Financial Services Management

DSIB-Resolution Requirements

Cite

Fed/FDIC, Advance Notice of Proposed Rulemaking (ANPR), Resolution-Related Resource Requirements for Large Banking Organizations

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Impact Assessment

- Any new DSIB-resolution requirements are likely to increase IDI-funding costs and/or reduce operational efficiency, but also increase resilience under stress and investor confidence in positive outcomes that may offset some debt or equity costs.
- All M&A transactions outstanding now or contemplated in this sector will need to consider the implications of any new requirements, some of which may be imposed as approval conditions even if the FRB and FDIC ultimately cannot agree on them as formal resolution requirements.
- Statutory changes to the FDIC's least-cost test and/or revisions to agency resolution actions that consider least-cost in a broader context might offset the perceived need for certain requirements, especially those germane to TLAC.
- The release's goal is to set new standards on which both the FRB and FDIC agree. Should this not be possible, then either agency could mandate what it wants in resolution-planning or other standards even though plan judgments and any penalties related to them require FDIC and Fed concurrence.

Overview

The FRB and FDIC have moved beyond the resolution-planning requirements mandated in the Dodd-Frank Act[1] then implemented over the years[2] to what could be a new resolution regime for banking organizations considered category II or III companies under the inter-agency tailoring rules.[3] Initially described as guidance when the agencies first announced this initiative, it appears likely that final standards will be more binding, which would almost certainly need to be the case under administrative

1 See **SYSTEMIC29**, *Financial Services Management*, July 13, 2010.

2 See Client Reports in the **RESOLVE** series.

3 See **SIFI34**, *Financial Services Management*, October 23, 2019.

procedures if the agencies decide not only to revise resolution planning on a sector or bank-by-bank case. This would be particularly likely if the agencies decide to include them in total loss-absorbency capacity (TLAC) standard for covered banking organizations akin to those now governing GSIBs.[4] The release notes that TLAC might adversely affect credit availability, but also describes how the single-point-of-entry (SPOE) regime works for GSIBs and why it could create a buffer of additional resources the parent holding company could downstream to subsidiaries or that could be held directly by insured depository institutions (IDIs). TLAC would, they posit, ensure orderly resolution likely via bridge entities across an enterprise and, if necessary, bankruptcy at the parent, not a taxpayer-backed rescue or use of Dodd-Frank's orderly liquidation authority (OLA).[5]

Impact

As the proposal details, the evolution of U.S. resolution standards has come sharply to differentiate between GSIBs and DSIBs – i.e., category II and III banking organizations. The difference is most notable not only with regard to the lack of TLAC and long-term debt (LTD) requirements for somewhat smaller banking organizations, but also exemption from clean BHC standards rules and qualified-financial contract (QFC) provisions.[6] DSIBs also have a longer-term resolution-plan filing schedule.

These differences concern the agencies because, as also documented in the proposal, banks at the larger end of the mid-size spectrum in 2008 have since consolidated and also grown sharply via organic asset increases. The proposal notes that category II and III banks differ from GSIBs in that the remain focused largely on traditional banking activities and their market share has remained relatively constant, but the sharp increase in size is said to raise new resolvability challenges.

These appear particularly problematic with regard to IDI subsidiaries of these category II and III BHCs. To address this, the FDIC has issued more stringent resolution large-IDI standards,[7] but it is now concerned that these do not suffice to ensure resolution without bailout or systemic risk due to the statutory "least-cost" test governing FDIC resolutions.[8]

The FDIC has typically resolved IDIs via "purchase-and-assumption" (P&A) transactions in which another BHC/IDI acquires some or all of the failed banking organization, but the size of DSIBs now makes it likely that any such transactions could only be consummated by a still larger bank. Dodd-Frank Act restrictions bar any IDI in the U.S. from holding more than a ten percent share of U.S. deposits via merger,[9] but exemptions are allowed in emergencies. As similar exemption allows the FDIC to

4 See **TLAC6**, *Financial Services Management*, December 21, 2016.

5 See **SYSTEMIC30**, *Financial Services Management*, July 22, 2010.

6 See **QFC6**, *Financial Services Management*, September 11, 2017.

7 See *Client Report* **RESOLVE10**, January 25, 2012.

8 See **MERGER10**, *Financial Services Management*, December 21, 2021.

9 See *Client Report* **FHC18**, June 1, 2010.

override the least-cost test, but this release indicates how reluctant the agency would be to do so due to systemic and concentration worries.

