Any Major Revamp of Bank Resolution Plan Requirements Should be Done Only Through Rulemaking

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Acting Comptroller Michael Hsu in a recent speech suggested that large regional banks (those with more than $500 billion in total assets) should radically reshape their living will plans by converting to a single-point-of-entry resolution strategy and significantly altering their funding models by issuing a large amount of unsecured long-term, so-called "bail-in-able" debt.[1] And because a rulemaking imposing this kind of requirement is the proper purview of the Fed and not the OCC, and a rulemaking "will take time," he suggested that the OCC is contemplating imposing such a new requirement as a condition to any merger approvals sought by these banks.

Setting aside the substantive policy merits of the idea, imposing such a requirement on large national banks via a condition to a merger approval raises serious procedural and fairness concerns -- namely, it would be inconsistent and possibly interfere with existing resolution planning requirements; it would circumvent the ordinary procedural safeguards Congress put in place to promote good policymaking through transparency and an opportunity for public notice and comment; it would create meaningful inequities among banks of similar size and risk profile; and it could operate as an effective and, we believe, impermissible moratorium on large regional bank mergers.

Set forth below is a more detailed explanation of the procedural and fairness concerns we have. BPI plans to opine on the substantive merits of Mr. Hsu's idea in the coming days and weeks.

A QUICK SUMMARY OF ACTING COMPTROLLER HSU'S POLICY PROPOSAL

In his remarks delivered to an academic conference at Wharton, Mr. Hsu declared that "we have a problem" because "if a large regional bank were to fail today, the only viable option would be to sell it to one of the GSIBs," which could, over time, add to financial stability risk.[2] Saying that "there needs to be a better way" and that "we need options," he went on to suggest that large regional banks should be required to radically reshape their "living will" plans by converting to a single-point-of-entry resolution (SPOE) strategy, issuing a large amount of bail-in-able

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[1] Single-point-of-entry is a resolution strategy developed for large, globally active banks that requires the top-tier parent to essentially pre-fund a recapitalization of all of its key operating subsidiaries should the organization become financially troubled. If executed, the strategy pushes all material losses up to the top-tier parent company, which fails, imposing those losses directly on the parent company's equity holders and bondholders; the freshly recapitalized operating subsidiaries continue as going concerns, serving customers. To make the strategy work, the top-tier parent is required to issue substantial amounts of unsecured bail-in-able debt, which, effectively, is used to pre-fund the recapitalizations of the key operating subsidiaries.

In regulatory parlance, qualifying bail-in-able debt can contribute to a bank's total loss-absorbing capacity or "TLAC". TLAC instruments must meet certain qualifications to assure they are available during resolution to absorb losses and support a recapitalization of the bank. Maintaining TLAC materially raises a bank's funding costs – i.e., by replacing ordinary, existing liabilities with higher-cost ones that are TLAC-eligible.

[2] Acting Comptroller Hsu repeated his remarks in a May 16 speech at Brookings in which he stated: "The issue for large regional banks can be boiled down to a simple question: 'If one were to fail, how would it be resolved?' If the answer is: It would have to be sold to one of the four megabanks, then, I would posit, we have a financial stability problem."

long-term debt (aka – TLAC), and taking further steps to ensure that they are more "separable" in resolution.[3] Doing so would give the "government … more options should the regional fail," which leads to enhanced resolvability and "defeased" financial stability risks, Mr. Hsu said.

But, because instituting these reforms "on a permanent basis would have to be done by the Federal Reserve and FDIC and would require rulemakings… [which] will take time," and noting that the bank merger pipeline is active, including for large banks, Mr. Hsu suggested a more expeditious path – specifically, that the OCC could "condition approval of a large bank merger on actions and credible commitments to achieving SPOE, TLAC, and separability." Absent such a condition, Mr. Hsu said he "has concerns that such [large regional bank] mergers could result in new TBTF firms, which would add to financial stability risk."[4]

He noted that this more expedient approach might be a way to potentially "reconcile" the tension between the competitive benefits of mergers, on the one hand, and the prospect of increased financial stability risks if the combined, post-M&A institution were to fail, on the other.

PROCEDURAL AND FAIRNESS CONCERNS WITH MR. HSU'S APPROACH

Imposing major resolution planning requirements like SPOE/TLAC on a bank via an M&A approval condition raises four serious procedural and fairness concerns.

