Federal Financial Analytics, Inc.

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

Submitted Via: Federal eRulemaking Portal: http://www.regulations.gov.

Dear Mr. Feldman

With this letter and the attached paper, Federal Financial Analytics, Inc. ("FedFin") is pleased to comment on the notice and request for comment on the single-point-of-entry" ("SPOE") resolution protocol as described therein by the Federal Deposit Insurance Corporation ("FDIC").[1] This letter and the more detailed paper attached hereto are solely my views and those of FedFin and do not necessarily represent those of the diverse group of bank, non-bank, and governmental agencies that are clients of the firm.[2] Key points made in this letter and the attached analysis are:

- SPOE is conceptually sound and statutorily robust. However, progress to date on orderly liquidation has been so cautious as to cloud the credibility of assertions that the largest U.S. financial isntitutions, especially the biggest banks, are no longer too big to fail ("TBTF"). Crafting a new resolution regime is of course a complex undertaking that benefits from as much consensus as possible. However, if definitive action is not quickly taken on a policy construct for single-point-of-entry resolutions resolving high-level questions about its practicality and functionality under stress, markets will revert to TBTF expectations that renew market distortions, place undue competitive pressure on small firms, and stoke systemic risk. Even more dangerous, the FDIC may not be ready when systemic risk strikes again.

- The longer it takes to finalize SPOE for the largest U. S. bank holding companies ("BHCs") – the only entities addressed in the FDIC's notice – the greater the risk that non-bank financial institutions and the technology firms with an ever larger role in the

[1] FDIC, *Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy* (Dec. 2013), *available at:* http://fdic.gov/news/board/2013/2013-12-10_notice_dis-b_fr.pdf.
[2] A list of FedFin clients may be found at: http://fedfin.com/about/clients/client-list.

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payment system will pose systemic risk. Big BHCs are covered by an array of capital, liquidity, and prudential standards that will only increase in severity as pending proposals are finalized. Further, SPOE imposes direct costs on BHCs – e.g., the cost of ensuring orderly resolution under the Bankruptcy Code through "living wills" and pending requirements for issuance of long-term, unsecured debt. Combined with the indirect cost of a credible SPOE regime – an end to TBTF expectations and, thus, to pricing advantages resulting from moral hazard – big BHCs could be at a significant competitive disadvantage to non-banks that take an even more formidable role in the financial system due to regulatory-arbitrage advantages. Empowering "shadow banks" by failing quickly to construct orderly-liquidation plans for them will distort financial markets in the near term and exacerbate systemic risk over time.

- Importantly, the FDIC may have less time than it hopes to craft this non-bank regime. As reforms drive derivatives and other markets to "financial market utilities" like central counterparties, risk is concentrated in new ways with growing systemic potential. SPOE for big BHCs is not a solution to systemic risk at these entities, especially given the large role played in them by non-bank entities.

In this comment letter and FedFin paper, we lay out the key questions we do not believe are answered in the SPOE release. Some of these are raised in the questions on which comment is solicited, and we are pleased to support further FDIC deliberations where these are already under way in hopes of speeding concrete proposals and then final action on issues already under review by the FDIC and the Board of Governors of the Federal Reserve System ("FRB"). Most urgent among these is the question of how much and what type of long-term unsecured debt is to be required not just of the largest BHCs (already under consideration by the FDIC and FRB), but also of other systemic entities to ensure that SPOE provides for sufficient private-sector resources to prevent a bail-out if bankruptcy resolution is not deemed viable.

We recognize that some have suggested that SPOE build-out be deferred until final action is concluded on this buffer against bail-out. However, there are so many critical questions to be addressed that – even though determinations of the level of debt and its market feasibility is essential to ensuring SPOE's effectiveness – further delay pending resolution of this matter will increase the chances that SPOE will be fragmentary when the next financial crisis is upon us.

As you know well, financial markets remain all too fragile six years after the crisis and many critical micro- and macro-prudential standards – especially for shadow banks – remain incomplete. In short, an imperfect solution to TBTF is better than a fully-constructed one that comes too late.

