Remarks by

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Introduction

I would like to thank the Wharton School, its Financial Institutions Center, the Law School, the Department of Economics, the Institute for Law and Economics, and the Penn Program on Regulation for inviting me to speak today.

I would also like to acknowledge Dick Herring of the Wharton School for his contributions to the FDIC's efforts to address the very challenging issue of the resolution of systemically important financial institutions (SIFIs).

Dick has served as a valuable member of the FDIC's Systemic Resolution Advisory Committee. He emphasized the importance of transparency of the living will resolution plans, and assisted us in identifying critical information that should be made available in the public portions of those plans.

He also hosted here at the Wharton School two meetings of bankruptcy experts, including judges, practitioners, and academics, to discuss the challenges associated with orderly resolution in bankruptcy.

Today, I would like to discuss why this work is so important, the progress that's been made, and why we need to remain focused on addressing this critical issue.

I joined the FDIC Board in 2005 and served through the financial crisis of 2008–2009, the enactment of the Dodd-Frank Act in 2010, and the post-crisis recovery. I became Acting Chairman in July 2011 and was confirmed as Chairman in November 2012. Much of my time at the FDIC has been spent responding to, and working to avoid another financial crisis.

A central objective of this effort has been developing the capability for the orderly failure of a systemically important financial institution, without taxpayer support, and with accountability for the shareholders, creditors, and management of the failed firm. This has been a top priority for the FDIC for several reasons.

First, the FDIC lacked the authority during the financial crisis to manage the orderly failure of a systemically important financial institution. As a result, the options available to the financial regulatory agencies during the crisis were limited to providing public support to open institutions at risk of failure – in other words, a bailout – or allowing a disorderly failure through the bankruptcy process as was experienced with Lehman Brothers. We needed a better option.

Second, market expectations that certain financial institutions will receive public support if they get into difficulty distort the marketplace. Creditors and counterparties, believing they might be protected by the government, can provide credit to larger or more complex institutions on advantageous terms – giving those institutions a competitive advantage and exacerbating the systemic risks they pose.

Third, the Dodd-Frank Act, through the Title I living will resolution plan requirement and the Title II Orderly Liquidation Authority, gave the FDIC important new authorities for the orderly failure of systemic financial institutions. It was clear that the credibility of the FDIC would be measured by how we implemented those authorities.

From financial stability, accountability, competitive equity, and reputational perspectives, the FDIC has a compelling interest in effectively addressing this issue.

Building a Framework for Systemic Resolution

The framework established by the Dodd-Frank Act for the resolution of systemically important firms introduced a new dimension to the regulation of financial institutions in the United States. Orderly resolution of systemic firms had never been an explicit goal of financial regulation in the United States prior to the recent crisis. In fact, it was never really contemplated. The experience of the crisis and the enactment of Dodd-Frank changed that.

The Act provided the Title I living will resolution plan process as a tool to require systemic institutions to make real-time changes in their structure and operations to facilitate orderly failure under bankruptcy. The FDIC and the Federal Reserve were given joint responsibility to oversee this process, and authorities to impose consequences for the failure of institutions to comply, including higher capital and liquidity requirements, limits on growth and activities, and ultimately divestiture of operations.

In addition, the Title II Orderly Liquidation Authority gave the FDIC new authority to manage the orderly failure of any financial institution whose failure in bankruptcy could pose a risk to the financial system. The new authorities provided to the FDIC under Title II include:

- The ability to place the financial firm, including its holding company, into a receivership process;
- An Orderly Liquidation Fund to assure liquidity for the orderly wind down and liquidation of the failed firm;
- Authority to impose a short stay on derivatives contracts; and
- The ability to coordinate with foreign authorities in the case of a firm with global operations.

The Title I and Title II authorities are complementary. The living will process requires the firms to make significant changes in their organizational structure and operations to facilitate orderly failure in bankruptcy. The Orderly Liquidation Authority is a backstop in the event failure in bankruptcy would threaten financial stability, but the changes implemented by the firms in the living will process would also facilitate a failure under Title II.

