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Expert Analysis

End of the Road: Resolution Models For Financial Companies

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Last month, I wrote about the Basel Committee's proposal to impose a capital surcharge on systemically important financial institutions (SIFIs).[1] However, if the capital surcharge and any other remedial measures imposed by the appropriate regulator in order to rehabilitate the SIFI to a safe and sound condition do not work, then the final step is intervention by the appropriate regulator, which, depending upon the law in that jurisdiction, can liquidate the company or rehabilitate and sell it. This month's column will explore new resolution proposals that may be adopted by the G20 later this year, and discuss the SIFI resolution model adopted by the United States in the Dodd-Frank Wall Street Reform and Consumer Protection Act.[2]

Financial Stability Board

The Financial Stability Board (FSB) is composed of regulators responsible for financial stability in the world's financial centers and works, along with other international regulators, to promote international standards for regulation and supervision of the financial markets.[3] In mid-July it issued for comment a proposal on resolutions of SIFIs in order to develop final recommendations for the G-20 Leaders Summit in Cannes on Nov. 3-4, 2011.[4] The comment period ended Sept. 2, and the FSB is now reviewing the comments and developing its final recommendations.

Specific Elements

Resolution planning needs to begin long before a resolution becomes necessary. The FSB has proposed that each SIFI be required to develop a recovery and resolution plan (RRP) which would be developed by each SIFI, approved by the appropriate regulators and reviewed and revised on a regular basis. Closely related to an RRP would be the resolution authority's ability to require changes to a SIFI's business practices, structure or organization in order to reduce the complexity and costliness of resolution, even before there is a need to consider resolution.

Critical to the utility of an RRP is identification of, and detailed data concerning, a SIFI's essential and systemically significant functions and what is necessary to keep them operating in either a recovery or resolution scenario. The recovery segment of the plan would include a description of workable options to cope with a range of stress scenarios affecting the SIFI, such as liquidity or capital crises or market-wide stress on the financial system. The goal of the resolution part of the plan is to assist the particular resolution authority in developing and implementing the specific resolution framework for the SIFI, to be accomplished without severe systemic disruption or exposing taxpayers to loss.

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The general framework for such a resolution regime, which should be flexible enough to apply to any SIFI, would include the following:

- A designated "resolution authority" in each country—a government agency or agencies with all necessary authority, and operational independence, to effectively resolve failing or failed SIFIs.
- Authority to act quickly when necessary with respect to some or all of a SIFI's operations, including the ability to operate and resolve the SIFI by taking any actions the resolution authority deems necessary;
- A requirement that a resolution authority consider the impact of its actions on the financial stability of its own jurisdiction and other jurisdictions where the SIFI had operations.

Jurisdictions should not rely on the SIFI being bailed out by government funds. If use of government funds and/or other temporary financing measures is necessary to maintain financial stability and provide for an orderly resolution, the law should provide for the resolution authority to be able to recoup losses from shareholders and unsecured creditors, access the central bank's liquidity facilities, and establish a process by which the industry could be required to pay for the costs of resolution. As a last resort, the law could provide for temporary public ownership of a SIFI.

Another option is the so-called "bail-in" option where the law would allow, on a discretionary basis, recapitalization of a SIFI by requiring debt-equity conversion and write-down tools as necessary to resolve a particular institution. The objective of the bail-in process would be to ensure that the costs of resolution are borne by the SIFI's shareholders and other unsecured and uninsured creditors, rather than by taxpayers.

Cross-Border Resolutions

Each country has its own resolution regime for financial institutions, and with respect to resolution of financial institutions such as banks, there has long been the issue of "ring-fencing" of assets. In New York, for example, were the state banking regulator to take possession of and close the New York State-licensed branch or agency of a non-U.S. bank, it would take possession of not only the assets of the New York office wherever located, it would also take possession of all the assets of the non-U.S. bank itself in New York. Given New York's global financial center status, that authority could result in a substantial amount of money for use by the New York banking regulator in its liquidation process.[5]

Resolution authority statutes addressing cross-border resolutions should provide for the following for both pre-closure and post-closure.

Pre-closure measures include:

- Regular information sharing among a SIFI's regulators on a confidential basis, to include all information relevant for recovery and resolution planning and regular reports on ongoing operations;
- Entry into institution-specific cooperation agreements between the SIFI's home and host jurisdiction authorities, establishing the roles of the authorities on a routine basis as well as in a crisis, and providing a process for information sharing among the authorities, coordination of changes in the SIFI's RRP, and prior notification and consultation when a resolution authority needs to take significant action with respect to a SIFI. Jurisdictions should ensure that there are no legal, regulatory or policy impediments that would hinder the appropriate exchange of information;
- Establishment of a cross-border Crisis Management Group (CMG) consisting of representatives of all the regulators of a particular SIFI, including representatives from any jurisdiction in

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which the SIFI has material operations—including central banks, finance ministries and supervisory authorities, not just the resolution authorities.

Post-closure measures include:

- No automatic action being triggered as a result of the resolution authority taking action to resolve the SIFI, but instead providing a right of discretionary national action if necessary for financial stability in the absence of international cooperation and information sharing;
- Authorization of a host resolution authority to support actions being taken by the home country's resolution authority while also allowing the resolution authority to take domestic action as needed to preserve its jurisdiction's financial stability;
- All creditors would be treated equally, regardless of where in the world the creditor or the creditor's claim is located;
- While ensuring that local creditors will be treated equally no matter where located, providing for an expedited process to provide the SIFI's home country resolution authority with the ability to gain control over assets located in a host country jurisdiction.