Questions addressed in detail in the attached paper and FedFin's answers to them are summarized below:

Q. Does SPOE work for complex BHCs? Can fast-flying derivatives be handled? Which subsidiaries will be saved?

A. SPOE is conceptually sound within the U.S. for the largest BHCs, with regard to credit, liquidity, and operational risk at individual firms and across the industry. However, bankruptcy resolution – always to be preferred over SPOE – is best achieved through statutory change in the U.S. to handle complex financial instruments. SPOE also cannot be operationalized without strong living wills that permit the FDIC quickly to identify which subsidiaries will be supported and which will fail in concert with the BHC or systemically-important financial institution ("SIFI").

The FDIC should play a strong and public role working with the Financial Stability Oversight Council ("FSOC"), the U.S. Congress, and other critical decision-makers to craft the required revisions to the U.S. Bankrupcy Code and press hard for statutory change without accompany repeal of Title II.

Q. Can big-bank resolutions be accomplished across national borders?

A. Recent FDIC efforts to craft cross-border resolution agreements are admirable, but unlikely to prove effective in a crisis. There is work under way to address this for banks, but cross-border resolution without government intervention is still at best uncertain for banks and wholly unlikely in non-bank systemic crises. Cross-border cooperative agreements based on SPOE or other protocols may advance, but their statutory backing is uncertain due in large part to the structural differences between U.S. banks that are supposed to fail when they become insolvent and "national-champion" banks that are arms of the state. A critical outstanding policy choice is between the benefits of cross-border branching for ongoing operations and the need instead for ex ante subsidiarization to ensure orderly cross-border bank resolutions.

Q. Can SPOE prevent downstreaming TBTF protection to subsidiary banks in the largest BHCs, just making a new class of TBTF banks?

A. SPOE is substantively different than the "source of support" doctrine cited in the notice to defend any potential that subsidiary insured depository institutions in a BHC could be "bullet-proofed" as a result of this resolution protocol. However, SPOE is structurally different, not least because of the potential for taxpayer support to the subsidiary bank if parent-company resources are insufficient. Non-systemic resolution of insured depositories by the FDIC protect only insured depositors to limited amounts from taxpayer-supported funding sources, putting counterparties at a risk they may think mitigated with resulting moral hazard under SPOE. SPOE thus needs a barrier so that taxpayer bail-out risk isn't downstreamed from big BHCs resolved through SPOE to subsidiaries into which investors park their risk in anticipation that holding-company resources combined with federal support will protect them.

To be sure, the industry – not taxpayers – must pay back any loss to the government, but market distortions due to moral hazard may remain despite SPOE. These could contribute to continued concentration of finance in large banking organizations.

Q. Are big BHCs the only systemic companies? If not, does SPOE handle other sources of systemic risk and ensure that TBTF doesn't just shift from banks to non-banks in the next financial crisis?

A. SPOE so far is bank-centric and thus not useful for non-bank SIFIs. As a result, it does not address non-bank risk nor impose on large non-bank financial institutions the same costs contemplated for big banks. This will simultaneously reinforce TBTF for these non-bank SIFIs and create strong regulatory drivers for markets to favor non-banks over BHCs. A potential perverse effect of this bank-centric approach is a downward spiral in which BHCs must issue more and more debt to protect subsidiaries while investors demand ever higher prices for debt due to diminished BHC profitability because more and more high-return activities go to non-bank competitors.

Q. Do financial-market utilities like central counterparties pose systemic risk?

A. A systemic-resolution protocol is urgently needed for central counterparties and other financial-market utilities granted critical systemic roles under Dodd-Frank and new global rules. Global regulators have proposed one such approach,[3] but many key questions are unanswered in the FSB global consultative report and none of these matters is included in the FDIC's notice. As more and more exposures now handled through the over-the-counter market shift to central counterparties and similar entities, risk concentrations will result that must be addressed not only through new prudential standards for these entities, but also by advance planning through a transparent resolution protocol that does not transmit TBTF risk from BHCs or SIFIs using these utilities to the central counterparty or similar entity.

These answers are more fully addressed in the attached paper, which cites various efforts under way by the FDIC, the FRB, the Financial Stability Board, and other entities to resolve them. However, as with SPOE, many if not most of these efforts have yet to begin in earnest or are only in very initial phases through conceptual consultative documents. We thus suggest specific actions that could be quickly advanced in the U.S. to address potential risk arising from insurance companies, broker-dealers, and asset managers within BHCs and subsidiary banks, as well as firms in these business lines already designated as SIFIS by the FSOC or pending this designation. We urge rapid action by the FDIC on these non-banking issues because risk parameters in the U.S. financial market have already begun to realign in the competitive favor of non-bank financial-services firms

[3] FSB, *Application of the Key Attributes of Effective Resolution Regimes to Non-Bank Financial Institutions* (August 12, 2013), *available at* http://www.financialstabilityboard.org/publications/r_130812a.pdf.

advantaged by limited (if any) capital and liquidity rules and the cost a strong, credible SPOE protocol will inevitably impose on BHCs.

