A Strategy to Resolve Large and Complex Financial Companies

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One of the many new responsibilities allocated to the Federal Deposit Insurance Corporation (“FDIC”) by the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank”) is the responsibility for liquidating U.S. systemically important financial institutions (“SIFIs”) when resolution under the Bankruptcy Code is not appropriate. Dodd-Frank established, in Title II, an entirely new resolution regime for that purpose, referred to as the “Orderly Liquidation Authority.”
On December 10, 2013, the FDIC issued a statement outlining its proposed “single-point-of-entry” (“SPOE”) strategy for resolving U.S. SIFIs, if and when Title II is invoked.\(^1\) Although this SPOE strategy has been a topic of discussion for some time,\(^2\) and has gained support from regulators in a number of jurisdictions,\(^3\) this statement is the first formal action by the agency endorsing the strategy. The statement represents a somewhat tentative, but meaningful, step in preparing the FDIC to implement the strategy should it ever become necessary.

A second step in implementing SPOE, anticipated for some time, now appears likely to be taken by the Board of Governors of the Federal Reserve System later this year: adoption of so-called “long-term debt” requirements intended to ensure that the parent company in a SIFI’s corporate structure has the resources available to absorb losses and to implement an SPOE resolution.\(^4\) Authorities in other jurisdictions have made similar proposals,\(^5\) and U.S. regulators have made repeated references to the importance of such requirements in ensuring the success of SPOE and SIFI resolution more broadly.\(^6\) In its SPOE statement, the FDIC went so far as to say that “it is critical that the top-tier holding company maintain a sufficient amount of equity and unsecured debt” for SPOE to be successful.\(^7\)

The importance of the long-term debt requirement and why it should be carefully designed to achieve its purpose becomes clear with an understanding of the way in which the FDIC would implement the SPOE strategy in the event of a SIFI failure.

**Understanding Title II’s Single-Point-of-Entry Approach**

The SPOE approach addresses the failure of a complex, multi-entity financial institution by placing the top-tier parent company into receivership and utilizing the parent company’s resources to recapitalize its material...

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1. Federal Deposit Insurance Corporation, Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76614 (December 18, 2013). Title II is to be invoked only if resolution of the SIFI under the Bankruptcy Code or otherwise applicable insolvency law would have “serious adverse effects on financial stability in the United States;” “no viable private sector alternative is available to prevent the default;” and resolution under Title II would “avoid or mitigate such adverse effects.” Dodd-Frank § 203(b)(2), (3), (5).


3. Regulatory authorities in the United Kingdom, Germany and Switzerland have indicated a preference for the SPOE strategy as a primary resolution mechanism. See the joint paper of the FDIC and Bank of England referred to in footnote 2; Martin J. Gruenberg, Chairman of the FDIC, Remarks at the Volcker Alliance Program, Washington, D.C., October 13, 2013. The European Union’s proposed European Bank Recovery and Resolution Directive also includes the use of an SPOE strategy through a “single resolution mechanism.” See Proposal for a Directive of the European Parliament and of the Council Establishing a Framework for the Recovery and Resolution of Credit Institutions and Investment Firms (December 18, 2013).

4. The proposal to adopt long-term debt requirements may be accompanied by an advance notice of proposed rulemaking relating to the composition of the assets of an affected bank holding company (i.e., the “left side” balance sheet requirements described later).

5. In the U.K., the “Vickers Report” recommended that banks be required to hold “primary loss absorbing capacity,” or “PLAC”, equal to at least 17-20% of risk-weighted assets, including long-term debt that can be bailed in to absorb losses, Independent Commission on Banking, Final Report: Recommendations (September 2011), available at http://webarchive.nationalarchives.gov.uk/20131003105424/https://hmt-sanctions.s3.amazonaws.com/ICB%20final%20report/IC%2520final%2520Report%5B1%5D.pdf; in the EU, the proposal is to require “minimum requirements for own funds and eligible liabilities,” or “MREL”, of the Council of the European Union, Bank recovery and resolution: Council confirms agreement with EP (December 20, 2013); while the Financial Stability Board has focused on requiring “gone-concern loss absorbing capital,” or “GLAC,” which would absorb losses in failure after equity has been wiped out, Financial Stability Board, Progress and Next Steps towards Ending “Too-Big-To-Fail” (TBTF): Report of the Financial Stability Board to the G-20 (September 2, 2013), available at https://www.financialstabilityboard.org/publications/c_130902.htm.


subsidiary operating companies as needed. By taking this approach, the relevant authorities can:

- Provide for the continuity of the company’s significant business operations, including banks, broker-dealers, insurance companies, and other significant operations, thereby avoiding interruption of key or critical economic functions.

