Implementing Dodd–Frank: Orderly resolution

Martin J. Gruenberg

I would like to take the opportunity to discuss one of those challenging issues—the orderly resolution of systemically important financial institutions (SIFIs). The Dodd–Frank Wall Street Reform and Consumer Protection Act provided important new authority to the Federal Deposit Insurance Corporation (FDIC) to resolve SIFIs. Prior to the recent crisis, the FDIC's receivership authority was limited to federally insured banks and thrift institutions. There was no authority to place the holding company or affiliates of an insured institution or any other nonbank financial company into an FDIC receivership to avoid systemic consequences. The lack of this authority severely constrained the ability of the government to resolve a SIFI. This authority has now been provided to the FDIC under the Dodd–Frank Act.

The question is whether the FDIC can develop the operational capability to utilize this authority effectively and a credible strategy under which an orderly resolution of a SIFI can be carried out without putting the financial system itself at risk. These key challenges have been the focus of the FDIC's efforts since the enactment of Dodd–Frank in July 2010. I would like to focus my comments on the progress we have made in meeting these important challenges.

Orderly liquidation authority, resolution planning, and the Office of Complex Financial Institutions

The FDIC has taken a number of steps since Dodd–Frank was passed to carry out its new systemic resolution responsibilities.

First, the FDIC established a new Office of Complex Financial Institutions to carry out three core functions:

- Monitor risk within and across these large, complex financial firms from the standpoint of resolution;
- Conduct resolution planning and develop strategies to respond to potential crisis situations; and
- Coordinate with regulators overseas regarding the significant challenges associated with cross-border resolution.

For the past year, this office has been developing its own resolution plans in order to be ready to resolve a failing systemic financial company. These internal FDIC resolution plans, developed pursuant to the orderly liquidation authority provided under title II of Dodd–Frank, apply to a SIFI many of the same powers that the FDIC has long used to manage failed-bank receiverships. This internal resolution planning

Martin J. Gruenberg is the acting chairman of the Federal Deposit Insurance Corporation (FDIC). *The views expressed in this article are the author's and do not necessarily reflect the views of the FDIC.*

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work is the foundation of the FDIC's implementation of its new responsibilities under Dodd–Frank.

Second, the FDIC has largely completed the basic rulemaking necessary to carry out its responsibilities under Dodd–Frank.

In July 2011, the FDIC Board approved a final rule implementing title II—orderly liquidation authority. This rule addressed, among other things, the priority of claims and the treatment of similarly situated creditors.

Last September, the FDIC Board adopted two rules regarding resolution plans that systemically important financial institutions themselves will be required to prepare—the so-called living wills.

The first resolution plan rule, jointly issued with the Federal Reserve, requires bank holding companies with total consolidated assets of $50 billion or more, and certain nonbank financial companies that the Financial Stability Oversight Council designates as systemic, to develop, maintain, and periodically submit resolution plans to regulators.

Complementing this joint rulemaking, the FDIC issued another rule requiring any FDIC-insured depository institution with assets over $50 billion to develop, maintain, and periodically submit plans outlining how the FDIC would resolve it through the FDIC's traditional resolution powers under the Federal Deposit Insurance Act.

These two resolution plan rules are designed to work in tandem and complement each other by covering the full range of business lines, legal entities, and capital-structure combinations within a large financial firm. Both of these resolution plan requirements will improve efficiencies, risk management, and contingency planning at the institutions themselves. Importantly, they will supplement the FDIC's own resolution planning work with information that would help facilitate an orderly resolution in the event of failure.

With the joint rule final, the FDIC and the Federal Reserve have started the process of engaging with individual companies on the preparation of their resolution plans. The first plans, for companies with assets over $250 billion, were due in 2012.

Resolution strategy

What I would like to do now is describe the current thinking on our strategy for resolving a large systemically important financial firm.

