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An Underappreciated Risk:
The Resolution of Large Regional Banks in the United States

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Introduction

I would like to begin by thanking the Brookings Center on Regulation and Markets, and Aaron Klein, for the invitation to speak here today.

The subject I would like to discuss – the resolution of large, regional banks in the United States – has received relatively little attention during the ten years since the financial crisis of 2008-2009. Most of the attention, appropriately, has been on the challenges posed by the resolution of Global Systemically Important Banks (GSIBs).[1]

However, regional banks, which for the purposes of today's discussion I will categorize as banks with assets between $50 billion and $500 billion, pose very significant resolution challenges to the FDIC distinct from those posed by GSIBs and by smaller banks. Their size, complexity, and reliance on market funding and uninsured deposits would present very substantial risks in resolution, with potential systemic consequences.

I view today's program as an opportunity to have a public discussion about the risks and challenges presented by the resolution of large regional banks.

In order to establish a common baseline of understanding, I will begin today's discussion with a brief description of the FDIC's resolution process under the Federal Deposit Insurance Act. I will then discuss the distinct and underappreciated challenges posed by the resolution of regional banks. Finally, I will conclude with an overview of the actions taken by the FDIC to date to address these challenges.

The FDIC's Resolution Process Under the Federal Deposit Insurance Act

Under the Federal Deposit Insurance Act, the FDIC has the exclusive authority to act as the receiver, or liquidating agent, for failed federally insured depository institutions (IDIs).[2]

As described in the FDIC's Resolutions Handbook,[3] when a bank fails the chartering authority typically revokes the bank's charter and appoints the FDIC as receiver.[4] The chartering

[1] The eight U.S. GSIBs are: Bank of America; Bank of New York Mellon; Citigroup; Goldman Sachs; JPMorgan Chase; Morgan Stanley; State Street; and Wells Fargo.

[2] These insured depository institutions may be banks or thrifts, with national or state charters, but for ease of reference, I will refer to them all as banks in my remarks unless context requires otherwise.

authority is the Office of Comptroller of the Currency (OCC) for nationally chartered banks, and the state banking regulator for state chartered banks.

Prior to failure, a bank's chartering authority notifies the FDIC that the bank is in troubled condition. There is, of course, a supervisory process that may already be underway to avert the failure of the institution. But for purposes of today's discussion, the assumption is that the institution will fail.

Since the passage of the Federal Deposit Insurance Corporation Improvement Act of 1991, the FDIC has been required to choose the resolution method that is least costly to the FDIC's Deposit Insurance Fund. This is the "least cost test."[5]

As a general matter, the FDIC has two options for the resolution of a failed bank.

First, the FDIC can sell some or most of the assets of the failed bank to a healthy acquiring bank, which would also generally assume all of the deposits or only the insured deposits of the failed bank along with some or most of the remaining liabilities. This is generally called a "purchase and assumption transaction".[6] Those assets and liabilities not included in the transaction remain in a receivership administered by the FDIC.

A special type of purchase and assumption transaction that is used when additional time is needed to market a failed institution is a bridge bank. Although it has not been commonly used, it has particular application to the resolution of a large regional bank.

A "bridge bank" is a bank chartered by the OCC and temporarily owned and operated by the FDIC to bridge the time between the date of failure and the date of sale to an acquiring

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[3] FDIC Resolutions Handbook, Revised January 15, 2019: https://www.fdic.gov/bank/historical/reshandbook/index.html; See also Crisis and Response: An FDIC History, 2008-2013: https://www.fdic.gov/bank/historical/crisis/

[4] In certain circumstances, the FDIC has authority to appoint itself as receiver but that authority is seldom exercised. 12 U.S.C. 1821(c).

[5] 12 U.S.C. 1823(c)(4).

[6] FDIC Resolutions Handbook, Chapter 4.

institution.[7] A bridge bank is established only if it is projected to be the least costly resolution alternative for the Deposit Insurance Fund. Before establishing a bridge bank, a cost analysis must show that the "franchise value" of the bank is greater than the marginal cost of operating a bridge bank, thus being less costly than a payout of insured deposits.

A bridge bank may be utilized when a troubled bank fails suddenly, generally because of liquidity issues, preventing timely marketing of the institution; when the failed bank is too complex for potential bidders to conduct due diligence in the normal time frame to submit a bid that accurately captures the franchise value of the failed institution; or both. These are reasons the bridge bank option has particular applicability to the resolution of large regional banks.

