The Clearing House

February 18, 2011

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

Re: Comments on Notice of Interim Final Rule Implementing Certain Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act – 12 CFR Part 380

Dear Mr. Feldman:

The Clearing House Association L.L.C. ("**The Clearing House**")[1] respectfully submits this comment letter in response to the Notice of Interim Final Rule Implementing Certain Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("**Dodd-Frank**" or the "**Act**") published by the Federal Deposit Insurance Corporation (the "**FDIC**") in the *Federal Register* on January 25, 2011 (the "**NIFR**").[2]

We commend the FDIC for adopting the rule in interim final form and remaining open to the comments and suggestions of market participants.

As the NIFR states, the interim final rule is generally unchanged from the rule that was

[1] Established in 1853, The Clearing House is the nation's oldest banking association and payments company. It is owned by the world's largest commercial banks, which collectively employ 1.4 million people in the United States and hold more than half of all U.S. deposits. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing—through regulatory comment letters, amicus briefs and white papers—the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the U.S. *See* The Clearing House's web page at www.theclearinghouse.org.

[2] 76 Fed. Reg. 4207 (Jan. 25, 2011).

initially proposed. As a result, all the comments we made in our prior two comment letters responding to the Notice of Proposed Rulemaking (our "**November letter**" and "**January letter**," as applicable, and, together, our "**prior letters**") remain applicable except for those relating to the collateral-security language that was deleted from proposed rule 380.4(c).[3]

This letter responds to the additional questions in the Notice and the changes made to the proposed rule. For ease of reference, we include the text of the questions below and provide our responses following each question. We use the term **"covered financial companies"** to refer to both those companies that actually are subject to a Dodd-Frank liquidation proceeding and those that may be subject to such a proceeding in the event of a receivership established by the FDIC pursuant to its powers under the Act.

**Executive Summary**

As we explained in our prior letters, all of our comments are based on the key concerns that, to the maximum extent possible, (1) creditors be treated no more severely under the Dodd-Frank orderly liquidation authority ("**OLA**") than under pre-existing insolvency law, primarily the Bankruptcy Code,[4] (2) the regulations adopted by the FDIC under Title II reduce the risk that an institution will fail and, at a minimum, should not enhance the likelihood of failure or any associated systemic risk, and (3) the regulations permit parties dealing with financial companies to predict with confidence how their claims will be treated, adjudicated and reviewed if their counterparty becomes subject to OLA. All of these criteria must be met, if the liquidation authority is to meet its overall objective of preventing systemic risk and eliminating bail-outs. We believe that all the questions set forth in the NIFR can be answered by looking to the results that would be obtained under the Bankruptcy Code. This approach would ease implementation of OLA as well as settle market expectations, which have until the present been built on existing insolvency law.

**Responses to NIFR Questions**

**1. Are there additional ways to reduce moral hazard and increase market discipline and to clarify that all creditors should assume that they will receive no additional payments and their recovery will be limited to what will be paid according to the order of priorities established under Section 201(b)[5]?**

As a preliminary matter, we believe it is important to recall that the amount that a creditor will receive in a proceeding under the Act will be determined not only by the priorities

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[3] Our November letter is available at www.theclearinghouse.org/reference/comment_letters/commentLetterDocs/071045.pdf, and our January letter at www.theclearinghouse.org/reference/comment_letters/commentLetterDocs/071378.pdf.

[4] Title 11 of the United States Code.

[5] Section, subsection and title numbers refer to corresponding portions of the Act in the form in which it was enacted or to the interim final rule as adopted in the NIFR, as appropriate, unless the context otherwise requires.

set forth in Section 201(b), but also by the principle set forth in Section 210(a)(7)(B) ("**Minimum Recovery**"). We believe that providing clarity and certainty as to the manner in which the FDIC will carry out the Congressional mandate to satisfy the Minimum Recovery requirement and otherwise to conform to the treatment of claims under the Bankruptcy Code is the best way to guide creditors to expect their recoveries to be consistent with the recoveries that they would obtain under the Bankruptcy Code. In essence, by conforming to this mandate, the FDIC would lead the market to understand that the Title II liquidation proceeding is intended to avoid harmful effects on the market as a whole, not to change the position of individual creditors.

