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VIA COURIER AND E-MAIL

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

Re: RIN 3064-AD37: Modification of Temporary Liquidity Guarantee Program

Dear Mr. Feldman:

We are writing to comment on the FDIC's interim rule (the "Interim Rule")[1] that modifies the Temporary Liquidity Guarantee Program ("TLGP") to provide for the guarantee of mandatory convertible debt ("MCD"). We share the FDIC's view that the TLGP has had favorable effects on the financial services industry, and we agree that the inclusion of MCD in the program enhances and the program and will further benefit the industry. We very much appreciate the opportunity to submit two formal comments on the Interim Rule and to propose that the FDIC revisit three other elements of the original rule (the "October Rule")[2] so as to ensure consistency with the extension of the TLGP to MCD.

We support the core of the Interim Rule and its extension to MCD. Under the Interim Rule, as we understand it, the FDIC now will guarantee newly issued senior unsecured debt with a feature that mandates conversion of the debt into common shares of the issuing entity at a specified date no later than June 30, 2012—the expiration date of the FDIC's guarantee under the program.

We have five suggestions, a summary of which follows. We then discuss in detail the reasons for each suggestion. Many of our proposals are driven by the bifurcated structure of most MCD (described below) or other market-based elements. As a result, while we have two comments on the Interim Rule, we have three other proposals that relate to provisions in the October Rule, the existing terms of which, when applied to

[1] *See* 74 Fed. Reg. 9522 (Mar. 4, 2009).
[2] *See* 73 Fed. Reg. 64179 (Oct. 29, 2008).

MCD, may limit the success of the extension of the TLGP to MCD. We recognize that the request for comments on the Interim Rule does not specifically invite comments concerning the October Rule, but we would urge the FDIC to consider revisiting the portions of that rule identified below that may have unintended consequences respecting MCD.

- Section 370.2(m): Clarify the reference in the Interim Rule to "required by the terms of the debt instrument" so as to recognize bifurcated structure of the MCD structure.
- Section 370.3(d): Clarify this provision in the Interim Rule to confirm that the proceeds from the settlement of purchase contracts can be used to prepay any existing debt, including debt not guaranteed by the FDIC.
- Section 370.3(c): Revisit this provision of the October Rule to extend the guarantee of MCD through the maturity of any re-marketed debt obligation.
- Section 370.3(a): Revisit this provision of the October Rule to extend the guarantee to contract payments.
- Section 370.2(e): Revisit this provision in the October Rule to expand the scope to cover subordinated notes that underlie trust-preferred securities.

Discussion

First, with respect to the definition of MCD in section 370.2(m), the Interim Rule does not appear to contemplate the typical bifurcated structure of mandatory convertible debt financings. The definition appears to require that the conversion feature be embedded in the debt obligation itself – to be eligible, MCD must provide "by the terms of the debt instrument to convert into common shares of the issuing entity."

In practice, in order to preserve the deductibility of interest paid on the debt component of the instrument prior to conversion, mandatory convertible debt financings usually are structured as a sale of both a non-convertible debt obligation and a forward contract to purchase shares of common stock, with interest being paid on the debt obligation and periodic contract payments being paid on the purchase contracts until settlement. The purchase contracts generally settle two to three years after issuance but are not settled by surrender of the debt obligations. Instead, prior to the settlement date the debt obligations are re-marketed to new investors on market terms, after which the repriced debt obligations remain outstanding for an additional number of years. The proceeds of the re-marketing are used by the investors to settle their obligations under the purchase contracts.

To the extent the FDIC intends to limit covered MCD to integrated instruments with an embedded conversion feature, the after-tax cost of this form of financing (even with the substantial interest rate subsidy resulting from the FDIC's guarantee) may well be higher than the cost of a more traditional financing without an FDIC guarantee. If, by virtue of the definition in section 370.2(m), the FDIC guarantee is limited to MCD where the conversion feature is contained in the debt instrument, favorable tax treatment of the MCD is likely to be unavailable. Such favorable treatment is available for a bifurcated mandatory conversion because the forward purchase contract disappears in a bankruptcy of the issuer and the holder of the debt instrument becomes a creditor in the bankruptcy proceeding. If, however, the FDIC guarantee covers the debt instrument rather than the forward contract, then holder would presumably look to the FDIC for payment, not the bankrupt issuer, and favorable tax treatment probably would disappear.

