May 23, 2011

By electronic submission to www.fdic.gov

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

Re: FDIC's Second Notice of Proposed Rulemaking under Title II of the Dodd-Frank Act
FR Docket No. 2011-6705

- Recapitalizations as an Effective Way to Resolve Systemically Important Banks and Non-Bank Financial Companies on a Closed Basis without Taxpayer-Funded Bailouts

Ladies and Gentlemen:

The Securities Industry and Financial Markets Association ("**SIFMA**")[1] and The Clearing House Association L.L.C. ("**The Clearing House**" or "**TCH**")[2]

---

[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

[2] 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.

respectfully submit this comment letter in response to the second Notice of Proposed Rulemaking (the "**Second NPR**") published by the FDIC on March 23, 2011,[3] to implement certain provisions of the orderly liquidation authority contained in Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**").[4]

We are submitting two separate but joint comment letters on the Second NPR. The first comment letter addresses the specific proposed rules and the questions posed in the Second NPR.[5] This second comment letter submits a joint SIFMA and TCH working paper on recapitalizations as an effective way to resolve systemically important banks and non-bank financial institutions (collectively, "**SIFIs**") on a closed basis without taxpayer-funded bailouts. The working paper is attached as Annex A to this comment letter.

Recapitalizations as a Credible Alternative

The working paper presents recapitalizations as an option in the FDIC's orderly resolution toolkit. We believe that recapitalizations are likely to be more effective during a financial panic than a liquidation of financial assets or the sale of a troubled or insolvent SIFI to a third party pursuant to a traditional purchase-and-assumption agreement. We also believe they provide a credible alternative to the Hobson's choice between a taxpayer-funded bailout and a "disorderly" liquidation or reorganization of a failed SIFI that could result in a severe destabilization or collapse of the financial system during a financial panic.

Resolving SIFIs by recapitalizing the systemically important or other viable parts of their businesses should reduce the incentive of creditors to run at the first sign of trouble, while ensuring that any and all losses are ultimately borne by shareholders and creditors rather than taxpayers. As a result, it should be more effective than the liquidation of financial assets or the traditional purchase-and-assumption technique in balancing the FDIC's duties to maximize value, minimize losses, preserve or restore financial stability and confidence in the financial system, minimize moral hazard and maximize market discipline.

---

[3] Federal Deposit Insurance Corporation, Second Notice of Proposed Rulemaking Implementing Certain Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, 76 *Fed. Reg.* 16324 (March 23, 2011).

[4] Pub. L. No. 111-203, § 201 et seq., 124 Stat. 1376 (2010).

[5] *See* Letter from SIFMA, The Clearing House, the American Bankers Association, and the Financial Services Roundtable, to the FDIC, *Comments on Notice of Proposed Rulemaking Implementing Certain Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act* (May 23, 2011).

The working paper is not limited to non-bank SIFIs that are subject to resolution under Title II of the Dodd-Frank Act. It also applies to systemically important banks that are subject to resolution under the Federal Deposit Insurance Act (the "**FDI Act**").[6] We believe it would be misleading and unproductive to discuss the one without the other, since many non-bank SIFIs have one or more bank SIFIs as their most important subsidiaries.

The working paper is designed as a starting point in what we hope will be a fruitful public discussion about using the recapitalization technique as an effective way to resolve bank and non-bank SIFIs. We believe this paper should eliminate misperceptions that Title II requires the value-destroying liquidation of financial assets at the bottom of the market during a financial crisis. It should also reduce concerns that there may not be enough or even any institutions confident enough during a financial crisis to acquire a troubled or insolvent SIFI pursuant to a traditional purchase-and-assumption agreement. It should also reduce concerns that the "going-concern surplus" of a bank or non-bank SIFI—the difference between the going-concern value and the liquidation value of a bank or non-bank SIFI—will be transferred at a discount to a third party at the expense of creditors rather than being preserved for their benefit.

Summary of the Recapitalization Proposal

Under the FDI Act and Title II, the FDIC is appointed as receiver of the failed bank and non-bank SIFI, respectively. The failed bank or non-bank SIFI that is put in receivership under the FDI Act or Title II is typically liquidated, but the FDIC as receiver may elect to do so after transferring all or any portion of the closed institution's assets and liabilities to a bridge entity, which it is authorized to charter.

As described in more detail in Annex A, the proposed recapitalization technique involves using the FDIC's traditional and new receivership powers to create a bridge entity, transfer the systemically important and viable part of the closed institution's business to the bridge entity, recapitalize that business by exchanging debt claims against the closed institution for equity in the bridge entity, and liquidate the closed institution left behind. Thus, the FDIC could transfer to the bridge entity those parts of a closed institution's business that are deemed to be more valuable as a going concern, systemically important or otherwise viable. The FDIC as receiver would have the power to turn the bridge entity over to the closed institution's creditors by issuing equity in the bridge entity in satisfaction of their claims against the closed institution.

---

[6] Federal Deposit Insurance Act, 12 U.S.C. § 1811 et seq.

While the transfer of assets and liabilities to a bridge may be necessary within a compressed timeframe, the conversion of claims against the failed institution for equity in the bridge need not be rushed, and could take place during the normal claims and liquidation process. We believe that the FDIC currently has all the authority necessary to put this proposed recapitalization technique into effect.

Recapitalizations as a Bridge Between Orderly Liquidation Authority and Other Proposals Being Discussed Internationally

Our recapitalization proposal is also a useful bridge between orderly liquidation authority and various going concern bail-in or contingent-capital proposals that are being discussed internationally. As a result, it should facilitate discussions about how to resolve a global SIFI with cross-border operations. Orderly liquidation authority and such other proposals are not mutually exclusive or necessarily competing alternatives. Instead, they could supplement or substitute for each other. The orderly resolution provisions in Title II and the FDI Act are flexible enough to be used to recapitalize the systemically important or other viable parts of the business of a bank or non-bank SIFI that has been placed in an FDIC receivership. In this sense, they can be used to produce outcomes that are very similar to a write-down of debt or the exchange of debt for equity on the eve of a SIFI's insolvency. A recapitalization under Title II is, however, substantially different from going concern bail-in or contingent-capital proposals with early triggers, both of which would result in a write-down or conversion of debt to equity long before insolvency. These other proposals could, however, supplement a recapitalization under Title II if it were determined that they were desirable.

The working paper does not, however, address all of the potential issues that might arise out of the cross-border resolution of a global SIFI. Our conviction is that it will be more productive and useful to address issues for an effective resolution on a domestic basis first, and then address how recapitalizations could be used to facilitate the cross-border resolution of a global SIFI in a second step. This is not to say that developing credible plans for cross-border resolutions of global SIFIs is not an important or even the predominant issue. Like most other complex problems, this one is more likely to be solved effectively if it is broken down into parts and solved one step at a time. We expect to revise the working paper in the near future to address these important cross-border issues after the public discussion of the working paper is under way.

