The Resolution of Distressed Financial Conglomerates

Howell E. Jackson & Stephanie Massman*

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Abstract

One of the most elegant legal innovations to emerge from the Dodd Frank Wall Street Reform and Consumer Protection Act of 2010 is the FDIC's Single Point of Entry (SPOE) initiative, whereby regulatory authorities will be in a position to resolve the failure of large financial conglomerates (corporate groups with regulated financial entities as subsidiaries) by seizing a top tier holding company, down-streaming holding company resources to distressed subsidiaries, wiping out holding-company shareholders while simultaneously imposing additional losses on holding company creditors, and allowing the government to resolve the entire group without disrupting business operations of operating subsidiaries (even those operating overseas) or risking systemic consequences for the broader economy .

Although there is much to admire in the creativity underlying SPOE, the approach's design also raises a host of novel and challenging questions of implementation. This chapter explores a number of these questions and elaborates upon the following points. First, in contrast to traditional approaches to resolving financial conglomerates, SPOE is premised on the continued support of all material operating subsidiaries, thereby potentially extending the scope of government support and thus posing the possibility of mission creep and expanded moral hazard. Second, SPOE contemplates the automatic down-streaming of resources to operating subsidiaries in distress, but effecting that support is likely to be more difficult than commonly understood. If too much support is positioned in advance, there may be inadequate reserves at the top level to support a single subsidiary that gets into an unexpectedly large amount of trouble. Alternatively, if too many reserves are retained at the holding company level, commitments of subsidiary support may not be credible (especially to foreign authorities) and it may become difficult legally and practically to deploy those resources in times of distress.

SPOE is most easy to envision operating in conjunction with the FDIC's expanded authority under its Orderly Liquidation Authority (OLA) established under Title II of the Dodd-Frank Act. However, the act's preferred regime for resolving failed financial conglomerates is the U.S. Bankruptcy Code (where Lehman was resolved) and not OLA. Several complexities could arise were a bankruptcy court today called upon to implement a SPOE resolution plan. While many legal experts are working on legislative proposals to amend the Bankruptcy Code to facilitate SPOE resolutions, there are a number of legal levers that federal authorities could deploy under current law to increase the likelihood that the SPOE strategy could be effected through traditional bankruptcy procedures. The task would be challenging and would require considerable advanced planning. But there are substantial benefits to be had from taking steps now to increase the likelihood that the bankruptcy option represents a viable and credible alternative for effecting SPOE transactions without resort to OLA and Title II of the Dodd-Frank Act.

Keywords: financial conglomerates, single point of entry, orderly liquidation, authority, Dodd-Frank Act, financial regulation

* Howell E. Jackson is the James S. Reid, Jr., Professor of Law at Harvard University. Stephanie Massman received her J.D. from Harvard Law School in 2015. In writing this chapter, we benefitted from helpful comments and suggestions from Michael Barr, Donald Bernstein, Mark Roe, David Skeel, Margaret Tahyar, Paul Tucker, Eli Vonnegut, and two anonymous referees. Direct correspondence to: Howell Jackson at hjackson@law.harvard.edu, Griswold 510, Harvard Law School, Cambridge, MA 02138; and Stephanie Massman at smassman@jd15.law.harvard.edu.

If a regulatory Rip Van Winkle had wandered up into the Catskill Mountains in the summer of 1996 only to emerge again twenty years later, in 2016, much of the supervisory landscape would appear strange and unfamiliar: stress tests and centralized clearing of derivatives; new regulatory actors in the form of the Financial Stability Oversight Council and the Consumer Financial Protection Bureau; and billion-dollar enforcement settlements with major financial conglomerates announced with startling frequency. But one of today's leading regulatory challenges, the resolution of financial conglomerates, would strike a familiar note for our latter-day Knickerbocker. That topic was also a source of intense controversy in policy circles back in 1990's, and one that echoes (albeit imperfectly) in today's debates over regulatory reform and the resolution of financial conglomerates.

The problem of failed financial conglomerates emerged on the national stage back in 1984 when the Federal Deposit Insurance Corporation (FDIC) intervened with an investment in the Continental Illinois holding company. Although shareholders of the holding company were largely wiped out, the FDIC's action saved holding-company bondholders from suffering losses and prompted scathing criticisms that the FDIC had overstepped its statutory mandate to protect insured depositors. A few years later, the Federal Reserve Board raised industry hackles in advancing a new "source-of-strength" doctrine under which bank holding companies might be called upon to infuse capital into failing bank subsidiaries, undermining (in the view of industry opponents) principles of limited liability and corporate separateness within financial groups. Statutory amendments adopted through the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 partially codified the source-of-strength doctrine and when the Bank of New England failed in the early 1990s, the FDIC was able to invoke these new FDICIA provisions to lay claim to conglomerate-wide resources to reduce the corporations' resolution costs.[1]

To a person steeped in banking policy debates of the 1990s, the emerging policy debates over the Orderly Liquidation Authority (OLA) of Title II of the Dodd-Frank Act[2] along with the FDIC's single-point-of-entry (SPOE) proposal would seem eerily familiar. Under this new resolution strategy, the FDIC is to be appointed receiver of the top-tier U.S. holding company of a systemically important financial institution (SIFI).[3] As contemplated under SPOE, the receivership would absorb losses incurred by all material operating subsidiaries and then recapitalize those subsidiaries as needed with a combination of holding company reserves and the conversion of pre-positioned intra-corporate loans. Federal authorities would then organize a new bridge holding company to receive assets from the receivership estate. As envisioned, these transferred assets would consist primarily of the receivership's investments in recapitalized down-streams subsidiaries and other healthy affiliates. The equity holders' and unsecured creditors' claims of the old holding company would remain in the receivership, bearing losses according to their priority. These claims would either be wiped out or satisfied through a securities-for-claims exchange, giving these claimants equity in the new bridge holding company. In theory, this approach would ensure that the original holding-company's stockholders and debt holders will absorb all losses of the consolidated company while transferring support down to operating subsidiaries to allow operations (most significantly, their systemically important operations) to continue uninterrupted during the course of resolution.

[1] The source-of-strength doctrine was ultimately fully codified in the Dodd-Frank Act. For an analysis of these doctrinal developments in the 1990s, see Jackson 1994. For more recent and comprehensive work tracing the history of the source-of-strength doctrine through the Dodd-Frank Act, see Lee 2012a; Lee 2012b.

[2] See Sections 201-214 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. For an overview of OLA and the ways in which it differs from traditional bankruptcy procedures, see Massman 2015.

[3] Request for Comments regarding Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76,614, 76,616 (Dec. 18, 2013). There is an extensive literature on SPOE from early articulations in Guynn 2012 through more complete accounts Bovenzi, Guynn, and Jackson 2013, PwC 2015, and Skeel 2014. For a critical perspective, see Kupiec and Wallison 2014.

The down-streaming of holding-company resources to cover losses in failing subsidiaries in the first phase of SPOE is just what the Federal Reserve Board's original source-of-strength doctrine was designed to accomplish. And to the extent that the SPOE proposal would pass those losses along to holding company creditors, that is also consistent with the Fed's original source-of-strength approach in that the assignment of losses to holding company creditors corrects the most widely-criticized aspects of the FDIC's bailout of Continental Illinois bondholders.

To be sure, the logic underlying OLA and SPOE is not exactly the same as the original source-of-strength doctrine and related innovations of the 1990s.   There are two key differences: First, those earlier interventions were primarily aimed at reducing resolution costs and solving a moral-hazard problem. To the extent that holding companies allowed their subsidiaries to take on financial risks and incur financial losses, the source-of -strength doctrine forced the holding companies to internalize those losses, thereby correcting incentives and diminishing moral hazard concerns. While OLA-SPOE also has these salutary incentive effects, the structure is centrally designed to address systemic risk concerns (whether of contagion or inter-connectedness) by creating a structure that permits the downstream subsidiaries of financial conglomerates to remain in business and honor their creditors (especially runnable short-term creditors). Although fear of subsidiary creditors' losses had clearly been a concern underlying the FDIC's intervention in Continental Illinois, avoiding losses to subsidiary creditors was not central to other major bank holding company failures following the Continental Illinois failure (such as MCorp or Bank of New England) where the principal operating subsidiaries were clearly insolvent and were headed into receivership and supervisory mergers. The primary government concern in both cases was to pass along the cost of those failures to holding-company creditors so as to minimize government losses and establish appropriate incentives for the future.

Another key difference between the FDIC's new SPOE approach and its pre-Dodd-Frank Act precursors is the extent to which regulatory authorities are doing extensive advanced planning to facilitate orderly resolution in times of financial crisis. Although in former times financial holding companies, at least in the United States, were subject to consolidated capital requirements and activities restrictions, little else was required to ensure that these holding companies would retain adequate additional reserves to come to the assistance of their banking subsidiaries in times of distress. The source-of-strength doctrine was largely limited to the assets that happened to be available when subsidiary banks failed, and little regulatory attention was given to making sure that a financial conglomerate organized itself in a manner that would facilitate down-streaming value to insured banks when crises rose. In the wake of Dodd-Frank, however, considerable advanced planning is required. In particular, systemically important financial institutions are required to develop acceptable living wills (resolution plans) with considerable attention to precise steps that will be taken to resolve the firm in an orderly manner should financial difficulties arise. (Barr, Jackson and Tahyar 2016, ch. 9.3.)

