EXPANDING FDIC RESOLUTION AUTHORITY

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In this presentation I consider the expansion, with modifications, of FDIC resolution-type authority as an alternative to use of the general bankruptcy laws for the resolution of systemically important nondepositary financial intermediaries. This topic has become one of extensive discussion and is the subject of legislative consideration in the House and the Senate. Detailed proposals for a bank resolution type approach have been made by others, including the Federal Reserve Bank of Kansas City\(^1\) and the Pew Financial Reform Task Force,\(^2\) and it is the basis of the Obama Administration’s proposal. I will consider here: (1) some advantages, as compared to bankruptcy, of the bank resolutions model currently as currently implemented by the Federal Deposit Insurance Corporation (FDIC) under the Federal Deposit Insurance Act (FDIA), (2) the manner in which that model currently operates in situations involving “systemic risk” and the identification of such situations, (3) whether, as suggested in current legislative proposals, including that by the Obama Administration, the bank resolutions model can and should be adapted to the resolution more generally of nondeposit “systemically important financial institutions” (“SIFI’s”), and (4) some of the major issues arising with respect to such

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\(^1\) “Resolution Process for Financial Companies that Pose Systemic Risk to the Financial System and Overall Economy,” prepared by Thomas M. Koenig, Charles S. Morris and Kenneth Spring, Federal Reserve Bank of Kansas City (September 2009).

adaptation. I will also specifically consider whether the bank resolutions model, as adapted, has the potential to avoid some of the disadvantages of a bankruptcy approach without deteriorating into ad hoc bailouts and how the model can be implemented legislatively in a manner that avoids excessive and unnecessary use. I have benefited greatly in the discussions with other presenters leading up to the recent policy workshop on “Ending Bailouts as We Know Them.” I would suggest that the adaptation of the bank resolutions model, in some form, offers real promise for what George Schultz has suggested: “[T]he clear and creditable measures … that convince everybody that failure will be allowed [and] bailouts, and the expectations of bailouts, will recede and even disappear.”

Many of the precise details of the adaptation of the “bank” resolutions model of course can be varied. These include whether the FDIC or another government entity is the authority that conducts the systemic resolution, the details of decision-making to invoke systemic resolution instead of the use of bankruptcy, whether resolution costs arising from the exercise of this authority are paid from an ex ante fund or financed by the U.S. government with an ex post assessment on financial intermediaries (or a subset thereof), the financial intermediaries subject to any such assessment, and a number of other factors. I regard these as beyond the scope of my presentation. I believe for purposes here the key points are whether the bank-resolutions type model can be adapted in some form to systemic nonbank resolutions (i) so as to minimize
external systemic economic effects without overprotection of creditors, and the consequent loss of market discipline, and (ii) so as to be limited to truly systemic situations and not overused.

Whatever the precise details, the bank resolutions model has a number of advantages compared to the bankruptcy model. I would suggest that its expanded use provides an alternative to bankruptcy as a route to avoiding ad hoc bailouts such as those in the fall of 2008 with respect to nonbank financial intermediaries such as AIG. The principal advantages of the bank resolutions model, which are reciprocal with the disadvantages of the bankruptcy model, include: (1) speed of resolution; (2) low relative administrative costs, since assets are returned to the private sector, or at least to private sector management, immediately without contested adversary proceedings or formal judicial consideration and decision; (3) a higher likelihood of ownership and management being placed in the hands of experienced and capable successors rather than some interim administration selected by pre-existing creditors; (4) explicit consideration and focus on specific non-firm general costs in considering whether the situation is systemic and requires special resolution; and (5) immediate decisions on the details of resolution.

