Financial Services Management

Single Point of Entry Resolution Implementation

Cite
FDIC Notice
Request for Comment
The Resolution of Systemically Important Financial Institutions:
The Single Point of Entry Strategy

Recommended Distribution:
Public Policy, Legal, Government Relations

Websites
http://fdic.gov/news/news/press/2013/pr13112.html

Impact Assessment

- Success of SPOE is essential for credible solution to TBTF.

- The FDIC approach is premised on the holding company serving as a source of support for operating subsidiaries, preventing TBTF but ensuring orderly operation in crisis and subsequent restructuring. Critical to successful SPOE is sufficient debt and equity at the parent to recapitalize subsidiaries and controls to prevent TBTF risk from downstreaming to operating subsidiaries like banks.

- Treatment of SIFIs that are not BHCs is left unclear, and numerous questions also remain as to orderly cross-border resolutions for all covered financial firms.

- Significant questions also surround the treatment of derivatives and other "qualified financial contracts," with SPOE function in part depending on the ability of the FDIC and other resolution authorities to impose automatic stays when a bridge company is chartered to prevent fire-sale risk at the rescued firm and throughout the financial system.

©2013. Federal Financial Analytics, Inc.

Overview

Building on an initial accord with the U.K.,[1] the FDIC is now seeking comment on the policy and practical issues that must be addressed before its single-point-of-entry (SPOE) resolution protocol for systemically-important financial institutions (SIFIs) can be considered a viable resolution strategy. In SPOE, SIFIs will have issued sufficient debt and equity for the FDIC to recapitalize their subsidiaries quickly and in an orderly fashion to avoid "fire sales" or other market actions that create contagion risk or prevent SIFI and their subsidiaries from performing vital financial-market and economic services. Numerous procedural complexities to SPOE are explored and, the FDIC hopes, resolved in this paper. However, policy questions remain on which comment is solicited. These include the extent to which a SIFI's subsidiaries would become *de facto* too-big-to-fail (TBTF) entities, remaining SIFI funding advantages, FDIC discretion to treat similarly-situated creditors differently, and the ability of SPOE to execute an orderly resolution for a cross-border financial institution. Although SPOE is to handle all SIFIs, its structure is in many ways premised on the SIFI being a bank holding company, raising questions about its functionality for any non-bank SIFIs, although the FDIC does not raise these in its request for comment.

Impact

As described in detail in this notice, the FDIC in an SPOE resolution would shutter a U.S. top-tier company, convert it into a bridge holding company, and then use the equity and debt of the parent to recapitalize operating subsidiaries. The hope is that, by doing so, SPOE punishes the shareholders, unsecured creditors, and culpable management of the liquidating parent, while ensuring that critical services – the reason the firm was a SIFI and not resolved through bankruptcy – are continued. The hope also is that the subsidiaries can be so quickly recapitalized that normal operations without FDIC support resume very quickly, minimizing or even eliminating the need for any taxpayer backstop in the event of a SIFI resolution.

In similar hope of averting bail-outs, global regulators through the Financial Stability Board (FSB) are also looking at SPOE, although the FSB has also outlined a multiple-point-of-entry alternative designed to address SIFIs without a top-tier parent (very often not found outside the U.S.).[2] The FSB is also working on resolution protocols for non-banks – an issue not clearly addressed in the FDIC's current SPOE protocol and request for comment. Outstanding FSB resolution proposals cover insurance

[1] See **RESOLVE15**, *Financial Services Management*, December 19, 2012.

[2] See **RESOLVE13**, *Financial Services Management*, November 13, 2012.

©2013. Federal Financial Analytics, Inc.

companies,[3] Financial Market Infrastructure,[4] and firms that hold the assets of others.[5] The Dodd-Frank Act[6] requires the FDIC to work with the SEC to address SIFIs that own broker-dealers and also to plan for resolution of insurance-related SIFIs. A recent report from the Treasury's Federal Insurance Office also deals with insurance companies, noting an array of concerns with regard to orderly resolution of diverse or interstate insurers.[7] SPOE may address this to some extent, but much in the FDIC notice appears premised on banking organizations.

