Unedited Event Transcript

Progress Report on the Resolution of Systemically Important Financial Institutions

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Morris Goldstein: Good afternoon and welcome to the Peterson Institute for International Economics. I am Morris Goldstein. I have been a senior fellow at PIIE since 1994. Peterson’s President couldn’t be here today, so I am going to Chair today’s meeting. We are delighted to have as our speaker, Martin Gruenberg, the Chairman of the Federal Deposit Insurance Corporation.

Mr. Gruenberg has served as the 20th Chairman of the FDIC since November, 2012. Previously he held the position of Vice Chairman and member of the FDIC Board of Directors, from August, 2005. Internationally, Mr. Gruenberg has served as Chairman of the Executive Council, and President of the International Association of Deposit Insurance, from November, 2007 to November, 2012.

Before that he served as Senior Counsel to Senator Paul Sarbanes, on the staff of the Senate Committee on Banking, Houses and Urban Affairs, from 1993 to 2005. Going even farther back, Mr. Gruenberg was the Staff Director of the Bank Committee Subcommittee on International Financing Monetary Policy and he played an active role in the development of major US legislation, including FIRREA, FDICIA, Gramm-Leach-Bliley, and Sarbanes-Oxley.

Today Chairman Gruenberg is going to give us a progress report on the resolution of systemically important financial institutions. Put in other words, he’s going to tell us where we stand on ending Too Big To Fail, arguably the leading issue coming out of the global economic and financial crisis.

The game plan is as follows: Chairman Gruenberg will offer his remarks. We will then have adequate time for questions and answers with our distinguished and perhaps by then aroused audience. And we plan to close the meeting at about 1:30. This meeting is on the record. So without further ado, let me invite Chairman Gruenberg to take the podium.

Martin Gruenberg: Morris, thank you for that kind introduction. It’s a privilege for me to be here at the Peterson Institute.
Morris mentioned that I worked for Senator Sarbanes on the staff of the Senate Banking Committee for a long time. Senator Sarbanes was among the members of the Senate to take, really an intense interest in international economic issues, so we frequently drew upon the expertise of the Peterson Institute for assistance and support and Fred Bergsten in particular on many occasions was of great assistance us. So it’s really, really a pleasure for me to be here and give this talk here at the Peterson Institute.

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

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

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

Looking back it is clear that the major countries of the world were unprepared for the challenges they faced. Lacking the necessary authorities to manage the orderly failure of a large, complex financial institution, policymakers were forced to choose between two bad options: taxpayer bailouts or financial collapse.
In the United States it was clear that our resolution authorities had not kept pace with changes in our financial system. While long-established, specialized, public resolution regimes existed for particular types of financial institutions, such as banks and broker dealers. No agency had the authority to manage the orderly resolution of a large, complex financial institution, even if the failure of that institution could significantly destabilize the financial system and severely impact the economy. Rather, the only option available for the resolution of such an institution was a bankruptcy process that lacked the tools essential for facilitating the orderly unwind of a financial firm of the size, complexity, and international reach of the largest, most complex financial institutions.

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

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

This framework helps to ensure that financial markets and the broader economy can weather the failure of the SIFI; that shareholders, creditors, and culpable management of the firm will be held accountable without cost to taxpayers; and that such an institution can be wound down and liquidated in an orderly way. And it’s this framework and the progress we’ve made implementing it that I really would like to walk through with you in some detail.

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

The agencies may also restrict the firm’s growth, activities, or operations. If, after two years, the firm still fails to submit an acceptable plan the agencies may order a firm to divest certain assets or operations to facilitate an orderly resolution under the Bankruptcy Code. That’s the framework for Living Wills.

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

In August of last year, 2014, the FDIC and the Federal Reserve Board delivered individual letters to 11 of the largest financial firms regarding their second resolution plan submissions. In the letters the agencies jointly identified common shortcomings of the plans, including the use of assumptions that the agencies regarded as unrealistic or inadequately supported. Further, the agencies found that the firms failed to make or even identify the kinds of changes in firm structure and practices that would be necessary to enhance the prospects for orderly failure under bankruptcy. As a result the agencies directed the firms to demonstrate in their 2015 plans that they are making significant progress to address all the shortcomings identified in the letter.

