STATEMENT OF

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BEFORE

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THE COMMITTEE ON THE JUDICIARY

U.S. HOUSE OF REPRESENTATIVES

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H.R. ____, THE "FINANCIAL INSTITUTION BANKRUPTCY ACT OF 2015"

Thank you for inviting me to testify once again on the subject of the resolution of financial institutions under the Bankruptcy Code. I am Donald S. Bernstein, co-chair of the Insolvency and Restructuring Group at Davis Polk & Wardwell LLP. I am on the Board of Editors of Collier on Bankruptcy, President and Chair of the International Insolvency Institute, a past Commissioner on the American Bankruptcy Institute's Commission on the Reform of Chapter 11, and a past Chair of the National Bankruptcy Conference.

I had the honor of appearing before this Subcommittee at an oversight hearing on this subject in December 2013 and at a subsequent hearing in December 2014 at which the Subcommittee considered a draft of the bill that became H.R. 5421, the Financial Institution Bankruptcy Act of 2014 ("FIBA"). FIBA was passed by the House during the closing days of the 113th Congress. I focus today on the anticipated introduction in the current Congress of a bill substantially similar to FIBA, "H.R. ____, the "Financial Institution Bankruptcy Act of 2015."

During the past few years, I have spent a significant portion of my time working on resolution plans for large financial firms under Section 165(d) of the Dodd-Frank Act. I have also represented financial industry organizations, such as The Clearing House Association and SIFMA on issues related to the resolution of financial firms. I am, however, here in my individual capacity and not on behalf of any client, though I expect to be asked by clients to help them evaluate the proposed bill we are discussing today. The views I express are my own, and not those of Davis Polk, any client or any organization with which I am affiliated.

The Single-Point of Entry Approach to Resolution

It will not surprise any of the members who attended last year's hearing that I continue to strongly support the idea that the Bankruptcy Code should be amended to add tools to facilitate speedy recapitalization of the largest financial firms. Because of the bank holding company structure used in the United States and the availability of substantial loss absorbing capacity at the holding companies of our largest and most systemic financial firms, the single-point-of-entry approach developed by the Federal Deposit Insurance Corporation under Title II of the Dodd-Frank Act ("Orderly Liquidation Authority" or "OLA") can be adapted for the resolution of such firms under the Bankruptcy Code. Improvements in the Bankruptcy Code would reinforce the idea that bankruptcy is the preferred method of resolving such firms and that Orderly Liquidation Authority is a backup to be used only in rare and unusual circumstances. I strongly agree, however, with the view expressed in the June 18, 2015 letter of the National Bankruptcy Conference addressed to, among others, the Chair of this Subcommittee that Orderly Liquidation Authority should be retained as a backup resolution tool even if FIBA is passed, but the goal of FIBA should be to add resolution tools to the Bankruptcy Code so that OLA is unlikely to be used.

The single-point-of-entry approach to the resolution of a financial firm involves commencing resolution or bankruptcy proceedings only with respect to the financial firm's top-level parent holding company, with all losses of the distressed financial firm being borne by shareholders and creditors of that entity and not by taxpayers. Material operating subsidiaries, like the firm's significant banking or broker-dealer subsidiaries, would not be placed in insolvency or resolution proceedings. They would be recapitalized using assets of the holding company and, promptly after the commencement of the holding company's bankruptcy proceedings, their stock would be transferred to a new, substantially debt free, bridge company. The subsidiaries would continue as going concerns, paying all of their obligations, until they are disposed of or have been wound down in an orderly way.

By recapitalizing the firm's operating subsidiaries with holding company assets at the outset of the process, the single-point-of-entry approach preserves the continuity of the financial firm's systemically critical operations and the value of its operating businesses, and pushes the firm's operating losses up to the old holding company to be absorbed by the holding company's shareholders and creditors. Customers and counterparties can continue to be served by the ongoing businesses of the firm or can migrate to competitors in an orderly fashion as businesses are wound down; fire sales of the firm's assets are avoided; and the residual value of the firm's operations is maximized for ultimate distribution to creditors and other stakeholders left behind in the holding company's bankruptcy proceedings.

Recent Progress Enhancing the Resolvability of Financial Firms

A number of concrete actions have been or are being taken to enhance the resolvability of the largest U.S. financial firms, whether under Orderly Liquidation Authority or under the Bankruptcy Code. Many of these steps were already in progress when I testified last year, and additional progress has been made since that time in a number of key areas.

