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FDIC and Bank of England Signal Significant Cooperation on Resolution Issues in Joint Paper Describing "Single Point of Entry" Resolution of a Cross-border SIFI

On December 10, 2012, the Federal Deposit Insurance Corporation ("FDIC") and the Bank of England ("BoE") released a joint paper entitled "Resolving Globally Active, Systemically Important, Financial Institutions" (the "Joint Paper") outlining a resolution strategy for global systemically important financial institutions ("G-SIFIs").[1] The Joint Paper coincided with the participation of Paul Tucker, BoE Deputy Governor for Financial Stability, in the FDIC's recent Systemic Resolution Advisory Committee ("SRAC") meeting addressing cross-border cooperation and resolution.[2] This paper and Deputy Governor Tucker's comments at the SRAC demonstrate the continuing cooperation between the FDIC and the BoE and are the product of their increasingly close collaboration in recent years. This cooperative effort is essential to achieve progress towards both regulators' stated goal of ending "Too Big to Fail."

Unfortunately, other recent initiatives – such as the U.K. Financial Services Authority's September Consultation Paper on depositor preference and the Federal Reserve's proposed prudential supervisory framework for foreign banking organizations active in the U.S. – could undercut efforts towards greater cross-border cooperation. These initiatives appear focused on ensuring that cross-border financial companies can be regulated, and potentially resolved, separately within host jurisdictions, rather than as a whole.

The Single Point of Entry Resolution Strategy

The Joint Paper describes a "top down" or "single point of entry" ("SPOE") strategy for using the new resolution powers adopted in the United States and the United Kingdom in

[1] Available at http://www.fdic.gov/about/srac/2012/gsifi.pdf. See also the Financial Times op-ed FDIC Chairman Martin Gruenberg and BoE Deputy Governor Paul Tucker, "When global banks fail, resolve them globally", December 10, 2012, *available at* http://www.ft.com/intl/cms/s/0/fd66d172-3fd4-11e2-b0ce-00144feabdc0.html#axzz2FEJH53Ol.

[2] FDIC Systemic Resolution Advisory Committee Meeting, http://www.fdic.gov/about/srac/2012/2012_12_10_agenda.html

the wake of the recent financial crisis.[3] In an SPOE resolution, only the top-level entity in a failing financial group (whether a holding company or an operating company) would enter resolution, with the operating subsidiaries continuing operations uninterrupted. As described in the Joint Paper, the top-level company of the failing financial group would be resolved and losses imposed on that company's shareholders and creditors, while viable subsidiaries would continue to operate without being placed into insolvency proceedings.

Through its focus on resolving the top-level company only, the SPOE strategy allows otherwise viable operating subsidiaries to continue operations on a going concern basis, with additional liquidity and other resources supplied by the resolution authority as needed. While the legal authorities in the U.S. and the U.K. differ in some material ways, the strategy in both cases is designed to limit the cascades of separate insolvencies of subsidiaries within a financial group, the unwinding of group and subsidiary financial contracts, and the potential systemic consequences of the failure of multiple companies within a large, cross-border financial group. Limiting insolvency proceedings to only the top-level company, while maintaining funding for the continued operation of subsidiaries, could limit many of the complications caused by the need to coordinate multiple insolvencies under frameworks in different jurisdictions.

The Joint Paper identifies the preferred 'exit strategy' as a recapitalization accomplished by converting certain creditor claims against the failed financial company into equity in a newly restructured financial company. This would have the effect of imposing losses on existing equity, subordinated and senior unsecured debt, and converting part of the remaining debt into the new equity according to the order of creditor priority. As a result, ownership of the restructured group would shift to the former creditors of the parent entity. This debt for equity conversion process would likely be accompanied by other restructuring actions to address the causes of failure, such as winding down troubled assets or unprofitable lines of business, and may include splitting the group into smaller, less systemically significant groups of companies. As the Joint Paper notes, many details remain to be developed, but the common efforts of the U.S. and U.K. authorities are a critical step forward.

