Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

DATE: March 25, 2024

Last January, we sent a forecast of likely regulatory action and what I called a "philosophical reflection" on the contradiction between the sum total of rules premised on unstoppable taxpayer rescues and U.S. policy that no bank be too big to fail. Much in our forecast is now coming into public view due to Chair Powell and Vice Chair Barr; more on that to come, but these rules like the proposals are still premised on big-bank blow-outs. I thus turn here from the philosophical to the pragmatic when it comes to bank resolution, picking up on a stunning admission in the FDIC's proposed merger policy to ponder what's really next for U.S. banks regardless of what any of the agencies say will result from all the new rules.

Let me quote at some length from the FDIC's proposed merger policy:

> In particular, the failure of a large IDI could present greater challenges to the FDIC's resolution and receivership functions, and could present a broader financial stability threat. For various reasons, including their size, sources of funding, and other organizational complexities, the resolution of large IDIs can present significant risk to the Deposit Insurance Fund (DIF), as well as material operational risk for the FDIC. In addition, as a practical matter, the size of an IDI may limit the resolution options available to the FDIC in the event of failure.

In short, the FDIC wants to block most big-bank mergers because it can't ensure orderly resolution of a large insured depository institution even though that's what Congress mandated over and over when it provided formidable statutory authority up to and including the orderly liquidation authority (OLA) for systemic resolutions which the FDIC's OIG also says the agency cannot deploy. As the FDIC itself makes clear, it wants to ban mergers at least as much because it doesn't know how to do its job as because it wants to choke budding monopolists.

Chair Powell also knows how little the FDIC can do when it comes to doing its job. For example, he told Senate Banking that the agencies need mandatory long-term debt from regional banks because the FDIC doesn't know how to shut them down.

The FDIC from time to time blames its inability to do its fundamental job on the statutory "least-cost test" it says forced it most recently to resolve SVB and Signature via systemic declaration and to hand First Republic over to JP Morgan. This would be more persuasive if its deals were not so generous, one of the banks – NYCB – proved unable to execute a sound deal, SVB's parent company wasn't still in such deep clover, and JPM hadn't made so much money so fast.

And where was the Fed? It has express authority to require holding companies to serve as sources of strength, but this wasn't done when it could have been done – again, see SVB. Was the Fed's

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super-generous Bank Term Funding Program tacit acknowledgement that more regional banks were on the ropes and the FDIC couldn't handle them and the Fed didn't want to? We'll never know, although we certainly should.

The most basic tenet of U.S. financial policy established in 1932, 1970, and – with teeth – in 2008 is that no financial company shall be too big to fail. If markets believed this, market discipline would be credible. If regulators could adhere to it, then the thousands of pages of unaccountable and often-incoherent resolution plans big banks now file would be boiled down to ensure far less complexity, greater operational and liquidity resilience, and sure and certain investor and large-counterparty cost. If the FDIC knew what it was supposed to do and then knew how to do it, size thresholds for when banks are "too big" would be set not by the FDIC's own pain point due to operational incompetence, but instead by differentiation between banks that may be too dominant regardless of asset size and those cut down to size only because the FDIC has made all but the smallest banks too big to fail by its failure to do its job as both an IDI and systemic resolution authority. If the FDIC did its job and the Fed redefined emergency liquidity facilities and used its source-of-strength authority, financial companies – bank and nonbank – would no longer profit from moral hazard. That's what Congress demands, the FDIC and Fed are chartered to do, and a few good rules and a modern-day merger policy backed by effective supervision and enforcement would go a long way to ensure.