Occupy the SEC

http://www.occupythesec.org

March 18, 2014

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

Re: Resolution of a Systemically Important Financial Institution: The Single Point of Entry Strategy

Dear Sir:

Occupy the SEC[1] submits this comment letter in response to the Federal Deposit Insurance Corporation's ("FDIC"; "Corporation") Request for Comment ("Notice") on its proposed Single Point of Entry Strategy for the resolution of failing Systemically Important Financial Institutions ("SIFIs").

Title II of the Dodd-Frank Act ("DFA") contains vital provisions that, if properly implemented, would help address the troublesome risks presented by "Too Big to Fail" ("TBTF") financial institutions. The current financial system is replete with moral hazard -- TBTF institutions are incentivized to undertake catastrophic risks because these institutions enjoy an implied promise of impunity that can take the form of government bailouts, unfettered access to tens of trillions of dollars of easy financing under the discount window and quantitative easing, and other government policies. We are heartened that the FDIC is poised to promulgate regulations that would implement Title II in a thorough and vigorous manner that could spare taxpayers the undue burden of supporting the colossal financial conglomerates that led to the 2008 financial crisis.

I. The FDIC Must Utilize Its Authority Under Title II

As elementary as it sounds, the first step that the FDIC must take in its implementation of Title II is to ready itself to actually utilizing that authority. Section 203 of the Dodd Frank Act permits

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[1] Occupy the SEC (http://occupythesec.org) is a group of concerned citizens, activists, and financial professionals that works to ensure that financial regulators protect the interests of the public, not Wall Street.

the FDIC and the Federal Reserve Board to recommend, **on their own initiative**, that the Secretary of the Treasury appoint the FDIC as a receiver if a financial company is "in default or in danger of default."[2]

Oftentimes whether a bank is "in danger of default" is not altogether clear until the very last minute. The FDIC need look no further than the example of Lehman Brothers, which quickly collapsed largely under the weight of risky bets in illiquid markets.[3] If the Agencies wait until a SIFI has already collapsed, Title II receivership would be of limited use as the SIFI's assets would be valued under fire sale conditions. Such post-hoc designation under Title II would be akin to "closing the barn door after the horse has left." For this reason, the Agencies must be aggressively poised to proactively designate financial companies "in danger of default."

We fully anticipate that the FDIC will doubtlessly face a tumult of resistance to recommending that a particular company be placed under Title II receivership. Such resistance will take the forms of both industry lobbying and political pressure from pro-business Members of Congress. Even so, we emphasize that the Corporation must exercise its independent judgment as a non-political administrative agency and, together with the FRB, actually make Title II recommendations as liberally as possible under the law. Title II authority can only benefit taxpayers if it is actually used in a timely manner.

II. The FDIC Must Attach Stringent Conditions to Utilization of the Orderly Liquidation Fund

At its core, the Orderly Liquidation Fund (OLF) is a bailout fund. It is imperative that the FDIC attach "strings" to any financial company's reliance on the fund. The mistakes made by the government in handing out a billion dollar under the Troubled Asset Relief Program (TARP), **completely free of any meaningful warrants or conditions**, must not be repeated. Any guarantees or loans made pursuant to the OFL must be accompanied by interest rates that greatly exceed industry standards and limitations on executive compensation for senior management at the borrowing company.

As will be explained below, excessive compensation should be viewed as an impermissible drain on capital, particularly for troubled companies on the verge of bankruptcy. Indeed, we encourage the FDIC to require that OLF funds be paid ahead of executive compensation for senior-level management at the bridge financial company and any subsequent NewCos.

For instance, the FDIC could establish a ceiling for executive compensation (e.g. at $100,000), and subordinate any owed compensation in excess of that ceiling to OLF repayment. This arrangement would help the government achieve its goal of promoting market discipline. Senior management would be punished for failing to repay OLF debts (by losing any salary above $100,000), and would concomitantly be rewarded for repaying OLF debts (by possibly keeping any salary above $100,000). Such an arrangement would also fully comport with Section 204 of the Dodd Frank Act, which directs the FDIC to "take all steps necessary and appropriate to

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[2] 12 U.S.C. § 5383 (2014).

