SPEECH

Title II Resolution, a Useful Tool but Not a Panacea

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The topic of how systemically important financial institutions (SIFIs) will be resolved is a very important subject. As we saw during the financial crisis, the failure of Lehman Brothers generated huge shocks across the global financial system that led to a deep global downturn. That is not an acceptable regime and I am very glad we are working hard to change it.

I thank the organizers for giving me the opportunity to make some short remarks. Today, I'm going to take a somewhat broader view than some of the other speakers, focusing on two issues:

- Some outstanding questions about how the "single point of entry" strategy under the Title II resolution regime would work in practice.
- How the resolution regime fits within the broader supervisory agenda of ending "too big to fail" and making the financial system more resilient and robust.

As always, what I have to say today reflects my own views and not necessarily those of the Federal Reserve System.

The first point I'd make is that I very much endorse the single point of entry framework for resolution as proposed by the Federal Deposit Insurance Corporation (FDIC). I think it is the best plan for implementing Title II given the complexity and scope of large, global financial institutions and I also think it is well-suited to the U.S. bank holding company framework. By assigning losses to shareholders and unsecured creditors of the holding company and transferring sound operating subsidiaries to a new solvent entity, such a "top-down" resolution strategy will facilitate continuity for the critical services performed by the firm's subsidiaries. This will reduce the costs associated with the failure of the parent company and reduce the degree of disruption to financial markets and financial stability.

While the Title II single point of entry strategy holds tremendous promise, I think it is important not to declare victory prematurely. First, there are still significant issues about how the resolution of a large systemically complex firm would work in practice. Second, even assuming that our efforts to overcome these challenges are ultimately fully successful, resolution is still likely to represent a "second best" outcome compared to preventing a systemically important financial institution from failing in the first place. After first describing some of the current implementation challenges associated with Title II resolution, I will return to this second issue.

Implementing the resolution regime on a cross-border basis remains one of the most significant challenges. U.S. authorities are working with authorities abroad on the issues that require international collaboration, but the financial industry also has a role to play in overcoming these challenges. I encourage the industry to promptly address the matters that require action on their part.

In particular, I am worried about two current shortcomings:

- The reach of Title II's one-day stay on the close-out of qualified financial contracts is incomplete and does not extend to contracts governed by non-U.S. law with non-U.S. counterparties.
- The placement of the parent company into receivership may be treated by these counterparties as an event of default due to the presence of a parent guarantee or other cross-default provisions triggered by the parent-level insolvency.

Unless market participants make the appropriate contractual changes that will ensure that the entry of the parent company into Title II will not trigger the close-out provisions of those over-the-counter derivatives and other qualified financial contracts that are outside the reach of Title II's U.S. application, foreign counterparties to the systemically important firm will tend to exercise this right whenever it is in their individual economic interest to do so. This would create significant difficulties because such actions could greatly complicate the operations of the firm during a time when it is already under considerable stress and would propagate stress more broadly in financial markets.

There are two main options for addressing this issue, and they are not mutually exclusive. Existing derivative contracts need to be amended and future contracts need to provide that the parent's entry into the Title II proceeding does not trigger the close-out option, or legal changes need to be

into the Title II proceeding does not trigger the close out option, or legal changes need to be implemented abroad so that the "one-day stay" that applies to qualified financial contracts governed by U.S. law is enforceable against those contracts governed by foreign law. Only by making these changes can we avoid the potential for disruptive close-outs. I strongly encourage the ongoing efforts to address this critical issue.

A second issue with respect to Title II resolution is that we cannot be certain how foreign authorities will react when the parent is put into the Title II proceeding. While the U.S. authorities have been in discussion with our colleagues abroad to enable the coordination needed for a smooth cross-border resolution process, we cannot always be certain of the circumstances under which host authorities may choose to take or be required to take actions such as unilateral "ring-fencing" that might disrupt the implementation of the single point of entry approach. Thus, we need to continue to work with foreign regulators to iron out any issues ahead of time so that the resolution regime will work well for global, systemically important firms.

The smooth operation of a resolution proceeding also depends on the existence of adequate liquidity in the early days of the process. One of the key pillars of Title II is that, unlike a bankruptcy proceeding, the FDIC will have access to liquidity from the U.S. Treasury to help ensure an effective resolution. While this access provides significant support for an effective resolution, it will still be important for the resolution authorities to provide clarity about the timing and the amount of liquidity resources that will be made available after a firm enters into resolution. This clarity will likely be necessary in order to calm creditors and markets at the time of resolution. Under the single point of entry framework, the intent is to create a highly capitalized bridge entity so that counterparties will be willing to stay engaged based upon the improved creditworthiness of the bridge parent and its recapitalized subsidiaries. If successful, this will reduce the need for the up-front provision of external liquidity resources. Nevertheless, to make the viability of the bridge entity fully credible, market participants must believe that the bridge company has access in a timely way to whatever additional liquidity resources might prove necessary.

In addition, under the Dodd-Frank Act, Title II is not the baseline or preferred approach for dealing with the failure of a large complex firm. For a firm to go through Title II, a determination must first be made that the failure of the firm and its resolution would have serious adverse effects on U.S. financial stability under the insolvency law that would otherwise apply. Because market participants will not know for certain which path U.S. authorities will ultimately take—allowing resolution under ordinary insolvency law, as contemplated under Title I, or instead initiating a Title II resolution—this uncertainty

in and of itself could cause investors in short-term obligations that are likely to be protected under Title II to run.

