Resolving Globally Active, Systemically Important, Financial Institutions

A joint paper by the Federal Deposit Insurance Corporation and the Bank of England

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Executive summary

The financial crisis that began in 2007 has driven home the importance of an orderly resolution process for globally active, systemically important, financial institutions (G-SIFIs). Given that challenge, the authorities in the United States (U.S.) and the United Kingdom (U.K.) have been working together to develop resolution strategies that could be applied to their largest financial institutions. These strategies have been designed to enable large and complex cross-border firms to be resolved without threatening financial stability and without putting public funds at risk. This work has taken place in connection with the implementation of the G20 Financial Stability Board's *Key Attributes of Effective Resolution Regimes for Financial Institutions*. The joint planning has been productive and effective. It has enhanced the resolution planning process in both jurisdictions, tackled key issues in relation to cross-border coordination, and identified potential challenges that will be addressed through further work.

This paper focuses on the application of "top-down" resolution strategies that involve a single resolution authority applying its powers to the top of a financial group, that is, at the parent company level. The paper discusses how such a top-down strategy could be implemented for a U.S. or a U.K. financial group in a cross-border context.

In the U.S., the strategy has been developed in the context of the powers provided by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Such a strategy would apply a single receivership at the top-tier holding company, assign losses to shareholders and unsecured creditors of the holding company, and transfer sound operating subsidiaries to a new solvent entity or entities.

In the U.K., the strategy has been developed on the basis of the powers provided by the U.K. Banking Act 2009 and in anticipation of the further powers that will be provided by the European Union Recovery and Resolution Directive and the domestic reforms that implement the recommendations of the U.K. Independent Commission on Banking. Such a strategy would involve the bail-in (write-down or conversion) of creditors at the top of the group in order to restore the whole group to solvency.

Both the U.S. and U.K. approaches ensure continuity of all critical services performed by the operating firm(s), thereby reducing risks to financial stability. Both approaches ensure activities of the firm in the foreign jurisdictions in which it operates are unaffected, thereby minimizing risks to cross-border implementation. The unsecured debt holders can expect that their claims would be written down to reflect any losses that shareholders cannot cover, with some converted partly into equity in order to provide sufficient capital to return the sound businesses of the G-SIFI to private sector operation. Sound subsidiaries (domestic and foreign) would be kept open and operating, thereby limiting contagion effects and cross-border complications. In both countries, whether during execution of the resolution or thereafter, restructuring measures may be taken, especially in the parts of the business causing the distress, including shrinking those businesses, breaking them into smaller entities, and/or liquidating or closing certain operations. Both approaches would be accompanied by the replacement of culpable senior management.

This paper outlines several common considerations that affect these particular approaches to resolution in the U.S. and the U.K., including the need to ensure sufficient loss absorbency at the top of the group. The Federal Deposit Insurance Corporation and the Bank of England will continue to work together on these resolution strategies.

Resolving Globally Active, Systemically Important, Financial Institutions
Federal Deposit Insurance Corporation and the Bank of England[1]

Introduction

1 The Federal Deposit Insurance Corporation (FDIC) and the Bank of England—together with the Board of Governors of the Federal Reserve System, the Federal Reserve Bank of New York, and the Financial Services Authority—have been working to develop resolution strategies for the failure of globally active, systemically important, financial institutions (SIFIs or G-SIFIs) with significant operations on both sides of the Atlantic. This work has taken place in connection with the implementation of the Financial Stability Board's (FSB) *Key Attributes of Effective Resolution Regimes for Financial Institutions* (Key Attributes), as well as in connection with the reforms to the legal arrangements for handling the failure of financial institutions that were instituted in the United States (U.S.) and the United Kingdom (U.K.) in response to the recent financial crisis.

2 The goal is to produce resolution strategies that could be implemented for the failure of one or more of the largest financial institutions with extensive activities in our respective jurisdictions. These resolution strategies should maintain systemically important operations and contain threats to financial stability. They should also assign losses to shareholders and unsecured creditors in the group, thereby avoiding the need for a bailout by taxpayers. These strategies should be sufficiently robust to manage the challenges of cross-border implementation and to the operational challenges of execution.

3 As highlighted in the FSB's recently published draft Guidance on Recovery and Resolution Planning,[2] strategies for resolution may broadly be categorized as either applying resolution powers to the top of a group by a single national resolution authority (single point of entry), or applying resolution tools to different parts of the group by two or more resolution authorities acting in a coordinated way (multiple points of entry). Which strategy is most suitable to resolving the group will depend upon a range of factors. For example, a single point of entry strategy may offer the simplest and most effective choice if the debt issued at the top of the group is sufficient to absorb the group's losses. Where this is not the case, a multiple points of entry strategy will be more suitable, particularly if different parts of the group can continue on a standalone basis.

4 The focus of this paper is on a single point of entry resolution approach. It is hoped that the detail it provides on the single point of entry approach, when combined with the published FSB Guidance on Recovery and Resolution Planning, will give greater predictability for market participants about how resolution authorities may approach a resolution. This predictability cannot, however, be absolute, as the resolution authorities must not be constrained in exercising discretion in pursuit of their statutory objectives in how best to resolve a firm.

