Global Cooperation in Resolution
Of
Systemically Important Financial Institutions
-- Remarks by
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Introduction

It is a pleasure to be here this evening. I want to thank the Japan Financial News Company for arranging this program and for the invitation from President Mizushima to address this distinguished audience. This morning, I visited Commissioner Hatanaka and Vice Commissioner Kono of the Japan Financial Services Agency. Tomorrow I will visit Governor Kuroda and Deputy Governor Nakaso of the Bank of Japan, and Governor Tanabe and Deputy Governor Obata of the Deposit Insurance Corporation of Japan.

These discussions are important because Japan and the United States are home to 11 of the globally active financial companies designated as being systemically important by the Financial Stability Board (FSB) of the G-20. Japan is the home country for three global systemically important financial institutions, and the United States is the home country for eight. These global, systemically important financial institutions – often referred to as G-SIFIs – are large, complex and highly integrated companies with significant operations worldwide. The U.S. G-SIFIs have major operations in Japan; likewise, Japan's G-SIFIs have major operations in the United States. Further, these institutions are important counterparties to each other. Given the significance of Japan and the United States in the global operation of these companies, cooperation and coordination among regulatory authorities in our countries is particularly important both for the orderly resolution of G-SIFIs and for maintaining financial stability in Japan and the United States.

I would note that the FDIC was pleased to learn that the Diet in Japan passed the Law with Regard to Amendment of the Financial Instruments and Exchange Act, Etc. in June 2013. The new legislation, among other things, expands the scope of the existing bank resolution regime in Japan to cover not only deposit-taking financial institutions but also insurance companies, securities firms, financial holding companies, and foreign bank branches. The new legislation also gives the Deposit Insurance Corporation of Japan operating responsibilities for the orderly resolution of a G-SIFI.

The new orderly resolution mechanism may be triggered after the deliberation of the Financial Crisis Response Council once the Prime Minister confirms the need to implement the mechanism to avoid severe turmoil in financial markets or the financial system in Japan. The Financial Crisis Response Council is composed of the Prime Minister, the Chief Cabinet Secretary, the Minister of Finance, the Minister of State for Financial Services, the Governor of Bank of Japan, and the Commissioner of the Japan Financial Services Agency.

The resolution measures available to the Japanese regulatory authorities are similar to those of the U.S. resolution regime for SIFIs. They include write-downs of equity, conversion of debt to equity, a stay of early termination rights on qualified financial contracts, and the provision of liquidity if necessary. We understand that this legislation is in compliance with the FSB's Key Attributes of Effective Resolution Regimes for Financial Institutions. We look forward to the legislation's taking effect in March 2014 and learning about the implementing rules that are currently being prepared.

Both of our countries have made great progress in enacting legislation that would allow us to resolve a failed or failing G-SIFI. However, the success of our efforts will depend heavily on our ability to work with one another should one of these institutions require resolution. In this regard, the FDIC places a high priority on deepening our working relationships with our Japanese counterparts.

The meetings we are having with the Japanese authorities reflect the willingness of the FDIC and our Japanese colleagues to cooperate in the interest of fulfilling our respective statutory obligations. It also provides a means to further our understanding of the complexities of the cross-border operations of our respective G-SIFIs. We look forward to continuing to work with our Japanese colleagues at the principal and staff levels to meet our respective goals of maintaining confidence and stability in the financial systems of Japan and the United States, and to be able to manage the orderly resolution of a global SIFI.

My remaining remarks this evening will focus on two subjects important to both Japan and the United States: the development of a viable strategy for resolving G-SIFIs and the importance of international cooperation and communication in cross border resolution. . I will focus on the FDIC's efforts in both of these areas.

Broadly speaking, prior to the recent crisis, the major national authorities in the U.S. and abroad did not envision that G-SIFIs could fail, and thus little thought was devoted to their resolution. G-SIFIs, although large and complex, were considered to be well-diversified with global operations, 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, that proved to be a mistaken assumption. After Lehman Brothers filed for bankruptcy, market liquidity dried up and the capital markets were unwilling to provide additional capital to financial firms whose viability appeared uncertain.

In retrospect, the major countries of the world were unprepared for the challenge they faced. When failing, G-SIFIs required not only a forceful national response but also close cross-border communication and cooperation among home- and host-country regulators. The necessary national authorities and cross-border arrangements simply did not exist.

Over the intervening years, U.S. regulators, foreign regulators, and the Financial Stability Board on a multilateral basis have tried to come to grips with these issues that were not well understood in 2008.

