E-ALERT | Financial Institutions

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FDIC OUTLINES "SINGLE POINT OF ENTRY" STRATEGY FOR RESOLVING SYSTEMICALLY IMPORTANT FINANCIAL INSTITUTIONS

Yesterday, the Federal Deposit Insurance Corporation ("FDIC") issued for public comment a long-awaited notice ("Notice") describing its strategy – referred to as "single point of entry" ("SPOE") – for implementing Title II of the Dodd-Frank Act to resolve systemically important financial institutions ("SIFIs").[1] Title II was enacted to give the FDIC authority to resolve a failing SIFI where (1) no private sector alternative is available to prevent the institution's default, and (2) the bankruptcy of the institution under the U.S. Bankruptcy Code would have serious adverse effects on U.S. financial stability.[2] Under the Notice, the FDIC determines that SPOE would effectuate the policy interests underlying Title II by providing for orderly resolution and stability for financial markets, while at the same time holding shareholders, debt holders, and culpable management accountable for the failure of the SIFI.

While there are few surprises in the Notice, it does provide more detail about how the FDIC would approach SPOE resolution. In addition, the Notice seeks public input on several of the more controversial issues arising from the SPOE strategy; the resolution of these important issues will not occur until the Notice is finalized.

SINGLE POINT OF ENTRY STRATEGY

Under the strategy described in the FDIC's Notice, upon a SIFI's default or near default, the FDIC would be appointed receiver of only the top-tier U.S. holding company of the SIFI, and not of any of the SIFI's operating subsidiaries (which is why the strategy is called "single point of entry"). The FDIC would organize and oversee a bridge financial company to which the FDIC would transfer the assets from the failed SIFI's receivership estate, including the failed SIFI's operating subsidiaries. These subsidiaries would continue to operate as subsidiaries of the bridge financial company. Meanwhile, any losses of these subsidiaries would effectively stay behind in the receivership, and such losses would be absorbed by the shareholders and unsecured creditors of the failed SIFI according to the statutory priority of their claims. After absorbing these losses, any remaining claims of these stakeholders would eventually be satisfied through the receipt of equity and debt securities issued by "NewCo," the recapitalized company that would succeed the bridge financial company.

The bridge financial company would be expected to access funding from customary market sources. In the very likely event that such funding were not immediately available, Title II establishes an Orderly Liquidation Fund ("OLF") to serve as a back-up source of liquidity secured by a pledge of the bridge financial company's assets. The OLF can be used to provide funding directly to the bridge financial company, or it can be used to guarantee private-sector funding to achieve the same goal.

[1] *See* Pub. L. No. 111-203, tit. II (July 30, 2010). In general, a SIFI is a bank holding company with total consolidated assets of $50 billion or more and any nonbank financial company supervised by the Federal Reserve Board as a result of its designation by the Financial Stability Oversight Council.

[2] Prior to enactment of Title II, the FDIC's resolution authority extended only to federally-insured depository institutions.

OLF funding would be repaid from recoveries of the failed SIFI or, in the event such recoveries are insufficient, from assessments on non-failing SIFIs.

The Notice provides further detail regarding important aspects of the strategy, including the following:

- *Appointment of the FDIC as Receiver* – For a SIFI to be resolved under Title II, two-thirds of the Federal Reserve Board and FDIC Board of Directors must recommend appointment of the FDIC to the U.S. Secretary of the Treasury, who is required to consult with the President and ultimately approve the appointment, subject to a one-day period for judicial review if the appointment is challenged. Upon the FDIC's appointment, the FDIC would charter a bridge financial company and appoint a new Board of Directors and Chief Executive Officer.
- *Organization and Operation of the Bridge Financial Company* – The bridge financial company would enter into an operating agreement with the FDIC that would require, among other items, a business plan, including asset disposition strategies that maximize recoveries and avoid fire sales of assets. Day-to-day management of the bridge financial company would continue by the officers and directors, but the FDIC would retain control over high-level matters important to the company's governance. The FDIC would remove and replace management determined to be responsible for the SIFI's failure.
- *Funding* – The FDIC expects that the bridge financial company will be able to raise new funds from private market sources given its strong balance sheet: the bridge company would receive assets from the failed SIFI's receivership estate, while most of the failed SIFI's liabilities would remain with the estate. If the company were nevertheless unable to raise new funds from the marketplace, OLF funding or guarantees would be made temporarily available, subject to statutory restrictions on the overall amount of funding provided.
- *Claims Determination* – Dodd-Frank establishes a claims priority process to be followed by the FDIC in determining payouts to claimants of the failed SIFI's receivership estate. The FDIC is required to treat creditors of the receivership within the same class and priority in a similar manner, except that the FDIC is authorized to treat similarly situated creditors differently if doing so maximizes the return to creditors left in the receivership and if it is necessary to initiate and continue operations essential to the bridge financial company. In any event, under Title II all creditors are required to receive through the FDIC's claims process at least the amount they would have received if the company was liquidated in a Chapter 7 bankruptcy. The FDIC generally expects that shareholders' equity, subordinated debt, and other unsecured liabilities of the failed SIFI (with the exception of credit extended by essential vendors) to remain as claims against the receivership; these claims would not be transferred to and paid in full by the bridge financial company.
- *Capitalization of NewCo* – SPOE provides for the payment of stakeholders' claims in the receivership – to the extent that resources are available to pay such claims – through the transfer to such stakeholders of securities in NewCo, the company that will succeed the bridge financial company. Such securities will likely take the form of equity, debt, and possibly contingent equity such as warrants or call options. In order to effect such a transfer of securities, the FDIC first would be required to approve the bridge financial company's valuation using independent experts. Following the valuation, the bridge financial company would issue audited financial statements as promptly as possible based on the "fresh start" model, which requires a determination of the fair value measurement of the assets of the company based on the price at which each asset would be transferred between market participants at an

established date.[3] The Notice provides a helpful illustration of how the capitalization process for Newco would proceed based on a hypothetical resolution. In the illustration, shareholders and subordinated debt holders of the failed SIFI lose their entire claims but receive call options, warrants, or other contingent value rights in NewCo; unsecured debt holders lose a small portion of their claims but receive equity, subordinated debt, and unsecured debt in NewCo; and secured debt holders remain secured debt holders of NewCo.

- *Restructuring and the Emergence of NewCo* – The FDIC expects the bridge financial company would exist for six-to-nine months until the failed SIFI's claims were converted to NewCo's securities as part of the NewCo capitalization process. In addition, the bridge financial company would be terminated only upon the FDIC's approval of a restructuring plan under which NewCo would be resolvable in the future under the Bankruptcy Code, without having to resort once again to Title II resolution in the event of its failure.
- *Reporting* – The bridge financial company would continue to comply with disclosure and reporting requirements under banking and securities laws, although the FDIC would work with the Securities and Exchange Commission to set appropriate disclosure standards if standards cannot be met because audited financial statements are not available for the bridge financial company. The FDIC would provide the best available information regarding the financial condition of the bridge financial company to the SIFI's creditors.

REQUEST FOR COMMENT

The Notice requests comment generally on the SPOE strategy and specifically on a number of issues:

