



Banking Brief White Paper Series

Ending “Too-Big-to-Fail”:

Title II of the Dodd-Frank Act
and the Approach of
“Single Point of Entry” Private Sector Recapitalization
of a Failed Financial Company

January 2013

Ladies and Gentlemen:

The Clearing House is pleased to present this White Paper on the crucial issue of “Ending Too-Big-to-Fail: Title II of the Dodd-Frank Act.” Drawing on the experience gained through TCH’s recent Resolution Simulation Exercise, the White Paper concludes that a Title II “single point of entry” private sector recapitalization provides a viable process for handling the failure of a large, complex financial institution without significant systemic consequences and without cost to taxpayers. The Clearing House gratefully acknowledges the contribution of its Owner Banks and John Dugan and Keith Noreika at Covington & Burling LLP in the development of this paper.

The White Paper notes, at the outset, that a special resolution arrangement for large, complex financial institutions is consistent with, rather than a departure from, the general approach adopted by Congress over decades. Recognizing that financial institutions are different from commercial and industrial companies, special statutory resolution regimes have long been established for banks, insurance companies, and broker-dealers. The Title II resolution arrangement is available only when the pre-existing resolution mechanisms – e.g., bankruptcy for the holding company and FDIC-administered resolution for the bank – would result in significant adverse systemic consequences. It ends the perceived “too-big-to-fail” problem in the United States by requiring that shareholders lose their entire investment, creditors bear all the remaining losses, culpable management is terminated, and no cost is imposed on the taxpayer.

The White Paper – like the Simulation Exercise – addresses only a so-called Title II “single point of entry” private sector recapitalization approach to the failure of a large, complex financial institution. Under that approach, the FDIC establishes a bridge company to which the parent company’s assets, predominantly the stock of its operating subsidiaries, are transferred along with secured creditor liabilities, while the unsecured liabilities and equity are retained in the receivership estate. Capital shortfalls in the operating subsidiaries are restored by a down-streaming of assets from the parent holding company and the extinguishment of debt of the operating subsidiaries to the parent holding company. Any necessary liquidity not provided by the private sector would be provided by the Orderly Liquidation Fund (“OLF”) established under Title II, but the OLF is fully protected against any loss by the priority of its claim on the bridge company and its ultimate call on all other systemically important financial institutions for any short-fall. The bridge company is ultimately recapitalized, similar to a Chapter 11 bankruptcy, by converting the creditors’ claims into the equity of the bridge company.

It is important to emphasize that the “single point of entry” private sector recapitalization approach is not the only possible resolution option under Title II. There could be, for example, one or more sales of principal operating subsidiaries and a liquidation of the remaining assets and operations. Or, if a

depository institution or other operating subsidiary were not salvageable because of contingent liabilities, it could be separately resolved. It is also important to emphasize that Title II can be invoked only if resolution under the Bankruptcy Code and the existing bank resolution regimes would not prevent serious adverse systemic consequences. Accordingly, Title II in any form would only rarely be used, and the resolution mechanisms existing before Dodd-Frank would continue to be the preferred method for handling banking institution failures. Title II does, however, provide an important “safety valve” for use in extraordinary circumstances where failure poses significant adverse systemic risks.

Regulators are working to develop more specific rules relating to how to deal with failures of financial institutions under the pre-Dodd-Frank resolution framework as well as under Title II, and will have to take into account differences among institutions as they do so. Because the form of Title II resolution for any particular institution cannot be determined *ex ante*, and because the business models of financial institutions potentially subject to Title II differ so widely, regulators should resist imposing on all institutions a “one-size-fits-all” set of requirements designed to facilitate a pre-determined Title II resolution approach. Any such universal requirement, which could include a requirement to hold minimum amounts of long term debt, would inevitably be insufficient for some institutions and impose an unfair and unnecessary burden on others. Instead, we recommend that regulators develop a flexible and clearly targeted approach to any long term debt or other requirements that are intended to facilitate a Title II resolution to ensure that any such requirements are applied only to the relevant universe of institutions and appropriately take into account the differences in the business models of such institutions.

We hope that this White Paper makes a meaningful and constructive contribution to the broader dialogue about the resolvability of large, complex financial institutions and the ongoing preservation of financial stability.

Sincerely,



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President of the Association
EVP and General Counsel of the Payments Company

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I. Executive Summary and Overview of “Single Point of Entry” Private Sector Recapitalization Approach

Banks and other financial institutions perform critically important functions for the real economy: transforming short-term, liquid deposits and debt into longer-term, less liquid loans and investments. But these critical functions also make financial institution susceptible to severe liquidity problems that can spread to the financial system and cause deep economic contraction. In particular, some of the worst problems of large distressed financial institutions arise from short-term deposits not covered by deposit insurance and from other short-term obligations that can “run.” With little or no advance notice, these uninsured depositors and short-term creditors have the ability to withdraw funds that they have lent to a financial institution or to decline to renew obligations as they come due. When they do so suddenly and in large quantities – a run – the financial institution may not have enough cash on hand or readily available from third parties to meet the surge in demand. If it does not, it will fail. When that happens, those depositors and short-term creditors that were first in line would have gotten all of their money out before the institution failed, while those at the back of the line still waiting for their money would suffer severe losses. Knowing this can happen, uninsured depositors and short-term creditors have a very strong incentive to withdraw their funds immediately whenever a financial institution shows signs of serious distress – real or perceived – even if that withdrawal will help precipitate the very failure that they are trying to avoid.

A run can quickly spread from a sick institution to a healthy one if uninsured depositors and short-term creditors begin to believe or fear that the same type of losses will

emerge in other institutions, or that the failure of one financial institution will cause losses and failures at others that are its customers or counterparties. The resulting loss of confidence and panic can bring the financial system to a grinding halt, as it nearly did in the fall of 2008 prior to massive government intervention.¹

This in turn can cause severe damage to the real economy. Rather than making loans or investments, financial institutions increase their cash reserves to meet the extreme and unpredictable demand for withdrawals.² With severely reduced credit and investment capital available to them, businesses contract and lay off workers, and households severely curtail spending.³ The result is recession and, in severe cases, depression.⁴

To avoid these potentially severe systemic shocks to the economy, financial institutions, and especially banks, have long been subject to a high level of government regulation designed to prevent their failure. Indeed, in the wake of the financial crisis, the Dodd-Frank Act has substantially increased the regulatory requirements applicable to all financial institutions operating in the United States.⁵ For example, large bank holding companies must now hold far higher levels of common equity and liquidity than was previously required. These and other requirements have made these banking organizations much stronger, safer, and better able to withstand deep financial shocks that might otherwise lead to distress and failure.

But no regulatory regime can – or should – guarantee that financial institutions will never fail. As a result, in addition to imposing extensive regulation to prevent failures, governments have long adopted special measures to address the unique problems that arise when financial institutions do fail. During the extraordinary circumstances of the financial crisis,

however, those specialized regimes proved inadequate at times, especially for large financial institutions that were not banks. The result was either panic-inducing failure – *e.g.*, Lehman Brothers – or government assistance provided to financial institutions like AIG. Among other things, such assistance exposed taxpayers to losses and created moral hazard risks with respect to financial institutions – the perceived “too-big-to-fail” problem.

In the wake of the crisis, there was broad consensus among both policymakers and the financial industry that too-big-to-fail and taxpayer exposure to losses of financial institutions should be eliminated. In most circumstances, generally applicable bankruptcy and bank resolution procedures facilitate the orderly failure of financial institutions – including large and diversified financial companies – just as bankruptcy facilitates orderly failures of other types of companies. But in truly extraordinary circumstances these generally applicable procedures may not be able to result in failures that are orderly. These extraordinary circumstances are ones where the failure under traditional bankruptcy and bank resolution laws is likely to have serious adverse effects on financial stability, for example, by triggering runs, contagion, and panic. These extraordinary circumstances are likely to be rare, and whether they do occur – as they did during the deep systemic panic of the fall of 2008 – will very much depend on the interaction of a number of factors at the time of failure, including the fragility of economic and financial conditions and the size and nature of the financial institution’s business.

What is needed for these extraordinary circumstances is a “safety valve” option that can be used if and when it becomes likely that a failure under generally applicable bankruptcy and bank resolution procedures will have serious systemic consequences. This safety

valve option, however, should be a uniquely designed failure resolution process that incorporates many of the key elements of bankruptcy – imposing losses on shareholders and creditors, rather than taxpayers – while protecting against runs and systemic panic. Congress recognized this, and the result was the “Orderly Liquidation Authority” in Title II of the Dodd-Frank Act,⁶ as supplemented by the “living will” provision in Title I of that Act.⁷ Taken together, these provisions establish a new resolution framework available for those extraordinary circumstances where the failure of a financial institution would clearly present systemic risk. This new failure resolution framework (1) imposes financial institution losses on shareholders and creditors,⁸ (2) flatly prohibits taxpayer payments for such losses,⁹ and (3) enables the resolution of the failure in a manner that, rather than causing runs or financial panic, is *orderly*.

