Opening Statement by FDIC Director Jeremiah Norton on Single Point of Entry Strategy

December 10, 2013

Mr. Chairman, I would like to thank the staff, particularly in the Office of Complex Financial Institutions and the Legal Division, for its work in preparing this request for comment.

Today's action requesting comments on the Single Point of Entry strategy represents the latest effort on the path towards planning for a Title II resolution, which the FDIC may utilize only if a Title I bankruptcy would result in serious adverse consequences to U.S. financial stability. There are a number of key issues that require further consideration and analysis, including but not limited to a minimum long-term debt requirement, competitive equality, cross-border contracts, and ring-fencing.[1] Along with this brief statement, I am submitting for the record an Appendix highlighting each of these issues in more detail.

(1) Given that debt is necessary for a Single Point of Entry strategy, the calibration of the amount and the positioning of long-term debt is a critical issue;

(2) Given that the Single Point of Entry strategy would provide for the continuing operation of the operating subsidiaries, it is important to consider potential impacts on the competitive landscape;

(3) A full discussion is necessary regarding how cross-border contract issues will impact resolution strategies generally, and the Single Point of Entry strategy specifically, including derivatives contracts governed by foreign law; and

(4) Ex-ante and ex-post ring-fencing in host jurisdictions should be considered in the context of any resolution regime.

I look forward to reviewing comments on these and other issues. Thank you.

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[1] *See generally* Jeremiah O. Norton, Member, Board of Directors of the Federal Deposit Insurance Corporation, "Discussion on the Current State of Resolution Planning," Remarks to the American Bankers Association (October 21, 2013) *available at* http://www.fdic.gov/news/news/speeches/spoct2113.html.

Appendix – The Calibration of Long-Term Debt

The cornerstone of the SPE strategy is a holding company creditor-funded recapitalization of troubled operating subsidiaries. The approach would require sufficient long-term unsecured debt issued at the holding company level to recapitalize the newly formed holding company following its exit from the receivership and bridge entities.[1] Key policymakers at the Federal Reserve have commented that the Board of Governors is considering a proposal that would require LCFIs to maintain a minimum amount of long-term unsecured debt at the holding company level.[2] The calibration of a debt requirement, both with respect to its size and how it is apportioned across and within organizations, is critically important to the SPE model. Further, a key premise upon which the effectiveness of a long-term debt requirement is based is that creditors of the holding company will monitor and discipline the entire organization.

A primary consideration is how to establish the level of long-term debt that will be required. Given some of the historical shortcomings of an ex-ante risk-weighted approach, the ex-post framework for recapitalizing failed entities might not be served well by basing debt requirements solely on a risk-weighted asset basis. A long-term debt requirement could be implemented using both total assets and risk-weighted assets.

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[1] *See* Daniel K. Tarullo, Governor of the Board of Governors of the Federal Reserve System, "Dodd-Frank Implementation" Before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (July 11, 2013) *available at* http://www.federalreserve.gov/newsevents/testimony/tarullo20130711a.htm ("[s]uccessful execution by the FDIC of its preferred SPE approach in OLA depends on the availability of a sufficient combined amount of equity and loss-absorbing debt at the parent holding company of the failed firm. Accordingly, in consultation with the FDIC, the Federal Reserve is working on a regulatory proposal that requires the largest, most complex U.S. banking firms to maintain a minimum amount of outstanding long-term unsecured debt on top of their regulatory capital requirements.").

[2] *See id*. *See also* Jerome H. Powell, Governor of the Board of Governors of the Federal Reserve System, "Ending Too Big to Fail" (March 4, 2013) *available at* http://www.federalreserve.gov/newsevents/speech/powell20130304a.htm; Daniel K. Tarullo, Governor of the Board of Governors of the Federal Reserve System, "Industry Structure and Systemic Risk Regulation" (December 4, 2012) *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20121204a.htm.

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.

Appendix – Competitive Landscape

One of the central advantages of the SPE strategy is that it would provide for the continuing operation and viability of operating subsidiaries by focusing the resolution at the holding company level. However, this approach could also impact the competitive landscape. For example, creditors of these subsidiaries could perceive that they would not take a loss upon distress at an LCFI and therefore would require a lower return on transactions or investments. Similarly, clients and counterparties might transact with LCFI subsidiaries based on where they perceive greater safety and stability because of government policy to prevent operational disruption and distress. To be clear, in the event sufficient debt is not required, the market equilibrium could shift in favor of LCFI subsidiaries. The converse could be true if too much debt is required at LCFIs, contingent on appropriate market discipline. To remedy this competitive dynamic would require either: (1) market participants transacting under the assumption that all firms would be subject to the normal bankruptcy process, or (2) regulators calibrating the long-term debt requirement at LCFIs with sufficient accuracy to eliminate non-market advantages and incentives at their operating subsidiaries.

