"Single Point of Entry" Resolution Strategy for U.S. Global Systemically Important Banking Groups (G-SIBs)

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Panel on Crisis Management: Are we ready to handle failures?
18th Annual International Conference on Policy Challenges for the Financial Sector
World Bank – IMF – Federal Reserve
June 6, 2018

Davis Polk

Single Point of Entry Resolution

U.S.-style BHC structure facilitates SPOE resolution

- Bail-in of bank holding company (BHC) long-term debt simply by placing BHC alone into bankruptcy
- Bank and broker-dealer subsidiaries can be recapitalized and kept out of bankruptcy or resolution

Critical components of "Single Point of Entry" Resolution

- Sufficient External "TLAC"—Total Loss Absorbing Capacity—at BHC
  - New requirements for **BHC capital** and **TLAC (long-term) debt**
- Sufficient corresponding BHC assets to push capital down to subsidiaries to recapitalize losses
- Ability to protect recapitalization from avoidance or other attack
- Sufficient liquidity to sustain subsidiary operations until they stabilize
- Legal tool to prevent QFC close-outs upon BHC bankruptcy
- Cooperation by local regulators (no seizure or ring-fencing of operations)

If successful, a "single point of entry" resolution strategy can resolve a failed financial institution while minimizing systemic impact

Single Point of Entry Resolution

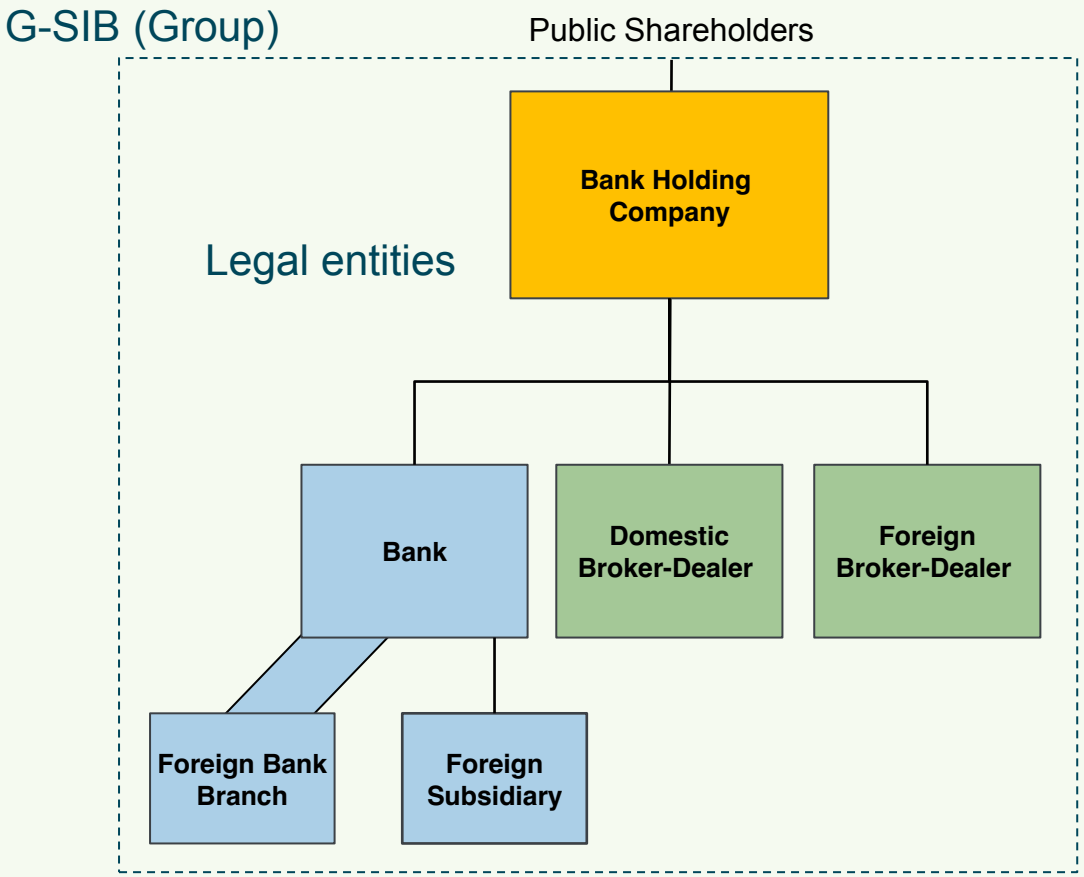
BASICS

Basics of SPOE resolution strategy

- Bankruptcy or special resolution proceedings (e.g., OLA) are commenced for top-tier parent BHC only
- Operating companies ("OpCos") are recapitalized using BHC's assets
  - OpCos continue in business outside bankruptcy or resolution proceeding
  - Going concern value of OpCos is preserved until orderly sale (including IPO), wind-down or distribution of shares to bankruptcy estate
  - Systemic risk is minimized
- Losses are absorbed by external shareholders and long-term creditors of BHC (external TLAC holders), but recoveries are enhanced by preservation of going concern value of OpCos

Single Point of Entry Resolution

HYPOTHETICAL U.S.-STYLE BHC STRUCTURE FOR DISCUSSION



Note: This is a hypothetical and greatly simplified U.S.-style BHC structure. The location of various legal entities, including whether they are in a separate legal chain or in a chain with a domestic insured bank, varies from firm to firm. Asset management entities are not shown.

Single Point of Entry Resolution

HYPOTHETICAL U.S.-STYLE BHC STRUCTURE BEFORE FINANCIAL DISTRESS (cont.)

Top-Tier BHC Stand-alone Balance Sheet ($bn)*

Assets		Liabilities	
Cash and Other HQLAs	25	Unsecured long-term debt (external TLAC debt)	100
BHC Deposits in Bank	35		
Advances to Domestic Broker-Dealer	15		
Advances to Foreign Broker-Dealer	10		
Equity of Bank	75	Unsecured short-term debt	0
Equity of Domestic Broker-Dealer	15		
Equity of Foreign Broker-Dealer	10		
Other Assets	15		
		Equity	**100**
Total	**200**	**Total**	**200**

These BHC assets can be used to recapitalize and provide liquidity to OpCos after the onset of financial distress

External TLAC

* The figures used in this SPOE hypothetical are meant to be illustrative only.

Note: This is a BHC stand-alone balance sheet, which shows only BHC investments in OpCos, and not the OpCos' assets and liabilities. A consolidated balance sheet would show that the firm has $850bn – $1tn in assets.