In conclusion, the FDIC outline is an important first step, but four years after Dodd-Frank's enactment, it is critical not only to pick up the pace and implement a complete systemic-resolution framework for the largest BHCs in final form, but also to assess the extent to which SPOE works for non-banks, including critical infrastructure. Caution is understandable – the stakes here are high – but credibility will drain from efforts to end taxpayer bail-outs if meaningful standards are not quickly put in place to make bankruptcy a viable systemic resolution option and to end ongoing market expectations of TBTF rescues.

Sincerely,

Karen Shaw Petrou

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Karen Shaw Petrou
Managing Partner

If SIFIs Can't Be Scuppered, TBTF Sails:

What It Takes to Make the FDIC Resolution Proposal Work

February 12, 2014

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In 2010, the Dodd-Frank Act included unprecedented provisions designed to end forever U.S. expectations that large financial institutions – both banks and non-banks – are too big to fail. Almost four years later, and this wish has yet to be fulfilled in final U.S. rule and effective cross-border protocols. Some resolution standards for the largest banks are in sight, but those for non-banks like next-generation AIGs, Lehmans and GSEs are at best incomplete. As a result, the U.S. financial market is even riskier than it was in 2008 because investors and counterparties expect a bail-out and the law says none is permissible. This special report assesses the critical questions that must quickly be answered to make the FDIC's single-point-of-entry resolution framework a credible, forward-looking policy before the next financial crisis forces government intervention that converts the largest banks into financial utilities – if they and we are lucky. Incentives in the current framework that simply push systemic risk to "shadow" firms not now addressed by the FDIC are also detailed, as a shift to non-bank firms that might still need a bail-out poses not just systemic risk, but also a serious threat to financial-market integrity.

Executive Summary

This paper represents solely the views of Federal Financial Analytics, Inc. (FedFin). It is based on substantive analytics referenced throughout the document that may either be found on the firm's website[1] or provided upon request. As in a 2012 paper on this topic,[2] FedFin's premise is that the best solution to moral hazard is an end to market expectations that systemically-important financial institutions (SIFIs) are too big to fail (TBTF), with our read of Title II of the Dodd-Frank Wall-Street Reform and Recovery Act (Dodd-Frank)[3] persuading us that the legal framework here is a robust barrier to ad hoc decisions by the U. S. President, Treasury, and financial regulators that would recreate the rescue packages provided in 2008.

However, just because the law says bail-outs are barred doesn't mean regulators are ready to shutter a SIFI through bankruptcy or that counterparties and investors expect the law's robust requirements will be honored in a crisis. Indeed, all too many expect that, law notwithstanding, protection will be provided because robust resolution protocols remain hypothetical. And, as long as markets make clear that they are betting on a bail-out, policy advocates can persuasively argue that big banks remain TBTF.

The Federal Deposit Insurance Corporation (FDIC) has sought to allay these expectations with a new, single-point-of-entry (SPOE) resolution concept recently outlined for public comment.[4] In this report, which is also submitted by FedFin as a comment to the FDIC, we lay out the critical questions that must quickly be answered for SPOE to prove itself a meaningful answer to SIFI risk and, thus, to become a countervailing force against regulatory drivers pushing finance outside of large banking organizations and those seeking simply to break up the biggest banks.

The questions answered here are:

- Does SPOE work for complex BHCs? Can fast-flying derivatives be handled? Which subsidiaries will be saved? How much long-term debt is enough and can that much debt be sold without financial-system damage and risk to big BHCs?

- Can big-bank resolutions be accomplished across national borders?

- Can SPOE prevent downstreaming TBTF protection to subsidiary banks in the largest BHCs, just making a new class of TBTF banks?

- Are big BHCs the only systemic companies? If not, does SPOE handle other sources of systemic risk and ensure that TBTF doesn't just shift from banks to non-banks in the next financial crisis?