The FDIC's resolution strategy has three key goals. The first is financial stability, ensuring that the failure of the firm does not place the financial system itself at risk. The second is accountability, ensuring that the investors in the failed firm bear the firm's losses. The third is viability, converting the failed firm through the public receivership process into a new, well-capitalized, and viable private sector entity. As I describe the strategy, I will try to identify how each of these goals is being addressed.

We can start by considering the type of firm that we may be presented with. It is likely to be a firm with several business lines—perhaps commercial banking, capital markets, global asset management, and transaction services—and which operates across national borders. The corporate structure is likely to be a holding company with a parent at the top and multiple layers of subsidiaries. The number of subsidiaries will be in the hundreds, if not thousands. It is also likely that the structure of the legal entities within the company will not be aligned with the business lines. Additionally, intracompany risk transfers and financial relationships will not be transparent.

While there are numerous differences between a typical bank resolution and what the FDIC would face in resolving a SIFI, I want to focus on a few key differences.

The first is whether the proximate cause of failure is capital depletion or liquidity pressures. The typical path toward failure for an insured bank starts with bad loans. As the bank sets aside reserves for and charges off credit losses, capital ratios fall, triggering the requirements of prompt corrective action. The bank is required to either raise capital or find a buyer. In the meantime, the bank normally continues to operate in large measure because its major source of liquidity is insured deposits, which are not likely to run. Eventually, if it is unable to raise capital or find a buyer, the chartering agency closes the bank. Essentially, the bank has failed a market test of viability.

In the case of a large financial firm, it is likely that its problems will also arise from the losses it has suffered in one or more of its business lines. However, it is also likely that this firm relies to a greater extent on market sources of funding and thus would face liquidity pressures not typically present in the case of an insured bank. There are several implications to this. The FDIC and other regulators will have less time to craft a resolution. There may not be time for the firm to undergo a market test of viability. Finally, there may be a significant need to shore up liquidity in the course of the resolution.

In addition, the resolution of a large U.S. financial firm involves a more complex corporate structure than the resolution of a single insured bank. Large financial companies conduct business through multiple subsidiary legal entities with many interconnections, owned by a parent holding company. A resolution of the individual subsidiaries of the financial company would increase

the likelihood of disruption and loss of franchise value by disrupting the interrelationships among the subsidiary companies. A much more promising approach from the FDIC's point of view is to place into receivership only the parent holding company while maintaining the subsidiary interconnections.

Another difference arises from sheer size alone. In the typical bank failure, there are a number of banks capable of quickly handling the financial, managerial, and operational requirements of an acquisition. This is unlikely to be the case when a large financial firm fails. Even if it were the case, it may not be desirable to pursue a resolution that would result in an even larger, more complex institution. This suggests the need to create both a bridge financial institution and the means of returning control and ownership to private hands.

Finally, in the case of a failure of an insured bank, the FDIC acts as both a resolution authority and a deposit insurer. In resolving a firm that is not an insured bank, the FDIC will be acting only as a resolution authority and not in any capacity that is analogous to deposit insurer. The new resolution authority does not provide insurance or credit protection for creditors and counterparties, and creditors will always be subject to potential losses. This is a central feature of the new resolution authority and is designed to ensure that there is market accountability.

Taking these factors into account, let me now describe how we envision the resolution of a large, systemically important financial institution. Assume for this exercise that credit or market losses have weakened the capital position of the firm, causing funding sources to withdraw and creating severe liquidity pressure. Despite the losses sustained, the firm has several business lines that have considerable value if the operations are preserved.

As I suggested earlier, the most promising resolution strategy from the FDIC's point of view will be to place the parent company into receivership and to pass its assets, principally investments in its subsidiaries, to a newly created bridge holding company. This will allow subsidiaries that are equity solvent and contribute to the franchise value of the firm to remain open and avoid the disruption that would likely accompany their closing. Because these subsidiaries will remain open and operating as going-concern counterparties, we expect that qualified financial contracts will continue to function normally as the termination, netting, and liquidation will be minimal. In short, we believe that this resolution strategy will preserve the franchise value of the firm and mitigate systemic consequences. This responds to the goal of financial stability.

