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Is Dodd Frank Orderly Liquidation Authority Necessary to Fix Too-Big-to-Fail?

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ABSTRACT

The Dodd-Frank Act (DFA) Orderly Liquidation Authority (OLA) has many legal issues that could prevent its use. Should there be a next financial crisis, regulators may again be forced to sell a large failing bank to a larger banking institution, creating yet another too-big-to-fail (TBTF) institution.

Regulatory plans for using OLA focus on injecting parent holding company capital into the critical operating subsidiaries of systemically important financial institutions (SIFIs) to keep these subsidiaries open and operating. This goal can be achieved without OLA by imposing substantially higher minimum capital requirements on critical operating subsidiaries instead of imposing them on parent SIFIs. But, replacing OLA with this simple alternative, alone, will not solve the TBTF problem.

Investor perceptions of TBTF arise naturally given flaws in the existing deposit insurance bank resolution process, and the predilection for regulatory forbearance created by conflicting responsibilities assigned to the Federal Reserve Board (FRB). The FRB duty to be the consolidated supervisor of largest BHCs and other designated SIFIs, the guardian of financial stability, and the lender of last resort make it rational for investors to expect large financial institution to receive special assistance to forestall their failure or protect their creditors from loss. In contrast, other institutions that offer similar financial services will be allowed to fail and impose losses on similarly situated creditors.

To end TBTF, financial regulation must be refocused on: (i) ensuring the uninterrupted operation of important subsidiaries by increasing capital requirements on banks and critical functionally-regulated affiliates—not parent holding companies; (ii) reforming the deposit insurance bank resolution process to mandate the break-up of large failing banks; (iii) removing the regulatory structure that creates TBTF investor expectations; and (iv) requiring SIFI parent companies to reorganize or liquidate using a judicial bankruptcy process in which similarly situated creditors are treated equally.

The alternative approach of higher capital requirements at operating subsidiaries does not require OLA or new regulations to operationalize OLA—rules requiring minimum total loss absorbing capacity or contingent convertible debt. If higher capital requirements at critical subsidiaries are funded with debt issued by the parent holding company, there will be no reduction in SIFIs' consolidated interest tax shields and consequently no increase in the cost of commercial and consumer credit. These reforms will simplify regulation, improve transparency, protect taxpayers from the expense of future SIFI bailouts and eliminate the TBTF subsidy without abridging property rights and legal protection for parent SIFI creditors.

Key Words: Reforming the Dodd-Frank Act, ending too-big-to-fail

JEL Classification: G18, G21, G28

Is Dodd-Frank Orderly Liquidation Authority Really Necessary?

1. Introduction

One of the primary goals of the Dodd-Frank Act (DFA or the Act) was to solve the too-big-to-fail (TBTF) problem for the largest financial institutions. The DFA preamble states,

[An Act] To promote the financial stability of the United States by improving accountability and transparency in the financial system, to end “too big to fail”, to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes.

DFA Title II—Orderly Resolution Authority (OLA)—the Act’s legislative solution to the TBTF problem—is based on the premise that a large systemically important financial institution (SIFI) cannot fail in a judicial bankruptcy without *causing* a financial crisis. Because of the alleged ramifications of a SIFI failure, investors rationally conjecture that governments will bail out SIFIs rather than let them fail. As a consequence, investors treat the liabilities of SIFI institutions as if they have an implicit government guarantee. This TBTF guarantee gives SIFI institutions access to subsidized funding and creates incentives for SIFI management to overleverage and expand SIFI investments into high-risk assets and activities.

The DFA starts from the premise that the TBTF hypothesis is true, and creates a 4-layered approach to solve the problem. First, it designates some BHCs *de facto* as SIFIs. Second, it specifies general criteria that characterize SIFIs and empowers a group of government regulators—the financial stability oversight council (FSOC)—to examine all non-BHC financial institutions and identify those that satisfy SIFI criteria. Third, it requires the Federal Reserve Board (FRB) to impose new heightened prudential regulatory standards and undertake supervisory efforts to ensure that the probability of an individual SIFI’s financial distress is especially remote. And lastly, should a SIFI become financially distressed, the DFA has created a new resolution framework—OLA—in which the Federal Deposit Insurance Corporation (FDIC) acts as receiver and “liquidates” the SIFI outside of judicial bankruptcy in an administrative resolution process. OLA is supposed to allow the FDIC to liquidate a failing SIFI without the need for taxpayer assistance and without creating a financial crisis.

The DFA was passed well before the true underlying causes of the financial crisis were identified and it left many specific details to be worked out by financial regulators. OLA in particular does not explain how the FDIC can use its powers to resolve a SIFI without triggering a wider financial crisis.

Since the passage of the DFA in 2010, the FDIC has formulated a concrete strategy for using OLA should it be called upon to resolve a failing SIFI. A key feature of the FDIC's strategy for resolving a distressed SIFI, the so-called "Single Point of Entry" (SPOE) strategy, is that the parent holding company can be liquidated without systemic consequences, provided the SIFI's operating subsidiaries remain open and operating. In fact, aside from satisfying DFA mandated claims priorities and management changes, the primary goal of the FDIC's OLA strategy is to keep critical operating subsidiaries functioning and protect them from their own bankruptcy or resolution proceedings, while the parent holding company is liquidated in an FDIC-OLA receivership.

There is a simple alternative approach to regulation that can achieve all of the FDIC's OLA resolution goals without using OLA. The approach requires: (i) increasing minimum regulatory capital requirements for depository institutions¹ and critical functionally-regulated subsidiaries;² (ii) increasing prompt corrective action intervention triggers; and, (iii) requiring mandatory contractual safeguards to ensure that banks and functionally-regulated subsidiaries are not overly exposed to affiliates and not dependent on parent SIFIs for employees or critical services that could be suspended in bankruptcy. These straight-forward changes will allow a distressed SIFI's parent to fail in bankruptcy without causing the failure of its critical operating subsidiaries. There is no need for OLA.

The most transparent way to ensure that critical operating subsidiaries remain open and operating is to substantially increase minimum capital requirements at these subsidiaries. The additional capital at operating subsidiaries should be required by law and imposed by functional regulators. Higher capital requirements should be complemented by corresponding increases in prompt corrective action intervention thresholds. These changes will ensure that critical subsidiaries maintain uninterrupted operations should a distressed parent holding company reorganize under bankruptcy protection. Because the SIFI's functional subsidiaries will remain solvent beyond

¹ Henceforth, to simplify the text, I will use the term "bank" and "depository institution" interchangeably. Should the discussion focus on a specific class of depository institutions, such as a thrift or savings bank, the distinction will be made clear in the text.

² The Gramm-Leach-Bliley Act defines functionally regulated subsidiaries as registered broker-dealers, registered investment advisors, registered investment companies, insurance companies subject to state supervision, and entities subject to regulation by the Commodities Futures Trading Commission. [See 12 U.S.C. § 1844(c)(5)].

question, nonbank subsidiaries will retain access to capital market financing and insured depositories will be eligible for *normal* liquidity borrowings from the Federal Reserve.³

Under this alternative approach, capital requirements at the parent holding company need not be increased as mandated by the DFA. In fact, minimum capital requirements at parent BHCs could be reduced or even eliminated entirely if the SIFIs' critical subsidiaries are required to be highly capitalized at all times on their own account.

Parent holding companies should be allowed to fund the new higher subsidiary equity capital requirements from the proceeds of debt issuance at the parent holding company without the constraint of meeting strict minimum regulatory capital requirements at the consolidated BHC level. Parent holding companies can be as resilient or as fragile as their shareholders choose without any adverse systemic risk consequences provided that their critical operating subsidiaries maintain "fortress" balance sheets that will be required by law.

Should a parent holding company fail, it must be liquidated or reorganized in bankruptcy. There must be no "special" alternative resolution mechanism that allows the possibility that some creditors or counterparties may receive special protections, or TBTF will continue to be problematic.

This transparent alternative approach will accomplish the goals of Title II using *bankruptcy* without the need for OLA, but it will not remove TBTF investor expectations. Contrary to political folklore, TBTF expectations are not primarily caused by the impossibility of safely reorganizing or liquidating a SIFI in bankruptcy.

TBTF expectations and implicit taxpayer subsidies arise when regulators expand explicit bank deposit insurance guarantees beyond legal limits or take emergency actions that prevent some—but not all—financial institutions from failing. Such actions protect the uninsured creditors in some financial institutions, but not others, and without imposing a fair-market tariff for the additional government protection.

³ Banks and other subsidiaries can continue to operate normally when their holding companies are in bankruptcy proceeding. Recent examples include BHCs that are in bankruptcy because of failure to make payment on Trust Preferred Security obligations. Most of the banks owned by these BHCs remain open and operating normally.

History shows that, should a *large* bank fail, the FDIC bank resolution process will inevitably protect all bank depositors. However, when a *small* bank fails, the same bank resolution process may impose losses on large uninsured deposit accounts. This facet of the bank resolution process effectively creates two different classes of deposit insurance protections: a small bank insurance system that protects all deposits under the legal limit, and a large bank insurance system that protects even the largest deposit accounts. Given this reality, it is not surprising that the largest banks have an advantage in attracting large deposits.

Moreover, the FDIC's existing bank resolution process is virtually *designed* to create new TBTF institutions. The FDIC's legal mandate to perform "least cost" resolutions ensures that, should there be a willing buyer, a large failing bank will be sold intact, usually with an agreement for the deposit insurance fund to absorb some portion of failing bank's losses. In such a transaction, insurance coverage is extended to all depositors, not just to those insured under the legal limit, and the acquiring bank is virtually guaranteed to be a large bank or BHC.⁴

This flawed deposit insurance bank resolution process remains fully intact after the DFA.⁵ Moreover, if a DFA-OLA-SPOE liquidation is implemented instead of a deposit insurance bank resolution, *all* creditors of the failing SIFI's bank subsidiary will be fully protected—not just the bank's depositors. The SPOE strategy recapitalizes failing bank subsidiaries using holding company money in an OLA "liquidation" and thereby protects all bank creditors from loss. Thus, OLA-SPOE creates a new avenue for government assistance beyond those that currently exist in the deposit insurance resolution system, but only for a select group of the largest financial institutions. Because similarly situated creditors of different institutions that provide comparable financial services may be treated differently, the OLA-SPOE "solution" actually reinforces the TBTF problem.

In addition to investor perceptions that the largest banks enjoy unlimited deposit insurance and potentially other creditor protections, investors also understand the inherent conflict created by a system that places supervisory authority over the largest financial institutions in a single

⁴ A large institution bias enters because the FDIC will only sell a failing bank to a "qualified" bank or BHC, meaning that the bidding institution must have the capital and management capacity to successfully manage the acquired institution. There is also evidence that banks offer higher prices to acquire institutions that will put them over the perceived TBTF size threshold. See Brewer and Jagtiani (2011).

⁵ DFA § 623(a) prohibits the FRB from approving a bank acquisition if the combined deposits of all banks in the resulting BHC would exceed 10 percent of total deposits in insured banks. However, § 623(b) provides an exemption from this deposit limit if the bank is being acquired from an FDIC failed bank receivership.

consolidated regulator that is also the lender of last resort. This mix of regulatory responsibility encourages the belief that the entire capital and liquidity resources of a consolidated entity—including access to Federal Reserve System liquidity—will be available to protect SIFI creditors and counterparties from loss. Unfortunately, the FRB’s actions taken before and during the prior financial crisis fully justify such expectations.

The DFA redoubled the FRB’s supervisory powers and assigned it a new “heightened prudential” duty to ensure that the likelihood of failure is especially remote for the largest BHCs and designated nonbank SIFIs. Given the FRB’s expansive new regulatory powers and its operational history, it is difficult to imagine how investors would reach any conclusion other than that SIFI institutions are TBTF.

The importance of these issues should not be underestimated. The TBTF problem will not be solved by merely eliminating Title II and replacing it with heightened capital requirements on critical operating subsidiaries. To end TBTF, Congress must also: (i) reform the FDIC’s bank resolution process to require it to breakup large failing banks in the resolution process;⁶ and, (ii) reorient financial regulation away from the FRB and remove or significantly curtail its current powers over consolidated capital regulation and supervision.

The paper is organized as follows. Section 2 reviews the legal structure of a typical US SIFI, including the procedures that apply should any of these companies fail. Section 3 discusses OLA. Section 4 reviews the SPOE strategy for implementing OLA. Section 5 discusses problematic aspects of the SPOE-OLA approach. Section 6 reviews the FRB’s source of strength doctrine. Section 7 discusses the TLAC regulations needed to operationalize the OLA-SPOE approach. Section 8 discusses TBTF investor expectations. Section 9 examines claims that the Lehman Brothers bankruptcy caused the financial crisis. Section 10 discusses the FRB’s history of using exemptions from Section 23A rules to provide emergency assistance to the BHCs it supervises. Section 11 summarizes the links between heightened FRB oversight and TBTF investor expectations. Section 12 concludes.

2. Bank Holding Company Organizational Structure and Special Subsidiary Status

⁶ Significantly higher capital requirements and prompt corrective action intervention thresholds will limit the extension of deposit insurance coverage to large shareholders because large depositories will be intervened and broken up by the FDIC before losses exhaust the failing bank’s capital.

This section provides an overview of the basic corporate structure used by all of the largest banking institutions in the US, and the normal protocols that apply when the parent corporation or one of their subsidiaries become financially distressed. Readers already familiar with these details can skip this section.

Most US banks, including the largest financial institutions, are organized as bank holding companies, or BHCs.⁷ In addition, DFA § 167(b)(1)(B) allows the FRB to require nonbank financial institutions designated by the FSOC to organize their systemically important financial activities under an intermediate financial holding company. An intermediate holding company has an organizational structure similar to a BHC, and it is subject to all of the FRB's bank holding company regulatory powers.

In a BHC corporate structure, a parent holding company holds the controlling interest in the equity shares of subsidiary corporations which can include separately incorporated banks, functionally regulated companies (e.g., broker-dealers, futures commission merchants, insurance companies), or other corporations involved in activities closely related to banking.⁸ Each of the parent's subsidiaries is a standalone corporation that can issue their own equity and debt securities.