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[1] www.fedfin.com

[2] Federal Financial Analytics, *Are U.S. SIFIs Still TBTF? An Assessment of the New Resolution Regime for Systemically-Important Financial Institutions* (Oct 2012), *available at:* http://www.fedfin.com/images/stories/client_reports/assessment%20of%20resolution%20regime%20for%20sifis.pdf.

[3]See **SYSTEMIC30**, *Financial Services Management*, July 22, 2010.

[4] FDIC, *Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy* (Dec. 2013), *available at:* http://fdic.gov/news/board/2013/2013-12-10_notice_dis-b_fr.pdf.

- Are financial-market utilities like CCPs the only non-banks that pose systemic and, thus, orderly-resolution risk?

We conclude that:

- SPOE is conceptually sound within the U.S. for the largest BHCs, with regard to credit, liquidity, and operational risk at individual firms and across the industry. However, bankruptcy resolution – always to be preferred over SPOE -- requires statutory change in the U.S. to handle complex financial instruments. SPOE also cannot be operationalized without strong living wills that permit the FDIC quickly to identify which subsidiaries will be supported and which will fail in concert with the BHC. It's too soon to judge SPOE as a whole because a critical missing element – the amount and structure of debt firms must issue – has yet even to be proposed.

- Recent FDIC efforts to craft cross-border resolution agreements are admirable, but unlikely to prove effective in a crisis. There is work under way to address this for banks, but cross-border resolution without government intervention is still at best uncertain for banks and wholly unlikely in non-bank systemic crises. Cross-border cooperative agreements based on SPOE or other protocols may advance, but their statutory backing is uncertain due in large part to the structural differences between U.S. banks that are supposed to fail when they become insolvent and "national-champion" banks that are arms of the state. A critical outstanding policy choice is between the benefits of cross-border branching for ongoing operations and the need instead for ex ante subsidiarization to ensure orderly cross-border bank resolutions.

- SPOE needs a barrier so that taxpayer bail-out risk isn't downstreamed from big BHCs resolved through SPOE to subsidiaries into which investors park their risk in anticipation that holding-company resources combined with federal support will protect them. The industry – not taxpayers – must pay back any loss to the government, but market distortions due to moral hazard may remain despite SPOE. These could contribute to continued concentration of finance in large banking organizations.

- SPOE so far is bank-centric and thus not useful for non-bank SIFIs. As a result, it does not address non-bank risk nor impose on large non-bank financial institutions the same costs contemplated for big banks. This will simultaneously reinforce TBTF for these non-bank SIFIs and create strong regulatory drivers for markets to favor non-banks over BHCs. A potential perverse effect of this bank-centric approach is a downward spiral in which BHCs must issue more and more debt to protect subsidiaries while investors demand ever higher prices for debt due to diminished BHC profitability because more and more high-return activities go to non-bank competitors.

- A systemic-resolution protocol is urgently needed for central counterparties and other financial-market utilities granted critical systemic roles under Dodd-Frank and new global rules. Global regulators have proposed one, but many key questions are unanswered and SPOE in the U.S. does not deal with this challenge.

The FDIC outline is an important first step, but four years after Dodd-Frank's enactment, it is critical not only to pick up the pace and implement a complete systemic-resolution framework for the largest BHCs in final form, but also to assess the extent to which SPOE works for non-banks, including critical infrastructure. Caution is understandable – the stakes here are high – but credibility will drain from efforts to end taxpayer bail-outs if meaningful standards are not quickly put in place to make bankruptcy a viable systemic resolution option and to end ongoing market expectations of TBTF rescues. In fact, investors could get what they expect – bail-out – if regulators do not move fast—markets remain all too fragile.

SPOE's Tough Questions and Our Answers

It is not the purpose of this paper to provide an in-depth analysis of the FDIC's single-point-of-entry resolution protocol or a number of alternatives to it. Readers are referred to FedFin's analysis of the FDIC's proposal[5] and to the additional in-depth reports referenced here, all of which provide links to underlying documents and related analytics. We here identify the most pressing questions commenters and the FDIC, in concert with its regulatory colleagues, must answer if SPOE is quickly to be constructed into a credible systemic-resolution paradigm.

