The FDIC's New Resolution Authority under the Dodd-Frank Act: Will it Work and Can It Prevent "Too Big to Fail"?

Presentation by

Randall D. Guynn

Head of the Financial
Institutions Group

Davis Polk & Wardwell LLP

September 27, 2010

Davis Polk

Federal Reserve Bank of St. Louis

The “Too Big to Fail” Debate

- Proponents: Better Regulation of SIFIs and the New Resolution Authority will Eliminate the Need for “Too Big to Fail” Bailouts
  - Heightened Capital and Liquidity Requirements, Living Wills, Cocos, Better Supervision
  - Restrictions on Emergency Stabilization Powers
  - Agency Control of Orderly Liquidation Process
- Opponents: These Two Features will Institutionalize “Too Big to Fail” Bailouts
  - Will create 30 Fannies and Freddies
  - Reduced Market Discipline

Will the New Resolution Authority End "Too Big To Fail?

- Unlikely, but could be good first step, depending on implementation.
- Limits:
  - Law is domestic; institutions are global.
  - During normal times, could increase costs and risks of credit risk management

What's Wrong with the Bankruptcy Code?

- Purposes Too Limited
  - Decide Who Gets What, in What Order
  - No Purpose, Tools or Experience to Preserve or Restore Financial Stability
  - Too Slow; Fire Sale Prices During Market Meltdown
- Creates an Irresistible Temptation to Bailout During Financial Panic
  - Fear of Chaos
  - Fear of Contagion
  - Fear of Downward Spiral

New Resolution Authority to the Rescue

- Supposed to Provide a Third Way
  - Mechanism for Orderly Liquidation by Financial Regulators
  - Includes Purpose, Tools and Experience to Preserve or Restore Financial Stability
    - **Core Resolution Powers, Including Cherry-Picking Powers**
    - **Bridge Financial Company**
  - Claims Proceeding for Left Behind Assets and Liabilities
  - Due Process Protections: Minimum Recovery Rights Based on Hypothetical Chapter 7 Liquidation
  - Moral Hazard Control: Potential Claw-Back of Excess Benefits
  - Either Removes the Temptation to Bailout . . .
  - Or Provides Effective Tools to Do So

Alternatives

- No reason Congress could not have started with the Bankruptcy Code and modified it to reflect financial stability goals
- Main weaknesses of Dodd-Frank Resolution Authority are the lack of transparency and due process, and risk that the rules of the game are changed on the eve of bankruptcy
  - Harmonization with Bankruptcy Code should have been more complete
  - Should have included stronger due process protections, such as practical remedy for minimum recovery rights and better after-the-fact judicial review
  - Should have given the Fed and Treasury more control over the resolution and rulemaking processes

Does the New Authority Automatically Replace the Bankruptcy Code?

- No, Important Procedural Hurdles
  - Heavy Presumption Against its Applicability
  - Reserved for Extreme Cases During Severe Financial Conditions

What Companies Could It Apply To?

- Any "Financial Company"
  - Not Limited to Systemically Important Companies
  - But GSEs and Certain Other Companies are Excluded
  - Special Treatment for Insurance Companies
  - Special Provisions for Broker-Dealers

- Probability Analysis
  - Most Likely: SIFIs during Market Meltdown
  - But Could Apply to Any Financial Company
  - Increases Costs of Ex-Ante Credit Risk Management

Process for Invoking

- "Triple-Key Process"
  - Treasury, 2/3 FRB, 2/3 FDIC Board (SEC, FIO) + President
  - Allowing Reorg or Liquidation under Bankruptcy Code Would be Destabilizing
  - Limited Judicial Review

What Happens if It is Invoked?

- FDIC is appointed as Receiver
  - Acts under New Resolution Authority, not Bankruptcy Code
  - Supersedes Pending Bankruptcy Filing
  - Discretion to Act as Receiver of Subsidiaries
  - Split Authority over Broker-Dealers with SIPC
  - Exception for Insurance Companies

Orderly Liquidation Authority v. Bankruptcy Code

- Major Differences in Rules Defining Creditors Rights
  - Federal Deposit Insurance Act
  - Bankruptcy Code
- Orderly Liquidation Authority
  - Original Version Reflected Major Differences
  - Most Differences Eliminated in Final Version
  - Minimum Recovery Right Based on Chapter 7

Major Differences Eliminated

- ~~Set Aside Security Interests Taken in Contemplation of Insolvency~~
  - In Favor of Rules on Preferential and Fraudulent Transfers under the Bankruptcy Code
- ~~Contingent Claims Wiped Out / No Damages~~
  - Adopt definition of “claims” (includes contingent claims) and valuation rule from Bankruptcy Code
- ~~Damages on Repudiated Debt Obligations~~
  - Adopt definition similar to Bankruptcy Code
  - Including post-appointment interest

