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The Resolution of Large Regional Banks - Lessons Learned
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Introduction

Good afternoon. I would like to thank the Brookings Institution Center on Regulation and Markets, and my friend Aaron Klein, for inviting me to speak here today.

Four years ago, I had the opportunity to speak at Brookings about an underappreciated risk – the resolution of large regional banks in the United States.¹

The key point made in that speech was that, while regional banks may not be as large, complex, and internationally active as the Global Systemically Important Banks – or G-SIBS as they are called – they would pose distinct and significant challenges in resolution that could raise serious financial stability risks. In particular, the speech pointed out the heavy reliance of regional banks on uninsured deposits for funding. That reliance has the potential to create a destabilizing contagion effect on other banks if one regional bank were to fail and uninsured depositors took losses.

In order to illustrate the point, the speech contrasted the failures of Washington Mutual Bank and IndyMac Bank during the Global Financial Crisis of 2008. Washington Mutual, a $300 billion thrift institution, was the largest bank failure in U.S. history. Yet it was resolved at no cost to the Deposit Insurance Fund,

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¹ Remarks by Martin J. Gruenberg, Member, Board of Directors of the Federal Deposit Insurance Corporation on An Underappreciated Risk: The Resolution of Large Regional Banks in the United States to The Brookings Institution Center on Regulation and Markets; Washington, D.C., October 16, 2019, available at FDIC: Speeches & Testimony - 10/16/2019
and uninsured depositors suffered no losses.\(^2\) IndyMac, a $30 billion thrift, was one-tenth the size of Washington Mutual. Yet it was the costliest failure in FDIC history up to that point, at over $12 billion, and uninsured depositors suffered losses.\(^3\)

A number of reasons led to the differing outcomes in these two cases. A particularly important one, that I will come back to discuss, was that Washington Mutual had sufficient unsecured debt to absorb all of the losses of the bank and IndyMac had none.

If we had any doubts about the challenges in resolving regional banks – and the potential for significant adverse impact on the financial system – they were dispelled by the failure this spring of three large regional banks - Silicon Valley Bank (SVB), Signature Bank (Signature), and First Republic Bank (First Republic). While the FDIC resolved all three institutions in a manner that mitigated systemic risk, that outcome was by no means certain. In particular, the resolution of SVB and Signature required the use of extraordinary authority by the FDIC, the Federal Reserve, and the Secretary of the Treasury -- the systemic risk exception under the Federal Deposit Insurance Act (FDI Act) -- to protect uninsured depositors at those institutions, setting aside the least cost requirement to the Deposit Insurance Fund.\(^4\)

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\(^3\) FDIC Establishes IndyMac Federal Bank, FSB as Successor to IndyMac Bank, F.S.B., Pasadena, California ; Crisis and Response at 117.

\(^4\) Joint Statement of the Department of the Treasury, Federal Reserve, and FDIC, March 12, 2023, available at FDIC: PR-17-2023 3/12/2023. As a general rule, section 13(c)(4) of the FDI Act requires the FDIC to resolve failed insured depository institutions at the least cost to the Deposit Insurance Fund, but provides an exception for instances where the failure will have would have serious adverse effects on economic conditions or financial stability, and any action to be taken would avoid or mitigate such adverse effects. 12 U.S.C. 1823(c)(4).
That experience should focus our attention on the need for meaningful action to improve the likelihood of an orderly resolution of large regional banks under the FDI Act, without the expectation of invoking the systemic risk exception.

Today I would like to revisit the issue of the resolution of large regional banks in the United States in light of our recent experience. In particular, I believe there are important changes to capital regulation, resolution planning requirements including long-term debt, bank supervision, and deposit insurance pricing that would make a repetition of what occurred much less likely.

Regional Bank Resolution and the Spring of 2023

Just to provide context, it may be worth recounting the events of earlier this year.

When Silicon Valley Bank failed overnight on Friday, March 10th, the FDIC initially established a Deposit Insurance National Bank (DINB), under FDIC control, so that depositors would have access to their insured funds on the Monday after failure. Uninsured depositors would have access to a substantial portion of their funds through the payment of an Advance Dividend. A portion of the uninsured deposits would be held back in the receivership and would experience losses depending on the losses to the Deposit Insurance Fund.5

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5 FDIC: PR-16-2023 3/10/2023. See 12 U.S.C. 1821(m). Under a Deposit Insurance National Bank structure, all insured depositors will typically have full access to their insured deposits no later than the next business day. The FDIC will pay uninsured depositors an advance dividend based on a valuation of the assets of the failed institution, and they will receive a receivership certificate for the remaining amount of their uninsured funds. As the FDIC sells the assets of the failed bank, future dividend payments may be made to uninsured depositors.
As it turned out, the prospect that uninsured depositors at Silicon Valley Bank would possibly experience losses alarmed uninsured depositors at other similarly situated banks, and they began to withdraw funds. Signature Bank and First Republic Bank also experienced heavy withdrawals. A contagion effect became apparent at these and other banks. There was clear evidence that the failure of a regional bank in which uninsured depositors faced losses could cause systemic disruption.