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[1] This paper has been written jointly by the Federal Deposit Insurance Corporation and the Bank of England.
[2] See FSB Consultative Document "Recovery and Resolution Planning: Making the Key Attributes Requirements Operational," www.financialstabilityboard.org/publications/r_121102.pdf.

Post-crisis resolution strategy

5 The financial crisis that began in late 2007 highlighted the shortcomings of the arrangements for handling the failure of large financial institutions that were in place on either side of the Atlantic. Large banking organizations in both the U.S. and the U.K. had become highly leveraged and complex, with numerous and dispersed financial operations, extensive off-balance-sheet activities, and opaque financial statements. These institutions were managed as single entities, despite their subsidiaries being structured as separate and distinct legal entities. They were highly interconnected through their capital markets activities, interbank lending, payments, and off-balance-sheet arrangements.

6 The legislative frameworks and resolution regimes at the time were ill-suited to dealing with financial institution failures of this scale and interconnectedness. In the U.S., the FDIC only had the power to place an insured depository institution into receivership; it could not resolve failed or failing bank holding companies or other nonbank financial companies that posed a systemic risk. In the U.K., until 2009 there was no special resolution regime available for banks or other financial companies, whatever their size or complexity, and as a result the U.K. was reliant on standard insolvency procedures such as administration.

7 As demonstrated by the Title I requirement of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act), the U.S. would prefer that large financial organizations be resolvable through ordinary bankruptcy. However, the U.S. bankruptcy process may not be able to handle the failure of a systemic financial institution without significant disruption to the financial system.

8 Similarly, the U.K. administration process often takes time and involves significant uncertainty regarding the outcome. Forcing large financial organizations through administration can create significant and systemic risks for the real economy by interrupting critical services, disrupting key financial relationships, and freezing financial markets. In addition, it can destroy value, harming the real economy.

9 Given these problems with the bankruptcy process, the U.S. and the U.K. authorities resorted to providing large scale public support to failing financial companies during the 2007-09 crisis to prevent further systemic disruption. This public support has exposed taxpayers to loss and resulted in the bailout of multiple financial institutions and their creditors.

10 Following the crisis, an overhaul of the framework for dealing with large and complex financial institution failures was required. While it may be useful to strengthen the current bankruptcy code or administration rules to improve the handling of financial failures, systemic considerations warrant having an alternative resolution strategy.

11 A resolution strategy for a failed or failing G-SIFI should assign losses to shareholders and unsecured creditors, and hold management responsible for the failure of the firm. The strategy should provide continuity of the critical services that the institution provides within the financial system and to the real economy, thereby minimizing systemic risk. The strategy should also enable a prompt transition of the firm's ongoing operations to full private ownership and control without taxpayer support. Given the cross-border nature of G-SIFIs, the resolution strategy should ensure financial stability concerns are addressed

across all jurisdictions in which the firm operates. To be successful, such an approach will require close cooperation between home and foreign authorities.

12 Under the strategies currently being developed by the U.S. and the U.K., the resolution authority could intervene at the top of the group. Culpable senior management of the parent and operating businesses would be removed, and losses would be apportioned to shareholders and unsecured creditors. In all likelihood, shareholders would lose all value and unsecured creditors should thus expect that their claims would be written down to reflect any losses that shareholders did not cover. Under both the U.S. and U.K. approaches, legal safeguards ensure that creditors recover no less than they would under insolvency.

13 An efficient path for returning the sound operations of the G-SIFI to the private sector would be provided by exchanging or converting a sufficient amount of the unsecured debt from the original creditors of the failed company into equity. In the U.S., the new equity would become capital in one or more newly formed operating entities. In the U.K., the same approach could be used, or the equity could be used to recapitalize the failing financial company itself—thus, the highest layer of surviving bailed-in creditors would become the owners of the resolved firm. In either country, the new equity holders would take on the corresponding risk of being shareholders in a financial institution. Throughout, subsidiaries (domestic and foreign) carrying out critical activities would be kept open and operating, thereby limiting contagion effects. Such a resolution strategy would ensure market discipline and maintain financial stability without cost to taxpayers.

Legislative frameworks for implementing the strategy

14 It should be stressed that the application of such a strategy can be achieved only within a legislative framework that provides authorities with key resolution powers. The FSB Key Attributes have established a crucial framework for the implementation of an effective set of resolution powers and practices into national regimes. In the U.S., these powers had already become available under the Dodd-Frank Act. In the U.K., the additional powers needed to enhance the existing resolution framework established under the Banking Act 2009 (the Banking Act) are expected to be fully provided by the European Commission's proposals for a European Union Recovery and Resolution Directive (RRD) and through the domestic reforms that implement the recommendations of the U.K. Independent Commission on Banking (ICB), enhancing the existing resolution framework established under the Banking Act. The development of effective resolution strategies is being carried out in anticipation of such legislation.

