



Cross-Border Resolutions: FDIC and Bank of England Release White Paper

On December 10, 2012, the Federal Deposit Insurance Corporation (“FDIC”) and the Bank of England released a white paper, *Resolving Globally Active, Systemically Important, Financial Institutions*,¹ describing how each would resolve a materially distressed or failing financial institution that is globally active and systemically important (“G-SIFI”) in order to maintain the G-SIFI’s ongoing and viable operations, and contain any threats to financial stability. The paper reflects the work of U.S. and UK authorities² in developing resolution strategies for the failure of G-SIFIs in accordance with standards developed by the Financial Stability Board,³ but does not go into detail on the strategic options that may be available.

The white paper warrants the close attention of G-SIFIs and their stakeholders, particularly their unsecured debtholders. The paper memorializes the consensus view of the FDIC and the Bank of England that a top-down or single-point-of-entry approach is the preferred (although not the sole) method of resolving a G-SIFI.⁴ This approach could transform certain unsecured debt into equity or convertible debt and should cause G-SIFIs to review their organizational structure. Also of interest are the FDIC’s and Bank of England’s perspectives on the critical powers and preconditions for a successful resolution and what legislative or regulatory changes may be necessary.

Structure of a top-down approach. The first step in this approach is the appointment of a receiver or administrator for the top-tier holding company. In the United States, the FDIC will make the appointment, after go-aheads from the Financial Stability Oversight Council, the Federal Reserve Board, and the Secretary of the Treasury. The UK process differs and fundamentally will depend on a decision by the soon-to-be-formed Prudential Regulatory Authority, which will operate under the auspices of the Bank of England in consultation with HM Treasury.

Losses in the G-SIFI will be allocated first to shareholders and then to unsecured creditors. Shareholders are likely to lose all value. The unsecured debt will be written down to cover losses remaining after the equity has been exhausted. After the write-down, the unsecured debt will be exchanged for equity, and possibly also some

¹ The white paper is available at <http://www.fdic.gov/about/srac/2012/gsifi.pdf>. The paper was released in conjunction with a meeting of the FDIC’s Advisory Committee on Systemic Resolution to discuss cross-border resolutions.

² The Federal Reserve Board, the Federal Reserve Bank of New York, and the UK Financial Services Authority have also been involved in this work.

³ The Financial Stability Board has published two papers of note: *Key Attributes of Effective Resolution Regimes for Financial Institutions* (Oct. 2011), available at http://www.financialstabilityboard.org/publications/r_111104cc.pdf; and a consultative document, *Recovery and Resolution Planning: Making the Key Attributes Requirements Operational* (Nov. 2012), available at http://www.financialstabilityboard.org/publications/r_121102.pdf.

⁴ This approach was first outlined in a speech on May 10, 2012, by FDIC Chairman Martin J. Gruenberg. The speech is available at <http://www.fdic.gov/news/news/speeches/chairman/spmay1012.html>. We discussed the top-down concept in a news bulletin, *Orderly Liquidation Authority: FDIC Announces Its Strategy* (May 16, 2012), available at <http://www.mofa.com/files/Uploads/Images/120516-Orderly-Liquidation-Authority-FDIC-Announces-Its-Strategy.pdf>.

subordinated convertible debt, in either a new bridge institution (in the United States and the United Kingdom) or possibly the original institution (in the United Kingdom). Culpable management will be removed. Viable subsidiaries will continue their operations, with funding to be arranged by the FDIC or the Bank of England if the private capital markets are unavailable.

Unsecured debtholders. The debt-for-equity exchange causes certain existing unsecured debt in the G-SIFIs operating today to take on certain features of convertible debt and a form of bail-in capital. For a G-SIFI whose top-tier holding company is in the United States, the FDIC will serve as receiver. Even before its formal appointment as receiver, the FDIC is likely to have chartered a new bridge corporation of which the FDIC will be the sole shareholder. Upon the FDIC's appointment as receiver, the FDIC will immediately transfer the assets of the G-SIFI to the bridge corporation. Liabilities and any equity in the original G-SIFI will remain behind in the receivership. Unless the equity is sufficient to cover all losses, debt—specifically, subordinated debt and possibly even senior unsecured debt claims—will be written down in an amount to cover the remaining losses. The remaining debt will be exchanged for equity or subordinated debt in the bridge institution.

