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Can the “single point of entry” strategy be used to recapitalize a failing bank?

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Can the “Single Point of Entry” Strategy be used to Recapitalize a Failing Bank?

By

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Abstract

We analyze the ability of the “Single Point of Entry” strategy (SPOE) to resolve large banks without financial market disruption. We identify several legal and financial impediments that could prevent SPOE’s use. In particular, Title II of the Dodd-Frank Act was conceived by Congress as an alternative to bankruptcy liquidation, not a mechanism for recapitalizing financial institutions through SPOE or otherwise, especially banks. The failure of the largest banks will not generally endanger the solvency of parent BHCs, preventing the secretary of the Treasury from using SPOE for these major institutions. However, other large BHCs would be bankrupt if their subsidiary bank failed, and here SPOE expands the government safety net and reinforces TBTF. On balance, the evidence suggests that SPOE does not solve TBTF or provide a way to recapitalize a failing bank.

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I. Introduction

The chaos surrounding the September 2008 bankruptcy of Lehman Brothers led the government to take unprecedented emergency measures, including the use of taxpayer funds to rescue the very firms blamed for the crisis. In the face of widespread disapproval from the public and their representatives in Congress, government officials claimed that they had no alternative. Bailouts using taxpayer funds, they argued, were the only means available to keep other large financial institutions from filing for bankruptcy and triggering a Lehman-like disruption of the entire financial system.

Within a few months after the crisis, Congress began to work on legislation that would allow financial regulators to require enhanced regulation of large bank holding companies (BHCs), large nonbank financial firms designated “systemically important,” and large insured depository institutions. In addition, the new legislation would allow financial regulators to take control of large nonbank financial institutions that are in “material distress” in order to effect an orderly liquidation if their failure could cause financial market instability. These efforts culminated in the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the act or DFA) in July 2010.

The DFA embodies two major objectives among its many regulatory changes. In Title I, the act seeks to impose more stringent prudential regulation on banks, BHCs and designated nonbank financial institutions, in the form of heightened prudential regulation by the Federal Reserve Board. Enhanced regulation is intended to reduce the likelihood of a large financial institution failure. DFA Title II, called the Orderly Liquidation Authority (OLA), provides new authority to the Federal Deposit Insurance Corporation (FDIC), acting as a receiver, to facilitate the “orderly liquidation” of large non-bank financial institutions outside the bankruptcy process.

DFA’s sponsors saw Title II as the heart of the act, because they believe it created a mechanism for liquidating large financial institutions that could eliminate the financial market disruptions caused by Lehman’s bankruptcy. Thus, Title II addressed regulator concerns that some institutions are “too big to fail” (TBTF) under prevailing bankruptcy rules. Notwithstanding its promise to end TBTF, Title II did not provide a specific administrative mechanism for the

liquidation of a failing nonbank financial institution or explain how the OLA was to accomplish this goal without disrupting the financial system.

In December 2013, the FDIC released for public comment a proposal to implement the OLA using the so-called “Single Point of Entry” (SPOE) strategy.² Under the SPOE, the secretary of the Treasury would use OLA authority to take control of the parent BHC of the distressed institution—the single point of entry—and use the parent BHC’s resources to recapitalize distressed BHC subsidiaries and—to prevent disruption of the financial system—keep them open and operating.

Given the objectives of Title II, the SPOE’s ability to prevent the disorderly failure of a large depository institution is arguably the most important test of its effectiveness. If the SPOE cannot facilitate the liquidation of a large bank, then it does not solve the TBTF problem or fulfill the DFA’s objective of preventing the disorderly collapse of a large financial institution without the use of public funds. Consequently, in the analysis that follows, we focus on issues that arise when OLA authority and the SPOE strategy are used to recapitalize an insolvent subsidiary bank of a large BHC.³

Several issues become apparent when we consider potential real-world applications in which the SPOE is used to liquidate a bank holding company (BHC) with a large failing bank subsidiary. One set of issues focuses on the legal basis for using OLA authority to recapitalize a failing depository institution. If the OLA does not permit recapitalization of a bank subsidiary, then SPOE cannot be used to keep a failing bank open and operating to prevent wider financial market distress.

Title II of the DFA is expressly described as a *liquidation* authority, and was designed by Congress as an alternative to a judicial bankruptcy liquidation. There is no specific language in Title II to suggest that it can be used to recapitalize (i.e. save) a subsidiary depository institution. Indeed, Title II expressly excludes banks as covered institutions or covered subsidiaries to which

² **Federal Register** / Vol. 78, No. 243 / Wednesday, December 18, 2013, pp. 76614-76624.

³ Similar problems may exist if SPOE liquidation is used to recapitalize large nonbank financial subsidiaries. However, it is unclear whether SPOE is intended to be used in the case of a large failing insurance company or other nonbank financial institution. In a public comments at a Federal Reserve Bank of Philadelphia in March 2014, FDIC office of complex institutions director Art Murton indicated that the FDIC could develop alternative Title II resolution strategies for large insurance or other non-bank institutions. To date, SPOE is the only Title II OLA strategy the FDIC has released for public comment.

OLA authority applies. In addition, the Orderly Liquidation Fund (OLF)—the OLA financing mechanism—also expressly prohibits OLF use for the benefit of the deposit insurance fund (DIF), a benefit which happens whenever the OLF is used to recapitalize a bank subsidiary using the SPOE strategy. Moreover, the OLA never assigns priority to depositor claims or otherwise specifies how OLA should interact with the FDIC’s administrative bank resolution process. In short, there is a strong legal argument that OLA powers were never intended to apply to banks or bank subsidiaries.

There are additional features in Title II that create new financial sector risks and legal hurdles that complicate OLA’s use. For example, Section 203 authorizes the Secretary of the Treasury to take control of a covered financial institution that is “in default or in danger of default,” and yet the act does not provide an unambiguous definition of this term. The resulting ambiguity itself could be especially important in times of financial market stress. Creditors of holding companies will recoil from additional lending if they could be saddled with the losses of a distressed bank subsidiary, and creditors of distressed banks will not advance additional funds to a weak bank if it appears that the secretary will not be able to insulate them from loss using the OLA and SPOE. These legal ambiguities will reduce the ability of BHCs and banks to retain and attract investors, especially under distress conditions when the need for additional liquidity is critical.

The requirement that the BHC be in default or danger of default also imposes serious limitations on the applicability of OLA and the SPOE strategy. If the failure of a bank subsidiary does not put the parent BHC into default or in danger of default, then the OLA cannot be invoked, the secretary cannot seize the BHC, and SPOE cannot be used to recapitalize a failing bank subsidiary. Instead, the bank must be consigned to an FDIC receivership and resolved under Federal Deposit Insurance Act (FDIA). Indeed, our analysis shows that the largest U.S. BHCs are in exactly this position today. The failure of the largest subsidiary bank, by itself, would not bankrupt the parent BHC, so the SPOE strategy may not be an option. In other words, a central objective of the DFA cannot be achieved.

Based on our analysis of the largest BHC’s and their bank subsidiary balance sheets, we argue that, if one or more of the largest banks in the US should fail, the FDIC bank resolution process will likely be the only mechanism available for resolving the failing bank. Under the least cost

resolution rules set forth in the Federal Deposit Insurance Corporation Improvement Act, the FDIC would be obligated to sell the large failing bank as a whole to a (large) healthier banking institution that bid on the receivership, and thereby create a new, still larger, TBTF institution. Under the FDIC bank resolution process, then, regulators would confront the same bank resolution problems they faced in the last crisis, only this time without the option of using FDIC open bank assistance to keep weak banks from failing.

Smaller but still very large BHCs pose a different set of issues for OLA and the SPOE strategy. There are 12 systemically important BHCs that own a single bank subsidiary and very few other subsidiaries of any size. These BHCs are likely to be insolvent if their bank subsidiary fails and hence they would be candidates for OLA and the SPOE strategy. Nevertheless, a close examination of the structure of these BHCs highlights issues that must be addressed before SPOE is considered a viable policy option, even in these cases. For example, for these BHCs, the use of the SPOE prevents financial market disruption by substantially widening the government safety net to cover all the subsidiary bank's creditors. Unless parent BHCs have substantial loss absorbing capacity, the SPOE strategy will mutualize bank losses through OLF assessments on other large BHCs and designated nonbank financial institutions that are subject to Federal Reserve oversight.

The SPOE objective, keeping systemically important subsidiaries open and operating by protecting bank creditors, substantially increases the moral hazard created by deposit insurance. Because depository institution subsidiaries often issue more uninsured liabilities than their parent BHCs, the SPOE strategy protects a far larger group of creditors at the bank level than it puts "at risk" at the BHC level. When this happens, as it often does, SPOE institutionalizes TBTF by providing assurances that all the creditors of large banks will be protected from loss—if necessary, by taxing other large financial firms to reimburse the OLF.

Even when the SPOE works as the FDIC intends, and it keeps large subsidiary banks open and operating by protecting subsidiary creditors, we see serious legal issues that must be addressed before the SPOE strategy becomes operational. For example, because many BHCs have limited amounts of unsecured debt relative to the amount of debt issued by their subsidiary institutions, it will likely be necessary for the FDIC to borrow from the Orderly Liquidation Fund (OLF) in order to effect a recapitalization. Title II requires that, when the OLF funds cannot be repaid in a

timely manner by receivership proceeds, borrowed funds must be repaid by assessments on other large financial firms. However, if courts subsequently decide that Title II prohibits a bank subsidiary recapitalization using OLF funds, the financial institutions that are assessed will have a strong legal defense, leaving taxpayers liable for the OLF's losses.

To prevent the need for OLF assessments, parent BHCs must have a substantial amount of unsecured debt that can be converted into receivership certificates as part of the SPOE recapitalization plan. Regulators have recognized that many BHCs may need more debt at the holding company level to serve as “loss-absorbing capacity”⁴ to facilitate a SPOE liquidation. So, in addition to meeting Basel III heightened prudential capital requirements, liquidity standards, and leverage limits (a maximum debt-to-equity ratio), parent holding companies will soon also be required to issue a *minimum* amount of debt. Regardless of the regulatory standards imposed, lenders will be reluctant to agree to provide this financing to BHCs unless there is a profitable use for these new funds. The idea that the funds are needed solely to create loss absorbing capacity for the recapitalization of a subsidiary bank is unlikely to be seen by lenders as a profitable BHC investment strategy.