Single Point of Entry Resolution

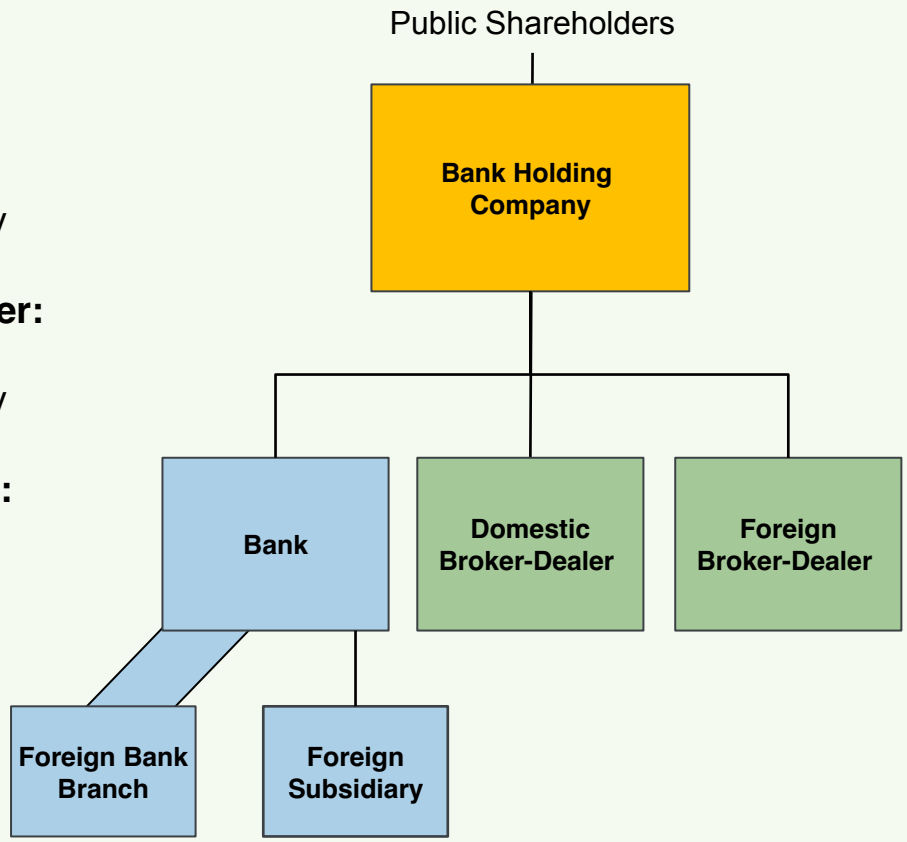
HYPOTHETICAL LOSSES

Losses in Subs ($bn)

Bank: $40 Loss
- $35 Remaining Equity

Domestic Broker-Dealer: $5 Loss
- $10 Remaining Equity

Foreign Broker-Dealer: $5 Loss
- $5 Remaining Equity



Total Losses: $50 bn
Remaining BHC Equity: $50 bn

Single Point of Entry Resolution

HYPOTHETICAL LOSSES (cont.)

Top-Tier BHC Stand-alone Balance Sheet After Losses and Before Recapitalization ($bn)

Assets		**Liabilities**	
Cash and Other HQLAs	25	Unsecured long-term debt	100
BHC Deposits in Bank	35		
Advances to Domestic Broker-Dealer	15		
Advances to Foreign Broker-Dealer	10		
Equity of Bank	75→**35**	Unsecured short-term debt	0
Equity of Domestic Broker-Dealer	15→**10**		
Equity of Foreign Broker-Dealer	10→**5**		
Other Assets	15		
		Equity	**100→50**
Total	**200→150**	**Total**	**200→150**

Single Point of Entry Resolution

OPCOS RECAPITALIZED AND PROVIDED LIQUIDITY

Contributions of capital and liquidity to OpCos must be structured to be resilient against avoidance and other legal challenges in BHC bankruptcy or resolution proceedings.

Top-Tier BHC Stand-alone Balance Sheet After Recapitalization Actions ($bn)

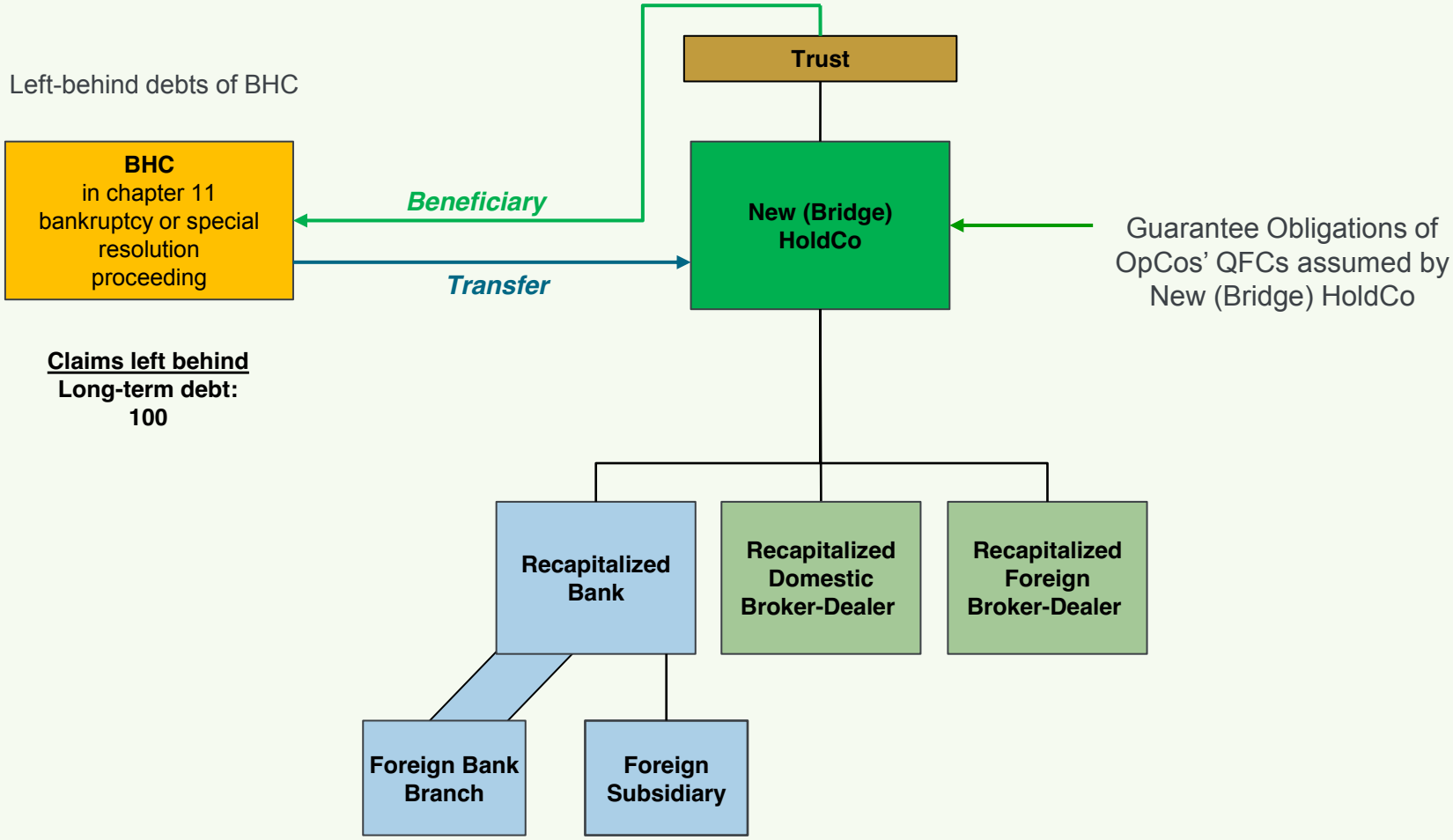
Assets		**Liabilities**	
Cash and Other HQLAs	25→**2**	Unsecured long-term debt	100
BHC Deposits in Bank	35→**0**		
Advances to Broker-Dealer 1	15→**0**		
Advances to Broker-Dealer 2	10→**0**		
Equity of Bank	35→**93**	Unsecured short-term debt	0
Equity of Broker-Dealer 1	10→**25**		
Equity of Broker-Dealer 2	5→**15**		
Other Assets	15		
		Equity	**50**
Total	**150**	**Total**	**150**

The BHC provides capital and liquidity to its OpCos pursuant to secured Support Agreement before commencing a bankruptcy proceeding.

