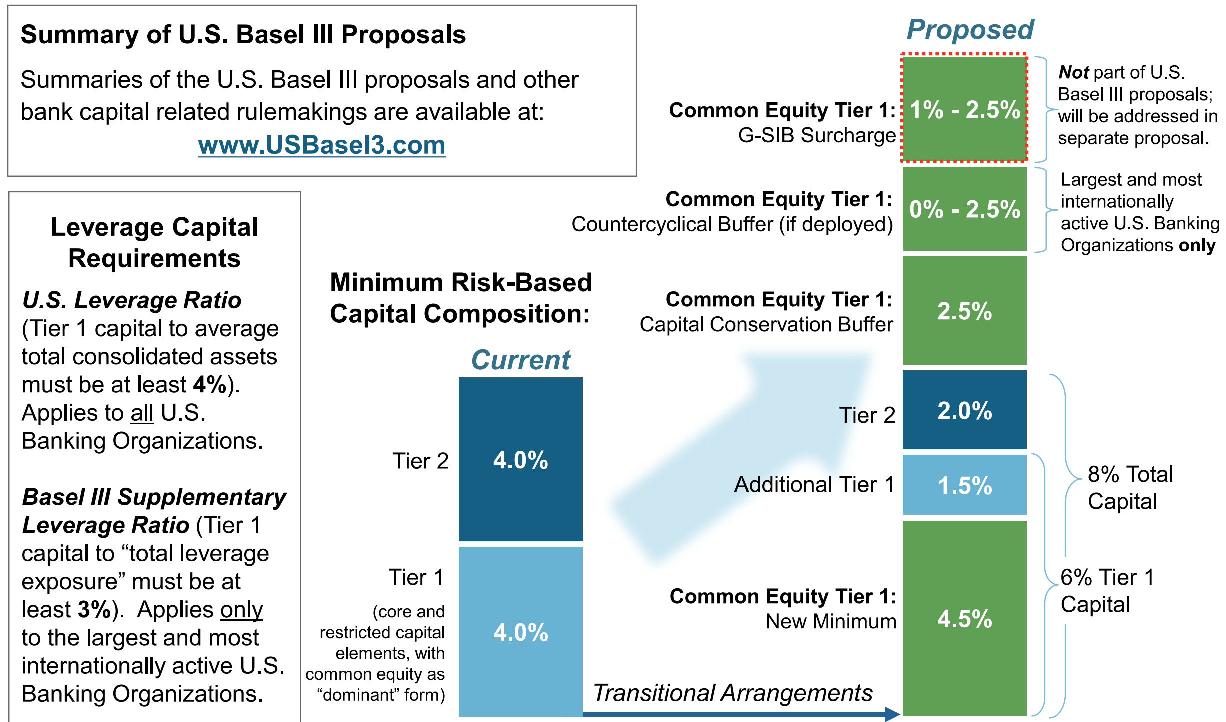
The distinction between ***capital*** and ***liquidity*** is critical. Under the law, the FDIC is only permitted to use the OLF to provide temporary fully secured liquidity to the bridge and its newly acquired operating subsidiaries, and not to provide capital to the failed parent, bridge or operating subsidiaries. New capital would be created solely by imposing losses on the holding company's creditors left behind in the receivership, and not by capital injections from the OLF. This distinction between prohibiting the OLF from being used to provide ***capital to absorb losses*** on the one hand, and allowing the OLF to be used to provide temporary ***secured liquidity*** to recapitalized bridge companies to stabilize the financial system on the other, is what distinguishes a taxpayer-funded bailout from traditional lender-of-last-resort facilities. The action of the government as lender-of-last-resort, including the Federal Reserve's discount window, has never been considered to be a taxpayer-funded bailout by the vast majority of observers, including such free market advocates as Milton Friedman, if the relevant lender-of-last-resort facilities satisfy the conditions of Bagehot's dictum.

Walter Bagehot in his classic 1873 book on central banking, defined the extension of credit under lender-of-last-resort-facilities such that it must only be made to solvent entities on a fully secured basis at above-market cost. If the OLF is used only as a temporary, fully secured ***liquidity facility*** that complies with the traditional safeguards for lender-of-last-resort facilities, it would ***not be a taxpayer bailout.***

Bagehot's solvency condition clearly would be satisfied in a SPOE recapitalization because the borrowers – the bridge and indirectly its new operating subsidiaries – would be more than solvent, having been recapitalized at generally applicable capital requirements, such as at fully phased in Basel III levels. When fully phased in, the U.S. version of Basel III will require banks and bank holding companies to have tangible common equity to risk-weighted assets of between 7 percent and 9.5 percent, depending on whether they are G-SIBs or G-SIFIs or not. See "Basel III" in the glossary contained in Annex B and as graphically illustrated in Figure 5. Taxpayers would be further insulated against any risk of loss by the fact that the statute requires the FDIC to recoup any losses that might nevertheless be