It is more than a little ironic that regulators are now arguing that the SPOE will only work if BHCs are required to have larger amounts of debt than their business needs require.⁵ While the thrust of Basel III and DFA requirements for enhanced prudential standards is that leverage must be limited because it creates externalities that give rise to financial instability, authorities now claim that it will be *beneficial* for BHCs to have minimum levels of debt outstanding—not for the business of the BHC, but so the debt can be used in a SPOE liquidation to recapitalize bank and non-bank subsidiaries.⁶

The remainder of the paper is organized as follows. In Section II, we review the FDIC's SPOE strategy for carrying out a Title II orderly liquidation. Section III reviews the conditions that justify the use of Title II Orderly Liquidation Authority and the requirements that the FDIC must

⁴ See, for example, John Glover and Jim Brunsten, Too-Big-To-Fail Banks Face Up to \$870 Billion Capital Gap, Bloomberg, October 14, 2014. <http://www.bloomberg.com/news/2014-10-13/too-big-fail-banks-seen-facing-capital-gap-of-up-to-870-billion.html>

⁵ See FDIC SPOE NPR, **Federal Register** / Vol. 78, No. 243 / Wednesday, December 18, 2013, p. 76623, or Jeremiah O. Norton, Speech to the American Bankers Association, October 21, 2013.

⁶ These new regulations are scheduled to be announced in November in a Basel III-like international agreement that specifies minimum debt issuance requirements for internationally active systemically important parent financial institutions.

satisfy when managing an OLA receivership. Section IV discusses legal issues associated with OLA and the use of the SPOE strategy. Section V provides an analysis of the structure of the largest bank holding companies with a view to determining the likelihood that the failure of a BHC's largest depository subsidiary would put the parent BHC "in default or in danger of default" and thereby make SPOE an option. In Section VI we analyze the implications of SPOE for other BHCs that are designated systemically important by the DFA but have only a single bank subsidiary. Section VII discusses the legal, moral hazard and TBTF implications associated with mutualizing the losses of the OLF in a SPOE transaction. Section VIII concludes.

II. The FDIC's Single Point of Entry (SPOE) Strategy for an Orderly Liquidation

Title II specifies the conditions that must be satisfied to invoke the OLA, its receivership powers, and the restrictions that must be respected in the orderly resolution process. But these details, reviewed in Section III, do not specify any operational aspects of an OLA liquidation. In particular, Title II does not explain how OLA powers will be used to liquidate a large financial firm like a BHC without causing financial market instability.

In December 2013, "after consultation with public and private stakeholders," the FDIC published a proposed mechanism for carrying out an orderly liquidation of a systemically important financial institution without disrupting the financial markets—the so-called "Single Point of Entry Strategy" or SPOE. According to the FDIC's public release,

The SPOE strategy is intended to minimize market disruption by isolating the failure and associated losses in a SIFI to the top-tier holding company while maintaining operations at the subsidiary level. In this manner, the resolution would be confined to one legal entity, the holding company, and would not trigger the need for resolution or bankruptcy across the operating subsidiaries, multiple business lines, or various sovereign jurisdictions.⁷

In a SPOE liquidation as outlined by the FDIC, the agency is appointed receiver of the top holding company in a corporate group and immediately charts a bridge financial company (bridge). As authorized by Title II, the FDIC as receiver then transfers all holding company assets and secured liabilities to the bridge institution, including the company's equity position in

⁷ **Federal Register** / Vol. 78, No. 243 / Wednesday, December 18, 2013, p. 76623.

all its subsidiaries.⁸ The bridge then functions as the new BHC and the FDIC appoints new management to operate the BHC and the subsidiaries as the recapitalization is effected.

Left behind in the receivership are the shareholders of the failed BHC and most of the failed BHC's unsecured liabilities. The FDIC has authority in Title II to treat similarly situated creditors differently, and is likely to use this authority to maintain continuity in essential services by transferring the parent's vendor and employee liabilities to the bridge. Other BHC liabilities with the same claims priority will remain in the receivership.

The liabilities of the failed BHC left in the receivership will be converted into receivership certificates, so the new bridge BHC will have little debt when it is first formed. Using the OLF if necessary, the bridge institution will issue new debt instruments and downstream the proceeds to recapitalize the bank. This is intended to relieve the bank of the need to engage in a "fire sale" of assets in order to meet redemption demands and to provide liquidity for its continuing operations. The FDIC believes that private financing sources will lend to the bridge BHC at this point because the bridge will have no debt and is exempt from taxes, so the profits of the recapitalized bank will be seen as sufficient to repay the loans over time. However, if private funds are not available, the FDIC can borrow from the Orderly Liquidation Fund, a Treasury fund of \$100 billion, although the use of that fund is limited as described below.

The overarching goal of the SPOE is to keep the critical subsidiaries of the BHC open and operating, including bank subsidiaries to facilitate market stability, prevent "ring-fencing" induced by multiple competing insolvencies, maintain access to clearing and payments systems, and to eliminate or reduce counterparty reactions that create operational difficulties or systemic risk.

⁸ Ibid. p. 76617.

III. Title II Orderly Liquidation Authority

1. When can the Secretary Invoke Title II and use the SPOE Strategy?

Section 203 of the Dodd-Frank Act authorizes the secretary of the Treasury, with the approval of two-thirds of the voting members of the Financial Stability Oversight Council, to begin the “orderly liquidation” of a covered financial company if, in the secretary’s judgment, “the financial company is in default or in danger of default” and the failure of the company and its resolution under any other federal or state law “would have serious adverse effects on the financial stability of the United States.” When this test has been met, the secretary is authorized to take control of the financial company and appoint the FDIC as receiver with powers and duties enumerated under Section 204 of the act.

The secretary’s authority to invoke OLA is available for any covered financial company and is not limited to BHCs with \$50 billion in assets or more, or to firms that have been designated systemically important financial institutions (SIFIs). Section 201 of the act specifies that bank holding companies are eligible for Section 204 orderly resolution, but the insured bank subsidiaries of a BHC are not (Sec 201(a)(8)(B)). Nor are insured bank subsidiaries included as covered subsidiaries under Title II (Sec 201(a)(9)(A)).

Because it allows large financial institutions to fail without creating systemic disorder, Title II has been presented by supporters of the Dodd-Frank Act as a solution to the too-big-to-fail (TBTF) problem for banks. However, unless the secretary can take control of the BHC, and the SPOE can be used to recapitalize a failing banks subsidiary, Title II does not provide a solution to the TBTF problem for banks. The secretary’s authority is severely limited under Section 203, which allows the secretary to seize a BHC if and only if the BHC is in “default or in danger of default.” Because there are many important and unanswered questions associated with the secretary’s authority under Section 203, it is not clear that the SPOE will always be available when a large bank is in financial distress.

Section 203(b)(4) provides several definitions of “default or in danger of default” that are more inclusive than the “payment default” or “technical default” definitions typically used in credit risk measurement and bankruptcy literatures:⁹

DEFAULT OR IN DANGER OF DEFAULT.—For purposes of this title, a financial company shall be considered to be in default or in danger of default if..

(A) a case has been, or likely will promptly be, commenced with respect to the financial company under the Bankruptcy Code;

(B) the financial company has incurred, or is likely to incur, losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the company to avoid such depletion;

(C) the assets of the financial company are, or are likely to be, less than its obligations to creditors and others;

or

(D) the financial company is, or is likely to be, unable to pay its obligations (other than those subject to a bona fide dispute) in the normal course of business.

Still, these definitions of “default or in danger of default” leave much unclear and thus create uncertainty about the secretary’s ability to invoke the SPOE. Where that uncertainty exists, the market will not know whether the creditors of the BHC or the creditors of the bank will take the loss if the subsidiary bank fails.

Definition (A) defines default as any event that can trigger a bankruptcy proceeding. Section 201 defines a bankruptcy as any Title 11 proceeding.¹⁰ This is a known list and does not create ambiguity, but at the same time is not likely to be a source for the secretary’s action if the BHC is meeting its obligations as they come due.

Definition (B) refers to a loss (incurred or likely to be incurred) that is likely to deplete “all or substantially all of [a BHC’s] capital.” This definition leaves open the possibility that the BHC could be put into receivership with positive capital, but the *de minimis* amount of capital needed to avoid invoking OLA is not specified. Section 201 is also not clear what is meant by the term “capital,” which has different meanings in financial accounting, regulatory accounting and corporate law.

⁹ Payment default is the failure to make timely payment of principal or interest. “Technical default” occurs when a debtor is current on principal and interest payments, but has otherwise violated covenants in the loan agreement. Technical default often triggers some type of remedial action or penalty such as an increase in the interest rate on the loan but would not normally trigger a legal petition for involuntary bankruptcy.

¹⁰ Title 11 includes both liquidations and voluntary reorganizations.

Definition (C) covers cases in which the financial company's assets are less than its "obligations to creditors and others." The broad term "obligations" creates ambiguity as we explain below. Finally, criterion (D) applies where a company is unlikely to be able to meet its obligations "in the normal course of business." Even here, the subjective term "unlikely" interjects uncertainty into the determination decision.

As we discuss in Section IV, the ambiguities that are implicit in this language will create uncertainty about the conditions which allow the SPOE to be used to recapitalize a failing bank.

2. OLA Duties, Powers and Responsibilities that Apply Under SPOE

In legislating Title II, Congress intended to provide the FDIC with "the necessary authority to liquidate failing financial companies that pose a significant risk to the financial stability of the United States in a manner that mitigates such risk and minimizes moral hazard (Section 204)."

The FDIC's OLA powers are modeled after its FDIA powers for bank resolution. Although Title II circumscribes the FDIC's OLA powers and responsibilities, it grants the FDIC wide discretion over the specific processes or strategies that the FDIC might use to liquidate a non-bank financial institution.