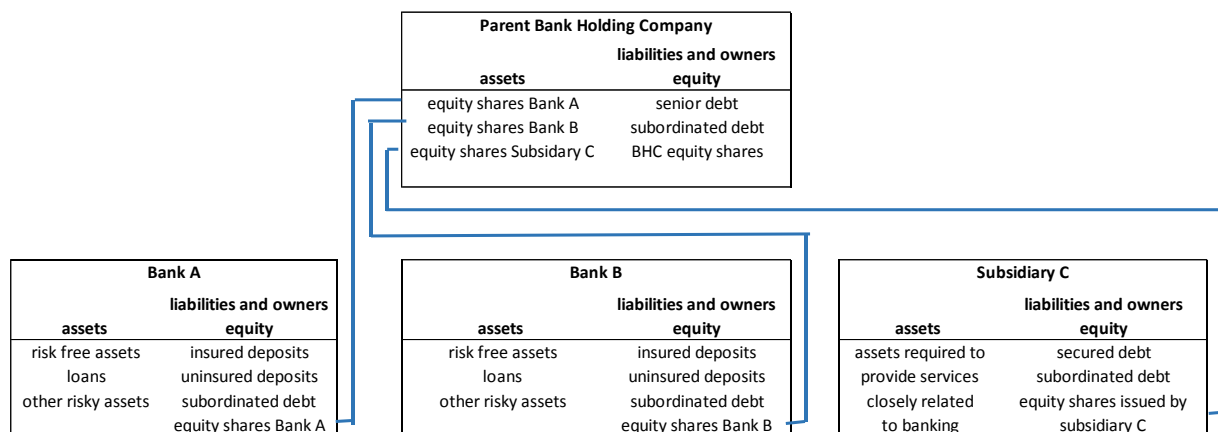
Figure 1 illustrates a simple stylized bank holding company structure. In figure 1, subsidiaries are represented by Bank A, Bank B, and Subsidiary C. Subsidiary C could be a functionally regulated subsidiary, regulated by the SEC, CFTC, or a state insurance regulator.

The parent raises funds by issuing its own debt and equity securities. The parent uses the proceeds from issuing these securities to purchase the equity securities issued by its subsidiaries, to lend to its subsidiaries, or to invest in other affiliated firms. The parent also may guarantee the debt of its subsidiaries issued to outside investors or any derivative contracts the subsidiaries may enter.

⁷ Nearly 85 percent of all depository institutions are owned by a BHC. See, <https://www.fedpartnership.gov/bank-life-cycle/grow-shareholder-value/bank-holding-companies>

⁸ A bank holding company application is required when the FRB determines that a covered company has a 'controlling interest' in a bank. The Federal Reserve Board regulates the permissible activities of bank holding companies. The Bank Holding Company Act of 1956 limits bank holding company activities to activities deemed too be "closely related to banking." Over time, the list of permissible BHC activities has expanded to include mortgage banking, loan servicing, commercial and consumer financing, leasing, collection agency services, asset management, trust companies, real estate appraisal services, management consulting, employee benefits consulting, career counselling services and certain insurance-related activities.

Figure 1: Stylized Example of a Bank Holding Company Organizational Structure



Subsidiaries may also lend to the parent holding company, to other subsidiaries within the group, or even guarantee the debt issued by the parent or other subsidiaries. However, bank subsidiaries are limited in their ability to lend or transact under limits set by Congress in Section 23A and Section 23B of the Federal Reserve Act. The restrictions are discussed in detail in Section 10. In the simple stylized example in Figure 1, I assume that the parent owns only the equity of its subsidiary companies.

Within this organizational structure, subsidiaries of bank holding companies that are functionally regulated or deposit-taking institutions are special corporations in respect to their permitted activities, regulatory oversight, and their treatment in insolvency. The following paragraphs provide a brief overview of the special characteristics associated with banks, broker-dealers and insurance companies.

Deposit-taking institutions—commercial banks, thrifts, and savings and loans institutions—are subject to extensive regulation at both the state and federal level.⁹ Only banks can issue insured deposits and access Federal Reserve System discount window liquidity without penalty should they be well-capitalized and hold high supervisory ratings.¹⁰ Should a bank become financially

⁹ Credit unions also provide insured deposit accounts. They can be federally chartered in which case they are regulated by the National Credit Union Administration or chartered and regulated by a state government authority (e.g. credit unions chartered in the state of Virginia are regulated by the Virginia Bureau of Financial Institutions). The discussion excludes credit unions since they are excluded from bank holding company regulations by the Competitive Equality Banking Act of 1987 and unlikely to be considered candidates for an OLA liquidation.

¹⁰ <http://www.ny.frb.org/aboutthefed/fedpoint/fed18.html> provides details on bank access to the discount window.

distressed and unable to meet current payment liabilities or become undercapitalized by regulatory minimum standards, or otherwise be shown to operate in an unsafe and unsound manner, it is required to comply with regulatory cease and desist orders that mandate remedial action. Should the bank fail to comply or remedy identified issues, it can be closed by their primary regulator and liquidated using a special administrative process managed by the FDIC.¹¹

If a subsidiary bank of a BHC should become undercapitalized or experience financial distress, the bank holding company powers of the FRB can also impact the bank recovery or resolution process. In particular, the FRB's source of strength doctrine can be used to encourage a bank holding company to interject capital into an undercapitalized depository subsidiary. The FRB's source of strength doctrine is important, controversial, and potentially a critical aspect of the SIFI resolution strategy articulated by the FDIC. For these reasons, I devote an entire section to its discussion (Section 6).

Registered broker-dealers are functionally regulated subsidiaries supervised by the Securities and Exchange Commission (SEC), registered exchanges, and the Financial Industry Regulatory Association (FINRA).¹² Broker-dealers face minimum capital regulation and strict rules governing the management of their customer accounts. Should a broker dealer fail to meet its minimum capital requirements, the SEC can require it to cease operations and force its liquidation. A broker-dealer will liquidate either in a distressed sale, under special rules that apply under Chapter 7 of the Bankruptcy Code, or under the provisions of the Securities Investor Protection Act ("SIPA"). Because almost all broker-dealers are registered with the SEC are required to be members of Securities Investor Protection Corporation (SIPC), most liquidations are conducted under SIPA rules and not under Chapter 7 of the Bankruptcy Code.

When a broker-dealer is liquidated, either in a Chapter 7 bankruptcy or in a SIPA liquidation, the goal is to protect and return its customers' securities and cash deposits. A court-appointed trustee will transfer customer accounts to a financially sound broker-dealers. Similar to insured depositories, broker-dealer insolvencies are settled using special legal rules that are designed to

¹¹ The FDIC has the power to close an insured depository institution without the consent of the bank's primary federal regulator, but typically the primary federal regulator is the agency that revokes the bank's charter. A bank could choose to liquidate voluntarily without any regulatory or FDIC intervention. See the FDIC (2015) "Resolutions Handbook."

¹² Routine surveillance of registered broker dealers to conducted by exchanges and FINRA, the industry's non-profit self-regulatory agency as authorized by 15 U.S.C. § 78iii(c).

assign the highest priority to returning broker-dealer customer securities and cash deposits. A SPIA liquidation also includes limited insurance benefits.¹³ In a SPIA liquidation, securities in customer accounts are insured up to \$500,000 whereas cash deposits are insured up to \$250,000.¹⁴ Broker-dealer unsecured creditor claims have secondary priority, and there is no provision for using SIPA insurance and there is no SEC emergency authority that allows for the protection of broker-dealer creditors or shareholders from loss.¹⁵

Insurance companies are functionally regulated entities. Unlike banks and broker-dealers, there is no federal insurance charter and no federal supervisory insurance agency.¹⁶ Each insurance company's primary regulator is the insurance regulator in the state in which the company is chartered. Insurance can be sold across state lines but insurers must be licensed to do so. Depending on the state, regulators may not only regulate minimum solvency standards for insurers, but they may regulate and approve policy terms, sales practices and insurance products premium rates.

An insurer's solvency is measured against a minimum regulatory solvency formula that provides a measure of an insurer's ability to pay policy claims. The solvency rules differ by the type of insurance underwritten and solvency compliance is monitored by the insurer's home state regulator as well as by insurance rating agencies and the state insurance regulators in each state where the insurer is licensed to sell policies. Independent agency ratings for insurers are based on rating agency assessments of the insurer's ability to pay policy claims and not on the insurer's ability to make timely payments on its unsecured debt obligations.

¹³The legal claims priority in an SPIA liquidation are defined in 15 U.S.C. § 78fff-2(c)-(f).

¹⁴ The legal processes and procedures for an SPIA liquidation are described at <http://www.sipc.org/about-sipc/statute-and-rules/statute> SPIA insurance seeks to guarantee the return the customers property (i.e. securities holdings and cash at the liquidating broker-dealers), and if that is not possible guarantees their market-to market value at the time of failure. Customer securities are insured up to a value up to \$500,000 [15 U.S.C § 78fff-3(a)] if for some reason fraud or mismanagement is involved and the broker-dealer has not properly segregated customer security holding. 15 U.S.C § 78fff-3(d) insurers customer cash deposits at registered broker dealers up to \$250,000.

¹⁵ 15 U.S.C. § 78ddd(g) empowers the Securities and Exchange Commission to make loans to the SIPC up to a total amount of \$2.5 billion if the SIPC's insurance fund lacks the resources necessary to perform on its customer account insurance obligations and the SEC determines that additional SPIC funding is needed to maintain investor confidence in the system. SIPC has never used its SEC backup line of credit.

¹⁶ The Federal Insurance Office, created by the Dodd-Frank Act, does not supervise or monitor any individual insurance firms. Following the passage of the DFA, the FRB has used its new powers over thrift holding companies, including its new power to examine non-bank thrift holding company subsidiaries and affiliates even if they are functionally regulated, to initiate an on-site examination program for insurance company subsidiaries. This newly expanded effort has made the Federal Reserve a *de facto* national insurance regulator against the express intent of the Congress. Further details are provided Senate banking committee testimony by Kupiec (March 2015).

Regulators can impose corrective measures on insurers they deem to be in a hazardous financial condition even if the insurer exceeds required solvency standards, but these corrective measures can be challenged in court. Typically regulators begin to impose corrective actions as an insurance company weakens but still meets regulatory solvency standards. If the regulatory actions do not return the insurer to financial health and its solvency condition continues to deteriorate, the regulator can negotiate a sale or merger of the troubled company or, failing this, can liquidate undercapitalized insurers.

In an insurance company liquidation, the home state regulator appoints a receiver to manage claims and sell the failed insurer's assets. The process is overseen by a state court. Licensed insurers are required to belong to separate state insurance guarantee associations for their property-casualty and life and health insurance businesses in every state in which they sell policies. In the case of liquidation, state guarantee associations insure policyholder claims up to a maximum claim value that varies by state.

Unless the OLA is invoked, a financially distressed SIFI parent holding company will be reorganized or liquidated in bankruptcy. As a consequence of the corporate separateness of the individual subsidiaries in the SIFI organization, and the limited liability of equity claims, subsidiaries can fail without causing a parent holding company failure, and the parent holding company can also enter bankruptcy without causing the failure of a subsidiary.

Should a bank subsidiary fail and the parent bank holding company's exposure be limited to its ownership of the failed bank's equity shares, the holding company's direct losses are limited to its equity investment. Under special circumstances, the parent holding company may be exposed to additional losses through enforcement of FRB source of strength agreements. The circumstances under which may happen are discussed in detail in the Section 6. The parent the holding company may also have indirect exposure if the failure of its bank subsidiary causes losses to the FDIC deposit insurance fund. The FDIC can assess the parent holding company's surviving banks for the losses the bank insurance fund incurs in the bank resolution process. The Federal Deposit Insurance Company Improvement Act (FDICIA) does not allow the FDIC to assess the parent bank holding company directly for its insurance fund's losses; it may only assess another bank that is under common control with the failed institution.

Bank holding companies are special corporations in their own right as they are subject to extensive Federal Reserve Board regulations under the 1956 Bank Holding Company Act (BHCA) and subsequent amendments. The BHCA was originally enacted to control geographic concentration of large bank groups, to prevent banking across state lines except in limited cases, to keep banking activities separate from commercial activities outside of limited exemptions provided in law, and to limit BHCs activities to businesses closely related to banking.¹⁷

BHCs are subject to comprehensive consolidated regulation and supervision by the FRB. The FRB has authority to determine BHCs' permitted activities and investments, to approve applications for mergers and acquisitions, to set consolidated minimum capital regulations, to impose inter-company credit exposure limits and provide special exemptions from these limits, and more recently, the power to impose enhanced prudential standards of supervision and regulation on specially designated (large) BHCs and financial holding companies.

There are many historical instances in which the bank subsidiary (subsidiaries) of a BHC were closed and liquidated in an FDIC resolution without a concurrent bankruptcy of the parent bank holding company. Similarly, there are many instances when bank holding companies entered bankruptcy while their banks and other subsidiaries remained open and operating.¹⁸ The failure of a bank holding company subsidiary—bank, broker-dealer, insurance company or otherwise—need not trigger a bankruptcy filing for the parent company nor must the bankruptcy of a parent company trigger the liquidation of a subsidiary bank or functionally regulated corporation.

3. Dodd-Frank Orderly Liquidation Authority

Section 203 of the Dodd-Frank Act authorizes the secretary of the Treasury, with appropriate regulatory approval,¹⁹ to begin the “orderly liquidation” of a covered financial company if, in the secretary’s judgment, “the financial company is in default or in danger of default”²⁰ and the

¹⁷ Omarova and Tahyar (2011-2012) review the Congressional intent behind the enactment of the Bank Holding Company Act of 1956 and its subsequent amendments.

¹⁸ For example, there have been many recent bankruptcy filings for holding companies driven by payment delinquencies on parent holding company Trust Preferred Securities while bank subsidiaries have remained well-capitalized, open, and operating.

¹⁹ § 201 specifies that bank holding companies are eligible for OLA, but the insured bank subsidiaries of a BHC are not eligible (§ 201(a)(8)(B)). Nor are insured bank subsidiaries included as covered subsidiaries under Title II (§ 201(a)(9)(A)).

²⁰ For purposes of Title 2, a financial company shall be considered to be in default or in danger of default if: (A) a case has been, or likely will promptly be, commenced with respect to the financial company under the Bankruptcy Code; (B) the financial company has incurred, or is likely to incur, losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the company to avoid such depletion; (C) the assets of the

failure of the company and its resolution under any other federal or state law “would have serious adverse effects on the financial stability of the United States.” When prerequisite conditions are satisfied, the secretary is authorized to take control of the financial company and appoint the FDIC as receiver with powers and duties enumerated under § 204 of the act.

The FDIC’s OLA powers are similar to the FDIC’s bank resolution powers under the Federal Deposit Insurance Act (FDIA) and its amendments. Among the powers granted to the FDIC is the power to charter a bridge financial institution to facilitate the SIFI liquidation. The bridge, it is exempt from regulatory capital requirements and all taxes (US, state, county, territory, municipality, or other local taxing authority). The bridge company charter expires after two years unless it is extended by the FDIC up to a maximum life of five years.

The FDIC may move any assets and liabilities from the receivership into the bridge financial company. The FDIC is prohibited from taking an equity interest or becoming a shareholder in the bridge holding company or any of its subsidiaries.

To provide temporary funding to the OLA receivership, the DFA establishes the “Orderly Liquidation Fund” (OLF). The OLF is a line of credit with the US Treasury that allows the FDIC to pledge assets of the bridge to obtain funding.²¹ The secretary of the Treasury must approve the FDIC’s strategy for liquidating receivership assets to repay OLF loan balances, including interest payments. The interest rate on an OLF loan will be set by the secretary, but it must be at least as large as the prevailing interest rate on similar maturity corporate loans.²²

If the projected repayment schedule from the receivership liquidation plan fails to discharge the OLF loan terms within 60 months of the loan initiation, the FDIC must impose a risk-based assessment on all BHCs with consolidated assets equal to or greater than \$50 billion and any

financial company are, or are likely to be, less than its obligations to creditors and others; or, (D) the financial company is, or is likely to be, unable to pay its obligations (other than those subject to a bona fide dispute) in the normal course of business.