Comparison with Dodd-Frank. Many of the FSB recommendations on the domestic side are already incorporated into the U.S. law, in most cases through Dodd-Frank; the cross-border resolution recommendations less so.

Title I Systemic Risk

While the financial company still is alive, with respect to a large bank holding company or a SIFI, the Board of Governors of the Federal Reserve System (FRB) has very broad powers and tools similar to many of the FSB recommendations, such as replacement of directors and senior management, imposition of enhanced capital and liquidity requirements, reduction of concentrations of credit, and sale of parts of its business operations.[6] In addition, there is an RRP requirement (referred to colloquially as "living wills") that is applicable to large bank holding companies and SIFIs.[7] The question of whether SIFIs and large bank holding companies should maintain contingent capital convertible into equity is being studied.

Title II Resolution Authority

Title II of Dodd-Frank sets up a process for receivership by the Federal Deposit Insurance Corporation (FDIC) for U.S. non-bank "financial companies," similar to the FDIC authority in bank receiverships.[8]

Generally, companies other than banks are resolved in accordance with the U.S. Bankruptcy Code, although some regulated entities, such as banks, broker-dealers and insurance companies are treated differently. Under Title II, the FDIC authority to become the receiver for a qualifying non-bank financial company would be invoked if the Treasury Secretary, upon the recommendation of the FRB and the FDIC, and in consultation with the President, determines that a failed financial company cannot be resolved under traditional means without posing a systemic risk.

There are special procedures for broker-dealers (the Securities and Exchange Commission is to be consulted) and insurance companies (the director of the Treasury Department's new Federal Insurance Office is to be consulted). The FDIC's appointment as receiver must end within three years after the date of the appointment, although that period may be extended for up to two additional years. The FDIC must promulgate rules regarding how it executes its authority under Title II, including with respect to the termination of receiverships.

The resolution process is similar to that of a bank receivership, including providing for a claims process, a one-business-day hold on termination of financial market contracts such as swaps and derivatives, and repudiation of contracts.

One element of protracted debate in Congress was how this liquidation was to be financed. Dodd-Frank is clear that there can be no taxpayer funding of such a liquidation. While the FDIC under certain circumstances can borrow from the U.S. Treasury Department, the FDIC is to be reimbursed by other financial companies through a three-tiered special assessment process. An "Orderly Liquidation Fund" is established by Title II, but remains unfunded until after the commencement of a receivership, at which point the FDIC is authorized to borrow from the U.S. Treasury to obtain funding for the liquidation process after it has submitted an acceptable "Orderly Liquidation Plan" to the Treasury Secretary.

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If the assets of the liquidated entity prove insufficient to repay the amounts owed to the Fund following the liquidation process, the FDIC must charge risk-based assessments to make up for the shortfall under a three-step process:

(i) First, creditors who received more in the FDIC liquidation than they would have received under an ordinary liquidation are assessed;

(ii) Next, there would be assessments against bank holding companies with total consolidated assets of $50 billion or more and any nonbank SIFIs supervised by the FRB;

(iii) Finally, if there still is a deficiency, then the FDIC could assess other non-SIFI nonbank financial companies with total consolidated assets of $50 billion or greater, even if not supervised by the FRB.

Regulations required on the levy of these risk-based assessments must take into account various factors including assessments paid by regulated entities (e.g., insurance companies) to other regulators.

In addition to ensuring that creditors and shareholders of the failed financial company bear the losses of the financial company, the FDIC is authorized to seek recovery from directors and officers of the company to the extent they contributed to the company's insolvency, including recoupment of up to two years past compensation (in the case of fraud, no time limit) and recovery of damages attributable to gross negligence by such individuals. In addition, in particularly egregious cases, the FDIC (or FRB, as appropriate) may prohibit directors and senior executive officers from participating in the affairs of a financial company for two years or more, similar to the power already vested in the federal banking agencies with respect to insured depository institutions. The FDIC and the FRB must jointly issue rules addressing the terms of such prohibitions.

The FDIC has begun promulgating regulations to implement its authority under Title II, including a claims process and priority of payment of accepted claims, recoupment of compensation of senior executive officers and management, and management of secured creditors' claims.[9]

Conclusion

Cross-border resolution should be an issue closely watched by non-U.S. banks and U.S. banks with substantial international operations. On the international cooperation and coordination side, while Dodd-Frank has several provisions requiring consultation, information sharing and coordination with other regulators, the United States cannot act alone—it needs the cooperation of the other countries. Whether adoption of the recommendations by the G20 leaders in November will lead to progress in the area of international cooperation remains to be seen.

1. Different terms are used to denote financial institutions that are of systemic importance but this column will use the term SIFI throughout for ease of reference.
2. Pub.L. 111-203, July 21, 2010.
3. See www.financialstabilityboard.org for more information.
4. Financial Stability Board, "Consultative Document: Effective Resolution of Systemically Important Financial Institutions," July 19, 2011.
5. See New York Banking Law, §606(4). The only claims paid are those that arise out of transactions with the New York branch or agency of the non-U.S. bank. The surplus is eventually sent to the liquidators of the head office, after it is shared with the liquidating authority of any of the non-U.S. bank's other U.S. offices.
6. See Pub.L 111-203, §§115, 165.
7. Pub.L. 111-203, §165(d).
8. See Pub.L. 111-203, section 201 et seq. Titles I and II of Dodd-Frank are codified at 12 U.S.C. Chapter 53, Subchapters I and II, starting with section 5301.
9. See 76 Fed. Reg. 41626 (July 15, 2011).