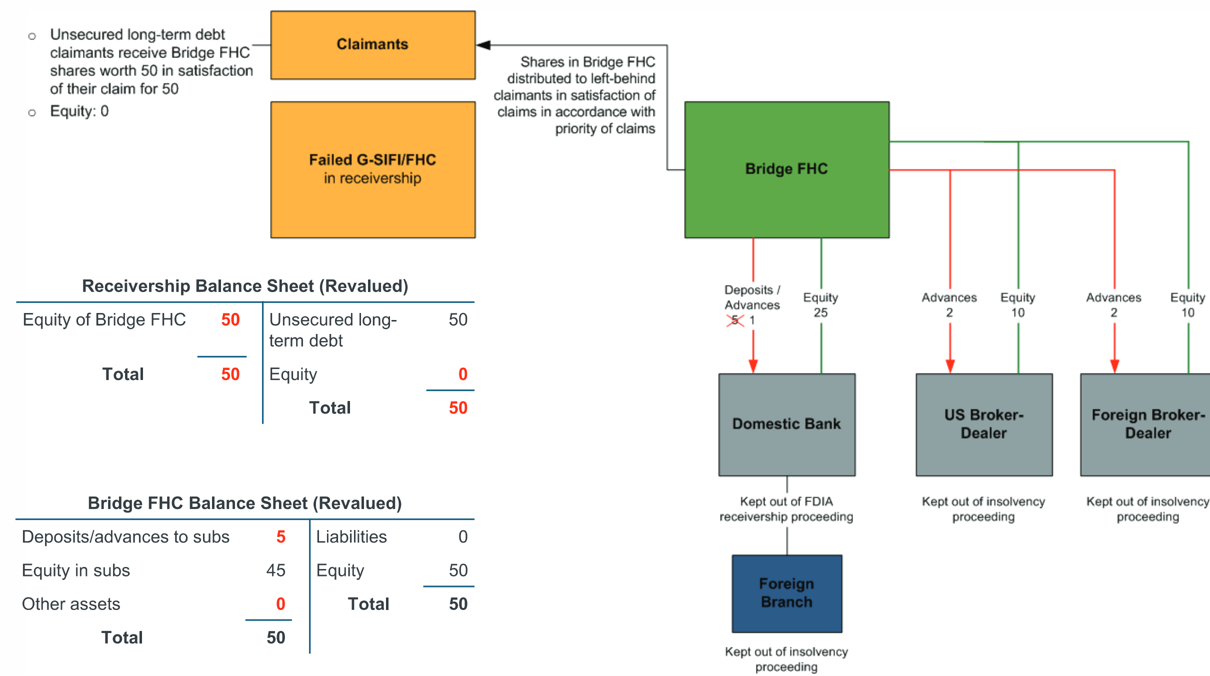
sustained by the OLF – for example by mistakes in valuing collateral – by imposing assessments on large, private-sector financial institutions.

Figure 5. U.S. Basel III Proposals



Source: Davis Polk & Wardwell LLP

Figure 6. SPOE Step 3: Distribution of Equity in Bridge FHC in Satisfaction of Claims Left Behind in Receivership



