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"Mitigating TBTF With Recovery Planning"

Remarks at Entrepreneurship, Markets and Technology: Regulation's Challenges in a Changing World Conference

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Thank you for inviting me to speak here at the Vanderbilt Law School/University of Zurich Law School Conference.

Today I would like to talk about recovery planning. More specifically, I want to explain why recovery planning is so important and how robust recovery planning can help mitigate the too-big-to-fail (TBTF) problem. Ensuring effective recovery planning at large banks is especially important given last year's bank failures in the U.S. and Credit Suisse's distress and eventual acquisition by UBS.

Admittedly, recovery planning tends to be overshadowed by resolution planning and debates about capital and liquidity. Practitioners of bank crises know, however, that strong recovery plans can and do make a critical difference when a large bank is under severe stress.

The Trolley Problem

Let's start with the "why." Why is recovery planning so important? What exactly does a recovery plan achieve?

To answer these, it helps to consider an analogy. If you will indulge me, I would like to take us on a brief detour into moral philosophy and discuss the trolley problem.

The set up of the trolley problem is simple. There is a runaway trolley with brakes that no longer work. On the track ahead lies a group of five people tied to the track. If nothing is done, the trolley will kill them. Between the trolley and the people, though, is a fork. You can pull a lever and switch the trolley to another track to avoid killing the group. But on the other track lies one person. If you do nothing, five people die. If you switch tracks one person will die who otherwise would have lived. What do you do?

The trolley problem has been used by ethicists and moral philosophers to ponder a range of dilemmas and situations, ranging from organ transplants to autonomous driving. In banking, the trolley problem aptly describes the dilemma facing regulators when a large bank under stress is headed toward disorderly failure. If regulators do nothing, they risk financial instability. Or they could switch tracks by taking extraordinary action, such as invoking the systemic risk exception, establishing new emergency lending facilities, or providing novel guarantees—any of which would invite criticism of a bailout.

Avoidance of the trolley problem, of course, is first best. Risk management, capital, and liquidity serve as a trolley's brakes. Prudent risk management, robust capital and liquidity requirements, and strong supervision can help avoid the trolley problem entirely. That is Plan A.

As last year showed, however, Plan A is not foolproof. Depositors, counterparties, and investors may lose confidence in a large bank. When that happens, the risk of disorderly failure increases and regulators may be confronted with the trolley problem.

Recovery actions can provide a way out. A robust recovery plan provides a bank and its regulators with options to stabilize the institution and shore up confidence when it is under stress. Actions may include limiting growth or reducing risk weighted assets, selling certain portfolios or businesses, increasing and terming out liquidity, or raising capital.

In the spring of 2009, for instance, at the height of the financial crisis, Barclays sold its asset management business, Barclays Global Investment, to BlackRock for $13.5 billion. The sale provided Barclays with much-needed capital, helping to stabilize it and restoring confidence during a particularly perilous time in the market.

Having actionable recovery options effectively creates new tracks that a bank can switch to when it is in stress, enabling it to avoid disorderly failure and mitigating the trolley problem.

Strong, Effective Recovery Plans

Of course, not all recovery plans are created equal. To understand the importance of strong, effective recovery planning, it helps to consider what happens when a bank in distress is underprepared for recovery.

Imagine the following scenario. Sustained rumors have triggered heightened market scrutiny of a large bank, leading some counterparties to pull back, driving more rumors. Creditors are shortening funding terms to overnight. Depositors are beginning to withdraw their money. Trading partners are asking for more collateral and reallocating new trades to peers. In short, everyone is inching toward the exit. The bank's stock price is down, its CDS spread is up, and there are twice-a-day calls with global regulators demanding to know the bank's most current liquidity position.

The bank "activates" its contingency plan, which includes a range of options identified through its recovery planning process. As the bank considers those options, though, it becomes clear that none of them can actually be implemented. Aside from the PowerPoint presentation and memo that the bank's board approved, no other preparations were made. The portfolios to be sold have changed, the contingent funding lines to be drawn were never established, the businesses to be marketed were never engaged, and the execution of the other steps listed in the plan would have second-order impacts that would reinforce market rumors and lead to a further loss of confidence.