Drawing on insights into the regulation of financial conglomerates developed in the debates of the 1990s, this chapter explores a series of questions about the evolving SPOE strategy that U.S. authorities are currently developing. Our goal is to highlight several important challenges to successful implementation of the SPOE strategy, as well as a handful of possible solutions available under existing statutory standards. This entails some discussion of technical issues of banking regulation and bankruptcy law is necessarily entailed, but we attempt to keep these technical references to a minimum and to stress the overarching policy issues. We also do not attempt to replicate an excellent growing literature proposing ways in which the federal Bankruptcy Code could be amended to accommodate SPOE resolutions.[4]

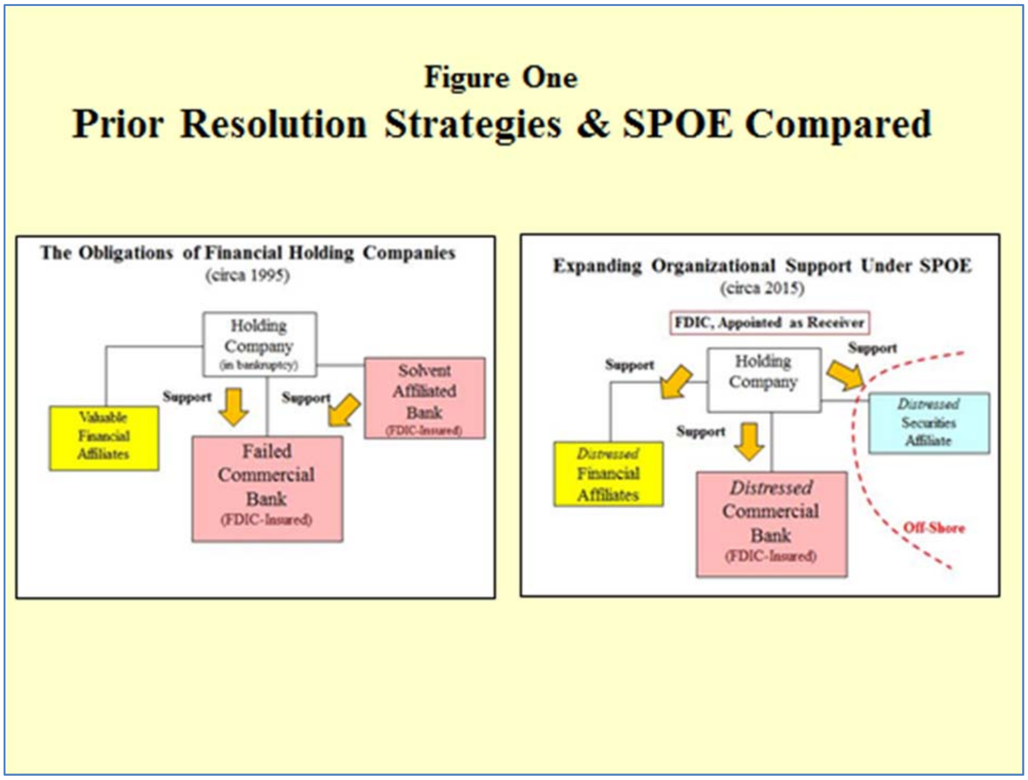
The article has four main parts. The first part explores a series of design challenges in the SPOE approach to resolving financial conglomerates, challenges that the emerging literature on the subject (much of it quite illuminating) has failed to examine adequately. The second section sketches out what is emerging as a complex choice architecture for the resolution of financial conglomerates, a choice architecture that is built around a statutory presumption that financial conglomerates will be resolved

4 See Skeel 2014; Huertus 2015; Jackson 2015; Lee 2015; and Skeel 2016.

through traditional bankruptcy procedures and not the highly publicized OLA procedures established in Title II of the Dodd-Frank Act. The third part focuses in on a central, but potentially problematic resolution alternative: application of SPOE resolution under the existing federal Bankruptcy Code. Here we flag several key difficulties and suggest potential work-arounds under current law. In the last section we conclude with some preliminary thoughts on deeper issues of regulatory philosophy underlying emerging approaches to the resolution of financial conglomerates.

Design Challenges of Implementing SPOE

One of the striking features of the SPOE approach is the extent to which it expands the scope of holding-company support obligations beyond what was contemplated in prior holding-company resolutions strategies under the original source-of-strength doctrine and related policies. (Baer 2014; Kupiec 2015.) This point is illustrated in Figure One. The diagram on the top left highlights the direction of financial support envisioned in the resolution of financial conglomerates in the 1990's. At that time, the sole recipient of capital contributions was the failing commercial bank within a corporate group. Support could be drawn from the holding company (under the sources-of-strength doctrine) or from healthy FDIC-insured depository institutions (via the cross-guarantee provisions of FDICIA). But the beneficiary was invariably an FDIC-insured banking subsidiary.



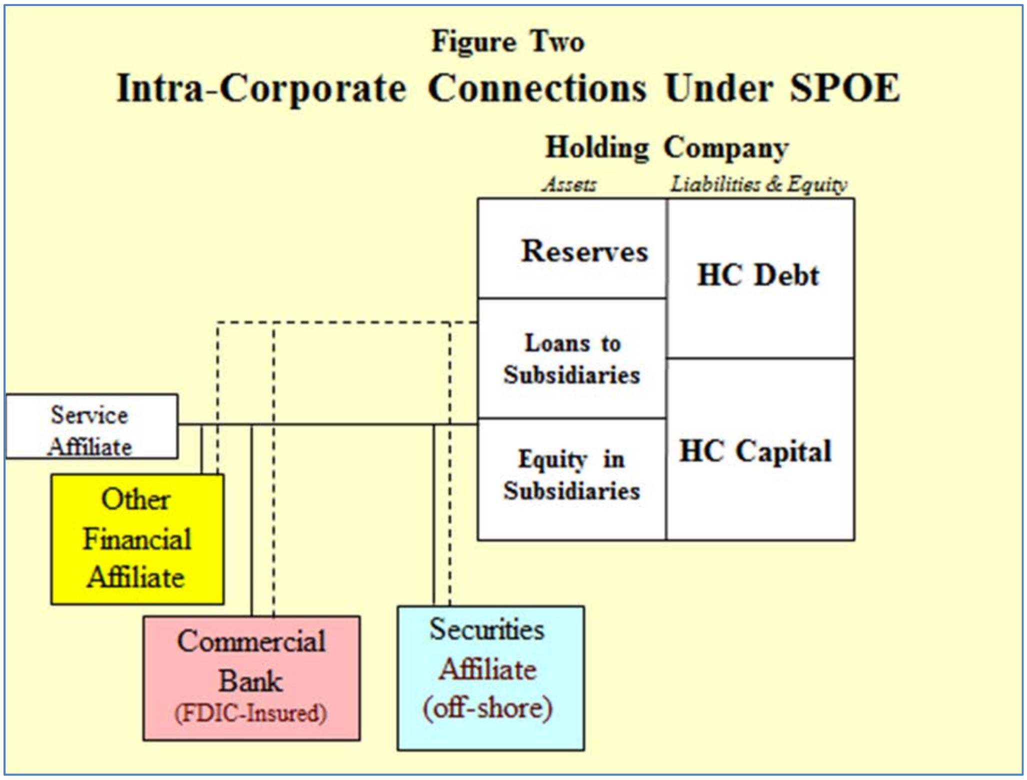
Under SPOE, however, the scope of coverage is potentially much broader. With its emphasis on preserving the going-concern value of all material operating affiliates, SPOE contemplates support being given to insolvent affiliates other than FDIC-insured depositories. Reflecting the runs, similar to bank runs, experienced at Lehman Brothers and Bear Stearns as well as the systemically destabilizing difficulties of AIG's financial affiliates operating out of London, SPOE contemplates a much wider umbrella of support, as illustrated by the diagram on the bottom of Figure One. The credibility of providing this support is especially important for distressed affiliates located offshore, as it is this commitment that is necessary to dissuade foreign authorities from seizing the assets of impaired foreign affiliates in order to protect creditors in local markets. Indeed, one of the major advantages of SPOE is that the approach is designed to centralize resolution efforts in the home country of internationally active financial firms where the holding company will presumably be located and to forestall the dissipation of going-concern value that took place in the aftermath of the Lehman Brothers failure, when innumerable local receiverships were declared.[5]

The Pre-Positioning Dilemma

The expansive scope of SPOE support obligations – combined with the importance of making credible commitments to foreign authorities – generates a "pre-positioning" dilemma for regulatory authorities. To appreciate this dilemma, one must consider the intra-corporate connections between financial holding companies and their downstream subsidiaries. Figure Two illustrates these relationships. As contemplated under SPOE, holding companies are to have three kinds of assets: direct equity investments in subsidiaries, loans to subsidiaries, and reserves of some sort (presumably marketable securities or cash equivalents).[6] When a subsidiary suffers serious losses, holding company equity in that subsidiary will immediately be written down. To recapitalize the subsidiary, the holding company (or perhaps receiver for the holding company) will convert some or all of the holding company's intra-corporate loans to the subsidiary into equity and, if necessary, also make additional contributions to the subsidiary from holding company reserves. In that manner, the holding company will downstream value to distressed subsidiaries, effectively recapitalizing the subsidiaries and transferring the subsidiary losses to holding-company shareholders and debt holders.

[5] Among the early proponents of the SPOE approach were senior officials at the Bank of England who recognized the potential value of the strategy for the successful resolution of global firms. See Tucker 2014. For additional background on collaborations between the FDIC and Bank of England officials as early as 2012, see Skeel 2016.

[6] This intra-corporate support – whether equity, loans or holding company reserves – is commonly called internal total loss-absorbing capital (or internal TLAC) and is distinguished from external TLAC, which consists of both equity and potentially loss-absorbing debt, mostly commonly, at least for US financial conglomerates, to be issued at the holding company level. See Federal Reserve Board Notice of Proposed Rulemaking on Total Loss-Absorbing Capacity, 80 Fed. Reg. 24,926 (November 30, 2015). See also Financial Stability Board 2014. For additional insights on TLAC, see Gordon and Ringe 2015.