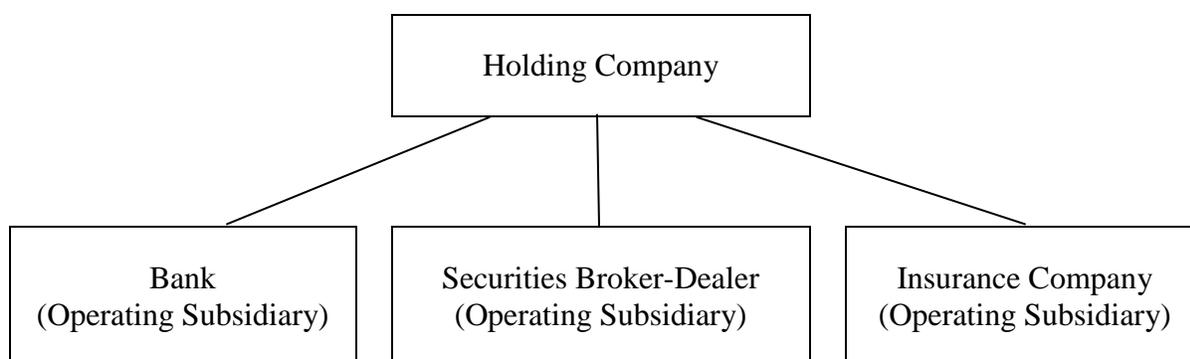
The Dodd-Frank Title II option is meant to be used rarely – again, only in those extraordinary circumstances where a financial institution’s failure and resolution under laws that would otherwise apply would cause severe adverse effects on U.S. financial stability – and only where a finding to that effect is made at the most senior levels of the Treasury Department, Federal Reserve, and the Federal Deposit Insurance Corporation (FDIC).¹⁰ Moreover, this option is consistent with, and not a departure from, the longstanding congressional policy of dealing with the failure of financial institutions. For many years, there have been special resolution regimes for depository institutions, insurance companies, and securities broker-dealers, each of which recognizes the special attributes and characteristics of these institutions and the needs of their customers. Accordingly, the new Title II option is a logical extension of the current resolution regimes for financial institutions and, indeed, strengthens them. Whether it

will be used in a particular case will depend on all the relevant facts and circumstances at the time, including the overall economic and financial scenario, the business and financial condition of the failed financial institution, and the reasons for its failure.

Since the enactment of Dodd-Frank, the FDIC has issued important regulations to implement and clarify the Title II resolution provisions.¹¹ Even more important, agency officials have outlined the FDIC's intent to use its new Title II authority to put a large, complex financial institution, in the right circumstances, through a private sector recapitalization process¹² – in a manner that has important similarities to the type of reorganization and recapitalization that occurs under Chapter 11 of the United States Bankruptcy Code. The Title II approach would, however, not be used except in the extraordinary circumstances of systemic risk described above. For all other situations, failure is more appropriately addressed under the pre-Dodd-Frank resolution regime of the Federal Deposit Insurance Act for the bank and the Bankruptcy Code for the holding company – and in fact, there is considerable flexibility under both statutes to facilitate orderly resolution of financial institutions that vary considerably in terms of size and business model. And the new approach might not be appropriate for the U.S. operations of financial institutions headquartered outside the United States.¹³ But in those extraordinary circumstances where the failure of a financial institution under the pre-Dodd-Frank resolution regime would pose real systemic risk, the FDIC's new resolution approach under Title II is a critical safety valve option for addressing the perceived too-big-to-fail problem.

This new Title II approach reflects the fact that large, diversified U.S. financial institutions are usually structured with a holding company that owns various operating subsidiaries, such as a bank, broker-dealer, and/or insurance company. See Figure 1.

Figure 1: Corporate Structure of Large U.S. Financial Institutions (Simplified)



The problems that can topple this type of organization almost always begin with severe losses at one or more of the operating subsidiaries. The FDIC’s new approach under Title II – the “single point of entry” holding company approach to private sector recapitalization – focuses entirely on having the holding company absorb *all* of the organization’s losses, *including those sustained by its operating subsidiaries*.¹⁴ Thus, rather than fail, a severely distressed operating subsidiary would be restored *by its holding company* to sound financial condition. This would allow the subsidiary to stay open, continuing to serve its customers and the real economy, but under new ownership and new management¹⁵ – just as a failed airline stays open and operating when it is reorganized under Chapter 11 of the Bankruptcy Code. As a result, *the shareholders and creditors of the holding company – not the taxpayer* – would absorb all of the organization’s losses.¹⁶

Under this process, the FDIC would ensure that holding company assets are downstreamed as necessary – either directly or by forgiving debt obligations – to recapitalize any critical operating subsidiary that sustains losses, including a subsidiary bank. As a result, the subsidiary would not fail, but would instead continue to operate and meet all its obligations in full to depositors, creditors, and customers. Meanwhile, however, because the holding company alone would absorb all material losses of its subsidiaries, the holding company alone would likely fail (assuming the losses were sufficiently large).

Under this approach, shareholders of the holding company would absorb first losses. If the losses were large enough, the value of the holding company shares would be eliminated, with holding company creditors absorbing any additional losses in the priority order of their claims.¹⁷ Then, holding company creditors would have a portion (or all) of their remaining claims converted to equity and would become the new owners of the financial institution (just as often occurs in a Chapter 11 reorganization).¹⁸ Meanwhile, management held responsible for the organization's losses would be replaced.¹⁹

There are clear benefits to the single point of entry holding company approach, where only the holding company fails but its critical operating subsidiaries are restored to sound financial condition by *private sector capital*, i.e., the capital provided by existing shareholders and debtholders of the holding company, *not* the taxpayers. In particular, this approach avoids a number of the most disruptive problems that can arise when large, complex financial institutions fail. These problems include, as described above, the potential for severely destructive runs by uninsured depositors and short-term creditors. Likewise, when such an institution fails, its

derivative instruments can be difficult to unwind and can cause close-out disruptions. And the prospect of such problems can also cause foreign regulators to “ring fence” an institution’s assets located in their jurisdictions in an effort to protect local businesses and consumers, making resolution of the total entity far more difficult and disruptive.

But the critical point is that the deposits, short-term obligations, and derivatives causing these problems are either exclusively or primarily issued by the *operating subsidiaries* of financial companies, not by their holding companies. As a result, if only the holding company were placed into receivership and its operating subsidiaries were restored to health, the single point of entry holding company recapitalization would avoid the critical problem of runs by uninsured depositors and short-term creditors of the operating subsidiary: these stakeholders would have no reason to run because their obligations would be satisfied in full. Likewise, there would be no defaults on the derivative instruments issued by the bank subsidiary or other operating subsidiaries. And there would be no incentive for a foreign regulator to ring fence assets of one of these subsidiaries doing business in its jurisdiction: local creditors of the subsidiary would not be suffering losses because the subsidiary would not fail.

Instead, losses would be borne solely by shareholders and creditors of the holding company – and as a practical matter, the credit obligations of the holding company tend to be long-term in duration. This is a key point, *because neither shareholders nor long-term creditors can run*. The single point of entry holding company approach would avoid runs at the recapitalized operating subsidiaries, because stakeholders there would have no reason to run, and also at the holding company level, because the long-term stakeholders there would have no

ability to run. As a result, the failure of only the holding company would likely be more orderly than the failure of *both* the holding company *and* the operating subsidiaries that sustain losses – with the further advantage that key operating businesses would stay open. And a failure of only the holding company would be far less likely to generate panic and runs at healthy financial firms, because depositors, short-term creditors, and derivatives counterparties of the operating subsidiaries of these healthy institutions would take comfort in the notion that the Title II process would not result in their having to sustain losses.

Of course, when the holding company absorbs the losses of its subsidiary, by definition both the shareholders and creditors of the subsidiary benefit. The shareholder benefit is illusory, however, since the holding company is generally the sole shareholder of the subsidiary,²⁰ and the shareholders of the holding company – the ultimate owners of the subsidiary – will likely lose the full value of their shares when the holding company fails. The benefit to creditors of the subsidiary is real, however – the viability of the subsidiary is maintained, and that is what prevents runs.

Despite this fundamental benefit of preventing runs, some may seek to criticize the fact that the single point of entry holding company approach will fully protect all creditors of subsidiaries, arguing that this is a “bailout” that will decrease market discipline and increase perceived “moral hazard” for these subsidiaries. There are multiple rebuttals to this argument. First, the new approach plainly is no “bailout” since none of the subsidiaries’ losses are borne by *taxpayers*; they are instead fully absorbed by *the private sector shareholders and long-term creditors of the holding company*. Second, market discipline will be increased, not decreased:

the very same holding company shareholders and long-term creditors that will be on notice and first in line to absorb losses incurred by subsidiaries will have maximum incentive to restrain excessive risk-taking by these subsidiaries. Third, even with respect to creditors of the subsidiaries, there is no guarantee *ex ante* of full protection in the event of the financial institution's failure: as described above, the Bankruptcy Code and the pre-existing tailored resolution regimes are the preferred alternative under Dodd-Frank, and Title II can be invoked only in extraordinary circumstances of systemic risk. As a result, the risk of loss for creditors of subsidiaries of a holding company will continue to exist until the moment that Title II is invoked and the FDIC announces its intent to use the single point of entry holding company approach to resolve that holding company. The uncertainty of loss protection before that moment acts as a shield against increased perceived moral hazard for the subsidiaries.