Q. Does SPOE work for complex BHCs?

A. The jury here is out for several reasons.

First, there is continued uncertainty about complex financial commitments generally known as qualified financial contracts (QFCs). Dodd-Frank gives the FDIC sufficient authority over QFCs and the European Union late last December approved the Bank Resolution and Recovery Directive (BRRD) designed to ensure orderly resolution related to QFCs. This may well address U.S.-EU counterparty risk, but the ability of the EU to harmonize group-wide resolution to the point at which this is assured remains uncertain.

Reflecting this, the FDIC and several global regulators have petitioned QFC counterparties to revise contractual standards to provide for an automatic stay when a resolution authority seizes a financial institution, giving the resolver time to assess resources and structure an orderly payment process that blocks the race to the exit generally called fire-sale risk. To date, market participants have worked with regulators, but no final agreement on voluntary contractual provisions has been reached nor is it clear that bilateral contracts would follow master-contractual terms were mutually-satisfactory language concluded. If SPOE and BRRD cover most QFCs regardless of counterparty – as many in the industry believe – the lack of voluntary contractual language should not create fire-sale risk when SPOE is deployed, but it does reinforce the need for governmental intervention that triggers the termination of contractual rights instead of reliance on bankruptcy or other insolvency laws that would force market self-sufficiency.

A measure to rewrite the law here has been introduced in the U.S. Senate,[6] but its prospects to create the so-called Chapter 14 of the U. S. Bankruptcy Code are at best uncertain. It is also made more controversial because it not only addresses the complex QFC issue, but does so in concert with repealing Dodd-Frank's orderly-liquidation authority (OLA) , eliminating any potential bridge facility or other governmental backstop for orderly resolutions under systemic stress.

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[5] See **RESOLVE23**, *Financial Services Management*, December 17, 2013.
[6] See **RESOLVE24**, *Financial Services Management,* January 14, 2014.

In short, OLA as is may not address QFCs, especially those with cross-default clauses, in a definitive fashion or in a manner that quashes TBTF expectations. Given this, the FDIC might feel itself forced to differentiate between similarly-situated creditors so that those whose distress could cause systemic risk are protected at the expense of smaller counterparties. This could protect financial behemoths and insulate them from market discipline as was done when the Federal Reserve protected firms like Goldman Sachs during AIG's resolution. It might also, OLA critics fear, give the FDIC the right politically to distinguish among firms based on factors such as political contributions, perceived social-policy benefits, or other non-market factors. We do not believe the FDIC would act in a political or discriminatory fashion, but questions surrounding QFCs and authority to treat similarly-situated creditors differently undermines market discipline in the absence of legal protection or a strong, forward-looking FDIC statement that does not hedge the agency's bets by reserving its rights to pick and choose among creditors.

How to fix this? FedFin recommends quick action on Chapter 14 legislation in the U.S. without the Title II repeal proposal. The better the Bankruptcy Code mandates a time-out for QFC counterparties, the more likely markets are to behave in an orderly fashion thereafter. Chapter 14 and Title II repealed together, however, is too risky too fast. At least one systemic episode must pass with Chapter 14 in place before analysts can conclude that it is sufficient under acute stress to obviate the need for a federal backstop.

Critically, SPOE only works – as the FDIC readily acknowledges – if there is sufficient shareholder equity and unsecured-debt at the top-tier level to fund a resolution without resort to taxpayer support. Dodd-Frank does bar long-term loss to taxpayers,[7] but the amounts involved – estimated by the Congressional Budget Office as perhaps $20 billion – and the uncertainty of financial-industry repayment under stress – make it essential for SPOE to work as desired and handle resolutions without anything other than a very short-term call on the "Orderly Liquidation Fund" established to handle these resolutions.

Thus, for SPOE to work, there must be sufficient parent-company resources to handle any claims that could pose systemic risk. There is as yet no proposal from the Federal Reserve detailing how much unsecured debt is enough and what debt would count for how long to make SPOE sufficiently strong. In the absence of final standards, this critical SPOE element is among the many that must be considered at least provisional, if not uncertain. Questions here yet to be answered include:

- the amount of debt covered BHCs would have to issue and the impact this would have on current funding strategies and liquidity risk since BHCs might fund themselves to the greatest extent possible through short-term instruments the market believes would be protected under SPOE or through insured deposits;

- the relative competitive impact this would have on large U.S. BHCs vis-a-vis foreign banks and the manner in which a comparable requirement would be imposed on foreign banks doing business in the U.S.;

- the price the market would demand for this debt, especially if debt purchasers could not include other presumptively systemic BHCs and non-banks due to fears of contagion risk;

[7] See **SYSTEMIC30**, *Financial Services Management*, July 22, 2010.