Developing effective design standards for these intra-corporate connections poses numerous challenges. One, which has already received considerable attention, is figuring out how much additional funding capacity financial conglomerates should maintain at the holding company level. In the parlance of Figure Two, that means how large the reserves and loans to subsidiaries must be to ensure that the holding company has the financial wherewithal to absorb subsidiaries' losses in times of financial distress. (The whole purpose of the SPOE exercise is to provide for the automatic recapitalization of operating subsidiaries without resort to new capital-raising in the midst of a financial crisis). But a separate and related design question for SPOE concerns how much holding-company capacity should be "pre-positioned" into operating subsidiaries in the form of loans or similar forms of intra-corporate indebtedness.[7] The advantage of the pre-positioning through loans is that pre-positioned assets are potentially more credible commitments with a higher degree of automaticity. Indeed, the goal of the pre-

[7] From a theoretical perspective, it might seem irrelevant whether reserves are held at the holding-company level or downstream in the form of a loan that will be forgiven in the event of subsidiary losses, but there are important differences in terms of credibility, especially when the subsidiary is located in other jurisdictions. Reserves that must be down-streamed in times of crisis have less "automaticity" than do loans that are automatically forgiven upon the occurrence of some pre-determined trigger.

positioning is to provide foreign regulators with ex ante assurance that the holding company will indeed bear losses. (Tucker 2014.) But the drawback is that pre-positioned assets reduce holding company flexibility in times of financial stress. If, as is almost always the case, losses are not evenly distributed across operating subsidiaries, a SPOE based on fully pre-positioned financial assets may not be effective.[8] On the other hand, an SPOE strategy with 100 percent of holding-company resources held in reserve may not provide a credible commitment to subsidiary creditors or foreign regulators supervising off-shore affiliates.[9] Recognizing the multitude of potential problems associated with each of the foregoing strategies, the Federal Reserve Board and the FDIC have advocated for a mixed approach, noting that firms should "not rely exclusively on either full pre-positioning or [assets held by] the parent" and they "should not assume that a net liquidity surplus at one material entity can be moved to meet net liquidity deficits at other material entities or to augment parent resources." (Bank of America 2016, 7; see also Morgan Stanley 2016, 7; JPMorgan Chase 2016, 8, for substantially similar language).

Anticipating Uncooperative Holding Company Creditors

[8] Creative lawyering could, no doubt, come up with potential solutions for the pre-positioning dilemma. One possible solution, to be used only in times of financial crisis, might be to allow holding companies to use intra-corporate loans made to healthy subsidiaries as an asset that the holding companies could contributed to unhealthy subsidiaries with higher-than-anticipated losses. Assuming regulatory authorities would allow for such a transfer, this approach would increase the available resources that the holding company could transfer to unhealthy subsidiaries and diminish some of the rigidity of pre-positioning. Whether foreign officials would find such a capital contribution (with its intra-corporate exposures) as credible as a cash infusion or the forgiveness of parent to subsidiary debt is an open question. Consider, for example, if serious losses occurred at a London affiliate of a major US insurance company. How much confidence would it give a Bank of England official to be told that the loan subsidiary was to be recapitalized with a loan to an affiliate in Nebraska (which, as far as the BoE official knows may also be facing serious losses)? Furthermore, there is the risk that defensive "ring-fencing" by foreign jurisdictions could prevent the free flow of assets from an affiliate in one jurisdiction to an affiliate in another jurisdiction in times of financial distress. In their review of 2015 living wills, the Federal Reserve Board and the FDIC specifically identified ring-fencing as a significant threat to a successful SPOE bankruptcy strategy. See JPMorgan Chase Letter 2016, at 6. See also Morgan Stanley Letter 2016, at 5 and Bank of America Letter 2016, at 6.

[9] One measure that has been suggested to enhance the credibility of unfunded commitments to shore up foreign affiliates would be to provide some sort of security for the commitment, likely in the form of pledging marketable securities held at the holding company level. Putting to one side the question of whether such pledges could be enforced efficiently in the midst of financial stress, this approach is really a variant of pre-positioning, with the actual downstreaming of assets to be executed at the very last minute. One issue that would need to be sorted out is how rights under such pledge agreements would be shared, if at all, among different affiliates. And, if shared, the question to consider is whether such sharing would constitute a credible commitment for foreign authorities likely operating under the fog of market instability. As discussed in note 11, one advantage of providing security to subsidiary-support commitments is that it diminishes the likelihood that other holding company creditors could object to the holding company's honoring commitments in times of financial stress.

Whatever share of holding-company resources are pre-positioned in operating subsidiaries, the execution of the SPOE strategy is quite possibly going to prompt hostile and aggressive reactions from holding-company creditors. (One of the lessons of prior experiences with the source-of-strength doctrine is that holding-company creditors invariably resist the down-streaming of value to failed subsidiaries, and bankruptcy courts, oriented as they are toward the protection of creditors rights, have been surprisingly hostile to intra-corporate transfers of value to distressed subsidiaries in manners inconsistent with ordinary principles of limited liability (Lee 2012a; Lee 2012b). At the very least, resistance of this sort is something that authorities need to consider carefully in their review of living wills designed to facilitate resolutions under SPOE.

To understand the perspective of creditors in such situations, consider again the relationships illustrated above in Figure Two. Even with a total loss of the holding company's equity investment in subsidiaries, holding-company creditors could still look to the company's reserves and loans to subsidiaries as sources of repayment if the holding company were to go into receivership. Those creditors may well be better off if the holding-company receiver declined to downstream reserves to distressed subsidiaries or converted loans into equity investments as the SPOE strategy contemplates.[10] If the past is any guide, counsel for those creditors might easily characterize efforts to down-stream value to distressed subsidiaries as fraudulent conveyances or possibly improper preferences in violation of traditional bankruptcy principles.[11] Even though objections of this sort may not prove persuasive to the FDIC acting as receiver under OLA as established by Title II of the Dodd-Frank Act, the arguments may be much

[10] To be sure, the inverse may also be true. There may well be circumstances where the holding company (and its creditors) will be better off if the holding company downstreams value to a subsidiary in difficulty. Preservation of going-concern value in the subsidiary's business may warrant additional investments, and in some cases the holding company may have guaranteed the debt of subsidiaries such that the financial fate of the two entities is already bound together. Effective supervision of subsidiary activities and higher subsidiary capital requirements will also make it more likely that preservation of the subsidiary is in the best interest of holding-company creditors. The interesting case, however, and the case that has occurred with some frequency in the past is when the subsidiary really is a black hole and holding-company creditors would much prefer to cut off support and retain assets at the holding company level.

[11] Note that if holding-company commitments were secured by marketable assets at the holding company level (see note 9), these concerns would be much diminished. The characterization of downstream transfers as a preference could also be resisted if there were no pre-existing commitment to make those transfers. But, as discussed earlier (see note 8), pre-commitments to support material subsidiaries, particularly those located in foreign jurisdictions, are central to the SPOE strategy.

more compelling to a bankruptcy court judge coming to the transaction with a quite different professional orientation (with a focus on protecting creditor rights).

As is explored in more detail below, Congress amended the Bankruptcy Code back in 1990 to clarify the rights of the Federal Reserve Board to enforce its source-of-strength doctrine against bankruptcy estates, creating with section 365(o) of the Bankruptcy Code a priority for capital commitments to FDIC-insured bank subsidiaries. Even with this priority in place, federal authorities have not always been able to prevail against objections of holding company creditors in bankruptcy proceedings. (Lee 2012b.) Moreover, nothing in the Dodd-Frank Act created similar privileges for obligations to support non-banking affiliates of failing financial conglomerates, as contemplated under SPOE. Accordingly, it does not seem to be much of a stretch to predict that holding company creditors may contest efforts to downstream value within failing financial conglomerates to the extent that those transactions diminish the returns to creditors.

Reorienting Regulators from the Right-Hand Side of the Holding Company Balance Sheet

A third and more subtle reorientation of the SPOE strategy is a shift in regulatory attention away from the right-hand side of the holding-company balance sheet. As described earlier, the source-of-strength doctrine was primarily intended to solve a moral hazard problem by imposing losses on holding company creditors and shareholders. The idea was that enhanced financial obligations of financial conglomerates would force holding-company stakeholders to monitor more carefully the activities of the entire corporate group, especially FDIC-insured bank subsidiaries. For conglomerates that did not credibly rein in the riskiness of their activities, the capital market would impose an ex ante penalty in the form of higher interest charges and costs of capital. But the work was being done, by and large, on the right hand side of the holding-company balance sheets.

The SPOE strategy retains this logic, but also imposes considerable attention on the left-hand side of the holding-company balance sheet. One of the manifestations of this change is our earlier discussion of pre-positioning assets in intra-corporate loans. Among other things, the SPOE strategy requires regulatory authorities to consider how holding-company reserves will be deployed. But SPOE's interventions into the left-hand side of holding-company balance sheets go considerably beyond pre-positioning (Jarque and Price 2015). The entire exercise of drafting and reviewing resolution plans for systemically important financial conglomerates is based on the assumption that regulatory authorities should have a say in the organization of financial conglomerates, including which activities should be located in which legal entities and the degree of complexity permitted in intra-corporate servicing arrangements.[12] To be sure, this analysis and preparation is well-intended: its goal is to make financial conglomerates more resolvable in times of financial stress. This advanced planning may be essential to the operation of a workable SPOE strategy.   But it takes regulatory authorities substantially deeper into the business decisions of financial groups than was ever the case with old-fashioned – that is, pre-Dodd-Frank Act—limitations on permissible holding-company activities under the Bank Holding Company Act of 1956.   This expansion of the regulatory perimeter also carries with it risks of its own, including both additional costs from regulatory oversight and the potential that supervisors may be fostering identical business strategies and hence correlated risks across the financial services sector.[13]

Multiplicity of Resolution Alternatives and Complexity of Choice Architecture

One of the somewhat surprising artifacts of the Dodd-Frank Act reforms is that the United States now has in place a multiplicity of resolution alternatives for financial conglomerates. The United States now maintains at least three basic systems for resolving large financial groups, each with a distinctive structure (see table 1).

[12] Many of the of the FDIC and Federal Reserve Board's objections to recent living wills relate to concerns that the firms in questions had not sufficiently simplified their organizational structures. See Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation 2016.

