REPORT TO THE CONGRESS ON SECURED CREDITOR HAIRCUTS

FINANCIAL STABILITY OVERSIGHT COUNCIL

Completed pursuant to Section 215 of the Dodd-Frank Wall Street Reform and Consumer Protection Act
July 2011

Contents of the Financial Stability Oversight Council Secured Creditor Haircuts Study

I. Introduction and Executive Summary 1

II. Key Questions 2

III. Secured Creditor Haircuts 5

A. Mechanics of Secured Creditor Haircuts 5

B. Assessing the Impact of Secured Creditor Haircuts 7

IV. Comparison of Treatment of Secured Creditors under Different Resolution Mechanisms 12

A. Overview 12

B. Bankruptcy Code 12

C. Federal Deposit Insurance Act 17

D. Orderly Liquidation Authority 23

E. Summary of Comparison of Resolution Mechanisms 27

V. Other Reforms that Protect Taxpayers from Loss and Promote Market Discipline 29

A. Title I of the Dodd-Frank Act 30

B. Basel III 32

C. Increased Transparency of Funding Arrangements 35

Appendix A: Overview of Certain Forms of Secured Lending 39

I. Repurchase Agreements 39

II. Stock Loan and Stock Borrow 42

III. Sell-Buyback Arrangements 43

I. Introduction and Executive Summary

On July 21, 2010, President Obama signed into law the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[1] Two of the goals of the Dodd-Frank Act are to promote market discipline and taxpayer protection. Section 215 of the Dodd-Frank Act calls on the Financial Stability Oversight Council ("Council") to study whether allowing regulators in a resolution proceeding to treat a portion of fully secured creditors' claims as unsecured ("secured creditor haircuts") would promote these objectives.[2] While section 215 contemplates evaluating secured creditor haircuts in the utilization of the orderly liquidation authority ("Orderly Liquidation Authority" or "OLA") authorized by Title II of the Dodd-Frank Act, OLA provides no authority to impose secured creditor haircuts.[3]

Proponents of secured creditor haircuts believe secured creditor haircuts would be an effective means of promoting market discipline and taxpayer protection. They argue that secured creditor haircuts would: (a) cause secured creditors to engage in more extensive credit analysis and monitoring, thereby limiting the ability of the largest, most interconnected financial firms to pose a risk to U.S. financial stability; (b) promote taxpayer protection by giving the United States priority over a portion of the secured claims of other creditors; and (c) reduce collateral demands on distressed firms and discourage secured creditors from taking value-destroying actions that would force borrowers into failure.

Others have questioned the efficacy of secured creditor haircuts in promoting market discipline and taxpayer protection, and have argued that secured creditor haircuts may have significant drawbacks. They believe that secured creditor haircuts would: (1) reduce financial stability, including by limiting the availability of secured lending in a crisis; (2) have a negative impact on borrowers' cost of funds, increasing the cost of funds for financial firms directly and for other

---

[1] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[2] Section 215 of the Dodd-Frank Act requires the Council to:

> [C]onduct a study evaluating the importance of maximizing United States taxpayer protections and promoting market discipline with respect to the treatment of fully secured creditors in the utilization of the orderly liquidation authority authorized by this Act. In carrying out such study, the Council shall— (1) not be prejudicial to current or past laws or regulations with respect to secured creditor treatment in a resolution process; (2) study the similarities and differences between the resolution mechanisms authorized by the Bankruptcy Code, the Federal Deposit Insurance Corporation Improvement Act of 1991, and the orderly liquidation authority authorized by this Act; (3) determine how various secured creditors are treated in such resolution mechanisms and examine how a haircut (of various degrees) on secured creditors could improve market discipline and protect taxpayers; (4) compare the benefits and dynamics of prudent lending practices by depository institutions in secured loans for consumers and small businesses to the lending practices of secured creditors to large, interconnected financial firms; (5) consider whether credit differs according to different types of collateral and different terms and timing of the extension of credit; and (6) include an examination of stakeholders who were unsecured or under-collateralized and seek collateral when a firm is failing, and the impact that such behavior has on financial stability and an orderly resolution that protects taxpayers if the firm fails.

[3] *See* 12 U.S.C. §§ 5390(a)(3)(D), (b)(5).

firms indirectly; and (3) lead financial firms to rely more heavily on other forms of financing, which could reduce funds available for resolution should such firms fail.

This report evaluates these and related topics. *Section II* ("Key Questions") summarizes the Council's evaluation of each of the issues the Council is required to assess under section 215(a)(2)-(6) of the Dodd-Frank Act. *Section III* ("Secured Creditor Haircuts") describes the mechanics of secured creditor haircuts, and evaluates their intended benefits and potential drawbacks. *Section IV* ("Comparison of Treatment of Secured Creditors under Different Resolution Mechanisms") sets out aspects of the Bankruptcy Code, the Federal Deposit Insurance Act, and the Orderly Liquidation Authority that bear on the issue of secured creditor haircuts. Finally, *Section V* ("Other Reforms that Protect Taxpayers from Loss and Promote Market Discipline") reviews other reforms that would help to achieve the same goals of market discipline and taxpayer protection as secured creditor haircuts would be intended to achieve.

The report supports the view that the combination of the Orderly Liquidation Authority and the new supervisory framework provided by Title I of the Dodd-Frank Act[4] can be used to achieve the goals of market discipline and taxpayer protection effectively in the absence of secured creditor haircuts.

II. Key Questions

Consistent with its statutory mandate, the Council evaluated each of the questions posed below in preparing this report on secured creditor haircuts.

- **What are the similarities and differences between the resolution mechanisms authorized by the Bankruptcy Code, the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") and the Orderly Liquidation Authority?**

  The U.S. Bankruptcy Code, the Federal Deposit Insurance Act (as amended by FDICIA, "FDIA"), and OLA have different goals. The primary goal of the bankruptcy process is to maximize the value of a debtor's assets for the benefit of its stakeholders and, if justified, provide the debtor with the ability to reorganize.[5] The Federal Deposit Insurance Corporation's ("FDIC") process for resolving and liquidating a failed insured depository institution ("IDI") under the FDIA is driven by the FDIC's mandate to maintain confidence in the banking system, including through the protection of insured depositors from losses, and to liquidate a failed IDI in the manner least costly to the Deposit Insurance Fund ("DIF"). The objective of OLA is to prevent serious adverse effects on U.S. financial stability, while prioritizing the goals of protecting taxpayers and maintaining market discipline above the goals of preserving the going-concern value of the debtor's estate solely for the benefit of the failed firm's stakeholders. The differing goals of the Bankruptcy Code, FDIA, and OLA give rise to other key distinctions, including the types of institutions subject

[4] As discussed in *Section V*, the new supervisory framework provided by Title I of the Dodd-Frank Act is complemented by other recent reforms, including new "Basel III" capital, leverage and liquidity requirements.
[5] THOMAS JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW, 10-17, 20 (Beard Books 2001).

to each resolution mechanism, the manner in which each mechanism is initiated, and the scope and role of judicial review.

- **How are secured creditors treated in such resolution mechanisms, and how might a haircut (of various degrees) on secured creditors improve market discipline and protect taxpayers?**

  The U.S. bankruptcy process generally allows a secured creditor to retain the benefit of its superior non-bankruptcy rights by granting the creditor's secured claim full priority over other claims up to the value of its security interest, by providing the secured creditor "adequate protection" against a loss during the debtor's retention of collateral, and by providing for judicial involvement at the time creditors' rights are determined. The FDIC IDI resolution process under the FDIA is an administrative process designed to help the FDIC carry out its responsibility to maintain confidence in the banking system.[6] The FDIC as receiver has many of the same authorities under the FDIA that a bankruptcy trustee has under the Bankruptcy Code for recovery of the debtor's property that was transferred prior to the point of bankruptcy or receivership to both secured and unsecured creditors (e.g., avoidance of preferential transfer and fraudulent conveyance in cases of actual fraud). As compared to the bankruptcy process, administrative processes by design have less contemporaneous judicial involvement. OLA continues to protect the contractual rights of secured creditors in many of the same ways as the Bankruptcy Code, while adopting many of the expanded authorities available to the FDIC for resolving IDIs.[7]

  As discussed in more detail below, proponents of secured creditor haircuts argue that secured creditor haircuts would promote market discipline and strengthen taxpayer protection by creating incentives for secured creditors to engage in more extensive credit analysis and monitoring, giving the United States priority over a portion of the secured claims of other creditors, and reducing collateral demands on distressed firms. However, others believe secured creditor haircuts could reduce financial stability by severely limiting the availability of credit in a crisis, raise the cost of funds for financial firms and other borrowers throughout the economy, and increase the use of other forms of financing that could reduce funds available for resolution.

- **How do the benefits and dynamics of prudent lending practices by depository institutions in secured loans for consumers and small businesses compare to the lending practices of secured creditors to large, interconnected financial firms?**

  Prudent lending practices by depository institutions generally involve extensive credit analysis for each loan extended to a consumer or small business. Such loan-by-loan credit analysis is an important means of limiting risk when lenders do not already have substantial knowledge of borrowers, particularly when loans are long-duration, secured by illiquid collateral or would be subject to the automatic stay and avoidance provisions of the

---

[6] The FDIC's powers include: (1) the ability to transfer assets or liabilities quickly without counterparty or judicial consent to a bridge depository institution; (2) the ability to place failing IDIs into receivership prior to actual default, subject to *ex post* court review and other safeguards; and (3) the ability to place a temporary limitations on creditors' rights to unwind financial contracts of the failed firm.

[7] *See* 12 C.F.R. pt. 380 (2011).

Bankruptcy Code if the borrower were to enter a bankruptcy proceeding. Lenders to large, interconnected financial firms may have less need to engage in this type of credit analysis because, for example, they may have an understanding of the firms' credit profile from repeated dealings and from publicly available sources, such as audited financial statements, material event disclosures, and market analyst reports. Further, secured lenders to major financial firms may manage risk by adjusting the duration of loans, obtaining high quality collateral, and entering into lending agreements that would allow them to obtain their collateral immediately if the borrower becomes insolvent or files for bankruptcy. Differences in the form of credit analysis do not necessarily indicate a lack of market discipline.

- **Does credit differ according to different types of collateral and different terms and timing of the extension of credit?**

  Extensions of credit differ along many dimensions, including loan duration, the nature of collateral, and the applicable legal structure. In the context of secured lending to consumers and small businesses, credit is often long-duration, secured by relatively illiquid collateral, and could be subject to the automatic stay, and to avoidance provisions of the Bankruptcy Code if the lender sought to obtain its collateral shortly before the borrower filed for bankruptcy. A significant portion of secured lending to large, interconnected financial firms is short-term, secured by highly liquid collateral, and qualifies for the "safe harbor" provisions of the Bankruptcy Code for "qualified financial contracts" ("QFCs" and "QFC Safe Harbors").[8]

- **What was the impact, on both financial stability and on an orderly liquidation that protects taxpayers, of stakeholders who were unsecured or under-collateralized and sought collateral when a firm was failing?**

  During the recent financial crisis, creditors of certain large, interconnected financial firms increasingly sought collateral from firms whose failure seemed imminent.[9] Some have argued that these creditors, some of whom were initially unsecured or under-collateralized, precipitated the firms' failures and, by removing or encumbering valuable assets of the firm while curtailing further credit extensions, reduced the amount available for distribution to creditors who did not have the benefit of the QFC Safe Harbors. Others have argued that preventing these creditors from limiting risk by seeking additional collateral might have either led them to terminate their lending arrangements earlier or increased the potential for broad contagion upon the borrower's default. Thus, depending on the specific circumstances, preventing unsecured and under-collateralized creditors from limiting risk by seeking additional collateral could have had either a positive or a negative impact on the distressed firm's survival, as well as on financial stability and taxpayer protection.

[8] 11 U.S.C. §§ 362(b)(6), (7), (17); 546(e), (f), (g); 555; 556; 559; 560. Under the QFC Safe Harbors, QFC counterparties can close out their contracts and obtain their collateral notwithstanding the automatic stay and avoidance provisions of the Bankruptcy Code. *See infra* Section III.A.6. at nn. 12–14 and accompanying text.
[9] *See, e.g.*, Darrell Duffie, *"The Failure Mechanics of Dealer Banks"* (Bank for Int'l Settlements, BIS Working Paper No. 301, 2010), *available at* http://www.bis.org/publ/work301.pdf.

III. Secured Creditor Haircuts

A. Mechanics of Secured Creditor Haircuts

Section 215 of the Dodd-Frank Act focuses on the treatment of fully secured creditors in the utilization of OLA. The following description of the mechanics of secured creditor haircuts therefore assumes that secured creditor haircuts, if authorized by statute, would only apply in OLA. However, as noted above, OLA provides no authority to impose secured creditor haircuts. Accordingly, the following discussion is solely for purposes of meeting the requirements of section 215 of the Dodd-Frank Act and is not a description of existing law or policy.

1. Haircuts on the Value of the Secured Claim

Secured creditor haircuts would be based on the value of a creditor's secured claim. A claim is fully secured when the value of the collateral securing the claim is equal to or greater than the face value of the claim. When the collateral securing a claim is worth less than the face value of the claim, the claim is secured up to the value of the collateral and the remainder of the claim is unsecured.

How secured creditor haircuts would work in practice can be clarified using three examples. In the first example, a creditor has a 100-dollar claim secured by 100 dollars of collateral. Assuming a haircut of 20 percent, this creditor would be left with a secured claim of 80 dollars and an unsecured claim of 20 dollars. In the second example, the creditor has a 100-dollar claim secured by 105 dollars of collateral. Because this creditor's secured claim is limited to 100 dollars, a 20 percent haircut would leave this creditor, like the creditor in the first example, with a secured claim of 80 dollars and an unsecured claim of 20 dollars. In the third example, the creditor has a 100-dollar claim secured by 80 dollars of collateral. Because this creditor's secured claim is only 80 dollars, the creditor would be subject to a haircut of 16 dollars (i.e., 20 percent of the 80 dollar secured claim), leaving the creditor with a secured claim of 64 dollars and an unsecured claim of 36 dollars.

2. Determining the Haircut Amount

Secured creditor haircuts could be structured such that the entity responsible for the resolution of the failed firm has discretion over the amount of the haircut up to a specified limit. If applied in the context of OLA, such an approach might allow the FDIC in its capacity as receiver ("FDIC-Receiver") to impose secured creditor haircuts up to the specified limit on a case-by-case basis as necessary to repay amounts owed by a financial company in receivership ("covered financial company") to the United States and to the fund (the "Orderly Liquidation Fund") created by Title II of the Dodd-Frank Act. Such discretion would enable the FDIC-Receiver to retain more funding than otherwise would be available to satisfy the receivership's obligations to the United States and the Orderly Liquidation Fund, while at the same time providing the FDIC with the flexibility to impose a haircut on some secured creditors but not others and only to the extent necessary.

