FedFin Client Report

Thursday, February 22, 2018

FedFin Assessment: OLA in the Trump Administration

Client Report: **RESOLVE47**

Executive Summary

In this report, we build on our prior alert on Treasury's latest reform report focused on ways to redesign resolutions in crises that threaten financial-market stability. Treasury's approach includes a new Chapter 14 of the Bankruptcy Code to handle most, if not all, of these cases along with a series of changes designed to ensure that any resolution costs the market, not taxpayers. Although the President last April (see Client Report **RESOLVE44**) rejected use of Dodd-Frank's orderly-liquidation authority (OLA) and Secretary Mnuchin cast considerable doubt on whether Treasury would ever authorize it, the new report stands by OLA even as it recommends significant changes to reduce the chances of creditor, counterparty, or acquirer advantage. As we noted following the April action, the Administration's stand at the time led regulators around the world to increase demands that U.S. operations in their nations be ring-fenced or otherwise subsidiarized to ensure orderly resolution. It was also feared that ambiguities over OLA would exacerbate panics should any large American financial institution show signs of weakness. With this report, Treasury has conceded to international and industry pressure, rejecting arguments voiced by Chairman Hensarling (R-TX) and other conservative Republicans who have long sought to repeal this Dodd-Frank provision. It is unclear if this new Treasury policy will soften subsidiarization demands, which have taken on a life of their own in the wake of Brexit. They do, however, chart a path not only to changes the FDIC may well make under new leadership, but also statutory changes possible should there be any House-Senate finreg conference following Senate action on pending reform legislation (see Client Report **SIFI25**).

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Analysis

Chapter 14

Following a more complete understanding of Dodd-Frank's limitations after the law was implemented, the Obama Administration recommended and the House has repeatedly passed changes to the Bankruptcy Code to handle automatic stays for qualified financial contracts (QFCs) in stress scenarios. Treasury's report supports this broad goal but lays out a technically different approach through creation of a new Chapter 14 to the Code. The differences between these approaches are complex, but Treasury is at pains to emphasize that it believes its approach ensures resolution without rescue. For example, "bail-in" obligations (which it calls "capital-structure debt" also known as TLAC) would be used to fund resolution at cost to debt-holders.

OLA Revisions

Recommendations here address:

- Judicial OLA review: Current law permits only 24-hour judicial review of two of the seven counts under which Treasury can agree to an OLA resolution. Treasury recommends statutory change to subject all seven of these counts to the court under the "arbitrary-and-capricious" standard. The court thus would not second guess Treasury as to the substance but would be a layer of protection against interventions some might characterize as politically-motivated rescues. Treasury also wants Congress to give the court more time to review an OLA determination after a receivership has begun. This was not included in Dodd-Frank out of fear that bridge companies then would not have their desired, stabilizing influence.
- Similarly-Situated Creditors: Treasury calls provisions in both law and rule that give the FDIC authority to differentiate among similarly-situated creditors "*ad hoc* disparate treatment" and proposes to eliminate it. The report recommends strictly following Bankruptcy Code priorities, protecting only "critical vendors" needed for the bridge company vis-à-vis otherwise seemingly comparable creditors. Although this approach addresses longstanding GOP objections to OLA as a process that would dictate winners and losers for political reasons, it also reflects criticism laid out in 2016 by senior Senate Banking Committee Democrats (see Client Report **RESOLVE43**). They argued that discretion would, for example, adversely affect small businesses serving local branches versus huge service providers to the parent bank and that bank pensioners could be

losers even though QFC counterparties would be fully protected. Under Treasury's approach, a bankruptcy court – not the FDIC – would adjudicate claims, with the FDIC perhaps being wholly excluded from this process in favor of the court. The FDIC can and indeed may well revise or repeal its current discretion (see Client Report **RESOLVE6**), but it will take a statutory change to substitute the bankruptcy court.

- Bridge Companies: Statutory change is also necessary to achieve Treasury's recommendation that bridge companies formed by OLA be tax-exempt. Treasury argues that tax exemption is a government-conferred competitive advantage (as it indeed has been in the GSE conservatorships). Tax payments to federal and state authorities will reduce the proceeds of a final disposition of the bridge company, lowering the value received by an acquirer and increasing creditor and counterparty risk. This would also be the result of another Treasury recommendation – that the FDIC provide bridge-company support through guarantees or other backstops to private capital, not direct capital infusions. The choice of FDIC support vehicle is up to the FDIC, but Treasury also says that it should use its control over the Orderly Liquidation Fund (OLF) to ensure that terms and conditions of any such support are market-based. Treasury funding for the OLF to be used by the FDIC for direct support would come, the report says, only if the loan is secured by bridge-company collateral suitable for similar types of private-sector facilities. OLF loans would also be limited to fixed, short terms.
- Resolution Process: The FDIC has never issued a rule or even clear guidance on how it would use its preferred single-point-of-entry (SPOE) strategy. It issued a proposal in 2013 (see FSM Report **RESOLVE23**) on which extensive comment was filed but to which no final answers were provided. Treasury urges it to do so and also make clear when a multiple-point-of-entry approach would be required. We expect the FDIC to turn to this under new leadership, although whether clarity is in fact provided will be determined in part by the extent to which FDIC and Fed staff – long believers in "constructive ambiguity" – implement this revised approach.
- OLF Funding: Treasury recommends that the assessments to large BHCs and any designated SIFIs designed to reimburse the OLF be instituted as quickly as possible. The CBO has estimated that taxpayers could be out as much as $20 billion for an OLA resolution. Treasury's approach is designed to minimize this cost not only with the OLF terms and conditions discussed above, but also with rapid industry reimbursement.

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Treasury's report describes, but does not address several other outstanding resolution questions. These include the ongoing differences in cross-border practice most recently reiterated in an FSB consultation on bail-in obligations (see FSM Report **RESOLVE46**) and the manner in which insurance companies would be resolved given the critical importance of state guaranty associations. The Obama Administration was skeptical of their ability to do so, but Treasury does not go into this question.

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