Along with specifying a general goal, OLA assigns the FDIC some specific responsibilities it must satisfy in any Title II liquidation including a SPOE liquidation. These include:¹¹

- Managing the receivership to promote financial stability, not to preserve the failed institution
- Ensuring that the receivership recoveries respect Title II claims priority
- Ensuring that the failed institution's management and board of directors is removed
- Managing the receivership assets to maximize the value of the receivership consistent with promoting financial stability
- Ensuring that the maximum liability imposed on any receivership claimant is consistent with the amount the claimant would receive in a Chapter 7 Bankruptcy
- Develop a plan for repaying borrowings from the orderly liquidation fund (OLF), including making risk-based assessments of financial companies larger than \$50 billion should projections of the bridge financial entity's revenues fall short of the amount needed to repay the OLF within 6 months of the date the obligations were incurred.

¹¹ These responsibilities are summarized in DFA Sections 206-210.

In managing the OLA receivership, the FDIC may not take an equity interest or become a shareholder in the bridge holding company or any of its subsidiaries. When making recovery payments to the failed institutions liability holders, the FDIC must abide by the specific claim priorities listed in Table 1. For comparison purposes, Table I also lists the receivership claims priority for bank resolutions as mandated by the FDIA and the National Depositor Preference Amendment.

Table 1: Claims Priority under Title II Orderly Liquidation and FDIA Bank Resolution

Priority	Title II Orderly Liquidation Claims Priority	FDIA Bank Receivership Claims Priority
1	Administrative expenses of the receiver	Administrative expenses of the receiver
2	Amounts owed the US government	Domestic deposit liability claims
3	Employee salary and benefits	Other general or senior unsecured liabilities
4	Other general or senior unsecured liabilities	Subordinated obligations
5	Subordinated debt holder claims	Shareholder claims
6	Wage & benefits of senior officers & directors	-
7	Shareholder claims	-

The OLA gives top priority to the recovery of resources provided by the OLF. Another interesting feature of the OLA claims priority is that it makes no mention of bank depositor priority. In part this reflects the fact that financial holding companies do not have depositors; any deposits in the consolidated BHC are held by a subsidiary depository institution. The omission of bank deposits in OLA claims priority is consistent with other language in Title II that suggests that OLA was not intended to apply to banks. We take up this issue in more detail in Section IV.

Title II allows the FDIC to treat similarly situated creditors differently if doing so will prevent financial instability or maximize overall receivership recoveries.¹² In its discussion of the SPOE, the FDIC has interpreted language in Section 210 as a legal requirement that disadvantaged claimants receive a recovery at least as large as they would receive in Chapter 7 bankruptcy.¹³ While this interpretation of Section 210, if correct, may help the FDIC dampen concerns

¹² The FDIC board has further limited its options to treat similarly-situated claimants differently by adopting a policy that it will only use this discretion on holding company liabilities with maturity less a year.

¹³ **Federal Register** / Vol. 78, No. 243 / Wednesday, December 18, 2013, p. 76618.

regarding the treatment of disadvantaged creditors in a SPOE liquidation, it is difficult to find explicit support for the FDIC's interpretation in the OLA language.

DFA Section 210 (h) grants the FDIC authority to charter one or more bridge financial companies to effect a Title II liquidation. The FDIC can move any assets and liabilities from the receivership into the bridge financial company. The bridge financial company is exempt from regulatory capital requirements and all taxes (US, state, county, territory, municipality, or other local taxing authority), and the bridge company charter will expire after two years unless it is extended by the FDIC up to a maximum life of five years.

The DFA establishes the "Orderly Liquidation Fund" (OLF), a line of credit with the US Treasury that allows the FDIC to pledge the assets of the bridge financial company to obtain funding to support the OLA. Within the first 30 days of the appointment of the FDIC as receiver, the amount of OLF funding is limited to 10 percent of the consolidated assets of the distressed holding company as reported on its last available financial statement. After 30 days, the FDIC can borrow up to "90 percent of the fair value of the total consolidated assets of each covered financial company that are available for repayment." [Section 210 (n)(6)(A)]

The secretary of the Treasury must approve the FDIC's use of the OLF in the context of an approved orderly liquidation plan. This plan must provide a strategy for liquidating receivership assets and demonstrate an ability to amortize OLF loan balances, including interest payments, consistent with the OLF repayment schedule agreement. The interest rate on the OLF loan will be set by the secretary, but it must be at least as large as the prevailing interest rate on similar maturity corporate loans.¹⁴

If the projected repayment schedule from the receivership liquidation plan falls short of fully discharging the OLF loan terms within 60 months of the loan initiation, the FDIC must follow a prescribed assessment protocol to collect the additional funds needed to discharge the debt. In

¹⁴ The DFA says the interest rate must be at least as large as the prevailing rate on US government obligations of a similar maturity plus an interest rate premium at least as large as the difference between the prevailing rate in a corporate bond index of similar maturity and the prevailing rate on US government securities of a similar maturity. The DFA does not specify the credit quality of the corporate bonds that should be used to set a lower bound on the credit spread.

this protocol, the FDIC must first recover any additional benefits that it paid out to similarly situated creditors in order to maximize the recovery value of the receivership or attenuate systemic risk (Section 210 (o)(1) (D)). If this recovery is insufficient, the FDIC then must impose a risk-based assessment on all BHCs with assets equal to or greater than \$50 billion and any nonbank financial company supervised by the Federal Reserve. There is an extensive list of criteria the FDIC must consider in setting the assessment rate.¹⁵ The Financial Stability Oversight Council is directed to provide the FDIC with a “risk matrix” for the list of criteria that the FDIC must take under consideration when setting OLF repayment assessment rates. Other important legal restrictions on the use of the OLF are discussed in Section IV.

IV. Legal Issues Raised by Title II

1. Can the SPOE be used to Recapitalize Failing Bank Subsidiaries?

There are at least two serious legal issues that may not have been adequately considered in designing the SPOE. First, Title II, called the Orderly Liquidation Authority, is concerned solely with the liquidation of failing nonbank financial institutions and was designed by Congress as an alternative to a judicially-supervised bankruptcy. The FDIC’s interpretation of OLA asserts that the OLA authorizes the recapitalization (the opposite of liquidation) of a subsidiary bank or any other financial subsidiary, but in fact, Title II is solely focused on orderly liquidation and does not specifically authorize the recapitalization of any failing subsidiary institution.¹⁶

Second, even if a judicial challenge should find that Title II allows recapitalizations of “covered financial companies” in addition to liquidations, Title II explicitly states that its provisions do not apply to banks, making clear that the OLA cannot be used to recapitalize a subsidiary bank. According to Section 201(a)(8)(B) , “The term ‘covered financial company’...(B) does not include an insured depository institution,” and Section 201(a)(9)(A) says, “The term ‘covered subsidiary’ means a subsidiary of a covered financial company, other than...an insured

¹⁵ The criteria are given in Section 210(o)(4). Among these, is a particularly striking catchall criterion: “any risks presented by the financial company in the 10-year period immediately prior to the appointment of the Corporation as receiver for the covered financial company that contributed to the failure of the covered financial company (p. 1511).”

¹⁶ The word “recapitalization” does not appear in the text of the DFA, and it is clear that a recapitalization is not a liquidation.

depository institution.” Thus, the most straight forward reading of the legislative language is that the provisions of Title II do not apply to failing banks.

The interpretation that OLA does not apply to bank subsidiaries is also supported by the fact that Title II provides no information or guidance that explains how OLA interfaces with the Federal Deposit Insurance Act and National Depositor Preference Act (henceforth FDIA), the laws that define the resolution framework for a failing bank. Indeed other specific language in Title II strongly suggests that Title II was not intended to exempt a failing bank from the FDIA bank resolution process. The mandatory claims priority in the OLA, Section 210(b)(1), for example, does not mention bank deposits or insured deposits. Moreover, Section 210(n)(8)(i) prohibits the FDIC from using the OLF “to assist the Deposit Insurance Fund or to assist any financial company under applicable law other than this Act.” Clearly a SPOE-based recapitalization of a bank would “assist” the DIF, and thus appears to be prohibited by Title II.¹⁷

Accordingly, it is difficult to find in Title II any basis for the apparent belief at the FDIC that Title II somehow empowers the agency to use BHC resources for recapitalizing (but not liquidating) an insolvent subsidiary bank.

2. Legal Uncertainties in the “Definition of Default or in Danger of Default”

Despite our view that the language of Title II is a serious obstacle to the implementation of any plan to recapitalize a bank, for the balance of the discussion in this section we will assume that the FDIC’s Title II interpretation that allows for the recapitalization of a subsidiary bank withstands legal challenge. Even then, other legal issues arise in the context of SPOE implementation. In particular, the conditions under which the secretary has the legal authority under Title II to seize a BHC and appoint the FDIC as its receiver.

The authority of the secretary to invoke OLA authorities depends entirely on whether the BHC is, according to Title II, “in default or in danger of default.” If the failure of a bank subsidiary does not trigger losses that lead to violations of a BHC’s debt covenants, the BHC can continue

¹⁷ An alternative reading of Section 210(n)(8)(i)—that assistance to the Deposit Insurance Fund is possible in the context of a Title II liquidation—would be a highly strained interpretation and inconsistent with clear language elsewhere that banks were excluded from Title II.

to meet its obligations as they come due, and the value of the BHC's assets exceed its liabilities, the BHC is not likely to be considered in default or in danger of default according to normal credit market definitions of default. Of course, the secretary has substantial discretion under Title II, but the government would be opening itself to substantial liability if the secretary attempted to seize a BHC that was not generally seen as in any distress, even after the insolvency of a subsidiary bank. Thus, there are conditions under which the SPOE would not be available as a means of implementing a recapitalization of a failing bank, even when the bank's failure might be deemed to create systemic risk for the financial system.