Among the actions being required to improve resolvability in bankruptcy are:

- Establishing a rational and less complex legal structure that would take into account the best alignment of legal entities in business lines.
- Developing a holding company structure that supports resolvability. Amending qualified financial contracts to address the risk of counter-party actions.
- Demonstrating that shared services which support critical operations and core business lines, such as information technology services, would continue throughout the resolution process.
- And demonstrating that operational capabilities, such as providing information on a timely basis necessary for resolution purposes are in place.
The letters also noted that given the important objectives to provide transparency on firm resolvability to the public the agencies will work with the firms to enhance the transparency of future plans. These letters are part of a broader effort to provide more direct feedback to firms about the agencies’ expectations and the need for immediate structural changes. As noted in the letters, failure by firms to make significant progress with respect to the identified shortcomings and to become more resolvable in bankruptcy may result in determinations by the agencies. The plans are not credible or would not facilitate an orderly resolution under the Bankruptcy Code as provided for under the Dodd-Frank Act.

Now the actions the firms are being required to take focus in particular on reducing the interconnectedness between the legal entities within the firms and I’d like to take a moment here to elaborate on this issue, because it’s quite central to this whole process.

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

To improve resolvability the firms must now show how their legal entities can be separated from their parent company and their affiliates, that the default or failure of one entity will not trigger the default or failure of other entities, and that critical operations will continue to function in resolution.

To do this, firms must undertake three distinct, but related efforts. First, they must map their material legal entities to their business lines. Next, they must address cross guarantees and potential cross defaults that spread risk and tie disparate legal entities and operations together. Finally, they must take steps to ensure that the information technology and other services essential to the functioning of their material entities would continue under their resolution strategies. Ensuring that firms can disentangle their business lines and services into separate legal entities so that critical operations can be maintained during resolution will better enable firms to be split apart and liquidated in resolution.
By addressing these shortcomings firms will increase the available options for resolution in bankruptcy. Actions that promote separability of material entities will lessen the problem of knock-on effects created by interconnectedness, potentially allowing a firm to place its troubled entity into bankruptcy or its existing resolution regime. Such an outcome would increase the likelihood that failure would be orderly, minimizing any potential instability for the financial system as a whole; a problem that greatly influenced policymakers’ responses in 2008.

Now if I may, let me turn to the Orderly Liquidation Authority as the backstop to bankruptcy. While we regard reducing interconnectedness, as well as other changes required under the living will process, as essential to facilitating an orderly resolution under bankruptcy, we cannot rule out that in the future policymakers may face a situation in which resolution in bankruptcy would result in severe economic distress.

Given the challenges and the uncertainty surrounding any particular failure scenario, Title II of the Dodd-Frank Act, provides the Orderly Liquidation Authority, which is effectively a public-sector bankruptcy process for institutions whose resolution under the US Bankruptcy Code would pose systemic concerns. This authority is only triggered after recommendations by the appropriate federal agencies and a determination by the Secretary of the Treasury in consultation with the President.

The Orderly Liquidation Authority is the mechanism for ensuring that policymakers will not be faced with the same poor choices they faced in 2008. Its tools are intended to enable the FDIC to carry out the process of winding down and liquidating the firm, while ensuring that shareholders, creditors, and culpable management are held accountable and that taxpayers do not bear losses.

The Orderly Liquidation Authority provides the FDIC several authorities, not all of which are available under bankruptcy, that are broadly similar to those the FDIC has to resolve banks. They include the authority to establish a bridge financial company, to stay the termination of certain financial contracts, to provide temporary liquidity that may not otherwise be available, to convert debt to equity, and to coordinate with domestic and foreign authorities in advance of a resolution to better address any cross border impediments. The ability to plan and the availability of a large team of professionals experienced in financial institution resolution are additional advantages that the FDIC can bring to bear.