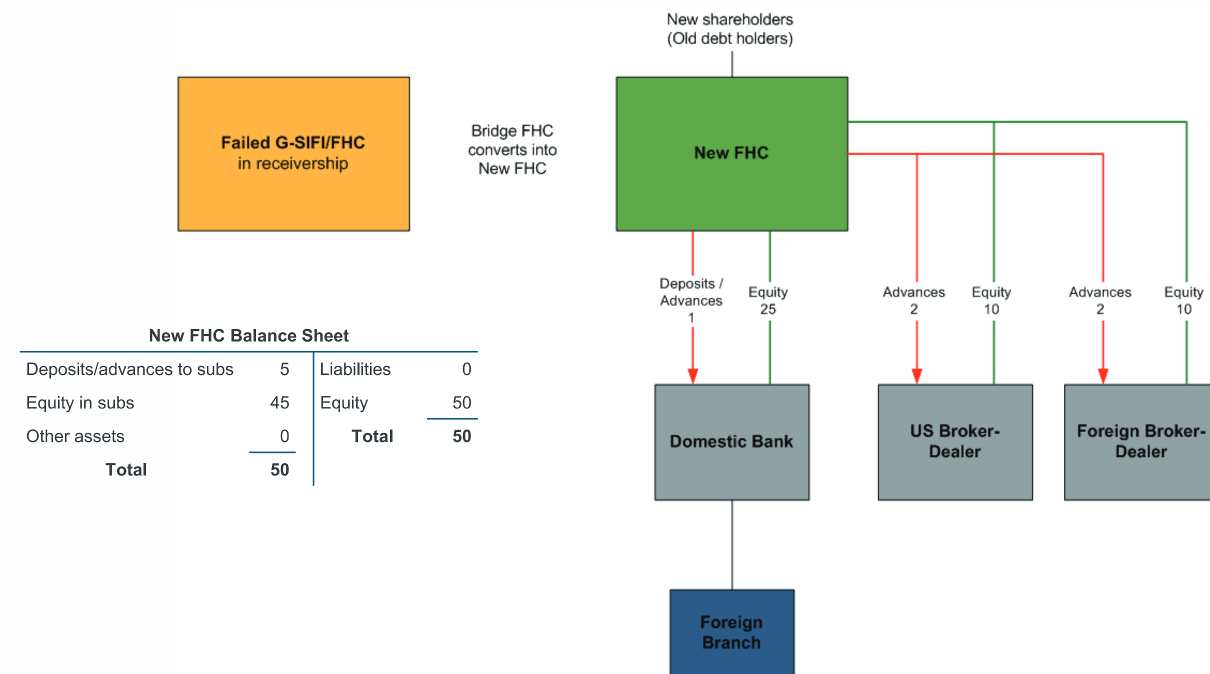
Receivership Balance Sheet (Revalued)

Equity of Bridge FHC	50	Unsecured long-term debt	50
Total	**50**	Equity	0
		Total	**50**

Bridge FHC Balance Sheet (Revalued)

Deposits/advances to subs	5	Liabilities	0
Equity in subs	45	Equity	50
Other assets	0	**Total**	**50**
Total	**50**		

Figure 7. SPOE Step 4: Termination of Bridge Status



New FHC Balance Sheet

Deposits/advances to subs	5	Liabilities	0
Equity in subs	45	Equity	50
Other assets	0	**Total**	**50**
Total	**50**		

After a normal claims process, the holders of the failed holding company's equity, long-term unsecured debt and other similar capital structure liabilities left behind in the receivership would receive all of the residual value of the recapitalized bridge holding company – that is, its equity – in satisfaction of their claims against the failed company in accordance with the predetermined priority-of-claims rules. At the same time, the bridge holding company would be converted into a normal state- or federally chartered corporation. See Figures 6 and 7. As a result, all of the group's losses would be borne by the failed parent holding company's equity, long-term unsecured debt holders and any other claimants left behind in the receivership, and not by taxpayers.

The failed holding company's combined equity, long-term unsecured debt and other similar capital structure liabilities would act as a shield against any losses by short-term creditors and the holders of other operating liabilities at the operating company level. As a result, using the SPOE strategy to recapitalize the group should, like deposit insurance, greatly reduce or even eliminate the incentive of the group's demand depositors, repo lenders, and holders of other money-like claims to run or for contagious runs to spread throughout the system. Using the OLF to provide interim liquidity to the bridge and its subsidiaries until confidence in the recapitalized group could be restored would further reduce the incentive to run.

A key to making this work is the distinction between capital structure liabilities, including long-term unsecured debt, and operating liabilities, including short-term debt. The reason for preferring short-term creditors and other holders of operating liabilities over long-term, unsecured creditors and other holders of capital structure liabilities is that they are not really similarly situated during a financial crisis. Short-term creditors and the holders of other operating liabilities have effectively bargained for the right to "run" during a financial crisis because they have the right to demand the return of their money or demand additional cash or liquid collateral immediately or within a very short period of time. They have also effectively paid for such rights, since the return on short-term debt and other operating liabilities is generally lower than the return on long-term debt and other capital structure liabilities of the same debtor.

By clearly making long-term, unsecured debt and other capital structure liabilities structurally or legally subordinate to the group's short-term debt and other operating liabilities in advance, the SPOE recap strategy signals to the market that these two types of liabilities are not similarly situated during a financial crisis and therefore will not be treated as if they were a single class. This signaling will result in efficient market pricing of long-term, unsecured debt and other capital structure liabilities, on the one hand, and short-term debt and other operating liabilities, on the other, thus eliminating any unfairness that might arise from a last-minute, unexpected discretionary decision to treat long-term, unsecured debt or other capital structure liabilities as subordinate to short-term unsecured debt and other operating liabilities.

The SPOE recap strategy is functionally equivalent to a high-speed reorganization of the failed parent holding company under Chapter 11 of the Bankruptcy Code, where the

essential features of the reorganization are completed over resolution weekend or even overnight. The going concern value of the systemically important and other viable part of the business is preserved, with the final distribution of value taking place at the end of the claims process. Most importantly the clients and customers of the operating subsidiaries will continue to be served without interruption.