- how long term this long-term debt would need to be;
- what types of debt instruments would be allowed; and
- whether the market could handle comparable amounts of long-term, unsecured debt from systemic non-banks that would also need to come under SPOE if systemic risk does not simply transfer from BHCs to these non-banking entities.

Q. Can big-bank resolutions be accomplished across national borders?

A. Not yet.

The U.S. and U.K. have signed an agreement to use SPOE,[8] but key aspects of it remain unresolved, as do similar in-principal agreements between other nations and the U.S. Indeed, the European Union has, despite finalization of the BRRD, had tremendous difficulty finalizing a resolution funding mechanism on which nations in the Eurozone can agree, in part because many nations there – as in Japan, China, and other countries – view large banks not as fully private entities, but rather as "national champions" protected by the state as long as their financial-intermediation activities promote national, as well as shareholder, interests. This is a fundamental structural difference in global finance that wishing TBTF away cannot resolve.

Even if this were not the case, legal differences among key nations seriously complicate cross-border agreements. Key issues here include automatic stays for QFCs and derivative cross-default agreements, with the latter posing particularly significant cross-border concerns because of the ability of counterparties to exercise claims against a U.S.-controlled entity in a host-country without regulatory termination rights absent statutory or contractual limitations. As noted, the FDIC has worked with its English, German, and Swiss colleagues to call on an international industry organization to restructure master contracts in this arena.

Another cross-border concern is "depositor preference," laws that as in the U.S. require resolution authorities to favor certain depositor classes ahead of other creditors in a way that could leave host-country operations denuded of capital and liquidity when a home-country parent is seized for resolution purposes. "Subsidiarization" – that is, separate legal entities for bank operations in individual countries – may well be required de facto, if not de jure, to give host-country regulators the reassurance they demand if a home-country government's resolution regime requires losses to uninsured depositors, unsecured creditors, and investors in unconsolidated entities.

And, even if these cross-border agreements are all struck in principle, the ability of regulators to adhere to them under stress is at best uncertain. Some have suggested that international treaty agreements would resolve this and thus make SPOE a viable cross-border regime. However, the timing needed first to convene a conference to set any such treaty and then to win statutory recognition for it in key nations is, at best, a long haul. The U.S. is particularly wary of global treaties – it has, for example, been unable to ratify even a largely rhetorical international one on rights for persons with disabilities. Agreement to

[8] See **RESOLVE15**, *Financial Services Management*, December 19, 2012.

any international treaty that might be seen as disadvantaging U.S. creditors or otherwise subsuming financial-market sovereignty will be at best a long-term prospect upon which regulators cannot count ahead of the next financial crisis.

The solution to the cross-border resolution quandary is, thus, not high hopes for new law or – still more ambitious – a global treaty. Instead, it is finalization of bank and non-bank resolution protocols through substantive agreements like SPOE and the BRRD. Where these do not exist – e.g., for non-banks and for SIFIs outside relevant jurisdictions – ex ante barriers to risk transmission should be required by resolution plans or host-country statute.

Q. Can SPOE prevent downstreaming TBTF protection to subsidiary banks in the largest BHCs?

A. This is most unclear, but it is a critical question regulators must answer if TBTF is to be decisively quashed by way of SPOE.

As the FDIC says in its request for views on SPOE, U.S. BHCs have long been required to serve as sources of support for subsidiary insured depositories. As a result, the notice argues that, to the extent SPOE bullet-proofs insured depository institutions (IDIs) owned by a BHC, there is no fundamental policy shift.

This is not, however, accurate when systemic-risk considerations are taken into account. Current "source-of-support" requirements[9] are designed to protect the IDI by requiring the BHC to downstream support to prevent failure if at all possible – a demand most often breached in practice as was again evident in the 2008 crisis and one of questionable enforceability under the Bankruptcy Code once the FDIC has seized a failed IDI.