By providing additional clarity about the available resolution mechanisms, the single point of entry holding company approach should also benefit the creditors of the holding company. That is, the holding company's recapitalization of the subsidiary and absorption of its losses keeps that subsidiary open and preserves its going concern and franchise value. As a result, when the holding company is ultimately recapitalized under Title II, its creditors are very likely to sustain lower losses than would have otherwise been incurred if the operating subsidiary had been liquidated. Moreover, to the extent that holding company creditor losses are greater than would otherwise be the case, Title II guarantees that they will always recover at least what they would have received in a liquidation of the holding company under Chapter 7 of the Bankruptcy Code.²¹

Finally, the FDIC's approach would provide the agency with substantial flexibility to restructure and/or downsize the recapitalized company as necessary to mitigate against future systemic risk – which is exactly what the agency has said it will do if Title II is ever invoked.²²

In short, the FDIC's single point of entry holding company recapitalization approach under Title II of the Dodd-Frank Act would be the resolution of a failure in which shareholders and creditors of the organization's holding company would absorb the losses, as they should; taxpayers would bear no losses, as they should not; critical operating businesses of the organization would stay open to serve the real economy; new management and new ownership would be put in place; and the failure would not cause runs, defaults on derivatives, or financial panic.

Set forth below is a more detailed description of (1) key limitations of the pre-Dodd-Frank resolution regime; (2) the policy response of Dodd-Frank; and (3) how the FDIC's single point of entry holding company approach under Title II, in the rare circumstances where it is invoked, will work in practice to achieve orderly resolutions without exposing taxpayers to losses – thereby ending the perceived problem of too-big-to-fail.

II. Key Limitations of Pre-Dodd-Frank Failure Regime

As described above, large diversified banking organizations in the United States typically operate through a non-operating holding company that owns operating financial institutions as subsidiaries, including one or more banks. Before enactment of the Dodd-Frank Act in 2010, the failure regime applicable to such organizations was bifurcated. The holding

company was subject to the Bankruptcy Code, just like most industrial and commercial companies that become insolvent.²³ But the bank subsidiary was (and remains) subject to a special insolvency regime tailored to the unique features of banks, which is administered by the FDIC.²⁴ This specialized banking regime includes unique rules designed to protect depositors and the deposit insurance fund, avoid depositor runs, and achieve swift and orderly resolutions of failed banks in a manner that minimizes disruptions to bank customers, the bank's community, and to the banking system more generally.

Similarly, before 2008 large financial holding companies that owned securities broker dealers or insurance companies were subject to a bifurcated failure regime: the Bankruptcy Code for the holding company, and a specialized insolvency regime for the broker-dealer, administered by the Securities Investor Protection Corporation, or for the insurance company, administered by state insurance regulators.²⁵

These bifurcated regimes worked well for a range of institutions. In particular, the bank failure regime administered by the FDIC proved to be very effective in dealing in an orderly way with the wave of depository institution failures of the 1980s and 1990s,²⁶ and the same was true for hundreds of depository institutions (including some regional and larger institutions) that have failed since the beginning of 2007. In most of these cases, the failure resolution was straightforward: the failed depository institution was the sole or predominant asset of the holding company; its balance sheet was relatively simple (deposits and loans); and the resolution was facilitated by an acquiring bank willing to take on all or most of the assets and liabilities of the failed bank, with limited assistance provided by the FDIC through the deposit

insurance fund. In addition, the orderliness of resolutions was helped by the fact that the FDIC's governing statute provides the agency with special powers as receiver of the failed depository institution to act swiftly, usually over a weekend, to facilitate an acquisition by a healthy acquirer.

Another helpful special power of the FDIC as receiver for depository institutions is the ability to administer the insolvency claims process in a more expedited manner than is possible under the Bankruptcy Code.²⁷ In addition, in certain circumstances the FDIC has limited power to provide differential treatment to depository institution creditors from the same priority class – for example, by providing full payment of the claims of some unsecured creditors, while providing others only partial payment.²⁸

The FDIC has other specialized powers to handle depository institution failures in an orderly manner that are particularly useful for larger or somewhat more complex institutions. It can, for example, establish a “bridge bank” into which the agency temporarily transfers some or all of the assets and liabilities of the failed depository institution.²⁹ This allows the FDIC to buy precious time: it can operate the bridge bank as a going concern until the agency can either find a third-party buyer, return the institution to the private markets through a public offering, or liquidate the depository institution in an orderly manner.³⁰

The FDIC can also secure funding for a failing institution or bridge bank³¹ – which is absolutely critical for such institutions since a substantial portion of their liabilities are short-term deposits that can run. For example, because a bridge bank is typically chartered as a national bank, it may issue insured deposits, and it has limited access to secured borrowing from

the Federal Reserve's discount window. In certain circumstances the FDIC can also provide "working capital" financing to facilitate the disposition of assets of failed depository institutions.³²

Using all of these tools, the FDIC has been able to resolve a wide range of depository institutions in a manner that is orderly. However, because the FDIC's insolvency regime applies only to depository institutions, before the Dodd-Frank Act the agency had no jurisdiction over the failure of a depository institution's holding company or of nonbanking subsidiaries of the holding company. Accordingly, these special tools available to the FDIC to manage the failure of a depository institution in an orderly manner were *not* available to the FDIC – or any other agency – to manage the failure of the holding company or nonbank subsidiaries of a large or complex financial institution, even in those extraordinary circumstances where the failure could cause systemic risk. As described above, the insolvencies of these other legal entities were exclusively governed by the Bankruptcy Code or other specialized failure regimes. Thus, where – as is common – a large multi-faceted bank holding company owns several nonbanking subsidiaries that engage in a substantial amount of financial activities, and these subsidiaries in turn have their own substantial credit relationships with third parties, the bifurcated failure regimes have created significant difficulties.³³ In particular, the FDIC has been unable to use its special bank resolution powers to address failures that occur outside a bank either in the bank's parent holding company or in its affiliated nonbanking entities – even though severe problems in these affiliated entities can potentially precipitate a run on the bank.

At the same time, in extraordinary circumstances involving severe systemic risk – as occurred in the fall of 2008 – the existing provisions of the Bankruptcy Code may prove inadequate to address the insolvency of a large nonbank financial institution that has substantial amounts of short-term creditors that can run, as was the case, for example, with Lehman Brothers and AIG. Just as is true of banks that fail with large amounts of uninsured deposit liabilities, other types of financial institutions that similarly rely on short-term funding need to be resolved swiftly when they fail in order to avoid runs – especially during a period of widespread concerns about investor confidence. Likewise, in such extraordinary circumstances, it is possible that market participants will refuse to provide new funding to the institution if short-term creditors decline to renew their funding as it comes due. As a result, there may need to be an alternative source of funding available to prevent the institution from seizing up and immediately shutting down its operations. *The fundamental point is that funding is the critical fuel that financial institutions require to operate and keep their doors open.*

Unfortunately, and unlike the depository institution failure resolution regime, the Bankruptcy Code may be slow, particularly during period of systemic stress. In addition, its special “Debtor-in-Possession” mechanism to encourage private sector funding may prove inadequate for a failed financial institution during a period of systemic risk; private sector creditors are likely to shy away because of the deep uncertainty about the institution’s balance sheet and prospects for timely repayment. Also, bankruptcy courts have no special expertise to deal with the peculiar problems arising in large, complex financial institution failures. In extraordinary circumstances presenting real systemic risk, these attributes of the Bankruptcy

Code can be problematic, as was evident in the financial crisis of 2008. There, Lehman Brothers suffered a run that precipitated a sudden and disorderly bankruptcy under the Bankruptcy Code with significant adverse systemic consequences.³⁴ The prospect of a similar run, defaults on derivatives, and an even more disorderly bankruptcy of AIG prompted the Federal Reserve and ultimately the Treasury to inject large amounts of capital into it, exposing taxpayers to potential losses.³⁵ The FDIC was able to execute a reasonably orderly resolution of the failure of Washington Mutual, then the country's largest thrift institution, but in that case the vast majority of the institution's assets were in the insured depository institution subsidiaries; the organization's balance sheet was relatively uncomplicated (loans and deposits); there was a buyer available (JPMorgan Chase) to assume all the assets and senior unsecured liabilities of the failed depository institution; the organization did not engage in a substantial amount of nonbanking businesses; the holding company did not have a substantial amount of short-term liabilities at risk; and the bank itself had a substantial amount of subordinated debt that absorbed losses such that the FDIC sustained no losses in the resolution.³⁶

In sum, the 2008 financial crisis demonstrated the limitations of the failure resolution regime applicable to large and multi-faceted failing U.S. financial institutions during an extraordinary period of systemic instability. Regulators and policymakers faced the terrible choice between chaotic, panic-inducing bankruptcy or extraordinary taxpayer assistance and exposure to losses. While the traditional bifurcated failure resolution regime can prove adequate for such institutions in ordinary circumstances, there was and remains a consensus that it can also prove inadequate in extraordinary circumstances involving systemic risk and market distress.

