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Orderly Liquidation Authority

This In Focus provides background information and discusses some of the issues related to the Orderly Liquidation Authority (OLA), an authority Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act; P.L. 111-203) granted to the Federal Deposit Insurance Corporation (FDIC) to resolve large, failing financial institutions under certain circumstances. The Financial CHOICE Act of 2017 (H.R. 10) that passed the House in June 2017 would repeal OLA.

Background

Companies in a market economy are generally restrained in their risk-taking by *market discipline*—potential losses incent firms to carefully manage risk. If risks are not appropriately managed and a firm fails as a result, the judicial bankruptcy process under the Bankruptcy Code can impose losses on stakeholders. However, this process arguably may not always be amenable to smoothly resolving certain financial firms.

Liquidating a firm vitally important to financial market segments could disrupt the availability of credit, and the potentially deliberate pace of the bankruptcy process may not be equipped to avoid the runs and contagion characteristic of a financial firm failure. Such disruptions can cause devastating economic outcomes. To address this potential problem at depository institutions, the FDIC has the authority to resolve FDIC-insured, deposit-taking institutions outside of bankruptcy in an administrative resolution regime.

Table 1. Acronyms

BHC	Bank Holding Company
FDIC	Federal Deposit Insurance Corporation
OLA	Orderly Liquidation Authority
TBTF	Too Big To Fail

Source: CRS.

The ability to resolve a financial firm (whether a depository or non-depository) without causing systemic disruption may reduce the likelihood that the government would feel compelled to save the firm with measures such as providing emergency funding. If it is expected that a firm's failure would result in such a response, it is said to be "too big to fail" (TBTF).

The expectation of government support to a TBTF firm exposes taxpayers to losses and causes market distortions, including creating *moral hazard*—excessive risk taking due to protection from losses—and lower funding costs for TBTF firms relative to competitors. Many observers assert that certain events of the financial crisis were a demonstration of TBTF problems. Certain large institutions had taken on out-sized risks that ultimately caused their failure. In response, the U.S. government took actions to stabilize the financial system, including infusing large amounts of government funds into certain individual institutions.

Following the crisis, certain analysts asserted that the FDIC's existing authority was insufficient to contain systemic distress. Many large, complex financial firms are not depositories, and the largest and most complex are generally *bank holding companies* (BHCs) that own many non-depository subsidiaries. Furthermore, the bankruptcy process under the current Bankruptcy Code does not take systemic stability implications of a firm's failure into consideration. Proponents of this view commonly cite what they assert to be the chaotic aftermath of the Lehman Brothers bankruptcy filing as an illustration of this problem.

Dodd-Frank Title II

The Dodd-Frank Act implemented multiple mechanisms to try to eliminate the taxpayer exposures and distorted incentives created by institutions whose failure could destabilize the financial system. One approach was to create the OLA (Title II of the Dodd-Frank Act), a resolution regime designed specifically for certain financial institutions outside of the Bankruptcy Code. OLA is an administrative process in which the FDIC is granted the authority to resolve a financial institution if the Secretary of the Treasury determines (following a recommendation by the Federal Reserve and FDIC) that (1) the institution is in default or likely to default and (2) the default would pose a systemic risk. The institution is granted the opportunity to appeal the determination in court. Although it differs from the FDIC's existing depository resolution authority in certain ways, OLA is sometimes described as extending a similar resolution regime to certain non-depository institutions.

OLA can only be used to wind down a firm, and the FDIC must liquidate the company in a manner that mitigates systemic risk and minimizes moral hazard. To accomplish this, the FDIC would take control of the failing institution and have the authority to transfer or sell assets. In addition, the FDIC can set up "bridge" companies to take ownership of certain assets and assume certain liabilities in order to facilitate the liquidation. The FDIC first uses proceeds it generates through the liquidation to cover costs related to receivership. If those proceeds are insufficient, the FDIC may draw funds from the Orderly Liquidation Fund (OLF) at the Treasury. The OLF is not prefunded, but the FDIC is required to repay the funds used after the fact through assessments on certain large financial institutions. Title II also sets out liquidation rules and claim priorities designed to ensure that losses resulting from the failure are borne by the shareholders and not by the government and taxpayers.

