COMMITTEE ON CAPITAL MARKETS REGULATION

November 15, 2010

Robert E. Feldman
Executive Secretary
Attention: Comments, Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429

Re: Implementing Certain Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 75 Fed. Reg. 64,173.

Dear Mr. Feldman:

The Committee on Capital Markets Regulation appreciates the opportunity to comment on the Federal Deposit Insurance Corporation's (FDIC) proposed rule (Proposed Rule)[1] implementing its authority to resolve systemically important financial institutions under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

Since 2005 the Committee on Capital Markets Regulation (Committee) has been dedicated to improving the regulation of U.S. capital markets. Our research has provided an independent and empirical foundation for public policy. In May 2009, the Committee released a comprehensive report entitled *The Global Financial Crisis: A Plan for Regulatory Reform*, which contains 57 recommendations for making the U.S. financial regulatory structure more integrated, more effective and more protective of investors in the wake of the financial crisis of 2008.[2] Since then, the Committee has continued to make recommendations for regulatory reform of major areas of the U.S. financial system.[3]

The Committee strongly supports the FDIC's efforts to develop procedures governing the resolution of systemically important financial institutions (so-called "covered financial companies") under the orderly liquidation authority of Title II of the Dodd-Frank Act.[4] Effective resolution procedures serve an overarching objective of the Dodd-Frank Act: to internalize the

[1] 75 Fed. Reg. 64,173 (Oct. 19, 2010) (to be codified at 12 C.F.R. Part 380) [hereinafter "Proposed Rule"].
[2] COMM. ON CAPITAL MKTS. REG., THE GLOBAL FINANCIAL CRISIS: A PLAN FOR REGULATORY REFORM (May 2009), *available at* http://www.capmktsreg.org/research.html.
[3] *See, e.g.*, Letter from the Comm. on Capital Mkts. Regulation to Christopher Dodd, Chairman, Richard Shelby, Ranking Member, S. Comm. on Banking, Hous. & Urban Affairs and Barney Frank, Chairman, Spencer Bachus, Ranking Member, H. Comm. on Fin. Servs. (Mar. 4, 2010) (proposing a comprehensive approach to reducing systemic risk from over-the-counter derivatives); *see also* Letter from the Comm. on Capital Mkts. Regulation to Christopher Dodd, Chairman, Richard Shelby, Ranking Member, S. Comm. on Banking, Hous. & Urban Affairs, Barney Frank, Chairman, Spencer Bachus, Ranking Member, H. Comm. on Fin. Servs. (June 14, 2010).
[4] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 201(a)(8), 203(b) [hereinafter "Dodd-Frank Act"] (defining "covered financial company").

costs of a major failure by a systemically important financial institution while limiting its impact on the stability of the financial system.

The comments below evaluate the provisions of the Proposed Rule, contained in § 380.2, governing the determination of financial recoveries paid to creditors and shareholders in the context of a resolution. Those provisions reserve too much discretionary authority to the FDIC to adjust payments to short-term debt, which may actually increase overall instability in the financial system by reducing predictability. Moreover, the Committee believes that any resolution procedure is unlikely to function effectively unless it is coordinated with a larger regulatory framework oriented at minimizing systemic risk. For these reasons, the Committee favors deferring a final decision on resolution procedures for systemically important financial institutions until appropriate policy responses to other dimensions of the central problem of systemic risk in the U.S. financial system have been devised and implemented.

Twin Goals for an Adequate Resolution Procedure

As the background to the Proposed Rule explains, § 204(a) of the Dodd-Frank Act defines the policy objective embodied in the resolution authority as facilitating the wind-up of "failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard."[5] Under the Act, an adequate resolution procedure must satisfy two basic criteria: First, it must *contain* the risks to the financial system as a whole that are imposed when a systemically important institution fails or threatens to fail. Second, it must *internalize* the costs of the failure and resolution in a way that minimizes moral hazard, *i.e.*, by requiring creditors and shareholders to absorb losses.[6]

Only a resolution procedure that enables the government to credibly commit to allowing systemically important financial institutions to fail in a crisis, by containing systemic risk and the threat of generalized financial panic or contagion, will meaningfully reduce moral hazard. An important step is to announce in advance clear rules governing the treatment of all the liabilities that compose the capital structure of systemically important institutions. Clear rules will allow the market to appropriately price the cost of capital that should be borne by issuers, and will allow creditors to engage in informed contingency planning that contemplates the possibility that these issuers may one day fail.

