JEB HENSARLING, TX , CHAIRMAN

United States House of Representatives
Committee on Financial Services
Washington, D.C. 20515

MAXINE WATERS, CA, RANKING MEMBER

M E M O R A N D U M

To: Members of the Committee on Financial Services

From: Financial Services Committee Majority Staff

Date: June 21, 2013

Subject: June 26, 2013, Full Committee hearing entitled "Examining How the Dodd-Frank Act Could Result in More Taxpayer-Funded Bailouts"

The Committee on Financial Services will hold a hearing entitled "Examining How the Dodd-Frank Act Could Result in More Taxpayer-Funded Bailouts" on June 26, 2013, at 10:00 a.m. in room 2128 of the Rayburn House Office Building. This hearing will focus on the broad contours of Titles I and II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. No. 111-203) (the "Dodd-Frank Act") and will examine whether these provisions achieve Dodd-Frank's stated objective of eliminating the possibility of taxpayer-funded support of large, complex financial institutions.

This will be a one panel hearing with the following witnesses:

- The Honorable Thomas Hoenig, Vice Chairman, Federal Deposit Insurance Corporation
- Mr. Richard W. Fisher, President and CEO, Federal Reserve Bank of Dallas
- Mr. Jeffrey Lacker, President and CEO, Federal Reserve Bank of Richmond
- The Honorable Sheila Bair, Chair, Systemic Risk Council, Pew Charitable Trust

Title I of the Dodd-Frank Act: "Financial Stability"

Title I of the Dodd-Frank Act contains provisions intended by its supporters to mitigate systemic risk caused by large financial institutions and to end the phenomenon of "too big to fail" ("TBTF").[1] The provisions of title I that are relevant to this hearing are described below.

Financial Stability Oversight Council and Dodd-Frank Act Section 113

Title I established the Financial Stability Oversight Council (FSOC) and charged it with identifying "risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace;"

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[1] For example, during debate on the House Floor, Rep. Barney Frank, then the Chairman of the Financial Services Committee and the co-author of the Dodd-Frank Act, stated: "No institution will be too big to fail under [the Dodd-Frank Act]." CONG. REC. H4290 (daily ed. June 9, 2010). Speaking on the Senate Floor, Sen. Christopher Dodd said: "To review, our bill imposes tougher standards on large, risky Wall Street firms. It eliminates the Federal Government's capacity to bail out individual companies." CONG. REC. S2260 (daily ed. March 26, 2010). These assessments were echoed by then-Speaker of the House Nancy Pelosi: "[The Dodd-Frank Act] makes commonsense reforms that end the era of taxpayer bailouts and "too big to fail" financial firms." CONG. REC. H5252 (daily ed. June 30, 2010).

eliminating expectations that the federal government will bail out such companies in the event of failure; and responding to emerging threats to the stability of the financial system of the United States.[2] To carry out its mandate, the Dodd-Frank Act confers a number of duties and powers upon the FSOC. Section 113, for example, authorizes the FSOC to identify U.S. and foreign nonbank financial institutions whose failure or activities "could pose a threat to the financial stability of the United States" and requires these institutions to be supervised by the Federal Reserve upon designation by the FSOC as a "systemically important financial institution."[3]

Dodd-Frank Act Section 121: "*Mitigation of the Risks to Financial Stability*"

Section 121 of the Dodd-Frank Act requires the Federal Reserve Board, in certain circumstances, to impose limits on the activities of large financial companies to mitigate "grave threats" to the financial system of the United States.[4] Subsection (a) directs the Federal Reserve to require a bank holding company with total consolidated assets of $50 billion or more or a nonbank financial company supervised by the Federal Reserve (collectively, "covered companies"), to undertake certain measures if the Federal Reserve determines that the company poses a grave threat to the financial stability of the United States.

Dodd-Frank Act Section 165: "Enhanced Prudential Standards" and "Resolution Plans"

Section 165 of Dodd-Frank requires the Federal Reserve to establish stricter prudential standards for covered companies.[5] Congress authorized the Federal Reserve to impose these standards "[i]n order to prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected financial institutions."[6] Section 165 also requires covered companies to submit resolution plans known as "living wills," which must demonstrate how a covered company could be resolved under the Bankruptcy Code without posing systemic risk to the financial system of the United States and without requiring government assistance.[7]

If the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) jointly determine that a company's living will is not credible or would not facilitate an orderly resolution of the covered company under the Bankruptcy Code, the covered company must resubmit a revised living will.[8] If a covered company fails to submit an acceptable revised living will in a timely manner, subsection (d)(5)(A) provides that the Federal Reserve and the FDIC "may jointly impose

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[2] Dodd-Frank Wall Street Reform and Consumer Protection Act [*hereinafter* "Dodd-Frank Act"] § 112(a), 12 U.S.C. 5322 (2012).

