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FINANCIAL INSTITUTIONS ADVISORY & FINANCIAL REGULATORY, FINANCIAL RESTRUCTURING & INSOLVENCY

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FDIC Board Releases Single Point of Entry Resolution Strategy for Public Comment

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On December 18, 2013, the Board of Directors of the Federal Deposit Insurance Corporation ("FDIC") published a widely anticipated notice in the Federal Register (the "Notice") setting forth the FDIC's single point of entry strategy ("SPOE") for resolutions under the Orderly Liquidation Authority ("OLA") contained in Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act") and requesting comment.[1] The FDIC has viewed SPOE as a preferred resolution strategy for over a year.[2] The release provides greater detail regarding the strategy as well as issues that have been identified with respect to it.

[1] "Resolution of Systemically Import Financial Institutions: The Single Point of Entry Strategy," 78 Fed. Reg. 243 (December 18, 2013), pp. 76614-76624. A copy of the Notice is *available at*: http://www.gpo.gov/fdsys/pkg/FR-2013-12-18/pdf/2013-30057.pdf.

[2] Notably, in May 2012, FDIC Chairman Martin J. Gruenberg indicated that SPOE is the FDIC's preferred resolution strategy under OLA. *See* Remarks by Martin J. Gruenberg Acting Chairman, FDIC to the Federal Reserve Bank of Chicago Bank Structure Conference (May 10, 2012), *available at* http://www.fdic.gov/news/news/speeches/chairman/spmay1012.html. The FDIC has also issued a joint paper with the Bank of England advocating SPOE (*available at* http://www.fdic.gov/about/srac/2012/gsifi.pdf) and FDIC Chairman Gruenberg and Bank of England Deputy Governor for Financial Stability Paul Tucker have published an editorial in the *Financial Times* advocating the strategy (*available at* http://www.ft.com/intl/cms/s/0/fd66d172-3fd4-11e2-b0ce-00144feabdc0.html#axzz2nIajZxxV).

Purpose of the Strategy

OLA was designed to deal with the "too big to fail" problem that became apparent in the wake of the 2008 financial crisis. In essence, OLA provides a back-up authority to place systemically important financial institutions ("SIFI") into an FDIC receivership process if there is no private sector alternative to prevent the SIFI's default and if the SIFI's resolution under the US Bankruptcy Code would have serious adverse effects on the financial stability of the United States. Although the Dodd-Frank Act does not specify how the resolution of a SIFI should be structured, it does establish certain policy goals and parameters, including that taxpayers not make payments for losses[3] and that management and board members be held accountable for the failure.[4]

The SPOE Approach Generally

SPOE is a recapitalization resolution strategy that looks to take advantage of the fact that US SIFIs predominantly are organized under a holding company structure with a top-tier parent holding company and operating subsidiaries. Under the SPOE approach described in detail in the Notice, upon failure of a SIFI, the parent holding company would be put into an FDIC receivership under OLA with the SIFI's bank, broker-dealer and other operating subsidiaries remaining open for business. The key to the SPOE approach is that, upon the parent holding company being placed into receivership, the FDIC would organize a bridge financial company into which it would transfer the assets of the failed parent holding company's estate, including ownership interests in, and intercompany loans to, the operating subsidiaries.

Steps to Execution

Transfer to Bridge Company

As described by the Notice, although the assets of the parent holding company would be transferred to the new bridge company, the equity, long-term unsecured debt and other similar liabilities of the failed parent holding company would remain in the existing holding company in the receivership.[5] Recognizing that an absolute break between the assets and liabilities of the existing parent holding company could engender market-related risks, the SPOE contemplates that certain obligations of the holding company could be transferred to the bridge financial company to facilitate its operation and mitigate systemic risk. The Notice mentions that, among the obligations that could be transferred to the bridge company are obligations that are similar to "critical vendor" obligations that are approved as a matter of standard practice as "first day" orders in chapter 11 cases.[6]

Structure of Bridge Company

The FDIC, upon its appointment as receiver of the failed holding company, would adopt articles of association and bylaws for the bridge financial company. The FDIC would then establish a board of directors and chairman from "a pre-screened

[3] Title II states that "[t]axpayers shall bear no losses from the exercise of any authority under [Title II]." 12 U.S.C. § 5394(c).

[4] *See* 12 U.S.C. § 5386(4)-(5).

[5] The Dodd-Frank Act authorizes the FDIC to establish a "bridge financial company" to temporarily succeed to selected assets and liabilities of the SIFI. 12 U.S.C. § 5390(h).