[3] *See* Abigail Field, *Lehman Report: The Business Decisions That Brought Lehman Down*, Daily Finance, Mar. 14, 2010, http://www.dailyfinance.com/2010/03/14/lehman-report-the-business-decisions-that-brought-lehman-down/.

assure that all parties, including management, directors, and third parties, having responsibility for the conditions of the financial company bear losses consistent with their responsibility."[4]

III. The FDIC, as Receiver, Should Aggressively Exercise Its Broad Managerial Authority

The Act provides broad authority to the FDIC to act as receiver, including the authority to "perform all functions of the covered financial company, in the name of the covered financial company" and "manage the assets and property of the covered financial company, consistent with maximization of the value of the assets in the context of the orderly liquidation."[5] This veritable statutory *carte blanche* grants the FDIC a wide swathe of managerial authority. We recommend that the FDIC undertake a number of important steps pursuant to that authority, so as to mitigate systemic risk and to minimize the chances of future taxpayer bailouts.

A. The FDIC Should Recoup Compensation from Culpable Management in a Systematic Fashion

The FDIC is authorized to recoup at least two years worth of executive compensation from those substantially responsible for the failed condition of a covered financial company.[6] We encourage the FDIC to avoid the fraught task of identifying those "substantially responsible" on a case-by-case basis. Any particular decision by the Corporation to penalize one executive instead of another will likely result in litigation opposing that decision.

Instead of making particularized decisions, the FDIC should levy an across-the-board recoupment against all executives in the top .1% of compensation at the troubled financial company. This approach makes sense, as the highest paid employees will invariably be those with the greatest level of authority (and consequently, culpability) vis-à-vis a failing company's operations. After all, once a company is under Title II receivership, its senior-most management has incontrovertibly failed. Congress has granted the FDIC broad authority to define the contours of Title II recoupment, and the systematic approach suggested here would likely survive judicial scrutiny under *Chevron*[7] deference. In contrast, judicial deference may be less obtainable if the FDIC approaches the recoupment issue haphazardly.

B. The FDIC Should Set Limits on Executive Compensation at Bridge Financial Companies Under Receivership in Order to Avoid Draining Capital

In addition to establishing an across-the-board levy on executive compensation, the FDIC should also set hard caps on executive compensation in light of the fact that excessive executive compensation at a trouble SIFI would only serve to drain vital capital, which in turn would exacerbate the risk that taxpayers may need to eventually bailout the company.

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[4] 12 U.S.C. § 5384(a)(3).
[5] *Id.* at § 5390(a)(1)(B).
[6] *Id.* at § 5390(s).
[7] *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984).

Recent history has demonstrated that large financial institutions are prone to dissipating exorbitant amounts of capital on employee compensation. In most industries, bonuses are not issued if a particular company has experienced financial distress or a recent history of losses. Banks and other major financial institutions are different. At these institutions, the inquiry is not whether to issue employees exorbitant bonuses, but how large a bonus to give. Former Attorney General of New York Andrew Cuomo's investigation into Wall Street bank bonuses found that "when the banks did well, their employees were paid well. When the banks did poorly, their employees were paid well."[8]

For instance, a February 2012 report by New York State's comptroller found that total payouts to finance industry employees in New York in 2011 only dropped 14 percent during bonus season, even though profits had plunged by a whopping 51 percent.[9] Securities firms in New York earned $13.5 billion in 2011, down from $27.6 billion in 2010. Nevertheless, these firms paid roughly $20 billion in year-end cash bonuses, averaging $121,150 per person. A.I.G. famously issued multi-million-dollar bonuses to employees even though it was relying on a $100 billion lifeline to stay solvent. Excessive compensation can also take the form of shares and share options, which can have a dilutive effect on equity, not to mention revenues and retained earnings.

