FS Regulatory Brief

Proposed US/UK resolution strategy – more questions than answers

We are a long way from a global resolution regime

December 2012

The FDIC's Systemic Resolution Advisory Committee (Committee)[1] held an open meeting on December 10, 2012 spotlighting a Joint Paper[2] by the FDIC and Bank of England which proposed a joint US/UK resolution regime for globally systemically important financial institutions (G-SIFI).

In support of the Joint Paper's strategy, the Deputy Governor of the Bank of England, Paul Tucker, indicated at the meeting that UK authorities are prepared, at least in principle, to rely on the FDIC to resolve the UK operations of a US G-SIFI. He and Martin Gruenberg, Chairman of the FDIC, had published that morning a joint op-ed in the *Financial Times* stating that their cooperation represented serious progress to end the "too big to fail problem" of large international banks.

However, a parallel contradictory story also exists. Despite Tucker's statement at the meeting that his office would rely on FDIC resolution of UK operations, Gruenberg did not provide the same assurance to rely on UK authorities to resolve the US operations of a UK G-SIFI. Gruenberg's reluctance can be understood in light of the Federal Reserve Board's proposed rule approved for publication on December 14th calling for more capital and liquidity in a proposed US intermediate holding company of a non-US G-SIFI. The Federal Reserve proposal takes a more US-centric view in the resolution of a non-US G-SIFI to ensure there is adequate capital and liquidity located in the US to protect the US financial system.

This **PwC FS Regulatory Brief** highlights key points from the Joint Paper and places them within the broader context of the Federal Reserve action.

The Joint Paper

The Joint Paper written by the FDIC and the Bank of England, with input from the Federal Reserve and the UK Financial Services Authority, outlines two resolution strategies for G-SIFIs with extensive activities in both the US and UK: one where resolution powers and authority are directly applied at the top of the bank by a single national resolution authority called "single point of entry" (SPE), and one where resolution powers are distributed across multiple authorities, legal entities and jurisdictions called "multiple points of entry" (MPE).

The Joint Paper advocates SPE as the optimal approach for resolution in an effort to avoid separate territorial and entity-focused insolvency proceedings. However, the Federal Reserve Board's proposal just a few days later, calling for more capital and liquidity in a US intermediate holding company, appears to in fact advocate for MPE, at least as applied to the resolution of non-US GSIFIs with subsidiaries in the US.

[1] The FDIC created the Committee in June 2011 to provide advice and guidance on the resolution of large, systemically important institutions. The Committee members have a range of experience, including managing complex firms; administering bankruptcies; working in the legal system, accounting field, and academia; and other relevant expertise. The December 2012 meeting was the Committee's third.
[2] The Joint Paper is entitled "Resolving Globally Active, Systemically Important, Financial Institutions" and can be found here: http://www.fdic.gov/about/srac/2012/gsifi.pdf

For this and other reasons, it is questionable if SPE can be practically executed in times of crisis when each jurisdiction's first instinct is to protect its own market. A suggestion of the Joint Paper that is more likely to gain global traction, and was also discussed at the meeting, is the call for regulatory intervention that would force the write-down of equity and the conversion of parent company debt into equity in order to recapitalize the global organization.

The SPE strategy

Although not finalized, the direction of SPE strategy is somewhat different in the US than in the UK. In the US, there would likely be a single receivership at the top-tier holding company, losses would be assigned to shareholders and unsecured creditors of the holding company, and sound operating subsidiaries would be transferred to a new solvent entity or entities. In the UK, the approach would involve write-down or conversion of creditors at the top of the group in order to restore the whole group to solvency (i.e., "bail-in").

The goal of both approaches is to reduce financial instability by ensuring that critical operations continue and that foreign subsidiaries continue unimpaired. Under both, the unsecured debt holders can expect that their claims would be written down to reflect any losses that shareholders cannot cover, with some debt converted into equity in order to provide sufficient capital to return the sound businesses of the G-SIFI to private sector operation.

Legislative frameworks for implementing SPE

The Joint Paper underscores that the application of SPE can be achieved only within a legislative framework that provides authorities with key resolution powers. The US and UK are at different stages of rulemaking in this regard.

Title II of Dodd-Frank granted orderly liquidation authority (OLA) to the FDIC which is appointed the receiver for any US financial company whose resolution under the US Bankruptcy Code (or other applicable insolvency process) would likely create systemic instability. Under Title II, the losses of any financial company placed into receivership are expected to not be borne by taxpayers, but by equity and debt holders, and other unsecured creditors.[3] As such, the FDIC has the authority currently to write down equity and force the conversion of parent company debt.