²¹ Within the first 30 days of the appointment of the FDIC as receiver, the amount of OLF funding is limited to 10 percent of the consolidated assets of the distressed holding company as reported on its last available financial statement. After 30 days, the FDIC can borrow up to “90 percent of the fair value of the total consolidated assets of each covered financial company that are available for repayment” [§ 210 (n)(6)(A)].

²² The DFA requires an interest rate at least as large as the prevailing rate on U.S. government obligations of a similar maturity plus a risk premium at least as large as the difference between the prevailing rate in a corporate bond index of similar maturity and the prevailing rate on U.S. government securities of a similar maturity. The DFA does not specify any specific credit quality for the corporate bonds index.

nonbank financial company supervised by the FRB (i.e., nonbank firms that have been designated as SIFIs).²³

Title II § 206-§ 210 describe the FDIC's OLA responsibilities.²⁴ When making recovery payments to the failed SIFI's liability holders, the FDIC must abide by a specific claim priority. The highest claims priority is recovering any funds the FDIC borrowed from the OLF. The OLA also empowers the FDIC to treat similarly situated receivership creditors differently if doing so will prevent financial instability or maximize overall receivership recoveries, but disadvantaged claimants must receive a recovery at least as large as they would receive in Chapter 7 bankruptcy.^{25,26}

The DFA does not explain how these OLA powers will be used to resolve a failing SIFI without creating a financial crisis. The strategy for employing OLA powers is left to FDIC discretion, so it is important to understand how the FDIC will approach the resolution of a BHC SIFI should it be called on to use OLA.

4. The FDIC's Single Point of Entry Approach for Resolving a Failing SIFI

In December 2013, the FDIC issued a Federal Register Notice which outlined a "Single Point of Entry" (or SPOE) strategy for conducting an orderly resolution.²⁷ The overriding goal of the SPOE is to keep the failing SIFI's critical operating subsidiaries open and operating with adequate capital and liquidity to keep them out of their own bankruptcy or administrative resolution processes, and to avoid the need for asset fire sales.

In a joint paper on SIFI resolution policy,²⁸ the Bank of England and the FDIC have agreed that the key to achieving the orderly resolution of a SIFI without disrupting financial markets is to

²³ There is an extensive list of criteria the FDIC must consider in setting the assessment rates [§ 210(o)(4)].

²⁴ These include: managing the receivership to promote financial stability, not to preserve the failed institution; ensuring that the receivership recoveries respect Title II claims priority; ensuring that the failed institution's management and board of directors are removed; managing the receivership assets to maximize the value of the receivership consistent with promoting financial stability; and, ensuring that the maximum liability imposed on any receivership claimant is consistent with the amount the claimant would receive in a Chapter 7 Bankruptcy.

²⁵ The FDIC board has adopted a policy to limit use of its discretionary power over similarly-situated claimants to holding company liabilities with maturity less a year.

²⁶ FDIC SPOE NPR p. 76618. This interpretation of § 210(10)(B)(5)(I) is based on the FDIC's authority to repudiate parent BHC contracts and the legal limits on recovery should the FDIC's action be successfully challenged in court.

²⁷ Federal Deposit Insurance Corporation SPOE NPR, (2013).

²⁸ Federal Deposit Insurance Corporation and Bank of England (2012).

recapitalize SIFI operating subsidiaries to keep them open, liquid, operating and out of competing insolvency proceedings.

The FDIC-Bank of England views regarding SIFI resolution are more widely shared among national financial regulators. In 2011, the Financial Stability Board (FSB)—an international organization of central banks and bank regulators empowered by the G-20 leaders to reform the international financial system²⁹— issued a report, *Key Attributes of Effective Resolution Regimes for Financial Institutions*. The report summarizes the G-20’s thinking on strategies to resolve failing SIFIs and stresses the importance of “[E]nsuring continuity of systemically important (or “critical”) functions.” [p. 5].

While specific details will vary across countries, the FSB argues that SIFI resolution is best accomplished using a recapitalization strategies that: (i) imposes first losses on SIFI shareholders; (ii) converts unsecured and uninsured SIFI creditor claims into equity or receivership certificates; and (iii) uses the resources of the SIFI creditors left in receivership to absorb residual losses and recapitalize subsidiaries so they can continue to provide critical functions. The FDIC’s SPOE strategy is fully consistent with the FSB’s prescription for the orderly resolution of a distressed SIFI.

In a SPOE resolution, the FDIC will be appointed receiver of the top holding company in a BHC corporate group. The FDIC will then charter a bridge institution and transfer all holding company assets and secured liabilities to the bridge, including the company’s equity position in all subsidiaries.³⁰ The bridge will function as the new parent BHC, and the FDIC will appoint new management to operate the bridge and its subsidiaries.

The FDIC will leave the shareholders of the failed BHC parent and most of the failed parent BHC’s unsecured liabilities in the receivership. These claims will be converted into receivership certificates, so the bridge will have little debt when it is first formed. This transaction expropriates the value of shareholder and unsecured creditor positions in the parent BHC and makes it available to support the operations of the SIFI’s subsidiaries.

The SPOE approach for using OLA removes the parent BHC’s limited liability protection, and holding company investors can be required to absorb losses that far exceed their equity

²⁹ Financial Stability Board (2009).

³⁰ FDIC SPOE NPR p. 76617.

investments in subsidiaries. In other words, when the secretary invokes OLA, it triggers a change in parent company investor property rights under the unproven theory that expropriating the resources owned by parent company's investors and using them to protect creditors of the SIFI's subsidiaries will protect the financial system from crisis.

The FDIC will then use the bridge institution to issue new debt, using the DFA Orderly Liquidation Fund if necessary.³¹ The proceeds will be down-streamed to recapitalize and liquefy distressed subsidiaries to keep them out of bankruptcy or receivership, to allow them to meet investor redemption demands without the need to engage in asset "fire sales."

If the parent holding company has insufficient resources available for the FDIC to expropriate, the FDIC will use taxpayer assistance in the form of an OLF to loan to effect the SPOE resolution. To avoid using taxpayer funds, the FDIC and FRB are planning to issue new regulations that mandate a minimum level of total loss absorbing capacity (TLAC) at parent holding companies. Because the design of TLAC requirements is an important issue for the SPOE, TLAC regulations are discussed in a separate section.

5. Can the SPOE Prevent SIFI Distress from Sparking a Financial Crisis?

The theory behind the FDIC's SPOE-OLA strategy is that the probability of triggering a financial crisis is minimized if the parent holding company resources can be used to keep the SIFI's critical operating subsidiaries open and operating while the FDIC reorganizes parent SIFI's operations in a bridge institution. To facilitate this plan, the FDIC must be able to assume ownership of a SIFI parent holding company's assets, and there must be a legal avenue available to raise new funds using these assets, and to downstream the proceeds to failing subsidiaries. There are a number of important issues that could prevent the FDIC from carrying out this plan.

First, consider a situation where a SIFI's very large bank subsidiary is in danger of default. For the Secretary of Treasury to invoke OLA and appoint the FDIC receiver of the parent SIFI, the parent also must be in danger of default. Kupiec and Wallison (2015) analyze data on the largest banks and their parent SIFI BHCs and conclude that, should the largest banks in the US suffer losses that wipe out their total equity positions, very few parent BHCs would suffer a loss that endangers their default. The analysis raises the unforeseen possibility that large and important

³¹ The bridge could borrow from Treasury using the Orderly Liquidation Fund (OLF) or it could use the OLF to guarantee bridge liabilities that will sold to the market.

operating subsidiaries could be in danger of default, and OLA-SPOE strategy would not be an available option.

Critics of Kupiec and Wallison's analysis argue that the FRB would use its source of strength power to require the parent BHC not only to bear the loss of its equity investment in the bank subsidiary, but also to fully recapitalize the failing bank.³² If the parent could not comply with the FRB source of strength recapitalization order, the secretary could consider the parent to be in danger of default and invoke OLA. The FRB's source of strength doctrine plays a key role in the arguments of those that claim that OLA and SPOE will almost certainly be an option should a large depository institution fail, and so I review the laws and court rulings related to the source of strength doctrine in Section 6.

The legislative and judicial history shows that the FRB's source of strength powers have clearly defined limits. The parent holding company need not agree to guarantee a prompt corrective action recapitalization plan for its failing bank subsidiary, and even if it does, its loss exposure is limited to at most to an additional 5 percent of the value of the subsidiary bank's assets. While this could be a large loss, in most cases, the analysis in Kupiec and Wallison shows that the largest SIFI BHCs have sufficient capitalized to absorb this additional loss without being in danger of default.

If the OLA cannot be invoked because the parent BHC is not in danger of default, the FDIC will be forced to resolve the failing bank subsidiary using its Federal Deposit Insurance Act bank resolution powers. In the case of large banks, this nearly always entails a whole bank purchase and assumption sale, perhaps with a loss share agreement. In other words, the FDIC will sell the large failing bank intact to a larger healthier bank, fully protecting uninsured depositors and often agreeing to absorb a large share of the losses on the failing institution's nonperforming assets. The TBTF discussion in Section 8 highlights this type of transaction as a major factor that reinforces investor exceptions of TBTF because it protects all bank deposits including those over the insurance limit.

Should a large, critically important nonbank subsidiary be in danger of default, the probability the secretary would authorize an OLA-SPOE resolution may also be remote. There is an inherent

³² In a public event at the American Enterprise Institute, Randy Guynn and Gregory Baer both argued that the Board's source of strength doctrine would allow the Secretary of the Treasury to invoke OLA, invalidating the issue raised by Kupiec and Wallison. See <https://www.aei.org/events/fdics-single-point-entry-strategy-eliminate-big-fail/>

conflict of interest that may prevent the FRB from allowing the failure of an entity under its heightened prudential supervision. An important factor limiting the use of OLA-SPOE is the real possibility that the FRB will allow a SIFI's bank subsidiary to provide emergency liquidity support to a distressed nonbank affiliate to keep the nonbank affiliate from failing. The FRB has encouraged this type of support in the past, and there is nothing in the DFA that prevents it from happening again.

In the last financial crisis, critical nonbank financial firms ultimately failed because of severe liquidity stress. Investors refused to rollover short-term loans to Bear Sterns and Lehman Brothers. The immediate cause of default or near default of these firms was not a regulatory capital deficiency, but a failure to attract sufficient short-term market funding.

The discussion in Section 10 shows that, in the last financial crisis, the FRB granted temporary exemptions from Section 23A and 23B rules to allow BHC bank subsidiaries to provide exceptionally large amounts of credit to their distressed nonbank affiliates. Neither Lehman nor Bear Sterns were given such exemptions.³³ The FRB's ability to grant Section 23A and 23B waivers has not been eliminated in the DFA. It is not beyond my imagination to think that the FRB would use a future waiver to allow a FRB-supervised SIFI to fund its nonbank subsidiaries using an exceptional amount of credit from a bank affiliate.

Should the FRB not intervene and allow a critical nonbank SIFI subsidiary to fail, unlike in the case of a failing bank subsidiary, bank-style prompt corrective rules may not apply. Functionally regulated nonbank subsidiaries are not yet subject to bank prompt corrective action laws. Nor does the DFA explicitly include FRB source of strength power over nonbank functionally-regulated subsidiaries. However, some have argued that the DFA does empower the FRB to require a SIFI to inject new capital to support a nonbank subsidiary.

The DFA explicitly includes the FRB power to require a parent holding company to be a source of strength to the intermediate holding company, but there is no requirement that a BHC or an

³³ There is no public record (of which I am aware) that indicates that any of the non-BHC financial holding companies that owned depository institution ever asked the FRB for a Section 23A exemption to channel bank funding to nonbank affiliates. Such a request would not be made public if it was not approved. Lehman Brothers owned an Industrial Loan Corporation (a special type of depository charter) that was supervised by the FDIC. Lehman's ILC did not fail when Lehman Brothers filed for bankruptcy. Merrill Lynch and Goldman Sachs also owned ILCs and neither of them received a Section 23A waiver until after the parent companies were converted into BHCs.

intermediate holding company be a source of strength to a failing nonbank subsidiary. However, the DFA does grant the FRB other regulatory powers that may allow the FRB to assert source of strength powers relative to nonbank subsidiaries, but these powers are not yet developed.³⁴ This issue is discussed at length in Section 6.

Suppose the failure of one or more operating subsidiaries does put the parent holding company in danger of default and the OLA can be invoked. Will the SPOE be able to inject capital into these subsidiaries to prevent their failure from causing a financial crisis? The answer depends on type of SIFI operating subsidiaries that have become financially distressed.

In the case of a distressed subsidiary bank, there is an important legal issue of whether Congress intended that OLA be used to recapitalize a failing bank. OLA is concerned solely with the *liquidation* of failing nonbank financial institutions. The word “recapitalization” does not appear anywhere in DFA; § 214(a) explicitly says, “All financial companies put into receivership under this title shall be liquidated.”³⁵

Title II explicitly states that its provisions do not apply to banks. DFA § 201(a)(8)(B) states that, “The term ‘covered financial company’ ...does not include an insured depository institution,” and § 201(a)(9)(A) says, “The term ‘covered subsidiary’ means a subsidiary of a covered financial company, other than...an insured depository institution.” Based on this explicit language, it is hard to image that an FDIC’s action to use OLA to recapitalize a failing bank subsidiary would stand after judicial review.

Other specific language in Title II also indicates that OLA was not intended to apply to banks. The OLA mandatory claims priority, § 210(b)(1), for example, does not mention bank deposits or insured deposits. Moreover, § 210(n)(8)(i) expressly prohibits the FDIC from using the OLF “to assist the Deposit Insurance Fund (...).” A SPOE-based bank recapitalization clearly “assists” the Deposit Insurance Fund (DIF) if it recapitalizes a failing bank subsidiary and

³⁴ Many would argue that, because the FRB regulates the parent holding company, ignoring the Board’s order to inject capital into a nonbank subsidiary would create “long-run regulatory costs” that make it in the shareholders’ interest to comply with the FRB’s initial capital injection order. While the FRB is certainly not beyond coercion, the OLA cannot be said to “work” if regulators must rely on extra-legal means to recapitalize a distressed critical nonbank subsidiary. This coercive mechanism, moreover, reinforces an implicit government guarantee that creates the TBTF problem.

³⁵ The tension between a SPOE recapitalization and the OLA requirement for a liquidation has been recognized by Skeel (2013, 2014), Taylor (2013), Rosner (2013), Fisher (2013) and Lubben (2013).

consequently would appear to be prohibited in a Title II liquidation.³⁶ The explicit prohibition against using the OLF to favor the Deposit Insurance Fund could perhaps explain the priority regulators have put on imposing new minimum TLAC rules (discussed in Section 7).

