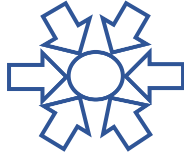

FedFin Client Report

Tuesday, March 28, 2023

FedFin Assessment: Policy Implications of FDIC-Resolution Innovations

Client Report: RESOLVE50

Executive Summary

As noted yesterday, the FDIC's recent rescues have had several unusual features with implications not only for future policy, but also for pending special assessments to replenish the DIF for the $22.5 billion estimated costs to the Deposit Insurance Fund. Analyzed here, new tools – e.g., voluntary liquidation, equity-appreciation rights, lines of credit – have determine the extent to which this estimate holds, how FHLB advances are treated in future resolutions, and the role the FDIC may play in companies that acquire failed IDIs. A forthcoming FedFin report will assess another issue sure to come up at Congressional hearings: why the FDIC and other agencies used these options in concert with a systemic designation protecting uninsured depositors rather than their OLA powers designed to prevent both uninsured-depositor protection and the most recent of the Fed's facilities backing the banking system.

Analysis

Resolution Strategy

The Silvergate, SVB, and Signature resolutions are ground-breaking in many ways:

- Silvergate did not technically fail. Instead, it went into "voluntary liquidation," a move made possible by the bank's ability to sell government securities and thus make whole both insured and uninsured depositors. The bank could not do so to avoid failure as asset sales at market prices made it insolvent, but the proceeds of these sales upon liquidation avoided the need for FDIC intervention and gave Silvergate's parent company greater options in bankruptcy along with better protection against FDIC efforts to claw back compensation or pursue other enforcement actions. While this was most unusual, it is the course of action larger banks anticipate in their resolution plans. FDIC and Fed rules may soon be tightened not only to reinstate more frequent living-will submissions, but also make voluntary liquidation a more credible option via requirements such as pre-positioned liquidity to handle deposit claims under more acute stress than is now generally anticipated.

- As noted, the SVB and Signature resolutions for the first time involved FDIC equity-appreciation rights for the appreciated value of holding-company stock following the subsidized acquisition of teach IDI. Each of these rights appears to ha a limited time span and is clearly designed to

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capture stock-price rallies largely attributable to these acquisitions, not broader parent-company factors. The FDIC's estimate of realized equity in each transaction is surely reflected in the bottom-line resolution costs it has disclosed; to the extent these rights result in significant gains, resolution costs may be somewhat less. Regardless, it seems likely that these warrant-like rights will be a feature of prospective resolutions, possibly with longer tenors and even at least some ownership rights designed not only to address resolution costs, but also broader FDIC concerns about bank consolidation.

- Loss-Shares: The SVB and Signature resolutions has loss-sharing agreements similar to albeit often more generous than those reached in prior purchase-and-assumption transactions, but the FDIC also agreed to a very large loan on favorable terms to encourage First Citizens' SVB acquisition. In essence, the FDIC has retained the acquiring bank to manage SVB's loan book at very little risk to itself. Most of the loans will likely be allowed to run off, leaving a major vacuum in VC finance that will be hard to fill from regulated banks and even other institutions given the current, "risk-off" market.

- Line of Credit: First Citizens also received a $70 billion line of credit to ensure that ongoing SVB deposit flight would not drain the bank's own liquidity resources. It seems likely that this line will also be needed to handle SVB's large FHLB advances as these mature, with this funding option an innovative way to honor the FHLB's prior lien without incurring the prepayment or other costs that could have ensued absent this acquisition. Silvergate's decision to pay off the San Francisco Home Loan Bank ahead of its liquidation also made it easier to accomplish the liquidation rather than a costly receivership in which the FDIC would have had to repay the Home Loan bank. Options based on this precedent are interesting in cases in which a failing bank has sufficient assets to honor insured-depositor claims, but not necessarily also those of uninsured depositors. Absent a systemic-risk situation, the FDIC may press for voluntary liquidation in these cases, avoiding a receivership and forcing the Home Loan Banks to take their place as creditors in a bankruptcy. To be sure, the Banks would be preferred creditors, but their ability to be assured of full pay-out no matter the risks would be considerably less certain and delays in the course of a bankruptcy proceeding are also likely.

- Special Assessment: As Mr. Gruenberg also noted yesterday, FDIC-loss estimates are preliminary. To the extent equity appreciation is low, losses are greater on FDIC-retained assets, and/or acquirers renegotiate key terms, loss may grow and the special assessment be still more eye-popping and procyclical. As detailed in our deposit-insurance forecast (see *Client Report* **DEPOSITINSURANCE118**), the FDIC may try quickly to issue new risk-based assessment rules minimizing the cost of these assessments to community banks even as it conducts the broader reevaluation promised in Mr. Gruenberg's testimony.

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