THE UNSETTLED STATE OF U.S. RESOLUTION

Congress will have a lot on its plate when they return after Labor Day – the Iran deal and, even more important for financial markets, the budget and debt limit are at the top of that list. However, before the August recess, committees in both the House and Senate turned to the long-festering question of how to make giant U.S. financial-services firms resolvable under the Bankruptcy Code. Earlier this summer, the Basel Committee laid out final principles for global banks (see FSM Report RESOLVE33). Aspects of the Congressional approach are compatible with the global framework, but the push to repeal Dodd-Frank’s orderly-liquidation authority (OLA) could put the U.S. very much at odds with global practice. For all the talk of ending too big to fail, most nations outside the U.S. have just a few, very big banks that are so intertwined with the national government and economy as to make them impregnable – or, at least, impregnable once taxpayer support is factored into the backstop equation. The U.S. Congress – and most especially its Republican Members – will have nothing to do with any resolution regime that includes a taxpayer backstop. The clearest expression of this is new legislation in the Senate (see FSM Report RESOLVE34) that not only creates a new chapter of the U.S. Bankruptcy Code to settle SIFIs, but also repeals OLA. Taken together with legislation to constrain the FRB’s emergency-liquidity powers, the new construct poses major policy issues. These include:

- Whether the new regime will work for non-banks. The bills, like the FDIC’s resolution protocols are largely premised on what is expected when bank holding companies fail. However, asset managers, insurance companies, CCPs, and other non-banks now pose at least as much systemic risk as the nation’s banks. Aspects of the proposed new bankruptcy regime (generally known as Chapter 14 in the Senate and Subchapter V of Chapter 11 in the House) work better than current law for these firms, but many questions remain unanswered;

- The extent to which a single bridge company works for complex financial institutions that may well require resolution through multiple points of entry;

- The degree to which the new approach settles cross-border resolutions any better than current law, especially with regard to automatic stays. Bankruptcy
now could handle these—under current law, this is possible only under OLA—but that’s still only for counterparties subject to U.S. law;

- The extent to which U.S. companies could operate branches across national borders given the tough-love approach of the revised Bankruptcy Code; and

- Most of all, whether the U.S. financial system will be safer without OLA because investors will truly ensure that the largest financial-services firms can be shuttered without collateral damage.

We doubt Congress will resolve any of these issues in the fall, but many of them will advance. Any bill that repeals OLA will be vetoed, but all of them will color negotiations in the fall over global resolution protocols as the G-20 revs up, discussions over subsidiarization and ring-fencing at the IMF-World Bank annual meetings, and global and U.S. action on total loss-absorption capacity (TLAC) regulations. Global counterparties have no disagreement with making the U.S. Bankruptcy Code work better for SIFIs, but they have a lot of angst over any approach that takes away a government backstop, especially if intermediate emergency-liquidity support from the FRB or FDIC is also yanked. Congress doesn’t much care if U.S. banks are safe and sound from a global perspective as long as taxpayers aren’t at risk; global counterparties look to their own interests and are afraid.

Headlines From the Past Week’s Daily Briefings

August 17

- **FRB-NY Uncertain if Market Liquidity Sufficient for Tail Event** - The Federal Reserve Bank of New York released the first of a five-part series on liquidity, concluding that most measures indicate sufficient average liquidity in Treasury markets. However, the findings do not necessarily lead to a conclusion that markets are stable, with the FRB-NY noting the possibility that markets may become less liquid due to structural changes in the demand and supply of Treasuries coupled with monetary-policy normalization and the attendant rise in volatility. Furthermore, the authors did not examine less-liquid Treasuries, fixed-income securities, or liquidity risk (tail events where liquidity evaporates, such as during the October 15 flash crash). Such sharp, unexplained price changes in sovereign debt may be the types of events that concern market participants, and not a sustained decline in liquidity which is the post’s main focus.

August 18

- **FRB-NY Examines the How, not the Why, of Flash Events** - The Federal Reserve Bank of New York released its second post on market liquidity,
analyzing three recent flash events without drawing any policy or market-structure conclusions. The events examined are movements in U.S. equities on May 2010, in the Treasury markets on October 2014, and in the euro-dollar FX market on March 2015. All three did not appear to be linked to any fundamental economic news, unlike movements in the Swiss franc or the taper tantrum. In all three, prices changed considerably before correcting, and volume per second spiked in the first phase of all three events, with each correcting amid much lower volume.

- **Marketplace RFI Deadline Extended to Give Lenders More Time to Mount Defense** - The Treasury Department extended the deadline for comments on its request for views on the role and risks of marketplace lenders from August 31 to September 30, a move reflecting not only the summer doldrums, but also requests from the P2P sector and other non-traditional lenders working on a set of best practices they hope will allay Treasury’s concerns. We previously provided clients with an assessment of this RFI in FSM Report **LENDING7**. As noted, Treasury is taking very preliminary steps toward action in the shadow banking arena, with this RFI focused on assessing how online marketplace lenders are regulated and the risks posed by any disparities between their framework and that governing established players. Although Treasury lacks any direct authority to govern both bank and non-bank lenders, Dodd-Frank does give FSOC the authority to recommend regulation when it believes activities and practices may pose systemic risk.

