Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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A week from today, FDIC Chairman Gruenberg will lay out his latest thinking on large-bank resolution. If recent history is any guide, his comments augur action advancing regional-bank TLAC rules just as his defense of the new capital rules presaged the proposal. Mr. Gruenberg was right in 2019 when he mourned the FDIC's inability to resolve a large regional bank; he's wrong now if he thinks lots of long-term debt will do the Fed and FDIC's job for them. The agencies have all the tools they need to resolve super-regionals and they've one more knock-out punch to protect taxpayers: enforceable source-of-strength authority. None of these tools were used in the last four failures and the agencies should get their own house in order before mandating anything but urgent repairs at banks already struggling with structural market changes in the higher-for-longer regime.

Although there's no excuse for it, there's also no denying that the FDIC can't resolve troubled regionals. The Silicon Valley and Signature failures should have been handled in due course under regular FDIC intervention – preferably before collapse as the law allows. If that isn't enough, then the FDIC could have used its orderly liquidation authority (OLA) if the case was truly systemic and neither the Fed nor FDIC could figure out another way. Under either regular resolution or orderly liquidation, shareholders and uninsured depositors would have suffered and that's all to the good of a disciplined financial system.

Six weeks later when the FDIC had ample, ample notice that First Republic was a goner, it still didn't know what to do. It thus sold the failed bank to JPMorgan, making the world's bigger bank still bigger and even more profitable. Bully for them; not so much for disciplined resolution.

And, as it turns out, the FDIC's Silicon Valley Bank resolution was even more badly designed than immediately clear. Here, though, it shares blame with the Fed. Of the three failed banks, SVB was the only one with a parent holding company. Why Signature and First Republic were allowed such light-touch regulation in the absence of a parent company is a question for another – hopefully soon – day, but the facts on the ground are that SVB had a parent holding company and that parent holding companies are supposed to be a "source of strength" for subsidiary banks.

Congress said so after a raft of bank failures in the 1980s and 1990s and, when the law's drafting came under legal attack, and did so again with teeth in Dodd-Frank. As laid out in a masterful op-ed by Todd Baker, the insured depository was instead turned into a piggybank for the parent holding company. Not only did SVB's parent company escape orders to support its subsidiary bank or backstop the FDIC as the law not just allows but demands, the parent company is still very much in the thick of things for its shareholders. Just this Friday, SVB's still-extant VC-affiliate participated in a deal to buy some of the subsidiary bank's dud loans. They, doubtless better than anyone and especially the FDIC knew what they were buying.

Instead of getting what it can from the holding company, the FDIC is charging other banks a special assessment to top up its coffers. Instead of reviewing its failure to use the source-of-strength doctrine to protect the FDIC, the Fed – which did not even mention this sin of omission in its SVB mea culpa – is pressing a raft of new rules – some needed, some not, none addressing the root causes of recent systemic, high-cost resolutions.

Which brings me back to TLAC. As detailed in the Fed/FDIC advance notice of proposed rulemaking, the idea here is to force larger banks to join GSIBs in forced issuance of long-term debt (LTD) that is thought to be a still better buffer against costly resolution than all the capital and liquidity and resolution plans demanded under all the other rules. This LTD of course comes from investors, investors who of course will demand much in return for funds that banks must then determine how to put to profitable use backed by still more capital that can't be deployed for loans or other economysustaining forms of financial intermediation.

Policy dictates that those who should first suffer in a bank failure are shareholders and, for BHCs, that means parent-company shareholders at least as much as those of a bank because, as noted, BHC shareholders come under an express, statutory source-of-strength doctrine. The Fed needs to remember it has this power and work with the FDIC, which needs to remember that it also has the right to demand a commitment from parent companies to reduce resolution costs. If they can't remember without writing another rule to remind themselves as well as BHC shareholders, so be it.

A resolution rule stipulating how the Fed and FDIC will do their jobs is a far better place to start than mandating TLAC atop a still-dysfunctional resolution framework. Congress gave the Fed and FDIC the powers they need to do a lot better than they've done so far. That they don't know how to use them is no excuse for demanding banks fill in the blanks.