REPORT

ON THE

ORDERLY LIQUIDATION AUTHORITY

RESOLUTION SYMPOSIUM AND SIMULATION

JANUARY 2013

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I. Introduction

The Clearing House Association L.L.C. ("TCH")[1] organized and conducted an Orderly Liquidation Authority ("OLA") Resolution Symposium and Simulation Exercise (the "Simulation Exercise"), which took place on November 8 and 9, 2012 at a conference center in Rye Brook, New York. The Simulation Exercise was a comprehensive exercise that was designed to simulate systemic and bank-specific stresses leading to the failure of a large, international systemically important financial institution ("SIFI") and the resolution of the SIFI under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Over 160 individuals participated in the Simulation Exercise, including representatives from TCH, 17 TCH owner banks and five non-TCH owner banks, former regulators, consultants from Ernst & Young LLP and Promontory Financial Group, LLC and attorneys from five leading law firms, as well as academic observers engaged by one of the law firms.

The Simulation Exercise was preceded by over ten months of planning and preparation. A steering committee was formed to manage the development of the Simulation Exercise, while a planning committee provided strategic oversight.[2] TCH, in association with its planning and steering committees and Ernst & Young LLP as the Simulation Exercise's overall project manager, created the underlying framework for the simulation. This included the development of broad economic, financial and market conditions, as well as detailed information about three hypothetical global SIFIs (*e.g.*, financial statements at the consolidated level and for each key operating subsidiary, summaries of resolution and recovery plans ("RRPs"), organizational charts, business and operational profiles, and information on counterparty exposures and business relationships).

1 Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. It is owned by the world's largest commercial banks, which collectively employ over 2 million people and hold more than half of all U.S. deposits. TCH is a nonpartisan advocacy organization representing – through regulatory comment letters, amicus briefs and white papers – the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated clearing house, funds transfer, and check-image payments made in the United States. *See,* TCH's web page at www.theclearinghouse.org.

2 The steering committee was chaired by Paul Saltzman, President of TCH, Executive Vice President and General Counsel of The Clearing House Payments Company, and consisted of other representatives from TCH, attorneys from Sullivan & Cromwell LLP, Cleary Gottlieb Steen & Hamilton LLP, Covington & Burling LLP, Clifford Chance LLP and Davis Polk & Wardwell LLP, and consultants from Ernst & Young LLP and Promontory Financial Group, LLC. The planning committee consisted of representatives from TCH member banks.

Three principal purposes drove the Simulation Exercise:

1. to determine whether a Title II resolution could be implemented effectively;

2. to identify the legal, practical and operational challenges that may arise in a Title II resolution; and

3. to assess how those challenges may be addressed to ensure that any actual resolution process can be as successful as possible in achieving the goals of Title II.

II. Simulation Exercise Design

Role Player Groups

Eleven role-player groups were formed in the Simulation Exercise, representing the following hypothetical institutions or actors and regulatory authorities:

1. SIFI A, a U.S.-based SIFI with $1.9 trillion in assets ("SIFI A");

2. SIFI B, a U.S.-based SIFI with $850 billion in assets ("SIFI B");

3. SIFI C, a UK-based SIFI with $2.5 trillion in assets ("SIFI C");

4. the Federal Deposit Insurance Corporation (the "FDIC");

5. other U.S. authorities, including the Board of Governors of the Federal Reserve System ("FRB"), the Office of the Comptroller of the Currency, the Commodity Futures Trading Commission, the Securities and Exchange Commission, the Securities Investor Protection Corporation, the Federal Home Loan Banks, and the Federal Reserve Bank of New York (collectively, "Other U.S. Regulators");

6. UK authorities, including the Bank of England and the Financial Services Authority ("UK Regulators");

7. payment, clearing and settlement systems (collectively "Financial Market Utilities" or "FMUs");

8. hedge funds, money market funds and institutional investors (collectively, "Buy-Side Investors");

9. media;

10. U.S. legislators; and

11. a "Command Central" unit that oversaw the Simulation Exercise and played the roles of the Executive Branch, U.S. Secretary of the Treasury, the UK Chancellor of the Exchequer, the boards of directors of SIFI A, SIFI B and SIFI C, and the credit rating agencies.

