Regulatory brief
A publication of PwC's financial services regulatory practice
October 2013

Resolution planning: Bail-in debt rule slowly taking form

Overview

More than 100 financial companies are deep in the throes of completing their first annual resolution plans (due in December), while those with the most US nonbank assets are anxiously awaiting regulators' response to their submissions from earlier this year.[1] If the Federal Reserve ("FRB") and the FDIC do not find the companies' resolution plans credible, they hold significant powers to force change either through increased capital or liquidity requirements or, in the extreme, corporate restructurings and divestitures.

As a result, resolution planning already has the attention of the thousands of people on whose shoulders the construction of these plans rest. Beyond them, there are as many regulators and industry watchers who fully appreciate the gravity of resolution planning and its potential to dramatically influence the ever-changing financial landscape.

It therefore comes as no surprise that the FRB's and Federal Reserve Bank of Richmond's jointly-sponsored conference on resolution planning on October 18th received wide attendance and participation. The invitation-only event focused on Category 1 and Category 2 plan filers (i.e., those with US nonbank assets of at least $100 billion and global assets of at least $50 billion ("US-SIFIs")) in a discussion of industry-wide challenges for the orderly resolution of large and complex financial institutions under the Dodd-Frank Act. Its purpose was to "stimulate constructive dialogue among knowledgeable professionals and the practitioners involved in constructing and assessing resolution plans." Participants included not just regulators and the regulated, but also other members of industry including lawyers, consultants, rating agencies, buy-side investors, and think tanks.

In our view, the high level takeaways from the event are the following:

- Universal agreement exists that a Title I resolution of a US-SIFI would still be quite challenging.[2]
- Nonetheless, the single point-of-entry model ("SPOE") is gaining traction as a Title I resolution approach.

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[1] For a review of the most recent resolution plan submissions, see PwC's *Financial Services Regulatory Brief, Resolution planning: A public peak into the plans* (October 2013).

[2] Title I of Dodd-Frank requires large US financial institutions to prepare and submit written plans to US regulators for orderly resolution under the bankruptcy code without government financial assistance. Title II empowers the FDIC to take a failing firm into receivership if the firm's failure would have serious adverse effects on financial stability. Unlike Title I, in a Title II resolution the FDIC may borrow funds from the US Treasury to facilitate the resolution process.

- Important issues remain unresolved in order for a Title I SPOE to be successfully executed, including both legal issues and the need for sources of private sector capital and liquidity (widely expected to be addressed in future proposals for minimum "bail-in" debt).
- The impact of SPOE and possible associated requirements on investors and US-SIFIs have yet to be addressed.

This **Financial Services Regulatory Brief** details each of these key points.

Some universal agreement

The debate generated across the day's several panel discussions carefully paid much homage to common ground before getting into the stickier issues. In particular, many at the event acknowledged several key areas of near-universal agreement, including the following:

- A program similar to TARP could not be passed into law today given the political environment, so it is incumbent upon the industry to find workable solutions that do not require assistance from taxpayer-sourced funds.
- It is far less likely that a private sector "white knight" rescuer would be willing to buy a troubled company today, given the experience of those that acquired the entirety of Bear Stearns (i.e., JPMorgan Chase), Countrywide (i.e., Bank of America), and others in 2008 and 2009.
- The resolution of a US-SIFI under the US Bankruptcy Code today would still be challenging, in part because the liquidation of key businesses and asset holdings would likely lead to market disruption and significant destruction of value.

These factors highlight the importance of addressing the impediments to orderly resolution under Title I because, while Title II remains available as a back-stop, there is an extremely high threshold for its use including the agreement of the Secretary of the Treasury in consultation with the president.

Many of the challenges to the orderly resolution of US-SIFIs under Title I are exacerbated by firms' global scope of operations and the considerable interconnectivity within each firm and across major market players. This complexity paired with disparate legal frameworks and objectives in the US and abroad presents significant hurdles.[3] Judge James Peck, the presiding judge in the Lehman Bankruptcy and a panelist at the conference, noted there has been "no significant convergence in applicable insolvency law" despite five years of discussion toward global convergence. As a result, a US-SIFI seeking resolution under the US Bankruptcy Code today would be subject to a multiple point-of-entry ("MPE") strategy – i.e., its numerous subsidiaries would enter resolution under different legal regimes. In the US, the regime would be based on the type of entity being resolved (e.g., FDIC receivership for banks, SIPA proceedings for broker-dealers, etc.), and abroad it would depend on each jurisdiction's resolution regimes for particular types of entities.

[3] See PwC's *Financial Services Regulatory Brief, Living wills: Global resolution remains a reach* (August 2013).

Nirvana – The Single Point-of-Entry: Developed for Title II but gaining traction for Title I

The FDIC is empowered by Dodd-Frank with Orderly Liquidation Authority under Title II. Although the FDIC's leaders have repeatedly underscored that Title II is the method of last resort, the FDIC must be ready to resolve a US-SIFI under Title II if a situation arises that meets certain criteria (including the determination that a failure would have "serious adverse effects on financial stability in the US and that no viable private sector alternative is available").[4]

To that end, the FDIC developed the SPOE approach, under which the FDIC would be appointed receiver of the holding company. It would then form a bridge holding company ("Newco") and transfer the failed holding company's ownership of healthy operating subsidiaries into it, leaving the holding company shareholders and creditors behind in the estate of the failed holding company. SPOE under Title II would benefit from the FDIC's access to the Orderly Liquidation Fund, to the extent any borrowings from the fund can be fully secured and repaid.

Most Category 1 filers considered a SPOE strategy in their 2013 resolution plans as indicated by the public sections of their plans; however, many noted that a Title I SPOE faces a number of legal and regulatory hurdles including certain provisions of the US Bankruptcy Code.

