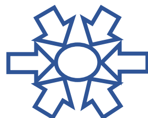

Financial Services Management

DIF Special Assessment

Cite

FDIC, Final rule; Special Assessment Pursuant to Systemic Risk Determination

Recommended Distribution

CFO, Asset/Liability Management, Treasurer, Policy, Legal, Government Relations

Website

https://www.fdic.gov/news/board-matters/2023/2023-11-16-notational-fr-b.pdf

Impact Assessment

- Many large banks subject to the new special assessment will face near-term capital and income challenges, exacerbating stress at weaker banks and broader procyclicality in the construct of bank regulation.
- Some IDIs may seek to reduce DIF premiums by reducing assets, limiting balance-sheet growth by cutting credit offerings and/or funneling larger deposits into asset-management products with limited financial-intermediation benefit.
- Because the special assessment is retroactive, it does not directly affect the cost of accepting additional uninsured deposits, but many banks may be unwilling to do so out of fears that the new charge will be reflected in a broader rewrite of risk-based DIF premiums. Funding costs and/or FHLB borrowing could thus increase.
- Premium assessments on uninsured deposits are likely to blur the difference between insured and uninsured liabilities, furthering market expectations of de facto unlimited deposit insurance.

Overview

As the law requires and the FDIC Chairman promised after SVB and Signature Bank were declared systemic,[1] the FDIC has finalized its proposed approach to imposing a systemic assessment to reimburse the Deposit Insurance Fund (DIF) for the resolution costs related to uninsured deposits following a systemic designation.[2] The FDIC will do so via an assessment covering IDIs with uninsured-deposit holdings above $5 billion that have assets over $5 billion. This exempts most smaller banks, with the FDIC adopting this approach on grounds that it justly penalizes large IDIs it believes benefited the most from these systemic rescues. The new assessment will be applied over at least eight quarters beginning in April of 2024 for the first quarter of that year, with the FDIC's analysis persuading it that the capital and income costs of this targeted approach are

[1] See *Client Report*, **REFORM217**, March 28, 2023.

[2] See **DEPOSITINSURANCE120**, *Financial Services Management*, May 15, 2023.

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sustainable on average for all covered banks. In practice, this may not prove the case for many IDIs because the final special-assessment rate is even higher than that originally proposed and even the average capital and income costs are substantial on their own and likely still more problematic given other pending costly proposals.

Impact

The FDIC reads governing law to state that the FDIC is required to cover all losses due to a systemic designation from a special assessment, but the rule does so only for losses attributed to uninsured deposits under the agency's methodology detailed. As a result, even though small banks are not covered by the assessment, they would still bear some of the cost of the resolutions, but the bulk of its cost would be derived from institutions that the FDIC believes were most benefited by the systemic designation's protection against depositor expectations of loss at other banks that did not result in outflows once depositors believed themselves protected. The FDIC does not directly assert that uninsured deposits caused SVB and Signature's failure, only that the designation had the effect of protecting uninsured deposits across the banking system. In its report on Signature's failure,[3] the FDIC attributed it principally to bad management, the cause also cited by the FRB in its report on SVB.[4]

Importantly, these two failures are not the only ones with which the FDIC has coped in recent months. First Republic Bank was closed by the FDIC on May 1 in concert with arranging the sale of the IDI to JPMorgan in a transaction involving numerous FDIC backstops estimated to cost the FDIC $13 billion. While very costly, this resolution was not systemic and therefore does not fall under provisions in law mandating this special assessment. The FDIC will consider the extent to which premiums will need to rise above their recently hiked levels in the wake of this failure or any other reason when it assesses the DIF's level. However, the FDIC chose to leave current premiums as is when it approved the special assessment.

The final rule is largely as proposed. For example, the agency rejected comments seeking to redefine the assessment base, including by covering all deposits, not just uninsured ones or by exempting certain deposits such as collateralized public deposits, operational deposits and even intra-company deposits. As a result, banks that focus on municipalities or wholesale /custody services will find their DIF premiums particularly elevated by the new special assessment and its strategic consequences still more problematic.