- Preserve the material operating subsidiaries as going concerns, thereby preserving their value for the benefit of the company’s creditors and reducing the risk of economic disruption.

- Impose the losses arising from the company’s failure on the shareholders and creditors of the parent company, thereby avoiding the need to turn to taxpayers or other external sources to absorb those losses.

Furthermore, by providing for the continuity of both domestic and non-U.S. significant subsidiaries, the SPOE strategy may reduce the potential for conflict between regulators in different jurisdictions, as well as the risk that the subsidiaries’ contractual counterparties will exercise termination rights as a result of the parent’s failure.8

SPOE is by no means the only possible strategy for resolving a failed SIFI,9 and it may not be the best strategy for certain types of institutions or in certain circumstances. However, for a global SIFI that takes the form of a typical U.S. bank holding company structure, in which the parent entity is generally not an operating company, regulators have suggested that SPOE may be the preferred strategy in many circumstances where ordinary bankruptcy may not be appropriate.10 Indeed, as noted by Federal Reserve Board Governor Daniel K. Tarullo, “In many ways, Title II has become a model resolution regime for the international community.”11

Under the SPOE approach, the holding company of the failed SIFI would be placed into FDIC receivership and, upon its appointment, the FDIC would transfer assets of the SIFI, including investments in and loans to subsidiaries, to a bridge financial company, along with the holding company’s secured liabilities and very limited unsecured liabilities necessary to facilitate the operation of the bridge financial company.12 Shareholder equity in the failed holding company, senior unsecured debt, and subordinated debt would not be transferred to the bridge financial company (potentially with very limited

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8 Many contracts include cross-defaults that give a party the right to exercise remedies against a counterparty that is clearly solvent and performing its obligations if the counterparty’s parent or guarantor suffers a failure. Section 210(c)(16) of Dodd-Frank prohibits the exercise of such cross-defaults, and similar remedies, if certain protective conditions are satisfied. However, although Dodd-Frank itself does not limit its jurisdictional reach to creditors in the United States, it is possible that creditors located outside the United States will choose to ignore the restrictions of 210(c) (16) and that courts outside the United States will permit them to do so. If a resolution proceeding is conducted using the SPOE approach, that fact alone could be sufficient to persuade some creditors to at least wait to exercise remedies, if they believe that the restructured entity will continue to perform its obligations. Furthermore, as SPOE becomes more broadly accepted around the world, regulators in other jurisdictions may be given the authority to recognize and cooperate with the FDIC’s actions to resolve the entity, including by applying similar restrictions on the exercise of cross-default remedies under local law. This type of authority has been proposed by the Council of the European Union, for example, in the recent Proposal for a Directive of the European Parliament and of the Council Establishing a Framework for the Recovery and Resolution of Credit Institutions and Investment Firms (final compromise text), document 17958/13 (December 18, 2013).


10 Martin J. Gruenberg, Acting Chairman of the FDIC, Remarks to the Federal Reserve Bank of Chicago Bank Structure Conference, Chicago, IL, May 10, 2012 (referring to SPOE as the “most promising” strategy). In his speech mentioned above, Governor Tarullo stated that “the single-point-of-entry approach offers the best potential for the orderly resolution of a systemic financial firm under Title II, in part because of its potential to mitigate run risks and credibly impose losses on parent holding company creditors and, thereby, to enhance market discipline.”


12 As examples of unsecured liabilities that could be transferred to the bridge, the FDIC has cited obligations of vendors providing services necessary to keep day-to-day operations of the bridge running smoothly. Requiring the bridge to assume the pre-failure holding company’s obligations to such creditors is analogous to the “first-day” orders granted in bankruptcy cases to provide for the continuation of services that are critical to the debtor’s operations.
exceptions); instead, claims arising from those positions would remain as claims in the receivership for the former holding company, to be satisfied out of the proceeds of the receivership estate, which will consist of the equity in the bridge financial company and the limited assets not transferred to the bridge financial company.

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The FDIC would replace the board of directors of the bridge financial company and, in keeping with the mandate of Title II, replace the management of the SIFI responsible for its failure. However, the receiver would retain most other personnel, unless and until it makes changes to the business and operations of the bridge financial company. The bridge financial company would operate under an agreement with the FDIC that would provide for:

- A review of the company to determine what caused its failure and how to mitigate future risk to the bridge financial company.

- Development of a business plan for the bridge financial company, including a plan for disposition of assets in an orderly fashion.

- Retention of advisors, consultants, and accountants.