***First*, it would be inconsistent, and potentially interfere, with existing Dodd-Frank Act resolution planning requirements administered by the Federal Reserve and the FDIC.** Consistent with the overall statutory framework governing financial stability and the receivership process, Congress via Section 165 of the Dodd Frank Act gave the Fed and the FDIC (and <u>not</u> the OCC) authority to determine the appropriate requirements for ensuring that large banks are resolvable in an orderly way.[5] Section 165(d) of the Dodd-Frank Act requires all large banking organizations, including large regional banks, to prepare resolution plans providing for their "rapid and orderly resolution in the event of material financial distress or failure" under the Bankruptcy Code and requires the Federal Reserve and FDIC to review the plans to determine whether they are credible or not.

In 2011, the Fed and the FDIC initially developed a joint regulation to implement this statutory mandate. The joint rule has been revised through notice and comment over time to reflect statutory changes as well as agency experience with the requirements. Preparation and review of the resolution plans in accordance with the extensive and demanding information and resolvability requirements of the rules constitutes a major undertaking for covered financial institutions and regulators, alike.[6]

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3 See note 1.

4 The TLAC requirements that the Acting Comptroller referred to were finalized in December 2016 by the Fed, after consultations with various stakeholders including the OCC and FDIC. The TLAC rule applies to the largest and most systemic U.S. banking organizations (U.S. GSIBs). Should a merger involving a large regional bank result in the formation of a new GSIB, the TLAC requirements would apply to the GSIB in accordance with the Fed's rule.

5 Note that, in 2016, the OCC issued a rule (12 CFR 30, appendix E, "OCC Guidelines Establishing Standards for Recovery Planning by Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches") to address recovery planning at large banks. Recovery planning and resolution planning may be developed using similar processes, management oversight, operational frameworks, and financial tools. Recovery plans assume severe stress that, if not addressed, could lead to the covered bank's failure. Resolution plans, on the other hand, assume that a failure has already taken place and require the institution to plan its resolution in a rapid and orderly way.

6 Once a completed plan is submitted, it is reviewed for shortcomings, deficiencies and credibility. The Dodd-Frank Act provides that the Fed and FDIC may jointly determine that a submitted plan is not credible or would not facilitate the orderly resolution of the submitting financial institution.

In view of the complexity of the planning requirements, there was a learning and testing period of a few years for both institutions and the U.S. regulators as they attempted to better understand organizational structures, interconnectivity both within firms and the wider market, and a host of other intricate issues—ultimately determining what critical activities needed to continue through a failure and how that could be achieved. To date, under this framework, large regional banks have gone through several rounds of resolution plan submissions.[7] Initially, agency findings relating to the plans were announced publicly. More recently, feedback on the plans has been provided to institutions on a non-public basis as part of the ordinary examination process.[8]

While best practices continue to emerge over time, each institution's resolution plan is intended to be a unique, evolving and dynamic document. The plans are intended to be periodically updated and revised as necessary in accordance with the regulatory framework established by the Fed and FDIC under Section 165(d) taking into account structural changes to the institution over time.

Given the existing statutory, regulatory and supervisory framework governing large bank resolution, and the exclusive role conferred by Congress upon the Fed and FDIC, it would appear to be clear regulatory overreach for the OCC to take it upon itself to impose a new resolution strategy and resolvability requirements on large regional banks via the "back door" as a condition to an M&A approval. It would also override the careful, diligent and iterative resolution planning processes that the Fed, FDIC and each of the large regional banks have engaged in for the past 10 years.

Large regional bank resolution plans – which do not rely on SPOE/TLAC strategies but rather generally provide for different resolution options which may include plans to sell to multiple acquirers – have been reviewed by the Fed and FDIC taking into account the considerations described above.[9] To the extent the agencies' review yields any identified shortcomings or deficiencies, the banks are required to remediate them promptly. Accordingly, conditioning M&A approvals on an entirely different resolution approach (i.e., the SPOE/TLAC approach) would seemingly disregard determinations made by other regulatory agencies that are specifically vested by Congress with the authority to evaluate the credibility of resolution plans, and which have invested resources and time to develop staff expertise on resolution issues. Moreover, even if a SPOE/TLAC approach is determined to be warranted, any OCC action to impose SPOE/TLAC as a condition to M&A approval would appear to upend the procedural notice and opportunity for cure elements Congress required under Section 165(d) for addressing plan deficiencies identified by agency staff.