The result of this consensus was the development of the new Title II safety valve option for the failure of those financial institutions that, in certain circumstances, could cause severe systemic disruption.

III. The Dodd-Frank Response: Orderly Liquidation Authority, Living Wills, and a Flat Prohibition on Taxpayer Bailouts

Set forth below is a description of the key characteristics of the new Title II regime.

A. Applicability to All Systemically Important Financial Institutions

Title II may apply only in the limited circumstances of a “financial company” whose failure under the Bankruptcy Code or other applicable resolution regimes “would have serious adverse effects on the financial stability of the United States.”³⁷ A “financial company” includes not only bank holding companies, but any nonbank financial company designated by the Financial Stability Oversight Council as a systemically important financial institution, as well as any other company that is predominantly engaged in financial activities.³⁸ This provision ensures that a systemically important financial company like AIG, which was lightly regulated before the financial crisis in key parts of its operations but ultimately required an infusion of \$180 billion in taxpayer funds, can be regulated and resolved in the same orderly manner as a systemically important banking organization.

B. Taxpayer Payments for Losses Flatly Prohibited

Title II provides simply, expressly, and categorically that “[t]axpayers shall bear no losses from the exercise of any authority under [Title II].”³⁹ While some have asserted that the new law somehow preserves the government’s ability to pay for these losses at large

financial institutions, the statutory language clearly makes such payments unlawful; they cannot be made.

C. New Regime to Apply Only When Absolutely Necessary

Title II prohibits the use of the new failure regime except in extraordinary circumstances where systemic stability is threatened.⁴⁰ In all other cases, the pre-Dodd-Frank regime remains in place, with the Bankruptcy Code providing a credible resolution framework, and specialized insolvency regimes, such as the depository institution receivership provisions, sometimes applying as well. To ensure that use of the Title II regime is rare, the statute establishes substantial procedural hurdles that must be cleared, as well as clear accountability from the highest levels of the federal government.⁴¹ That is, two-thirds majorities of the Federal Reserve Board and the FDIC Board must recommend its use.⁴² In addition, based on that recommendation, the Secretary of the Treasury, after consulting with the President, can only invoke the new regime if the Secretary determines that, among other things, the failure of the company and its resolution under the Bankruptcy Code and otherwise applicable law would have serious adverse effects on the financial stability of the United States, and that the application of Title II would avoid or mitigate such adverse effects.⁴³

Of course, because Title II will rarely be invoked, it is critically important for both markets and non-U.S. regulators that the FDIC provide as much transparency as possible – in advance – about its generally preferred course of action for this type of resolution.⁴⁴ As described below, the FDIC has stated publicly that the single point of entry holding company

approach is its preferred course of action under Title II,⁴⁵ and it is anticipated that even more clarity on this point will be provided in formal guidance or a rulemaking in the coming months.

D. “Living Wills” Required

Consistent with the principle that the Title II regime should only be invoked in the rarest of circumstances, the statute requires large bank holding companies and other covered financial institutions to prepare resolution plans or “living wills” that describe how the company could be resolved in an orderly fashion under the Bankruptcy Code and other applicable regimes – not Title II.⁴⁶ Notwithstanding the many benefits of the single point of entry holding company approach under Title II, the bifurcated Bankruptcy Code and specialized resolution regimes are expected to be workable in the vast majority of financial institution failures – and the living will process will help ensure that result, making the traditional resolution process more orderly in a broad range of circumstances that can be anticipated and addressed through careful advance planning.

The extensive planning process for these living wills, which must be updated every year, should produce substantial collateral benefits as well. For example, the information and insights gathered in this annual process will prove valuable not just for a Bankruptcy Code resolution, but also, where extraordinary circumstances demand it, for a Title II resolution. In addition, the extensive annual review and evaluation of the plans by the FDIC, the Federal Reserve and other regulators should greatly facilitate the development and maintenance of the ongoing knowledge and expertise base they will need to resolve large, complex financial

institutions – whether that resolution occurs under the Bankruptcy Code, the depository institution receivership regime, or Title II.

E. Management Replaced

If Title II is invoked, the statute expressly requires replacement of the management responsible for the failed financial condition of the company.⁴⁷ It also authorizes the FDIC to recoup two years of compensation from any senior executive or director that was substantially responsible for that failed condition.⁴⁸ This new set of requirements, which does not exist under the Bankruptcy Code, will make it easier and more orderly to put new management in place to reorganize the institution than would otherwise be the case, create disincentives to take undue risk, and increase confidence in the process.

F. New Failure Regime to Maximize Resolutions that Are Orderly

Given the systemic consequences that can potentially arise as a result of the failures of systemically important financial institutions – runs, defaults on derivatives, “ring-fencing” in foreign jurisdictions, market turmoil, and contagious panic – the new Title II regime is designed to assure that resolutions of such failures are *orderly*. Like the Bankruptcy Code, Title II imposes failure losses on shareholders and creditors, not the taxpayer;⁴⁹ but it does so in a manner that avoids the problems that can precipitate financial instability, panic, and the public pressure on the government to provide extraordinary assistance that exposes taxpayers to loss. Set forth below are the key features of the new regime that are designed to facilitate private sector recapitalizations of failed financial institutions that are orderly.

1. Depository Institution Receivership Regime as Model

As described above, the specialized depository institution receivership regime is expressly designed to maximize the orderliness of depository institution resolutions and minimize disruptions to communities and the banking system. This regime has in fact worked very well – and should continue to work well – to achieve the orderly resolution of the failures of a wide range of depository institutions. As a result, the new Title II regime is largely (though not exclusively) modeled on the depository institution receivership regime, adopting many of the unique tools that the FDIC has historically used in the depository institution context to promote orderly resolutions, including the use of bridge companies, providing access to ready sources of temporary liquidity funding if needed, and expediting the claims process.

2. Expertise

The FDIC will be appointed receiver for any failed financial company that is subjected to the Title II resolution regime,⁵⁰ just as it is appointed receiver for failed depository institutions.⁵¹ Thus, unlike bankruptcy judges who have no specialized knowledge or expertise associated with failed financial institutions, the FDIC as Title II receiver will be able to tap the substantial institutional expertise it has developed in resolving hundreds of failed depository institutions under a specialized resolution regime that is very similar in many ways to the new Title II regime. While it is true that the FDIC’s resolution experience has been much more focused on smaller institutions rather than larger ones, that experience is nevertheless valuable. The agency has also had relevant experience with the failures of some of the largest depository institutions (*e.g.*, Washington Mutual, Continental Illinois, and First Republic). And perhaps

most important, in the wake of Dodd-Frank and its annual living will process, the FDIC has developed and will continue to build an understanding of the very largest institutions that is clearly focused on resolution planning; this expertise should prove invaluable in the unlikely event that Title II must be invoked.

3. Speed

Because a large portion of their funding is short-term and subject to runs, banks depend fundamentally on creditor confidence to stay in business. Long periods of uncertainty about the fate of a distressed or failing institution can sap that confidence, cause creditors to run, and accelerate the institution's failure in an extremely disorderly manner.⁵² As a result, in extraordinary circumstances of systemic risk, an orderly failure of a financial institution can depend very much on the ability to take swift actions to maintain or restore creditor and customer confidence. Unfortunately, the Bankruptcy Code resolution process can be slow and cumbersome. Title II addresses this problem through provisions designed to expedite the recapitalization process, some drawn from the depository institution receivership regime, and others put in place for the first time. For example, the process for invoking Title II can be accomplished in 24 hours,⁵³ and even faster with the consent of management and the board of directors of the failing institution⁵⁴ – and there are strong incentives for them to provide such consent.⁵⁵ Similarly, the FDIC can immediately establish a bridge financial company, described below, to temporarily take over the critical businesses of the failed company and run them pending the company's orderly private sector recapitalization (or other ultimate resolution).⁵⁶

4. Bridge Financial Company

A critical aspect of the new Title II resolution regime is its authorization of the FDIC to establish a “bridge financial company” to temporarily take over the critical businesses, assets, and liabilities of a failed large holding company pending its orderly private sector recapitalization (or other resolution).⁵⁷ In the depository institution receivership context, it may not always be possible to have a buyer ready to purchase a distressed bank at the time of its failure, especially a larger or more complex bank. It therefore obtained authority from Congress to establish a “bridge bank” to take over the failed bank’s critical businesses and run them on a temporary basis until it could find a buyer for all or parts of the bank’s operations, or, failing that, liquidate the institution. As described previously, buying time with a bridge bank results in a resolution that is orderly, since it avoids franchise value destruction and the enormous disruption and widespread impact that would result from an immediate “fire sale” liquidation. It also allows the FDIC to obtain more proceeds from the later sale of the entity as a going concern, where franchise value is preserved, than would be the case with an immediate liquidation, thereby lowering its costs and preventing unnecessary losses.