While the FDIC is still working out the final details of this strategy, the FDIC's SPOE recap approach should solve the too-big-to-fail problem for SIFIs, including G-SIFIs, by providing a viable alternative to the unpalatable choice between bailout and the sort of contagious panic that can bring down the financial system if properly implemented. The essential conditions for this result to be achieved are as follows:

- ***Pre-Announced, Predictable and Viable Strategy***. The FDIC must publicly announce in a policy statement in advance of any particular SIFI's or G-SIFI's failure that it will use the SPOE recapitalization strategy to resolve certain types of SIFIs under OLA if invoked, so that the market and foreign regulators can rely on its public commitment to do so.
- ***Sufficient Loss-Absorbing Capacity***. The parent holding company of the SIFI has enough loss-absorbing capacity in its capital structure to immediately recapitalize its business if transferred to a bridge and all of its operating subsidiaries at whatever levels are generally required (e.g., fully phased-in Basel III levels), assuming the group suffers losses of some specified amount greater than those projected under the most severely adverse scenario used by the Federal Reserve in its most recent Comprehensive Capital Analysis and Review (CCAR) process.
- ***Structural or Legal Subordination***. The parent's equity, long-term unsecured debt, and other similar capital structure liabilities counted in its loss-absorbing capacity are either structurally subordinate to all material claims by the group's depositors, short-term creditors and other holders of operating liabilities, or the FDIC has publicly committed to exercise its discretionary authority to treat operating liabilities as if they were senior to capital structure liabilities.
- ***Secured Liquidity Facility.*** The OLF provides the bridge holding company with access to temporary, fully secured liquidity that is secured by any of its assets or those of its subsidiaries that are pledged or repledged to the OLF in an amount equal to the fair market value of such assets less reasonable haircuts.

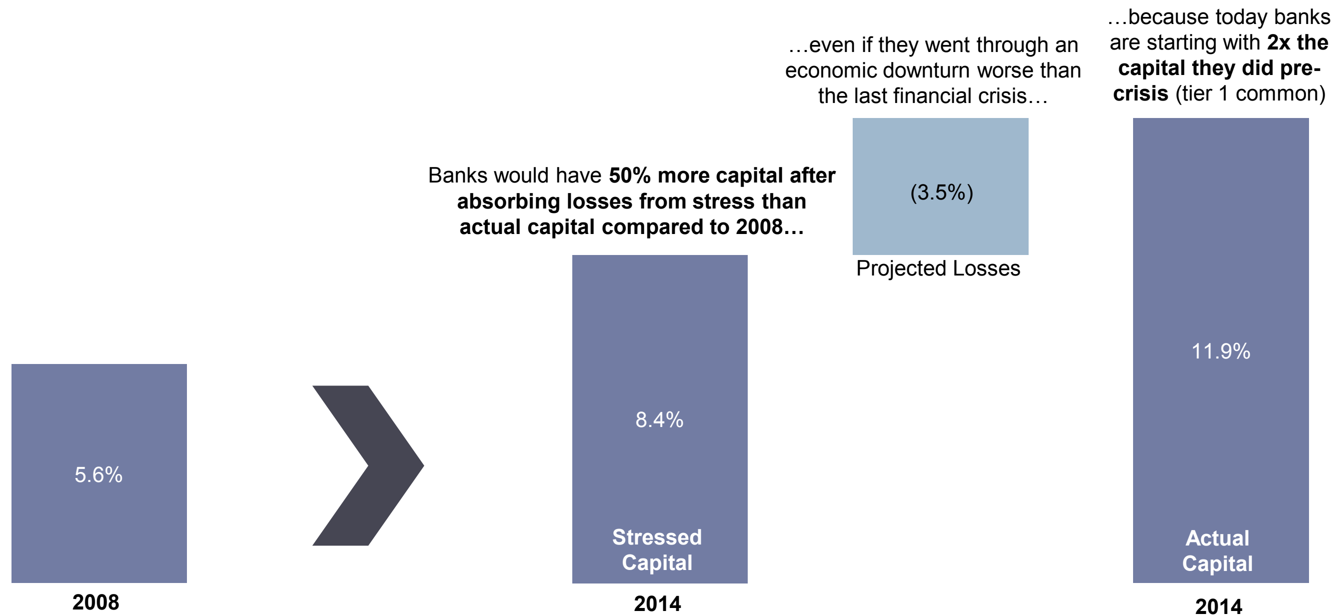
This report also recommends that the FDIC have the option of distributing the residual value of the resolved SIFI among the claimants left behind in the receivership based on ***relative priority***. This will minimize valuation disputes, reduce the risk of legitimate claims based on violations of constitutionally protected property rights, and effectively mirror the distributions produced by "***bail-in***" proposals currently being considered in Europe.