* * * * * * *

We are grateful to the FDIC for providing us with this opportunity to submit this recapitalization proposal in response to the FDIC's request for comments on the Second NPR. If you have any questions, please do not hesitate to call Kenneth E. Bentsen, Jr. for SIFMA, at 202-962-7400, Mark Zingale for The Clearing House, at 212-613-9812, or Randall D. Guynn at Davis Polk & Wardwell LLP, at 212-450-4239.

Sincerely,

Kenneth E. Bentsen, Jr.
Executive Vice President,
Public Policy and Advocacy
Securities Industry and Financial
Markets Association

Mark Zingale
Senior Vice President and
Associate General Counsel
The Clearing House Association

cc: Sheila C. Bair
Chairman
Federal Deposit Insurance Corporation

Martin J. Gruenberg
Vice Chairman
Federal Deposit Insurance Corporation

Thomas J. Curry
Director
Federal Deposit Insurance Corporation

John Walsh
Acting Comptroller of the Currency
Director
Federal Deposit Insurance Corporation

John E. Bowman
Acting Director of the Office of Thrift Supervision
Director
Federal Deposit Insurance Corporation

****

Timothy F. Geithner
Secretary of the Treasury
U.S. Department of the Treasury

****

Benjamin S. Bernanke
Chairman
Board of Governors of the Federal Reserve System

William C. Dudley
President and Chief Executive Officer
Federal Reserve Bank of New York

****

Michael H. Krimminger, Esq.
General Counsel
Legal Division
Federal Deposit Insurance Corporation

James Wigand
Director, Office of Complex Financial Institutions
Federal Deposit Insurance Corporation

Arthur Murton
Director, Division of Insurance and Research
Federal Deposit Insurance Corporation

R. Penfield Starke, Esq.
Senior Counsel, Receivership Policy Unit
Litigation and Resolutions Branch
Legal Division
Federal Deposit Insurance Corporation

John V. Thomas, Esq.
Deputy General Counsel, Supervision Branch
Legal Division
Federal Deposit Insurance Corporation

Marc Steckel
Associate Director, Financial Risk Management Branch
Financial Risk Management and Research
Division of Insurance and Research
Federal Deposit Insurance Corporation

David N. Wall, Esq.
Assistant General Counsel, Receivership Section
Litigation and Resolutions Branch
Legal Division
Federal Deposit Insurance Corporation

Herbert J. Held
Associate Director, Resolution Strategy
Franchise and Asset Marketing Branch
Division of Resolutions and Receiverships
Federal Deposit Insurance Corporation

Ryan K. Clougherty
Senior Attorney
Federal Deposit Insurance Corporation

Phillip E. Sloan
Counsel
Federal Deposit Insurance Corporation

Patricia G. Butler
Counsel
Federal Deposit Insurance Corporation

Elizabeth Falloon
Counsel
Federal Deposit Insurance Corporation

Thomas Bolt
Supervisory Counsel
Federal Deposit Insurance Corporation

****

Timothy G. Massad
Acting Assistant Secretary for Financial Stability
U.S. Department of the Treasury

Laurie Schaffer, Esq.
Assistant General Counsel for Banking and Finance
U.S. Department of the Treasury

Felton C. Booker
Acting Director
Office of Financial Institutions Policy
U.S. Department of the Treasury

****

Patrick M. Parkinson
Director
Division of Banking Supervision and Regulation
Board of Governors of the Federal Reserve System

Mark E. Van Der Weide
Senior Associate Director
Division of Banking Supervision and Regulation
Board of Governors of the Federal Reserve System

Barbara J. Bouchard
Senior Associate Director
Division of Banking Supervision and Regulation
Board of Governors of the Federal Reserve System

Scott G. Alvarez, Esq.
General Counsel
Board of Governors of the Federal Reserve System

Christine M. Cumming
First Vice President
Federal Reserve Bank of New York

Jeanmarie Davis
Senior Vice President
Federal Reserve Bank of New York

Thomas C. Baxter, Jr., Esq.
General Counsel and Executive Vice President
Federal Reserve Bank of New York

Joyce M. Hansen, Esq.
Deputy General Counsel and Senior Vice President
Federal Reserve Bank of New York

******

Carter McDowell
Managing Director and Associate General Counsel
Securities Industry and Financial Markets Association

SIFMA Systemic Risk & Prudential Standards Committee

SIFMA Resolution Authority and Living Wills Committee

****

Paul Saltzman, Esq.
General Counsel and Head of The Clearing House Association
The Clearing House Association L.L.C.

The Clearing House Association Advisory Group on Orderly Liquidation Authority

The Clearing House Association Bank Regulatory Committee

The Clearing House Association Government and Legislative Affairs Committee

The Clearing House Association Working Groups on Basel Capital Proposals

****

H. Rodgin Cohen, Esq.
Senior Chairman and Partner
Sullivan & Cromwell LLP

Rebecca J. Simmons, Esq.
Partner
Sullivan & Cromwell LLP

William F. Kroener, III, Esq.
Counsel
Sullivan & Cromwell LLP

Seth Grosshandler, Esq.
Partner
Cleary Gottlieb Steen & Hamilton LLP

Karen Shaw Petrou
Managing Partner
Federal Financial Analytics, Inc.

Susan Krause Bell
Partner
Promontory Financial Group, LLC

Donald Bernstein, Esq.
Partner and Head of Insolvency and Restructuring Practice
Davis Polk & Wardwell LLP

John L. Douglas, Esq.
Partner and Head of Bank Regulatory Practice
Davis Polk & Wardwell LLP

Randall D. Guynn, Esq.
Partner and Head of Financial Institutions Group
Davis Polk & Wardwell LLP

Margaret E. Tahyar, Esq.
Partner, Financial Institutions Group
Davis Polk & Wardwell LLP

Reena Agrawal Sahni, Esq.
Counsel, Financial Institutions Group
Davis Polk & Wardwell LLP

<u>ANNEX A</u>

RECAPITALIZATIONS AS AN EFFECTIVE WAY TO RESOLVE SYSTEMICALLY IMPORTANT BANK AND NON-BANK FINANCIAL INSTITUTIONS ON A CLOSED BASIS WITHOUT TAXPAYER-FUNDED BAILOUTS

Joint Working Paper of
The Securities Industry and Financial Markets Association and
The Clearing House Association L.L.C.

May 23, 2011

1. INTRODUCTION

1.1. The purpose of this working paper is to explain how the FDIC can use its traditional and new resolution powers to close, liquidate and resolve systemically important banks and non-bank financial institutions that become "gone concerns" during a financial crisis:

- without a taxpayer-funded bailout;

- in a way that:

    - ensures that shareholders and creditors, rather than taxpayers, bear the losses of the closed institutions (thereby minimizing moral hazard and maximizing market discipline);

    - ensures that managers responsible for the failures of the closed firms that have not already been replaced can be replaced with competent new managers in a way that preserves and does not destroy value (therefore minimizing moral hazard and maximizing market discipline);

    - mitigates or avoids a severe destabilization or collapse of the financial system by:

        - avoiding the value destruction inherent in a fire sale or disorderly liquidation of the closed firms or their assets, and by an immediate close out of the derivatives book, at the bottom of the market during a financial crisis;

        - preserving the operation of systemically important functions of an institution during a financial panic (such as payment systems, security settlement systems or other functions that a significant portion of the market relies on);

- preserving the going-concern surplus of the systemically important and other viable parts of the businesses of the closed firms for the benefit of their creditors and without transferring that surplus to third parties for less than equivalent value; and

- returning the systemically important and viable part of the businesses of the closed firms to the private sector promptly and without a lengthy and potentially costly period of government control;

- without having to sell or merge all or a portion of the closed firms to, with or into other firms during a financial crisis.