[13] The impact of adopting credible living wills comes, of course, on top of many substantive changes in legal requirements, many required by the Dodd-Frank Act, that also increase the cost of operations, require the maintenance of greater liquidity reserves and capital cushions, and potentially reduce further variations in business strategies across financial conglomerates.

The traditional approach to the failure of a financial group (Option C in Table One), contemplates the primary resolution's being conducted at the level of the regulated subsidiary by financial supervisors, and the holding-company liquidation being handled separately under the federal Bankruptcy Code. This is how the FDIC deals with routine failures of banks and thrifts, with the regulated depository typically being taken over by another bank through a purchase and assumption transaction or some other form of deposit transfer. Although a holding-company bankruptcy may also occur, it traditionally has been of only marginal importance unless the holding company happens to have substantial resources, which banking authorities might try to claim in a source-of-strength proceeding to mitigate FDIC losses. Prior to the Dodd-Frank Act, Option C was the only resolution approach available and it was the manner in which the Lehman resolution was handled: SIPC dealt with the receivership of the firm's flagship broker-dealer and the bankruptcy court handled the holding-company bankruptcy. Option C remains available today, and is, as a practical matter, the only alternative available for small bank holding companies (those with less than $50 billion in assets) and is, at least in our view, the presumptive approach even for bank holding companies above the $50 billion asset level but beneath the threshold of a major regional with more than $100 billion of assets.

Title II of the Dodd-Frank Act creates a new resolution alternative, the Orderly Liquidation Authority (OLA), for large financial conglomerates (Massman, 2015.) As implemented under the FDIC's SPOE approach and as outlined earlier in this paper, the alternative (Option A in Table One), envisions the appointment of the FDIC as receiver of the holding company and the continued conduct of business without formal receivership proceeds of major operating subsidiaries. Thus, in contrast, with Option C, this alternative has no receiverships imposed at the subsidiary level. Rather, the resolution is conducted at the holding-company level. Under the Dodd-Frank Act, OLA is technically available for all bank holding companies, as well as non-bank SIFIs previously designated by FSOC under Title I of the Dodd-Frank Act and certain other large undesignated financial firms meeting statutory standards. The procedures are not available unless determinations of systemic risk are made by the secretary of the treasury, a super-majority of the board of governors of the Federal Reserve, and a qualifying vote of one other body (either the FDIC, SEC, or FIO, depending on the financial conglomerate in question).

Table One

An Overview of Resolution Alternatives and Their (Presumptive) Application

Type of Institution	Resolution Alternatives: Orderly Liquidation Authority Under Applied with Respect to Holding Company Under SPOE Approach Via Title II of DFA	SPOE-Like Resolution of Holding Company Under Bankruptcy Code	Primary Resolution through Receiverships of Regulated Subsidiaries with Holding Companies Resolved Under Bankruptcy Code, As Needed
	Option A	***Option B***	***Option C***
Bank Holding Companies			
G-SIBs	*Possible*	*Supposedly Presumptive*	*Unlikely*
Major Regional BHCs	*Possible*	*Supposedly Presumptive*	*Conceivable*
BHCs with Assets >$50 bn	*Unlikely*	*Possible, but Unlikely*	*Presumptive*
Non-Bank SIFIs Designated by FSOC	*Possible*	*Supposedly Presumptive*	*Unlikely*
Other Large Undesignated Financial Firms	*Available, but Unlikey*	*Available, but Unlikely*	*Presumptive*

Located somewhat awkwardly between Options A and C is an SPOE-like resolution of a financial holding company under the federal Bankruptcy Code. Unlike Option A, this approach does not contemplate the use of OLA and Title II of the Dodd-Frank Act. Unlike Option C it does not contemplate the appointment of receivers for regulated subsidiaries. Rather, Option B envisions the use of an SPOE resolution but under the federal Bankruptcy Code, with bankruptcy judges presiding, as opposed to the FDIC under OLA.[14] But unlike Option A resolutions, this resolution approach is not governed by the special receivership powers of Title II and does not have access to the sort of debtor-in-possession financing ("DIP financing") that the Orderly Liquidation Fund ("OLF") provides for OLA proceedings.

Although Option B is something of an ungainly creature, it is the resolution alternative that the Dodd-Frank Act establishes as statutorily presumptive for most major financial conglomerates in the United States. In preparing the living wills that Title I of the Dodd-Frank Act requires of all major bank

[14] Opinions as to the viability of Option B have evolved over time, but many experts working in the field seem now to be squarely of the view that such resolutions are possible. See, for example, Guynn 2014, who states, "Whether it is possible to execute SPOE recapitalization under the Bankruptcy Code was once an open question. It is now understood to be possible" (296). Considerable attention, however, is also being devoted to amending the Bankruptcy Code to make it easier to implement SPOE resolutions. See sources cited in note 4. As a practical matter, SIFIs and their counsel are under considerable pressure to characterize their Option B plans as credible, as that is a statutory requirement for such plans under the Dodd-Frank Act. See next note.

holding companies (those with more than $50 billion in assets) and FSOC-designated non-bank SIFIs (such as AIG, Prudential Insurance, and GE Capital), firms are called upon to make representations that the resolution plans could be credibly executed under the federal Bankruptcy Code.[15] These plans, which would also provide a blue print for the FDIC were it to resolve the firm under OLA in a Title II (Option A) proceeding,[16] contemplate an SPOE approach with resolution at the holding company level and the continued conduct of business at the operating subsidiary level.

To summarize, the U.S. legal system currently allows for three quite different approaches to the resolution of financial conglomerates. The law does not offer clear guidance as to which approaches to take in which circumstances, but we believe that one can discern presumptive approaches with more and less plausible alternatives for different classes of firms. Our interpretation of this logic (summarized in Table One), proceeds as follows.

Start with the smaller bank holding companies defined as systemically important under the Dodd-Frank Act: those with more than $50 billion in assets but falling beneath the level of a major regional. These firms are subject to the living will requirements of Title I of the Dodd Frank Act and enhanced supervision of various sorts, yet their failure is unlikely to pose systemic risk concerns of the sort required for designation under Option A or even the SPOE-treatment associated with Option B. Our presumption therefore is that these kinds of institutions would be treated with the FDIC's traditional bank resolution procedures under Option C. If these firms get into trouble, absent dire market conditions, there will be no grounds for taking the somewhat extraordinary and costly steps associated with holding-company

[15] See Section 165(d)(4)(B) of the Dodd-Frank Act "[Each SIFI] shall resubmit [a] resolution plan within a timeframe determined by the Board of Governors and the Corporation, with revisions demonstrating that the plan is credible and would result in an orderly resolution under title 11, United States Code, including any proposed changes in business operations and corporate structure to facilitate implementation of the plan.". In their most recent assessments of living wills for a number of prominent systemically important firms, federal authorities expressly identified bankruptcy resolution plans as failing this credibility standard. See Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation 2016. The precise bases of these findings have not been made public; the problems we identify and discuss in this chapter may well be part of the reasoning.

[16] For an overview of how the FDIC might have made use of living wills in the application of an Option A resolution of the Lehman Brothers collapse (if the Dodd-Frank Act had been in effect at the time), see Federal Deposit Insurance Corporation 2011.

resolution procedures rather than simply disposing of regulated subsidiaries through sale to other acquiring firms in standard purchase and assumption transactions.[17]

Another group of firms that we would presumptively locate in Options C are large financial conglomerates that lack bank affiliates (and hence bank holding company status) and that also have not been previously designated as systemically important by the FSOC. Although these firms could theoretically qualify for resolution under OLA, our suspicion is that federal authorities would be extremely reluctant to invoke Title II of the Dodd Frank Act without the preparations associated with FSOC designations under Title I. These firms would not have submitted living wills or otherwise provided regulatory authorities with the kinds of information on corporate structures and resolution plans required of other designated non-bank SIFIs. They would, moreover, not have the capital structures or intra-corporate connections required to effect an SPOE disposition. And, just as these firms would not be prepared for Option A's resolution under OLA, they would be unprepared for Option B's SPOE-like resolution under the federal Bankruptcy Code, making Option C their default alternative and presumptive approach. To be sure, should a truly large financial firm not designated as an SIFI – perhaps a firm on the scale of Berkshire Hathaway – encounter sudden and unexpected financial distress, one could imagine federal authorities attempting Option A or Option B on the fly, but it would be a treacherous path to negotiate and one likely to end in a messy ditch.

What remains then are a core group of systemically important institutions, already subject to enhanced prudential oversight by the Federal Reserve Board with resolution plans already prepared and reviewed by regulatory authorities. These firms are also the ones with potential systemic consequences in the event of failure. Under the Dodd-Frank Act, resolution of this group is, in theory, presumed to take place under Option B, but these entities are also the firms for which Title II was created and it is at least

[17] There have, apparently, been some limited examples of traditional bank failures that have been resolved at the holding-company level through section 363 transactions and prepackaged reorganizations. See Christiansen et al. 2014. Arguably, these approaches represent a further Option D, holding-company resolution outside of SPOE. Interestingly, at least two major conglomerates – Wells Fargo and Bank of New York Mellon – have submitted living wills contemplating Option C resolutions. See PwC 2015.

conceivable that they would be resolved under Option A. It is also possible, at least for the major regionals, that federal authorities might conclude that systemic risks were not at issue and traditional resolution procedures (that is Option C) would be appropriate. This decision would be largely in the hands of the FDIC, which has the power to force Option C by imposing a receivership on FDIC-insured bank subsidiaries that become insolvent. And the imposition of such a receivership would (absent extraordinary efforts) violate the principles of SPOE and render both Option A and Option B unavailable.