Notwithstanding the uncertain legal basis for using OLA to recapitalize failing bank subsidiaries, the FDIC's public campaign to implement the SPOE strategy suggests that the FDIC will likely ignore the issues raised in this section. Should the SPOE be available to recapitalize a failing bank, then the government has a new option. On a case-by-case basis, the government can decide to impose bank subsidiary losses on either a bank's creditors using an FDIA resolution, or on BHC creditors using the SPOE strategy. This option introduces an entirely new source of systemic risk.

The "resolution risk" created by the possibility of using SPOE to recapitalize a failing bank will create new liquidity stresses in the next financial crisis. Investors will be reluctant to fund either the parent BHC or their subsidiary banks if lenders are uncertain which lending channel could expose them to resolution loss. This source of systemic liquidity risk did not exist in the prior crisis; it has been newly created by OLA-SPOE approach for SIFI resolution.

6. The Federal Reserve Board Source of Strength Doctrine

Writing in *Banking Perspectives*, Gregory Baer, former senior counsel at the Federal Reserve Board and Assistant Secretary of the Treasury, characterizes the FDIC's SPOE strategy as, "[T]he final step in implementing the source of strength doctrine that the Federal Reserve Board has enunciated for decades."³⁷ While the source of strength doctrine may have motivated the SPOE approach for SIFI resolution, there are important unsettled questions about the limits of the FRB's source of strength powers that are important for understanding whether an OLA-SPOE strategy is likely to be available as a SIFI resolution option.

The source of strength doctrine is rooted in the FRB's power to approve mergers and acquisitions under the 1956 Bank Holding Company Act.³⁸ In approving (or disapproving) a

³⁶ An OLA-SPOE resolution that recapitalizes a failing bank subsidiary will protect all the bank's creditors, not just all its depositors. This "solution" extends the deposit insurance guarantee beyond large uninsured depositors and creates a new source for TBTF subsidies, as some large banks would be "eligible" for OLA protection while other banks would not. See Kupiec and Wallison (2015) for further discussion of this issue.

³⁷ Baer (2014) p. 2.

³⁸ Public Law 84-511, 84th Congress. H.R. 6227.

bank holding company application, § 3(c)(1)-(2) requires the FRB to consider “the financial history and condition of the company or companies and banks considered; and (2), their prospects.” The FRB interpreted this requirement as Congressional empowerment to determine, on a case-by-case basis, the minimum capitalization condition that the FRB deems acceptable to approve BHC applications.

In 1976, the FRB rejected an application by First Lincolnwood Corporation to establish a BHC to assume control of the shares of a bank. The owners of the bank and the shareholders of the prospective BHC had borrowed to buy the controlling shares in the bank. In the process of reorganizing their controlling ownership through a BHC, the applicants wanted to replace the personal debt they had incurred to purchase the bank shares with BHC debt. The FRB rejected this application arguing that the holding company would have high indebtedness which could inhibit it from assisting the BHC’s bank subsidiary should the bank experience difficulties.

The FRB’s First Lincolnwood decision was appealed, and the court ruled against the FRB. The court argued that the transaction under consideration did not change the financial condition of the bank. This ruling in favor of Lincolnwood was subsequently overturned on appeal by the Supreme Court. The Supreme Court’s ruling established that the FRB had the undisputed legal power to require additional capital as a condition for approving a BHC application.³⁹

In 1984, the FRB revised its Regulation Y, adding a requirement that, “a bank holding company should serve as a source of strength for its bank subsidiaries, and conduct its bank and nonbank operations in accordance with sound banking policy and practice.” The FRB justified this regulation by virtue of its power to set holding company capital from § 3(c)(2) of the BHCA, and its power granted by the Financial Institutions Supervisory Act (FISA) to issue cease and desist (C&D) orders to stop unsafe and unsound banking practices.

In 1987, the FRB issued a C&D order for unsafe practices to Hawkeye Bancorp because Hawkeye had failed to contribute capital to a failing bank subsidiary. Since the bank was taken into receivership before the FRB acted, the FRB subsequently withdrew the order, but publically reaffirmed its policy requiring BHCs to provide financial assistance to distressed bank subsidiaries.

³⁹ 439 U.S.

In 1988, the FRB issued a C&D order for unsafe and unsound banking practices against MCorp because MCorp failed to inject additional capital into its failing bank subsidiaries. The FRB required MCorp to submit a capital plan in which “all of MCorp’s available assets are used to recapitalize the Subsidiary Banks [*sic*] that are suffering capital deficiencies.”⁴⁰

Subsequently, a number of MCorp banks were put into receivership and the FRB filed additional C&D orders alleging that MCorp had violated Section 23A of the Federal Reserve Act. MCorp petitioned a district court to enjoin the FRB’s C&D actions. The district court ruled in favor of MCorp and the FRB appealed the decision.

The Fifth Circuit court was decisive in rendering an opinion on appeal. The court’s opinion first argued that the FRB’s power to require additional capital applies only in the holding company application approval process,

The BCHA does not grant the Board [*FRB*] authority to consider the financial and managerial soundness of the subsidiary banks after it approves the application, and First Lincolnwood finds this regulatory authority lacking in the day-to-day operations of a subsidiary bank. For these reasons, we conclude that the Board is without authority under the BHCA to require MCorp to transfer its funds to its troubled subsidiary bank.⁴¹

The second notable aspect of the appellate court decision involves the FRB’s claim that safe and sound banking practice require a BHC to inject additional capital into a failing bank subsidiary. In a clear rejection of the FRB’s interpretation of “safe and sound banking practice,” the court wrote,

Enforcement of the Board’s source of strength regulation requiring MCorp to transfer MCorp’s funds to the troubled subsidiary banks can hardly be considered a “generally accepted standard[] [*sic*]of prudent operation.” Such a transfer of funds could require MCorp to disregard its own corporation’s separate status; it would amount to a wasting of the holding company’s assets in violation of its duty to shareholders.⁴² ...

This strongly supports MCorp’s argument that Congress never intended to grant authority to the Board to require a holding company to inject capital into subsidiary banks as a safeguard against “unsafe and unsound” practices.⁴³

The FRB appealed the decision to the Supreme Court. The Supreme Court reviewed the case and ruled that the district and appeals courts did not have jurisdiction to enjoin the FRB’s actions.

⁴⁰ MCorp Financial v. Board of Governors of the Federal Reserve System, 900 F.2d 852 para. 2.

⁴¹ MCorp v. Board of Governors of the Federal Reserve System, United States Court of Appeals, Fifth Circuit [900 F.2d 852], para. 65.

⁴² *Ibid.* para. 75.

⁴³ *Ibid.*, para. 76.

The Supreme Court's technical dismissal of the lower courts' decisions nullified the clear legal ruling against the FRB's interpretation of its source of strength powers. Unfortunately, the Supreme Court ruling did not speak to the merits of the MCorp complaint. Consequently, the legal limits to the FRB's source of strength powers remained an unsettled legal issue.

Following the savings and loan crisis of the late 1980s, the FRB's strategy for imposing its source of strength doctrine changed as new legal tools became available. In 1991, Congress passed the Federal Deposit Insurance Improvement Act (FDICIA) which included new prompt corrective action regulatory powers. Prompt corrective action legislation requires that undercapitalized depository institutions submit an acceptable capital restoration plan to their primarily federal regulator. To be acceptable, the law requires:

[E]ach company having control of the institution has—(I) guaranteed that the institution will comply with the plan until the institution has been adequately capitalized on average during each of the 4 consecutive calendar quarters; and (II) provided appropriate assurances of performance.⁴⁴

While regulators must require appropriate assurances from the holding company for the capital resolution plan to be acceptable, subsequent litigation shows that the holding company need not provide explicit capital injection guarantees. Should a holding company provide an explicit enforceable guarantee, FDICIA explicitly limits the holding company's exposure to the lesser of: (i) 5 percent of the distressed institution's assets measured at the time the guarantee is made; or, (ii) the amount needed to bring the institution into compliance with minimum capital standards.⁴⁵ Moreover, the regulator cannot require a company other than the company that controls the depository institution to guarantee the capital restoration plan, nor can the regulator require any nonbank subsidiaries or affiliates of the holding company to submit to a capital restoration plan.⁴⁶

Prompt corrective legislation places explicit limits on the support that a parent holding company must supply to its failing bank subsidiaries. The statute also explicitly rules out prompt corrective action capital restoration plan powers for nonbank holding company subsidiaries and affiliates.

⁴⁴ Public Law 102-242, § 38(e)(2)(C)(ii).

⁴⁵ *Ibid.*, § 38(e)(2)(E)(i).

⁴⁶ *Ibid.*, § 38(e)(2)(E)(ii).

In addition to prompt corrective action, Congress made changes to the bankruptcy code that gave priority to any holding company commitments made to a federal regulators for the purpose of maintaining the capital of its insured depository institutions. However, the ability to enforce BHC capital restoration plan commitments has been mixed in holding company bankruptcy cases. Courts sometimes uphold, and sometimes dismiss, regulatory claims against holding company bankruptcy estates based on implied holding company “commitments” made in capital restoration plans or in memorandum of understanding agreements for settling FRB C&D orders mandating holding company source of strength support.

A recent bankruptcy case testing these authorities further demonstrates the limits of the FRB’s power to enforce a source of strength capital maintenance agreement in a holding company bankruptcy. Unless these agreements are clear and explicit, and linked directly to a holding company application approval or to a prompt corrective action capital restoration guarantee, they are unlikely to be binding in bankruptcy. In the Colonial Bancgroup bankruptcy [436 B.R. 713 (Bankr. M.D. Ala. 2010)], the court held that,

Each of the documents [that claim to establish a claim against the bankruptcy estate] requires the Debtor to assist the Bank in complying with the Bank MOU or the Bank C&D, whether by "taking steps designed to ensure that the Bank complies," or by utilizing "its financial and managerial resources to assist" the Bank, or by taking "appropriate steps to ensure that the Bank complies." The documents do not require the Debtor to comply on behalf of the Bank or impose liability on the Debtor in the event the Bank fails to reach the required capital ratios. In other words, the language in the documents does not make the Debtor either primarily or secondarily liable for the Bank's obligations.

The language is broad and general and requires only that the Debtor "assist" the Bank. The language does not specify any particular method of assistance or prescribe specific steps that the Debtor must take. The language does not dictate what financial and managerial resources the Debtor must utilize. Nor does it require the Debtor to serve as a guarantor of the capital ratios or to pledge any assets to secure any capital deficiency. Most importantly, the language does not require the Debtor to make a capital infusion, in any amount, in the Bank.

The court has found no case law supporting the FDIC's position that these documents create a commitment within the meaning of 11 U.S.C. § 365(o). There are cases in which a commitment has been found. However, the commitment language in those cases differs from the language in the instant documents. In addition, the circumstances under which those commitments were made differ as well. Three of those cases involve commitments made as a condition of approval of an acquisition. The fourth involves the prompt corrective action statute.

Legislation and case law suggest that, prior to the implementation of the DFA, there were clear limits on the FRB's ability to require holding companies to inject capital into failing bank subsidiaries. The courts have established that the FRB has the legal power to set BHC-specific capital requirements in the BHCA application approval process. If, in a memorandum of understanding addressing the prompt correction action capital restoration plan for a bank subsidiary, a holding company clearly and unambiguously agrees to guarantee the capital injections in the restoration plan, then the holding company owners can be on the hook for injecting capital, even if the holding company subsequently declares bankruptcy.

But even when there is an enforceable prompt correction action capital restoration plan guarantee, the law places clear limits on the parent holding company's exposure. Moreover, there is no requirement that the holding company sign a guarantee agreement. It can submit a capital restoration plan with an ambiguous unenforceable statement of support and take its chances on whether the regulator finds it acceptable. There is no law or legal case that supports the claim that the FRB has the power to *require* a bank holding company to inject *unlimited* amounts of capital into a failing bank subsidiary. The limited nature of the source of strength doctrine is potentially an important issue that might make OLA unavailable in many cases.⁴⁷

Prior to the passage of the DFA, the FRB's source of strength powers were not explicitly granted in law, but engineered by the FRB's legal interpretation of its approval powers under the BHCA and its power to issue C&D orders under FISA. In 2010, the Congress explicitly recognized the Board's source of strength power in DFA § 616. "Source of financial strength" is defined as,

[T]he ability of a company that directly or indirectly owns or controls an insured depository institution to provide financial assistance to such insured depository institution in the event of the financial distress of the insured depository institution.

Section 616 does not provide any clarity on the limits of the FRB's source of strength power. The language "ability to provide financial assistance" does not imply *the obligation* to recapitalize a subsidiary depository regardless of the cost to the parent. Congress could have given the FRB authority to require a BHC to recapitalize a failing bank subsidiary, but it did not; § 616 simply endorses the source of strength doctrine without clarifying the limits of this power.

⁴⁷ The implications of the limits on source of strength powers for OLA and SPOE is discussed in Section 5.

The language in § 616, moreover, explicitly restricts the use of the source of strength doctrine to the support of subsidiary depository institutions, Section 616(d) states,

The appropriate Federal banking agency for a bank holding company or savings and loan holding company shall require the bank holding company or savings and loan holding company to serve as a source of financial strength for any subsidiary of the bank holding company or savings and loan holding company that is a depository institution.

Contrary to what some scholars may have written, the DFA language does not explicitly recognize source of strength powers for non-depository subsidiaries or affiliates of BHCs or thrift or savings and loan holding company.⁴⁸ The DFA does not extend the FRB's source of strength powers to nonbank subsidiaries or affiliates except in the specific case an intermediate financial holding company.

Section 167 of the DFA gives the FRB the authority to require nonbank SIFIs designated by the FSOC to place their financial activities in an intermediate holding company that will be supervised by the FRB. This intermediate holding company is subject to all FRB rules and regulations that apply to BHCs under the Bank Holding Company Act and its amendments. Section 167(b)(3) requires the parent nonbank SIFI to act as a "source of strength" to its intermediate holding company. Similarly, § 626(b)(1) gives the FRB the power to require a unitary thrift or savings and loan holding company to place its financial activities under an intermediate financial holding company and § 626(b)(3) requires that a parent holding company must act as a source of strength to its intermediate holding company.⁴⁹

Notwithstanding FRB powers granted by § 167 and § 626, there is no explicit DFA requirement that a BHC or an intermediate holding company must act as a source of financial strength to a subsidiary unless the subsidiary is a depository institution.⁵⁰ However, § 166 allows the FRB to issue prompt corrective rules that apply to nonbank affiliates of BHCs and non-bank designated SIFIs, and such rules could include capital restoration plans and language with source of strength provisions.

⁴⁸ For example, Lee (2012) presumes that Congress intended to extend this power to nonbank subsidiaries. Litan (2012) explicitly argues that the DFA extended the Board's source of powers to nonbank subsidiaries citing Lee (2012). Baer (2014) also make this claim without reference to Lee.