Because of these advantages, there is widespread support in the current legislative debate for an orderly resolution regime for nonbank financial intermediaries patterned on the bank resolutions model. The most important advantage in bank resolutions is the speed, and resulting preservation of value, due to earlier intervention and the absence of an automatic stay.
In bankruptcy, by comparison, there is an automatic stay of uncertain but possibly considerable duration while a plan is developed by creditors and submitted for judicial approval. However much this period can be shortened, there is time for values to vary and dissipate, and for external systemic losses to increase, in a bankruptcy proceeding. By comparison, the bank resolutions model operates to effect a solution, even if it is only the temporary solution of a bridge institution, immediately. (The longest “stay” in the bankruptcy sense is one business day with respect to qualified financial contracts in a receivership to permit consideration of their orderly transfer.\(^3\)) In bank resolutions, there is an explicit focus on spillover systemic effects. This is a significant advantage where the principal purpose of the operation is to protect against systemic external effects not explicitly taken into account in bankruptcy proceedings. In addition, in most bank resolutions experienced management is immediately put in place. And there is a form of expert decision-making involved, by experienced financial agency personnel, rather than an Article III judge, in determining the nature of the resolution. (As noted, the resolution decision-making authority need not be the FDIC, although by experience it is well-adapted for this role.)

On the other hand, there are also some disadvantages to the bank resolutions model as compared to bankruptcy. These include: (1) a less clear and predictable set of rules on

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\(^3\) Any “automatic stay” is limited only to certain qualified financial contracts, and only to a single business day, so values do not dissipate with continuing market adjustments.
creditor priorities, since these may be varied to accommodate the situation; (2) an essentially political decision whether the situation is one involving “systemic” risk; (3) based on experience, a bias toward a finding of systemic risk in order to minimize disorder and disruption and (4) timing uncertainties and very broad governmental discretion. Moreover, there is general agreement that the bank resolutions model works less well, and higher losses are realized, in sudden liquidity failures.⁴ Even in these cases, however, the decision-making process is faster and there is more financial expertise brought to bear than may be the case in bankruptcy.

Another major disadvantage of the bank resolutions model that has been widely identified is the fixed, non-negotiable treatment of, and possibly inadequate consideration of, creditor claims. The problem seems to be that while there is a fixed and clear priority scheme, there is much less opportunity, if any, for ex post correction in the value of claims. Some also claim a degree of arbitrariness in the claims process as administered by the FDIC. I believe this is a by-product, perhaps a necessary one, of the speed and certainty of the bank resolutions model.

There is a significant set of questions as to how an “insolvency/failure” regime patterned on the bank resolutions model should work for SIFI’s that are not banks. Systemic

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⁴ Indymac is an example. There it was necessary for the FDIC, which lacked bridge back authority for OTS institutions at the time of the failure, to use a pass-through receivership to a conservatorship because of the absence of bidders. Such authority was added in Federal housing legislation at the request of the FDIC in the week following the failure.
cases are currently identified by an assessment of anticipated adverse effects on the national or regional economy. The trigger mechanism involves a supermajority vote of the FDIC and Federal Reserve Boards, and approval of the Secretary of Treasury after consultation with the U.S. President. The test proposed by the Administration in proposed legislation is very similar for SIFIs that are nondeposit institutions, but is tighter by requiring adverse effects on the national or international economy. A serious potential disadvantage, as many have noted, and as suggested by the Wachovia experience and by the FDIC’s own administrative history, is that there can be a tendency – political or otherwise – to be overly quick in determining that a “systemic” situation exists and action is needed to prevent market disorder. This tendency would seem to me to be stronger if there is an *ex ante* fund available for such systemic resolutions, as proposed by the FDIC and others and included in the most recent version House proposal. And of course there is extraordinary discretion as to both timing and nature of the resolution.\(^5\) Some proposals, including one considered in the House, seek to further strengthen the test in order to prevent overuse. The Obama Administration has proposed essentially an extension of the bank resolutions model with a regime analogous to the FDIA for SIFI entities.\(^6\) The most recent

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\(^5\) The prompt connective action provisions put in by FDICIA in the early 1990’s after the thrift crisis have had only limited impact because bank accounting remains largely tied to historic cost conventions and therefore is generally backward-looking and slow to recognize economic problems.