Single Point of Entry Resolution

TRANSFER OF OPCOS TO DEBT-FREE NEW (BRIDGE) HOLDCO OWNED BY TRUST FOR BENEFIT OF BANKRUPTCY ESTATE OR RECEIVERSHIP OF BHC

Recapitalized OpCos are transferred to New (Bridge) HoldCo owned by Trust for benefit of bankruptcy estate or receivership of BHC



Single Point of Entry Resolution

NEW (BRIDGE) HOLDCO STAND-ALONE BALANCE SHEET

Only some of the BHC's liquid resources are transferred to New (Bridge) HoldCo; the remainder is left behind in the BHC to cover bankruptcy or resolution administrative expenses (not shown here). This is New Bridge HoldCo's balance sheet. As adjusted, $1 billion is transferred to New HoldCo, and $1 billion is left behind in the bankruptcy estate or receivership of BHC.

New (Bridge) HoldCo Stand-alone Balance Sheet ($bn)

Assets		**Liabilities**	
Cash and Other HQLAs	1	Unsecured long-term debt	0
Equity of Bank	93	Unsecured short-term debt	0
Equity of Broker-Dealer 1	25		
Equity of Broker-Dealer 2	15		
Other Assets	15		
		Equity	149
Total	**149**	**Total**	**149**

Capital Levels of recapitalized OpCos and New (Bridge) HoldCo exceed pre-loss levels to facilitate stabilization*

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* The New (Bridge) Holdco will be required to comply with capital requirements generally applicable to fully capitalized and open bank holding companies.

Planning for SPOE Resolution: Prerequisites

Prerequisite	Resolution Readiness Feature(s)
1. Sufficiency of Resources in Resolution	➢ Capital and liquidity resources higher at the onset of material financial distress ➢ External TLAC debt (and corresponding contributable assets) ➢ Internal TLAC debt (prepositioning of assets, including liquid assets) ➢ BHC bankruptcy or resolution proceeding must be commenced while capital and liquidity resources remain sufficient for SPOE resolution strategy (governance triggers)
2. No QFC Closeouts	➢ Contractual waiver of QFC closeout rights conditioned upon timely approval of emergency motion (see below)
3. Resilience of Opco Support to Legal Challenges	➢ Secured support agreement to provide capital and liquidity to support Opcos ➢ Security interest in contributable assets securing Support Agreement ➢ Prior notice/disclosure of structural changes and resolution strategy
4. Timely Transfer of "Good Bank" to New (Bridge) Holdco	➢ Notice of proceedings ➢ Limited relief requested ➢ Preservation of value for the estate ➢ No need to value consideration received ➢ Mitigation of systemic risk ➢ Performance of QFCs by OpCos
5. Foreign Regulator Cooperation	➢ Meeting or exceeding minimum regulatory capital requirements at all times ➢ Conservative assumptions about inter-affiliate transactions during the reorganization period

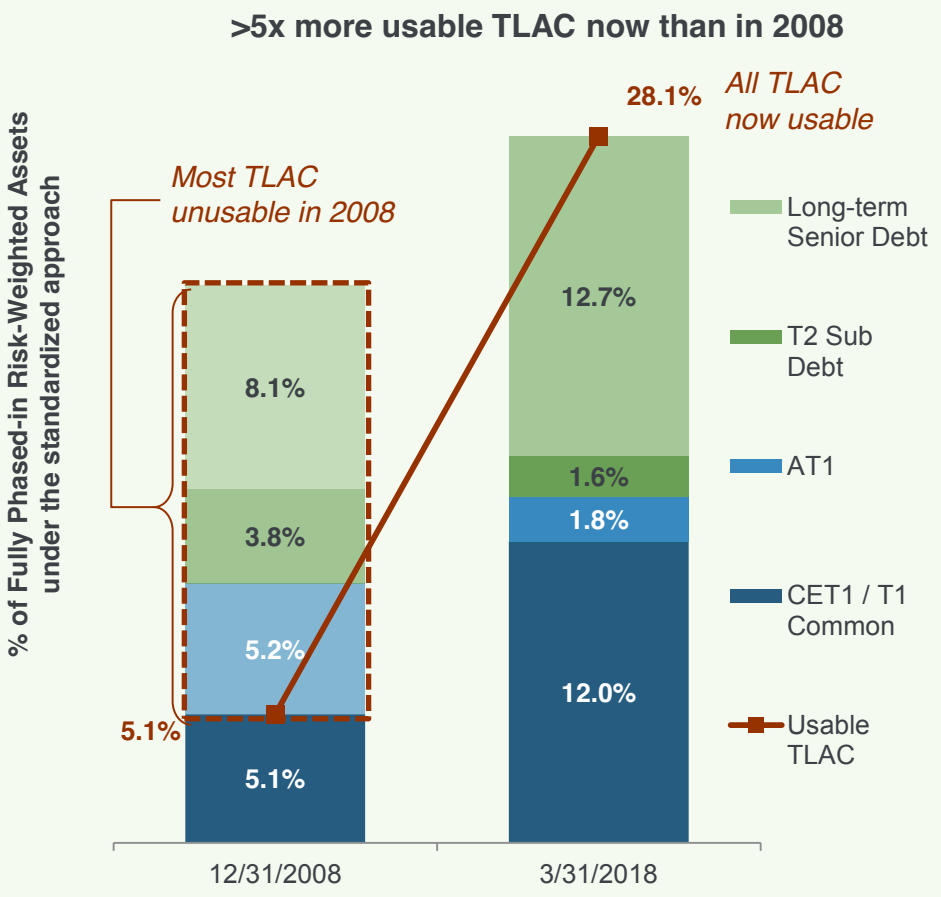
Assuring Sufficiency of Resolution Resources

The following slides are based on the briefing materials prepared by Davis Polk for the Wharton Financial Institutions Center's workshop on Resolution of Global Systemically Important Financial Institutions Under the Bankruptcy Code, dated December 7, 2016, *available at* https://fic.wharton.upenn.edu/resolution-under-bankruptcy/. We have made slight changes to the Wharton Financial Institutions Center materials to incorporate them in this presentation.