Here are some of the key areas where progress has been made:

1. *Capital and Total Loss Absorbing Capacity.* A critical element of the ability to recapitalize a distressed U.S. financial firm is having sufficient loss absorbing capacity in the firm's bank holding company. This includes both capital and structurally subordinated capital structure debt issued by the firm's holding company that can be "bailed-in" in connection with the recapitalization of the firm. The capital levels of the largest U.S. bank holding companies are now more than double what they were in 2008, and the largest firms' holding companies currently have, even in advance of the issuance of so-called "TLAC" ("total loss absorbing capacity") requirements, substantial amounts of long-term capital structure debt in addition to their capital, effectively doubling again the loss absorbing capacity at their holding companies available for the recapitalization of the firm.
2. *Mitigation of QFC Cross-Defaults.* In October 2014, the Financial Stability Board announced another important enhancement in the resolvability of global financial firms. Eighteen global systemically important banking groups have adhered to a protocol (the "ISDA Protocol") that modifies the terms of ISDA Master Agreements to assure the cross-border enforceability of provisions in special resolution regimes, like OLA, that override cross-defaults in such agreements arising out of the resolution of an affiliated credit support provider, such as a parent holding company that guarantees the obligations of a subsidiary under the subsidiary's financial contracts. Regulations are expected to be issued by U.S. regulators in the near future mandating implementation of these

provisions with respect to a broader range of counterparties of financial firms and under a broader range of financial contracts. Importantly, the ISDA Protocol provides that, when the regulations take effect, the termination rights of adhering parties based on the commencement of bankruptcy proceedings by a holding company that is a credit support provider will also be overridden in a single-point-of-entry resolution if certain conditions designed to protect counterparties are met. These contractual provisions, which seek to eliminate disruptive financial contract closeouts in a single-point-of-entry resolution, address one of the major obstacles to orderly resolution identified in the aftermath of the Lehman Brothers bankruptcy. Market-wide implementation of these provisions would avoid the enormous losses reportedly suffered by Lehman Brothers in connection with such closeouts and also eliminate the possible contagion effects of the sale of large volumes of collateral by counterparties seeking to satisfy their claims.

3. *Increased Liquidity.* The amount of high quality liquid assets maintained on the balance sheets of the largest U.S. financial firms has increased substantially since 2008 and the reliance by the firms on short term wholesale funding (for example, overnight repurchase agreements) has been substantially reduced. These changes, which serve to reduce the severity of any run on the firm's liquidity and to increase the ability of the firm to meet a run, permit the firms to absorb extraordinary liquidity shocks even in severely adverse economic conditions. They are designed to meet the stringent liquidity coverage requirements imposed

by regulators since 2008 and also to provide a funding reserve that will sustain a single-point-of-entry resolution of the firm if necessary.

4. *Clean Holding Companies.* The largest U.S. firms are eliminating the issuance of short term runnable debt from their holding companies and minimizing operating activities conducted at the holding company level. This clean holding company structure will facilitate the separation of recapitalized ongoing operating subsidiaries from the distressed bank holding company in connection with a single-point-of-entry resolution.

5. *Continuity of Shared Services.* Because, in a single-point-of-entry resolution operating subsidiaries are recapitalized and do not enter into resolution proceedings, the single-point-of-entry resolution approach preserves the continuity of ongoing inter-company services among the members of the financial firm's corporate group. Nevertheless, the firms are doing detailed mappings of such inter-company services, and are formalizing inter-company contractual commitments with respect to such services, or, in some cases creating separately incorporated and capitalized service companies to further assure the continuity of such services in resolution.

6. *Operational Capabilities.* The firms are enhancing operational capabilities, including management information systems, to facilitate continuous access to real time information necessary for resolution of the firms.

7. *Financial Market Utilities.* The firms are engaged in an ongoing dialogue with financial market utilities ("FMUs") to develop playbooks to

assure continued access to the services of FMU's during a period of financial distress and in resolution.