U.S. regime

15 The framework provided by the Dodd-Frank Act in the U.S. greatly enhances the ability of regulators to address the problems of large, complex financial institutions in any future crisis. Title I of the Dodd-Frank Act requires each G-SIFI to periodically submit to the FDIC and the Federal Reserve a resolution plan that must address the company's plans for its rapid and orderly resolution under the U.S. Bankruptcy Code. The FDIC and the Federal Reserve are required to review the plans to determine jointly whether a company's plan is credible. If a plan is found to be deficient and adequate revisions are not made, the FDIC and the Federal Reserve may jointly impose more stringent capital, leverage, or liquidity requirements, or restrictions on growth, activities, or operations of the company, including its subsidiaries. Ultimately, the company could be ordered to divest assets or operations to

facilitate an orderly resolution under bankruptcy in the event of failure. Once submitted and accepted, the SIFIs' plans for resolution under bankruptcy will support the FDIC's planning for the exercise of its resolution powers by providing the FDIC with an understanding of each SIFI's structure, complexity, and processes.

16 Title II of the Dodd-Frank Act provides the FDIC with new powers to resolve SIFIs by establishing the orderly liquidation authority (OLA). Under the OLA, the FDIC may be appointed receiver for any U.S. financial company that meets specified criteria, including being in default or in danger of default, and whose resolution under the U.S. Bankruptcy Code (or other relevant insolvency process) would likely create systemic instability.[3] Title II requires that the losses of any financial company placed into receivership will not be borne by taxpayers, but by common and preferred stockholders, debt holders, and other unsecured creditors, and that management responsible for the condition of the financial company will be replaced. Once appointed receiver for a failed financial company, the FDIC would be required to carry out a resolution of the company in a manner that mitigates risk to financial stability and minimizes moral hazard.[4] Any costs borne by the U.S. authorities in resolving the institution not paid from proceeds of the resolution will be recovered from the industry.

U.K. regime

17 In the U.K., the Banking Act provides the Bank of England with tools for resolving failing deposit-taking banks and building societies.[5] Powers similar to those of the FDIC are available, including powers to transfer all or part of a failed bank's business to a private sector purchaser or to a bridge bank until a private purchaser can be found. The Banking Act also provides the U.K. authorities with a bespoke bank insolvency procedure that fully protects insured depositors while liquidating a failed bank's assets. These powers have proved valuable; for example, during the crisis they allowed the authorities to transfer the retail and wholesale deposits, branches, and a significant proportion of the residential mortgage portfolio of a failed building society to another building society.

18 The Banking Act powers do not, however, provide a wholly effective solution to the failure of a large, complex, and international financial firm. The critical economic functions of a G-SIFI are currently intertwined legally, operationally, and financially across jurisdictions and legal entities. For U.K. firms, these functions frequently reside in the same entities as the firms' core unsecured liabilities. Using the existing statutory transfer powers would involve separating and transferring large and complex businesses from within operating entities to a purchaser or bridge bank, while leaving behind the remaining liabilities and bad assets in the failed firm to be wound up through insolvency. These operating companies may have several thousand counterparties, customers, and contracts. Such a transfer would be almost impossible to achieve over a resolution weekend without destroying value and causing financial stability concerns in multiple jurisdictions.

[3] The process for such appointment is set forth in Sections 202 and 203 of the Dodd-Frank Act, 12 U.S.C. §§ 5382 and 3.

[4] See Section 204(a) of the Dodd-Frank Act, 12 U.S.C. § 5384.

[5] In addition, the U.K. Treasury is empowered to take a bank into Temporary Public Ownership where the power is necessary to resolve or reduce a serious threat to U.K. financial stability. The powers are set out in Articles 9 and 13 of the Banking Act.

19 The introduction of a statutory bail-in resolution tool (the power to write down or convert into equity the liabilities of a failing firm) under the RRD is critical to implementing a whole group resolution of U.K. firms in a way that reduces the risks to financial stability. A bail-in tool would enable the U.K. authorities to recapitalize an institution by allocating losses to its shareholders and unsecured creditors, thereby avoiding the need to split or transfer operating entities. The provisions in the RRD that enable the resolution authority to impose a temporary stay on the exercise of termination rights by counterparties in the event of a firm's entry into resolution (in other words, preventing counterparties from terminating their contractual arrangements with a firm solely as a result of the firm's entry into resolution) will be needed to ensure the bail-in is executed in an orderly manner.

20 The existing Banking Act does not cover nondeposit-taking financial firms, notably investment banks and financial market infrastructures (clearing houses in particular), the failure of which, in many cases, would also have significant financial stability consequences. The Banking Act also has limitations with regard to the application of resolution tools to financial holding companies. The U.K. is in the process of expanding the scope of the Banking Act to include these firms. This is expected to be achieved through the introduction of the U.K. Financial Services Bill,[6] which is due to complete its passage through Parliament by the end of this year.

21 In addition to expanding the U.K. resolution regime, the Financial Services Bill will significantly enhance the U.K.'s approach to banking supervision. Going forward, the framework for prudential supervision in the U.K. will emphasize supervisory judgment, rather than supervision based solely on rules. Under this framework, considerations of resolvability or ease of resolution would become a core part of the supervisory process.

