

**Remarks by FDIC Chairman Martin J. Gruenberg
To the FDIC Banking Research Conference; Arlington, VA
September 17, 2015**

Good afternoon. I am pleased to have the opportunity to speak with you today. Thank you to Jack Reidhill, Haluk Unal and their colleagues on the organizing committee for putting this program together and extending the invitation to speak. This is the 15th Annual Research Conference at the FDIC, which speaks to the enduring success of the partnership between our Center for Financial Research and the Journal of Financial Services Research. It seems that the conference program is stronger every year, and I know our economists feel that this year is no exception. We thank all of you for your participation.

I also want to take a moment to thank those in the audience who have been affiliated with the Center for Financial Research over the years. I know that several of you have been Visiting Scholars or Fellows at the Center, and many more have participated in the Center's Seminar Series and conferences and have co-authored papers with FDIC economists. This type of engagement with the scholarly community is critical to our Center's role as a leading source of forward-looking research on banking and the financial markets in which banks operate. We greatly value the relationships that sustain the Center's research program, so thank you for supporting it. We look forward to strengthening and expanding these relationships as we go forward.

I would like to take the opportunity today to speak to you about the progress the FDIC has made in developing a framework under the Dodd-Frank Act for the orderly failure of a large, complex, systemically important financial institution while avoiding the taxpayer bailouts and the market breakdowns that took place during the recent financial crisis. In my view, the progress has been impressive and somewhat underappreciated.

Broadly speaking, prior to the recent financial crisis, the major jurisdictions around the world did not envision that these globally active, systemically important financial institutions—termed G-SIFIs or SIFIs—could fail. As a result, little thought was devoted to their resolution and there were no public authorities beyond bankruptcy for handling the failure of one of these firms. G-SIFIs, although large and complex, were considered well-diversified with operations spanning global markets, putting them, it was thought, at a low risk of failure. It was assumed that G-SIFIs had ready sources of liquidity and, should problems arise, that they would be able to raise large amounts of equity or debt.

In hindsight, those proved to be mistaken assumptions. After Lehman Brothers filed for bankruptcy, market liquidity dried up and the capital markets were unwilling to provide additional capital to other financial firms whose viability appeared uncertain. The ensuing disruptions triggered the worst financial crisis since the Depression and contributed to the most severe recession since World War II. More than 8 million people lost jobs, more than 9 million homes went into foreclosure, GDP declined more than 4 percent, and virtually the entire net income of the banking industry for two years was wiped out despite unprecedented government intervention in support of the industry.

Looking back, it is clear that the major countries of the world were unprepared for the challenges they faced. Lacking the necessary authorities to manage the orderly failure of a large, complex financial institution, policymakers were forced to choose between two bad options: taxpayer bailouts or financial collapse.

In the United States it was clear that our resolution authorities had not kept pace with changes in our financial system. While long-established, specialized, public resolution regimes existed for particular types of financial institutions—such as banks and broker dealers—no agency had the authority to manage the orderly resolution of a large, complex financial institution, even if the failure of that institution could significantly destabilize the financial system and severely impact the economy. Rather, the only option available for the resolution of such an institution was a bankruptcy process that lacked the tools essential for facilitating the orderly unwind of a financial firm of the size, complexity, and international reach of the largest, most complex financial institutions.

The Dodd-Frank Act passed by Congress in 2010 addressed these critical gaps in authority. The Act established a framework designed to ensure that policymakers and taxpayers would not be put in the same position as in the fall of 2008. As I indicated, it is this framework and the progress we have made implementing it that I want to focus on today.

Bankruptcy is the statutory first option under the framework. The largest bank holding companies and designated non-bank financial companies are required to prepare resolution plans, also referred to as "living wills," under Title I of the Dodd-Frank Act. These living wills must demonstrate that the firm could be resolved under bankruptcy without severe adverse consequences for the financial system or the U.S. economy. As a backstop, for circumstances in which an orderly bankruptcy process might not be possible, Title II of the Dodd-Frank Act provides the Orderly Liquidation Authority. This public resolution authority allows the FDIC to manage the orderly failure of the firm.