Since the bridge institution will be well capitalized (as a result of taking on the assets but not the liabilities of the G-SIFI in receivership), the equity or subordinated debt issued to the debtholders will have some value. The former debtholders may be able to realize this value in the relatively near term if the receiver succeeds in promptly selling the bridge company to a third party. Securities laws may require the registration of any securities transferred to the debtholders; the white paper notes this issue as one for discussion between the relevant regulators.

Subsidiaries. The FDIC and the Bank of England have designed the top-down approach to have little, if no, effect on viable and operating subsidiaries. A receiver or similar authority will not automatically be appointed for subsidiaries, and if a subsidiary should be liquidated or resolved, well-established bankruptcy or similar proceedings should be sufficient.

Nevertheless, the top-down approach has several consequences that could be material to a G-SIFI or its subsidiaries:

- A top-down resolution that does not affect operating subsidiaries will be possible only if there is sufficient capacity—both equity and long-term unsecured debt—at the top-tier company to absorb losses from subsidiaries. In general, according to the white paper, top-tier companies in the United States maintain such capacity, while many such companies in the United Kingdom do not. This fact seems likely to force restructuring at appropriate UK companies further down the corporate ownership chain. In any event, if a top-tier company, wherever located, does not maintain such capacity, then the FDIC or the Bank of England may use a multi-pronged approach, rather than the single-point-of-entry approach.
- The receiver of the top-tier company will have, at most, very limited jurisdiction over foreign subsidiaries. The white paper notes this fact, observing only that the home-country regulator must coordinate closely with the appropriate foreign regulators. Settling this issue is critical, however, to a successful resolution of a G-SIFI.
- The FDIC and the Bank of England appear to assume that the liquidation or resolution of the top-tier company will have little or no effect on the subsidiary's access to funding. This view seems optimistic, perhaps unduly so, but in any event the FDIC and the Bank of England are prepared, at least in concept, to fund the operations of any viable subsidiary, whether domestic or foreign. In the United States, the source of funding will be a line of credit from the Treasury Department that involves somewhat complicated mechanics. In the United Kingdom, it is possible that funding would be provided through extensions to the scope of the Bank of England's Discounted Window Facility or through one or more of its other facilities, such as repo operations.

- The rights of third-party shareholders and unsecured debtholders of a viable subsidiary will not be affected by proceedings at the top-tier company. Given this feature of a top-down resolution, a G-SIFI should consider whether its subsidiary structure will provide the greatest degree of protection to investors, and whether subsidiaries should raise greater amounts of capital directly. The new limitations in Basel III on the inclusion in capital of minority interests in consolidated subsidiaries may offset any such effort, however.

Preconditions. In order for the top-down approach to work, the FDIC and the Bank of England believe that various preconditions, including the grant of necessary powers to the appropriate government authority, must be in place. The FDIC further believes that it has the required legal powers, and that other preconditions are in place. However, the Bank of England requires two legislative actions before it will have the critical powers. First, the European Council and the European Parliament must approve the European Union Recovery and Resolution Directive (“RRD”), which would provide the Bank with a bail-in tool to allocate losses to unsecured creditors, and authorize it to impose a temporary stay on the exercise of termination rights by counterparties. Second, enactment of the proposed Financial Services Bill in the United Kingdom will give the Bank power to resolve non-deposit-taking financial firms (notably including clearinghouses). The Financial Services Bill also would provide a framework for prudential supervision, and would provide the legal foundation for ringfencing retail banks from other parts of their organizations. The bill would empower UK authorities to require minimum levels of loss-absorbing (or “bail-inable”) capital to be held by ringfenced retail banks and by UK-incorporated G-SIFIs.

Crisis Management Groups. Although the white paper is a bilateral issuance, it recognizes the need for comprehensive multinational groups to plan for the possible resolution or liquidation of each G-SIFI. Both the FDIC and the Bank of England have been active in these efforts, presumably taking the lead on addressing the G-SIFIs headquartered in the United States and the United Kingdom, respectively. The proposed RRD also provides for the establishment of crisis management groups within the European Union. The white paper states that CMGs will complete firm-specific resolution plans for all G-SIFIs in the first half of 2013, followed by resolvability assessments in the second half of next year.

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