If the FDIC does not receive any acceptable bids for a purchase and assumption transaction, or a bridge bank is not less costly, then the FDIC will execute an insured deposit payout, which is the second resolution option. In an insured deposit payout, the insured deposits are paid in full and all assets and the remaining liabilities of the failed bank go into an FDIC receivership for liquidation.

Since 2007, the FDIC has served as receiver for over 525 banks. Only 9 of these failed banks had assets over $10 billion. Thus, the overwhelming majority, over 98 percent, had assets under $10 billion.[8]

Approximately 95 percent of resolutions conducted by the FDIC since 2007 involved purchase and assumption transactions, generally involving a single acquirer assuming nearly all of the failing bank's liabilities.[9] This resolution approach, particularly applicable to community banks, is generally the least disruptive both to depositors and the local community, and the easiest for the FDIC to execute. Only 25 banks since 2007 were resolved through insured deposit

[7] 12 U.S.C. 1821(n).

[8]fdic.gov/bank/individual/failed/bank list.html

[9] Advance Notice of Proposed Rulemaking: Resolution Plans Required for Insured Depository Institutions with $50 Billion or More in Total Assets, 84 Fed. Reg. 16620, 16621 (April 22, 2019).

payouts, reflecting the general availability of acquirers for purchase and assumption transactions for smaller institutions.[10]

In only three resolutions since 2007 was a bridge bank utilized, and only one of those three cases involved an institution with assets above $10 billion.[11] This is really the lead in to the discussion of the challenges posed by the failure of a large regional bank.

Large Regional Bank Resolution

As of the second quarter of this year, there were 39 banks in the United States with total assets between $50 billion and $500 billion. Collectively they hold approximately $6 trillion in assets, or nearly 33 percent of banking industry assets. They hold $4.3 trillion of deposits, or 31 percent of total deposits in 189 million deposit accounts. Of these deposits, $1.8 trillion, or approximately 43 percent, are uninsured based on both the average and the median.[12] These uninsured deposits typically would include business payroll accounts, deposits from large, not-for-profit institutions, and individuals with large balances such as retirees.

The size of these institutions, by definition, limits the universe of banks with the capability to acquire them if they fail. The criteria used by the FDIC to select potential bidders include asset size, capital level, regulatory ratings, geographic location, and minority-owned status.[13] Even a $50 billion bank would be a substantial acquisition for a very large bank to absorb. At the top of the scale at $500 billion, only a GSIB would likely have the capacity to make such an acquisition.

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[10] Beginning in October 2008, Congress had increased the basic deposit insurance amount from $100,000 to $250,000, and separately the FDIC, acting under a systemic risk exception, provided full deposit insurance coverage for non-interest-bearing transaction accounts. The increase to $250,000 was ultimately made permanent in the Dodd-Frank Wall Street Reform and Consumer Protection Act, and the non-interest-bearing transaction account coverage terminated by law on December 31, 2012. The increased deposit insurance coverage during the crisis facilitated all deposit acquisitions by reducing the amounts of uninsured deposits at the time of failure.

[11] One of the three institutions was IndyMac Bank, a $30 billion thrift. Because IndyMac was a thrift, it was technically resolved through a conservatorship. However, the IndyMac conservatorship was functionally equivalent to a bridge bank. Prior to enactment of the Housing and Economic Recovery Act of 2008, Pub. L. No. 110-289 (July 30, 2008), the FDIC's authority to establish a bridge bank did not apply to a thrift. Given this change in the law, future transactions are expected to involve bridge banks rather than conservatorships.

[12] Federal Financial Institutions Examination Council Reports of Condition and Income, Second Quarter 2019.

[13] FDIC Resolution Handbook, Chapter 3, p. 11.

Given the limited number of banks with the capability to acquire a failed regional bank through a traditional purchase and assumption transaction, there is a significant possibility, if not probability, that the FDIC would have to establish a bridge bank to manage the orderly failure of the institution. Managing a failed regional bank through a bridge bank would pose a number of challenges to the FDIC, some of which could also apply in the traditional purchase and assumption transaction.

First, even though regional banks generally do not have the extensive international operations and diversified nonbank business lines that characterize the Global Systemically Important Banks, many nevertheless have large branch networks, substantial IT systems, and millions of account holders. This complexity, certainly as compared to smaller banks, would make the management of a bridge bank a significant operational challenge for the FDIC.

