February 18, 2014

Mr. Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

VIA ELECTRONIC MAIL: comments@fdic.gov

Re: Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76,614 (the "**Notice**")

Dear Sir or Madam:

The Committee on Capital Markets Regulation (the "**Committee**") is grateful for the opportunity to comment on the Notice[1] released by the Federal Deposit Insurance Corporation (the "**FDIC**"), which details the Single Point of Entry ("**SPOE**") strategy that the FDIC plans to employ when resolving a systemically important financial institution under the Orderly Liquidation Authority ("**OLA**") established in Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**").[2]

Founded in 2006, the Committee is dedicated to enhancing the competitiveness of U.S. capital markets and ensuring the stability of the U.S. financial system. Our membership includes thirty-three leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by R. Glenn Hubbard (Dean, Columbia Business School) and John L. Thornton (Chairman, The Brookings Institution) and directed by Hal S. Scott (Nomura Professor and Director of the Program on International Financial Systems, Harvard Law School). The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

The Committee commends the FDIC on the general thrust of the SPOE strategy, leaving operational subsidiaries intact while only restructuring the holding company.[3] This avoids imposing losses on short-term creditors of the operating subsidiaries, or disrupting their critical functions, which could spark contagion.[4] The approach is much simpler and easier to accomplish than restructuring all of the operating subsidiaries. In addition, if other key countries cooperate with the FDIC, it will make it easier to resolve multinational financial institutions. We do, however, think the FDIC should be more detailed over time on how this process will actually work.

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[1] Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76,614 (released Dec. 18, 2013).
[2] 12 U.S.C. §§ 5381-5394 (2012).
[3] Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76,614, 76,615-76,616 (released Dec. 18, 2013).
[4] *Id.* at 76,616.

Overall, the Committee believes that much of the SPOE strategy discussed in the Notice has already been public knowledge for some time. The FDIC should include much greater detail regarding its OLA procedure than has been provided. First, the Notice fails to distinguish adequately the differences in recapitalizing the consolidated holding company entity and recapitalizing the operating subsidiaries. The Notice should discuss in greater detail the mechanisms through which the parent will inject capital into the operating subsidiaries, since these are where the losses are likely to be. We outline the possible mechanisms below and believe the FDIC should include a similar discussion in its Notice. Second, the Notice should confirm the permissible uses of the Orderly Liquidation Fund ("**OLF**") in providing funding to the bridge holding company that are passed down to operating subsidiaries. Third, the FDIC should provide a detailed discussion of its plan to identify and preserve critical functions when separately resolving operating subsidiaries that cannot be recapitalized through the SPOE process. To the extent that resolution plans outlined in living wills are to serve as guidance in resolving operating subsidiaries, as suggested in the Notice,[5] the FDIC should outline the role of living wills in greater detail. Finally, the SPOE approach introduces a number of cross-border issues that must be addressed by the FDIC.

Overview of the SPOE Strategy

Under a SPOE approach, the FDIC would be appointed as receiver to the top-tier parent of the U.S. holding company.[6] As receiver, the FDIC's first step would be the creation of a bridge holding company, where all the assets of the troubled holding company, primarily investments in subsidiaries, would be transferred.[7] The equity, subordinated debt and senior unsecured debt of the troubled institution would be left behind in receivership to absorb the losses that triggered resolution.[8] As a result, the bridge financial company will be capitalized almost entirely with equity, which will be held by the receivership. Ultimately, upon valuing the bridge company equity with consultation from accountants and investment bankers, the FDIC will issue new debt and equity securities based on that valuation to satisfy the claims of the creditors in receivership.[9] The FDIC estimates that the valuation process and new issuance of securities will take six to nine months, during which time the bridge financial company will remain under FDIC control.[10]