\(^6\) Treasury White Paper, pp. 76-78.
variation in the House sets a very high standard for the decision that a situation is systemic. The
decision whether a particular situation may present systematic risks would be made in a manner
similar to the current FDIA procedure involving supermajority sign-off by the relevant regulator
(FDIC or SEC) and the Fed, and approval by the Secretary of Treasury after consultation with
the President. Treasury would then determine in systemic cases whether the resolution would be
conducted by the FDIC or the SEC, presumably depending on the nature of the organization. A
number of variations are possible, including a bifurcation into globally systemic and smaller but
possibly systemic institutions as suggested recently by the Kansas City Fed.7 Recently, in
amendments to the Frank bill, the circumstances where there is authority to make this
determination have been proposed to be limited to **overall** systemic risks to the entire economy in
order to control the possibility of overuse. I would suggest that this may be too stringent a test,
and that a single entity in at least some circumstances could pose systemic risks. I believe it may
be short-sighted to try to limit a situations that may be “systemic” too closely to those similar to
the events of 2008. It would be preferable, in my view, to create additional flexibility since it
may be needed. If systemic situations are too closely _______ by legislative, there is a risk of


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A variety of *ex ante* or *ex post* funding schemes are possible. As initially proposed by Treasury, funding would be fronted by U.S. government but come ultimately from all financial intermediary holding companies rather than only institutions that have been previously identified as potential SIFI’s. As noted previously, in my view the creator of an *ex ante* fund would risk overuse of systemic resolution authority.

As compared to the other potential SIFI resolution regime – bankruptcy – the bank resolutions model appears to have the same advantages and disadvantages as the FDIA does for banks. The question is whether the advantages of control, low transaction costs and others outweigh the potential disadvantages of higher potential political influence or a likely rush to find systemic situations in nonbank cases. Extending the bank resolutions regime to SIFI’s in appropriate circumstances would also bring a variety of additional issues that would have to be considered and dealt with in the new construct. These include the focus on a broader group of stakeholders, not just depositors, and the possible need for an examination and enforcement functions in some form extending to SIFI’s.

A major issue is whether and how to identify SIFI’s in advance and whether particular types of SIFI’s (other than depository institutions) should be subject to different rules. Identification in advance has the advantage of allowing special regulatory requirements to be imposed on SIFI’s or potential SIFI’s – higher capital requirements, closer supervisory scrutiny.
and the like. A major disadvantage, however, may be a further tendency to expand the “too big to fail” category and thereby reduce market discipline. I would suggest that a further and very important possible method of preventing overuse, and instituting continuing market discipline, is a requirement that any systemic resolution, including those involving bridge authority, be accomplished through a receivership rather than a conservatorship. This would serve to assure that there are appropriate costs imposed on management and general creditors.

Special mention should be made of qualified financial contracts (QFC’s). There are particular advantages to the FDIC bank resolutions regime, as compared to existing bankruptcy law, in dealing with QFC’s since it is possible to preserve a book of business, or at least the “in the money portion,” in an FDIC resolution process. The existing FDIA provisions effectively allow transfer of QFC’s if completed by the close of business on the business day after failure. By comparison, QFC’s are quickly closed out and unavailable as part of a continuing business or preservation of goodwill in bankruptcy. I would suggest that in systemic nonbank resolutions the provisions related to QFC’s should be modelled on those in bank resolutions.

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8 Indeed a technical problem in the Bear Stearns resolution was the need for a JPM Chase guarantee of all transactions, initially drafted overbroadly and then revised a week later. It should be noted that there have been recent changes to the FDIC rule on QFC’s that may undermine this advantage by allowing the FDIC to pick and chose the QFC’s that are transferred based on the net overall position with a counterparty and its affiliates. 12 CFR 371, 73 Fed reg. 78162 (Dec 22, 2008).
The question at the end remains whether, for nondeposit SIFI’s, an FDIA-type regime is preferable to bankruptcy and can successfully avoid *ad hoc* bailouts. I think it is fair to say that the discussions leading to this workshop have produced something of a convergence in trying to capture and combine advantages of the bank resolutions and bankruptcy resolutions in dealing with systemic financial intermediaries. Those that advocate the bankruptcy regime are looking for modifications that produce speed, expertise and sensible limits on the automatic stay. These already exist in the bank resolutions model. Those that are attracted to the bank resolutions model need to deal with risks of overuse and discipline on the decision process so as to avoid reducing the process to *ad hoc* bailouts and overprotection of creditors. I believe from my experience that the bank resolutions model can be adapted to protect business values and limit spillover effects, appropriately penalize managers and shareholders, and instill creditor discipline in a way that is more effective than a bankruptcy-based model.