Solving for "To Fail" in "Too Big To Fail:"

The FDICs Single Point of Entry Recapitalization Procedure*

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The Bipartisan Policy Center has released a paper that addresses the resolution of systemically important financial firms.[1] The paper recommends that the Federal Deposit Insurance Corporation (FDIC) utilize a "single point of entry" recapitalization procedure to resolve such firms when using the orderly liquidation authority established in Title II of the Dodd-Frank Act. The paper also recommends that Congress amend the Bankruptcy Code to facilitate a similar process under that Code.

What is this "single point of entry" recapitalization procedure? This article summarizes its key features.

The single point of entry, or SPOE, recapitalization procedure has been developed by the FDIC and foreign banking regulators, particularly in the UK, as a means to resolve systemically important financial organizations.[2] The procedure is an alternative to reliance upon existing bankruptcy codes, which can be inefficient in a crisis, especially if a company has operations in multiple countries. In contrast to normal bankruptcy proceedings, a resolution under SPOE can be accomplished quickly — overnight or over a weekend. This process also can avoid cross border resolution problems because only the parent holding company is placed into a receivership — not its operating subsidiaries.

*The information contained in this newsletter does not constitute legal advice. This newsletter is intended for educational and informational purposes only.

[1] "Too Big to Fail: The Path to a Solution," authored by John F. Bovenzi, Randall D. Guynn, and Thomas H. Jackson, and published by the Bipartisan Policy Center as part of the Center's Financial Regulatory Reform Initiative.

[2] "Resolving Globally Active, Systemically Important, Financial Institutions," A joint paper by the Federal Deposit Insurance Corporation and the Bank of England, December 10, 2012.

The SPOE approach is intended to avoid — or at least minimize — the type of liquidity crunch we saw in the last crisis when short-term creditors stopped providing funding for firms that they feared were in trouble. It achieves this goal because it makes it clear to markets and creditors that it is the equity holders and long-term debt holders that will bear the losses in a failure rather than short-term creditors or taxpayers.

The FDIC is working out the details of this proposal and is expected to release a policy statement later this year that clarifies how it would apply. This policy statement is intended to give markets and all creditors a clear understanding of what to expect in the resolution process. Some have started to call this a "presumptive path."

To be clear, this is a process that would apply only rarely. The default method of resolving bank holding companies under the Dodd-Frank Act is the Bankruptcy Code. Yet, the Act acknowledges that in a crisis the Bankruptcy process could be too cumbersome, especially in the case of a large, systemically important bank. Therefore, the Act provides for an alternative resolution process to be administered by the FDIC. Triggering this process requires a recommendation by a majority of the Boards of the FDIC and the Federal Reserve Board, as well as an affirmative determination by the Secretary of the Treasury, following consultation with the President.

Long-Term Debt Proposal

Central to the SPOE recapitalization procedure is the establishment of a bridge holding company to hold the good assets, including the operating subsidiaries of a failed holding company. In other words, the SPOE process envisions splitting a failing company into two parts: (1) the failing holding company, which is placed into a receivership; and (2) a bridge holding company into which the good assets, including operating subsidiaries that have left their losses behind in the receivership, are transferred.

The Federal Reserve Board has signaled that it is working on a proposal to have large bank holding companies hold a certain amount of unsecured long-term debt that could be converted into equity and capitalize the bridge in the event of the failure of the holding company. The Board is expected

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to issue a proposed regulation that would impose this debt requirement on certain holding companies at some point this year.

This debt would serve as a means to capitalize a bridge holding company and to serve as a shield against any losses by short-term creditors of operating subsidiaries. In other words, it should reduce or eliminate the incentive for short-term creditors to run in a crisis because they would know in advance that losses would be imposed on equity holders and long-term debt holders.

While all details of this debt requirement have not been developed, it is assumed that —

- This debt requirement will apply only to the very largest bank holding companies that could require a special resolution other than Bankruptcy in the event of a crisis;
- Companies subject to the requirement will need to hold a certain amount of long-term debt at the parent level, and this level may vary from company to company based upon risk. It is not clear at this time what level the Board may propose, but larger bank holding companies currently hold a fair amount of long-term debt, so it may not be much of a stretch for covered companies to meet the requirement;
- The Board will need to define what constitutes "long-term" debt. The paper released by the Bipartisan Policy Center suggests that a reasonable definition would be debt with an original maturity of one year or more;
- Based upon statements given by Board officials, it appears that the debt will be unsecured, and that it must be contractually subordinated to senior long-term debt;
- It is possible that in conjunction with the long-term debt requirement, the Board may propose to prohibit or limit the ability of a holding company to hold short-term debt; presumably this would help markets understand that it is the long-term debt holders that will suffer losses in the event of a failure, and not the short-term debt holders; this also

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would help to prevent short-term creditors from running and triggering a liquidity crisis; and

- Also, it is possible that the Board may place some limits on who could purchase the long-term debt issued by a holding company. For example, there could be a limit on the ability of one bank holding company to purchase the debt of another bank holding company since that could have a domino effect in a crisis. Likewise, because of long-standing policies that are designed to separate banking and commerce, the Board may not want a commercial company to purchase the debt since the commercial company could end up controlling a bank when the debt is converted into the equity of the bridge holding company.

The Mechanics of the SPOE Process

The key features of the SPOE process are as follows:

- All of the losses embedded in the organization — including the losses in the operating subsidiaries — would remain in the receivership.
- All of the assets of the holding company — including its interests in subsidiaries and intercompany loans — and other liabilities would be transferred to a bridge holding company formed by the FDIC.
- The equity and some or all of the unsecured long-term debt that had been issued by the holding company would stay in the receivership.
- All directors and officers of the failed company would be removed and new directors and management brought in to operate the bridge holding company.
- The bridge holding company would recapitalize the operating subsidiaries by contributing assets to them or forgiving intercompany loans.
- The bridge holding company could get up and running quickly — over a weekend. Since all the losses would remain in the receivership, the bridge holding company would be a viable operating entity.

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- Any liquidity needs of the bridge holding company would be met by an orderly liquidation fund that was created in Dodd-Frank. This particular feature of the Dodd-Frank Act has been criticized by some as a form of taxpayer support for large banks. According to the paper released by the Bipartisan Policy Center, this criticism misses the mark. This financial support is no different than debtor-in-possession financing that is arranged in a bankruptcy. It is needed to enable the bridge holding company and its subsidiaries to operate without having to dispose of illiquid assets at fire sale prices. To address this criticism, the Bipartisan Policy Center has recommended that the FDIC makes it clear that the orderly liquidation fund will be used only for liquidity purposes, and cannot be used to capitalize the bridge holding company or its subsidiaries, and that loans from the fund will be fully secured.

- The receivership would go through a normal claims process. Since the equity holders in the failed company would be first in line to absorb losses, they presumably would be wiped out entirely. The holders of the long-term debt would receive equity in the bridge holding company in satisfaction of their claims. The bridge holding company could then emerge from FDIC control and operate under the control of the new equity owners.

As noted above, the Bipartisan Policy Center has proposed that, with some modifications to the Bankruptcy Code, the SPOE recapitalization procedure also could be applied in a bankruptcy setting.

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