[3] For more information on the statutory responsibilities of the FSOC under the Dodd-Frank Act, see the hearing memorandum for the March 14, 2013, Subcommittee on Oversight and Investigations hearing entitled "Who is Too Big to Fail? GAO's Assessment of the Financial Stability Oversight Council and the Office of Financial Research" *available at* http://financialservices.house.gov/uploadedfiles/031413_oversight_memo.pdf.

[4] Dodd-Frank Act § 121, 12 U.S.C. 5331 (2012). For more information on sections 121 and 165 of the Dodd-Frank Act, see the hearing memorandum for the April 16, 2013, Subcommittee on Oversight and Investigations hearing entitled "Who is Too Big to Fail: Does Dodd-Frank Authorize the Government to Break Up Financial Institutions?" *available at* http://financialservices.house.gov/uploadedfiles/041613_committee_memo.pdf.

[5] Dodd-Frank Act § 165, 12 U.S.C. 5365 (2012). For more information on section 165, *see* note 4, *supra*.

[6] *Id.* § 165(a)(1).

[7] *Id.* § 165(d). For the regulations promulgated under this statute, *see* 12 C.F.R. §§ 381.1-381.9 (2013).

[8] *Id.* § 165(d)(4).

more stringent capital, leverage, or liquidity requirements, or restrictions on the growth, activities, or operations of a covered company[.]" Subsection 165(d)(5)(B) further provides that the Federal Reserve and the FDIC "may jointly direct a [covered company], by order, to divest certain assets or operations . . . to facilitate an orderly resolution" of the company in bankruptcy whenever more stringent requirements have been imposed under §165(d)(5)(A) and the covered company has failed to submit a credible living will within two years from the date on which such requirements were imposed.

The Federal Reserve and the FDIC have required covered companies to begin submitting living wills in three groups under a staggered schedule. The largest, most complex companies were to submit their living wills by July 1, 2012.[9] To date, the Federal Reserve and the FDIC have not determined that any living will submitted by the first group is deficient. Covered companies in the second group will submit living wills by July 1, 2013, and the third group of covered companies will submit living wills by December 31, 2013.[10]

Title II of the Dodd-Frank Act: Orderly Liquidation Authority

Title II of the Dodd-Frank Act contains provisions that, according to the law's supporters, are designed to facilitate the orderly resolution of a systemically significant bank or nonbank financial institution. In an orderly liquidation proceeding under Title II, the FDIC acts as the receiver for a systemically significant financial institution, following a determination by the Treasury Secretary and a written recommendation of the FDIC's board of directors and the Federal Reserve Board that the financial institution is in default or danger of default and that the failure of the institution would have serious adverse effects on the financial stability of the economy of the United States. The Dodd-Frank Act provides that the so-called Orderly Liquidation Authority (OLA) must be exercised so that: (1) the creditors and shareholders of the failed institution bear the losses of the financial company; (2) the management responsible for the condition of the financial company will not be retained; and (3) all parties, including management, directors, and third parties, will bear losses consistent with their responsibility for the condition of the financial company, including through actions for damages, restitution, and recoupment of compensation.[11]

Initiating the Orderly Liquidation Process

Section 201: Definition of a Covered Financial Company

Only a "covered financial company" may be resolved under the OLA. The Dodd-Frank Act defines a financial company as any company that is: (1) a bank holding company; (2) a nonbank financial company supervised by the Federal Reserve; (3) a company predominantly engaged in activities that are financial in nature or incidental thereto; or (4) a subsidiary of any company that is itself predominantly engaged in financial activities (other than an insured depository institution or an insurance company).[12] The FDIC, in consultation with the Treasury Secretary, is required to issue criteria specifying what constitutes "predominantly engaged" in "financial activities" for

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[9] 12 C.F.R. § 381.3(a)(i).
[10] *Id.* § 381.3(a)(ii).
[11] Dodd-Frank Act § 204(a).
[12] *Id.* § 201(a)(11).

purposes of determining whether a firm is a "financial company."[13] A final rule on this definition was published in the Federal Register on June 10, 2013.[14]

