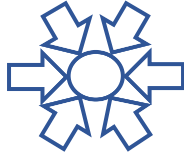

FedFin Client Report

Thursday, April 11, 2024

FedFin Assessment: FDIC Plan to Resolve GSIBs Fails to Answer Many Key Questions

Client Report: RESOLVE51

Executive Summary

In its first public statement since 2013 about how it would execute an SPOE resolution (see FSM Report **RESOLVE23**), the FDIC yesterday released a report Chair Gruenberg described as demonstrating the FDIC's readiness to resolve a U.S. GSIB and the process it has developed for doing so under the orderly liquidation authority (OLA) provided in the Dodd-Frank Act (see FSM Report **SYSTEMIC30**). As detailed in this FedFin report, the FDIC's goal is to set stakeholder expectations regarding what to expect in an OLA resolution of a U.S. GSIB, but much reiterates current law and prior actions such as GSIB filings related to their resolution plans and the FRB's TLAC standards (see FSM Report **TLAC6**). Although perhaps released by the Chairman at least in part to assert FDIC capabilities at a time of internal stress and Congressional criticism, it remains unclear the extent to which the FDIC is ready and able to execute the protocols it describes. The paper principally addresses only SPOE resolutions, which it states are best suited to OLA without making clear what it would do if a GSIB chose MPOE (none have so far although this is permitted under the living-will rules), a regional bank found to be systemic used MPOE (as several do), or if resolution involves a nonbank, where MPOE might well be preferable. The report does, however, contain a box addressing how the FDIC would handle a non-U.S. GSIB using MPOE to handle its U.S. operations, including those housed in an IHC (see below). As detailed here, many other stakeholder-critical questions – e.g., how IDI deposits are handled, if the FDIC is ready to ensure operational continuity, what would happen if foreign supervisors differed – are also not specified in ways likely to ensure stability should a GSIB's condition falter or other events augur possible systemic risk.

Analysis

The report clearly responds to the agency's OIG's finding that the FDIC is in fact unready to execute an OLA resolution, a finding the FDIC acknowledged when it planned to improve the process by next year. Here, the agency asserts that the OLA process is well-established. The report also does not address another OIG finding: that the FDIC is also unready to handle a nonbank or FMU systemic failure, although it does say that this report lays out "many" of the steps the FDIC would take in a nonbank case. However, no mention is made of FMUs nor are challenges addressed due to the fact that the FDIC would not have the living wills or TLAC authority on which its GSIB-resolution confidence rests, nor is the treatment of qualified

Federal Financial Analytics, Inc.
2101 L Street, NW – Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com

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financial contracts (QFCs) clear in the absence of bank standards related to them (see FSM Report **QFC6**) and the revisions to the Bankruptcy Code known to be necessary after the Great Financial Crisis but still unenacted.

The report also discusses key GSIB challenges such as the difficulty of knowing when to initiate an OLA resolution, saying that intervention should be "timely" without making clear what factors weigh into knowing when this occurs beyond the conflicting issues raised by the prospect of recovery versus the cost of failure. Using OLA before bankruptcy is clearly preferable to the FDIC if it has any doubts about a bank's liquidity under acute stress, but this may conflict with the statutory preference for bankruptcy. The report is, though, clear that the ideal time for closing a bank is after markets close in New York on a Friday afternoon.

As noted, the report includes a short discussion of foreign-GSIB MPOE resolutions. These will be led by the home country, with the FDIC expecting this to allow U.S. subsidiaries to remain operational while the parent is resolved thanks in part to the internal TLAC mandated for them by the FRB. If this does not work, then the FDIC expects to use its ordinary resolution procedures, not OLA (i.e., bankruptcy for the IHC, FDIC resolution for the IDI, SIPC resolution for any broker-dealer). All this said, OLA might be used if the FDIC thinks necessary.

The paper focuses principally on SPOE for U.S. GSIBs, noting that these resolutions are made easier when companies have sufficient capital to ensure ongoing operation – true, of course, but also problematic if a company crosses failure or in-danger-of-default criteria essential to initiate resolution. The report also notes the challenges of handling foreign entities of a U.S. GSIB, noting it will generally defer to host-country agencies even though its foreign GSIB strategy expects foreign entities quickly to recapitalize their U.S.-domiciled operations. If foreign authorities have a like-kind expectation of the FDIC, then it will need to take action not clearly contemplated in this plan.

Further, IDI deposits are said to be protected in an SPOE resolution, which the FDIC says would leave the IDI open for business. This would be done by using the failed GSIBs capital to recapitalize the IDI; what would be done if this does not suffice or if doing so leaves other key subsidiaries unable to operate is not made clear. However, the ability of the FDIC to handle an IDI in this manner in an MPOE resolution would not likely follow this course, perhaps forcing the FDIC into a costly IDI resolution. The paper does not address the extent to which depositors, especially uninsured ones, would be able to tell the difference between banks with SPOE and MPOE plans and thus not engage in runs at SPOE entities nor does it address contagion or other risks from MPOEs to other banks.

The paper lays out additional operational issues in an OLA resolution, largely reiterating how a bridge entity works as stipulated under Title II of the Dodd-Frank Act. However, in several areas – e.g., how claims will be handled – the paper lays out options with considerably different consequences, undermining the certainty Chair Gruenberg promised in releasing the paper and likely creating the potential for considerable instability. The paper also often states how the FDIC hopes to proceed, going on to detail challenges that may await without always

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2101 L Street, NW – Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com

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making it clear how each challenge or something still more unexpected would be addressed to ensure that critical objectives – e.g., continuing bridge-company operation – are achieved.

Reflecting U.S. policy against TBTF banking, the paper states that an OLA resolution will be funded by the failed entity's resources "to the greatest extent possible," but the FDIC would turn to draws from the Treasury or guarantees as authorized in Title II if these prove insufficient. The agency states that its IDI resolutions give it the experience necessary to anticipate a failed GSIB's funding needs.

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E-mail: info@fedfin.com www.fedfin.com

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