Financial Services Management

Orderly Liquidation Process for Systemic Firms

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Overview

In this report, FedFin analyzes the new systemic-resolution framework established in the Dodd-Frank Act. The new orderly-liquidation authority is sharply different from systemic rescues during the crisis (e.g., Bear Stearns, AIG) and, while modeled on FDIC receiverships for failed banks, the new resolution procedure is nonetheless substantively different from it.

As a result, a significant and immediate concern is the degree to which counterparties are now at greater risk if a systemic institution comes under the orderly-liquidation process. Because the final version of the law seeks to parallel bankruptcy to the greatest degree possible, the safety nets available to the FDIC or crafted by Treasury and the FRB are no longer allowed. As a result, counterparties to a firm and/or any of its subsidiaries are at greater risk and may seek to reduce this both through immediate action and by withdrawing as they perceive growing problems at a firm potentially subject to the new resolution process. This could, as advocates hope, reduce "moral hazard," but it could also worsen short-term problems sparked by liquidity stress and create panics or other pressures that cause failures where they might otherwise have been averted. At the least, new risks will lead to lower ratings and other market pressures that will increase funding costs, reduce capital availability and otherwise stress systemic institutions.

The tough approach results in part from the requirement that no taxpayer dollars be used to pay for systemic resolutions, with the law barring conservatorship, open-firm assistance and other tactics used not just for insured depositories, but also for Fannie Mae and Freddie Mac. At one point in the legislative process, the bill would have forced the GSEs also into this liquidation framework. However, as enacted, HERA resolutions[1] can proceed and the current conservatorships are not disrupted.

Large financial institutions won a major victory in the debate leading to enactment because the Dodd-Frank Act does not require them to fund in advance FDIC receivership costs. Instead, they will be assessed "ex post" for costs for specific failures. However, the law is very clear: no taxpayer money can be used for systemic resolutions and even the FDIC's start-up costs to establish this process must come from financial institutions. As a result, immediate assessments are certain even though the largest costs associated with any failures will come after the fact.

Analysis

A. Coverage

Systemic resolutions could occur for any "covered" financial company, with these definitions tracking those in the broader systemic-risk regulatory framework.[2] However, orderly liquidations do not cover:

- SEC-regulated broker-dealers covered by SIPC. If a systemic resolution involves a covered broker-dealer backed by the SIPC, a process detailed in law instructs SIPC on its actions to protect customer accounts and limits its ability to engage in any action that would adversely affect the FDIC's broader claims, including with regard to qualified financial contracts (see below). Customers are to get at least what they would in an SIPC-led resolution, with the FDIC instructed to make up any shortfall;
- insured depositories;
- insurance companies if principally engaged in insurance, regulated by the states and covered by a resolution facility;
- Fannie Mae, Freddie Mac or a Federal Home Loan Bank; or
- an entity regulated under the Farm Credit Act.

[1] See Client Report GSE105, *Financial Services Management*, August 11, 2008.

[2] See Client Report SYSTEMIC29, *Financial Services Management*, July 13, 2010.

An entity subject to the orderly-liquidation process would still be subject to bankruptcy proceedings in which the FDIC serves as receiver unless the process detailed below is invoked. It should be noted that a financial company need not have been previously found to be systemic by the Financial Stability Oversight Council to be governed by the orderly-liquidation process – emergency declarations are possible even if a company was not previously subject to systemic regulation.

B. Process

1. Receivership

If Treasury deems a systemic company in danger of failure or if it has failed, it must tell the FDIC and the company. If the company acquiesces, the FDIC is appointed receiver. If not, Treasury must petition the District Court for the District of Columbia to appoint the FDIC as receiver. The law then details a process – quick and confidential – in which the court considers the petition and a company subject to it may appeal. In general, the court may only deny a Treasury petition if it is filed against an inappropriate company or is otherwise found arbitrary and capricious. The court will need to establish procedures for ordering receiverships within six months of enactment.

If the FDIC is appointed receiver under the orderly-liquidation process, the receivership must terminate within three years, although this could be extended one additional year if the FDIC certifies that this is necessary to improve its net present value, reduce loss and protect the stability of the U.S. financial system. An additional year beyond this likely four-year period is possible after joint certification by the FDIC and Treasury subject to still more stringent conditions. Extending receiverships to complete litigation is also allowed if stringent findings are met.