3. Limitation on Orderly Liquidation Authority

Under OLA, covered financial companies can include bank holding companies and nonbank financial companies, but only if it is determined that their failure and resolution under otherwise applicable federal or state law would have serious adverse effects on the financial stability of the United States.[10] This is a significant limitation on the applicability of OLA and would correspondingly limit the applicability of secured creditor haircuts if authorized in the context of OLA. However, since creditors of financial firms would not know whether a given financial firm would be resolved under OLA, a secured creditor haircut provision that would only apply in OLA would likely affect decisions about lending to financial firms even if those financial firms were ultimately resolved under the Bankruptcy Code.

4. Amounts Realized in Resolution

If secured creditor haircuts were designed to serve the goal of taxpayer protection in the context of OLA, their application could be limited to situations in which the amounts realized in resolution are less than amounts owed to the United States or to the Orderly Liquidation Fund. Under the Orderly Liquidation Authority, unsecured claims of the United States generally rank second in priority of payment and are only exceeded in priority by payment of the receiver's administrative expenses.[11] The fact that amounts owed to the United States already have high priority under OLA might lessen the number of instances in which secured creditor haircuts would be invoked.

5. Security Interests of the Federal Government

Further, secured creditor haircuts could be structured not to apply to any security interest held by the federal government. Otherwise, under certain circumstances, secured creditor haircuts would simply transfer the costs of resolving a covered financial company from one federal entity to another. Security interests held by the federal government would likely include amounts owed to the U.S. Treasury and the FDIC arising from the resolution of a financial firm.

6. Relationship to the QFC Safe Harbors

Secured creditor haircuts could be structured to apply to secured claims arising from contracts that qualify for the QFC Safe Harbors.[12] The QFC Safe Harbors provide a fairly extensive

[10] The Secretary of the Treasury must, for example, determine, in consultation with the President, that: (1) the financial company is in default or in danger of default; (2) the failure of the financial company and its resolution under otherwise applicable Federal or State law would have serious adverse effects on financial stability; and (3) any funding provided would avoid or mitigate such adverse effects. That determination generally may only be made after such a determination has been recommended by both the Federal Reserve Board and the appropriate federal regulator (either the FDIC or the U.S. Securities and Exchange Commission). Furthermore, those recommendations may only be made with the consent of two-thirds of the Federal Reserve Board and two-thirds of the board or commission of the applicable federal regulator. *See* Section 203(b) of the Dodd-Frank Act.

[11] *See* Section 210(b)(1)(B) of the Dodd-Frank Act. S*ee also* 12 C.F.R. § 380.23.

[12] QFCs include repurchase agreements, commodity contracts, forward contracts, securities contracts, swap agreements and master netting agreements. Subject to certain limitations, the QFC Safe Harbors in the Bankruptcy Code exempt most QFC counterparties from its automatic stay and from the effect of most of its avoidance action provisions. The legislative history states that the amendments that created the QFC Safe Harbors were intended to "minimize the displacement caused in the commodities and securities markets in the event of a major bankruptcy

exemption for QFC counterparties from the "automatic stay," allowing such counterparties to terminate contracts and exercise setoff and netting rights without seeking bankruptcy court approval. In addition, the QFC Safe Harbors exempt QFC counterparties from the Bankruptcy Code's rules governing preferential transfers, fraudulent conveyances absent actual fraud, and *ipso facto* clauses.[13] QFC counterparties enjoy many of the same rights under OLA as they have under the QFC Safe Harbors of the Bankruptcy Code, with the exception of the one-day stay combined with the power to transfer the QFC intact to a bridge financial company.[14]

B. Assessing the Impact of Secured Creditor Haircuts

1. Intended Benefits of Secured Creditor Haircuts

(a) *Market Discipline*

One of the principal arguments cited by supporters of secured creditor haircuts is that secured creditor haircuts would encourage greater due diligence and monitoring by secured creditors of large, interconnected financial firms. According to this argument, if those secured creditors were put at risk of losing a percentage of their secured claims, they would have greater incentives to investigate borrowers' credit quality before entering into lending arrangements and to terminate such arrangements as borrowers' credit quality decreases. Similarly, some believe that enacting a secured creditor haircut provision would cause secured creditors to shift their exposure to safer firms and thereby limit the ability of financial firms to use leverage to become large enough for their failures to pose a risk to U.S. financial stability.

(b) *Taxpayer Protection*

Supporters of secured creditor haircuts that would apply in the context of OLA argue that such haircuts would provide taxpayers a measure of protection that they otherwise would not have. Such supporters advocate giving the United States and the Orderly Liquidation Fund priority over up to a specified percentage of the secured claims of other creditors. They argue that because secured lending is a significant funding source for large, interconnected financial firms, the resulting benefits in terms of taxpayer protection could arguably be substantial in some cases.

---

affecting those industries" and to "prevent the insolvency of one commodity [or securities] firm from spreading to other brokers or clearing agencies and possibly threatening the collapse of the market." H.R. REP. NO. 97-420 (1982).

[13] Subject to exceptions, the Bankruptcy Code generally authorizes the trustee or debtor-in-possession to recover amounts paid by an insolvent debtor on pre-bankruptcy loans within 90 days of the commencement of bankruptcy ("preferential transfers"); allows the debtor to recover amounts lost through the pre-bankruptcy transfer of assets for less than fair value made while the debtor was insolvent ("fraudulent conveyances"); and renders unenforceable contractual provisions that would otherwise allow parties to an executory contract to terminate it or modify its terms based on the debtor's bankruptcy or insolvency ("*ipso facto* clauses").

[14] There is currently a vigorous academic debate about amending the QFC Safe Harbors that raises many of the same issues as are raised by the issue of secured creditor haircuts. A full assessment of arguments for or against amending the QFC Safe Harbors is outside the scope of this study. However, such an assessment would likely involve many of the same considerations as are involved in assessing secured creditor haircuts.

(c) *Collateral Demands on Distressed Firms*

Some proponents of secured creditor haircuts claim that the demise of certain large, interconnected financial firms during the recent financial crisis was precipitated at least in part by increasing demands for collateral by their creditors. They argue that demands of creditors for increasing amounts of collateral during the period immediately preceding failure not only left fewer assets for distribution to other creditors, but also enabled some secured creditors to quickly obtain full payment of their claims before other creditors, regardless of the impact on the viability of the distressed firm. They argue that by exposing a fully secured creditor to a possible haircut on a percentage of its secured claim, secured creditor haircuts would create a disincentive for such creditors to take actions that would force a borrower into failure; and that a secured creditor haircut provision might thereby limit collateral demands on distressed firms, especially where the firm might have remained viable in the absence of such collateral demands.

2. Qualifications Regarding the Intended Benefits of Secured Creditor Haircuts

(a) *Qualifications Regarding Market Discipline*

The extent to which secured creditors of large, interconnected financial firms already engage in due diligence and monitoring of their borrowers could arguably weaken the case for secured creditor haircuts. Even in the absence of the kind of loan-by-loan credit analysis typical in the consumer or small business contexts, decisions by lenders to large, interconnected financial firms are often based on knowledge of borrowers' credit quality obtained in the course of repeated dealings and on analysis of information contained in publicly available sources, such as audited financials, material event disclosures, and market analyst reports. Further, secured lenders to large, interconnected financial firms may manage risk in other ways, such as by retaining the right not to roll over funding, requiring borrowers to post high-quality collateral, or obtaining other creditor control provisions that would be triggered by a decline in borrowers' financial condition. These means of managing risk are also ways of imposing market discipline on borrowers and junior creditors. Differences in the form of credit analysis do not necessarily indicate a lack of market discipline.

In addition, secured creditor haircuts might not increase due diligence or monitoring by those secured creditors of large, interconnected financial firms that are not well-positioned to engage in transactions with meaningful default risk. For example, some have argued that ultra-short term funding sources (e.g., cash-suppliers in 24-hour repurchase agreements ("repo agreements" or "repos") or other overnight and intraday creditors) should be viewed as similar to individual bank depositors who are disinterested in performing extensive credit risk analysis or independent monitoring of the firms in which they "deposit" their funds.[15] The reason for this, it has been argued, is that the short duration of the credit extension, the fact that it qualifies for the QFC Safe Harbors, and the fact that it is often fully secured, make ultra-short term lenders relatively insensitive to the borrower's fundamental condition. According to these arguments, increasing the risk of loss for such creditors might do less to promote market discipline than to promote rapid reduction in the availability of credit during times of severe economic distress. On the other hand, others have argued that ultra-short term creditors, because they regularly extend

[15] *See, e.g.,* Morgan Ricks, "Regulating Money Creation after the Crisis," *1 Harvard Business Law Rev.* 75 (2011).

significant amounts of credit, could more cost-effectively conduct due diligence and monitoring than other creditors.

As further described in *Section IV* and *Section V*, the Orderly Liquidation Authority, together with the new heightened prudential standards to be imposed on largest, most interconnected financial firms, will promote market discipline by helping to force such firms to internalize the full cost that their failure would impose on the financial system.

(b) ***Qualifications Regarding Taxpayer Protection***

Secured creditor haircuts that would apply in the context of OLA have been promoted as a way to protect taxpayers by allowing a specified percentage of a creditor's secured claim to be treated as unsecured. But in the absence of the other reforms contained in the Dodd-Frank Act, there could be cases in which the secured creditor haircut amount specified would be insufficient to protect taxpayers from loss.

The Orderly Liquidation Authority and the supervisory framework for the largest, most interconnected firms set out in Title I of the Dodd-Frank Act may already provide a significant new measure of taxpayer protection. As described in more detail below, these reforms are designed to reduce the probability that a large, interconnected firm would fail, and in the event that such a firm does fail, allow regulators to wind it down, break it apart, and liquidate it without forcing taxpayers to bear any of the costs. If the proceeds from an orderly liquidation are insufficient to repay amounts owed to the U.S. Government, the FDIC ultimately has the authority to assess large financial companies to repay those amounts.[16] These reforms therefore lessen the need for the potential taxpayer protection that the addition of the secured creditor haircuts might arguably afford.

(c) ***Qualifications Regarding Collateral Demands on Distressed Firms***

In the case of secured creditor haircuts based on the value of creditors' secured claims, creditors whose claims are less than fully secured would still have an incentive to seek collateral from distressed firms. Creditors who were initially fully secured would continue to have an incentive to seek additional collateral to compensate for any impairment to the value of collateral originally posted. Creditors who were initially unsecured or under-collateralized might continue to seek collateral based on "collateral-on-downgrade" or similar provisions in loans and other agreements that provide for collateral and other credit enhancements as the borrower's financial condition weakens. Thus, secured creditor haircuts based on the value of creditors' secured claims would have a limited ability to prevent the kind of liquidity shocks that may have resulted from collateral demands triggered by such provisions during the lead-up to the recent financial crisis.[17]

Depending on their structure, secured creditor haircuts would not eliminate the incentive to obtain more collateral even in the case of fully-secured creditors. Secured creditor haircuts

---

[16] *See* Section 210(o) of the Dodd-Frank Act.

[17] As discussed in more detail below, some argue that secured creditor haircuts could also contribute to liquidity shocks by causing creditors to withdraw funding from distressed firms.

might apply only if: (a) the borrower is resolved using the Orderly Liquidation Authority; (b) amounts realized from the resolution are insufficient to satisfy any amounts owed to the United States or to the Orderly Liquidation Fund; and (c) the FDIC exercises discretion to impose secured creditor haircuts. Given that creditors would not know in advance whether any of these conditions would be met, they may seek additional collateral to avoid being put at a disadvantage relative to other creditors even in cases where secured creditor haircuts would ultimately apply.

3. Potential Drawbacks of Secured Creditor Haircuts

(a) *Financial Stability*

Critics of secured creditor haircuts argue that secured creditor haircuts could reduce the availability of secured lending in a crisis, transforming the "run on collateral" witnessed during the recent financial crisis into, at least, an equally disruptive flight from lending to financial firms.[18] Creditors unable to protect themselves by securing their extensions of credit might withdraw credit more quickly, resulting in more sudden and intense liquidity shocks. Repo counterparties might structure their loans on a shorter-term basis in order to terminate funding arrangements at the first sign of distress. IDIs might also be more likely to pull out of the lending relationship with a weakened financial firm rather than continue to extend credit under circumstances requiring a loan loss reserve on account of a potential secured creditor haircut.

Critics also argue that secured creditor haircuts could undermine financial stability by imposing losses on secured creditors. Secured creditors of large, interconnected firms might themselves be sufficiently large or interconnected that losses they would incur as a result of secured creditor haircuts could act as a vehicle for contagion throughout the financial system. In cases where creditors are investing funds of customers or investors, losses stemming from secured creditor haircuts could result in harm to those customers or investors (e.g., money market mutual funds). While appropriate forms of prudential regulation can reduce these risks to an extent, prudential regulation is unlikely to eliminate these risks completely.

Further, critics argue that secured creditor haircuts could threaten financial stability by limiting the extension of credit to financial firms by the Federal Reserve Banks or the Federal Home Loan Banks. If lending by the Federal Reserve Banks or the Federal Home Loan Banks were made subject to secured creditor haircuts, the Federal Reserve Banks or Federal Home Loan Banks might be unable to lend to financial firms, either due to legal limitations or risk management practices. Other lenders, even if not legally prohibited from lending under circumstances that would render them partially unsecured, might nonetheless limit such lending on risk management grounds. In addition to increasing the cost of capital as a general matter, the absence of this liquidity could have negative implications for financial stability, particularly in circumstances where availability of credit is otherwise limited.

---

[18] *See, e.g.*, Letter from the Comm. on Capital Mkts. Regulation to Christopher Dodd, Chairman, Richard Shelby Ranking Member, S. Comm. On Banking, Hous. & Urban Affairs and Blanche Lincoln, Chairman, Saxby Chambliss, Ranking Member, S. Comm. on Agric., Nutrition & Forestry 26 (Apr. 26, 2010), available at http://www.capmktsreg.org/pdfs/4.26.10_CCMR_Response_to_Senate_bills.pdf.

(b) ***Cost of Capital***

Secured creditor haircuts could increase funding costs directly for financial firms and indirectly for other borrowers.

Secured creditor haircuts that applied only in the context of OLA could increase the cost of borrowed funds for large, interconnected financial firms because lenders would demand higher rates of interest to compensate for the potential impact of secured creditor haircuts. These effects could be significant, since secured lending provides a major source of funding for financial firms.[19] While the impact of secured creditor haircuts that applied only in the context of OLA would be somewhat reduced to the extent that those haircuts would only apply if further conditions were met,[20] significant uncertainty about whether these conditions would be met in the case of any particular covered financial company could increase funding costs more broadly. Such uncertainties might not be easy to address given the importance of preserving the discretion of the FDIC-Receiver to administer the receivership of a covered financial company as effectively as possible in light of the particular facts and circumstances of each case.

