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FINANCIAL INSTITUTIONS

# The FDIC's Hedgehog Strategy May Hold The Key To Cross-Border Resolution

BY HARVEY R. MILLER AND MAURICE HORWITZ

The ancient Greek Archilochus said that "the fox knows many things, but the hedgehog knows one big thing." When it comes to dealing with the next Lehman, it appears that the Federal Deposit Insurance Corporation (FDIC), like the hedgehog, has settled on its one big thing.

This big idea is the "single point-of-entry" ("SPOE") strategy that the FDIC plans to implement under Title II (Orderly Liquidation Authority) of the Dodd-Frank Act – the statute that empowers the FDIC to appoint itself as receiver for a failed, "systematically important financial institution" ("SIFI"). Under this strategy, the FDIC would limit the receivership to the SIFI's parent holding company without affecting the operations of its subsidiaries and affiliates. The ownership of those subsidiaries and affiliates would be transferred to a bridge financial company organized by the FDIC. To the extent that the subsidiaries require liquidity to operate, they would borrow from the bridge, which in turn may borrow from an "orderly liquidation fund" established and funded by the Treasury.

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The strategy has garnered support, most recently from the FSB in a paper published last month. While flawed, it has one potentially redeeming quality: it might avoid the commencement of multiple, competing insolvency proceedings, as occurred in Lehman. A similar strategy was adopted in Texaco's Chapter 11 case. In that case, sufficient time was allotted before the Chapter 11 filing so that assets and cash could be transferred to foreign subsidiaries all over the world, enabling them to operate independently of the parent. This way, only the parent and two financing subsidiaries went into Chapter 11.

One problem with this strategy is that often, it is not the holding company, but rather, one or more of its operating subsidiaries that are the most distressed. A single subsidiary, harboring a single London Whale, may threaten to sink the entire institution. For example, AIG Financial Products Corp., a subsidiary of AIG, incurred enormous CDS losses during 2008 and nearly brought the enterprise to its knees. Borrowings from the Treasury by such subsidiaries might mount to hundreds of billions of dollars.

Such intercompany lending to foreign affiliates raises several problems. Will host-country regulators keep these foreign entities out of receivership or liquidation? If not, will the FDIC's loans to these subsidiaries become mere claims in the liquidation, recovering pennies on the dollar? Will they recover anything at all? Possibly not in some jurisdictions. In Germany, for example, pre-insolvency loans from the parent are statutorily subordinated to the claims of other general unsecured creditors.

Because of such risks, the bankruptcy court overseeing Lehman's Chapter 11 cases placed certain restrictions on the holding company's ability to lend to its subsidiaries. Lehman had to use commercially reasonable

efforts to obtain a note accruing interest at a market rate, secured by a valid, perfected lien against tangible adequate property.

What if the same were required of the FDIC? Such a requirement might encourage the FDIC and foreign regulators to agree to a framework for cross-border cooperation in the context of a potential SPOE receivership.

The Bank of England, for one, has explicitly endorsed the SPOE strategy and stated its intent to apply a similar strategy for resolving UK based institutions.[1] Both the FDIC and the Bank of England must therefore recognize that for the SPOE strategy to work, depending on where a parent holding company is based, either the FDIC will need to authorize loans to a UK subsidiary or *viceversa*. If both regulators were required, by rulemaking or statute, to obtain a note and adequate lien from borrowing subsidiaries before lending from their respective ''orderly liquidation funds,'' it would be in their best interests to enter into a form of master agreement *today* that would govern the general terms of such loans, with final, primarily economic terms to be agreed upon an ad hoc basis when the need arises.

For example, the FDIC and the Bank of England could agree, pursuant to a master loan agreement, that if either is appointed the receiver of a SIFI's parent company, it will only lend to regulated subsidiaries in the other's jurisdiction if such loans are adequately secured by collateral provided by the subsidiary-borrower's chief regulator – the FDIC, or the Bank of England. Such master agreements could also set forth the basic framework for cooperation between national regulators in other aspects of a single receivership. None of the terms would be binding, unless and until loans are advanced under the facility. But they would substantially reduce the credit risk associated with the SPOE strategy, and be a first step towards a credible framework for cross-border resolution.

That would make the FDIC's hedgehog strategy a truly ''big thing.''

[1] ''Resolving Globally Active, Systemically Important, Financial Institutions – a joint paper by the Federal Deposit Insurance Corporation and the Bank of England'' (December 10, 2012).

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