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November 2018

FINANCIAL COMPANY BANKRUPTCIES

Experts Had Mixed Views on Companies' Controls for Mitigating Obstacles

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GAO-19-30

GAO Highlights

Highlights of GAO-19-30, a report to congressional requesters

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Why GAO Did This Study

Legal and financial obstacles can undermine a GSIB's orderly resolution under the Code and result in a failure that harms U.S. financial stability. Pursuant to resolution plan authorities under the Dodd-Frank Act, FDIC and the Federal Reserve identified legal and financial obstacles they expected GSIBs to mitigate to show their ability to execute their SPOE strategies under the Code. Members of Congress and experts have proposed amending the Code to enhance the resolvability of GSIBs.

GAO was asked to review actions to mitigate financial and legal obstacles GSIBs could face under the Code. This report (1) describes actions GSIBs took to mitigate such obstacles and (2) analyzes expert views on the effectiveness of the actions, need for additional actions, and likely success of an SPOE strategy. GAO focused on five U.S. GSIBs with large portfolios of derivatives (because of resolution obstacles such financial contracts pose).

GAO reviewed and analyzed academic and industry studies on resolution of large financial firms; public sections of GSIB resolution plans; laws, regulations, and regulatory guidance on GSIB resolution plans; and proposals to amend the Code. GAO judgmentally selected and interviewed 30 experts (judges, academics, attorneys, other professional service providers, and counterparties) based on their knowledge of the Code and GSIB resolution. GAO also interviewed federal banking regulators and the five GSIBs covered by GAO's review.

View GAO-19-30. For more information, contact Alicia Puente Cackley at (202) 512-8678 or cackleya@gao.gov.

What GAO Found

The five U.S. global systemically important bank holding companies (GSIB) in GAO's review incorporated procedures and other controls in their 2017 resolution plans to mitigate financial and legal obstacles to orderly resolution under the U.S. Bankruptcy Code (Code). The distress or failure of a GSIB could cause significant disruption to the financial system or economy because of attributes such as its size, complexity, or interconnectedness. The GSIBs' plans describe their strategies for rapid and orderly resolution under the Code in the event of financial distress or failure. Each GSIB developed a resolution strategy using a single point-of-entry (SPOE); that is, only the GSIB holding company would enter bankruptcy. Before entering bankruptcy, the holding company would provide its subsidiaries with capital and liquidity to keep them solvent and enable their orderly wind-down or sale. However, a GSIB could lack sufficient capital and liquidity to keep subsidiaries solvent or face legal challenges from creditors. To mitigate such obstacles, the five GSIBs estimated the financial needs of subsidiaries under SPOE, pre-positioned loss-absorbing capital and long-term debt at key subsidiaries conducted legal analysis to identify potential creditor challenges, and took other actions. In their review, the Federal Deposit Insurance Corporation (FDIC) and Board of Governors of the Federal Reserve System (Federal Reserve) found no deficiencies with the GSIBs' 2017 plans.

Because no GSIBs have gone through bankruptcy using SPOE, the potential effectiveness of their controls cannot be known. However, experts GAO interviewed had the following views on the five GSIBs' controls to mitigate obstacles, the need for additional actions, and SPOE strategies.

- Most experts viewed GSIB controls to mitigate financial obstacles as potentially somewhat effective. But some expressed concerns about the controls, partly because of the difficulty of forecasting capital and liquidity needs of subsidiaries and uncertainty about future events in a GSIB failure. To further mitigate financial obstacles, experts' suggestions included that the federal government provide a failed GSIB's subsidiaries with access to liquidity to promote market confidence. But a few experts said that such access would create moral hazard and reduce market discipline.
- Experts had mixed views on the potential effectiveness of GSIB controls to mitigate creditor challenges and other legal obstacles but supported certain Code amendments to further mitigate the obstacles. Most experts generally supported amending the Code to limit creditors from challenging a GSIB's provision of capital and liquidity to its subsidiaries before filing for bankruptcy. But some were concerned about tradeoffs between interests of creditors and the public associated with such an amendment.
- Most experts said a GSIB likely could execute its SPOE strategy successfully if its failure affected only itself. But most viewed success as unlikely if the failure occurred during a widespread market disruption. In that regard, some experts said it was important not to repeal the Orderly Liquidation Authority of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)—which allows the federal government, if warranted, to resolve a GSIB outside the Code.

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Abbreviations

Code	U.S. Bankruptcy Code
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010
FDIC	Federal Deposit Insurance Corporation
Federal Reserve	Board of Governors of the Federal Reserve System
GSIB	global systemically important bank holding company
IHC	intermediate holding company
ISDA	International Swaps and Derivatives Association
ISDA Stay Protocol	International Swaps and Derivatives Association 2015 Universal Resolution Stay Protocol
QFC	qualified financial contract
SPOE	single point-of-entry

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November 8, 2018

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate

The Honorable Jack Reed
United States Senate

During the financial crisis of 2007–2009, the U.S. government provided unprecedented assistance to financial institutions—helping to avert a more serious crisis but heightening concerns that market participants had come to view several of the largest U.S. financial institutions as too-big-to-fail.[1] The government provided tens of billions of dollars of capital and other support to a few large troubled financial institutions out of concern that allowing them to enter bankruptcy would have further disrupted credit markets and damaged confidence in the U.S. financial system.[2] Such interventions led to debate about how to decrease the likelihood of future federal rescues for failing financial institutions and limit the scope of federal safety nets for such institutions.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) and the actions of U.S. financial regulators to implement the act help protect U.S. financial stability and address the too-big-to-fail problem.[3] The act's prudential reforms seek to reduce the risk that a large

[1]"Too big to fail" refers to a market notion that to avoid harm to the economy, the federal government would intervene to prevent the failure of a large, interconnected financial institution. Market expectations of government rescues can distort the incentives of investors and counterparties to properly price and restrain the risks of firms they believe to be too big to fail, potentially giving rise to funding cost and other advantages for these firms relative to smaller competitors.

[2]Bankruptcy is governed by a federal court procedure conducted under rules and requirements of the U.S. Bankruptcy Code. *See* generally Title 11 of the United States Code.

[3]*See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203,124 Stat. 1376 (2010).

financial institution's failure would adversely affect U.S. financial stability.[4] For example, the act directed the Board of Governors of the Federal Reserve System (Federal Reserve) to require large, interconnected financial institutions to prepare resolution plans that describe their strategies, if needed, for rapid and orderly resolution under the U.S. Bankruptcy Code (Code) without federal assistance.[5] Such financial institutions include global systemically important bank holding companies (GSIB).[6]

Legal, financial, or other obstacles can undermine a GSIB's ability to be resolved in an orderly manner under the Code. For example, Lehman Brothers was a party to a large volume of swaps and other types of financial derivatives that firms generally use to hedge risk or speculate. Such contracts are often referred to as qualified financial contracts (QFC)

[4]Under the Dodd-Frank Act, as amended, entities that must submit resolution plans to the Board of Governors of the Federal Reserve System (Federal Reserve), the Federal Deposit Insurance Corporation (FDIC), and the Financial Stability Oversight Council include (i) bank holding companies with $250 billion or more in total consolidated assets; (ii) any bank holding company that has been identified as a global systemically important bank holding company (GSIB); (iii) any bank holding company with total consolidated assets equal to or greater than $100 billion that the Federal Reserve has directed, by order or rule, to submit resolution plans; and (iv) nonbank financial companies designated by the Financial Stability Oversight Council as systemically important. *See* 12 U.S.C. § 5365(d). The Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174 § 401(a), 132 Stat.1296 (2018), raised the asset threshold for application of the resolution plan requirement in two stages. As of May 24, 2018, immediately after the act's enactment, bank holding companies with less than $100 billion in total consolidated assets were no longer subject to the resolution plan requirement. Eighteen months after the date of enactment, bank holding companies with total consolidated assets of less than $250 billion (other than any U.S. GSIB) will no longer be subject to the resolution plan requirements, unless the Federal Reserve determines, by order or regulation, to apply the requirement to such firms after making certain statutory findings. For purposes of Title I of the Dodd-Frank Act, a bank holding company includes a foreign bank or company treated as a bank holding company under the Bank Holding Company Act of 1956, pursuant to Section 8(a) of the International Banking Act of 1978. *See Dodd-Frank Act,* Pub. L. No. 111-203, § 102(a)(1),124 Stat. 1376, 1391 (2010). In 2011, the Federal Reserve and FDIC jointly issued a final rule to implement the resolution plan requirement. *See* 76 Fed. Reg. 67323 (Nov. 1, 2011).

[5]An orderly resolution refers to a resolution that does not cause severe systemic disruption or expose taxpayers to the risk of loss.

[6]GSIBs are banking organizations whose distress or disorderly failure would cause significant disruption to the wider financial system and economy (because of attributes such as their size, complexity, and interconnectedness). The Federal Reserve established criteria for identifying a GSIB in 2015. *See* 80 Fed. Reg. 49082 (Aug. 14, 2015).

because they qualify for special treatment under the Code.[7] When Lehman Brothers filed for bankruptcy in 2008, its QFC counterparties were allowed under their default rights to terminate their contracts early. Such early terminations disrupted financial markets and exacerbated Lehman Brothers' financial distress.[8] Some experts have raised concerns about GSIBs' ability to mitigate the risk of QFC counterparties exercising their default rights and other potential obstacles and proposed amending the Code to make it more effective for resolving a failed GSIB.

You asked us to analyze how, if at all, QFCs and other legal and financial obstacles could affect the ability of large financial institutions, if required, to be resolved in an orderly manner under the Code. In this report, we focus on five U.S. GSIBs with large portfolios of derivatives because derivatives, as QFCs, could pose a resolution obstacle under the Code: Bank of America Corporation; Citigroup, Inc.; Goldman Sachs Group, Inc.; JPMorgan Chase & Co.; and Morgan Stanley.[9] This report

1. identifies and describes actions the five GSIBs have taken based on their resolution plans to mitigate financial and legal obstacles to orderly resolution under the Code and regulators' assessment of such actions;

[7]The Code does not use the term "qualified financial contract;" but the term encompasses derivatives and other complex financial contracts that are addressed in the Code, including qualifying swap agreements, repurchase agreements, reverse repurchase agreements, commodities contracts, forward contracts, securities contracts, and master netting agreements. When we use the term "QFC" in this report, we are referring to contracts that qualify for safe harbor treatment under the Code.

[8]When Lehman Brothers' holding company declared bankruptcy, many of Lehman Brothers' counterparties exercised their default rights. Lehman Brothers' default caused disruptions in the swaps and derivatives markets and a rapid, market-wide unwinding of trading positions. According to the report of Lehman Brothers' bankruptcy examiner, the chief restructuring officer told the examiner that the bankruptcy resulted in the loss of 70 percent of $48 billion of receivables from derivatives that otherwise could have been unwound.

[9]The Federal Reserve identified eight U.S. bank holding companies as GSIBs: Bank of America Corporation; The Bank of New York Mellon Corporation; Citigroup, Inc.; Goldman Sachs Group, Inc.; JPMorgan Chase & Co.; Morgan Stanley; State Street Corporation; and Wells Fargo & Company. The Federal Reserve and FDIC resolution plan guidance has included sections specifically for the firms' derivatives and trading activities. See ex. Federal Deposit Insurance Corporation and the Board of Governors of the Federal Reserve System, Guidance for 2017 §165(d) Annual Resolution Plan Submissions by Domestic Covered Companies That Submitted Resolution Plans in July 2015, § VII (2016) (hereinafter "Guidance for 2017 §156(d) Annual Resolution Plan Submissions").

2. obtains and analyzes the views of experts on the potential effectiveness of the actions taken by the five GSIBs' to mitigate financial obstacles and the need for any additional actions to further mitigate such obstacles;
3. obtains and analyzes the views of experts on the potential effectiveness of the actions taken by the five GSIBs to mitigate legal obstacles and the need for any additional actions to further mitigate such obstacles, and
4. obtains and analyzes the views of experts on the likelihood the five GSIBs could be resolved, if needed, under the Code in an orderly manner.

To identify and describe actions the five GSIBs took to mitigate financial and legal obstacles to their resolution under the Code, we reviewed the public sections of the 2017 resolution plans the five GSIBs submitted and their annual financial filings. We interviewed officials from the five GSIBs about their resolution plans and any need for additional actions. To analyze the Federal Deposit Insurance Corporation (FDIC) and Federal Reserve's assessment of the five GSIBs' actions to mitigate potential obstacles, we reviewed their joint guidance for July 2017 resolution plan submissions; joint determinations and feedback letters for the 2017 plans GSIBs submitted; policies and procedures used to review GSIB resolution plans; and regulations covering liquidity, total loss-absorbing capacity, and QFCs.[10] We interviewed staff from FDIC, the Federal Reserve, Department of the Treasury, and the Office of the Comptroller of the Currency about the GSIBs' resolution plans and any need for additional actions.

To obtain and analyze the views of experts on the effectiveness of the five GSIBs' actions to mitigate potential obstacles, need for any additional actions, and likelihood of orderly resolution, we conducted structured interviews by telephone with a nongeneralizable sample of 30 individuals or groups of individuals knowledgeable about the resolution of large bank holding companies under the Code. We selected the experts largely based on their published or other publicly available work, employment history, professional affiliations, or recommendations by other experts. We selected and interviewed 5 bankruptcy court judges; 14 academics, such as law, economics, or finance professors; 7 providers of professional services to financial institutions, such as attorneys,

[10]See *Guidance for 2017 §165(d) Annual Resolution Plan Submissions.*

consultants, and a credit rating agency; and 4 QFC counterparties, such as asset managers and financial institutions. Our interviews comprised closed-ended and open-ended questions about GSIB resolution under the Code and related issues. We used “few,” “some,” “around half,” “most,” and “almost all” to characterize the response rates. We defined few as 1–15 percent of respondents, some as 16–45 percent of respondents, around half as 46–55 percent of respondents, most as 56–85 percent of respondents, and almost all as 86–100 percent of respondents. See appendix I for more information about our scope and methodology and appendix II for a list of individuals or organizations we interviewed.

We conducted this performance audit from August 2017 to November 2018 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Background

Overview of Chapter 11 Bankruptcy Process

Bankruptcy is governed by a federal court procedure conducted under rules and requirements of the Code. Bankruptcy helps individuals and businesses eliminate or restructure debts they cannot repay and helps creditors receive some payment in an equitable manner. Generally, the filing of a bankruptcy petition operates as an automatic stay; that is, it stops most lawsuits, foreclosures, and other collection activities against the debtor. A creditor must obtain the court’s permission to continue pursuing such actions against the debtor. Equitable treatment of creditors means that all similarly situated creditors receive the same treatment.

Business debtors may seek liquidation, governed primarily by Chapter 7 of the Code, or reorganization, governed by Chapter 11. Chapters 7 and 11 proceedings can be voluntary (initiated by the debtor) or involuntary (generally initiated by at least three creditors holding at least a certain minimum dollar amount in claims against the debtor).

Reorganizations under Chapter 11 allow debtors to continue some or all of their operations subject to court supervision. The debtor typically remains in control of its assets and is called a debtor-in-possession.

Under certain circumstances, the court can direct the appointment of a Chapter 11 trustee to take over the affairs of the debtor.[11] As shown in figure 1, a firm going through Chapter 11 generally will pass through several stages, including the following:

- **First-day motions.** Common first-day motions relate to the continued operation of the debtor's business and can involve requests to use cash collateral—liquid assets on which secured creditors have a lien or claim—and obtain financing.
- **Disclosure.** As a prerequisite to seeking confirmation of a Chapter 11 plan, the debtor generally must file a disclosure statement that includes information such as the debtor's assets, liabilities, and business affairs that is sufficient to enable creditors to make informed judgments about how to vote on the debtor's reorganization plan. The disclosure statement must be approved by the bankruptcy court before the debtor may seek approval of its Chapter 11 plan.
- **Plan of reorganization.** A debtor generally has the exclusive right to file a plan of reorganization within the first 120 days of bankruptcy. The plan describes how the debtor intends to reorganize and treat its creditors, divides claims against the debtor into separate classes, and specifies the treatment each class will receive.[12] The court may confirm the plan if, among other things, each class of creditors has accepted the plan or the class is not impaired by the plan.[13] If not all classes of impaired creditors vote to accept the plan, the court can still confirm the plan if it is shown that it does not discriminate unfairly and is fair and equitable to each class of impaired creditors that has not accepted the plan.[14]

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[11]At any time after the commencement of the case but before confirmation of a plan, on request of a party in interest or the United States trustee, and after notice and a hearing, the court can order the appointment of trustee for reasons such as incompetence or gross mismanagement of the affairs of the debtor by the current management.

[12]The plan generally prioritizes claim holders as secured creditors, unsecured creditors entitled to priority, general unsecured creditors, and equity security holders.

[13]Impaired means the plan alters the rights of a class of creditors compared to their contractual rights before bankruptcy. Unimpaired creditors do not have their rights changed by the plan.

[14]A court must make many findings to confirm a plan of reorganization, aside from acceptance or lack of impairment. For example, the court must find that the plan is feasible (not likely to be followed by liquidation or the need for further financial reorganization). *See* 11 U.S.C. § 1129(a)(11).

- **Reorganization.** Possible outcomes, which can be used in combination, include

  (1) a pre-plan sale of company assets (in whole or in part), sometimes called a Section 363 sale. Section 363 of the Code, subject to certain requirements, authorizes a debtor to sell its assets outside the ordinary course of business and permits sales that are free and clear of creditor claims on the property being sold;[15]

  (2) liquidation of the company's assets and distribution of the proceeds to creditors with approval of the court, through a Chapter 11 liquidation plan; and

  (3) reorganization of the company through a Chapter 11 plan of reorganization. Following confirmation of the plan, the debtor emerges from bankruptcy with new contractual rights and obligations that generally replace and supersede those it had before filing for bankruptcy protection.[16]

To approve a Section 363 sale, the court must find that a number of requirements are met, including an articulated business justification for the sale. The speed of a Section 363 sale may vary.[17] The Federal Rules of Bankruptcy Procedure generally prohibit sales within 21 days after the filing, unless necessary to avoid immediate and irreparable harm.[18] For example, in the liquidation of Lehman Brothers Holdings in 2008, one key Lehman Brothers' asset, the North American investment banking and capital markets business, was sold to a buyer 5 days after the bankruptcy filing.