The Dodd-Frank Act

When the financial crisis developed in 2008, the FDIC's receivership authorities were limited to federally insured banks and thrift institutions. G-SIFIs, which as I indicated are global, diversified and highly complex, could not be resolved under these authorities. Specifically, the FDIC lacked the authority to place the holding company or affiliates of an insured depository, or any other non-bank financial company like Lehman Brothers that might pose a risk to the financial system, into an FDIC receivership. The FDIC's resolution authority – limited to the insured depository – was wholly inadequate to deal with the orderly resolution of a G-SIFI. In addition, since the possibility of failure of these companies was not seriously contemplated, there was no planning for their resolution. The only option available for failure was the U.S. bankruptcy process, which was equally unprepared to handle the failure of a SIFI as was demonstrated by the Lehman Brothers case. This left extraordinary public support to these firms on an open institution basis as the last resort to mitigate further damage to the financial system and the economy.

To address these critical gaps in resolution authority, the Dodd-Frank Act, signed in July 2010, provided significant new authorities to the FDIC and other U.S. regulators to plan for and effectively manage the orderly failure of a SIFI. Title I of the Act requires all bank holding companies with assets over $50 billion, as well as non-bank financial companies designated as systemic by the U.S. Financial Stability Oversight Council, to prepare resolution plans, or “living wills,” to demonstrate how they would be resolved in a rapid and orderly manner under the U.S. Bankruptcy Code in the event of material financial distress or failure. Title II of the Act provides the FDIC with a back-up authority to place a failing SIFI, including a consolidated bank holding company or a non-bank financial company deemed to pose a risk to the financial system, into an FDIC receivership should an orderly resolution under the Bankruptcy Code not be possible. I would like to first discuss the living will process.

Title I – Living Wills

As I indicated, U.S. SIFIs present a challenge to resolution in bankruptcy or under an FDIC receivership because they are organized under a holding company structure with a top-tier parent and operating subsidiaries that comprise hundreds, or even thousands,

of interconnected entities that span legal and regulatory jurisdictions across international borders and share funding and critical support services.

Title I of the Dodd-Frank Act provided new authorities intended to make these companies resolvable under the Bankruptcy Code. Title I requires all covered companies to prepare a resolution plan, often referred to as a “living will,” to demonstrate that the firm could be resolved under the Bankruptcy Code without posing a systemic risk to the U.S. financial system. The Title I process is jointly overseen by the FDIC and the Board of Governors of the Federal Reserve System.

Following review of the initial resolution plans received in 2012 from the 11 largest, most systemically significant SIFIs with operations in the United States, the Federal Reserve and the FDIC developed guidance that provided benchmarks for the firms to address in their second-round resolution plans, which were submitted on October 1. The benchmarks included global cooperation, multiple insolvencies, counterparty actions, maintenance of critical operations, and funding and liquidity. The firms were required to provide analysis to support the strategies and assumptions contained in the resolution plans. These revised plans, as I indicated, have now been submitted and will be evaluated by the agencies under the standards provided in the statute.

Title II – Orderly Liquidation Authority

Although the statute makes clear that bankruptcy is the preferred resolution framework in the event of the failure of a SIFI, the U.S. Congress recognized that a SIFI may not be resolvable under bankruptcy without posing a systemic risk to the U.S. financial system. Title II provides broad new back-up authorities to place any SIFI into an FDIC receivership process if no viable private-sector alternative is available to prevent the default of the financial company and if a resolution through the bankruptcy process would have serious adverse effects on U.S. financial stability.

In the three years since the passage of the Dodd-Frank Act, the FDIC has concentrated its efforts on developing the capability to carry out a successful resolution under Title II. We have, I believe, developed a viable strategy, termed the Single Point of Entry (SPOE), under which the FDIC would take control of the parent holding company of a failed or failing SIFI, allowing the firm's operating subsidiaries, domestic and foreign, to remain open and operating, and diminishing contagion effects while removing culpable management and imposing losses on shareholders and unsecured creditors with no cost to the taxpayer.

Let me outline briefly how we envision this process playing out.

The Dodd-Frank Act generally requires recommendations by two-thirds vote of the Federal Reserve Board and the FDIC Board and a determination by the Treasury Secretary, in consultation with the President of the United States, in order to invoke the Title II authorities that could be applied to a financial company whose failure is deemed to pose a risk to the financial system.