In response, on Sunday the U.S. authorities invoked the systemic risk exception to the least-cost test. This allowed the FDIC to fully protect all depositors at Silicon Valley Bank and Signature Bank. They were placed into separate bridge banks under FDIC control. Signature Bank was sold a week later to Flagstar Bank, a subsidiary of New York Community Bank, and Silicon Valley Bank was sold two weeks later to First Citizens Bank of North Carolina.

As you know, First Republic Bank also experienced large deposit outflows that weekend but managed to survive. The bank spent the next few weeks trying to raise capital, but was unsuccessful. On May 1st, the state of California closed the bank. The FDIC had time before the bank was closed to conduct a competitive bidding process, which resulted in JPMorgan Chase submitting the least-cost bid and purchasing all of the assets and assuming all of the deposits of First Republic. The winning bid covered all uninsured depositors under the least-cost test and did not require a systemic risk exception.

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7 FDIC: PR-21-2023 3/19/2023  
8 FDIC: PR-23-2023 3/26/2023  
9 FDIC: PR-34-2023 5/1/2023
Lessons Learned and Next Steps

So what are the lessons to take away from this experience?

The three banks that failed this spring shared common characteristics that made them more vulnerable to a run.

Reports from the Federal Reserve and the FDIC on the failures of Silicon Valley Bank and Signature Bank, respectively, found that they were poorly managed and not responsive to supervisory feedback, and their supervisors were not forceful enough in requiring them to take corrective measures.\(^{10}\)

In addition, the three banks grew rapidly and relied heavily on uninsured deposits for funding. Two of them had uninsured deposits approximating 90 percent of their funding, and the third approached 70 percent.

Further, two of them had unrealized losses on securities or low yield loan portfolios that were large relative to their capital base. All three had little or no long-term debt outstanding.

These characteristics proved to be a toxic combination when each bank faced stress. In addition, the resolution plans that had been received from two of the three banks were limited in content.

\(^{10}\) Available at [The Fed - Review of the Federal Reserve’s Supervision and Regulation of Silicon Valley Bank](https://www.federalreserve.gov/pubs/oss/oss167.htm) and [FDIC’S SUPERVISION OF SIGNATURE BANK](https://www.fdic.gov/bank/individual/failed/2023/svb/si_signbank107523.pdf)
There are some obvious lessons here that we now have an opportunity to address.

**Capital Treatment of Unrealized Losses**

In late July, the three federal banking agencies issued a Notice of Proposed Rulemaking to implement the Basel III capital rule. There are many aspects to this proposal, but one in particular is a step toward addressing one of the key vulnerabilities of the recent failures. Under the proposal, unrealized losses on available for sale securities would flow through regulatory capital for all banks with more than $100 billion in assets. This means that these banks, in order to maintain their capital levels, would need to retain or raise more capital as these unrealized losses occur.

It is worth noting that, although Silicon Valley Bank’s failure was caused by a liquidity run, the loss of market confidence that precipitated the run was prompted by the sale of available for sale securities at a substantial loss that raised questions about the capital adequacy of the bank. This loss of confidence followed the announced self-liquidation of another local institution, Silvergate, a day earlier. That institution had announced its sale of available for sale securities at a substantial loss and planned capital raise just a week earlier. Had Silicon Valley Bank been required to hold capital against the unrealized losses on its available for sale securities, as the proposed Basel III framework would require, the bank might have averted the loss of market confidence and the liquidity run. That is because there would have been more capital held against these assets.

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Long-Term Debt Requirement

In addition to capital, the banking agencies will in the near future propose a long-term debt requirement for banks with $100 billion or more in assets.

In October 2022, the FDIC and Federal Reserve jointly issued an Advance Notice of Proposed Rulemaking (ANPR) on Resolution-Related Resource Requirements for Large Banking Organizations. Based on the feedback from the ANPR, the agencies, joined by the Office of the Comptroller of the Currency, have worked to develop a proposed rulemaking. The three agencies look forward to acting on that proposal soon.

The agencies expect to propose that each covered bank be required to issue long-term debt sufficient to recapitalize the bank in resolution. While many regional banks have some outstanding long-term debt, the new proposal will likely require issuance of new debt.