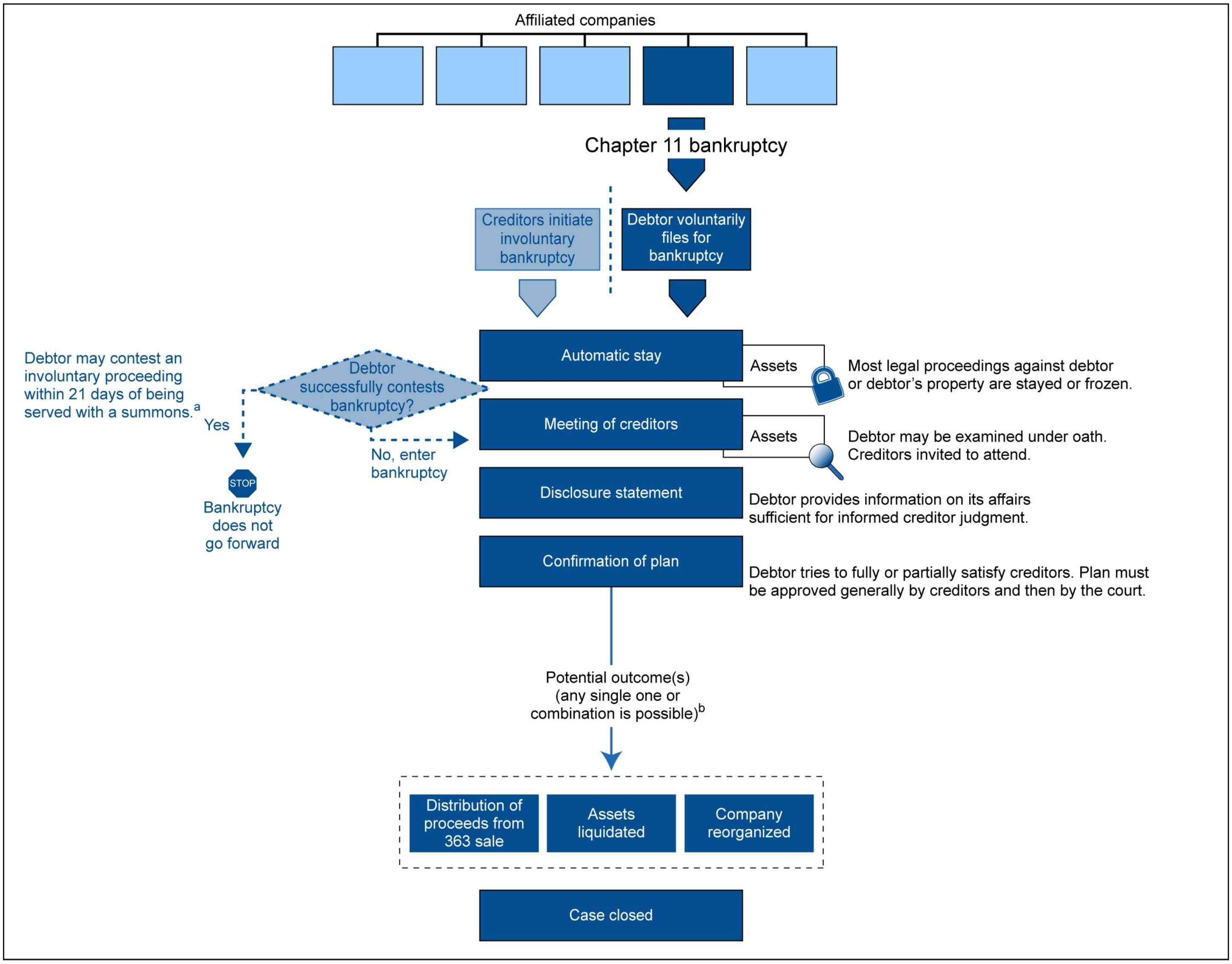
[15]Usually, lienholders must be paid in full at the time of sale, and any surplus proceeds are held by the trustee or debtor-in-possession for later distribution to creditors.

[16]Potential outcomes also include dismissal of the case or conversion to Chapter 7 liquidation.

[17]One study found that since 1979, the median time from filing to sale in large public company bankruptcy cases has been 110 days, and that the median time has dropped by about 2 weeks since 2000. See Melissa B. Jacoby and Edward J. Janger, "Allocating the Price of Process in Chapter 11 Bankruptcy," *The Yale Law Journal*, 123, no. 4 (2014).

[18]See Fed. R. of Bankr. Procedure R. 6003.

Figure 1: Overview of Chapter 11 Bankruptcy Process



Source: GAO analysis of U.S. Court information. | GAO-19-30

[a]Except that if service is made by publication on a party or partner not residing or found within the state in which the court sits, the court shall prescribe the time for filing and serving the response.

[b]Potential outcomes also include dismissal of the case or conversion to a Chapter 7 liquidation. A 363 sale refers to that section of the U.S. Bankruptcy Code that permits sales free and clear of creditor claims if certain requirements are met.

The debtor, creditors, U.S. Trustee, or other interested parties may initiate adversary proceedings—in effect, a lawsuit within the bankruptcy case to preserve or recover money or property, subordinate a claim of another creditor to their own claims, or for similar reasons. Such parties also may bring a preference claim challenging certain transfers made by a debtor to a creditor (generally within 90 days) before the bankruptcy filing; or a fraudulent transfer claim (generally, transfers made within 2 years before a bankruptcy) if the transfers were determined to be made with actual intent to hinder, delay, or defraud or were made for less than reasonably equivalent value under certain circumstances.[19] If successful, the value of such transfers may be returned to the debtor's estate.

Current Safe-Harbor Treatment for Financial Contracts under the Code

The Code's automatic stay is subject to exceptions, commonly referred to as "safe harbor provisions." Under these provisions, most counterparties to a qualifying transaction with the debtor may exercise certain contractual rights under an exception to the automatic stay.[20] When the debtor files for bankruptcy, the nondefaulting party in a QFC is not prohibited from liquidating, terminating, or accelerating the contract, or from offsetting (netting) any termination value, payment amount, or other transfer obligation under the contract. That is, the nondefaulting counterparty is not prohibited from subtracting what it owes the debtor from what that debtor owes it (netting), often across multiple contracts. If the result is positive, the nondefaulting counterparty can sell any collateral it holds to offset what the debtor owes it. If that does not fully settle what it is owed, the nondefaulting counterparty may file a proof of claim seeking treatment as an unsecured creditor in any final liquidation or reorganization.

The types of contracts eligible for the safe harbors are defined in the Code.[21] They include financial derivatives, such as swap agreements that

[19]A preference claim can be asserted for payments made to an insider creditor, such as a director or relative of the debtor, within a year prior to the bankruptcy filing. State laws may provide a longer look-back period. For example, under Delaware law (where all five GSIBs in our review are incorporated), a 4-year statute of limitations for fraudulent transfer actions generally applies.

[20]A contractual right includes a right set forth in the rules or bylaws of entities that include a derivatives clearing organization, multilateral clearing organization, national securities exchange or association, and securities clearing agency.

[21]These contracts include swap agreements, repurchase agreements, reverse repurchase agreements, commodities contracts, forward contracts, securities contracts and master netting agreements. *See* 11 U.S.C. §362(b)(6), (7), (17) and (27), and 11 U.S.C. §101(25), (38A),(47), (53B).

companies use to hedge against losses from other transactions or speculate on the likelihood of future economic developments. Repurchase agreements, which are collateralized instruments that provide short-term financing for financial companies and others, also generally receive safe-harbor treatment.

Resolution Plans

Title I of the Dodd-Frank Act, as amended, currently requires bank holding companies with $100 billion or more in total consolidated assets and nonbank financial companies designated by the Financial Stability Oversight Council as systemically important to periodically submit resolution plans to FDIC, the Federal Reserve, and the Financial Stability Oversight Council.[22] The plans are to detail how the companies could be resolved in a rapid and orderly manner under the Code in the event of material financial distress or failure.

If FDIC and the Federal Reserve jointly determine that a resolution plan is not credible or would not facilitate an orderly resolution under the Code, they must notify the company of such a determination and identify the aspects of the plan that the regulators jointly found deficient. The company must submit a revised plan that remedies the deficiencies.

If the company fails to resubmit a credible plan that adequately remedies the deficiencies, FDIC and the Federal Reserve jointly may impose more stringent capital, leverage, or liquidity requirements; or restrict growth, activities, or operations. Additionally, if within 2 years after imposing the more stringent requirements the company has failed to resubmit a resolution plan with the required revisions, FDIC and the Federal Reserve, in consultation with the Financial Stability Oversight Council, may require the company to divest itself of certain assets or operations.

[22]As previously mentioned, the general filing requirement threshold for bank holding companies will rise to $250 billion in November 2019. The Dodd-Frank Act established the Financial Stability Oversight Council to monitor the stability of the U.S. financial system and take steps to mitigate risks that might destabilize the system. The act gave the council significant authorities, including authority to designate nonbank financial companies for Federal Reserve supervision. For additional information, see GAO, *Financial Stability Oversight Council: Further Actions Could Improve the Nonbank Designation Process,* GAO-15-51 (Washington, D.C.: Nov. 20, 2014).

FDIC and the Federal Reserve's final resolution plan rule took effect in November 2011.[23]

According to the resolution plan rule, a company's plan must be divided into a public section and a confidential section. The resolution plan must include eight informational sections: (1) executive summary, (2) strategic analysis, (3) description of corporate governance relating to resolution planning, (4) description of organizational structure and related information, (5) management information systems, (6) interconnections and interdependencies, (7) supervisory and regulatory information, and (8) contact information.[24] In the strategic analysis section—generally the most substantive component—each company must describe, among other things, the key assumptions and supporting analysis underlying the plan, the specific actions the company will take to facilitate a rapid and orderly resolution, the strategy for maintaining the operations of and funding for the company and its material entities, and actions the company will take to prevent or mitigate any adverse effects of a failure. The strategy also must describe any potential material weaknesses or impediments to the plan, and the actions and steps the company has taken or proposes to take to remediate or otherwise mitigate weaknesses or impediments identified by the company.

The largest bank holding companies were required to file their initial resolution plans in 2012, while the other companies covered by the resolution plan rule were not required to file their initial plans until 2013 or later. Since 2016, FDIC and the Federal Reserve have extended the resolution plan submission dates for the GSIBs, generally requiring them to file their plans bi-annually.

[23]76 Fed. Reg. 67323 (Nov. 1, 2011).

[24]Under the final rule, domestic companies must generally present the eight informational sections for subsidiaries and operations domiciled in the United States, as well as foreign subsidiaries, offices, and operations. Foreign-based companies generally must address subsidiaries, branches and agencies, and key activities domiciled in the United States or conducted there in whole or in material part. The rule generally allows companies with less than $100 billion in total nonbank assets and at least 85 percent of total consolidated assets in insured depository institutions to file a tailored resolution plan. The tailored plan must include all eight informational sections, but the presentation generally may be limited to the company and its nonbanking material entities and operations. An eligible company may file a tailored plan unless FDIC and the Federal Reserve have jointly determined that the company must provide a plan that meets some or all of the requirements of a full plan. *See* 76 Fed. Reg. 67323 (Nov. 1, 2011).

Orderly Liquidation Authority

In cases in which resolution of a financial company under the Code may result in serious adverse effects on U.S. financial stability, the Orderly Liquidation Authority set out in Title II of the Dodd-Frank Act serves as the backstop alternative.[25] Orderly Liquidation Authority allows FDIC, subject to certain constraints, to resolve large financial companies outside the bankruptcy process. FDIC may be appointed as receiver of a financial company if the Secretary of the Treasury, in consultation with the President, determines, among other things, that the company is in danger of default, its failure and resolution under applicable federal or state law, including bankruptcy, would have serious adverse effects on U.S. financial stability, and no viable private-sector alternative is available to prevent default.[26] While the Dodd-Frank Act does not specify the strategy FDIC must exercise under its Orderly Liquidation Authority, FDIC has been developing potential approaches to resolve a company under this authority.[27]

[25] *See* Dodd-Frank Act, Pub. L. No. 111-203, § 204, 124 Stat. 1376, 1451 (codified at 12 U.S.C. § 5384). For additional information on the Orderly Liquidation Authority, see GAO, *Bankruptcy: Agencies Continue Rulemakings for Clarifying Specific Provisions of Orderly Liquidation Authority,* GAO-12-735 (Washington, D.C.: July 12, 2012).

[26] *See* Pub. L. No. 111-203, § 201, et seq., 124 Stat. 1376, 1450 (codified at 12 U.S.C. § 5381 et seq. Before the Secretary of the Treasury, in consultation with the President, makes a decision to seek the appointment of FDIC as receiver of a financial company, at least two-thirds of those serving on the Federal Reserve Board and at least two-thirds of those serving on the Board of Directors of FDIC must vote to make a written recommendation to the Secretary to appoint FDIC as receiver. Pub. L. No. 111-203, § 203(a)(1)(A), 124 Stat. at 1450 (codified at 12 U.S.C. § 5383(a)(1)(A)). In the case of a broker-dealer, the recommendation must come from the Federal Reserve Board and the Securities and Exchange Commission, in consultation with FDIC—and in the case of an insurance company, from the Federal Reserve Board and the Director of the Federal Insurance Office, in consultation with FDIC. Pub. L. No. 111-203, § 203(a)(1)(B)-(C), 124 Stat. at 1450 (codified at 12 U.S.C. § 5383(a)(1)(B)-(C)).

[27] *See*, for example, Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76614 (Dec. 18, 2013).

GSIBs We Reviewed Incorporated Controls in Their 2017 Resolution Plans to Mitigate Financial and Legal Obstacles Identified by Regulators

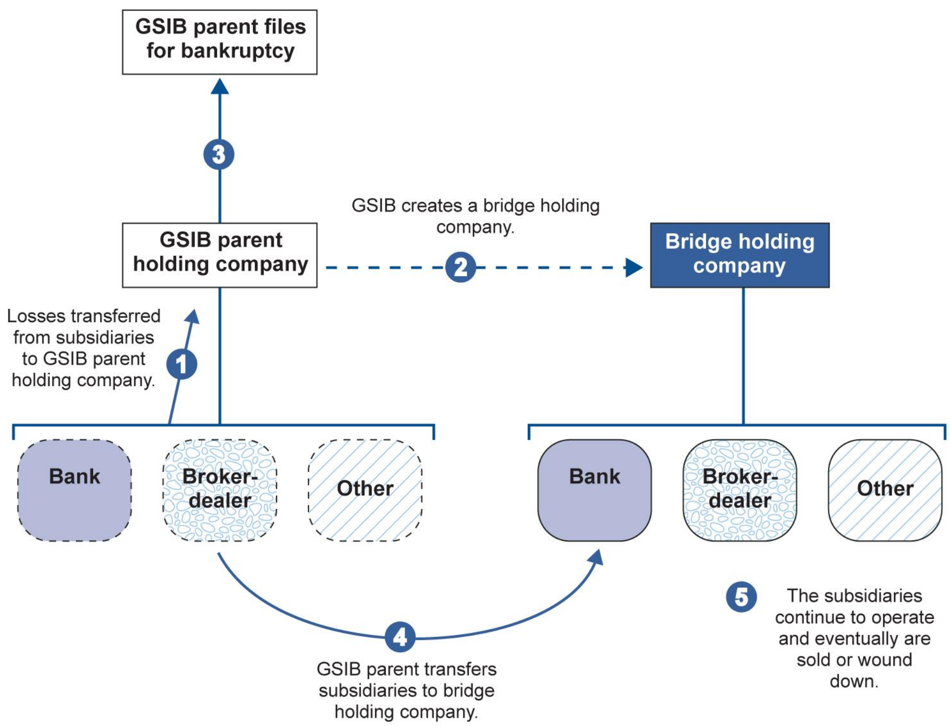
Each GSIB in Our Review Adopted Single Point-of-Entry Resolution Strategy under the Code

Under their 2015 resolution plans, each of the five GSIBs in our review adopted a preferred resolution strategy under the Code that utilizes a single point-of-entry (SPOE). An SPOE strategy serves to enable the GSIB subsidiaries to continue to operate while the GSIB parent holding company enters bankruptcy, with the goal of reducing the potential for the parent's bankruptcy to have a negative impact on customers and the overall economy. Before filing for bankruptcy, the GSIB would use its financial resources, as needed, to recapitalize and provide liquidity to keep subsidiaries operating and solvent and preserve their value as they continue to operate. The losses that caused the GSIB to fail would be passed up from the subsidiaries and absorbed by the GSIB parent's shareholders and certain creditors, which would have the effect of recapitalizing the GSIB's subsidiaries.

Under the resolution plans of three of the five GSIBs, the parent would seek court approval to transfer its subsidiaries to a newly created, debt-free bridge holding company through a Section 363 sale (see fig. 2). In this case, the subsidiaries would continue to operate and eventually be sold or wound down in an orderly manner. Under the resolution plans of the other two GSIBs, the parents do not plan to transfer their subsidiaries to a bridge holding company but plan to take steps to sell or wind them down in an orderly manner.[28]

[28]The two GSIBs that do not plan to transfer their subsidiaries to a bridge holding company plan to seek court permission to elevate the claims of QFC counterparties, if any, to administrative expense status. Administrative expenses are given one of the highest priorities of payment in bankruptcy payout order. See 11 U.S.C. §§ 503, 507. Under each GSIB's SPOE strategy, both the Section 363 sale and elevation approaches are designed to meet conditions of the International Swaps and Derivatives Association's 2015 Universal Resolution Stay Protocol.

Figure 2: Overview of Process for a Global Systemically Important Bank Holding Company (GSIB) Implementing a Single Point-of-Entry Strategy into Bankruptcy



Source: GAO. | GAO-19-30

Regulators Identified Obstacles for GSIBs to Address in 2017 Plans

Based on their review of the GSIBs' July 2015 resolution plans, the Federal Reserve and FDIC provided the U.S. GSIBs, including the five in our review, with additional guidance to further develop resolution strategies in their 2017 plans.[29] In the guidance, the Federal Reserve and FDIC highlighted specific areas where the GSIBs should provide additional details and develop certain capabilities to demonstrate that each one is able to mitigate financial and legal obstacles to the successful

[29]*See Guidance for 2017 §165(d) Annual Resolution Plan Submissions*. The Federal Reserve and FDIC's review of the July 2015 resolution plans covered eight GSIBs: Bank of America Corporation; The Bank of New York Mellon Corporation; Citigroup, Inc.; Goldman Sachs Group, Inc.; JPMorgan Chase & Co.; Morgan Stanley; State Street Corporation; and Wells Fargo & Company.

implementation of its SPOE strategy. As indicated in the guidance, such obstacles could arise before, during, and after filing for bankruptcy, as discussed below:

Before bankruptcy filing

- Before filing for bankruptcy, a GSIB parent plans under its SPOE strategy to provide its key subsidiaries with the financial resources needed to keep them capitalized and funded through the parent's bankruptcy process.[30] However, a GSIB could lack sufficient financial resources to absorb severe losses suffered by its key subsidiaries and recapitalize them before filing for bankruptcy. As a result, one or more of the GSIB's subsidiaries could fail—preventing the GSIB from executing its SPOE strategy.

During a bankruptcy filing

- A GSIB parent's board of directors is responsible for determining whether the parent should file a voluntary petition with the bankruptcy court. However, the board of directors may not make the decision in a timely manner. For example, the board of directors may delay the decision regarding bankruptcy due to concerns about its liability for its decisions or reputation. If a GSIB parent failed to file in a timely manner, it might not have sufficient financial resources to execute its SPOE strategy.
- Under state law or the Code, a GSIB parent's creditors could bring claims against the parent for providing financial resources to, or recapitalizing, its key subsidiaries before bankruptcy, which could impede or prevent the parent's execution of its SPOE strategy. For example, the creditors could bring a preferential or fraudulent transfer claim challenging the provision of capital and liquidity to subsidiaries. These claims could be brought when the GSIB parent enters bankruptcy or within a limited period thereafter.[31]

[30]We use "key subsidiary" generally to mean a material entity, which FDIC and the Federal Reserve's resolution plan rule defines as a subsidiary or foreign office of the covered company that is significant to the activities of a critical operation or core business line. *See* 76 Fed. Reg. 67323, 67327 (Nov. 1, 2011), (codified at 12 C.F.R. § 360.10(b)(8)).