Those individuals who played the role of the regulatory authorities performed actions and made decisions based on what they believed those authorities would actually do in such a crisis situation upon being presented with the advice of counsel and a group of former regulators present at the Simulation Exercise.

Each of the 11 role-player groups were provided with a participant binder containing both information available to all participants (so-called "public information") and information specific to the role-player group. Each of the three SIFIs had a set of public financial statements and public profiles, a business and operational profile and organizational chart, credit rating information, as well as financial and operational interdependencies and relationships internally and with other financial institutions. In addition, the regulatory agencies had access to an RRP summary that was developed for each SIFI. The financial information for each SIFI was updated throughout the Simulation Exercise to reflect developments. Each participant binder contained role-player workbooks that presented in-detail each of the key issues and tasks to be addressed by each group throughout the Simulation Exercise. Finally, the Simulation Exercise had a media group that prepared hypothetical news stories which were disseminated throughout the event via live media feeds on television monitors. Participants were able to issue press releases and otherwise communicate with the media group, either on background or on the record, in order to simulate the communications processes (and related uncertainties) that would occur in a real crisis.

Phases of Simulation

The Simulation Exercise was divided into four phases:

1. Phase I. Phase I simulated a series of heightened stress and loss events leading to the failure of SIFI A. It began on Thursday morning in assumed stressed economic and financial conditions that had persisted generally

for the previous nine months, followed by an idiosyncratic loss at SIFI A's large UK broker-dealer subsidiary ("UK BD") on Friday morning GMT (which was reported in the media on Friday morning EST) and a separate idiosyncratic loss at SIFI A's insured depository institution subsidiary in the United States ("U.S. IDI") on early Friday afternoon EST. These events were assumed to lead to substantial runs on UK BD, U.S. IDI and the parent holding company of SIFI A ("SIFI A Parent") and to result in a liquidity crisis at SIFI A. It was further assumed that, by end of business hours on Friday, SIFI A Parent had exhausted its resources and could no longer act as a "source-of-strength" for U.S. IDI. In addition, Phase I also assumed that a significant payment on the outstanding long-term senior debt of SIFI A Parent would come due early in the following week and that, as a result of SIFI A's liquidity crisis, SIFI A would not be able to make this payment. This assumption helped to facilitate the determination by the authorities that SIFI A was "in danger of default" by the end of Phase I.

2. Phase II. Phase II began after markets closed on Friday and included actions performed during the first half of resolution weekend (Friday night until Saturday night), including the appointment of the FDIC as the receiver of SIFI A under Title II, the FDIC's formation of a bridge holding company ("BridgeCo") to acquire the operating subsidiaries of SIFI A, the assessment of the funding needs of BridgeCo and its operating subsidiaries and the provision of liquidity to BridgeCo through the Orderly Liquidation Fund ("OLF"). The FDIC took SIFI A Parent into receivership under a "single-point-of-entry" approach and transferred all the assets of SIFI A, including the ownership interests in its subsidiaries, to BridgeCo. SIFI A's critical operations and core businesses, as identified in its RRP summary, would continue to operate under BridgeCo. With respect to SIFI A Parent's liabilities, all secured debt and trade creditors were transferred to BridgeCo, while the equity holders and unsecured creditors of SIFI A Parent remained in the receivership. Private sector rescue acquisition proposals were also considered throughout this phase.

3. Phase III. Phase III simulated actions performed from Saturday night until Sunday evening when Asian markets reopened. During this phase, the FDIC, Other U.S. Regulators and UK Regulators engaged in a series of discussions with other market participants such as SIFI B, SIFI C, FMU and

Buy-Side Investors, encouraging them to continue to do business with BridgeCo and to maintain continuity when Asian markets reopened.