2. Subsidiaries

The FDIC could appoint itself as receiver for U.S. subsidiaries of failed firms (other than the exempted ones discussed above) if the need to do so is jointly determined by the FDIC and Treasury. However, intervention for a subsidiary is possible only if its failure would result in systemic risk. Thus, counterparties will need to evaluate not just their exposure to a financial firm, but also the actual legal entity to which it is provided and the resolution framework that might then cover the entity. For example, a systemic resolution could cover a bank holding company's derivatives operations housed in a subsidiary following the "Lincoln push-out" mandated elsewhere in the law,[3] but not a finance-company affiliate.

[3] See Client Report DERIVATIVES20, April 27, 2010.

3. Studies

The Administrative Office of the U.S. Courts and the GAO must study this process and report within one year of enactment and thereafter on ways to improve it. The GAO must also study international systemic resolutions, reporting one year after enactment. A GAO study on prompt corrective action for insured depositories is also mandated, with this due one year after enactment. Six months after receiving this study, the Financial Stability Oversight Council (FSOC) must tell Congress how it has responded and what recommendations have been made to the prudential regulators.

However, even as these studies are conducted, the FRB, in consultation with the court Administrative Office, must do a study in one year of whether a special financial-resolution court or similar process would permit liquidations analogous to bankruptcy without the receivership provisions under the FDIC authorized in this law. This study would need to be repeated for the four years following its initial report to Congress. An additional FRB and Administrative Office study is required on international financial-institution resolution, due one year after enactment.

The FSOC is also charged with assessing the benefits of mandating haircuts on secured creditors in systemic failures, including an examination of stakeholders in prior failures and the benefits haircuts would afford to market discipline and other factors. This study is due one year after enactment

4. Systemic-Risk Determination

For the orderly-liquidation process to occur, the Treasury, FRB and FDIC must find systemic risk by formal votes detailed in the law. If the firm involved is a broker-dealer or its major activities are housed in one, then the SEC must approve in place of the FDIC. If the firm is an insurance company or this constitutes its principal activity, then the director of the Federal Insurance Office established elsewhere in Dodd-Frank[4] and the FRB vote for the determination, doing so only at the request of the Secretary of the Treasury. State insurance resolution entities must handle the insurance companies involved, although not necessarily their affiliates, with the FDIC authorized to step in to resolve an insurer if the state does not act within sixty days. Various findings – including why a private-sector transaction or bankruptcy cannot occur – are necessary to invoke systemic resolutions. The President would need to be consulted on these findings and any petition to the court.

All of these findings must be disclosed in summary form, along with additional determinations to justify the receivership instead of bankruptcy or another resolution method. A subsequent report on how the orderly liquidation will be accomplished, private entities retained in connection with it, creditor treatment, funds expended and other matters is also required. GAO must also review any such cases. As soon as possible after enactment, the FDIC must set policies acceptable to Treasury on how it will conduct systemic resolutions.

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[4] See Client Report INSURANCE22, June 8, 2010.

C. FDIC Actions in Receivership

The FDIC is required to issue rules to implement the process described below, doing so in consultation with the FSOC and with attention to potential conflicts between this resolution regime and that governing insured depositories or that established for different systemic receiverships. It is required to harmonize its rules to the greatest possible extent with those that would otherwise apply to a failed or failing institution.

1. Purpose

The statute details the purposes that must guide FDIC receiverships, including loss to creditors, shareholders and prior management and directors. It also gives the FDIC authority to claim compensation paid to senior management and directors for the two years prior to seizure and, in case of fraud, for an unlimited period.

2. FDIC Authority

Any funds expended by the FDIC take priority in a systemic resolution over other claims. The FDIC could:

- Make loans or purchase securities from a covered firm or covered subsidiaries;
- Purchase or guarantee assets of the covered firm or covered subsidiary, doing so directly or through an entity established for this purpose;
- Assume or guarantee obligations;
- Take liens on assets;
- Sell or transfer all assets, liabilities or obligations; or
- Make payments as permitted under the claims process detailed below.

However, the FDIC may not take an equity interest in any covered entity in resolution. If it structures a merger or acquisition, then limited antitrust review is required under procedures detailed in the law.

3. Claims and Priorities

In general, the FDIC will review and honor claims against an entity in receivership in a manner similar to that done for a failed insured depository. This includes the authority to repudiate contracts and various agreements premised on a potential receivership. However, the FDIC is given new authority to treat similar claims differently to maximize recovery values or facilitate establishment of a bridge institution (see below). In addition, in contrast to a bank receivership, the law provides the FDIC with authority modeled after the Bankruptcy code related to issues such as preferences, fraudulent transfers and set-offs.