[31]Avoidance actions such as for preferential and fraudulent transfers are subject to statutes of limitations. In general, avoidance actions are barred after the later of (1) 2 years after the bankruptcy filing or (2) 1 year after the appointment of a trustee, if a trustee is appointed within 2 years of the filing. *See* 11 U.S.C. § 546.

- Under its SPOE strategy, a GSIB parent plans to file first-day motions with or shortly after its voluntary petition for bankruptcy. The GSIB's first-day motions generally seek immediate relief that is administrative in nature or necessary to the debtor's transition into bankruptcy. For example, as part of its first-day motions, a GSIB plans to include an emergency motion asking the bankruptcy court to approve a particular transaction that would put into effect the contractual stay on termination rights of QFCs under the International Swaps and Derivatives Association's (ISDA) 2015 Universal Resolution Stay Protocol (ISDA Stay Protocol).[32] This action would prohibit the counterparties of GSIB subsidiaries from terminating their QFCs based on cross-default rights, provided that the subsidiaries comply with the ISDA Stay Protocol's provisions and continue to perform their obligations under the QFCs.[33]
- Under the 2015 ISDA Stay Protocol, the stay period begins on the commencement of the Chapter 11 proceedings and ends at the later of 5 p.m. on the next business day or 48 hours following the commencement of the bankruptcy proceedings. Once the stay period elapses, the GSIB subsidiaries' counterparties could terminate their QFCs and cause one or more of the subsidiaries to fail.[34] However, the court may not be able to approve first-day motions in that time frame for various reasons, such as concerns about due process and governance of the bridge holding company.

[32]ISDA is an industry association with more than 900 member institutions from 68 countries. Its members are derivatives market participants, including corporations, investment managers, government entities, insurance companies, energy and commodities firms, and international and regional banks. The 2015 ISDA Stay Protocol, published by ISDA in November 2015, enables parties to voluntarily amend the terms of their protocol-covered agreements to contractually recognize the cross-border application of special resolution regimes applicable to certain financial companies and support the resolution of certain financial companies under the Code. Additionally, in July 2018, ISDA published its 2018 U.S. Resolution Stay Protocol, which serves a function similar to the 2015 ISDA Stay Protocol.

[33]Cross-default rights could allow the counterparty of a GSIB's subsidiary to liquidate, terminate, or accelerate the contract when the GSIB parent enters into bankruptcy, even if the subsidiary is not in resolution proceedings and continues to perform its obligations.

[34]The 2015 ISDA Stay Protocol generally prohibits the exercise of cross-default rights during the stay period. Federal Reserve and FDIC staff told us that the importance of the first-day motion to effectuate the protocol depends on the extent to which a GSIB provided guarantees for its subsidiaries' QFCs.

After a bankruptcy filing

- Even if a GSIB parent could recapitalize its subsidiaries, the parent might not be able to provide its subsidiaries with sufficient cash and other liquid resources to enable them to meet ongoing obligations and remain solvent while the parent is in bankruptcy. For example, QFC counterparties may transfer swaps or not renew lending agreements, or foreign regulators may “ring-fence” (trap financial resources in) a GSIB’s foreign subsidiaries or branches.[35] Such actions would reduce the subsidiaries’ liquidity. As a result, the lack of sufficient liquidity could impede or prevent the GSIB from executing its SPOE strategy successfully.

GSIBs in Our Review Incorporated Controls into 2017 Resolution Plans Designed to Mitigate Financial and Legal Obstacles

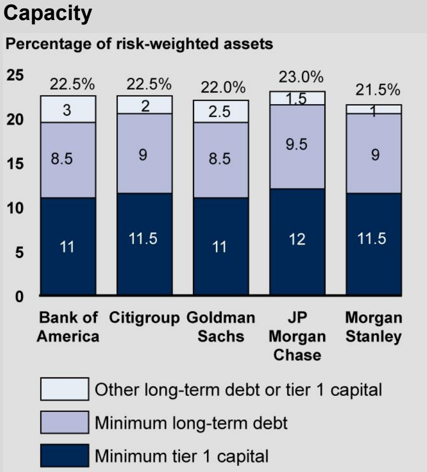
In response to the Federal Reserve and FDIC’s joint guidance, the five GSIBs in our review incorporated in their 2017 resolution plans actions designed to mitigate financial and legal obstacles to their orderly resolution under the Code. We generally refer to such actions as controls, which encompass plans, policies, procedures, tools, and methods. Although some controls serve to mitigate a specific financial or legal obstacle, other controls serve to mitigate both types of obstacles. (We discuss GSIB controls developed to mitigate specific financial and legal obstacles in more detail later in this report.) According to the public sections of their resolution plans, the five GSIBs put in place controls designed to mitigate financial and legal obstacles, which included the following:

[35]Ring-fencing refers to the practice by which local authorities set aside or shield assets of a local subsidiary or branch from the failed institution and insist that local creditors get paid first, before any funds are transferred to satisfy claims made against the failed parent.

Total Loss-Absorbing Capacity

Total loss-absorbing capacity comprises firm-issued capital and eligible external long-term debt. Under a 2017 Federal Reserve rule, global systemically important bank holding companies (GSIB) are projected to hold total loss-absorbing capacity nearly at or above the value of 20 percent of their risk-weighted assets. The Federal Reserve calibrated total loss-absorbing capacity based, in part, on an analysis of losses of U.S. financial firms in the 2007—2009 financial crisis. The amount of eligible external long-term debt the rule requires is the estimated amount necessary for a GSIB that depleted its equity capital to return to a sufficient level of going-concern capital without government assistance or outside investment.

Projected Minimum Total Loss-Absorbing Capacity



Source: Bank of America, Citigroup, Goldman Sachs, JP Morgan Chase, and Bank of America. | GAO-19-30

Note: "Other long-term debt or tier 1 capital" represents the additional loss-absorbing capacity GSIBs would be required to hold beyond their minimum tier 1 capital and long-term debt requirements.

Source: GAO | GAO-19-30

- **Tools to estimate financial resource needs.** The five GSIBs developed tools (1) to monitor the amount of financial resources (such as capital and liquidity) held by the GSIB parents and their key subsidiaries and (2) to estimate the amount of financial resources the parents would need to provide to the key subsidiaries to meet their capital and liquidity funding needs.[36] The GSIB parent would plan to file for bankruptcy when it still has sufficient financial resources to support its subsidiaries' needs through its resolution and the completion of the SPOE strategy. (A Federal Reserve rule sets the minimum amount of total loss-absorbing capacity that the GSIBs must hold to recapitalize key subsidiaries—see sidebar.) The five GSIBs' resolution plans considered the possibility of ring-fencing by foreign regulators, the need to wind down their derivatives portfolios, and other factors that could deplete financial resources. The GSIBs also pre-positioned some of their financial resources at key subsidiaries, in part to help ensure the availability of financial resources at key subsidiaries should legal challenges arise to the recapitalization of the subsidiaries.[37]
- **Triggers and governance playbooks.** The five GSIBs developed qualitative and quantitative triggers that link changes in their financial condition to specific resolution actions. When breached, the triggers are used to escalate critical information to the board of directors and senior management to assist them in making resolution decisions. The GSIBs also developed governance playbooks that incorporate the triggers and guide the actions directors and senior management would take to execute SPOE strategies, such as to vote on whether to file for bankruptcy when certain triggers are breached.

[36]According to FDIC and the Federal Reserve's guidance for 2017 resolution plan submissions, the models should ensure that the parent holding company holds sufficient high quality liquid assets to cover the sum of all stand-alone material entity net liquidity deficits. See Guidance for 2017 §165(d) Annual Resolution Plan Submissions, 7. The stand-alone net liquidity position of each material entity should be measured using the firm's internal liquidity stress test assumptions and should treat inter-affiliate exposures in the same manner as third-party exposures.

[37]In their guidance for 2017 resolution plan submissions, the Federal Reserve and FDIC advised firms to take account of both pre-positioning at material entities and holding resources at the parent, and the obstacles associated with each. See Guidance for 2017 §165(d) Annual Resolution Plan Submissions, 4. Accordingly, the regulators noted that the firm should not rely exclusively on either only pre-positioned or parent-held resources to recapitalize any material entity.

- **Intermediate holding companies (IHC)**, related funding entities, and secured support agreements. All but one of the five GSIBs created IHCs or related funding entities as vehicles to help fund their subsidiaries through resolution.[38] According to their public resolution plans, the four GSIBs executed secured support agreements that obligate (1) them to provide resources to their IHCs or related funding entities before filing for bankruptcy and (2) the IHCs or related funding entities to use those resources to support the subsidiaries to the extent that pre-positioned resources were insufficient to meet the subsidiaries' near-term needs during execution of the SPOE strategy.[39] The use of IHCs or related funding entities is designed to mitigate not only potential financial obstacles but also legal obstacles, particularly legal challenges from creditors (as discussed below).
- **Identification of creditor challenges.** The five GSIBs conducted legal analysis, including through external legal counsel, to identify sources of potential creditor challenges to provision of capital and liquidity to subsidiaries and identified and implemented measures to address these potential challenges.
- **Draft first-day motions.** The five GSIBs stated that they adhered to the 2015 ISDA Stay Protocol and prepared (1) draft first-day motions to meet the protocol's conditions; (2) analyses of issues likely to be raised at the first-day hearings, and (3) arguments in support of the motions.[40]

[38]IHCs or related funding entities are themselves key GSIB subsidiaries. For the purpose of this report, we distinguish IHCs or related funding entities from other key subsidiaries that they fund. Morgan Stanley has not established an IHC.

[39]Morgan Stanley's resolution plan stated that it executed a secured support agreement that contractually obligates the GSIB parent to provide financial resources to key subsidiaries directly.

[40]Nearly 300 counterparties have voluntarily adhered to the 2015 ISDA Stay Protocol. To meet certain conditions of the protocol, the GSIBs plan to file a first-day motion to (1) transfer subsidiaries and related QFC guarantees to a bridge holding company under Section 363 of the Bankruptcy Code, or (2) remain obligated for the QFC guarantees but elevate the obligations to administrative expense priority status. Officials from four of the GSIBs in our review told us that they prepared drafts of both types of motions in case the court does not approve their preferred motion.

Regulators Identified Shortcomings in Some GSIBs' Resolution Plans and Areas for Improvement

In December 2017, the Federal Reserve and FDIC jointly announced that their reviews of the July 2017 resolution plans of the five GSIBs in our review found no deficiencies—that is, weaknesses severe enough to trigger a resubmission process that could result in more stringent requirements for a firm.[41] The Federal Reserve and FDIC noted that the five GSIBs had made significant progress in their resolution planning. In their reviews of the 2015 plans, the regulators jointly determined that five of eight U.S. GSIBs—including two of the five GSIBs in our review—had deficiencies and directed them to remediate the deficiencies by October 1, 2016, or possibly be subject to more stringent prudential requirements.[42] In contrast, none of the five GSIBs in our review were required to resubmit their 2017 plans to address deficiencies and, thus, did not face the potential of more stringent prudential requirements.

In their review of the GSIB's resolution plans, the regulators determined whether the plans were not credible or would not facilitate an orderly resolution of the GSIBs under the Code. For the GSIBs to avoid such determinations, the regulators stated that the strategies had to include reasonable assumptions, contain detailed information as support, address key obstacles to orderly resolution, and be executable across a range of failure scenarios and market conditions.

[41]The regulators' 2017 review covered eight U.S. GSIBs: Bank of America Corporation; The Bank of New York Mellon Corporation; Citigroup, Inc.; Goldman Sachs Group, Inc.; JPMorgan Chase & Co.; Morgan Stanley; State Street Corporation; and Wells Fargo & Company.

[42]In April 2016, the regulators announced that they jointly determined, as provided under the Dodd-Frank Act and resolution plan rule, that the 2015 resolution plans of Bank of America Corporation, The Bank of New York Mellon, JPMorgan Chase & Co, State Street Corporation, and Wells Fargo & Company were not credible or would not facilitate an orderly resolution under the Code. Under the statute and resolution plan rule, the Federal Reserve and FDIC may jointly determine that a plan is not credible or would not facilitate an orderly resolution of the company under the Code. If a company fails to timely resubmit a plan that cures the deficiencies, the regulators may jointly impose on the company or its subsidiaries more stringent capital, leverage, or liquidity requirements, or restrictions on the company's growth, activities, or operations. In December 2016, the regulators jointly announced that Bank of America Corporation, The Bank of New York Mellon, JPMorgan Chase & Co, and State Street Corporation adequately remediated deficiencies in their 2015 resolution plans. Wells Fargo & Company failed to adequately remediate its deficiencies and was subject to growth restrictions but was able to adequately remediate the plan by April 2017. As a result of such remediation, the firm ceased to be subject to the growth restrictions.

In their assessment of the GSIBs' 2017 resolution plans, the regulators evaluated whether each GSIB's plan met the regulators' expectations detailed in the 2017 guidance and addressed related shortcomings that were previously identified. For example, the regulators evaluated each GSIB's capital and liquidity metrics, including whether it incorporated these metrics in its recapitalization and other triggers. They also evaluated, among other things, whether each GSIB established governance mechanisms to ensure execution of required board actions at the appropriate time and detailed actions for executing its strategy in its governance playbooks.

Although the Federal Reserve and FDIC did not jointly find any deficiencies, they jointly determined that of the five GSIBs included in our review, three had plans with shortcomings (less severe weaknesses) that the GSIBs had to address in their 2019 plans.[43] The shortcomings related to financial or legal obstacles and included the following:

- **Bank of America Corporation:** The plan did not adequately assess the complexity of the firm's derivatives portfolio and contained conflicting information on its residual portfolio. Although the plan included estimates of capital and liquidity needs under a scenario in which the firm let its derivatives contracts wind down and expire on their own, it lacked quantitative analysis and supporting assumptions for certain costs.
- **Goldman Sachs Group:** The plan's analysis related to its divestiture options did not include sufficient documentation and analysis on impediment identification and mitigation, which raised questions on the degree to which identified divestiture options were actionable.
- **Morgan Stanley:** The firm's legal entity structure increased the inherent risk of misallocating resources and therefore raised questions about the firm's ability to execute its resolution strategy across a range of scenarios.

According to the Federal Reserve and FDIC, inherent challenges and uncertainties are associated with the resolution of a GSIB. In that regard, the regulators identified four areas in which all the GSIBs, including the five in our review, needed to do more work to improve their resolvability: (1) intra-group liquidity; (2) internal loss-absorbing capacity; (3) derivatives; and (4) payment, clearing, and settlement activities. Federal

[43]A shortcoming is a weakness or a gap that raises questions about the feasibility of the firm's plan, but does not rise to the level of a deficiency for both regulators.

Reserve and FDIC staff told us that these are areas in which the regulators plan to perform additional work to better understand potential resolution challenges.

In June 2018, the Federal Reserve and FDIC announced that they sought public comment on revised resolution plan guidance for the eight U.S. GSIBs, including the five GSIBs discussed in this report. The announcement stated that the proposed guidance is largely based on the guidance the regulators issued in April 2016 and includes updates to expectations for how a firm's resolution strategy should address derivatives and trading activities and the firm's payment, clearing, and settlement activities.[44] Regarding intra-group liquidity and internal loss-absorbing capacity, Federal Reserve and FDIC staff said that they have been gathering information and have not yet issued any specific additional guidance to the GSIBs on these areas.

Most Experts Viewed Controls of Five GSIBs for Mitigating Financial Obstacles as Somewhat Effective, but Some Supported Additional Government Actions

The five GSIBs in our review have put in place controls designed to mitigate financial obstacles, including holding minimum levels of loss-absorbing capacity and developing models to estimate their liquidity needs. Because none of the five GSIBs have had to go through bankruptcy, the future effectiveness of their controls and SPOE strategies cannot be known. Absent such evidence, the views of experts help to provide insights about the potential effectiveness of the controls.

In our structured interviews, most of the experts we interviewed viewed the five GSIBs' controls relating to loss-absorbing capacity as somewhat effective, but some expressed concerns or uncertainty about the controls. Most of the experts viewed controls relating to liquidity as somewhat effective, but some also expressed concerns or uncertainty about liquidity estimates. Additionally, most experts broadly supported additional

[44] *Resolution Planning Guidance for Eight Large, Complex U.S. Banking Organizations*, 83 Fed. Reg. 32856 (proposed July 16, 2018).

government actions to address potential liquidity shortfalls and ring-fencing.

Most Experts Viewed Controls to Mitigate Risk of Insufficient Loss-Absorbing Capacity and Liquidity as Somewhat Effective but Expressed Uncertainty about the Controls

Most of the experts we interviewed regarded the types of controls put in place by the five GSIBs in our review as somewhat effective in mitigating the risk that a GSIB may lack sufficient financial resources to recapitalize key subsidiaries (see table 1). These experts included judges, academics, professional service providers, and counterparties.

Table 1: Expert Views on Effectiveness of Controls in Mitigating the Risk That a GSIB May Lack Sufficient Financial Resources to Recapitalize Key Subsidiaries

Responses:

	Very effective	Somewhat effective	Not effective	Total
Number of experts	6	15	2	**23**[a]

Source: GAO analysis of structured interview responses. | GAO-19-30

Note: A GSIB is a global systemically important bank holding company and generally refers to one of the five GSIBs covered in our review.

[a]Some experts told us that they did not have the knowledge to answer the question or had no opinion about the question. As a result, the total number of expert responses for this question is less than 30.

GSIB Controls to Mitigate Lack of Sufficient Loss-Absorbing Capacity

The five GSIBs in our review have developed controls designed to mitigate the risk of lacking sufficient loss-absorbing capacity to recapitalize their key subsidiaries. The GSIBs noted that they:

- hold a minimum amount of total loss-absorbing capacity calibrated to help ensure that key subsidiaries can be recapitalized and continue to operate if the GSIB parents are in bankruptcy.
- pre-positioned loss-absorbing capacity (such as long-term debt) directly at key subsidiaries but also hold such loss-absorbing capacity (liquid assets) at parents, intermediate holding companies, or related funding entities to meet unanticipated losses at subsidiaries.
- developed methodologies that incorporate forecasts for periodically estimating the capital they would need to support each key subsidiary after the parents' bankruptcy filings.
- developed governance playbooks that incorporate quantitative triggers to guide actions their directors and senior management would take, such as when the boards should file for bankruptcy.

Source: GAO analysis of five 2017 public resolution plans. | GAO-19-30

Note: A GSIB is a global systemically important bank holding company.

Based on the views of around half of these experts (judges, academics, professional service providers, and a counterparty), the types of controls put in place by the five GSIBs in our review help ensure that a GSIB can recapitalize its key subsidiaries. Some of these experts (academics, professional service providers, and a judge) said that the amount of total loss-absorbing capacity the GSIBs must hold should be sufficient to absorb significant losses and the triggers should result in the GSIBs filing for bankruptcy protection when they still have sufficient total loss-absorbing capacity.