In addition, secured creditor haircuts could increase the cost of borrowed funds by making it more difficult for money market mutual funds, as well as other lenders, to participate in the repo market.[21] Money market mutual funds are currently a major lender in the repo market, extending approximately $440 billion in credit through repo transactions in Q1 2011.[22] However, Rule 2a-7 under the Investment Company Act of 1940 limits money market mutual funds' ability to participate in repo transactions unless they are "Collateralized Fully."[23] To the extent that secured creditor haircuts would prevent repo transactions from meeting the definition of "Collateralized Fully," they could prevent institutions such as money market funds from participating in the repo market.

While secured creditor haircut provisions that apply only in the context of OLA would affect large, interconnected financial firms' borrowing costs directly, such provisions might affect borrowings costs for other firms indirectly. Securities prices reflect the cost of credit used to fund securities purchases. To the extent that credit becomes more expensive, securities prices will fall and securities issuers' cost of capital will increase.

---

[19] For example, in 2010, bank holding companies with more than $500 billion in assets used secured federal funds borrowings, repos and other collateralized lending arrangements to fund, on average, approximately 14% of their assets. Federal Reserve Bank of Chicago, Bank Holding Company Data 2001-2011, http://www.chicagofed.org/webpages/banking/financial_institution_reports/bhc_data_2001_2011.cfm (last visited June 22, 2011).

[20] For example, secured creditor haircuts that applied in the context of OLA might only be triggered if amounts realized in resolution were less than amounts owed to the United States or to the Orderly Liquidation Fund and if the FDIC-Receiver exercised its discretion accordingly.

[21] As noted in Appendix A, large, interconnected financial firms use repos to obtain a substantial majority of on-balance sheet secured funding.

[22] Board of Governors of the Federal Reserve System, Flow of Funds Accounts, http://www.federalreserve.gov/releases/z1/Current/z1r-4.pdf (last visited June 22, 2011).

[23] Specifically, Rule 2a-7 imposes a diversification requirement on money market mutual funds designed to prevent excessive exposure to any single issuer. A money market mutual fund cannot treat acquisition of a repo agreement as acquisition of the underlying collateral for purposes of the diversification requirement unless the repo agreement is deemed "Collateralized Fully." 17 C.F.R. § 270.2a-7.

(c) *Amounts Available to other Creditors*

If secured borrowing were to become significantly more costly as a result of secured creditors demanding increased interest rates to account for potential secured creditor haircuts, financial firms would opt for less expensive means of financing. These may include the issuance of asset-backed securities, shifting assets from their balance sheets to off-balance sheet vehicles or the outright sale of assets. As a general matter, a receiver would have greater flexibility when resolving a firm with secured debt rather than securitizations or an outright sale because secured borrowing allows unsecured creditors to benefit from any increase in the value of assets, while the creditors secured by those assets bear the cost of any decrease in the value of such assets.[24] Thus, if the secured borrowing is over-collateralized, then the receiver could determine to pay off the secured claim in cash up to the value of the pledged collateral, and retain the excess for distribution to other creditors. On the other hand, if the secured borrowing is under-collateralized, then the receiver could allow liquidation of the pledged collateral to pay off the secured portion of the claim and treat the remainder of the claim as unsecured. Accordingly, as compared with other means of financing, secured borrowing generally increases the receivership assets because the estate rather than a third-party receives the benefit of any over-collateralization.[25]

IV. Comparison of Treatment of Secured Creditors under Different Resolution Mechanisms

A. Overview

The United States has several distinct resolution mechanisms for resolving a failed financial firm, including the Bankruptcy Code, the FDIA, and OLA. The statutory authority on which each of these mechanisms is based reflects the distinctive purposes of each mechanism.

The following section describes each of the primary resolution mechanisms and their treatment of secured creditors, and in certain instances their perceived limitations or advantages for managing the resolution of a large, interconnected financial firm in a manner that preserves financial stability, and promotes taxpayer protection and market discipline.

B. Bankruptcy Code

1. Introduction

The U.S. Bankruptcy Code generally permits corporate firms to liquidate under Chapter 7, or to reorganize under Chapter 11. Bankruptcy is a process with the primary goal of maximizing the

---

[24] This analysis assumes that the securitization would qualify as a true sale; thus, the financial firm would have to surrender the control necessary to achieve this result. It also assumes that the firm has put the proceeds from such sales to other uses or paid them out to shareholders. Securitizations that do not qualify for true sale treatment would likely not be issued as securitization investors would not want to take the risk of potential haircuts.

[25] Further, since securitization standards have tightened through a combination of FAS 166/167 and the risk retention/disclosure requirements that increase the costs in structured finance, firms may not be able to issue securitizations at lower costs. As a consequence, they may opt for selling assets outright, thereby losing any increased value of the underlying assets.

value of a debtor's assets for the benefit of its stakeholders and, if justified, providing the debtor with the ability to reorganize.[26] At its most fundamental level, the U.S. bankruptcy process is a court-supervised forum for resolving conflicts among and between an insolvent debtor and other stakeholders regarding the allocation of the debtor's assets. Ideally, the forum offers a collective proceeding in which stakeholders can negotiate the terms under which the firm will continue as a going concern, or if beyond the point of viability, liquidate it for the benefit of its creditors.[27] One leading attribute of the bankruptcy process is that it is seen as providing participants with a transparent, efficient, and equitable mechanism for enforcing non-bankruptcy rights. In doing so, it facilitates the extension of credit on terms and at prices that take into account predictable risks and consequences of a debtor's insolvency.

Certain provisions of the Bankruptcy Code have the effect of modifying or negating provisions in secured lending agreements that were entered into prior to a debtor's entrance into a bankruptcy proceeding. These provisions include the automatic stay, the trustee's avoidance and recovery powers as well as the ability to retain a secured creditor's collateral (and surcharge a secured creditor for services that have benefitted such collateral). Some of the major allocative standards which affect secured creditors are discussed in detail below.

2. Automatic Stay

Upon the filing of a voluntary bankruptcy petition, all persons with claims against the debtor are subject to the "automatic stay," which, among other things, forbids any action against the debtor or its property to collect debts, seize assets, or otherwise exercise control over property of the debtor.

The purpose of the automatic stay, particularly with respect to secured creditors, is three-fold. First, it leaves intact the assets of the debtor which might be needed to run the debtor's business, whether it is the debtor's premises, equipment, inventory or operating capital. Second, it leaves in place assets which might have equity beyond the amount needed to satisfy the secured creditor's lien, thus giving the trustee or debtor in possession time to assess the scope of such equity and to realize on it for the benefit of unsecured creditors. Third, it reduces the amount the debtor might otherwise be required to spend to defend against disparate collection actions by bringing all such claims arising out of the various debtor-creditor relationships into a single forum where they can be addressed more comprehensively and cost-effectively. By shielding the debtor's assets and preventing a free-for-all rush to seize assets, the automatic stay avoids the disorderly dismemberment of a potentially viable firm and facilitates a process in which the debtor and its creditors can negotiate the terms under which the firm will be rehabilitated or, failing rehabilitation, permits the assets to be divided according to established priority schemes.[28]

While the automatic stay was intended to protect the interests of all creditors, it does not otherwise affect a secured creditor's status as a secured creditor. Rather, the Bankruptcy Code provides that a secured creditor may seek relief from the automatic stay to pursue its rights against the collateral securing its claim if it can show that its collateral is not adequately

---

[26] THOMAS JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW, 10-17, 20 (Beard Books 2001).
[27] Franklin R. Edwards & Edward R. Morrison, *"Derivatives and the Bankruptcy Code: Why the Special Treatment?,"* 22 YALE J. ON REG. 101 (2005).
[28] *Id.* at 105.

protected (e.g., if it is declining in value, is not insured, or is otherwise at risk), or if the debtor has no equity in the collateral and the collateral is not necessary to an effective reorganization. If, in the face of such a request, the trustee or debtor in possession wishes to keep the collateral for the reorganization of the business, or to market the collateral in an attempt to realize the equity, then the trustee or debtor in possession has the burden of establishing that the property is necessary to the debtor's reorganization and that adequate protection for the collateral exists, often in the form of payments or additional security. Thus, the Bankruptcy Code attempts to strike a balance between the protection of secured creditors' distributive rights and the preservation of assets to further the Code's allocative goals.

3. Avoidance and Recovery Powers

A second allocative standard of the Bankruptcy Code is that secured creditors who follow ordinary and prudent business practices and who act in good faith are generally protected, while those who overreach or take other extraordinary measures generally are not. This principle has been incorporated into the Bankruptcy Code as the various "avoidance" powers, such as the preference, statutory lien, fraudulent transfer and post-petition transaction avoidance powers that the bankruptcy trustee may exercise. Any property inappropriately transferred (or its value) may be "recovered" for the benefit of the bankruptcy estate. These provisions have the effect of (1) instilling a more disciplined approach to secured creditors' lending practices by incentivizing lenders to obtain adequate collateral at the outset of the lending relationship and to act promptly to perfect their security interest[29]; and (2) allowing the trustee to seek to enlarge the bankruptcy estate. The two most commonly invoked avoidance provisions, preference and fraudulent transfer, are described below.

(a) *Preference Avoidance*

Under normal circumstances, a prudent secured lender will enter into a security agreement with the borrower, or have the borrower execute a mortgage or deed of trust, at the time the loan is made, and will (in the case of personal property) promptly file a financing statement with the secretary of state's office where the borrower is domiciled, or (in the case of real property) record the deed of trust or mortgage with the county recorder's office where the property is located. Under non-bankruptcy law, these actions protect the secured creditor's interest in the collateral against most later-filed liens. On occasion, the lender will act slowly in recording its initial security documents, or will later request additional security. If the lender obtains such additional security, or perfects its lien on the original security while the debtor was insolvent and within 90 days prior to the filing of the bankruptcy petition, then the trustee or debtor in possession can set aside ("avoid") the new liens. If the secured creditor is an "insider" at the time of the transfer, any additional security acquired or late-perfected liens obtained within one year before the filing of the bankruptcy petition, can be avoided. The avoidance power also extends to judgment liens attached to property of the debtor within the 90-day or one-year periods described above.[30]

---

[29] The avoidance and recovery powers may also have the effect of incentivizing secured creditors to structure lending arrangements to take advantage of the QFC Safe Harbors.

[30] *See* 11 U.S.C. §§ 547, 550, 551.

(b) ***Fraudulent (Constructive) Transfer Avoidance***

Secured creditors sometimes seek credit enhancements from persons other than their borrower. These often come in the form of guaranties or collateral from a parent, subsidiary or affiliate of the borrower. Under normal circumstances, the law honors such agreements and will enforce the third party's obligations under the guaranty and will permit foreclosure of the collateral provided by the third party. However, different allocative principles are applied if the third party entered into the transaction with the intent to put its assets beyond the reach of its own creditors, or if, regardless of intent, the third party is left with too few assets to pay its own creditors. The Bankruptcy Code permits the trustee or debtor in possession to set aside such credit enhancements if they occurred within the two years prior to filing of the bankruptcy petition. The Bankruptcy Code also permits the trustee to apply state law, such as the state's version of the Uniform Fraudulent Transfer Act, to avoid the third party's guaranty or collateral pledge. This often allows a longer reach-back period than the two years provided for under the Bankruptcy Code.[31]

In addition to the constructive fraudulent transfer powers, the Bankruptcy Code gives the bankruptcy trustee the power to avoid transfers which are made with actual intent to hinder, delay or defraud any entity to which the debtor was (or thereafter became) indebted. Such avoidance actions are less common, but they are carved out of the QFC Safe Harbors, leaving QFC counterparties subject to them.

4. QFC Safe Harbors

As described in *Section III*, the Bankruptcy Code exempts most activities relating to QFCs from the automatic stay and from the effect of most avoidance action provisions when those actions are carried out by QFC counterparties. Counterparties whose transactions qualify for the QFC Safe Harbors are free to exercise their contractual rights upon a debtor's insolvency or bankruptcy filing, including rights that would allow the counterparty to liquidate, terminate, or accelerate the contract, and net any termination value, payment amount, or other transfer obligation arising under the contract when the debtor files for bankruptcy.

The QFC Safe Harbors were adopted, and over time expanded, to promote financial stability by reducing both the ability of the trustee to unwind a transaction which occurred prior to the filing of the bankruptcy petition, and the power of the bankruptcy court to stay termination of financial contracts upon the filing of a bankruptcy petition. Proponents argue that the QFC Safe Harbors reduce the probability of default by limiting the risk to creditors involved in lending to a troubled company up to the date that the company files a bankruptcy petition and, thereby constraining the flight impulse of certain short-term creditors to immediately withdraw all funding. They believe that any reduction of those protections could increase the run risk of short-term lenders for all troubled firms; and, in the case of a large, interconnected financial firm on the brink of failure, could initiate, or hasten, a financial crisis. In addition, they argue that the QFC Safe Harbors limit loss-given-default by allowing QFC counterparties to engage in close-out netting, which limits losses to solvent counterparties. They suggest that the QFC Safe Harbors thereby

---

[31] *See* 11 U.S.C. §§ 544, 548, 550, 551.

limit the risk that any shock from the bankruptcy filing of a large, interconnected financial firm will spread to other firms, destabilizing the financial markets.

Critics of the QFC Safe Harbors contend that the risk reduction that the QFC Safe Harbors were intended to provide comes at a high cost.[32] Such critics argue that in the recent financial crisis, the QFC Safe Harbors enabled certain creditors to demand large collateral posting on the eve of insolvency that they were permitted to keep, in circumstances under which traditional lenders would have been forced to return the collateral to the bankruptcy estate. They argue that, in addition to reducing the amount available for distribution under the Bankruptcy Code's priority scheme, QFC counterparties' ability to retain late-acquired collateral could decrease *ex ante* market discipline and, by effectively subsidizing QFC counterparties in this manner, encourage over-use of unreliable ultra-short term credit. While the availability of close-out netting enhances market stability by limiting losses to solvent counterparties, critics also believe close-outs can create market instability when a large volume of simultaneous close-outs gives rise to collateral fire sales.

5. Protections against Lien Stripping in Bankruptcy

Courts have held that, in a Chapter 7 bankruptcy liquidation, the full amount of a secured creditor's lien is protected even if, at the time of the bankruptcy, the collateral is worth less than the amount of the lien. In *Dewsnup v. Timm*, the U.S. Supreme Court refused to grant a Chapter 7 debtor's request to "strip down" the secured creditor's lien on the debtor's real property to the value of the property as determined by the court.[33]

In reaching its conclusion, the Supreme Court cited to the long history of protecting secured creditors under U.S. bankruptcy law.

