

Financial Stability Improvement Act: Summary and Comments

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This document summarizes the provisions of the October 27, 2009, draft Financial Stability Improvement Act related to the resolution of financial companies whose resolution through the Chapter 11 bankruptcy process could cause instability to the U.S. financial system or economy.

Summary of Provisions Related to Resolution

Subtitle A – Financial Services Oversight Council

- Voting members:
 - Secretary of the Treasury (Chair),
 - Comptroller of the Currency,
 - Chairman/Director of the Board of Governors of the Federal Reserve System (BOG)
 - Office of Thrift Supervision (until OTS powers transfer to OCC)
 - Securities and Exchange Commission
 - Commodity Futures Trading Commission
 - Federal Deposit Insurance Corporation
 - Federal Housing Finance Agency
 - National Credit Union Administration
- Nonvoting members (serve in an advisory capacity):
 - a state insurance commissioner
 - a state banking supervisor
- Duties are to:
 - Advise Congress on financial regulation and make recommendations to enhance the integrity, efficiency, orderliness, competitiveness, and stability of the U.S. financial markets.
 - Monitor the financial services marketplace to identify potential threats to the stability of the U.S. financial system.
 - Identify financial companies and financial activities that should be subject to heightened prudential standards in order to promote financial stability and mitigate systemic risk.
 - Issue formal recommendations that a Council member agency adopt heightened prudential standards for firms it regulates to mitigate systemic risk.
 - Facilitate information sharing and coordination among Council members on financial services policy development, rulemakings, examinations, reporting requirements, and enforcement actions.
 - Provide a forum for discussion and analysis of emerging market developments and financial regulatory issues among its members.
 - Resolve jurisdictional or regulatory disputes between members upon the request of one of the member agencies.
- Funded on an equal basis by departments and agencies represented by voting members.

Subtitle B – Prudential Regulation of Companies and Activities for Financial Stability Purposes

- The Council may subject a financial company (defined as any company incorporated or organized under U.S. or foreign country laws that is engaged in financial activities, or any branch or agency of a foreign bank) to heightened prudential standards if: (1) material financial distress at the company could pose a threat to financial stability or the economy, or (2) the

nature, scope, or mix of the company's activities could pose a threat to financial stability or the economy.

- Criteria for the above determination:
 - Amount and nature of the company's financial assets.
 - Amount and nature of the company's liabilities, including the reliance on short-term funding.
 - Extent and nature of the company's off-balance sheet exposures.
 - Extent and nature of the company's transactions and relationships with other financial companies.
 - Company's importance as a source of credit and liquidity.
 - Nature, scope, and mix of the company's activities.
 - Any other factors that the Council deems appropriate.
- For any of these "identified companies" that are not already bank holding companies (BHCs), they would be treated as a BHC if they only engage in financial activities. If an identified company also engages in nonfinancial activities, it would have to establish an intermediate holding company to conduct the financial activities.
- The BOG would be the consolidated prudential supervisor for all identified financial companies. The BOG would be required to impose "heightened prudential standards" for risk-based capital, leverage, liquidity, concentrations, prompt corrective action, resolution plans, and overall risk management, plus any additional standards the BOG deems advisable.
- Mitigation of Systemic Risk – If the BOG determines, after notice and an opportunity for hearing, that the size of an identified company or the scope or nature of its activities pose a threat to its safety and soundness or to U.S. financial stability, the BOG may require the company to sell assets or off-balance-sheet items to unaffiliated firms, to terminate activities, or to impose conditions on the continuation of the activities.
- Emergency financial stabilization – The FDIC may extend credit to or guarantee obligations of solvent insured depository institutions or other solvent companies that are predominantly engaged in financial activities to prevent financial instability during times of severe economic distress if at least two-thirds of the BOG, two-thirds of the FDIC Board and the Secretary of the Treasury (after consulting with the President) agree that it is necessary. The credit extension or guarantee of obligations cannot be in any form of equity.

Subtitle G – Enhanced Resolution Authority

- An identified financial company would be subject to the enhanced resolution process if:
 - It is recommended by the BOG and either the FDIC or SEC (if the largest subsidiary is a broker-dealer), and
 - The Secretary of the Treasury (in consultation with the President) determines that: (1) the identified company is in default or is in danger of default, (2) the failure of the identified company and its resolution under the normal bankruptcy process would have serious adverse effects on U.S. financial stability or economic conditions, and (3) any actions under the enhanced resolution authority would avoid or mitigate such adverse effects, taking into consideration the cost to the Treasury and the potential to increase moral hazard.
- The written recommendation of the BOG and either the FDIC or SEC must include a description of the effect that the default of the identified company would have on U.S.

economic conditions or financial stability and a recommendation on the actions to be taken under the enhanced resolution procedures described below.