Similarly, most of the experts we interviewed viewed the types of controls put in place by the five GSIBs as somewhat effective in mitigating the risk that a GSIB could lack sufficient liquidity to meet the funding needs of its subsidiaries throughout the parent's resolution (see table 2). These experts included academics, professional service providers, and a counterparty.

Table 2: Expert Views on the Effectiveness of Controls in Mitigating the Risk a GSIB Lacks Sufficient Liquidity to Meet the Funding Needs of Its Subsidiaries throughout Its Resolution

Responses:

	Very effective	Somewhat effective	Not effective	Total
Number of experts	3	14	4	21[a]

Source: GAO analysis of structured interview responses. | GAO-19-30

Note: A GSIB is a global systemically important bank holding company and generally refers to one of the five GSIBs covered in our review.

[a]Some experts told us that they did not have the knowledge to answer the question or had no opinion about the question. As a result, the total number of expert responses for this question is less than 30.

GSIB Controls to Mitigate Lack of Sufficient Liquidity

The five GSIBs in our review have developed controls designed to mitigate the risk of not being able to provide their subsidiaries with sufficient cash and other liquid assets to enable them to remain solvent while their parents are in bankruptcy. The GSIBs noted they

- developed models to estimate the liquidity held at each key subsidiary. Based on the models, the GSIBs pre-positioned liquid assets at subsidiaries to absorb potential losses and maintain such assets at parents, intermediate holding companies, or related funding entities.
- developed methodologies to estimate the liquidity needed after the bankruptcy filing to stabilize key subsidiaries and allow them to operate post-filing.
- developed governance playbooks to guide actions their directors and senior management would take and financial triggers related to resolution actions.
- incorporated ring-fencing assumptions into their capital and liquidity modeling and analyzed foreign resolution laws and rules.
- analyzed how they could actively wind down their derivatives portfolios (terminate or cancel out derivatives) or passively wind down such portfolios (allow derivatives to contractually mature). They incorporated the strategies into capital and liquidity methodologies.

Source: GAO analysis of five 2017 public resolution plans. | GAO-19-30

Note: A GSIB is a global systemically important bank holding company.

Based on the views of a few experts (a judge and professional service providers), GSIBs should have sufficient liquidity to execute their SPOE strategies because the estimates of their liquidity needs in resolution are based on conservative assumptions, including that they will not have access to government liquidity, foreign regulators will ring-fence, and market conditions will be stressed.

On the other hand, some experts (judges, academics, professional service providers, and counterparties) also expressed concerns or uncertainty about the controls. Some experts (academics and professional service providers) said that capital, potential loss, and other estimates are difficult to forecast and based on assumptions that might not be accurate, creating uncertainty about the adequacy of the GSIBs' financial resources to successfully recapitalize their subsidiaries. For example, the regulatory requirements for total loss-absorbing capacity were calibrated based in part on historical losses suffered during the previous financial crisis, but one service provider said that the next financial crisis could be worse.

Some experts (a judge, academics, professional service providers, and counterparties) expressed concerns or uncertainty about the accuracy of the GSIBs' liquidity estimates or reasonableness of the assumptions underlying the estimates. But a few experts (an academic and professional service providers) said that the GSIBs have improved their liquidity models.

They also commented—with other experts (academics, professional service providers, and counterparties)—that liquidity estimates are based on many assumptions (such as about market conditions, creditor and counterparty behavior, and asset prices) that may not prove realistic at the time of a GSIB's failure. For example, a few academics said that assets that seem liquid now may be less liquid in a time of economic stress. Similarly, one academic and a professional service provider questioned the assumption that the credit markets would operate normally within 90–120 days of a GSIB's failure. Around half of the experts (academics, professional service providers, and counterparties) expressed concerns about the potential for a GSIB's liquidity to be depleted by funding runs (activities that result in significant liquidity outflows) by creditors and counterparties and ring-fencing by foreign regulators. Finally, an academic and a professional service provider commented that unforeseen contingencies were likely to arise during a GSIB's failure.

Creditor and Counterparty Runs

Most of the experts we interviewed viewed a GSIB's plan to recapitalize its subsidiaries as somewhat effective in reducing the incentive of the subsidiaries' creditors and counterparties to engage in funding runs (see table 3). These experts included academics, professional service providers, and a counterparty.

Table 3: Expert Views on the Effectiveness of a GSIB's Recapitalization of Its Subsidiaries in Reducing Incentives of the Subsidiaries' Creditors and Counterparties to Engage in Funding Runs

Responses:

	Very effective	Somewhat effective	Not effective	Total
Number of experts	2	15	3	20[a]

Source: GAO analysis of structured interview responses. | GAO-19-30

Note: A GSIB is a global systemically important bank holding company and generally refers to one of the five GSIBs covered in our review.

[a]Some experts told us that they did not have the knowledge to answer the question or had no opinion about the question. As a result, the total number of expert responses for this question is less than 30.

Based on the views of some experts (academics and professional service providers), a GSIB's recapitalization will not eliminate the risk of a funding run, in part because creditors and counterparties would face uncertainty. A professional service provider and a counterparty said that a run would occur early, such as before or when a GSIB files for bankruptcy and continue until the market was confident the subsidiaries were effectively recapitalized and had adequate liquidity. One professional service provider said that it can be challenging to prove to the market that a GSIB's subsidiaries are financially sound after a recapitalization, especially during times of market stress.

Ring-Fencing

Most of the experts we interviewed viewed the types of controls the five GSIBs in our review put in place as somewhat effective in mitigating the potential for ring-fencing by foreign regulators to impede a GSIB's execution of its SPOE strategy (see table 4).[45] These experts included a judge, academics, professional service providers, and a counterparty.

Table 4: Expert Views on the Effectiveness of a GSIB's Controls in Mitigating the Risk of Ring-Fencing by Foreign Regulators

Responses:

	Very effective	Somewhat effective	Not effective	Total
Number of experts	2	10	5	17[a]

Source: GAO analysis of structured interview responses. | GAO-19-30

Note: A GSIB is a global systemically important bank holding company and generally refers to one of the five GSIBs covered in our review.

[a]Some experts told us that they did not have the knowledge to answer the question or had no opinion about the question. As a result, the total number of expert responses for this question is less than 30.

Based on the views of a few experts (a judge, academics, and professional service providers), incorporating a ring-fencing assumption into GSIB controls is one way to mitigate the obstacle, but other experts (a judge, an academic, and a counterparty) expressed the view that the likelihood of foreign regulators engaging in ring-fencing is unknown. These experts generally said U.S. and foreign regulators need to cooperate to avoid ring-fencing. A few experts (academics and professional service providers) said foreign regulators generally trust and understand the bankruptcy process less than a resolution administered by regulators.[46] In addition, one academic said that agreements between U.S. and foreign regulators might not be binding in a bankruptcy proceeding. Two service providers said that foreign regulators might be concerned whether GSIB subsidiaries in their jurisdictions have sufficient financial resources to maintain operations as the parent went through resolution.

[45]Because ring-fencing could trap financial resources at a GSIB's foreign subsidiaries and branches, the Federal Reserve and FDIC instructed the GSIBs to assume ring-fencing would occur and incorporate that assumption in their capital and liquidity planning.

[46]Some foreign jurisdictions created special resolution regimes to resolve a failed foreign GSIB or other systemically important firms. According to a Basel Committee report, in some cases, special resolution regimes are mainly administrative, whereby authorities can take control of financial companies before or upon insolvency. In other cases, special resolution regimes may be a hybrid of administrative and judicial regimes, in which banking supervisors or resolution authorities appoint special officials to implement resolution. Where restructuring is not possible, a forced liquidation or bankruptcy-type process may apply. See Bank for International Settlements, Basel Committee on Banking Supervision, Resolution Policies and Frameworks - *Progress So Far* (Basel, Switzerland: July 2011).

Most Experts We Interviewed Suggested Additional Government Actions to Address Potential Liquidity Shortfalls and Ring-Fencing

Most of the experts we interviewed supported additional government actions to address the risk that (1) GSIB subsidiaries might not have access to sufficient liquidity after their recapitalization or (2) foreign regulators might ring fence GSIB foreign subsidiaries.

Government-Sponsored Liquidity Facility

Most of the experts we interviewed viewed a GSIB's ability to execute its SPOE strategy in bankruptcy as greatly dependent on the IHC or key subsidiaries being able to access a government-sponsored source of liquidity (see table 5). These experts included a judge, academics, and professional service providers.

Table 5: Expert Views on the Extent to Which a GSIB's Ability to Execute SPOE Would Be Dependent on the IHC or Subsidiaries Having Access to a Government-Sponsored Source of Liquidity

Responses:

	Greatly dependent	Somewhat dependent	Not dependent	Total
Number of experts	14	3	3	20[a]

Source: GAO analysis of structured interview responses. | GAO-19-30

Note: A GSIB is a global systemically important bank holding company and generally refers to one of the five GSIBs covered in our review. SPOE is single point-of-entry and refers to a strategy for entry into bankruptcy. An IHC is an intermediate holding company.

[a]Some experts told us that they did not have the knowledge to answer the question or had no opinion about the question. As a result, the total number of expert responses for this question is less than 30.

Based on the views of a few experts (professional service providers and a counterparty), GSIBs should be able to execute their SPOE strategies without access to a government-sponsored liquidity facility, because regulators did not permit GSIBs to rely on the provision of extraordinary government support in their plans. These experts also mentioned that the

Dodd-Frank Act restricts the Federal Reserve's ability to provide liquidity to individual firms.[47]

Most of the experts (a judge, academics, professional service providers, and a counterparty) generally supported providing GSIBs with access to a government-sponsored liquidity facility for a number of related reasons, including the following:

- Debtor-in-possession financing may not be available to a GSIB's subsidiaries following their transfer to a bridge company, partly because they may not be under the GSIB parent in bankruptcy.[48]
- The existence of a government liquidity source would help instill market confidence in the GSIB's subsidiaries and reduce the likelihood of runs by creditors and counterparties and facilitate cooperation with foreign regulators. That is, the market would know that the subsidiaries, if solvent, could access liquidity to meet their obligations.
- Absent government financing, private-sector financing might not be available as quickly or on the scale that the bridge holding company and key subsidiaries might require in a distressed market.

Some academics said there were tradeoffs associated with a government-sponsored liquidity facility. A few academics said that such a facility would raise concerns about moral hazard and reduce market discipline, such as monitoring by creditors.[49] One professional service provider said that such a facility could be viewed as a government bailout, because subsidiaries accessing the facility might not be fully stable. On the other hand, a few experts (academics and professional service providers) said that they did not view the government's provision of

[47]The Dodd-Frank Act amended section 13(3) of the Federal Reserve Act to prohibit the establishment of an emergency lending program or facility for the purpose of assisting a single and specific company. The Federal Reserve may design emergency lending programs or facilities for the purpose of providing liquidity to the financial system. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 1101(a), 124 Stat. 1376, 2113 (2010).

[48]In a bankruptcy proceeding, creditors often provide financing (called debtor-in-possession financing) for the debtor to have immediate cash as well as ongoing working capital during reorganization.

[49]Moral hazard can occur when market participants expect similar emergency actions in future crises, thereby weakening their incentives to properly manage risks.

liquidity as a bailout if such lending was done on a fully secured, or collateralized, basis.

Similar to the experts we interviewed, officials from four of the GSIBs in our review told us their ability to execute their SPOE strategies is not dependent on access to government-provided liquidity but said that such a source of liquidity could be helpful. They said that a government-sponsored facility could provide reassurance to the markets and foreign regulators and bolster public perception about the financial condition of subsidiaries. They also said that a liquidity facility could provide further flexibility for subsidiaries to wind down over a longer period and to reduce the need to sell assets quickly (such sales could lead to declining asset values).

Officials from three of the five GSIBs in our review told us that debtor-in-possession financing likely would not be feasible under the SPOE strategy. Officials from two of the GSIBs said that lenders generally would require a debtor to provide liquid collateral to support a loan, but a GSIB parent would not have such collateral because it would have transferred its subsidiaries to a bridge holding company under the SPOE strategy. They also said that obtaining debtor-in-possession financing (before or after filing for bankruptcy) could undermine market confidence about a GSIB's health if such financing became public knowledge. Officials from another GSIB said that obtaining debtor-in-possession financing in advance of a bankruptcy would be difficult because the amount of financing that the firm would need and the price at which it could be obtained would depend on the facts and circumstances at the time of firm's failure. Such facts and circumstances are difficult to predict in advance, which would make it difficult to reach an agreement with potential creditors in advance.

Federal Reserve and FDIC staff told us that the premise of the resolution plans is that the GSIBs will pre-fund and self-fund their bankruptcies by design; thus, they should not need access to an external source of liquidity. Federal Reserve staff said there are scenarios, such as a broad-based market meltdown, in which a GSIB's resolution plan may not work and which required other tools, such as the Dodd-Frank Act's Orderly Liquidation Authority to address. Similarly, FDIC staff said that the Orderly Liquidation Authority provides a safeguard if a GSIB cannot be resolved under the Code in an orderly manner.

Foreign Regulators and Ring-Fencing

Most of the experts we interviewed (academics, professional service providers, and a counterparty) emphasized the need for continued or further coordination between U.S. and foreign regulators to prevent ring-fencing. Based on the views of a few experts (an academic, a professional service provider, and a counterparty), ring-fencing is a political decision made by foreign regulators to show that they have taken action to protect their country's creditors, but such actions trap capital and liquidity in foreign subsidiaries and can exacerbate losses. A professional service provider said that GSIBs could further mitigate the potential for ring-fencing by pre-positioning more capital at their foreign subsidiaries, but holding more capital is costly and could harm their competitiveness. Similarly, another professional service provider also expressed concern about foreign regulators potentially requiring U.S. GSIBs to pre-position more loss-absorbing capacity in their foreign subsidiaries, because such a requirement could trap such loss-absorbing capacity in foreign subsidiaries and reduce the GSIBs' flexibility to distribute financial resources where needed.

Based on the views of some experts (a judge, academics and a professional service provider), U.S. regulators should continue to work with foreign regulators through ongoing discussions and cooperative agreements. According to an academic, if foreign regulators become more familiar with the SPOE strategy, they will have more assurance that a SPOE strategy can be used successfully and that a GSIB's foreign subsidiaries will be protected. Based on the views of a few experts (academics and professional service providers), foreign regulators tend to be unfamiliar with the U.S. bankruptcy process because they have different resolution frameworks for financial institutions. To help prevent ring-fencing, a few experts said that U.S. regulators should enter into cooperative agreements, memorandums of understanding, or protocols with foreign regulators that address how they will cooperate to resolve a GSIB.

Federal Reserve and FDIC staff said that many cooperative arrangements, memorandums of understanding, escalation procedures, emergency contacts, and information-sharing arrangements are in place with key foreign authority counterparts.[50] For instance, the Federal Reserve and the FDIC co-chair crisis management groups that, among other activities, meet regularly to facilitate interaction among U.S. and foreign regulators and the GSIBs.[51] Federal Reserve and FDIC staff said foreign regulators continue to learn about the SPOE strategy under the Code and that education efforts are intended to help them become more comfortable with that strategy.

Similar to the opinions of a few experts, officials from four GSIBs in our review also said that U.S. regulators should continue efforts to educate and coordinate with foreign regulators. Officials from one of these GSIBs said that such education efforts would help mitigate the risk of ring-fencing by increasing foreign regulators' understanding of the GSIBs' resolution strategies and the benefits of these strategies to local jurisdictions.

Experts We Interviewed Expressed Mixed Views about the Five GSIBs' Controls to Mitigate Legal Obstacles but Supported Certain Code Amendments

As described in their public resolution plans, the five GSIBs in our review plan to file for bankruptcy under their SPOE strategies and seek the bankruptcy court's approval of their first-day motions, including one to effectuate a transaction contemplated in the 2015 ISDA Stay Protocol within 1-business day or 48 hours after the bankruptcy filing. As a result, the GSIBs and the court would need to make decisions in an expeditious manner. The five GSIBs have put in place controls designed to mitigate

[50]The Federal Reserve and FDIC staff said cross-border resolution cooperation and information-sharing arrangements related to resolution regimes among home and host authorities are not legally binding.

[51]The Federal Reserve is a member of the Financial Stability Board, an international body that monitors and makes recommendations about the global financial system. In 2014, the Financial Stability Board published a document describing standards for an effective resolution regime, including maintaining Crisis Management Groups for GSIBs. See Financial Stability Board, *Key Attributes of Effective Resolution Regimes for Financial Institutions* (Basel, Switzerland: Oct. 15, 2014). Federal Reserve and FDIC staff specifically pointed to the Crisis Management Groups as one way to bring together domestic and foreign regulators of GSIBs to discuss cross-border issues and development of effective resolution strategies.

legal obstacles. Because none of the GSIBs in our review have had to go through bankruptcy, the potential effectiveness of these controls cannot be known. Absent such evidence, expert views help to provide insights about the future effectiveness of the planned controls.

Experts we interviewed expressed mixed views about the controls the five GSIBs put in place to mitigate legal risks associated with timely filing, creditor challenges, and timely court approval of first-day motions. Members of Congress and experts have proposed Code amendments to further mitigate these legal risks. The experts we interviewed offered differing views on the potential effectiveness or need for such amendments.

Most Experts Viewed Controls to Mitigate the Risk of Untimely Filings as Somewhat Effective and Had Mixed Views on Proposals to Further Mitigate the Risk

Views on Effectiveness of Controls to Mitigate Risk of a GSIB's Board of Directors Not Filing in a Timely Manner

Most of the experts we interviewed viewed the types of controls put in place by the five GSIBs in our review as somewhat effective in mitigating the risk of a GSIB's board of directors not filing for bankruptcy in a timely manner (see table 6). These experts included judges, academics, professional service providers, and a counterparty.

Table 6: Expert Views on the Effectiveness of Controls in Mitigating the Risk of a GSIB's Board of Directors Not Filing for Bankruptcy in a Timely Manner

Responses:

	Very effective	Somewhat effective	Not effective	Total
Number of experts	4	16	6	26[a]

Source: GAO analysis of structured interview responses. | GAO-19-30

Note: A GSIB is a global systemically important bank holding company and generally refers to one of the five GSIBs covered in our review.

[a]Some experts told us that they did not have the knowledge to answer the question or had no opinion about the question. As a result, the total number of expert responses for this question is less than 30.

Based on the views of some of the experts (academics, professional service providers, and a judge), the five GSIBs in our review have put in place the right types of controls to help ensure that a GSIB's board of directors will file in a timely manner. Specifically, a few professional service providers said that a support agreement contractually requires the GSIB parent to transfer nearly all of its financial resources to the IHC or subsidiaries when triggers are breached.[52] The transfers would cause the GSIB board to file for bankruptcy because the GSIB parent would be unable to meet its debt obligations. Two of the professional service providers also said that if the GSIB parent did not provide resources to the IHCs and key subsidiaries pursuant to the support agreement, the key subsidiaries still would have claims to the parent's assets as secured creditors, putting them ahead of unsecured creditors. One professional service provider said that under the support agreement, a GSIB's board of directors would have greater liability for breaching the agreement than for not filing for bankruptcy.