Equity claims of the firm's shareholders and the claims of the subordinated and unsecured debtholders will be left behind in the receivership. In exchange, the receivership will have the equity in the bridge holding company as an asset.

Therefore, initially, the bridge holding company will be owned by the receivership. The next stage in the resolution is to transfer ownership and control of the surviving franchise to private hands. But before this happens, we must ensure that the bridge has a strong capital base and address whatever liquidity concerns remain.

To create the capital base of the bridge, some of the debt of the former parent company, which has been left in the receivership, will be converted to equity in the new bridge holding company. To do this, the FDIC will estimate the extent of losses in the receivership and apportion these losses to the firm's equity and subordinated and unsecured debtholders, according to their order of priority. In all likelihood, the firm's equity holders will be wiped out and their claims will likely have little or no value.

To capitalize the new company, therefore, the FDIC expects that it will have to look to subordinated debt or even senior unsecured debt claims as the immediate source of capital. These debtholders can thus expect that their claims will be written down to reflect any losses in the receivership that the shareholders cannot cover and that, like those of the shareholders, these claims will be left in the receivership.

At this point, the remaining claims of the debtholders will be converted, in part, into equity claims that will serve to capitalize the new company. The debtholders will also receive convertible subordinated debt in the new company. This debt will provide a cushion against further losses in the firm, as it can be converted into equity if needed. Finally, any remaining claims of the failed firm's debtholders will be transferred to the new firm in the form of new unsecured debt. These measures go to the goals of accountability for investors in the failed company and the viability of the new, well-capitalized private entity.

The transfer of the business lines from a weakened holding company to a newly capitalized bridge entity should do much to alleviate the liquidity pressures by allowing the bridge entity to fund itself directly from the market. Nevertheless, it may be the case that more liquidity support is needed, either for immediate cash needs or to allow parts of the organization to roll over its debt. The new resolution authority comes with access to a new source of liquidity support provided by the Dodd–Frank Act: the Orderly Liquidation Fund, or OLF, located in the Treasury Department. The OLF

must either be repaid from recoveries on the assets of the failed firm or from assessments against the largest, most complex financial companies. Taxpayers cannot bear any loss from the resolution of a financial company under the Dodd–Frank Act. The OLF does address a critical issue to prevent a systemwide collapse (such as we saw with the 2008 Lehman bankruptcy), because it provides an emergency source of liquidity to allow the bridge financial company to complete transactions that provide real value and prevent contagion effects.

While the OLF can be a source of direct funding for the resolution, it can also be used to provide guarantees, within limits, on the debt of the new company. The guarantees could be quite similar to the debt guarantee that was provided through the Debt Guarantee Program, or DGP, which was part of the FDIC's Temporary Liquidity Guarantee Program. Even though there were limits on firms' use of the DGP, the program was quite effective in allowing firms to access liquidity and in opening up credit markets. We expect that our resolution strategy will rely more on the use of guarantees than on direct funding from Treasury, while adhering to the statutory mandate confining its use to liquidity support.

In addition to capital and liquidity, effective governance will be an important issue to address for both the transitional bridge holding company and the newly recapitalized private sector company into which the bridge company will be converted. Initially, the FDIC, as receiver, will own the bridge company and will immediately appoint a temporary new board of directors and chief executive officer (CEO) from the private sector to run the bridge under the FDIC's oversight during the first step of the process.

The second step will be the conversion of the debtholders' claims to equity. The old debtholders of the failed parent will become the owners of the new company and, thus, be responsible for electing a new board of directors. The new board will in turn appoint a CEO of the fully privatized new company. For a variety of reasons, we would like this to be a rapid transition.