**August 19**

- **FRB-NY Lays Out Growing HFT Risk** - The Federal Reserve Bank of New York released its third post on market liquidity, examining high-frequency trading in the Treasury cash and futures markets. HFT has been a major concern of both the FRB and Treasury, with Counsellor Antonio Weiss recently worrying that automated traders may be able to “beat the system” and many new entrants that utilize HFT are not subject to supervision or sufficiently capitalized against stresses. However, at the time he called only for better data and an improved understanding of market dynamics – one of course now provided in part by the FRB-NY. Consistent with practice, the post does not lay out any recommendations or any views on risks, focusing instead on the linkages between Treasury markets. It does find that cross-market trading is now a significant portion of trading on both markets, reaching almost 20% of all activity on many days.

- **Global Regulators Expand Data-Aggregation Efforts** - The BIS’ Committee on Payments and Market Infrastructures (CPMI) and IOSCO released a consultation on a uniform Unique Transaction Identifier (UTI), which would identify each OTC derivatives transaction that must be reported to trade repositories. This follows preliminary efforts to harmonize data reporting
across jurisdictions (including work on establishing legal entity identifiers). CPMI and IOSCO will also issue a consultation on technical guidance for other data elements (that are not unique product identifiers) essential for aggregation of OTC derivatives data, but do not specify a date for the future consultation. All of these efforts are aimed at enhancing data-aggregation at the largest financial institutions – BIS and other studies show this lagging considerably behind mandated schedules, with regulators pushing hard on these issues due to fears that continued opacity exacerbates financial crises and stymies supervision aimed at preventing risk concentrations.

- **GSE Affordable-Housing Goals Hold Steady** - FHFA released its final rule on 2015-2017 affordable-housing goals for Fannie Mae and Freddie Mac, cutting a middle course sure to anger affordable-housing advocates without satisfying GOP critics who continue to believe that any GSE endeavors in this area distort markets and create taxpayer risk. The rule sets the GSEs’ purchase goal for single-family low-income homes at 24% of their purchases and their multifamily low-income goal at 300,000 units in each of the three years in question. The rule represents an increase of one percentage point from the 2014 benchmark goal for both Fannie and Freddie for single-family low-income home purchases, and an increase of 50,000 units for Fannie and 100,000 for Freddie from the 2014 multifamily low-income goal. The rule also sets several subgoals for the GSEs; for single-family housing, very low-income home purchases are to be set at 6% of purchases, low-income areas home purchases at 14%, and low-income refinances at 21%. For multifamily housing, very low-income purchases are to be set at 60,000 units, and the new rule establishes a new low-income purchase subgoal that would see both Fannie and Freddie purchase 6,000 “small” (5- to 50-unit) multifamily properties in 2015 and increase purchases by 2,000 units per year thorough 2017.

**August 20**

- **FRB-NY Adds Data to Demonstrate Growing HFT Risk** - The Federal Reserve Bank of New York released part four of its series on market liquidity, analyzing trading of on-the-run ten-year Treasuries in the interdealer market, finding that the "workup" protocol now plays an increasing role in the market. Data demonstrate both increased use of high-frequency trading and increased order speed in the Treasury markets, and the technological improvements underlying this increased use have made commonplace sophisticated automated trading strategies that once were rare. The post does not draw any conclusions regarding HFT from its data. However, given prior posts also showing the increased role of HFT, this post adds to findings likely to spur greater Treasury and FRB focus on potential regulations in this arena.
August 21

- **FRB-NY Concludes Regulations, Crisis, HFT All Crimping Dealer Balance Sheets** - The Federal Reserve Bank of New York released the final post of its series on liquidity, focusing on the causes of primary-dealer balance sheet stagnation. Data presented demonstrate that regulation is a driving factor, although the FRB-NY posits that decreased risk appetite, the housing bust, and high-frequency trading are also potential causes. A key chart shows that leverage of securities brokers -dealers was at 48:1 right before the crisis and dropped to around 25:1 before the passage of Dodd-Frank. In 2015, broker-dealer leverage stands at 20:1.

### This Week

No meetings of note – Congress is in recess.

### Recent Files Available for Downloading

The following reports and analyses have been sent to retainer clients recently. Copies are also available to retainer clients on the Archives section of Federal Financial Analytics’ website: [www.fedfin.com](http://www.fedfin.com) or clients may obtain the reports/analyses by e-mailing requests@fedfin.com giving the requested item name, firm, and e-mail address. To learn more about GSE Activity Reports, click: [http://www.fedfin.com/index.php?option=com_content&view=article&id=18&Itemid=18](http://www.fedfin.com/index.php?option=com_content&view=article&id=18&Itemid=18)

- **GSE-081915**: The question of whether banks are bulking up on retained mortgages has recently taken on emotional overtones, with some alleging that data show a significant trend towards bigger on-balance-sheet books and others countering that loans will be sold for as long as the GSEs and Ginnie are buying.

- **RESOLVE34**: In conjunction with a less-sweeping bill to rewrite the U.S. Bankruptcy Code to handle SIFI resolutions, a group of senior Senate Republicans has introduced legislation to rewrite the Bankruptcy Code to handle better complex financial institutions and repeal Dodd-Frank’s orderly-liquidation authority (OLA).

- **COMTRADE7**: The OCC has weighed in on the question of physical-commodity activities by national banks and federal branches and agencies of foreign banks, doing so in the absence of long-awaited FRB guidance in this controversial arena and continued Congressional interest in strictly limiting this line of business.

- **GSE-081215**: Another FHLB has added another REIT captive reinsurer to its membership ranks, FHFA notwithstanding. The REIT in question is Cherry Hill Mortgage Investment Corporation (CHMI), which is owned by Freedom Mortgage and controls a reinsurance company based in Michigan.