GSIB Controls to Mitigate Risk of a Board of Directors Not Filing in a Timely Manner

The five GSIBs in our review developed controls to mitigate the risk of their boards of directors not filing for bankruptcy in a timely manner—that is, when GSIBs still had sufficient financial resources to execute SPOE. The GSIBs noted that they

- established support agreements and triggers to inform and guide actions that their board and senior management should take to execute SPOE. Under its support agreement, a GSIB parent must contribute nearly all of its remaining assets to the intermediate holding company, related funding entities, or key subsidiaries when it breaches a liquidity or capital trigger. Shortly after this transfer, the GSIB board would decide if the GSIB should file for bankruptcy.
- established security agreements that secure the legal obligations under the support agreements to provide financial resources to key subsidiaries. As a result, the key subsidiaries are secured creditors to the parent.

Source: GAO analysis of five 2017 public resolution plans. | GAO-19-30

[52] As described in the public sections of their resolution plans, the GSIBs use various terms to identify the point at which a GSIB parent contributes nearly all of its remaining assets to the IHC or subsidiaries. Such terms include resolution trigger, support trigger, and point of non-viability.

Note: GSIB is global systemically important bank holding company; SPOE is single point-of-entry.

Similarly, officials from three of the five GSIBs in our review told us that because the parent would not be able to meet its own funding needs or debt obligations after transferring most of its financial resources to the IHC or subsidiaries, the parent would need to file for bankruptcy. Additionally, all five GSIBs stated in their resolution plans or told us that the support agreements contain liquidated damages provisions, which give key subsidiaries claims to a predetermined sum of damages if the GSIB parents breached the support agreement.[53] Officials from two GSIBs told us that the liquidated damages provisions make the GSIB parent and board more likely to perform on the support agreement because not doing so would lead to greater liability for the parent and board.

In contrast, some experts expressed uncertainty about whether GSIB boards of directors would file in a timely manner. These experts (academics, a professional service provider, and judges) said that although controls such as the governance playbooks and triggers guide a GSIB's board or management decision making, the board or management can deviate from these controls based on the circumstances at the time. For example, the public section of a GSIB's resolution plan notes that the GSIB's plan reflects the actions it believes the firm and other stakeholders would take in a resolution event, but the plan is hypothetical and not binding on the firm, a bankruptcy court, or other resolution authority.

A few experts (an academic, a judge, and a professional service provider) also expressed concern that information feeding into the quantitative triggers might be untimely or inaccurate, which could make a GSIB board's filing decision untimely. For example, two experts said that capital and liquidity metrics the GSIBs put in place might not sufficiently account for market confidence. They said that if the market lost confidence in a GSIB, the GSIB's liquidity could disappear quickly under stress and decrease the amount of financial resources available to subsidiaries. Additionally, one expert said that if the data underlying the triggers are not accurate, then the information would not make its way to the GSIB's board of directors in a timely or accurate manner, causing the controls to be ineffective.

[53]In Guidance for 2017 §165(d) Annual Resolution Plan Submissions, the Federal Reserve and FDIC asked the GSIBs to consider if the support agreement should contain liquidated damages provisions to make the agreement more enforceable.

Federal Reserve staff told us that the resolution plans seek to ensure that a GSIB's quantitative triggers provide the GSIB's board with sufficient information to make a timely filing decision but do not eliminate the use of the board's judgment in deciding when best to file. They said that quantitative triggers are fallible and relying solely on triggers could result in a GSIB filing too early or too late.

Views on Proposed Code Amendments to Further Mitigate Risk of a GSIB's Board of Directors Not Filing in a Timely Manner

To further mitigate the risk of a GSIB's board of directors not filing for bankruptcy in a timely manner, members of Congress and experts have proposed amendments to the Code. Two such amendments would do the following:

- Shield a GSIB's board of directors from liability for a good-faith bankruptcy filing.[54] A legal expert identified director liability, such as liability for a breach of fiduciary duty, as a factor that could delay or discourage a board from filing for bankruptcy.[55]
- Allow the primary regulator to file an involuntary petition if a GSIB was insolvent or in imminent danger of becoming insolvent to limit the spread of damage to other financial companies.[56] According to experts, this amendment could help address the possibility that a board of directors would resist filing for bankruptcy until it was too late for bankruptcy to be viable.

[54]Legislative proposals have included providing a safe harbor to the members of the board of directors (or body performing similar functions) for a covered financial corporation from liability to shareholders, creditors, or other parties of interest, for a good-faith filing of a petition to commence a bankruptcy. *See*, for example, Financial CHOICE Act of 2017, H.R. 10, 115th Cong. §122 (2017).

[55]For example, see *Financial Institution Bankruptcy Act of 2014*, *House Committee on the Judiciary, Subcommittee on Regulatory Reform, Commercial and Antitrust Law*, 113th Cong. (July 15, 2014); statement of Donald S. Bernstein, Davis, Polk, and Wardell, LLP.

[56]Currently, generally only creditors can initiate an involuntary petition for bankruptcy. *See* 11 U.S.C. § 303. Academic proposals have included allowing the Federal Reserve to file a petition with the bankruptcy court under various conditions, including if the financial corporation were insolvent or unable to pay its debts. For example, see Kenneth E. Scott and Thomas Jackson, eds., *Bankruptcy Not Bailout: A Special Chapter 14* (Stanford, Calif.: Hoover Institution Press, 2012).

Shielding a GSIB's Board of Directors from Liability

Around half of the experts we interviewed said a Code amendment to shield a GSIB's board of directors from liability for a good faith bankruptcy filing would further mitigate the risk of an untimely board filing to some extent (see table 7). These experts included judges, academics, and professional service providers.

Table 7: Expert Views on the Extent to Which Shielding a GSIB's Board of Directors from Liability for a Good-Faith Bankruptcy Filing Would Mitigate the Risk of the Board Not Filing in a Timely Manner

Responses:

	To a great extent	To some extent	To little or no extent	Total
Number of experts	3	10	8	21[a]

Source: GAO analysis of structured interview responses. | GAO-19-30

Note: A GSIB is a global systemically important bank holding company and generally refers to one of the five GSIBs covered in our review.

[a]Some experts told us that they did not have the knowledge to answer the question or had no opinion about the question. As a result, the total number of expert responses for this question is less than 30.

Based on the views of a few experts (academics and professional service providers), such an amendment could provide additional clarity and assurance to directors that they would not be held liable for the bankruptcy filing. One professional service provider said that the amendment would allow the board of directors to make decisions based on facts rather than concerns about liability.

In contrast, most of the experts (judges, academics, and professional service providers) expressed doubts about the utility and effectiveness of the amendment. For example, some experts said that the amendment might not be needed because it would be difficult to find a director liable for a business decision, such as filing for bankruptcy, under state law.[57] Two professional service providers said that directors are educated about resolution plans and the trigger framework, which helps the directors to

[57]The five GSIBs are incorporated in Delaware. Under Delaware law, corporate directors are generally afforded significant protections as long as they act in the best interest of the corporation, act in good faith, use the amount of care that an ordinarily careful and prudent person would use under similar circumstances, and consider all material information reasonably available in making business decisions. Directors also generally benefit from the business judgement rule, which is a presumption that directors making a business decision, not involving self-interest, act on an informed basis, in good faith, and in the honest belief that their actions are in the corporation's best interest.

make informed decisions and reduce their potential liability. Furthermore, some experts said that boards of directors might be reluctant to make a decision about whether to file for bankruptcy because of concerns other than liability, such as to protect their reputation. Some academics also cautioned that any such amendment should be drafted to ensure it does not create unintended effects, such as protecting mismanagement.

Similar to expert comments, officials from four GSIBs in our review said that the amendment would provide additional protection to directors for their decision to file for bankruptcy. However, officials from four GSIBs also said that the amendment might be unnecessary because the controls they have put in place mitigate this potential risk and existing state laws shield directors from liability for the bankruptcy filing.

Allowing Regulators to Commence an Involuntary GSIB Bankruptcy

Around half of the experts we interviewed said a Code amendment to allow regulators to commence an involuntary bankruptcy if the firm is insolvent or in imminent danger of becoming insolvent would further mitigate the risk of a GSIB's board of directors not filing for bankruptcy in a timely manner to a great extent (see table 8). These experts included judges, academics, and professional service providers.

Table 8: Expert Views on the Extent to Which Allowing Regulators to Commence an Involuntary Bankruptcy Would Further Mitigate the Risk of a GSIB's Board of Directors Not Filing in a Timely Manner

Responses:

	To a great extent	To some extent	To little or no extent	Total
Number of experts	13	8	4	25[a]

Source: GAO analysis of structured interview responses. | GAO-19-30

Note: A GSIB is a global systemically important bank holding company and generally refers to one of the five GSIBs covered in our review.

[a]Some experts told us that they did not have the knowledge to answer the question or had no opinion about the question. As a result, the total number of expert responses for this question is less than 30.

Some experts (a judge, academics, and professional service providers) identified potential benefits of amending the Code to allow regulators to file an involuntary petition. Specifically, some experts said that giving regulators the power to file an involuntary case would provide regulators with additional leverage to persuade a GSIB board to file for bankruptcy in a timely manner. A few experts said that regulatory intervention would benefit the public interest, in part because a delayed filing could increase systemic risk. A few academics also identified other benefits; for instance, that regulators may be more informed than a GSIB's board of directors about when best to file for bankruptcy and could better coordinate the filing with foreign regulators to avoid ring-fencing.

In contrast, most of the experts (a judge, academics, professional service providers, and a counterparty) said that the amendment might not be necessary and might have drawbacks. Some experts expressed concern that regulators might be unwilling to file or might not file in a timely manner for reasons such as political pressure.[58] A few academics said that the amendment might reduce accountability in relation to who should file (regulators or a GSIB board). Additionally, some experts said the amendment was unnecessary because regulators already have power to influence a GSIB's bankruptcy filing. For example, a few experts said regulators could use the threat of placing the firm into FDIC receivership under the Orderly Liquidation Authority if the firm did not file voluntarily for bankruptcy in a timely manner. Officials from one GSIB similarly told us

[58]Regulators also might not file in a timely manner for other reasons. For example, we reported previously that some experts noted that regulators have not always been able to determine when financial institutions are likely to fail or have a systemic impact. See GAO, *Bankruptcy: Complex Financial Institutions and International Coordination Pose Challenges,* GAO-11-707 (Washington, D.C.: July 19, 2011).

the Orderly Liquidation Authority could be used to resolve a GSIB if it did not file in a timely manner.

A few experts (a judge, an academic, and professional service providers) said that an involuntary filing by the regulators could complicate a GSIB's resolution because the GSIB may contest the filing in court and thereby defeat the purpose of a timely filing. Officials from three GSIBs raised a similar concern. Two academics told us that amending the Code to provide regulators with the ability to file a petition for a GSIB bankruptcy that the GSIB could not contest could address the issue of an untimely filing.

Consistent with such concerns, the authors who initially proposed a Code amendment for an involuntary filing by regulators later proposed allowing the primary regulator to file what they called a voluntary petition, or immediate order for relief, that could not be challenged.[59] They stated that there would not be time to have a meaningful insolvency hearing under very tight time constraints of a strategy like SPOE.

Around Half the Experts Viewed Controls to Mitigate Risk of Creditor Challenges to Recapitalization as Somewhat Effective and Had Mixed Views on Proposals to Further Mitigate the Risk

Views on Effectiveness of Controls to Mitigate Risk of Creditor Challenge to Recapitalization

Around half of the experts we interviewed viewed the controls put in place by the five GSIBs in our review as somewhat effective in mitigating the risk that creditor challenges could impede a GSIB's ability to execute its SPOE strategy under the Code (see table 9). These experts included judges, academics, professional service providers, and a counterparty.

[59]For this proposal, see Thomas H. Jackson, Kenneth E. Scott, and John B. Taylor, eds., *Making Failure Feasible: How Bankruptcy Reform Can End Too Big to Fail* (Stanford, Calif.: Hoover Institution Press, 2015): 15-58.

Table 9: Expert Views on the Effectiveness of a GSIB's Controls in Mitigating the Risk That Creditor Challenges Could Impede Execution of SPOE

Responses:

	Very effective	Somewhat effective	Not effective	Total
Number of experts	7	12	3	22[a]

Source: GAO analysis of structured interview responses. | GAO-19-30

Note: A GSIB is a global systemically important bank holding company and generally refers to one of the five GSIBs covered in our review. SPOE is single point-of-entry, a strategy to enter bankruptcy.

[a]Some experts told us that they did not have the knowledge to answer the question or had no opinion about the question. As a result, the total number of expert responses for this question is less than 30.

GSIB Controls to Mitigate Risk of Creditor Challenges to Recapitalizing Subsidiaries

The five GSIBs in our review developed controls to mitigate the risk of creditor challenges to a GSIB's provision of financial resources to its subsidiaries before filing for bankruptcy. The GSIBs noted that they

- engaged external legal counsel to identify sources of potential legal challenges to recapitalizing subsidiaries.
- established security and support agreements that contractually obligate the parents to provide financial resources to the subsidiaries. Three GSIBs noted that because the security and support agreements were established when the firms were financially healthy and clearly solvent, they provide meaningful protection against creditor challenge. Two GSIBs also noted that the disclosure of the agreements in their resolution plans and other public filings mitigates the risk of creditor challenges because creditors have been notified in advance.

Source: GAO analysis of five 2017 public resolution plans. | GAO-19-30

Note: A GSIB is a global systemically important bank holding company.

Some experts (judges, an academic, and a professional service provider) explained how the GSIBs' IHCs or related funding entities, security agreements, and support agreements provide a defense against creditor challenges. Some experts said that the GSIBs' disclosures of their plans (as in the public sections of their resolution plans) serve to notify creditors of their plans to transfer financial resources from the parent to key subsidiaries, making it difficult for creditors to claim that preferential or fraudulent transfer occurred. Similarly, one service provider said that establishing the security and support agreements while GSIB parents are solvent provides a defense because preferential and fraudulent transfers are most likely to occur when the parent company is under financial distress.[60] In addition, the professional service provider said that an IHC would be effective in defending against creditor challenges because the IHC has no creditors that could assert challenges to its contributions to the subsidiaries.

On the other hand, some experts (judges, academics, professional service providers, and a counterparty) said that the GSIB controls cannot eliminate all possible creditor challenges. For example, one judge said that creditors with the capacity to challenge the recapitalization will do so. Two academics also expressed concerns that creditor challenges could disrupt the resolution process and delay a judge from being able to approve the first-day motion within 48 hours (discussed below).

[60]Fraudulent transfers include transfers made while the debtor is insolvent or became insolvent as a result of the transfer. Preferential transfers similarly include transfers made while the debtor was insolvent. For a preference claim, the debtor is presumed to have been insolvent during the 90 days immediately preceding the bankruptcy but can be proven to have been insolvent earlier.

Views on Proposed Amendments to Further Mitigate Risk of Legal Challenges to a GSIB's Recapitalization

Concerned about the potential for a bankruptcy judge to require a GSIB to unwind the recapitalization of its subsidiaries, members of Congress and experts have proposed amending the Code to provide greater legal certainty for a recapitalization.[61] Two such amendments would

- prohibit creditors from challenging a GSIB's recapitalization of its subsidiaries (for example, as a preferential or fraudulent transfer);[62] and
- shield a GSIB's board of directors from liability for any reasonable action taken related to the recapitalization.[63]

Prohibit Creditors from Challenging a GSIB Recapitalization

Most of the experts we interviewed said that amending the Code to broadly prohibit creditors from challenging a GSIB's recapitalization would further mitigate potential creditor challenges to a great extent (see table 10). These experts included judges, academics, professional service providers, and a counterparty.

[61] For example, see Role of Bankruptcy Reform in Addressing Too-Big-to-Fail, Senate Committee on Banking, Housing, and Urban Affairs, 114th Cong. (July 29, 2015); statement of Randall D. Guynn, Davis, Polk, and Wardell, LLP. Also see the meeting of the Systemic Resolution Advisory Committee, https://www.fdic.gov/about/srac/2016/2016-04-14-minutes.pdf.

[62] Legislative and academic proposals have included prohibiting the avoidance of any transfer of obligations from the GSIB parent to the affiliate. For example, the Financial Institution Bankruptcy Act of 2017, H.R. 1667, 115th Cong. § 3 (2017), contains a provision that would prohibit the avoidance of certain transfers to a bridge holding company under various Code provisions covering preferential and fraudulent transfers. Also see *Making Failure Feasible*.

[63] Legislative proposals have included providing a safe harbor for directors for any reasonable action taken in good faith in contemplation of a covered bankruptcy petition, before or after the commencement of the case. *See* H.R. 1667, § 3 (2017).

Table 10: Expert Views on the Extent to Which Broadly Prohibiting Creditors from Challenging a GSIB's Recapitalization of Its Subsidiaries Would Further Mitigate Potential Creditor Challenges

Responses:

	To a great extent	To some extent	To little or no extent	Total
Number of experts	14	6	2	**22**[a]

Source: GAO analysis of structured interview responses. | GAO-19-30

Note: A GSIB is a global systemically important bank holding company and generally refers to one of the five GSIBs covered in our review.

[a]Some experts told us that they did not have the knowledge to answer the question or had no opinion about the question. As a result, the total number of expert responses for this question is less than 30.

Experts had mixed views on the proposed Code amendment. Some experts (judges, academics, and professional service providers) told us that the benefits of amending the Code to immunize a GSIB's recapitalization would include mitigating legal challenges, streamlining the SPOE strategy, and providing certainty that a recapitalization would not constitute a fraudulent or preferential transfer. A few experts (a judge, academics, and a professional service provider) said that while such an amendment would provide additional assurances, it might not be necessary because the court likely would dismiss creditor challenges due to the mitigating actions taken by the GSIBs. Two academics additionally expressed concern that such an amendment could be overly broad and protect financial transfers that should not be protected.

Some experts (judges, academics, and a counterparty) said that such an amendment would conflict with the Code's purpose and undermine creditor rights. For example, a judge who supported the amendment acknowledged that it would reduce creditor rights to be heard and limit transparency into a GSIB board's decision making. Similarly, two other judges and a professional service provider said the amendment seeks to expedite a GSIB's bankruptcy process for the public's benefits to the potential detriment of creditors. Finally, an academic and a counterparty said that the amendment would decrease protection for creditors and, as a result, could increase a GSIB's cost to issue debt because creditors may require a higher return on the debt in light of their decreased protection.

Shield Board of Directors from Liability

Some of the experts we interviewed said that a Code amendment to shield a GSIB's board of directors from liability for any reasonable action taken related to the recapitalization would further mitigate the risk of creditor challenges to some extent (see table 11). These experts included judges and academics.

Table 11: Expert Views on the Extent to Which Shielding a GSIB's Board of Directors from Liability for Any Reasonable Action Taken Related to Recapitalization Would Further Mitigate Legal Challenges

Responses:

	To a great extent	To some extent	To little or no extent	Total
Number of experts	7	8	5	20[a]

Source: GAO analysis of structured interview responses. | GAO-19-30

Note: A GSIB is a global systemically important bank holding company and generally refers to one of the five GSIBs covered in our review.

