BIPARTISAN POLICY CENTER

# *BPC's Overview and Principles On the FDIC Single Point of Entry Strategy*

On March 6, 2014, the Bipartisan Policy Center's (BPC) Financial Regulatory Reform Initiative (FRRI) Failure Resolution Task Force submitted comments on the Federal Deposit Insurance Corporation's (FDIC) Notice on *The Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy*. Building on the May 2013 report, *Too Big To Fail: The Path to a Solution,* the task force reiterates its strong support for the FDIC's Single Point of Entry (SPOE) strategy and suggests areas in which the notice could be strengthened.

**Historical Context**

The financial crisis underscored critical gaps in the authority of federal regulators to resolve systemically important financial institutions (SIFIs) without either disrupting the functioning of financial markets or forcing taxpayers to bail them out. The disorderly failure of Lehman Brothers, the need for Troubled Asset Relief Program (TARP) money to inject capital into major financial institutions and the Federal Reserve's use of its emergency lending powers to prevent AIG from entering bankruptcy all highlighted the need for a new legal mechanism to wind down SIFIs and particularly global SIFIs (G-SIFIs).

**Dodd-Frank's Proposed Solution**

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) was designed to address that gap and put an end to the "too-big-to-fail" problem. Alongside enhanced capital, liquidity and other prudential standards contained within the Act, Title II – entitled "Orderly Liquidation Authority" (OLA) – established a new process for resolving SIFIs and G-SIFIs. The OLA was not designed to replace, but rather supplement, the existing Bankruptcy Code for reorganizing or liquidating SIFIs. Under the OLA, the FDIC may be appointed as the receiver of a failed financial company if certain conditions are met. The FDIC was granted wide discretion in its choice of resolution strategy, providing it complied with its statutory duties of maximizing the value of the firm for the benefit of its creditors, while also promoting financial stability.

**SPOE Strategy**

The FDIC has made significant progress with respect to Title II implementation, most importantly in the development of the SPOE recapitalization strategy. Under the SPOE strategy, the FDIC would be appointed receiver of the parent holding company of the financial group. The parent company's assets would be transferred to a bridge financial holding company and its consolidated losses would be imposed on its equity and long-term unsecured debt holders. At the same time, its subsidiaries (both domestic and foreign) would be recapitalized with the parents assets and remain open and operating, therefore avoiding destabilizing insolvency proceedings at the subsidiary level and helping to ensure overall market stability. It is worth repeating that, under the SPOE recapitalization strategy, all losses would fall on the parent company's shareholders and long-term unsecured debt holders in accordance with previously established priority rights, not on taxpayers.

**BPC Supports the SPOE Strategy**
The task force report strongly supports the FDIC's SPOE strategy, agreeing that it "would be an effective means of resolving SIFIs, including those with significant cross-border or global operations" and that it has the potential to "succeed in solving a critical part of the too-big-to-fail problem, by allowing any SIFI to fail without resorting to taxpayer-funded bailouts or a collapse of the financial system."

In addition to the FDIC's important work on the SPOE strategy, the task force also recognizes the important progress the FDIC has made on the critical issue of cross-border resolutions of G-SIFIs, such as its joint paper with the Bank of England on the benefits and details of the SPOE recapitalization strategy. The FDIC has also created a working group with the European Commission and has an ongoing bilateral engagement with the Swiss and Japanese regulatory authorities on these issues. Furthermore, the task force commends the FDIC's multilateral efforts, particularly the leading role it has played on the Financial Stability Board (FSB) in developing greater cross-border resolution coordination as a member of the Resolution Steering Group and the Cross-Border Crisis Management Group.

**Room for Improvement**
The task force believes that the SPOE comment notice issued by the FDIC is another constructive step forward. More needs to be done, however, to promote market discipline, predictability, certainty and transparency for all stakeholders in the process. In order to be viewed as a viable alternative to either a contagious market panic or a government bailout, the task force believes that the following principles, amongst others, should be adopted or strengthened in the final FDIC rule:

- ***Predictability and Certainty:*** As the task force report makes clear, "the key to resolving SIFIs, including G-SIFIs, without triggering a contagious panic or resorting to taxpayer-funded bailouts is for there to be a pre-announced, predictable and viable strategy for the *high-speed recapitalization* of the parent holding companies and material operating subsidiaries of any such groups that fail." The task force encourages the FDIC to make a strong public commitment in favor of using SPOE resolution to resolve G-SIFIs in a manner that maximizes their value for the benefit of their stakeholders and promotes financial stability.

- ***Limit on Discretion to Discriminate:*** The task force supports the FDIC's stated intention to not discriminate among similarly situated creditors. However, the FDIC should state clearly that "it will not discriminate among similarly situated creditors at the parent holding company level unless necessary to maximize the recovery of the creditors left behind in the receivership, as permitted under the Bankruptcy Code." Doing so will promote both market discipline and financial stability by allowing long-term unsecured debt holders to estimate their potential losses with greater certainty.

- ***Value Maximization Duty:*** Consistent with its statutory obligations, the task force report strongly encouraged the FDIC to "exercise powers under the OLA in such a manner as to maximize the value of the covered company, except to the extent absolutely necessary to preserve or promote financial stability." The FDIC should clarify its intent to preserve the franchise value of the recapitalized group. If it does not, both the market and foreign regulators may assume it will sell valuable but illiquid assets for cash at fire-sale prices,

leading to contagious panics that could destabilize the financial system and lead foreign regulators to ring-fence local assets.

- ***Liquidity, not Capital:*** The task force report recommends that the FDIC confirm “that the Orderly Liquidation Fund will not be used to provide capital that insulates shareholders or creditors against losses.” The report also makes distinguishes “between providing capital to insolvent firms and providing temporary, fully secured liquidity at above-market rates to solvent, sufficiently capitalized (or recapitalized) institutions.” This distinction between the provision of equity and liquidity “marks the line between unacceptable taxpayer-funded bailouts and acceptable government-provided short-term liquidity that is fully secured by collateral.”

- ***Reconciling SPOE with the Bankruptcy Code:*** Although beyond the scope of the FDIC’s comment notice, the task force report urges the FDIC to play a constructive and proactive role in advocating for amendments to the Bankruptcy Code to reduce the need to invoke the authority contained within Dodd-Frank’s OLA. Specifically, the task force recommends amending the Bankruptcy Code to facilitate a SPOE recapitalization strategy, placing limitations on early termination rights and creating a secured liquidity facility, among other changes. Furthermore, the resolution planning process under Title I of the Dodd-Frank Act, which assumes that an institution will be resolved under the Bankruptcy Code, should converge with and reinforce the resolution process under Title II. The task force believes that harmonizing the two provisions would minimize any disruption from invoking the OLA.