Protections against lien stripping are also provided in Chapter 11 reorganization cases. Although the Bankruptcy Code permits non-consensual alteration of a secured creditor's rights ("cram-down"), this can occur only within certain parameters: First, the debtor's plan of reorganization must provide: (1) that the secured creditor retains its lien on the property and receives, on account of its claim, deferred cash payments totaling, as of the effective date of the plan, at least the value of its lien on the real property; (2) for the sale of the property, subject to the right of the secured creditor to credit bid the amount of its claim; or (3) for the realization by the secured creditor of the "indubitable equivalent" of its claim.[34]

Second, unless the secured creditor elects otherwise or the real property is to be sold, a secured creditor is treated as having recourse against the debtor even if the creditor would not have had recourse under applicable non-bankruptcy law. In this way, the secured creditor obtains a secured claim to the extent of the value of the real property and an unsecured claim for the balance owed to it. The creditor must be paid in full (perhaps over time) for the full present value of its secured claim, and may be paid pro rata on its unsecured claim based on the rate paid to other unsecured creditors. If the secured creditor makes the election permitted under the

[32] Mark J. Roe, *"The Derivatives Markets' Payment Priorities as Financial Accelerator,"* 63 STAN. LAW REV. 539, 550-551 (2011).
[33] *See* Dewsnup v. Timm, 502 U.S. 410, 417 (1992).
[34] *See* 11 U.S.C. § 1129(b)(2)(A).

Bankruptcy Code (commonly called an "1111(b) election"), then its entire claim is treated as a secured claim, even though the property may not at that time be worth enough to make the secured creditor whole. This allows the secured creditor to protect for itself the future increase in the value of the collateral—which may be undervalued in the confirmation process either because the market for the collateral is depressed at the time, or because the value as determined by the bankruptcy court in the confirmation process is less reliable than the value determined in an actual sale of the collateral—when the debtor wishes to retain the property for use in the reorganization.[35]

6. Surcharge of Secured Creditor's Collateral

Another allocative standard under the Bankruptcy Code is the power to surcharge the secured creditor's collateral. The Bankruptcy Code provides that the trustee or debtor in possession may recover, from property encumbered with a secured creditor's lien, the reasonable and necessary costs and expenses of preserving, or disposing of, the collateral, to the extent of any benefit to the secured creditor. If the trustee or debtor in possession has paid ad valorem property taxes, the value of these payments may be recovered from the collateral as well.

Typically, in the absence of a bankruptcy filing, the debtor is contractually obligated to the secured creditor to insure and maintain the value of the collateral. If the debtor fails to make such expenditures, the secured creditor normally has a right do so and to add the sums expended to the amount of its lien. Upon the filing of a bankruptcy petition, however, the task of caring for the collateral falls to the bankruptcy trustee or debtor in possession, who might choose to hold the collateral for a period of time while assessing whether it has equity or whether it will be needed in the reorganization. In cases where cash is scarce and unsecured creditors will not be paid in full, it is viewed as unfair for the trustee or debtor in possession to use its limited resources in a way that will not redound to the unsecured creditors' benefit.

In theory, the surcharge is limited to the benefit the secured creditor receives on account of the trustee's expenditures. In practice, the timeframe during which the trustee administers the property may be far longer than the timeframe to foreclosure under applicable non-bankruptcy law. Despite the fact that the secured creditor might have been able to mitigate the costs of preserving the collateral and to dispose of it more quickly and efficiently in the absence of a bankruptcy, the Bankruptcy Code alters the secured creditor's distributive rights in order to accomplish intertwined goals: to provide a breathing space to assess the potential benefit to other creditors of using or selling the collateral, while avoiding burdening the non-lien holder creditors with expenses that ultimately inure to the benefit of the secured creditor.[36]

C. Federal Deposit Insurance Act

The Federal Deposit Insurance Act provides a comprehensive scheme for the resolution and liquidation of a failed IDI. The FDIA confers on the FDIC, in its role as receiver of failed IDIs, extensive powers to resolve these institutions. The FDIC's primary mission is to maintain stability and public confidence in the U.S. banking system, including through insuring deposits, and to minimize disruptive effects from the failures of banks. The FDIC is responsible for

[35] *See* 11 U.S.C. § 1111.
[36] *See* 11 U.S.C. § 506(c).

effectively managing receivership operations and for making sure that failing institutions are resolved in the manner that will result in the least cost to the DIF.

In many ways the powers of the FDIC as receiver of a failed institution are similar to those of a bankruptcy trustee. Like a bankruptcy trustee, a receiver steps into the shoes of an insolvent party. The receiver may liquidate the insolvent institution or transfer some or all of its assets to an acquiring institution. However, the FDIA grants the FDIC additional powers that lead to critical differences between bankruptcy and the FDIC receivership process. These additional powers allow the FDIC to both expedite the liquidation process for IDIs in order to maintain confidence in the nation's banking system and to maximize the cost-effectiveness of the receivership process to preserve a strong insurance fund. The primary difference is that the FDIC, in administering the assets and liabilities of a failed institution as its receiver, is not subject to court supervision.

The purpose of a receivership is to market the assets of a failed institution, liquidate them, and distribute the proceeds to the institution's creditors. The FDIC as receiver succeeds to the rights, powers, and privileges of the institution and its stockholders, officers, and directors. The FDIC may collect the receivables owed to the institution, preserve or liquidate its assets, and perform any other function of the institution which is consistent with the appointment as receiver.

A receiver also has the power to merge a failed institution with another IDI and to transfer the failed institution's assets and liabilities without the consent or approval of any other agency, court, or party with contractual rights. Furthermore, a receiver may form a new institution, such as a bridge depository institution ("bridge bank" or "BDI"), to take over the assets and liabilities of the failed institution, or it may sell or pledge the assets of the failed institution to the FDIC in its corporate capacity.

1. 90-Day Receivership Stay

The FDIA provides the FDIC-Receiver with several procedural devices that help to conserve, and potentially increase, the receivership's assets. After the FDIC is appointed as receiver of a failed IDI, the FDIC may request a 90-day stay of all pending litigation and the courts in which such litigation is pending are required to grant such stays.[37] Although the courts must grant the FDIC-Receiver's request, unlike in bankruptcy, the stay is not automatic. Additionally, the FDIC-Receiver is not subject to any court's writ of attachment or execution on IDI assets that are in the FDIC-Receiver's possession.[38] The FDIC-Receiver is not required to post any bond in the event it desires to appeal a judgment,[39] and may bring actions on many tort claims arising from fraud, intentional misconduct resulting in unjust enrichment, or intentional misconduct resulting in substantial loss to the failed IDI, notwithstanding the expiration of state statutes of limitations.[40] A special statute of limitations exists for actions brought by a receiver. Under the FDIA, the receiver has up to six years to file a contract claim and up to three years to begin a tort suit.

[37] 12 U.S.C. § 1821(d)(12).
[38] 12 U.S.C. § 1821(d)(13)(C).
[39] 12 U.S.C. § 1821(d)(13)(B).
[40] 12 U.S.C. § 1821(d)(14)(C).

2. Avoidance and Recovery Powers

The FDIA grants the FDIC-Receiver some of the avoidance powers under the Bankruptcy Code. A bankruptcy trustee can avoid fraudulent transfers and recover property for the bankruptcy estate in cases of actual or constructive fraud. Similarly, the FDIC-Receiver may avoid a transfer of any interest of an institution-affiliated party, or any person who the FDIC determines is a debtor of the IDI, in property, or any obligation incurred by such person that was made within five years of the date on which the FDIC was appointed receiver if such person or party voluntarily or involuntarily made such transfer or incurred such liability with the intent to hinder, delay or defraud the IDI or the FDIC-Receiver.[41]

3. Mechanisms for Expanding and Administering the Estate

(a) *Power to Repudiate and Enforce Contracts*

In the critical area of contracting, the FDIA provides the FDIC-Receiver upon appointment with significant powers to affect contracts previously entered into by the failed IDI. The FDIA grants the FDIC-Receiver the power to repudiate contracts to which the failed IDI is a party that the FDIC finds to be burdensome or if doing so would promote the orderly administration of the receivership estate. [42] The power to disaffirm or repudiate a contract permits the receiver to terminate the contract, thereby ending any future obligations imposed by the contract, and limits the damages from repudiation to actual, direct, compensatory damages as of the date of the receiver's appointment. The receiver must act to repudiate a contract within a "reasonable time" after appointment.

In contracts involving the failed IDI and a landlord, the FDIA limits the FDIC-Receiver's damages only to contractual rent that has accrued as of the date of the FDIC-Receiver's repudiation of the contract.[43] Moreover, the FDIA provides the FDIC-Receiver with the power to enforce the contracts entered into by the IDI, in spite of presence of *ipso facto* clauses in the contract that would otherwise terminate or accelerate the contract upon insolvency of the IDI or the appointment of a receiver.[44] The power to enforce contracts under the FDIA allows the FDIC-Receiver to retain valuable contract rights and prevents improper preferences and allows for orderly resolution without disruption or loss of capital.

Additionally, the FDIA precludes parties who had contracted with the failed IDI from exercising a right or power to terminate, accelerate or declare a default under any contract to which the IDI was a party, or obtain possession of or exercise control over any property of the IDI for 90 days from the date of appointment of the FDIC-Receiver.[45] Although the FDIA grants the FDIC-Receiver broad powers to manage the failed IDI's contracts, the FDIC-Receiver does not

---

[41] 12 U.S.C. § 1821(d)(17).
[42] 12 U.S.C. § 1821(e)(3)(A)(i). Damages against the FDIC-Receiver may not include punitive or exemplary damages, damages for lost profit or opportunity, or damages for pain and suffering. 12 U.S.C. § 1821(e)(3)(B).
[43] 12 U.S.C. § 1821(e)(4).
[44] 12 U.S.C. § 1821(e)(13)(A). However, this enforcement provision shall not apply to a director and officer liability insurance contract, a depository institution bond, or to the rights of parties to certain QFCs pursuant to 12 U.S.C. § 1821(e)(8), or the rights of parties to netting contracts pursuant to 12 U.S.C. § 4401 et seq.
[45] 12 U.S.C. § 1821(e)(13)(C). This provision does not apply to director or officer liability insurance contracts, fidelity bond contracts, and to the rights of parties of certain financial contracts.

have the ability to prevent a counterparty from exercising a contractual right to terminate under a QFC.[46] However, the FDIA permits the FDIC-Receiver to transfer QFCs to another entity until 5 pm on the business day following the date of appointment of the FDIC-Receiver.[47] This authority limits the potential for settlement failures involving QFCs, thereby reducing the financial exposure of the FDIC-Receiver.

(b) *Bridge Depository Institution*

In situations where the FDIC has not been able to arrange for the sale or transfer of the assets and liabilities of the failing IDI prior to receivership, the FDIA permits the FDIC-Receiver to place the failed IDI into a BDI, and to transfer the assets and liabilities of the failed IDI into the BDI.[48] The BDI receives a charter from the Office of the Comptroller of the Currency ("OCC"),[49] and the FDIC-Receiver is not required to capitalize the institution, though it may make available to the BDI funds for the operation of the BDI.[50] A BDI is designed to bridge the gap between the failure of the IDI and the time when the FDIC can implement a satisfactory acquisition by third parties. The FDIA requires a BDI to terminate within two years following the date it was granted a charter, but that period may be extended for three additional one year periods at the discretion of the FDIC.[51] An important part of the FDIC's resolution process for large or complex failing IDI, a BDI provides the time the FDIC needs to take control of a failed IDI's business, stabilize the situation, effectively market the failed IDI's franchise, and determine an appropriate resolution.

Upon taking over a failing IDI, the FDIC-Receiver possesses the authority to obtain an order from the appropriate federal district court to freeze the assets in the failed IDI of any person designated by the FDIC-Receiver, and to have the court appoint a trustee to hold such assets.[52] This authority provides significant assistance to the FDIC-Receiver in preserving sources of recovery in civil actions brought against the failed IDI's directors and officers, who usually maintain accounts at the failed IDI.

(c) *Administration of the Receivership*

Unlike a bankruptcy proceeding, resolution by the FDIC-Receiver under the FDIA is an administrative proceeding. As receiver, the FDIC has broad discretion to manage the resolution of the failed IDI. As in most administrative proceedings, the FDIC administers the receivership without judicial supervision. A bankruptcy court typically rules on numerous intermediate matters (e.g., the choice of a trustee or disposition of assets). The parties may then choose to appeal these rulings, during which time the court may stay its own ruling until the appeals are resolved. Furthermore, once the FDIC-Receiver is appointed, there is no mechanism for creditors, management, or shareholders to participate in the decision-making process beyond the filing of claims and the provision of requested information.

---

[46] QFCs are included in the FDIA in 12 U.S.C. § 1821(e)(8) by list and include the following: (1) commodities contracts; (2) forward contracts; (3) swap agreements; (4) repurchase agreements; and (5) securities contracts.
[47] 12 U.S.C. § 1821(e)(9), (10).
[48] 12 U.S.C. § 1821(n)(1), (3).
[49] 12 U.S.C. § 1821(n)(2).
[50] 12 U.S.C. § 1821(n)(5)(A), (B).
[51] 12 U.S.C. § 1821(n)(9).
[52] 12 U.S.C. § 1821(d)(18).

In effect, claimants have no standing and very limited rights to appeal decisions before they are executed. However, some decisions of the FDIC-Receiver are subject to *ex post* judicial review, although damages are the only available remedy.

(d) ***Treatment of Secured Creditors***

Secured claims are satisfied in full up to the value of the collateral.

Under the FDIA, secured claims are treated similarly to the way they are treated in the bankruptcy process. Under section 11(e)(12) of the FDIA, secured creditors are fully protected for the amount of their claim up to the value of the collateral. Secured creditors have a claim to the collateral, up to the full amount of their claim for payment at the time of any default. If a secured creditor's claim exceeds the value of the collateral, the claim will be bifurcated and the deficiency will be treated as an unsecured claim. If the collateral is liquidated and the proceeds are in excess of the secured creditor's claim, the surplus is returned and used to pay the claims of unsecured creditors to the receivership estate.

The FDIC will generally recognize a security interest if: (1) the security agreement was entered into in the ordinary course of business; (2) the secured obligation represents a bona fide and arm's length transaction; (3) the secured creditor is not an insider or affiliate of the depository institution; (4) the security interest was granted for adequate consideration; and (5) the security interest is evidenced in a writing that was approved by the board of directors of the depository institution or its loan committee, and remains an official record of the depository institution.