[a]Some experts told us that they did not have the knowledge to answer the question or had no opinion about the question. As a result, the total number of expert responses for this question is less than 30.

Experts mentioned benefits and raised concerns similar to those expressed for an amendment to shield GSIB boards from liability for a good-faith filing. Some experts (judges, professional service providers, and academics) said that the amendment might mitigate creditor challenges; for example, by signaling that directors are protected when executing SPOE strategy. At the same time, around half of the experts (academics, professional service providers, and judges) said that the amendment would be unnecessary, in part because it already would be difficult to find a director liable for such decisions under applicable state law. A professional service provider said the amendment might be interpreted too broadly—for example, to allow directors to pay inappropriate bonuses to management.

Some of the Experts Viewed Controls to Mitigate Risk of Delays in Approval of First-Day Motions as Somewhat Effective and Generally Supported Related Code Amendments

Views on Controls to Mitigate Risk of Delays in Obtaining Court Approval of First-Day Motions

Around half of the experts we interviewed regarded the types of controls put in place by the five GSIBs in our review as somewhat effective in mitigating potential legal challenges that could prevent or delay a GSIB from obtaining the court's timely approval of its first-day motions (see table 12). These experts included judges, academics, professional service providers, and a counterparty.

Table 12: Expert Views on the Effectiveness of Controls in Mitigating Potential Legal Challenges That Could Prevent or Delay a GSIB from Obtaining the Court's Timely Approval of First-Day Motions

Responses:

	Very effective	Somewhat effective	Not effective	Total
Number of experts	9	11	2	22[a]

Source: GAO analysis of structured interview responses. | GAO-19-30

Note: A GSIB is a global systemically important bank holding company and generally refers to one of the five GSIBs covered in our review.

[a]Some experts told us that they did not have the knowledge to answer the question or had no opinion about the question. As a result, the total number of expert responses for this question is less than 30.

GSIB Controls to Mitigate Risk of Delays in Obtaining Court Approval of First-Day Motions

The five GSIBs in our review have developed controls to mitigate the risk that a court may delay approving their first-day motions. The GSIBs noted that they

- drafted bankruptcy documents that could be filed immediately after the GSIB parent filed for bankruptcy, including draft first-day motions that seek to obtain the court's approval to take actions to effectuate the International Swaps and Derivatives Association's 2015 Universal Resolution Stay Protocol within 1-business day or 48 hours after the bankruptcy filing.
- prepared analysis of issues likely to be raised at the hearing on the first-day motions and arguments in support of the motions.

Source: GAO analysis of five 2017 public resolution plans. | GAO-19-30

Note: A GSIB is a global systemically important bank holding company.

Based on the views of some of the experts (judges, academics, a professional service provider, and a counterparty), judges are likely to approve first-day motions, such as because a strong legal foundation underlies the first-day motions and judges likely would not find creditor challenges persuasive due to the information GSIBs publicly disclose about their resolution plans. Two judges said the preparation of the first-day motions and circulation of the resolution plans help the court make decisions and address creditor issues within a 48-hour period. An academic and a judge said that because SPOE requires a judge to make critical but complex decisions within the first 48 hours to avoid systemic risk, the judge would not have a reasonable choice other than to rule quickly on the first-day motions.

Some experts (judges, an academic, professional service providers, and a counterparty) said the GSIBs cannot eliminate all challenges to the approval of first-day motions within 48 hours. In particular, a judge and a professional service provider said GSIB controls could not entirely eliminate delays due to deliberations or due process concerns. Additionally, a counterparty and a professional service provider said that the controls are untested. Similarly, two academics said that a judge might not have the expertise and capacity to make all the required decisions on the first-day motions within 48 hours.

Most of the experts we interviewed viewed the 2015 ISDA Stay Protocol as at least somewhat effective in mitigating the risk of QFC counterparties exercising their default rights if the court approved the first-day motions (see table 13). These experts included judges, academics, professional service providers, and counterparties.

Table 13: Expert Views on the Effectiveness of a GSIB's Controls in Mitigating Risk of Counterparties Exercising Default Rights after Court Approval of First-Day Motions

Responses:

	Very effective	Somewhat effective	Not effective	Total
Number of experts	10	10	2	22[a]

Source: GAO analysis of structured interview responses. | GAO-19-30

Note: A GSIB is a global systemically important bank holding company and generally refers to one of the five GSIBs covered in our review.

[a]Some experts told us that they did not have the knowledge to answer the question or had no opinion about the question. As a result, the total number of expert responses for this question is less than 30.

Based on the views of around half the experts (judges, academics, professional service providers, and a counterparty), the 2015 ISDA Stay Protocol is likely to be enforceable and effective in preventing the exercise of cross-default rights by counterparties of GSIB subsidiaries. In particular, some experts (judges, academics, a professional service provider, and a counterparty) said that counterparties would follow the court's orders and not exercise their cross-default rights. Three professional service providers told us that the cross-default provision would become less of a risk over time, because GSIBs have been excluding that right in new QFCs pursuant to the federal banking regulators' QFC rules.[64] Under these rules, GSIBs and their subsidiaries must include provisions in their QFCs that would prevent counterparties from exercising default rights based on entry into a bankruptcy or resolution proceedings.

Some experts expressed concerns about the effectiveness of the 2015 ISDA Stay Protocol. While the protocol recognizes the cross-border application of various resolution regimes, including the Code, a few experts (academics and a professional service provider) told us that foreign counterparties outside the U.S. court's jurisdiction might not abide by the protocol and exercise their cross-default rights.

Additionally, a few experts (academics and a professional service provider) told us that counterparties may seek to incorporate other triggers in their QFCs designed to circumvent the protocol. For example, they said that cross-default rights could be triggered by changes in a GSIB's credit rating or changes in interest rates. One professional service provider said the QFC rules and the 2015 ISDA Stay Protocol may address such possibilities. For example, the Federal Reserve's QFC rule

[64] In 2017, the Federal Reserve, FDIC, and the Office of the Comptroller of the Currency, respectively, issued final rules regarding new restrictions on QFCs for U.S. GSIBs and their subsidiaries and the U.S. operations of foreign GSIBs. *See* 82 Fed. Reg. 42882 (Sept. 12, 2017); 82 Fed. Reg. 50228 (Oct. 30, 2017), and 82 Fed. Reg. 56630 (Nov. 29, 2017). These final rules generally prohibit cross-default rights in a QFC based on the parent or other affiliate becoming subject to insolvency proceedings. The new rules also prohibit QFC restrictions on the transfers of any guarantee or credit support upon the insolvency of the support provider. The final rules generally require covered entities to ensure that QFCs include cross-border recognition that default rights and restrictions on the transfer of QFCs are limited as they would be under U.S. special resolution regimes, such as the Orderly Liquidation Authority. The regulations permit compliance by adherence to the 2015 ISDA Stay Protocol or the U.S. protocol, as defined in the agencies' final rules. Although ISDA published the 2018 U.S. Resolution Stay Protocol, the agencies have not yet stated that it satisfies the definition of the U.S. protocol.

prohibits exercise of default rights triggered by an event that is not the resolution of an affiliate but caused by the resolution, such as a credit rating downgrade.[65] Under the 2015 ISDA Stay Protocol, if an adhering party under a covered agreement became subject to resolution, a counterparty generally would be prevented from exercising related default rights, unless the subsidiary failed to continue to meet its obligations under the QFC.[66] A few experts (a professional service provider, a judge, and academics) expressed concern that the protocol is voluntary and said the Code should be amended to incorporate a stay similar to the protocol.[67]

As discussed earlier, the Code includes safe-harbor provisions that generally allow counterparties to QFCs to exercise certain contractual rights even if doing so otherwise would violate the Code's automatic stay. Appendix III includes the views of experts on the systemic risk implications of the Code's QFC safe harbors.

Views on Proposed Amendments to Further Mitigate Risk of Delays in Obtaining Court Approval of First-Day Motions

Members of Congress, academics, and others have proposed amendments to the Code to mitigate legal challenges to the court's approval of the first-day motions under an expedited timeline. Six examples of such amendments would do the following:

[65]The Federal Reserve's final rule prohibits contractual provisions that permit the exercise of default rights directly or indirectly related to the resolution of an affiliate, including but not limited to a credit rating downgrade. *See* 82 Fed. Reg. 42882 (Sept. 12, 2017); *see* also 82 Fed. Reg. 50228 (Oct. 30, 2017), and 82 Fed. Reg. 56630 (Nov. 29, 2017).

[66]Under the 2015 ISDA Stay Protocol, once an affiliate enters proceedings under the Code, a counterparty generally cannot exercise default rights except (1) those based on non-performance of payment or delivery obligations by the operating subsidiary that is the direct party to the QFC or failure of the credit support provider to satisfy any actual payment or delivery obligation to the counterparty ; or (2) default rights that can be shown by clear and convincing evidence to not be directly or indirectly related to an affiliate becoming subject to U.S. insolvency proceedings, or to any transfer to a bankruptcy bridge company or third-party transferee.

[67]Academic and legislative proposals have included providing a stay on the termination, acceleration, or modification of any QFCs due to several conditions, including insolvency or commencement of a bankruptcy. For example, see *Making Failure Feasible* and H.R. 10, § 122 (2017).

- Clarify that a court may order a transfer of the property of the estate from the debtor GSIB to a bridge holding company within a certain time frame, such as 48 hours after the bankruptcy filing, and that a GSIB may transfer its subsidiaries to a bridge company within 48 hours of the bankruptcy filing under Section 363 of the Code.[68] One expert noted that such amendments would increase the certainty of application of current law in connection with an SPOE strategy.[69]
- Allow regulators to raise, appear, and be heard on any issues related to a GSIB bankruptcy case and allow court deference to the Federal Reserve's determination on the implications of the bankruptcy proceedings on U.S. financial stability. [70] Experts stated that these two amendments would incorporate the expertise and perspectives of the regulators in the bankruptcy process.
- Allow the court to consider the effect of its decision on U.S. financial stability.[71] Experts noted that the Code does not explicitly address whether the court can consider the functioning of the financial system.
- Designate bankruptcy judges to a GSIB bankruptcy case.[72] Experts proposed this amendment to ensure that the judge would have the requisite financial expertise to deal with a GSIB bankruptcy.

[68]Legislative proposals have included language regarding the conditions under which the court may order the transfer of the property of the estate and the assignment of qualified financial contracts, unexpired leases, and executory contracts to a bridge company under Section 363 of the Code. *See*, for example, H.R. 1667 § 3 (2017).

[69]See *Role of Bankruptcy Reform in Addressing Too-Big-To-Fail, Senate Committee on Banking, Housing, and Urban Affairs*.

[70]Academic and legislative proposals have included providing regulators with standing to be heard on issues. For example, see *Making Failure Feasible* and H.R. 1667 § 3 (2017). Additionally, a 2018 report by the Department of the Treasury on bankruptcy reform recommended that a Federal Reserve determination on financial stability should be afforded judicial deference. See Department of the Treasury, *Orderly Liquidation Authority and Bankruptcy Reform*, a report to the President of the United States, pursuant to the Presidential Memorandum issued April 21, 2017 (Washington, D.C.: Feb. 21, 2018).

[71]Legislative proposals have included allowing the bankruptcy court to consider the effect of any decision in connection with the bankruptcy filing on U.S. financial stability. For example, *see* H.R. 1667 § 3 (2017) and H.R.10 § 122 (2017). These proposals also include a provision to prohibit the court from ordering a transfer to the bridge holding company unless the court determined, based on a preponderance of evidence, that a transfer would be necessary to prevent serious adverse effects on U.S. financial stability.

[72]Generally, bankruptcy cases are assigned on a random basis to judges within the district in which they are filed. Academic and legislative proposals have included designating district court judges or a certain number of bankruptcy judges to hear GSIB bankruptcy cases. For example, see *Making Failure Feasible* and H.R. 1667 § 4 (2017).

Clarify That GSIB Transfer of Subsidiaries to a Bridge Holding Company and Court Approval of First-Day Motions Can Be Made within 48 Hours of Bankruptcy Filing

Most of the experts we interviewed said that a Code amendment to clarify that a GSIB may transfer its IHC and other subsidiaries within 48 hours of the bankruptcy filing to a bridge holding company would mitigate potential challenges to the transfer to a great extent (see table 14). These experts included judges, academics, and professional service providers.

Table 14: Expert Views on the Extent to Which Clarifying That a GSIB May Transfer Its IHC and Subsidiaries within 48 Hours Would Further Mitigate Challenges to Approval of First-Day Motions

Responses:

	To a great extent	To some extent	To little or no extent	Total
Number of experts	15	2	5	22[a]

Source: GAO analysis of structured interview responses. | GAO-19-30

Note: A GSIB is a global systemically important bank holding company. IHC is an intermediate holding company. Three GSIBs in our review had plans to include in their first-day motions a request to transfer their IHC and subsidiaries to a newly established bridge holding company.

[a]Some experts told us that they did not have the knowledge to answer the question or had no opinion about the question. As a result, the total number of expert responses for this question is less than 30.

Some experts (judges, academics, and professional service providers) said that the amendment would be helpful and provide clarity to a GSIB bankruptcy. For example, a judge said it would be helpful for a judge to rely on a statutory set of standards for approving the transfer. A professional service provider said that because SPOE depends on the approval of the transfer motion, it is important to clarify in the Code that such transfers are allowed. A few experts (academics and a professional service provider) said that Section 363 of the Code currently allows GSIBs to make such transfers, but a Code amendment would clarify any legal ambiguity and mitigate the risk of potential due process or other challenges. An academic said that the amendment would allow a GSIB to make the transfer and, thus, limit the issues to be discussed within the first 48 hours.

Most of the experts we interviewed said a Code amendment to provide a time frame (such as 48 hours) within which a judge may decide whether to approve a transfer motion would mitigate potential challenges to a great extent (see table 15). These experts included judges, academics, and professional service providers.

Table 15: Expert Views on the Extent to Which Providing a Time Frame within Which a Judge May Approve a Transfer Motion Would Further Mitigate Challenges to Approval of First-Day Motions

Responses:

	To a great extent	To some extent	To little or no extent	Total
Number of experts	12	7	2	21[a]

Source: GAO analysis of structured interview responses. | GAO-19-30

[a]Some experts told us that they did not have the knowledge to answer the question or had no opinion about the question. As a result, the total number of expert responses for this question is less than 30.

Experts provided varying views on the benefits of the amendment. Some experts (judges, academics, and professional service providers) said an amendment could assure judges that they may approve a transfer in as quickly as 48 hours. For example, an academic said that without express authority under the Code to allow the court to approve the transfer in 48 hours, the transfer would be subject to the risk of not being approved in that time frame. In contrast, some experts (a judge, academics, a professional service provider, and a counterparty) commented that a court essentially would need to approve the first-day motions within 48 hours to meet the deadlines under the 2015 ISDA Stay Protocol; otherwise, the SPOE strategy would not work.

Some experts (a judge, academics, and a professional service provider) raised creditor rights issues in relation to both amendments. For example, an academic said that because the judge would not have time to determine which assets would be transferred, the judge would be rubber-stamping the approval.[73] Similarly, a judge said that judges should not be forced to make decisions under a rigid timeline under which the court would be used as a means to an end and the judge would not be

[73]Federal Reserve and FDIC staff told us that a court can draft an order preserving the ability of a debtor or a creditors' committee to pursue litigation of claims, including claims of fraudulent transfer and preference, after the approval of the first-day motions.

deliberative. Two academics said that 48 hours is not long enough for creditors to challenge the transfer.[74]

In contrast, some experts (judges, academics, and a professional service provider) said that experienced judges should be able to make the decision and address due process concerns within 48 hours. For example, a professional service provider said that judges should be in a position to make a decision within 48 hours because the transfer of the subsidiaries to a bridge company held by a trust for the sole benefit of a parent's bankruptcy estate is not a true sale, as compared to the sale of a subsidiary to a third party (such as Lehman Brothers' sale of its U.K. broker-dealer). As a result, the expert said that the request is limited and the hearing should be simpler because the court does not need to assess whether the GSIB received adequate consideration or a reasonable equivalent value for its assets. Additionally, two academics said that while an expedited transfer might lead to an unfair distribution of assets to creditors, the creditors also would benefit from the expedited transfer because any delays would cause asset values to decline and harm both the creditors and financial stability.

Officials from all five GSIBs in our review said that these two amendments would help to provide clarity and certainty to judges and allow them to make the decision within 48 hours. At the same time, officials from two of the GSIBs said that the judges would approve the first-day motions without such amendments. These GSIBs said that they expected a court would act expeditiously to protect U.S. financial stability

[74]We also asked experts for their views on the hypothetical: If the Code was revised to provide that (1) in the case of an emergency motion to transfer a GSIB's IHC and subsidiaries to a bridge holding company, that (2) holders of the 20 largest secured and unsecured claims against the debtor be notified not less than 24 hours before the transfer was granted, what is the risk the bridge holding company still would be held liable for the debts of the GSIB parent due to lack of notice to injured parties? This hypothetical in some ways draws from a 2016 case out of the United States Court of Appeals for the Second Circuit, in which the court found that GM's failure to provide potential creditors with adequate notice of a sale under Section 363 of the Code prevented GM's good-faith purchasing successor company from benefiting from Section 363's "free and clear" protections from successor liability. *See Elliott v. GM LLC (In re Motors Liquidation Co.)*, 829 F.3d 135 (2016). Expert opinions on the question were split, with some experts saying that the risk to a GSIB successor bridge company would be small and others expressing concerns about the adequacy of such notice. Two experts pointed out that this would be an issue for the courts to resolve and it was difficult to answer with any certainty. In April 2017, the Supreme Court denied a petition for a writ of certiorari in the Elliott v. GM case and the law surrounding the issue remains fact-specific and unsettled.

and approve the transfer because it would promote creditors' recovery of value of the assets.

Allow Relevant Regulators to Appear and Be Heard in the GSIB Bankruptcy Case

Around half of the experts we interviewed said that a Code amendment to allow relevant regulators to appear and be heard in a GSIB bankruptcy case would further mitigate challenges associated with the approval of the first-day motions to some extent (see table 16). These experts included academics, professional service providers, and counterparties.

Table 16: Expert Views on the Extent to Which Allowing Regulators to Appear and Be Heard in a GSIB's Bankruptcy Case Would Further Mitigate Challenges to Approval of First-Day Motions

Responses:

	To a great extent	To some extent	To little or no extent	Total
Number of experts	10	11	3	24[a]

Source: GAO analysis of structured interview responses. | GAO-19-30

Note: A GSIB is a global systemically important bank holding company and generally refers to one of the five GSIBs covered in our review.

[a]Some experts told us that they did not have the knowledge to answer the question or had no opinion about the question. As a result, the total number of expert responses for this question is less than 30.

Some of the experts (judges, academics, professional service providers, and a counterparty) said regulatory perspectives in court have benefits such as helping the court understand bankruptcy under SPOE and the potential effects of its decisions on financial stability, facilitating cross-border cooperation, and providing information to help expedite the court's decision. However, a judge and a few academics said that allowing regulators to be heard could slow down or complicate the court's decisions—for example, if regulators or regulators and the GSIB disagreed. In a 2018 report, the Department of the Treasury supported this amendment and stated that providing a clear ability for U.S. regulators to raise and be heard on any issues in the bankruptcy case would ensure that the court obtained the benefit of the regulators' expertise on financial corporations and implications of the proceedings on U.S. financial stability.[75]

[75]Department of the Treasury, *Orderly Liquidation Authority and Bankruptcy Reform*.