Still, the default definitions in Section 203 offer some latitude for a secretary who is eager to seize a BHC and place it in receivership under the OLA. One issue is the interpretation of definition (B) described earlier, which refers to a default as a BHC's loss of all or substantially all its capital. The term "capital" is critical for this definition, and yet it is not defined in the law. Congress could have intended "capital" to mean some specific regulatory measure—for example risk-based capital as defined in Basel III.¹⁸ Alternatively, Congress could have intended capital to be shareholder common equity measured according to generally accepted accounting principles. In addition, in using the term "substantially all its capital" definition (B) leaves open the possibility that Title II could be invoked when the BHC still has a small positive capital position net of its bank subsidiary losses. Although these lacunae in the legislative language provide the secretary with some latitude for interpretation, it creates serious market uncertainty about how or whether the OLA will be implemented. This could be particularly troublesome when a bank is in distress and may require a rescue. If the SPOE is applicable, the creditors of the BHC will take the losses; if it is not, the creditors of the bank will be the losers. That ambiguity itself could cause serious market disruption.

Another important question is whether the insolvency of a subsidiary bank will mean that the BHC is in default or in danger of default no matter how that term is defined. As we will show in Section V, many of the largest BHCs have valuable non-bank subsidiaries that reduce the likelihood that the insolvency of the largest subsidiary bank will cause the loss of all or substantially all the BHC's capital. Indeed, our analysis shows that several of the largest

¹⁸ The use of Basel III risk-based regulatory capital as the Title II criterion would add a great deal ambiguity to the term "capital" as banks and regulators are constantly debating the correct risk weights that apply to their assets.

BHCs—exactly the ones for which the SPOE strategy was designed—have substantially more capital than their investments in their largest subsidiary bank. In these cases, the SPOE would not be available as an option for the secretary even if all the prior legal obstacles we discussed were cleared away.

The language in definition (C), “obligations to creditors and others,” introduces an additional issue associated with the Federal Reserve’s “source of strength” doctrine and FDIC’s cross guarantee powers. The “source of strength doctrine” is a long-held Federal Reserve view that a BHC has an obligation to provide financial or managerial resources to its subsidiary banks. This doctrine has been the cornerstone of Federal Reserve holding company talking points and supervision for almost 40 years, but it has never been fully defined by the Fed in a regulation or affirmed by the courts. Nevertheless, it was given statutory recognition—a “codification” many have called it—in Section 616 of Dodd-Frank, which states,

The appropriate Federal banking agency for a bank holding company...shall require the bank holding company...to serve as a source of financial strength for any subsidiary of the bank holding company...that is a depository institution.

Section 616 provides no new guidance on the limits of Federal Reserve source of strength powers. It is not clear what Congress intended by the “codification” language, since the scope of the source of strength doctrine is unknown. Congress could have said that the Fed has the authority to require a BHC to recapitalize a failing bank subsidiary, but it did not; it simply endorsed the source of strength doctrine, leaving unclear how far that idea was intended to go.

There are policy reasons why a BHC’s relationship to a subsidiary insured bank should be different from the normal relationship between a parent and subsidiary company,¹⁹ but requiring parent companies to recapitalize subsidiaries would be a major change in U.S. corporate law and the courts have not yet accepted such an interpretation. In the leading case, *MCorp v. Board of Governors*,²⁰ the 5th Circuit Court of Appeals held that the Fed did not have the authority to force a BHC to recapitalize a subsidiary, but the decision was reversed on technical grounds by the Supreme Court and not litigated further. Some commentators argue that this reversal “reinstated”

¹⁹ Paul L. Lee, “The Source-of-Strength: Revered and Revisited—Part I,” *The Banking Law Journal*, Vol. 129, No. 9, October 2012; a good discussion of the policy arguments pro and con the source of strength doctrine appears in Craig L. Brown, “Board of Governors v. MCorp Financial Inc.: Evaluating the Source of Strength Doctrine,” *Hofstra Law Review*, vol. 21, p235, 1992.

²⁰ 900 F.2d 852, 863 (5th Cir., 1991)

the source of strength doctrine, but that—like the language in Section 616—simply begs the question about what the doctrine actually requires and whether—if it were interpreted to require the recapitalization of a bank subsidiary—it would survive a challenge founded on the very strong principles of corporate separateness and the BHC’s fiduciary obligations to its shareholders.

So the question remains whether the Fed has the authority—even after Section 616 of Dodd-Frank—to force a solvent BHC to recapitalize the losses suffered by a subsidiary bank. If so, that could be seen as an “obligation” under definition (C), and thus a possible source of default or danger of default for a BHC that is the parent of an insolvent bank subsidiary. As in the case of definition (B), clarity on this issue is critical for the orderly resolution authority and the SPOE to be a source of stability in the markets rather than a source of uncertainty. As noted above, the resolution process and investor loss outcomes are very different if a BHC may be deemed to be in default or danger of default because it is required to fully recapitalize losses in a failing bank subsidiary, but would otherwise be solvent. But if the source of strength doctrine does not legally obligate a BHC to recapitalize its sub—and at this point there is no clear legal obligation—the secretary would be on weak legal grounds if the takeover of an otherwise solvent BHC were based on the claim that the source of strength doctrine would have rendered it insolvent.

There are other considerations that might be seen to limit the scope of the source of strength doctrine. It seems clear that Congress has not been willing in the past to give the Fed the full scope of authority it may have wanted under the source of strength policy, even when a failing bank would cause losses to the bank insurance fund. In this respect, the cross-guarantee system that Congress authorized for the FDIC in the 1980s is instructive.²¹ Under that system, the FDIC may assess healthy banks that are under common control with a failing institution for any losses to the insurance fund that the failing institution may cause. A more direct solution might have been to expand the scope of the source of strength doctrine, but Congress was apparently unwilling to do that. Instead, it chose to assess only insured banks, and only for losses to what was called the Bank Insurance Fund at the time, without going so far as to require a BHC to recapitalize a failing bank subsidiary.

²¹ This power was conveyed in the Financial Institutions Reform, Recovery and Enforcement Act of 1989.

Under Section 202 of the act, if the board of directors of the BHC refuses to accede to the secretary's demand for appointment of the FDIC as receiver for the firm, the secretary may invoke a court to order compliance. The court, incredibly, is given only a single day to render its judgment and there is no stay on the FDIC's actions if the court's decision is appealed. Most lawyers have assumed that the court would simply refuse to rule on a complicated question such as whether the BHC is in danger of default, and given the ambiguity and complexity associated with determining whether a BHC is in default or in danger of default, that outcome seems highly likely. In that case, Section 202 provides that the FDIC is appointed as the BHC's receiver "as a matter of law." Section 202(a)(1)(B) prohibits an injunction or stay if the court doesn't act or makes a determination that the secretary acted within his authority. However, there is no provision in Title II that prohibits a covered financial company from using the courts to enjoin the secretary from declaring the company to be in default or in danger of default.

V. Can the SPOE be used for the Largest Banks in the Biggest BHCs?

To avoid disrupting financial markets, the SPOE strategy is designed to use holding company resources to keep critical subsidiaries open and operating. The most critical subsidiaries of the big BHCs are large banks, and so—assuming that the SPOE strategy survives the legal obstacles outlined above—the SPOE will be available for recapitalizing the largest banks but only if the bank's failure puts the parent BHC in default or danger of default. While the underlying ideas of the SPOE strategy have been positively received by the banking industry,²² the SPOE strategy is only an option if the Treasury secretary can invoke OLA. Our analysis suggests, however, that most of the largest BHCs are unlikely to be in danger of default if their largest bank were to become insolvent.

The largest banks are all subsidiaries of large BHCs. Table 2 lists the 20 largest banks by asset size and the corresponding parent BHC as of March 31, 2014. For SPOE to be a policy option for addressing a large bank failure, the subsidiary bank's losses must fully deplete or nearly deplete the parent BHC's equity capital or fall within another default definition discussed above.

²² See for example the joint comment letter on SPOE filed by The Clearing House, American Bankers Association, Financial Services Roundtable, sifma, and gfma, <https://www.theclearinghouse.org/~media/Files/Association%20Documents/20140218%20Single%20Point%20of%20Entry%20Comment%20Letter.pdf>

Using public information, we can determine the equity position of the parent BHC and the balance sheet equity of the BHC's largest bank subsidiary. We cannot determine if the parent BHC owns all of the equity in this bank subsidiary or whether there are minority shareholders. Nor can we assess what other investments (such as loans) the parent BHC may have invested in this subsidiary bank.

Table 2: The Largest 20 Banking Institutions

Rank	Name of Depository Institution	Asset Size	Name of Parent Holding Company
1	JPMorgan Chase Bank, National Association	\$1,970,450,000	JPMORGAN CHASE & CO.
2	Bank of America, National Association	\$1,457,856,000	BANK OF AMERICA CORPORATION
3	Wells Fargo Bank, National Association	\$1,388,274,000	WELLS FARGO & COMPANY
4	Citibank, National Association	\$1,353,237,000	CITIGROUP INC.
5	U.S. Bank National Association	\$367,103,430	U.S. BANCORP
6	PNC Bank, National Association	\$313,362,161	PNC FINANCIAL SERVICES GROUP, INC., THE
7	The Bank of New York Mellon	\$288,176,000	BANK OF NEW YORK MELLON CORPORATION, THE
8	State Street Bank and Trust Company	\$252,493,360	STATE STREET CORPORATION
9	Capital One, National Association	\$236,546,436	CAPITAL ONE FINANCIAL CORPORATION
10	TD Bank, National Association	\$220,863,416	TORONTO-DOMINION BANK, THE
11	Branch Banking and Trust Company	\$180,652,467	BB&T CORPORATION
12	HSBC Bank USA, National Association	\$179,597,719	HSBC HOLDINGS PLC
13	SunTrust Bank	\$175,463,961	SUNTRUST BANKS, INC.
14	FIA Card Services, National Association	\$155,801,000	BANK OF AMERICA CORPORATION
15	Fifth Third Bank	\$127,330,617	FIFTH THIRD BANCORP
16	Chase Bank USA, National Association	\$125,334,786	JPMORGAN CHASE & CO.
17	Regions Bank	\$117,078,660	REGIONS FINANCIAL CORPORATION
18	Morgan Stanley Bank, National Association	\$108,837,000	MORGAN STANLEY DELTA HOLDINGS LLC
19	Union Bank, National Association	\$106,696,283	MITSUBISHI UFJ FINANCIAL GROUP, INC.
20	Goldman Sachs Bank USA	\$104,767,000	GOLDMAN SACHS GROUP, INC., THE

Source: FDIC Statistics in Depository Institutions. Data as of March 31, 2014.