1.2. The proposed technique involves using the FDIC's traditional and new resolution powers to transfer the systemically important and viable part of the business of a closed bank or nonbank financial institution to a bridge entity and recapitalizing that business by exchanging debt claims against the closed firm for equity in the bridge. Alternatively, if useful to facilitate a cross-border resolution, it could involve transferring everything but the systemically important and viable part of the business of a closed bank or nonbank financial institution to a bridge entity and recapitalizing the business left behind by exchanging debt claims against the bridge for equity in the closed firm left behind. We believe that the FDIC currently has all the authority necessary to put this proposed technique into effect.

1.3. This approach is **not** a bail-in, but has all of the advantages of a bail-in while addressing many of the challenges faced by bail-in and other recapitalization proposals.

1.4. This approach is not preclusive of other resolution techniques, such as purchase-and-assumption sales to third parties with or without loss-sharing. Rather, it is simply another tool in the FDIC's toolkit that we believe is better designed to close, liquidate and resolve systemically important banks and non-bank financial institutions during a financial crisis when the purchase-and-assumption technique may be ineffective or inconsistent with the goals of avoiding or mitigating a severe destabilization or collapse of the financial system.

1.5. Nor is our proposal preclusive of pre-receivership measures, such as prompt corrective action, recovery plans or various going concern bail-in or contingent-capital proposals being discussed internationally.[1] Indeed, our proposal has been

[1] Bail-in and contingent capital instruments may be used as tools for recapitalizing SIFIs ***before*** (sometimes well before) any insolvency, receivership or other similar proceedings have been commenced, depending on where the trigger for conversion is fixed. Statutory bail-in refers to the power to convert debt to equity upon the occurrence of certain triggers without obtaining the consent of creditors. Contractual bail-in or contingent capital refers to instruments that convert from debt to equity based upon the occurrence of certain contractually agreed upon triggers. *See, e.g.*, Clifford Chance, *Legal Aspects of Bank Bail-Ins* (2011), *available at* http://www.cliffordchance.com/publicationviews/publications/2011/05/legal_aspects_ofbankbail-ins.html; Institute of International Finance, *Addressing Priority Issues in Cross-Border Resolution* (2011), *available*

consciously designed to be ***neutral*** as to these other proposals. This working paper neither endorses nor rejects these other proposals as substitutes or supplements to resolution authority. Instead, our proposal is offered as a final, credible and fail-safe option in case any pre-receivership measures are not successful.

1.5.1. Our proposal is different from the going concern bail-in and contingent-capital proposals currently being discussed because our proposal would only be effected ***after*** an institution has been closed and placed into a receivership proceeding, rather than before it has been placed into a receivership, insolvency or other similar proceeding.

1.5.2. Nevertheless, we believe it will provide a useful bridge between orderly liquidation authority and these other proposals. As a result, it should facilitate international discussions about how to resolve a systemically important financial institution with cross-border operations. It will eliminate the misimpression that Title II and the Federal Deposit Insurance Act (the "**FDI Act**") require value-destroying liquidations of financial assets at the bottom of the market during a financial crisis. It should provide comfort that the resolution authority is actually designed to maximize the value of an institution and minimize losses for the benefit of its creditors. In this sense, our proposal shows that resolution authority can be used to produce outcomes that are very similar to a statutory bail-in effected on the eve of insolvency or similar proceedings.

2. NATURE OF THE "TOO SYSTEMICALLY IMPORTANT TO FAIL" DILEMMA

2.1. The "too systemically important to fail" dilemma, cast prominently into focus by the recent financial crisis, refers to the suboptimal choice between letting a systemically important bank or non-bank financial institution fail and potentially destabilize the financial system, or bailing out the institution with taxpayer funds, with related moral hazard consequences.[2]

2.2. Title II of the Dodd-Frank Act was enacted to provide a means of resolving a nonbank financial company in an attempt to address too systemically important to fail by fulfilling a dual statutory mandate: (i) eliminating taxpayer-funded bailouts and minimizing moral hazard by closing and liquidating a failed institution in a manner that ensures that shareholders and creditors instead of

---

at http://www.iif.com/press/press+187.php; Calello & Ervin, *From Bail-Out to Bail-In*, in THE ECONOMIST (Jan 28, 2010), *available at* http://www.economist.com/node/15392186?story_id=15392186; Huertas, *The Road to Better Resolution: From Bail-Out to Bail-In* (LSE Fin. Mkts. Group Paper Series, Special Paper 195, 2010), *available at* http://www2.lse.ac.uk/fmg/workingPapers/specialPapers/SP195.pdf.

[2] *See, e.g.*, Remarks by FDIC Chairman Sheila C. Bair, "Ending Too Big to Fail: The FDIC and Financial Reform," 2010 Glauber Lecture at the John F. Kennedy, Jr. Forum, Harvard University (Oct. 20, 2010). *See also* Guynn, *Are Bailouts Inevitable?*, YALE J. ON REG. (forthcoming Fall 2011).

taxpayers bear its losses and that managers responsible for the failed institution's failure are replaced with responsible and competent new managers, while (ii) avoiding or minimizing severe financial instability or a collapse of the financial system that could result from runs or other self-preservation reactions, by preserving the going-concern value of the systemically important and other viable portions of the closed firm's business for the benefit of the closed firm's creditors, and otherwise avoiding value destruction.[3] Clear communication of how the FDIC's authority under Title II and the FDI Act could be implemented in a way that maximizes creditor recoveries and thereby mitigates financial instability is also important to efforts to strengthen the credibility and market acceptance of Title II.

2.3. Title II was modeled on the bank receivership provisions in the FDI Act, which includes similar statutory powers to resolve insured depository institutions.[4] Together with Title II, the bank receivership provisions of the FDI Act give the FDIC full power to resolve systemically important bank and non-bank financial institutions in the manner proposed by this working paper. The insolvency of insurance subsidiaries is not addressed by this proposal, nor is the insolvency of non-U.S. subsidiaries.

2.4. Until the FDIC released its report (the "**Lehman Report**") on how it could have used its new orderly liquidation authority to resolve Lehman Brothers in a more orderly fashion than how that institution was resolved under the Bankruptcy

---

[3] Title II of the Dodd-Frank Act establishes a new system for resolution of bank holding companies, nonbank financial companies supervised by the Federal Reserve, and companies that are predominately engaged in financial-in-nature activities, the failure of which could cause serious adverse effects to financial stability in the United States if resolved under normal insolvency law and the use of Title II would avoid or mitigate such adverse effects. *See* Sections 201(a)(11) and 203(b) of the Dodd-Frank Act. In those circumstances, Title II would displace the Bankruptcy Code as the statute governing their liquidation.