Finally, there is no guarantee that any resolution-related requirements imposed by the OCC via a merger condition would be met with satisfaction by the staff of the Fed and FDIC reviewing the bank's resolution plan. In effect, a bank would be forced to serve two sets of resolution masters (the Fed and the FDIC on the one hand with 165(d) resolution plans, and the OCC on the other hand with its bespoke merger conditions), and these two sets of regulators are under no obligation to agree with each other. It's untenable, unwise, and not what Congress envisaged, at all.

***Second,* questions of large regional bank resolvability and related regulatory requirements are significant and complex, and all stakeholders should have the opportunity to consider perceived policy concerns and, more importantly, major policy prescriptions through the Administrative Procedure Act (APA) notice-and-comment**

7 Separately, the FDIC requires insured banks to file stand-alone resolution plans for how the insured bank subsidiary would be resolved.

8 Based on our review, the last publicly available resolution plan feedback letters on the Fed's website from 2019 did not identify any deficiencies in any of the large regional bank plans.

9 The Fed and FDIC each have dedicated staff that have developed expertise in reviewing and evaluating resolution plans over the past decade.

rulemaking process. Imposing SPOE/TLAC requirements on large regional banks on a one-off basis via merger conditions is not an appropriate or practical way to implement new policies in an area as complex as resolvability. The policy prescription represents an entirely new set of resolution-related requirements for these firms, perhaps even inconsistent with prior resolution planning requirements mandated by the Fed and FDIC, and therefore such a substantial policy change should be subject to the APA's procedural safeguards, like notice and a chance to comment.[10] (It is also worth noting that a merger condition would allow the OCC to potentially sidestep Congress's review of the agency action as a "rule" under the Congressional Review Act.)

As a general matter, a notice-and-comment rulemaking facilitates better rules by ensuring that agencies obtain information from the widest range of relevant stakeholders. In this case, the OCC likely cannot foresee all the possible consequences of requiring a dramatic change to the capital structure of a bank through negotiated commitments and conditions on its own especially relating to a topic as complex as resolvability. Moreover, SPOE/TLAC requirements effectively require banks to structure their debt in such a way that any losses would be incurred first by one set of creditors (senior unsecured bondholders of the parent holding company) before other creditors. The investor community, including bondholders among others with a vested interest, has a legitimate interest in procedural transparency and the opportunity to inform any such requirements.

Finally, it took several years to develop and implement the SPOE/TLAC requirements for GSIBs – the Financial Stability Board spent several years developing TLAC standards, completing them in 2015 after which the Fed engaged in an APA rulemaking process over two years, resulting in final TLAC rules becoming effective in 2017, with an ample compliance transition period in recognition of the complexity of the requirements and the need for a transition period for any bank to make such a significant change to its capital structure.

That process, as well as every other effort to "tailor" prudential standards based on an institution's size/risk profile, has been done via rulemaking in accordance with congressional direction under Section 165 of the Dodd-Frank Act, as amended by the 2018 Economic Growth, Regulatory Relief, and Consumer Protection Act. Accordingly, tailoring Section 165 requirements such as resolution planning via bespoke M&A conditions rather than a thoughtful, deliberate and transparent APA-compliant rulemaking process would be a considerable departure from past practice.[11]

One wonders: what makes large regional banks different from GSIBs in that they should not receive the same procedural safeguards -- i.e., specifically, the opportunity to comment on proposed prudential/resolution-related

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[10] The APA requires notice-and-comment rulemaking when agencies promulgate "legislative rules" that have the "force and effect of law." A "legislative rule" is a rule that expresses a change in substantive law or policy that the agency intends to make binding. A pronouncement – even if not characterized as a rule – may be binding in application.

Moreover, the OMB's Final Bulletin on Agency Good Guidance Practices requires agencies to use notice and comment when they issue "economically significant guidance documents" that would not otherwise require notice and comment under the APA. An "economically significant guidance document" is a "significant guidance document that may reasonably be anticipated to lead to an annual effect on the economy of $100 million or more or adversely affect in a material way the economy or a sector of the economy". Any new approach will adversely affect the banking sector in a material way if they impose standards that deviate materially from longstanding policy and protocols relating to resolution plan review, and disregard determinations made by other agencies under Section 165(d) that are specifically vested by Congress with the authority to evaluate the credibility of resolution plans.

[11] Imposing SPOE/TLAC-related commitments on institutions seeking to grow via M&A could also potentially detract from the regulators' ability to engage in a considered and transparent interagency rulemaking process in the future. In particular, existing commitments could taint the process as any meaningful deviations from the commitments could lead to significant burdens and/or market disruptions for institutions as well as investors in outstanding TLAC instruments.

requirements such as SPOE/TLAC, and an adequate and clear timeframe within which such requirements must be met?