In the years since enactment of Dodd-Frank, the FDIC has made significant progress in developing the operational capabilities to carry out a resolution if needed. I’d now like to discuss those capabilities in more detail and walk-through the items I just outlined.
First the Bridge Financial Company. The concept of using a Bridge Financial Company in the resolution of a large complex financial institution builds off the FDIC’s experience using bridge banks to resolve certain failed banks. Congress granted the FDIC authority to establish a bridge bank as a resolution method during the financial crisis in the 1980s. That authority provides the FDIC with a temporary vehicle to take over and maintain critical services for the customers of the failed bank until a permanent resolution can be achieved.

Similarly, Congress granted the FDIC the authority to establish a bridge financial company for a SIFI, including setting the terms and conditions governing its management and operations under the orderly liquidation authority.

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

In this way, the firm’s critical subsidiaries, which perform operations and provide services that affect the broader financial system and ultimately the economy, would be stabilized to facilitate liquidation through the wind down of the firm. This process would avoid the disruption that would otherwise accompany the firm’s sudden collapse. Customers would have time to transition to new service providers and the resolution process would end with the termination of the bridge financial company.

To operate the bridge financial company the FDIC would appoint a new board of directors and senior management, who would be charged with managing the wind down of the firm in a way that minimizes systemic disruption. In addition to being an essential tool to preserve financial stability the bridge institution is also an important means for ensuring accountability for stakeholders of the failed firm. Shareholders would be wiped out, creditors would take losses, and culpable management would be replaced. As you know, such accountability is essential to minimizing moral hazard and promoting market discipline.
Now let me turn to the central issues of liquidity and capital. From the outset the bridge financial company would have a strong balance sheet because the unsecured debt obligations of the failed firm would be left as claims in the receivership, while all the assets would be transferred to the bridge company. As a well-capitalized entity the FDIC expects that the bridge financial company and its subsidiaries would be in a position to borrow from customary sources in private markets to meet its liquidity needs. However, if such funding is not immediately available the law provides the Orderly Liquidation Fund, a dedicated, back-up source of liquidity, not capital, to be used if necessary in the initial stage of resolution until private funding can be accessed. The Orderly Liquidation Fund would only be used when private sector funding is unavailable and there are a number of important limitations on its use.

For example, the statute limits the amount that can be borrowed and requires that any Orderly Liquidation Fund borrowing must be paid from recoveries on the assets of the failed firm. If that should prove insufficient assessments would be levied on the largest financial companies. Under the law taxpayers cannot bear losses. Instead, as I indicated, losses are first borne by the failed company through its shareholders and its creditors and if necessary, by assessments on the financial industry.

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

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

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

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

Now let me turn to the critical issue of qualified financial contracts, derivatives. Another major impediment to the orderly resolution of a financial firm that emerged during the crisis of 2008 was the inability of the bankruptcy process to stay the early termination of certain financial contracts, commonly referred to as "qualified financial contracts," or "QFCs." In the case of the Lehman Brothers bankruptcy parties to such contracts, which include derivatives contracts valued in the trillions of dollars, were able to exercise early termination rights, resulting in the disorderly termination of the contracts and the fire sale of underlying assets. The Orderly Liquidation Authority provides the FDIC with the ability to impose a temporary stay on QFCs, preventing parties from terminating their contracts immediately upon a firm being placed into an FDIC receivership.

Though this stay helps address risks posed by such contracts written under US law, questions remain regarding contracts not subject to US law, leaving legal uncertainty for cross border contracts. Currently the Bankruptcy Code does not provide a stay for these contracts. So in developing a resolution strategy the United States and other jurisdictions facing this same problem needed to find a solution to avoid the early termination of contracts written under foreign laws.

In November of last year the International Swaps and Derivatives Association, the acronym is ISDA as you may know, issued a protocol that ends the automatic termination of covered derivative contracts in the event of a bankruptcy or a public resolution of a systemic financial institution. Eighteen of the largest global financial institutions, which collectively represent a majority of the swaps market, voluntarily agreed to adhere to the protocol.
The Federal Reserve is expected to engage in rule-making to codify compliance with the protocol. These efforts are essential to avoid gaming and to provide a level playing field for those institutions included in the rule-making. The rule-making and the adoption of the protocol will reduce the legal uncertainty regarding the termination of derivative contracts in the context of cross border resolutions. Importantly, these efforts improve resolution under both the Orderly Liquidation Authority and bankruptcy by helping to address some of the cross border uncertainty and contagion risks in both regimes.

