March 22, 2016

The Honorable Martin Gruenberg, Chairman
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

The Honorable Janet L. Yellen, Chair
Board of Governors of the Federal Reserve System
20th Street and Constitution Ave., NW
Washington DC, 20551

On behalf of Americans for Financial Reform, we are writing with regard to the decision you currently face regarding the certification of the 2015 round of resolution plans by major banks.[1] As you know, the Dodd-Frank Act require you to review these plans to determine whether they would credibly permit an orderly resolution of major bank holding companies under a conventional (Chapter 11) private sector bankruptcy procedure.

We view this decision as a major milestone in the effort to end 'too big to fail' and accompanying distortions of the financial system. In summer 2014, the Federal Deposit Insurance Corporation and the Federal Reserve (the 'Agencies') warned that the 2014 resolution plans were inadequate in numerous ways and the 2015 round of resolution plans would be held to a higher standard.[2] Over the course of the past year, the Agencies have also provided ample additional guidance to major banks as to the specific goals of this year's resolution plans.

It is now time to ensure that banks are actually prepared for an orderly conventional bankruptcy, including requiring downsizing or restructuring if necessary. While it is possible that banks have addressed the grave inadequacies cited in the rejection of last year's plans, there is no clear public evidence that they have done so. Certainly the past two years have not seen major visible restructuring or downsizing of the largest 'too big to fail' banks. As a group, the six largest banks hold about $9.7 trillion in assets, approximately the same as they did two years ago, and no single bank has reduced its asset size by more than eight percent.

It appears that numerous extremely doubtful assumptions are necessary to find that the largest banks in the U.S. financial system could actually undergo a Chapter 11 bankruptcy proceeding without major economic disruption. These assumptions include the availability of private sector liquidity support on an unprecedented scale and a dramatic simplification of bank internal

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[1] Americans for Financial Reform is an unprecedented coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups. A list of coalition members is available at http://ourfinancialsecurity.org/about/our-coalition/

[2] Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation, "Agencies Provide Feedback on Second Round Resolution Plans of First-Wave Filers", Press Release, Washington DC, August 5, 2014. Available at https://www.fdic.gov/news/news/press/2014/pr14067.html.

structure as compared to the levels of complexity seen during the 2008 financial crisis. If these issues are not addressed, your review of resolution plans should find them to be 'not credible'.

Below, we describe three key questions related to these assumptions:

1) Will banks be able to access adequate liquidity funding during bankruptcy?

2) Have banks simplified their complex internal structures enough to achieve 'separability', or the ability to separately liquidate troubled subsidiaries without impeding the functioning of other parts of the bank?

3) Do the resolution methods laid out in the plans of major banks accord with U.S. bankruptcy law?

If you find that banks' resolution plans are credible (or, equivalently, fail to find that they are not credible), the public needs and deserves a clear and detailed response to the questions above. If you believe that the 2015 resolution plans would in fact facilitate an orderly resolution through Chapter 11 of the Bankruptcy Code, you should provide an explanation of the reasons why the very considerable barriers to orderly bankruptcy would not apply or could be overcome.

A conventional bankruptcy for institutions of this size, conducted without public support and without significant economic disruption, would be an unprecedented undertaking. The largest bankruptcy in U.S. history to be conducted in this manner was of a $103 billion company, Worldcom. The eight U.S. systemically important global banks (GSIFIs) range from roughly two and a half times (State Street) to twenty-four times (JP Morgan) larger than Worldcom.

The largest conventional bankruptcy of a financial institution ever attempted in the US was of Lehman Brothers, a $654 billion institution, smaller than four current US GSIFIs. It was far from an 'orderly resolution' – the process continued for over five years, creditors only recovered 28 percent of their claims, and the bankruptcy contributed to massive disruption of financial markets and the broader economy. This outcome occurred despite the availability of substantial Federal Reserve liquidity assistance in the first weeks of the Lehman bankruptcy.[3]

The challenge of conventional bankruptcy is if anything heightened by the fact that most (six out of eight) of the largest U.S. systemically important financial institutions have chosen a so-called 'single point of entry' (SPOE) resolution strategy, to be conducted through a Chapter 11 proceeding. This strategy commits them to maintaining the continuous functioning of all or almost all bank operating entities over the initial stage of resolution, retaining only the non-operating holding company in the official bankruptcy proceeding and very rapidly removing operating subsidiaries from Chapter 11.