The more interesting decision point, however, is between the use of Option A or Option B for a bank holding company that was arguably systemically important or a non-bank SIFI previously designated by the FSOC. A number of factors could militate against invoking the much-publicized OLA powers of Title II for even these firms. To begin with, there are numerous congressional statements indicating that OLA should be used only as a resolution alternative of last resort. The sentiments underlying these statements resonate with on-going concerns in some quarters that OLA resolutions are synonymous with federal bail-outs (presumably as a result of the availability of federal funding via the OLF).[18] Conceivably such concerns could lead critical officials, perhaps a new secretary of the treasury acting on campaign commitments to address issues regarding "too big to fail" entities, not to turn one of the keys necessary to invoke OLA. But even less dogmatic government officials might choose not to invoke Option A if the failure in question was seen as idiosyncratic and not as the consequence of wide-spread market disruptions. Certainly, there would be advantages in demonstrating that Option B offered a feasible means to resolve large financial firms in a non-disruptive, SPOE-like manner under the ordinary rules of bankruptcy and without reliance on OLA's special rules and access to federal funds. While one

[18] The authors of the Dodd-Frank Act went to considerable lengths to structure OLF funding so as to limit its use to liquidity funding and to minimize the risk of losses to the federal government. In extreme cases, the measures could include special assessments on other financial institutions to prevent any costs being passed on to taxpayers. See Massman 2015. However well-intended those measures may be, there remains some risk that regulatory authorities in the future will underestimate the losses of a failing firm in times of financial stress and choose not to invoke recoupment options (possibly out of legitimate fears of pro-cyclical effects). Commentators have widely different assessments of the likelihood of OLF funding being deployed in such as manner as to constitute a shareholder or creditor bailout at the expense of taxpayers. Nevertheless, invoking Title II and tapping into the OLF clearly pose some degree of political risk even if federal funds are ultimately repaid and all losses are imposed on private parties. In addition, legal challenges to Title II procedures remain a possibility. See Merrill and Merrill 2014. Together these factors along with other considerations noted in the main text could steer government officials away from Option A and towards Option B if the path forward seemed clear.

might imagine a failing conglomerate preferring to have its resolution assigned to the more robust regime that OLA creates, public authorities might well conclude that invoking Option B in appropriate cases would generate fewer moral-hazard concerns and less political backlash down the road. It is, moreover, possible for regulatory authorities to begin a SPOE-like resolution under the federal Bankruptcy Code and then transfer it to OLA if difficulties arise as the proceedings develop. Accordingly, at least when financial markets are not in the midst of a September 2008 style free-fall, Option B may well turn out to be the resolution alternative of choice, even for systemically important firms. That is, of course, if Option B can be turned into a viable alternative, the topic to which we now turn.

Limits of the Existing Bankruptcy Code and Some Partial Solutions (in the Absence of Statutory Reform)

Resort to federal bankruptcy courts for the resolution of distressed financial companies in an SPOE-like transaction presents a number of potential challenges, many of which have been discussed in the rich body of literature on resolution planning under the Dodd-Frank Act. In our view, there are three critical issues as well as a larger background concern about the capacity of regulatory officials, notably the FDIC, to control resolution strategies in bankruptcy courts. We will begin with a summary of each of these issues and then offer a set of regulatory solutions, all of which entail significant advance planning on the part of regulatory authorities, some of which is already under way. In general, what we suggest in the following pages is the creative, but hopefully not implausible, invocation of existing regulatory authority on the part of the FDIC and Federal Reserve Board to prepare financial conglomerates for SPOE-like resolution under the Bankruptcy Code. Critically, none of these solutions rely upon the amendment of current law and therefore do not depend upon the vagaries of current legislative processes in the United States. But they do necessitate careful attention to how living wills and other resolutions plans are structured well before a firm encounters financial difficulties.

Cross-Defaults on Qualified Financial Contracts with Affiliated Entities.

An initial and significant problem in resolving financial conglomerates under the Bankruptcy Code is the possibility that counterparts on derivatives contracts and other qualified financial contracts (QFCs) will exercise existing contractual rights to close out their transactions with affiliated entities, precipitating a run on the corporate group and dissipating going-concern value that the SPOE approach is designed to preserve. The Dodd-Frank Act addressed this problem, at least in part, by staying such actions with respect to counterparties of affiliates of conglomerates being resolved under OLA proceedings. The Dodd-Frank Act stay, however, does not extend to firms being resolved under the Bankruptcy Code, that is, to the Option B alternative (Roe and Adams 2015). Moreover, there exists a separate concern that the Dodd-Frank Act stay may not be enforced by courts in foreign jurisdictions. Over the past few years, federal authorities have attempted to address both of these issues by encouraging amendments to International Swaps and Derivatives Association (ISDA) Master agreements.[19] But the ISDA reforms represent an imperfect solution, being of a voluntary nature and not necessarily covering all QFCs that could run in the face of financial distress. Accordingly, under current law, there is a risk that federal authorities may not be able to prevent a run by the derivatives counterparties of affiliates of holding companies that are resolved under the federal Bankruptcy Code. Thus, the risk of QFC runs with an Option B resolution is potentially substantial.

Resistance by Holding-Company Creditors and Bankruptcy Courts to the Recapitalization of Operating Subsidiaries.

As explained, one of the lessons of regulatory efforts to enforce the source-of-strength doctrine has been persistent resistance of holding company creditors and bankruptcy courts to transactions that recapitalize downstream subsidiaries but impair the value of holding-company creditors. Under plausible

[19] For an overview of these reforms, see Geen et al. 2015 and Sidley Austin LLP 2015. While the revisions of the ISDA master agreements were clearly taken with the encouragement of regulatory authorities, the reforms were not the product of a legal requirement and, as is explored in note 20, do not necessarily cover all contexts or counterparties that regulatory authorities would want to stay in the face of an Option B resolution.

interpretations of the Bankruptcy Code, downstreaming reserves or converting intra-corporate loans into equity can be characterized as impermissible preferences or fraudulent conveyances. The FDIC and the Federal Reserve Board identified problems in the resolution plans of all six firms submitting SPOE-based 2015 resolution plans. For future plans, those firms were directed to "include a detailed legal analysis of the potential state law and bankruptcy law challenges and mitigants to the planned provision of [capital and liquidity to subsidiaries prior to bankruptcy] . . . In identifying appropriate mitigants, [the firms were directed to] . . . consider the effectiveness, alone or in combination, of a contractually binding mechanism, prepositioning of financial resources in material entities, and the creation of an intermediate holding company" (Bank of America 2016, 12; see also State Street 2016, 13; Morgan Stanley 2016, 10; Citigroup 2016, 7; Goldman Sachs 2016, 10–11; and JPMorgan Chase 2016, 17–18 (all substantially similar language). Even though comparable issues theoretically arise with financial conglomerates resolved under OLA proceedings of Title II, a critical difference is that the FDIC will exercise considerable control over the operation of OLA receiverships, whereas the bankruptcy court will preside over Option B resolutions. While a bankruptcy court judge might ultimately accept the downstream of holding company value that SPOE strategy contemplates, experience with the source-of-strength doctrine suggests the process will not be easy, adding another mark against the bankruptcy court alternative as opposed to OLA under Title II.[20]

Lack of DIP Financing.

The third commonly-cited concern with bankruptcy court resolutions for financial conglomerates is the lack of an obvious source of DIP financing. Whereas, with OLA, the FDIC receiver has statutory authority to tap into the Treasury's OLF with ample sources of liquidity, there is no comparable source of public financing for financial conglomerates resolved under the federal Bankruptcy Code. This is, indeed, a critical distinction between the two processes and one of the reasons that OLA is denominated

[20] For a review of legal challenges to the source-of-strength doctrine, see Lee 2012b. Conceivably, the courts would be less resistant to the doctrine in light of the Dodd-Frank Act's statutory codification, but that remains a source of uncertainty.

by some as a form of federal bailout, whereas resolution under the federal Bankruptcy Code is not. As set forth in the margins, this characterization of OLA can be understood in a number of ways,[21] but for current purposes what is important to note is that the OLF is not available to financial conglomerates resolved under Option B and many informed experts are concerned that private sources of DIP financing would either be unavailable or at least inadequate for major financial conglomerates forced into a bankruptcy under the federal Bankruptcy Code.[22] Even if runs by counterparties on derivative transactions with affiliates were somehow addressed, financial conglomerates in bankruptcy could still encounter the runoff of substantial amounts of other short-term liabilities and would require substantial liquidity support at the holding company level, support that would be difficult to obtain from private sources, especially in periods of financial distress.

Lack of Expertise in and Advanced Planning by Bankruptcy Courts.

A final and more generalized concern about reliance on bankruptcy courts to resolve financial conglomerates sounds in institutional competence. The best articulation of this perspective comes from a paper by FDIC officials several years ago explaining why OLA procedures would have been much more effective in dealing with the insolvency of Lehman Brothers in September of 2008 than the bankruptcy court actually was. Among other differences, "The Orderly Liquidation of Lehman Brothers Holdings Inc. under the Dodd-Frank Act" (Federal Deposit Insurance Corporation 2011) focused on the bankruptcy court's very limited understanding of Lehman when it was forced into bankruptcy and on the incapacity of the parties to line up immediate DIP financing to stabilize operations and retain control over foreign

[21] As discussed in note 18, one characterization is based on an assessment that, notwithstanding statutory restrictions, OFL funds might ultimately be used to support shareholders and creditors at the expense of taxpayers. Another and more extreme position characterizes the use of any sort of government funding, even for liquidity purposes on terms that would satisfy traditional lender-of-last-resort support, as constituting a form of government bailout. Those adopting the latter position implicitly object to any sort of government financing for financial firms in periods of financial stress, even perhaps access to the discount window or traditional lender-of-last resort activities.

[22] For a thorough discussion of this issue, see Skeel 2015. It is telling that all six of the firms submitting SPOE-based 2015 resolution plans faced either deficiency or shortcoming notices with regard to their models and processes for estimating liquidity needs for material operating entities during a resolution period. Only three firms faced problems with regard to the adequacy of their planned liquidity sources; however, it is possible that better modeling will demonstrate adequacy failures at the other firms as well.

affiliates. As portrayed in the article, the bankruptcy court lacked both the knowledge and the tools to move quickly enough to resolve a distressed firm on the scale of Lehman Brothers in a timely and orderly manner.

