Focus on

Bank Resolution

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I. Resolution: US v. EU

US: Resolution Under Auspices of FDIC established in the 1930s

"Resolution": the FDIC --

i) takes over failing bank

(ii) arranges a transaction in which a transferee bank takes over deposits (and some assets), receiving Deposit Insurance Fund payout to cover valuation shortfall

(ii) imposes losses on bank shareholders and (some) bank creditors

Resolution: US v. EU, 2

- Financial Crisis revealed flaw: significant bank-like activity had moved outside the official banking system

- Resolution for failing firms: Alternatives were bankruptcy (disorderly resolution: see Lehman) or ad-hoc resolutions (Bear, AIG) that partially protected shareholders and fully protected creditors

Resolution: US v. EU, 3

- **Post-Crisis Fix: Dodd-Frank, Title II, "Orderly Liquidation Authority"**

-- Extended FDIC Resolution Authority to Non-Banks:

"*Systemically Important Financial Institutions*"

-- Strengthened mandate of FDIC to impose losses on creditors of failing institution rather than mutualize losses (Deposit Insurance Fund) or taxpayer "bail-out"

-- In implementing regulations, FDIC developed new resolution technology, "Single Point of Entry" (SPOE), designed to minimize disruption costs and thereby make resolution credible, even of SIFI, and end "Too Big To Fail"

Resolution: US v. EU, 4

- EU: Came to the Crisis with no strong tradition of regularized bank resolution at Member State level, none at EU level despite increasing cross-border activity
- Organic Differences, so that in EU vs. US:
  - most credit intermediation runs through banking system
  - banking system much more concentrated
  - more frequent state ownership of banks, historically and currently
  - In general, symbiotic relationship between state and bank

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Resolution: US v EU, 5

- Initial conflict between the EU “project” and bank rescue:
    - In immediate post-Lehman crisis period, EU complicated rescues through constraints on “state aid,” as if the most serious issue was avoidance of protectionist/mercantilist advantage-seeking by Member States

Resolution

- I will talk about the US Dodd-Frank scheme of resolution for SIFIs
- Patrick Bolton will address the choice of resolution or (improved) bankruptcy for a SIFI
- Martin Hellwig will address the newly adopted EU Resolution scheme (critically)
- Our distinguished panelists will respond

II. Ad Hoc Resolution in 2008, US

For non-bank financial firms, the only alternatives to bankruptcy were **merger** (Bear-Stearns) and **recapitalization** (AIG)

Merger requires:

-- By statute: target shareholder approval, majority of outstanding stock

-- By practical necessity for financial firms: given the significant time period between "signing" the merger agreement and "closing" the merger, a guarantee of target obligations (to avoid unraveling of franchise value)

-- Target shareholders will not be wiped out (given their voting rights)

-- Target creditors, even unsecured, are fully protected (merger statute)

-- Target counterparties are fully protected (merger statute)

Ad Hoc Resolution in 2008, 2

- For Bear, Fed facilitated the transaction with JPMC by lending to off-balance sheet SPE ("Maiden Lane I") which bought $30 BB in "troubled assets" from Bear; JPMC taking $1 BB first loss position.

Ad Hoc Resolution in 2008, 3

- For Lehman, Barclays was unable to provide guarantee because of shareholder approval rights that the UK government would not waive.
- Fed could not/would not provide open-ended guarantee
- Cross-border resolution problems were simply unanticipated and proved disastrous:
  - US kept Lehman (NY) broker-dealer sub afloat pending a sale;
  - UK did not for London broker-dealer sub

Ad Hoc Resolution in 2008, 4

- **Recapitalization** (AIG) with 3d party assistance requires: shareholder approval (which limits extent of dilution)
- Creditors, even unsecured, are protected
- Counterparty claims are protected
- Requires 3d party funder (here: the Fed, lending on assets it believed made it adequately collateralized)

Ad Hoc Resolution in 2008, 5

- One person's "resolution" is another person's "bailout"

III. Resolution: Key US lessons from Financial Crisis

1. Huge social costs from Disorderly Resolution (Lehman Brothers)
2. Key to Efficient (thus credible) Resolution is to avoid value destruction from runs by depositors and other short-term credit providers, which produces fire sale liquidations, collapse of bank balance sheets, and credit rationing to real economy.