The rationale for Title II’s bridge financial company is similar. Where no buyer is poised to purchase a failed financial company, the new authority will allow the FDIC to immediately, but temporarily, take over and keep operating the critical businesses of that company. It will also allow the agency to provide immediate assurances to the marketplace about the bridge financial company’s continued access to funding (see below) and ability to satisfy any new obligations incurred by the company. Such assurances in a time of crisis are

critical to maintaining customer and counterparty confidence and to avoiding the risks of contagion – that is, runs on healthy institutions by depositors and creditors who fear losses, even where those fears are entirely irrational.

5. Temporary Liquidity Funding

As previously discussed, access to temporary liquidity funding is absolutely essential to the day-to-day operation of financial institutions; it is the basic fuel for their activities. When a financial institution becomes distressed and approaches failure, its short-term creditors will run if they believe that there is any chance that their funding to the institution will not be repaid in full. However, even a failed institution needs liquidity funding in order to maintain critical operations and franchise value until it can be sold, recapitalized, or liquidated in an orderly manner. Conversely, without such funding, the institution would seize up immediately and create extreme disruptions in a fire-sale liquidation process – the very opposite of an orderly resolution – with severe systemic consequences. There is a long-standing historical responsibility of central banks to act as the “lender of last resort” by providing liquidity to both individual financial institutions and financial markets more broadly.⁵⁸ The goal of such measures is to prevent failures which can result in market contagion and knock-on effects throughout the financial system.⁵⁹ The provision of liquidity funding under Title II is an essential extension of these historical principles.

The “debtor-in-possession” or “DIP” financing authorized under the Bankruptcy Code can be a very powerful tool to provide a credible framework for a failed financial company to obtain necessary funding from private market participants. However, in extraordinary

circumstances involving systemic risk and severely depressed market confidence, it may not be possible to obtain adequate amounts of market funding on the expedited basis needed for an orderly resolution of a failed financial institution. Although potential DIP creditors receive a super-priority lien as an inducement to provide such funding, the very real concern is that, in a period of financial crisis, they might shy away from a failed financial institution because of the deep uncertainty about the value of the institution's balance sheet and the possibility of delays in repayment. Indeed, these were the very concerns that caused private market creditors during the recent financial crisis to refuse to lend to distressed institutions even when fully secured by U.S. Treasury obligations.⁶⁰

Title II expressly recognizes the critical need for temporary funding for a failed institution pending its recapitalization by shareholders and creditors, as well as the very real possibility that market funding will not immediately be available once failure occurs. It does this by providing a source of temporary liquidity funding that the FDIC may obtain from the Treasury Department in order to lend to the failed company, but the FDIC has stated that the agency would not expect to resort to such funding unless private market funding proves unavailable.⁶¹ In any event, this temporary government funding *cannot* be used as a taxpayer bailout in disguise, *because the statute flatly prohibits the use of this funding as a means to shift losses of the failed institution to taxpayers.*⁶² Indeed, the statute includes *five* strong safeguards to ensure that taxpayers *never* sustain losses from such funding.

First, any loans made to the failed company take first priority ahead of *all* unsecured creditors, in terms of claims on the unencumbered assets of the company.⁶³ This

safeguard, by itself, should be more than adequate to ensure repayment of any loans made by the FDIC in nearly all circumstances.

Second, there is a statutory cap on the amount of temporary loans that may be provided.⁶⁴ Within 30 days of the appointment of the FDIC as receiver under Title II, the total amount lent by the FDIC to the failed company may not exceed 10 percent of the book value of the company's consolidated assets (or, if the FDIC has calculated the fair value of the company's assets, 90 percent of their fair value).⁶⁵ After the 30-day period, the 90-percent-of-fair-value cap continues to apply.⁶⁶

Third, the Secretary of the Treasury may not provide funds to the FDIC unless the two entities enter into an agreement that (1) provides a specific plan and schedule for full repayment of the funding and (2) demonstrates that the FDIC will receive proceeds from the liquidation of the assets of the failed company and from any other sources that will be sufficient to repay the loans within the period agreed to in the plan.⁶⁷ This written and transparent plan will put further pressure on the two government bodies to ensure that taxpayer losses never occur.

Fourth, in the highly unlikely event that the assets of the failed company prove inadequate to fully repay the temporary funding, the FDIC will impose "clawback" assessments on certain creditors of the failed company (with limited exceptions) to the extent that they received certain payments in excess of the amounts that they would have received if the failing company had been liquidated under Chapter 7 of the Bankruptcy Code.⁶⁸

Fifth, in the even more unlikely event that the proceeds from the assets and the clawback payments are insufficient to fully repay the amounts outstanding, then the statute requires the FDIC to recover any remaining difference by imposing risk-based assessments on financial institutions with consolidated assets of \$50 billion or more.⁶⁹ This final line of defense ensures that taxpayers will *never* be tapped for losses because the potential assessment revenue from the aggregate resources of large financial institutions is immense. In addition, making healthy, large financial institutions ultimately responsible for extraordinary losses associated with the orderly failure resolution of “one of their own” is fully consistent with the deposit insurance system that has applied to depository institution failures for 80 years; there, through industry assessments mainly by large banks, healthy depository institutions have always paid for the costs of orderly resolution of failed depository institutions that are not absorbed by shareholders and creditors.⁷⁰

a) Budget Scoring of Temporary Funding: Loans v. Guarantees

Notwithstanding the safeguards described above, concerns have been raised about Congressional Budget Office (CBO) projections that the liquidity funding in Title II will result in an approximately \$20 billion increase in federal spending, with the implication that that constitutes evidence of taxpayer payment for losses.⁷¹ That is not the case, however. The projected net increase in federal spending arises only because of the peculiar timing assumptions of federal budget scoring, as CBO recognized.⁷² It is an apparent, not real, projected increase in total spending.

The CBO projections assume that, despite all the Dodd-Frank changes to make financial institutions safer, one or more large, complex institutions will fail; that the Title II resolution authority will be invoked to address these failures; and that the FDIC's subsequent actions will affect the federal deficit. It is true that amounts lent by the FDIC to a failed financial company under Title II would "score" as federal spending. But it is also true that the repayment of such loans from sales of the company's assets or from industry assessments would score as federal receipts. *The disconnect occurs because the CBO projections are limited to a finite period of 10 years.*⁷³ The CBO (for undisclosed reasons) assumed that, sometime in the next ten years, loans would be extended to the failed company or companies and that full repayment would not occur until *after* the expiration of the budget scoring period. Solely as a result of this timing assumption, the CBO projections captured the increase in federal spending resulting from the extension of loans that occurred before the end of the scoring period, but it did not capture the offsetting decrease in federal spending resulting from the repayment of the loans occurring after the end of the scoring period, as required under Title II. The result was a substantial net projected increase in federal spending that does not factor in subsequent projected receipts, as the CBO itself acknowledged.⁷⁴ The asserted increase in the deficit – and the asserted "savings" if Title II did not exist – are entirely imaginary.

6. Treatment of Derivatives

Swaps and other derivative instruments typically allow a party to terminate a derivative contract in the event of a counterparty's failure. Some instruments also allow termination where an affiliate of a counterparty defaults – a so-called "cross-default" provision.

As a result, the failure of a financial institution with a large derivatives business could trigger a wave of derivative terminations that could be disruptive. Drawing on a comparable provision in bank receivership law, Title II precludes derivative counterparties of a covered failed financial company (which does not include a bank) from exercising such termination rights based solely on the company's failure – so long as the failed company's derivative contracts are transferred to a third party, such as the bridge financial company, within 24 hours of the appointment of the Title II receiver.⁷⁵

This protection from close-out may not be as important in a single point of entry recapitalization, because only the holding company would fail, and unlike its subsidiaries, the holding company would be unlikely to have a substantial amount of direct derivatives exposures. But a related provision in Title II could prove considerably more important for such recapitalizations. That is, based on an express provision in Title II,⁷⁶ the FDIC has clarified by regulation that the same preclusion on counterparty termination applies to prevent a cross-default termination where a counterparty's *affiliate* is a failed financial institution that has been placed into receivership under Title II.⁷⁷ For example, if a holding company fails and is placed into receivership under Title II, but its operating subsidiary does not fail, a derivatives counterparty to the operating subsidiary may not invoke a cross-default provision to terminate a derivatives contract solely because of the failure of the operating subsidiary's parent.⁷⁸

These derivatives provisions in Title II will make resolutions of financial institutions holding large amounts of derivatives far more orderly than would otherwise be the case.