8. *Greater Coordination Among Global Regulators.* Through the Financial Stability Board and direct bilateral and multilateral initiatives, regulators around the world have been actively engaged in efforts to coordinate their actions in the event of the need to resolve a global financial firm. FDIC Chairman Martin Gruenberg recently noted, for example, that the FDIC has worked closely with all major financial jurisdictions, including the United Kingdom, Germany, Switzerland and Japan, as well as newly created European resolution and supervisory entities, on identifying and addressing obstacles to cross-border resolution.[1]

Each of these actions addresses a potential obstacle to orderly resolution that has been identified based on the Lehman Brothers experience or based on the detailed analysis undertaken by both the firms and regulators in the resolution planning process. The firms have added TLAC and liquidity to help them effectuate a recapitalization of their operations and a single-point-of-entry resolution, whether under OLA or under the Bankruptcy Code. They are taking steps to assure the continuity of shared services and to put in place the necessary operational capabilities. They are in the process of eliminating financial contract

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[1] Martin J. Gruenberg, Chairman, Fed. Deposit Insr. Corp., A Progress Report on the Resolution of the Systemically Important Financial Institutions (May 12, 2015), available at https://www.fdic.gov/news/news/speeches/spmay1215.html.

termination rights. They are developing plans to assure access to financial market utilities. And, importantly, global regulators are improving their coordination and cooperation, so that orderly resolution is not thwarted by precipitous action by local authorities. For all of these reasons, the feasibility of resolving a large financial firm without significant systemic disruption and without placing taxpayer funds at risk is far greater today that it has ever been before.

Resolution Tools and FIBA

While the steps identified above are designed to make single-point-of-entry resolution under the Bankruptcy Code feasible even under current law (for example, by maintaining the resources needed to recapitalize operating entities and by overriding bankruptcy-related cross-defaults under financial contracts), tools should nevertheless be added to the Bankruptcy Code to further enhance the ability to resolve large financial firms under the Bankruptcy Code using the single-point-of-entry approach. In my 2013 testimony, I identified four key additions I felt would be desirable. They were:

- Clarifying that bank holding companies can recapitalize their operating subsidiaries prior to the commencement of bankruptcy proceedings.
- Clarifying that section 363 of the Bankruptcy Code can be used to transfer the recapitalized operating subsidiaries to a new holding company using a bridge company structure.
- Adding provisions that permit a short stay of close-outs and allow the assumption and preservation of qualified financial contracts, and

overriding ipso facto (bankruptcy) defaults or cross-defaults that might impede the resolution process.

- Providing for some form of fully secured liquidity resource that would offer financing to help stabilize the recapitalized firm and prevent fire sales until access to market liquidity returns.

The first two of these features would increase the certainty of application of current law to actions that must be taken in connection with a single-point-of-entry resolution in bankruptcy.

The third of these features currently is being addressed by contractual workarounds like the ISDA Protocol, but it would be far better if the Bankruptcy Code were amended to include provisions similar to those contained in special resolution regimes, like OLA and the European Bank Resolution and Recovery Directive, that provide for the override of cross-defaults under financial contracts in a single-point-of-entry resolution.

The last of these features is being addressed by the substantially increased liquidity reserves on the balance sheets of the largest financial firms, though once they have been recapitalized in a single-point-of-entry resolution, there is no reason why traditional, secured lender-of-last-resort liquidity should not be available to non-bankrupt, fully capitalized, going concern subsidiaries of the firms. The availability of such liquidity, if properly structured, would involve no risk of loss to taxpayers, and would help to mitigate any panic run on subsidiary liquidity after the holding company commences its bankruptcy proceedings.

Although FIBA leaves the availability of lender-of-last-resort liquidity to otherwise applicable law, it would amend the Bankruptcy Code to add the first three features I have identified. For this reason I strongly support the enactment of FIBA in the form in which it was passed by the House during the last Congress.

Comments on Two Provisions of FIBA

It is worth highlighting two particular provisions of FIBA as to which further comment is warranted.

Right of Federal Reserve Board to File A Petition for Relief. The first provision of FIBA I want to comment on is in section 1183(a)(2), which provides for the commencement of a subchapter V proceeding by the Federal Reserve Board (the "FRB") if certain conditions are met. The commencement of such a proceeding by the FRB can be contested, but the timeline for entry of the order for relief and for an appeal from such order is necessarily very short. The timeline is dictated by the need to be able to create and transfer the stock of the firm's operating entities to a bridge company over a proverbial "resolution weekend." Any disputes over the commencement of the case must be resolved in sufficient time so the Bankruptcy Court can hear and approve a transfer motion under Section 1185 before the firm reopens for business on Monday morning.