Second, regional banks rely to a larger extent on credit sensitive market funding than smaller banks. They are thus more susceptible to a rapid failure caused by a lack of liquidity, greatly complicating an orderly resolution.

Third, the sheer volume of accounts held by these institutions would pose a large challenge to the FDIC to make a rapid determination over the weekend after the failure of the institution as to which accounts were insured and which were not. As of the second quarter of 2019, these banks had an average of 4.8 million deposit accounts, with 27.4 million deposit accounts at the institution at the top of the range.[14] A rapid determination and payment of insured accounts is essential for an orderly resolution.

Fourth, unlike GSIBs, which are required to maintain a minimum amount of long-term[15] unsecured debt to absorb losses in the event of failure, regional banks are not subject to such a requirement. As a result, there is significant variability in the holdings of unsecured debt by regional banks. On average, these banks hold $3.9 billion in long-term unsecured debt, which is 2.5 percent of total assets. While five of these banks hold long-term unsecured debt of 4.5

[14] FFIEC Reports of Condition and Income, Second Quarter 2019.

[15] Long-term debt typically refers to debt with a remaining maturity of 12 months or longer. See, e.g., 12 C.F.R. Part 252.

percent or more of total assets, eight report no long-term unsecured debt.[16] Depending on the institution, a buffer of unsecured debt to absorb losses in resolution might or might not be available.

Finally, the heavy reliance of these institutions on uninsured deposits would pose a significant resolution challenge. As I mentioned, the most recent Call Report data indicate that, on average, approximately 43 percent of the deposits at regional banks with assets from $50 to $500 billion are uninsured. Although the FDIC's resolution experience indicates that Call Report data generally overstate the volume of uninsured deposits to some degree, it is nonetheless clear that regional banks have a heavy reliance on uninsured deposits for funding. In a resolution where there is no acquiring institution, and possibly little or no unsecured debt to absorb losses, it is likely that the least cost test would require that uninsured depositors take losses.

Given the heavy reliance of regional banks on uninsured deposits, uninsured depositors' taking losses at a failed regional bank could have knock-on consequences for other regional banks, particularly in a stressed economic environment.

<u>The Examples of Washington Mutual Bank and IndyMac</u>

The challenges posed by a regional bank failure are illustrated by two examples from the financial crisis: Washington Mutual Bank and IndyMac Bank.

Washington Mutual, with over $300 billion in assets at the time of its failure in September 2008, was the largest thrift institution in the United States and the 6th largest insured depository institution. Its failure was the largest in the FDIC's history.[17]

Several factors made it possible for Washington Mutual to fail with no loss to the Deposit Insurance Fund and no loss imposed on its $45 billion of uninsured deposits, which was approximately 24 percent of total deposits.[18]

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[16] FFIEC Reports of Condition and Income, Second Quarter 2019.
[17] Crisis and Response at 182.
[18] FFIEC Reports of Condition and Income, Second Quarter 2008.

First, there was an acquirer for Washington Mutual with the capacity to assume all the assets and all the deposits – both insured and uninsured– of the failed institution through a traditional purchase and assumption transaction.

Second, not only did the acquirer have the capacity to undertake the transaction, but because it had attempted to acquire Washington Mutual on an open institution basis prior to its failure, the acquirer had already done the due diligence necessary to enable it to act quickly when Washington Mutual failed.

Third, Washington Mutual had a substantial volume of unsecured debt -- $13.8 billion, or 4.5 percent of total assets -- which was available to absorb losses in resolution.[19] This loss absorbing capacity was essential to meeting the least cost test and for uninsured depositors to avoid taking a loss.

If these factors had not been in place at the time of Washington Mutual's failure, the FDIC likely would have had to establish a bridge bank and take over the operation of the failed institution. The failure of Washington Mutual in that scenario would have wiped out the Deposit Insurance Fund, and uninsured depositors would likely have had to take a loss in order to meet the least cost test.[20]

Given the stressed economic and financial environment in September 2008 when Washington Mutual failed, imposing a loss on $45 billion of uninsured deposits could have had a significantly destabilizing effect. The only way to avoid that outcome would have been for the FDIC to exercise the systemic risk exception available under the Federal Deposit Insurance Act in order to set aside the least cost test. That would have been a very difficult judgment to make, and illustrates the potential systemic risk associated with the failure of a large regional bank.