Assuring Sufficiency of Resolution Resources

EXTERNAL TLAC: TODAY vs. 2008

U.S. G-SIBs have substantially increased and restructured their equity and long-term unsecured debt so that all of it can now be used to absorb losses without threatening financial stability



- **TLAC** consists of **equity** plus **long-term unsecured debt** that can be converted to common equity in bankruptcy
- U.S. G-SIBs now have >5 times more usable TLAC
- In 2008, long-term senior debt not usable without imposing losses pro rata on short-term senior debt (e.g., commercial paper)
- Subordinated debt and Additional Tier 1 were considered unusable in 2008 because of market confusion about loss waterfall
- U.S. G-SIBs have restructured themselves to make all external unsecured long-term debt at top-tier parent level structurally or contractually junior to all external short-term debt
- Enough long-term debt (senior + subordinate) to recapitalize U.S. G-SIBs at full Basel III capital levels under conditions twice as severe as 2008

Source: Wharton Workshop materials, updated for 2018Q1 reported amounts.

All capital ratios presented on an aggregate (weighted average) basis. Long-term senior debt is estimated based on the long-term non-subordinated borrowings of parent holding companies of all U.S. G-SIBs

Sources: Federal Reserve, SNL Financial, Regulatory Filings

Assuring Sufficiency of Resolution Resources

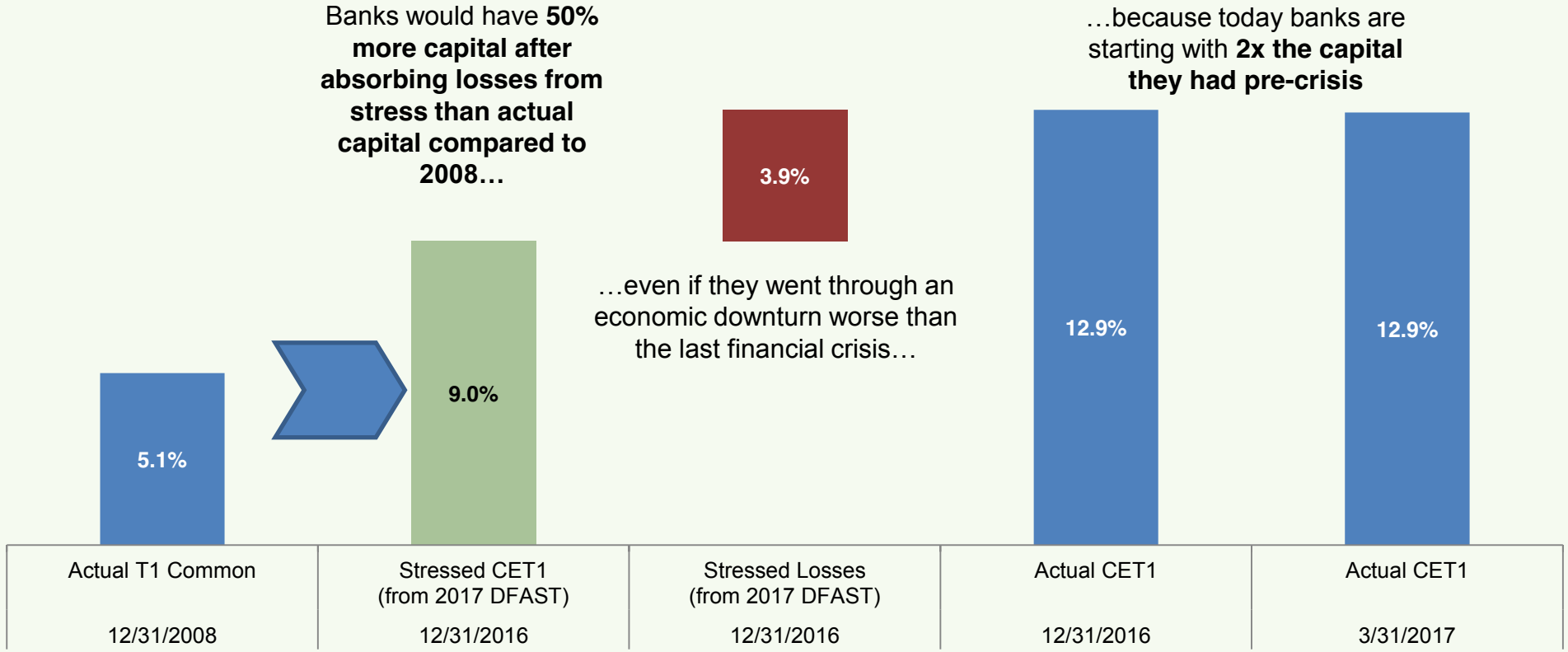
EXTERNAL TLAC: TODAY vs. 2008

- External TLAC Must Be "Usable" for Resolution Purposes
  - Structurally or Contractually Subordinated to All External Short-Term (Runnable) Debt
- Fed's Final TLAC and Clean Holding Company Rule
  - Requires External TLAC Debt To Be Structurally Subordinated With Respect to Subsidiary Creditors and Assets
  - Prohibits external short-term debt and financial contracts at top-tier parent
  - All external short-term debt and financial contracts at operating subsidiaries
  - Impact: external short-term debt has first claim on subsidiaries' assets – ahead of external TLAC at parent level
- Secured Support Agreement
  - Creates contractual commitment by parent to recapitalize subsidiaries in distress scenario secured by a lien on parent's cash, intercompany receivables and other financial assets (contributable assets)
  - Impact: subordinates external TLAC to parent's "contributable assets"

Assuring Sufficiency of Resolution Resources

CAPITAL: TODAY VS. 2008

U.S. G-SIBs have higher risk-based capital ratios today in a stressed environment than actual risk-based capital ratios in 2008



All capital ratios presented on an aggregate (weighted average) basis. Actual T1 Common as of 12/31/2008 reflects the Tier 1 Common ratio in effect prior to Basel III for all U.S. G-SIBs. Stressed CET1 as of 12/31/2016 reflects the minimum CET1 ratio (under Basel III) under the supervisor-run severely adverse scenario, based on supervisory results of the 2017 DFAST process, for all U.S. G-SIBS. Actual CET1 reflects the reported CET1 ratio for all U.S. G-SIBs.
Sources: SNL Financial, Regulatory Filings, 2017 DFAST Results

Source: Wharton Workshop materials, but updated for 2017 figures.