- Default or danger of default is determined if the company has filed or is likely to file for Chapter 11; is critically undercapitalized; has incurred, or is likely to incur, losses that deplete its capital; the company's assets are, or are likely to be, less than its obligations; or is, or is likely to be, unable to pay its obligations.
- If the Secretary makes this default determination:
 - The Secretary must appoint the FDIC as receiver or qualified receiver (defined below) for the company. There is a strong presumption that the FDIC will be appointed as a receiver, with appointment as a qualified receiver only if the Secretary, BOG, and FDIC all agree it is necessary to avoid or mitigate serious adverse effects on financial stability.
 - The FDIC as receiver or qualified receiver must consult with the regulators of the company and its subsidiaries to ensure an orderly resolution and may consult with outside experts on resolution matters.
 - The FDIC, with approval from the Secretary, may lend to the company; purchase assets; assume or guarantee obligations; acquire any type of equity interest; take a lien on assets to secure repayment; or sell assets, liabilities, or equity interests subject to the following conditions:
 - the Secretary and FDIC determine it is necessary for financial stability and not to preserve the company,
 - shareholders of a covered financial company do not receive payment until after all other claims are fully paid,
 - unsecured creditors bear losses, and
 - management responsible for the failed condition of the company is removed.
- The legislation specifies that the FDIC as a qualified receiver may take actions necessary to put the company in a sound and solvent condition and appropriate for carrying on its business and preserve and conserve its assets and property. (Note: A qualified receiver seems to be similar to a conservatorship.) After two years, the qualified receivership turns into a receivership unless at an earlier date the Secretary and BOG agreed the company could come out of qualified receivership (presumably as a private company). The qualified receivership can be extended for up to three additional one-year periods, with approval of the Secretary and the BOG, if necessary to promote financial stability.
- Priority of paying expenses and unsecured claims:
 - The order of priority is: administrative expenses of the receiver; amounts owed to the United States; general or senior unsecured claims; obligations subordinated to general creditors; obligations to shareholders, members, and partners.
 - While all creditors in a given priority group are generally treated the same, the FDIC can treat them differently if doing so is necessary to maximize the value of the company's assets, minimize related costs, or contain or address serious adverse effects on U.S. financial stability or the U.S. economy. For example, this provision might allow the FDIC to give short-term creditors quicker access to a larger portion of their funds than longer-term creditors, if doing so would reduce financial and economic instability. However, the legislation requires that all claimants in a particular group should not receive less than they would if the company were liquidated through a Chapter 11 bankruptcy process.
- The FDIC as receiver can transfer any of the assets and liabilities of the company to a newly chartered bridge financial company.

- A systemic resolution fund would be created on an ex post basis to recover the costs of a resolution through assessments on financial companies with more than \$10 billion in consolidated assets. The assessments would be risk-based, and the assessment rate would increase with the size of the company. Credit would be given for fees paid to deposit insurance, investor protection, or insurance company funds.

Comments

Subtitle G – Enhanced Resolution

The draft legislation is significantly better than the original Treasury proposal because there is no discretion to provide open-institution assistance to a systemically significant financial company that has failed or is about to fail. Under the proposed legislation, once it is determined that a company is in default or danger of default and that use of the bankruptcy process would create financial or economic instability, the Treasury and FDIC must take actions that lead to the removal of management responsible for the problems and impose costs on shareholders and creditors. However, many of the other concerns that we had with the original proposal remain.