Resolution: Key US lessons,2

3. Efficient Resolution must also avoid value destruction from resolution regimes applied inconsistently across firms with operations in multiple jurisdictions

4. Conventional Deposit Insurance is neither sufficient to avoid runs nor necessary in design of Efficient Resolution procedure

   -- Not sufficient: because capped

   -- Not necessary: if non-runnable unsecured term debt is available to absorb losses ("bail-in")

Resolution, Key US Lessons, 3

- Although “Bail-Out” is not necessary, Efficient Resolution requires liquidity provision to post-resolution firm and capacity to provide liquidity to remainder of financial sector because of limited direct market access in post-resolution uncertainty

IV. FDIC's "Orderly Liquidation" (OLA) strategy

Dodd-Frank Act, Title II ("Orderly Liquidation Authority"), implemented as **"Single Point of Entry"**

- Put Holding Company ("Topco") into FDIC receivership, using Topco debt to cover losses throughout the group and to re-equitize a Bridgeco successor; do not resolve operating subsidiaries

“Single Point of Entry” (“SPOE”)

“Single-point-of-entry resolution involves working downwards from the top company (Topco) in the group in an exercise that resolves the group as a whole, wherever its problems began. Think of it this way. Losses in subsidiaries are first transferred within the group to the Topco. If Topco is bankrupt as a result, the group needs resolving. Bailin can then be applied to the Topco’s capital structure: writing off the equity and, most likely, subordinated debt; and writing down and partially converting into equity the senior (bonded) debt issued by Topco. Those bondholders become the new owners.”

---Paul Tucker, Resolution and Future of Finance (May 20, 2013)

FDIC's OLA strategy, 2

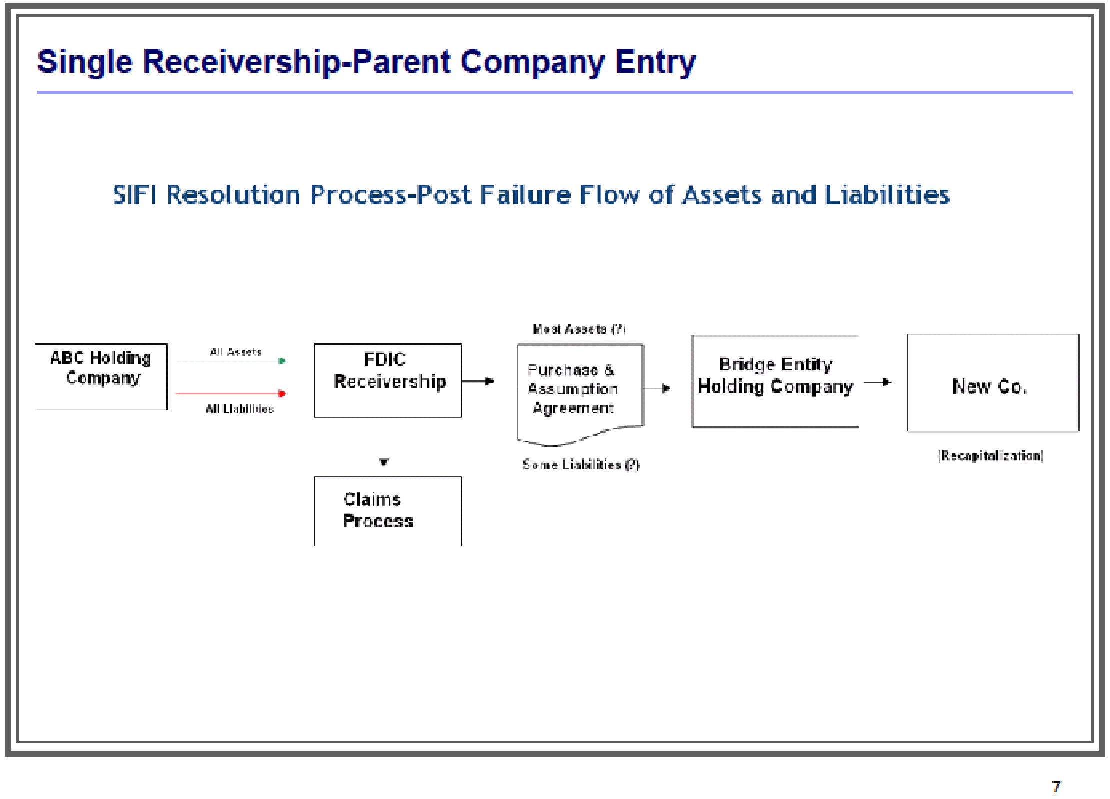
Goals:

- preserve going concern value/ franchise value/ credit channel
- avoid follow on counterparty failure
- minimize systemic distress

FDIC's OLA strategy, 3

- Financing of group at Topco level; write off intercompany loans/manage intergroup resources as necessary to re-equitize loss-making subs
- After imposition of a receivership, Topco's main assets – its shares in the subs – are transferred to a 'Bridge Company' (Bridgeco)
- Topco's unsecured term debt is left in the receivership
  - Estimate losses; write down Topco debt in accordance with priority
  - Recapitalize Bridgeco by converting remaining Topco debt into Bridgeco equity: 'Bail In'
  - Topco debt holders become Bridgeco shareholders
- FDIC provides liquidity to Bridgeco (credit line at Treasury; full faith & credit guarantees of Bridgeco debt issuances)

FDIC’s OLA strategy, 4



FDIC’s OLA strategy, 5

- NB: this solves the cross-border insolvency problem, since non-US subs will be able to perform on obligations (-> Lehman!)
- US-UK accord in which UK regulator agrees to rely on US to protect UK subs; follow-up accords with other regulators
- **November 2012 simulation: It Works!**

V. OLA, Key elements

1) Holding Company structure

“Fortuity” of tortuous history of banking in the US, which, e.g., never permitted “banks” to underwrite corporate securities, which meant they conducted securities markets activity through affiliates under common ownership.