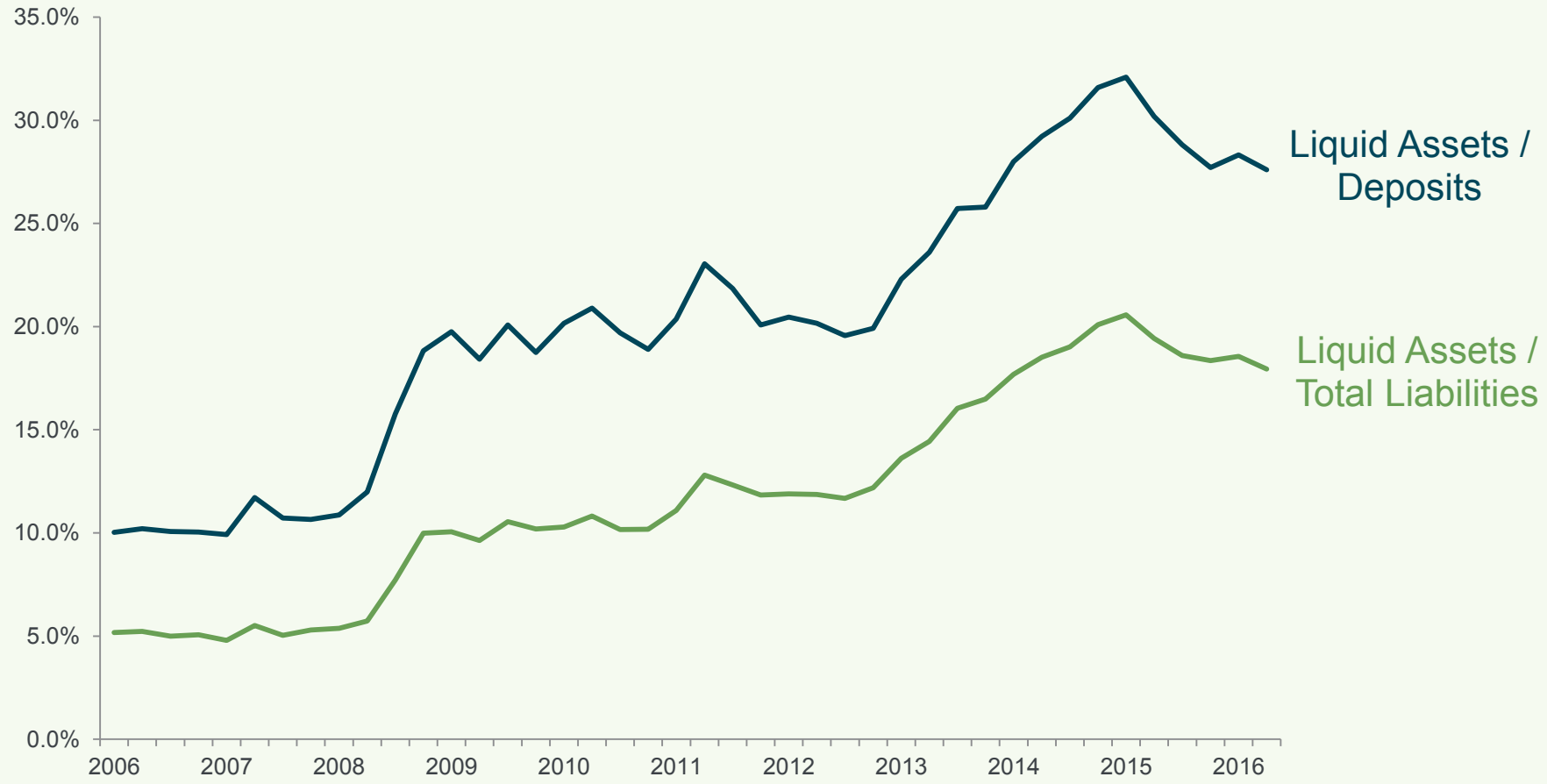
* CET1 = Common Equity Tier 1 capital, a measurement of a bank's core equity capital, subject to adjustments and deductions under Basel III

** DFAST = Dodd-Frank Act Stress Testing

Assuring Sufficiency of Resolution Resources

LIQUIDITY: TODAY vs. 2008

U.S. G-SIBs have 3x more liquid assets (defined as cash, bank deposits and U.S. Treasury and Agency debt securities) as a percentage of total liabilities compared to before the 2008 financial crisis



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Source: Wharton Workshop materials.

Liquid Assets = Cash and Due from Banks + U.S. Treasury, Agencies and GSE Debt (held to maturity and available for sale). Average Liquidity Ratio = weighted average for BAC, BNYM, C, JPM, STT and WFC.

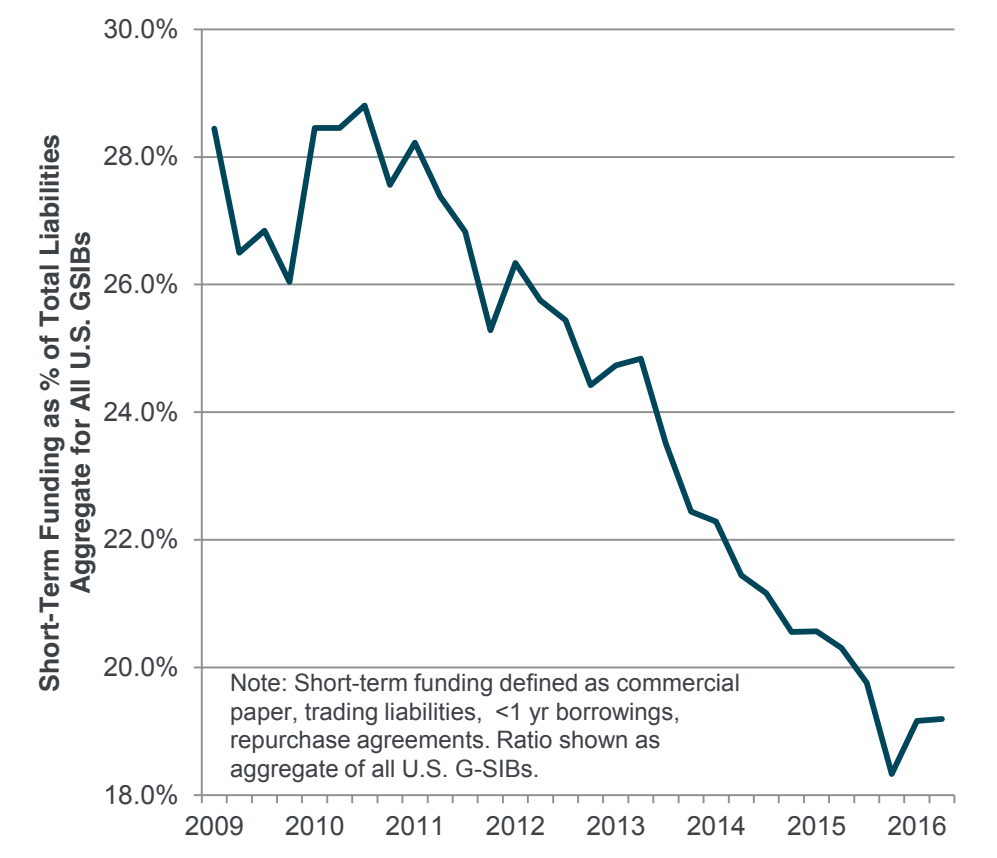
Sources: SNL Financial, Regulatory Filings