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

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

As an indication of the priority that the senior officials of these two jurisdictions attach to this working relationship, in October of last year the FDIC hosted a meeting of the heads of the Treasuries, central banks, and leading financial regulatory bodies of the United States and the United Kingdom. This event's high level discussion furthered understanding among the principals in regard to key challenges and to the successful resolution of US and UK G-SIFIs and how the two jurisdictions would cooperate in the event of a cross border resolution. This event built upon prior bilateral work between the authorities in our two countries, which since late 2012 has included the publication of a joint paper on G-SIFI resolution and participation in detailed simulation exercises among our respective staffs.
Now last year the European Parliament established a Single Resolution Mechanism for the resolution of financial institutions in Europe. This SRM as it’s called, creates a centralized resolution authority framework for the 19 Eurozone Member States and many of its authorities mirror those of the FDIC under the Orderly Liquidation Authority. The FDIC is actively engaging with the new Single Resolution Board, which oversees the Single Resolution Mechanism to be of assistance in its setup and to discuss cooperation and resolution planning for G-SIFIs with assets and operations in the United States and the Eurozone.

The FDIC and the European Commission have established a joint Working Group to focus on both resolution and deposit insurance issues. In addition, the FDIC participates in the Crisis Management Groups for G-SIFIs with significant assets and operations in the United States. Deepening our cross border relationships with the key foreign jurisdictions will be an ongoing priority for the FDIC's work on systemic resolution.

So in conclusion, while there is still much work to do, and I want to underscore that point, if there’s one point I would like to conclude with today is that there has been a transformational change in the United States and internationally since the financial crisis in regard to the resolution of systemically important financial institutions that perhaps has been under-appreciated.

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

In the United States all of those issues have been or are in the process of being addressed. The living wills are an important new tool to require institutions to address the deep interconnectedness within their own organizational structures that is a central impediment to orderly resolution under bankruptcy, as well as under the Orderly Liquidation Authority. The stay on the automatic termination of derivative contracts, whether written under US or foreign law, in the event of an insolvency proceeding in bankruptcy or under the Orderly Liquidation Authority is a major step forward. The ability to convert unsecured debt to equity, to facilitate an orderly failure in bankruptcy or under the Orderly Liquidation Authority, addresses another essential issue.
The fact that the senior financial officials of the world's two leading financial jurisdictions, the United States and the United Kingdom, met in October to discuss how they would cooperate in the event of a cross border failure of a systemic financial institution underscores the high priority that is being placed on this issue. The establishment by the European Union of a new Single Resolution Mechanism for Europe to complement the Single Supervisory Mechanism will add a major new piece to the international infrastructure for cross border resolution. And I think it is fair to say that all of the major jurisdictions of the world are focused on this issue.

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

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

One other thing that is also clear, is that without these authorities we would be back in the same position as 2008, with the same set of bad choices. I would suggest that there has been no greater or more important regulatory challenge in the aftermath of the financial crisis than developing the capability for the orderly failure of a systemically important financial institution. While there is still a lot of work to do, looking at where we were and where we are today, in my view the progress has been impressive. Thank you very much.

Morris Goldstein:

Let me begin by thanking Chairman Gruenberg for such a comprehensive, frank, and enlightening report on where we stand with regard to the orderly resolution of complex financial institutions. Before I turn to the audience for questions, allow me to get the ball rolling by offering a question/comment of my own.

On the whole, Marty, you've offered a relatively upbeat assessment of prospects for resolving systemically important financial institutions without either drawing on taxpayer money or suffering severe market disruption. Suffice to say that not everyone is so optimistic and for at least, I think, three reasons, most of which come under what you would call, “Work Left to Do”.
First if you look at the measure of bank capital that seems to distinguish best, sick from healthy banks in the run-up to the crisis, namely the unweighted leverage ratio, US G-SIBs, that is the group of Systemically Important Banks in the US, don’t have much equity capital. According to the FDIC’s latest capital report the average tangible leverage ratio was about 5%. During the crisis US banks lost about 7% of total assets, according to the IMF. So the equity cushion is, at least on this measure, rather modest. Yes, we now have the G20 Summit and the Financial Stability Report and the TLAC agreement, which specifies how much total loss absorbing capital these large institutions must have, but if you look at no less than an authority, that former Treasury Secretary Geithner has argued in his book *Stress Test*, that during the crisis, it proved to be extremely difficult to put haircuts on bondholders, on bank debt during the crisis.