This framework helps to ensure that financial markets and the broader economy can weather the failure of a SIFI; that shareholders, creditors, and culpable management of the firm will be held accountable without cost to taxpayers; and that such an institution can be wound down and liquidated in an orderly way.

Strengthening Bankruptcy

The Living Will Process

In regard to living wills, the FDIC and the Board of Governors of the Federal Reserve System are charged with reviewing and assessing each firm's plan. If a plan does not demonstrate the firm's resolvability, the FDIC and the Federal Reserve may jointly determine that it is not credible or would not facilitate an orderly resolution of the company under the Bankruptcy Code and issue a notice of deficiencies. The notice must identify the deficiencies of the plan and provide the firm with the opportunity to remedy them. Ultimately, if a firm fails to submit a plan that demonstrates its resolvability in bankruptcy, the agencies may jointly impose requirements or restrictions on the firm or its subsidiaries, including more stringent capital, leverage, or liquidity requirements. The agencies may also restrict the firm's growth, activities, or operations.

If, after two years, the firm still fails to submit an acceptable plan, the agencies may order a firm to divest certain assets or operations to facilitate an orderly resolution under the Bankruptcy Code.

The FDIC and the Federal Reserve have taken a number of important steps to ensure that the objectives of the living will requirement are being met. Following the review of the initial plans submitted by the largest U.S. bank holding companies and foreign banking organizations with U.S. operations in 2012, the agencies provided additional guidance to the firms in March 2013 regarding their plans. Included in the guidance were instructions to provide more detailed information on, and analysis of, obstacles to resolvability under the Bankruptcy Code. In particular, five issues were to be addressed: funding and liquidity, global cooperation, operations and interconnectedness, counterparty risk, and multiple competing insolvencies.

In August of last year, the FDIC and the Federal Reserve Board delivered individual letters to the largest financial firms regarding their second resolution plan submissions. In the letters, the agencies jointly identified common shortcomings of the plans, including the use of assumptions the agencies regarded as unrealistic or inadequately supported. Further, the agencies found that the firms failed to make, or even identify, the kinds of changes in firm structure and practices that would be necessary to enhance the prospects for orderly failure under bankruptcy.

As a result, the agencies directed the firms to demonstrate in their 2015 plans that they are making significant progress to address all the shortcomings identified in the letters. Among the actions being required to improve resolvability in bankruptcy are:

- establishing a rational and less complex legal structure that would take into account the best alignment of legal entities and business lines;
- developing a holding company structure that supports resolvability;
- amending qualified financial contracts to address the risk of counterparty actions;
- demonstrating that shared services, which support critical operations and core business lines—such as information technology services—would continue throughout the resolution process; and
- demonstrating that operational capabilities—such as providing information on a timely basis—necessary for resolution purposes are in place.

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The letters also noted that, given the important objective to provide transparency on firm resolvability to the public, the agencies will work with the firms to enhance the transparency of future plans.

The letters are part of a broader effort to provide more direct feedback to firms about the agencies' expectations and the need for immediate structural changes. As noted in the letters, failure by firms to make significant progress with respect to the identified shortcomings and to become more resolvable in bankruptcy may result in determinations by the agencies that plans are not credible or would not facilitate an orderly resolution under the Bankruptcy Code as provided for under the Dodd-Frank Act. The 2015 plans were submitted on July 1 and are now under review by the FDIC and the Federal Reserve.

The Issue of Interconnectedness

The actions the firms are being required to take focus in particular on reducing the interconnectedness between legal entities within the firms.