In previous speeches I have discussed in some detail the progress the FDIC has made in developing and making operational the Orderly Liquidation Authority, including establishing strong cross-border relationships. In my remarks today I want to focus on the progress we have made through the living will resolution plan process in bringing about tangible changes to the structure and operations of the eight U.S. Global Systemically Important Banks – or GSIBs – to enhance the resolvability of these firms and avoid the bailouts of the last crisis.

The progress has been substantial and I believe not well appreciated.

The Evolution of the Living Will Process

In order to place this work in perspective, I would like to describe briefly the evolution of the living will process.

As I indicated, the living will process was an entirely new authority in the regulatory framework when it was enacted in 2010. It required both the Federal Reserve and the FDIC to consider the objectives of the process, the standards and the guidance that would need to be provided to the firms to achieve the objectives, and the means of engagement with the firms to assist them in following the guidance.

This joint agency approach proved to be enormously valuable. Each agency brought to the process a particular expertise. The Federal Reserve brought its in-depth knowledge of the firms as their holding company regulator and experience in macro-prudential supervision. The FDIC brought its long history and experience in bank resolution and the insights gained from its new responsibilities as receiver under the Title II Orderly Liquidation Authority.

After enactment of the Dodd-Frank Act in 2010, the agencies issued for public notice and comment a joint rule finalized in 2011. Reflecting the statute, the rule laid out the key elements that would have to be addressed in each firm's living will. These requirements include:

- The firm's strategy for orderly resolution in bankruptcy during times of financial distress;
- The range of actions the firm proposes to take in resolution;
- Liquidity and capital needs and resources of the firm;
- A description of the firm's organizational structure, material entities, interconnections, and interdependencies; and
- The firm's corporate governance process.

It also established a process to remedy deficiencies and a requirement that firms include a public portion of the plan so that market participants and interested parties could judge for themselves whether firms were taking appropriate actions.

After the firms' first resolution plan filings in 2012, the FDIC and Federal Reserve reviewed the plans and issued joint guidance in April 2013. The guidance identified five significant obstacles to rapid and orderly resolution that the firms were required to address in subsequent filings. These included:

- **multiple competing insolvencies:** the risk that multiple, competing insolvency proceedings under different insolvency frameworks or jurisdictions could have systemic consequences;

- **ring-fencing:** the risk that firm actions/inactions could cause foreign host supervisors, resolution authorities, or third parties to take actions that could result in ring-fencing, which in turn could exacerbate U.S. financial stability;

- **critical services**: the risk that services, data, or contracts provided by an affiliate, third party, or financial market utility (FMU) might be interrupted, lost, liquidated, or rejected;
- **counterparty actions**: the risk that counterparty actions create firm or FMU operational challenges, and systemic market disruption; and
- **insufficient liquidity:** the risk of insufficient liquidity to maintain critical operations, including increased margin, reduced short-term borrowing, loss of access to credit, and restructuring expenses.

Pursuant to this guidance, the firms filed an additional set of plans in October 2013. In August 2014 the agencies completed their review and provided firm-specific letters that identified serious shortcomings in all of the plans. Among the concerns were unrealistic and unsupported assumptions and the failure to make, or even to identify, the kinds of changes in firm structure and practices that would be necessary to enhance the prospects for orderly resolution.

The agencies also provided feedback in the letters for the firms' next plans due in 2015. They noted that the firms should demonstrate in their next plans that they were making significant progress and were taking actions to improve their resolvability under the Bankruptcy Code, including by:

- Establishing a rational and less complex legal structure to improve the firm's resolvability;
- Developing a holding company structure that supports resolvability;
- Amending financial contracts to provide for a stay of certain early termination rights of external counterparties triggered by insolvency proceedings;
- Ensuring the continuity of shared services that support critical operations and core business lines throughout the resolution process; and
- Demonstrating operational capabilities for resolution preparedness.

The Federal Reserve and the FDIC stated in the letters that if the firms failed to satisfactorily address the shortcomings, the agencies could jointly determine that the plans were not credible or would not facilitate an orderly resolution.