For example, after JP Morgan-Chase took over Washington Mutual, debt holders received a haircut, but there was so much contagion after that, that soon after there was a wide-ranging guarantee on new bank debt.

So the question is, if you have a set of institutions and you have to do that can you pull the trigger? And I want to make it clear, I’m not against these, I’m just raising concerns.

Third, suppose you do pull the trigger on the bail-in bonds. Then you have to ask, “Who’s holding them?” It probably won’t be other banks or money market funds. Suppose it’s pension funds and insurance companies. Then John Q. Public doesn’t have to see his taxes go up, but he might not be too pleased to find that he has to pay higher insurance premiums or he has a reduced pension. We could talk about other holders; hedge funds, large asset managers, or what the implication would be. But it’s not clear that if taxpayers don’t have to put up money there won’t be some losses to be distributed and in the end there’s just households.

So one of my favorite movies is *The Big Lebowski* and in that movie John Goodman asks over and over again, “Am I wrong?” So anyway I don’t want to give the impression that I don’t think a lot of progress has been made, but there is, I think, those questions.

Do you want to do them one-by-one, I mean or save them up?

Martin Gruenberg: No I’m happy to do them. I filibustered as long as I could to avoid this session I should tell you. I’m trying to figure out how to begin the response.
I think, as I pointed out in a speech in 2008, we really had no capabilities to deal with any of these issues. We didn’t even have the threshold authorities to place one of these SIFIs into a public resolution process. Let me just say, we couldn’t of even had this discussion in 2008, because the threshold capabilities, as well as the strategic thinking as how to utilize those authorities had really not been done. So we really are in a very different place today and the fact that we can have this discussion now, frankly, is a reflection, if I may say, of the progress that’s been made.

And you raised two particular points on capital and then the holders of the unsecured debt of these firms. On capital, I mean frankly, as you know, the FDIC agrees with you that a strong leverage ratio capital requirements is quite essential, particularly for these large systemic institutions. And you know the Basel III Capital Accord established a minimum 3% leverage ratio requirement, which we felt and indeed, our analysis showed would not have been sufficient to significantly constrain leverage in the run-up to the financial crisis and it’s widened the final rule adopted here in the United States. We went substantially beyond the minimal international leverage requirement of 3% to require a 6% requirement of the bank and a five percent minimum on the holding company.

So as a threshold we wanted a stronger cushion of leverage capital as a buffer against failure and frankly, to reduce the probability of failure and default and if things go bad, give us more time with the resolution planning process. So we agree with you on that point and I think we’re moving in a positive direction. And those strengthened credential standards, in regard to capital and liquidity, supervision of derivatives, I would suggest a pretty significant prudential changes that we’ve implemented since the crisis that strengthens prudential supervision of these firms and I would hope reduces the probability of failure.

But if we get to the point of failure we clearly have a whole new set of authorities and capabilities that we didn’t have before and we now understand that we have a resource available in resolution that would provide an alternative to taxpayer provided capital, which we had to resort to in 2008. The unsecured debt of these large systemic firms presents a resource through which we can impose on private creditors, the cost of capitalizing the failed institution to facilitate the orderly resolution process. That was a capability we simply didn’t have in 2008. So we can now put private creditors on the hook to take the losses and to manage the orderly liquidation of a firm. We didn’t have that capability.

Now Morris raises a question of who would hold this debt. And it’s a fair question to raise and look, we don’t particularly want this debt to be held by other SIFIs, because we’re obviously concerned about knock-on
contagion effects that could exacerbate a stressed financial environment. But I would make a couple of points.

One, first these are private creditors on the hook. They would take the losses, initialing this debt. We, the regulators would make it very clear the risk associated with holding this debt. So investors should have full opportunity to make informed decisions about their investments. And look, there are a lot of sophisticated investors out there and I would mention hedge funds and asset managers, that are also likely to be holders of this debt and certainly are fully capable of evaluating any risks associated with it.