Under Title II, the FDIC is required to liquidate the closed financial company, but may elect to do so after transferring all or any portion of the covered financial company's assets and liabilities (such as the systemically important and other viable portion of the covered financial company's business) to a bridge financial company. Alternatively, if useful to facilitate a cross-border resolution, it should be able to satisfy this liquidation requirement by transferring all but the systemically important and other viable part of the covered financial company's business to the bridge, subject to certain conditions, and liquidate the bridge. As a result, Title II does not mandate the liquidation of financial assets at the bottom of the market during a financial crisis. Instead, it gives the FDIC an important tool to preserve the going-concern value of these assets by transferring them and any related liabilities to a bridge and ensuring that the bridge is a creditworthy counterparty with sufficient liquidity to operate efficiently, or leaving that portion of the business behind and ensuring that the covered financial company is a creditworthy counterparty with sufficient liquidity to operate efficiently.

[4] For a comprehensive discussion of the FDIC's resolution powers under the FDI Act and Title II, see Douglas and Guynn, *Resolution of U.S. Banks and Other Financial Institutions*, in DEBT RESTRUCTURING (Look Chan Ho & Nick Segal consultant eds., Oxford Univ. Press 2011).

Code,[5] the FDIC's public statements regarding the resolution of systemically important financial institutions ("**SIFIs**")[6] had focused mainly on how it would use its new orderly liquidation authority to minimize any moral hazard by ensuring that the shareholders and creditors of a failed SIFI would ultimately bear any and all of its losses should it fail. In its Lehman Report, the FDIC clarified how Title II could be used to provide liquidity or even loss-sharing support to a bridge in order to maximize its value, minimize its losses and preserve or restore financial stability during a financial crisis, without having to resort to a taxpayer-funded bailout.

2.5. The filing by a non-bank financial company of a petition under the Bankruptcy Code or the appointment of the FDIC as receiver of a bank commences what many refer to as a "melting ice cube" process in which franchise value rapidly deteriorates until the financial company or bank is liquidated or sold. While many businesses can continue to operate as a debtor in bankruptcy, it is difficult for a bank or other financial institution to do so. Financial institution bankruptcies therefore often commence with fire-sales of assets and businesses, and bank receiverships with fire-sale purchase-and-assumption sales of the closed banks or its assets to third parties, in order to raise cash, and to halt the destruction of the institution's going-concern value. One of the purposes of the FDI Act and Title II of the Dodd-Frank Act is to provide a means of resolving a bank or non-bank SIFI in a way that avoids this value destruction and preserves going-concern value for the benefit of its creditors.

3. RECAPITALIZATIONS UNDER THE FDI ACT AND TITLE II

3.1. We believe that among the important tools that could be used to address too systemically important to fail are recapitalizations of the systemically important and other viable portions of a closed institution's business under the FDI Act or Title II of the Dodd-Frank Act, and liquidation of the remaining portion of the closed institution's business. Such recapitalizations involve the transfer of such businesses to a bridge company, the exchange of claims against the closed

[5] *See* FDIC, *The Orderly Liquidation of Lehman Brothers Holdings Inc. under the Dodd-Frank Act*, FDIC Quarterly, vol. 5, No. 2 (forthcoming 2011), *available at* http://www.fdic.gov/bank/analytical/quarterly/2011_vol5_2/lehman.pdf.

[6] Throughout this proposal, we refer to systemically important bank and non-bank financial institutions collectively as systemically important financial institutions or SIFIs. We refer to SIFIs with significant cross-border operations as global SIFIs. We have chosen to use the terms SIFI and global SIFI because those terms have achieved a widespread international usage. When we use the term "bank," however, we mean all "insured depository institutions" for purposes of the FDI Act and Title II of the Dodd-Frank Act and when we use the term "financial institution" we mean "financial company" for purposes of Title II of the Dodd-Frank Act. Although the FDI Act and Title II of the Dodd-Frank Act are not limited to systemically important banks and non-bank financial institutions, we have focused on SIFIs and global SIFIs because they are most relevant for purposes of the "too significant to fail" dilemma and are most likely to be subject to the Title II orderly liquidation provisions.

institution for equity in a bridge, and liquidation of the closed institution left behind.

3.2. Prior to passage of the Dodd-Frank Act, U.S. regulators lacked a mechanism to close and resolve a non-bank SIFI. The FDI Act and Title II, however, now provide the FDIC with ample power to resolve both bank and non-bank SIFIs by recapitalizing the viable parts of their businesses by transferring those businesses to a bridge entity and exchanging claims against the closed non-bank SIFI for equity in the bridge.

3.3. The transfer of the business to a bridge, followed by a recapitalization of the transferred business, will allow that business to continue to operate without an immediate sale to a third party. This will allow the FDIC to minimize the systemic risk of a contagion that could result in a substantial destabilization of the financial system upon the collapse of a SIFI during a financial crisis. It would do so without a taxpayer-funded government bailout.

3.4. Recapitalization should mitigate the risk of so-called "runs" by creditors during a financial panic—the classic "herding" behavior of "runable" creditors during a financial panic—by taking steps to give them confidence that their claims will be transferred to a creditworthy bridge or their downside exposure will be limited by their pro-rata share of the going-concern value of the viable part of the closed institution's business (rather than its far lower liquidation value). As proposed below, runable creditors of the failed SIFI would become creditors of a solvent, well-capitalized bridge, and would be repaid in full, in the ordinary course of business. Funding should therefore continue to be available to the financial system—especially if creditors are confident that the FDIC will resolve other SIFIs in this way, should additional failures occur. Subordinated and other nonrunable creditors would become the new owners of the bridge by exchanging enough of their claims against the closed institution for equity in the bridge to fully capitalize the bridge, in reverse order of their relative priorities working up the capital stack from the most junior to the most senior. Clear communications by the FDIC of their ability and intent to use such tools in such a manner, as the FDIC has done with respect to bank insolvencies under the FDI Act, will be critical for establishing a smoothly functioning, risk aware market.

3.5. Recapitalizations under the FDI Act and Title II have the following characteristics, which distinguish them from certain other resolution techniques:

3.5.1. All or a portion of the SIFI's operations would continue after the recapitalization, without transferring the firm or the firm's going-concern surplus to a third party without the consent or at the expense of the failed institution's creditors;

3.5.2. Legal claims of creditors would be reduced or eliminated in exchange for equity in a bridge bank or other bridge financial institution to which all or the viable portion of the closed institution's business were transferred (FDI Act or Title II);[7]

3.5.3. The recapitalization could be implemented by a regulatory body over a weekend or some other compressed time frame, or over a more extended period of time, depending on which approach would be most likely to maximize value, minimize losses, preserve or restore financial stability and market confidence, minimize moral hazard and maximize market discipline;[8] and

3.5.4. Results could be imposed without negotiation with the failing institution or its creditors,[9] and without the need for injections of new equity into the institution.