Current doctrine also does not assume SPOE resources that – if the resolution protocol works as anticipated – insulate IDIs from risk. Since it is likely that an IDI in a systemic BHC is the source of its systemic risk – in general, U.S. BHCs are largely just operating companies – the downstreamed recapitalization from the BHC to the IDI could make counterparties view the IDI as TBTF. BHCs could then downstream risky activities from the parent to the IDI to benefit from lower-cost funding and other TBTF assumptions.

The OCC has recently proposed guidelines to block this,[10] but absent this and comparable standards by the FRB and FDIC, large subsidiary IDIs might engage in proprietary trading, risky structured investments, and similar operations that could be exacerbated if moral hazard by IDI counterparties and investors results from expectations that the parent BHC will bail out the IDI in its entirety. This is also possible when a parent is a foreign financial institution (bank or non-bank) controlling a U.S. IDI, as this parent could put U.S.-permissible activities in a U.S.-domiciled IDI to create what the market might deem to be an entity insulated from risk – even for uninsured depositors and unsecured creditors – due to SPOE.

Addressing this, FRB Gov. Tarullo has talked about "internal bail-in" debt issued by IDIs as a cure to this concern, suggesting that the top-tier holding company would have also to hold minimum amounts of

[9] See **FHC19**, *Financial Services Management*, July 29, 2010.
[10] See **RISKMANAGEMENT9**, *Financial Services Management*, January 31, 2014.

debt issued by its material operating subsidiaries that could be converted into subsidiary equity if needed for recapitalization. Essentially a way to create a level of long-term, unsecured creditors in subsidiary banks, this idea holds considerable promise but cannot be evaluated in the absence of a specific proposal addressing the same questions posed above for bail-in debt required of the top-tier parent. And, as with the top-tier debt requirement, there is clearly a boundary at which neither the BHC nor the IDI can continue to issue long-term, unsecured debt to protect taxpayers if markets prices prove prohibitive due to added risk and any demand limitations resulting from investor restrictions to prevent contagion risk. The more debt the BHC and IDI issue at ever higher cost, the lower firm profitability and the greater the incentive for markets to shift to shadow financial-services entities.

Although Mr. Tarullo proposes his approach for all material operating subsidiaries – not just IDIs – there is to date no policy framework for U. S. BHC support to other subsidiaries – e.g., broker-dealers or insurance companies – also controlled by the company where individual consumers or businesses are protected to some extent by existing federal or state safeguards. Dodd-Frank requires the FDIC to work with the SEC on broker-dealer resolution and also to assess insurance-company subsidiaries, but nothing has so far been made public about any such work nor is it addressed in the pending request for comment.

To the extent SPOE permits a bank to take on more risk or forces the BHC to support the IDI, other subsidiaries that could have been supported by BHC resources with both adverse investor and market impact could experience runs or insolvency with systemic impact and undue cost to vulnerable persons. U. S. BHCs also have major asset-management operations – sometimes structured within the BHC and often housed within the IDI. Asset managers themselves do not hold assets and are therefore not directly subject to solvency risk. Liquidity risk can, however, occur if assets are rehypothecated and sudden redemptions based on fears about the parent firm can also pose systemic risk, as the FSB recently noted in a proposed methodology for designating SIFIs that are neither banks nor insurance companies.[11]

Again, SPOE does not address the interconnection within a large BHC of assets housed in an IDI and those in non-bank subsidiaries or the degree to which claims on these non-bank activities in or out of the IDI can determine the ability of SPOE to handle stress without taxpayer risk. Thus, SPOE protocols that neglect non-bank activities – especially those touching retail customers – are incomplete from both a functional and social-policy perspective.

Q. Are big BHCs the only systemic companies? If not, does SPOE handle other sources of systemic risk and ensure that TBTF doesn't just shift from banks to non-banks in the next financial crisis?

A. So far, SPOE is bank-centric, meaning that all of the SIFIs designated by the U.S. Financial Stability Oversight Council, those covered by the FSB, and those that surprise regulators and arise under stress may well not be resolvable without taxpayer bail-out.

First, BHCs aren't the only source of systemic risk, as the 2007-08 crisis showed all too clearly. And, even if big BHCs were then the only source of systemic risk – which they weren't – the post-crisis reform framework is creating concentrated, centralized providers of critical payment, settlement, and clearing

[11] See **SYSTEMIC70**, *Financial Services Management*, January 28, 2014.

services. Some of these entities – dubbed financial-market utilities (FMUs) in the U.S. or financial-market infrastructure in the global arena – are firms that have long been vital cross-roads of these services under resolution regimes that were and still are at best uncertain. Other FMUs are new or restructured entities established to perform the roles of central counterparties (CCPs), trade repositories, and other functions required by Dodd-Frank and under construction in the European Union.