We expect the proposal to provide for a reasonable timeline to meet the debt requirement and to take into account existing debt outstanding. As indicated, the proposal is likely to apply to all banks over $100 billion in total assets, an outcome certainly influenced by the events of earlier this year.

Such a long-term debt requirement bolsters financial stability in several ways. It absorbs losses before the depositor class – the FDIC and uninsured

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depositors – take losses. This lowers the incentive for uninsured depositors to run. Even if the institution fails, the buffer of long-term debt reduces cost to the Deposit Insurance Fund, and makes it more likely that a closing weekend sale could comply with the statutory least-cost test and avoid the need for a systemic risk exception. Further, it creates additional options in resolution, such as recapitalizing the failed bank under new ownership or breaking up the bank and selling portions of it to different acquirers, as an alternative to a merger with another large institution.

Since this debt is long-term, it will not be a source of liquidity pressure when problems become apparent. Unlike uninsured depositors, investors in this debt know that they will not be able to run when problems arise. This gives them a greater incentive to monitor risk in these banks and exert pressure on management to better manage risk. Finally, because these instruments are publicly traded, their prices serve as a signal of the market’s view of risk in these banks.

Resolution Plans for Insured Depository Institutions (IDI Plans)

An important complement to a long-term debt requirement is meaningful resolution plans for these large regional banks. There is currently a requirement for these banks to file plans that address the resolution of the insured depository institution under the FDI Act.13 This is separate from the Dodd-Frank Act Title I resolution plans that apply to large bank holding companies. The FDIC will soon propose changes to the IDI plan requirements that would make them significantly more effective.

13 12 CFR 360.10.
The IDI Plan Rule, first adopted in 2011, requires banks with over $50 billion in total assets to periodically submit resolution plans to provide the FDIC with information about the bank that is essential to effective resolution planning, and to support the execution of a resolution if necessary. The Rule requires covered banks to “develop and submit detailed plans demonstrating how [they] could be resolved in an orderly and timely manner in the event of receivership.”14 Over the years, the FDIC has given banks feedback and guidance with respect to their plans and has considered different approaches to the planning requirements.

The FDIC has continued to consider ways to improve the effectiveness of these resolution plans and to set clear expectations for the banks with respect to the content of these plans. We have determined that a rulemaking is the best approach to meet those goals in a way that is both transparent and effective. To that end, the FDIC plans to issue a notice of proposed rulemaking in the near future that will be a comprehensive restatement of the rule for notice and comment. In developing the proposal, we have incorporated the most useful elements of past feedback and guidance, as well as lessons learned from past plans and resolutions.

Institutions under $100 billion can also present resolution challenges, and while we do not propose requiring full plans for these banks under the strengthened rule, we will propose requiring certain information from banks over $50 billion to inform our resolution planning.

The importance of this work was underscored this spring. While Silicon Valley Bank and First Republic had been required to file resolution plans which provided basic information that was useful, far more robust plans would have been helpful in dealing with the failure of these institutions. Signature Bank failed before it would have been required to file its first resolution plan in June.

For example, some of the elements that would have been helpful this spring include the bank’s:

- capability to promptly establish a virtual due diligence data room, and populate it with enough information for interested parties to bid on the bank or certain of its assets or operations;
- maintenance of information necessary for operational continuity of the bank, including a more thorough description of key personnel and retention plans, critical third party and shared services, and payments and trading activities; and
- ability to describe communications systems and strategies for reaching internal and external key stakeholders in the event of a resolution.

While each of the three bank failures this spring ultimately concluded in a sale to a single acquirer, it is also clear that a sale to a single acquirer may not always be possible. Therefore the proposed rule will seek to expand the options available to the FDIC.

The proposed rule would require a bank to provide a strategy that is not dependent on an over-the-weekend sale. It would require a bank to explain how it could be placed into a bridge, how operations could continue while separating
itself from its parent and affiliates, and the actions that would be needed to stabilize a bridge.

The rule would also require banks to identify franchise components, such as asset portfolios or lines of business that could be separated and sold, in order to provide additional options for exiting from resolution by disposing of parts of the bank to reduce the size of a remaining bank and expand the universe of possible acquirers.

A stronger resolution planning requirement for large regional banks, combined with a long-term debt requirement, would provide a much stronger foundation for the orderly resolution of these institutions.