7. Potential for Differential Treatment of Similarly Situated Creditors

Under Title II, the FDIC may in limited circumstances make greater payments to some creditors within a creditor class than to others, so long as all creditors receive at least as much as they would have received in a liquidation under Chapter 7 of the Bankruptcy Code.⁷⁹ This is very similar to the differential payment power that the FDIC has had and used judiciously for decades under the depository institution receivership regime.⁸⁰

Concerns have been raised that the FDIC could abuse this authority to unfairly favor certain groups of creditors, depending on the circumstances.⁸¹ But given the agency's long history of administering comparable authority in the similar context of failed depository institutions,⁸² there is no historical basis for this concern. Moreover, in rulemaking, the FDIC has squarely addressed the issue.⁸³ First, it has interpreted Title II to flatly prohibit more favorable treatment for longer-term creditors within a priority class, *i.e.*, obligations with terms longer than 360 days.⁸⁴ Second, for shorter-term unsecured creditors, it has made clear that it will only use this authority to treat them more favorably when it is truly necessary for an orderly resolution, such as protecting trade creditors when transferring critical businesses to a bridge financial company in order to receive the essential services necessary to keep the businesses open and operating.⁸⁵ In addition, because of the potential controversy associated with even these limited actions to deviate from the otherwise applicable statutory priority of claims, they could only be taken with the specific approval of the full Board of Directors of the FDIC.⁸⁶ And again, under no circumstances could the FDIC use this authority to deny the failed holding company's creditors the full amount that they would have received under a Chapter 7

Bankruptcy Code liquidation; this minimum recovery amount is expressly guaranteed under Title II.⁸⁷

Finally – and this is the most important point – it is unlikely that the FDIC would need to use its differential payment authority to protect large classes of short-term creditors in a Title II single point of entry holding company recapitalization for this simple reason: the non-operating holding companies of large financial institutions are unlikely to have significant amounts of short-term debt at the time of failure. Many such institutions already issue the predominant majority of their short-term debt at the operating subsidiary level – at the bank or broker-dealer subsidiary – not at the holding company. And in stressed circumstances, to the extent that some short-term debt continues to be outstanding at the holding company, it is very likely to be reduced substantially in the run-up to a company’s failure as short-term creditors refuse to “roll over” their funding to the company.

IV. Reasons for the FDIC’s Approach Under Title II of Single Point of Entry Private Sector Recapitalization

In using the authority under Title II, the FDIC has three basic orderly resolution options for the failure of a financial company: sales to third parties, liquidation, or private sector recapitalization (or some combination of these options). A sale to one or more third parties could be very orderly because it could be accomplished relatively quickly; it would presumably keep the failed company’s critical operating businesses open; it would minimize the involvement of the government in running the business, even on a temporary basis; and counterparties and customers would take comfort in dealing with the healthy entity that acquires the failing

company. This option may be especially viable for a financial institution that has the majority of its assets in insured depository institution subsidiaries and a relatively uncomplicated balance sheet.

There could be fundamental challenges to such a sale, however. First and foremost, it would likely require a very large healthy institution to acquire a very large failed institution as a whole, and the resulting institution could prove to be unacceptably large and complex for regulators to approve. In addition, any of the few potential acquirers large and strong enough to make such an acquisition may be unwilling to do so, even if regulators were amenable: under post-financial crisis rules, capital requirements increase and regulatory costs and scrutiny intensify if the very largest institutions grow even larger. Moreover, in a time of financial uncertainty, even very healthy institutions may not be willing to assume the risk associated with a major acquisition, including the risk of “look back” enforcement.

Liquidation and wind-down are also a potentially viable option, but this approach has challenges, too. The use of a bridge financial company would allow for a liquidation and wind-down to be more orderly than would be the case with an immediate “fire-sale” of company businesses and assets, especially where the range of businesses and amount of assets is extensive. A depository institution could be split along product or geographic lines, and certain businesses could be sold in parts over time, with unsold businesses gradually liquidated. A concern with this approach, however, is that, even with the use of the bridge institution, the liquidation and wind-down could take a relatively long time to accomplish, with all of the problems attendant to prolonged government control. During that time, it may prove difficult to keep people-

dependent financial businesses intact. The concern is that, to the extent that these are key businesses, they could deteriorate rapidly and ultimately fail at the operating subsidiary level, resulting not only in substantial losses for the FDIC as receiver and for creditors at all levels, but perhaps more importantly, significant market disruptions that would substantially reduce confidence in what could be a very fragile financial climate.

The third option is private sector recapitalization, where the value of shareholders' equity is likely eliminated, creditors would become owners of the failed company, and key businesses would continue to operate. This option can be accomplished far more quickly than a managed liquidation and with less systemic risk. With advance planning of the kind being done through the living will process, critical businesses would stay in operation; non-critical businesses would be sold off or wound down; the duration of the government's involvement would be substantially reduced by an early hand-off to new ownership by the creditors; and by maintaining franchise value for key businesses, recovery rates for creditors would be substantially greater than would be true for a liquidation.

For all these reasons, FDIC officials have stated publicly that, in the extraordinary circumstances where Title II is invoked, single point of entry private sector recapitalization could indeed present the most attractive feasible option for resolving the failure of a large diversified financial institution, and the agency has committed to work through the practical issues and impacts associated with this option.⁸⁸ This in turn has led to their preferred Title II approach of single point of entry private sector recapitalization of the holding company.

As previously discussed, the FDIC's single point of entry holding company approach is expressly designed to avoid the destabilizing problems that can result from financial institution failures that could produce systemic risk, *i.e.*, the prospect of runs, disorderly close-outs of derivative contracts, fire-sales of financial assets, and ring-fencing of assets in foreign jurisdictions. By having the holding company absorb all the losses of its operating subsidiaries to keep them open, healthy, and fully able to meet their obligations, the customers and counterparties of these subsidiaries would have no reason to run or close out their derivatives contracts, and foreign regulators would have no reason to ring-fence assets of these subsidiaries to protect local creditors. And by having only the holding company fail, these destabilizing problems are also avoided at the holding company level: by the time of failure the holding company generally would have little or no short-term creditors that could run, derivatives contracts that could be closed out, or foreign assets that could be ring-fenced. With these destabilizing problems avoided, the holding company could then be reorganized and recapitalized in a truly orderly fashion, so that the shareholders and long-term creditors of the holding company would absorb all the losses, not taxpayers, and management held responsible for the company's problems would be swiftly replaced.

Of course, in order to make the single point of entry approach work in practice where the holding company would be recapitalized by converting its debt to equity, the holding company would need to have enough capital and unsecured long-term debt to fully absorb the level of net losses that would likely be sustained if the company were to fail.⁸⁹ It would also need to have a sufficient amount of liquid assets or other resources available to recapitalize key

operating subsidiaries that sustain losses, which could include holding company loans to these subsidiaries that could be forgiven. Maintaining such adequate levels of capital, unsecured long-term debt and liquidity would all work to substantially decrease the chances that the holding company would fail – but they would, in combination with forgivable loans to subsidiaries, also provide the private sector capital needed in the unlikely event that failure does occur.

On the first point regarding sufficient levels of capital and long-term debt, the recent and ongoing increases in capital levels of large U.S. bank holding companies – as required by Dodd-Frank and the international Basel III agreement – will substantially bolster the capacity of these companies to absorb losses. The combination of that capital and long-term debt (or other “equitizable” opportunities) should create the type of holding company loss absorption capacity that would make a single point of entry approach an entirely feasible option for recapitalization of the largest and most diversified U.S. financial companies. Moreover, because the single point of entry holding company approach will maximize preservation of the failed institution’s value, it by definition will reduce the amount of loss that holding company debt holders would have to absorb – and that in turn should reduce the amount of such debt that a financial company would need for a single point of entry resolution.

For purposes of such a resolution, unsecured long-term debt need not be subordinated debt, and indeed, the vast majority of unsecured long-term debt currently issued by bank holding companies is *not* subordinated debt. So long as there is minimal or no amount of short-term debt at the holding company at the time of failure, the key characteristic required for

the type of unsecured holding company debt needed for single point of entry recapitalization is that it be long-term in nature so it cannot run; it does not need to be subordinated as well.

Of course, the total amount of unsecured long-term debt required would need to be calibrated to the institution's size, complexity, relative footprint (including globally), business model, and risk profile of its assets, liabilities, and operations.⁹⁰ The business models and balance sheet complexity of those institutions that may be subject to Title II and single point of entry will vary significantly. It would therefore be inappropriate for regulators to adopt a "one-size-fits-all" approach in setting the appropriate level of long-term debt that must be held by these institutions. The application of such a uniform standard would inevitably result in some institutions holding insufficient levels of debt while others would be forced to issue debt that is wholly unnecessary for their business model and level of complexity. Instead, regulators should adopt a flexible and targeted approach that takes into account the unique characteristics of each company as well as recent and ongoing increases in the capital levels required of large banking organizations. Indeed, this flexible, targeted approach should be a fundamental part of the living will planning process. As a result, some financial institutions may need higher levels of long-term debt than others, especially those institutions for which Title II is more likely to be invoked in the event that extraordinary circumstances occur. Conversely, those institutions for which Title II is unlikely to be invoked should not be subject to any required new level of long-term debt.

On the second point regarding the need for adequate holding company resources to recapitalize subsidiary losses, liquid assets held by the holding company, along with

subsidiary debt obligations held by the holding company that could be forgiven if necessary (including deposits), should generally provide adequate resources for doing so. Again, the circumstances of individual institutions will vary; specific approaches will need to be calibrated to reflect an institution's business model, organizational structure, balance sheet, and risk profile; and additional requirements should not apply to those institutions for which Title II is unlikely to be invoked. As a result, any additional amounts of holding company resources required for orderly resolution of a particular institution can and should be addressed in the living will planning process – and of course, new liquidity requirements applicable to large bank holding companies and those nonbank financial institutions designated as systemically important will also help ensure that adequate amounts of liquid resources are available if a single point of entry approach is employed.