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[19] Unsecured debt is from the Receivership Balance Sheet, Second Quarter 2019, https://receivership.fdic.gov/drripbal/bank/10015 , and total assets are from the FFIEC Reports of Condition and Income, Second Quarter 2008.

[20] Notice of Proposed Rulemaking: Proposed Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements, 83 Fed. Reg. 66024, 66029 fn. 27 (Dec. 21, 2018), citing Offices of Inspector General, U.S. Department of Treasury and FDIC, Evaluation of Federal Regulatory Oversight of Washington Mutual Bank (April 2010).

The risks of a regional bank resolution are illustrated further by the failure in July 2008 of IndyMac Bank, a $30 billion thrift.

When IndyMac failed, there was no viable acquirer, and it had no unsecured debt. The FDIC had to establish a bridge bank,[21] impose a loss on $2.6 billion of uninsured deposits, which was almost 14 percent of total deposits,[22] and then manage the failed institution over a nine-month period during which the failed institution was partially wound down and eventually sold.

The lack of public familiarity with the failure of an institution of even this size was enough to cause a local reaction and lines around the institution on the Monday after failure. IndyMac turned out to be the most costly failure in the FDIC's history, resulting in a $12.4 billion loss to the Deposit Insurance Fund.[23]

The lesson here is pretty clear. A $300 billion institution could fail without cost to the Deposit Insurance Fund and no losses to uninsured depositors, so long as there was a viable acquirer who could undertake an all-deposit purchase and assumption transaction and unsecured debt available to absorb losses. However, a $30 billion institution which had no unsecured debt and for which there was no viable acquirer resulted in the largest loss to the Deposit Insurance Fund in the FDIC's history, losses to uninsured depositors, and some reaction in the local community.

FDIC Actions to Address Regional Bank Resolution

Since the financial crisis, the FDIC has undertaken a number of initiatives to enhance its ability to manage the orderly failure of a regional bank, including through a bridge bank if necessary.

Since 2011, the FDIC has by rule required banks with assets over $50 billion to prepare resolution plans for the insured depository institution as a complement to the holding company resolution plan required under Title I of the Dodd-Frank Act.

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[21] See footnote 10.

[22] Uninsured deposit losses in IndyMac were reduced as a result of section 335 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, enacted in July 2010. The Act applied the increase in deposit insurance coverage to $250,000 retroactively to any failure on or after January 1, 2008, and made it permanent. Pub. L. No. 111-203 (July 21, 2010). 12 U.S.C. 1821(a)(1)(E).

[23] Crisis and Response at 182.

The preamble to the 2011 rule stated its purpose, "the Rule requires a limited number of the largest insured depository institutions to provide the FDIC with essential information concerning their structure, operations, business practices, financial responsibilities, and risk exposures. The Rule requires these institutions to develop and submit detailed plans demonstrating how such insured depository institutions could be resolved in an orderly and timely manner in the event of receivership."[24]

In 2014, the federal banking agencies adopted a rule implementing a quantitative liquidity coverage ratio.[25] A company subject to the rule was required to maintain an amount of high quality liquid assets that is no less than 100 percent of its total net cash outflows over a prospective 30-calendar day period. The rule applied to bank holding companies and insured depository institutions with $250 billion or more in total assets. The Federal Reserve also adopted a modified liquidity coverage ratio standard based on a 21-calendar day stress scenario that applied to bank holding companies with total consolidated assets between $100 billion and $250 billion.

This rule, like the resolution plan rule, was based on the experience from the financial crisis that the liquidity failure of a large banking organization can occur very quickly. High quality liquid assets sufficient to provide a 30-day runway before failure for institutions with assets over $250 billion, and a 21-day runway for institutions with assets between $100 billion and $250 billion, were important requirements, from the FDIC's perspective, given the risks associated with the failure of institutions of that size and the value to the FDIC of having an assured minimum period of time for preparation before the failure of such institutions.

Finally, in November 2016, the FDIC adopted a rule requiring institutions with over two million deposit accounts to improve the quality of their deposit data and make changes to their information systems so that the FDIC could make a rapid and accurate deposit insurance determination to facilitate the prompt payment of FDIC-insured deposits when large depository institutions fail. As the preamble to the final rule pointed out, "prompt payment of deposit insurance maintains public confidence in the FDIC, the banking system and overall financial

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[24] Interim Final Rule: Resolution Plans Required for Insured Depository Institution with $50 Billion or more in Total Assets, 76 Fed. Reg. 58379 (Sept. 21, 2011).