Assuring Sufficiency of Resolution Resources

LIQUIDITY: TODAY vs. 2008

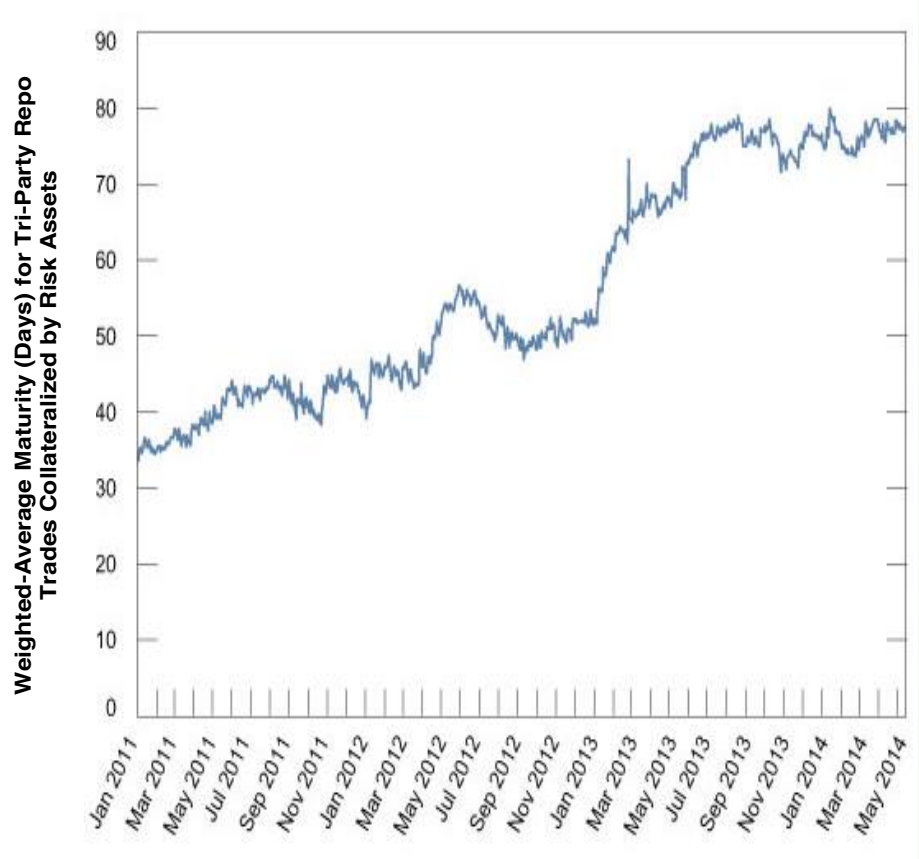
U.S. G-SIBs have reduced their reliance on short-term wholesale funding

U.S. G-SIBs have significantly lowered their reliance on short-term wholesale funding…



Sources: SNL Financial, Regulatory Filings

…and pushed out the duration of any remaining short-term wholesale funding



Source: Liberty Street Economics' Paper "What's Your WAM? Taking Stock of Dealers' Funding Durability" published 6/9/2014; FRBNY

Source: Wharton Workshop materials.

Assuring Sufficiency of Resolution Resources

POSITIONING LIQUIDITY AND TRIGGERS: RCAP, RLAP, RCEN, AND RLEN

- Four new resolution planning concepts introduced in the Fed/FDIC Guidance for 2017 Resolution Plans by U.S. G-SIBs under Title I of the Dodd-Frank Act ("**2017 Guidance**")* address positioning of resources and triggers for recapitalization and bankruptcy
  - Resolution Capital Adequacy and Positioning ("**RCAP**")
  - Resolution Liquidity Adequacy and Positioning ("**RLAP**")
  - Resolution Capital Execution Need ("**RCEN**")
  - Resolution Liquidity Execution Need ("**RLEN**")

* "Guidance for 2017 § 165(d) Annual Resolution Plan Submissions By Domestic Covered Companies that Submitted Resolution Plans in July 2015" published by the FDIC and the Board of Governors of the Federal Reserve System

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* "Guidance for 2017 § 165(d) Annual Resolution Plan Submissions By Domestic Covered Companies that Submitted Resolution Plans in July 2015" published by the FDIC and the Board of Governors of the Federal Reserve System

Assuring Sufficiency of Resolution Resources

POSITIONING LIQUIDITY AND TRIGGERS: RCAP, RLAP, RCEN, AND RLEN (cont.)

- **RCAP and RLAP: Positioning Resources for a Hypothetical Future SPOE Resolution**
  - Firms must "position" appropriate balance of contributable and prepositioned (internal) capital and liquidity resources during business as usual ("**BAU**") to anticipate a stress scenario
- **RCEN and RLEN: Projecting <u>Actual</u> Needs of OpCos to Make SPOE Resolution Feasible**
  - When under financial stress, firms are required to make real-time projections of capital and liquidity needs of OpCos during resolution period
  - Projections comparable to projections provided to debtor-in-possession ("**DIP**") lenders in a conventional bankruptcy reorganization proceeding

Assuring Sufficiency of Resolution Resources

PROJECTING REAL TIME RESOLUTION NEEDS: RCEN AND RLEN

During a stress period, U.S. G-SIBs are required to estimate and regularly update projected capital and liquidity needed to implement SPOE Resolution based on facts unfolding in the actual stress scenario being experienced by the group

RCEN — **Projected capital resources needed at each OpCo following the BHC's bankruptcy filing to cover projected losses while SPOE Resolution is executed**

- Must be sufficient to ensure compliance with capital requirements applicable to each OpCo after absorbing losses both before and after commencement of bankruptcy or resolution proceedings
- Updated daily during stress period

RLEN — **Projected liquidity resources needed at each OpCo after the BHC's bankruptcy filing to cover net liquidity outflows until liquidity levels stabilize (the "Stabilization Date")**

- Must be sufficient to cover both:
  - cumulative net outflows during period after commencement of bankruptcy or resolution proceedings (after offsetting inflows) until Stabilization Date, and
  - peak intra-day liquidity needs
- Updated daily during stress period

RCEN and RLEN are used to formulate triggers so action is taken while sufficient resources remain to execute SPOE Resolution

Assuring Sufficiency of Resolution Resources

RECAPITALIZATION TRIGGER

- **Recapitalization Trigger** occurs when the HQLAs and other assets held at the BHC or IHC level that are available for contribution to the OpCos approach the aggregate capital or liquidity needs of the OpCos based on the RCEN/RLEN shortfall calculation

Recapitalization Trigger

$$\frac{\text{Available Financial Resources}}{\text{Aggregate Resource Needs}} \rightarrow 1.0$$