We also believe that unfounded expectations of "additional payments" will be forestalled if the FDIC's rules explain to market participants exactly (a) how their claims will be treated in the event that (i) a bridge is established and their claims are transferred to it, (ii) a bridge is established and their claims are not transferred to it or (iii) no bridge is established and (b) the manner in which the FDIC will "claw back" additional payments through the assessment process. In other words, providing market certainty as to what the FDIC *will* do will reduce expectations regarding what it will *not* do.

**2. Subsection 380.2 precludes any "additional payments" under the statute to holders of long term debt, which is defined as debt with a term in excess of 360 days. What are the positive and negative consequences that this may have for market stability? What effect might this have on long term debt and its role in funding for financial companies? Is additional flexibility needed? Are there additional ways to counteract any impression that shorter term debt is not at risk? Does using a term of 360 days adequately distinguish longer term from shorter term debt? Should a different period be used?**

As we explained in our January letter, we believe it is important that the FDIC not "fight the last war" by adopting regulations based only on experiences liquidating banks or on the last market crisis. There are significant differences between the funding and contract profiles of banks and those of non-bank financial companies. It may be true that the FDIC has not found it necessary to make current payments to long-term debtholders in bank failures or to transfer long-term debt to bridge banks. However, the reason for this history appears to lie in the funding profile that a typical bank would maintain. Insured deposits provide the primary source of funding for most banks (especially the smaller ones usually involved in an FDIC resolution); they generally rely on long-term debt at considerably lower levels than non-bank financial companies do. Indeed, raising uninsured long-term debt, for group-wide use, is a key function of non-insured affiliates of banks as well as financial companies that are not expressly affiliated with any depository institution. Creating even the mere perception that the FDIC may be predisposed toward treating short-term debt more favorably than long-term debt only exacerbates the existing pernicious tendency of counterparties to insist on increasingly shorter terms and more heavily secured financing arrangements when dealing with financial companies that the market suspects may be troubled. Deposit insurance blunts the tendency towards runs in the traditional banking context, and the FDIC should take care not to create the opposite effect when dealing with uninsured financial companies. It is thus not feasible to take the same approach when establishing a bridge in connection with the failure of a covered financial company as the FDIC traditionally would with a failing bank.

We believe that it would be a grave mistake for the FDIC to tie its hands through the rulemaking process based on a misplaced reliance on prior history. It is impossible to tell, from the present vantage point, what function long-term debt would play in the capital structure of a covered financial company in the future, or what systemic damage might result if the FDIC prevented itself from making payments or taking other actions with respect to long-term debt in circumstances in which those actions would be authorized under the statute. Fundamentally, the restrictions on “additional payments” set forth in the statute make it plain that no creditor, ex ante, can effectively rely on receiving these payments, because they will be made only if the aggregate systemic damage caused by the failure of the covered financial company would be reduced by the payment—and not based on the interests of the long-term debtholder. Accordingly, we urge the FDIC to reconsider Rule 380.2 in light of the comments made in our initial comment letter.

If, despite these points of deep concern, the FDIC still deems it desirable to establish a categorical rule foreclosing additional payments towards certain types of debt, it should issue such a rule only after consultations with the appropriate prudential regulators and target it only at instruments that are intended to be deemed regulatory capital. Ultimately, the FDIC must ensure that its focus on avoiding moral hazard works in tandem with the primary purpose of the Act: to avoid market crises in the first place. The FDIC must focus on this purpose at least as much as it targets moral hazard.