As noted, the agencies favor the SPOE resolution strategies adopted by all U.S. GSIBs. However, some large banks with significant foreign or nonbank operations now plan to be resolved under a multiple-point-of-entry (MPOE) approach. This now appears to satisfy the least-cost test, but the FDIC doubts this suffices without an added loss-absorbing buffer. It is unclear if adopting a SPOE approach instead of MPOE would satisfy the FDIC's preference for a TLAC/LTD buffer, but the overall discussion of TLAC suggests that this might not be the case.

The release does request comment not just on whether TLAC and/or long-term debt (LTD) requirements are advisable FSIBs, but whether these should be required of parent companies, IDIs, or one or the other in a banking organization. Were the FRB to decide that TLAC for DSIBs is not necessary, the FDIC could still mandate IDI-level TLAC/LTD. Whether it would need to revise its current IDI-resolution standards via a rulemaking or just do so on a case-by-case basis would then need to be determined. FDIC action on its own would not necessarily doom the agreement with the Fed required to approve resolution plans, but the Fed might defer to the FDIC on this issue in at least some cases. The consequences of failing to have a resolution plan approved may be considerable, as the agencies have the power under the Dodd-Frank Act to mandate restructuring or other procedures if agreement cannot be reached with the target BHC or IDI.

As detailed also in the OCC's conditional approval of the USB/MUFG/Union merger,[10] these new resolution plans might need to include "severability" plans if the FRB and FDIC also decide that these are necessary to protect IDIs and other essential activities in an orderly resolution without the need for a problematic P&A transaction. Severability standards would require some or all DSIBs to plan ahead to divest or "firewall" certain portfolios, business lines, or activities if these come under stress or the organization as a whole were to do so. Severability might, for example, force a DSIB to obtain third-party and/or parent-company funding for certain activities so that the operation could recover or even continue in bridge form without significant infusions of cash from an affiliated IDI. These standards would better insulate the IDI but could significantly raise the cost of doing certain lines of business or engaging in targeted activities. Depending on how stringent these severability standards are defined by rule or in individual transactions, they could come to offset some of the advantages of conducting certain nonbanking activities within a banking organization.

The agencies are also concerned that categories II and III IDIs now rely far more on uninsured deposits. The release does not make it clear why this is troublesome as it would reduce cost to the FDIC unless resulting run-risk is believed to increase the probability of acute stress. The release says only that GSIB resolution plans address uninsured-deposit funding, suggesting new standards for DSIBs would need to do the same. The discussion of nonbank activities is similar – i.e., it is said to have become far more common at DSIBs and to be ill-addressed in current resolution plans.

10 See *Client Report* **MERGER11**, October 19, 2022.

What's Next

The Federal Reserve released this ANPR on October 14; the FDIC did so following a 3-0 vote to approve it on October 18.[11] Comment must be received 60 days after publication in the *Federal Register*.

As noted in the discussion of the recent DSIB merger, the agencies are free to impose any resolution-related planning requirements on their own as a condition of merger approval. The OCC plays no role in setting resolution-planning standards, but it has direct authority over any M&A transaction involving a federally-chartered institution and thus could do as it chooses on a case-by-case basis before final standards are set by the FRB and FDIC or in lieu thereof. The Fed can also do so for parent organizations, with the FDIC's direct role outside the rules more limited because it is not the primary supervisor of most large DSIBs and thus its approval is not required for M&A consummation.

Analysis

These final standards would govern any DSIB that had not received "guidance" detailing its resolution plans. Comments are expressly sought on:

- **TLAC:** The agencies are assessing the extent to which long-term debt, likely also at the IDI level, would enhance resolvability. Views are sought on whether something akin to TLAC is appropriate and, if so, how best to structure it for DSIBs in SPOE and MPOE resolutions. Options such as the "internal TLAC" structured by global regulators[12] are also discussed, with questions posed on potential adverse consequences and competitive equity of DSIB-TLAC requirements, as well as the extent to which only some large banks (i.e., those with significant nonbanking activities, with foreign parents) might need to be subject to them.

- **Clearing Holding Companies:** The agencies seek views on whether this requirement should also govern DSIBs and, if so, how it might need to be codified.

- **Disclosure:** Comment is sought on appropriate disclosures to long-term debt investors to clarify their status in the event of a resolution.

- **Severability:** As noted, the OCC clearly favors these. This would require resolution plans to include express procedures to liquidate business lines, activities, portfolios, or other operations under defined stress conditions or in resolution. Questions are also posed on how DSIB requirements should be harmonized.

11 See *Client Report* **DEPOSITINSURANCE115**, October 18, 2022.

12 See **TLAC4**, *Financial Services Management*, November 24, 2015.