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Treasury Issues Regulatory Reform Recommendations for the Orderly Liquidation Authority

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On Wednesday, February 21, the Treasury Department issued a report regarding the Orderly Liquidation Authority ("OLA") established by Title II of the Dodd-Frank Act under which the FDIC may be appointed as receiver of a severely distressed and systemically important financial company. This report was prepared in response to the President's April 21, 2017 memorandum directing the Secretary of the Treasury to examine the OLA to propose recommendations for reform consistent with the President's seven "Core Principles" for financial regulatory reform set forth in an Executive Order of February 3, 2017, and to determine whether reforms to the Bankruptcy Code are appropriate.[1]

The OLA has been controversial since the Dodd-Frank Act was enacted because critics have worried that it encourages excessive risk-taking, moral hazard, and exposure to taxpayers. Treasury agrees that, as enacted, Title II "confers far too much unchecked administrative discretion, could be misused to bail out creditors, and runs the risk of weakening market discipline."

As it currently stands, a failing systemically important financial institution may be subject to the OLA if, among other things, the FDIC, the Federal Reserve Board, and the Secretary of the Treasury have made certain findings, including that no private sector recapitalization or acquisition alternative is available and that resolution of the company under the Bankruptcy Code would have serious adverse effects on U.S. financial stability. The establishment of a specialized resolution process under the Bankruptcy Code was considered at the time Dodd-Frank was enacted, and legislative proposals to create such a bankruptcy mechanism have emerged from time to time since then, but Congress has not taken action.

A central part of the report's recommendations is to establish a specialized bankruptcy process for financial companies, which if enacted, would be "the resolution method of first resort," leaving the OLA as a last resort. Treasury refers to the revised bankruptcy process as "Chapter 14" bankruptcy, under which the shareholders, executives, and creditors of the financial company will ultimately bear all losses from the failure. Under this new framework, which is modeled on a "single point of entry" approach to resolution, a bridge company would be established within 48 hours after the bankruptcy court approves the transfer of assets, including the ownership interests of operating subsidiaries. Operating subsidiaries such as insured depository institutions would remain open and continue to service customers, thereby lessening the potential for depositors to run and the need for other insolvency regimes such as the Federal Deposit Insurance Act to resolve the failing institution. The existing directors and management of the failed company would be dismissed, and directors and management of the new company would be chosen by the new owners of the bridge company.

Importantly, the OLA would be modified but not eliminated. Recommended modifications in the report include elimination of ad-hoc decisions by the FDIC, provision for adjudication of claims by a bankruptcy court, repeal of the tax-exempt status of a bridge company, and greater clarity on resolution strategy. Under the Treasury's assessment, "without assurance of OLA as an emergency tool, foreign regulators would be more likely to impose immediate new requirements on foreign affiliates of U.S. bank holding companies, raising their costs of business and harming their ability to compete internationally."

[1] The OLA report is the fourth report from Treasury on the Administration's Core Principles for Financial Regulation. Treasury previously issued reports on asset management and insurance, capital markets, and banks and credit unions.