22 In conjunction with the Financial Services Bill, the adoption of the recommendations of the ICB will also significantly improve the resolvability of the U.K. domestic retail bank by ringfencing it from the rest of the group. This will help to preserve core domestic intermediation services if a group-wide resolution is not feasible for some reason.

23 To ensure that banks are resolvable, the Financial Services Authority (and in the future, the Prudential Regulation Authority[7] (PRA)) will require firms under the Financial Services Act 2010 to produce Recovery and Resolution Plans (RRPs). Firms will submit the information that the authorities will need to prepare resolution plans and to assess resolvability. Where barriers to resolution are identified, firms will be required to remove them through changes to their structure and operations. The proposed RRD provides authorities with the necessary powers to achieve this, including the ability to require changes to the legal or operational structures of institutions, and to require firms to cease specific activities.[8]

[6] See http://www.hm-treasury.gov.uk/consult_financial_sector_resolution_broadening_regime.htm.

[7] Once the Financial Services Bill comes into force in 2013, the Financial Services Authority will be replaced by two new regulatory bodies, the PRA and the Financial Conduct Authority. The PRA, a subsidiary of the Bank of England, will become the prudential regulator of deposit-takers, insurers, and the largest investment firms. It will have the objective of promoting the safety and soundness of these firms, in part through minimizing the adverse effect of their failure on the U.K. financial system.

[8] See Article 14(4) of the proposed RRD, including 14(4)(e) "requiring the institution to limit or cease specific existing or proposed activities," and 14(4)(g) "requiring changes to legal or operational structures of the institution so as to reduce complexity in order to ensure that critical functions may be legally and economically separated from other functions through the application of the resolution tools."

Description of the resolution strategies

U.S. approach to single point of entry resolution strategy

24 Under the U.S. approach, the FDIC will be appointed receiver of the top-tier parent holding company of the financial group following the company's failure and the completion of the appointment process set forth under the Dodd-Frank Act. Immediately after the parent holding company is placed into receivership, the FDIC will transfer assets (primarily the equity and investments in subsidiaries) from the receivership estate to a bridge financial holding company. By taking control of the SIFI at the top of the group, subsidiaries (domestic and foreign) carrying out critical services can remain open and operating, limiting the need for destabilizing insolvency proceedings at the subsidiary level. Equity claims of the shareholders and the claims of the subordinated and unsecured debt holders will likely remain in the receivership.

25 Initially, the bridge holding company will be controlled by the FDIC as receiver. The next stage in the resolution is to transfer ownership and control of the surviving operations to private hands. Before this happens, the FDIC must ensure that the bridge has a strong capital base and must address whatever liquidity concerns remain. The FDIC would also likely require the restructuring of the firm—potentially into one or more smaller, non-systemic firms that could be resolved under bankruptcy.

26 By leaving behind substantial unsecured liabilities and stockholder equity in the receivership, assets transferred to the bridge holding company will significantly exceed its liabilities, resulting in a well-capitalized holding company. After the creation of the bridge financial company, but before any transition to the private sector, a valuation process would be undertaken to estimate the extent of losses in the receivership and apportion these losses to the equity holders and subordinated and unsecured creditors according to their order of priority. In all likelihood, the equity holders would be wiped out and their claims would have little or no value.

27 To capitalize the new operations—one or more new private entities—the FDIC expects that it will have to look to subordinated debt or even senior unsecured debt claims as the immediate source of capital. The original debt holders can thus expect that their claims will be written down to reflect any losses in the receivership of the parent that the shareholders cannot cover and that, like those of the shareholders, these claims will be left in the receivership.

28 At this point, the remaining claims of the debt holders will be converted, in part, into equity claims that will serve to capitalize the new operations. The debt holders may also receive convertible subordinated debt in the new operations. This debt would provide a cushion against further losses in the firm, as it can be converted into equity if needed. Any remaining claims of the debt holders could be transferred to the new operations in the form of new unsecured debt.

29 The transfer of equity and investments in operating subsidiaries to the bridge holding company should do much to alleviate liquidity pressures. Ongoing operations and their attendant liabilities also will be supported by assurances from the FDIC, as receiver. As demonstrated by past bridge-bank operations, the assurance of performance should encourage market funding and stabilize the bridge financial company. However, in the case where credit

markets are impaired and market funding is not available in the short term, the Dodd-Frank Act provides for FDIC access to the Orderly Liquidation Fund (OLF), a fund within the U.S. Treasury. In addition to providing a back-up source of funding, the OLF may also be used to provide guarantees, within limits, on the debt of the new operations. An expected goal of the strategy is to minimize or avoid use of the OLF. To the extent that the OLF is used, it must either be repaid from recoveries on the assets of the failed financial company or from assessments against the largest, most complex financial companies.[9] The Dodd-Frank Act prohibits the loss of any taxpayer money in the orderly liquidation process.

U.K. approach to single point of entry resolution strategy

30 The U.K.'s planned approach to single point of entry also involves a top-down resolution. On the basis that the RRD will introduce a broad bail-in power, the U.K. authorities would seek to recapitalize the financial group through the imposition of losses on shareholders and, as appropriate, creditors of the firm via the exercise of a statutory bail-in power. This U.K. group resolution approach need not employ a bridge bank and administration, although such powers are available in the U.K. and may be appropriate under certain circumstances.