3.6. What follows is a discussion of how the FDI Act and Title II could be used to effect such a recapitalization.

4. Pre-Dodd-Frank Act Resolutions under the FDI Act

4.1. The FDIC has long had the power under the FDI Act to resolve a systemically important bank by transferring the viable part of its business to a bridge bank.[10]

---

[7] We would anticipate that only certain classes of debt would be exchanged for equity and that shareholder claims would remain behind in the receivership. We can envision circumstances where all subordinated debt and even a portion of the general creditor claims would be exchanged for equity in the bridge, with the rest of the general creditor claims, and secured claims, being transferred to the bridge, depending upon an assessment of the value of the assets transferred to the bridge bank and the assets left behind in the receivership. We believe that litigation claims should be left behind in the failed bank or non-bank SIFI, and not transferred to a bridge, but this issue should probably be studied further in light of the goals of minimizing moral hazard and avoiding or mitigating severe financial instability during a financial crisis.

[8] Under the FDI Act or Title II, the FDIC has the flexibility to transfer all of the assets and liabilities of the failed institution to a bridge (subject to the requirement in the case of Title II only that the aggregate liabilities cannot exceed the aggregate assets transferred to a bridge), transfer only some of them, transfer assets and liabilities back and forth between the receivership and the bridge, establish a second or any number of additional bridges, and transfer any and all assets and liabilities to such other bridge.

[9] We would anticipate that the FDIC may want to confer with certain classes of creditors of the closed institution to determine the feasibility of the creditors assuming the role of equity holders in the bridge. This could be done as part of the contingent-planning or living-wills process long in advance of an insolvency. Alternatively, if the FDIC chooses to execute the recapitalization only after transferring the business to a bridge and operating the bridge for a period of time, this could be done after the institution is closed.

[10] The FDIC has used its bridge-bank authority on several occasions during the current crisis, including the resolutions of Silverton Bank, Atlanta, Georgia and Independent Bankers' Bank, Springfield, Illinois. In both situations, it was prepared to establish a second bridge if necessary to sell the viable part of the first bridge banks' businesses to a third party. On both occasions, the FDIC subsequently liquidated the

Typically the FDIC would operate the bridge bank for some period of time and then engage in some sale or liquidation of the bridge. It also has the power to exchange claims against the failed bank for equity in the bridge bank. While the FDIC did not use this technique to resolve a failed bank during the recent financial crisis,[11] the Resolution Trust Corporation arguably used a version of this technique to resolve Crossland Savings during the savings and loan crisis.[12] The FDIC has traditionally used different techniques to resolve community or other banks that were not systemically important. It experimented with a variety of techniques during the savings and loan crisis of the 1980s and early 1990s.[13] But during the most recent financial crisis, the FDIC has relied almost exclusively on a technique consisting of a purchase-and-assumption agreement, with or without loss-sharing, to sell failed institutions to a third party.

4.2. Many observers are concerned, however, that the purchase-and-assumption technique may not produce the most desirable or least-cost outcome, or even be feasible, in the case of a systemically important bank or non-bank financial institution that fails in the middle of a widespread financial panic. It may be impossible during a financial panic to find a third-party buyer large enough and confident enough about its own viability to bid for such a bank or non-bank SIFI. If not, the FDIC could be forced to operate the closed institution or a bridge for an extended period of time in order to liquidate its assets in an orderly fashion, and thereby become exposed to ever-increasing losses. While substantial losses at AIG have been avoided by selling its assets over an extended period of time instead of at fire-sale prices at the bottom of the market during the recent financial crisis, the experiences with the conservatorships of Indymac, Fannie

---

original bridge bank. On other occasions, including the resolution of IndyMac, the assets and liabilities of the bridge bank were subsequently sold to a third party.

[11] One reason for this is that in most of the bank failures during the current crisis, there were insufficient assets to cover even the insured deposit liabilities, leaving little room for a debt-for-equity exchange. Indeed, under the FDI Act provisions dealing with bridge banks, there is no requirement that a bridge bank have equity. Further, in most of the bank failures, the non-deposit creditors are poorly organized and lack the cohesion even to propose a debt-for-equity swap. In the case of a non-bank SIFI, we would anticipate that (i) as there are no deposit liabilities, there would in fact be substantial non-deposit debt, and (ii) there would be more likelihood of non-deposit debt being sufficiently organized to consider such an option. Bank SIFIs are more likely than community or regional banks to have a substantial percentage of their liabilities in the form of uninsured deposits or non-deposit, unsecured liabilities, increasing the usefulness of a debt-for-equity swap as an alternative to bailout and to avoid or mitigate a substantial adverse effect on U.S. financial stability.

[12] *See, e.g., FDIC, Managing the Crisis: The FDIC and RTC Experience 1980-1994*, at 685-704 (August 1998).

[13] *See, e.g., FDIC, Managing the Crisis: The FDIC and RTC Experience 1980-1994* (August 1998); FDIC, *An Examination of the Banking Crises of the 1980s and Early 1990s*, in HISTORY OF THE EIGHTIES LESSONS FOR THE FUTURE, Volume 1 (December 1997); FDIC, *Resolutions Handbook* (April 2, 2003).

Mae and Freddie Mac have not been encouraging, where government losses have grown substantially beyond initial estimates.[14]

4.3. Even if a third-party buyer of a failed SIFI could be found during a financial crisis, it may be unwilling to pay a price that even approaches the closed institution's long-term going-concern value. Under such extreme financial conditions, the difference between a firm's liquidation and going-concern values (the so-called "going-concern surplus") may be temporarily exaggerated. As a result, the price offered is likely to be a fire-sale price, resulting in unnecessary value destruction from the perspective of the closed institution's creditors. Thus, an immediate sale of the closed firm will likely minimize its value, maximize the losses borne by its creditors, and thereby contribute to financial instability. In other words, this technique could result in transferring the benefit of the firm's going-concern surplus to the third party, without the consent and at the expense of the firm's creditors. An immediate fire-sale is further destabilizing in a financial crisis by increasing the incentive for creditors to run from the institution in advance of failure, thereby precipitating its decline and financial panic throughout the system.

5. THE FDI ACT AND TITLE II AS VEHICLES TO RECAPITALIZE THE VIABLE PART OF THE BUSINESS OF CLOSED BANK AND NON-BANK SIFIS

5.1. The FDI Act establishes a system for the resolution of bank SIFIs, and Title II establishes a similar system for resolving non-bank SIFIs. Non-bank SIFIs may include bank holding companies, nonbank financial companies supervised by the Federal Reserve, and companies that are predominately engaged in financial-in-nature activities. Although Title II incorporates a strong presumption in favor of using the Bankruptcy Code or other applicable insolvency law to resolve non-bank SIFIs, Title II may be invoked if the Treasury Secretary, upon the recommendation of the FDIC and the Federal Reserve in most instances, and in consultation with the President, determines that the resolution of a non-bank SIFI under the Bankruptcy Code or other applicable insolvency law would cause serious adverse effects to the financial stability of the United States and the use of Title II would avoid or mitigate those adverse effects. While the failed bank or non-bank SIFI that is the subject of a proceeding under the FDI Act or Title II would typically be liquidated, both laws provide a framework for preserving and recapitalizing the systemically important and other viable portion of the business of the failed bank or non-bank SIFI by transferring it to a bridge entity.