4. Division of Assets among the Parties

The National Depositor Preference Act ("NDPA"),[53] codified in the FDIA, established a federal scheme of priority of payment for members of the different classes of a failed IDI's receivership estate. Prior to the passage of the NDPA, the FDIC utilized the priority schemes of the different states in determining the order of payment among the different classes of creditors of a failed IDI. The FDIC's reliance on state priority of payment schemes created conflicts in the resolution of failed banks, as some state schemes equated uninsured depositor claims with general creditor claims, while other states gave uninsured depositor claims a higher priority than general creditor claims. Congress resolved this tension in 1993 with the passage of the NDPA, which established that uninsured depositor claims are a higher priority than general creditor claims and must be paid in full before payment of any general creditor claims. The priority payment scheme of the NDPA is as follows: (1) administrative expenses; (2) depositor claims; (3) general creditor claims; (4) subordinated debt obligations; and (5) shareholders of the IDI. Secured creditors holding a legally enforceable or perfected security interest in any of the assets of any failed IDI receive their secured interest in the value of the collateral, except where the security interest was taken in contemplation of the institution's insolvency or with intent to hinder, delay or defraud the institution or the creditors of the institution.[54]

[53] 12 U.S.C. § 1821(d)(11).
[54] 12 U.S.C. § 1821(e)(12).

5. The Systemic Risk Exception to the Least Cost Resolution Requirement

Before 1991, Congress granted broad discretion to the FDIC to incur costs in resolving an IDI, requiring only that the cost of the FDIC resolution strategy be less than the cost of liquidating the IDI. In 1982, with the passage of the Garn—St. Germain Depository Institutions Act, the FDIC received broad authority from the U.S. Congress that allowed it to provide open bank assistance if the cost of such assistance was less than the cost of liquidating the bank. From that point until 1991, the FDIC used "open bank assistance transactions"[55] in 133 cases to resolve some larger banks, including Continental Illinois in 1984 and First City Bancorporation in 1988. Smaller community banks objected to FDIC open bank assistance practices, claiming that the FDIC assisted only those IDIs deemed by the agency to be too big to fail. In response, Congress passed the FDICIA, which, among other things, required the FDIC to use the resolution method that was the "least costly" to the DIF of all possible methods for meeting the FDIC's obligations to resolve failing IDIs ("Least Cost Resolution").[56] This new statutory provision virtually eliminated the FDIC's prior practice of using open bank assistance to help troubled banks.

The only exception to the Least Cost Resolution requirement that allowed for use of FDIC open bank assistance is the "systemic risk exception" in the FDIA ("Systemic Risk Exception").[57] Under the Systemic Risk Exception, if the Secretary of the Treasury, in consultation with the President and upon the written recommendations of not less than two thirds of the members of the Board of Directors of the FDIC and of the Board of Governors of the Federal Reserve System (the "Board"), determines that the FDIC's compliance with Least Cost Resolution would have serious adverse effects on economic conditions or financial stability, then the FDIC may take such action as is necessary to avoid or mitigate these effects. Under a Systemic Risk Exception determination, the FDIC is not bound to implement the least cost resolution strategy and may provide assistance (such as debt or deposit guarantees) that protects uninsured depositors and creditors who otherwise might suffer losses under a least cost resolution.[58]

Prior to the fall of 2008, the FDIC, the Board, and the Secretary of the Treasury had never invoked the Systemic Risk Exception. Between September 2008 and the date of enactment of the Dodd-Frank Act, the FDIC and the Board recommended that the Treasury make a Systemic Risk Exception determination on five separate occasions. The Treasury made the determination on three of those five occasions. The first Systemic Risk Exception determination, on September 29, 2008, authorized the FDIC to provide assistance to arrange for the acquisition of Wachovia by Citigroup. The second determination, on October 14, 2008, allowed the FDIC to provide certain assistance to IDIs, their holding companies, and qualified affiliates under the Temporary

---

[55] In an open bank assistance transaction, the FDIC provided financial assistance to an operating IDI to restore deficit capital to a positive level. Open bank assistance was structured as cash contributions to, loans to, the purchase of assets of, or the placement of deposits in the troubled IDI. For large institutions, the FDIC used a note or a loan. In addition, the FDIC covered losses for a specific amount on a pool of assets over a specific period of time. Such assistance was frequently used to facilitate the acquisition of the failing IDI by a healthy institution.
[56] *See* 12 U.S.C. § 1823(c)(4)(A)(ii).
[57] 12 U.S.C. § 1823(c)(4)(G).
[58] U.S. GEN. ACCOUNTING OFFICE, FEDERAL DEPOSIT INSURANCE ACT REGULATORS' USE OF SYSTEMIC RISK EXCEPTION RAISES MORAL HAZARD CONCERNS AND OPPORTUNITIES EXIST TO CLARIFY THE PROVISION 12 (2010).

Liquidity Guaranty Program ("TLGP").[59] The third determination, on January 15, 2009, authorized the FDIC to provide assistance to Citigroup relating to a designated pool of troubled assets of Citigroup. The FDIC and the Board also made two other recommendations for Systemic Risk Exception determinations—to authorize the FDIC to provide assistance to Bank of America relating to a designated pool of troubled assets of Bank of America, and to support the Public-Private Investment Program's proposed Legacy Loans Program—but neither resulted in the Treasury making such a determination.

D. Orderly Liquidation Authority

1. Introduction

Title II of the Dodd-Frank Act authorizes a special resolution proceeding for certain financial companies.[60] The Orderly Liquidation Authority may generally be invoked with respect to a particular financial company only upon a recommendation by the Board and the FDIC's Board of Directors (both by a two-thirds vote); and a determination by the Secretary of the Treasury, in consultation with the President, that, among other things, the financial company is in default or in danger of default, and the company's failure and resolution under the Bankruptcy Code would have serious adverse effects on U.S. financial stability, and resolution under OLA would avoid or mitigate these adverse effects. The U.S. Securities and Exchange Commission (the "Commission") would substitute for the FDIC in this recommendation process if the firm, or its largest subsidiary, is a broker-dealer. The FDIC is then appointed as the FDIC-Receiver if, for example, the covered financial company consents or acquiesces to such appointment.

The powers granted to the FDIC-Receiver under OLA to resolve a covered financial company are analogous to those the FDIC uses to resolve failed IDIs under the FDIA. Although many of these authorities differ from those available to a trustee or debtor in a bankruptcy proceeding, they are consistent with the FDIC-Receiver's duties under OLA to preserve financial stability while minimizing moral hazard and maximizing market discipline. Five of the most important elements of those authorities are: (i) the ability to conduct advance resolution planning for bank holding companies with assets of $50 billion or more and nonbank financial companies designated by the Council ("Firms Subject to Heightened Prudential Standards"); (ii) an immediate source of liquidity for an orderly liquidation, which allows continuation of essential functions and maintains asset values; (iii) the ability to make advance dividends on creditor claims and prompt distributions to creditors based upon expected recoveries; (iv) the ability to continue key, systemically important operations, including through the formation of one or more bridge financial companies; and (v) the ability to transfer all qualified financial contracts with a given counterparty to another entity (such as a bridge financial company) and avoid their immediate termination and liquidation to preserve value and promote stability.

[59] Under TLGP, the FDIC had guaranteed newly issued senior unsecured debt up to prescribed limits for insured institutions, their holding companies, and qualified affiliates and provided temporary unlimited coverage for certain non-interest bearing transaction accounts at insured institutions.

[60] Section 201(a)(11) of the Dodd-Frank Act defines a "financial company" as an entity organized under federal or state law that is (1) a bank holding company as defined in the Bank Holding Company Act of 1956 (as amended, BHC Act); (2) a nonbank financial company supervised by the Board; (3) any company that is predominantly engaged in activities that the Board has determined to be financial in nature or incidental thereto; or (4) any subsidiary (other than an IDI or an insurance company) of one of the three types of entities if the subsidiary is predominantly engaged in such financial activities.

Title II of the Dodd Frank Act provides that the distribution provisions of the FDIC-Receiver under OLA "shall not affect secured claims" except with respect to any unsecured portion of such claims resulting from the insufficiency of the security interest to satisfy the claim.[61] The FDIC has initiated an on-going rulemaking effort to promulgate regulations that satisfy that statutory directive, and to harmonize the treatment of creditors in an OLA liquidation with such treatment under otherwise applicable insolvency laws, including, with relevant provisions of the Bankruptcy Code. Like the Bankruptcy Code, OLA alters certain distributive rights of secured creditors in order to meet the allocative goals of the Act. OLA is an administrative process, and therefore, unlike the bankruptcy process in which the negotiation among stakeholders is refereed by an impartial court, the FDIC-Receiver is given considerable authority to manage the orderly liquidation of a covered financial company without the contemporaneous involvement of a court.

Generally, OLA seeks to adhere to the core rights and restrictions of the Bankruptcy Code, except where deviation is necessary to achieve the primary objectives of these reforms: financial stability, taxpayer protection and market discipline. However, in some ways, OLA's alterations of distributive rights meaningfully deviate from similar provisions of the Bankruptcy Code. The analysis set forth below describes some of the ways OLA's alterations of distributive rights deviate from similar provisions of the Bankruptcy Code, including comparisons between the ways a secured creditor's rights are altered under OLA and the way they are altered under the Bankruptcy Code.

2. Impact on Secured Creditors of the Orderly Liquidation Authority

(a) *Automatic Stay*

Like the FDIA, OLA provides for an automatic stay of a secured creditor's right to foreclose on its collateral pursuant to *ipso facto* clauses for 90 days from the date of appointment of the FDIC-Receiver.[62] The automatic stay imposed under the Bankruptcy Code remains in effect until either the time the case is closed or dismissed, or a discharge is granted or denied, unless relief from the automatic stay is granted upon motion by the secured creditor and approval of the Bankruptcy Court.[63] If a motion for relief from the automatic stay is denied, the Bankruptcy Court may grant the secured creditor adequate protection to protect the creditor against diminutions in the value of the collateral securing the creditor's claim.[64]

Under OLA, except in very limited circumstances, there is no statutory right to adequate protection of claims in the receivership. However, by regulation the FDIC has provided a secured creditor under OLA with the ability to receive additional collateral or payments on its debt to compensate it for a decline in the value of its collateral.[65] In addition, a secured creditor under OLA may request that its claim be determined on an expedited basis (i.e., within 90 days rather than the normal 180 days from the filing of the claim). In this process, the claimant must

---

[61] 12 U.S.C. § 5390(b)(5).
[62] 12 U.S.C. § 5390(c)(13)(C). Compare to 12 U.S.C. § 5390(a)(8), which provides for a 90-day stay of any pending litigation upon the FDIC-Receiver filing a request with the court.
[63] 11 U.S.C. § 362(a)-(d).
[64] 11 U.S.C. § 361.
[65] 12 C.F.R § 380.52.

show that irreparable injury will occur if the normal claims procedure is followed.[66] A secured creditor that requests expedited determination of its claim may seek review of the FDIC-Receiver's decision on its secured claim within 30 days after the earlier of the date the decision is rendered, or 90 days after the claim was filed.[67]

Another source of protection available for all creditors under OLA is the ability of the FDIC-Receiver to make prompt interim distributions to creditors based on the FDIC-Receiver's estimate of the amount on hand and/or the amount likely to be recovered from the liquidation of assets. Because this power is discretionary, however, a creditor cannot demand it as of right.

(b) ***Avoidance and Recovery Actions***

Like a trustee under the Bankruptcy Code, OLA empowers the FDIC-Receiver to avoid certain transfers of assets made prior to the commencement of the receivership and recover their value for the benefit of the receivership estate.[68] The exercise of this authority can have the effect of altering secured creditors' distributive rights that would otherwise apply. The avoidance powers under OLA are generally analogous in scope to those under the Bankruptcy Code. They cover: (1) fraudulent transfers (actual and constructive), (2) preferences and (3) unauthorized post-receivership transactions.[69] Similar to those under the Bankruptcy Code, Title II avoidance provisions have the dual effect of (1) incentivizing lenders to obtain adequate collateral at the outset of the lending relationship and to act promptly to perfect their security interests, and (2) permitting the FDIC-Receiver to seek to enlarge the estate.

3. Advance Planning under the Dodd-Frank Act

As discussed below, bankruptcy proceedings can be challenging in the case of a large, interconnected financial firm in part due to the lack of tools and discretion in the Bankruptcy Code to manage a bankruptcy process for the purpose of preserving financial stability, protecting taxpayers and promoting market discipline. A key feature of a disorderly, value-depleting, resolution of a large, interconnected financial firm is that the participants may have little notice or opportunity for advance preparation or coordination. An important tool for an effective resolution under OLA is advance planning, including the requirement that Firms Subject to

---

[66] 12 U.S.C. § 5390(a)(5)(A).

[67] 12 U.S.C. § 5390(a)(5)(C). Separate rules apply to QFCs. Under Title II, counterparties are stayed until 5:00 p.m. on the business day following the date of appointment of a receiver from exercising termination, liquidation or netting rights under the QFC. 12 U.S.C. § 5390(c)(10)(B)(i)(I). If the QFCs are transferred to a solvent third party before the stay expires, the counterparty is permanently enjoined from exercising such rights based upon the appointment of the receiver, but is not stayed from exercising such rights based upon other events of default. *See* 12 U.S.C. § 5390(c)(10)(B)(i)(II).

[68] When the covered financial company subject to resolution under OLA is a SIPC-member broker-dealer, OLA reserves to SIPC, as trustee for the liquidation of the broker-dealer under the Securities Investor Protection Act ("SIPA"), all of the powers and duties provided by SIPA, "including, without limitation, all rights of action against third parties." *See* 12 U.S.C. § 5385(b)(1). SIPA incorporates by reference the avoidance provisions of the Bankruptcy Code, inter alia, to the extent consistent with SIPA. *See generally* 15 U.S.C. § 78fff(b). The avoidance powers conferred through those provisions are comparable in scope to those enjoyed by the FDIC-Receiver under OLA.

[69] 12 U.S.C. § 5390(a)(11). There is no right to avoid any transfer of money or other property in connection with a QFC absent actual intent to hinder, delay or defraud. 12 U.S.C. § 5390(c)(8)(C).

Heightened Prudential Standards maintain and submit to government regulators well-developed, firm-specific resolution plans and credit exposure reports.