31 Current proposals for implementing such a strategy incorporate a period in which equity and debt securities would be transferred from the shareholders and debt holders to an appointed trustee. The trustee would hold the securities during a valuation period in which the extent of the losses expected to be incurred by the firm would be established and, in turn, the recapitalization requirement determined. During this period, listing of the company's equity securities (and potentially debt securities) would be suspended. Once the recapitalization requirement has been determined, an announcement of the final terms of the bail-in would be made to the previous security holders. This announcement would include full details of the write-down and/or conversion.

32 Debt securities would be cancelled or written down in order to return the firm to solvency by reducing the level of outstanding liabilities. The losses would be applied up the firm's capital structure in a process that respects the existing creditor hierarchy under insolvency law. The value of any loans from the parent to its operating subsidiaries would be written down in a manner that ensures that the subsidiaries remain solvent and viable.

33 Completion of the exchange would see the trustee transfer the equity (and potentially some of the existing debt securities written down accordingly) back to the original creditors of the firm. Those creditors unable to hold equity securities (for example, for reasons of investment mandate restrictions) would be able to request that the trustee sell the equity securities on their behalf. The trust would then be dissolved and the equity securities (and potentially debt securities) of the firm would resume trading. The firm would now be recapitalized and primarily owned by the (appropriate layer of) original creditors of the institution. As described later, the process would be accompanied by restructuring measures to address the causes of the firm's failure and to restore the business to viability.

[9] The FDIC is also allowed to claw back any advance payments to claimants of the receivership if losses exceed original estimates. The set of companies that may be subject to an assessment, and the extent to which their assessment is subject to adjustment for certain risk factors, is set out in Section 210(o) of the Dodd-Frank Act.

34 The U.K. has also given consideration to the recapitalization process in a scenario in which a G-SIFI's liabilities do not include much debt issuance at the holding company or parent bank level but instead comprise insured retail deposits held in the operating subsidiaries. Under such a scenario, deposit guarantee schemes may be required to contribute to the recapitalization of the firm, as they may do under the Banking Act in the use of other resolution tools. The proposed RRD also permits such an approach because it allows deposit guarantee scheme funds to be used to support the use of resolution tools, including bail-in, provided that the amount contributed does not exceed what the deposit guarantee scheme would have as a claimant in liquidation if it had made a payout to the insured depositors. That is consistent with the contribution requirement that is already imposed on the Financial Services Compensation Scheme in the U.K. in the exercise of resolution powers[10] and simulates the losses that would have been incurred by those deposit guarantee schemes during bank insolvency. But insofar as a bail-in provides for continuity in operations and preserves value, losses to a deposit guarantee scheme in a bail-in should be much lower than in liquidation. Insured depositors themselves would remain unaffected. Uninsured deposits would be treated in line with other similarly ranked liabilities in the resolution process, with the expectation that they might be written down.

35 Following the recapitalization process, the firm would be restructured to address the causes of its failure. It should then be solvent and viable, and as a result in a position to access market funding. In recognition of the fact that it will take time for losses to be assessed for purposes of recapitalization, and that it will take time to execute the restructuring plan that will underpin the firm's viability, immediate access may prove difficult. In certain circumstances, to reduce the immediate funding need and so facilitate market access, illiquid assets might be removed from the balance sheet of the firm and transferred into an asset management company to be worked out over a longer period.

36 If market funding were not immediately available, temporary funding may need to be provided by the authorities to meet the firms' liquidity needs. The funding would only be provided on a fully collateralized basis with appropriate haircuts applied to the collateral to reduce further the risk of loss. In the unlikely event that losses were associated with the provision of temporary public sector support, such losses would be recovered from the financial sector.

37 It is important to note that the strategy described above would not necessarily be appropriate for all U.K. G-SIFIs in all circumstances. Other strategies may be more appropriate depending on the structure of a group, the nature of its business, and the size and location of the group's losses. For example, in cases where the losses on assets in a particular operating subsidiary were potentially so great that they could not be absorbed by bailing in at group level or where the business had incurred such significant losses and was so weighed down by toxic assets that the capital needs in resolution were too difficult to estimate credibly, resolution at the level of one or more operating subsidiaries may be more appropriate. In this situation, the application of resolution tools to operating subsidiaries would be easier if the subsidiaries providing critical economic services were operationally and financially ringfenced from the rest of the group.

[10] The provisions for the Financial Services Compensation Scheme to contribute to the costs of a resolution are set out in Article 171ff of the Banking Act 2009.

38 This is one of the advantages of the ringfence which is being introduced in the U.K. It will provide flexibility in the event of fatal problems elsewhere in the group to transfer the ringfenced entity to a bridge bank or purchaser in its entirety. If losses were concentrated in the ringfenced entity and capital in the ringfenced entity was insufficient to absorb them, then losses could be borne by creditors of the ringfenced bank (including debt holders where the ringfenced bank had issued debt into the market). This could be achieved either by bail-in or by transferring the operations of the ringfenced bank to a bridge bank, leaving uninsured creditors behind in administration. Draft legislation to establish this ringfence of the largest retail deposit-takers is due to be introduced into Parliament early in 2013 and if passed will provide valuable additional flexibility in implementing resolution strategies to preserve the provision of core services in the U.K. business of U.K. G-SIFIs.