- Development of a strategy to reduce the company’s size or complexity to ensure that it is more easily resolvable in future crises.

THE FDIC WOULD RETAIN CONTROL OVER MAJOR FINANCIAL, STRATEGIC, AND GOVERNANCE MATTERS.

The bridge financial company would be very well capitalized immediately after the transfer of the assets of the failed SIFI because those assets would be conveyed without any significant debt or other claims against them. As a result, the bridge financial company should be able to obtain financing from the private markets, at least once the situation has stabilized. In addition, if funding is not immediately available from private sources, the FDIC, as receiver and as operator of the bridge financial company, would have the ability to obtain liquidity for the company from the “Orderly Liquidation Fund” (“OLF”) established by Title II, either by borrowing directly from the OLF or by obtaining a guarantee from the OLF of its obligations under borrowings from third parties.

The OLF has the authority to obtain some funding from the U.S. Treasury, subject to limitations intended to ensure that the assets of the bridge financial company will be sufficient to repay any borrowings from the OLF. However, if the bridge financial company’s assets prove to be insufficient, the amounts due to the OLF must be repaid by means of assessments on other financial companies, and may not be recouped from taxpayers. As noted by Governor Tarullo, these collateralized OLF funds are akin to debtor-in-possession financing under the Bankruptcy Code: they can inject capital liquidity to increase the going-concern value of the firm without putting taxpayers at risk.13

In parallel with the stabilization of the bridge financial company, the FDIC would conduct an administrative procedure to determine the claims of the failed holding company’s creditors, including those of the holders of long-term debt and equity left behind in the receivership. This claims process would be similar to the process conducted in bank receiverships under the Federal Deposit Insurance Act. The process would determine the

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13 From Daniel K. Tarullo, Toward Building a More Effective Resolution Regime: Progress and Challenges, referred to above: “It is important to note, though, that the underlying concept has the same roots as ‘DIP’ (debtor in possession) financing — lending that will maintain or increase the going-concern value of the firm, not absorb losses. It is not a capital injection and does not put taxpayers at risk. The FDIC has indicated that it will, in order to protect taxpayers more fully, require that the financing be collateralized and if, for any reason, the FDIC cannot recover the full amount of credit extended, the shortfall is to be made up by a tax on other large financial firms.”
proportional interests of all the claimants in the assets of the receivership including, most importantly, the bridge financial company itself.

Once the bridge financial company is stabilized and an exit strategy is determined, the FDIC would return the bridge financial company to private hands. A key component of this process would be the allocation of interests in the emerging bridge financial company, or “NewCo,” to the claimants in the receivership in satisfaction of their claims. The FDIC has indicated that these interests may take the form of newly issued debt, equity, and, possibly, contingent securities such as warrants or options for purposes of protecting lower priority claimants against a potential undervaluation of the emerging company. The company may also issue shares or debt to the public or new investors to complete its recapitalization.

The Importance of Resources at the Parent Company

The critical element of the SPOE strategy is the recapitalization of the company’s material operating subsidiaries with the resources of the parent company. For the SPOE top-down approach to work effectively, there must be sufficient resources at the holding company level to absorb all the losses of the firm, including losses sustained by the operating subsidiaries. The capitalization of the bridge financial company must be sufficient, simply by virtue of the fact that the failed holding company’s indebtedness is not transferred to the bridge, not only to allow the operating subsidiaries to obtain needed capital from the bridge to continue operations but also to allow stakeholders and the broader public to view the entity as safe and viable as it transitions from failed firm to bridge financial company, and ultimately to emergence as a new firm.

Regulators have focused on the issuance of long-term debt as a way to ensure the availability of resources at the holding company. As noted above, the FDIC’s statement indicates that “it is critical that the top-tier holding company maintain a sufficient amount of equity and unsecured debt that would be available to recapitalize (and insulate) the operating subsidiaries and allow termination of the bridge financial company and establishment of NewCo (or NewCos).”14 Governor Tarullo has stated that “if an extreme tail event occurs and the equity of the firm is wiped out, successful resolution without taxpayer assistance would be most effectively accomplished if a firm had sufficient long-term, unsecured debt to absorb additional losses and to recapitalize the business transferred to the bridge operating company.”15 Legislators also have commented on this issue.16

The existence of resources at the holding company is indeed critical to the success of the SPOE strategy, but the existence of long-term debt, specifically, is neither necessary nor sufficient for this purpose. The requirement for loss-absorbing resources should be designed to provide those resources in the form best calculated to ensure their availability to the FDIC at the critical time. Concerns about loss-absorbing resources should not eclipse the need to capitalize a holding company in a manner best calculated to ensure its successful operation and avoid the need for resolution in the first place.