We will now sketch out a series of proposed solutions to these problems, starting with the general point about bankruptcy court capabilities and then working through the three more technical concerns summarized earlier. Our analysis here is necessarily skeletal but it offers what might be seen as a more muscular regulatory posture that could, in our view, respond to the major limitations of bankruptcy resolution for financial conglomerates. A recurring theme in this discussion is the importance of federal authorities' deploying, well in advance of financial crises, a range of supervisory tools to shape the structure of resolution plans so as to maximize the likelihood of successful Option B resolutions.

Proactive Planning for Option B Resolutions with an Option C Stick in the Closet

We start with a few preliminary points about the ability of federal regulators – and most particularly the FDIC and Federal Reserve Board – to prepare in advance for the resolution of a major financial conglomerate in bankruptcy. In stark contrast with the actual Lehman filing, financial regulators in the post-Dodd Frank Act environment will have done immeasurably more advanced planning than was possible in 2008. As long as the financial conglomerate is either regulated as a major bank holding company or has been designated by FSOC as systemically important, the firm will have produced – and both the FDIC and Federal Reserve Board will have critiqued and reviewed – a resolution plan with a detailed analysis of how the entity might be resolved in a bankruptcy proceeding. This should provide authorities with an in-depth understanding of the firm's operations and material subsidiaries as well as a game plan for resolving the firm through a SPOE-type resolution.[23] Whereas Lehman Brothers

[23] The Federal Reserve Board and the FDIC have stressed bankruptcy preparedness in a firm's resolution plan by requiring governance mechanisms which provide for, among other things, the "timely execution of a bankruptcy filing and related pre-filing actions," including "any emergency motion[s] required to be decided on the first day of the firm's bankruptcy." See, for example, JPMorgan 2016, 17. Furthermore, the agencies have also encouraged firms to complete draft emergency motions and proposed forms of order. See, for example, Goldman Sachs 2016, 12 (draft emergency motion for continued stay relief under ISDA Resolution Stay Protocol). Such advanced planning for bankruptcy filings will likely allow firms to submit to the bankruptcy court the best information

entered bankruptcy in a chaotic environment with negligible advanced planning and much uncertainty, future transactions of this sort will come after much groundwork has been laid. Indeed, if federal authorities choose to attempt Option B – that is, if they impose an SPOE-like resolution in bankruptcy – they will be coming with a pre-packaged plan to transfer valuable holding-company assets to a bridge holding company in something not too different from the increasingly popular section 363 transactions now routinely used in ordinary corporate reorganizations.[24] So, whereas the Lehman Brother's filing presented the bankruptcy courts with a very big headache, which has taken years to resolve, a future bankruptcy filing of a financial conglomerate will, if properly prepared, arrive as a neatly wrapped package, courtesy of the FDIC and Federal Reserve Board staff operating under powers granted them under Title I of the Dodd-Frank Act.

In addition, federal authorities will come with a fairly big stick with which to constrain holding-company creditors inclined to resist their pre-packaged plan. If, as will almost always be the case, the distressed conglomerate includes a troubled regulated entity, an FDIC-insured bank or an SEC-registered broker-dealer or a major insurance company, authorities have the power to seize that subsidiary through non-bankruptcy processes, effectively moving resolution to Option C. Federal authorities may not want to go down that route for reasons of systemic risk; Option C will also be an extremely unattractive choice for holding-company creditors as it will likely dissipate going-concern value and further impair the interests of holding-company creditors. As discussed in the next section, additional steps should be taken to weaken legal arguments that holding-company creditors might raise to resist Option B resolution plans. The power of regulatory authorities to threaten subsidiary seizures should a bankruptcy court delay in approving a pre-packaged resolution plan greatly enhances the ability of the FDIC and Federal Reserve

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possible as quickly as possible. Moreover, to the extent such drafts are made public, it would be both possible and beneficial for bankruptcy judges to familiarize themselves with such draft filings prior to an actual financial conglomerate's bankruptcy filing.

[24] Arguably, the transfer would be even simpler than typical section 363 transfers because in an Option B resolution it is contemplated that subsidiaries would be transferred to a new bridge holding company that would be controlled by a fiduciary for the sole benefit of the bankruptcy estate of the bankrupt holding company. There would arguably be no need to value the business as would be required if the sale were being made for consideration to a third party.

Board to shape the course of an Option B resolution. Their control is not formally the same as in OLA under Option A, but in practice the differences may not be material.

Taking a More Muscular Approach to Cross-Defaults on QFC

We now turn to technical challenges in resolving financial conglomerates through bankruptcy proceedings, starting first with the problem of cross-defaults on QFCs with holding company affiliates. Recall that the problem here is two-fold. First, the stay provisions written into Title II of the Dodd-Frank Act do not extend to firms being resolved in bankruptcy. Second, federal authorities' current approach to addressing the residual cross-default problems depend on voluntary adjustments to ISDA agreements, which entail a complicated process of negotiation among private parties, are not mandatory, and as currently drafted do not deal with all potential problems that could arise should a large and global financial conglomerate become financially distressed.

There is, however, a straightforward regulatory solution to the problem, which would solve all cross-default problems for both OLA and bankruptcy. Under section 165(b) of the Dodd-Frank Act, the board of governors can adopt "such other prudential standards as the Board of Governors . . . determines are appropriate" for systemically important financial conglomerates.[25] The board of governors, could, in our view, use this authority to adopt a regulation that prohibits any affiliate of a systemically important financial conglomerate to enter into a QFCs that grants counter-parties authority to exercise any sort of

[25] The text of the provision, with emphasis to key language added, reads:

> (1) IN GENERAL.— (A) REQUIRED STANDARDS.—The Board of Governors shall establish prudential standards for nonbank financial companies supervised by the Board of Governors and bank holding companies described in subsection (a), that shall include— [capital, liquidity requirements, risk management requirements, resolution plan requirements, and concentration limits] . . .
> (B) ADDITIONAL STANDARDS AUTHORIZED.—<u>The Board of Governors may establish additional prudential standards</u> for nonbank financial companies supervised by the Board of Governors and bank holding companies described in subsection (a), that include—
>
> (i) a contingent capital requirement;
> (ii) enhanced public disclosures;
> (iii) short-term debt limits; and
> (iv) <u>such other prudential standards as the Board or Governors</u>, on its own or pursuant to a recommendation made by the Council in accordance with section 115, <u>determines are appropriate.</u>

right of acceleration or collateral call for a limited number of days following the filing of a resolution plan under either OLA or the federal Bankruptcy Code. These requirements need not be limited to the stay provisions of Title II of the Dodd-Frank Act and could be designed with an eye towards improving the viability of both Option A and Option B resolution alternatives. To be sure, the board would need to justify the terms of this requirement in its proposal and adopting release, but its legal authority is sufficient to prohibit any QFC terms that would impair the ability of federal authorities to use the resolution technique of their choice.[26]

In a similar vein, the Federal Reserve and the FDIC could use their authority to review and assess the credibility of resolution plans under section 165(d) of the Dodd-Frank Act to police the QFCs and other contractual commitments of systemically important financial conglomerates so as to override safe-harbor protections under the federal Bankruptcy Code or similarly spirited rules in other jurisdictions. To some degree, federal authorities may, in effect, be pursuing something like this approach in all but mandating that systemically important institutions accept reforms embodied in recent ISDA protocols.[27] But it remains available to government authorities to condition the determination of credibility of a firm's living will on the adoption of amended ISDA agreements that would increase the likelihood of Option B resolutions.[28]

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26 Among other things, such a regulatory requirement could address situations when an affiliated entity itself is in default on a swap agreement (something not currently covered in the ISDA reforms; see Roe and Adams 2015). In addition, it could impose restrictions on regulated entities doing business with other entities that have not already adopted the ISDA reforms. In fact, in the Spring of 2016, the Board has announced a proposed rule pursuant to its § 165(b) authority that would go a good deal of the way toward the goal of correcting the cross-default problem by effectively mandating adherence to the ISDA reforms or equivalent QFC contract amendments. See Restrictions on Qualified Financial Contracts of Systemically Important U.S. Banking Organizations and the U.S. Operations of Systemically Important Foreign Banking Organizations; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions, 81 Fed. Reg. 29,169 (May 11, 2016) (proposing release). See also Davis Polk & Wardwell 2016. While we think this proposed rule represents a strong and important step in the right direction, there remain potential gaps in the proposal's coverage, and it does not necessarily cover all QFCs that could run in the face of financial distress.

27 See Sidley Austin LLP 2015.

28 In practice, federal authorities would likely need only to threaten such a formal requirement to lead ISDA to adopt further reforms. From the outside, it is difficult to ascertain how far federal authorities might wish to push ISDA reforms. Our point here is that these officials, especially if they work with foreign counterparts through the FSB, have considerable leverage to impose stay procedures that facilitate Option B resolutions and they need not demure if private-party solutions are not fully satisfactory.

Clearing Potential Obstacle to Down-Streaming Value and Intra-Corporate Loan Conversion

Federal authorities also have the capacity to address potential legal obstacles to down-streaming value or converting intra-corporate loans in an SPOE-like resolution plan executed under the federal Bankruptcy Code.[29] As mentioned earlier, creditor resistance to the board's initial efforts to establish a holding-company source-of-strength doctrine back in the 1990's led Congress to amend the federal Bankruptcy Code with a new section 365(o), which creates a priority for "any commitment [of a holding company placed in bankruptcy] to maintain the capital of an insured depository."[30] By its terms, this provision makes it possible for the FDIC to gain bankruptcy priority for a holding company's downstream commitments under an SPOE strategy with respect to insured depository institution subsidiaries. As a result, holding company creditors in a bankruptcy proceeding should not be able to object to well-drafted holding company obligations to FDIC-insured bank subsidiaries.