Exhibit B

Increased Capital

Banks have more ***stressed*** capital today than they had ***actual*** capital in August 2008

Banks have higher capital today in a stressed environment than actual capital in August 2008…



…making them more resilient against insolvency…

…which has been noted by regulators: Quotes from Fed Chairs Janet Yellen and Ben Bernanke

- "From **early 2009 through 2014, capital held** by the eight most systemically important U.S. bank holding companies **more than doubled, reflecting an increase of almost $500 billion** in the strongest form of capital held by these companies" – Janet Yellen
- "Even under the severely adverse scenario of the latest stress test, **the estimate of these firms' post-stress tier 1 common capital ratio is more than 2 percentage points higher than actual capital levels at the end of 2008.**" – Ben Bernanke

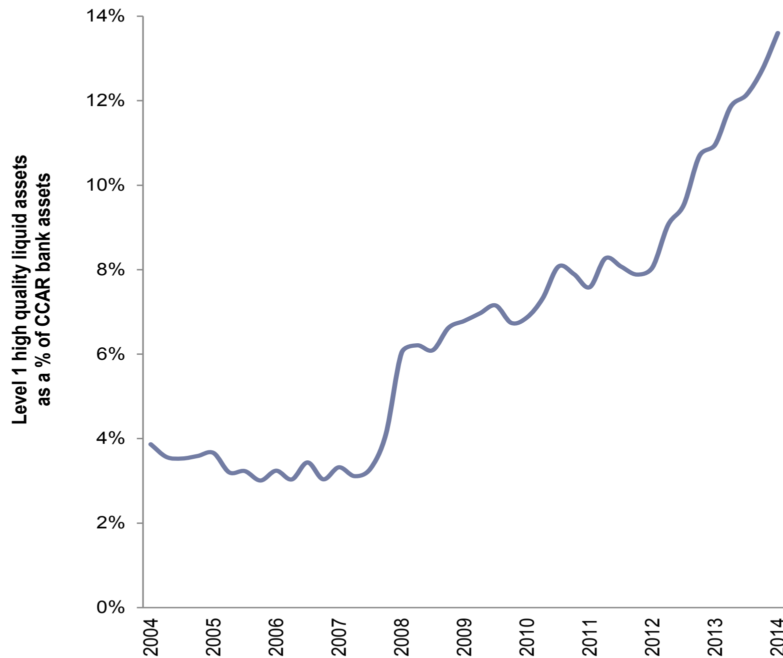
Note: Actual and stressed tier 1 capital ratios reflective of CCAR banks in 2015 DFAST stress test
Source: *Federal Reserve, SNL Financial.*

Exhibit C

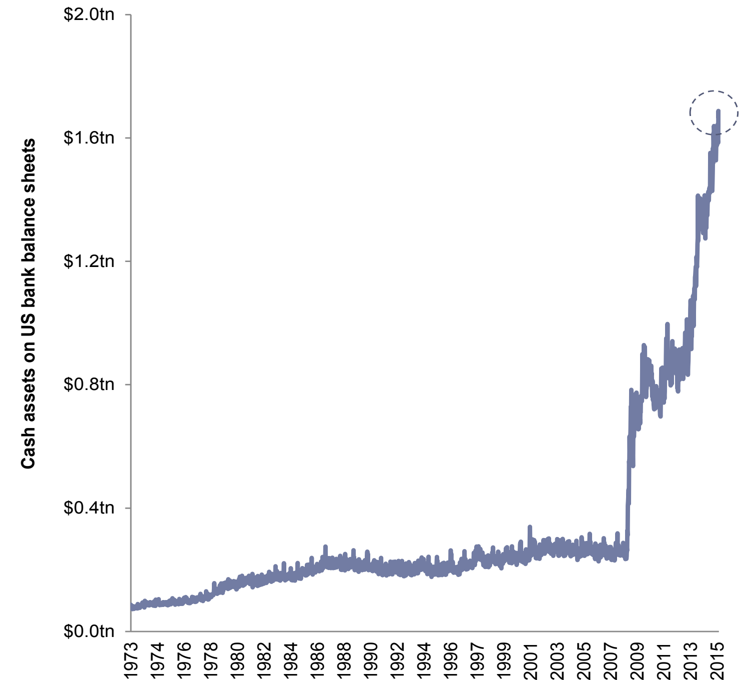
Increased Liquidity:
More Cash and HQLAs

Banks also have significantly more liquid balance sheets, making them more resilient against runs and contagion

Banks have more than 3 times the amount of high-quality liquid assets compared to 2008…



…and cash assets in the U.S. banking system are now more than 5 times their 2008 level