So we do view this as a critical new element to facilitate an orderly resolution without taxpayers bearing the cost.

Morris Goldstein: Thank you. Let’s open it up. Would you go to the mic and we recognize, would you please identify yourself?

Jo Marie Greisgraber: While the rest of you are warming up for your questions. Jo Marie Greisgraber with New Rules for Global Finance.

First, I really want to thank you for the work you’ve done. There are a group of civil society organizations who are like the cheerleaders for regulators. We want you to succeed.

Martin Gruenberg: Bo, am I glad to hear you, thank you.

Jo Marie Greisgraber: Hey, I wish this was a paid commercial-

Martin Gruenberg: I feel better now.

Jo Marie Greisgraber: But I don’t get paid.

I did want to ask for clarification, when you talk about G-SIFIs, do you include the non-bank, non-insurance financial institutions that are globally significant. You’d be creeping into the shadow-banking world, but what is—who all is under that umbrella?

Martin Gruenberg: At this threshold, as I indicated in my remarks, there are eight US financial institutions that have been designated by international policy makers as global SIFIs as it were and all of those happen to be bank holding companies. There may well be other financial institutions, non-bank in the United States and elsewhere that may potentially be of systemic consequence. But for the initial cut and this initial effort, the
focus has been on those eight SIFIs that have been designated internationally.

Morris Goldstein: Nicolai.

Nicolas Veron: Nicolas Veron of the Institute. Thank you Chairman for your remarks on the new framework.

My question is about international integration, financially and economically. There are a number of financial organizations out there headquartered in the US or elsewhere, which have a model, which is largely integrated at the global level. The lack of trust between authorities, as it is negotiated in the [inaudible 00:52:27] framework, results in requirements for geographical ring fencing and fragmentation of the capital and liquidity within those banking groups. Specifically, the single point of fencing model, which is supposed to be the more integrated one, requires a so-called prepositioned [inaudible 00:52:47], which is affected in different countries and limits the ability of those groups to have circulation of liquidity and capital internally, including to address crisis in specific jurisdictions.

So my question is how do you assess the economy consequences of that, both in terms of growth and the efficiency of allocation of capital, but also in terms of stability and the ability of banks to wipe-out losses or to bridge gaps, in terms of capital and liquidity and insure subsidiaries or branches in specific jurisdictions by using capital that have been positioned somewhere else? Thank you.

Martin Gruenberg: You know you raise a threshold question. There are costs for these institutions to put themselves in a position to facilitate their orderly failure and during the recent crisis and prior to the recent crisis, those institutions did not have to absorb the costs of making themselves resolvable and they in effect, were able to externalize those costs on the public.

And in some sense the living will process that we have, in terms of requiring these firms to prepare their own resolution plans, is really at the end of the day, an exercise in requiring these firms to internalize the costs of placing themselves in a position in which they could be resolved in an orderly way, so that they have an organizational structure and operational supports and capabilities that would facilitate orderly failure.

Now, that may result for costs for the firms, but at the end of the day, I think the premise of the statutory requirement is that those firms should bear that cost internally, rather than being allowed to impose it externally on the public and the taxpayers.
Danny Indiviglio: Danny Indiviglio, from Reuters Breaking News.

I was wondering if you could give a little more explanation in terms of how the process works with the living will failures. I mean, until now, Wells was sort of the only big institution out there it seems like it’s almost passing. The rest you just keep saying they’re not credible. At what point does it become like not credible to an actual problem where you put these guys on the road to winding some parts off or whatever other consequences might occur?

Martin Gruenberg: Thanks for the question and I tried to describe it in my remarks. The law provides a pretty straightforward process. As a threshold the Federal Reserve and the FDIC have the joint authority to review these plans and the law provides that if the two agencies jointly determine that a plan is not credible or does not facilitate resolution under bankruptcy then we are required to issue a notice of deficiencies to the firms and the notice of deficiency has to outline the shortcomings in the plan and give the firm an opportunity to address the shortcomings.