Treatment of Creditors Under the Proposed Rule

The Proposed Rule envisions that loss absorption on the part of creditors and shareholders in the context of a resolution—one of the Act's twin goals—will proceed according to two basic principles:

- First, long-term unsecured senior debt (defined as maturing more than 360 days after issuance), subordinated debt,[7] and shareholders[8] will receive no preferential treatment

[5] *Id.* § 204(a).
[6] Proposed Rule § 380.2(b); *see also* Dodd-Frank Act § 210(h)(3)(B) (barring federal bailout of systemically important financial institutions).
[7] Proposed Rule § 380.2(b)(2).

relative to other general creditors of a systemically important financial institution resolved through the FDIC's procedure. The FDIC will have no discretion to make additional payments to these debt- and equity holders beyond what would be recovered through the application of normal priority rules to their claims.[9]

- Second, shorter-term debt (maturing within 360 days of issuance)[10] would be eligible, on a case-by-case basis, to receive "additional payments" at the FDIC's discretion if "such payments meet all of the statutory requirements,"[11] including the Act's requirement that the FDIC maximize going-concern value and minimize resolution costs.[12] These payments would be an effective carve-out from normal priority rules. The decision to award exempted status to short-term debt is made by the FDIC Board of Directors.[13]

This approach, although designed to enforce loss absorption by long-term creditors and to deter moral hazard, injects too much uncertainty into the calculus of the resolution process and will ultimately not work under the statute.

There are at least three discrete ways in which this feature of the Proposed Rule could contribute to market instability:

1. Flight of Short-Term Debtholders

Short-term debt holders who perceive that the failure of their issuing institution is imminent will have a strong incentive to withdraw their capital and flee, because no one will know with confidence whether the FDIC will choose to intervene by effectively exempting short-term debt from the coverage of priority-based recovery rules or not. This will accelerate the erosion of liquidity at failing institutions and may irremediably damage their ability to operate on a going-concern basis.

2. Distortion of Market for Short-Term Debt

The proposal may also increase the market's general bias for short-term funding. Recognizing that long-term debt holders are exposed to mandatory write-offs in the event their issuer fails, prospective lenders to systemically important institutions will prefer to supply funding in the form of shorter-term instruments to capture the "option value" in the FDIC's discretionary authority. This preference could shift systemically important financial institutions toward overall greater reliance on short-term debt, compounding the systemic effects of a mass-exit by short-term creditors. Even if regulators assigned short-term debt holders some form of nominal immunity from write-offs in a resolution, this guarantee might fail to forestall a run if a systemically important institution issued too much short-term debt, undermining market confidence that its assets were sufficient to make all short-term creditors whole.

[8] *Id.* § 380.2(b)(3).
[9] *Id.* §§ 380.2(b)(1)-(4).
[10] *Id.* § 380.2(b)(1).
[11] *Id.* at 64,178; *accord id.* at § 380.2(b)(4).
[12] Dodd-Frank Act §§ 210(b)(4), (d)(4), (h)(5)(E).
[13] Proposed Rule § 380.2(b)(4).

3. Market's Access to Information

The application of the Proposed Rule is limited to non-bank financial institutions determined by regulators to be of systemic importance. Short-term debt issued by a non-bank financial institution that does *not* present a systemic threat may be subject to different recovery rules. Determining whether a financial institution is systemically important, either *ex ante* or on the eve of bankruptcy, poses significant challenges for regulators.[14] If short-term debt holders do not know if their issuer will be deemed systemically important, then they will not know which resolution principles will apply to them, compounding uncertainty in the marketplace.