Although there are many questions about the functionality of SPOE discussed below, one critical challenge is the fundamental reason it is required instead of simple use of bankruptcy to resolve all financial firms. The Dodd-Frank Act requires that its orderly-liquidation authority (OLA) and, thus SPOE, be used only in extraordinary circumstances when a complex approval process finds that ordinary insolvency proceedings would result in systemic risk. "Living wills" required by the Act are also mandated so that firms themselves plan for bankruptcy resolution, with regulators told to sanction or even restructure SIFIs if their living wills are not credible plans for bankruptcy resolution. The FDIC paper finds that SIFIs are so complex that most could not be resolved in this fashion, but it does not make clear why, if living wills meet their accomplished goal, this could not be done over time, obviating the need for SPOE except, perhaps, in situations of contagion risk across the financial sector. Advocates of breaking up big banks cite this problem as a reason not only to abandon OLA, but also to restructure the industry through size and/or activity restrictions; SPOE and OLA defenders counter that complexity is an inherent aspect of the current financial system and that, while bankruptcy can be made more possible through living wills and additional statutory refinements to OLA, its success cannot always be assured nor is it always possible that its use would permit the continuation of critical services provided by a faltering SIFI to the financial system or broader economy.

As noted, key to SPOE is sufficient debt and equity at the holding-company level to ensure orderly restructuring of operating subsidiaries that would then quickly be restructured as newly-operating, privately-owned firms (newcos). The FRB, not the FDIC, has the statutory authority to dictate debt and equity issuance for SIFIs, and it is currently working on a proposal expected to be released for public comment early next year. The FDIC now asks for views on this issue, creating a framework sure to inform subsequent

[3] See **INSURANCE37**, *Financial Services Management*, October 17, 2013.

[4] See **FMU7**, *Financial Services Management*, August 21, 2013.

[5] See **RESOLVE20**, *Financial Services Management*, August 26, 2013.

[6] See **SYSTEMIC30**, *Financial Services Management*, July 22, 2010.

[7] See Client Report **INSURANCE38**, December 13, 2013.

Federal Financial Analytics, Inc.
1121 Fourteenth Street, N.W., Washington, D.C. 20005
Phone: (202) 589-0880 Fax: (202) 589-0423
E-mail: info@fedfin.com Web Site: www.fedfin.com

© 2013. Federal Financial Analytics, Inc. All rights reserved.

FRB action. Key issues here on which comment is solicited is the structure of this debt and equity and how much is enough. The FDIC does not, however, explore how to ensure this system works not just for banking organizations, but also for non-bank SIFIs. It also does not now seek views on the impact of issuing all this additional debt on SIFIs, the number of bank holding companies over $50 billion in assets that would be required to do so, and the market's capacity to absorb all this additional unsecured debt and equity (a concern exacerbated by likely prohibitions on cross-SIFI holdings).

Additional SPOE Questions include:

- **Cross-Border Resolution**: Not only are SIFIs very differently structured in other nations, but there are also far-reaching policy variations – some nations join the U.S. in seeking an end to taxpayer support and use only of ordinary insolvency law in the event of a SIFI failure, but other nations (e.g., Japan, China) see banks as arms of the state and some (e.g., the European Union) remain unsure of how to shutter a SIFI – especially a non-bank – without governmental intervention. The FDIC is working on agreements with other nations similar to the one with the U.K. to establish the way in which cross-border banks would be resolved, but many questions remain about the practical implementation and legal standing of these agreements. Even if they are viable and supported by host-country statute, some fear that, in a crisis, host-country regulators would ring-fence or otherwise take charge of U.S. operations in their nation if SPOE resolution endangered their creditors, depositors, or broader financial-market.

- **Treatment of Derivatives and Similar Exposures**: One cause of systemic risk is the ability of counterparties in "qualified financial contracts" (QFCs) to terminate agreements and regain collateral. The FDIC has joined with global regulators to urge counterparties by contract to limit these rights when SPOE or a similar resolution protocol is used to give resolution authorities time to restructure a firm and ensure an orderly unwinding of QFCs through use of the closed holding company's (oldco's) unsecured debt and equity. This not only requires sufficient amounts of prior debt and equity (see above), but also may contribute to the downstreaming of QFCs to subsidiary firms that, because they remain operational in SPOE, do not expose counterparties to risk. Conversely, if automatic stays – especially cross-border ones – are not in place when a bridge company is established, SPOE may contribute to TBTF expectations without actually preventing systemic risk or averting use of taxpayer resources.