In the analysis that follows, we assume that the parent owns the entire equity of its largest bank subsidiary. Further, we assume that the largest bank subsidiary suffers a loss that exhausts its book equity. We then assess the remaining equity of the parent BHC net of a loss equal to the equity in its largest bank subsidiary. Table 3 reports the results of this hypothetical exercise for the 15 largest BHCs measured by consolidated assets.

The final column in Table 3 shows that, among the largest BHCs measured by consolidated assets, only TD Bank US Holding Company, the smallest of the group, would clearly be insolvent on a book equity basis if it suffered a loss that depleted all of the equity in its largest bank subsidiary. Among the remaining BHCs, it is conceivable that a case could be made that a loss of the entire equity of the largest bank subsidiary would deplete all or substantially all of the

parent holding company's capital for State Street Corporation and US Bank Corporation. If the secretary were to take an even more aggressive position, it might be argued that such a loss would deplete substantially all the capital in PNC Financial. In the remaining 11 BHCs, however, the BHCS with by far the largest bank subsidiaries, a loss that depleted the entire equity capital at the largest bank subsidiary would not come close to depleting all or substantially all of the parent BHC's equity capital.

Table 3: Parent BHC Capital after the Loss of its Equity Investment in its Largest Bank

Rank by consolidated asset size	Holding Company	Consolidated BHC Assets	Parent Assets	Parent Equity	Equity in Bank Subsidiaries	Total equity in subsidiary banks and holding companies	Book equity of largest subsidiary bank	Parent equity less equity of largest bank subsidiary
1	JPMorgan Chase	\$2,476,986,000	\$474,646,000	\$227,314,000	\$179,630,000	\$209,059,000	\$173,854,000	\$53,460,000
2	Bank of America	\$2,152,533,000	\$466,366,000	\$237,411,000	\$0	\$269,335,000	\$180,119,000	\$57,292,000
3	Citi Group	\$1,894,736,000	\$407,893,000	\$211,362,000	\$0	\$150,325,000	\$148,373,000	\$62,989,000
4	Wells Fargo	\$1,546,707,000	\$302,139,000	\$180,859,000	\$0	\$161,535,000	\$139,286,000	\$41,573,000
5	Goldman Sachs Group Inc	\$915,705,000	\$280,651,000	\$81,629,000	\$20,685,000	\$20,685,000	\$20,426,000	\$61,203,000
6	Morgan Stanley	\$831,381,000	\$256,801,902	\$70,755,318	\$0	\$24,948,264	\$10,809,000	\$59,946,318
7	American International Group	\$547,111,000	\$143,344,000	\$103,833,000	\$0	\$0	\$0	\$103,833,000
8	General Electric	\$516,971,228	\$570,279,066	\$85,809,299	\$0	\$14,033,659	\$6,076,598	\$79,732,701
9	U.S. Bancorp	\$371,289,000	\$56,302,362	\$42,700,000	\$39,470,686	\$39,470,686	\$40,948,948	\$1,751,052
10	Bank of New York Mellon	\$368,241,000	\$63,275,000	\$38,326,000	\$26,061,000	\$26,337,000	\$20,587,000	\$17,739,000
11	PNC Financial	\$323,586,973	\$47,352,194	\$44,204,590	\$550,000	\$41,548,462	\$39,051,066	\$5,153,524
12	HSBC North American Holding	\$308,847,926	\$37,043,283	\$31,344,044	\$0	\$27,851,471	\$18,458,031	\$12,886,013
13	Capital One Financial	\$290,886,180	\$56,264,022	\$43,814,768	\$42,913,895	\$42,913,895	\$34,128,786	\$9,685,982
14	State Street Corporation	\$256,672,720	\$30,806,288	\$21,699,811	\$21,102,481	\$21,102,481	\$20,254,266	\$1,445,545
15	TD Bank US Holding Company	\$237,493,754	\$34,425,136	\$25,153,278	\$30,256,097	\$30,256,097	\$28,672,839	-\$3,519,561

Bank holding company data based on March 2014 regulatory reports publicly available from the Federal Reserve National Information Center. Data on equity of the holding companies' banks subsidiaries is from the March 2014 FDIC Statistics on Depository Institutions.

While it is unrealistic to assume that a BHC's largest bank subsidiary would suffer a catastrophic loss in isolation, the exercise is instructive about the potential applicability of SPOE to the failure of the largest depository institutions. For the SPOE to be useful in keeping the largest US banks open and operating, and thereby avoiding financial market disruptions, the largest BHCs would have to suffer catastrophic losses simultaneously at many of their largest subsidiaries before the equity capital of the parent BHC would be depleted. While a severe liquidity crisis that renders a BHC incapable of meeting payment obligations could also trigger a Title II resolution, it appears that there is a very low probability that the SPOE might be invoked at the largest BHCs based on book equity insolvency resulting from losses in its largest bank subsidiary.

V. Comparing SPOE Orderly Liquidation to Bank Resolution under the FDI Act

The DFA specifically designates BHCs with consolidated assets in excess of \$50 billion as systemically important institutions. Among these BHCs, there is a wide range of institutional

complexity. Some BHCs include multiple banks, credit card operations, broker dealers, and other financial activities while others are less complex. In this section we analyze the implications of a SPOE liquidation for the simplest subset of the systemically important BHCs—those with a single bank subsidiary. We focus on these institutions because most are relatively simple bank-dominated organizations, a feature which allows us to compare the implications of an orderly liquidation under the SPOE to a bank resolution under the FDIA.

On March 31, 2014, 39 BHCs exceeded \$50 billion in consolidated assets. Of these, 13 BHCs had a single bank subsidiary. Table 4 reports on selective characteristics of these 13 BHCs. The second column of Table 4 reports the BHC's consolidated assets; the third column reports the assets in the lead bank subsidiary and, the fourth column reports the proportion of the holding company's assets in the bank. Except for Goldman Sachs and Ally Financial, the vast majority of the consolidated assets in these BHCs are held in a single bank subsidiary.

With the exception of Goldman Sachs, each BHC in Table 4 would be in default or in danger of default if its bank subsidiary were to fail. Because there is little activity in these institutions outside of the bank subsidiary, there is little danger that a parent BHC bankruptcy by itself would generate systemic risk. If systemic risk is an issue at all for these BHCs, it will be generated by the failure of the bank subsidiary. By focusing on these BHCs, we can more easily see the implications of using the SPOE strategy to effect an orderly liquidation when a bank subsidiary is the source of the parent BHC's loss.

First, it is important to understand that the normal FDIA resolution process and a SPOE Title II liquidation impose losses on different groups of investors. Under an FDIA resolution, the bank shareholders, subordinated note and debenture holders, uninsured depositors and the deposit insurance fund, bear the losses. In a large bank resolution, all of the depositors, including uninsured depositors, are typically protected as the entire deposit franchise is usually sold to another large bank that bids for the entity in the FDIC's receivership. While the bank losses would also accrue to the shareholders of the parent BHC (the beneficial owner of the bank subsidiary's shares), the bank's subordinated notes and debentures bear the bank's losses and these securities are not owned by the parent BHC. Similarly, losses to the deposit insurance fund

do not accrue to the parent. In an FDIA bank resolution that also triggers the bankruptcy of the parent BHC, the parent BHC's creditors are not directly exposed to bank losses beyond the BHC's equity investment unless the BHC has made other direct investments in the failing subsidiary bank or has issued cross guarantees to the subsidiary bank's creditors.

Table 4: Single Bank BHCs Assets

Institution	Holding company consolidated assets	Subsidiary bank assets	Bank assets as share of holding company assets
Goldman Sachs	\$915,705,000	\$104,767,000	11.44%
US Bancorp	\$371,289,000	\$367,103,430	98.87%
PNC Financial Services	\$323,586,973	\$313,362,161	96.84%
State Street	\$256,672,720	\$252,493,360	98.37%
BB&T	\$184,651,158	\$180,652,467	97.83%
Suntrust	\$179,553,408	\$175,463,961	97.72%
Ally Financial	\$148,452,000	\$97,800,297	65.88%
Fifth-Third	\$129,654,487	\$127,330,617	98.21%
Regions	\$118,136,516	\$117,078,660	99.10%
Northern Trust	\$103,832,578	\$103,499,014	99.68%
Key Corp	\$90,928,218	\$88,164,989	96.96%
Huntington Bancshares	\$61,145,753	\$60,961,626	99.70%
BBVA	NA	\$74,640,511	

Source: Federal Reserve National Information Center and FDIC Statistics on Depository Institutions and authors calculations.

Under a SPOE liquidation that recapitalizes a subsidiary bank, the bank's subordinated notes and debentures and the deposit insurance fund will be fully protected against loss by the equity and debt issued by the parent BHC and any borrowings from the OLF that may be required. The idea behind the SPOE strategy is that the protection of the bank's creditors is the mechanism that ensures the stability of the financial markets. The bank's losses are in effect up-streamed to the non-systemic parent and are imposed on the holders of the BHC's equity, subordinated notes and debentures, and on more senior holding company claimants if the magnitude of the loss makes this necessary.

Table 5 shows that, excluding Goldman Sachs, most of the equity in the BHCs consists of their equity investment in the bank subsidiary. So, for a given dollar loss generated in the bank

subsidiary, the equity capacity to bear loss is about equal between an FDIA resolution and a SPOE liquidation, because the parent BHC has little additional equity value beyond the amount invested in the equity of the subsidiary bank. Consequently, any difference in loss absorbing capacity between a SPOE liquidation and FDIA resolution is determined by the relative size of the borrowings of the bank and the BHC.