Excessive employee compensation is a drain on a financial institution's resources, and is therefore a liquidity/capital issue just as dividends and share repurchases are. One can easily anticipate the bank lobby's retort: that exorbitant compensation is (ostensibly) necessary for retention of qualified employees. This argument rings hollow when one compares bank compensation in the United States to that in overseas markets.

> [Financial institutions] have claimed it is impossible to recruit people without paying such compensation. Yet, if you look at the pay levels in Europe and in a lot of Asian countries, somehow they manage to find people who can run major global firms while making a fraction of what they make in the U.S.[10]

The fact is that employee compensation at major U.S. banks and other large-scale financial institutions is largely unmatched world-wide, especially for higher level employees. Non-pareto-optimal compensation is essentially equivalent to wasted capital that could have been better utilized for the purposes of financial stability, liquidity and capital adequacy.

C. The FDIC Should Set Limits on Executive Compensation at Bridge Financial Companies to Minimize Systemic Risk

The FDIC should also impose hard caps on executive compensation at financial companies under receivership in order to reduce systemic risk.

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[8] Andrew M. Cuomo, N.Y. State Office of the Att'y Gen., No Rhyme or Reason: The "Heads I Win, Tails You Lose' Bank Bonus Culture 1 (2009).
[9] *Executive Pay*, N.Y. Times, Apr. 20, 2012, *at* http://topics.nytimes.com/top/reference/timestopics/subjects/e/executive_pay/index.html.
[10] Steve Eder, *Study Shows U.S. Bank CEO Pay Dwarfs Rest of World*, Reuters, Sep. 23, 2009, *available at* http://www.reuters.com/article/2009/09/23/us-compensation-exclusive-idUSTRE58M2QU20090923.

The Notice recognizes that the current TBTF system essentially compels the government to provide bailouts in order to avoid disorderly bankruptcies of SIFIs.[11] Market participants are also well aware of this fact. This creates a classic agency problem whereby financial companies are incentivized to reward risky activities that could maximize profit (or lead to financial ruin). When these risky activities are undertaken at systemically important financial institutions, such risk is borne not just by the financial institution but by the global economy as a whole.

Compensation plays a significant role in creating these perverse incentives for risk-taking. German economists have developed a theoretical model demonstrating that financial companies (and their shareholders) react to bail-out expectations by designing bonus schemes that reward managers for taking higher levels of risk.[12] Where bailout expectations are high, the potential downside of speculative activity is stripped away, leaving only the upside. However, this situation hurts the overall economy, as society-at-large ends up bearing the costs of inefficient speculation. According to the German model, "ceilings on bonus payments can be welfare-increasing, especially if bail-outs are expected with a high probability."[13] "[A] sufficiently large increase in bail-out perceptions *always* makes it optimal for a welfare-maximizing regulator to impose ceilings on bank bonuses."[14] Thus, the imposition of compensation ceilings counteracts bailout perceptions and removes incentives for excess risk-taking, thereby promoting prudent risk management.

Therefore, it behooves the FDIC to maximize economic welfare by increasing the role of compensation restrictions in its implementation of Title II. The interests of overall financial stability demand this action, even if it comes at the detriment of a select few.

IV. The FDIC Should Encourage Spinoffs of Subsidiaries for Capital Accumulation and Risk Management Purposes

The FDIC should exercise its broad authority under Title II to encourage spinoffs of subsidiaries of troubled SIFIs as well as sales of subsidiary assets.

A SIFI under Title II receivership is very likely to be strapped for cash. Selling off subsidiaries or their assets can be a ready source of capital for these companies. Encouraging such divestitures would also reduce both intra-conglomerate risk as well as systemic risk (especially for the largest systemically important financial institutions). If a SIFI under Title II receivership is forced to divest itself of subsidiary assets, that only serves to dilute risk across a greater number of entities, which in turn reduces the risk that any of those entities will be considered "Too Big to Fail" due to systemic inter-connectedness.