(a) ***Resolution Plans***

Under the resolution plan provisions of the Dodd-Frank Act, the Board and the FDIC are to jointly issue regulations that require Firms Subject to Heightened Prudential Standards to report periodically to the Board, the FDIC, and the Council their plans for rapid and orderly resolution in the event of material financial distress or failure. The Dodd-Frank Act requires that the resolution plans include information about the manner and extent to which any IDIs affiliated with a Firm Subject to Heightened Prudential Standards are adequately protected from risks arising from the activities of the nonbank subsidiaries of the Firm Subject to Heightened Prudential Standards. The resolution plan for any Firm Subject to Heightened Prudential Standards also must describe such firm's ownership structure, assets, liabilities, and contractual obligations, identify cross guarantees tied to different securities, identify major counterparties and identify a process for determining to whom collateral of the company has been pledged. The Board and FDIC can require additional information as well.[70] The elements contained in a resolution plan will not only help the FDIC and other domestic regulators to better understand a firm's business and how that entity may be resolved, but will also enhance the FDIC's ability to coordinate with foreign regulators in an effort to develop a comprehensive and coordinated resolution strategy for a cross-border firm.

If, after reviewing a resolution plan of any Firm Subject to Heightened Prudential Standards, the Board and the FDIC jointly determine the plan is deficient,[71] the agencies, together, must notify the company of the plan's deficiencies. If a Firm Subject to Heightened Prudential Standards fails to effectively resubmit a plan that corrects identified deficiencies, the agencies may jointly impose more stringent capital, leverage, or liquidity requirements, or restrictions on the growth, activities or operations of the company. In some cases, the Board and the FDIC, in consultation with the Council, may jointly require a Firm Subject to Heightened Prudential Standards to divest certain assets or operations. Overall, under the resolution planning process, Firms Subject to Heightened Prudential Standards will be required to make a careful assessment of their structure and operations and determine, in conjunction with supervisory oversight, whether modifications should be made to facilitate resolution in times of financial stress.

(b) ***Credit Exposure Reports***

The credit exposure reports required under section 165(d)(2) of the Dodd-Frank Act will also provide important information critical to the FDIC's planning processes by identifying the company's significant credit exposures, its component exposures, and other key information across the entity and its affiliates.

On April 22, 2011, the Board and the FDIC issued for public comment a joint notice of proposed rulemaking that would implement the credit exposure report requirements of the Dodd-Frank

[70] On April 22, 2011, the Board and the FDIC issued a notice of proposed rulemaking to implement the resolution plan and credit exposure report requirements of section 165(d) of the Dodd-Frank Act. 76 Fed. Reg. 22,648.

[71] That is, the plan is not credible or would not facilitate an orderly resolution of the Firm Subject to Heightened Prudential Standards under the Bankruptcy Code.

Act.[72] Section 165(d)(2) of the Dodd-Frank Act provides that the Board and the FDIC will jointly issue rules under which the Board shall require each Firm Subject to Heightened Prudential Standards to report periodically to the Board, the Council, and the FDIC on: (a) the nature and extent to which the company has credit exposure to other significant nonbank financial companies and significant bank holding companies; and (b) the nature and extent to which other significant nonbank financial companies and significant bank holding companies have credit exposure to that company.

Under the proposal, a credit exposure report for a Firm Subject to Heightened Prudential Standards would be required to include information related to the aggregate credit exposure associated with a range of transactions with every large financial firm. In particular, under the proposal, each Firm Subject to Heightened Prudential Standards must report, on a quarterly basis (or more frequently if requested), its aggregate level of each of the following: extensions of credit, including loans, leases, and funded lines of credit, repo and reverse repo agreements (gross and net), securities borrowing and lending activities (gross and net), counterparty credit exposure (gross and net) in connection with all derivative transactions, and guarantees by the Firm Subject to Heightened Prudential Standards (including its subsidiaries) to each significant bank holding company or significant nonbank financial company (including their subsidiaries). The proposal also requires each Firm Subject to Heightened Prudential Standards to report which large financial firms have any of the same categories of credit exposure to it.

E. Summary of Comparison of Resolution Mechanisms

Corporate bankruptcy is the dominant process for liquidating (Chapter 7) or reorganizing (Chapter 11) a failing firm in the United States. Nearly all large firm bankruptcies in the U.S. are initiated under Chapter 11, a court supervised process with the primary goal of allowing stakeholders to negotiate the distribution of rights to the debtor's assets in the manner that maximizes the value of such assets primarily for the benefit of the debtor's creditors. In most cases, the bankruptcy process provides an appropriate framework for the resolution of nonbank financial firms. However, some argue that, in its current form, the bankruptcy process does not sufficiently protect the public interest in ensuring the orderly resolution of a nonbank financial firm whose failure would pose a substantial risk to U.S. financial stability.[73] In the wake of the recent financial crisis, Congress concluded that the absence of a legal regime to address the unique challenges posed by the failure of such a firm left the government without an alternative to the unattractive options of value-depleting bankruptcy proceedings, on the one hand, or taxpayer "bailouts," on the other. The creation of OLA was needed to enhance the government's ability to mitigate the impact of the failure of a large, interconnected financial firm on U.S. financial stability; and, together with enhanced prudential supervision, to protect taxpayers and promote market discipline.

---

[72] 76 Fed. Reg. 22,648 (Apr. 22, 2011). The comment period for the proposed rule ended on June 10, 2011. The Dodd-Frank Act requires a final rule to be in place no later than January 21, 2012.

[73] Kenneth Scott, A Guide to the Resolution of Failed Financial Institutions: Dodd-Frank Title II and Proposed Chapter 14 (Apr. 21, 2011), available at http://media.hoover.org/sites/default/files/documents/ken-scott-guide-to-resolution-project.pdf; s*ee also* Squam Lake Working Group on Financial Regulation, *"Improving Resolution Options for Systemically Relevant Financial Institutions,"* (October 2009), available at http://www.squamlakegroup.org.

The Orderly Liquidation Authority created by Title II of the Dodd-Frank Act authorizes the government to address the potential failure of a bank holding company or other nonbank financial firm when the stability of the U.S. financial system is at risk. The new resolution regime is thus an important component of the principal reform objectives of protecting taxpayers and promoting market discipline.

The authority granted under OLA addresses several of the most perceived weaknesses of the existing Bankruptcy Code.[74] OLA addresses the lack of tools or discretion in the Code by allowing government regulators to manage the resolution of a firm with the goal of preserving financial stability rather than maximizing the value of the firm's assets for the benefit of its stakeholders. For example, the current Bankruptcy Code: (1) does not give government regulators the ability to force a nonbank financial firm on the eve of failure into a resolution proceeding; (2) is slower than some argue is necessary to manage the resolution of a large, interconnected financial firm during a financial emergency without first negotiating with the failed firm's stakeholders; (3) does not provide an immediate source of funding to temporarily continue essential functions of the failed firm to minimize the cost of resolution (unless the conditions for debtor-in-possession financing are met); and (4) requires that similarly situated creditors be treated similarly.

OLA thus fills an important regulatory gap. It provides that, to the extent possible, the FDIC shall seek to harmonize the rules and regulations applicable to OLA with the insolvency laws that would otherwise apply to a covered financial company,[75] including the Bankruptcy Code. The bankruptcy process generally allows a secured creditor to retain the benefit of its superior rights by: granting creditors' secured claims full priority over any unsecured or junior secured claims; providing "adequate protection" of the value of the secured claim if there is a loss due to the debtor's use or detention of the collateral; and providing for judicial involvement at the time creditors' rights are determined. Although the process is somewhat different, OLA's protections of the contractual rights of secured creditors are substantively similar to those provided under the Bankruptcy Code.[76] In addition, the FDIC has initiated an ongoing rulemaking process to further harmonize the treatment of secured creditors in an OLA liquidation with treatment under the relevant provisions of the Bankruptcy Code, including the ability of secured claimants to exercise rights against collateral and obtain adequate protection of their interests. In time, the FDIC will continue to issue policies, rules and regulations that help creditors to determine in advance how they will be treated in a proceeding under OLA.

However, the process established by OLA differs from the bankruptcy process in that OLA gives the FDIC-Receiver authorities commensurate with the FDIC-Receiver's duties to preserve U.S. financial stability while minimizing moral hazard and maximizing market discipline. These authorities are largely adapted from the FDIC's IDI resolution authorities under the FDIA. As under FDIA, some of the FDIC-Receiver's authorities under OLA with respect to treatment of secured creditors are more expansive than those available to a bankruptcy trustee. These

---

[74] *See* Randall D. Guynn, *"Are Bailouts Inevitable?,"* YALE J. ON REG (forthcoming Fall 2011).

[75] 12 U.S.C. § 5389.

[76] *See, e.g.*, Douglas G. Baird and Edward R. Morrison, *"Dodd-Frank for Bankruptcy Lawyers"* (2011), *available at* http://www.law.northwestern.edu/searlecenter/jep/symposia/documents/Baird_Dodd-Frank_for_Bankruptcy_Lawyers.pdf.

authorities include the ability to (1) treat unsecured creditors of the same class differently under certain circumstances, (2) transfer assets or liabilities to a solvent third-party, including a bridge financial company, without counterparty or judicial consent, (3) temporarily stay the right of a counterparty to a QFC to close out, net and liquidate collateral securing its claim and (4) promptly provide partial satisfaction of creditor claims – particularly claims of key counterparties – where doing so would mitigate risk to U.S. financial stability and protect taxpayers.

The role of the court will also be different in an OLA claims determination process than it would in bankruptcy. In contrast to a case under the Bankruptcy Code, in which a debtor's or trustee's actions are subject to prior approval by a court, a receivership of a covered financial company is an administrative proceeding conducted by the FDIC-Receiver. Under OLA and FDIC implementing regulations, court jurisdiction is limited and subject to exhaustion of the receivership claims process.[77] In the midst of a financial crisis, when time is of the essence, the existing bankruptcy process cannot always provide the speed and decisiveness afforded by an administrative process. Such speed and decisiveness is needed to manage the failure of a large, interconnected financial firm to preserve U.S. financial stability, protect taxpayers, and promote market discipline. While a claimant in an OLA process may have its day in court, judicial review of claims occurs after the FDIC-Receiver has first made a determination regarding the claim or the claimant's rights.

V. Other Reforms that Protect Taxpayers from Loss and Promote Market Discipline

Title I of the Dodd-Frank Act provides a new regulatory framework under which Firms Subject to Heighted Prudential Standards are subject to consolidated supervision by the Board. Because the new supervisory framework is "macroprudential" in nature, prudential standards applicable to such firms will be more stringent than those applicable to other financial firms that do not present similar risks to financial stability, and must increase in stringency as the risk to financial stability posed by such firms increases. This is intended to compel Firms Subject to Heightened Prudential Standards to internalize the full range of risks associated with their failure, which will give those institutions an incentive to reduce those risks.

Paralleling the new regulatory framework under Title I of the Dodd-Frank Act, the Basel Committee on Banking Supervision issued a package of reforms in December 2010 designed to strengthen global capital and liquidity rules with the goal of promoting a more resilient banking sector ("Basel III").[78] Similar to Title I of the Dodd-Frank Act, the broad objective of the reforms is to improve the banking sector's ability to absorb shocks arising from financial and economic stress, thereby reducing the risk of spillover from the financial sector to the broader economy.

[77] *See, e.g.*, 12 C.F.R. § 380.38.
[78] See Basel Comm. on Banking Supervision ("Basel Comm."), Basel III: A global regulatory framework for more resilient banks and banking systems (rev. June 2011) (2010); Basel Comm., Basel III: International framework for liquidity risk measurement, standards and monitoring (Dec. 2010); Basel Comm., Guidance for national authorities operating the countercyclical capital buffer (Dec. 2010).

Still other reforms will increase the transparency of certain broadly used funding arrangements. Ideally, increasing transparency would reduce creditors' impulse to run while increasing cost of capital for firms that over-rely on short-term debt.

Taken together, these reforms lessen the need for secured creditor haircuts to promote either taxpayer protection or market discipline. With respect to taxpayer protection, these reforms will help to avoid future taxpayer-funded bailouts by limiting the probability that a large, interconnected firm would fail and by reducing the knock-on effects of any such failure. These reforms will also promote more effective market discipline by forcing a firm's creditors (and other stakeholders) to bear the costs of its failure.

A. Title I of the Dodd-Frank Act

The recent financial crisis demonstrated that effective prudential regulation of Firms Subject to Heightened Prudential Standards requires regulators to have the ability to monitor and address risks across the entire organization. Title I of the Dodd-Frank Act achieves this result by subjecting Firms Subject to Heightened Prudential Standards to consolidated supervision by the Board, while maintaining oversight of certain subsidiaries by their primary federal financial regulator.

In addition, Title I of the Dodd-Frank Act provides that Firms Subject to Heightened Prudential Standards will be subject to more stringent requirements covering, among other things, risk-based capital, leverage and liquidity requirements; stress testing; single counterparty credit exposure limits; and, as discussed in *Section IV*, the development of resolution plans and credit exposure reports. The Dodd-Frank Act requires the Board to establish an early remediation framework for Firms Subject to Heightened Prudential Standards to mitigate financial distress.

1. Capital, Leverage and Liquidity

Under Title I of the Dodd-Frank Act, capital, leverage and liquidity requirements applicable to Firms Subject to Heightened Prudential Standards must be more stringent than the standards applicable to other financial firms that do not present similar risks, and must increase in stringency relative to the risk posed. When calculating compliance with capital requirements, the Dodd-Frank Act requires off-balance sheet activities to be taken into account. The Dodd-Frank Act also directs the Board to require any Firm Subject to Heightened Prudential Standards that the Council determines poses a grave threat to the financial stability of the United States to maintain a debt-to-equity ratio of no more than 15-to-1 if necessary to mitigate such threat.

2. Stress Testing

Title I of the Dodd-Frank Act requires the Board to conduct annual analyses of Firms Subject to Heightened Prudential Standards to determine whether such companies have enough capital, on a total consolidated basis, to absorb losses as a result of adverse economic conditions. The Board must provide at least three different sets of conditions for the analyses – a baseline scenario, an adverse scenario, and a severely adverse scenario. The Board must require a Firm Subject to Heightened Prudential Standards to update its resolution plan, based on the results of those analyses. In addition, each Firm Subject to Heightened Prudential Standards must itself conduct

semi-annual stress tests. All other financial companies that have total consolidated assets of more than $10 billion and are regulated by a primary federal financial regulatory agency must conduct an annual stress test. The federal primary financial regulatory agencies must issue regulations to implement this requirement. The regulations must establish methodologies for the conduct of the stress tests under the same three sets of conditions described above (i.e., a baseline scenario, an adverse scenario, and a severely adverse scenario).

The Board currently is working on a notice of proposed rulemaking to implement the enhanced prudential standard requirement of section 165 (a), (b), and (e)—(k). Under the Dodd-Frank Act, final rules must be in place no later than January 21, 2012.