In order to understand why reducing this internal interconnectedness is being stressed, it is important to recognize how the largest, most complex financial firms are organized and what would happen if one were to fail. These firms are extremely complex with hundreds, if not thousands, of legal entities, which operate on a business line—not legal-entity—basis. While business lines stretch across multiple legal entities, foreign and domestic, failure occurs on a legal-entity basis. The inability to resolve one legal entity without causing knock-on effects that may propel the failure of other legal entities within the firm makes the orderly resolution of one of these firms extremely problematic.

To improve resolvability, firms must show how their legal entities can be separated from their parent company and their affiliates, that the default or failure of one entity will not trigger the default or failure of other entities, and that critical operations will continue to function in resolution. To do this, firms must undertake three distinct, but related, efforts. First, they must map their material legal entities to their business lines. Next, they must address cross-guarantees and potential cross-defaults that spread risk and tie disparate legal entities and operations together. Finally, they must take steps to ensure that the information technology and other services essential to the functioning of their material legal entities would continue under their resolution strategies. Ensuring that firms can disentangle their business lines and services into separate legal entities so that critical operations can be maintained during resolution will better enable firms to be split apart and liquidated in resolution.

By addressing these shortcomings, firms will increase the available options for resolution in bankruptcy. Actions that promote separability of material entities will lessen the problem of knock-on effects created by interconnectedness, potentially allowing a firm to place its troubled entity into bankruptcy, or its existing resolution regime. Such an outcome would increase the likelihood that failure would be orderly, minimizing any potential instability for the financial system as a whole, a problem that greatly influenced policymakers' responses in 2008.

The Orderly Liquidation Authority—A Backstop to Bankruptcy

While we regard reducing interconnectedness, as well as other changes required under the living will process, as essential to facilitating an orderly resolution under bankruptcy, we cannot rule out that in the future policymakers may face a situation in which resolution in bankruptcy would result in severe economic distress. Given the challenges and the uncertainty surrounding any particular failure scenario, Title II of the Dodd-Frank Act provides the Orderly Liquidation Authority, which is effectively a public-sector bankruptcy process for institutions whose resolution under the U.S. Bankruptcy Code would pose systemic concerns. This authority is only triggered after recommendations by the appropriate federal agencies and a determination by the Secretary of the Treasury in consultation with the President.

The Orderly Liquidation Authority is the mechanism for ensuring that policymakers will not be faced with the same poor choices they faced in 2008. Its tools are intended to enable the FDIC to

carry out the process of winding down and liquidating the firm, while ensuring that shareholders, creditors, and culpable management are held accountable and taxpayers do not bear losses.

The Orderly Liquidation Authority provides the FDIC several authorities—not all of which are available under bankruptcy—that are broadly similar to those the FDIC has to resolve banks. They include the authority to establish a bridge financial company, to stay the termination of certain financial contracts, to provide temporary liquidity that may not otherwise be available, to convert debt to equity, and to coordinate with domestic and foreign authorities in advance of a resolution to better address any cross-border impediments. The ability to plan and the availability of a large team of professionals experienced in financial institution resolution are additional advantages the FDIC can bring to bear. In the years since enactment of Dodd-Frank, the FDIC has made significant progress in developing the operational capabilities to carry out a resolution if needed. I'd now like to discuss these capabilities in more detail.

Bridge Financial Company

The concept of using a bridge financial company in the resolution of a large, complex financial institution builds off the FDIC's experience using bridge banks to resolve certain failed banks. Congress granted the FDIC authority to establish a bridge bank as a resolution method during the financial crisis of the 1980s. That authority provides the FDIC with a temporary vehicle to take over and maintain critical services for the customers of a failed bank until a permanent resolution can be achieved. Similarly, Congress granted the FDIC the authority to establish a bridge financial company for a SIFI, including setting the terms and conditions governing its management and operations, under the Orderly Liquidation Authority.