…which has been noted by regulators: Quote from Fed Chair Janet Yellen

- "Likewise, the Federal Reserve's increased focus on liquidity has contributed to significant increases in firms' liquidity. The **high-quality liquid assets** held by [the] eight [U.S. G-SIB] firms **has increased by roughly one-third since 2012**, and their **reliance on short-term wholesale funding has dropped considerably**." – Janet Yellen

Note: Level 1 HQLA defined as cash, U.S. Treasuries, and GNMA RMBS. Left chart reflects all CCAR banks; right chart reflects U.S. domestic banks.
Source: *SNL Financial, Regulatory Filings, Federal Reserve*

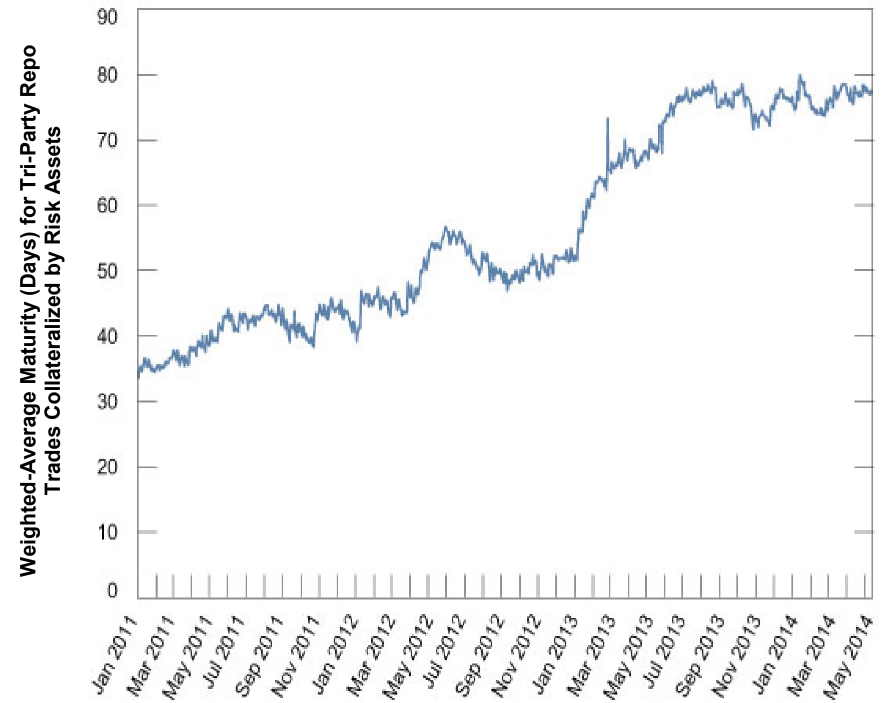
Exhibit D

Increased Liquidity:
Reduced Reliance on Short-Term Wholesale Funding

Banks have also reduced their reliance on short-term wholesale funding, making them more resilient against runs and contagion

Banks have significantly lowered their reliance on short-term wholesale funding…

…and pushed out the duration of any remaining short-term wholesale funding



Note: Left chart, short term financing defined as commercial paper, trading liabilities, <1 yr borrowings, repurchase agreements, reflective of all U.S. G-SIBs.
Source*: SNL Financial, Regulatory Filings, FRBNY, Liberty Street Economics' Paper "What's Your WAM? Taking Stock of Dealers' Funding Durability" published 6/9/2014*

Exhibit E

U.S Regulatory Standards

Stronger U.S. regulatory standards increase with size and complexity of U.S. banks…

Regulation	Less than $10bn assets	$10-$50bn	$50-$250bn	>$250 (not G-SIBs)	U.S. G-SIBs
Recovery Plans					✓
TLAC Requirement					✓
G-SIB Capital Surcharges					✓
Supplementary Leverage Ratio (5% / 6% requirement)(1)					✓
AOCI included in Basel 3 capital				✓	✓
Full Liquidity Coverage Ratio				✓	✓
Supplementary Leverage Ratio (3% requirement)				✓	✓
Advanced Approach RWA				✓	✓
Resolution Plans			✓	✓	✓
Early Remediation Tools			✓	✓	✓
Modified Liquidity Coverage Ratio			✓	✓	✓
Annual Fed-run Capital Plan and Stress Test			✓	✓	✓
Annual Company-run Stress Test		✓	✓	✓	✓
Durbin (interchange) Amendment		✓	✓	✓	✓
Subject to Regulation by CFPB	Certain Products	✓	✓	✓	✓
Prompt Corrective Action Tools	✓	✓	✓	✓	✓
Volcker Rule	✓	✓	✓	✓	✓

