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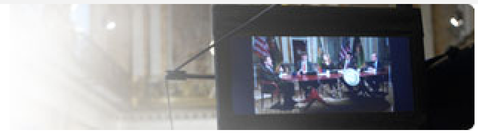
# Treasury Proposes Legislation for Resolution Authority

United States: Department of the Treasury

U.S. DEPARTMENT OF THE TREASURY

## Press Center



### Treasury Proposes Legislation for Resolution Authority

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Treasury Secretary Timothy Geithner on Monday called for new legislation granting additional tools to address systemically significant financial institutions that fall outside of the existing resolution regime under the FDIC. A draft bill will be sent to Congress this week and several key features are highlighted below.

The legislative proposal would fill a significant void in the current financial services regulatory structure and is one piece of a comprehensive regulatory reform strategy that will mitigate systemic risk, enhance consumer and investor protection, while eliminating gaps in the regulatory structure.

<u>Why We Need Resolution Authority:</u>

The current financial crisis reveals the consequences of this regulatory gap. Generally when a large, interconnected non-bank financial firm is in severe distress, there are currently only two options:

1. Obtain outside capital or funding from the US government as in the case of AIG

2. File for bankruptcy as we witnessed with Lehman Brothers

Those options do not provide the government with the necessary tools to manage the resolution of the firm efficiently and effectively in a manner that limits the systemic risk with the least cost to the taxpayer.

- In the case of AIG, the government has provided financial assistance in order to avert the risks to the global financial system of the rapid and disorderly failure of such a large, complex entity in a fragile market environment. Had the government possessed the authorities contained in the proposed legislation, it could have resolved AIG in an orderly manner that shared losses among equity and debt holders in a way that maintained confidence in the institution's ability to fulfill its obligations to insurance policyholders and other systemically important customers.

- The Lehman Brothers bankruptcy illustrates the potential impact of the bankruptcy of a large interconnected financial firm during a period of severe financial stress. Several money market funds had significant exposure to Lehman. Concern about the stability of money market funds caused investors to withdraw funds, thus creating further instability in the financial system. That instability ultimately obliged the Treasury Department to establish the money market fund guarantee program.

<u>What the Legislation Would Do:</u>

Instead of subjecting a firm to bankruptcy or simply injecting taxpayers' funds with no real control, the legislation would:

- Grant the US government resolution authority, which would allow the government to put the firm into conservatorship or receivership and then to administer its effective, orderly reorganization or wind-down.

- Enable the government to reduce the need for taxpayer funds. For example, it would enable the federal agency acting as conservator or receiver to sell or transfer the assets or liabilities of the institution in question, to renegotiate or repudiate the institution's contracts (including with its employees), and to address the derivatives portfolio, thus reducing the potential for further disruption

<u>More Details on the Proposed Legislation:</u>

- The legislation would authorize the US government, in appropriately limited circumstances, to intervene at the appropriate time to avert the systemic risks posed by the potential insolvency of a significant financial firm.

- Many aspects of the bill are modeled on the statutory framework that governs the FDIC's exercise of emergency resolution and other authority with respect to banks.

  <u>Key Features of the Proposed Legislation:</u>

- *Covered institutions*: It would cover financial institutions that have the potential to pose systemic risks to our economy but that are not currently subject to the resolution authority of the FDIC. This would include bank and thrift holding companies and holding companies that control broker-dealers, insurance companies, and futures commission merchants.

- *Prerequisites for the actions to be taken*: Parallel to the current provisions of law that apply to depository institutions, before any of the emergency measures specified in the proposed legislation may be taken, the Secretary, upon the positive recommendations of both the Federal Reserve Board and the appropriate federal regulatory agency and in consultation with the President, must make a triggering determination that --

  (1) the financial institution in question is in danger of becoming insolvent;
  (2) its insolvency would have serious adverse effects on economic conditions or financial stability in the United States; and
  (3) taking emergency action as provided for in the law would avoid or mitigate those adverse effects.

- *Selection of emergency measures:* The decision whether to provide financial assistance to the institution or to put it into conservatorship/receivership will be made by the Secretary and the FDIC, and will be informed by the recommendations of the Federal Reserve Board and the appropriate federal regulatory agency (if different from the FDIC).

- *Financial assistance measures*: The proposed legislation permits the US government to utilize a number of different forms of financial assistance in order to stabilize the institution in question. These include making loans to the financial institution in question, purchasing its obligations or assets, assuming or guaranteeing its liabilities, and purchasing an equity interest in the institution. This authority is modeled on current law with respect to banks. The Deposit Insurance Fund will not be used to fund such assistance.

- *Conservatorship/receivership*: This authority is modeled on the resolution authority that the FDIC has under current law with respect to banks and that the Federal Housing Finance Agency has with regard to the GSEs.
    - The objective of a conservatorship is to take actions that are necessary and appropriate to restore the institution to a position of solvency so that it can carry on its business; the objective of a receivership is to provide for the orderly liquidation of the institution.
    - Here, the goal of the conservatorships or receiverships would be to minimize the impact of the potential failure of the financial institution on the financial system and consumers as a whole, rather than simply addressing the rights of the institution's creditors as in bankruptcy.
    - The trustee of the conservatorship or receivership would have broad powers, including to sell or transfer the assets or liabilities of the institution in question, to renegotiate or repudiate the institution's contracts (including with its employees), and to deal with a derivatives book. A conservator would also have the power to fundamentally restructure the institution by, for example, replacing its board of directors and its senior officers. None of these actions would be subject to the approval of the institution's creditors or other stakeholders.
- *Funding*: The proposed legislation would create an appropriate mechanism to fund the appropriately limited exercise of the resolution authorities it confers. This could take the form of a mandatory appropriation to the FDIC out of the general fund of the Treasury (subject to all the restrictions on the use of appropriated funds, including apportionments under the Anti-Deficiency Act), and/or through a scheme of assessments, ex ante or ex post, on the financial institutions covered by the legislation. The government would also receive repayment from the redemption of any loans made to the financial institution in question, and from the ultimate sale of any equity interest taken by the government in the institution.

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- Proposed Legislation