- **TBTF Concerns**: This downstreaming could ensure the orderly operations SPOE intends, but perhaps do move TBTF status to these

©2013. Federal Financial Analytics, Inc.

subsidiaries by ensuring that QFC creditors take no risk and thus act with the impunity borne of moral hazard. Other unsecured creditors – e.g., debtors that are the equivalent of bank uninsured depositors – could also limit their exposure to oldco subsidiaries they expect to receive sufficient support from the oldco to protect them in full. The FDIC notes that subsidiaries may be liquidated after the bridge company prevents systemic peril, but delayed risk may not ensure appropriate market discipline. As a result, SIFIs could retain funding advantages that create competitive challenges and market-integrity concerns, although the FDIC also notes that holding companies have long been expected – at least in banking organizations – to serve as a source of strength. FRB Gov. Tarullo has suggested that "internal bail-in debt" might be used in SPOE to address these concerns.

- **Taxpayer Risk**: The FDIC expects that the bridge would operate and support subsidiaries first from oldco's debt and equity and then from ordinary access to financial markets once panic has subsided. However, if private capital is not available, the FDIC could deploy the Orderly Liquidation Fund (OLF) authorized by Dodd-Frank, deriving funds from Treasury that would then be repaid by the bridge, the new companies (newcos) created from it, or through assessment on surviving SIFIs. The SPOE paper also contemplates potential bridge-company support through bonds issued by the bridge guaranteed by the FDIC. The FDIC believes that OLF or other use of FDIC backstops would be temporary and so fully secured as not to pose taxpayer risk, but questions about this remain. The Congressional Budget Office has, for example, concluded that OLA might cost taxpayers as much as $20 billion that would only be recovered over an extended period of time.

- **Treatment of Creditors**: The FDIC in this notice makes clear that it would treat similarly-situated creditors differently in only rare circumstances and in accordance with its regulations.[8] Nevertheless, a critical difference between OLA (including SPOE) and ordinary bankruptcy is the power granted to the FDIC. If this is used in the same, limited fashion conventional in ordinary insolvencies (i.e., to protect vendors on the "first day" of a resolution to permit ongoing orderly operation of the bridge), then there will be limited market or policy impact from this discretion; if, however, the FDIC protects some institutions over others as was done, for example, by U.S. regulators in

[8] See Client Reports in the **RESOLVE** series.

Federal Financial Analytics, Inc.
1121 Fourteenth Street, N.W., Washington, D.C. 20005
Phone: (202) 589-0880 Fax: (202) 589-0423
E-mail: info@fedfin.com Web Site: www.fedfin.com

© 2013. Federal Financial Analytics, Inc. All rights reserved.

the AIG rescue, TBTF and market-integrity risks may remain unaddressed.

- **Cross-Border Resolutions**: As noted, the FSB is seeking to enact cross-border standards to harmonize not only resolution, but also living-will and recovery planning not just for large banks, but also other SIFIs. However, work to date has been largely unimplemented outside the U.S. Thus, the practical ability of foreign governments to join the FDIC in a SPOE resolution remains unclear. Fears also remain that, even if a foreign regulator agrees to SPOE resolution, its willingness to act on it may be far less certain if failure of host-country operations of a U.S. SIFI pose macroeconomic or taxpayer risk in that nation when SPOE discipline is exerted in the U.S. This is particularly worrisome with regard to bank-branch operations, which host countries could seek to ring-fence from parents either before failure or upon it in ways that increase risk to the FDIC.

As discussed below, a primary focus of SPOE is use of the bridge to raise sufficient liquidity to keep subsidiaries functioning as desired. Access to taxpayer resources is presumed to be rare and very short-lived because there will be sufficient resources in the oldco even if it takes some time to mobilize them. However, liquidity risk can quickly turn into solvency risk or even be created by it. SPOE is premised on the view that solvency risk is rare, perhaps a reasonable expectation based on the tough new capital standards under way for the largest U.S. banks. It is, however, unclear if contagion risk that turns into solvency risk by way of firesales across a sector can be thwarted by SPOE or if solvency risk in non-bank sectors (e.g., insurers not deemed likely subject to liquidity risk) can be easily averted.

What's Next

The FDIC approved this notice on December 10.[9] The vote to do so was unanimous, but several board members expressed serious reservations with SPOE from both a policy and practical perspective. Issues raised are among those discussed above as well as those on which comment is solicited. However, given the sharp differences of opinion on SPOE, it may take considerable effort for the FDIC to finalize it as initially envisioned. If not, significant concerns may well resurface with regard to TBTF. FinServ Chairman Hensarling (R-TX) has repeatedly proposed repealing Titles I[10] and II[11] of the Act, and the House has also repealed OLA in connection with its budget on grounds that taxpayers would need to support a SIFI resolution.