How would these FMUs be resolved? New rules for them are supposed to mandate default funding and counterparty capital requirements sufficient to insulate them from risk. However, as the crisis demonstrated, rules may be stringent, but backstops remain essential since regulatory standards cannot simultaneously be tough enough to make a financial institution bullet-proof and at the same time ensure it is a viable business venture with reasonable return to investors.

The FSB has recognized this challenge. It has thus recently proposed the outline of a global protocol for resolving FMUs.[12] This framework is substantively different from SPOE because CCPs and similar entities are structurally different from BHCs in most critical respects. For the U.S. regime truly to end TBTF, a resolution framework for FMUs must be quickly undertaken. If Dodd-Frank does not provide for it – uncertain under the law – then this should be an urgent regulatory priority.

Q. Are financial-market utilities like CCPs the only non-banks that pose systemic and, thus, orderly-resolution risk?

A. No.

As noted, many different types of non-banks were at the heart of the financial crisis in addition to some large, high-risk banks. Some of these risks may have resulted from the interconnectedness of these non-banks with large banking organizations, but the scope of these firms – especially in nations like the U.S. that do not principally rely on banks for financial intermediation and maturity transformation – is significant on its own. To the extent that SPOE creates counterparty and investor risk in BHCs, non-banks seemingly exempt from it will only gain strength and pose still greater moral hazard and TBTF risk.

Global efforts to address this have begun. In addition to FSB work on FMUs, global regulators have proposed a new orderly-resolution protocol for what they call global systemically-important insurers (G-SIIs).[13] In the U.S., resolution for G-SIIs and any insurance entity systemic within this country is a complex of varying resolution regimes that complicate orderly resolution and pose systemic risk.

Here, insurance companies are resolved under state insolvency proceedings in which the insurance commissioner serves as receiver and buyers of most types of consumer-oriented insurance products are protected by state guaranty associations (also known as "guaranty funds") for life, health, and property-and-casualty insurance. In the case of the insolvency of a company insuring non-consumer insurance contracts (e.g., for monoline municipal-bond and mortgage insurers), the sole recourse of the contract owner is recovery from the assets of the estate of the insolvent insurer.

[12]See **FMU7**, *Financial Services Management Report*, August 21, 2013.
[13] See **INSURANCE34**, *Financial Services Management*, August 19, 2013.

Functionally-regulated U.S. insurers are ineligible to be "debtors" in federal bankruptcy, although parent entities that are not licensed to issue insurance contracts are resolved under the Bankruptcy Code unless OLA applies to the parent company or a foreign insolvency regime is involved. However, the resolution of any insolvent subsidiary that is a regulated insurer is conducted outside of bankruptcy, with the insurer's assets and liabilities omitted from the federal bankruptcy estate of the parent.

A recent report from the Treasury Department's Federal Insurance Office (FIO) picks up on this problem, finding that the laws governing insurer receiverships are inconsistent across state borders, with FIO pressing for an updated statutory framework and greater transparency and accountability.[14] The FIO Report also notes that resolutions of insurers whose contracts are not covered by guaranty funds have led to significant unpaid claims, raising the potential for future systemic risk.

The FSB proposal could address some of these issues, but only upon significant changes in federal and state law that handle not only these resolution issues, but also the extent to which insurance companies can offer deposit-like and other non-traditional insurance products that raise the QFC issues described above. Under the FSB protocol, insurance companies would also need to hold far more long-term, unsecured debt than most now do, raising issues akin to those for U.S. BHCs discussed above.

As noted, a global protocol has also been outlined for entities that hold other people's assets, going beyond the custody banks presumably addressed by SPOE also to cover non-bank prime brokers, asset managers, and hedge funds. Much in the FSB paper is very high-level and designed to apply across all these very different business models in very different national frameworks. It thus raises many questions about the extent to which it, like the insurance and FMU resolution proposals, can be reconciled with SPOE either for large BHCs or in concert with an effort to use SPOE for these non-banks on their own.

[14] See Client Report **INSURANCE38**, December 13, 2013.