Senate Judiciary Committee
"Big Bank Bankruptcy: 10 Years After Lehman Brothers"
Response of Donald S. Bernstein to
Questions for the Record
November 13, 2018

QUESTION FROM SENATOR KLOBUCHAR

Question for Mr. Bernstein, Partner at Davis Polk & Wardwell LLP

- When Lehman Brothers collapsed, the impact was felt across the globe because Lehman had significant investments and counterparties located outside of the United States. In your experience as a practitioner, are U.S. bankruptcy courts positioned to consider and resolve claims made by foreign creditors?

RESPONSE: To serve their customers and counterparties, global financial institutions operate in key financial markets domestically and in multiple foreign jurisdictions, including in Europe, Asia, Latin America and other parts of the world. As a result, foreign parties are likely to be creditors of a global financial institution's domestic operations, and, more significantly for purposes of the orderly resolution of the firm in a distress scenario, the firm is likely to have foreign bank branches, as well as foreign bank and broker-dealer subsidiaries, each with its own local, non-U.S. depositors, creditors and counterparties.

U.S. bankruptcy courts are well equipped to address claims made by non-U.S. creditors against a failed global financial institution's domestic subsidiaries that become subject to bankruptcy proceedings in the United States because such entities have their principal operations and assets in the United States. However, because a financial institution's foreign bank branches and foreign bank and broker-dealer subsidiaries operate and have their assets outside the United States, such entities must be resolved in accordance with local resolution procedures under foreign law rather than in the United States. Accordingly, resolution procedures with respect to such entities typically would be commenced by and proceed under the supervision of local judicial or regulatory authorities and/or locally appointed fiduciaries, and such procedures will inevitably be more protective of the local interests of the host country than the interests of the home country (in this case, the United States). In particular, such procedures will be focused on local systemic impacts and the recoveries of local creditors, rather than systemic impacts or creditors in the United States.

A "multiple point of entry" resolution process like the one used for Lehman Brothers, with each domestic and foreign entity separately utilizing the locally applicable resolution procedure, can destroy value and be systemically disruptive. In the case of Lehman, there were multiple, uncoordinated, insolvency proceedings controlled by diverse parties with conflicting interests, which greatly amplified the adverse systemic impact, in both the United States and other countries, of the failure of Lehman Brothers. For example, while Lehman's U.S. operations were wound down in U.S. bankruptcy proceedings, the liquidation of the firm's large U.K. broker-dealer was separately administered by liquidators appointed in the U.K. In a number of instances, the U.K. liquidators were obliged to take actions in resolution that were adverse to Lehman Brothers in the United States, resulting in increased systemic disruption and a significant loss of value in the United States.

The "single point of entry" resolution approach adopted by TPRRA is designed to avoid the harm resulting from this kind of balkanization of a global financial institution in resolution. In a single point of entry resolution of a U.S.-based global financial institution, bankruptcy proceedings would be commenced only against the domestic bank holding company — the top-tier parent — of the financial institution's global group. The material domestic and foreign operating subsidiaries of the firm would remain outside of bankruptcy proceedings, they would be recapitalized and they would either continue in business or be wound down outside of resolution. This would facilitate the orderly, value-maximizing resolution of the firm in a manner that minimizes the systemic disruption resulting from the firm's failure, both in the United States and globally. In addition, as described in my written testimony, in a single point of entry resolution the failing financial institution's losses would be borne by structurally subordinated private sector equity and debt holders of the firm's bankrupt parent holding company rather than by taxpayers.

Avoiding the systemic disruption caused by the commencement of multiple separate resolution proceedings with respect to each domestic and foreign branch and operating subsidiary of a global financial institution through use of a single point of entry resolution procedure is one of the most significant benefits TPRRA.

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QUESTIONS FROM SENATOR BOOKER

1. In light of the massive liquidity needs of the largest global financial institutions, do you believe that the liquidity needs of the recapitalized bridge company of such an institution could realistically be satisfied through private sector lending alone, during the immediate period that such a bridge company re-opened for business after the brief Chapter 14 bankruptcy procedure? On what evidence do you base your judgement?