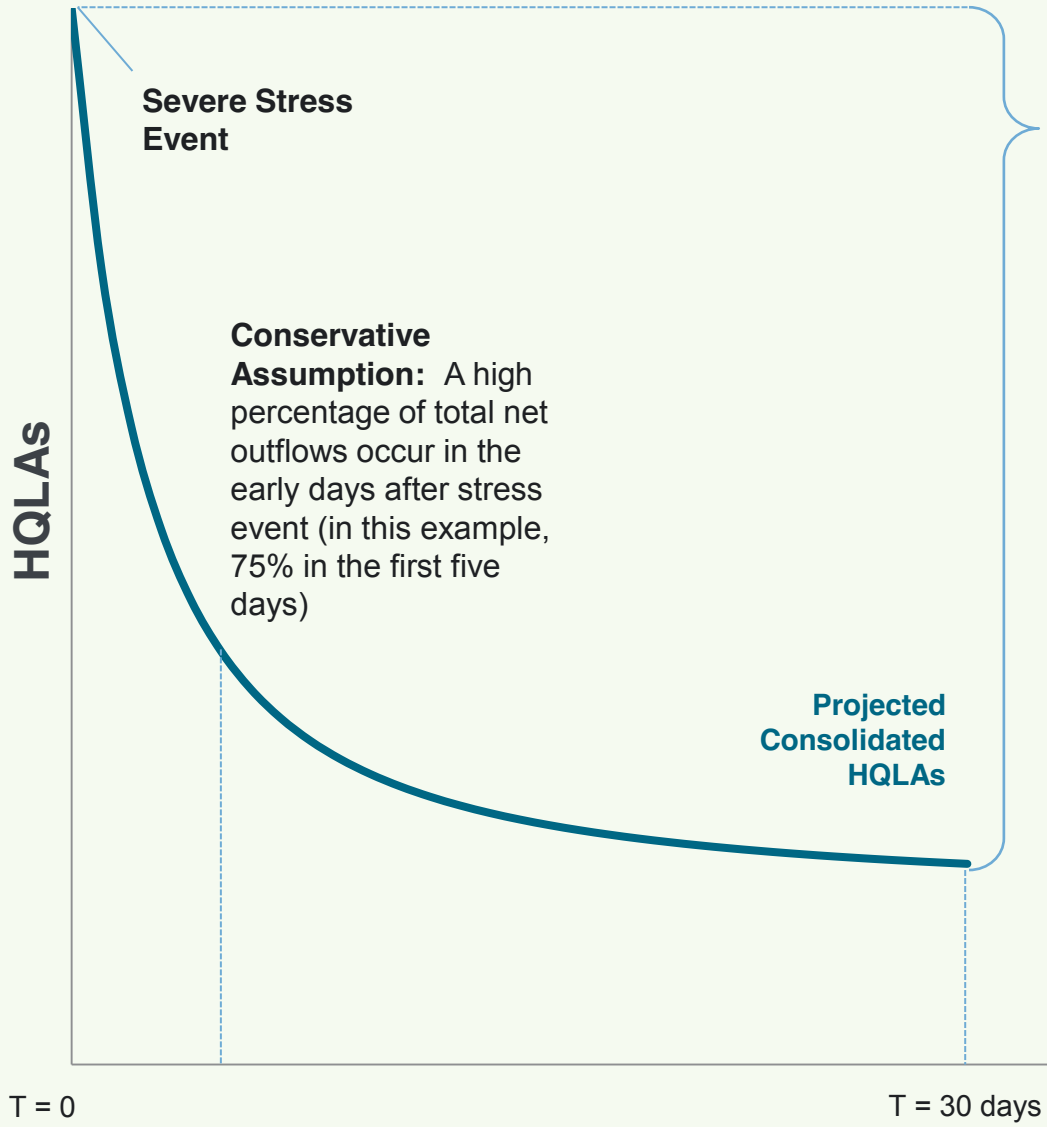
Buffers are built into the trigger calculation so the recapitalization and the BHC's bankruptcy occur while available resources remain sufficient to meet capital and liquidity needs during the resolution period.

  - The precise ratio in the Recapitalization Trigger will depend upon where the buffers are built into the system (RLEN/RCEN or the recapitalization ratio).

- **Upon occurrence of the Recapitalization Trigger:**
  - The BHC's remaining contributable assets are contributed to the OpCos or an IHC
  - Thereafter, the BHC files for protection under chapter 11
    - **The Recapitalization Trigger is also a governance trigger for the BHC director and management action regarding the BHC's chapter 11 proceedings**