The FDIC envisions that the swift creation of a well-capitalized bridge holding company will allow the bridge company to provide the necessary holding company support to its operating subsidiaries.[11] Furthermore, if either the parent or the subsidiaries are in need of temporary liquidity that the bridge holding company cannot obtain in the private market, the Dodd-Frank Act authorizes an OLF, with proper approvals, to provide temporary funding to the bridge holding company, secured by parent-level or subsidiary assets.[12] The OLF liquidity can then be passed down to the operating subsidiaries.[13] However, funding provided by the OLF must be

[5] *Id.* at 76,620 (stating that the restructuring "would be facilitated to the extent the former company's Title I process was effective in mitigating obstacles and addressing impediments to resolvability under the Bankruptcy Code.").
[6] *Id.* at 76,616.
[7] *Id.*
[8] *Id.*
[9] *Id.*
[10] *Id.* at 76,620.
[11] *Id*.
[12] *Id.* at 76,617.
[13] *Id.* at 76,616.

short-term and must be lent on a fully-secured basis.[14] Furthermore, OLF funding is capped at ten percent of the consolidated assets of the bridge holding company, which increases to 90 percent upon a preliminary valuation of the assets and an FDIC-prepared repayment plan.[15] Finally, the OLF can issue guarantees to help secure private sector liquidity, but it cannot be used to provide capital support to the bridge holding company.[16]

The Committee believes the FDIC needs to provide further clarification regarding the restructuring of a troubled holding company through a SPOE process. For there to be a successful restructuring of the holding company, there must be enough loss-absorbing instruments at the parent level, such as equity and unsecured liabilities that can be bailed in, to capitalize the bridge holding company on a consolidated basis at a sufficiently strong level. The imposition of losses on the parent level debt, thus protecting subsidiary creditors, will be reflected in the overall cost of capital for the consolidated entity. The impending Federal Reserve rules on minimum levels of loss-absorbing capacity will address this requirement. At that point, the FDIC should provide a detailed discussion of the implications of these rules on the SPOE process with particular attention to the ability of the parent to absorb subsidiary losses and leave enough equity to capitalize the bridge holding company.

Continued Operations of Subsidiaries

In employing an SPOE strategy that only restructures the top-level parent of the holding company, the FDIC intends to ensure that subsidiaries continue to operate unimpeded.[17] The upstreaming of losses from subsidiaries to the parent, thus imposing the losses on the equity and debt of the parent, is a crucial feature of the SPOE approach.[18] The FDIC states that for SPOE to be successful "it is critical that the top-tier holding company maintain a sufficient amount of equity and unsecured debt that would be available to recapitalize the operating subsidiaries...."[19]

The Committee agrees that the SPOE strategy requires an adequate amount of equity and debt on the right side of the parent-level balance sheet that is capable of absorbing losses and more detail should be provided as to how such adequacy can be insured. However, the Committee also believes that the Notice should much more fully discuss the dynamics on the left side of the balance sheet. The left side of the balance sheet will dictate the mechanisms through which operating subsidiaries will be recapitalized by the bridge holding company. While it is certainly true that the capital of the consolidated holding company is generated on the right side of the parent-level balance sheet (i.e. its liabilities and equity), the recapitalization of the subsidiaries occurs through the use of the left side of the parent-level balance sheet (i.e. its assets) through the cancellation of parent-to-subsidiary loans or transfers of eligible assets to the subsidiary.[20]

While the Notice's discussion of a right-side requirement on the parent balance sheet (i.e. a sufficient amount of equity and unsecured debt to absorb losses and recapitalize the operating

[14] *Id.* at 76,616.
[15] *Id*. at 76,617.
[16] *Id.* at 76,617-76,622.
[17] *Id.* at 76,623.
[18] *Id.*
[19] *Id.*
[20] *See* Thomas Huertas, *A Resolvable Bank*, Feb. 11, 2014.

subsidiaries)[21] will ensure an adequate *quantity* of assets that can be injected into the subsidiary, attention must also be given to the left side of the parent's assets to ensure an appropriate *quality* of assets. Parent-to-subsidiary loans are an example of assets that can be used to provide capital support to a subsidiary through the cancellation of the loans. Other eligible assets include cash, portfolio securities, and interests in other subsidiaries. However, some assets of the parent may not be eligible to be transferred to a subsidiary.[22] For example, an insured bank subsidiary may not be able to own equity securities in a broker-dealer affiliate engaged in activities that the bank is not permitted to conduct directly.[23] As a result, while the right side of the holding company's balance sheet may be able to absorb the subsidiary's losses, there may be a reduced capacity for assets to be transferred to particular subsidiaries.