OLA, Key elements, 2

2) Thick-enough layer of unsecured term debt at Topco level

- will require follow-on regulation
- NB: debt needs to be subordinate to all credit issuances by all operating subsidiaries

3) How much Topco unsecured term debt?

- FDIC/Fed currently consulting
- Tucker: "provisional view": "sum of the firm's regulatory equity requirement plus a margin (X) less any surplus equity"

OLA, Key elements, 3

- So that: Firm could suffer full wipeout of regulatory capital, plus more (X), and after recap through bail-in, Bridgeco will satisfy regulatory capital requirement

Is this enough?

4) Deep reservoir of liquidity for Bridgeco during post-OLA reorganization period

-- Here: FDIC's line at Treasury (capped as % of FMV of institution's assets); FDIC's guarantee authority (not capped); but not the Fed (except through generally available facility)

OLA, Key elements, 4

5) Deposit Insurance is NOT part of this Story!

Yet: All deposits and all short term credit issuances by operating subs are protected.

Meaning: no runs, no fire-sale liquidations. Asset write-downs reflect valuations of orderly market

6) Advantage of "efficient resolution" drives the policy:

Lehman/OLA – estimated loss of only 3%, not 79%.

Huge gain in orderly resolution reduces debt buffer requirement

If losses from resolution are (in expectation) non-catastrophic, governments can avoid "bailout" pressure ex post and thus SIFIs will face better risk-taking incentives ex ante.

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Resource on mergers as resolution mechanism (From Gordon & Muller, Confronting Financial Crisis, 2011, Yale J.Reg. 28:151-211)

Merger as a resolution mechanism suffers from two inconvenient institutional facts. **First, mergers under standard U.S. state corporation statutes require, at a minimum, approval of those shareholders holding a majority of outstanding common shares of the target**. This constraint has three practical entailments. **First, target shareholders must receive some appreciable share of the post-rescue value of the firm as inducement for their consent.** Otherwise, they may roll the dice on the value of the firm in a changed economic environment.

Two, less obviously, target shareholders get a free option with respect to the rescue proposal during the proxy solicitation period, a minimum of 40 days under the federal securities law. This is because during the post-signing/pre-closing period, someone needs to guarantee the debts and trading obligations of the rescued firm to avoid its unraveling, and to be effective, this guarantee must cover obligations entered into during this period even if the merger is subsequently terminated. Target shareholders can exploit this "bridge guarantee" to look for a better offer or simply to hope for a turnaround in the economic environment that would let them renegotiate the deal. Meantime, the guarantor bears the risk of loss.

Three, the combination of the first two points means that a merger agreement probably must contain either or both of (i) deal-forcing provisions, “lock-ups,” designed to deprive target shareholders of effective choice, or (ii) compensatory provisions such as high break-fees or uncapped stock options that give the first bidder a significant payoff from a higher-valuing bid. Otherwise, the bridge guarantor would bear too much uncompensated-for risk. But the required deal protections would probably exceed the conventional limits of mergers and acquisitions law and so require a kind of judicial forbearance. That itself injects some uncertainty. **In other words, the corporate governance provisions of “merger” create deal uncertainty that makes it much harder to put together a transaction, as proved grimly in the case of Lehman Brothers.**

The second inconvenient institutional fact is the hard-wiring in the merger statutes that requires the acquirer to take on the debts and other obligations of the target. There is no provision in “merger” for imposing loss-sharing, or contingent loss-sharing, on any creditor of a financially-distressed or insolvent firm. “Merger” provides no way to distinguish between senior and subordinated creditors, secured or unsecured, or to require creditors to swap debt for equity or in any other way to act to facilitate a merger that might well enhance the enterprise value of the firm. If the acquirer is unwilling to bear such losses, or the risk of loss on hard-to-value assets, then a transaction is not possible unless third parties, public or private, with systemic interests provide financial assistance. Similarly, the merger statutes do not permit the acquirer to reject or unilaterally modify contractual obligations of the target, such as executive compensation contracts.

Both of these structural limitations of “merger” as a resolution mechanism increase third party rescue costs. Since the increased costs inure to the benefit of a failing firm’s shareholders and creditors, merger as a resolution mechanism promotes moral hazard. If the third party is a public entity, the visible limits to loss sharing will predictably stir political backlash.

There is an additional inconvenient fact about a “merger” that follows its accomplishment: The resulting financial firm is bigger. This concentrates systemic risk and may put an implicit government guarantee behind an institution that has become “too big to fail.” Moreover, the merger may reduce competition in the relevant consumer, commercial and investment banking markets. These are major long-run costs.