Once approved, the FDIC, in order to implement the single point of entry strategy, would place the parent holding company of the failed institution into an FDIC receivership. The FDIC would then organize a new financial holding company – termed a bridge financial holding company – as authorized by the Dodd-Frank Act, into which it would transfer assets from the receivership, leaving the liabilities behind.

The newly formed bridge financial holding company would continue to provide the functions of the failed parent holding company. The company's subsidiaries would remain open and operating, allowing them to continue critical operations and avoid the disruption that would otherwise accompany their closings.

Under the Dodd-Frank Act, the officers and directors responsible for the failure of the SIFI cannot be retained and would be replaced. The FDIC would appoint a board of directors and would nominate a new chief executive officer and other key managers from the private sector to replace those officers who had been removed. This new management team would run the bridge financial company under the FDIC's oversight during the first step of the process.

During the resolution process, restructuring measures would be taken to address the problems that led to the company's failure. These could include changes in the company's businesses including shrinking those businesses, breaking them into smaller entities, and/or liquidating certain subsidiaries or business lines or closing certain operations. An explicit objective of the Title II process would be to restructure the firm into one or more smaller companies that could be resolved under bankruptcy without causing significant adverse effect to the U.S. financial system or economy.

From the outset, the bridge financial company would be created by transferring sufficient assets from the receivership to ensure that the bridge company is well-capitalized. The well-capitalized bridge financial company should be able to fund its ordinary operations through customary private market sources. The FDIC's explicit objective is to ensure that the bridge financial company can secure private sector funding as soon as possible after it is established.

The Dodd-Frank Act does provide for an Orderly Liquidation Fund managed by the FDIC using the proceeds of obligations issued by the Treasury to serve as a back-up source of liquidity support for the bridge financial company. This source of liquidity would only be available on a fully secured basis. If needed at all, the FDIC anticipates that any borrowings would only be issued in limited amounts for a brief transitional period in the initial phase of the resolution process and would be repaid promptly once access to private funding resumed. Any borrowings must be repaid either from recoveries on the assets of the failed firm or, in the unlikely event of a loss on the collateralized borrowings, from assessments against the largest financial companies. The law expressly prohibits taxpayer losses from the use of the Title II authority.

During the operation of the bridge financial company, losses would be calculated as the assets are marked to market. These losses would be apportioned according to the order of statutory priority among the claims of the former shareholders and unsecured creditors of the firm, whose equity, subordinated debt and unsecured debt remained in the receivership. If the assets of the parent company were not sufficient to absorb the losses, then creditors at the subsidiary level would be at risk. Of course, under any circumstances insured depositors will be protected.

Through a securities-for-claims exchange, the claims of creditors in the receivership would be satisfied by the issuance of securities representing debt and equity of the new company or companies that would be created from the bridge holding company. In this manner, debt in the failed company would be converted into equity that would serve to ensure that the new operations would be well-capitalized.

This strategy will only be successful if there is sufficient debt and equity at the parent holding company to both absorb losses in the failed firm and fully capitalize the newly privatized companies. That happens to be the way the largest U.S. financial firms are currently structured. To ensure that these firms continue to maintain sufficient debt at the parent level, the Federal Reserve, in consultation with the FDIC, is currently developing a proposed rulemaking to require a minimum amount of unsecured holding company debt.

An objective of the FDIC is to limit the time during which the failed SIFI is under public control. Accordingly, the FDIC expects the bridge financial company to be ready to execute its securities-for-claims exchange within six-to-nine months. The execution of this exchange will result in the termination of the bridge financial company's charter and the establishment of one or more new, well-capitalized companies under private ownership and management.

This description of our resolution strategy is a simple overview of a complex process, describing how it would address the key issues of liquidity, capital, restructuring, and governance. These issues would benefit from broader review and discussion. With this in mind, the FDIC plans to release later this year a fuller description of this resolution process for public comment.

International Cooperation and Coordination

Given the global operations of our largest, most systemically important financial institutions, a threshold issue and priority for the successful execution of the FDIC's resolution strategy is effective cross-border cooperation and coordination with key foreign regulatory authorities. It is critical that home and host jurisdictions understand well the approach to resolution of their counterpart and work together to develop a cooperative approach to the orderly resolution of the failed company. Our discussions with our counterparts in Japan are an important contribution to these efforts.