3. Single Counterparty Credit Exposure Limits

Section 165(e) of the Dodd-Frank Act directs the Board to prescribe standards that limit Firms Subject to Heightened Prudential Standards from having credit exposure[79] to any unaffiliated company that exceeds 25 percent of capital stock and surplus. The Board may lower the level as necessary to mitigate risks to financial stability. The single counterparty credit exposure limits required under the Dodd-Frank Act[80] provide more broad-based restrictions on credit exposures of Firms Subject to Heightened Prudential Standards than the existing national bank legal lending limit. The Dodd-Frank Act requires the Board to impose credit exposure limits on the consolidated organization rather than the depository institution and imposes limits on a broad range of credit exposures, including counterparty credit exposures associated with securities financing and derivative exposures. By capping exposures of Firms Subject to Heightened Prudential Standards to any single counterparty, the credit exposure limits are intended to help limit interconnectedness among large financial firms going forward.

The Board may exempt transactions in whole or in part from the definition of credit exposure if it is determined to be in the public interest or consistent with the purpose of the Dodd-Frank Act credit exposure limits. The standards do not become effective until three years after the enactment of the Dodd-Frank Act, and the Board may extend the transition period for two additional years. The Board may also, pursuant to a recommendation from the Council, establish an asset threshold above $50 billion for the application of the credit concentration limit standard to certain Firms Subject to Heightened Prudential Standards.

The Board is currently working on a notice of proposed rulemaking to implement the credit exposure limit provisions of the Dodd-Frank Act. Under the Dodd-Frank Act, final rules must be in place no later than January 21, 2012.

---

[79] Credit exposure to a company is defined as: all extensions of credit to a company (including loans, deposits, and lines of credit); all repo and reverse repo agreements with the company (if credit exposure is created); all securities borrowing and lending transactions with the company (if credit exposure is created); all guarantees, acceptances, or letters of credit (including endorsement or standby letters of credit) issued on behalf of the company; all purchases of or investments in securities issued by the company; counterparty credit exposure to the company in connection with derivative transactions between the Firm Subject to Heightened Prudential Standards and that company; and any other similar transaction the Board determines to be a credit exposure.

[80] 12 U.S.C. § 5365(e)(2).

4. Early Remediation

Section 166 of the Dodd-Frank Act requires the Board, in consultation with the FDIC and the Council, to prescribe regulations that provide for the early remediation of financial distress of a Firm Subject to Heightened Prudential Standards. The purpose of this requirement is expressly identified as being to establish a series of specific remedial actions for Firms Subject to Heightened Prudential Standards to take in order to minimize (1) the probability that they will become insolvent, and (2) the potential harm of such insolvency to the financial stability of the United States. The Board has substantial discretion to implement this provision in a manner that it determines best achieves the objective, but the statute requires the Board to define measures of financial condition using regulatory capital, liquidity measures, and other forward-looking indicators. Further, the remediation provisions must increase in stringency as the financial condition of the company declines and remediation actions must include limits on capital distributions, acquisitions, and asset growth in the initial stages of financial decline and a capital restoration plan and capital raising requirements, limits on transactions with affiliates, management changes, and asset sales in later stages of financial decline.

The Board currently is working on a notice of proposed rulemaking to implement section 166. Under the Dodd-Frank Act, final rules must be in place no later than January 21, 2012.

B. Basel III

Basel III imposes more stringent risk-based capital requirements; backstops those capital requirements with a new leverage standard; and requires relevant firms to increase their ability to withstand liquidity shocks.

1. Capital and Leverage

(a) *The Definition of Capital*

Basel III increases the quality, consistency and transparency of the capital base. Deductions from capital currently applied at the tier 1 or total capital level will be harmonized internationally and applied at the common equity tier 1 level. The common equity tier 1 level includes common equity, and minority interests (subject to limits) in the form of common equity. Since credit losses and write-downs come out of retained earnings, a component of common equity, the new common equity tier 1 requirements are expected to help banking organizations better absorb losses on a going concern basis. Other regulatory deductions from capital, such as, for example, goodwill, deferred tax assets, and shortfalls in loss provisions, also will be made from common equity tier 1. Basel III imposes a minimum common equity tier 1 ratio (4.5 percent), raises the minimum tier 1 ratio (from 4 percent to 6 percent), establishes stricter criteria for tier 1 eligibility, simplifies tier 2 capital requirements and eliminates tier 3 capital. The new capital requirements will be phased in over a period of time, with full implementation expected by January 2018.

(b) *Enhanced Risk Coverage*

A key lesson from the recent financial crisis is the importance of appropriately recognizing on- and off-balance sheet risks, as well as derivative exposures. The Basel Committee has adopted

reforms that will raise capital requirements for the trading book and for complex securitization exposures. It also has implemented higher capital requirements for resecuritizations in both the banking and trading books. The Basel Committee also is conducting a fundamental review of the trading book, which has a target completion date of year-end 2011.[81]

Basel III strengthens the capital requirements for counterparty credit exposures arising from derivatives, repo agreements, and securities financing activities. These reforms will raise the capital charges for these exposures and provide incentives to move over-the-counter derivative contracts to central counterparties, helping to promote financial stability. Specifically, capital requirements for counterparty credit risk will be determined using stressed inputs, which will address concerns about capital charges becoming too low during periods of compressed market volatility and help address procyclicality.[82]

(c) *Other Mechanisms to Limit Procyclicality*

The Basel Committee also has introduced measures to promote the buildup of capital buffers in good times that can be drawn upon in periods of stress. The capital conservation buffer will be in addition to the capital minimums and will be composed solely of common equity. The capital conservation buffer has been set at 2.5 percent of risk-weighted assets. Banks will be able to draw on this additional capital during periods of financial stress; however, as a bank's capital ratio gets closer to the minimum requirements, it will have greater constraints on earnings distributions. This new capital requirement will be phased in over several years. The countercyclical buffer will be implemented subject to national discretion. It represents an additional capital requirement ranging from zero percent to 2.5 percent of risk-weighted assets and will be applied to each bank in such a way that it reflects the banks' geographic composition of its credit exposures.

(d) *The Leverage Ratio*

The Basel III leverage ratio is intended to serve as a supplementary measure, or backstop, to the risk-based ratios. It is a simple, transparent measure that reflects tier 1 capital relative to total exposure, both on- and off-balance sheet. The Basel Committee's analysis shows that bank leverage was a key factor distinguishing between banks that ultimately failed during the crisis or required government capital injections, and those that did not.[83] From a macro-prudential perspective, the leverage ratio will limit excessive leverage in the financial system. The Basel Committee intends to monitor bank data over a multi-year period to assess the proposed design and calibration of the 3 percent leverage ratio over a full credit cycle to increase the probability that identified objectives are ultimately realized.

---

[81] *See* BASEL COMMITTEE ON BANKING SUPERVISION, "ANALYSIS IN THE TRADING BOOK QUANTITATIVE IMPACT STUDY" (October 2009), *available at* http://www.bis.org/publ/bcbs163.htm.

[82] In addition, the reforms will incorporate a capital charge add-on to better capture credit valuation adjustments based on "bond equivalent" measures used in a VaR framework, double the margin period for large netting sets for banks that use internal modeling methodologies for counterparty credit risk, and create a separate supervisory haircut category for repo-style transactions using securitization collateral and prohibiting resecuritizations as eligible financial collateral.

[83] *See* Stefan Walter, Sec'y Gen., Basel Comm. On Banking Supervision, Basel III: Stronger Banks and a More Resilient Financial System, Speech at the Conference on Basel III (April 6, 2011), *available at* http://www.bis.org/speeches/sp110406.pdf.

Notably, the exposure measure used to calculate the Basel III leverage ratio is the same whether or not the exposure is secured. Assuming that more favorable treatment of secured lending under current capital rules artificially increases the supply of secured credit, the Basel III leverage ratio will serve to reduce the distortion. The shift to unsecured credit that could result from removing that distortion might promote market discipline to the extent that unsecured lenders have a greater incentive to impose market discipline.

2. Liquidity Measures

An important part of the Basel III framework is a new framework for liquidity risk measurement, standards and monitoring. The objective of the liquidity reforms is to improve the banking sector's ability to absorb shocks arising from financial and economic stress, thereby reducing the risk of spillover from the financial sector to the real economy. The Basel Committee developed two minimum standards for funding liquidity. They are designed to achieve two distinct but complementary objectives. The first standard, the Liquidity Coverage Ratio ("LCR"), is designed to promote short-term resilience of a bank's liquidity risk profile by ensuring it has sufficient high-quality liquid assets to survive a significant stress scenario for one month. The second standard, the Net Stable Funding Ratio ("NSFR"), was developed to promote resilience over a longer time horizon – one year – by providing a sustainable maturity structure of assets and liabilities. Together, these two measures establish minimum levels of liquidity for internationally active banks. In addition, the Basel Committee has developed a set of monitoring tools to assist in assessing the liquidity risk exposures of banks, and in communicating these exposures among home and host supervisors.

The LCR is the ratio of high-quality liquid assets to total net cash outflows in stressed conditions over 30 calendar days. This ratio must be equal to or greater than 100 percent on a continuous basis and must be satisfied with unencumbered, high-quality liquid assets. High quality liquid assets are those that can be easily and immediately converted into cash at little or no loss of value. In general, characteristics of such assets are low credit and market risk, an ease and certainty of valuation, low correlation with risky assets, and listing on a developed and recognized exchange market. In addition, certain market-related characteristics must be satisfied – there should be an active and sizable market, the presence of committed market makers, low market concentration, and historically, the market must have shown tendencies to move to these types of assets during times of financial instability.

The NSFR is defined as the ratio of the available amount of stable funding to the required amount of stable funding, which must be greater than 100 percent. The NSFR is a longer term structural ratio to address liquidity mismatches and provide incentives for banks to use stable sources to fund their activities. Stable funding in this context means the portion of those types and amounts of equity and liability financing expected to be reliable sources of funds over a one-year time horizon under conditions of extended stress. The NSFR aims to limit imbalances that occur when longer-term, illiquid assets are funded with shorter-term, less stable funding, and encourages better assessment of liquidity risk across all on- and off-balance sheet items. Additionally, the NSFR approach offsets incentives for institutions to fund their stock of liquid assets with short-term funds that mature just outside of the 30 day window used for the LCR standard.

The net effect of the new LCR and NSFR will be to increase the cost of relying on potentially unstable means of funding illiquid assets. At the same time, this approach, which would give firms greater flexibility to fund highly liquid assets with short-term borrowings, is consistent in spirit with secured creditor haircut proposals that would exempt secured borrowings collateralized by liquid instruments including U.S. Treasuries and government-sponsored enterprise debt.

Currently, the Basel Committee is monitoring the implications of these standards for financial markets, credit extension and economic growth. Beginning in 2012, banking organizations would report the two ratios to their supervisors. The Basel Committee has noted it may make modifications to the standards if needed to address unintended consequences identified during the monitoring period. Under the current timetable, the LCR is expected to become applicable in 2015 and the NSFR would become applicable beginning in 2018.

C. Increased Transparency of Funding Arrangements

Recent reforms that increase the transparency of funding arrangements would provide market participants with greater clarity in the context of tri-party repo and would require public companies to provide greater disclosure regarding short-term funding arrangements.

1. Transparency in the Context of Tri-Party Repo

In September 2009, the Payments Risk Committee of the Federal Reserve Bank of New York established a Task Force on Tri-Party Repo Infrastructure ("Task Force").[84] On May 10, 2010, the Task Force issued a report with specific recommendations directed to various participants in this market, several of which could significantly increase transparency in the tri-party repo market.

One such recommendation – publication of monthly statistics provided by market participants on the Task Force's website (hosted by the Federal Reserve Bank of New York) – already has been implemented. These statistics bring new transparency to investors, providing market participants, supervisors and the public with direct information concerning the composition, concentration, and quality of collateral in the tri-party repo market and the margins assessed by lenders to mitigate the credit risk of trades. Enhanced transparency around collateral and margin requirements could mitigate the risk of runs by repo lenders during times of financial distress. Similarly, the regular publication of margin levels in the tri-party repo market can aid market participants in setting appropriate margin levels and thereby reduce the probability of sudden margin level increases.

A second Task Force recommendation is to reduce the use of intraday credit extended by clearing banks. To the extent that intraday credit continues to be provided by the two clearing banks, it will be done on a committed basis, which should bring greater clarity with respect to its availability. Numerous changes are required to the systems and processes of all tri-party market participants to achieve the goal of reducing reliance on intraday credit in accordance with the

[84] The Task Force includes representatives from institutions that play a significant role in the tri-party repo market, including lenders (notably money market funds), borrowers (broker-dealers), and the clearing banks.

Task Force's timetable. Alongside the effort to reduce intra-day credit provided by clearing banks, the Task Force noted it is important to reinforce the understanding that cash investors are at risk if their repo counterparty defaults. When complete, these efforts should yield a more conservatively collateralized tri-party repo market in which repo lenders face stronger incentives to conduct appropriate counterparty risk management.

Other Task Force recommendations focus on risk management practices of money market funds and broker-dealers. Recommendations directed at money market funds and other lenders include stress testing of exposures and contingency planning for management of collateral in the event of default by a tri-party counterparty. With respect to broker-dealers, including those affiliated with bank holding companies, the Board and other supervisors are focusing on the development of more robust contingency funding plans and better matching of the maturities of assets and liabilities.

2. Transparency of Short-Term Funding Arrangements

A company's use of short-term financing arrangements can fluctuate significantly during a reporting period. As such, when a company reports at the end of a reporting period the amount of short-term borrowings outstanding, that amount is not always indicative of its funding needs or activities during the full period. Recent revelations[85] have suggested that investors and other market participants could benefit from additional transparency about companies' short-term borrowings, and, in particular, whether those borrowings vary materially during the reporting period as compared to period-end.

On September 17, 2010, the Commission therefore issued a proposed rule designed to enhance disclosure of a company's short-term borrowing practices.[86] The proposed rule would apply to financial and non-financial companies, and would require disclosure of both quantitative data (including average and maximum amounts outstanding during the period) and qualitative information (including a discussion of the types of financing arrangements and the company's reliance on those arrangements, and an explanation of variations in the levels of short-term borrowings during the period compared to period end). At its core, the rule's aim is to enable better understanding of the use and impact of short-term borrowing arrangements throughout the reporting period.

The proposed rule defines the phrase "short-term borrowings," which would mean amounts payable for short-term obligations that are: (1) federal funds purchased and securities sold under agreements to repurchase; (2) commercial paper; (3) borrowings from banks; (4) borrowings from factors or other financial institutions; (5) any other short-term borrowings reflected on the registrant's balance sheet.[87] The proposed requirement is designed to enhance disclosure about

[85] For example, the Lehman Brothers Holdings Inc. Chapter 11 Proceedings Examiner's Report found that Lehman characterized certain overcollateralized repurchase transactions as securities sales, thereby reducing Lehman's stated financing transactions at the end of a reporting period. *See* 3 Lehman Brothers Holdings Inc. Chapter 11 Proceedings Examiner's Report 732 (March 11, 2010), *available at* http://lehmanreport.jenner.com/VOLUME%203.pdf.