Section 365(o) can also be used to prioritize holding-company commitments to other material affiliates as well. Figure Three illustrates a three-step process that federal authorities might use to extend section 365(o) priorities to holding-company commitments to other affiliates. First, in Step A, the holding company would make a commitment to downstream value and convert intra-corporate loans to other affiliates (for example, off-shore securities affiliates) in accordance with the firm's SPOE resolution plan. Then, in Step B, an FDIC-insured

[29] Another tactic, beyond those discussed in the text, would be to limit the range of liabilities that holding companies can incur and to make those that remain contractually subordinated to any holding-company obligations to support material subsidiaries. While unlikely to be foolproof, this pre-planning could reduce the likelihood of effective challenges from bankruptcy creditors.

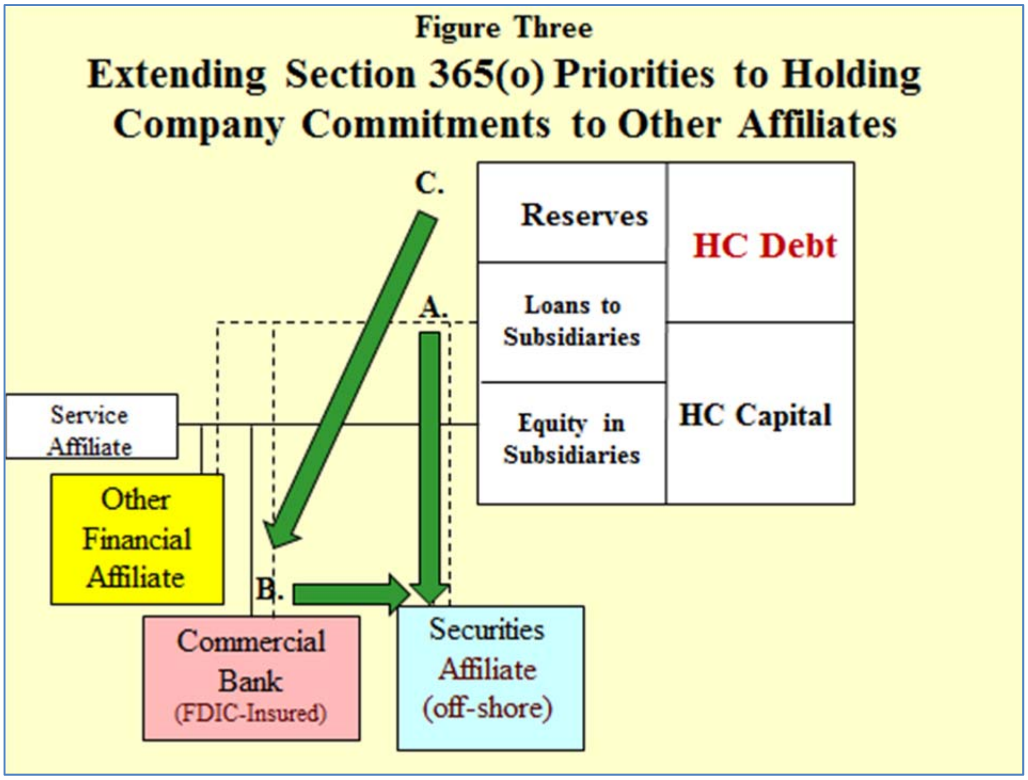
[30] Section 365(o) of the Bankruptcy Code (emphasis to key language added) reads in full as follows:

> In a case under chapter 11 of this title, the trustee shall be deemed to have assumed (consistent with the debtor's other obligations under section 507), and shall immediately cure any deficit under, <u>any commitment by the debtor to a Federal depository institutions regulatory agency </u>(or predecessor to such agency) <u>to maintain the capital of an insured depository institution</u>, and any claim for a subsequent breach of the obligations thereunder shall be entitled to priority under section 507. This subsection shall not extend any commitment that would otherwise be terminated by any act of such an agency.

bank subsidiary would guarantee the holding company's commitment made in Step A.[31] Finally, in Step C, the holding company would make a 365(o) qualified commitment to maintain the capital of the FDIC-insured bank subsidiary for any losses caused as a result of that subsidiary's honoring the guarantee made in Step B. With these three steps in place, holding-company commitments to all material affiliates can gain priority in bankruptcy. If holding-company creditors attempt to block the holding company's commitments to the securities affiliate in Step A, the Step B guarantee will kick in, and the holding company's Step C prioritized commitment to its FDIC-insured subsidiary will come into play. The tactic is, admittedly, a bit artful, but hardly exceptional when compared to the sort of intra-corporate commitments that one routinely encounters in modern finance.[32]

[31] Section 23A of the Federal Reserve Act, which is designed to limit extensions of credit from FDIC-insured banks to affiliates, could present a technical impediment to this guarantee, and so the approach might require a waiver from regulatory authorities. See Section 608 of the Dodd-Frank Act, discussed in Barr, Jackson, and Tahyar 2016, at 224-25. Although federal authorities may be disinclined to accept such proposal waivers as formal components of Section 165(d) resolution plans, the capacity to provide such waivers might still remain available in times of financial stress if necessary to achieve an Option B resolution.

[32] Conceptually, this three-step strategy makes the FDIC-insured affiliate the linchpin of holding-company commitments. In contrast to the traditional source-of-strength doctrine, where all commitments ran to the FDIC-insured entity, this approach creates commitments running out to other material affiliates. However, this reversal is necessary to make the SPOE strategy work. One needs a mechanism to ensure that holding-company commitments to all material subsidiaries are given priority in bankruptcy. Since section 365(o) as currently drafted only covers commitments to FDIC-insured bank subsidiaries, the bank subsidiary necessarily becomes the clearing house for holding-company support. Should federal authorities pursue this strategy, it may well be necessary for them to require non-bank SIFIs to create an FDIC-insured bank affiliate to make section 365(o) available in bankruptcy. Note that many of the proposals to amend the federal Bankruptcy Code to facilitate Option B resolutions include amendments of section 365(o) to expand the scope of the priority along the lines this work around is designed to accomplish.



Providing Credible Liquidity in Bankruptcy

The final, and in some respects most challenging, technical obstacle to using bankruptcy proceedings to resolve distressed financial conglomerates is access to liquidity or DIP financing during bankruptcy proceedings. As other commentators have noted, the liquidity needs of major financial conglomerates in bankruptcy can be substantial (Skeel 2015). Although a number of revisions in ex ante liquidity regulation will likely ameliorate this problem – the imposition of an effective stay of QFCs for affiliate firms would also be helpful – federal authorities clearly need to have a credible strategy for providing liquidity for a distressed financial conglomerate before allowing that entity to seek protection under the federal bankruptcy code. In descending order of desirability,[33] we offer four approaches:

1. *Prepackaged DIP Financing*: As discussed earlier, major holding company resolution in bankruptcy should look less like the chaotic Lehman Brother's filing of September 2008 and

[33] Again, several of these approaches might not be acceptable in formal Section 165(d) resolution plans; nevertheless they would be available in an actual resolution under the federal Bankruptcy Code, when regulatory authorities would be shaping events.

more like a routine section 363 transaction, planned well in advance. Just as the FDIC lines up bidders to take over typical bank failures in purchase and assumption transactions resolved over weekends, the FDIC could attempt to line up private DIP financing before a bankruptcy filing is made. Especially for distressed financial conglomerates resolved when not in an existential financial crisis, a private solution may well be viable, with sufficient advanced planning.

2. *Broad-Based Lender-of-Last-Resort Programs and Facilities Available Under Section 13(3).* Under reforms of the Dodd-Frank Act, the Federal Reserve Board is precluded from using its section 13(3) powers to extend credit to insolvent borrowers, including borrowers in bankruptcy or in OLA proceedings under Title II of the Dodd-Frank Act.[34] So section 13(3) is likely not a viable source of liquidity for holding companies being resolved in the bankruptcy court. In unusual or exigent circumstances, however, the Federal Reserve Board retains its capacity to engage in lender-of-last-resort functions for appropriately collateralized credit under a "program or facility with broad-based eligibility." Such programs and facilities, to the extent they are implemented, should be open to operating subsidiaries of financial conglomerates under an SPOE approach, as these entities are supposed to remain solvent and viable.[35] Although it may be difficult to predict the availability of such broad-based programs far into the future, in the days and weeks immediately preceding an Option B resolution, federal authorities will have a very good idea which broad-based programs and facilities the Federal Reserve Board is prepared to launch.[36] Thus, as the agencies finalize the terms of a pre-packaged SPOE-style resolution effort to be run through bankruptcy court and approach private lenders to assemble a DIP financing consortium, they may well be able to factor in support likely to be forthcoming from the Federal

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34 See 12 U.S.C. § 343.

35 To comply with the solvency requirement, care would need to be taken that any distressed operating subsidiary was recapitalized before the section 13(3) credit was extended. That is, the downstreaming of holding company value and the conversion of intra-corporate loans would have to occur first. Only after the recapitalization took place would section 13(3) be available to an affiliate that had been in financial distress. Healthy affiliates, in contrast, should be eligible before recapitalization.

36 For example, section 13(3) lending might be employed to support an specific asset class held by many entities including affiliates of a conglomerate in financial difficulties.

Reserve Board under section 13(3). Such lending must have appropriate collateral. While any such credit will undoubtedly be subject to intensive after-the-fact review by Congress, the availability of broad-based credit facilities under section 13(3) can somewhat ameliorate the financing requirements for financial conglomerates being resolved under Option B. By assuring private lenders that such Federal Reserve Board support is likely to be forthcoming, federal authorities may have an easier time lining up private DIP financing.