4. Phase IV. Phase IV, the last phase of the Simulation Exercise, consisted of a series of panel discussions, "flashing forward" as the financial markets stabilized several months after the resolution weekend. The various topics discussed during this phase included the treatment of short-term and long-term creditors, the termination of BridgeCo's status as a bridge and its reincorporation under an appropriate state law, the exchange by the creditors remaining in the receivership of their claims for equity or debt in a new, privately owned, well-capitalized company ("NewCo"), NewCo's access to private capital markets (which entailed a number of issues such as valuation of assets and compliance with securities laws), and, more generally, whether Title II preserved the systemically important operations of the failed SIFI and limited market contagion.

Regulatory and Other Assumptions

When framing the regulatory background for this Simulation Exercise, the following rules and regulations were assumed effective:

1. enhanced prudential standards and early remediation requirements, including the Fed's proposed rule implementing single-counterparty credit limits ("SCCL") pursuant to section 165 of the Dodd-Frank Act,

2. Basel III capital requirements,

3. liquidity coverage ratio,

4. financial stability factor pursuant to Section 604 of the Dodd-Frank Act, and

5. the derivative "push-out" provisions of section 716 of the Dodd-Frank Act.[3]

It was noted that certain of these regulations would become effective substantially after the date of the Simulation Exercise, while others were still in proposed form.

[3] A number of other rules and regulations proposed under the Dodd-Frank Act also were assumed to be effective, but their effect on the Simulation Exercise was minimal.

However, because regulators often require regulated institutions to comply in substance with major proposed regulations even before those regulations are effective and in order to ensure that the results of the Simulation Exercise remain timely even after the implementation of new regulations, the steering committee believed that it was reasonable to make the assumptions described above. In addition, assuming these regulations to be effective allowed participants the opportunity to assess how the regulations would interact with a Title II resolution.

As in any simulation, the Simulation Exercise also adopted several underlying assumptions regarding the basic conditions of the Simulation Exercise. While these assumptions were generally consistent with the outcomes observed in the recent financial crisis or otherwise deemed reasonable, it was necessarily true that the Simulation Exercise might have unfolded differently if different assumptions had been made. The impact of these assumptions was discussed by the participants during Phase IV of the Simulation Exercise, and this discussion is reflected in the summary of "Key Observations" below. In many instances, the assumptions made were designed to make the simulation more rather than less challenging.

III. Results of the Simulation Exercise

The Simulation Exercise confirmed the views that have been expressed by banking regulators and Members of Congress that Title II OLA can be a viable mechanism for resolution of a large, complex SIFI. Although there were many issues to be resolved and difficult decisions to be made, as well as inevitable confusion and uncertainty that accompanies a crisis at a large financial institution, the first phase of the Title II resolution process for the failing SIFI A that began on a Friday evening was successfully completed by Sunday evening before the Asian markets reopened. As described above, the FDIC took SIFI A into receivership using a "single-point-of-entry" strategy under Title II and created a BridgeCo to house all of the assets of SIFI A's Parent, including the ownership interests in its subsidiaries and claims against them. Short-term and long-term unsecured creditors, subordinated creditors and equity holders of SIFI A remained in the receivership. When markets reopened, SIFI A's critical operations and core businesses continued to operate under BridgeCo and, because it was assumed that insufficient private market funding was accessible, immediate temporary funding was made available to BridgeCo and its subsidiaries through the OLF guarantees. Given (i) the strong capital structure of BridgeCo, (ii) the recapitalization of SIFI A's operating subsidiaries (by "equitizing" the intercompany debt of these subsidiaries to SIFI A Parent), (iii) the availability of temporary funding from the OLF, (iv) guarantees of critical obligations by the OLF and (v) assurances from the FDIC as to its intended operation of BridgeCo, market participants such as SIFI B and SIFI C were sufficiently comfortable to continue trading with BridgeCo's subsidiaries when markets reopened.

The Simulation Exercise assumed that the idiosyncratic losses at SIFI A occurred during a period of general financial stress throughout the markets, so that there was an increased concern about contagion. The swift execution of the initial phase of resolution for SIFI A under Title II was instrumental in preventing contagion from occurring. Furthermore, the Simulation Exercise also included a significant cross-border resolution complication, *i.e.*, UK BD was itself systemically important in the UK. The Simulation Exercise considered the possible differences of views between the U.S. and UK authorities, as well as the possibility of a separate insolvency proceeding for UK BD.