Important Remaining Differences

- Oral Contracts Unenforceable
- Compromise on Additional Requirements for Written Contracts
- Ipso Facto Clauses Unenforceable
- Repudiation of Contracts
- One-Day Stay of QFC Close-out Rights
- Setoff Rights – Reflects Bankruptcy Code, with Important Modifications
- **But** Minimum Recovery Right Based on Chapter 7

Minimum Recovery Right

- What Creditor Would Have Received in Chapter 7 Liquidation
- Remedy: Court Order to Pay Shortfall
- FDIC Recoups Cost:
  - Clawing Back "Excess Benefits" from Lucky Creditors
  - Assessments on Large Financial Institutions
- Not a Practical Remedy for Most Persons

Customers of Covered Broker-Dealers

- Goal: Achieve Same Result as Normal SIPA Proceeding
- FDIC – Assets and Liabilities Transferred to Bridge Financial Company
- SIPC – Trustee of Covered Broker-Dealer
  - Liquidation of Covered Broker-Dealer
  - Allocation of Customer Property to Customers
- **But** No Similar Provisions for Customers of Banks and Other Non-Broker-Dealer Custodians

FDIC Rulemaking – The Long Road Ahead

- Many Questions Remain to be Clarified by Regulations
- Mandatory Rulemaking
- **But** No Deadline, and Providing Ex Ante Legal Certainty is Against FDIC Culture

Davis Polk

In the Meantime . . .

THE WALL STREET JOURNAL.

WEDNESDAY, JULY 14, 2010

The Uncertainty Principle

Dodd-Frank will require at least 243 new federal rule-makings.

So Republicans Scott Brown, Olympia Snowe and Susan Collins now say they'll provide the last crucial votes to get the Dodd-Frank financial reform through the Senate. Hmmm. Could this be Minority Leader Mitch McConnell's secret plan to take back the Senate, guaranteeing another year or two of regulatory and lending uncertainty and thus slower economic growth?

Probably not, but that still may be the practical effect. This week White House aides leaked to the press that President Obama may seek a review of regulations that are restraining business confidence and ba... Yet

pants will need to make strategic decisions in an environment of regulatory uncertainty." The lawyers needed 26 pages of flow charts merely to illustrate the timeline for implementing the new rules, the last of which will be phased in after a mere 12 years.

Because Congress abdicated its responsibility to set clear rules of the road, the lobbying will only grow more intense after the President signs Dodd-Frank. According to the attorneys, "The legislation is complicated and contains substantial ambiguities, many of which will not be resolved until regulations are adopted, and even then, many questions ...ist that will require con-

sion, he and Mr. Dodd made a particular mess of the derivatives provisions. They now say they didn't really mean to force billions of dollars in new collateral payments from industrial companies on existing contracts that present no systemic risk. But that's precisely what the regulators could demand under the current language, and the courts will ultimately decide when everyone sues after the new rules are issued.

Taxpayers might naturally ask why legislators don't simply draft a better bill now. But for Democrats the current and only priority is to pass something they can claim whacks ...nks and which they can...

Other Risks . . .

- Miller-Moore Amendment – Haircuts on Secured Credit
  - Reduced to Study
  - **But** Like a Bad Penny
- Nelson Amendment – 90-Day Stay of QFC Close-out Rights
  - Opponents, including Treasury and Fed, prevailed
  - But continued support from some prominent bankruptcy lawyers and professors

Davis Polk

Will it Work?

- Depends on Who is Exercising the Discretion
- Risks:
  - New Authority is Domestic; Companies are Global
  - Doesn't Apply to Insurance Companies
  - FDIC Model or Methods Wrong
    - Purchase and Assumption Method Won't Work because no one is big enough to buy most SIFIs
  - Lack of FDIC Experience with SIFIs
  - Bridge Financial Companies

Will it Work? (Cont'd)

- Risks (Cont'd):
  - Limits on Emergency Stabilization Powers
    - Ineffective
    - Incentive to Bailout Everyone
  - Potentially Destabilizing Features:
    - "Rules of the Game" Changing on Eve of Bankruptcy
    - Lack of Effective Remedy for Minimum Recovery Right
    - Lack of Due Process, Effective Judicial Review for Creditors
    - Uncertainty About Valuations

Will it Work? (Cont'd)

- Risks (Cont'd):
  - Potentially Destabilizing Features (Cont'd):
    - Lack of Regulatory Clarity
      - Rule of Law vs. Ad Hoc Human Discretion
      - FDIC's Habits and Culture
    - Clawback Power
    - Lack of Due Process

Alternatives

- Contingent Convertible Debt
- Bail-ins (Mandatory Recapitalization Programs)
- Issues:
  - Triggers
  - Dilution Issues
  - Contractual vs. Statutory
  - Pricing
- New FDIC Resolution Methods