Table 5: Equity in Single Bank BHCs

Institution	Holding company equity	Subsidiary bank equity	Holding company equity as a percentage of bank assets
Goldman Sachs	\$79,099,000	\$20,426,000	75.50%
US Bancorp	\$42,054,000	\$40,948,948	11.46%
PNC Financial Services	\$43,320,810	\$39,051,066	13.82%
State Street	\$21,272,889	\$20,254,266	8.43%
BB&T	\$23,461,756	\$22,613,033	12.99%
Suntrust	\$21,690,901	\$21,973,921	12.36%
Ally Financial	\$14,459,000	\$15,228,240	14.78%
Fifth-Third	\$14,825,682	\$15,970,502	11.64%
Regions	\$16,131,983	\$16,074,579	13.78%
Northern Trust	\$7,948,343	\$7,199,366	7.68%
Key Corp	\$10,402,420	\$9,567,416	11.80%
Huntington Bancshares	\$6,176,131	\$6,186,936	10.13%
BBVA	\$11,700,374	\$11,520,347	15.68%

Source: Federal Reserve National Information Center and FDIC Statistics on Depository Institutions and authors calculations.

Table 6 reports the subordinated notes and debentures issued by the parent BHC and its subsidiary bank. In 10 of 13 cases, the loss absorbing capacity of subordinated creditors is largest at the subsidiary bank. In other words, for 10 institutions, once subsidiary bank losses exhaust equity capital, an FDIA resolution will have a much larger buffer of debt to absorb losses compared to a SPOE liquidation. Another way of putting this is that, for these institutions, an FDIA resolution can require private market creditors to absorb a much larger volume of losses before a government safety net—the deposit insurance fund or the OLF, depending on the mechanism used to resolve the failing institution—is required to bear any loss.

Table 6: Subordinated Notes and Debentures in Single Bank BHCs

Institution	Holding company subordinated notes and debentures	Subsidiary bank subordinated notes and debenture	Difference (bank less parent)
Goldman Sachs	\$16,561,000	\$0	(16,561,000)
US Bancorp	\$1,999,473	\$4,623,000	2,623,527
PNC Financial Services	\$623,122	\$7,195,908	6,572,786
State Street	\$1,498,622	\$2,537,071	1,038,449
BB&T	\$2,381,037	\$1,034,247	(1,346,790)
Suntrust	\$199,923	\$1,807,371	1,607,448
Ally Financial	\$277,000	\$0	(277,000)
Fifth-Third	\$3,301,989	\$519,037	(2,782,952)
Regions	\$560,510	\$1,601,019	1,040,509
Northern Trust	\$749,148	\$1,852,721	1,103,573
Key Corp	\$0	\$2,447,592	2,447,592
Huntington Bancshares	\$325,451	\$337,235	11,784
BBVA	0	\$719,320	719,320

Source: Federal Reserve National Information Center and FDIC Statistics on Depository Institutions and authors' calculations.

An alternative way to think about the SPOE strategy and the degree to which it expands the government safety net is to compare the size of the liabilities that would be protected from loss. The SPOE guarantees all the liabilities of the subsidiary bank and shifts subsidiary losses to investors who hold claims against the parent BHC. Table 7 compares the outstanding liabilities issued by these 13 BHC parents to the outstanding liabilities issued by their respective bank subsidiaries. For all but Goldman Sachs, the outstanding balance of parent BHC liabilities is only a very small fraction of the liabilities issued by the bank subsidiary and thus protected in a SPOE liquidation.

The overall loss bearing capacity in the parent BHC under a SPOE liquidation is limited by two additional factors yet to be discussed: (1) the parent BHC must repay its borrowings from affiliates and subsidiaries; and (2) if the FDIC treats similarly situated creditors differently to keep certain holding company functions operating, it may not have the capacity to impose losses on all the parent's creditors. If the parent does not repay loans from its subsidiaries, the subsidiaries will face losses that may require recapitalization. If the FDIC treats some similarly situated creditors differently, it will reduce the loss absorbing capacity at the BHC by transferring some creditors who legally could have been left in the receivership to the bridge. We

can use public data to correct for the first issue, but the importance of the second issue will be determined by the FDIC on a case-by-case basis and so cannot be accounted for based on balance sheet data alone.

Table 7: Comparison of Parent and Subsidiary Bank Liabilities

Institution	Parent holding company liabilities	Bank liabilities	Parent liabilities as a percentage of bank liabilities
Goldman Sachs	\$198,261,000	\$84,341,000	235.07%
US Bancorp	\$13,054,119	\$326,154,482	4.00%
PNC Financial Services	\$2,371,454	\$274,311,095	0.86%
State Street	\$9,158,101	\$232,239,094	3.94%
BB&T	\$10,311,260	\$158,039,434	6.52%
Suntrust	\$7,275,141	\$153,490,040	4.74%
Ally Financial	\$30,765,000	\$82,572,057	37.26%
Fifth-Third	\$5,781,902	\$111,360,115	5.19%
Regions	\$2,504,733	\$101,004,081	2.48%
Northern Trust	\$3,403,814	\$96,299,648	3.53%
Key Corp	\$3,349,783	\$78,597,573	4.26%
Huntington Bancshares	\$1,600,186	\$54,774,690	2.92%
BBVA	\$122,173	\$63,120,164	0.19%

Source: Federal Reserve National Information Center and FDIC Statistics on Depository Institutions and authors' calculations.

Table 8 compares the maximum resources available for a SPOE liquidation and an FDIA resolution net of parent company borrowings from affiliates and subsidiaries²³ before considering the need, if any, to treat similarly situated creditors differently in a SPOE liquidation to maintain critical BHC operations. In the case of a large bank FDIA resolution, deposits, even uninsured deposits, will generally not bear losses because the entire deposit franchise will be sold to an acquiring bank. As a consequence, we exclude bank deposits from the resources available to absorb losses in an FDIA resolution. Table 8 shows that, again with the exception of Goldman Sachs, there are far more resources available to absorb losses in an FDIA resolution than there are in a Title II SPOE liquidation of the parent BHC.

²³ We assume that these holding company liabilities will be moved to new bridge financial corporation and be fully protected in the liquidation of the parent BHC.

Table 8: Maximum Resources Available to Absorb Losses

Institution	Maximum resources available	
	Maximum resources at parent available to absorb losses in a SPOE resolution	at bank subsidiary to absorb losses in an FDI Act resolution
Goldman Sachs	\$264,605,000	\$84,341,000
US Bancorp	\$54,930,348	\$326,154,482
PNC Financial Services	\$45,386,428	\$274,311,095
State Street	\$29,438,059	\$232,239,094
BB&T	\$33,709,493	\$158,039,434
Suntrust	\$27,564,954	\$153,490,040
Ally Financial	\$39,097,000	\$82,572,057
Fifth-Third	\$20,605,224	\$111,360,115
Regions	\$18,636,716	\$101,004,081
Northern Trust	\$11,074,536	\$96,299,648
Key Corp	\$13,347,077	\$78,597,573
Huntington Bancshares	\$7,453,838	\$54,774,690
BBVA	\$11,718,567	\$63,120,164

Source: Federal Reserve National Information Center and FDIC Statistics on Depository Institutions and authors' calculations.

Thus, among the 13 SIFIs with a single bank subsidiary, the FDIC's use of the SPOE strategy in a Title II liquidation will extend the government safety net far beyond those who are usually covered in an FDIA resolution. Indeed, among these 13 relatively large banks—all of them considered SIFIs under the DFA—Goldman Sachs is the only BHC candidate that could use a SPOE transaction to recapitalize the bank without extending the government safety net beyond guarantees provided by deposit insurance. The moral hazard arising out of this extension of the safety net is discussed in Section VII.

For these BHCs in particular, not only does SPOE create substantial moral hazard, but it also creates a much higher likelihood that the OLF will bear losses instead of the deposit insurance fund. If the SPOE liquidation cannot recoup its costs from the shareholders and creditors of the parent BHC, which seems unlikely for 12 of these BHCs, the SPOE will have shifted some bank insurance fund exposure to the OLF and ultimately to the financial firms that are at risk to pay OLF assessments.

Here again the SPOE can be challenged on legal grounds. In Section IV we argued that depository institutions are specifically excluded from the category of firms that are covered by OLA and that Title II prohibits the OLF from "assisting" the deposit insurance fund. Moreover,

as also discussed above, the legislative language authorizing the OLA and the OLF specifically excludes insured depository institutions as “covered financial companies” under Title II. Thus the OLF may not be used for the recapitalizations of the subsidiary banks of BHCs that do not have sufficient debt to absorb losses and provide for the recapitalization of their subsidiary banks.

The use of the OLF raises another legal stumbling block for the SPOE strategy. Given the limited resources available to absorb losses at 12 of the BHCs listed in Table 8, the use of the OLF is likely to be necessary to provide the funds needed to recapitalize a failed subsidiary bank. Recall that if receivership proceeds are unable to repay the OLF within five years, all BHCs with at least \$50 billion in assets and all financial firms supervised by the Fed will be assessed for these costs. However, under these circumstances, the language in Title II will provide any firm that might be assessed to reimburse the OLF with grounds to mount a strong legal defense against the OLF assessment. If these arguments prevail in court, the taxpayers will be at risk for the liquidation loss.

VI. Which Creditors Bear a Subsidiary Bank’s Losses?

Comparing investor exposure to subsidiary bank losses in a Title II SPOE liquidation versus investor exposure in an FDIC bank resolution and possible BHC bankruptcy is informative for the TBTF debate. Rather than ending too-big-to fail, the analysis in the prior section shows that the SPOE guarantee of bank subsidiary liabilities preserves and extends TBTF by extending the government safety net guarantee to a class of investors who would not be protected in an FDIA resolution and imposes losses on a completely different investor class that had not assumed the direct risk of a bank’s losses when they advanced credit to the BHC.

This raises the possibility that the FDIC’s use of the SPOE strategy to recapitalize a bank could result in a substantial claim against the FDIC as receiver of a BHC. Section 210(d)(2) provides that claimants in an FDIC liquidation under Title II can recover up to the amount they would have received if the BHC had been “liquidated under Chapter 7 of the Bankruptcy Code.” If the FDIC’s use of the SPOE strategy is ultimately found to be impermissible, the creditors of the BHC could have such a claim, especially if the BHC was not insolvent in Chapter 7 terms when it was taken over by the FDIC as receiver. They would argue that the bank should have been

resolved under the FDIA, not under the OLA, and if the FDIA had been used the BHC and they would not have suffered losses of the size they did under the SPOE liquidation strategy.