(1) 5% requirement at the holding company, 6% at insured depository institutions

Source: *Federal Reserve, FDIC.*

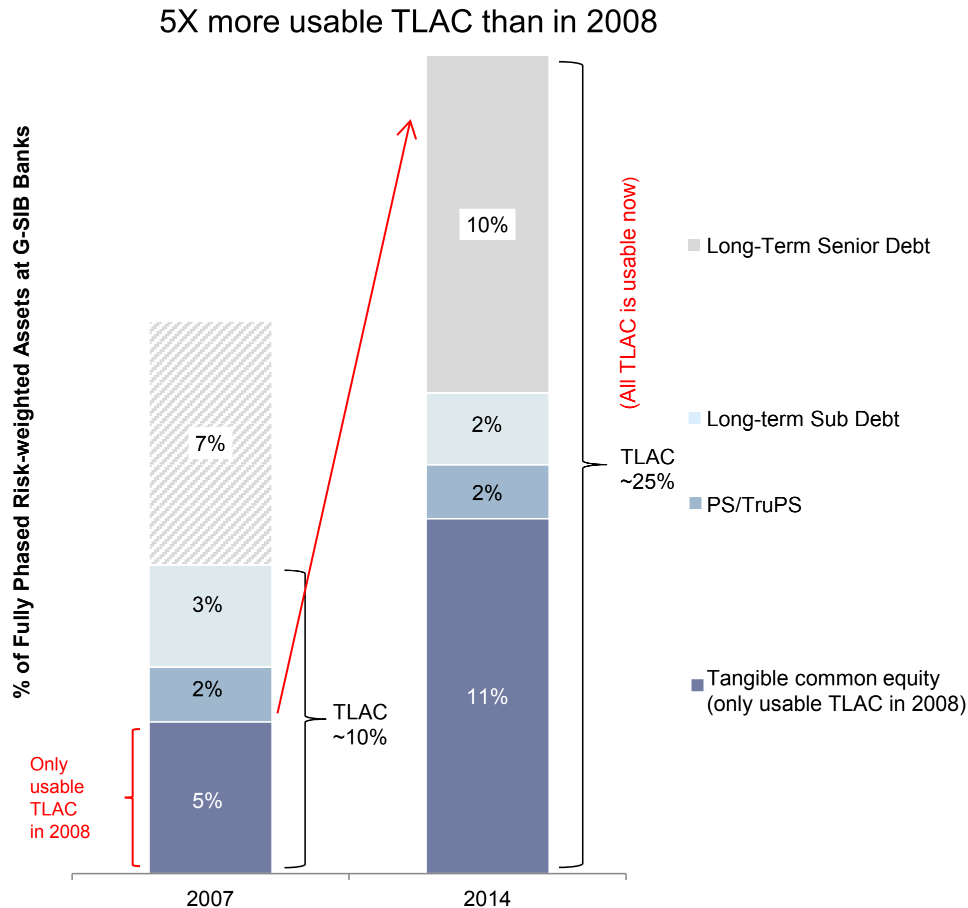
Exhibit F

Increased Usable TLAC

Usable TLAC: The most important structural change that most people have never heard of . . .

U.S. G-SIBs have substantially increased and restructured their equity and long-term unsecured debt so that all of it can now be used to absorb losses without threatening financial stability

5X more usable TLAC than in 2008



Note: TLAC estimate reflects all U.S. G-SIBs.
Source: *Federal Reserve, SNL Financial, Regulatory Filings.*

- Total loss-absorbing capacity (TLAC) consists of equity plus long-term unsecured debt that can be converted to common equity in bankruptcy
- In 2008, long-term senior debt not usable without causing contagion; could not legally impose losses on senior debt without doing so on short-term debt
- Even subordinated debt, preferred stock and trust preferred securities (TruPS) unusable in 2008 because market confusion about loss waterfall
- U.S. G-SIBs have restructured themselves to make long-term senior debt structurally subordinate to short-term debt
- Long-term senior debt can now be converted to common equity without converting short-term debt or causing contagion or financial instability
- U.S. G-SIBs now have **5X more usable TLAC** than in 2008
- No more market confusion about loss waterfall
- Enough TLAC to recapitalize U.S. G-SIBs at full Basel III capital levels under conditions twice as severe as 2008 financial crisis

Exhibit G

Increased Usable TLAC: Reaction of Markets and Regulators

Both market and regulators expect this structural change to make U.S. G-SIBs more resolvable under the Bankruptcy Code

During 2008 financial crisis, market expected both long-term debt and short-term debt of U.S. G-SIBs to be bailed out because losses could not be imposed on long-term debt without imposing losses pro rata on short-term debt, which would have fostered contagion and threatened financial stability