[6] *See* Notice at p. 76622.

pool of eligible candidates," which in turn would appoint a CEO of the bridge financial company from pre-screened candidates and other experienced senior managers.[7]

Although, consistent with the Dodd-Frank Act's view that management responsible for the failure of the institution should feel the effects of the failure, senior management will have been replaced, the FDIC "expects that the bridge financial company would retain most of the employees in order to maintain the appropriate skills and expertise to operate the businesses and most employees of subsidiaries and affiliates would be unaffected."[8] The FDIC would also retain control over certain key high-level governance matters, including stock issuance, dividend distributions and board changes.[9]

Addressing the Problem

As part of the process described in the Notice, measures would be taken to address the problems that led to the failure. Such measures could include, among other things, the divestiture or discontinuance of certain business lines with the potential that the "restructuring of the firm might result in one or more smaller companies that would be able to be resolved under bankruptcy without causing significant adverse effect to the US economy."[10]

Planning with respect to these measures would begin at the outset of the proceeding. In this regard, the Notice indicates that in connection with the formation of the bridge financial company, the FDIC would require the company to enter into an initial operating agreement requiring certain actions including, among others:

(i) review of the risk management policies and practices of the SIFI that led to the failure and prompt development of a plan to address them;

(ii) preparation and delivery of a business plan for the bridge financial company (including asset disposition strategies);

(iii) preparation of a capital, liquidity and funding plan consistent with the terms of any mandatory repayment plan and the capital and liquidity requirements established by regulators with respect to the SIFI's operating entities;

(iv) retention of FDIC-approved accounting and valuation consultants; and

(v) preparation of a restructuring plan to make the emerging company resolvable under the US Bankruptcy Code.[11]

Orderly Liquidation Fund

By establishing the bridge financial company with significant assets of the parent holding company, but no (or few) liabilities, it is expected that the bridge financial company would have a strong balance sheet that would put it in a strong position to borrow money from customary market sources. If, however, those customary sources are not immediately available, the FDIC has indicated that it may provide guarantees backed by its authority to obtain funding through the

[7] *Id.* at pp. 76616-76617.

[8] *Id.* at p. 76617.

[9] *See id.*

[10] *Id.* at p. 76616.

[11] *See id.* at p. 76617.

Orderly Liquidation Fund ("OLF"), or even secured funding directly from the OLF.[12] These obligations would, however, "only be issued in limited amounts for a brief transitional period in the initial phase of the resolution process and would be repaid promptly once access to private funding resumed."[13]

All OLF advances would be secured by liens on assets of the bridge financial company and its subsidiaries. If the pledged assets ever proved insufficient to fully repay the OLF advances, the FDIC would "impose risk-based assessments on eligible financial companies" to ensure that any OLF assets are repaid without loss to the taxpayer."[14] Operating subsidiaries could be recapitalized as necessary via the bridge financial company's contribution of assets (or forgiveness of intercompany loans).[15]

Claims Process

OLA requires the FDIC to conduct a claims process and establishes a claims priority pyramid for the satisfaction of claims without the use of taxpayer funds.[16] Following the claims process, claims against the receivership would be satisfied through a debt-for-securities exchange in accordance with their priority under OLA through the issuance of debt and equity in a new holding company. Prior to the exchange of securities for claims, the FDIC would determine the value of the bridge financial company based upon a valuation performed by the consultants selected by the board of the bridge financial company. The FDIC has indicated that "[c]ontingent value rights, such as warrants or options allowing the purchase of equity in [the new holding company] or other instruments, might be issued to enable claimants in impaired classes to recover value in the event that the approved valuation point underestimates the market value of the company."[17]

Timing

The FDIC expects that the bridge financial company would be ready to execute the debt-for-securities exchange within six to nine months of the commencement of the OLA proceedings. The termination of the bridge financial company, however, would only occur after the FDIC has approved the restructuring plan, and it is clear that the new holding company would meet or exceed regulatory capital requirements.[18]

Provision of Information

The Notice indicates that in implementing the SPOE proposal, the FDIC would "provide the best available information regarding the financial condition of the bridge financial company to creditors of the covered financial company." Further, the bridge financial company would comply with all disclosure and reporting requirements under applicable securities laws; although, if audited financial statements are not available, the FDIC would work with the Securities and Exchange Commission to set appropriate disclosure standards.[19]

[12] The Dodd-Frank Act provides for the OLF to serve as a back-up source of liquidity support. 12 U.S.C. § 5384(d).

[13] Notice at p. 76616.

[14] *Id.* at p. 76617.

[15] *See id.* at p. 76623.

[16] *See id.* at pp. 76617-76618.

[17] *See id.* at pp. 76618-76619.

[18] *See id.* at p. 76620.

[19] *See id.* at pp. 76621-76622.

Challenges

SPOE has emerged as the FDIC's preferred OLA resolution strategy in large part because of the advantages it has over other alternatives (namely, sale and liquidation and wind-down strategies) and the fact that it solves many of the resolution impediments that have been identified since the Dodd-Frank Act's enactment. In this regard, although a resolution strategy for a SIFI that contemplates a sale (rather than capitalization) of material assets to a third party has appealing aspects, it faces the fundamental challenge that there may not be acquirers with the desire and financial strength to make the acquisition even if their regulators were willing to permit such an acquisition to go forward.

A resolution strategy that contemplates a full liquidation and wind-down resolution strategy also has a number of significant risks and challenges, including, among other things, that it can be time-consuming and result in the loss of going concern value for creditors and the loss of critical services provided by the SIFI to the overall economy. In contrast to those approaches, the FDIC believes that an SPOE recapitalization can be accomplished relatively quickly, will allow the continued operation of key businesses, and is not dependent on a willing and able acquirer.