Key common considerations for U.S. and U.K. approaches

39 As outlined above, high-level transaction structures have been developed for each jurisdiction. As discussed in the FSB Guidance on Recovery and Resolution Planning, for any resolution to be effective, consideration needs to be given in advance to various preconditions and operational requirements. Several of these considerations in relation to a top-down resolution strategy are discussed in more detail below.

Resolution and restructuring measures

40 A top-down resolution by definition focuses on assigning losses and establishing new capital structures at the top of the group. This approach keeps the rest of the group, potentially comprised of hundreds or thousands of legal entities, intact. However, a top-down resolution would need to be accompanied, or shortly followed, by significant restructuring measures to address the causes of the firm's failure and to underpin the firm's viability. Such a restructuring may include shrinking the G-SIFI's balance sheet, breaking the company up into smaller entities, and/or selling or closing certain operations. The newly restructured companies will all need to have strong corporate governance and management oversight, which would likely necessitate significant changes to management and board personnel and processes. In both countries, it is likely that supervisory actions will continue after the return to private ownership to ensure that the firm is on a stable and sustainable footing and the problems that caused the firm to fail in the first place have been properly dealt with.

41 In the U.S., effective governance will be an important issue for both the transitional bridge financial company and the newly capitalized entity or entities into which the bridge will transition. The FDIC, as receiver, will control the bridge financial company and would immediately appoint a temporary board of directors and Chief Executive Officer (CEO) to run the bridge. The claims of the failed G-SIFI's unsecured creditors will be converted into equity and, as a result, the former creditors will become owners of the new private sector operations. They will thereafter be responsible for electing a new board of directors, which will in turn appoint a new CEO.

42 During the period in which the FDIC controls the bridge financial company, decisions will be made on how to on simplify and shrink the institution. It also would likely require restructuring of the firm—perhaps into one or more smaller, non-systemic firms. Consideration will also be given to how to create a more stable, less systemically important institution. Required changes, including divestiture, may be influenced by the failed firm's Title I resolution plan. Once determined, the required actions and relevant time frames for

their execution will be specified in formal supervisory agreements with the new owners of the private sector operations.

43 The required actions would be executed in private markets by the new owners. For example, the new owners might be required to sell a portion of their branch structure to reduce their footprint, divest their foreign operations, or separate their commercial and investment banking operations. The resulting new private sector operations would be smaller, more manageable—and perhaps more profitable. They would also be easier to examine and supervise. Importantly, all new operations must be resolvable under bankruptcy without public support.

44 In the U.K., similar considerations would enter into decisions on the restructuring process. Depending on the specific timeline for resolution, the restructuring may occur primarily either during the trustee stage (before the delivery of equity securities to the creditors) or during the stage following the dissolution of the trust. The extent of the restructuring measures required would depend on the cause of failure, and the extent to which losses were contained within a particular pool of assets or legal entity. If losses at the firm were localized, the restructuring measures required may be limited. These would likely require a sale or wind-down of relevant business lines and withdrawal from loss-making activities. The senior management that were responsible for bringing the firm into distress would also be replaced. On the other hand, if losses at the firm were pervasive and spread across multiple business lines, a more fundamental restructuring of the firm's business would be required. This would likely include a complete governance overhaul and a thorough reorganization of the activities of the institution. In the extreme case, much of the institution may enter managed wind-down over a prolonged period of time. In such a scenario, it is likely that a legal and operational ringfencing of a banking group's retail banking activities from the group's investment banking activities would prove particularly valuable in facilitating such a restructuring.

Maintaining financial stability

45 Both the U.S. and U.K. resolution proposals are designed to maintain financial stability by ensuring that critical business functions continue to be performed. Critical business functions are generally performed at the level of the operating subsidiaries—assets of the holding companies of U.S. and U.K. G-SIFIs tend to comprise little more than the equity stakes in the operating subsidiaries. The newly resolved group would be solvent and viable, and should be in a position therefore to access market funding or, if necessary, funding from the authorities as discussed above. Liquidity will be downstreamed in a "business as usual" manner to the operating subsidiaries immediately following the resolution weekend. As described above, the balance sheets of the operating subsidiaries should be broadly unaffected by the resolution action at the top of the group. To recapitalize the operating subsidiaries that had incurred losses, the equity or debt held by the parent in those subsidiaries would need to be written down. The parent and, indirectly, the subsidiary operating companies may also be subject to change of control procedures arising from a switch of ownership from the existing shareholders to creditors.[11] Provision of critical shared services across the group should be unaffected.

[11] Subject to appropriate regulatory approvals.