During the last phase of the Simulation Exercise, the panel discussed how the FDIC would work to return BridgeCo to private ownership. In particular, it was discussed that non-core assets or businesses would be divested, operating subsidiaries would be recapitalized by extinguishing intercompany debt of the subsidiaries to parent, market resources would replace temporary funding through OLF guarantees, and, ultimately, creditors remaining in the receivership would exchange their claims for equity in NewCo, which would establish NewCo as a well-capitalized SIFI. The value of NewCo's equity, and thereby the level of the loss suffered by SIFI A's creditors, would depend on, among other inputs, the trading value of NewCo's equity. If NewCo's equity were to be traded at book value, which is optimistic in view of current market metrics for bank stocks, the creditors' loss of principal would have been approximately 4%.[4] Finally, equity holders of the failed SIFI A would either be wiped out or receive far-out-of-the-money warrants with value contingent on the performance of NewCo.[5]

IV. Key Observations

Although the Simulation Exercise was successful there were a number of key observations from the Simulation Exercise, which are briefly summarized below.

1. *Value of Simulation*. The simulation technique is an effective tool for predicting possible outcomes of a real-world process. Accordingly, there can be tremendous value in conducting a simulation – as was the case in the Simulation Exercise. In particular, the Simulation Exercise offered participants the opportunity to practice critical crisis management skills that would be necessary to undertake a real Title II resolution. It would be beneficial for regulators to perform their own Title II

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[4] If, however, NewCo's equity was traded at only 75% of book value, the creditors' loss could have been 28%.

[5] Due to the timing and space limitations of the Simulation Exercise, alternatives to the recapitalization or "single-point-of-entry" approach, such as the sale of SIFI A's principal operating subsidiaries or liquidation of the subsidiaries that precipitated the failure, were not demonstrated. It is anticipated that further evaluation of these alternatives will be necessary for use in those situations where the "single-point-of-entry" approach is not appropriate.

simulations, ideally with some private sector involvement, so that regulators can themselves better understand the mechanics of Title II and identify and resolve in advance any potential impediments to an orderly resolution under Title II. TCH is considering conducting another simulation exercise with the involvement of other third parties including possibly regulators that would assess other hypothetical failure situations and explore in greater detail what would occur after resolution weekend.

2. *Title II can be used as an effective tool for resolving a SIFI*. Title II can be used as an effective tool for resolving a failing U.S.-based SIFI in a way that prevents any exposure of taxpayers to losses arising out of the failure, wipes out the SIFI's shareholders, imposes losses on creditors, preserves the SIFI's critical operations and core businesses, holds culpable management accountable, and prevents runs, cascading defaults on derivatives and financial panic. In conjunction with Title I recovery and resolution plans as well as other prudential tools available to regulatory agencies, Title II ends "Too-Big-To-Fail" and eliminates the need for future government bailouts by allowing a SIFI to fail and providing a special resolution regime to resolve the SIFI in a manner that limits market contagion.

3. *Communication protocol*. During the Simulation Exercise, communications at multiple levels were strained, and the lack of communications, especially prompt public communications from the authorities, exacerbated market concerns. Although some degree of confusion may be inherent in these circumstances depending on how suddenly an institution faces default, a comprehensive communication protocol to provide timely and accurate information to the public and other stakeholders should be developed *ex-ante* by the key regulatory agencies. Other market participants, such as FMUs, also should have in place similar communication strategies and proactive processes for reviewing their structures, crisis management plans and options. In addition, the FDIC and other regulatory authorities should have in place a communications protocol with the FMUs to promote efficiency of the resolution process. In all cases, it should be emphasized that transparency and communications are key to maintaining market confidence.