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[11] Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy, 78 Fed. Reg. 76614, 76615 (Dec. 18, 2013).
[12] Hendrik Hakenes & Isabel Schnabel, *Bank Bonuses and Bail-outs* (Feb. 8, 2012), http://www.financial.economics.uni-mainz.de/Dateien/Hakenes_Schnabel_Bonus.pdf.
[13] *Id.* at 2.
[14] *Id.* at 3 (emphasis in original).

Moreover, reducing the footprint of troubled financial conglomerates through subsidiary spinoffs would help placate legitimate concerns about the inordinate market power of TBTF SIFIs. The financial industry is essentially an oligopoly,[15] with only a handful of major players dominating the industry. Under classical economic theory, the most efficient markets are typically those having an almost infinite number of competitors, while the most inefficient ones are monopolies and oligopolies.[16] Thus, the FDIC can help promote greater market efficiency by trimming the balance sheets of bloated SIFI-oligopolists. Financial markets can only benefit where a larger number of firms are permitted to compete in the stead of inefficient and failing SIFI conglomerates under Title II receivership.

The FDIC's Comment raises the prospect of ringfencing by foreign regulatory bodies, and describes how such ringfencing would impede its SPOE strategy. We remind the Corporation that subsidiary spinoffs could serve as a ready solution to the ringfencing problem. If the FDIC, as receiver, causes foreign subsidiaries to be sold for cash, U.S. regulators no longer need to rely on the cooperation of their foreign counterparts (which, realistically speaking, cannot be expected in every case anyway).

We fully anticipate that the FDIC would face stiff opposition to the strategy of spinning off SIFIs' subsidiaries. For instance, financial companies may argue that they should retain their subsidiaries because they enjoy economies of scale from owning those subsidiaries. Such arguments miss the mark. In the case of troubled SIFIs, the dangers attendant to scale, including risk concentration and interconnectedness, should be foremost on the FDIC's agenda. Indeed, if a SIFI conglomerate truly enjoyed valuable economies of scale, presumably those economies would have averted the need for Title II resolution in the first place.

V. Conclusion

Two points are certain. First, the country will invariably face another economic downturn in the future. Second, the nation's largest financial institutions are now bigger than ever, and there is no real prospect of that trend abating in the near future.[17] The combination of these facts means that the FDIC will almost certainly need to rely on Title II resolution at some point in the future. This somber reality underscores the pressing need for the FDIC to promulgate stringent Title II regulations that insure that taxpayers are not charged with future bailouts.

In crafting regulations implementing Title II, the FDIC has been given an historic opportunity to redress the grave issue of TBTF financial institutions, the machinations of which caused the most recent financial crisis. We hope that the FDIC will take up this task by promulgating bold strictures that protect the interests of taxpayers and not SIFI management. It is imperative that the FDIC craft punitive measures, such as the compensation and spinoff requirements suggested here, into its Title II regulations. The final regulations must contain serious disincentives for

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[15] Adam Davidson, *It's the Economy: The Wild West of Finance*, N.Y. Times, Dec. 7, 2011, *available at* http://www.nytimes.com/2011/12/11/magazine/adam-davidson-wild-west-of-finance.html ("There are nearly 8,000 banks in the United States, but the top 20 control more than 90 percent of the market.").
[16] *See* K. Jothi Sivagnanam, *Business Economics* 155-56 (2010).
[17] Stephen Gandel, *By Every Measure, the Big Banks are Bigger*, CNN Money, Sep. 13, 2013, *available at* http:// http://finance.fortune.cnn.com/2013/09/13/too-big-to-fail-banks/.

SIFIs to undergo Title II receivership, otherwise the resolution process will become just another version of a government bailout.

Thank you.

Sincerely,
/s/
Occupy the SEC

Akshat Tewary
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