- Moody's has eliminated uplift on ratings of U.S. G-SIBs from expected government support, because government bailouts no longer expected
- S&P expects to remove such uplift soon
- No more market confusion about loss waterfall
- Market understands that long-term unsecured debt will act as a private-sector buffer against losses by short-term unsecured debt
- Spreads on long-term debt of U.S. G-SIBs are now higher than spreads on long-term debt of other U.S. banks
- Current amount of usable TLAC should make SPoE and other resolution strategies feasible under ordinary bankruptcy laws
- FSB has issued minimum TLAC proposal
- Fed has indicated it plans to issue "gold-plated" TLAC proposal for U.S. G-SIBs

"Rather than relying on public funds to bail-out one of [the U.S. G-SIBs], we expect that bank holding company creditors will be bailed-in and thereby shoulder much of the burden to help recapitalize a failing bank."

- Robert Young, Moody's Managing Director (April 2013)

"[S]uccessful 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 unsecured 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."

- Fed Governor Tarullo (Senate Testimony, September 2014)

"[I]t is notable that, at present, large U.S. firms have substantial amounts of long-term debt on their balance sheets."

- Fed Governor Tarullo (December 2012)

Exhibit H

ISDA Resolution Stay Protocol

U.S. G-SIBs have also taken significant actions to address early termination issues in financial contracts

ISDA Protocol and Regulations

- 6 of 8 U.S. G-SIBs are among 18 G-SIBs adhering to new ISDA Stay Protocol
- Protocol imposes temporary stay on direct defaults and overrides cross-defaults in existing and future ISDA contracts among 18 G-SIBs
- ISDA Protocol is being reflected in all new financial contracts
- Support regulations to expand principles of ISDA Protocol to more counterparties and financial contracts
- No similar mechanism existed during the 2008 crisis

Eliminate Impediment to Resolution

- Overriding cross-defaults prevents liquidity runs when parent fails but direct counterparty operating subsidiary is still performing on financial contracts
- Temporary stay gives bankruptcy courts more time to avoid value destruction from early termination without undermining risk management function of financial contracts
- Pause in the collection of swaps collateral could give U.S. G-SIBs enough time to re-capitalize and avoid the kind of panic that followed the 2008 failure of Lehman Brothers

"This is a major achievement, by the industry….With the adoption of the protocol by the top 18 dealer G-SIBs in November, over 90% of their OTC bilateral trading activity will be covered by stays of either a contractual or statutory nature."

- Financial Stability Board, Press Release (October 2014)

"This initiative is an important step toward mitigating the financial stability risks associated with the early termination of bilateral, OTC derivatives contracts triggered by the failure of a global banking firm with significant cross-border derivatives activities."

- Federal Reserve Board and FDIC Joint Press Release (October 2014)

Exhibit I

Recognized Progress in Improving Resolvability

The regulators have recognized the progress the U.S. G-SIBs have made in improving their resolvability

“I would suggest that there has been no greater or more important regulatory challenge in the aftermath of the financial crisis than **developing the capability for the orderly failure of a systemically important financial institution**. While there is still a lot of work to do, looking at where we were and where we are today, in my view **the progress has been impressive**…

"While there is still much work to do, if there is one point I would like to conclude with today it is that there has been a **transformational change** in the United States and internationally since the financial crisis in regard to the resolution of systemically important financial institutions that perhaps has been **underappreciated**.”

- FDIC Chairman Gruenberg (May 2015)

“Work on the use of the resolution mechanisms set out in the Dodd-Frank Act, based on the principle of a single point of entry … holds the **promise of making it possible** to resolve banks in difficulty **at no direct cost** to the taxpayer.

“**[C]onsiderable progress** has been made … in developing suitable resolution regimes for financial institutions”

- Fed Vice Chairman Fischer (August 2014)

“My view is that those steps have made the system **safer, sounder and more resilient**—and by a wide margin. It’s frankly hard to overestimate the impact of Dodd-Frank. The Volcker Rule, the Financial Stability Oversight Council, risk retention, enhanced resolution authority—these and a dozen other important provisions of that historic law laid the groundwork for a **safer** and **more stable financial system**.”

- Comptroller of the Currency Curry (June 2015)

“[W]e established a set of enhanced standards for large U.S. banking organizations to **help increase the resiliency** of their operations and thus promote financial stability. … These and other measures have already created a financial regulatory architecture that is **much stronger and much more focused on financial stability** than the framework in existence at the advent of the financial crisis.”

- Fed Governor Tarullo (September 2014)

“The **single-point-of-entry** approach offers the **best potential** for the orderly resolution of a systemic firm …, in part because of its potential to mitigate run risks and credibly impose losses on parent holding company creditors and, thereby, to enhance market discipline.”

- Fed Governor Tarullo (October 2013)