Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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In 2013, the FDIC issued a short, unilluminating paper purporting to show how the agency would implement one aspect of the orderly-liquidation authority (OLA) Congress granted in 2010 to prevent the profligate bailouts that blighted the great financial crisis. I was unconvinced by the 2013 paper and even more perplexed when years passed and the utterance on single-point-of-entry (SPOE) resolutions was all the FDIC deigned to pronounce. After all, if big banks and systemic nonbanks can't be closed without bailouts, then moral hazard triumphs and crashes become still more frequent and pernicious. Last week, mountains moved and Chair Gruenberg said that anything big will not be bailed out. Would this were true, but it's not.

Despite the agency's failure last year to find a solution other than a bailout for high-risk regional banks and an Inspector-General report finding the FDIC most OLA-unready, the FDIC now is confident that it can handle even the biggest blow-out at U.S. global systemically-important banks. This derives from untested faith in SPOE, the FRB's TLAC rule, GSIB living wills, and what it calls legal certainty pertaining to qualified financial contracts (QFCs).

Maybe so re GSIBs, but this sangfroid is still more puzzling when one reads on and finds that the FDIC thinks so well of its GSIB OLA capabilities that it says that it's also ready to deploy them for foreign-GSIB operations in the U.S., any regional bank that hits a systemic bump, and even nonbank SIFIs. Nothing is said about the fact that QFC contractual commitments are unlikely to work under many of these stress scenarios, some big banks prefer multiple point of entry, foreign regulators may well differ with the FDIC's blithe assertion that they'll support U.S. operations in their jurisdictions, and – no technicality – many potentially systemic nonbank entities do not fall under any of the rules on which the FDIC counts for so much when it comes to GSIBs.

Worse, the FDIC's sanguine assurances that everything will fall into place in a systemic crisis does not make clear how this dream comes operationally true. This sleight-of-hand increases the odds that markets – which will read every word of this policy when risks materialize – will be still more spooked at the first sign of trouble.

Case in point: the FDIC policy says that all deposits at a GSIB's subsidiary bank are safe because it's confident that GSIB insured depositories will require no FDIC rescue. This is not only premised on what could prove faulty assumptions about how the bank would be recapitalized following FDIC takeover of the parent holding company, but also reliance for these assumptions on only one possible resolution course: SPOE. All U.S. GSIBs now aspire to SPOE, but that is emphatically not the case for foreign banks with big U.S. footprints and many large regional banks.

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Will depositors at other entities flock to GSIBs with even more alacrity than they did last year? And, if the GSIB is the troubled entity, will depositors know the difference between banks based on their largely-confidential resolution plans? Of course not. Most thus will run to the exit even if the FDIC manages to make up its mind about when to step in based on all the conflicting statements in the policy about how and when this might actually be done.

Before the great financial crisis, big-bank resolution policy was based on what Alan Greenspan called "constructive ambiguity" – i.e., an opaque policy meant to stoke market discipline without impeding the Fed from rescuing anyone anytime as it all too often did. What the FDIC has done in practice with its new policy in light of all its assumptions and uncertainties is to replace Greenspan's constructive ambiguity with what can best be called destructive ambiguity. Greenspan's construct wasn't all that ambiguous, resting as it did on market confidence that the Fed had its back, as indeed it always did. It thus needed a total rewrite, and the FDIC's statement obligingly declares that too-big-to-fail is no more. But TBTF is still the most likely option because the FDIC's ability to rely on bankruptcy as the law requires and deploy OLA only as a last resort rests on so many wings and prayers as to be no more than an aspirational statement, not the long-overdue concrete, operationalized policy essential to ensuring market discipline and systemic resilience.