The Committee believes that while prescriptive rules governing financial institutions' assets should be avoided, the left side of the balance sheet should be analyzed under the framework of the SPOE strategy. The FDIC should consult with the Federal Reserve in implementing a Federal Reserve review of the left side of the balance sheet as part of the supervisory process to ensure that a holding company holds an adequate quality of assets that can be used to recapitalize subsidiaries.

Use of OLF Funds

The Committee believes the FDIC should confirm the permissible uses of OLF funding as governed by the Dodd-Frank Act. The Notice highlights the Dodd-Frank Act's explicit prohibition against the use of OLF funding to provide capital support to the bridge holding company.[24] Thus, it is clear that the FDIC cannot inject capital into the bridge financial company or its subsidiaries using the Treasury-funded OLF.[25] However, we believe that it would be consistent with the statutory mandate for OLF funding to be subsequently lent to operating subsidiaries. These loans could then be immediately cancelled to the extent that the subsidiary needed to be recapitalized. We believe this does not constitute an injection of capital by the OLF.

Any bridge holding company asset that is capable of being valued and held by an operating subsidiary can in principle be used to recapitalize an operating subsidiary. However, as discussed above, certain assets may not be eligible to be directly transferred to a subsidiary.[26] A bridge holding company can convert ineligible assets into eligible assets, such as cash, by selling them into the market, but the feasibility of this maneuver may be limited by the liquidity of the assets. In that case, the bridge holding company has a liquidity need that can be met by pledging these ineligible assets to the OLF in exchange for cash. Having converted illiquid ineligible assets into liquid eligible cash, the bridge holding company should be able to then inject the cash into the subsidiary as part of a recapitalization of the subsidiary.

The Committee believes that such a transaction with the OLF is consistent with the Dodd-Frank Act since it is intended to meet a liquidity need of the bridge holding company, even

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[21] Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76,614, 76,623 (Dec. 18, 2013).
[22] *See* 12 U.S.C. § 371c-1 (2012).
[23] *See Id.*
[24] Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76,614, 76,622 (Dec. 18, 2013).
[25] *Id.*
[26] *Id.*

if the funds are subsequently used to meet the capital needs of an operating subsidiary. Given that the OLF funding is fully-secured by the bridge holding company assets,[27] the subsequent injection of the funds into a subsidiary should not trigger the Dodd-Frank Act prohibition against OLF as a source of capital. The consolidated entity will have sufficient capital, but may require liquidity that is used by the parent or by one of its subsidiaries. Whether the liquidity is passed down to a subsidiary through a loan or capital injection, the transaction does not affect the capitalization of the consolidated entity.[28] Since the capital position of the consolidated entity does not change through the OLF borrowing, no direct capital support has been provided. In addition, the intragroup transfer does not change the character of the transaction between the parent and the OLF, which remains a fully-secured loan. The FDIC should confirm its position on the use of the OLF to convert parent-level assets into cash that is subsequently injected into subsidiaries as capital.