   In addition, it was observed during the Resolution Exercise that rumors and perception played a significant role in driving market behavior. In the absence of a comprehensive communication protocol and a "presumptive path" on how the FDIC would exercise its OLA, the default position was to de-leverage or otherwise engage in actions to lay off risk. For example, short-term creditors would run and new short-term and long-term credit would dry up, foreign authorities would threaten to

ring-fence local assets or put the local subsidiary in a separate insolvency proceeding and the failing SIFI and other similarly threatened SIFIs would scramble to pledge or sell assets at fire-sale prices and on other fire-sale terms in order to improve liquidity. The lesson to be drawn, which accords with past experience, is that it is essential for the authorities to take prompt action and to keep the market fully informed in a timely fashion. Furthermore, the FDIC should consider what types of assurances creditors would need to prevent runs and close-outs and communicate those appropriately to the market.

4. *Access to Title II resolution plan*. The participants generally agreed that a Title I RRP is useful as it provides important advance planning to regulators and helps identify critical operations and core businesses of the failing SIFI. However, the Simulation Exercise indicated that the development of a resolution approach for SIFI A was hampered by the fact that SIFI A had no access to the Title II resolution plan prepared for it by the FDIC (and was therefore operating solely under its Title I RRP, which contemplated a different resolution, *i.e.*, under the Bankruptcy Code). The FDIC should consider sharing its Title II resolution plan with the relevant SIFI or making the Title II resolution planning process a joint exercise with each SIFI, at least in part. In addition, strong consideration should be given to having a SIFI include in its RRP an analysis of how it would be resolved under Title II. This inclusion could make the RRPs much more useful and practical, both in preventing failure of large, complex SIFIs and in resolving them.

5. *Cross-border coordination*. Given the likely global nature of the operations of a SIFI resolved under Title II, it is critical to ensure that the Title II resolution regime can operate effectively in a cross-border setting. In the event that a U.S. SIFI has a branch or subsidiary in another jurisdiction that is both material to the SIFI and systemically significant in the other jurisdiction, both the SIFI's RRP and the FDIC's Title II resolution plan should be coordinated in advance between the two jurisdictions (perhaps, through a memorandum of understanding). Any such coordination should be SIFI-specific. Furthermore, U.S. and non-U.S. authorities should coordinate ahead of time about the kinds of financial resources that would be available in a host country jurisdiction in the event of a SIFI's failure and what role, if any, the host country's central bank would play in providing local liquidity support. In the Simulation Exercise, for example, the UK Regulators were willing to provide local financing to the UK BD by having the Bank of England act as counterparty on the UK BD's repo roll-overs, but it was clear that advance regulator coordination in this area would be beneficial.

6. *Cross-border treatment of derivatives*. The treatment of derivative contracts is another important topic that should be addressed by the authorities in the key jurisdictions. Specifically, there is a need for the international regulatory community to work together to formulate a plan of action and communications on what happens to derivatives contracts during a crisis situation to help stabilize the market and avoid spreading runs. In the Simulation Exercise, a majority of SIFI A's derivatives were booked in UK BD (as a result of the derivative "push-out" provisions in the Dodd-Frank Act), thereby putting those derivatives outside the reach of the limitations on the exercise of cross-defaults contained in Section 210(c)(16) of the Dodd-Frank Act. It would be helpful if the authorities in other jurisdictions (particularly, the United Kingdom, given the importance of the London markets in international financial contracts) obtained the authority under local law to recognize and give effect to Section 210(c)(16), when the FDIC is appointed as receiver, or alternatively, have equivalent powers that can be used to prevent close-outs of local subsidiaries' derivative contracts that would otherwise be triggered by the receivership of the U.S.-based holding company. This would reduce liquidity needs of foreign-based subsidiaries and minimize market disruption. In addition, the private sector should consider whether amendments to underlying contractual documentation could help to address this issue.