Section 203(a): Written Recommendation and Vote of Federal Reserve Board and FDIC Board

To initiate the OLA with respect to a given financial institution, Title II requires that two-thirds of the Federal Reserve Board and two-thirds of the board of directors of the FDIC vote to make a written recommendation to the Treasury Secretary to appoint the FDIC as receiver of the company. (For broker-dealers, two-thirds of the commissioners of the Securities and Exchange Commission must vote to make a written recommendation, in addition to a two-thirds vote of the Federal Reserve Board. For insurance companies, two-thirds of the Federal Reserve Board must vote to make a written recommendation, with the approval of the Director of the Federal Insurance Office at the Treasury Department and in consultation with the FDIC.) The written recommendation must evaluate a number of factors, including whether the financial company is "in default or danger of default;" the effect that the company's failure would have on financial stability in the United States; the effect of the company's failure on the economic condition or financial stability of low-income, minority or underserved communities; the likelihood of a private sector alternative to prevent default; and an evaluation of why the company cannot be reorganized or liquidated under the Bankruptcy Code.

Section 203(b): Determination of Treasury Secretary to Appoint FDIC as Receiver

After the Treasury Secretary receives a written recommendation to appoint the FDIC as receiver for the company, the Secretary must make additional determinations before the company can be placed in OLA. The Treasury Secretary, in consultation with the President, must determine that: (1) the financial company is "in default or in danger of default"; (2) the failure of the financial company and its resolution under otherwise applicable insolvency laws would have serious adverse effects on financial stability; (3) no viable private sector alternative is available; (4) the effect on the claims of creditors, counterparties and shareholders is appropriate; (5) any action under section 204 would avoid or mitigate certain adverse effects; (6) a Federal regulatory agency has ordered the financial company to convert all of its convertible debt instruments; and (7) the company satisfies the definition of "financial company" contained in the statute. The Treasury Secretary must document its determination regarding whether a financial company should be placed into receivership, retain the documentation for review, and notify the FDIC and the financial company of his determination.[15]

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[13] *Id.* § 201(b).

[14] Definition of 'Predominantly Engaged in Activities That Are Financial in Nature or Incidental Thereto,' 78 Fed. Reg. 34,712 (June 10, 2013) (to be codified at 12 C.F.R. pt. 380).

[15] Dodd-Frank Act § 203(c)(1). Section 203(c) also requires Treasury to make several reports to Congress following a determination. Within 24 hours of the FDIC's appointment as receiver, the Treasury Secretary must provide written notice of the recommendations required under Section 203(a) and the determination by the Treasury Secretary under Section 203(b), to Congressional leadership. The notice must summarize the basis for the determination. Within 60 days of being appointed receiver, the FDIC must submit a report to Congress describing the financial condition of the company, the FDIC's plan to wind down the company, the expected cost of the orderly liquidation and the reasons for any use of the Orderly Liquidation Fund, any differential treatment among similarly situated creditors, any additional payments, and any instance in which the FDIC waived any conflict of interest. The FDIC and the covered financial company's primary financial regulatory agency, if any, must appear before Congress, if requested, not later than 30 days after the date on which the FDIC files the required report. The report must be posted on the FDIC's website and updated quarterly.

Funding and Operations of the Orderly Liquidation Authority

Section 204(d): Funding for Orderly Liquidation Authority

The FDIC may, subject to certain limitations, make funds available for the orderly liquidation of a covered financial company. Among other things, the FDIC can use these funds to make loans to, or purchase the debt of, the covered financial company or any covered subsidiary; purchase or guarantee against loss the assets of the covered financial company or any covered subsidiary; assume or guarantee the obligations of the covered financial company or any covered subsidiary to one or more third parties; sell or transfer all, or any part, of such acquired assets, liabilities, or obligations of the covered financial company or any covered subsidiary; or make payments to creditors of the covered financial company or any covered subsidiary. Funds spent by the FDIC for the orderly liquidation of a covered financial company have priority over other unsecured claims against the company.