In addition, the value of the additional payments themselves is highly questionable because they will likely have to be taken back under § 210(o)(1)(D). That section requires assessments against claimants that received additional payments from §§ 210(b)(4), (d)(4), or (h)(5)(E), "except for payments or amounts necessary to initiate and continue operations essential to implementation of the receivership or any bridge financial company." The additional payments contemplated by the FDIC's rule cannot be so justified. Rather, they would be intended to send a signal to short-term creditors of other institutions that they may receive a preference, as a way to mitigate contagion. Priority for short-term creditors could be justified as part of ordinary debtor-in-possession (DIP) roll up financing, in which creditors are preferenced on their existing debt if they extend new money. But this preference would be given to all creditors, not just short-term ones and does not in any event seem to be the objective of the proposal. Thus, creditors will know that if they receive such payments they will be clawed back and will, therefore, have to accrue the obligation to return the payments, nullifying any value the additional payments may have had in the first place.

Resolution as a Mitigant for Contagion and Systemic Risk

Strong resolution rules for systemically important financial institutions must be deployed with a view toward protecting and stabilizing the financial system as a whole. There are four possible approaches to the treatment of short-term debt, each contemplating a different set of prospective benefits and costs:

1. Discretionary Application of Priority Recovery Rules to Short-Term Debt (current Proposed Rule)

The principal costs of the Proposed Rule are those enumerated above—namely, undesirable incentives to increase short-term debt and will not work under the existing Dodd-Frank framework.

[14] *See* Comm. on Capital Mkts. Regulation, comment to Financial Stability Oversight Council Advance Notice of Proposed Rulemaking, *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, 75 Fed. Reg. 61,653 (filed November [ ], 2010).

2. Continue to Employ Current FDIC Resolution Rules for Short-Term Debt in Systemically Important Institutional Resolutions (Existing Priority Rule)

Under current FDIC priority rules, short-term debt, with other general unsecured liabilities, is subordinated in right of payment to administrative expenses and depositor liability claims in a resolution.[15] The FDIC is entitled to first priority payment, after administrative expenses, for the amount of any insured deposits.[16] In effect, this rule imposes contract-based priority recovery on short-term debt with no discretionary carve-out.[17] It forces short-term debt to internalize the costs of failure and informs the marketplace in advance. However, imposing normal priority rules, now used for banks in FDIC resolutions, on all short-term debt, increases the incentive for short-term debt holders of non-bank financial institutions to preemptively withdraw from a systemically important institution that is perceived to be failing, instead of running the risk of impairment in a resolution. This is much less a problem for banks whose short-term debt is largely in the form of deposits. For other systemically important institutions that are substantially dependent on short-term funding as a source of liquidity, the effect of a mass exit will be severely destabilizing. Moreover, a run at one failing institution might mutate into genuine contagion if it prompts short-term creditors at other institutions to run.

3. Exemption for Short-Term Debt From Priority Recovery (Absolute Carve-Out)

Under this approach, short-term debt would be subject to a blanket exemption from the application of normal priority rules to the calculation of financial recovery, conferring an effective special guarantee, if not supplemented by other limitations, to short-term debt. While this might suppress the impulse on the part of short-term creditors to run (if there were sufficient debt subordinated to their priority), it could also promote over-reliance on short-term funding by systemically important financial institutions. It would also require a statutory change.

4. Leave Treatment of Short-Term Debt Unresolved for Now

The fourth approach, favored by the Committee, is to defer formulating final resolution procedures for systemically important financial institutions until appropriate policy responses to other dimensions of the central problem of systemic risk in the U.S. financial system have been devised and implemented by congressional and regulatory authorities.

The fundamental purpose of an effective resolution regime is to contain the risk of financial contagion associated with the failure of systemically important financial institutions. From a review of the prospective costs associated with each rule considered above, however, it is clear that any set of resolution procedures needs to be coordinated with other regulatory and statutory measures that act in concert to contain risk to the financial system. These might include, for example, the extension of a deposit-insurance regime to other short-term debt, limitations on the amount of short-term debt that systemically important financial institutions can issue, or new liquidity rules, or some combination of these and other measures.

[15] 12 C.F.R. § 360.3.
[16] *Id.*
[17] *See* 12 U.S.C. § 1821(d)(11).

Since the Dodd-Frank Act does not require that the FDIC formulate the standards governing its orderly liquidation authority immediately, the Committee recommends deferring conclusions on a final rule until FSOC can coordinate an overall government response to contagion. The determination of appropriate resolution procedures should follow from, not precede, the design of overall regulatory policy.

Thank you for considering our comments. Please do not hesitate to contact us at (617) 384-5364 if we can be of any further assistance.

Respectfully submitted,

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