7. *Treatment of short-term creditors*. There was significant debate about how the receiver should treat short-term creditors of SIFI A that under the traditional bankruptcy code would be in the same priority class as unsecured long-term creditors. In the end, the Simulation Exercise assumed that short-term debt was treated the same as long-term debt, *i.e.*, short-term debt was left behind in the receivership and the FDIC did not exercise its discretionary authority to provide preferential treatment to the short-term debt by transferring it to BridgeCo. There were, however, a number of competing considerations. It was assumed that there was a relatively small amount of short-term debt left at the holding company at the time of its failure, which is consistent with the current practice of some large bank holding companies not to use the holding company as a primary source of such funding, as well as the fact that, in the run-up to failure, it would have been difficult for the holding company to obtain or roll over short-term obligations. Notwithstanding the relatively modest amount remaining, there was some concern that a decision not to transfer the remaining short-term debt to BridgeCo could potentially trigger a run on short-term debt at other financial institutions and lead to a disruption in short-term funding markets. On the other hand, using the FDIC's discretionary authority to make an exception to the normal bankruptcy priority rules could send the wrong message to the market that the FDIC would always be willing

to protect short-term creditors in a resolution. Because the amount of short-term debt at issue was relatively modest, the amount of losses that would be sustained by such creditors would also be modest. In that context, it was determined that the importance of adhering to the normal statutory priority rules outweighed the relatively low risk that that the modest losses suffered would precipitate a contagious run.

8. *Recapitalization and "single-point-of-entry."* It is important to note that the resolution of SIFI A in the specific format utilized might not have been successful if there had not been (i) sufficient long-term debt at parent level, which, in effect, could be "equitized" by being left behind in the receivership and (ii) sufficient intercompany debt obligations of the U.S. IDI and UK BD to SIFI A, which could, again, be "equitized" and thereby create equity capital for those subsidiaries. Clearly, a Title II resolution using the "single-point-of-entry" approach is made easier if the failing SIFI has the type of loss absorption capacity at the holding company level that was assumed in this Simulation Exercise. It would be useful for regulators to provide clarity to the market as to the sufficiency and nature of debt that could be "equitized" in a Title II resolution process. Of course, the "single-point-of-entry" strategy is not the only resolution approach under Title II. In some cases, resolution at the operating subsidiary level may be the appropriate course of action; in others, liquidation of failing subsidiaries and disposal of others may be appropriate; in others, some other combination of approaches may be most effective. Substantial long-term debt at the holding company level may not be necessary for these other approaches.

9. *Governance arrangements for BridgeCo*. There needs to be further pre-planning of the governance arrangements for BridgeCo both on the first day of its formal operation after resolution weekend and promptly thereafter, including, among other things, clear identification of the individuals who sit on the board of directors and who have senior management responsibilities at the entity and of their respective formal roles. Clarity and effective governance arrangements for board members, senior executives and management are critical for BridgeCo to regain market confidence.

10. *Continuity of critical operations and retention of key employees*. The Simulation Exercise confirmed that there is a need for the FDIC to ensure that critical operational and risk management functions continue to be carried out uninterrupted, *e.g.*, through efficient communications with, and retention of, key employees. There was a degree of confusion amongst participants during resolution

weekend about who was, and would remain, in charge of the critical operations conducted by SIFI A. A well-crafted employee retention and communication plan and, if necessary, an incentive program are therefore essential to ensuring confidence in the continuous operational oversight of systemically important functions.

11. *No viable private sector alternative*. It was observed during the Simulation Exercise that the FDIC was expected to make strong efforts to find a private sector solution before it resorted to Title II or otherwise concluded that "no viable private sector alternative was available to prevent the default." If the FDIC simply assumed the unavailability of such a private sector solution, the FDIC would likely face substantial public criticism. However, during the Simulation Exercise, the perceived inevitability of the invocation of Title II seemed to chill and thereby inhibit possible private sector solutions, although it is not clear whether the prospect of a different resolution mechanism would have had a different result.

12. *OLF-guaranteed private funding to BridgeCo*. This Simulation Exercise assumed that the FDIC was able to arrange a lending facility that was funded by institutional investors and guaranteed by the OLF. This is a type of arrangement that could benefit from early planning and discussion. Capital markets professionals and senior management of potential participants to this type of financing should be involved in this planning and discussion. For example, the form of OLF guarantee could be prepared and reviewed ahead of time by counsel of those potential participants. Pricing also could be considered in advance and factored into the FDIC's Title II resolution plans. However, it is critical that the public and private sector collaborate to develop some standardized documentation and a basic framework of terms by which private liquidity could be provided to an institution undergoing a Title II resolution.