Supervision and Deposit Insurance Pricing to Address to the Liquidity Risks of Uninsured Deposits

Finally, the bank failures earlier this year highlighted the vulnerabilities that can result when banks have a heavy reliance on uninsured deposits for funding. The significant proportion of uninsured deposit balances exacerbated deposit run vulnerabilities and made all three banks susceptible to contagion effects from the quickly evolving financial developments.

Heavy reliance on uninsured deposits for funding carries a number of liquidity risks. First, large uninsured depositors, such as businesses, non-profit organizations, and wealthy depositors, are likely to be more sophisticated and more attuned to market developments than retail depositors, and thus may be more likely
to withdraw funds quickly. Second, such deposit accounts are often concentrated in a relatively small number of depositors, also making them more susceptible to runs. Third, electronic banking services allow for the instantaneous withdrawal of large uninsured deposits. Finally, liquidity runs on uninsured deposits can be amplified and exacerbated through social media.

For the banking industry as a whole, reliance on uninsured deposit funding has been increasing. The FDIC’s report, Options for Deposit Insurance Reform,\(^\text{15}\) notes that in the aggregate, uninsured deposits rose from about 18 percent of domestic deposits in 1991 to nearly 47 percent at their peak in 2021, higher than at any time since 1949. The aggregate concentration of uninsured deposit funding has since come down slightly from 2021 but still remains high.

Concentrations of uninsured deposit funding are more common among large banks. At year-end 2022, banks with more than $50 billion in assets were approximately one percent of banks but held nearly 80 percent of all uninsured deposits. And, the majority of domestic deposits were uninsured for more than 40 percent of those banks. Although reliance on uninsured deposits is a more common issue for larger banks, it is not exclusively a large bank issue. Uninsured deposits comprised the majority of domestic deposits for about 15 percent of banks between $1 billion and $50 billion in assets.

As noted previously, uninsured deposit funding tends to come from a relatively small number of depositors. At the end of 2022, less than one percent of all deposit accounts had balances above the deposit insurance limit of $250,000 but

\(^{15}\) FDIC: Options for Deposit Insurance Reform (May 1, 2023), available at [FDIC: Options for Deposit Insurance Reform](https://www.fdic.gov/boards/commissions/insurance/改革/Options_for_Deposit_Insurance_Reform.html).
accounted for over 40 percent of banking industry deposits. At the time of its failure, Silicon Valley Bank’s ten largest deposit accounts collectively held $13.3 billion in deposits.¹⁶

More forward-leaning supervision of large regional banks is certainly a key lesson from the events earlier this year. In particular, the FDIC is reviewing whether its supervisory instructions on funding concentrations should be bolstered to better capture risks related to high levels of uninsured deposits generally or types of deposits more specifically, such as business operating account deposits. For example, FDIC examiner instructions could establish a specific threshold for concentrations of uninsured deposits, which would require examiners to devote supervisory attention to the concentration. Regulators and other stakeholders may also benefit from more granular, and more frequent, reporting of deposits. These are matters of priority attention for the FDIC.

In addition, risk-based deposit insurance pricing¹⁷ can deter banks from relying too heavily on less stable forms of funding such as uninsured deposits and can maintain fairness by charging banks with unstable funding sources for the risk they pose to the Deposit Insurance Fund. For this reason, it is worth reexamining the ways in which deposit insurance pricing captures the risks of uninsured deposits. However, calibrating precisely the risk of uninsured deposits is a challenge. Therefore, while deposit insurance pricing may be a useful tool, it is best seen as a complement to other tools that mitigate the risk of over-reliance on uninsured deposits.

¹⁶ This information is taken from Silicon Valley Bank’s records at the time of failure.
¹⁷ See section 7(b) of the FDI Act (12 U.S.C. 1817(b)), requiring a risk-based pricing system, and 12 CFR Part 327, the FDIC’s implementing regulations
Conclusion

In conclusion, the failure of three large regional banks this spring, and the need to exercise a systemic risk exception to protect uninsured depositors at two of them, demonstrated clearly the risk to financial stability that large regional banks can pose. It makes a compelling case for action by the federal bank regulatory agencies to address the underlying vulnerabilities that made the failure of these institutions possible.

The federal banking agencies have the statutory authorities to address these vulnerabilities. As I have outlined, the agencies’ actions include requiring long-term debt, capital recognition for unrealized losses for available for sale securities, and strengthened bank resolution plans, as well as enhancing supervisory attention to uninsured deposit concentrations and considering adjustments to risk-based pricing for deposit insurance. Once implemented, these measures will mitigate these risks and enhance the stability and resilience of the U.S. banking system.

These are perhaps lessons we should have learned from the 2008 financial crisis. The events of earlier this year provide us with another opportunity. This time I don’t think we’ll miss.

Thank you.