Resolution Plan Liquidity Outflow Assumptions

MODELS ASSUME RAPID DEPLETION OF HQLAs DURING RUNWAY PERIOD PRIOR TO RESOLUTION

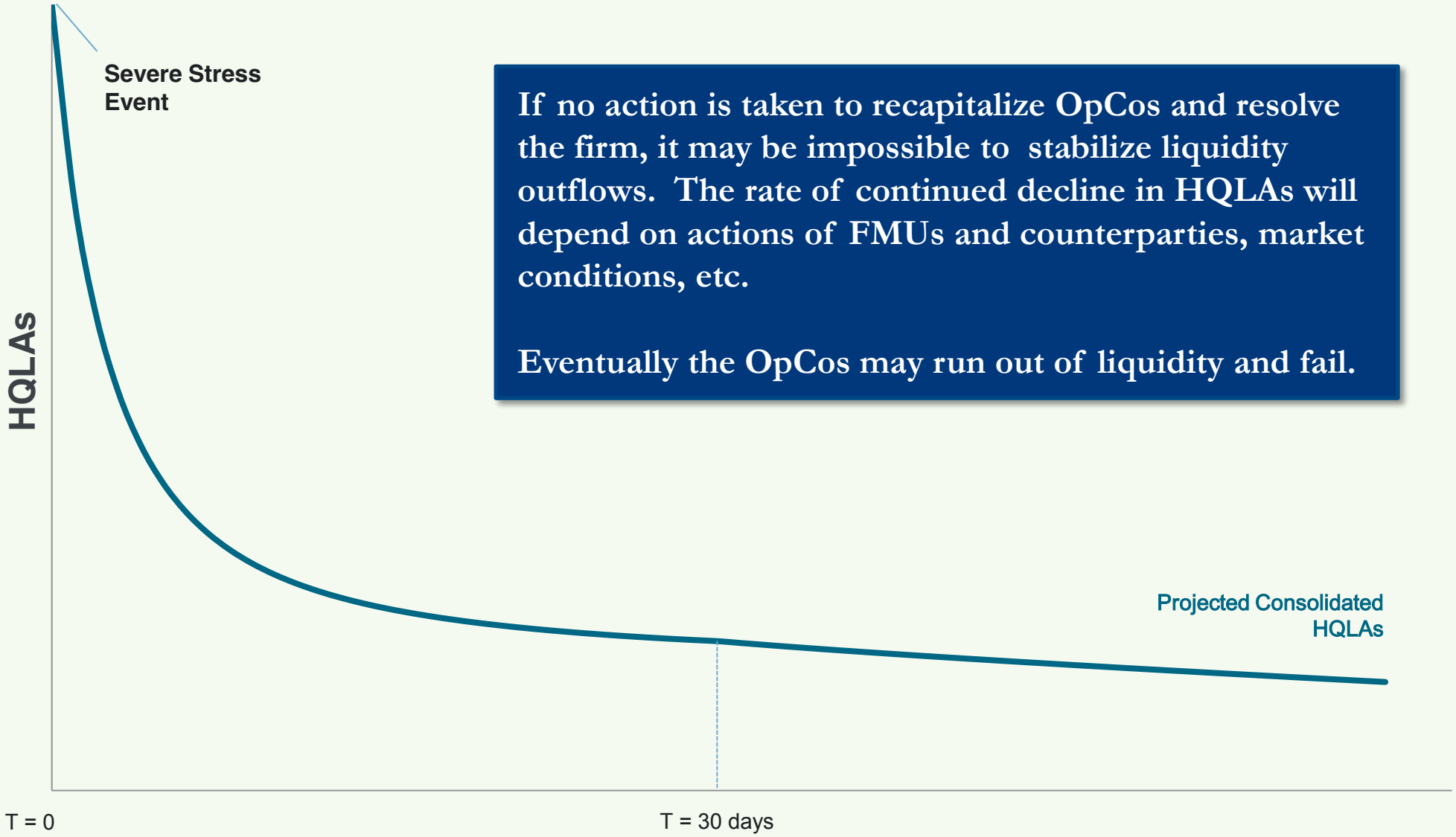


RLAP models require U.S. G-SIBs to hold HQLAs to cover liquidity deficits (Cumulative Net Outflows) of material entities for a stress period of at least 30 days. (See note below.)

Note: Regulatory guidance provides that: "With respect to RLAP, the firm should be able to measure the stand-alone liquidity position of each material entity (including material entities that are non-U.S. branches) — i.e., the high-quality liquid assets (HQLA) at the material entity less net outflows to third parties and affiliates — and ensure that liquidity is readily available to meet any deficits. The RLAP model should cover a period of at least 30 days and reflect the idiosyncratic liquidity profile and risk of the firm. . . . The stand-alone net liquidity position of each material entity (HQLA less net outflows) should be measured using the firm's internal liquidity stress test assumptions." *Agency Guidance for July 2017 Submissions*

Resolution Plan Liquidity Outflow Assumptions

HQLA DEPLETION WILL CONTINUE WITHOUT SPOE RESOLUTION

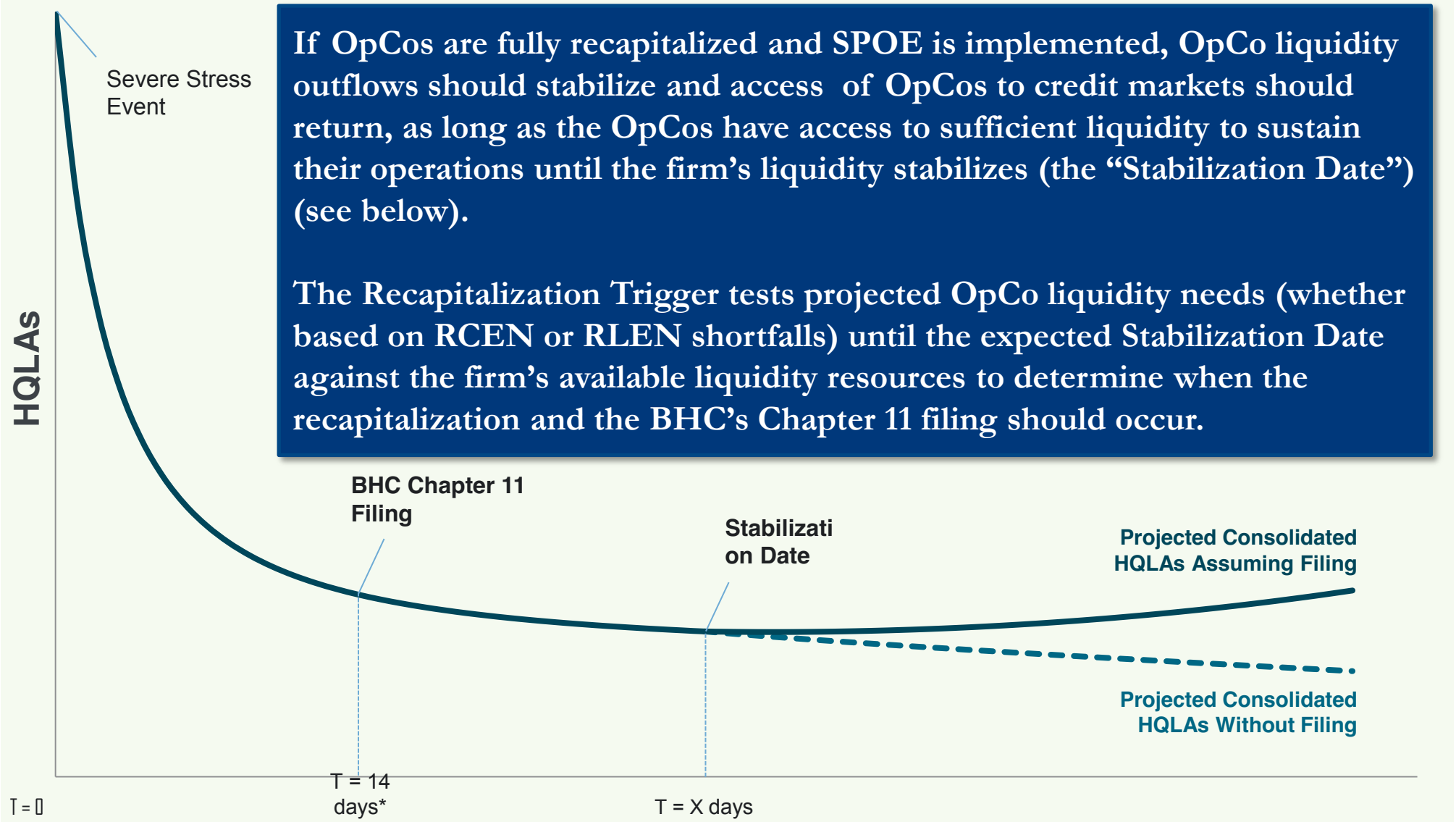


If no action is taken to recapitalize OpCos and resolve the firm, it may be impossible to stabilize liquidity outflows. The rate of continued decline in HQLAs will depend on actions of FMUs and counterparties, market conditions, etc.

Eventually the OpCos may run out of liquidity and fail.

Resolution Plan Liquidity Outflow Assumptions

IMPACT ON HQLAs OF COMMENCEMENT OF SPOE RESOLUTION AT DAY 14



If OpCos are fully recapitalized and SPOE is implemented, OpCo liquidity outflows should stabilize and access of OpCos to credit markets should return, as long as the OpCos have access to sufficient liquidity to sustain their operations until the firm's liquidity stabilizes (the "Stabilization Date") (see below).

The Recapitalization Trigger tests projected OpCo liquidity needs (whether based on RCEN or RLEN shortfalls) until the expected Stabilization Date against the firm's available liquidity resources to determine when the recapitalization and the BHC's Chapter 11 filing should occur.

* For purposes of this illustration it is assumed that, based on the daily RLEN and RCEN calculations, the G-SIB determines that the Recapitalization Trigger has occurred shortly before day 14, triggering final BHC support contributions to the OpCos, or an IHC if one is used, and BHC's bankruptcy filing promptly thereafter.