Appendix – Cross-Border Contracts

Derivatives contracts typically contain provisions that allow a party to terminate the contract if its counterparty fails or defaults. A non-defaulting party could have an incentive to exercise its termination rights when its position with respect to a particular transaction is "in the money." The failure of a financial institution with a large derivatives business could trigger a wave of derivative terminations that is disruptive. This risk is magnified if the derivatives contracts contain cross-default provisions, which allow a non-defaulting party to terminate a contract if an affiliate of its counterparty defaults or fails.[3] Cross-default provisions thus have the potential to create significant instability in derivatives markets if non-defaulting parties exercise their right to terminate their positions with all affiliates of a single defaulting party.

Title II of the Dodd-Frank Act, through Section 210(c)(16), attempts to address the risk posed by cross-default provisions in the context of OLA. The cross-default provisions are generally unenforceable pursuant to Title II,[4] though the statute carves out a safe harbor for qualified financial contracts ("QFCs") if the QFCs are not transferred to either a third-party acquirer or to a newly formed bridge company within one day after the FDIC is appointed as receiver for the CFC.[5] This safe harbor reinforces the importance of the early termination

[3] The ISDA Master Agreement defines "cross-default" as "(1) a default, event of default or other similar condition or event (however described) in respect of such party, any Credit Support Provider of such party or any applicable Specified Entity of such party under one or more agreements or instruments relating to Specified Indebtedness of any of them (individually or collectively) where the aggregate principal amount of such agreements or instruments, either alone or together with the amount, if any, referred to in clause (2) below, is not less than the applicable Threshold Amount (as specified in the Schedule) which has resulted in such Specified Indebtedness becoming, or becoming capable at such time of being declared, due and payable under such agreements or instruments before it would otherwise have been due and payable; or
(2) a default by such party, such Credit Support Provider or such Specified Entity (individually or collectively) in making one or more payments under such agreements or instruments on the due date for payment (after giving effect to any applicable notice requirement or grace period) in an aggregate amount, either alone or together with the amount, if any, referred to in clause (1) above, of not less than the applicable Threshold Amount." ISDA Master Agreement at § 5(a)(vi).

[4] 12 U.S.C. § 5390(c)(13)(C).

[5] 12 U.S.C. §§5390(c)(8)-(c)(11).

provisions in derivatives contracts. On October 9, 2012, the FDIC promulgated a Final Rule that clarifies the scope of authority granted by the statute and defines key terms. The FDIC's goal, as expressed in the preamble to the Final Rule, is to suspend "any provision that gives any counterparty a right to terminate, accelerate or exercise default rights or remedies as a result of any action or circumstance that results in or arises out of the exercise of the orderly liquidation authority."[6]

The statute and the Final Rule take measures to address the risks posed by cross-default provisions in effecting a Title II resolution strategy. However, Title II, like any U.S. statute or rule, applies to contracts that are governed by U.S. law. Title II defines a "financial company" as being "incorporated or organized under any provision of Federal law or the laws of any State."[7] Thus, the suspension of early termination remedies afforded by the Act and the Final Rule likely does not apply to contracts that are governed by foreign law. It is a longstanding principle of American law that when "a statute gives no clear indication of an extraterritorial application, it has none."[8] In Title II, the Congress directs the FDIC to coordinate with foreign financial authorities regarding the orderly liquidation of any CFC that has assets or operations outside the U.S. and stops short of applying Title II extraterritorially to foreign subsidiaries or affiliates of U.S. institutions.[9] Mutual recognition agreements or adoption of a treaty to address this limitation, however, would require further legislative and executive action.

Contractual changes could address the challenges posed by foreign law cross-defaults. To that end, the FDIC, the Bank of England, German Federal Financial Supervisory Authority

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[6] Enforcement of Subsidiary and Affiliate Contracts by the FDIC as Receiver of a Covered Financial Company, Final Rule, 77 Fed. Reg. 63205, 63211 (October 16, 2012).
[7] 12 U.S.C. § 5381(a)(11).
[8] *Morrison v. National Australia Bank Ltd.*, 130 S.Ct. 2869, 2878 (2010).
[9] 12 U.S.C. § 5390(a)(1)(N).

(BaFin), and Swiss Financial Market Supervisory Authority (FINMA) recently drafted a joint letter to ISDA seeking ISDA's assistance in ensuring that cross-border derivatives contracts do not contain early termination rights that would render resolution impracticable.[10]

A contractual solution, however, poses challenges because while ISDA can formulate a master agreement, the practice of negotiating individual contracts occurs bilaterally between counterparties. Instead, if regulators were to require contractual changes prospectively, then new provisions would need to include both a suspension of early termination rights triggered by cross-default clauses as well as contractual recognition of home-country resolution and insolvency proceedings, which in the U.S. would include the Bankruptcy Code and OLA.

[10] Letter from Federal Deposit Insurance Corporation, Bank of England, German Federal Financial Supervisory Authority, and Swiss Financial Market Supervisory Authority to Stephen O'Connor, Chairman, International Swaps and Derivatives Association, Inc. (November 5, 2013) *available at* http://www.fdic.gov/news/news/press/2013/pr13099a.pdf at 1.