⁴⁹ Lee (2012), p. 884-885 *presumes* that the language in § 626(b)(3) gives the Board the power to require capital injections into a failing nonbank subsidiary. However, the DFA does not explicitly authorize such an action.

⁵⁰ Intermediate holding companies are subject to bank holding company rules, so they must act as a source of financial strength to subsidiary depository institutions.

Section 166 requires the FRB, in consultation with other regulatory agencies, to prescribe prompt correction rules action to provide, “early remediation of financial distress of a nonbank financial company supervised by the Board of Governors or a bank holding company described in section 165(a)...”⁵¹ Such rules could include source of strength provisions as well as other intrusive remedial powers. However, to the best of my knowledge, the FRB has not promulgated any prompt corrective action rules for the nonbank SIFIs or large BHCs that are subject to its heightened supervision regime.

Thus, at present, here is no explicit DFA language or FRB regulation that explicitly grants or asserts the FRB power to require a BHC or intermediate financial holding company to be a source strength to a non-depository subsidiary institution. However, history suggests that, should it find the need for such a power in the future, the FRB would likely use its § 166 powers and issue prompt corrective actions regulations that include source of strength powers over nonbank affiliates. But even then, as in the case of BHC bank subsidiaries, there will be limits on the FRB’s ability to require a parent to make capital injections into a failing nonbank subsidiary. The issue would almost certainly be litigated, and the courts would again be asked to interpret the limits that apply to the FRB’s source of strength power.

To date, the FRB has only limited ability to require a parent BHCs to recapitalize its failing bank subsidiaries, and no explicit power to require recapitalization of nonbank subsidiaries. Granting the FRB the discretionary powers to pierce parent company limited liability and corporate separateness by requiring parent companies to recapitalize any subsidiary regardless of loss would be a major change in US corporate law. The courts have not yet accepted such an interpretation and there is no language in the DFA that overturns the source of strength limits that have been set by the courts.

7. SPOE Requires New Minimum Total Loss Absorbing Capacity Regulations

For the OLA-SPOE strategy to work without OLF borrowing, the parent holding company must have sufficient resources available for the FDIC to expropriate and use to recapitalize critical operating subsidiaries in the resolution. To ensure that the parent has sufficient resources, the FDIC and FRB plan to issue new regulations to require BHC SIFIs to meet minimum “total loss absorbing capacity” or TLAC requirements.

⁵¹ § 165 (a) applies to BHCs with consolidated assets of at least \$50 billion.

While the US regulators have not yet released a notice of proposed rulemaking for US TLAC regulations, the FSB has released a consultative document that provides an outline for US TLAC rules. TLAC represents resources that are available at the parent holding company that can be used to provide capital and funding for subsidiaries should the parent holding company face severe financial distress.⁵²

The FSB has issued a proposal that would require global systemically important banks [G-SIBs] to meet and maintain new minimum TLAC standards.⁵³ These restrictions may require G-SIBs to issue substantial amounts of unsecured debt that can be converted into equity to avoid bankruptcy in a bail-in strategy,⁵⁴ or converted into receivership certificates in a regulator-administered resolution process. In certain specific instances, the TLAC proposal calls for parent companies to issue TLAC debt and re-lend the proceeds to critical subsidiaries so that this debt can be converted to equity or be forgiven by the parent company should the subsidiary need to be recapitalized.⁵⁵

In the FSB proposal, G-SIB TLAC is comprised of equity and external debt issued by the parent holding company provided the debt is unsecured, subordinated to most other claims, and has a remaining maturity of at least one-year. The FSB recommends a TLAC requirement in the range of 16-20 percent of risk-weighted assets, with an absolute TLAC floor of 2 times the Basel III leverage ratio.⁵⁶ The final calibration of minimum TLAC requirements is left to the discretion of national supervisory authorities.^{57,58}

⁵² In Europe, TLAC may take the form of contingent convertible debt (so-called co-cos) issued by the parent holding company that can be converted into equity “automatically” by a capital adequacy or regulatory triggering mechanism. In the US, TLAC is likely to take the form of subordinated debt issued by the parent holding company that can be converted in equity in an FDIC SPOE resolution.

⁵³ Financial Stability Board (2014).

⁵⁴ So called bail-in strategies rely on parent company issuance of co-cos. See for example, discussions in Calomiris and Herring (2012, 2013), Culp (2009), Flannery (2009), or Avdjiev, Kartasheva and Bogdanova,(2013).

⁵⁵ The TLAC proposal does not specify a mechanism for conversion of the subsidiary debt into equity.

⁵⁶ The Basle III leverage ratio is Tier 1 capital divided by total consolidated exposure which include all on- and off-balance sheet positions calculated using specific regulatory guidelines. The minimum Basel III leverage ratio is 3 percent; the U.S. minimum Basel III leverage ratio is 5 percent for all advanced approach BHCs and 6 percent for all advanced approach banks.

⁵⁷ The specific details of U.S. regulations specifying BHC minimum total loss absorbing capacity (TLAC) have not been finalized, preliminary indications are that most large BHCs will be expected to have TLAC in the range of 16 to 20 percent of their risk weighted assets while the largest BHCs could face TLACs as high as 25 percent. Financial Stability Board (2014) p. 6, and p. 13. It is also unclear whether the U.S. would apply G-SIB TLAC requirements to non-bank SIFIs designated by the U.S. Financial Stability Oversight Council under Dodd-Frank Title I authorities.

According to the FSB (2014, p. 13), the objective of the TLAC requirement is,

[T]o ensure that the G-SIBs have the loss absorbing and recapitalization capacity necessary to help ensure that, in and immediately following a resolution, critical functions can be continued without taxpayers' funds (public funds) or financial stability being put at risk.

Moreover, the FSB believes that,

TLAC, in conjunction with other measures should act to remove the implicit public subsidy from which G-SIBs currently benefit when they issue debt and incentivize creditors to better monitor G-SIBs' risk taking [FSB (2014), p. 6].

There are many ways a G-SIB might alter its capital structure and investments to satisfy the FSB's TLAC proposal. For example, the parent company of a TLAC resolution group might issue TLAC-compliant debt and invest the proceeds in low-risk assets. Alternatively the parent might issue TLAC compliant debt and lend the proceeds to a subsidiary bank which in turn will determine how to use the proceeds.

In a related paper [Kupiec (2015)], I analyze the impact of alternative strategies a BHC might employ in order to comply with the FSB proposed TLAC rules.⁵⁹ Using an equilibrium asset pricing model to formally analyze the economic consequences of alternative strategies, I show that the efficacy of a minimum TLAC regulation depends not only on the amount of TLAC debt securities the parent holding company is required to issue, but also on how the proceeds from the issuance of new TLAC debt are employed within the BHC.

If the proceeds from new TLAC debt issuance are retained at the parent holding company and invested in activities independent of the holding company's subsidiary activities (e.g., the parent invests in Treasury Bills), the increase in TLAC need not reduce the BHC's TBTF implicit interest rate subsidy. For example, the assets the parent company buys using the proceeds of the required TLAC debt issue may strengthen the financial condition of the parent holding company and make it more difficult to invoke OLA should a subsidiary bank become financially distressed.⁶⁰

⁵⁸ Federal Reserve officials have suggested that future U.S. TLAC requirements will be stricter than the FSB proposal. See, for example, Joe Adler, "Ending Too Big to Fail at the Push of a Button," *American Banker*, October 30, 2014.

⁵⁹ Apologies for sending the reader to a different paper. However, the arguments in Kupiec (2015) are mathematical, and in addition to being out of character for this paper, including them would make this long paper even longer.

⁶⁰ For example, depending on how the parent invests the TLAC proceeds, it may have no trouble servicing its TLAC debt, making it much harder for the secretary to make the claim that the parent is in danger of default.

In order for a TLAC rule to meet the goals of the DFA (ending TBTF) and the FDIC's SPOE strategy (keeping critical operating subsidiaries open and operating), the rule must require TLAC debt at each critical subsidiary that needs to remain open and operating; it cannot just require TLAC debt at the parent holding company. Moreover, the TLAC regulations must also include restrictions on how subsidiaries may use the proceeds from their new TLAC debt. In order to reduce the TBTF subsidy and increase the probability that these subsidiaries remain open and operating should the parent become financially distressed, the subsidiary's TLAC debt proceeds must be invested in very low risk assets or used to replace insured deposits in the subsidiary bank. If the TLAC proceeds are used to replace existing external uninsured bank liabilities, the TLAC regulation will not diminish the bank's implicit funding subsidy.

The results show that, should the TLAC rule require: (a) a sufficient volume of parent TLAC; (b) that the proceeds from the parent TLAC issues be used to fund an equivalent total amount of TLAC debt issued by critical operating subsidiaries including all depository subsidiaries (back-to-back TLAC); and, (c) that the proceeds from subsidiary TLAC debt either: (i) replace insured deposit funding, or (ii) be invested in risk free assets; then the TLAC debt will accomplish the stated twin goals of removing the TBTF subsidy and keeping subsidiaries open and operating. A TLAC rule that satisfies these conditions is economically equivalent to increasing the regulatory capital requirement (the required minimum equity-asset ratio) at the BHC's critical operating subsidiaries and all depository subsidiaries.⁶¹

This alternative solution—raising minimum equity capital requirements at subsidiary banks and functionally regulated subsidiaries—is far simpler and refreshingly transparent compared to the DFA-OLA-SPOE-TLAC solution. To accomplish the same job, DFA requires: (i) enhanced consolidated capital requirements for large BHCs and designated SIFIs; (ii) expensive, intrusive, and imprecise and expensive annual FRB stress tests; (iii) new expansive FRB examination powers that duplicate examinations already conducted by functional regulators; (iv) a new TLAC requirement for designated parent SIFIs that also must include subsidiary TLAC requirements and asset investment restrictions; (v) a new administrative resolution scheme that the government can elect to use (but is not required to use); and (vi) new powers that allow the government to select, on a case-by-case basis, which investors suffer a loss when a large financial institution fails.

⁶¹ This claim is formally proved in Kupiec (2015).

The solution of heightened regulatory capital for subsidiary banks and critical functionally-regulated affiliates will of course be unappealing to bankers because it will reduce the implicit safety net subsidies they enjoy. The simplicity of this alternative capital approach is also likely to be unappealing to regulators, given their revealed preference for regulatory complexity and supervisory discretion.

To meet these new heightened subsidiary capital requirements, parent holding companies should be allowed to borrow the funds just as they would if they were forced to issue TLAC-qualifying debt. But in the alternative approach of imposing higher regulatory capital requirements on the SIFI operating subsidiaries and not the parent, the capital (and loss bearing) capacity of the critical banks and other subsidiaries are transparent in all states of the economy without any complications associated with debt conversion in a bail-in, or SPOE-TLAC in the OLA approach. Moreover, allowing BHCs to borrow the necessary funds to meet these new higher minimum regulatory requirements for subsidiaries preserves the BHC's debt finance tax benefit since tax liability is calculated on a BHC's consolidated income.

8. Origins of the TBTF Problem

The prior sections have discussed how a simple set of alternative capital regulations can replace the complex, messy and expensive OLA mechanism imposed by the DFA. However, these changes alone are unlikely to eliminate TBTF subsidies. The TBTF problem is the consequence of a wider set of issues than those associated with DFA Title II.

The TBTF problem arises when investors believe that the government will take special measures to forestall the failure of some financial institutions, but not others, even though these institutions provide nearly identical financial services. The TBTF problem is also created when there is the possibility that, should a financial institution fail, the creditors and counterparties of some financial institutions will be protected by special government measures that shield them from losses while the creditors and counterparties of other financial institutions offering similar financial services will not be protected by the government. When investors believe that the government will provide either of these selected protections without imposing an explicit fair-market charge for the protection, the government creates a TBTF problem.

When investors treat the liabilities of SIFI institutions as if they have an implicit government guarantee, they behave as if the government—not the investor—will absorb the risk if a SIFI

experiences a large losses. Consequently investors do not charge the SIFI the full interest rate that is justified by the SIFI's risk profile. The SIFI enjoys an interest rate subsidy because, correctly or incorrectly, investors believe that the government will protect them from loss should the SIFI experience losses that threaten its solvency.

The TBTF implicit subsidy creates a situation where SIFI shareholders' gain at taxpayer expense. When investors believe that the government will take measures to keep a SIFI open and operating even when it faces extreme losses, the belief indirectly encourages the SIFI's management to take on additional risk. Since the SIFI does not pay a fair price for this government protection, shareholders get to keep outsized positive returns while the government shifts outsized losses to the taxpayer and, all the while, the SIFI makes high-risk investments at artificially low borrowing costs.

The implicit government guarantee creates a misallocation of resources—SIFIs are implicitly subsidized to make high-risk investments that would not be selected except for the implicit government guarantee. Implicit government guarantees, even incomplete ones that protect only a limited class of investors, distort investments into activities that would not be appealing to investors without the potential for taxpayer bailouts.

Why do investors continue to believe that the government will bailout distressed SIFIs using taxpayer money, even though some government officials emphatically deny that bailouts are still possible after the passage of the DFA? Investors, especially uninsured institutional investors who gain the most from implicit government subsidies, understand that history and existing law suggest that some financial institutions are likely to receive special government treatment should they face financial distress. And they expect that the special government treatment will shield them from the SIFI's losses.

Other things equal, it is always better to lend money to the institutions who are likely to get special treatment from the government—especially when there no fair-market charge for the special treatment. The remainder of this section discusses some of the most important issues that lead investors to rationally conclude that SIFIs will receive special government support should they become financially distressed.

It is important to understand that the TBTF problem does not exist because SIFIs are too-big-to-fail in bankruptcy. They are not. This folklore was politically useful to shift responsibility away from the regulators and policies that failed in the last crisis, and to pass new legislation that increased discretionary government powers. Maybe in the past financial crisis it was too costly to allow many SIFIs to enter bankruptcy at the same time in part because their operating subsidiaries would have failed as well. With an appropriate capital requirement, operational and contracting safeguards, and prompt corrective action thresholds in place, parent SIFIs, perhaps many of them, could have been allowed to fail without magnifying financial instability.

The facts of Lehman Brothers bankruptcy [reviewed in Section 9] show that a single large important financial institution can fail and be liquidated in judicial bankruptcy—even in the midst of an on-going financial crisis—without causing a cascade of other financial firm failures. Even more amazing, the direct knock-on damage from the Lehman Brothers bankruptcy was minimal, even though the bankruptcy filing was completely disorganized and without any benefit from planning.

Even without the regulatory capital reforms recommended in this paper, many legal experts believe that bankruptcy, and not Orderly Liquidation Authority, is the best answer for facilitating a SIFI failure.⁶² For example H.R. 5421, “The Financial Institution Bankruptcy Act of 2014,” commonly known as “Chapter 14” amends the bankruptcy code so that it can more efficiently handle the failure and reorganization of a SIFI in a Chapter 11 bankruptcy.⁶³ Impartial courts, not government agencies, are best equipped to provide equal protections for investor property rights, and ensure that these protections are maintained over time.⁶⁴

Notwithstanding dubious claims about the impossibility of a SIFI bankruptcy, there are many features in the regulatory landscape that promote TBTF expectations. Unfortunately, many of these regulatory features were magnified— not removed—by the sweeping regulatory changes enacted in the DFA.