Strong and effective recovery planning, by contrast, would have provided the bank's leaders with actionable options that could have stabilized the situation. What makes for a strong and effective recovery plan?

As highlighted in the OCC's "Guidelines Establishing Standards for Recovery Planning," there are eight key elements of an effective recovery plan.[1] While all elements are important, I will focus today on three: triggers, options, and impact assessments.

Banks in stress tend to do too little too late, as the sense of urgency needed to compel recovery action often sets in only after the window for taking such action has closed. Thoughtful, credible triggers can mitigate this risk by ensuring that recovery actions are considered in a timely manner. Triggers can be quantitative or qualitative. Quantitative triggers may be related to a bank's liquidity and capital levels or to its stock price or CDS spread. Qualitative triggers might include credit rating downgrades, severe financial stress at major counterparties, or significant operational risk events.

Actionable options are the core of effective recovery plans. Generally, they can help restore confidence in a bank by improving its liquidity or capital position, by reducing key uncertainty, or by simplifying the banking organization's operations. Options can range from sales of portfolios or lines of business to securing of long-term funding to capital preservation measures. The more numerous and wide-ranging the options a bank has the better. Importantly,

[1] See 12 CFR 30, Appendix E, as well as the *Comptroller's Handbook* "Recovery Planning" booklet.

recovery options need to be *actionable*. It is not enough for a bank to simply assert that it can, for example, sell a line of business. For such an option to be actionable, a bank needs to be specific in demarcating the object of sale, identifying potential bidders, analyzing legal and regulatory impediments, and preparing to populate a data room to enable buyer due diligence. In short, banks should actively work each option so that it can in fact be acted upon when needed.

Finally, impact assessments are important so that managers and boards of directors can understand the full range of consequences of taking certain actions. For instance, selling a portfolio of assets to generate liquidity could result in a hit to capital and loss of earnings power, risking a ratings downgrade, or could affect a material legal entity disproportionately. Analyzing the direct and indirect impacts of each option can help with planning and limit the risk of surprise when banks in stress contemplate their recovery options.

Mitigating TBTF with Recovery Planning

One reason why I am such a strong proponent of recovery planning is that it can be highly effective in combatting TBTF.

As a financial regulator in the 2008 financial crisis, I had a front seat to the collapses of Lehman Brothers and AIG. In a way, they represent the two tracks of the trolley problem. With Lehman, the firm filed for bankruptcy and the result was financial instability, while with AIG, extraordinary government actions were taken to protect the financial system and the result was a loss of trust in government.

Neither outcome was right. Strong and effective recovery planning at those firms could have helped in two ways.

First, well-designed triggers and proper governance could have prompted timely consideration of recovery options and compelled each firm to act much earlier. Such actions—instead of mere words or aspirations—might have provided investors and counterparties with enough confidence to stay the course instead of cutting lines and running.

Second, well-prepared recovery options to sell portfolios and lines of business would have enabled both firms to shrink quickly and in an orderly manner, even post-failure. Breaking up a large bank is impossible without proper planning. Strong recovery planning, coupled with resolution-required separability, make an orderly downsizing and break-up of a large financial institution feasible.

Conclusion

I have focused my remarks today on explaining why effective recovery planning is so important and how it can mitigate the TBTF problem. So what's next?

The OCC's recovery planning guidelines currently apply to large banks with at least $250 billion in assets. Given last year's banking turmoil, I believe expanding the application of the guidelines to all large banks with at least $100 billion in assets warrants serious consideration. While counterfactuals are hard to prove, one does not have to strain to see how strong recovery planning might have mitigated the failures of Silicon Valley Bank and Signature Bank. At a minimum, such planning would have made their resolutions more orderly and less costly to the Deposit Insurance Fund.

Thank you.