While it is beneficial for the FRB to have the ability to act under the Bankruptcy Code if the financial firm is not doing so, the ability of the Federal Reserve to commence a subchapter V case is not integral to the purposes of subchapter V. If the shortness of the timeline to contest a bankruptcy petition filed by the FRB is deemed objectionable, rather than extending the timeline, which would adversely affect the ability to resolve the firm, defeating the purposes of subchapter V, the right to contest the FRB's petition could be eliminated or, alternatively, the ability of the FRB to commence a case under subchapter V could simply be removed from the bill. Selecting the latter option should not adversely affect the ability to achieve the goals of subchapter V. Even without the ability of the FRB to commence a subchapter V proceeding, U.S. regulators have more than sufficient supervisory and other authority, including the ability to commence proceedings under OLA, to assure that financial firms take the steps necessary to protect the U.S. financial system.

Suspension of Financial Contract Cross-Defaults. The provisions permitting the assumption and assignment of financial contracts within 48 hours after commencement of the case also deserve mention. As I have noted, based on the experience in the Lehman Brothers case, financial firms, regulators and commentators identified the inability to preserve and continue to perform financial contracts of operating subsidiaries due to cross defaults related to the commencement of bankruptcy proceedings by a holding company credit support provider as a significant impediment to the orderly resolution of systemically important financial firms. To address this impediment, it is essential that any procedure for the orderly resolution of financial firms provide for the ability of the failing firm to preserve its subsidiaries' financial contract books if it continues to perform its obligations in respect of such contracts and if appropriate protections for counterparties are provided. Provisions overriding financial contract termination rights are recommended by the Financial Stability Board's *Key Attributes of Effective Resolution Regimes For Financial Institutions*, and, as previously mentioned, are included in Orderly Liquidation Authority and the European Bank Resolution and Recovery Directive, among other resolution procedures. The absence of such provisions in the Bankruptcy Code is among the reasons that U.S. regulators have pressed vigorously for implementation of contractual workarounds like the ISDA Protocol.

While the volatility and purposes of financial contracts justify including appropriate protections for counterparties, Section 1188 of FIBA, which overrides cross-defaults relating to a credit support provider's bankruptcy, strikes a balance between preservation of the non-bankrupt recapitalized subsidiaries' financial contracts on the one hand and the protection of counterparties on the other. The counterparty protections in section 1188 include:

- Requiring the debtor or its affiliate under the qualified financial contract to perform all of its payment and delivery obligations thereunder during the short, temporary stay period pending approval of a transfer motion under Section 1185, and terminating the stay of termination rights if such obligations are not performed.
- Requiring all qualified financial contracts between the counterparty and the debtor to be assigned to and assumed by the bridge company in the transfer under section 1185, and all claims against the debtor in respect of such contracts to be assumed by the bridge company.
- Requiring all property securing or any other credit enhancements, such as guarantees, furnished by the debtor for qualified financial contracts, including those of subsidiaries transferred to the bridge company, to be assigned to and assumed by the bridge company.

Simply expressed, the counterparty's termination rights arising out of cross-defaults are overridden only if all payment and delivery obligations in respect of the counterparty's contracts continue to be performed and any guarantees or other credit support obligations of the bankrupt holding company are assumed by the fully capitalized, non-bankrupt bridge company. The counterparty's position is enhanced not only through the recapitalization of its subsidiary obligor, but also because any credit enhancements are now provided by the bridge company, free of the old holding company's capital structure debt, which has been left behind in the former holding company's bankruptcy proceedings. These provisions provide substantial protection to the counterparty whose cross-default rights are overridden to facilitate the orderly resolution of the firm.

Conclusion

While there is no one-size-fits-all strategy for effective resolution of a large financial firm, there is an increasing consensus that our largest financial firms can be resolved under the Bankruptcy Code in an orderly way without a taxpayer bailout if their holding companies maintain sufficient loss absorbency and liquidity resources and the firms and their regulators complete the actions they have undertaken to enhance the resolution-readiness of the firms. The enactment of FIBA would build upon these actions by providing a clearer and easier path to the single-point-of-entry resolution of the largest, most systemically important financial firms.