Given the challenges presented in the resolution of a large, complex financial company—especially as these companies are currently organized and operated—the FDIC initially focused its efforts on developing a resolution strategy termed the single point of entry. That strategy would place the top-tier parent company of the firm into receivership while establishing a temporary bridge financial company to hold and manage its critical operating subsidiaries while the process of breaking up and winding down the operations of the firm is carried out. Assets of the top-tier parent company would be transferred from the receivership to the bridge financial company, as bank assets are transferred to a bridge bank in certain bank failures. Liabilities of the top-tier parent company would be left in the receivership to cover the losses and expenses from the firm's failure and to capitalize the subsidiaries through the liquidation process.

In this way, the firm's critical subsidiaries, which perform operations and provide services that affect the broader financial system and ultimately the economy, would be stabilized to facilitate liquidation through the wind-down of the firm. This process would avoid the disruption that would otherwise accompany the firm's sudden collapse. The exact path through resolution will vary depending on the particular failure scenario, but we would expect some business lines or subsidiaries (such as broker-dealers) to quickly shrink and wind down and for others to be sold off. This strategy helps ensure there is sufficient time and liquidity for customers to transition to new service providers. It also enables the wind down and sale of discrete businesses and asset portfolios to occur in an orderly way. The resolution process would end with the termination of

the bridge financial company. An explicit objective is to ensure that no systemically significant entity emerges from this process.

To operate the bridge financial company, the FDIC would appoint a new board of directors and senior management who would be charged with managing the wind-down of the firm in a way that minimizes systemic disruption. In addition to being an essential tool to preserve financial stability, the bridge institution is also an important means for ensuring accountability for stakeholders of the failed firm. Shareholders would be wiped out, creditors would take losses, and culpable management would be replaced. As you know, such accountability is essential to minimizing moral hazard and promoting market discipline.

Liquidity and Capital

From the outset, the bridge financial company would have a strong balance sheet because the unsecured debt obligations of the failed firm would be left as claims in the receivership, while all the assets would be transferred to the bridge company. As a well-capitalized entity, the FDIC expects the bridge financial company and its subsidiaries to be in a position to borrow from customary sources in private markets to meet its liquidity needs. However, if such funding is not immediately available, the law provides the Orderly Liquidation Fund: a dedicated, back-up source of liquidity—not capital—to be used, if necessary, in the initial stage of resolution until private funding can be accessed.

The Orderly Liquidation Fund would only be used when private-sector funding is unavailable, and there are a number of important limitations on its use. For example, the statute limits the amount that can be borrowed and requires that any Orderly Liquidation Fund borrowing must be repaid from recoveries on the assets of the failed firm. If that should prove insufficient, assessments would be levied on the largest financial companies. Under the law, taxpayers cannot bear losses. Instead, losses are first borne by the failed company through its shareholders and its creditors, and, if necessary, by assessments on the financial industry.

As I indicated earlier, the firm's debt will provide the means to capitalize the bridge institution and its material entities. During the operation of the bridge financial company, losses would be calculated and apportioned among the claims of the former shareholders and unsecured creditors. Sufficient debt at the parent company that can be converted into equity to absorb losses in the failed firm will allow for the recapitalization of any critical subsidiaries until such time as they can be wound down and liquidated. In the event losses exceed the bridge financial company's ability to recapitalize a material subsidiary, the subsidiary would be placed into a separate receivership under bankruptcy, its appropriate resolution regime, or the Orderly Liquidation Authority, exposing creditors of those subsidiaries to loss.

The Federal Reserve has been working to develop a long-term debt requirement for the largest, most complex U.S. banking firms to maintain a minimum amount of long-term unsecured debt outstanding at the holding company level. Most major U.S. firms currently have substantial amounts of unsecured debt at the holding company. A rulemaking by the Federal Reserve Board would ensure that a minimum amount of long-term debt would be maintained by these firms.

While minimum capital requirements are designed to cover losses in a firm on an open institution basis, in resolution the expectation is that equity will be gone, as has been the experience with past bank failures. Thus, the long-term debt requirement is intended to provide capital resources from private creditors for the wind-down and liquidation of a firm without cost to taxpayers. Such a requirement will enable authorities to implement a resolution strategy that provides for the continuity of a firm's critical operations during the resolution process, minimizing the risk of runs and fire sales that threaten financial stability.