13. *Potential regulatory impediments*. The Simulation Exercise showed that a number of regulatory requirements (and potential requirements) hindered the most effective resolution of SIFI A and/or amplified the related contagion risk. These requirements included the derivative push-out provisions of Section 716 of the Dodd-Frank Act, SCCL, removal of the existing filter of certain unrealized gains and losses on financial instruments (the "AOCI filter") from regulatory capital components, restrictions on acquisitions and enforcement/litigation risk relating to actions of the acquired institution pre-acquisition. To illustrate, SCCL limited SIFI B's ability to provide financing to SIFI A and restrictions on acquisitions limited SIFI B's ability to participate in any proposed rescue acquisition of all or part of the assets of SIFI A.

The derivative push-out provisions resulted in the majority of SIFI A's derivatives being booked in UK BD, thereby increasing the interdependence between legal entities, as well as putting those foreign derivatives outside the reach of Section 210(c)(16) of the Dodd-Frank Act. The removal of the AOCI filter exacerbated contagion by reducing capital at multiple institutions. Many of these issues could be corrected in the near-term through regulatory or supervisory action.

In addition, the Simulation Exercise also demonstrated that the ability of the authorities to act swiftly to limit market contagion has been significantly curtailed as a result of a number of the Dodd-Frank provisions. For example, after the Dodd-Frank Act, the FRB can no longer extend credit to a corporation pursuant to Section 13(3) of the Federal Reserve Act other than through a "program with broad-based eligibility." Pursuant to Section 13(3), these emergency facilities can only be created with prior approval of the U.S. Secretary of the Treasury and must be for the purpose of providing liquidity to the financial system and not to aid a "single and specific" failing financial company. As demonstrated in the Simulation Exercise, this "broad-based eligibility" requirement brought about an unintended consequence of putting pressure on the authorities to determine, in an environment of uncertainty and imperfect information, whether the financial condition of SIFI A was an idiosyncratic failure or part of a broader market deterioration (with SIFI A arguing for the latter and the other SIFIs arguing the former). This requirement took away from the authorities an effective tool in dealing with a financial crisis.

14. *Advance discussion with FMUs*. Several FMU-specific issues were identified in the Simulation Exercise: (i) whether a Title II resolution would trigger a change of control and, therefore, whether UK BD's membership, as well those of other SIFI A subsidiaries, would still be valid, (ii) whether, and under what circumstances, the UK BD's and other of SIFI A's subsidiaries' transactions with the FMUs could be guaranteed by the OLF and (iii) whether a backstop structure could be put in place to deal with certain contingencies (*e.g.*, the FRB steps in to clear transactions for customers of an insolvent FMU member as historically done). The authorities should engage in advance discussion with FMUs to inform FMUs of the Title II resolution process and to address these issues.

15. *Valuation and financial reporting*. There needs to be much more clarity about the timing and rules for determining the valuation of the assets of the failed SIFI (including its subsidiaries), which is critical for determining the size of the ultimate loss and the amount of equity needed to recapitalize NewCo. Furthermore, the effect of this valuation on the value of comparable assets at other institutions should

be fully analyzed and evaluated. The authorities should also address other issues such as trading of NewCo's equity and NewCo's compliance with U.S. securities law.

16. *SCCL for long-term debt*. A sub-category of SCCL for long-term debt may be useful to prevent contagion risk. In particular, it may be necessary to limit a SIFI's holding of long-term debt in other SIFIs. There are, however, two important caveats to limiting SIFI investments this way. First, the exception for market making by a SIFI in the debt of other SIFIs will be important to get right. Otherwise, there will be a risk of decreased liquidity for SIFI debt precisely at the time the authorities may be directing certain SIFIs to increase the amount of long-term debt issued. Second, the authorities need to evaluate the market cost and the impact of any such limitation on SIFIs' capital structures.