In summary, what we envision is a resolution strategy under which the FDIC takes control of the failed firm at the parent holding company level and establishes a bridge holding company as an interim step in the conversion of the failed firm into a new, well-capitalized private sector entity. We believe this strategy holds the best possibility of achieving our key goals of maintaining financial stability, holding investors in the failed firm accountable for the losses of the company, and producing a new, viable private sector company out of the process.

Cross-border issues

I would like to say a few words about the crucial international and cross-border issues. As I mentioned earlier, the type of firm we would need to resolve will likely have significant international operations. This creates a number of challenges, as the International Conference co-sponsored each fall by the Federal Reserve Bank of Chicago has explored over the years.[1] We take these challenges very seriously, and we have been actively working on them with our foreign colleagues.

The FDIC has participated in the work of the Financial Stability Board through its membership on the Resolution Steering Group, which produced the *Key Attributes of Effective Resolution Regimes for Financial Institutions*.[2] We have also participated in the Cross-Border Crisis Management Group and a number of technical working groups, and have co-chaired the Basel Committee's Cross-border Bank Resolution Group since its inception in 2007.

In addition, the FDIC is actively reaching out on a bilateral basis to the foreign supervisors and resolution authorities with jurisdiction over the foreign operations of key U.S. SIFIs. Our goal is to forge a more collaborative process and lay the foundation for more reliable cooperation based on mutual interests in national and global financial stability. The focus of our bilateral discussions has been to identify and mitigate impediments to orderly resolution that are unique to specific jurisdictions and to examine possible resolution strategies and practical issues related to their implementation.

We conducted a heat-map exercise that determined that the operations of U.S. SIFIs are concentrated in a relatively small number of jurisdictions, particularly the United Kingdom (UK). Working with the authorities in the UK, we have made substantial progress in understanding how possible U.S. resolution structures might be treated under existing UK legal and policy frameworks. We have examined potential impediments to efficient resolutions in depth, and we are working on a cooperative basis to explore methods of resolving them.

The FDIC is also negotiating the terms of memoranda of understanding pertaining to resolutions with regulators in various countries that will provide a formal basis for information sharing and cooperation, relating to our resolution planning and implementation functions under the legal framework of the Dodd–Frank Act.

While a full discussion of this topic is beyond the scope of this article, I will offer one point. The resolution strategy we have outlined, which calls for the continued operations of key subsidiaries both here and abroad, offers the promise of overcoming many of the cross-border issues that have been identified in both theory and practice.

Conclusion

In conclusion, I have tried to sketch out the progress the FDIC has made since the enactment of the Dodd–Frank Act to develop the operational capability to carry out its new systemic resolution authorities, as well as a resolution strategy that can credibly envision how a SIFI can be closed without putting the financial system itself at risk. As we carry forward this work, we believe it is important to be as transparent as possible so as to gain the benefit of the wisdom of others, as well as to establish an understanding by financial markets and the public of what we are doing. For this reason, we have been actively reaching out to the financial industry, academia, and the public interest community.

I would like to conclude by noting that developing a credible capacity to place a systemically important financial institution into an orderly resolution process is essential to subjecting these companies to meaningful market discipline. Without this capability, these institutions—which by definition pose a risk to the financial system—create an expectation of public support to avert failure. That distorts the financial marketplace, giving these institutions a competitive advantage that allows them to take on even greater risk, and creating an unlevel playing field for other financial institutions that are not perceived as benefiting from potential public support. Therefore, there is a very strong public interest in the FDIC developing the capability to carry out its new systemic resolution responsibilities in a credible and effective way.

NOTES

[1]More information about this conference series is available at www.chicagofed.org/webpages/events/international_series.cfm.

[2]For further information, see Financial Stability Board, 2011, *Key Attributes of Effective Resolution Regimes for Financial Institutions*, report, October, available at www.financialstabilityboard.org/publications/r_111104cc.pdf.