On the other hand, some experts (judges, academics, and professional service providers) said the amendment might be unnecessary because regulators already can appear and be heard in court, but that the amendment would have no negative impact.[76] For example, a judge told us that the regulators are already parties-in-interest who can appear in court and the judge in the Lehman Brothers case heard from all regulators. Similarly, officials from all five GSIBs in our review told us that they viewed the amendment as beneficial. However, officials from four of the GSIBs also said that the court already allows the regulators to appear and be heard.

Allow the Court to Consider the Effect of Its Decision on U.S. Financial Stability

Most of the experts we interviewed said that a Code amendment to allow the court to consider the effect of its decisions on U.S. financial stability would further mitigate potential challenges associated with the approval of the first-day motions to some extent (see table 17). These experts included judges, academics, professional service providers, and a counterparty.

Table 17: Expert Views on the Extent to Which Allowing the Court to Consider the Effect of Its Decisions on U.S. Financial Stability Would Further Mitigate Challenges to Approval of First-Day Motions

Responses:

	To a great extent	To some extent	To little or no extent	Total
Number of experts	8	14	2	24[a]

Source: GAO analysis of structured interview responses. | GAO-19-30

[a]Some experts told us that they did not have the knowledge to answer the question or had no opinion about the question. As a result, the total number of expert responses for this question is less than 30.

Some experts (judges, academics, and a counterparty) said that explicitly allowing the court to consider the effect of its decision on U.S. financial stability would provide the court with greater flexibility to consider more

[76]The Securities and Exchange Commission and a party in interest may raise, appear, and be heard on any issues in a Chapter 11 case. *See* 11 U.S.C. § 1109. The Code has a non-exhaustive list of "parties-in-interest," such as a creditor and a creditor's committee. Academic and legislative proposals include allowing relevant regulators, such as the Federal Reserve, Securities and Exchange Commission, Office of the Comptroller of the Currency, FDIC, and the Commodity Futures Trading Commission to raise, appear, and be heard on any issues pertaining to the bankruptcy.

than the interests of the creditors. A few of these experts explained that this is due to the Code's focus on the impact of the bankruptcy on creditors, such as maximizing the value of the bankruptcy estate for creditors. However, two academics said that the amendment would involve tradeoffs between the interests of creditors and the public. For example, an academic said that the amendment would make it harder for creditors to challenge the judge's decision to take into consideration the impact on the financial system. However, the academic also said the amendment would make some derivatives agreements that are seen as more important to preventing a crisis more likely to be paid off as compared with other types of transactions, thereby creating moral hazard. In contrast, some experts (judges, an academic, and professional service providers) said the amendment might not have a great effect because judges might consider and have considered financial stability in their decisions under the current Code.

Around half of the experts raised questions about how the court would determine whether its decision would affect U.S. financial stability. For example, some experts (professional service providers and counterparties) said that determining such an impact is the purview of the regulators, and a judge said that judges do not have the necessary capacity to make a determination about a Federal Reserve finding on financial stability. Additionally, a professional service provider and two academics said that the court's debate on the issue may add to the decisions the court must make within a 48-hour window. Two experts said that the court should be allowed but not be required to consider U.S. financial stability in its decision.

Court Deference to Federal Reserve Determination on the Implications of the Bankruptcy Proceedings on U.S. Financial Stability

Almost all the experts we interviewed said that a Code amendment to have a court give deference to a Federal Reserve determination on the financial stability implication of a GSIB's transfer of its subsidiaries to a bridge holding company would mitigate potential challenges to approval of first-day motions to at least some extent (see table 18). These experts included judges, academics, and professional service providers.

Table 18: Expert Views on the Extent to Which Court Deference to a Federal Reserve Determination on Financial Stability Implications Would Further Mitigate Challenges to Approval of First-Day Motions

Responses:

	To a great extent	To some extent	To little or no extent	Total
Number of experts	12	12	1	25[a]

Source: GAO analysis of structured interview responses. | GAO-19-30

[a]Some experts told us that they did not have the knowledge to answer the question or had no opinion about the question. As a result, the total number of expert responses for this question is less than 30.

Some experts (judges, academics, professional service providers, and a counterparty) said that allowing a court to defer to the Federal Reserve on such determinations could have benefits, such as mitigating creditor challenges and expediting a court's approval of first-day motions. A few experts (academics and a professional service provider) also said that the Federal Reserve was in the best position to make financial stability determinations. In its 2018 report, the Department of the Treasury supported this amendment and stated that the court's deference to a Federal Reserve determination would allow the court to leverage the Federal Reserve's expertise and be more confident in quickly approving first-day transfer motions.[77]

On the other hand, a few experts (judges and academics) raised concern that having the court defer to the Federal Reserve could interfere with the court's independence. For example, a judge and an academic said that if such an amendment were enacted, the court should be allowed but not required to consider the Federal Reserve's determination. Another judge said that requiring the court to defer to the Federal Reserve's determination would be akin to rubber stamping the decision.

Officials from four of the GSIBs in our review also told us that the Federal Reserve's determination on the financial stability implication would help courts make more informed decisions. However, officials from one GSIB also said that the regulators' views on financial stability should not outweigh the court's viewpoint.

[77]Department of the Treasury, *Orderly Liquidation Authority and Bankruptcy Reform*.

Designate Bankruptcy Judges to Preside over GSIB Bankruptcy Cases

Most of the experts we interviewed said that a Code amendment to require that a certain number of bankruptcy judges be designated to hear GSIB bankruptcy cases would further mitigate potential challenges associated with the approval of the first-day motions to a great extent (see table 19). These experts included judges, academics, professional service providers, and a counterparty.

Table 19: Expert Views on the Extent to Which Designating a Certain Number of Bankruptcy Judges to Hear a GSIB's Bankruptcy Case Would Further Mitigate Challenges to Approval of First-Day Motions

Responses:

	To a great extent	To some extent	To little or no extent	Total
Number of experts	15	8	2	25[a]

Source: GAO analysis of structured interview responses. | GAO-19-30

Note: A GSIB is a global systemically important bank holding company and generally refers to one of the five GSIBs covered in our review.

[a]Some experts told us that they did not have the knowledge to answer the question or had no opinion about the question. As a result, the total number of expert responses for this question is less than 30.

Almost all the experts told us it would be helpful to have judges who were educated in advance about GSIB resolution and SPOE to preside over a GSIB bankruptcy case. For example, one judge said that if a judge had to act within 48 hours of the bankruptcy filing, the judge would need to be able to understand the complexities of a GSIB bankruptcy. Another judge said that having a group of judges with expertise in financial markets and systemic risk would expedite a court's approval of the first-day motions and enhance the court's ability to deal with an SPOE resolution. According to a judge, efforts are underway to educate judges about SPOE, such as the preparation of an SPOE handbook by the Federal Judicial Center, a judicial branch research and education agency.

Three judges also commented that while it is important to have a designated pool of judges available to hear GSIB cases, there could be challenges or tradeoffs in determining which judges should be in the pool or selected to hear a GSIB case. For example, one judge questioned who would pick the judges, what level of sophistication the judges should have, and whether the judges would be quasi-regulators. Another judge said that the selection of judges should not be limited to a small group of judges or judges from certain geographic regions.

In addition, a few academics raised the issue of whether the designated judges should be bankruptcy court judges or district court judges—commenting that the former have greater bankruptcy expertise but the latter have greater authority.[78] In its 2018 report, the Department of the Treasury supported the designation of bankruptcy judges, and also recommended the alternative of designating district court judges. The report stated that appeals from district judges' decisions would go directly to the relevant court of appeals without an intermediate appeal, achieving finality of judgement more quickly.[79]

Officials from four of the GSIBs in our review said that having judges who were educated about GSIB resolution and the SPOE strategy would be helpful. However, officials from two of the GSIBs also said that the amendment might not be necessary because the education of judges is already underway through outreach events.

Most Experts Viewed the SPOE Strategy as Likely to Work If Only One GSIB Was Affected but Not in a Widespread Market Disruption

According to the Federal Reserve and FDIC, the goal of the Dodd-Frank Act's resolution planning process is to help ensure that a firm's failure would not have serious adverse effects on U.S. financial stability.[80] The regulators noted that the resolution planning process requires firms to demonstrate that they have adequately assessed the challenges that their structure and business activities pose to resolution and taken action to address those issues. The regulators also expect the firms to create options for selling operations and business lines to generate resources that could further minimize the direct impact of distress or failure on the broader financial system and allow for restructuring under stress, including through the sale or wind-down of businesses.

[78]U.S. bankruptcy courts are courts created under Article I of the U.S. Constitution, and U.S. district courts are created under Article III. Bankruptcy court decisions are subject to appeal to the district court. While district court judges review a broad set of cases, bankruptcy courts have jurisdiction only over bankruptcy cases.

[79]Department of the Treasury, *Orderly Liquidation Authority and Bankruptcy Reform*.

[80]For example, see Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation, *Resolution Plan Assessment Framework and Firm Determinations (2016)* (Washington D.C.: Apr. 13, 2016).

Since 2012, the five GSIBs in our review have submitted plans for their orderly resolution under the Code in the event of their material financial distress or failure. The Federal Reserve and FDIC permitted each GSIB to assume its failure would be caused by idiosyncratic loss events that affected only that one GSIB.[81] As discussed previously, the Federal Reserve and FDIC did not find any deficiencies in the GSIBs' 2017 resolution plans. However, the lack of an identified deficiency does not necessarily mean the resolution plans will work. It remains uncertain if the GSIBs could execute their SPOE strategies successfully, because no GSIB has gone through bankruptcy and tested its resolution plan.

Most of the experts we interviewed said it was somewhat likely or highly likely that a GSIB could execute its SPOE strategy and be resolved in an orderly manner under the Code if the GSIB filed for bankruptcy because of an idiosyncratic event (see table 20). These experts included judges, academics, professional service providers, and a counterparty.

Table 20: Expert Views on the Likelihood That a GSIB Could Execute SPOE and Be Resolved in an Orderly Manner in an Idiosyncratic Event

Responses:

	Highly likely	Somewhat likely	Not likely	Total
Number of experts	11	11	4	26[a]

Source: GAO analysis of structured interview responses. | GAO-19-30

Note: A GSIB is global systemically important bank holding company and generally refers to one of the five GSIBs covered in our review. SPOE is single point-of-entry, a strategy to enter bankruptcy.

[a]Some experts told us that they did not have the knowledge to answer the question or had no opinion about the question. As a result, the total number of expert responses for this question is less than 30.

However, most of the experts we interviewed said it would be unlikely that a GSIB could execute its SPOE strategy and be resolved in an orderly manner under the Code if the GSIB filed for bankruptcy during a widespread market disruption (see table 21). These experts included a judge, academics, professional service providers, and a counterparty.

[81]In past instructions to the GSIBs, regulators stated that the resolution strategy being applied may be based on an idiosyncratic event or action. See Federal Deposit Insurance Corporation and the Board of Governors of the Federal Reserve System, *Guidance for 2013 §165(d) Annual Resolution Plan Submissions by Domestic Covered Companies That Submitted Initial Resolution Plans in 2012,* 8 (2013).

Table 21: Expert Views on the Likelihood That a GSIB Could Execute SPOE and Be Resolved in an Orderly Manner under the Bankruptcy Code in a Widespread Market Disruption

Responses:

	Highly likely	Somewhat likely	Not likely	Total
Number of experts	4	6	15	25[a]

Source: GAO analysis of structured interview responses. | GAO-19-30

Note: A GSIB is global systemically important bank holding company and generally refers to one of the five GSIBs covered in our review. SPOE is single point-of-entry, a strategy to enter bankruptcy.

[a]Some experts told us that they did not have the knowledge to answer the question or had no opinion about the question. As a result, the total number of expert responses for this question is less than 30.

Experts who elaborated on their responses generally told us that the ability of GSIBs to execute their SPOE strategies largely would depend on whether the credit markets were functioning and whether foreign regulators ring fenced. In that regard, some experts (a judge, academics, and professional service providers) who said an SPOE strategy would work in an idiosyncratic failure assumed that GSIBs would have adequate financial resources, credit markets would function, and foreign regulators would not ring fence. Some experts (academics, professional service providers, and a counterparty) said such assumptions likely would not hold true during a widespread financial crisis; thus, a GSIB likely would not be able to execute its SPOE strategy. A few added that the GSIB would need access to a government-sponsored liquidity facility to execute its SPOE strategy during a financial crisis.

In addition, a few experts (academics and professional service providers) commented that it is difficult to determine whether an SPOE strategy would be successful, partly because the circumstances surrounding GSIB failures are unpredictable and SPOE strategies are untested. An academic and a counterparty said that more transparency or information about the GSIBs' SPOE strategies would be helpful in assessing the effectiveness of the strategies. Additionally, some experts (a judge, academics, professional service providers, and counterparties) said that an SPOE strategy would be more effective if the Code was amended by proposals such as those discussed previously.[82]

[82]In particular, some experts referred to the creation of a new chapter in the Code as proposed by a Hoover Institution resolution group at Stanford University. The group's proposed new chapter—Chapter 14—aims to address bankruptcies of large financial companies. For these proposals, see *Bankruptcy Not Bailout: A Special Chapter 14*.

A few experts (academics and a counterparty) said that a GSIB failure could not be an idiosyncratic event because such an event likely would affect other GSIBs. An academic and a professional service provider said that the Code is not suitable for resolving a GSIB. They said regulators most likely would need to resolve a failed GSIB under the Orderly Liquidation Authority.

Finally, some experts (judges, academics, professional service providers, and a counterparty) said it was important to maintain the Orderly Liquidation Authority as a backstop to resolving a GSIB under the Code. For example, a few experts (a judge, service providers and a counterparty) told us the Orderly Liquidation Authority provides the federal government with a helpful tool to address a GSIB failure, such as in an extreme situation. Some experts (academics, professional service providers, and a counterparty) said that, unlike the Code, Orderly Liquidation Authority could be used more effectively by U.S. regulators to address the timing of a GSIB's resolution; provide liquidity to GSIB subsidiaries and, in turn, alleviate creditor and counterparty runs; or coordinate with foreign regulators, such as to avoid ring-fencing.[83] In its 2018 report, the Department of the Treasury recommended retaining the Orderly Liquidation Authority, with additional reforms, to use under extraordinary circumstances, including when bankruptcy may not be feasible. [84]

[83]If private-sector liquidity cannot be obtained to fund an Orderly Liquidation Authority resolution, the Dodd-Frank Act provides for an Orderly Liquidation Fund to serve as a back-up source of liquidity support that would be available only on a fully secured basis and that must be repaid by FDIC. If FDIC were unable to repay borrowings from the Orderly Liquidation Fund from the liquidated assets of the financial company, the funds must be repaid in accordance with the Orderly Liquidation Authority procedures, including, if necessary, through assessments on the financial services industry.

[84]Department of the Treasury, *Orderly Liquidation Authority and Bankruptcy Reform*.

Agency Comments

We provided a draft of this report to the Department of the Treasury, FDIC, the Federal Reserve, and the Office of the Comptroller of the Currency for their review and comment. Department of the Treasury, FDIC, and Federal Reserve staff provided technical comments, which we incorporated, as appropriate.

As agreed with your offices, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days from the report date. At that time, we will send copies to FDIC, the Federal Reserve, the Department of the Treasury, the Office of the Comptroller of the Currency, and other interested parties. In addition, the report is available at no charge on the GAO website at http://www.gao.gov.

If you or your staff members have any questions about this report, please contact Alicia Puente Cackley at (202) 512-8678 or cackleya@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. Major contributors to this report are listed in appendix IV.

Alicia Puente Cackley

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Director, Financial Markets and Community Investment

Appendix I: Objectives, Scope, and Methodology

We reviewed how, if at all, legal and financial obstacles could affect the ability of large financial institutions, if required, to be resolved in an orderly manner under the U.S. Bankruptcy Code (Code).[1] We focused on five global systemically important bank holding companies (GSIB) with large portfolios of derivatives: Bank of America Corporation; Citigroup,

[1]Under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), as amended, entities required to submit resolution plans to the Board of Governors of the Federal Reserve System (Federal Reserve), Federal Deposit Insurance Corporation (FDIC), and the Financial Stability Oversight Council include (i) bank holding companies with $250 billion or more in total consolidated assets; (ii) any bank holding company that has been identified as a global systemically important bank holding company (GSIB); (iii) any bank holding company with total consolidated assets equal to or greater than $100 billion that the Federal Reserve has directed, by order or rule, to submit resolution plans; and (iv) nonbank financial companies designated by the Financial Stability Oversight Council as systemically important. See 12 U.S.C. § 5365(d). The Economic Growth, Regulatory Relief, and Consumer Protection Act, Pub. L. No. 115-174 § 401(a), 132 Stat.1296 (2018), raised the asset threshold for application of the resolution plan requirement in two stages. As of May 24, 2018, immediately after the act’s enactment, bank holding companies with less than $100 billion in total consolidated assets were no longer subject to the resolution plan requirement. Eighteen months after the date of enactment, bank holding companies with total consolidated assets of less than $250 billion (other than any U.S. GSIB) will no longer be subject to the resolution plan requirements, unless the Federal Reserve Board determines, by order or regulation, to apply the requirement to such firms after making certain statutory findings. For purposes of Title I of the Dodd-Frank Act, a bank holding company includes a foreign bank or company treated as a bank holding company under the Bank Holding Company Act of 1956, pursuant to Section 8(a) of the International Banking Act of 1978. See Dodd-Frank Act, Pub. L. No. 111-203, § 102(a)(1), 124 Stat. 1376, 1391 (2010). In 2011, the Federal Reserve and FDIC jointly issued a final rule to implement the resolution plan requirement. See 76 Fed. Reg. 67323 (Nov. 1, 2011). GSIBs are banking organizations whose distress or disorderly failure would cause significant disruption to the wider financial system and economy (because of attributes such as their size, complexity, and interconnectedness).

Inc.; Goldman Sachs Group, Inc.; JPMorgan Chase & Co.; and Morgan Stanley.[2] Specifically, we

- identified and described actions the five GSIBs have taken based on their resolution plans to mitigate financial and legal obstacles to orderly resolution under the Code and regulators' assessment of such actions;
- obtained and analyzed the views of experts on the potential effectiveness of the actions taken by the five GSIBs' to mitigate financial obstacles and the need for any additional actions to further mitigate such obstacles;
- obtained and analyzed the views of experts on the potential effectiveness of the actions taken by the five GSIBs to mitigate legal obstacles and the need for any additional actions to further mitigate such obstacles, and
- obtained and analyzed the views of experts on the likelihood the five GSIBs could be resolved, if needed, under the Code in an orderly manner.

To identify and describe actions the five GSIBs took to mitigate potential obstacles to their resolution under the Code, we reviewed the public sections of the 2017 resolution plans submitted by the five GSIBs listed previously. We focused on the five with large derivative portfolios because of the resolution obstacles posed by such financial contracts. We reviewed these companies' annual financial filings (10-K reports) to analyze actions they took to mitigate potential obstacles to their resolution under the Code. We also interviewed officials from the five GSIBs about their resolution plans and any need for additional actions to mitigate resolution obstacles under the Code.