⁶² See for example, [Bankruptcy Not Bailout](#) (2012), or Taylor (2015).

⁶³ H.R. in the US House of Representatives and S. 1861 in the US Senate

⁶⁴ Given the latitude for government action granted by OLA, the government is very likely to alter investor protections across SIFI resolutions as the current political fashion changes, and as unique background factors make a particular loss assignment the most expedient one for government regulators at that date and time.

One regulatory feature that promotes TBTF expectations is the conflict created by assigning the FRB the dual role as the supreme consolidated SIFI regulator-supervisor and lender of last resort. The Federal Reserve is the only government agency that can take independent actions to help forestall SIFI failures by providing emergency liquidity assistance, and yet the FRB is also the institution appointed by the DFA to ensure that the largest financial firms—large BHCs and FSOC-designated nonbank SIFIs—will not fail.

Through its powers to regulate BHCs, the FRB has long wielded consolidated supervision powers over BHCs. With the passage of the DFA, Congress singled out a new special group of financial institutions—BHCs with consolidated assets greater than \$50 billion and any financial companies designated by the FSOC—and gave the FRB new expanded powers and a responsibility to safeguard the solvency of this special group of institutions.

The discussion in subsequent sections will show that the combination of: (i) new FRB expanded powers and responsibilities, (ii) the DFA's emphasis on consolidated capital adequacy and "source of strength doctrine" and, (iii) the FRB's historical predilection for waving prudent lending exposure limits for loans and guarantees to companies within a BHC it regulates raise irreconcilable conflicts that make it advantageous for the FRB to assist a SIFI rather than allow an embarrassing failure.

The DFA codifies a regulatory system in which the FRB has a strong incentives to take extraordinary measures to save institutions that are subjected to FRB heightened supervision and regulation should any of them become financially distressed. The reality of the post-Dodd-Frank regulatory structure is well described by Skeel (2010),

Dodd-Frank singles out a group of financial institutions for special treatment. The banks that meet the \$50 billion threshold, and the non-bank institutions designated by the new Financial Stability Oversight Council as systemically important will be put in their own separate category. Unlike in the New Deal, there is no serious effort to break the largest of these banks up or to meaningfully scale them down. Because they are special, and because no one really believes the largest will be allowed to fail, they will have a competitive advantage over other institutions. They will be able to borrow money more cheaply, for instance, than banks that are not in the club. Dodd-Frank also gives regulators a variety of mechanisms they can use to channel political policy through the dominant institutions. The partnership works in both directions: special treatment for Wall Street Giants, new political policy levers for government.

There are important regulatory features outside the DFA that promote the development of TBTF institutions. Foremost among these are the laws that govern the deposit insurance bank resolution process.

In the past, when a large bank fails, the FDIC has prevented a market disruption by selling the large failing bank to a single healthier (and typically larger) BHC. In most cases, large BHC's are the only institutions that are qualified to bid to acquire a failed bank from an FDIC receivership. To qualify as a bidder, an institution must be eligible to own a bank and have the capital, management systems and managerial capacity successfully manage the acquired institution. Moreover, academic evidence suggests that banks and BHC's are willing to bid a premium when an acquisition reinforces their TBTF status.⁶⁵

If no buyer can be found, the FDIC has used open bank assistance to keep large distressed banks open and operating.⁶⁶ When a buyer can be identified, a bank purchase and assumption transaction, often with an FDIC loss sharing agreement, has almost always been the least cost resolution for the bank insurance fund.

The Federal Deposit Insurance Corporation Improvement Act (FDICIA) requires the FDIC to resolve a failing bank using the least-costly method that is available at the time of failure. Should a buyer be identified, whole-bank purchase and assumptions are not only the least-costly method, they have the additional benefit that they avoid the disruption in banking services that would be associated with a depositor payout and liquidation of a large failing bank's assets.

The FDIC has never had the capacity to make timely deposit insurance coverage assessments when a large bank fails. In other words, the FDIC cannot close a large bank on Friday night and have insured depositor funds available the following Monday morning because the FDIC cannot

⁶⁵ Brewer and Jagtiani (2011).

⁶⁶ In 1984, when the FDIC could not find a buyer Continental Illinois Bank, it recapitalized the institution by extending unlimited deposit guarantees, purchasing billions of dollars of the bank's bad loans, and injecting new preferred equity and subordinated debt. The 1991 Federal Deposit Insurance Corporation Improvement Act (FDICIA) limited the FDIC's ability to provide "open bank assistance" and instead required the FDIC to choose a resolution method that imposed the least cost on the deposit insurance fund. FDICIA allows the FDIC to bypass the least cost method if it "would have serious adverse effects on economic conditions or financial stability" and if bypassing the least cost method would "avoid or mitigate such adverse effects." A FDIA systemic risk exception required a special approval process including consultation with the President. The FDIC used the systemic risk exception to provide open bank assistance to many institutions in the financial crisis. Section 1105 of the DFA amended the FDICIA systemic risk exception to require Congressional approval and limit the methods the FDIC can use to provide open bank assistance in exceptional circumstances. For further discussion of FDIC systemic risk powers see, Committee on Capital Market Regulation (2014) pp. 6-7.

determine which deposits are covered by deposit insurance and which are not covered.⁶⁷ If the FDIC manages the failed bank using a bridge bank receivership, it will have to open the bank on Monday morning. If by that time, the FDIC cannot separate insured from uninsured deposit accounts, it will create a depositor run as it did in the case of the Indy Mac failure.⁶⁸ To avoid this problem, when a large bank fails, the FDIC favors any solution that transfers all of the failing bank's deposit accounts to an acquiring bank in a purchase and assumption transaction. This approach justifies TBTF investor expectations because the transaction protects all depositors from loss, including large deposits that should have absorbed bank losses.⁶⁹

The policy of selling large failing banks to larger more stable institutions is also the key mechanism that created several giant US banks that many investors now consider TBTF. To end this problem, the FDIA bank resolution process should be amended by law to require the FDIC to break up banks over a certain asset-size threshold should they fail. Such a change will require that the FDIC's mandate for "least cost resolution" be modified to require the least costly resolution within the context of the mandatory break up of large failing banks. This change in policy would have prohibited, for example, the acquisition of the failed Washington Mutual Bank and Washington Mutual FSB by JPMorgan Chase in the last financial crisis.⁷⁰

The FDIA bank resolution process should be amended to explicitly prevent the bank resolution process from creating TBTF institutions. It might also be sensible to concurrently amend the Dodd-Frank Title I "living will" requirement [§ 165(d)(1)] so that it is refocused on ensuring that processes and procedure are in place to enable the FDIC to break up a large failing depository institution in an FDIA resolution at minimal cost.

9. Did a SIFI Bankruptcy Cause the Last Financial Crisis?

There is no direct evidence that a SIFI bankruptcy will cause a wider financial crisis. The recent financial market experience has often been cited as *prima facie* evidence to support the TBTF

⁶⁷ There are many complicated but legal ways to structure deposit accounts so that an individual can get insurance coverage that is greater than the nominal deposit insurance limit. See, <https://www.fdic.gov/deposit/covered/>

⁶⁸ The FDIC's inability to determine which depositors were covered by deposit insurance and inform depositors in a timely manner fueled a bank run when the FDIC closed Indy Mac in July 2008. For a concurrent local news report see, <https://www.youtube.com/watch?v=IVRgZ9LizZQ>

⁶⁹ These losses are instead transferred to the deposit insurance fund.

⁷⁰ While Wachovia was on the verge of failure, it was acquired without being placed under FDIC receivership.

hypothesis.^{71,72} On September 15, 2008, Lehman Brothers filed for bankruptcy, and its filing was followed by additional financial institution failures, mergers, and numerous government bailout programs.

Except in one special and relatively minor case, the Lehman failure did not generate losses that directly caused other large financial institutions to fail. A coincidence in the timing of events does not establish causality, and indeed, the causality is probably reversed. It is likely that the Lehman Brothers bankruptcy was not the cause of the financial crisis; rather, the Lehman Brothers bankruptcy and other SIFI failures and near failures were jointly caused by a deepening financial crisis that began more than a year earlier.⁷³ The latter interpretation is consistent with testimony of Chairman Dimon of JPMorgan Chase,⁷⁴

“I didn’t think it [Lehman bankruptcy] was so bad. I hate to say that. . . . But I [thought] it was almost the same if on Monday morning the government had saved Lehman. . . . You still would have terrible things happen. . . . AIG was going to have their problems that had nothing to do with Lehman. You were still going to have the runs on the other banks and you were going to have absolute fear and panic in the global markets. Whether Lehman itself got saved or not . . . the crisis would have unfolded along a different path, but it probably would have unfolded.”

OLA is based on the presumption that a disorganized SIFI bankruptcy causes large losses that disrupt financial markets and endanger the solvency of other connected financial institutions. There is no question the Lehman bankruptcy was disorganized. Lehman management did not seriously consider bankruptcy or initiate any bankruptcy planning in large part because Lehman management believed the firm would be rescued by the government.⁷⁵ It did not hire bankruptcy council until September 10, 2008, or begin to prepare a bankruptcy petition until September 11.⁷⁶

⁷¹ The only direct failure tied to the Lehman bankruptcy was the failure of an institution-only money market fund, the Reserve Primary Fund. Fund shareholders eventually recovered more than 98 percent of their investment.

⁷² There are many examples that claim that the Lehman Bankruptcy was an important contributing cause of the financial crisis. See for example, FDIC (2011), pp.3-4, or Federal Reserve Chairman Bernanke’s testimony before the FCIC, Hearing on Too Big to Fail: Expectations and Impact of Extraordinary Government Intervention and the Role of Systemic Risk in the Financial Crisis, session 1: The Federal Reserve, September 2, transcript, p. 78.

⁷³ When Lehman Brothers failed without a government rescue in September 2008—the failure did not directly drag down any other significant financial firm, even though Lehman was one of the largest nonbank financial institutions in the US. The chaos following Lehman’s bankruptcy reflected the government reversal on its policy of rescuing large financial firms (the Bear Stearns rescue in March 2008 and Fannie Mae and Freddie Mac rescue earlier in September). This reversal shattered investor expectations who responded by hoarding cash, shunning financial institution exposure, and draining liquidity from the financial system.

⁷⁴ James Dimon interview by Financial Crisis Inquiry Commission, October 20, 2010.

⁷⁵ See the discussion in Valukas (2010), p. 718.

⁷⁶ Valukas,, p. 719.

Lehman's failure to adequately plan for bankruptcy has been estimated to have cost its bankruptcy estate as much as \$75 billion.⁷⁷ But Lehman's failure to plan for an orderly bankruptcy filing has not been identified as a casual factor in the failure of any Lehman counterparty.^{78,79} To the contrary, Lehman's managerial failure to plan for the most advantageous bankruptcy possible for its shareholders and creditors is estimated to have *saved* Lehman's counterparties an estimated \$75 billion in immediate losses.⁸⁰

The only sizeable institution to directly fail as a consequence of its exposure to Lehman Brothers was an investment fund—an institution-only money market fund—the Reserve Primary Fund. This high-risk money market fund had a significant concentration in Lehman Brothers commercial paper.⁸¹ Lehman's default triggered a run by the Reserve Primary's institutional investors. The run caused the fund to “break the buck” which forced the fund to liquidate under Securities and Exchange Commission regulations. While this failure is often discussed as if it was a singular traumatic event for the mutual fund industry, to keep this event in proper perspective it is important to remember the Reserve Primary Funds remaining shareholders quickly recovered more than 98 percent of their investment.⁸²

The Lehman failure did trigger a number of legal complications associated with the closeout of derivative positions. Most of these complications can be traced to the lack of legal experience and undeveloped case law on issues related to the exercise of ISDA master agreement close-out

⁷⁷ Valukas, p. 725.

⁷⁸ Reportedly, \$468 million in customer assets were temporarily seized in the wind-down of Lehman broker-dealer operations. These assets were returned in February 2009. This “disorderly” aspect of the Lehman failure has not been identified as a cause of and specific knock-on failures. See FDIC (2011), p. 4.

⁷⁹ The bankruptcy filing by Lehman Brother parent company subsequently triggered a SPIA liquidation of Lehman Brothers US broker-dealer subsidiary. The SPIA liquidation process returned 100 percent of the broker-dealer's customer collateral without any loss to the SIPC insurance fund. See, <http://www.sipc.org/news-and-media/news-releases/20130607>

⁸⁰ These bankruptcy losses from lack of proper planning should have been collected and made available to Lehman creditors. But these losses to Lehman creditors are gains to the Lehman counterparties who would have had to make payments or returned collateral in a well-organized bankruptcy.

⁸¹ See, Ozgur, Griffiths and Winters (2015).

⁸² The run on mutual funds in the wake of Lehman Brothers default did not occur in a vacuum. The commercial paper market had already experienced a severe crisis the prior summer when default rates in the subprime mortgage backed securities caused investors to withdraw from investing in asset-backed commercial paper issues. See Covitz, Liang, and Suarez (2013).

clauses. These issues would have arisen the first time any significant derivatives dealer failed. It just so happens the first significant derivatives dealer-failure happened to be Lehman Brothers.⁸³

Under ISDA Master Agreements that govern derivative transactions between counterparties, the default of a counterparty triggers a close-out netting process that unwinds the failing counterparty's derivative positions. In theory, bankruptcy should trigger a process where all contracts to the failing counterparty under an ISDA master agreement are valued and netted. If the failing counterparty is owed money after netting, the claim is registered against the bankruptcy estate; if a counterparty owes money to the bankrupt estate, it must be promptly paid.

In reality, close-out netting is not so orderly. The Lehman estate had many ISDA master agreements. Derivative positions had to be netted under the correct master agreement, which, in many cases may not have been immediately obvious.

A second issue was, because there are multiple closeout options, it was a strategic decision to choose the contract termination process that had the most beneficial implication for a counterparty. ISDA master agreements have two protocols. One—automatic early termination—includes no optionality; all contracts with this clause terminate when one of the counterparties experiences an event of default. The second ISDA protocol gives the non-defaulting counterparty the option of early termination. If the derivative contract has a positive mark-to-market value to the bankrupt estate, the non-defaulting counterparty may choose not to terminate the contract to avoid making a close-out payment.

There are other closeout choices that can be used by counterparties to impact the closeout payoff or liability to the bankruptcy estate. ISDA master agreements provide for a number of alternative valuation methods including specific dealer quotes, a mid-market method, and a loss method that utilizes model-based valuation. In the Lehman close-out netting process, because of the on-going financial crisis, derivative market liquidity evaporated. The lack of transparent verifiable transactions prices made the choice of a close-out valuation method especially important.