To avoid an effective requirement that banking institutions use a tax-inefficient structure in order to participate in the program, we urge the FDIC to revise section 370.2(m) to clarify that covered MCD include those with a bifurcated structure that implements the conversion feature through separate forward purchase contract.

Second, with respect to section 370.3(d), which is contained in the Interim Rule, part of the FDIC's stated rationale for promoting issuances of mandatory convertible debt is to relieve a refinancing log-jam as FDIC-guaranteed debt matures in 2011 and 2012 and would otherwise have to be rolled over. As noted in our second comment, however, typical MCD structures will still require a re-marketing of debt during a relatively narrow market window. The proceeds from settlement of the purchase contracts could be used to repay maturing non-convertible FDIC-guaranteed debt, so the FDIC's stated concerns may be addressed, at least indirectly.

Accordingly, we suggest that the FDIC revise section 370.3(d) to allow the proceeds from the settlement of purchase contracts to be used to prepay any existing debt, including non-FDIC guaranteed debt.

Third, as to section 370.3(c), originally set forth in the October Rule, this provision contemplates that the debt obligation guaranteed by the FDIC will be extinguished at the time of conversion/settlement. As mentioned above, because the underlying debt obligation typically would be re-marketed, rather than extinguished, this limitation of the guarantee is likely to limit its success. If the debt obligation must be re-marketed without an FDIC guarantee (or with an FDIC guarantee that will expire prior to maturity), there is a risk either that the re-marketed debt may be re-priced at rates that are economically unattractive to the issuer or that the issuer may not be able to re-market the debt obligation at all, resulting in a failed re-marketing. Failed re-marketings are expressly addressed in standard documentation. (The substance of the customary provision is that, after several failed re-marketings, the issuer may settle the purchase contracts by essentially foreclosing on the existing debt obligations, which are pledged as collateral for the purchase contracts). However, it is critical to the tax treatment that the issuer be able to demonstrate at the time the units were issued that a future re-marketing was "substantially certain to succeed," which may be difficult in the current environment absent an FDIC guarantee that extends through the remarketing.

Accordingly, we suggest that the FDIC consider revising section 370.3(c) to extend the applicable guarantee to the re-marketed debt obligation through maturity.

Fourth, regarding section 370.3(a) of the October Rule, the bifurcated structure of many MCD financings typically requires interest payments on the debt obligation and periodic contract payments on the purchase contracts until settlement. Under the current rule, the FDIC's guarantee would extend only to the interest payments, and not to the contract payments. By so limiting the guarantee, the rule is likely to limit the meaning of the guarantee to investors. We recommend that the FDIC consider extending the guarantee, in the case of MCD, to contract payments on the forward purchase contracts.

Fifth, as to section 370.2(e) of the October Rule, in order to yield favorable regulatory capital treatment, much of the mandatory convertible debt issued by banking organizations has been structured utilizing a trust preferred security (TPS). Most TPS are issued by a holding company, with the proceeds often downstreamed into a subsidiary bank as Tier 1 capital. If the bank were to fail, the receivership would have the benefit of the proceeds of the TPS sale that originally were downstreamed to the bank, and the TPS holders would have no claim to that money.

The October Rule currently excludes subordinated debt from the FDIC's guarantee. However, in a receivership scenario, an FDIC guarantee of the subordinated note would provide holders with substantial protection from what they otherwise would face -- a claim against the holding company, often in bankruptcy. An FDIC guarantee for holding company subordinated notes (including TPS) would likely attract new capital to banks. We therefore recommend that the FDIC consider revising the scope of the definition of "senior unsecured debt" in section 370.2(e) to include subordinated notes in TPS structures.

Once more, we want to express our appreciation for this opportunity to comment on the Interim Rule. If you have questions about any view expressed in this letter, please do not hesitate to contact me.

Sincerely,

Dwight C. Smith III

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