The exact nature of the SPOE plan varies by the reporting institution. For example, Citigroup promises that "all of Citi's operating subsidiaries [will] remain solvent and fully operational

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[3] Fleming, Michael and Asani Sarkar, "The Failure Resolution of Lehman Brothers", Federal Reserve Bank of New York Economic Policy Review, Volume 20, Number 2, December, 2014. Available at https://www.newyorkfed.org/research/epr/2014/1412flem.html

throughout the resolution process" and "remain outside of applicable resolution or insolvency proceedings". JP Morgan Chase states that the vast majority of JP Morgan operations would remain functioning outside of bankruptcy but JP Morgan Energy Ventures and possibly the bank's European wealth management subsidiary would be liquidated along with the holding company.[4] But all the SPOE plans have in common the optimistic assumption that the great majority of bank subsidiaries could be successfully recapitalized, exit bankruptcy within days if not hours, and if necessary be restructured through a gradual process under trustee ownership.

Some have touted the SPOE method as making it simpler to put a mega-bank through conventional bankruptcy. But this depends on major assumptions about the feasibility and costs of keeping subsidiaries in operation even temporarily, particularly without the benefit of the public liquidity support available in a Title II resolution. At the least, responsible bankruptcy planning requires some preparation for the possibility that a pure SPOE resolution will not be feasible – in other words, that some operating subsidiaries of the bank cannot remain solvent in the short term, and might have to remain in bankruptcy as well. The consideration of this possibility must also be part of any reasonable bankruptcy planning process.

We appreciate that much of your judgement as to the credibility of these bankruptcy plans will rely on confidential supervisory information and the detailed private resolution plans submitted by the banks. However, any such judgement must be accompanied by a clear explanation to the public as to the ways in which the largest U.S. global systemically important financial institutions (GSIFIs) have met the major challenges of preparing for conventional bankruptcy. Such an explanation should include, at minimum, public responses to three key questions.

Question 1: Will Banks Be Able To Access Adequate Liquidity Funding During Bankruptcy?

The actual liquidity demands on a bank going through a resolution process are hard to predict. But according to data gathered by international regulators, cash liquidity demands on a major international bank during a 30 day period of stress would typically exceed 20 percent of liabilities.[5] This implies that the largest U.S. banks such as JP Morgan and Bank of America could require over $400 billion in short-term funding in order to continue operations and maintain investor confidence during a crisis. This is particularly true if the ambition is to maintain all bank subsidiaries in operation at least temporarily, as is contemplated in the single point of entry approach.

In contrast, the largest private debtor in possession (DIP) loan to a bankrupt entity in history was $10 billion to Calpine in 2007.[6] History also offers few examples of sizable private consortiums arranging large amounts of ongoing liquidity support for a bankrupt financial entity. The

[4] See July 1st, 2015 resolution plans for the relevant banks, available at http://www.federalreserve.gov/bankinforeg/resolution-plans.htm. Many of the foreign-owned banks operating in the U.S. market also claim that they will use a SPOE resolution strategy.
[5] See Table 5 in Basel Committee on Banking Supervision, "Basel III Monitoring Report", Bank of International Settlements, March, 2016. Available at http://www.bis.org/bcbs/publ/d354.pdf
[6] Steinberg, Kenneth and Christopher Robertson, "Key Developments and Trends in DIP Financing", Davis Polk & Wardwell Practical Law, February 19, 2015. Available at http://www.davispolk.com/sites/default/files/kenstein.chrobert.practical.law_.finance.article.03.24.15.PDF

liquidity demands of a major international bank are likely to dwarf the resources typically available to insolvent companies through the private sector. Indeed, in a recent consultative paper the Financial Stability Board expressed the view that private funding alone would likely be inadequate to take a large global financial institution through an orderly bankruptcy, stating that "historical experience…suggests that such private funding support is likely to be limited in size and challenging to obtain when markets are broadly under stress."[7] Absent public financial support, the failure to meet bank liquidity demands could cause significant financial disruption.

Title II resolution provides an explicit government liquidity backstop. However, conventional bankruptcy does not. While the Federal Reserve discount window would presumably be open to even an insolvent bank, lending to such an entity would require high-quality unencumbered collateral. Large amounts of such collateral are unlikely to be available to an insolvent entity. A reliance on significant amounts of public support for a conventional bankruptcy would imply that banks remain 'too big to fail' without public financial assistance.