RESPONSE: It is anticipated that, for some period of time after the non-bankrupt material subsidiaries of a large global financial institution are transferred to a bridge company under Chapter 14, private sector lending alone will not be sufficient to satisfy the liquidity needs of the ongoing firm. For this reason, among others, the FDIC and the Federal Reserve require the largest global financial institutions to maintain a sufficient amount of excess high quality liquid assets (HQLAs) on their balance sheets to satisfy three separate liquidity requirements—a liquidity coverage ratio (LCR) requirement,[1] a resolution liquidity adequacy and positioning (RLAP) requirement,[2] and a resolution liquidity execution need (RLEN) requirement.[3] The LCR and RLAP requirements set minimum benchmarks for the firm's liquidity resources during ordinary course operations,[4] and the RLEN requirement sets a minimum benchmark for firm's liquidity resources at the time of resolution,[5] in order to ensure that a financial institution in need of resolution will commence bankruptcy proceedings when it still has enough cash, U.S. Treasuries and other HQLAs to satisfy the recapitalized firm's liquidity needs until sufficient sources of external funding become

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[1] See 12 C.F.R. Part 249, Subpart B for the Federal Reserve's LCR requirement and 12 C.F.R. Part 329, Subpart B for the FDIC's LCR requirement; *see also* 12 C.F.R. Part 50 establishing a parallel OCC LCR requirement for large national banks and Federal savings associations.
[2] Federal Reserve and FDIC, Guidance for 2017 §165(d) Annual Resolution Plan Submissions By Domestic Covered Companies that Submitted Resolution Plans in July 2015 (the "2017 Guidance") at 6. In June 2018, the Federal Reserve and FDIC issued proposed 2019 resolution plan guidance, which would amend the 2017 Guidance (*see* 83 Fed. Reg. at 32,856). However, the proposed amendments would affect neither the RLAP requirement nor the RLEN requirement referenced in footnote 3. below.
[3] 2017 Guidance at 7.
[4] *See* footnote 1. above regarding the LCR; *see* 2017 Guidance at 6-7 regarding the RLAP requirement.
[5] *See* 2017 Guidance at 7-8.

available.

The LCR, which is publicly reported, requires a firm to maintain an amount of HQLAs at least equal to 100% of the net outflows during a severe 30-day stress period based on standardized net outflow assumptions established by U.S. regulators. RLAP, which typically exceeds the LCR requirement, requires a firm to maintain an amount of HQLAs that takes into account the firm's anticipated net outflows during a hypothetical future resolution scenario based on projections subject to review by the FDIC and the Federal Reserve.[6] Because of these requirements, the largest U.S. financial institutions currently maintain substantially more liquidity on their balance sheets than they need in the ordinary course of their business.

RLEN requires a firm to project on a real time basis during an actual period of severe stress the anticipated net outflows during a resolution of the firm in bankruptcy should it become necessary, including any period during which the firm does not expect to have access to external lending sources.[7] After the onset of financial distress, the distressed financial institution would be required to track on a real-time basis the amount by which the firm's HQLAs and other internal liquidity resources exceed regularly updated projections of RLEN. If internal liquidity resources decline to the point where they are approaching the RLEN projected to be required for successful resolution of the firm, the firm's bank holding company would be required to commence bankruptcy proceedings and dedicate the firm's remaining liquidity resources to the continuation or orderly wind down of the firm's non-bankrupt operating subsidiaries.

As a component of their resolution plans filed under Section 165(d) of the Dodd-Frank Act, the largest U.S. financial institutions are implementing the RLEN requirement by memorializing the HQLA/RLEN trigger in the legally binding secured support agreements referred to in my written testimony.[8] The real time comparison of available HQLAs to RLEN has thus been made integral to the resolution plans of the largest U.S. financial institutions in order to assure the timely commencement of bankruptcy proceedings with respect the firm's bank holding company should it become necessary.

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[6] The 2017 Guidance states that a firm should be able to measure the stand-alone liquidity position of each material entity based on a model that covers a period of at least 30 days and reflects the idiosyncratic liquidity profile and risk of the firm, *see* 2017 Guidance at 7.
[7] 2017 Guidance at 7.
[8] Statement of Donald S. Bernstein Before the Committee on the Judiciary, United States Senate (Nov. 13, 2018) at 5.

It should be noted that resolution of a global financial institution under Chapter 14 should facilitate access of the firm's recapitalized operating subsidiaries to private sector lending. First, execution in Chapter 14 of the single point of entry (SPOE) resolution strategy by a prompt transfer of the bankrupt holding company's non-bankrupt operating subsidiaries to a new, non-bankrupt debt-free bridge company owned by a private special trust will leave behind the former holding company's capital structure debt (largely structurally subordinated bond debt), thereby reducing the amount of debt service payable by the recapitalized firm. In addition, Chapter 14 provides that after a qualifying transfer to a bridge company, financial contracts of the firm's operating subsidiaries may not be terminated by counterparties, thereby eliminating the immediate drain on liquid assets that would result from such terminations, as well as the dumping of collateral for such transactions on the market and the resulting dissipation of the value of the financial contract portfolio of the ongoing firm. These and other elements of Chapter 14 should help to stabilize the liquidity of the ongoing firm with greater speed and certainty than would be the case under current law.