---

[14] *See* Karey Wutkowski, *FDIC Says Indymac Failure Costlier Than Expected*, REUTERS, Aug. 26, 2008; Press Release, FDIC, FDIC Establishes IndyMac Federal Bank, FSB as Successor to IndyMac Bank, F.S.B., Pasadena, California (July 11, 2008), *available at* http://www.fdic.gov/news/news/press/2008/pr08056.html; Press Release, FDIC, FDIC Closes Sale of Indymac Federal Bank, Pasadena, California (Mar. 19, 2009), *available at* http://www.fdic.gov/news/news/press/2009/pr09042.html; Lorraine Woellert and John Gittelsohn, *Fannie-Freddie Fix at $160 Billion With $1 Trillion Worst Case*, BLOOMBERG, June 13, 2010.

5.2. Neither the FDI Act nor Title II is self-executing, but both give the FDIC broad powers and significant discretion to resolve or effect an "orderly liquidation" of a failed bank or non-bank SIFI. If implemented properly, the FDI Act and Title II provide the FDIC with tools to address the "too systemically important to fail" dilemma by recapitalizing the systemically and viable portion of a closed SIFI's business during a financial crisis:

- without a taxpayer-funded bailout;
- in a way that:
  - ensures that shareholders and creditors, rather than taxpayers, bear the losses of the closed institutions (thereby minimizing moral hazard and maximizing market discipline);
  - ensures that managers responsible for the failure of the closed firms that have not already been replaced can be replaced with competent new managers in a way that preserves and does not destroy value (therefore minimizing moral hazard and maximizing market discipline);
  - mitigates or avoids a severe destabilization or collapse of the financial system by:
    - avoiding the value destruction inherent in a fire sale or disorderly liquidation of the closed firms or their assets, and by an immediate close out of the derivatives book, at the bottom of the market during a financial crisis;
    - preserving the operation of systemically important functions of an institution during a financial panic (such as payment systems, security settlement systems or other functions that a significant portion of the market relies on);
    - preserving the going-concern surplus of the systemically important and other viable parts of the businesses of the closed firms for the benefit of their creditors and without transferring that surplus to third parties for less than equivalent value; and
    - returning the systemically important and viable part of the businesses of the closed firms to the private sector promptly and without a lengthy and potentially costly period of government control;
- without having to sell or merge all or a portion of the closed firms to, with or into other firms during a financial crisis.

5.3. What follows is a brief description of the steps that the FDIC could take to conduct such a recapitalization:

5.4. Charter of bridge entities. The failed bank or non-bank SIFI that is put in receivership would typically be liquidated under the FDI Act or Title II, respectively. However, both the FDI Act and Title II authorize the FDIC, as receiver of a bank or non-bank SIFI, respectively, to charter one or more bridge banks or other bridge financial companies.

5.5. Transfer of all or any portion of the assets to bridge. Under both the FDI Act and Title II, the FDIC has virtually unfettered discretion to transfer all or any assets or liabilities of the SIFI to a bridge bank or other bridge financial company free and clear of some or all of the debt obligations of the SIFI without obtaining any judicial or affected creditor consent. The FDIC is given the discretion under both the FDI Act and Title II to effect a transaction extremely quickly (such as over a weekend) or over a more extended period of time, depending on which approach will be most effective in reducing the incentive to run or take other value-destroying self-interested actions that could reduce the value of the institution or result in a severe destabilization or collapse of the financial system.

5.5.1. Timing of Recapitalization. While the transfer of assets and liabilities to a bridge may be necessary within a compressed timeframe, the conversion of claims against the failed institution for equity in the bridge need not be rushed and could take place during the normal claims and liquidation process.

5.5.2. Conditions of Uncertainty. If it were impossible to determine quickly which assets and liabilities to transfer to the bridge, Title II and the FDI Act provide the FDIC with the flexibility to transfer all or almost all of the assets and liabilities to a bridge initially and then either transfer some back to the receivership, or create an additional bridge and transfer selected assets and liabilities to the new bridge, while liquidating the assets and liabilities left behind.

5.5.3. Alternative Structure to Facilitate Cross-Border Resolutions. If it would eliminate the need for change-of-control approvals or otherwise facilitate the resolution of a global SIFI with cross-border operations, the FDIC could alter the structure of this transaction by transferring all assets and liabilities other than the systemically important and other viable part of the SIFI's business to a bridge, subject to any limitations in the relevant statute,[15] and leaving the systemically important and other viable portion of the SIFI's business behind. In that case, the firm left behind would be recapitalized by exchanging claims against the bridge for equity in the firm left behind, and the bridge would be liquidated.

[15] Under Title II, but not the FDI Act, the liabilities transferred to a bridge entity may not exceed the value of the assets transferred.

5.6. Transfers of all or any employees or management to the bridge. Under both the FDI Act and Title II, the FDIC would have the option to transfer all or any employees, including management, of the closed institution to the bridge. It could thus effectively terminate management that was responsible for the closed institution's failure by failing to transfer them to the bridge, provided it arranged for new management to be appointed by the FDIC or the bridge's new owners (*i.e.*, the creditors of the closed institution whose claims are swapped for equity in the bridge), subject to their ratification or replacement by the new owners of the bridge.

5.6.1. Contingency Planning – Interim Management. It would be possible as part of the living-wills process to arrange for an organized management team, with pre-approval from the regulators, to be in position to move quickly and step in as interim management upon an institution's failure.[16] Pre-approval of interim management would also give creditors the time to organize themselves as the owners of the new bridge who would be capable of installing permanent management.

5.6.2. Input from Creditors. As long as any bridge bank is receiving liquidity from the Deposit Insurance Fund or any bridge financial company is receiving liquidity from the FDIC under Title II, the FDIC could continue to control the bridge, with the input of the failed institution's creditors who are expected to become the bridge entity's new equity holders, until they are able to arrange alternative funding from the private sector. This arrangement would allow the parties that have the risk of loss to have a say in how the bridge entity is run.

5.7. Preservation (or creation) of going-concern value in solvent bridge for the benefit of the failed institution's creditors.

5.7.1. One of the purposes of the FDI Act and Title II of Dodd-Frank is to provide a means of resolving a bank or non-bank SIFI in a way that avoids value destruction and preserves the going-concern value of the closed institution's business for the benefit of its creditors. The filing by a financial company of a petition under the Bankruptcy Code commences what many refer to as a "melting ice cube" process in which franchise value rapidly deteriorates until the financial company is liquidated or sold.[17]

---

[16] *See generally* Davis Polk and McKinsey, *Credible Living Wills: The First Generation* (Apr. 25, 2011), *available at* http://www.davispolk.com/files/Publication/37a3a804-6a6c-4e10-a628-7a1dbbaece7c/Presentation/PublicationAttachment/c621815c-9413-436b-91ea-3451b2b4cf32/042611_DavisPolkMcKinsey_LivingWills_Whitepaper.pdf.

