Toward Orderly Resolution
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Welcome to the Federal Reserve 2013 Resolution Conference. This gathering is sponsored jointly by the Board of Governors of the Federal Reserve System and the Federal Reserve Bank of Richmond. Our objective is to stimulate constructive dialogue among knowledgeable professionals and the practitioners involved in constructing and assessing resolution plans. This is a critically important element of our collective response to the financial crisis.

Title I of the Dodd-Frank Act requires that certain large U.S. financial institutions submit resolution plans to the Federal Reserve and the Federal Deposit Insurance Corporation. As most of you know, a resolution plan describes a firm's strategy for liquidation or reorganization under the U.S. bankruptcy code, without extraordinary government assistance, in the event of material financial distress or failure. The heart of the plan is the specification of the actions the firm would take to facilitate rapid and orderly resolution and prevent adverse effects of failure, including the firm's strategy for maintaining the operations of and funding for its critical operations and material entities.

Separate from Title I, Title II of the Dodd-Frank Act provides for the FDIC to take a firm into receivership if there is a determination that, among other things, the firm's failure under the U.S. bankruptcy code would have serious adverse effects on "financial stability." One difference between Title II and the bankruptcy code is that Title II gives the FDIC the ability to borrow funds from the U.S. Treasury to make payments to creditors of the failed firm or to guarantee the liabilities of the failed firm.[1] The funds are to be repaid from recoveries on the assets of the failed firm or from assessments against the largest, most complex financial companies.

Clearly, the Dodd-Frank Act envisions bankruptcy without government support as the first and most preferable option in the case of a failing financial institution, and for good reason, in my opinion. If Title I resolution comes to be expected as the norm, the incentives of market participants will be much better aligned with our public policy goal of a financial system that effectively allocates capital and risks. Large financial firms will prefer to be less leveraged and less reliant on short-term funding. Institutions and markets would, accordingly, be more resilient in response to financial stress. Policymakers could then credibly commit to avoiding rescues, which would reinforce appropriate incentives. In short, robust Title I resolution planning is a strong complement to the array of ongoing enhancements to prudential supervision that are aimed at reducing the likelihood of failure.

A critical success factor for resolution plans is that, in the event of financial distress, policymakers will view them as making bankruptcy preferable to alternative approaches, such as Title II, in which government funding protects some creditors, the prospect of which blunts incentives. Title I stipulates that the Federal Reserve and the FDIC can jointly determine that a plan is “not credible,” meaning that it would not facilitate an orderly resolution under the bankruptcy code. In this case, the firm would be required to submit a revised plan to address identified deficiencies, including altering business operations or corporate structure. If the Fed and the FDIC jointly determine that the revised plan does not remedy identified deficiencies, they can mandate tighter capital, leverage or liquidity requirements, or restrict the growth, activities or operations of the firm. In essence, regulators can order changes in the structure and operations of a firm to make it resolvable in bankruptcy *without* government assistance.

A veritable army of professionals has been devoting considerable time and effort to crafting and evaluating Title I resolution plans. Many of you have enlisted in this army, although some of you may have been drafted. The initial wave of firms has provided two rounds of submissions already. Another wave of firms submitted plans midyear, and a third wave is slated to submit plans at year-end. Substantial work remains to be done, however, and substantial issues remain to be sorted out before regulators and policymakers can convince market participants of the credibility of these plans.

Ensuring that the relevant portion of the financial sector is covered by robust and credible resolution plans can seem like a daunting task. The critical feature to keep in mind, however, is that resolution planning in some sense *reverses* the usual bankruptcy planning exercise. Instead of asking how to take a given financial institution through bankruptcy, Title I asks us to work backward from bankruptcy resolution and determine what the institution needs to look like in order for that bankruptcy to be orderly. It invites us to not take any aspect of the structure and financing of a large financial institution as fixed.

This perspective casts a new light on financial firm characteristics — such as short-term funding strategies — that might appear to pose impediments to orderly resolution without government support. Credibility may require altering the funding profile of the firm so that debtor-in-possession financing needs in bankruptcy are manageable without public sector funds.

Resolution planning *will* require a great deal of hard work. But I see no other way to ensure that policymakers have confidence in unassisted bankruptcy and that investors are convinced that unassisted bankruptcy is the norm, both of which strike me as necessary to solving the “too big to fail” problem. Resolution planning provides a framework for identifying the actions we need to take now to ensure that the next financial crisis is handled appropriately, in a way that is fair to taxpayers and establishes the right incentives. While I expect we will hear diverse perspectives today on many key issues, I am sure we all share that goal. To that end, I am very much looking forward to our discussions today.

[1] For a comparison of the Orderly Liquidation Authority provisions with the U.S. bankruptcy process, see Sabrina R. Pellerin and John R. Walter, "Orderly Liquidation Authority as an Alternative to Bankruptcy," Federal Reserve Bank of Richmond Economic Quarterly, First Quarter 2012, vol. 98, no. 1, pp. 1-31.