Appendix – Ring-Fencing

A challenge to cross-border resolution arises as a result of the changing incentives faced by regulators upon the prospect of and during an international financial crisis. Recent stress in the global financial markets has resurfaced questions and considerations for how host-country regulators would respond to a situation in which depositors, other creditors, and clients from their country face risk of significant losses caused by the distress of a foreign financial institution. A rational actor standard as well as recent history suggest that host-country authorities have incentives to engage in ring-fencing, both ex-ante and ex-post distress in financial markets. Also, existing statutes and proposed regulations provide for various forms of ring-fencing, such as ex-ante capital and liquidity requirements and ex-post ring-fencing of assets in a crisis scenario.

In addition to longstanding receivership processes for the U.S. branches of foreign banks at both the federal[11] and state level,[12] in December 2012, the Federal Reserve issued a Notice of Proposed Rulemaking that would require foreign banking organizations with $50 billion or more in total global consolidated assets and $10 billion or more in total consolidated non-branch or agency assets in the U.S. to create an intermediate holding company ("IHC") to house all operations of foreign banking organizations except branches and agencies ("FBO NPR").[13] The IHCs would be required to comply with U.S. capital and liquidity standards and those with $50 billion or more of U.S. assets also would have to meet U.S.-specific requirements, such as single counterparty credit limits, enhanced risk management practices, and early remediation

[11] *See* 12 U.S.C. § 3102(j).
[12] *See* N.Y. Banking Law § 606(4)
[13] Board of Governors of the Federal Reserve System, Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies, Notice of Proposed Rulemaking, 77 FR 76628 (December 28, 2012).

requirements.[14] In its proposing release, the Federal Reserve pointed to the resolvability benefits of ring-fencing stating that:

> *The financial crisis also demonstrated that in the resolution of a failing financial firm, the location of capital is critical and that companies that managed resources on a decentralized basis were generally less exposed to disruptions in international markets than those that solely managed resources on a centralized basis.*[15]

The acknowledgment that ring fencing, both ex-ante and ex-post, exists extends beyond the U.S. Andrew Bailey, the Chief Executive Officer of the Prudential Regulation Authority at the Bank of England, recently commented that:

> *[t]he banking system has become more fragmented or 'balkanised', with a preference for banks to subsidiarise in countries beyond their home state, and for regulators to wish for – and achieve – the location of more capital and larger pools of liquid assets in their jurisdictions.*[16]

Developments around the world support these observations. In the wake of the crisis, multiple governments have considered many measures aimed at minimizing the distress of and simplifying the resolution of the operations of foreign bank parents including: increased requirements for liquidity to cover local operations of domestic and foreign banks and nonbanks, limits on intragroup exposures of domestic banks to foreign subsidiaries, and requirements to prioritize or segregate home country retail operations.[17] Most recently, in November 2013, the

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[14] *Id.* at 76631.
[15] *Id.* at 76639.
[16] Andrew Bailey, "Regulating International Banks," Remarks to the British Bankers Association Annual Banking Conference (October 17, 2013) *available at* http://www.bis.org/review/r131018f.pdf?frames=0.
[17] *See, e.g.*, Independent Commission on Banking, Final Report Recommendations (September 2011), *available at* http://bankingcommission.s3.amazonaws.com/wp-content/uploads/2010/07/ICBFinal-Report.pdf; Eugenio Cerutti, Anna Ilyina, Yulia Makarova, and Christian Schmieder, International Monetary Fund, "Bankers without Borders? Implications of Ring-Fencing for European Cross-Border Banks (November 2010) at 5 n.5 (citing the head of Turkey's bank regulatory agency as saying, "it is our natural right to expect those profits generated in this country to be invested and used in credit extension again in this country."); State Secretariat for International Financial Matters SIF, Final report of the 'too big to fail' commission of experts: Final report of the Commission of Experts for

Reserve Bank of India also took steps towards a subsidiarization model for foreign banking organizations that commenced business in India after August 2010.[18]

limiting the economic risks posed by large companies (September 30, 2010), *available at* www.sif.admin.ch/dokumentation/00514/00519/00592/index.html?lang=en; Financial Services Authority, Strengthening Liquidity Standards (October 2009), *available at* www.fsa.gov.uk/pubs/policy/ps09_16.pdf; Financial Services Authority, The Turner Review: A regulatory response to the global banking crisis (March 2009), *available at* www.fsa.gov.uk/pubs/other/turner_review.pdf; Financial Services Authority, A regulatory response to the global banking crisis (March 2009) *available at* http://www.fsa.gov.uk/pubs/discussion/dp09_02.pdf;. Dr Željko Rohatinski, Governor of the Croatian National Bank, Recent economic and financial developments in Croatia (February 18, 2009) *available at* http://www.bis.org/review/r090326d.pdf ("the CNB would not look favorably upon attempts to withdraw capital, deposits, or pay out total accumulated profits, because that would destabilize the domestic banking system. In such a case, the CNB would be forced to undertake protective measures, regardless of thus connected risks.").

[18] Reserve Bank of India, "Scheme for Setting up of Wholly-Owned Subsidiaries by foreign banks in India," (November 6, 2013) *available at* http://www.rbi.org.in/scripts/BS_PressReleaseDisplay.aspx?prid=29922.