---

[9] See **RESOLVE22**, *Financial Services Management*, December 10, 2013.
[10] See **SYSTEMIC29**, *Financial Services Management*, July 13, 2010.
[11] See **SYSTEMIC30**, *Financial Services Management*, July 22, 2010.

©2013. Federal Financial Analytics, Inc.

None of this legislation has advanced, but it or other TBTF measures could gain renewed momentum if SPOE bogs down.

The SPOE notice has yet to be published in the *Federal Register*. Comment on it will be due sixty days thereafter.

Analysis

A. SPOE Process

The FDIC's notice includes a description of how SPOE would work and the steps the agency will take in advance to ensure it proceeds as planned. For example, the bridge would be quickly staffed by a CEO and other senior officers. These officers could immediately undertake actions to mitigate the risks that led to receivership, ensure stable operations, and restructure the bridge holding company and its subsidiaries to permit liquidation, sale, or other resolution steps that prevent renewed systemic risk. The bridge could pay the FDIC back for any support and otherwise create viable, resolvable entities from the debris of the oldco. Culpable management would be identified and dismissed, but the bridge would largely be staffed by oldco employees.

The FDIC would retain certain rights over the bridge, with the agency expecting that the bridge management's first task will be to fund the bridge to ensure resumption of orderly operations This, it posits, will not be difficult because of the recapitalization of the bridge from oldco debt and equity. Oldco creditors (other than vendors to the bridge and certain others) would be paid over time to the extent possible through a security-for-claims exchange. Under this, as noted, the FDIC has discretion to treat similarly-situated creditors differently, but this would only be done if this maximizes the return to those creditors left in the receivership and if the FDIC finds it necessary to continue operations essential to the bridge. The consent of creditors is not required for any such disparate treatment, although the FDIC is required by law to compensate them at least as much as would have occurred under bankruptcy. The FDIC would also need to follow procedures before invoking disparate treatment and handle creditor claims in a process detailed in the notice.

The bridge would be recapitalized through issuance of securities for its claims after valuing itself in accordance with a process also detailed in the notice. When creditor claims have been satisfied through this process (expected to take no more than nine months), the bridge company's charter would terminate and it would become one or more state-chartered financial companies (newcos). The FDIC and SEC believe "fresh-start" accounting will be most appropriate for the newcos, with the FDIC noting that all surviving

© 2013. Federal Financial Analytics, Inc. All rights reserved.

newcos would be structured to ensure each can be resolved through bankruptcy, not renewed use of OLA.

The notice also details how the FDIC would make its actions in SPOE transparent to Congress, other regulators, and the market. Various reports required by Dodd-Frank will be filed and made public to the greatest extent possible.

B. Request For Comment

Views are solicited on:

- whether the controls cited above to limit disparate treatment of creditors are still insufficient;
- if use of OLF or other FDIC support would, despite the limits noted above, still result in SIFI bail-outs;
- if SIFIs would have a funding advantage because of SPOE. As noted subsidiaries would remain operational, which might create incentives for unsecured creditors to downstream risk from the oldco and receive *de facto* TBTF protection. The notice indicates that oldco support to subsidiaries is consistent with the current "source of strength" doctrine. However, it also notes that subsidiaries with the greatest loss that cannot be sustained by oldco resources could be put into receivership in the order required to stabilize remaining subsidiaries, exposing uninsured depositors and other unsecured creditors in subsidiaries to risk of loss. However, this might take time and the drafting of the notice does not clearly commit the FDIC to putting any such subsidiaries into receivership. Comment on this is solicited, as well as on additional steps needed to offset any remaining SIFI funding advantage;
- oldco debt and equity: As noted, a critical element of SPOE is sufficient oldco unsecured debt and equity to permit orderly recapitalization. Comment is solicited on the amount of required debt and equity, the types of instruments required, the benefit of using risk-based versus leverage capital to set equity levels, and the ability of SPOE to function as desired for cross-border resolutions. Of particular concern here is the potential that host-country regulators will ring-fence U.S.-controlled operations of an insured depository institution. Comment is sought on the FSB's multiple-point-of-entry option with regard to bank branches versus ring-fenced host-country subsidiaries;
- potential disparate treatment of creditors in SPOE;
- the manner in which bridge-company assets would be valued and the extent to which contingent-value securities for creditors could resolve potential concerns;
- SPOE transparency; and
- other options.

©2013. Federal Financial Analytics, Inc.