At the international level, the FDIC and the Federal Reserve have been working through the Basel Committee on Banking Supervision and the Financial Stability Board to finalize an international proposal to establish a minimum total loss absorbing capacity requirement for global, systemically important banks. There is now broad international agreement on the need for a minimum standard to provide loss-absorbing capacity in the event of a failure of a large, complex financial institution.

Qualified Financial Contracts

Another major impediment to the orderly resolution of a financial firm that emerged during the crisis of 2008 was the inability of the bankruptcy process to stay the early termination of certain financial contracts, commonly referred to as "qualified financial contracts," or "QFCs." In the case of the Lehman Brothers bankruptcy, parties to such contracts—which included derivatives contracts valued in the trillions of dollars—were able to exercise early termination rights, resulting in the disorderly termination of the contracts and the fire sale of underlying assets. The Orderly Liquidation Authority provides the FDIC with the ability to impose a temporary stay on QFCs, preventing parties from terminating their contracts immediately upon a firm being placed into an FDIC receivership. Though this stay helps address risks posed by such contracts written under U.S. law, questions remain regarding contracts not subject to U.S. law, leaving legal uncertainty for cross-border contracts. Currently, the Bankruptcy Code does not provide a stay for these contracts.

In developing a resolution strategy, therefore, the United States and other jurisdictions facing this same problem needed to find a solution to avoid the early termination of contracts written under foreign laws. In November of last year, the International Swaps and Derivatives Association (ISDA) issued a protocol that ends the automatic termination of covered derivative contracts in the event of a bankruptcy or public resolution of a systemic financial institution. Eighteen of the largest global financial institutions, which collectively represent a majority of the swaps market, voluntarily agreed to adhere to the protocol.

The Federal Reserve is expected to engage in rulemaking to codify compliance with the protocol. These efforts are essential to avoid gaming and to provide a level playing field for those institutions included in the rulemaking. The rulemaking and the adoption of the protocol will reduce the legal uncertainty regarding the termination of derivative contracts in the context of cross-border resolutions. Importantly, these efforts improve resolution under both the Orderly Liquidation Authority and bankruptcy by helping to address some of the cross-border uncertainty and contagion risks in both regimes.

Cross-Border Coordination

Since passage of the Dodd-Frank Act, other major jurisdictions have followed the United States in enacting systemic resolution authorities that are comparable to those provided in the Dodd-Frank Act. Pursuant to provisions of the Orderly Liquidation Authority, the FDIC has worked closely with all the major financial jurisdictions, including the United Kingdom, Germany, France, Switzerland, and Japan as well as European entities including the new Single Resolution Board and Single Supervisory Mechanism. This cooperation is essential to identifying issues and to addressing obstacles to cross-border resolution.

The bilateral relationship between the United States and the United Kingdom is of particular importance in cross-border resolution. Of the 30 global, systemically important financial institutions (G-SIFIs) identified by international policymakers, four are headquartered in the United Kingdom and eight are headquartered in the United States. Moreover, more than two-thirds of the reported foreign activities of the eight U.S. G-SIFIs are conducted in the United Kingdom. As a result, the U.S. relationship with the United Kingdom on cross-border resolution is a particular priority.

As an indication of the priority the senior officials of the two jurisdictions attach to this working relationship, in October of last year the FDIC hosted a meeting of the heads of the Treasuries, central banks, and leading financial regulatory bodies of the United States and United Kingdom. This event's high-level discussion furthered understanding among the principals in regard to key challenges to the successful resolution of U.S. and U.K. G-SIFIs, and how the two jurisdictions would cooperate in the event of a cross-border resolution. The event built upon prior bilateral work between authorities in our two countries, which, since late 2012, has included the publication of a joint paper on G-SIFI resolution and participation in detailed simulation exercises among our respective staffs.