46 Given minimal disruption to the balance sheet of the operating companies, and given that the group should be recapitalized following the assignment of losses to shareholders and creditors, counterparties should not have strong incentives to cease trading with the operating companies during and following the resolution. The contingency plans are designed to minimize the triggering of cross-defaults or closeout of netting arrangements at the operating companies. In certain cases, a stay on termination rights may be applied to ensure that termination of counterparty relationships cannot be triggered solely as a result of entry into resolution. A stay may assist in promoting the continuity of a variety of critical economic functions that are dependent on maintaining counterparty relationships (for example, those functions relating to wholesale market activities) and also avoiding the rapid, disorderly, and potentially value-destructive closeout of financial contracts and liquidation of securities. The stay could also minimize the closeout risk that may result from cross-default clauses within financial contracts. In the scenario in which the holding company is placed into receivership, the stay would extend to certain subsidiary counterparties subject to financial contracts that reference the holding company. Given cross-border considerations, it is important that stays on termination apply to both domestic and foreign operations of G-SIFIs. In certain cases, authorities cannot currently extend stays on termination to foreign operations. Supporting actions by host authorities may be required (as included in the Key Attributes), or it may be necessary to introduce clauses that recognize foreign resolution actions, including stays on termination, into counterparty documentation.

47 Similarly, because the group remains solvent, retail or corporate depositors should not have an incentive to “run” from the firm under resolution insofar as their banking arrangements, transacted at the operating company level, remain unaffected. In order to achieve this, the authorities recognize the need for effective communication to depositors, making it clear that their deposits will be protected.

48 If continuity of critical functions is to be achieved, the firm will need continuing access to core services provided by the financial market infrastructures (for example, payment systems and central counterparties) during and following resolution. To achieve this, authorities in both the U.S. and U.K. have begun a process of engaging with such infrastructures to develop effective procedures relating to the treatment of members who have entered resolution.

Minimization of cross-border coordination risk

49 It should be stressed that a key advantage of a whole group, single point of entry approach is that it avoids the need to commence separate territorial and entity-focused insolvency proceedings, which could be disruptive, difficult to coordinate, and would depend on the satisfaction of a large number of pre-conditions in terms of structure and operations of the group for successful execution. Because the whole group resolution strategies maintain continuity of business at the subsidiary level, foreign subsidiaries and branches should be broadly unaffected by the resolution action taken at the home holding company level. The strategies remove the need to commence foreign insolvency proceedings or enforce legal powers over foreign assets (although, as discussed later, it may be necessary to write down or convert debt at the top of the group that are subject to foreign law). Liquidity should continue to be downstreamed from the holding company to foreign subsidiaries and branches. Given minimal disruption to operating entities, resolution authorities, directors, and creditors of foreign subsidiaries and branches should have little incentive to take action other than to cooperate with the implementation of the group resolution. In particular, host stakeholders

should not have an incentive to ringfence assets or petition for a preemptive insolvency—preemptive actions that would otherwise destroy value and may disrupt markets at home and abroad.

50 A key part of the work undertaken by the U.S. and the U.K. has been to identify the regulatory obligations of foreign authorities in response to a resolution originated by a home authority. Where any impediments to effective whole group resolution have been identified, authorities are in the process of exploring methods to overcome them.

51 The Key Attributes stress the importance of a globally coordinated approach to resolution, and emphasize that resolution authorities should consider the potential impact of their resolution actions on the financial stability of foreign jurisdictions. The Key Attributes propose a framework that would facilitate cross-border cooperation between resolution authorities. This framework would help to ensure that local resolution authorities support a resolution carried out by a foreign authority.

52 A central element of the cross-border cooperation process set out in the Key Attributes is the establishment of Crisis Management Groups (CMGs)—groups composed of supervisors, central banks, and resolution authorities of the key jurisdictions in which a G-SIFI operates. Members of these groups are expected to enter into firm-specific cross-border cooperation agreements that detail the proposed means by which a particular resolution should be coordinated between authorities. To provide a platform for such cooperation agreements, authorities in the home jurisdiction are required to submit firm-specific resolution strategies to members of the CMG for consultation by the end of 2012.[12]

53 These resolution strategies set out at a high level the key elements of the approach to resolution and outline the use of key resolution powers. The strategies will be translated into detailed resolution plans for each firm during the first half of 2013.[13] These resolution plans will provide specific detail on implementing the proposed resolution strategy, including consideration of entities to which resolution powers may be applied and the possible roles of relevant national resolution authorities. Subsequently, firm-specific resolvability assessments will be developed by the end of 2013. The resolvability assessments will identify barriers to implementation of the resolution plans, and will be key to demonstrating 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. In addition, certain U.S. and U.K. G-SIFIs have been required to make their first full RRP submissions in 2012 to support the development of viable resolution plans by the authorities. These submissions will help to expose, among other things, actions that firms will need to take to improve their resolvability.

Write-down of liabilities and conversion of debt into equity

54 Under a top-down resolution, shareholders and certain creditors at the top of the group absorb losses and recapitalize the group as whole. 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.

[12] See FSB Progress Report on the Resolution of SIFIs, http://www.financialstabilityboard.org/publications/r_121031aa.pdf

[13] See aforementioned FSB Guidance for Recovery and Resolution Planning.