In light of the ongoing challenges, the agencies also increased their collaboration with each other, the firms, and outside experts during this period. Staff at both agencies jointly met with firms on a regular basis to discuss their work, their progress, and to answer questions. Agency staff worked with each of the firms to discuss expected improvements in the resolution plans and the efforts, both proposed and already in progress, to facilitate each firm's preferred resolution strategy.

We also reached out to experts to check our own thinking and learn as much as we could. At the FDIC, we established a Systemic Resolution Advisory Committee, made up of a diverse array of experts – like Dick Herring – with both public and private sector experience. We also reached out to bankruptcy experts – judges, practitioners, and academics – for their thoughts on how to apply the bankruptcy process to the failure of a systemic financial institution. This communication and outreach has proven invaluable.

April 2016

The firms filed their next set of plans in July 2015. The agencies provided the firms feedback in April 2016, which turned out to be a watershed development in the living will process for two reasons.

First, the FDIC and the Federal Reserve jointly determined for the first time that some of the plans were not credible or would not facilitate an orderly resolution of the firm under the Bankruptcy Code. In fact, five of the eight plans received that determination. In addition, the agencies greatly increased the transparency of the living will process.

As required by the statute, the agencies identified the deficiencies in those five plans and focused on six key areas: liquidity, capital, derivatives and trading activities, legal entity rationalization, critical services, and governance mechanisms. Firms were given until October 2016 to remedy their deficiencies or risk sanctions as provided in the Act and the rule.

In October 2016 these five firms provided new submissions to address the deficiencies. The agencies found that four of the five plans remedied the deficiencies. The agencies found that one firm had not and, following the statutory process, subjected it to restrictions on the growth of its international and non-bank activities. They also prohibited it from establishing international bank entities or acquiring any non-bank subsidiary while the deficiency remained outstanding. The firm later resubmitted and, in March 2017, the agencies found that the firm had adequately remediated the deficiencies and the restrictions no longer applied.

In addition to the deficiencies, the agencies also identified “shortcomings” in all of the 2015 plans. These are weaknesses or gaps that raise questions about the feasibility of plans, but do not rise to the level of a deficiency. Firms were directed to address all shortcomings in their next plan submissions.

The agencies also issued guidance to the firms on further developing preferred resolution strategies. The guidance described the expectations of the FDIC and FRB regarding the firms’ resolution plans to be filed in 2017, and highlighted specific areas where additional detail should be provided and where certain capabilities or optionality should be developed to demonstrate that each firm has considered fully, and is able to mitigate, obstacles to the successful implementation of its preferred strategy. The guidance addressed, among other items, the six key vulnerabilities previously identified.

As previously mentioned, the agencies also dramatically increased the public transparency around the plans and the plan review process. In addition to making the public portions of the plans far more robust, the agencies made public key documents related to the plan review process: the guidance provided to the firms for preparing their plans, the framework for the evaluation of the plans, and the firm-specific feedback letters themselves. We wanted to make this process as transparent as possible so that all interested parties could evaluate what was being done, and frankly to enhance the credibility of the process.

The agencies moved from a one-year to a two-year cycle for submission and review of plans. This cycle would give the agencies time to review the plans, provide meaningful feedback, and still enable firms to make structural and operational changes necessary to address their issues. This additional time also enabled more extensive dialogue between the firms and the agency staff, which proved valuable to both.

Progress Made

The firms filed their most recent resolution plans in July 2017. As noted in the agencies' December 2017 joint feedback letters, the agencies found that the U.S. GSIBs have made substantial progress, although in my view, there is still a great deal of work to do.

Specifically, the firms have made progress in the following areas.

- **Established clean holding companies with pre-funded loss absorbing capacity.** Firms have simplified their holding company funding structures, eliminating short-term debt from the holding company and issuing and maintaining required amounts of long-term debt and loss absorbing capacity to help ensure that pre-funded resources are available to bear losses without transmitting systemic risk.

- **Rationalized their legal entity structures to align those structures and support their preferred resolution strategy**. These efforts include eliminating legal entities, improving funding lines, and establishing and pre-funding intermediate holding companies to support the resolution strategy. Rather than focusing solely on tax or other considerations, firms now take resolvability into account.

