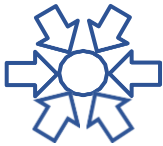

Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

DATE: May 15, 2023

As our forthcoming in-depth analysis will detail, the FDIC's proposed special assessment raises a raft of policy problems not contemplated by the FDIC despite a steep price tag warranting careful thought at a time of financial instability and recessionary risk. The FedFin analysis will detail the proposal, what the FDIC thinks, and what the proposal might do to whom, but here's my opinion: the FDIC's decision to allocate blame for SVB and Signature's failures to a select group of surviving larger banks is a politically-expedient violation of the principal of insurance and a terrible precedent for the future of federal deposit coverage.

First problem: the FDIC assigns blame to a large group of bigger banks even though its own analysis of the SVB and SBNY failures points to a different underlying reason for the systemic designation. In the proposal, the FDIC targets large holdings of uninsured deposits even though both its post-mortem and the Fed's of the two systemic failures cites bad management as the most important cause of death. Both agencies do note the new risks posed by social-media runs that hastened the banks' passing, but each also makes it clear that these new-age runs are an endemic challenge to bank resilience, not a risk unique to SVB and Signature or other banks with large amounts of uninsured deposits. The FDIC proposal contains no explanation of why uninsured-depositories are the systemic rescue's fall guys even though these deposits aren't the cause of the two bank failures and the risks they may pose are now set for remediation via new rules.

Second: the FDIC doesn't say why it decided that one amount of uninsured deposits – $5 billion – is toxic instead of looking at uninsured deposits as a share of total deposits to see how vulnerable a bank might actually be. Surely, an insured depository with $6 billion in total deposits of which $5 billion are uninsured is at greater run risk than a $100 billion bank with the same $5 billion uninsured base. The decision to exempt smaller banks is politically expedient, but the rationale for doing so is substantively spurious.

Third: once the FDIC starts assigning blame to DIF losses, it can presumably pick on anyone it wants anytime it wants for additional or costlier premiums. What happens now if small or midsize bank failures increase as a result of the very large exposures to commercial real estate that characterize these smaller institutions? Will the FDIC tax surviving banks below a certain asset size essentially for consorting with like-sized banks that couldn't handle a higher-risk asset class?

And, what would happen if the FDIC assessed premiums based on its actual thinking about recent failures and penalized only banks with bad management? That's at least as fair as doing so by some arbitrary amount of one form of deposits. The M in CAMELS should tell the agencies which badly-managed banks are, but then again the Fed and FDIC thought both SVB and Signature were pristine until the day before they failed. Bad management may have doomed the banks, but lax supervision nailed the coffin at great cost. Given that the Fed and FDIC missed so many warning signs, maybe they should chip in a bit for the special assessment.

Even more importantly, uninsured deposits aren't supposed to be insured. Demanding premiums based on them is like requiring homeowners or drivers to pay premiums for total loss no matter how much of a deductible a customer selects or setting health premiums based on total charges no matter exclusions or deductibles. Under the FDIC's plan, a depositor ready to take more risk for better return won't get one after the premium tax on uninsured deposits goes up. This is money for nothing and the depositor will thus find other ways to arbitrage yields via brokered or reciprocal deposits while banks rely still more on Federal Home Loan Bank advances and remain in permanent servitude to Fed rescue windows. This will hike the FDIC's risk and obliterate the remnants of market discipline.

Does the FDIC have to charge uninsured depositors for the privilege of insurance they aren't supposed to receive at banks that are supposed to be able to fail without bailout? No.

As with other insurance carriers, the FDIC already has a way of setting risk-based premiums in its risk-based assessment rules. The law demands a special assessment to bring the Deposit Insurance Fund to its designated reserve ratio, but the FDIC need not target specific types of banks and should not do so unless it for some reason can't reckon with new risks in revised risk-based premiums.

And, as we noted last week, the special assessment isn't the last of the FDIC's premium hikes given the $13 billion cost of First Republic's arranged marriage with JPMorgan. Would it not make more sense to calibrate the special assessment in line with anticipated premiums to bring the DIF as a whole back above water without accidentally redefining banking any more than high premiums at a stressful time are already sure to do?

Although the law gives the FDIC the option of structuring a special assessment based in part on which banks benefited from it, the law also demands attention to the industry as a whole and to broader economic conditions. Congress never anticipated that the systemic special assessment would be selectively applied by an arbitrary size threshold premised on an unproven theory. The FDIC should stop watching its political back and instead face the consequences of its policies over the years that blurred the boundaries between insured and uninsured funds, allowed high-risk institutions to go unchecked, and left it no option but systemic intervention in the absence of advance planning for regional-bank resolution.