[4] See presentation by the FDIC's James Wigand to the US Senate's Subcommittee on National Security and International Trade and Finance (May 15, 2013).

Unresolved issues for Single Point-of-Entry under Title I

As postulated by the conference panelists, SPOE under Title I could be structured to allow its initiation by either the US-SIFI or its primary regulator. However, the panelists noted a number of impediments would need to be addressed:

Changes to bankruptcy law and terms of Qualified Financial Contracts would be required

Chapter 11 of the US Bankruptcy Code is not conducive to the resolution of financial institutions in a very compressed period of time (e.g., over a weekend), which would be necessary to ensure that all systemic functions are maintained and market disruption is avoided. In response to this concern, regulatory policymakers have been considering the possibility of a new chapter of the US Bankruptcy Code (known as "Chapter 14") for complex financial institutions.

While the Chapter 14 concept is far from fully developed, its key distinguishing features from Chapter 11 would be the following:

- It would be designed to process the bankruptcy filing and key aspects of the legal reorganization in order to create a private sector version of Newco as quickly as over a weekend.
- Chapter 14 cases would be assigned to select bankruptcy judges with specific expertise in complex financial institutions.

Another issue under consideration is the addition of a temporary stay of close-out or termination rights (including those that arise from cross-default provisions) which are currently included as provisions of qualified financial contracts ("QFCs").[5] This possible temporary stay, which is currently permissible under an FDIC receivership, would run head-on into existing rules that specifically grant those rights to QFC counterparties in the event of default.

Sources of capital for Newco – bail-in debt

To capitalize Newco under a Title I resolution, a robust source of capital is needed to allow Newco to continue all systemically important operations. Governor Tarullo indicated in his keynote address that the FRB, in consultation with the FDIC, will be issuing in the next few months a proposal that would require the largest, most complex banking firms to hold minimum amounts of long-term, unsecured debt at the holding company level that could be converted into equity within Newco if the firm were to fail.[6]

Governor Tarullo went on to say that minimum holding company debt levels would not necessarily suffice to recapitalize operating subsidiaries. One way to address this in his view would be to require operating subsidiaries to issue debt to their US-SIFI holding companies; in resolution, that debt could be converted into equity of the operating subsidiaries. This intra-group debt would thus be subject to "internal bail-in debt" in resolution, effectively mirroring the bail-in concept providing for the conversion of investor-owned holding company debt into equity in resolution.

William Dudley, President of the Federal Reserve Bank of New York, added his view to Tarullo's by stating that a substantial amount of long-term debt would be required at the holding company level, and that it would be useful to require that some portion of debt mature each year to enhance market discipline. That said, many US-SIFIs have a history of regular debt issuance, often many times each year, and thus are already subject to the market discipline that arises from setting terms and pricing to investor appetite. Further, there are actively traded credit default swaps that reference many of the larger tranches of US-SIFI debt providing a market view of the value of such debt on an ongoing basis. Nevertheless, for those institutions that are less frequent issuers of debt, specifically holding company debt, this could be a material change. Such regulatory requirements (that would specify the amount, type, and legal entity location of debt, etc.) further erode management's authority to determine their capital structure, and directly impact capital efficiency and earnings.

Potential restrictions on the use of parent company debt proceeds are unclear

Liquidity is not the same as capital. A requirement to issue debt, absent other requirements, does not ensure that the proceeds of that debt will be available in liquid form in resolution. Governor Tarullo indicated that the SPOE approach would be "facilitated by the presence of a sufficient amount of assets of the right types at the [US-SIFI] parent", which suggests that the expected proposal on holding company debt will be accompanied by requirements pertinent to the holding of the debt proceeds. For many of the US-SIFIs, obtaining a reliable source of liquidity in resolution under Title I is a far more formidable issue than sourcing capital. Further, as noted by Dudley, the liquidity issue is complicated by the propensity for significant asset liquidations by a US-SIFI to negatively affect market price levels.

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[5] QFCs are certain types of financial contracts including certain securities contracts, commodity contracts, forward contracts, repurchase agreements, and swap agreements that are subject to the "safe harbor provisions" of the US Bankruptcy Code.

[6] We have been expecting such a "bail-in debt" proposal from the FRB since this summer. See PwC's *Financial Services Regulatory Brief, Basel & prudential standards: US moving faster than world* (August 2013).

Investors' interests critical but not (yet) addressed; impact on US-SIFIs' profits not (yet) a consideration

Indicative of the evolution of current thinking around this subject, the vast majority of the conference discussion was legal and regulatory in nature (which is to be expected as these perspectives are key drivers to successful resolution planning). However, asset manager and rating agency representatives helped highlight investor concerns and their potential unwillingness to fund a Newco and its subsidiaries.

One of the key issues raised was the need to eliminate as much uncertainty as possible by educating the investment community on the resolution process and associated risks, including expected regulatory behavior. This is critical to minimizing the risk premium that investors will demand to compensate for the risk uncertainty.

As noted above, any restrictions on the use of parent company debt proceeds will have downstream effects on US-SIFIs' financial performance metrics. Yet, noticeably absent from any of the day's panels was discussion of the impact on US-SIFIs' margins and profitability, or on other practices such as asset-liability management. This is likely to add an additional controversial dimension to the debate once regulators' proposals on required amounts and types of debt are released.

Additional information

For additional information about PwC's Financial Services Regulatory Practice and how we can help you, please contact:

Dan Ryan
Financial Services Regulatory Practice Chairman
646 471 8488
daniel.ryan@us.pwc.com

Alison Gilmore
646 471 0588
alison.gilmore@us.pwc.com

Contributors: Sharon Haas and Coryann Stefansson.

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