Whereas in the UK, the additional powers needed to enhance the existing resolution framework are "expected" to be provided by the European Commission's proposals for a European Union Recovery and Resolution Directive (RRD) and by domestic legislative enhancements that implement the recommendations of the UK Independent Commission on Banking (ICB).

The Joint Paper emphasizes that a statutory bail-in resolution tool under the RRD is critical to implementing group resolution of UK firms. A bail-in tool would enable the UK authorities to recapitalize an institution by allocating losses to its shareholders and unsecured creditors, thereby avoiding the need to split or transfer operating entities. Also critical are RRD provisions that enable a temporary stay on the exercise of termination rights by counterparties in the event of entry into resolution (i.e., counterparties will be prevented from terminating their contractual arrangements with a firm solely as a result of the firm's entry into resolution). Resolution strategies in the UK are being developed in anticipation of such legislation.

Minimizing cross-border coordination risk

A key advantage of SPE is avoiding the need for separate territorial and entity-focused insolvency proceedings which could be

[3] An example of a hypothetical loss estimate and recapitalized new company in a Title II SPE receivership was provided by the FDIC at an earlier Committee meeting on January 25, 2012. See Appendix and complete presentation at http://www.fdic.gov/about/srac/2012/2012-01-25_resolution-strategy.pdf

disruptive and difficult to coordinate. Because SPE resolution strategies maintain continuity of business at the subsidiary level, a key premise is that foreign subsidiaries and branches should be broadly unaffected by the resolution action taken at the home holding company level. In addition, the Joint Paper suggests that host stakeholders should not have an incentive under a SPE approach to ring fence assets or petition for preemptive insolvency.

At this time, however, this aspiration may be more achievable within the EU, given recent progress towards a single European bank regulator. In the US, the Federal Reserve has proposed that additional capital and liquidity be kept at a US top-tier holding company which could serve as a US-only SPE for the resolution of a non-US G-SIFI's operations in the US.

Detailed resolution plans for G-SIFIs

The resolution strategies in the Joint Paper set out at a high level the key elements of the SPE approach to resolution and outline the use of key resolution powers. These strategies are expected to be translated into detailed resolution plans for each G-SIFI in 2013.

The Joint Paper also indicates that firm-specific resolvability assessments will be developed in 2013. The resolvability assessments will identify barriers to implementation of the resolution plans, and will be needed to demonstrate the extent to which the resolution plan for each G-SIFI is feasible and credible without severe systemic disruption and without exposing taxpayers to loss.

Write-down of liabilities and conversion of debt into equity

Perhaps the most practical proposal from the Joint Paper may be the call for forced write-down of equity and the conversion of parent company debt into equity to support a failing G-SIFI. Under a top-down resolution, shareholders and certain creditors at the top of the group absorb losses and recapitalize the group as whole. However, for a top-down approach to work there must be sufficient loss-absorbing capacity available at the top of the group to absorb losses sustained within operational subsidiaries.

The Joint Paper notes that the Federal Reserve and FDIC are discussing new regulations to ensure that sufficient debt is held at the top-tier holding company level. PwC believes the methodology that may be proposed to determine the required amount of long term debt (LTD) at the holding company level will likely focus on LTD's relationship to equity, not to assets. The minimum threshold may be around 25% LTD / Total Equity.

In the UK, financial holding companies at the top of the group often do not account for a significant proportion of the group's unsecured debt raised externally. Either the groups could restructure so that more debt is issued out of the holding company, or the UK authorities could look to bail-in the liabilities of the top operating companies within each group.

The Joint Paper also points out that consideration needs to be given to ensuring that debt issued at the top of the group that is subject to foreign law can be written down or converted alongside liabilities subject to the law of the home jurisdiction. This may be crucial to ensuring that the firm's recapitalization needs can be met and that creditors are treated fairly and may require the inclusion of contractual recognition of foreign resolution proceedings within debt contracts.

PwC points of view on the Joint Paper

We are a long way from a global resolution regime

- The Joint Paper's articulated preference to resolve G-SIFIs by SPE is a logical approach; however, the discussion fell short on describing the mechanics of how SPE could be accomplished, particularly in light of regulatory developments in the

US signaling a move towards more local capital and subsidiarization.

- Although the Joint Paper indicates that the US and UK will resolve their banks' global operations (and, implicitly, perhaps stand behind operations outside of the home country), it is not clear how many countries will be willing and able to do so.
- Also it appears that the SPE approach works only when there is a holding company at the top tier; many non-US banking organizations have a bank as the top-tier parent which would have to be resolved under a bank resolution regime dedicated to protecting depositors.