In the absence of liquidity, derivative bid prices fell far more than asked prices, lowering mid-market valuations. Specific dealer quotes for an in-the-money derivatives might also be

⁸³ Bear Sterns derivative positions were not subject to ISDA close-out procedures as Bear did not fail before it was absorbed by JP Morgan Chase.

abnormally low because of excessive dealer risk aversion, sometimes called “fire sale conditions,” which are reflected in lower bid prices. The final acceptable valuation approach is model-based valuation. In practice, model-based valuation is very flexible and can produce a wide range of “reasonable” close-out valuation estimates.

The multiplicity of derivative close-out valuation options added to the complexity of the Lehman close-out process. The Lehman bankruptcy trustee has argued that many Lehman counterparties “gamed” their valuation estimates to overstate the amount that Lehman owed them or to reduce the amount the counterparties owed to the Lehman bankruptcy estate. For example, in one case, a counterparty that owed Lehman in the close-out used the dealer quote method to value its positions whereas Lehman argued that the positions should have been valued using the mid-market method. The mid-market method would have produced a significantly larger payment to the bankruptcy estate.⁸⁴

The closeout of Lehman derivative positions with structured finance vehicles—CDOs and other securitizations—also created legal issues. Many structured finance products are backed by collateral pools but they also include derivatives positions to hedge or enhance specific risk characteristics. The normal cash flow waterfalls associated with structured finance vehicles account for normal expected derivative contract payment liabilities in the highest claim priority tranche—payments that must be made before allocating cash flows to investors. However, when cash flow are generated by the default of a derivative counterparty, the payment priority in many structured products was designed to change.

Many CDOs and securitizations included “flip clauses” that lowered the priority of cash payments to derivative counterparties if the payments were generated by the default of a derivative counterparty. Without flip clauses, should a derivative be “out of the money” when the derivative counterparty defaults, the structured vehicle could be required to make large unscheduled payments to the bankrupt counterparty’s estate. Without a flip clause, this unscheduled payment erodes the claims priority of the structured product’s senior investors.

Flip clauses became an important legal issue in the Lehman bankruptcy. UK courts had recognized the validity of structured financial product flip clauses, but when the issue was

⁸⁴ See, *Michigan State Housing Development Authority v. Lehman Brothers Derivatives Products Inc. and Lehman Brothers Holdings Inc. (In re Lehman Brothers Holdings Inc.)*, [2013 WL 6671630 \(Bankr. S.D.N.Y. Dec. 19, 2013\)](#).

litigated in the United States, the court ruled that these clauses are not enforceable.^{85, 86}

Subsequent to this ruling, the Lehman estate initiated a class action law suit in the United States to recover as much as \$3 billion from structured investment vehicle counterparties that had exercised flip clauses to calculate close out valuations.⁸⁷

In summary, there is little question that the Lehman Brothers bankruptcy was poorly planned and disorderly. However, poor planning on the part of Lehman Brothers management resulted in billions of dollars of losses to the Lehman estate, thereby *saving* Lehman's counterparties an equal amount of losses. A more efficient bankruptcy filing would have imposed much larger and more immediate losses on Lehman's financial counterparties, potentially weakening their post-bankruptcy financial condition.⁸⁸ It is difficult to see how a more efficient Lehman bankruptcy would have improved financial stability.

The Lehman Brothers derivatives close-out process generated substantial litigation, but the litigation would have been created by the failure of any sizable derivatives dealer given the untested nature of the ISDA close-out process. For the most part, the litigation has been focused on the Lehman estate collecting additional funds from derivative counterparties. So again, for many counterparties, the extended derivatives litigation lessened the immediate loss and financial shock generated by the Lehman bankruptcy. On balance, there is little if any evidence that suggests that a more orderly Lehman Brothers bankruptcy would have lessened the severity of the prior financial crisis.

10. TBTF Expectations and FRB Exemptions from Section 23A and 23B Rules

The FRB "source of strength doctrine" is, in part, a tacit FRB admission that parent holding company shareholders accrue government safety net benefits from controlling the shares of a subsidiary insured depository institution. In return for these benefits, the FRB expects BHC

⁸⁵ The UK Supreme Court upheld the validity of flip clauses in *Belmont Part Investments PTY Limited (respondent) v. BNY Corporate Trustee Services Limited and Lehman Brothers Special Financing Inc.* (appellant) [2011] UKSC 38.

⁸⁶ See, *Lehman Brothers Special Financing Inc. v. BNY Corp. Services Ltd.*, Case No. 08-13555, Adv. No. 09-01242 (*Bankr. S. D.N. Y. Jan 25, 2010*).

⁸⁷ "Lehman Seeks to Force Defendant Class in \$3B Derivative Suit," *Law360*, October 28, 2014.

⁸⁸ The losses to the Lehman estate caused a single failure. It is possible that should the bankruptcy have been better planned, the estate could have recovered additional value from counterparties and turned these over to creditors including the Reserve Primary Fund. The financial stability impact of a more efficient bankruptcy filing would depend on whether the additional recovery by the Lehman estate would have prevented the Reserve Primary Fund from defaulting and simultaneously would not have caused any other Lehman counterparties paying these claims to default.

shareholders to inject new capital should a subsidiary depository institution become undercapitalized.

The source of strength contingent call on parent holding company capital is, in effect, the price the parent BHC's shareholders are expected to pay for access to subsidized funding through their subsidiary bank(s). Sections 23A and 23B, incorporated into the Federal Reserve Act by Congress in 1933, are rules intended to limit the ability of a parent BHC and its nonbank affiliates' to extract safety net benefits from the BHC's subsidiary insured depository institutions.

Section 23A restricts a depository institutions exposure in "covered transactions" with its BHC "affiliates." "Covered transactions" and "affiliates" are carefully defined in the amended Federal Reserve Act or by subsequent FRB regulations. Regardless, the definition of "affiliates" and "covered transactions" both include many specific exemptions.

Section 23A limits covered transactions with a single affiliate to 10 percent of the depository institution's capital stock and surplus. Total exposure to all affiliates is limited to 20 percent.⁸⁹ Section 23A prohibits the purchase of "low quality assets" from affiliates.⁹⁰ It requires that extensions of credit to affiliates be adequately collateralized at initiation, but it exempts loans and guarantees that are collateralized by US government obligations from the definition of covered transactions. Section 23A has a "catch-all" requirement that that all affiliate transactions be consistent with safe and sound banking practices.⁹¹

Section 23B requires that any transactions with affiliates involving covered transactions be conducted on terms that are at least as favorable to the depository institution as the terms that would be available to the depository in an identical transaction with an unaffiliated counterparty.

Following the passage of the Gramm-Leach-Bliley Act, the Federal Reserve Board issued Regulation W to provide rules and procedures that clarify the FRB's enforcement of Section 23A

⁸⁹ "Covered transactions" include extensions of credit and guarantees, the purchase of an affiliate's securities, and the purchase of affiliate assets unless there is an active market for these assets and they are purchased at the market price. Section 23A explicitly excludes from cover assets the purchase of nonrecourse loans from affiliates.

⁹⁰ Low quality assets are defined as assets classified as substandard, doubtful, loss, or special mention, assets that are in nonaccrual status, assets that are more than thirty days past due, or an assets with terms that have been renegotiated due to a deterioration in the financial condition of the obligor [Federal Reserve Board, Regulation W; Docket No. R-1130, p. 27].

⁹¹ Section 23A restriction are given in 12 U.S.C. § 371c.

and 23B restrictions.⁹² Prior to issuing Regulation W, the FRB had no formal public guidance on its interpretation and enforcement of Section 23A restrictions.

Regulation W defines “capital stock and surplus,” which, up to that point, had not had a clear legal definition. In addition, Regulation W clarifies which institutions are included as affiliates. Importantly, when it issued regulation W, the FRB did not include “Special Purpose Entities” in the definition of affiliates:

Due to complexities of this issue and the pending proposal by the Financial Accounting Standards Board (“FASB”) on the consolidation of SPEs, the Board [FRB] is deferring at this time any rulemaking with respect to the relationships between member banks and SPEs.⁹³

This omission, which remained in place throughout the crisis,⁹⁴ allowed banks to create large uncontrolled exposures by extending liquidity and credit guarantees to affiliate SPEs that issued subprime MBS and CDOs to outside investors.⁹⁵

Regulation W excluded derivatives, other than credit default swaps, from the definition of covered transactions, but requires that all derivative transactions comply with Section 23B rules:

Banks are expected to: “have policies and procedures to monitor and control the bank’s credit exposure to affiliates in derivative transactions (...) and insure that its derivative transactions with affiliates comply with Section 23B.”⁹⁶

The reasoning behind excluding derivatives, other than credit derivatives, was to allow the BHC to use derivatives to hedge its exposure on a consolidated basis.

The derivative exemption allowed substantial uncollateralized exposures between banks and affiliated companies. By excluding derivatives from Section 23A limits, the failure of a nonbank affiliate could endanger the solvency of the BHC bank subsidiary if the bank had taken a large position on behalf of the affiliate.⁹⁷ In this case, the FRB was effectively relying on its

⁹² Regulation W [12 CFR Part 223] became effective April 1, 2003.

⁹³ Federal Reserve Board, Regulation W; Docket No. R-1130, p. 20.

www.federalreserve.gov/boarddocs/press/bcreg/2002/20021127/attachment1.pdf

⁹⁴ The first amendment to Regulation W listed on the Federal Reserve Board’s website was a temporary exemption that allowed banks to extend credit for securities financial transactions with affiliates effective September 14, 2008.

⁹⁵ BHCs also developed guarantee contracts that minimized or even avoided any regulatory capital requirement for SPE guarantees. See, for example, the discussion in Acharya, Schnabl and Suarez (2013).

⁹⁶ FRB, Docket No. R-1130, p. 70.

⁹⁷ For example, the bank might enter into an energy derivative contract with an energy trading affiliate, and then do a back-to-back transaction with an outside dealer, which except for credit risk, hedges the bank’s energy exposure from the affiliate trade. The energy affiliate might prefer this indirect method of trading if the bank gets more favorable derivative terms (on price or collateral) due to its more favorable external credit rating.

consolidated supervision and source of strength powers—not Section 23A limits—to ensure that an insolvency at a BHC nonbank affiliate did not endanger the group’s consolidated performance on positions with external counterparties.⁹⁸

Regulation W also allows the FRB to grant discretionary exemptions from Rule 23A and 23B.⁹⁹ To request a Section 23A exemption, an institution must: (i) explain the details of the transactions and its relationship with affiliates; (ii) explain the rationale for requesting the exemption; and, (iii) explain why the exemption is in the public interest and consistent with the purposes of the law. Regulation W does not explain the requirements for requesting a Section 23B exemption.

Furthermore, there is no publicly available comprehensive record of FRB decisions regarding bank specific requests for Section 23A exemptions.¹⁰⁰ Decisions are taken informally through preemptive orders, interpretive issuances¹⁰¹ and through private communications with the banks. Bank requests for specific exemptions that are unlikely to be approved are discouraged informally at an early stage. As a consequence, there is little if any public information on specific exemption requests that the FRB declined to approve.

Table 1 provides a summary of the publicly available information on Section 23A exemptions granted by the FRB over the period 2003-2009. Exemptions may be required when a bank extends credit to an affiliate that exceeds Section 23A limits or when it purchases the securities issued by an affiliate or purchases assets from an affiliate other than assets or affiliates that are explicitly exempt from Section 23A.¹⁰² Merging an affiliate into a member bank is considered a “purchase of assets” and can trigger Section 23A limits.¹⁰³ Section 23A expressly prohibits a bank from purchasing low quality assets from an affiliate.

⁹⁸ Market participants did not rely solely of FRB source of strength assurances. Instead it is common to require cross guarantee provisions in the ISDA agreements between the parent BHC and affiliates to ensure group performance on consolidated derivative positions.

⁹⁹ The authorizing law allows the FRB to make such exemptions [12 U.S.C. § 371c(f)(2) and § 371c-1(e)(1)].

¹⁰⁰ This section borrows from Omarova (2011) and her extensive research on FRB Section 23A exemptions.

¹⁰¹ For example some of the specific requests for interpretations of Section 23A and 23B rules are posted in the FRB’s *Legal Interpretations*, <http://www.federalreserve.gov/boarddocs/legalint/>

¹⁰² For example, a bank purchase of assets from a wholly-owned subsidiary of the bank are not subject to Section 23A restrictions because the bank’s consolidated position already includes exposure to its subsidiaries’ assets.

¹⁰³ FRB, Docket No. R-1130, p. 30.

Between 2003 and 2006, the entries in Table 1 show that the FRB approved a number of Section 23A exemptions that allowed banks to move potentially risky assets from affiliates into BHCs' large insured depository institutions. The data show that Citibank was the beneficiary of a number of these exemptions. HSBC and GMAC also received exemptions to consolidate potentially risky assets into their insured depositories.

In the case of Citibank, the multiple 23A exemptions granted by the FRB allowed high risk assets, including nearly \$20 billion in subprime mortgages assets, to be transferred from nonbank affiliates into Citibank, the largest insured bank subsidiary in Citigroup.¹⁰⁴ All of the exemption requests in Table 1 were reviewed by the OCC and FDIC, including the Citibank exemptions, and neither the OCC nor the FDIC raised objections to any of these transactions.

Another notable pattern in the exemptions data reported in Table 1 is the number of exemptions granted for securities lending operations. Two distinct kinds of exemptions were granted, and the dual character of these exemptions is informative.

¹⁰⁴ John C Dugan, Comptroller of the Currency, Statement before the Financial Crisis Inquiry Commission, April 8, 2010.