* * *

In sum, financial institutions have become safer and far less likely to fail as the result of increased capital ratios, stronger liquidity levels, and greatly enhanced prudential standards adopted in the wake of the financial crisis. Yet the possibility of failure will continue to exist. In ordinary circumstances, the Bankruptcy Code and the specialized failure regimes tailored to financial institutions will prove adequate to resolve all types of financial institutions. But in extraordinary circumstances raising real concerns about systemic risk, a single point of entry private sector recapitalization under Title II of the Dodd-Frank Act is a truly viable safety valve option for handling the failure of a financial institution in a manner that is orderly, not panic-inducing. It therefore does not require – and is prohibited from requiring – the taxpayer

exposure to losses that proved so damaging during the financial crisis. And it ensures the application of true market discipline from long-term creditors and shareholders of these companies.

In short, it ends the perceived problem of “too-big-to-fail.”

¹ See generally Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, Speech at the Economic Club of New York (Oct. 15, 2008), *available at* <http://www.federalreserve.gov/newsevents/speech/bernanke20081015a.htm>.

² See Federal Reserve, Senior Loan Officer Opinion Survey on Bank Lending Practices, p. 2 (Jan. 2009).

³ See Elizabeth A. Duke, Governor of the Federal Reserve System, Speech at the Consumer Bankers Association Annual Conference (June 8, 2010), *available at* <http://www.federalreserve.gov/newsevents/speech/duke20100608a.htm>.

⁴ For a general discussion of the negative impact of financial crises on the real economy, see generally Carmen Reinhart & Kenneth Rogoff, THIS TIME IS DIFFERENT (2009).

⁵ Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”) §§ 165-166.

⁶ Dodd-Frank Act §§ 201–214, 12 U.S.C. §§ 5381–5394.

⁷ Dodd-Frank Act § 165(d), 12 U.S.C. § 5365(d). The Act also constrained the ability of the Federal Reserve to make emergency loans to individual nonbanking companies. Dodd-Frank Act § 1101(a), 12 U.S.C. § 343(A).

⁸ Dodd-Frank Act §§ 204(a)(1), 206(2)–(3), 12 U.S.C. §§ 5384(a)(1), 5386(2)–(3).

⁹ Dodd-Frank Act § 214(c), 12 U.S.C. § 5394(c).

¹⁰ See *infra*, p. 19.

¹¹ See generally 12 C.F.R. pt. 380.

¹² See, e.g., Martin J. Gruenberg, Acting Chairman, FDIC, Remarks 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>.

¹³ This paper addresses Title II in the context of the failure of a systemically important financial institution that is headquartered in the United States. It does not address the applicability of Title II to the U.S. operations of banking organizations headquartered outside of the United States.

¹⁴ See Gruenberg, *supra* note 12.

¹⁵ See *id.*

¹⁶ See *id.* In highly improbable circumstances, described *infra* at p. 27, to the extent that shareholder and creditor resources were insufficient to absorb all the losses of a failed financial company under Title II, other large and systemically important financial institutions would be assessed to pay for such additional losses.

¹⁷ See Gruenberg, *supra* note 12; see also Dodd-Frank Act § 210(b), 12 U.S.C. § 5390(b); 12 C.F.R. § 380.21.

¹⁸ See Gruenberg, *supra* note 12. This paper assumes that most, or even all, of the new capital for a recapitalized parent company is obtained by the conversion of outstanding debt at the parent holding company. This will not necessarily be the case, however. It could be possible to recapitalize the holding company, in whole or in part, with new equity issuances. The creditor recapitalization is assumed because it is likely to have greater certainty and may be accomplishable within a shorter timeframe.

¹⁹ See *id.*; see also Dodd-Frank Act § 206(4)–(5), 12 U.S.C. § 5386(4)–(5).

²⁰ In occasional circumstances, a holding company will not be the sole shareholder of a subsidiary, or even a majority owner. In that case, the recapitalization of the subsidiary under the single point of entry approach could be more difficult to accomplish.

²¹ See Dodd-Frank Act § 210(a)(7)(B), (b)(4), (d)(2)–(4), (h)(5)(E), 12 U.S.C. § 5390(a)(7)(B), (b)(4), (d)(2)–(4), (h)(5)(E); 12 C.F.R. § 380.27.

²² See FDIC & Bank of England, Resolving Globally Active, Systemically Important, Financial Institutions, pp. 6, 9-10 (Dec. 10, 2012).

²³ See 11 U.S.C. § 109(b), (d) (defining who may be a Chapter 7 or 11 debtor under the Bankruptcy Code).

²⁴ See generally 12 U.S.C. § 1821(b), *et seq.*

²⁵ See 11 U.S.C. § 109(b), (d); 15 U.S.C. § 78fff, *et seq.*; see, e.g., N.Y. Ins. Law § 7401, *et seq.*

²⁶ See Joseph Neely, Director, FDIC, Remarks Before the FDIC Symposium “Managing the Crisis: The FDIC and RTC Experience” (Apr. 29, 1998), available at <http://www.fdic.gov/bank/historical/managing/sym1-05.pdf>.

²⁷ See 12 U.S.C. § 1821(d)(3)–(8); FDIC Resolutions Handbook, The FDIC’s Role as Receiver, p. 63 (1998).

²⁸ 12 U.S.C. § 1821(i)(3).

²⁹ 12 U.S.C. § 1821(n).

³⁰ See 12 U.S.C. § 1821(n)(10)–(12). For example, the FDIC established bridge banks in resolving Independent Bankers’ Bank and Silverton Bank, N.A. See FDIC Press Release, FDIC Creates Bridge Bank to Take Over Operations of Independent Bankers’ Bank, Springfield, Illinois (Dec. 18, 2009); FDIC Press Release, FDIC Creates Bridge Bank to Take Over Operations of Silverton Bank, National Association, Atlanta, Georgia (May 1, 2009). See also FDIC, *MANAGING THE CRISIS: THE FDIC AND RTC EXPERIENCE*, p. 595 (describing the FDIC’s creation of a bridge bank in 1988 to resolve First Republic Banks, a group of 40 subsidiary banks with over \$33 billion in assets); FDIC, *MANAGING THE CRISIS: THE FDIC AND RTC EXPERIENCE*, p. 635 (describing the FDIC’s creation of a bridge bank in 1991 to resolve the Bank of New England, which had at the time over \$22 billion in assets).

³¹ 12 U.S.C. § 1821(n)(7).

³² See 12 U.S.C. § 1825.

³³ See *The Changing Role of the FDIC: Hearing Before the Subcomm. on TARP, Financial Services, and Bailouts of Public and Private Programs of the H. Comm. on Oversight and Government Reform*, 112th Cong. 12 (2011) (statement of Sheila C. Bair, Chairman, FDIC), available at <http://www.fdic.gov/news/news/speeches/chairman/spjun2211.html>. The challenges that stem from the existence of bifurcated resolution regimes, while present, do not ordinarily create substantial hurdles to the orderly resolution of bank holding companies with only limited or non-systemic nonbank operations.

³⁴ See *Public Policy Issues Raised by the Report of the Lehman Brothers Bankruptcy Examiner: Hearing Before the H. Comm. on Fin. Serv.*, 111th Cong. (2010) (statement of Hon. Timothy F. Geithner, Secretary, Department of the Treasury), available at <http://www.treasury.gov/press-center/press-releases/Pages/tg645.aspx>.

³⁵ See Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System, Speech at Morehouse College (Apr. 14, 2009), available at <http://www.federalreserve.gov/newsevents/speech/bernanke20090414a.htm>.

³⁶ See John Corston, Acting Deputy Director, Complex Financial Institutions Branch, Division of Supervision and Consumer Protection, FDIC, to the Financial Crisis Inquiry Commission (Sept. 1, 2010), available at <http://www.fdic.gov/news/news/speeches/archives/2010/spsep0110.html>.

³⁷ Dodd-Frank Act § 203(b)(2), 12 U.S.C. § 5383(b)(2). In order for Title II to apply to a financial company, other requirements must be satisfied as well, including that the company is in default or in danger of default and that no viable private sector alternative is available to prevent the company’s default. See Dodd-Frank Act § 203(b)(1), (3), 12 U.S.C. § 5382(b)(1), (3).

³⁸ Dodd-Frank Act §201(a)(11)(B)(i)–(iii), 12 U.S.C. § 5381(a)(11)(B)(i)–(iii). The term “financial company” also includes a subsidiary of a bank holding company, nonbank financial company designated by the Financial Stability Oversight Council as a systemically important financial institution, or other company predominantly engaged in financial activities, provided

that the subsidiary itself is predominantly engaged in financial activities; however, insured depository institution subsidiaries and insurance company subsidiaries are expressly excluded from the definition of the term and accordingly from resolution under Title II. *See* Dodd-Frank Act § 201(a)(11)(B)(iv), 12 U.S.C. § 5381(a)(11)(B)(iv).