- The Treasury Secretary still determines whether a financial company is in default or danger of default and whether it will create financial or economic instability. The proposed legislation could be improved by putting more of the decision framework under independent supervisory authorities, with the Treasury Department’s role confined primarily to signing off on these decisions.
 - Since the Secretary has no direct supervisory responsibilities, these decisions should be made by the primary supervisory authorities because they have the detailed, hands-on knowledge of the criteria specified by the legislation for determining default or danger of default – a company has filed or is likely to file for Chapter 11; is critically undercapitalized; is, or is likely to become, capital insolvent; is, or is likely to be, unable to pay its obligations.
 - In addition, replacing independent regulators with the Treasury Department as the final authority in this decision process could lead to delays or second-guessing of supervisory recommendations and greater political interference. For example, instead of focusing on cleaning up and creating stronger organizations, recent political pressure has seemingly centered more on executive compensation, an organization’s reluctance to use TARP money to expand lending, efforts and plans for mortgage loan mitigation, bank creditor concessions for GM and Chrysler, and other related issues.
- The legislation still creates uncertainty about which holding companies might be subject to the new resolution process and which ones would be under the traditional bankruptcy framework.
 - The legislation replaces the concept of Tier 1 financial companies with “identified financial companies.” Identified companies are those companies that would be subject to heightened prudential supervision because their activities or problems are determined to pose a threat to financial stability or the economy. These companies would be subject to the enhanced resolution authority if, after they are in default or danger of default, it is determined that resolution under the normal bankruptcy process would have serious adverse effects on U.S.

financial stability or economic conditions. Otherwise, a company would go through the Chapter 11 bankruptcy process.

- Ideally, creditors and stockholders should know how their claims would be handled before they invest in a company, especially since their rights and legal options under the enhanced resolution authority will be very different than in a bankruptcy proceeding.
- Another concern is that failure of a non-identified company could pose an unexpected, systemic risk during a financial crisis. However, the enhanced resolution authority could not be used to resolve such a company because it is available only to resolve identified companies. To overcome this problem, the Federal Reserve Bank of Kansas City's resolution proposal included a provision for identifying a second tier of companies that could be systemic in some situations and, therefore, potentially subject to the alternative resolution process.
- The legislation introduces the concept of a qualified receiver, which as noted in the summary, seems to be something like a conservator. However, it is not clear how this differs from a conservator or why it is necessary.
- The written recommendation from the BOG and FDIC or SEC to use the enhanced resolution authority is required to include a recommendation on the actions that should be taken as part of a resolution. However, it is not clear what the recommended actions could be since the legislation determines what decisions have to be made. Specifically, the Treasury Secretary must appoint a receiver or qualified receiver, and the FDIC must consult with the primary supervisors of the failed company. The FDIC can take a variety of actions (subject to approval from the Treasury Secretary and several stringent conditions), such as lending to a financial company in receivership, but these choices would best be made by the FDIC as receiver as it goes through the resolution process.
- The systemic resolution fund would be funded by all financial companies with more than \$10 billion in assets. The proposed funding mechanism is an improvement over the original proposal because it requires the assessment rate to increase with the size of a company.
 - However, it still raises some equity concerns because many of the companies required to pay premiums would not be considered systemically important or subject to this new resolution authority if they failed. Specifically, the vast majority of companies meeting the assessment criteria of at least \$10 billion in total assets will probably not be "identified companies." For example, most regional and mid-sized financial companies would meet these assessment criteria, but it is unlikely that they would be identified as a company needing heightened prudential supervision. In our District, this assessment group would include such regional organizations as UMB Financial Corporation or Commerce Bancshares.
 - In addition, it may be difficult to decide which companies meet the financial company definition of being "in whole or in part, directly or indirectly, engaged in financial activities" and how consolidated assets should be calculated for companies that engage in both financial and nonfinancial activities or have most of their activities in other countries.
 - Another concern is that determining equitable risk-based premiums will be difficult because of the variation in activities that may exist across financial companies. To the extent these premiums are collected after a resolution, the factors used to calculate premiums also may tend to be backward-looking.

Other Comments

- Subtitle A – While we understand the conceptual role for the Financial Services Oversight Council, in practice we question the effectiveness of a committee of 10 leaders (excluding the OTS director and including the nonvoting members) of separate agencies in achieving its goals. For example, the Federal Financial Institutions Examination Council (FFIEC), which was formed to promote consistency in the examination and supervision of financial institutions, is generally viewed as being ineffective, and it is composed of only five agency heads.
- Subtitle B – The consolidated supervisor is required to develop heightened prudential standards for identified financial companies. The recent crisis has shown the need for such standards to be simple, stringent, and enforceable rules for companies that pose systemic risk, especially in areas such as leverage and liquidity. This could be best accomplished by requiring the BOG as the consolidated supervisor to specify enforceable, rules-based (as opposed to principles-based) capital and liquidity standards to reduce financial company risk.
- The BOG is given broad authority to require a company to divest certain activities based on an assessment of the threat its size or activities pose to the financial system. While there is currently an active debate among policy commentators on whether there should be limits on the size or scope of activities in a financial holding company, those limitations should be determined by legislation (rule of law) as opposed to a regulatory agency making the decision.