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The treatment of qualified financial contracts (QFCs), which are derivatives and similar instruments, is generally similar to that for insured-bank resolutions, providing considerable protection for counterparties. However, counterparties cannot terminate QFCs immediately, as allowed under the Bankruptcy code, and must instead wait until the next day to do so, giving the FDIC an opportunity to deny any rights. The FDIC generally cannot pick and choose among any QFCs it may seek to repudiate or transfer; instead, it is required to treat all comparable QFCs in the same fashion (unlike the Bankruptcy Code). In addition, non-executive compensation is given a claim senior to general creditors and a reduced priority is accorded senior-executive pay-related claims.

In sharp contrast to bank failures, a creditor could generally get no more in a receivership than in a bankruptcy claim, although determining this amount may prove difficult for the FDIC, which is charged with doing so and could not be sued if creditors think its determinations mistaken. The FDIC is likely to err on the conservative side in granting claims because it will need to assess creditors and, perhaps, systemic financial institutions should its decisions be erroneous or based on crisis conditions that lead it to support claims in a manner later found "excessive."

4. Bridge Entities

Bridge entities are operating concerns formed from a receivership, with the FDIC authorized to create one or more of these for failed systemic firms. The provisions in law here are modeled after those the FDIC has long had to form bridge banking organizations, but they are different in numerous respects to reflect the various business models (e.g., broker-dealers) of covered financial companies and to give the FDIC more flexibility to structure bridge firms.

Bridge financial companies could purchase or assume all the liabilities and assets of a failed firm (including trust and custody assets) other than those considered regulatory capital, based on an FDIC determination. In doing so, the FDIC would generally need to treat all creditors equitably, although it could differentiate among them if it determines that this is necessary to facilitate an effective resolution and creditors get at least what they would have received in a bankruptcy liquidation. A bridge firm must have at least a minimum positive net worth upon establishment (meaning that transferred assets may not exceed transferred liabilities).

Bridge firms would receive a federal charter and operate according to terms detailed in the law. They would not be considered agencies of the U.S. Government. The FDIC need not capitalize a bridge firm, although it could sell shares in it to the public. The bridge firm can obtain credit and issue unsecured debt, with the FDIC permitted to allow it also to issue senior or secured debt. Bridge firms would need to be closed or restructured two years after establishment, although the FDIC could extend them for three additional one-year periods.

D. Orderly Liquidation Fund (OLF)

1. Establishment

The final version of Dodd-Frank includes an "ex post" fund to recover the costs of FDIC systemic resolutions instead of the $150 billion advance one included in the House version of this legislation.[5] This fund will cover the cost of orderly liquidations, FDIC administrative costs and the principal and interest due to Treasury when, as noted below, funds are advanced. However, the FDIC could begin to implement the orderly liquidation program with funds advanced to it from the FSOC (which in turn come from financial institutions). FDIC revenue associated with systemic resolutions are to be deposited into the OLF.

If the FDIC requires funding for systemic resolutions, it can issue obligations to Treasury which Treasury treats as a public-debt transaction, including payment of corporate-like interest by the FDIC to Treasury. The FDIC cannot obtain support from Treasury through the OLF for more than ten percent of a failed firm's consolidated assets and an amount equal to ninety percent of the fair value of the assets available from firms that will repay the OLF draw (see below). The FDIC and Treasury, in consultation with the FSOC, will issue rules on these calculations.

2. Repayment

Before Treasury can provide funds for the OLF and to reimburse it for start-up costs at the FDIC associated with the overall liquidation program, it and the FDIC must have agreed to a repayment plan. Congress would need to be consulted and see a copy of it. All Treasury expenditures would need to be repaid within five years (or longer if determined appropriate by the FDIC).

Assessments will be charged to make up any losses the FDIC suffers because claimants received more than in a liquidation, with these costs recovered first through claims on anyone receiving compensation from the FDIC in the receivership if amounts exceed the FDIC's view on what would have been recovered in liquidation. If these claims are insufficient to reimburse the FDIC for all of the cost of a systemic resolution – which seems likely – assessments could be made not only on systemic firms, but also on any financial company with assets over $50 billion. These assessments would be graduated with larger size and riskier assets increasing the cost. The FSOC will recommend a risk matrix for setting these assessments, based on criteria stipulated in the law, with the FDIC required to issue rules to implement the assessments.

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5 See Client Report SYSTEMIC15, October 28, 2009.

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