Work is needed to assess capital implications at the top holding company level for G-SIFIs in the US

- The SPE approach indicates a shift towards "paying" for resolution by imposing a debt for equity conversion in order to avoid a taxpayer or government bailout.
- These measures have potentially serious implications for parent headquarters financial holding companies in both the US and UK as regulators may in the future deem that there is "insufficient" debt and equity at the top of the group structure.
- If G-SIFIs are going to be required to hold more debt in their holding company, they will have to work out how this will be structured or restructured and the potential impacts to their corresponding subsidiaries and branch structure.
- What will be the market impact of debt-to-equity conversions?
- The reliance on debt to equity conversion is still up for discussion as there is concern that the regulatory efforts to protect taxpayers by applying the debt bail-in precedent could unintentionally expose taxpayers to a permanent rise in the cost of credit.
- Since banks finance much of their lending through bonds, bond holders are likely to require more interest if they are at risk of losing money to a bail in.
- A pricing incentive will emerge for both banks and markets if there is an expectation that more debt protection exists at the operational company versus the holding company.

Some renewed focus on global cross border cooperation has emerged

- Paul Tucker indicated that both the European Union and the narrower Eurozone Group will follow a similar SPE direction in the future.
- Both the recent Liikanen Report and the RRD share similarities in principle with the conversion of debt to equity approach, although the exact nature of the implementation will remain uncertain for some time to come.

What do US G-SIFIs need to do now?

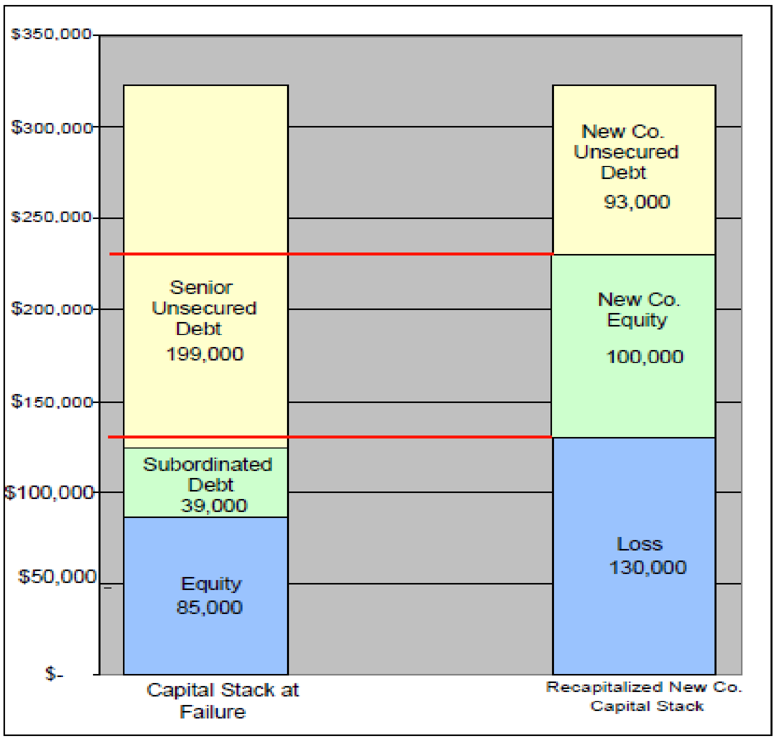
- Undertake confidential analysis of debt and equity in the parent holding company, and include similar analysis of branch structure and subsidiaries.
- Foreign banks should review the Federal Reserve proposed rule approved for publication on December 14, 2012 requiring large foreign banks to operate all bank and nonbank subsidiaries in the US under a US Intermediate Holding Company (which appears to signal a ring-fence approach to US subsidiaries).
- Executives of G-SIFIs responsible for Resolution Planning in the US will need to understand the evolving regulatory expectations towards Title II resolution and determine the implications for their bank.
- Be prepared for research papers or questions from analysts on holding company structure, including the mix of debt and equity and whether re-structuring will have to take place.

Appendix

Single receivership: Hypothetical loss estimate and recapitalization

A waterfall diagram broadly indicating the priority of creditors in a Title II receivership was presented at a Committee meeting on January 25, 2012. Per SPE strategy, the equity shareholders would be written-off first, followed by a sufficient write-off of the outstanding debt of the holding company into equity to recapitalize the insolvent entity. Fundamentally, the losses are pushed up to the holding company.

Unsecured Claims Waterfall



Source: FDIC

The diagram incorporates the following underlying assumptions:

- A market-based haircut will be assessed on the senior unsecured general creditors. In the example a 3% haircut was assumed.
- The senior unsecured general creditors exchange claims for:
  - New debt instruments
  - Convertible debt instruments
  - Equity (preferred/common)
- Former subordinated debt and equity holders could receive either:
  - Call options on equity to be distributed to senior classes
  - Warrants or other subordinated equity interests

Additional information

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