**3. What additional guidelines would be useful in creating certainty with respect to establishment of fair market value of various types of collateral for secured claims?**

Existing non-insolvency law establishes procedures for determining the fair market value of various types of collateral, whether tangible or intangible, liquid or illiquid. These procedures are respected under the Bankruptcy Code, and they should be under Title II as well. We do not believe that the FDIC should adopt different guidelines for determining the value of any type of collateral. Adopting any differing rule would distort the market for the collateral and skew the behavior of creditors in determining what types of collateral they will and will not accept. As a result, covered financial companies may be placed at a competitive disadvantage or may find their access to financing constrained. Moreover, any deviation from these well-established procedures may encourage precipitous action by creditors as a covered financial company appears to be failing, a consequence that could decrease systemic stability, not increase it.

However, we do believe that the FDIC must clarify the way in which it will determine the point in time at which the value of collateral will be fixed for various purposes under the Act. We note that the interim final rule contained in the NIFR states that value will be determined at the time of the appointment of the FDIC as receiver for a covered financial company.[6] This is

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[6] 12 C.F.R. § 380.2(c).

not consistent with the way in which collateral values are determined under the Bankruptcy Code[7] and may substantially disadvantage—or advantage—a creditor who is relying on the collateral. Any disadvantaged creditor would presumably make a claim against the covered financial company in default, thereby increasing the aggregate unsecured claims and harming other creditors.

The injustice (or windfall) to a creditor may be increased if the FDIC does not establish procedures for granting leave for a secured creditor to proceed against collateral early on in an insolvency under circumstances corresponding to those where the Bankruptcy Code would permit it.[8] The FDIC, under Section 210(a)(5), indeed has a statutory mandate to establish "a procedure for expedited relief outside of the [regular] claims process" for, among others, secured creditors. We urge the FDIC to model its expedited approach on established bankruptcy procedures, to the maximum extent practicable.[9]

We believe that the FDIC should clarify that the rights of a secured creditor under Title II will be determined in the same manner as they would under the Bankruptcy Code. As we stated in our prior letters, we believe that the treatment of collateral generally—not just the valuation issues—should be addressed in a coherent set of rules under Title II and that these rules should not be adopted piecemeal.

**4. Should the date of appointment of the receiver be used as the valuation date for all types of collateral, or only government securities or other publicly traded securities?**

As we discuss in our responses to Questions 3 and 5, we believe that the date of appointment of the receiver should not be used for all purposes as the valuation date for any type of collateral, nor should the timing of the valuation depend on the type of collateral. The FDIC should instead adopt regulations that would establish procedures for the valuation of collateral that correspond to those in effect under the Bankruptcy Code, which takes into

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[7] *See* 11 U.S.C. § 506(a)(1) ("[Collateral] value shall be determined in light of the purpose of the valuation and the propose disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest."). Bankruptcy courts have recognized that a variety of valuation times and methodologies are available under the Bankruptcy Code, depending on the circumstances of the case. *See Wood v. LA Bank*, 190 B.R. 788, 790-93 (Bankr. M.D. Pa. 1996) (collecting cases and adopting an 11-factor balancing test).

[8] *See* 11 U.S.C. § 362(d) (providing that, after notice and a hearing, a bankruptcy court may lift the automatic stay on actions with respect to debtor assets and allow secured creditors to take action with respect to collateral). The Bankruptcy Code permits the stay to be lifted if the creditor's interest in the collateral is inadequately protected, or if the debtor has no equity in the property and its presence in the estate is not necessary for an effective reorganization. *Id.* Appropriate relief is generally granted within 30 days of the request. *See id.* at § 362(e).

[9] In the context of insured depository institution receiverships, the FDIC has even taken the position that "self-help" liquidation of collateral by secured creditors would be acceptable, though it recommended the simultaneous filing of a "protective" proof of claim with the receiver as well. *See* Advisory Opinion: Self-Help Liquidation of Collateral by Secured Claimants in Insured Depository Institution Receiverships (Dec. 15, 1989) (avail. at www.fdic.gov/regulations/laws/rules/4000-5130.html#fdic400089-49).

account the timing and purpose of the valuation as well as the proposed action connected with the valuation.