How do banks which plan to maintain operations of most or all of their subsidiaries expect to access adequate liquidity support to avoid financial disruption? Do banks expect to rely mainly on private liquidity support, or do they plan to access large amounts of public support? Are liquidity support expectations realistic? Have banks engaged in sufficient pre-planning to be able to rapidly wind up operations that demand unrealistic levels of liquidity, and/or to use the bankruptcy stay to avoid such liquidity demands?

Question 2: Have banks simplified their complex internal structures enough to achieve 'separability', or the ability to separately liquidate troubled subsidiaries without impeding the functioning of other parts of the bank?

In an important May, 2015 speech FDIC chair Marty Gruenberg emphasized the advantages of 'separability' for orderly resolution. He stated:[8]

> "To improve resolvability, firms must show how their legal entities can be separated from their parent company and their affiliates, that the default or failure of one entity will not trigger the default or failure of other entities, and that critical operations will continue to function in resolution…Actions that promote separability of material entities will lessen the problem of knock-on effects created by interconnectedness, potentially allowing a firm to place its troubled entity into bankruptcy...Such an outcome would increase the likelihood that failure would be orderly, minimizing any potential instability for the financial system as a whole."

In other words, the separation or firewalling of different subsidiaries and business lines will make it possible to liquidate a single problematic business line or geographic entity in bankruptcy without having the problems in that entity spread to the other parts of the bank. This

[7] Financial Stability Board, "Guiding Principles on the Temporary Funding Needed To Support The Resolution of A Global Systemically Important Bank", November 3, 2015. Available at http://www.fsb.org/wp-content/uploads/Funding-in-Resolution-Guiding-Principles-Consultative-Document.pdf
[8] Gruenberg, Martin. Speech to the Peterson Institute, May 12, 2015, available at https://www.fdic.gov/news/news/speeches/spmay1215.html

would prevent, for example, losses in one area of a bank from creating unmanageable capital or liquidity demands on other parts of the holding company that might independently be sustainable sources of value. Ensuring separability is also important in planning for bank recovery prior to complete insolvency. Such recovery efforts may involve the sale and disposal of single subsidiaries or business lines in order to permit the continued solvency of the rest of the bank.[9]

Prior to the financial crisis, it is clear that there were enormous issues involving the internal complexity of 'too complex to manage' global financial institutions. This not only impeded risk management generally, but made clean and simple separation of particular business lines or international operations difficult to impossible. As one expert stated soon before the crisis, "financial companies have designed their corporate structures with a number of diverse goals in mind, including minimizing tax burdens and taking advantage of perceived laxity of regulation in some jurisdictions…In the process, their organization charts have begun to resemble a bowl of spaghetti with lines of communication, reporting, direction, and control becoming confusing, not only to outsiders looking in but to insiders as well."[10] These complexity issues played a major role in the difficulty of the Lehman bankruptcy, where the structural interdependence between numerous Lehman subsidiaries and the massive number of financial interconnections between them led to great difficulty in determining debt priority and even ownership of assets.[11]

If all the assumptions necessary for a successful 'single point of entry' resolution hold true, then 'separability' may seem less necessary, as all subsidiaries can be recapitalized by the top-tier holding company. But regulators and banks must be prepared for cases where these assumptions fail, such as the case that bankruptcy expert David Skeel has called the "messy subsidiary" problem.[12] This refers to a situation where there are significant issues in a single subsidiary or business line that must be addressed in bankruptcy, or they will cause continuing problems for the entire company. (An example might be the AIG Financial Products subsidiary in 2008, which had engaged in riskier activities than the rest of the holding company). Attempting to recapitalize such a troubled subsidiary so that it could continue operations without interruption would likely cause more harm than good. The entity would need to be rapidly separated from the rest of the company so that it could be restructured in bankruptcy.