Finally, as noted in my written testimony,[9] while the requirements to maintain excess internal liquidity and to commence bankruptcy proceedings when available liquidity resources still exceed RLEN will reduce the risk that the recapitalized subsidiaries will run out of liquidity before regaining access to private sector lending, I strongly support retaining Title II of the Dodd-Frank Act — Orderly Liquidation Authority (OLA) — as a back-up resolution procedure should access to additional liquidity be required for the orderly resolution of a large U.S. financial institution. I believe the existence of OLA will provide market participants and foreign regulators with additional confidence in the probability of a successful SPOE resolution of the firm under Chapter 14, and make it more likely that access to private sector lending sources will return quickly to the operating subsidiaries transferred to the bridge company, thereby reducing the likelihood that OLA will ever need to be invoked.

[9] *Id.*

a. If these liquidity needs were not met, and the bridge company failed, would this increase or decrease negative effects on the broader financial system as compared to a scenario where the initial resolution had been performed through Dodd-Frank Title II Orderly Liquidation Authority? In what ways would undergoing a failed TPRRA procedure make use of Title II Orderly Liquidation Authority more difficult?

RESPONSE: I do not believe that a failed TPRRA procedure would make use of OLA more difficult. After the commencement of the resolution process and transfer of the firm's operating subsidiaries to a bridge company, if the recapitalized operating subsidiaries fail to regain access to private sector lending after a reasonable period of time, OLA could be invoked and the necessary additional liquidity could be provided by the FDIC through the orderly liquidation fund (OLF). Such a scenario would undoubtedly reflect a lack of market confidence in the recapitalized operating subsidiaries of the firm, and, if such a lack of confidence exists, it is not clear that negative effects on the broader financial system would be more effectively avoided or mitigated if the same recapitalization had been accomplished by invoking OLA in the first place, rather than by invoking it as a back-up procedure after it becomes clear that the recapitalized subsidiaries cannot access sufficient private sector lending sources.

2. As you know, the Dodd-Frank Title I resolution planning process requires banks to make the changes necessary for an orderly resolution under Title 11 of the U.S. Code. In practice, this resolution planning process has required reorganization by large banks and also in many cases has required banks to reserve increased amounts of capital and liquidity. By changing the bankruptcy options under Title 11, the TPRAA could alter the compliance requirements for banks under Dodd-Frank resolution planning.

    a. Do you think that the TPRRA would make it easier for banks to comply with resolution planning requirements under Dodd-Frank? How would this be likely to affect the amount of capital and liquidity banks must reserve to comply with the resolution planning process? How would it be likely to affect any requirements for reducing organizational complexity?

RESPONSE: The resolution plans of the largest U.S. global financial institutions utilize, under current law, an SPOE procedure that is similar to the procedure under TPRRA. Successful SPOE resolution, as noted in my testimony and above, requires sufficient capital and other total loss absorbing capacity (TLAC) and liquidity to meet resolution needs, and these needs would not be eliminated by TPRRA. TPRRA provides a roadmap for courts to implement SPOE resolution and also eliminates the need to enter into costly contractual work-arounds, for example to address the risk of close-outs of qualified financial contracts. Thus, enactment of TPRRA would likely reduce the cost and complexity of implementing resolution plans under Dodd-Frank. TPRRA does not, however, alter the basic financial aspects of SPOE resolution, and therefore should not affect the amount of capital, TLAC and liquidity banking organizations must have to comply with resolution planning requirements. Similarly, the existence of TPRRA should not affect any requirements for reducing organizational complexity.

b. If TPRAA were to pass, and you were advising a bank on compliance with resolution planning requirements, how would your advice change as compared to the situation before TPRRA passed?

RESPONSE: The main effect of TPRRA would be to reduce the need for certain workarounds required for successful SPOE resolution under current bankruptcy law (particularly with respect to qualified financial contracts and the filing of certain emergency motions with the bankruptcy court). The enactment of TPRRA also would create greater certainty by providing a specific roadmap for SPOE resolution of a distressed global financial institution that can be followed in the firms' resolution plans. Firms would likely be advised to incorporate the elements of TPRRA into their resolution plans. As noted above, however, the resolution procedure provided for in TPRRA is similar to the SPOE procedure envisioned under current law in existing resolution plans, so, except for incorporation of the applicable provisions of TPRRA into the resolution plans, the enactment of TPRRA is not likely to require material changes to the firms' basic SPOE resolution strategy.