**5. Who should receive the benefit or burden of market fluctuation between the date of appointment of the receiver and the date of payment of a claim? For example, if a claim is for $100, and the collateral is valued at $98 on the date of appointment of the receiver, and at $102 at the date of payment of the claim, should the claimant receive $98 plus an unsecured claim of $2, should they receive the full value of their secured claim of $100, or should they receive the full value of the collateral, i.e., $102?**

We believe that the rights of secured creditors are one of the many areas in which conformity with Bankruptcy Code rules and practice will be most important to ensure the availability of credit to covered financial companies, whether in good times or bad. Furthermore, we believe that the timing of the valuation of collateral in a Title II proceeding should be tied to the purpose of the valuation.

While there is some variation in the practice of the courts under the Bankruptcy Code, courts have "virtually uniformly recognized that the value of property securing a claim, and thus the allowed amount of the secured claim, may change during the course of a bankruptcy case," whether as a result of payments made during the course of the case, fluctuations in the value of the collateral or changes in the applicable method of valuation.[10] As *Colliers* notes,

> the amount of a single item of property may be valued in different ways depending on the context of the valuation. At the outset of a case, the secured claim might be fixed at one amount in connection with a request for adequate protection or relief from stay. Later on, it might be fixed at another amount in connection with a determination of whether the creditor is adequately protected if a senior or equal lien is granted to a postpetition lender pursuant to section 364(d) [of the Bankruptcy Code]. Later still, the claim might be fixed at yet another amount in connection with a proposed disposition of the collateral, and still another amount for purposes of a plan. Thus, the amount of any claim secured by collateral may be regarded as something of a "moving target."[11]

A number of specific examples of this principle may be drawn from bankruptcy practice. For instance, if a creditor obtains relief (or is exempt) from the stay and is permitted to

[10] Collier on Bankruptcy ¶ 506.03[7][f] (2010). Because judicial circuits may split as to matters of law, we suggest that the FDIC select a specific judicial circuit—such as the Second Circuit—to guide its actions in the context of Title II.

[11] *Id.* Section 506(a)(2) of the Bankruptcy Code applies a different rule with respect to personal property in an individual case under Chapter 7 or 13 of the Bankruptcy Code, referring to the date of filing of the petition. However, this rule would not be applicable to cases such as those that would, by definition, be covered by Title II.

liquidate the collateral, then the actual value obtained in the liquidation would be used in determining the remaining unsecured portion of the claim.[12] The FDIC should adopt a similar approach under Title II: unless the propriety of the sale is in doubt, there is no reason here to use a valuation that would likely differ from the actual amount realized.

If leave to liquidate the collateral is not forthcoming, bankruptcy law provides that the secured creditor be granted adequate protection against the depreciation of collateral[13] and a superpriority administrative claim if the protection proves inadequate.[14] In such a case, the collateral is valued twice: first, at the inception of the case, in order to determine how much protection is to be provided, and second, at the time the collateral is disposed of (or a plan of reorganization confirmed), in order to ensure that the protection provided did not exceed or fall short of the amount required.[15] By contrast, creditors who turn out to be oversecured have claims limited to the face value of the debt, with an allowance for interest, fees and costs.[16] The FDIC should take a similarly bounded approach when dealing with collateral that is not immediately released in an OLA proceeding.

This non-exhaustive list, drawn from bankruptcy practice, emphasizes the extent to which a valuation procedure must be adapted to its functional context.

In our prior letters we urged the FDIC to address the rights of secured creditors in a single, coherent regulation. We believe that the timing and methodology of valuation can be addressed only when taking into account such questions as (i) how and when the secured creditor will be able to obtain relief from the stay on exercise of foreclosure remedies, (ii) how the FDIC will provide "adequate protection" to creditors entitled to it and (iii) where and how the valuations will be used.