[2]The Federal Reserve identified eight U.S. bank holding companies as GSIBs: Bank of America Corporation; The Bank of New York Mellon Corporation; Citigroup, Inc.; Goldman Sachs Group, Inc.; JPMorgan Chase & Co.; Morgan Stanley; State Street Corporation; and Wells Fargo & Company. Because derivatives, as qualified financial contracts, can pose a resolution obstacle under the Code, we focused on five GSIBs with large derivatives portfolios. The Federal Reserve and FDIC also identified the five as "dealer firms" and provided them with resolution plan guidance for derivatives and trading activities. See Federal Deposit Insurance Corporation and the Board of Governors of the Federal Reserve System, *Guidance for 2017 §165(d) Annual Resolution Plan Submissions by Domestic Covered Companies That Submitted Resolution Plans in July 2015* (Washington, D.C.: 2016).

To analyze assessments of the five GSIBs' actions to mitigate potential obstacles by the Federal Deposit Insurance Corporation (FDIC) and the Board of Governors of the Federal Reserve System (Federal Reserve), we reviewed

- their joint guidance for the July 2017 resolution plan submissions;[3]
- joint determinations and feedback letters for the July 2017 resolution plans submitted by GSIBs;
- policies and procedures used to review GSIB resolution plans; and
- regulations covering liquidity, total loss-absorbing capacity, and qualified financial contracts (QFC).

We also interviewed staff from FDIC, the Federal Reserve, the Department of the Treasury, and the Office of the Comptroller of the Currency about the GSIBs' resolution plans and any need for additional actions.

To provide background information on large financial institutions and bankruptcy, we reviewed relevant reports issued by GAO and federal agencies, including the Administrative Office of the U.S. Courts, the Department of the Treasury, and Federal Reserve; congressional hearings and testimonies on bankruptcy reform; and relevant studies, articles, or other publications by academics, public policy organizations, and attorneys. We identified such information by conducting a literature search of academic studies, government or federal agency publications, hearings, and industry studies. We searched for keywords using Google Scholar and Google search. We used a combination of key terms, such as "single point-of-entry," "Bankruptcy Code," "Chapter 11," "qualified financial contracts," "safe harbor," and "systemically important financial institutions." We reviewed synopses of the results and retained literature that were relevant to the discussion of GSIB resolution.

To obtain and analyze the views of experts on the effectiveness of the five GSIBs' actions to mitigate potential obstacles, the need for any additional actions, and the likelihood of orderly resolution for a GSIB, we conducted structured interviews with a nongeneralizable sample of 30 individuals or groups of individuals knowledgeable about the resolution of

[3] *Guidance for 2017 §165(d) Annual Resolution Plan Submissions by Domestic Covered Companies That Submitted Resolution Plans in July 2015* (2016).

a large bank holding company under the Code. We identified and selected these individuals based on their published or other publicly available work (identified through our literature review described above); employment history; professional affiliations, such as association memberships or participation on advisory groups; or recommendations by other experts. These considerations jointly informed whether the experts we selected would be knowledgeable or have expertise in issues related to the GSIBs' resolution.

Although a GSIB's resolution under the Code can raise a broad range of complex financial and legal issues, some experts may be knowledgeable about some but not all of the issues. To help ensure that we obtained the views of individuals with different types of expertise and perspectives, we developed four categories of experts and selected individuals falling within each category. The four categories were (1) bankruptcy court judges, (2) academics, (3) providers of professional services to GSIBs, and (4) QFC counterparties. Our definitions for each group are as follows:

- We define judges as those who served or currently serve as a judge on a U.S. Bankruptcy Court. We interviewed 5 judges who oversaw or studied the resolution of large banks.[4]
- We define academics as those who currently teach at a university or are fellows or hold similar positions at think tanks in the area of law, finance, or economics. We interviewed 14 academics who demonstrated their knowledge on resolution plans and changes to the Code to facilitate a GSIB's resolution. We identified these academics through their publications or testimonies on GSIB resolution or related issues.
- We define professional service providers as advisers or providers of services to GSIBs, such as lawyers, consultants, and credit rating agencies. We interviewed 7 professional service providers who demonstrated their knowledge on the GSIB resolution through publications or testimonies.
- We define counterparties as counterparties to qualified financial contracts with financial institutions, including swap dealers. We interviewed 4 such firms, which included hedge and pension funds and banks.

[4]This included three current judges and two former judges, one of whom now works for a law firm.

See appendix II for a list of the individuals or organizations we interviewed about the controls the five GSIBs put in place to mitigate financial and legal obstacles under their single point-of-entry resolution strategies and the need for any additional actions. Because none of the five GSIBs in our review have gone through bankruptcy, the future effectiveness of their controls cannot be known. Absent such evidence, we used the experts as a source of testimonial evidence. Their views or opinions help provide insights about the future effectiveness of the controls. Although we describe the level of agreement or variation among experts for our close-ended questions, agreement among the experts reflects a shared opinion and not necessarily a more accurate prediction of a future outcome. For this reason, we provide additional information about why experts held a particular view or opinion.

We developed our structured interview based on our review and analysis of FDIC and the Federal Reserve's guidance for the GSIBs' July 2017 resolution plans; public sections of the five GSIBs' 2017 resolution plans; and a literature search, which included congressional and other proposals to revise the Code and academic and industry research. We identified proposed amendments to the Code and potential reasons for the amendments from the literature search. In particular, we identified proposals from the Hoover Institution, proposed legislation, and testimonies.[5] In our structured interview, we asked about these proposals, but our questions addressed broad concepts relating to the proposed Code amendments rather than specific provisions that appear in proposed legislation.

Our structured interview included a series of closed-ended and open-ended questions about the GSIBs' controls designed to mitigate financial and legal obstacles, additional actions that could be taken to further mitigate such obstacles, the Code's safe-harbor treatment for QFCs, and the potential effectiveness of the single point-of-entry strategy. We pretested a draft of the structured interview by using it to interview two experts to determine if the respondents understood and answered the questions appropriately. We conducted the structured interviews by

[5]For example, see Thomas H. Jackson, Kenneth E. Scott, and John B. Taylor, eds., *Making Failure Feasible: How Bankruptcy Reform Can End Too Big to Fail* (Stanford, Calif.: Hoover Institution Press, 2015); Kenneth E. Scott and Thomas Jackson, eds., *Bankruptcy Not Bailout: A Special Chapter 14* (Stanford, Calif.: Hoover Institution Press, 2012); *Financial Institution Bankruptcy Act of 2017,* H.R. 1667, 115th Cong. (2017); and *Financial CHOICE Act of 2017,* H.R. 10, 115th Cong. §§ 121-23 (2017).

telephone from February through May 2018. The results from the structured interviews are not generalizable and represent the opinions of only the 30 individuals we interviewed. However, we took steps to obtain opinions from experts with different types of expertise and perspectives.

Our structured interview was divided into eight sections, with each section covering a separate resolution issue and including closed-ended and open-ended questions. During our interviews, we encountered several different response scenarios:

- experts said they had the expertise to answer the section's questions and generally provided responses to the section's close-ended and open-ended questions;
- experts said they had the expertise to answer the section's questions but responded to one or more of the section's closed-ended questions by either selecting the "no opinion" response option or not selecting any of the response options and, in some cases, explaining why; or
- experts said they did not have the expertise to answer the section's questions and skipped all closed-ended and open-ended questions in the section.

Because of the different response scenarios, the total number of experts who provided responses to each question varied by question.

We use the terms "few," "some," "around half," "most," and "almost all" to describe qualitatively the number of experts who provided open-ended and close-ended responses. We defined few as 1–15 percent of the total number of respondents, some as 16–45 percent of the total number of respondents, around half as 46–55 percent of the total number of respondents, most as 56–85 percent of the total number of respondents, and almost all as 86–100 percent of the total number of respondents. For our analysis of close-ended responses, we aggregated the responses that were the same, excluding non-responses or "no opinion" responses for each question. The total number of experts responding to each close-ended question, excluding those who said "no opinion," ranged from 14 to 26. We calculated the percentage of experts with the same answer for each question using the total number of respondents (excluding those who said "no opinion") as the denominator.

For our analysis of open-ended responses, we used NVivo, a software program designed for analyzing qualitative information. For each open-ended response, we coded, organized, and analyzed responses under a number of relevant themes. We included all comments from experts who said they had expertise in a topic area and provided open-ended responses, including those who may have said “no opinion” to a related close-ended response. The total possible number of experts who could provide open-ended responses—the number of experts who said they had expertise on a topic area a section covers—ranged from 25 to 29. We counted the number of experts who provided similar open-ended responses and used the number of possible experts as a denominator to determine the percentage. For an open-ended question to which 25 experts could possibly respond, few would mean 1–4 experts; some would mean 5–11 experts; around half would mean 12–14 experts; most would mean 15–21 experts; and almost all would mean 22–25 experts. We analyzed open-ended responses in a group setting in which three analysts discussed categorizations of the interview responses in detail. Possible alternative categorizations of the material were discussed and resolved jointly. This group-based method constituted our primary approach to validating the results of our analysis. All categorizations were sourced to the original interviews through the use of the NVivo software. Subsequently, a methodologist reviewed the themes to ensure they were logical.

We conducted this performance audit from August 2017 to November 2018 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Appendix II: Experts Who Participated in GAO's Structured Interviews

This appendix lists the experts who participated in GAO's structured interviews. Each of the named persons and institutions listed below agreed to have GAO name them.

Judges

Shelley Chapman, U.S. Bankruptcy Court, Southern District of New York

Allan Gropper, retired judge, U.S. Bankruptcy Court, Southern District of New York

Michelle Harner, U.S. Bankruptcy Court, District of Maryland

James Peck, retired judge, U.S. Bankruptcy Court, Southern District of New York

Mary Walrath, U.S. Bankruptcy Court, District of Delaware

Academics

Robert Bliss, Wake Forest University

Patrick Bolton, Columbia University

Darrell Duffie, Stanford University

Bruce Grohsgal, Widener University

Richard Herring, University of Pennsylvania

Howell Jackson, Harvard University

Thomas Jackson, University of Rochester

Adam Levitin, Georgetown University

Stephen Lubben, Seton Hall University

Mark Roe, Harvard University

David Skeel, University of Pennsylvania

John Taylor, Stanford University

Jay Westbrook, University of Texas

Arthur Wilmarth, Jr., George Washington University

Professional Service Providers

Donald Bernstein and Randall Guynn, Davis Polk & Wardwell

Richard Levin, Jenner & Block

Stephen Hessler and Anthony Grossi, Kirkland and Ellis

Jim Millstein, Guggenheim Securities

John Bovenzi, Oliver Wyman

PricewaterhouseCoopers[1]

A credit rating agency[2]

Counterparties[3]

California Public Employees' Retirement System

Convexity Capital Management

[1]The professional service provider asked us not to identify the employees we interviewed.

[2]The credit rating agency asked us not to identify it by name.

[3]The counterparties asked us not to identify the employees we interviewed.

PNC Financial Services

U.S. Bancorp

Appendix III: Expert Views on Systemic Risk and Amending the Safe-Harbor Provisions for Qualified Financial Contracts under the U.S. Bankruptcy Code

Qualified Financial Contracts (Safe-Harbor Provisions) in the U.S. Bankruptcy Code

Certain financial derivatives, repurchase agreements, and other qualified financial contracts (QFC) receive special treatment, called safe-harbor provisions, under the U.S. Bankruptcy Code (Code).[1] The safe-harbor provisions exempt QFCs from some of the Code's principal debtor protections.

- First, the safe-harbor provisions generally allow counterparties to QFCs to exercise their contractual rights, even if doing so otherwise would violate the Code's automatic stay provisions. This allows a counterparty to terminate its QFCs or exercise other default rights based on its counterparty's filing, which otherwise would be prohibited.
- Second, the provisions that exempt QFCs from the automatic stay allow counterparties to offset and net out the amounts owed to and from the debtor under their QFCs into a single net amount owed to or from the debtor. It also may allow counterparties to liquidate collateral backing the QFCs to cover any losses.

[1]The Code does not define a QFC or use the term specifically. Instead, the Code defines the types of contracts covered by the safe-harbor provisions. The safe-harbor provisions were first added to the Code in 1982 for forward contracts, commodity contracts, and security contracts. Over time, Congress expanded the types of contracts covered to include swap agreements, repurchase agreements, and master netting agreements.

- Third, the provisions exempt certain transfers from preferential and fraudulent transfer liability. This allows counterparties to terminate their QFCs with the confidence that they will not be avoided later by the bankruptcy judge.

According to the legislative history, QFC safe-harbor provisions are consistent with the policy goal to reduce systemic risk. According to a study by the Board of Governors of the Federal Reserve System, there was concern that without safe harbor provisions, counterparties that entered into QFCs with the debtor would be exposed to such a high degree of uncertainty—leading to a lack of liquidity—that it would pose a potential for systemic risk.[2] For example, there was concern that the debtor's failure could cause spillover effects with its QFC counterparties, which then could significantly impair other QFC counterparties and the market more broadly.

Expert Views on Systemic Risk and Amending the Code's Safe-Harbor Provisions for QFCs

As part of our review of the potential legal and financial obstacles that a global, systemically important bank holding company could face in executing its single point-of-entry strategy under the Code, we asked experts two questions on the Code's safe-harbor provisions for QFCs.

First, we asked experts to what extent eliminating the Code's safe harbors for QFCs would increase or decrease systemic risk. As shown in table 22, a few of the experts who responded said that such action would greatly increase systemic risk. These experts included a judge, academics, and a counterparty. The table also shows that around half of the experts who responded said that such action would greatly decrease systemic risk. These experts included a judge, academics, and professional service providers.

[2] Board of Governors of the Federal Reserve System, *Study on the Resolution of Financial Companies under the Bankruptcy Code* (Washington, D.C.: July 2011).

Table 22: Expert Views on the Systemic Risk Effect of Eliminating the U.S. Bankruptcy Code's Safe-Harbor Provisions for Qualified Financial Contracts

Responses:

	Greatly increase	Somewhat increase	No effect	Somewhat decrease	Greatly decrease	Total
Number of experts	4	2	1	6	11	24[a]

Source: GAO analysis of structured interviews with experts. | GAO-19-30

[a]Some experts told us that they did not have the knowledge to answer or had no opinion. As a result, the total number of expert responses for this question is less than 30.

Second, we asked experts whether the Code's QFC safe-harbor provisions should be repealed in full or in part (such as by excluding certain types of QFCs). As show on table 23, most of the experts who responded said such action should be taken. The experts included judges, academics, and professional service providers. In comparison, some experts who responded said the safe harbors should not be repealed. The experts included a judge, an academic, a professional service provider, and counterparties.

Table 23: Expert Views on Whether the U.S Bankruptcy Code's Safe-Harbor Provisions for Qualified Financial Contracts Should Be Repealed in Whole or in Part

Responses:

	Yes, repeal in full	Yes, repeal in part	No repeal	Total
Number of experts	8	11	5	24[a]

Source: GAO analysis of structured interviews with experts. | GAO-19-30

[a]Some experts told us that they did not have the knowledge to answer the question or had no opinion about the question. As a result, the total number of expert responses for this question is less than 30.

A few experts (a professional service provider and three counterparties) indicated that the QFC safe harbors should be preserved, in part to reduce systemic risk. A counterparty said that eliminating the safe harbors would cause counterparties to run (exit their QFCs with a GSIB) earlier than they otherwise would, which could disrupt the financial markets. Another counterparty said that counterparties would face risk and uncertainty if their QFCs were tied up in bankruptcy because they would not be able to hedge their risks with certainty. Similarly, a third counterparty said that the safe harbors are important to the safety and soundness of the derivatives markets and changing the safe harbors would be crippling to the industry and harm commercial firms that use derivatives. A professional service provider said the safe harbors should draw a distinction between counterparties whose QFC portfolios do or do not pose systemic risk and only apply to the latter since their QFCs can be easily replaced.

Based on the views of some experts (judges, academics, and professional service providers), the Code's QFC safe harbors have become too broad with potentially negative consequences. For example, a judge and three professional service providers said that the expansion of safe harbors over time has increased systemic risk, such as by increasing the size of the QFC markets, promoting greater speculation, or reducing counterparty monitoring. In contrast, a professional service provider said that the safe harbors do not reduce counterparty monitoring, because QFCs are collateralized and that collateralization depends on the creditworthiness of the counterparties. In addition, two academics commented that the safe harbors provide different treatment for similar credit instruments (such as loans) and, thus, transfer credit risk from QFC counterparties to non-QFC counterparties. Finally, two academics said that the safe harbors might make the bankruptcy process less effective or riskier by excluding QFCs from the bankruptcy process.

Based on the views of some experts (a judge, academics, and a professional service provider), narrowing the safe harbors could increase systemic risk in the short term by disrupting the QFC markets or decrease systemic risk in the long term by causing QFC markets to shrink. They generally commented that safe harbors have become part of or ingrained in QFCs. In that regard, an academic said that changes to the safe harbors would take years to work through the QFC markets and have a significant and potentially detrimental effect on counterparties. A judge said that the safe harbors could be narrowed over time to allow the markets to adjust gradually and minimize any negative effects.

Some experts (academics and professional service providers) said that recent developments have reduced the need for the QFC safe harbors. For example, an academic said that the safe harbors are less critical today because the 2015 Universal Resolution Stay Protocol of the International Swaps and Derivatives Association and QFC rules reduce the systemic risk posed by QFCs under a GSIB failure.[3] Similarly, a service provider said that a full repeal of the Code's QFC safe harbors

[3]As previously discussed, the 2015 protocol enables parties to voluntarily amend the terms of their protocol-covered agreements to contractually recognize the cross-border application of special resolution regimes applicable to certain financial companies and support the resolution of certain financial companies under the Code.

would maintain what has been put in place by the 2015 protocol and related actions. In addition, two academics said that the central clearing requirement for many QFCs in the Dodd-Frank Wall Street Reform and Consumer Protection Act reduces the need for the safe harbors, partly because the clearinghouse avoids liquidity disruptions by acting as the guarantor for all parties in a QFC.

Appendix IV: GAO Contact and Staff Acknowledgments

GAO Contact

Alicia Puente Cackley, (202) 512-8678 or CackleyA@gao.gov.

Staff Acknowledgments

In addition to the contact name above, Richard Tsuhara (Assistant Director), Weifei Zheng (Analyst in Charge), Caitlin Cusati, David Dornisch, Jill Lacey, Barbara Roesmann, Jena Sinkfield, Tyler Spunaugle, and Jason Wildhagen made significant contributions to this report.

Appendix V: Accessible Data

Data Tables

Data Table for Projected Minimum Total Loss-Absorbing Capacity

Financial Institution	Tier 1 capital	Minimum long-term debt	Other long-term debt or tier 1 capital
Bank of America	11	8.5	3
Citigroup	11.5	9	2
Goldman Sachs	11	8.5	2.5
JP Morgan Chase	12	9.5	1.5
Morgan Stanley	11.5	9	1

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