Although the SPOE strategy eliminates many of the concerns of other strategies, an SPOE strategy is not itself without issues and impediments. Among the major impediments is the risk that the effectiveness of the SPOE strategy could be impaired by the potential for ring fencing by non-US authorities that have jurisdiction over a SIFI or its assets. To address that risk, the Notice suggests that a multiple point of entry ("MPOE") resolution strategy could be utilized as an alternative. As described, the MPOE strategy would involve positioning multiple levels of holding companies in various jurisdictions that could then be used as a point of entry in the event of a crisis.[20]

Request for Comments

The Notice specifically requests comment on several of its key provisions, including:

Disparate Treatment

Under the OLA, a creditors' committee is not appointed and creditor approval is not necessary for the FDIC to treat similarly situated creditors differently. In addition to the protections afforded creditors under the Dodd-Frank Act,[21] the FDIC, in response to concerns regarding the possibility that stakeholders could receive disparate treatment, points to the fact that it has instituted regulations that limit its discretion to treat similarly situated creditors differently.[22] The Notice solicits comments "on whether there should be further limits or other ways to assure creditors of our prospective use of disparate treatment."[23]

[20] *Id.* at p. 76624.

[21] The Dodd-Frank Act provides that each creditor must receive at least the same mount that they would have received if the FDIC had not been appointed as receiver and the company had been liquidated under chapter 7 of the US Bankruptcy Code. See 12 U.S.C. § 5390(b)(4). Further, disparate treatment is only permissible under the Dodd-Frank Act to the extent necessary to continue essential operations or maximize recoveries. *See* 12 U.S.C. § 5390(d)(4).

[22] The FDIC has stated that it would not exercise its discretion in manner that would result in preferential treatment to holders of long-term senior debt, subordinated debt, or equity holders. *See* 12 CFR 380.27.

[23] Notice at p. 76620.

Use of the OLF

In the Notice, the FDIC recognizes that, to the extent that the SPOE solution contains the possibility that funds from the OLF may be utilized, the whole approach "might be considered equivalent to a public 'bail-out" of the company." Accordingly, the Notices seeks comments "on the FDIC's efforts to address the liquidity needs of the bridge financial company."[24]

Funding Advantages of SIFIs

The Notice notes that SIFIs have a perceived funding advantage over smaller competitors arising from a market expectation that SIFIs would be bailed out if they failed. The Notice indicates the FDIC's belief that the SPOE proposal potentially would limit the perceived advantage by making it clear that, upon the failure of a SIFI, loses would be imposed upon shareholders and unsecured creditors. The FDIC solicits commenters' views on this perceived funding advantage and specifically whether: (i) the potential to use OLF creates a funding advantage; (ii) any potential funding advantage would contribute to consolidation among the banking industry that would not otherwise occur; and (iii) there are any other measures and methods that can be used to address the perceived funding advantage.[25]

Capital and Debt Levels at the Holding Company

The SPOE approach only would be a viable solution if the recapitalization at the parent company level would generate sufficient value to allow for any necessary flow of assets to the subsidiary level. The Notice, therefore, seeks comment on capital issues, including the "amount of equity and unsecured debt that would be needed to effectuate a SPOE resolution and establish a [new bridge financial company]," as well as comment on the types of debt and maturity structures that "would be optimal to effectuate a SPOE resolution."[26]

Treatment of Foreign Operations of the Bridge Financial Company

The Notice indicates that it would welcome comments on "whether a subsidiarization requirement would facilitate the resolution of a SIFI under the MPOE or SPOE strategies or under the Bankruptcy Code," as well as "the impact a branch structure might have on a banking organization's ability to withstand adverse economic conditions that do not threaten the viability of the group."[27]

Cross-Border Treatment

The FDIC details steps that it has taken with respect to cross-border coordination, including the development of certain cross-border relationships and working groups, and "welcomes comment on the most important additional steps that can be taken with foreign regulatory authorities to achieve a successful resolution using the SPOE strategy."[28]

In addition to the issues identified above, the FDIC is soliciting comments on: (i) whether "there are particular creditors or groups of creditors for whom the securities-for-claims exchange strategy would present a particular difficulty or be unreasonably burdensome; (ii) whether "the issuance to creditors of contingent value securities, such as warrants, can be

[24] *Id.*

[25] *See id.* at pp. 76622-76623.

[26] *Id.* at pp. 76623.

[27] *Id.* at p. 76624.

[28] *Id.*

an effective tool to accommodate inevitable uncertainties in valuation" and what characteristics would be useful in structuring such securities; (iii) what financial reporting is the most important to claimants, the public and other stakeholders, and whether additional information about the administrative claims process would be useful; and (iv) whether there are there additional factors that should be considered in evaluating the effectiveness of SPOE or there are alternatives that would provide better results.[29]

Comments are due by February 18, 2014.

[29] *Id.*

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