3. *Liquidity Support Under the FDIC's Systemic Risk Exception*. Another source of liquidity funding could come from the FDIC itself. Under 12 U.S.C. 1823(c)(4)(G), the FDIC has wide latitude "to take other action or provide assistance . . . for the purpose of winding up the insured depository institution for which the Corporation has been appointed receiver" in the event that the action is necessary to avoid or mitigate "serious adverse effects on economic conditions or financial stability."[37] Provided certain procedural steps are taken – steps that are quite similar to the steps required to invoke OLA powers under Title II of the Dodd-Frank Act – the FDIC could use this power to extend credit to facilitate an SPOE-like transaction that transferred control to another party an FDIC-insured bank "in default" or "in danger of default." As a result of statutory amendments adopted as part of the Dodd-Frank Act, this emergency authority is only available "for the purpose of winding up the insured depository institution for which the [FDIC] has been appointed receiver." Accordingly, the FDIC would need to interpret the term "winding up" to include resolution under an SPOE-style plan executed at the holding company level. In

[37] 12 U.S.C. 1823(c)(4)(G) reads as follows (emphasis to key language added):
(G) Systemic risk.—
(i) Emergency determination by secretary of the treasury.— Notwithstanding subparagraphs (A) and (E), if, upon the written recommendation of the Board of Directors (upon a vote of not less than two-thirds of the members of the Board of Directors) and the Board of Governors of the Federal Reserve System (upon a vote of not less than two-thirds of the members of such Board), the Secretary of the Treasury (in consultation with the President) determines that

> (I) the Corporation's compliance with subparagraphs (A) and (E) with respect to an insured depository institution for which the Corporation has been appointed receiver would have serious adverse effects on economic conditions or financial stability; and
> (II) any action or assistance under this subparagraph would avoid or mitigate such adverse effects, <u>the Corporation may take other action or provide assistance under this section for the purpose of winding up the insured depository institution for which the Corporation has been appointed receiver</u> as necessary to avoid or mitigate such effects.

our view, this is a plausible reading given the FDIC's past practices of resolving bank failures through holding-company vehicles.[38] Certainly, distress at the holding-company level will typically be thought to impair operations of a banking affiliate and, if banking affiliates have entered into the guarantee arrangement for non-banking affiliates described earlier, the bank subsidiary would bear the risk of capital shortfalls of affiliated entities and be even more easily characterized as having to be wound up in an SPOE transaction.[39] One of the advantages of invoking the FDIC's emergency authority under section 1823(c)(4)(G) is that the provision includes an assessment mechanism to recoup any losses the FDIC suffers on such assistance through payments from other insured institutions. So, while the FDIC should only be using this power to provide liquidity support (as opposed to solvency coverage), the cost of error here would be borne by the financial services industry and not U.S. taxpayers.

4. *Transfer to Title II and Access to OLF*. A final solution, should other forms of liquidity prove inadequate, would be for the receivership to be transferred to an OLA proceeding under Title II of the Dodd-Frank Act, where funding under OLF would be available. Although such a transfer would represent a failure of the Option B alternative, the availability of such a transfer makes Option B a more viable approach. Having an OLA backup with OLF liquidity as a fallback position, federal authorities can accept some uncertainty as to whether other alternative forms of liquidity will prove adequate in a bankruptcy proceeding.

DIP financing for a major financial conglomerate in bankruptcy proceedings does pose genuine challenges for federal authorities contemplating an Option B resolution, but the task is not quite as insurmountable as some analysts suggest. Especially with careful advanced planning, a number of

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38 Federal authorities have been similarly creative in interpreting "liquidation" authority of title II of the Dodd-Frank Act to facilitate Option A-style reorganizations. Again, this approach might require waivers of section 23A of the Federal Reserve Act in order to facilitate the transfer of funds from an FDIC-insured affiliate to other entities within the corporate group. See note 31.

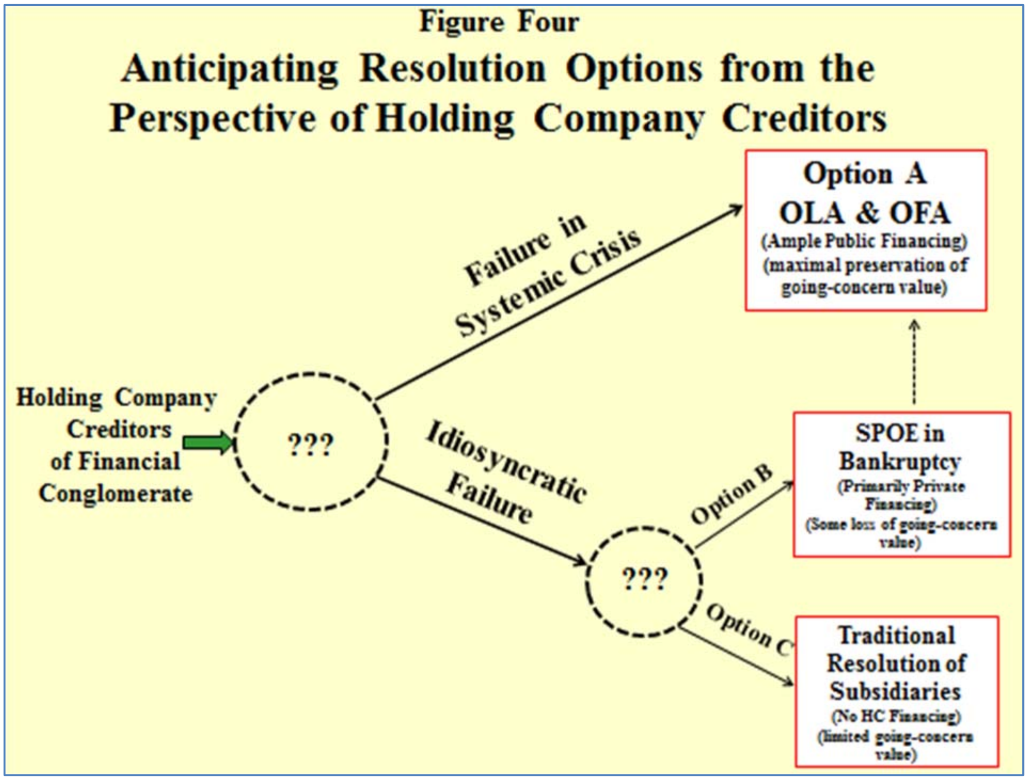
39 If a bank subsidiary were forced into FDIC receivership in order to pursue this strategy, care would need to be taken not to extend even broad-based Federal Reserve credit under section 13(3) lest that provision's solvency requirement be violated. See note 34.

sources of liquidity can be made available. And, of course, OLA remains available if matters do not pan out as planned.

Concluding Thoughts: Planning for Two (or more) Future States of the World

We conclude this essay with a few words explaining why we have made the effort to work through the major problems presented by an Option B resolution strategy. The Dodd-Frank Act created with Title II and OLA an exceptional regulatory tool designed to be capable of resolving major financial conglomerates in periods of financial distress of the sort experienced in September 2008. In addition to granting federal regulatory authorities an unusual and far-ranging set of new powers, the legislation provided for Title II resolutions with a very generous line of credit from the U.S. Treasury. The existence of this line of credit makes some critics of the Dodd-Frank Act fear that Title II perpetuates" too big to fail" and exposes taxpayers to the cost of potential bailouts down the road. That is not the way Title II was intended to work, but the concerns expressed over OLA are not entirely fanciful. At a minimum, the presence of Title II and the OLF may lead some financial institutions and holding-company creditors to conclude that ample public funding will be available for distressed financial conglomerates. To the extent that market participants now assume that Title II is the only viable approach to resolving financial conglomerates, the market, including holding-company creditors, may well be assessing the riskiness of financial conglomerates under the assumption that public financing will be forthcoming in resolution and there will be a maximal preservation of going-concern value in the event of failure.

Consequently, it is highly desirable to open up some additional resolution alternatives – in the language of this essay, to make Option B and perhaps even Option C credible – both to address the problems of political economy and render market assessments of financial conglomerate distress a bit less sanguine. Figure Four converts this point into a decision tree drawn from the perspective of holding-company creditors. As things currently stand, when holding-company creditors consider the likely outcome of the insolvency of a major financial conglomerate, they may well assume that the entity would be resolved under OLA and Title II of the Dodd-Frank Act. That means a resolution structure with access to ample public financing and a good chance to preserve going-concern value. To be sure, there remains some chance that the appropriate political triggers will not be pulled, but the received wisdom today in many circles is that neither Option B nor Option C is practical for a major financial firm, or that such a path threatens Lehman-like chaos.



If federal authorities implemented the reforms we have outlined, Option B would become imaginable for even very large firms if they became insolvent in an idiosyncratic failure rather than a systemic crisis of the September 2008 variety. From the ex ante perspective of holding-company creditors, that change would open up a whole new branch of the decision tree, where the primary source of liquidity funding would come from private resources and maximal preservation of going-concern value would not be assured. And, for creditors dealing with medium-sized financial firms that could conceivably be resolved through traditional resolution methods at the regulated subsidiary level, the potential for holding company creditor losses in the event of financial distress would be even more substantial.

The decision tree presented in Figure Four offers several insights. First, to the extent that one is concerned about the moral hazard effects of OLA and Title II, there is value in opening up other resolution alternatives that might be credible for at least idiosyncratic failures of financial firms. Devising resolution strategies that do not necessarily have access to public funding will increase the perceived ex ante risks to holding company creditors and reduce the moral-hazard cost of OLA and Title II. This will be true even if a resolution only starts in federal bankruptcy and ultimately must be moved into a Title II proceeding (the dotted line in Figure Four.)

A secondary implication is that to improve the capacity and incentives of holding company creditors to police the business strategies of financial conglomerates, regulators should err on the side of disclosing the potential costs to holding-company creditors in the event of resolution under all three options discussed in this essay. At least on an ex ante basis, authorities should attempt to increase the perceived likelihood of distressed firms being handled under Options B and C. If and when a financial crisis arises (or appears imminent), government officials may well need to pivot towards Option A to forestall market volatility and destabilizing runs. But ex ante, the smart money is on making Option B viable for as many financial conglomerates as possible. Presenting that case is the goal of this chapter.

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