The final rule sets the special assessment at 3.36 basis points for an annual rate of 1.34 bps atop ongoing DIF premiums. This is a higher special assessment than proposed because the FDIC's resolution costs related to SVB and SBNY uninsured deposits are higher than anticipated. Banks that fall under the new special assessment and/or additional higher premiums may seek to reduce the cost of FDIC insurance at a time when likely regulatory-capital hikes also make it less profitable to use increasingly high-cost deposits for new loans or most other assets. Large banks are often encouraging large depositors to convert funds into

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[3] See *Client Report,* **REFORM222,** May 1, 2023.

[4] See *Client Report,* **REFORM221,** May 1, 2023.

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investments in bank-sponsored MMFs or other vehicles, often into investments with limited direct benefits for economic growth and credit availability, especially for under-served communities.

The FDIC's cost-benefit analysis does not take these structural effects into account, assuming that banks bear all the costs of the newly higher special assessment. The analysis also does not anticipate how the special assessment would factor into higher DIF premiums now and come to affect bank earnings, capital, and competitiveness. The estimate specific to the special assessment also makes assumptions about how pre-tax costs affect bank capital based on additional assumptions about dividend policy and how banks suffering particularly sharp capital reductions due to the premium are likely to behave, further assuming that capital effects are phased in over eight quarters. While this may be technically the case, investors generally look at the total cost of new requirements and resulting profit implications in order to make immediate judgments about a bank's market capitalization.

The agency also finds that the assessment on its own on average will reduce Tier 1 capital at affected banks by an estimated 62 bps, an amount deemed minimal even though it is 15.5 percent of the four percent minimum ratio against which banks are judged adequately capitalized. It should be noted, however, that capital impact is likely to be higher for some banks and that all banks need to be well-capitalized not only to avoid adverse market reaction, but also remain eligible for certain regulatory privileges.

Further, the average income cost to covered banks is now found to be 20.4 percent in one quarter, a cost the agency as noted thinks companies can easily absorb. However, it is unlikely that this average income reflects what will happen at the most affected banks, where revenue challenges could be substantial – 34 percent of now-profitable banks will have income hits above average, according to the FDIC, which does not provide any insight into the magnitude of challenges for IDIs most affected. To the extent the special assessment is particularly costly for specific banks, these banks may see further, immediate, and significant drops in market capitalization, making it more difficult to raise capital in response.

What's Next

The FDIC voted 3-2 by notation on November 16 to approve the final rule. Assessments will begin in April for the first quarter of 2024, proceeding through the end of 2025 until the FDIC believes the DIF is replenished based on actual collections and any prospective adjustments to resolution costs. The agency reads the law as requiring that any excess collections go into the DIF. If the DIF is not replenished after eight quarters, then the assessment will continue or a shortfall assessment will be set by order and mandated at a time deemed appropriate by the agency. IDI assessments will not be adjusted to reflect those that would have applied to any IDI they purchase going forward, avoiding a penalty that could restrict M&A while covering bank mergers prior to the rule the FDIC believes benefited from the systemic designation. Should there be a significant jump in M&A for large banks, the odds of a shortfall assessment will rise for remaining IDIs

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despite individual assessment protection. Any IDI that terminates deposit-insurance coverage would need to pay its entire special assessment at the time of charter conversion. IDIs may protest their specific assessments.

Because of the problems observed with call-report filings, the FDIC is also conducting a review of how uninsured deposits and related data are reported. Changes to the call-report methodology could adjust how the special assessment affects some IDIs.

Analysis

The special assessment applies to IDIs with assets over $5 billion and exempts the first $5 billion of uninsured deposits. The final special assessment is then based on a covered IDI's uninsured deposits as of call-report data on December 31, 2022. Less the $5 billion of uninsured deposits are exempted from the assessment base. Subsequent to the proposed rule, the FDIC found that some IDIs may have altered uninsured-deposit filings to minimize the special assessment's cost. The final rule is based on corrected 2022 data where appropriate. The final rule continues to assess the premium as proposed on grounds that large banks disproportionately rely on uninsured deposits and benefited most from the systemic determination in terms of funding stability at the time. The retrospective assessment-base calculation is also premised on the view that banks which had the largest balances of uninsured deposits before the March 2023 failures benefited the most from the systemic designation that prevented uninsured-deposit outflows or even runs.

As noted, the final rule sets the special assessment at 3.36 basis points for an annual rate of 1.34 bps atop ongoing DIF premiums.

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