Our Perspectives:
Commentary on the economy & regulatory policies affecting financial companies

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A Review of Treasury's OLA Report*

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The Treasury Department has issued a report on the orderly liquidation authority (OLA) that is part of the Dodd-Frank Act. OLA is a mechanism for resolving the failure of large financial companies. Some members of Congress have called for the repeal of OLA on the grounds that it perpetuates "too-big-to-fail" firms. In its report, Treasury supports the retention of OLA as an "emergency tool" to be used only in extraordinary circumstances. Treasury's support for the retention of OLA is based, in part, upon concerns that traditional bankruptcy procedures are too cumbersome to address financial failures, which must be addressed quickly. Treasury also indicates that sole reliance on the bankruptcy process to handle a cross-border failure could encourage foreign financial regulators to pursue "ring fencing" U.S. banking operations in their countries. To ensure that OLA is used only as a last resort by policymakers, Treasury calls for the enactment of a new provision in the federal bankruptcy code (Chapter 14). The report also makes a series of additional recommendations aimed at reforming the OLA process.

Chapter 14

A SPOE Resolution Process

Treasury's Chapter 14 proposal is based upon a proposal developed by the Hoover Institution and upon bills introduced in Congress, one of which passed the House last year with bipartisan support. Chapter 14 would be a single point of entry (SPOE) process under which the parent company would be placed into receivership and most of its assets, including operating subsidiaries, and certain liabilities would be transferred to a bridge company within 48 hours (i.e., over a weekend). The losses at the parent company would be absorbed by the shareholders of the parent company and holders of "capital structure debt" in parent company. Treasury defines "capital structure debt" to mean any unsecured debt held by the parent plus that portion of debt secured by collateral that is in excess of the value of the collateral (i.e., deficiency claims). There also would be temporary stay on the termination or acceleration of qualified financial contracts during this 48 hour period.

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Role for Federal Regulators

Treasury supports an authorization for federal financial regulators to be heard by the bankruptcy court, and would support a similar opportunity for foreign regulations, when appropriate. Treasury notes that the Senate version of the Chapter 14 proposal would permit federal financial regulators to initiative a receivership, but suggests that a "middle ground" could be to have the bankruptcy court give deference to the Federal Reserve Board's assessment of the financial stability implications of establishing the bridge company.

Bankruptcy Judges

Treasury supports the designation of a set of bankruptcy judges for these cases, but recommends that additional consideration be given to designating judges from federal district courts because district court judges have a broader judicial experience that may be better suited to adding the financial stability issues in a Chapter 14 filing.

Definition of a Financial Company

Finally, Treasury recommends that there be a clear definition of what financial companies could be subject to a Chapter 14 filing, and specifically endorses the definition of a "financial company" used in Title II of Dodd-Frank, which covers companies in which 85% of their revenues are derived from activities that are financial in nature. Treasury also objects to any definition that includes an asset threshold because an asset threshold could suggest a company is systemically risky when, in fact, it is not.

Reforms to OLA

In addition to the enactment of a new Chapter 14 to the federal bankruptcy code, Treasury recommends several changes to OLA, which are designed to address some of the criticisms of those provisions. Specifically, Treasury recommends the following reforms:

- Eliminate the FDIC's authority to treated similarly situated creditors differently, and look to existing bankruptcy standards for ensuring that critical vendors continue to be paid following the receivership;
- Provide for a bankruptcy court to adjudicate claims on assets remaining in the receivership, not the FDIC;
- Eliminate the tax exempt status of a bridge company, as provided in title II of Dodd-Frank;
- Require the FDIC to clarify its commitment to use the SPOE process;
- Clarify what constitutes "in danger or default" as that standard applies to triggering OLA (Treasury suggests that specific metrics such as capital depletion be tied to a time period, such as 90 days);
- Provide that if the orderly liquidation funds are needed that the FDIC use loan guarantees before direct loans, and that the rates on loan guarantees and loans be at a significant premium;
- Require that orderly liquidation funds be secured by high quality assets (of the type the Federal Reserve Board accepts for discount window purposes);
- Provide that orderly liquidation funds be for a fixed term;

- Provide that, in the event orderly liquidation funds are not repaid, the assessment on the industry be imposed as quickly as possible;
- Strengthen the judicial review of the decision to invoke OLA by permitting a court to review all of the determination Treasury must make, and consider either: (1) actions to remove FDIC as a receiver within 30 days of appointment, and (2) permitting de novo review of a district court's approval of the appointment.

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