***Third,* imposing such transformative commitments and conditions only on large regional banks above an arbitrary asset size that engage in M&A transactions creates clear inequities among similarly situated market competitors, raising serious questions about fairness.** Under a SPOE/TLAC requirement linked to M&A, equivalent institutions posing similar risk could be subjected to very different requirements. For example, under the proposed approach, a national bank that surpasses $500 billion in assets through organic growth would not be subject to SPOE/TLAC requirements, but one that grows through M&A would. State-chartered banks (whether supervised by the Federal Reserve or the FDIC) may not be subject to these requirements at all if the approach is only adopted by the OCC. It creates disparate outcomes, and meaningful ones at that, for institutions that are broadly similar and present similar risks.

Moreover, even if the SPOE/TLAC commitments were applied on a case-by-case basis (i.e., $500 billion would not serve as an automatic trigger for the commitments), it is not at all clear what framework – beyond the existing Section 165(d) and FDIC resolution planning frameworks – the OCC would use to make a reasoned determination that a particular institution has different risks or structural features that would make its failure more systemically risky than another firm's (i.e., would the OCC establish a new approach to making these determinations and, if so, on what basis and using what information?).

***Fourth*, this approach likely will have such a chilling effect on future deals that it could effectively operate as an impermissible moratorium on large regional bank mergers.** Simply having this suggestion by a bank agency principal floating in the public dialogue has a chilling effect on potential future mergers given the uncertainty it creates about supervisory expectations for such transactions.

Banks need some sense of the universe of conditions that can be expected when assessing a deal, large or small. The federal banking agencies have created well-established standards over decades regarding how they evaluate bank mergers – a reliable and largely predictable regulatory approval policy produces societal benefits, such as: avoiding direct and indirect costs of a merger rejection (including employee, customer and community anxiety as well as potentially hurting the business prospects of the target in the transaction in irreparable ways); and preventing an unnecessary call on regulatory resources. At the same time, a new known condition that would require a large regional bank to overhaul its strategic and resolution plans and capital structure on a set timeframe post-merger (likely at a monumental but uncertain cost) in order to receive a regulatory approval, but in a way that may conflict with the bank's living will plan and its dealings with the Fed and FDIC, is likely a condition still steeped in too much uncertainty and unpredictability that the bank would pass on the transaction altogether.

Moreover, this policy proposal, by applying these new resolution-related requirements only on banks with more than $500 billion in assets post-merger, could have the effect of an unlawful size-based bank merger moratorium. As our colleagues have written about previously, announcing what is effectively a de facto moratorium violates the statutory requirements imposed on bank regulators with respect to their processing and evaluation of applications.[12]

CONCLUSION

The M&A approval process should not be employed – even for just a short interim period – as an end run around the carefully considered resolution planning requirements and administrative procedures fashioned by Congress. Requiring large regional banks to agree to SPOE/TLAC as a merger condition essentially forces GSIB-type

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12 See Greg Baer, *A bank-merger moratorium isn't just bad policy. It's illegal,* American Banker, Jan. 5, 2022. https://www.americanbanker.com/opinion/a-bank-merger-moratorium-isnt-just-bad-policy-its-illegal

requirements onto regionals with no notice and comment, and no basis other than citing their asset size which is just one small part of the merged bank's risk profile taken into account by the bank regulatory agencies in assessing financial stability risks.[13] Our concerns with this proposed approach are grounded in bedrock principles of fairness and due process.

To the extent an M&A transaction would constitute a material change from a resolvability-risk perspective and a resolution plan change would be merited, the current regulatory frameworks and procedural processes established pursuant to Section 165(d) of the Dodd-Frank Act, the bank merger acts, and the Fed's existing TLAC rule are fit for purpose to mitigate enhanced financial stability risks. For now, however, we are aware of no exigent circumstances that would warrant avoiding a notice-and-comment rulemaking process even assuming that appropriate policymakers determine that changes to resolvability requirements should be considered as a way to mitigate systemic risks.

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13 See Baer, Paridon, and Nelson, *Financial Stability Considerations for Bank Merger Analysis*. https://bpi.com/financial-stability-considerations-for-bank-merger-analysis/ Financial Stability Considerations for Bank Merger Analysis - Bank Policy Institute (bpi.com)