FDIC and BoE Cooperation on Resolution

Since the 2008 financial crisis, the FDIC and BoE have been engaged in active dialog about managing future crises and developing the tools and strategies necessary to successfully resolve a G-SIFI without imposing losses on taxpayers. In January 2010, the FDIC and BoE signed a memorandum of understanding recognizing the need for the FDIC

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3 The FDIC first introduced the SPOE strategy for the resolution of a U.S.-based G-SIFI under the Orderly Liquidation Authority provision of Title II of the Dodd-Frank Act ("OLA") at its SRAC meeting in January 2012. FDIC Systemic Resolution Advisory Committee Meeting, January 25, 2012, http://www.fdic.gov/about/srac/2012/2012-01-25_minutes.pdf

and BoE, alongside other U.S. and U.K. authorities, to work closely to maintain confidence and systemic stability. While building on pre-existing memoranda of understanding on supervisory issues, this new memorandum provided a framework for expanded cooperation and sharing of information specifically on resolution contingency planning and, should the need arise, resolution implementation. The FDIC's focus on cooperation and coordination with U.K. authorities was an obvious choice since the U.K. hosts 88% or more of the international assets and operations of top U.S. banks.[4] U.K. financial companies similarly have substantial majorities of their cross-border operations in the U.S.

The Joint Paper describes the way U.S. and U.K. resolution powers could be used to execute an SPOE resolution. OLA provides the essential statutory powers for the strategy, but the Joint Paper notes that the U.K.'s Banking Act 2009 and related laws lack several key powers needed to successfully execute an SPOE resolution. Most of these missing elements are included in the draft Recovery and Resolution Directive ("RRD"), which is expected to be finalized in 2013.[5] Once the RRD becomes effective, EU member states will be required to implement the regime described in the RRD at the local level, including by amending as necessary the Banking Act in the U.K.

Notably, at the FDIC's recent SRAC meeting, Deputy Governor Tucker stated affirmatively that U.K. authorities would work cooperatively with the FDIC and U.S. authorities to achieve a unified resolution of the U.K. operations of a U.S. financial group under an SPOE strategy. Deputy Governor Tucker agreed that the SPOE strategy was the optimal approach because continued operation, and funding, of the U.K. operations of the U.S. financial group meant the overall resolution could proceed without the U.K. regulators "grabbing the subsidiaries or the branches or the assets of the businesses that are domiciled in the U.K.". Such regulatory cooperation is critical to the success of an SPOE resolution of a G-SIFI: if host country regulators choose to place local operating subsidiaries into resolution proceedings, it could derail the coordinated SPOE approach and require that multiple operating subsidiaries around the globe be placed into separate resolution proceedings. Therefore, a key element of the SPOE strategy is providing host country regulators the confidence that the home country resolution authority will continue to support the global operations of the G-SIFI, including by downstreaming liquidity to host country entities as needed.

Because of the high concentration of international assets of U.S. and U.K. financial companies within the U.K. and U.S., respectively, coordination between these two key jurisdictions is critical to any cooperative resolution of U.S. or U.K. financial companies

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[4] See FDIC Slide presentations at January and December 2012 SRAC meetings.

[5] Proposal for a DIRECTIVE OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL establishing a framework for the recovery and resolution of credit institutions and investment firms, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=COM:2012:0280:FIN:EN:HTML.

with cross-border operations. The ongoing collaborative development of resolution strategies between the U.S. and the U.K. has also provided international leadership on greater cooperation on resolution issues. The Financial Stability Board's recognition of the potential of the SPOE strategy in its progress reports on efforts to improve international coordination has only highlighted the need for cooperation among resolution authorities.

Key Issues Going Forward

Going forward, the BoE and the FDIC will be closely watched as they work through the detailed issues underlying the Joint Paper's high-level statements regarding the SPOE strategy. These issues include, among others, finalizing additional needed resolution powers under U.K and EU law, addressing the potential for unwinding of positions caused by inter-company guarantees and cross-default provisions that may be triggered by insolvency proceedings involving the top-level company, operational and financial interconnections among subsidiaries, continuity in memberships in clearinghouses, exchanges and other financial market utilities.

The FDIC and BoE note that the SPOE strategy is not appropriate for all bank structures, but nonetheless discusses steps regulators or financial institutions could take to make the strategy more likely to succeed. Most notably, the Joint Paper discusses the possibility of requiring a sufficient amount of debt at the top-level entity in a group that could be restructured upon failure. This is an issue of great interest to financial institutions, as are other implications from further development of the SPOE approach, which could have far-reaching effects on capital structures, credit ratings, and the cost of debt and equity issued by top-level companies in a financial group.

Also discussed in the Joint Paper is the possibility of changes to financial contract documentation to give effect to the exercise of resolution powers under a law that is different from the law of the contract (e.g., by counterparties under a U.K. law governed contracts agreeing to be bound by the exercise of power under U.S. resolution authority). The regulators also stress the need for continued cooperation and highlighted the role of the crisis management groups being formed with respect to each G-SIFI.

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