Table 1: Publicly Available Information on Section 23A Exemptions, 2003-2009

Date	Bank receiving exemption	Reason for Section 23A exemption
27-Feb-03	Citibank	to acquire Citimortgage, Inc. St Louis
14-Aug-03	Valley Independent bank	to purchase loans from a Dutch affiliate bank
19-Nov-03	Bank of Wausau	to purchase premises from an affiliate
22-Dec-03	First Alliance Bank	to acquire AMC acquisition, Inc
29-Dec-03	HSBC Bank USA	to purchase mortgages from affiliates
10-Feb-04	Merrill Lynch Bank	to acquire Merrill Lynce Private Finance Inc
14-May-04	Citicorp Trust Bank	to acquire Citi Financial Mortgage Co. Inc., St Louis
7-Jul-04	GMAC Bank	to acquire mortgages from GMAC Commercial Holding Corp
22-Dec-04	HSBC Bank USA	to acquire assets from Household International Inc
1-Apr-05	Preferred Bank	to acquire assets from Klein Financial
8-Apr-05	Omni National Bank	to purchase aircraft from affiliate
5-May-05	Bank of New York	to extend credit to securities affiliate to support securities lending
7-Jun-05	Bank of America, NA	to extend credit to securities affiliate to support securities lending
3-Oct-05	Banco Popular de Puerto Rico	credit to customers secured by shares in an affiliate
25-Oct-05	Citibank	to enter into tax-sharing agreement with Australian affiliate
22-Nov-05	Charter One Bank	to acquire RBS Asset Finance, Inc
22-Nov-05	FirsTier Bank	to purchase premises from affiliate
1-May-06	Legg Mason Trust Co	to acquire Legg Mason Investment Counsel, Inc
30-Jun-06	Citibank	to acquire Citi Financial Mortgage Co. Inc. Irving Texas
29-Sep-06	Wachovia Bank	to extend credit to securities affiliate to support securities lending
24-Oct-06	E-Trade Bank	to acquire all the shares in E-Trade Clearing Corp
23-Jan-07	Bank of America, NA	to extend credit to securities affiliate to support securities lending
12-Jun-07	Wachovia Bank	to extend credit to securities affiliate to support securities lending
20-Sep-07	Citibank	to extend credit to securities affiliate to support securities lending
20-Sep-07	Bank of America, NA	to extend credit to securities affiliate to support securities lending
20-Sep-07	JPMorgan Chase, NA	to extend credit to securities affiliate to support securities lending
12-Oct-07	Deutsche Bank	to extend credit to securities affiliate to support securities lending
11-Nov-07	Barclays Bank, PLC	to extend credit to securities affiliate to support securities lending
12-Nov-07	Royal Bank of Scotland	to extend credit to securities affiliate to support securities lending
23-Nov-07	Citibank	to extend credit to securities affiliate to support securities lending
21-Dec-07	Capital One NA	to acquire all the shares of Capital One Autofinance, Plano TX
25-Mar-08	Minnwest Bank Metro	to acquire all shares in two non bank affiliates
1-Apr-08	JPMorgan Chase	to extend credit to Bear Sterns affiliates
19-May-08	Merrill Lynch Bank	to extend credit to Merrill Lynch mortgage affiliate
26-Jun-08	JPMorgan Chase	to exempt covered transactions with Maiden Lane LLC
23-Jul-08	generic	letter clarifying Board's position on affiliate status
6-Oct-08	redacted	to exempt purchases of assets from an affiliate MMMF
29-Oct-08	Wells Fargo Bank	purchase assets and loan commitments from nonbank affiliates
20-Nov-08	Wells Fargo Bank	to exempt extension of credit to Wachovia Bank National Assoc.
24-Nov-08	Union Bank and Trust	to exempt purchase of student loans from affiliates
1-Dec-08	redacted	to exempt purchases of assets from an affiliate MMMF
24-Dec-08	GMAC Bank	to exempt credit extended to affiliate autodealers
29-Dec-08	Wachovia Bank	to exempt purchase of auctionrate securities from affiliates
9-Jan-09	BB&T	to exempt purchase of auctionrate securities from affiliates
9-Jan-09	Northern Trust Bank	to exempt purchase of auctionrate securities from affiliates
12-Jan-09	GE Money Bank	to allow asset purchase from an affiliate
14-Jan-09	HSBC Bank USA	to allow asset purchase from an affiliate
30-Jan-09	Fifth Third Bank	to exempt purchase of auctionrate securities from affiliates
31-Mar-09	ING Bank	exempt credit extended to transfer ownership of MBS to an affiliate
13-Apr-09	CIT Bank	to acquire all assets of 3 affiliates
22-Apr-09	Morgan Stanley	to transfer assets to a subsidiary bank
22-Apr-09	Goldman Sachs	to transfer assets to a subsidiary bank
21-May-09	Ally Bank	to exempt credit extended to affiliate autodealers
23-Jun-09	First Farmers and Merchants State Bank	to acquire premises from an affiliate

Source: Federal Reserve Board Legal Interpretations of the Federal Reserve Act,
<http://www.federalreserve.gov/bankinfo/LegalInterpretations/legalinterpretations.htm>

Exemptions granted in 2005, prior to the financial crisis, facilitated securities transfers within the BHC group. For instance, one exemption allowed a trust bank to lend securities to affiliates who would in turn lend these securities to customers or use them in broker-dealer proprietary transactions.¹⁰⁵ In a second exemption granted in 2005, the bank was allowed to borrow securities from its affiliate broker-dealer so the bank could engage in proprietary trading and hedging activities.

From August 2007, the exemptions for securities financing transactions allowed affiliated broker-dealers to provide customers with loans collateralized by securities. The affiliated broker-dealers in turn would use securities to collateralize borrowing from an affiliated bank. These Section 23A exemptions coincided with the FRB's emergency 50 basis point reduction in the discount rate and the extension of discount window loan maturity from overnight to thirty days.¹⁰⁶ The link between Section 23A exemptions and emergency Fed liquidity became even more pronounced when the FRB created the Term Auction Facility in December 2007. This allowed banks to use pledged securities to access emergency funds without the "stigma" of discount window borrowing.

Thus, using its Section 23A exemption powers, the FRB provided emergency liquidity support to broker-dealers owned by large BHCs when the subsidiary bank had an approved exemption. At the same time, the Fed was *not* providing exceptional liquidity support to broker-dealers who were not affiliates of an FRB-regulated BHC, or did not ask for the exemption.¹⁰⁷ Eventually, the FRB created the Primary Dealer Credit Facility, a facility that would allow primary broker-dealers direct access to emergency Fed liquidity, but not until March 17, 2008, after the distress-sale of Bear Sterns took place. Goldman Sachs, Morgan Stanley, Merrill Lynch, Bear Sterns and Lehman Brothers all owned depository institutions and presumably could have asked for Section 23A exemptions for securities financing transactions to support their broker-dealer subsidiaries.¹⁰⁸

¹⁰⁵ For example to short-sell securities or to use in structured arbitrage trading strategies.

¹⁰⁶ Federal Reserve Board Press Release, August 17, 2007.

¹⁰⁷ Since the FRB does not publicly report on Section 23A exemption requests that it has denied, we do not really know if any other banks asked for Section 23A exemptions to support nonbank affiliates, but had their request denied by the FRB.

¹⁰⁸ In many cases, these institutions owned Industrial Loan Corporations supervised by the FDIC. Presumably these depository institutions could have asked for a Section 23A exemptions. Because the Board does not publish notices of exemption request denials, it is unknown whether these depositories requested exemptions and were discouraged

As the financial crisis progressed, the FRB used Section 23A exemptions repeatedly to allow banks to access Federal Reserve emergency liquidity and pass this liquidity on to support nonbank affiliates. This emergency provision of credit exposed banks beyond the limits Congress established in Section 23A legislation. These programs funneled emergency Federal Reserve liquidity support into bank affiliated money market mutual funds, asset-backed commercial paper conduits and other affiliated special purpose entities, as well as to broker-dealer affiliates that sponsored auction rate securities. This exceptional special liquidity support was not widely available and, according to the publically available record, was only made available to nonbank affiliates of a FRB-regulated BHC when the subsidiary bank asked for, and received, an FRB Section 23A exemption.

The FRB granted several other Section 23A exemptions to facilitate (*ex post*) the distressed sale “bailouts” of Bear Sterns, Wachovia, Merrill Lynch and GMAC/Ally Bank. In three of these cases, the FRB determined that it was in the public interest to waive section 23A limits to allow these distressed sales to create the largest TBTF institutions that exist to this day. The GMAC exemption was required to facilitate the bailouts of General Motors and Chrysler Corporations.

In many cases, the FRB exemptions granted in Section 23A included conditions that closely mimicked the FRB’s “source of strength doctrine.” The parent BHC was required to guarantee the financial health and capital adequacy of the bank as a condition for granting the Section 23A waiver. While the conditions for granting a waiver varied according to the type of transaction generating the request, conditions often included: bank exposure must be secured by high quality collateral; the exempted transaction must satisfy Section 23B; “low quality assets” must be offset with a transfer of cash or government securities; a parent pledge to repurchase any transferred assets that subsequently become “low quality” for a period up to two, and in some cases five years; a requirement that the bank and the parent BHC remain well-capitalized after the transaction.

The DFA included a number of amendments related to Section 23A. First, § 608 and § 611 require all derivatives to be included as Section 23A covered transactions. Other clauses in

from formally asking for an exemption, or whether perhaps they did not need an exemptions because their customer loan demand was not sufficient to test Section 23A limits. Discussions with knowledgeable industry professional who worked for the non-BHC institutions suggest that the former explanation is probably closer to describing the events that actually transpired, but there is no formal publically available record on these events.

§ 608 requires that Section 23A transactions be fully collateralized at all times, not just when the transaction is initiated. Section 608 also transfers exemption powers to the FDIC and the OCC when they are the primary federal regulator of the bank. Section § 608 also gives the FDIC the power to stop any exemption that would create undue risk for the deposit insurance fund. Section 609 eliminates the exemption of covered transactions between a bank and its subsidiary. The Volker Rule, § 619, prohibits (or severely limits) banks and their affiliates' ability to conduct proprietary trading or have ownership interests in a hedge fund.

Some of these DFA amendments place important limitations on the ability to transfer implicit insurance subsidies from banks to nonbank affiliates using Section 23A exemptions. Should the FDIC actually exercise its power to veto Section 23A exemptions, it could potentially be an important constraint.

Among the DFA changes to Section 23A, the Volcker rule almost certainly places new limits on a BHC's ability to exploit the implicit government guarantee. However, the new requirement to include all derivatives as covered transactions may have less of an impact than first appearances might suggest. Regulatory authorities have indicated that they intend to protect all legitimate derivative transactions in an OLA resolution, and large bank FDIC resolutions virtually always protect derivative transactions. Consequently, SIFI derivative counterparties are likely to be protected in a SIFI transactions regardless of whether the counterparty is the bank or a nonbank affiliate.¹⁰⁹

11. Should Investors Think Large BHCs and Non-Bank Designated Intuitions are TBTF?

The discussion in Section 9 shows that large nonbank financial institutions can fail in bankruptcy, even in a disorganized bankruptcy, in the midst of a financial crisis, and the bankruptcy need not cause a cascade of other financial institution failures. The claim that large financial institutions are TBTF because they cannot be reorganized or liquidated in a judicial bankruptcy process without causing a financial crisis is not supported by the historical facts.

The primary source of investor TBTF expectations is the design of our system of financial sector supervision and regulation. Overreliance on consolidated supervision and regulation encourages creditors and counterparties to view transactions with SIFIs as though they backed by the entire

¹⁰⁹ For additional details, see Kupiec (2014).

resources of a holding company instead of the resources of the single legal entity counterparty in the transaction. This belief is reinforced by the FRB's long-standing insistence that a parent BHC's entire resources will be made available, if necessary, to support the liabilities and creditors of a failing bank subsidiary.

The discussion of the FRB's "source of strength doctrine" in Section 6 and the FRB's history of Section 23A exemptions in Section 10 show how the FRB's past approach to consolidated supervision creates a rational investor perception that parent holding company capital and perhaps even emergency Federal Reserve liquidity support may be available to support the operations of bank and nonbank affiliates of FRB-supervised BHCs. Without extensive exemptions from Section 23A limits and emergency liquidity measures, the fate of the broker-dealers and other non-bank affiliates of some of the largest BHCs may have been different in the last financial crisis.

The DFA reinforces this source of TBTF expectations by "codifying" the FRB source of strength doctrine in multiple sections of the act and seemingly expanding this doctrine (if only imperfectly in the legislation) to cover nonbank affiliates of the largest BHCs and designated nonbank SIFIs subject to heightened FRB supervision. Moreover, the OLA-SPOE approach to resolution expands on the source of strength idea and promises to protect all the creditors and counterparties of a failing SIFI's "critical operating subsidiaries." The DFA requirements that the FRB impose heightened prudential capital standards, conduct annual SIFI stress tests, and be the guardian of financial sector stability only reinforces the perception that the largest financial firms will get special assistance to prevent their failure.¹¹⁰

Expectations that SIFI investors will benefit from special government protections in the future are fully rational. In the past, regulators have taken extraordinary measures to keep SIFI subsidiaries, especially large bank subsidiaries, open and operating when they otherwise might have failed. The DFA does not remove the FRB's discretionary power or its incentives to

¹¹⁰ Since, post DFA, virtually all large important financial firms are either large BHCs or designated SIFIs under heightened prudential supervision by the FED, and virtually of these institutions have a depository subsidiary, it is unclear why the FRB would still need Section 13(3) emergency lending powers. Should there be a next financial crisis, the FRB could instead do what it did in the last crisis— provide emergency liquidity to bank subsidiaries and waive Section 23A affiliate lending limits.

provide emergency assistance to keep one of its distressed SIFI clients from failing.¹¹¹ FDIC's bank resolution process is still in place—a process that protects all deposits in large failing banks, but not in small failing banks. And should the Secretary of the Treasury use OLA to “liquidate a distressed SIFI, the FDIC is likely to fully protect the creditors of large bank and other critical operating subsidiaries.

Some readers think it unfair to identify the FRB's Section 23A exemptions granted in the last financial crisis as a source of the TBTF problem. The FRB was of course acting in good faith to try to prevent an economic collapse. However, it is also undeniable that these preferential regulatory actions—which were only available to a select group of financial institutions regulated by the FRB—provided credit to nonbank affiliates at Federal Reserve window discount rates (not true market rates). This emergency support undoubtedly aided the nonbank affiliates that received it. Indeed some might have failed without this support. The TBTF problem arises when one group of distressed financial institutions receives special government support without charge and this support is withheld from other similar institutions. So regardless of whether this support was “in the public interest” at that time, without doubt, it helps to create the TBTF problem.

On balance, there is little wonder that investors treat SIFIs as TBTF. In its roles as lender of last resort, supreme macro prudential regulator, and the consolidated regulator of the largest financial institutions, the FRB has been given conflicted mandates. How can the FRB let a SIFI fail when it is charged with ensuring that its client SIFI's are ultra-safe? In the past, the FRB has taken extraordinary measures to keep the affiliates of the SIFIs it regulated, open and operating. The FRB and companion bank regulators still have the power to grant Section 23A exemptions. Would anyone stop the FRB, OCC or FDIC from granting temporary Section 23A exemptions to save SIFI affiliates in the next financial crisis?

¹¹¹ Before objecting to my word selection, let me point out that Merriam-Webster defines client as “one that is under the protection of another.”

12. Conclusion

The DFA Orderly Liquidation Authority has not ended TBTF. OLA has serious legal issues that may prevent it from being used, especially in the case of a large failing bank. So, even with the DFA, the FDIC may again be forced to sell a large failing bank to a large healthy BHC, protecting all depositors and creating a new TBTF institution.

Ending TBTF requires regulatory reform. The necessary reforms include: (i) increasing minimum regulatory capital requirements for depository institutions and critical functionally-regulated subsidiaries; (ii) increasing prompt corrective action intervention triggers; (iii) requiring mandatory contractual safeguards to ensure that banks and functionally regulated subsidiaries are not overly exposed to affiliates and do not depend on parent SIFIs for employees or critical services that could be suspended in bankruptcy; (iv) modifying the FDIC “least cost” resolution mandate to require the break-up of large failing banks; (v) removing the FRB-centric approach to consolidated supervision and capital regulation; and, (vi) relaxing the DFA heightened prudential capital requirements to allow parent holding companies to meet higher prudential subsidiary capital requirements by issuing debt at the parent holding company.

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