[17] Judge Peck, in explaining the exigencies driving his approval of the sale of the Lehman Brothers investment bank to Barclays Capital Inc. under section 363 of the Bankruptcy Code, emphasized this potential for value destruction. *See In re Lehman Brothers Holdings Inc.* No. 08-13555 (JMP) (Bankr. S.D.N.Y. Sept. 19, 2008).

5.7.2. By transferring the systemically important and other viable part of a failed institution's business to a bridge bank or other bridge financial company, the FDIC can preserve the going-concern value of that business pending the ultimate disposition of the institution's business, assets and liabilities.[18] As described below, this going-concern value for the benefit of its creditors should increase in value over time as the financial markets recover and the bridge entity continues to operate and conduct new business and market conditions return closer to normal. The increase in this equity value over time would represent both the recovery of intrinsic asset values in a better market, and value unlocked by moving the business of the SIFI to a solvent, well capitalized and ongoing business. Under optimal circumstances, the bridge entity *would create value* from the ongoing business of the SIFI, value that would not exist if assets were immediately sold upon commencement of FDIC receivership.

5.8. <u>Recapitalization of the transferred business by eventually exchanging claims against the failed institution not assumed by the bridge entity for equity in the bridge bank or other bridge financial company</u>.

5.8.1. The FDIC has the authority to satisfy claims against the failed institution by tendering equity of, or claims against, the bridge to creditors in exchange for all or a portion of their original claims, as long as it is satisfied that the going-concern value of the bridge is greater than the liquidation value of the failed institution's assets. The FDI Act provides that a creditor's maximum entitlement is the liquidation value of its claim, and Title II provides that a creditor's maximum and minimum entitlements are such liquidation value. The FDIC has a duty to exercise its authority in a manner that maximizes the value of the closed institution's assets for the benefit of creditors (subject to a minimum equal to their liquidation value), minimizes losses, prevents severe financial instability and minimizes moral hazard. We think that creditors

---

[18] Note that because insured deposit liabilities make up a substantial portion of the liabilities of most banks, the option of swapping the debt for equity may not be feasible in the resolution of community or regional banks under the FDI Act. Up to 98% of the liabilities of such banks often or even typically consist of insured and uninsured domestic deposits and secured credit from the Federal Reserve or the Federal Home Loan Bank systems. The balance sheets of systemically important banks are often quite different. A substantial portion and even a majority of their liabilities can consist of foreign deposits (which are treated the same as general creditor claims under Section 11(d)(11) of the FDI Act), long-term subordinated or other unsecured credit or other non-deposit, unsecured funding. The swapping of debt for equity is therefore likely to be just as feasible and beneficial for the creditors of bank SIFIs with such balance sheets as it would be for non-bank SIFIs. For instance, had Washington Mutual Bank's failure been handled through the use of a bridge bank, it is possible that the bank bondholders might have preferred to swap their indebtedness for equity in the bridge rather than be relegated to pursuing their claims in the bank receivership after the bank was sold. Because there is no one-size-fits-all solution, it is important that the resolution authority has a range of tools at its disposal.

have a right to the maximum value the FDIC can achieve exercising its authority properly, but not less than the liquidation value when the FDIC does so.

5.8.2. This authority to recapitalize the viable part of a failed institution's business in order to maximize value includes the power to capitalize the bridge at a level that would allow it to operate on a standalone basis as quickly as possible with minimal government assistance, while preserving the relative priorities of all stakeholders in the failed institution and ensuring that all losses and the costs of any temporary government assistance are ultimately borne by the failed institution's shareholders and creditors. After assessing the bridge and its ongoing funding requirements, the receiver would exchange claims against the failed institution not assumed by the bridge entity for equity in the bridge entity. A creditor claim of a certain class may be exchanged in whole or in part into an equity claim. If converted in part, then the creditor may retain a partial debt claim.

5.8.3. A creditor could choose not to accept the equity in the bridge in exchange for the debt claim, but in such circumstances the creditor would likely receive no more than the liquidation value of the claim.

5.8.4. If a particular creditor, having been converted into an equity holder of the bridge entity, would prefer the liquidation value of its claims, they would be free to (i) urge the management of the bridge to liquidate the bridge's assets or (ii) sell their equity or other interests in the bridge to a third party. Creditors are likely to encourage the management of the bridge to list the bridge's shares promptly on a recognized securities exchange in order to make the sale of the new equity or other interests more feasible at better prices.

5.8.5. If a bridge were recapitalized in this manner, the bridge would cease to be a bridge upon the conversion of claims against the failed institution into 80% or more of the bridge's capital because that would be the functional equivalent of selling 80% or more of its capital to a third party.[19]

5.8.6. The distribution of equity in the bridge entity to creditors and other stakeholders of the failed SIFI should ordinarily be made in a way that respects the priority waterfalls set forth in the FDI Act and Title II. It should start with the most junior claims (*e.g.*, subordinated debt) and work its way up the capital structure of the institution to senior unsecured debt until enough debt in the closed institution is exchanged for equity in the bridge to fully capitalize the bridge, assuming that all other *pari passu* or senior debt claims would be transferred to the bridge.

[19] Section 210(h)(14)(B) of the Dodd-Frank Act; Section 11(n)(10)(C) of the FDI Act, 12 U.S.C. 1821(n)(10)(C).

5.8.7. It may not be possible to identify all of the liabilities of a failed institution on the date of its receivership. Contingent claims, for example, would need to be estimated and either transferred to the bridge or exchanged for equity. If converted to equity, those claimants would also need to be provided with receivership certificates, warrants or some other security that would allow outstanding equity to be diluted and for such claimants to receive additional value in case the original estimate of the value of their contingent claims was too low.

5.8.8. The FDIC could also exercise its cherry-picking powers to transfer some claims to the bridge even if other claims within the same class or ranking are not, but it should only use these extraordinary powers if absolutely necessary to avoid a severe destabilization or collapse of the financial system.

5.8.9. A SIFI in receivership may have subsidiaries that are facing their own liquidity problems or have outside investors. The existence of these subsidiaries can complicate the resolution of the SIFI. Under our recapitalization proposal, the SIFI could sell an insolvent subsidiary, fund it or recapitalize it so that the subsidiary's equity holders are wiped out and its debt holders become its new equity holders. Such issues would need to be evaluated on a case-by-case basis.

5.9. Liquidity.

5.9.1. As noted above, neither the FDI Act nor Title II provides for or otherwise permits a taxpayer-funded bailout of SIFIs.

5.9.2. Even in highly suboptimal market conditions, private financing should generally be available to properly recapitalized bridge banks or other bridge financial companies to provide such entities with necessary funding and liquidity.

5.9.3. It is possible, however, that the FDI Act or Title II may be invoked in a financial panic during which private credit is unavailable—even to the most well-capitalized of institutions. Both the FDI Act and Title II authorize the FDIC to provide liquidity to a receivership or a bridge entity under certain circumstances.[20]

[20] *See* Section 210(n) of the Dodd-Frank Act. Note that liquidity is usually not a problem for insured banks as they have the benefits of FDIC deposit insurance. Even there, however, the FDIC is authorized to provide working capital if necessary. 12 U.S.C. § 1821(n)(5)(B). *See also* Lehman Report, cited above in footnote 5.