The FDIC has also had significant discussions with authorities in the United Kingdom, where nearly 70 percent of the on- and off-balance-sheet assets of our major institutions are held. Establishing a close working relationship with the UK authorities – initially the Bank of England and the Financial Services Authority, and now the Bank of England – was an important initial step. The development of this relationship was greatly facilitated by the fact that when we sat down with the UK authorities to discuss cross-border cooperation on SIFI resolution, we found that we both had determined that the single point of entry strategy appeared to be the most viable approach to the resolution of our respective systemically important financial institutions. As a result, we were able to move relatively quickly to joint resolution planning on our institutions of common interest. The working relationship that we developed was such that last December the FDIC and the Bank of England were able to release a joint paper outlining our common approach to SIFI resolution. If I may say, the collaboration continues to deepen at both the staff and principal level. Among other things, we are planning a staff-level cross-border tabletop exercise later this year and hope to organize a principal-level exercise next year.

We are also in the process of developing close working relationships with two other key foreign jurisdictions – Switzerland and Germany, two countries that are also home to large financial institutions that operate in the United States. We have had significant principal- and staff-level engagements with the responsible authorities in both jurisdictions, the Swiss Financial Market Supervisory Authority (FINMA), in the case of Switzerland, and the German Federal Financial Supervisory Authority (BaFin), in the case of Germany. Interestingly both jurisdictions have come to the conclusion that the single point of entry strategy is the most viable approach to the resolution of their SIFIs. We have discussed developing joint papers with both jurisdictions, similar to the one with the UK, as well as conducting cross border table top exercises and exchanging detailees. It is my observation that SIFI resolution has been made a high priority in both jurisdictions and they share a strong interest in developing a close working relationship with the FDIC.

Indicative of the working relationship we have developed, the FDIC, together with the Bank of England, BaFin and FINMA, sent a joint letter to the International Swaps and Derivatives Association (ISDA), to urge them to adopt language in derivatives contracts to delay the early termination of those contracts in the event of the resolution of a global systemically important financial institution. This joint letter reflects not only the progress we have made on the issue of limiting termination rights with respect to derivatives transactions, but also the progress we have made on global cooperation in resolution of systemically important financial institutions.

Last month, the FDIC visited the Chinese authorities in a similar effort to extend our working relationship in the areas of deposit insurance and resolution. The purpose of the visit was to develop and enhance the interaction between the FDIC and our Chinese counterparts and to demonstrate a shared commitment to cooperation among the relevant authorities.

The FDIC and the European Commission, I would note, have established a joint working group made up of senior executives from our respective organizations to focus on both resolution and deposit insurance issues. The agreement establishing the working group provides for meetings twice a year, one in Brussels and one in Washington, with electronic interchanges in between and the exchange of detailees. There have been two meetings held this year, the most recent in Brussels in September. We have had detailed discussions on the FDIC's experience with resolution and deposit insurance as well as our G-SIFI resolution strategy, and on the pending EU Recovery and Resolution Directive and proposal for a European Resolution Mechanism.

Finally, I should also mention in addition to our bilateral relationships, the important work of the Financial Stability Board, which has made cross-border resolution a top priority. The Resolution Steering Group of the FSB, of which the FDIC, the Bank of Japan, and the Japan Financial Services Agency are members, developed the first international standards for cross-border resolution, the Key Attributes of Effective Resolution Regimes for Financial Institutions, and is now in the process of developing a methodology for their implementation. And as you know, the FSB has also established Crisis Management Groups for each of the G-SIFIs that bring together regulators on a multilateral basis to discuss cross-border cooperation on particular institutions.

Conclusion

The concluding point I would like to make is that there has been a quiet transformation in the aftermath of this recent crisis in the approach nationally and internationally to this challenging issue of G-SIFI resolution. From a position prior to the crisis where this was not an issue of attention or concern, it has risen to a matter of high priority for national and regional jurisdictions, as well as for multilateral organizations. I would suggest that the recent crisis has produced a sea-change globally in how jurisdictions view the risks posed by G-SIFIS and a determination to develop alternatives to the provision of open-ended public support to address their potential failure.

Until an orderly failure of a G-SIFI is actually managed, there will no doubt continue to be skepticism about the capability and will of regulatory authorities to impose the consequences of failure on the shareholders, unsecured creditors, and managers of these firms. I would note, however, recent indications by rating agencies in the U.S. of the possibility of downgrades of some of these US G-SIFIs because of a reduced expectation of public support in the event of failure are a promising sign.

I believe through the authorities provided in the Dodd-Frank Act in the U.S., both for resolution plans for these firms under Title I and the resolution authorities under Title II, as well as the progress we are making on cross-border cooperation, including our important work with Japan, that we can have a different scenario for the resolution of these firms the next time around.

Thank you.

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