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Jeffrey M. Lacker
President

January 18, 2011

Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Via www.fdic.gov/regulations/laws/federal

Dear Mr. Feldman:

Notice of Proposed Rulemaking Implementing Certain Orderly Liquidation Authority Provisions of the Dodd-Frank Act

The Federal Reserve Bank of Richmond appreciates the opportunity to respond to the Federal Deposit Insurance Corporation's request for comment on the proposed rule to implement aspects of its new orderly liquidation authority. Members of our Supervision, Regulation and Credit, Research, and Legal Departments have considered the FDIC's request and are pleased to offer the following observations.

Sincerely yours,

Jeffrey M. Lacker
President

Enclosure

The FDIC asks, "What other specific areas relating to the FDIC's orderly liquidation authority under Title II would benefit from additional rulemaking?" In our opinion, the orderly liquidation authority should be as transparent, unambiguous, and predictable as possible, and Title II would benefit from any rulemaking that makes the FDIC's authority clearer and more consistent. For this reason, we're pleased to read that the proposed rule's purpose "is to provide clarity and certainty to the financial industry and to ensure that the liquidation process under Title II reflects the Dodd-Frank Act's mandate of transparency in the liquidation of failing systemic financial companies." We worry, however, that despite the FDIC's efforts to enhance the orderly liquidation authority's transparency and predictability, the constructive ambiguity that accompanies the FDIC's discretion is likely to breed market uncertainty, which can add to financial volatility when market participants are forced to speculate on the FDIC's treatment of various similarly situated creditors. The potential for panics and runs in the face of such ambiguity could in turn impinge on the FDIC's decision making in the midst of a crisis. Greater transparency and predictability would help limit this adverse feedback loop.

Similarly, greater transparency and predictability in collateral valuation and creditor treatment, two of the specific areas covered by this proposal, could help keep creditors from allowing a covered financial company to take on too much risk. Title II of the Dodd-Frank Act gives the FDIC the authority to make interim or advance payments to creditors of a covered financial company. The company's creditors must receive no less than they would have received in a Chapter 7 bankruptcy, so in an orderly liquidation under Title II the FDIC must quickly make a Chapter 7 valuation of the troubled firm, and pay creditors based on that valuation. The need to make hasty valuations in a crisis situation, with an eye toward stemming market disruption, could create a tendency to overestimate firm values.

To enhance creditor certainty about valuations and payouts, we suggest that the FDIC write rules clearly specifying the methods it intends to employ when making valuations of covered financial companies. Once the FDIC has valued a covered financial company it can make payouts based on the Title II priority rules and can limit additional payments in some of the ways specified in the proposed rule.

We hope, though, that the FDIC will more clearly define the creditors to whom additional payments, those extra amounts the FDIC can pay to some creditors of a certain priority but not others similarly situated, will be exempt from clawback. The proposed rule spells out categories of creditors who are ineligible to receive additional payments, and the FDIC explains that the rule excludes additional payments to holders of "long-term unsecured senior debt" in order to "distinguish bondholders from commercial lenders or other providers of financing who have made lines of credit available to the covered financial company that are essential for its continued operation and orderly liquidation." This language, of course, echoes Section 210(o)(1)(D)(i) of the Dodd-Frank Act, which shields from clawback "payments or amounts necessary to initiate and continue operations essential to implementation of the receivership and any bridge financial company." The FDIC's commentary suggests that the creditors eligible for additional payments are those extending "essential" credit, which, assuming deliberate use of the word "essential," suggests in turn that a lot of additional payments could be clawback-proof. Greater clarity here is

important to mitigate risks that could arise from the potentially volatile mixture of an inherently difficult collateral valuation process, the FDIC's understandable incentive to make additional payments in the interest of quelling market disruption, and creditors' understandable pursuit of protected additional payments.

Greater clarity in advance over which credits might be labeled essential has the undesirable consequence of creating an incentive for firms to overuse those types of credits in financing themselves, thereby creating a more fragile financial structure. Recognition of this adverse incentive effect leads us to argue that designation as essential should be rare. Still, we believe that clarity on this dimension is preferable to ambiguity, which would have similar incentive effects but also induce added volatility due to policy uncertainty.