Preserving Critical Functions

The Committee believes that the preservation of critical functions should be a focal point for the FDIC's resolution process. Critical functions include clearing, payment, and settlement systems that serve a role in the financial system "for which other firms lack the expertise or capacity to provide a ready substitute."[29] Even if an operating subsidiary is adequately recapitalized through the SPOE process, it may still need liquidity support to maintain any critical functions it provides. In that case, the bridge holding company can use the OLF to access the necessary liquidity.[30] However, if an operating subsidiary's losses are so large that the parent cannot absorb them through the SPOE approach, the Notice points out that the subsidiary will be closed as a separate receivership.[31] While the need to separately resolve a subsidiary should not materialize once the Federal Reserve has implemented rules ensuring sufficient loss-absorbing capacity at the parent level, it is important for the FDIC to plan for this contingency. If a failed subsidiary conducts any critical functions, it is crucial that those functions not be impaired. In that case, the FDIC implies that it will look to the Title I resolution plans in addressing Title II OLA issues.[32]

Section 165(d) of the Dodd-Frank Act requires bank holding companies and certain nonbank financial institutions to submit periodic resolution plans to regulators.[33] As part of these "living wills," the FDIC and the Federal Reserve require that a firm's critical functions be identified and a detailed plan be put in place to maintain operation of those functions in the event of insolvency.[34] The Committee believes that the FDIC should more fully explain its intended use of the Title I living wills in identifying and preserving critical functions during a Title II resolution procedure. Whether or not living wills are part of the approach, the FDIC should outline its back-up plan for preserving critical functions in case the SPOE strategy fails to recapitalize certain operating subsidiaries.

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[27] *Id.* at 76,616.
[28] The consolidated balance sheet does not distinguish between assets held at the parent level or at the subsidiary level, so parent-to-subsidiary transfers do not affect the consolidated balance sheet.
[29] Resolution Plans Required, 76 Fed. Reg. 67,323, 67,327 (Nov. 1, 2011).
[30] Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76,614, 76,616 (Dec. 18, 2013).
[31] *Id.* at 76,623.
[32] *Id.* at 76,620.
[33] 12 U.S.C § 5365(d) (2012).
[34] *See* 12 C.F.R. § 243.3 (2012).

Cross-Border Issues

The SPOE approach requires substantial cross-border cooperation with foreign regulators to be successful. The Notice leaves open a number of cross-border issues that must be addressed in greater detail by the FDIC. In particular, the FDIC will need to give credible assurances to foreign authorities that material subsidiaries operating outside the United States will be given fair treatment regarding capital injections.[35] In addition, the FDIC must ensure that the resolution strategy will preserve the critical functions operating in foreign jurisdictions.

One of our members has expressed a general concern about the SPOE strategy, which pre-announces the U.S. government's intention to protect a SIFI's operating subsidiaries from failure. The member believes that SPOE will introduce numerous distortions to the proper functioning of financial markets and SIFIs themselves. The SPOE strategy incentivizes counterparties to deal primarily with the operating subsidiaries, since counterparties now understand that financial assistance will be provided to the operating subsidiaries (and, hence, the subsidiaries' counterparties) in the event of a looming failure. This not only gives the operating subsidiaries of systemically important financial institutions a funding advantage over competitors not labeled systemically important, but it also encourages indiscriminate lending by counterparties to a SIFI's operating subsidiaries. An increase in leverage at the operating subsidiary increases the likelihood of the subsidiary's failure. This, in turn, threatens the solvency of the subsidiary's parent and corporate affiliates. Heavily indebted subsidiaries also magnify the possibility and effect of financial contagion, and the cost of an OLF contribution.

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Thank you very much for your consideration of the Committee's opinion. Should you have any questions or concerns, please do not hesitate to contact the Committee's Director, Prof. Hal S. Scott (hscott@law.harvard.edu); its Executive Director of Research, C. Wallace DeWitt (cwdewitt@capmktsreg.org); or Brian Johnson, Research Fellow (bjohnson@capmktsreg.org) at your convenience.

Respectfully submitted,

Robert Glenn Hubbard	John L. Thornton	Hal S. Scott
R. Glenn Hubbard	John L. Thornton	Hal S. Scott
CO-CHAIR	CO-CHAIR	DIRECTOR

[35] *See* Financial Stability Board, *Recovery and Resolution Planning for Systemically Important Financial Institutions: Guidance on Developing Effective Resolution Strategies* 1 (Jul. 16, 2013).