17. *Credit-default-swap writers and money market funds*. In order to gauge the risk of contagion from various aspects of a resolution plan, regulators need access to better information about the financial exposures of financial institutions other than bank-SIFIs, such as non-bank credit-default-swap writers and money market funds. However, any such information required to be provided to regulators should be appropriate in its scope, depth and application for the purpose intended, and may be addressed by trade reporting and clearing requirements that are currently being implemented under Title VII of the Dodd-Frank Act.

18. *Policy statement*. As demonstrated by the Simulation Exercise, market panic and loss of confidence caused by SIFI A's failure were aggravated by the fact that none of SIFI A, SIFI B, SIFI C, Buy-Side Investors, FMU and UK Regulators was able to predict reliably how the FDIC would exercise its OLA. While we recognize that it is impractical and even imprudent to promulgate a set of rules delineating how the FDIC will exercise its OLA in all circumstances, a "presumptive path" can certainly be helpful in calming the market in times of crisis. To create greater certainty and credibility, TCH recommends that the FDIC publish a policy statement, providing for appropriate notice and comment, describing the process it would presumptively undertake to use its Title II authority. For example, the FDIC should provide guidance on the "single-point-of-entry" and recapitalization strategy and the circumstances under which this strategy is preferred. It should be emphasized, however, that there is no one-size-fits-all approach for resolution of SIFIs, and the applicability of the "single-point-of-entry" approach depends very much on the particular characteristics and structure of the SIFI, including its size, relative footprint, business model and the risk profile of its assets. Treatment of short-term creditors *vis-à-vis* long-term creditors and valuation and financial reporting issues, as

discussed above, should also be addressed. Finally, this policy statement should clarify whether there would be any restriction on executive compensation and/or lobbying while the OLF funding is in place.

In addition to a policy statement, the Simulation Exercise indicated a need for the regulatory community to develop some of the documentation and consider key transactional terms that would be necessary during an actual Title II resolution in advance through collaboration with the industry, buy-side and key FMUs. This would help provide the market with greater *ex ante* clarity as well as provide some transactional certainty during resolution weekend.

V. Conclusion

Title II is a fundamental, indeed indispensable, tool for the authorities to deal with the largest SIFIs that encounter financial distress. Although there is additional work needed to fully accomplish the goals of Title II, we believe that Title II provides a viable and effective resolution regime for SIFIs. It allows a SIFI to be resolved in an expeditious and orderly way that preserves systemically important functions of a failing SIFI and minimizes the serious adverse effect that this failure would have on the U.S. financial system, thereby eliminating the need for future government bailouts and taxpayer exposure.

It is important to note that a special resolution regime like Title II for financial institutions is consistent with the long-standing legislative approach, rather than an aberration or codification of "Too-Big-To-Fail." By analogy with insurance companies, broker-dealers and insured depository institutions (all of which are subject to their own dedicated resolution regimes), SIFIs will ordinarily require a special resolution regime for themselves.

Finally, it should be emphasized that, in conjunction with Title I recovery and resolution plans as well as other prudential tools available to regulatory agencies, Title II ends "Too-Big-To-Fail" and flatly prohibits government bailouts of SIFIs. As demonstrated by the Simulation Exercise, Title II imposed losses on equity holders and creditors. The equity interests of the failed SIFI A were wiped out and creditors of SIFI A Parent received haircuts on their debt. Moreover, the temporary funding through the OLF can only be provided to a SIFI in Title II receivership or BridgeCo if (i) the government is fully protected by the unencumbered assets of the SIFI or BridgeCo and (ii) a credible repayment plan is in place. In the unlikely event that the proceeds of the liquidation are insufficient to repay the funding, there may be clawbacks from some creditors who receive payments beyond the liquidation value of their claims, and, eventually, a risk-based assessment on the industry to repay the funding. Consequently, there will be no government bailout and no taxpayer loss under Title II.

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The Clearing House wishes thank the participants in the Simulation Exercise and the attorneys and consultants who, as members of the steering committee, provided guidance throughout the planning of the Simulation Exercise. Any inquiries about this report or the Simulation Exercise can be directed to John Court (John.Court@theclearinghouse.org) or Alex Radetsky (Alex.Radetsky@theclearinghouse.org).