³⁹ Dodd-Frank Act § 214(c), 12 U.S.C. § 5394(c).

⁴⁰ *See* Dodd-Frank Act § 203(a)(2), (b), 12 U.S.C. § 5383(a)(2), (b).

⁴¹ *See* Dodd-Frank Act § 203(a), (c), 12 U.S.C. § 5383(a), (c).

⁴² Dodd-Frank Act § 203(a), 12 U.S.C. § 5383(a).

⁴³ Dodd-Frank Act § 203(b), 12 U.S.C. § 5383(b).

⁴⁴ The policy statement should address the FDIC's preferred course of action as well as other options and approaches available to the FDIC under Title II.

⁴⁵ *See* Gruenberg, *supra* note 12; FDIC & Bank of England, *supra* note 22.

⁴⁶ *See* Dodd-Frank Act § 165(d), 12 U.S.C. § 5365(d); 12 C.F.R. pt. 243.

⁴⁷ Dodd-Frank Act § 206(4)–(5), 12 U.S.C. § 5386(4)–(5).

⁴⁸ Dodd-Frank Act § 210(s), 12 U.S.C. § 5390(s).

⁴⁹ *Compare* 11 U.S.C. § 726, *with* Dodd-Frank Act § 210(b), 12 U.S.C. § 5390(b), *and* 12 C.F.R. § 380.21.

⁵⁰ Dodd-Frank Act § 204(b), 12 U.S.C. § 5384(b).

⁵¹ 12 U.S.C. § 1821(c).

⁵² *See, e.g.*, Andrew G. Haldane, Executive Director, Financial Stability, Bank of England, Speech Delivered at the Financial Student Association (Apr. 2009), *available at* <http://www.bankofengland.co.uk/publications/Documents/speeches/2009/speech386.pdf>.

⁵³ *See* Dodd-Frank Act § 202(a)(1)(A)(v), 12 U.S.C. § 5382(a)(1)(A)(v).

⁵⁴ Dodd-Frank Act § 202(a)(1)(A)(i), 12 U.S.C. § 5382(a)(1)(A)(i).

⁵⁵ *See* Dodd-Frank Act § 207, 12 U.S.C. § 5387 (shielding from liability the board of directors' decision to consent to the FDIC's appointment as receiver for the institution).

⁵⁶ *See* Dodd-Frank Act § 210(h), 12 U.S.C. § 5390(h).

⁵⁷ *See* Dodd-Frank Act § 210(h), 12 U.S.C. § 5390(h).

⁵⁸ *See* Stephen G. Cecchetti and Piti Disyatat, CENTRAL BANK TOOLS AND LIQUIDITY SHORTAGES, FRBNY Economic Policy Review (August 2010), at 29-30, *available at* <http://www.newyorkfed.org/research/epr/10v16n1/1008cecc.pdf>.

⁵⁹ See *Id.*

⁶⁰ See Ben S. Bernanke, Chairman, Board of Governors of the Federal Reserve System to the Financial Crisis Inquiry Commission (Sept. 2, 2010), *available at* <http://www.federalreserve.gov/newsevents/testimony/bernanke20100902a.pdf>.

⁶¹ See Dodd-Frank Act §§ 204(d), 210(n), 12 U.S.C. §§ 5384(d), 5390(n); FDIC & Bank of England, *supra* note 22, at pp. 6-7.

⁶² See Dodd-Frank Act § 214(c), 12 U.S.C. § 5394(c); *see also* Dodd-Frank Act § 210(o), 12 U.S.C. § 5390(o).

⁶³ Dodd-Frank Act § 210(b)(1)(B), 12 U.S.C. § 5390(b)(1)(B); 12 C.F.R. §§ 380.21(a)(3), 380.23. If unsecured credit is unavailable from the private market, then any temporary government funding also has priority over administrative expenses. Dodd-Frank Act § 210(b)(2), 12 U.S.C. § 5390(b)(2); 12 C.F.R. § 380.21(a)(1).

⁶⁴ Dodd-Frank Act § 210(n)(6), 12 U.S.C. § 5390(n)(6); 31 C.F.R. pt. 149.

⁶⁵ Dodd-Frank Act § 210(n)(6)(A), 12 U.S.C. § 5390(n)(6)(A); 31 C.F.R. § 149.3(a).

⁶⁶ Dodd-Frank Act § 210(n)(6)(B), 12 U.S.C. § 5390(n)(6)(B); 31 C.F.R. § 149.3(b).

⁶⁷ See Dodd-Frank Act § 210(n)(9)(B), 12 U.S.C. § 5390(n)(9)(B). The restriction on Treasury lending in the absence of an agreed-to plan does not apply to funds provided during the first 30 days after failure that are subject to the 10-percent-of-book-value cap.

⁶⁸ See Dodd-Frank Act § 210(o)(1)(D)(i), 12 U.S.C. § 5390(o)(1)(D)(i). The only creditors potentially subject to clawback are those that received more from the FDIC as receiver than other creditors in the same priority class. *See infra*, p. 26.

⁶⁹ Dodd-Frank Act § 210(o)(1)(D)(ii), 12 U.S.C. § 5390(o)(1)(D)(ii).

⁷⁰ See The Clearing House Association Banking Brief, Depositor Protections: The FDIC and the DIF (July 31, 2012), at 2, 10–11, *available at* <http://www.theclearinghouse.org/index.html?f=074137>.

⁷¹ See Congressional Budget Office, Review of CBO's Cost Estimate for the Dodd-Frank Wall Street Reform and Consumer Protection Act (March 30, 2011), at 2, 10–11, *available at* <http://www.cbo.gov/sites/default/files/cbofiles/ftpdocs/121xx/doc12120/03-29-dodd-frank.pdf>.

⁷² *Id.* at 10 (“Spending for resolution activities would increase outlays in the initial years of a liquidation, but that spending would be offset in subsequent years by income received from selling the assets of the failed firm and collecting fees to cover any losses. As a result, a snapshot of cash flows in any given 10-year budget window is unlikely to net to zero because the spending to liquidate a firm would occur before the income was received to cover those costs.”).

⁷³ *Id.*

⁷⁴ *Id.*

⁷⁵ Dodd-Frank Act § 210(c)(10)(B), 12 U.S.C. § 5390(c)(10)(B).

⁷⁶ Dodd-Frank Act § 210(c)(16)(A), 12 U.S.C. § 5390(c)(16)(A)

⁷⁷ 12 C.F.R. § 380.12.

⁷⁸ Unfortunately, this very important new provision of U.S. law to prevent a cross-default termination would be difficult to enforce with respect to a counterparty of a foreign operating subsidiary owned by a failed U.S. holding company (assuming the derivatives contract were governed by foreign law). There, foreign law, not U.S. law, would govern, and until such foreign laws are changed to align with U.S. law – as some foreign jurisdictions are now actively pursuing (*see, e.g.*, FDIC & Bank of England, *supra* note 22, at p. 5) – the risk of disruption from cross-default terminations remains significant.

⁷⁹ Dodd-Frank Act § 210(b)(4), (d)(2)–(4), (h)(5)(E), 12 U.S.C. § 5390(b)(4), (d)(2)–(4), (h)(5)(E); 12 C.F.R. § 380.27.

⁸⁰ *See* 12 U.S.C. § 1821(i)(3). Although there is no express requirement in the Federal Deposit Insurance Act for a minimum recovery amount equal to the liquidation value of a creditor's claim, that recovery standard has generally been satisfied by the FDIC, and its maximum liability obligation under the FDI Act to any claimant is that same liquidation value. *See id.* § 1821(i)(2).

⁸¹ *See* 79 Fed. Reg. 41,626, 41,627 (July 15, 2011) (acknowledging commenters' concerns with the differential payment power).

⁸² *See* 79 Fed. Reg. 4207, 4211 (Jan. 25, 2011) (describing aspects of the FDIC's exercise of its differential payment power over time in the course of bank resolutions).

⁸³ *See* 12 C.F.R. § 380.27; *see also* 76 Fed. Reg. 41,626, 41,634 (July 15, 2011) (discussing the new rule addressing similarly situated creditors).

⁸⁴ 12 C.F.R. § 380.27(a), (b)(1).

⁸⁵ *See* 12 C.F.R. § 380.27(b).

⁸⁶ *See* 12 C.F.R. § 380.27(b)(4).

⁸⁷ Dodd-Frank Act § 210(a)(7)(B), (b)(4), (d)(2)–(4), (h)(5)(E), 12 U.S.C. § 5390(a)(7)(B), (b)(4), (d)(2)–(4), (h)(5)(E); 12 C.F.R. § 380.27.

⁸⁸ *See* Gruenberg, *supra* note 12.

⁸⁹ Alternatively, the losses could possibly be absorbed through the issuance of new equity or a sale of assets.

⁹⁰ The calibration of long term debt requirements should be determined in reference to empirical analysis of the factors identified. The agencies should also take into account the intrinsic franchise value of the institution, which Title 2 is intended to preserve, in assessing potential recapitalization needs.