[25] Final Rule: Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, 79 Fed. Reg. 61439 (Oct. 10, 2014).

stability."[26] The rule applies to 23 of the 39 institutions with assets between $50 billion and $500 billion.

The preamble to the 2016 rule also stated the broad policy concern that led to its adoption, consistent with the resolution plan and liquidity coverage ratio rulemakings, "While the likelihood of any particular covered institution's failure may be low at a given point in time, history suggests that the financial condition of institutions that are perceived to be in good health can deteriorate quickly and with little notice. In 2008 and 2009, several large insured depository institutions failed, including IndyMac Bank and Washington Mutual Bank. In general, very large IDIs rely on credit-sensitive funding more than smaller IDIs do, which makes them more likely to suffer a rapid liquidity failure."[27]

In addition to these rulemakings, the FDIC has been focused internally on planning for the resolution of a large regional bank because of the risks discussed.

Based on the work done, an area where additional rulemaking might be prudent to facilitate the orderly failure of a large regional bank would be an unsecured debt requirement to assure a comparable measure of loss absorbing resources in resolution for these institutions.

Unfortunately, instead of further measures to strengthen the FDIC's capabilities, there have recently been a number of measures finalized or proposed that would weaken or remove the requirements of these rulemakings.

In July of this year, the FDIC approved a final rule to allow banks with two million or more deposit accounts to delay from 2020 to 2021 their compliance with the requirement to improve their data and reconfigure their systems to support the FDIC's ability to make rapid deposit insurance determinations in the event of the failure of the institution.[28] This additional year extended the original three-year compliance period in the 2016 rule, which took effect in April 2017. The final rule also weakened the compliance requirements that had been established to ensure effective implementation of the rule.

[26] Final Rule: Recordkeeping for Timely Deposit Insurance Determination, 81 Fed. Reg. 87734, 87746 (Dec. 5, 2016).
[27] Id.
[28] Final Rule: Recordkeeping for Timely Deposit Insurance Determination, 84 Fed. Reg. 37020 (July 30, 2019).

In April, the FDIC issued an Advance Notice of Proposed Rulemaking that, while identifying the risks associated with a large bank failure, nevertheless seeks comment on a number of proposals that would weaken the current resolution plan requirements for insured depository institutions.[29] For example, alternatives put forward for comment in the Advance Notice of Proposed Rulemaking would reduce the resolution plan content requirements for the largest insured depository institutions, reduce the frequency of resolution plan submissions, and eliminate the IDI plan all together for the smaller IDIs above $50 billion in assets.

Just yesterday, the FDIC Board adopted a joint final rule with the Federal Reserve that would eliminate the Dodd-Frank Act Title I resolution plan requirements at the holding company level, with one exception, for institutions with assets between $100 billion and $250 billion. It would also require the submission of such plans for institutions with assets between $250 billion and $500 billion just once every three years, with a full plan required only every six years, rather than every year as is now the case.[30]

In a separate joint final rule with the Federal Reserve and the OCC, the FDIC Board approved yesterday eliminating, with one exception, the liquidity coverage ratio for banking organizations with assets between $100 billion and $250 billion, and leaving in place a liquidity coverage ratio for banks with assets between $250 and $500 billion that would be only 85 percent of the current requirement.[31]

Given the risks associated with the failure of large regional banks, these measures are unwarranted and misguided. They only increase the challenges posed by the resolution of these institutions and the potential for disorderly failure, and disregard the lessons of the financial crisis.

[29] Advance Notice of Proposed Rulemaking: Resolution Plans Required for Insured Depository Institutions with $50 Billion or More in Total Assets, 84 Fed. Reg. 16620 (April 22, 2019).

[30] www.fdic.gov/news/board/2019/2019-10-15 .

[31] Id.

Conclusion

Thank you for the opportunity today to draw attention to the challenges posed by the failure of a large regional bank.

I have been increasingly concerned that the attention that has been given to the failure of Global Systemically Important Banks since the financial crisis, while entirely appropriate, may have obscured the risks associated with the failure of a large regional bank and permitted an unjustified sense of confidence to develop that the failure of such an institution would not be challenging. I believe the experience during the crisis of a large regional bank failure such as Washington Mutual, and even a smaller $30 billion institution failure such as IndyMac, illustrates the very real risks a regional bank failure would present.

Going forward, I believe that attention to this issue should be a top priority for the FDIC, for the other federal and state bank regulatory agencies, and for the banking industry.

Thank you.