- **Identified and positioned capital and liquidity across material entities to support an orderly failure.** Firms now have frameworks for estimating and positioning the capital and liquidity required to execute their preferred resolution strategy.

- **Implemented internal escalation triggers, playbooks, and other governance mechanisms to facilitate the timely execution of important recovery and resolution actions by the board of directors and senior management.** Taken together, the capital, liquidity, and governance mechanisms help ensure that resources exist for orderly resolution.

- **Adhered to the International Swaps and Derivatives Association (ISDA) 2015 Universal Resolution Stay Protocol, which provides for temporary stays on certain default and**

early termination rights for ISDA and other standard derivatives contracts. The temporary stays could help to mitigate certain contagion effects like those seen during the 2008 financial crisis. The firms also have provided analyses describing the potential wind-down of their derivatives activities over time.

- **Developed strategies and playbooks to maintain access to payment, clearing, and settlement services, including by describing operational and liquidity arrangements, such as increased margin and collateral requirements, to facilitate continued access to key FMUs.**

- **Taken steps to ensure that inter-company services shared by multiple affiliates will continue to be available in resolution to reduce the potential that the failure of one subsidiary within a firm will disrupt the operations of its affiliates and improve the firm's ability to separate affiliates during resolution.**

- **Modified their service contracts with key vendors to ensure the continuation of services as long as the firm continues to meet its obligations under the terms of the contract.**

- **Developed options for the sale of discrete businesses and assets under different market conditions to increase the flexibility of the firm's execution of its preferred resolution strategy and have taken steps to make those options actionable.**

In addition, individual firms have, through this process, made changes to their operations to address firm-specific issues. For example, some firms have been working to separate different brokerage or investment management activities in support of orderly resolution, and others have merged together entities that perform similar functions to reduce duplication and simplify the organization. Other firms have established wholly-owned subsidiaries to house, in one entity, key operations. Some firms have taken steps to detail early stress indicators, board involvement, and potential wind-down scenarios, and others have eliminated guarantees to foreign operations that could have posed risks to U.S. entities.

Conclusion

In summary, the living wills process has proven enormously helpful to firms and regulators. It has facilitated significant structural and operational improvements within firms to improve their resolvability. The process has been institutionalized and integrated into both the firms' business-as-usual planning and operations[1] and the regulators' supervisory and resolution-planning processes. The progress made resulted from an evolving and highly cooperative process over several years.

It is also important to remember that the resolvability of firms will change as markets change and as firms' activities, structures, and risk profiles change. As noted in the December 2017 joint feedback letters, the agencies expect the firms to remain vigilant in considering the resolution consequences of their management decisions.

In December 2017 the agencies identified four areas in which more work will need to be done by all eight U.S. GSIB firms to continue to improve their resolvability: intra-group liquidity; internal loss-absorbing capacity; derivatives; and payment, clearing, and settlement activities.

Given the size and complexity of these firms and the uncertainty of market developments, there are inherent challenges and uncertainties associated with the resolution of a systemically important financial institution. It is worth keeping in mind that we have not yet executed an orderly resolution of a financial institution of systemic consequence either under bankruptcy or the Orderly Liquidation Authority. We should therefore be cautious about making heroic statements.

But it is also true that we are in a different place today than we were in 2008.

Options and tools now exist that provide a path far better than existed in 2008 to help ensure that a systemic firm can fail, that shareholders, creditors, and management of the firm bear the

[1] In an April 2016 report, the U.S. Government Accountability Office noted that many plan filers indicated that the resolution planning process had positioned them for an orderly resolution or potentially could reduce systemic risk, caused them to engage in comprehensive thinking, led them to develop operational and business capabilities, and better positioned them by identifying and mitigating obstacles to resolution. See GAO-16-341 at https://www.gao.gov/assets/680/676497.pdf

consequences of their decisions, and that financial stability can be preserved during times of stress without taxpayer bailouts.

It is critical that this important work continue.

Thank you.