In at least one major recent FDIA resolution, the creditors of the holding company received 100 percent of what they were owed from the bankrupt estate of the holding company. This was the result in the failure of Washington Mutual, the largest depository institution failure to date. In the failure of Washington Mutual, the stock and subordinated debt holders in the WAMU depository institution lost everything, while the bondholders in the holding company ultimately recovered their full investment with accrued interest.

The FDIC reports that the Washington Mutual receivership included \$13.8 billion in senior and subordinated debt claims. The recovery on WAMU bank bonds is still unknown as settlement has been held up by litigation over claims against the roughly \$2 billion in assets still held by the FDIC receivership.²⁴ Roughly \$6 billion in senior bank bonds may ultimately receive a small recovery, but bank subordinated debt holders will lose everything. In contrast, the parent, Washington Mutual Holdings, had issued about \$6.4 billion in bonds, less than half the debt issued at the bank level. After prolonged negotiations with the FDIC and JPMorgan Chase, which included recovering BHC deposits and other disputed assets, the holding company senior and subordinated bondholders ultimately recovered 100 percent of their principal and interest.²⁵

If WAMU had been resolved using the SPOE, the bank's bondholders would have been protected and the holding company bondholders would have been completely wiped out. In addition, roughly \$7 billion in losses would have had to be financed by the OLF, assuming that the JPMorgan Chase bank purchase would have taken place on the same terms as it did under the FDIA resolution.²⁶

Accordingly, as in the WaMu case, if the government proceeds with a SPOE liquidation to recapitalize a failing bank subsidiary of any of the large single bank holding companies

²⁴ For pending litigation that prevents receivership dividends, see, http://www.fdic.gov/bank/individual/failed/wamu_settlement.html

²⁵ "WaMu gets \$6 billion in dispute with JPMorgan, FDIC", Seattle Times, March 12, 2010. http://seattletimes.com/html/business/technology/2011328562_wamu13.html

²⁶ This example is intended to illustrate differences in the SPOE and FDI Act resolutions. Title II is supposed to prevent the practice of resolving large failing banks by finding a larger bank and creating incentives for it to purchase the distressed institution.

examined in this section, BHC creditors could have a strong legal case that their investments were illegally confiscated in the SPOE liquidation. Given the large amount of debt issued at the bank subsidiary level, BHC debt holders would expect to receive substantial recoveries if the bank goes through FDIA resolution and the BHC into Chapter 7 bankruptcy.

Aside from the potential liability created under a SPOE liquidation that forces bank subsidiary losses on holding company creditors, the issue of creditor loss exposures has wider implications for financial stability. The option to impose bank subsidiary losses on either the bank's creditors using an FDIA resolution or BHC creditors using the SPOE strategy introduces new uncertainty into a creditor's lending decision. The market disruption associated with this new source of investor risk will be significant and further compound the liquidity problems that arise when a large proportion of creditors simultaneously seek to protect themselves.

By favoring large bank subsidiary creditors over BHC creditors, the SPOE will increase the difficulty that BHCs will face in attracting credit, especially when financial markets are under stress. Why lend funds to a BHC when a loan to one or more of its subsidiary banks would be far safer? This will be true if it appears that the secretary will be able to seize the holding company and that the SPOE can legally be used to recapitalize a bank, but it will be untrue if the most likely course of action will be an FDIA resolution. One can only imagine the chaos in the markets as lawyers try to advise their clients about the likely outcome in either case. Ironically, the more likely it appears that the secretary will seize a BHC and the FDIC will use the SPOE the less likely will the BHC be able to attract credit that will be available for use in a SPOE transaction.

VI. Does SPOE End Too-Big-to-Fail?

1. Defining TBTF

Since its enactment, DFA supporters have claimed that it solved the “too-big-to-fail” (TBTF) problem in banking. In this section, we consider the merits of this claim.

In the policy debate, TBTF has two very distinct meanings. The first—and the one frequently cited to support passage of the DFA—is that a firm should be considered TBTF if it is so large and interconnected that it could not be resolved through bankruptcy. Those supporting DFA Title

II point to the chaos that resulted after the Lehman Brothers bankruptcy as proof that bankruptcy is disorderly, disruptive and inadequate for the resolution of large financial institutions. With the DFA's new orderly liquidation process for large financial institutions, DFA supporters argue that the government will no longer be obligated to rescue a large failing financial firm using taxpayer money—as occurred, for example with Bear Stearns and AIG.²⁷ Thus, for those who believe that Title II provides an orderly mechanism for resolving failing financial firms outside bankruptcy, these firms are now quite literally no longer too big to fail. They can be allowed to fail, because the OLA is there to supplant a disorderly bankruptcy.

The second definition of TBTF applies to banks that are going-concerns, not financial firms that are failing. When a bank or other financial institution is considered TBTF, it is likely to be rescued by the government. The rescue will provide government protection to the institution's creditors, which translates into a reduction in creditor risk exposure and a lower cost of funds for the institution. The institution can further exploit this implicit government insurance by undertaking higher risk activities in the hope of generating higher returns. Since the institution's creditors expect to be protected from loss by the government, they will continue to fund the institution at lower cost than would be appropriate given the risk of the institution's activities. Thus, TBTF firms creates moral hazard as TBTF institutions are encouraged to take on more risk because shareholders and management keep the gains and creditors expect to be protected from loss.

2. Will the SPOE eliminate disruptive failures by large TBTF banks?

If a bank is large and systemically important, the need to use a Title II SPOE recapitalization strategy is an implicit recognition that the existing FDIA resolution process would disrupt financial markets. As discussed earlier, a SPOE recapitalization uses the BHC's resources to directly recapitalize the failing bank, avoiding the FDIA resolution process and the attendant losses for bank creditors.

²⁷ Although the Title II process is supposed to be invoked only after the secretary of the Treasury has determined that a normal bankruptcy will not be suitable, as a practical matter Title II will likely be used in every case in which a large financial institution is in danger of default. The “legend” of the Lehman Brothers bankruptcy—that it was disorderly and brought on a financial crisis—will make it very unlikely that the secretary would risk the possibility of allowing a bankruptcy that might result in similar chaotic market conditions in the future. The exceptional circumstances surrounding Lehman's failure will be ignored or forgotten, as the political class calculates how they might suffer the least blame from the actions they are required to take.

The resolution of failing banks has not been disruptive in the past, mostly because the FDIC sells large failing banks to healthier large institutions when a buyer can be identified. If no buyer can be found, the FDIC in the past used open bank assistance to keep distressed banks open and operating.²⁸ When a buyer can be identified, a bank purchase and assumption transaction, often with an FDIC loss sharing agreement, is almost always the least cost resolution for the bank insurance fund. The Federal Deposit Insurance Corporation Improvement Act requires that the FDIC resolve a bank using the least-cost method. Whole-bank purchase and assumptions are not only the least-cost method but have the additional benefit that they avoid disruption in banking services that would be associated with a depositor payout and liquidation of the failing bank's assets.²⁹

However, the policy of selling large failing banks to larger more stable institutions has been the principal mechanism that created several giant US banks that many consider TBTF. It is now generally recognized that making the largest banks still larger through the bank resolution process creates long-term problems that outweigh the short-term benefits of this resolution strategy. If the SPOE strategy cannot be used to recapitalize large failing banks, there is currently no resolution mechanism under the FDIA that both meets the least cost standard and does not involve selling a large bank to another large bank.

If the specific circumstances associated with a distressed financial institution do not allow the secretary to invoke OLA, or if—as we believe—Title II does not permit the FDIC to use SPOE to recapitalize a failing bank, then—contrary to the claims of DFA supporters—Title II it does not solve the first TBTF problem described above. Our analysis shows that, at least in the case

²⁸ In 1984, when the FDIC could not find a buyer Continental Illinois Bank, it recapitalized the institution by extending unlimited deposit guarantees, purchasing billions of dollars of the bank's bad loans, and injecting new preferred equity and subordinated debt. The 1991 Federal Deposit Insurance Corporation Improvement Act (FDICIA) limited the FDIC's ability to provide "open bank assistance" and instead required the FDIC to choose a resolution method that imposed the least cost on the deposit insurance fund. FDICIA allows the FDIC to bypass the least cost method if it "would have serious adverse effects on economic conditions or financial stability" and if bypassing the least cost method would "avoid or mitigate such adverse effects." A FDIA systemic risk exception required the approval of two thirds of the members of the FDIC's Board of Directors, two thirds of the members of the Board of Governors of the Federal Reserve System, and the Secretary of the U.S. Treasury, who must first consult with the President. During the financial crisis, the FDIC used the systemic risk exception to provide open bank assistance to many institutions through a new unlimited transaction account insurance guarantee program and a program that guaranteed new uninsured term debt issued by bank holding companies. Section 1105 of the DFA amended the FDICIA systemic risk exception to require Congressional approval and limit the methods the FDIC can use to provide open bank assistance in exceptional circumstances.

²⁹ Over the longer term, some academic studies have shown that the new bank management may decide forego the continuation of some customer relationships in the acquired bank.

of the largest US banks today—JPMorgan Chase, Bank of America, Citi or Wells Fargo among others—it is unlikely that OLA could be invoked unless many of these BHCs’ subsidiaries simultaneously experience large losses. Only in rare cases will subsidiary losses cause the parent BHC to become insolvent or appear to be clearly on the way to insolvency, and only in those cases can OLA and the SPOE be legally employed. In addition, even if the SPOE can be invoked in a particular case, there is a serious legal question whether the SPOE can be used for the recapitalization of a bank under Title II.

Other large BHCs present additional difficulties. Among large BHCs with a single bank subsidiary, most parent BHC are unlikely to have sufficient capacity to recapitalize their failing bank subsidiary without extensive draws on the OLF that would require subsequent financial industry assessments. Here again, the use of the OLF for a bank recapitalization seems to contravene the provisions in the statute and may provide the firms to be assessed with a strong legal defense against assessment.

In the future, when officials are faced with a failure by a large bank, and they may not—for reasons outlined above—use the SPOE strategy, they will again face a choice of either using taxpayer funds to rescue the bank or using the FDIA to resolve it, possibly through a sale to a larger healthy institution. If SPOE is unavailable because of legal issues or financial circumstance, it will be business as usual—same as the last crisis. Our analysis suggests, then, that Title II and the SPOE have not ended TBTF since many failing bank subsidiaries would likely have to be resolved through the FDIA resolution process.