- *Disparate Treatment of Creditors* – The FDIC is interested in views on whether there should be further limits on the FDIC's discretion to treat similarly situated creditors differently or ways to assure creditors of the prospective use of such treatment. The agency has already committed by regulation not to use this authority to provide preferred treatment to any unsecured obligation having a term exceeding one year.[4]
- *Use of the OLF* – The FDIC requests comment on OLF funding, its restrictions, and the FDIC's efforts to address the liquidity needs of the bridge financial company.
- *Perceived Funding Advantages of SIFIs over Small Institutions* – SIFIs may have a perceived funding advantage over smaller competitors due to the market expectation that SIFIs will receive public support in the event of financial difficulties. One goal of SPOE is to undercut this perceived advantage. SPOE enables operating subsidiaries of a SIFI to remain open and operating after resolution, with their creditors likely to be protected from loss as a result of the loss-absorbing function served by the SIFI holding company's equity and unsecured debt; such protection would not be provided by taxpayer funds. The Notice asks whether this protection of operating subsidiary creditors by holding company debt and equity will provide SIFIs with an unfair funding advantage over non-SIFIs that do not hold the same high level of equity and unsecured debt at their holding companies. The Notice further asks whether any perceived funding advantage may contribute to consolidation in the banking industry. The FDIC also asks whether there are other measures or methods that could be used to address any perceived funding advantage.
- *Required Capital and Debt for SPOE to be Effective* – For SPOE to be effective, it is critical that the top-tier holding company maintain a sufficient amount of equity and unsecured debt to absorb all losses of operating subsidiaries by recapitalizing them, and have enough left over to

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[3] The fresh start model generally is applied to companies emerging from bankruptcy under Chapter 11 of the Bankruptcy Code to determine their reorganization value and establish a new basis for financial reporting.

[4] *See* 12 C.F.R. § 380.27(b)(1).

recapitalize the holding company as NewCo – thereby allowing termination of the bridge financial company. The Federal Reserve is considering a minimum unsecured debt requirement for SIFIs and prepositioning of the proceeds of this minimum debt. The FDIC is interested in views on the amount of equity and unsecured debt that would be needed to effect an SPOE resolution, and whether the minimum amount should be calculated as a proportion of risk-based capital or of leverage capital. It also seeks comment on the types of debt and maturity structure that would be optimal for an SPOE resolution.

- *Foreign Operations of the Bridge Financial Company* – One challenge of an SPOE resolution is to avoid or minimize the potential negative effects of ring fencing of the SIFI's foreign operations by foreign supervisors in those jurisdictions. A requirement that SIFIs structure foreign operations as standalone subsidiaries could help address this challenge, but such required "subsidiarization" could have other negative consequences in terms of trapping capital and debt in different jurisdictions around the world. In this context, the FDIC requests comment on whether a subsidiarization requirement would facilitate the resolution of a SIFI and whether it would reduce the likelihood of ring fencing. Conversely, the FDIC also asks whether a branch structure provides funding efficiencies and the flexibility to manage liquidity and credit risks globally.
- *Cross-Border Cooperation Among U.S. and Foreign Regulatory Authorities* – The FDIC requests comment on the most important additional steps that can be taken with foreign regulatory authorities to achieve a successful resolution using SPOE.
- *Capitalization of NewCo through Conversion of Debt into Equity* – The FDIC asks whether there are any particular creditors or groups of creditors for whom the securities-for-claims exchange strategy would be particularly difficult or be unreasonably burdensome.
- *Valuation of the Bridge Financial Company's Assets* –The FDIC asks whether the issuance to creditors of contingent value securities would be an effective tool to accommodate inevitable uncertainties in valuation. Which characteristics, such as term or option pricing, would be useful in structuring such securities, and what is an appropriate methodology to determine these characteristics?
- *Information to be Reported by the Bridge Financial Company to the Public* – The FDIC requests comment on the information, reports, or disclosures by the bridge financial company that are most important to claimants, the public, or other stakeholders. What additional information or explanation about the claims process would be useful in addition to the information already provided by the Notice?
- *SPOE Effectiveness* – The FDIC welcomes comment on whether there are factors that should be considered as to whether SPOE would be effective for a particular SIFI. Also, is there an alternative to the SPOE strategy that would, in general, provide better results considering the goals of mitigating systemic risk to the financial system and ensuring that taxpayers would not be called upon to bail out the company?

Comments are required to be submitted within 60 days of the Notice's publication in the Federal Register.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our financial institutions practice group:

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