[86] Short-Term Borrowings Disclosure, Release Nos. 33-9143, 34-62932, 75 Fed. Reg. 59,866 (2010).

[87] Most repos are accounted for as financings on the balance sheet. As such, most repos would be covered by the proposed short-term borrowings disclosure requirements. If a repo is appropriately accounted for as a sale (and

the short-term borrowings items in a company's balance sheet, and does not cover "off-balance sheet" financing arrangements. The Commission's existing disclosure rules cover off-balance sheet arrangements.

In terms of the disclosure of quantitative data, a company would be required to provide quantitative information in the Management's Discussion and Analysis ("MD&A") section of Commission filings for each type of short-term borrowings a company uses, including: (1) the amount outstanding at the end of the reporting period and the weighted average interest rate on those borrowings; (2) the average amount outstanding during the period and the weighted average interest rate on those borrowings; and (3) the maximum amount outstanding during the period. To provide context for the quantitative data, companies would be required to disclose the following qualitative information: (1) a general description of the short-term borrowing arrangements included in each category and the business purpose of those arrangements; (2) the importance to the company of its short-term borrowing arrangements to its liquidity, capital resources, market-risk support, credit-risk support or other benefits; (3) the reasons for the maximum reported level for the reporting period; and (4) the reasons for any material differences between average short-term borrowings and period-end short-term borrowings.

The proposed rule distinguishes between "financial companies" and all other companies for purposes of the quantitative disclosure requirements. A "financial company" would mean a company, during the applicable reporting period, that is: (a) engaged to a significant extent in the business of lending, deposit-taking, insurance underwriting or providing investment advice; (b) a broker or dealer as defined in section 3 of the Securities Exchange Act of 1934; or (c) an entity that is, or is the holding company of, a bank, a savings association, an insurance company, a broker, a dealer, a business development company, an investment adviser, a futures commission merchant, a commodity trading advisor, a commodity pool operator, or a mortgage real estate investment trust. Financial companies would be required to provide averages calculated on a daily average basis (which is consistent with existing Commission guidance applicable to bank holding companies), and to disclose the maximum amount outstanding on any day in the period.

As proposed, a company that is engaged in both financial and non-financial businesses would be permitted to present the short-term borrowings information for its financial and non-financial businesses separately. It would be required to provide averages computed on a daily average basis and maximum daily amounts for the short-term borrowing arrangements of its financial operations, and it would be permitted to follow the requirements and instructions applicable to non-financial companies for purposes of the short-term borrowing arrangements of its non-financial operations. Non-financial companies would be permitted to calculate averages using an averaging period not to exceed a month and to disclose the maximum month-end amount during the period.

---

therefore is not reflected on the balance sheet as a liability), it must be assessed under the Commission's existing disclosure requirements for off-balance sheet arrangements. The Commission's existing rules require disclosure where the repo is reasonably likely to have an effect on the company that is material.

The Commission has received numerous comments on the proposed rule. The Commission staff is currently reviewing and analyzing those comments, and is in the process of developing final rule recommendations for Commission consideration.

Concurrently with the issuance of the proposed rule, the Commission issued interpretative guidance on existing requirements for liquidity and funding disclosure in MD&A, with a focus on addressing "window-dressing" or "debt masking" issues; this interpretive guidance was immediately effective. The interpretive release reflects the Commission's expectation that MD&A disclosure keep pace with the increasingly diverse and complex financing alternatives available to companies. Among other things, the interpretive release makes clear that a registrant cannot use financing structures (whether on-balance sheet or off-balance sheet) designed to mask the registrant's reported financial condition. Thus, if a company's financial statements do not adequately convey its use of financing arrangements and the impact of those arrangements, disclosure in MD&A is needed to provide a clear picture of the company's liquidity profile. Further, the interpretive release emphasizes that leverage ratios and other financial measures included in filings must be calculated and presented in a way that does not obscure the company's leverage profile or reported results. Finally, the interpretive release addresses divergent practices in the preparation of the contractual obligations table, and provides guidance to focus companies on providing informative and meaningful disclosure about their future payment obligations.

Appendix A

Overview of Certain Forms of Secured Lending

This Appendix is intended to provide a basic overview of certain forms of secured lending that could be affected by secured creditor haircuts. This Appendix focuses on repurchase agreements ("repo agreements" or "repos") because large, interconnected financial firms use repos to obtain a substantial majority of on-balance sheet secured funding. The Appendix also discusses two additional forms of secured lending – stock loan and stock borrow, and sell-buyback arrangements – that large, interconnected financial firms rely on to a lesser extent.

I. Repurchase Agreements

A. In General

Repo agreements are securities lending transactions in which one party (the "repo seller") agrees to sell securities to another party (the "repo buyer") against the transfer of funds, with a simultaneous agreement by the repo seller to repurchase from the repo buyer the same or equivalent securities at a specific price at a later date.[88]

Repos generally involve an interest component which is implicit in the pricing structure of the transaction. In repo transactions, securities are initially valued and sold at the current market price plus any accrued interest to date. At the termination of the repo transaction, the securities are resold at a predetermined price equal to the original sale price plus an agreed upon interest rate (the "repo rate").

When the repo transaction is driven by the repo sellers' demand for cash ("cash-driven repo"), the repurchase price is typically set so that the repo buyer earns the equivalent of money market yields. Conversely, when the repo transaction is driven by the repo buyers' desire to borrow the securities that collateralize the repo ("securities-driven repo"), the repo rate is usually less than current money market yields to account for the fact that the repo seller can invest the proceeds of the initial sale to earn the money market rate of return.

Depending on whether the repo transaction is securities-driven or cash-driven, the transfer of the interest in securities from the repo seller to the repo buyer may more closely approximate an outright sale or a secured loan. Securities-driven repo transactions more closely approximate outright sales, since the repo seller's interest in the purchased securities passes to the repo buyer, freeing the buyer to sell, transfer, pledge, or hypothecate the purchased securities. Cash-driven repo transactions more closely approximate secured loans, and repo sellers accordingly retain the ability to substitute new securities for the securities that serve to collateralize the transaction.

[88] A "reverse repo" is the same repurchase agreement from the buyer's viewpoint, not the seller's viewpoint. So a seller executing the transaction would describe it as a "repo" while the buyer in the same transaction would describe it as a "reverse repo." Typically, the broker-dealer refers to the transaction as a "reverse repo" whereas the banking and investment company industries refer to the transaction as a "repo."

In cash-driven repo transactions, the repo buyer obtains margin by pricing securities transferred as collateral at the market value minus a "haircut." In securities-driven transactions, the lender of securities will typically receive margin by pricing securities higher than their market value.

As noted above, repo is the dominant means by which most large, interconnected financial firms obtain on-balance sheet secured funding. To prepare this study, the Council gathered data on a sample of large, interconnected financial firms ("sample firms"). Since early 2009, the sample firms obtained aggregate repo financing in a range between $2 trillion and $2.5 trillion. This amount represents the bulk of the sample firms' total on-balance sheet secured funding, and is nearly equivalent to the sample firms' total on-balance sheet wholesale funding.

Approximately two-thirds of sample firms' currently outstanding repo transactions are secured by U.S. Treasuries, agency debt and agency mortgage-backed securities ("Treasury and Agency Collateral"). Approximately half of outstanding repo transactions for select firms are on an overnight basis, and roughly three-quarters mature in less than 30 days.

A more detailed breakdown of the sample firms' outstanding repo transactions by asset class of collateral and maturity is shown below.

Figure 1.

Repo Collateral and Maturities for Select Firms

	Matures overnight	Matures in less than 30 days
Treasury and Agency Collateral	39%	57%
Other Collateral	13%	22%

B. Tri-Party Repos and Intraday Lending

"Tri-party" repo agreements are a subset of repo transactions that settle on the books of one of the two clearing banks in the United States.[89] The tri-party repo structure developed in the 1980s in response to the desire to have collateral held by a third-party agent. In addition to the favorable treatment of repurchase transactions in bankruptcy, the attractiveness of the tri-party repo market is driven by the use of securities as collateral (including daily margining and haircuts), and the custodian services of the clearing banks which provide protections that do not exist for bilateral repo investors or unsecured creditors. The large U.S. securities firms and bank securities affiliates (collectively, "securities firms") use the tri-party repo market to finance the majority of their securities inventories.

Typically in these transactions, a repo buyer, such as a money market fund, will lend cash to a securities firm at the end of the day; the securities firm collateralizes the borrowing with securities; and the clearing bank holds the collateral. In the morning, the clearing bank unwinds the repo transaction; cash is returned to the repo buyer; the securities held as collateral are

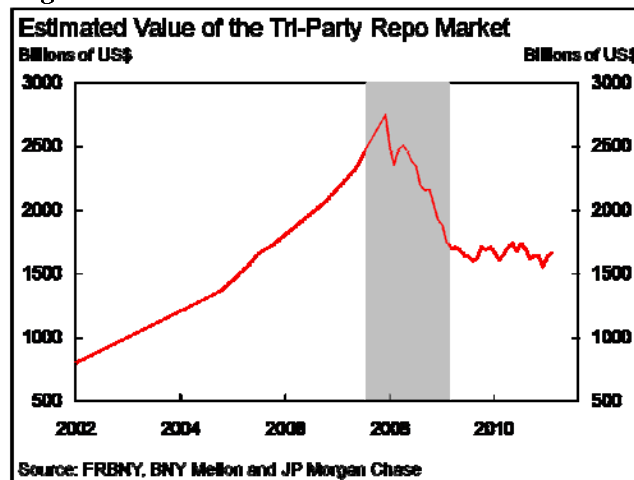
[89] The two clearing banks are J.P. Morgan Chase and Bank of New York Mellon.

returned to the securities firm; and the clearing bank extends intraday credit to the securities firm that is collateralized by the securities firm's securities until new repo transactions are established. That evening, the repo buyer would then again lend cash by purchasing the securities of the firm, and the firm would use those proceeds to repay the clearing bank.

Thus, the current structure of tri-party repo transactions entails an ongoing handoff of exposure between repo buyers, which bear the exposure overnight, and clearing banks, which bear the exposure during the day. As discussed above, the Tri-Party Repo Infrastructure Task Force made recommendations for reforming the tri-party repo market that include operational changes for significantly reducing the clearing banks' intraday exposures.

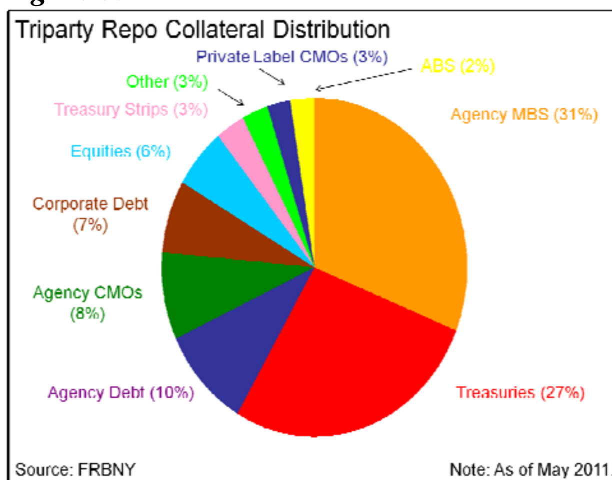
The current value of tri-party repo transactions outstanding is $1.6 trillion, down from $2.8 trillion before the financial crisis. Funding is provided by money market funds, securities lenders and other large financial institutions with excess cash.

Figure 2.



Approximately 80% of collateral in the tri-party repo market is liquid, consisting of Treasury and Agency Collateral.

Figure 3.



II. Stock Loan and Stock Borrow

In a securities loan transaction, the owner of securities lends securities to a borrower who becomes contractually obligated to redeliver a like quantity of the same security. Borrowers generally provide collateral to assure the performance of their redelivery obligation. Collateral may take the form of cash, other securities, or a bank-issued letter of credit. Lenders of securities typically receive margin or collateral in excess of the market value of the loaned securities, to act as a buffer against an adverse change in the price of the loaned securities relative to collateral in the event the borrower defaults. The lender also receives a fee that is negotiated at the time of the transaction. Loans can be made on an overnight, open (terminable on demand) or term basis.

The securities lender typically does not retain legal title to the securities that are loaned. The borrower obtains full title. The transaction would not be viable if the lender retained legal title to the securities it has loaned since the borrower may need legal title to the securities to transfer them to another party. Even if the borrower of the securities defaults on its redelivery obligation, the securities lender has no property interest in the original securities that could be asserted against any person to whom the securities purchaser may have transferred them. The securities lender's protection is the right to foreclose on the collateral.

While the securities lender does not retain legal title to the securities that are delivered to the borrower, it does retain contractual rights similar to beneficial ownership. Similarly, the securities borrower is entitled to receive all economic rights of beneficial ownership of the non-cash collateral to the extent it would be so entitled if the collateral had not been transferred to the lender. Further, the securities borrower generally has the right to return the securities at any time (subject to settlement on the day following the trade), and a securities lender has the right to return collateral and recall securities loaned at any time (subject to settlement three days following the trade).

Stock loan and stock borrow transactions may be used when a securities firm needs a security to deliver against a settling transaction, such as a short sale. A securities firm may also be involved in a finder's business, whereby securities are borrowed to relend to another broker-dealer, thus allowing the broker-dealer to earn a spread on the transaction. Broker-dealers may also engage in equity securities borrowed transactions solely to finance the positions of another broker-dealer where the equity securities are initially borrowed without a permitted purpose pursuant to Regulation T Section 220.10(a) and placed in a box location.

III. Sell-Buyback Arrangements

Market participants also effect securities lending transaction by entering into separate buy and sell trades. In a sell-buyback transaction, both the sell and buy trades are entered into at the same time, with the purchase transaction for settlement at a future date. An investment rate, typically the repo rate, is used to derive the forward contract price. In a sell-buyback, the purchaser of the securities (i.e., the borrower) receives legal title and beneficial ownership of the securities. The purchaser retains any accrued interest and coupon payments during the life of the transaction. The end price, however, reflects the economic benefits of a coupon being passed back to the seller.

Sell-buyback transactions are financing trades and limited to fixed income securities. A cash borrower does not normally have the right to substitute collateral. Margin is not provided in these transactions. Trade confirmations are delivered showing the details of the trade and that there is the forward obligation to honor the agreement. Sell-buyback transactions have traditionally taken place outside a fully documented legal framework.