Now, if the firm does not address the shortcomings then we have, the two agencies, have authority under the provision. In the first instance, to impose more stringent credential requirements on the firm’s higher capital liquidity, restraints on growth and operations, and the statute says specifically that if after two years the firm still does not comply, then we have authority to order divestiture of operations of the firm.

So it’s a pretty explicit and clear set of authorities that goes to a clearly defined statutory standard and the statutory standard is resolvability under bankruptcy. So as we utilize these authorities, the determination, notice of deficiency, et cetera, the object of the exercise has to be enhancing the resolution of the firm under bankruptcy.

Morris Goldstein: Yes.

Audience: My name is [inaudible 00:57:14], I’m a reporter with Reuters.

I wish to ask you if you could comment on the bill that was introduced today by Richard Shelby in the Senate. One of the measures proposed is to raise the automatic threshold for becoming a SIFI up to $500 billion, so that seems to go against a lot of the good news that you’ve just given us here.
Martin Gruenberg: All right, I guess I should say this morning I was pretty preoccupied with thinking about this speech, so I can’t say I’ve had a chance to look at the bill yet, so I think I’ll refrain from commenting on that.

Dennis Keller: Dennis Keller from Better Markets. I bet you’re really disappointed you didn’t get to read the Shelby bill instead of give this speech.

Yeah, I really appreciated the speech because too much of the discussion, in my view, around these issues focuses on the trees and not the forests. So it was very helpful I think, not just here, but in a larger community, to discuss this to have a broader picture, particularly one that ties the provisions that fall within what’s supposed to be resolvable in bankruptcy with OLA Authority. And as I understand it OLA Authority is supposed to be a fail-safe, last stop to be used only if all else fails.

And the good news is, is the FDIC took its job seriously, came out of the gate strong and OLA Authority stood up and then back in the weeds we’ve got the Fed in terms of resolvability under Chapter 7. You don’t have to agree with any of those descriptions and my friends from the Fed in the audience won’t either. But it seems to me that we have this problem of the work and effort done to get them resolvable and bankruptcy is lagging far, far behind the ability to deal with OLA Authority.

And you’ve touched on that with the living will rejection and there was a little bit of a separation between the Fed and the FDIC and the letter on the eleven. And then that has to come to the floor again this summer, I think, and correct me if I’m wrong, in terms of what they do with their next submissions and how the agencies react. But what’s the FDIC plan going forward to get the viability of resolvability in bankruptcy so you’d never have to use OLA Authority? What’s the plan to get that more viable?

Martin Gruenberg: Well that’s a great question and let me say I think the Living Will Authority really is a critical new authority that we did not have during the crisis. The ability to require real-time structural and operational changes in these firms to facilitate orderly resolution in bankruptcy is really a new thing in the regulatory framework. And it’s really, I think, an enormously important tool that will help facilitate resolution in bankruptcy and certainly would be helpful if you have to resort to the Orderly Liquidation Authority backstop.

And I will say that the FDIC and the Federal Reserve, in my view, now are working quite cooperatively with each other and with the firms to realize the potential that these authorities present. I think the 11 letters that we sent to the those firms, joint letters, by the Fed and the FDIC last August, in which we said the assumptions were unrealistic and
unsupported, we said that the plans that they submitted failed even to identify, much less implement meaningful structural changes and then we laid out five specific requirements and issues for them to address that really go to central questions of resolvability.

And we made clear in the letters that at the next submission, which would be in July of this year, the firms not only have to submit plans that provide a path, a credible path to resolution, but they have to make significant progress towards actually implementing the structural and operational changes to make those plans real.

And look, I think we and the Fed are at the staff level and now working closely with each of the firms to give them clear guidance in terms of implementing the requirements that we laid down, it’s my perception that the firms are taking this seriously and we’ll see what’s submitted to us on July 1 and we’ll have an opportunity to evaluate them. But I do view this, if I may say, as a very serious process, which if it fulfills its potential, if it carries through on implementation of what we’ve directed, will really result in basic structural and operational changes of these firms in real time that will facilitate orderly failure.

Morris Goldstein: Simon.