Section 210: Orderly Liquidation Fund, Orderly Liquidation Plan and Assessments to Repay the Orderly Liquidation Fund

Title II establishes the Orderly Liquidation Fund within the Treasury of the United States. Upon appointment as receiver, the FDIC has the authority to fund the costs of resolving a covered financial company by issuing obligations eligible for purchase by Treasury, up to a maximum amount for each covered financial company equal to: (1) during the 30-day period immediately following the appointment of the receiver, 10% of the covered financial company's total consolidated assets, based on its most recent financial statements available; and (2) after such 30-day period, 90% of the fair value of the company's total consolidated assets that are available for repayment.[16] The FDIC may not use any of its funding as receiver for any covered financial company unless and until such company has submitted an orderly liquidation plan for such company that is acceptable to the Treasury Secretary.[17] The FDIC and the Treasury Secretary must reach an agreement on the schedule for the repayment of borrowings from Treasury.[18]

The assets from a failed firm must be sufficient to repay to the Orderly Liquidation Fund any funds advanced. If a shortfall remains, then the FDIC is required to recover the shortfall by imposing graduated risk-based assessments upon "eligible financial companies" (defined as any bank holding company with total consolidated assets of $50 billion or more and any nonbank financial company designated as systemically important by the inter-agency FSOC) and financial companies with total consolidated assets of $50 billion or more. The FDIC must notify each financial company that is subject to such assessments, and any such financial company must pay the assessment.[19] The assessments must be used by the FDIC to repay its borrowings from Treasury within 60 months, or such longer period as approved by Treasury.[20] The FDIC may also

[16] *Id.* §§ 210(n)(5), (6).
[17] *Id.* § 210(n)(9)(B)(i). Section 210(n)(9)(B)(ii) also requires the FDIC and Treasury to report to Congress on this repayment plan. According to this section of the statute, the FDIC and Treasury Secretary must "consult with the Committee on Banking, Housing and Urban Affairs of the Senate and the Committee on Financial Services of the House of Representatives on the terms of the repayment schedule agreement," and must "submit a copy of the repayment schedule" to the Congressional committees no later than 30 days after the date on which any amount is provided to the FDIC by the Treasury Secretary.
[18] *Id.* § 210(n)(9)(B)(i).
[19] *Id.* § 210(o)(3).
[20] *Id.* § 210(o)(1-3).

recoup compensation from senior executives who are responsible for the failure of a covered financial company to recapitalize the Orderly Liquidation Fund.[21] If necessary, the FDIC can impose assessments "as soon as practicable" on any claimant that received more than what such claimant would be entitled to receive in a chapter 7 bankruptcy liquidation or in a Securities Investor Protection Corporation proceeding, except where the excess payments were deemed necessary to receivership or a bridge financial company.[22]

Other Provisions of Section 210: Bridge Financial Companies and Creditors Similarly Situated

As receiver for a failed financial company or in anticipation of becoming the receiver of such a company or companies, the FDIC may organize a bridge financial company which can assume liabilities of a covered company or companies, purchase assets of a covered company or companies, or perform any other function that the receiver deems appropriate.[23] The FDIC may grant a federal charter for a bridge financial company; however, Title II provides that a bridge financial company has no federal agency status and that its employees are not employees of the United States.[24] Title II also provides that a bridge financial company must terminate at the end of the two-year period following the date it was chartered. At its discretion, the FDIC can authorize three one-year extensions of this deadline.[25]

Title II requires that all creditors similarly situated in terms of priority of claims must be similarly treated, unless the FDIC determines it is necessary to treat them differently to accomplish one of the following goals: (1) to maximize the value of the assets of the covered financial company; (2) to initiate and continue operations essential to implementation of the receivership or any bridge financial company; (3) to maximize the present value return from the sale or other disposition of the assets of the covered financial company; or (4) to minimize the amount of any loss realized upon the sale or other disposition of the assets of the covered financial company.[26]

Section 214: Prohibition on Taxpayer Funding

Title II includes provisions that are supposed to prevent taxpayer-funded bail-outs. Section 214(a) provides that "no taxpayer funds may be used to prevent the liquidation of any financial company under this title." Section 214(b) requires that all funds expended in the liquidation of a covered financial company be recovered from the disposition of assets or through assessments on the financial sector. Section 214(c) provides that "taxpayers shall bear no losses from the exercise of any authority" under Title II.

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[21] *Id.* § 210(s). According to this section of the statute, the FDIC must issue rules to govern the FDIC's power to recover up to two years of compensation, or for an unlimited time period in the case of fraud, "from any current or former senior executive or director substantially responsible" for the failure of a covered financial company.
[22] *Id.* § 210(o)(1)(D)(i).
[23] *Id.* §§ 210(a)(1)(F), (h)(1).
[24] *Id.* §§ 210(h)(2), (8).
[25] *Id.* § 210(h)(12).
[26] *Id.* § 210(b)(4).