**6. Should the FDIC designate a specific time during the term of the receivership to estimate contingent claims?**

We believe that the FDIC should adopt a rule specifying the treatment of contingent claims and that this rule should conform to the treatment of such claims under the Bankruptcy Code. Accordingly, the rule should not specify the time in relation to the appointment of the receiver, but rather should recognize that claims may become fixed so long as the contingency is satisfied before such recognition would unduly delay the administration of the receivership. This approach would be consistent with Section 502(c) of the Bankruptcy Code, which provides

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[12] S*ee* Collier on Bankruptcy ¶ 506.03[6][b] (2010) ("if an actual sale (or equivalent disposition) is to occur, the value of the collateral should be based on the consideration"); *see also* 11 U.S.C. § 506(a)(1) (permitting the bifurcation of an undersecured claim into a secured claim up to the value of the collateral, and an unsecured claim for amounts above such value).

[13] *See* 11 U.S.C. § 361.

[14] *See* 11 U.S.C. § 507(b).

[15] *See In re Callister*, 15 B.R. 521 (D. Utah 1981).

[16] *See* 11 U.S.C. § 506(b).

that a contingent claim will be estimated only if the fixing or liquidation of the claim would "unduly delay the administration of the case."

We reaffirm the other comments that we made in our prior letter with respect to the treatment of contingent claims, and note again that addressing these issues will assist in permitting the FDIC to satisfy the Minimum Recovery requirement of the Act.

**General**

We have addressed a number of issues relating to the substantive rights of creditors in our prior letters and in this letter, including the "Minimum Recovery" requirement that is so fundamental to the protection of creditors of a covered financial company and thus critical to drawing a floor under the markets in a time of panic. We cannot overemphasize, however, the importance of providing clear procedural guidelines and protections for creditors in a Title II liquidation proceeding. The FDIC must establish by regulation procedures to permit creditors to obtain a full hearing of their claims and an impartial third-party review of determinations made at the administrative level. As we discussed in our prior letters, creditors must know how their claims will be determined and how they may dispute or appeal determinations with respect to those claims. The ability to obtain judicial review of determinations by the receiver—whether in resolving claims submitted by creditors or in pursuing claims against creditors (such as preference and fraudulent-transfer clawbacks)—is essential to the fairness of the process. We urge the FDIC to implement Title II in a manner that assures creditors that they will be treated fairly, and that the tools necessary to ensure this fairness will be in place when a crisis occurs.

**Conclusion**

The Clearing House appreciates your consideration of the views expressed in this letter. We believe that the understanding of the application of the new liquidation authority will develop in the future, as the full range of entities and transactions that must be addressed by the new regime is worked through by regulators, creditors and other parties.

Fundamentally, we believe that three overarching principles should guide the FDIC (in consultation with the Financial Stability Oversight Council) when developing OLA rules in the months ahead. First, predictable, transparent, fair and well-integrated procedures must be established by the FDIC with respect to its OLA powers. Without unduly constraining its discretion and flexibility under OLA, the FDIC should provide a transparent framework in which it would exercise its judgment under Title II. Second, the substantive approaches and functional results pursued by the FDIC should, to the greatest extent practicable, reflect those that would apply to a covered financial company under the Bankruptcy Code and, in all cases, work towards guaranteeing the Minimum Recovery. Any firm that is potentially subject to one of two conflicting or incompatible insolvency regimes is, ex ante, effectively subject to both at the same time, as customers, creditors and counterparties seek to structure their relationships to accommodate both sets of rules. Unless managed with utmost care, such a circumstance can easily lead to confusion, inefficiency, wasted resources, and potentially devastating surprises at inopportune moments. Third, and finally, the regulations adopted under Title II must reduce, or at least not enhance, the likelihood of failure; reducing moral hazard and managing systemic risk must be complementary, not conflicting, activities.

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We welcome the opportunity to meet with you on an ongoing basis to discuss the proposed rules and our comments in our letters. If you have any questions or need further information, please contact me at (212) 613-9812 (or Mark.Zingale@TheClearingHouse.org) or Eli Peterson at (202) 649-4602 (or Eli.Peterson@TheClearingHouse.org).

Very truly yours,

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