55 In the U.S., the capital structures of large financial holding companies are characterized by equity and large amounts of unsecured debt of various maturities. This debt is structurally subordinated within the group, and limited external unsecured debt tends to be raised at entities below the financial holding company. Regulation may be adopted to ensure that sufficient debt is held at the top-tier holding company level.

56 In the U.K., on the other hand, financial holding companies at the top of the group often do not account for a significant proportion of the group's unsecured debt raised by groups externally. Looking ahead, either the groups could restructure so that more debt is issued out of the holding company or the U.K. authorities could look to bail-in the liabilities of the top operating companies within each group. The latter course would require careful planning given that senior unsecured bonds typically rank alongside other unsecured liabilities that are unlikely to be bailed-in. Detailed consideration of this part of the resolution strategy for individual banking groups will need to take account of the precise provisions of the RRD as eventually passed into law. Also, both the draft RRD and the U.K. government's plans for implementing the ICB report include requirements aimed at ensuring that banks have sufficient capital and debt in issue to make them resolvable using bail-in or other resolution tools. The U.K. authorities will in due course consider how the final versions of those requirements should be applied to U.K. G-SIFIs given their group structures and resolvability.

57 Consideration also 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. Ensuring that foreign law securities can be written down or converted into equity alongside securities issued under the law of the home jurisdiction may require the inclusion of contractual recognition of foreign resolution proceedings within debt contracts.

Valuation

58 During resolution, a valuation process will need to be undertaken to assess the losses on assets that the firm has incurred and the capital needed under stress assumptions to restore confidence in the firm, which will determine the extent to which creditor claims should be written down and converted. The valuation will determine how far up the capital structure the write down or conversion of debt may need to apply (that is, whether shareholders and subordinated debt holders can fully absorb losses in order to recapitalize the firm, or whether senior unsecured creditors would also need to be included). The valuation process will in turn determine what financial instruments if any—for example, common equity in the new firm or warrants—the different classes of original creditors of the firm should receive.

59 Given the differences in the U.S. and U.K. resolution processes, the precise valuation requirements and timelines are unlikely to be the same for the two jurisdictions. Consideration is being given in both jurisdictions as to how much of the valuation process can be prepared in advance of resolution (for example, as part of enhanced preparation under the U.K. Proactive Intervention Framework[14]). Consideration is also being given as to

[14] The PRA's Proactive Intervention Framework will provide a systematic approach for the assessment of a firm's proximity to failure to enable supervisors to identify and respond to emerging risks at an early stage. See "The PRA's approach to banking supervision," October 2012.

whether new financial statements would be required, and whether the firm's external auditors would need to be replaced for the valuation process to provide sufficient comfort to the market that the ongoing operations were fully (re)capitalized and solvent. An effective valuation process should facilitate the issuance of new securities and other financial instruments, and would likely be required by rating agencies in order to make a judgment on the creditworthiness of the resolved institution. The U.S. and U.K. authorities are considering how a credible valuation could be carried out quickly and effectively, and with flexibility to respond to the characteristics of particular institutions and the nature of their failures.

Listing requirements post-resolution

60 To return the firm to the market effectively, the public listing of its equity and debt securities would need to resume. Insofar as new debt or equity instruments are issued, listing rules may require that a prospectus or other offering documentation be provided to investors. This would likely include audited financial statements for the firm, and may therefore take a significant amount of time to achieve.

61 Under the U.S. approach, a new parent entity is established during resolution. Therefore, new securities would need to be issued in satisfaction of creditor claims. Such securities would either need to be issued pursuant to effective registration statements, or may, in certain instances, be listed pursuant to an exemption from registration.

62 In the case of a U.K. resolution, new equity and debt securities would not necessarily need to be issued following resolution. Under certain circumstances, it is possible, subject to a number of conditions, that existing equity and debt securities could resume trading without the need for a prospectus.

63 In both jurisdictions, engagement with securities regulators well in advance of, and also during, resolution will be key to ensuring that public listing can be achieved in a timely manner following resolution.

Conclusion

64 In both the U.S. and the U.K., legislative reforms already made or planned in response to the financial crisis provide new powers for resolving failed or failing G-SIFIs. The FDIC and the Bank of England have developed resolution strategies that take control of the failed company at the top of the group, impose losses on shareholders and unsecured creditors—not on taxpayers—and remove top management and hold them accountable for their actions. These strategies provide an efficient path for returning the systemically important parts of the G-SIFI to the private sector by exchanging or converting a sufficient amount of creditor claims from the failed company into capital in the newly resolved entities. Because the resolution action is taken at the top of the group and by the home authorities, continuity of all critical services would be maintained and subsidiaries (foreign and domestic) would remain open and operating with access to sufficient liquidity. As a result, the strategy achieves the important goals of imposing market accountability and maintaining financial stability in all jurisdictions in which the firm operates.

65 The FDIC and the Bank of England continue to work to ensure that their respective resolution strategies will be fully operational. Importantly, the process of cross-border dialogue that has facilitated the above strategies reflects a shared public interest in developing

the capacity to resolve a G-SIFI in a credible and effective manner, and offers a model for multilateral resolution planning more broadly.