Applicability of the Proposed Requirements

The relevant requirements should appropriately take into account the differences in the business models of institutions likely to be resolved using the SPOE strategy if they fail, and should ensure that institutions unlikely to fall under Title II are not subject to these new requirements. The complexity involved in designing, proposing, and refining new requirements that achieve these goals will make the process very challenging and demand careful consideration by regulators and industry participants.

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15 See Daniel K. Tarullo, Toward Building a More Effective Resolution Regime: Progress and Challenges, referred to above.
16 See SBC hears from Fed Chair Janet Yellen and The Semiannual Monetary Policy Report to the Congress (February 27, 2014) http://www.sifma.org/members/hearings.aspx?id=8589947822: "Corker followed up and said he hopes rules require a ‘very large amount’ of debt at the holding company level.")
As an initial matter, the FDIC has indicated that the SPOE strategy was developed primarily as a means to resolve U.S. globally systemically important banking organizations (“G-SIBs”) and is generally not intended to be used for non-U.S. G-SIBs, smaller SIFIs, or non-bank SIFIs.

Non-U.S. SIFIs are subject to resolution in the manner determined by their home country authorities, and will also be subject to whatever pre-resolution requirements those authorities may impose. Layering additional long-term debt requirements on non-U.S. SIFIs, or their U.S. operations, would create a burden on those institutions without a corresponding benefit. SPOE has been developed specifically to address the resolution of a bank holding company operating through multiple operating subsidiaries. The applicability of the approach to SIFIs operating through other types of corporate structures is not yet clear, and it would be inappropriate and potentially counterproductive to subject those SIFIs to new long-term debt requirements, at least until the impact of those requirements on those SIFIs has been fully assessed.

**“Right Side” and “Left Side” Requirements**

Most of the commentary regarding the availability of parent company resources for subsidiary recapitalization has focused on long-term debt—the liabilities that appear on the “right side” of the parent company’s balance sheet. However, for those SIFIs that are reasonably likely to be the subject of an SPOE proceeding if they fail, the new requirements should address the “left side” of the parent holding company’s balance sheet as well. For both, the requirements should be straightforward and transparent, and they should reflect the risk posed by the relevant SIFI.

Two important questions about the “right side” of the balance sheet are: *how much* long-term debt or other loss-absorbing resources should be required, and *what type* of instruments will satisfy the requirement. Addressing the first, the requirement should be based on a formula that is *simple and transparent*, ideally capable of being understood and calculated, not only by the SIFI itself, but also by investors and analysts utilizing information in the SIFI’s public reports. It should also be *risk-based*, measuring the required level of loss-absorbing resources against the risk-weighted assets of the institution. A measure based on a leverage ratio (which does not reflect the risk inherent in an institution’s asset base) would likely require firms with lower-risk asset pools to significantly overfund their operations, imposing a significant cost on their operations without any corresponding benefit. Furthermore, the required amount should not establish substantial additional capital requirements beyond those that will already apply, including the G-SIB surcharge.

Addressing the second question, unsecured long-term debt should not be the only type of instrument that satisfies this requirement. In view of the FDIC’s authority to leave any or all claims against the failed SIFI holding company in the receivership, the FDIC can effectively convert into bridge financial company equity any “right side” instrument that is outstanding at the time of the SIFI’s failure, regardless of its pre-resolution status, unless the instrument is secured. As a result, resources to satisfy the new requirements should include all instruments and interests, other than secured obligations, that are likely to be outstanding when resolution begins. Both senior, unsecured obligations and subordinated, unsecured obligations, as well as equity, and any other liabilities that provide stable, long-term funding to the SIFI holding company should be included within the loss-absorbing resources available in an SPOE resolution. Accordingly, the only liabilities excluded would be those that may “run” in the face of an impending crisis (such as short-term commercial paper and similar instruments), secured liabilities, etc.

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17 One argument in favor of a leverage-based “long-term debt” requirement is that it would be more likely to ensure that the bridge financial company would meet all the capital requirements to which it will be subject immediately upon its establishment, including the leverage capital requirement. This argument does not, however, sufficiently take into account the likely use of low-risk assets to obtain liquidity for the SIFI as it begins to suffer financial distress, which may result in a substantially smaller level of such assets as a SIFI enters resolution and a convergence of the leverage and risk-based capital ratios.