5.9.4. Such borrowings, while critically important sources of liquidity, are not ultimately funded by the U.S. government. In the case of a bridge bank, any losses on the borrowings would be funded by the Deposit Insurance Fund, which is funded by banks, not taxpayers. In the case of a bridge financial company, the FDIC would have the authority to recoup any losses through risk-based assessments, (i) on entities that received "additional payments" from the FDIC in the resolution, and (ii) if necessary, on bank holding companies with total consolidated assets of $50 billion or more, nonbank financial companies subject to Federal Reserve supervision, and other financial companies with total consolidated assets of $50 billion or more.

5.9.5. Using recapitalization as a means of preserving going-concern value reduces the riskiness of such liquidation financing.

5.10. Market Valuation and Monetization of Claims.

5.10.1. Recapitalizations should provide an opportunity for market validation or market pricing of the equity value of the newly capitalized financial institution. It would allow creditors who do not want to retain their claim against the failed institution to exit from the investment by giving them a security that they can sell into the market at a market-validated price. Such a monetization of value should have a market-stabilizing effect.

5.10.2. Creditors of non-bank SIFIs that are subject to Title II would have less of an incentive to run in anticipation of the institution's failure if they were confident that they would receive a fair, market-validated value for their claim.

5.10.3. There could be several ways of providing such a market validation of value and providing an exit. One way would be to list the shares of the recapitalized bridge; another would be for the new owners to sell shares to outside investors. The securities could be issued in compliance with the securities laws or could be made exempt from registration by the SEC.[21]

5.10.4. Some creditors may not be in a position to hold equity in the bridge because of investment limitations or because they lack the necessary regulatory approvals. The ability to monetize their interest in the bridge would allow former claimants against the failed institution to hold or trade their equity interest in the bridge, which is an option that would have value in and of itself to creditors.

[21] *See e.g.*, 11 U.S.C. § 1145 (an exemption from securities registration in the Bankruptcy Code for equity provided in exchange for claims against the debtor).

6. VALUE OF OUR PROPOSAL IN FACILITATING CROSS-BORDER RESOLUTIONS

6.1. Our recapitalization proposal provides a useful bridge between orderly liquidation authority and various bail-in or going concern contingent-capital proposals that are being discussed in this country and internationally.[22] It shows that orderly liquidation authority and these other proposals are not mutually exclusive or necessarily competing alternatives. Indeed, our proposal has been consciously designed to be ***neutral*** as to these other proposals. This working paper neither endorses nor rejects these other proposals as substitutes or supplements to resolution authority. Instead, our proposal is offered as a final, credible and fail-safe option in case any pre-receivership measures, such as prompt corrective action, recovery plans, or these other proposals are not successful.

6.2. As a result, our proposal should facilitate international discussions about how to resolve a global SIFI on a cross-border basis.

6.3. Policymakers in other countries have mistakenly perceived that the new orderly liquidation authority and the bank receivership statute require value-destroying liquidations of financial assets at the bottom of the market during a financial crisis. Our proposal should eliminate this misimpression. It should provide comfort that resolution authority is actually designed to maximize the value of an institution and minimize its losses for the benefit of its creditors.

6.4. The orderly resolution provisions in Title II and the FDI Act are flexible enough to be used to recapitalize the systemically important or other viable parts of the business of a bank or non-bank SIFI that has been placed in an FDIC receivership.

6.5. Our proposal is different from going concern bail-in and contingent-capital proposals because our proposal would only be effected ***after*** an institution has been closed and placed into a receivership proceeding, rather than before it has been placed into a receivership, insolvency or other similar proceeding.

---

[22] *See, e.g.*, Clifford Chance, *Legal Aspects of Bank Bail-Ins* (2011), *available at* http://www.cliffordchance.com/publicationviews/publications/2011/05/legal_aspects_ofbankbail-ins.html; Institute of International Finance, *Addressing Priority Issues in Cross-Border Resolution* (2011), *available at* http://www.iif.com/press/press+187.php; Calello & Ervin, *From Bail-Out to Bail-In*, in THE ECONOMIST (Jan 28, 2010), *available at* http://www.economist.com/node/15392186?story_id=15392186; Huertas, *The Road to Better Resolution: From Bail-Out to Bail-In* (LSE Fin. Mkts. Group Paper Series, Special Paper 195, 2010), *available at* http://www2.lse.ac.uk/fmg/workingPapers/specialPapers/SP195.pdf.

6.6. Going concern bail-in and contingent capital are generally described as tools for recapitalizing SIFIs ***before*** (sometimes well before) any insolvency, receivership or other similar proceedings have been commenced. Statutory bail-in refers to the power to convert debt to equity upon the occurrence of certain triggers without obtaining the consent of creditors. Contractual bail-in or contingent capital refers to instruments that convert from debt to equity based upon the occurrence of certain contractually agreed upon triggers.

6.7. Our proposal shows that resolution authority can be used to produce outcomes that are very similar to a write-down or bail-in that is effected on the eve of insolvency or similar proceedings.

6.8. A recapitalization under the FDI Act or Title II would be substantially different from bail-in or contingent-capital proposals with early triggers, both of which could result in a write-down or conversion of debt to equity long before insolvency, but is broadly aligned with "point of non-viability bail-ins" being discussed in other jurisdictions.

6.9. The FDI Act and Title II have certain characteristics that do not exist under current point of non-viability bail-in regimes, including: (1) a relatively clear standard for determining when a recapitalization can be effected (only after an institution has been placed in receivership), (2) a ready source of liquidity to fund the recapitalized business until it can obtain funding from the private sector on its own, (3) a statutory provision that suspends the enforceability of cross-default and other ipso facto clauses that permit the acceleration or close-out of contracts solely as a result of insolvency or the appointment of a receiver, including derivative contracts that are transferred to and assumed by a bridge or third party, and (4) a statutory framework that is not likely to raise serious constitutional or similar legal concerns related to the taking of property or the interference with contractual rights.[23]

6.10. Our recapitalization proposal also avoids the investor and market challenges that must be addressed in any contractual write-down, bail-in or contingent-capital regime. Debt securities that are convertible into equity by consent may be treated as perpetual equity securities for purposes of (1) investment restrictions on certain institutional investors, making them ineligible for investment, and (2) the deductibility of distributions under certain tax codes, making their distributions not tax deductible under certain tax codes. In contrast, debt securities that are subject to being converted into equity securities only in an insolvency proceeding are generally treated as debt securities for these purposes.

[23] The International Bar Association's Task Force on the Financial Crisis recently completed a report on legal issues presented by current proposals intended to increase the loss-absorbency capacity of banks (the "**IBA Bail-in Survey**"). The IBA Bail-in Survey was submitted to members of the Basel Committee on Banking Supervision in November 2010 and January 2011, and has not been published. John L. Douglas, Randall D. Guynn and Joerg Riegel of Davis Polk & Wardwell LLP contributed the U.S. section of the IBA Bail-in Survey.