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[9] Promontory Financial Group, LLC and Sullivan & Cromwell LLP, *Recovery and Resolution Planning: Some Practical Considerations*, November 2011, available at https://www.sullcrom.com/siteFiles/Publications/PFG-RecoveryWP-live6.PDF

[10] Rosenblum, Harvey, "What Reforms Are Needed To Improve The Safety and Soundness of the Banking System", Economic Review, Federal Reserve Bank of Atlanta, First and Second Quarters 2007, Available at https://www.frbatlanta.org/-/media/Documents/research/publications/economic-review/2007/vol92no1_rosenblum.pdf?la=en

[11] Price Waterhouse Coopers, "The Lehman Bankruptcy: Lessons Learned For Survivors", Informational Presentation, August, 2009, available at http://www.pwc.com/jg/en/events/lessons-learned-for-the-survivors.pdf; United States Bankruptcy Court, Southern District of New York, "In Re Lehman Brothers Holdings, Order Confirming Modified Third Amended Joint Chapter 11 Plan of Lehman Brothers Holdings Inc, And Its Affiliated Debtors", Chapter 11 Case No. 08-13555, December 6, 2011. available at http://business-finance-restructuring.weil.com/wp-content/uploads/2011/12/23023-Order-Confirming-Plan.pdf

[12] Skeel, David, "Single Point of Entry And the Bankruptcy Alternative", University of Pennsylvania Faculty Scholarship Paper Number 949, February 26, 2014, available at http://scholarship.law.upenn.edu/cgi/viewcontent.cgi?article=1949&context=faculty_scholarship

Ensuring separability of subsidiaries on a geographic basis is also crucial to prevent the potential harmful effects of multiple competing insolvencies across international lines – another major contributor to the problems in the Lehman bankruptcy. Major systemically significant banks operate in dozens of countries, each of which have different bankruptcy laws and could ring-fence resources within their jurisdiction. Again, if the optimistic assumptions of single point of entry resolution are fulfilled, these widespread subsidiaries could be effectively recapitalized and remain in operation, and multiple insolvencies in different jurisdictions could be avoided. But given the possibility of a particularly troubled subsidiary, as well as the potential lack of liquidity sources, an extended bankruptcy across geographic lines remains a possibility.

What concrete steps have major banks taken to simplify their internal structure and effectively firewall different business lines and subsidiaries, so that major business lines or subsidiaries could be restructured in bankruptcy separately from the rest of the bank? In what specific ways have the 'too complex to manage' issues that were clearly present prior to the financial crisis been addressed since the crisis occurred? Does the reliance by most of the largest banks on SPOE resolution methods imply that they do not expect such separation to be necessary or that they are not prepared if it is?

Question 3: Do the resolution methods laid out in the plans of major banks accord with U.S. bankruptcy law?

The SPOE resolution methods laid out by the major bank resolution plans rely on significant transfers of resources (both capital and liquidity) from the holding company that is entering bankruptcy to operating subsidiaries that are not in the bankruptcy proceeding. There is no doubt that such transfers would be possible within a Title II resolution. However, under current U.S. law governing Chapter 11 bankruptcy as well as under applicable state law, it is possible that any such transfer on the eve of a bankruptcy could be challenged as a fraudulent transfer, an impermissible transfer of value by an insolvent company for which it did not receive reasonably equivalent value.[13] In such a case, a bankruptcy court on the request of creditors or other parties could avoid the transfer and the operating subsidiaries would be forced to return the funds to the holding company.

Whether the transfer would be held fraudulent and ordered avoided would depend on the a court's ruling in the case, but on its face it seems that the assumption that holding company resources could easily be transferred out of the bankruptcy is at least highly questionable under bankruptcy law. The Dodd-Frank Act clearly states that banks are to demonstrate that they could achieve an orderly resolution under a conventional Chapter 11 bankruptcy, not simply under a Title II resolution.

Why and how do regulators believe that the transfers of value clearly contemplated in the public versions of bank resolution plans would not come under challenge in a Chapter 11 bankruptcy, and have banks prepared a method for orderly resolution if such challenges do take place?

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[13] Lubben, Stephen, "Title II Vs. Bankruptcy", Presentation at Americans for Financial Reform Conference 'Can Regulators End Too Big to Fail?', November, 2015. Available at http://ourfinancialsecurity.org/wp-content/uploads/2015/11/Stephen-Lubben-Resolution-Slides.pdf

These three questions clearly do not exhaust the issues surrounding preparation for a conventional bankruptcy. However, they address three of the major reasons to believe that an orderly Chapter 11 bankruptcy may not be credible for institutions of the size and complexity of the largest banks operating in the US financial system. We believe that giving the public clarity on the answers to these questions, particularly the first, is crucial to your credibility when you assert that 'too big to fail' has been adequately addressed and banks are prepared to enter into an orderly bankruptcy process under Chapter 11 of the US Code. We urge you to include detailed responses to these questions in your release of whatever decision you make concerning the 2015 bank resolution plans that are currently under review.

Sincerely,

Americans for Financial Reform