Notably, a resolution under the Bankruptcy Code of a systemic financial firm remains the first option for the resolution of financial institutions under Title II. OLA is designed to be only an alternative if the aforementioned conditions are met. In addition, to facilitate a preplanned bankruptcy process, Title I of the Dodd-Frank Act requires certain financial companies to periodically submit "living wills" to financial regulators. Living wills are meant to demonstrate how a company would be resolved under the Bankruptcy Code without posing systemic risk and must be approved by regulators. Only when the Secretary of the Treasury determines such a resolution is not feasible or poses a systemic risk would a resolution under OLA begin.

Policy Issues

Proponents argue that OLA offers an alternative to saving failing institutions with government assistance or suffering systemic consequences. They assert a preplanned orderly resolution of complex financial institutions carried out by technical experts familiar with the institution is likely to be less disruptive to the financial system than a process overseen by a bankruptcy judge who may be unfamiliar or inexperienced with such institutions. Also, because bank regulators across countries may more regularly coordinate and share information than bankruptcies judges, OLA may facilitate better international coordination during the resolution of an internationally active firm.

In addition, proponents note the similarities between the OLA and the FDIC's depository resolution regime, which successfully resolved large depositories—such as Washington Mutual—during the crisis. Furthermore, the resolution of more than 500 depository institutions during and after the crisis was arguably less disruptive to the financial system than the failure of Lehman Brothers, which went through the bankruptcy process.

Critics argue that the resolution of a depository—even a large one—is substantially different from the resolution of a more complex firm and voice doubts that the OLA could smoothly resolve such an institution. Also, critics assert that the OLA gives policymakers too much discretionary power, which could result in higher costs to the government and preferential treatment of favored creditors during the resolution, thus perpetuating the moral hazard problem.

Furthermore, if the FDIC does face the same short-term incentives to limit creditor losses in order to contain systemic risk that caused policymakers to rescue firms in the recent crisis, the only difference between a resolution regime and a "bailout" might be that shareholder equity is wiped out, which may not generate enough savings to avoid costs to the government. Because the OLF is not "prefunded," there could be temporary taxpayer losses. Also, given the large size of potential losses, some question whether the FDIC would ultimately be able to fully recoup losses through assessments on the industry.

Fiscal Implications

In May 2017, the Congressional Budget Office (CBO) projected that the elimination of the OLA would reduce the budget deficit by $14.5 billion over 10 years based on the probability of a firm being resolved through OLA over the next 10 years multiplied by the net cost to the government of doing so. The deficit reduction is mainly due to scoring conventions. The FDIC is required to assess sufficient fees on large financial firms after the fact to completely offset the costs of an OLA resolution. CBO assumes that some of these fees and proceeds from asset sales would be collected outside of the 10-year scoring window.

Legislative Alternatives

Opponents to the OLA assert that large financial firms should be resolved through bankruptcies to instill market discipline and protect taxpayers from potential losses. If Congress agrees, it could repeal the OLA. Furthermore, Congress could amend the Bankruptcy Code to create a special chapter designed to address the unique characteristics of complex financial firms.

Some have suggested OLA could potentially be repealed through the budget reconciliation process; however, OLA's eligibility for this is unclear. For more information on reconciliation, see CRS Report R40480, *Budget Reconciliation Measures Enacted Into Law: 1980-2010*, by Megan S. Lynch.

Conclusion

Until OLA is used, it is an open question as to whether it could successfully achieve what it is intended to do—shut down a failing firm without triggering systemic disruption or exposing taxpayers to losses more efficiently than a resolution through bankruptcy. Given the size of the firms involved and the unanticipated transmission of systemic risk, no consensus exists on the best policy alternative.

CRS Resources

CRS Report R42150, *Systemically Important or "Too Big to Fail" Financial Institutions*, by Marc Labonte

CRS Report R43801, *"Living Wills": The Legal Regime for Constructing Resolution Plans for Certain Financial Institutions*, by David H. Carpenter

CRS Report R44839, *The Financial CHOICE Act in the 115th Congress: Selected Policy Issues*, by Marc Labonte et al.

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