18 Governor Tarullo has argued for incentives to reduce reliance by SIFIs upon short-term funding. “A capital surcharge based on short-term wholesale funding usage would add an incentive to use more stable funding and, where a firm concluded that higher levels of such funding were nonetheless economically sensible, the surcharge would increase the loss absorbency of the firm. Such a requirement would be consistent with, though distinct from, the long-term debt requirement that the Federal Reserve Board will be proposing to enhance prospects for resolving large firms without taxpayer assistance.” Shadow Banking and Systemic Risk Regulation, speech by Governor Daniel K. Tarullo at the Americans for Financial Reform and Economic Policy Institute Conference, Washington, D.C., November 22, 2013.
and liabilities that by their nature do not reflect the availability of resources (such as litigation reserves).

The mechanism for “converting” those resources into new capital for operating subsidiaries must also be considered because for recapitalization to occur, the bridge financial company must contribute assets to an operating subsidiary in some manner—hence the consideration of “left side” requirements. All assets of the parent holding company should be considered eligible for this purpose, so long as they have a reasonably ascertainable value and can be converted into equity or transferred to the subsidiary, either by forgiveness or by contribution. For example, an intercompany loan extended by a parent holding company to its bank subsidiary has a reasonably ascertainable value and, if the FDIC determines it to be necessary, could be contributed to the bank as additional capital by exchanging it for new equity or by forgiving the obligation. Similarly, valuable property held on the books of the parent can be contributed to a subsidiary in order to increase its capital. Parents can also support their subsidiaries by extending guarantees backed or secured by such property.

In most cases, for purposes of restoring capital, the assets to be contributed need not be liquid—though as noted above, their value must be ascertainable. However, the asset must not be subject to regulatory or contractual restrictions that would prevent a contribution to the relevant subsidiary. Because it is not possible to predict exactly where a crisis within any particular institution will arise, and therefore exactly where these assets will be required, it will also be important that at least some portion of these eligible assets generally be available to be used as needed in the context of a particular crisis—not tied or committed to any particular subsidiary. Regulators have raised the possibility of requiring U.S. G-SIBs to pre-position some amount of loss-absorbing resources at their non-U.S. operating subsidiaries, and some non-U.S. regulators have sought some level of pre-positioning as well.

Pre-positioning could take a number of forms, including the issuance of intercompany loss-absorbing instruments such as contingent convertible securities, or “CoCos,” and the establishment of capital commitments that are secured by eligible assets. The fundamental premise of the SPOE strategy is to preserve the continuing operations of a SIFI’s subsidiaries as going concerns, and this premise would not be served if material non-U.S. subsidiaries were not transferred to the bridge financial company and recapitalized by the FDIC. Nevertheless, it may be that non-U.S. regulators will require some reassurance as to the FDIC’s intentions by requiring some level of pre-positioning at these subsidiaries, at least until more robust cooperative arrangements can be developed among regulators. If this proves to be the case, the level of pre-positioning should be carefully controlled to ensure that sufficient loss-absorbing resources remain available at the parent holding company to permit the FDIC to allocate resources where they are needed.

The FDIC is to be commended for pursuing the strategy with thought and care. As these issues demonstrate, the development of the SPOE strategy is complex. However, the strategy promises a viable solution to the failure of a G-SIB in those circumstances where bankruptcy is not appropriate. The issuance of the FDIC’s SPOE statement along with the development of the Federal Reserve’s related requirements represent a major step forward.

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19 See, for example, the Opening Statement by FDIC Director Jeremiah Norton on Single Point of Entry Strategy on December 10, 2013, given in connection with the FDIC’s approval of the SPOE Statement, available at http://www.fdic.gov/about/learn/board/norton/statement12-10-2013.html: “In addition to the amount of debt required, the use of the debt is important to the SPE strategy. Without sufficient intra-company debt to recapitalize a failed subsidiary, the desired orderliness of a Title II SPE approach might not be achievable. In order to effectuate an SPE resolution, policymakers might need to consider requiring that the debt be apportioned, or pre-positioned, in a particular way among subsidiaries.”

20 “CoCos” are “hybrid capital securities that absorb losses in accordance with their contractual terms when the capital of the issuing bank falls below a certain level.” Stefan Avdjiev, Anastasia Kartasheva, and Bilyana Bogdanova, CoCos: a primer, in BIS Quarterly Review 43, 44 (September 2013). “CoCos can absorb losses either by converting into common equity or by suffering a principal writedown. The trigger can be either mechanical (ie defined numerically in terms of a specific capital ratio) or discretionary (ie subject to supervisory judgment).” Id. CoCos do not qualify as Tier 1 capital under the U.S. rules, including the revised rules that were adopted by the U.S. bank regulators in July 2013, but may qualify as Additional Tier 1 or Tier 2 capital under the Basel III framework. Id. at 46.