Last year, the European Parliament established a Single Resolution Mechanism (SRM) for the resolution of financial institutions in Europe. The SRM creates a centralized resolution authority framework for the 19 Eurozone Member States, and many of its authorities mirror those of the FDIC under the Orderly Liquidation Authority. The FDIC is actively engaging with the new Single Resolution Board, which oversees the SRM, to be of assistance in its set up and to discuss cooperation and resolution planning for G-SIFIs with assets and operations in the United States and the Eurozone. The FDIC and the European Commission have established a joint Working Group to focus on both resolution and deposit insurance issues. In addition, the FDIC participates in the Crisis Management Groups for G-SIFIs with significant assets and operations in the United States. Deepening our cross-border relationships with the key foreign jurisdictions will be an ongoing priority for the FDIC's work on systemic resolution.

Public Portions of Living Wills

I would also like to talk briefly about the public portions of the latest round of living wills that were submitted in July. Public and market understanding of the process for improving the resolvability of G-SIFIs is important for a number of reasons, including allowing for the

development of realistic market expectations about how the resolution of a G-SIFI might proceed.

As I mentioned earlier, in August of last year we told the firms that we expected them to improve the transparency of their plans. In the past year the agencies provided guidance to the firms requiring that the public plans include more detailed information in a number of areas. These areas include a discussion of the strategy for resolving each material entity in a manner that mitigates systemic risk, a high-level description of what the firm would look like following resolution, and a description of the steps that each firm is taking to improve its ability to be resolved in an orderly manner in bankruptcy. In addition, the agencies notified the firms that public plans should include more detail on each material entity, such as the type of business conducted, interconnectedness among entities, and a general indication of capital and funding sources.

As a result, this year's public plans provide substantially more information. Improving the transparency of resolution plans will be an ongoing priority of the living will process.

Conclusion

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.

Prior to the crisis, the major jurisdictions of the world, including the United States, lacked the basic statutory authorities to address this issue. No solutions were available to address the critical resolution challenges of capital, liquidity, derivative contracts, maintenance of critical operations, and cross-border cooperation. No authorities were available to require firms to make essential changes in their organizational structures and operations to address major impediments to resolution prior to a failure.

In the United States, all of those issues have been or are in the process of being addressed. The living wills are an important new tool to require institutions to address the deep interconnectedness within their own organizational structures that is a central impediment to orderly resolution under bankruptcy as well as under the Orderly Liquidation Authority. The stay on the automatic termination of derivative contracts, whether written under U.S. or foreign law, in the event of an insolvency proceeding in bankruptcy or under the Orderly Liquidation Authority is a major step forward. The ability to convert unsecured debt to equity to facilitate an orderly failure in bankruptcy or under the Orderly Liquidation Authority addresses another essential issue.

The fact that the senior financial officials of the world's two leading financial jurisdictions, the United States and the United Kingdom, met in October to discuss how they would cooperate in the event of a cross-border failure of a systemic financial institution underscores the high priority that is being placed on this issue. The establishment by the European Union of a new Single Resolution Mechanism for Europe, to complement the Single Supervisory Mechanism, will add a

major new piece to the international infrastructure for cross-border resolution. I think it is fair to say that all of the major jurisdictions of the world are focused on this issue.

In the United States, the statutory mandate for the FDIC is clear: Use the living will process to bring about real-time changes in the structure and operations of firms to facilitate orderly resolution under bankruptcy. And, if necessary, be prepared to use the powers available under the Orderly Liquidation Authority to manage the orderly failure of a firm.

And to be clear, if the FDIC had to use the Orderly Liquidation Authority, it would result in the following consequences for the firm: shareholders would lose their investments, unsecured creditors would suffer losses in accordance with the losses of the firm, culpable management would be replaced, and the firm would be wound down and liquidated in an orderly manner at no cost to taxpayers.

One other thing that is also clear is that without these authorities, we would be back in the same position as 2008, with the same set of bad choices.

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.

Thank you.