3. *The SPOE and operating TBTF banks*

The second definition of TBTF is a belief among creditors that a financial firm is so large that it can’t effectively be resolved without disrupting the financial system, and consequently it will be rescued by the government. In this case, the likelihood of a government rescue, in which creditors are also rescued, makes TBTF institutions seem less risky compared to non-TBTF competitors. The implicit government guarantee creates a subsidy in the form of a lower cost of credit for TBTF institutions.

In arguing for the SPOE, the FDIC made clear that its principal objective was not the resolution through liquidation of a failed bank but the stabilization of the bank and its linkages within the

financial system. If the SPOE works as intended, the failing bank or other critical subsidiary will survive. Nothing could be more favorable to the interests of creditors. In discussing the SPOE, the FDIC argued that the SPOE would provide “stability to financial markets by allowing vital linkages among the critical operating subsidiaries of the firm to remain intact and preserving the continuity of services between the firm and financial markets that are necessary for the uninterrupted operation of the payments and clearing systems, among other functions.”³⁰ In other words, through the SPOE, the FDIC will recapitalize failing banks (or other systemically important subsidiaries of holding companies) in order to produce a stable market.

Because the SPOE avowedly seeks to avoid a disruptive resolution of a failing bank or other financial subsidiary by recapitalizing failing subsidiaries without cost to its creditors, it creates moral hazard that makes the TBTF problem considerably worse. Moreover, by favoring the creditors of banks over the creditors of BHCs, the SPOE encourages potential creditors of any banking organization to lend to the subsidiary bank rather than the BHC. Loans to the BHC would be in danger of conversion into equity in a SPOE-based liquidation, while creditors of the failing subsidiary bank would be spared loss.

4. The Regulatory Solution: Increasing BHC Leverage and Complexity

The SPOE strategy uses the assets of the parent BHC to recapitalize failing systemically important subsidiaries and leaves most of the parent BHC’s liabilities behind in the bankrupt receivership estate of the holding company.³¹ The FDIC claims that “the bridge financial company would have a strong balance sheet with assets significantly greater than liabilities since unsecured debt obligations would be left as claims in the receivership [of the former holding company] while all assets will be transferred.”³² However, in many cases, the holding company may have relatively few assets other than its equity interests in the operating subsidiaries. Many BHCs will not have a sufficient amount of outstanding debt in relation to the size of their subsidiary banks to achieve the required recapitalization without extensive use of the OLF.

³⁰ FDIC, SPOE NPR, **Federal Register** / Vol. 78, No. 243 / Wednesday, December 18, 2013, p. 76615.

³¹ The FDIC assumes that the disavowal of the unsecured debt of the holding company will not itself create a disruptive event in the financial system.

³² *Ibid.*, p. 76617.

The SPOE strategy assumes that the bridge institution and its [solvent] subsidiaries will be able to “borrow from customary sources in the private markets in order to meet liquidity needs.”³³ But the amount that the bridge can borrow in a market transaction without borrowing from the OLF or relying on an OLF guarantee will be limited by the profitability of the assets it retains, the likely profitability of its solvent subsidiaries, including the recapitalized bank, and the amount of long-term unsecured debt that the holding company carried before it was taken over by the secretary of the Treasury. The more debt the SPOE can leave behind in the receivership, the greater the bridge’s capacity to borrow the funds necessary to recapitalize a failing bank or other subsidiary.

This has led to the odd notion among regulators that the FDIC should be able to determine by regulation the amount of debt the BHC must issue so that the debt can be left behind in the receivership if a failed subsidiary bank is recapitalized. In a 2013 speech, for example, Jeremiah O. Norton, a member of the FDIC Board of Directors stated: “Without sufficient intra-company debt to recapitalize a failed subsidiary, the desired orderliness of a Title II [SPOE] approach might not be achievable.” Further:

In order to effectuate an SPE resolution, policymakers might need to consider requiring that the debt be apportioned, or pre-positioned, in a particular way among subsidiaries. Such a requirement could lead further down a path in which traditional business operational and funding decisions are no longer the primary domain of management and boards of directors, but instead are left to the prescription of the regulatory community.³⁴

In other words, the amount of debt that will be issued by the BHC and its subsidiaries will be determined by bank regulators, not by the management and board of directors of the BHC. Moreover, it will not be determined on the basis of the BHC’s or subsidiaries’ business needs, but by the amount of debt that will be necessary in order for the SPOE to operate as intended should one of the BHC’s subsidiaries should become insolvent.

Two months later, when it came time to issue its NPR on the SPOE, the FDIC had not apparently made any additional progress on resolving this issue. The SPOE NPR states:

³³ Ibid.

³⁴ Jeremiah O. Norton, Speech to the American Bankers Association, October 21, 2013

The discussion of the appropriate amount of equity and unsecured debt in the holding company that would be needed to successfully implement a SPOE resolution has begun. Regulators are considering minimum unsecured debt requirements in conjunction with minimum capital requirements for SIFIs. In addition, consideration of the appropriate *pre-positioning* of the proceeds from the holding company's debt issuance is a critical issue for the successful implementation of the SPOE strategy.³⁵ [emphasis supplied]

Thus, the proposed “solution” to ensuring that there are sufficient resources to implement SPOE, without mutualizing losses through OLF assessments, is to require that BHCs issue a minimum amount of debt. After years of decrying excessive leverage in banking, the bank regulators now are considering requiring *more* leverage at the BHC level—not to increase the profitability of banking organizations, but simply to make it easier to resolve failing banks.

Moreover, the idea for requiring additional “pre-positioned” debt ignores the reality that, to borrow, a BHC has to persuade its creditors that the borrowed funds will be used for some profitable purpose. Unless the new holding company debt is going to replace holding company equity, the BHC must have a profitable use for the debt proceeds. If there is no productive use, and the debt's only use is to serve as a sacrificial lamb when it becomes necessary to recapitalize a subsidiary bank, creditors will be reluctant to participate.

Finally, even if BHCs can find a profitable use for their new required borrowings, the new debt requirement and associated investment will necessarily make BHCs bigger and more complex. These debt new requirements directly conflict with DFA Title I mandates that require new heightened prudential standards and living will requirements that are specifically designed to reduce leverage and complexity of large systemically important financial institutions.³⁶

VII. Conclusion

Our analysis raises serious doubts about claims that the Dodd Frank Act has solved the TBTF problem for banks or indeed that it has provided a reliable solution to preventing the disorderly failure of a systemically important bank. We have identified legal issues suggesting strongly that the OLA in Title II cannot be used for depository institutions and, in particular, cannot be used to

³⁵ FDIC SPOE NPR, **Federal Register** / Vol. 78, No. 243 / Wednesday, December 18, 2013, p. 76623.

³⁶ Nevertheless, the regulators are preparing to announce the increased debt requirement at a November 2014 Financial Stability Board meeting in Australia. See, for example, Joe Adler, “Ending Too Big To Fail at the Push of a Button,” *American Banker*, October 30, 2014.

recapitalize a failing bank subsidiary. If our analysis is correct, the Dodd-Frank Act has set out an alternative means for liquidating large nonbank financial institutions outside of bankruptcy, but the FDIC has not yet shown how OLA authorities would be used to liquidate the failing institution without widespread disruption of the financial system.

Apart from this problem, even if the legal obstacles we have identified can be overcome, the SPOE strategy is unavailable unless a parent BHC is in default or in danger of default. The ambiguity associated with this term introduces substantial uncertainty into the question of whether a bank subsidiary will be resolved through the SPOE strategy or through the FDIA process. That, in turn, causes uncertainty about which set of creditors—those at the banks or those at the BHC—will bear the loss. At a time of financial stress, this could add substantially to the difficulty BHCs and banks will encounter in raising new financing.

Our analysis of the largest banks shows that most of these institutions could fail without causing their parent BHCs to be in default or in danger of default. For the parent BHCs to be in danger of default, they would have to experience massive losses simultaneously in many or all of their bank and nonbank subsidiaries. So when it comes to the largest US depository institutions—the institutions that pose the greatest threat of a disorderly failure—there can be no assurance that the OLA and the SPOE will be available. In many cases, large failing banks will have no alternative but FDIA resolution process which typically sells a large failing institution to a larger healthy institution thereby creating a new larger TBTF institution. It seems likely, particularly in the case of large banks—the part of the financial system most likely to cause a systemic event if they fail—that the DFA has not provided a solution to this problem. Indeed, although the act purported to solve the TBTF problem, it has left the US economy with no mechanism with which to safely liquidate a large failing bank.

For BHCs that will clearly become insolvent if their bank subsidiary fails, the SPOE can be invoked, but the mechanism it uses to prevent financial market disruptions is an extension of the government safety net. Under SPOE, unless BHC's are required to issue more unsecured debt than their bank subsidiaries, a much larger group of creditors will be protected under a SPOE liquidation compared to an FDIA bank resolution. Thus, in instances when it could be used, rather than ending TBTF for banks, the SPOE institutionalizes it. It will protect all large bank

creditors from losses by transferring bank losses to the parent BHC's creditors and potentially to unaffiliated institutions that will be assessed to repay the OLF. Here, the SPOE strategy—because it promises to bail out failing large banks—reinforces the TBTF problem at the largest banking institutions.

Beyond legal issues, the SPOE interjects a new source of uncertainty for BHC creditors that will make it more difficult for BHCs to fund themselves in the next financial crisis. Creditors are going to be less willing to extend credit to BHCs when they believe that regulators are likely to impose subsidiary losses on the parent. And in many cases, parent BHCs will not have sufficient equity and debt to absorb and recapitalize subsidiary losses.

To address SPOE's potential loss absorbing shortfall, regulators plan to require the largest systemically important financial institutions to *increase* their leverage and issue more debt to increase the parent's holding company's loss absorbing capacity. These new requirements run counter to the DFA's Title I heightened prudential standards and will increase BHC leverage and complexity in order to create the illusion that they could be readily resolved through a Title II SPOE liquidation.

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