Several other issues are also worthy of note. First, for the Title II single point of entry strategy to work properly, there needs to be a sufficient amount of debt outstanding at the parent company that can be converted by the FDIC into equity to ensure that the bridge company will be demonstrably well-capitalized. We don't yet have a long term debt requirement—this is an area where we are still working out the details. My own view is that a holding company needs a substantial amount of long term-debt to ensure that the newly created bridge company is viewed as fully viable by its counterparties.

We also need to ensure that the holding company is structured so that the bridge bank formed upon resolution can easily downstream capital to its operating subsidiaries. The ability to do this will help reduce the risks of preemptive ring-fencing by foreign regulators and runs by counterparties of the foreign operations of U.S. firms.

Turning to the second main theme I would like to discuss, resolution is being offered up by some as not only a necessary element of the solution to the too big to fail problem (a proposition I agree with), but also as an entirely sufficient solution that eliminates the need for heightened prudential standards to reduce the probability of failure in the first place. The argument is based on the view that, in resolution, shareholders' equity will be wiped out and that some portion of the long-term debt will be converted to equity. The prospect of this outcome will, it is argued, lead to a disciplining effect by the parent company's long-term debt holders, who will demand higher yields now that the prospect of failure is credible. This, in turn, will help to eliminate the implicit subsidy of too big to fail. Under this theory, Title II would also limit the incentives for firms to become larger and more complex in order to gain this funding subsidy.

By itself, however, Title II does not entirely eliminate the advantages of being large and complex. That is because large, complex firms are more likely to go through Title II than smaller, less complex bank holding companies, who will generally go through a Chapter 11 bankruptcy proceeding. Also, only large firms will benefit from Title II's one-day stay on qualified financial contracts. Finally, under the Title II resolution regime, the businesses and the franchise value of the subsidiary-level customer relationships will be maintained relative to a traditional bankruptcy proceeding, which in the past has often led to the liquidation of the bankrupt entity. As we saw in the case of Lehman Brothers, for financial firms, bankruptcy can destroy considerable value.

This isn't an argument against Title II resolution. Dodd-Frank's addition of Title II to the resolution toolkit was an important advance to regulators' ability to mitigate financial instability. But we must recognize that Title II by itself it is not sufficient to eliminate the advantages of being perceived as too big to undergo ordinary bankruptcy at the holding company level.

Moreover, even with a viable Title II resolution regime in place, we must recognize that there still will be disruption to the financial system when a large firm fails. This suggests to me that while a Title II single point of entry resolution is a very useful tool that we should continue to develop, we should view it as more preferable to prevent the failure of the SIFI in the first place.

In this regard, I think we have made considerable progress by raising capital and liquidity requirements

for large, complex firms. In addition to the role of these requirements in reducing the probability of failure, higher capital and liquidity requirements for large, complex firms also have the ancillary benefit of offsetting any residual competitive advantage that might remain for SIFIs because of how they are likely to be treated under Title II resolution.

The Comprehensive Capital Analysis and Review (CCAR) stress tests are important in this regard because they make the capital requirements for large, complex institutions forward looking. What matters is not just the current capital ratio, but also what the capital ratio could be if a stress environment were to materialize. The CCAR process is also useful because it focuses on the quality of the bank's capital planning processes. It is not sufficient just to have enough capital; the bank's management and directors need to be able to evaluate the bank's ongoing capital needs in a

thoughtful and thorough manner.

The responsibility of the management of a large, complex firm does not end with capital planning. Firms' managers need to ensure that they can respond to financial or operational weakness of any type by having robust recovery plans that get triggered long before resolution becomes necessary. Firms should develop and track metrics that not only identify when they are on the verge of insolvency or default, but also trigger appropriate remediation actions whenever the firm begins to become stressed. These plans should identify actionable options that the firm can take in response to financial weakness that will restore the confidence of the firm's counterparties in the firm without the need for extraordinary official sector support. Firms must also have disciplined processes that analyze the root causes of their problems and identify longer-term strategies that will need to be employed as other recovery options to restore capital and liquidity are being executed. And firms must support the viability of their contingency and recovery plans by implementing the internal governance necessary to develop, test, update and implement them credibly.

There is also more work that we, as supervisors, can do to reduce the probability of failure and to incent firm managers to act well before resolution becomes necessary. We need to do more to create incentives to force banks to act sooner to steer away from impending icebergs—cut capital distributions earlier, raise new capital faster, restructure businesses sooner, and restructure senior management and boards of directors more radically when the firm is not performing well. For example, one approach might be to implement a long-term debt requirement in a way that enhances market discipline.

Another reform would be to reduce the incentives of large, complex firms to rely on short-term wholesale funding to finance longer-term, illiquid assets. Among other benefits, reducing a firm's susceptibility to sudden runs associated with short-term wholesale funding will lengthen the "runway" for management to implement the strategic actions that would restore the firm to health.

Let me conclude by emphasizing that these two paths—reducing the financial stability costs associated with the failure of a systemically important financial firm versus applying tougher capital and liquidity standards for such firms that reduce the probability of failure—are complements not substitutes. We need to keep pushing forward with both approaches in order to make the financial system more resilient and robust.

Thank you for your kind attention. I would be happy to take a few questions.