Simon: Thank you very much Chairman Gruenberg for coming to speak to us today. I think this is an incredibly important speech. You’ve done really a lot of great work on these issues and I think you need to communicate more frequently these same points. In fact, we’re available every Tuesday if you want to come back on a regular basis.

Martin Gruenberg: Simon I’m always glad to come by.

Simon: I would just like to invite you to reiterate one of the most important points that you’ve made today, which is about the requirement of Dodd-Frank and the expectation and I think, the statutory requirements of living wills. And I have heard on numerous occasions in the past nearly five years people from the industry and officials, and I heard some of them talking about this yesterday afternoon, along the lines of, “Don’t worry about Too Big To Fail, we have Title II and the FDIC will in some form will ride to the rescue.”

But my understanding of the law and of what you just said is the standard for the living wills is that every single firm, financial or otherwise in the United States, must be to the best of your determination and information of the Federal Reserve, resolvable under bankruptcy. Without any kind of government intervention or support and presumably and closely connected
to that, without causing any kind of knock-on, major, global systemic financial effect. Have I understood you correctly on this key issue?

Martin Gruenberg: I think that’s what the statute provides. Can I just ...

Morris Goldstein: Why don't we just …. Sure, sure.

Martin Gruenberg: Just to be clear, and I made this point in my remarks, the goal is resolvability under bankruptcy and I think we are able to use these living will plans really to advance that objective. I would say two things. One, I made this point, in a stressed environment you can’t be sure what the scenario would be and I would argue you need the backstop of a public resolution process in the event that bankruptcy can’t handle an orderly failure. And just to be clear, I don’t think any firm that’s subjected to Ordering Liquidation Authority will view the FDIC as riding to the rescue. That firm will fail, the shareholders will be wiped out, the creditors will take losses according to the losses of the firm, culpable management will be replaced and will then undertake an orderly process for the wind down and liquidation of the firm.

So I think that’s the outcome of Title II Orderly Liquidation, which I agree we would like to avoid the necessity to use and do everything we can to facilitate an orderly failure under the bankruptcy process.

Morris Goldstein: Last question, Bill Cline.

Bill Cline: With the benefit of hindsight we know that Lennon was the only insolvency, the other big support exercises were cases of illiquidity and the Badgett Principle says that it was correct to provide support in case of illiquidity. Dodd-Frank constrains what the Fed can do under the previous Section 13, which you could do anything. This structure of having the head, the holding company bankrupt, but all the subs are supposed to have wonderful access to the market, is always struck me as very strange.

So I guess my basic question is, do you worry that at the end of the day, the effect of all of this is to undermine the flexibility of the Fed to fulfill the Badgett Mandate or not?

Martin Gruenberg: Well I think the issue here is providing an open institution public support to failing companies, that essentially protects them from the consequences of their actions. We’re not talking about well capitalized viable companies. The failures here, the liquidity crisis was triggered by deep concerns about asset quality on the books of those institutions. And the intervention that was taken and I don’t second guess it because we didn’t have a lot of alternative. So if the option was really collapsed, so that these
institutions with severe, systemic disruption, the intervention is hard to second guess.

But if you have an institution that gets into difficulty and you have the ability to intervene so that the institution itself is allowed to fail with the shareholder/creditors and management suffering those consequences and you then if you need to use public authorities, and we just talked about trying to enhance the ability of bankruptcy in the first instance to handle the situation, but if you have to resort to public authorities you want to do it on a closed institution basis, after the firm has failed, after the accountable stakeholders have suffered the consequences of their action, and then intervene to stabilize and then manage the orderly wind down of the firm.

I think that’s what we envision. I think that that is what we are trying to establish the capability of doing now, that we had no capacity to do in 2008 and that’s a different scenario. And I will say if you can intervene forcefully in that way at the early stage of problems developing, let’s say the first institution that gets into difficulty so that you can manage an orderly failure while avoiding, hopefully, the most severe disruptive effects, you really then have the potential for a different scenario. And that’s a set of capabilities I think we have and are developing today that we didn’t have in 2008.

Morris Goldstein: Well we are at the end of our allotted time, so please join me in thanking Chairman Gruenberg for increasing our understanding and being so generous of his time. Thank you all for coming.