Bank Resolution
SPE Bail-in: Contracts and Stays

October 2013

Single point of entry (SPE) strategy

FDIC SPE strategy recapitalizes a bank via internal capital resources

- Holding company debt effectively converted to equity as needed
- Preserve operating functions and operating subsidiaries
- Economic outcome similar to a high-speed Chapter 11 “pre-pack”

Goals

- Avoid taxpayer burdens and address moral hazard
- Preserve systemic functions and minimize losses to avoid economic shock. (Key for a truly practical, usable solution)

Comparison of SPE to (Lehman) bankruptcy is illustrative

- BK process has benefits in terms of substantial due process – but also some downsides (complex, time consuming)
- In particular, actual BK resulted in much larger losses than a Lehman “going concern recap”.
- SPE / Ch 14 should not repeat that outcome unnecessarily

SPE and Contracts

Preserving critical functions is key to minimize losses & systemic impact

- Need to avoid mass terminations/ unwinds/ loss of FMI access
- Contributed to major extra losses in the Lehman case

If a bank fails, most swap contracts allow the non-defaulting party to unwind

- Counterparties have some incentives to unwind (run)

Lehman swap book terminated in the week after BK

- Unwind was <u>functional</u> – risk disruptions managed (pretty) well
- Unwind was <u>expensive</u> to estate – additional ~$20 to 50bn of claims

A different approach could provide a better result

- Unwind is <u>unnecessary</u> if contracts kept current & moved to a SPE bridge

  → better for markets, better for estate, better for investors

- DFA Title II powers allow FDIC to stay contracts -- to suppress runs

Contracts and Stays

But, stay powers don't automatically apply in all jurisdictions (e.g. offshore)

- Need to analyze where they work and address remainder
  - Statutory solves many elements
  - Cross-border recognition could solve others
  - Contractual solutions can also play an important role

Key considerations:

- Dealers, Buy-Side, CCPs, other counterparties
- Key jurisdictions (esp. London and NY)
- Key contract types (Swaps, FX, Repo, etc)
- OLA vs Chapter 14 vs other BK solutions
- Role of industry and official sector
- Related problems (deterring arbitrage, RRPs)

Appendix: a (simplified) case study of Bail-in

Balance Sheet	Pre crisis	Actual bankruptcy	Bail-in pro forma
Assets	600	~450	575
Other Liabilities	430	420	430
Senior Debt	120	30	102 (debt) +Equity
Sub. Debt	25	0	0 (debt) +Equity
Equity	25	0	0 - warrants

Ex ante loss estimate ~ $25bn

Bankruptcy loss est. >$100bn

18 bn equity from 15% senior debt conversion

25 bn equity from 100% sub. debt conversion

Re-capitalized: Hard asset values & 43 bn of new equity

Advantages of Bail-in

- Bank fully re-capitalized – via accelerated “Chapter 11”-style process
- No taxpayer capital at risk (though central bank liquidity procedures important)
- No loss of customer functions
- Systemic risk much reduced – avoids loss amplification of bankruptcy, and run