Comments on:

Long-Term Debt Requirements for Large Bank Holding Companies, Certain Intermediate Holding Companies of Foreign Banking Organizations, and Large Insured Depository Institutions

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Introduction

I gladly respond to the notice of proposed rulemaking (NPR) regarding long-term debt (LTD) requirements issued by the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board), and the Federal Deposit Insurance Corporation (FDIC and, together with the OCC and Board, the Agencies).[1] If implemented effectively, this proposed rule will enhance financial stability, encourage market discipline, mitigate systemic risk in the financial system, and provide the FDIC significantly greater leeway in resolving systemically important financial institutions (SIFIs).[2]

The Agencies should consider the following changes to enhance the rule's effectiveness should it be adopted:

1. Add a conversion feature to the LTD required of insured depository institutions (IDIs).
2. Base the amount of LTD to be held by IDIs on expected failure costs.
3. Phase in the IDI LTD requirement.
4. Implement a rolling requirement for LTD maturities.
5. Reconsider certain requirements for externally issued LTD.
6. Remove LTD dollar requirements for covered holding companies (HCs).

These proposed changes are discussed in more detail below. But first, I cover the objectives of the NPR and then turn to an analysis of the three SIFIs that failed earlier this year: Silicon Valley Bank (SVB), Santa Clara, California; Signature Bank (SBNY), New York, New York; and First Republic Bank (First Republic and, together with SVB and SBNY, the 2023 Failures), San Francisco, California. The lessons learned from the 2023 Failures and those from the 2008 resolutions shed essential light on the need for an effective LTD requirement and its attributes.

NPR Objectives

The Agencies' objectives, as stated in the NPR, include the following:

1. Reduce systemic risk contagion.
2. Safeguard stability in the financial system.
3. Promote resiliency among banking organizations.
4. Reduce potential costs to the Deposit Insurance Fund (DIF).
5. Expand the options available in resolving failed entities, increasing the likelihood of an orderly resolution.
6. Ensure there will be a sufficient amount of LTD for the institution to meet leverage capital requirements, common equity tier 1 risk-based capital requirements, and the capital conservation buffer in the event of failure.
7. Ensure that bank holding companies (BHCs) and savings and loan holding companies (SLHCs) serve as a source of strength to subsidiary entities.
8. Enhance market discipline.

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[1] See 88 Federal Register 64524 (September 19, 2023) at https://www.govinfo.gov/content/pkg/FR-2023-09-19/pdf/2023-19265.pdf.
[2] I am an FDIC retiree (2014) who joined the agency in 1980 after receiving a Ph.D. in Economics from Iowa State University. I started with the FDIC's Division of Research and Strategic Planning but eventually moved to the Division of Resolutions and Receiverships. My large-bank resolution experience dates back to the collapse of Continental Illinois National Bank and Trust in 1984. The views and opinions expressed herein are mine alone.

Many of these objectives are interrelated. Safeguarding financial stability and promoting resiliency among banking organizations are directly related to systemic risk. Expanding options to resolve failed entities will most certainly reduce costs to the DIF, as another example. However, reducing systemic risk contagion stands out among these eight objectives. The failures of SVB and SBNY required a systemic risk exception that protected all depositors, something considered an option of last resort, especially since it involved consultation with the President of the United States and an implicit admission of plans gone wrong. The Dodd–Frank Wall Street Reform and Consumer Protection Act devoted much effort to eliminating systemic risk exceptions.

Protection of all deposits by the FDIC in select bank failures contradicts its intended mission of covering only insured deposits. It is unfair to other IDIs not afforded this governmental subsidy. Throughout this paper, the primary objective is the mitigation of systemic risk. If implemented effectively, the LTD proposal outlined in the NPR will significantly diminish systemic risk in the financial system. To underscore why, I now discuss the 2023 Failures (in the order in which they occurred).

2023 Failures

SVB

SVB had total assets of $209 billion, making it (briefly) the second largest failure in FDIC history, eclipsed only by the September 25, 2008 failure of the $307 billion Washington Mutual Bank (WaMu). Interestingly, the WaMu transaction was costless to the FDIC thanks mainly to the bank holding $7.7 billion of subordinated debt and $6.1 billion of long-term senior notes (amounting to 4.5 percent of total assets).[3] In comparison, the SVB failure is now the FDIC's most expensive resolution at an estimated cost of $17.8 billion.[4] SVB's estimated failure costs amount to 8.5 percent of total assets, an unusually high level for a bank of this size. In contrast to WaMu, SVB held no subordinated debt or senior long-term notes.

SVB was owned by SVB Financial Group (SVB Financial), a diversified financial services company, a bank holding company, and a financial holding company.[5] SVB Financial offered services primarily to technology, life science/healthcare, private equity/venture capital, and premium wine industries through its subsidiaries and affiliates. SVB Financial's subsidiaries included SVB, SVB Capital (a venture capital and credit investment group), and SVB Securities (an investment bank). SVB had a subsidiary bank in the U.K. and branch offices in Germany, Canada, and the Cayman Islands.

SVB grew rapidly in the years immediately before failure, going from $70 billion in total assets at year-end 2019 to $209 billion at the time of failure. Despite this growth, SVB and SVB Financial were very well capitalized at the end of 2022 (see Table 1).

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[3] See FDIC, WASHINGTON MUTUAL BANK - Receivership Balance Sheet Summary at https://receivership.fdic.gov/drripbal/bank/10015?FIN=10015.

[4] See FDIC, BankFind Suite: Bank Failures & Assistance Data at https://banks.data.fdic.gov/bankfind-suite/failures?.

[5] For more information, see SVB Financial Group's 2022 Form 10-K at https://d18rn0p25nwr6d.cloudfront.net/CIK-0000719739/f36fc4d7-9459-41d7-9e3d-2c468971b386.pdf.

Table 1. SVB Financial December 31, 2022, Capital Positions[6]

	SVB Financial	SVB	Required Ratio
CET1 Risked-Based Capital	12.05%	15.26%	7.0%
Tier 1 Risked-Based Capital	15.40%	15.26%	8.5%
Total Risked-Based Capital	16.18%	16.05%	10.5%
Tier 1 Leverage	8.11%	7.96%	4.0%

SBNY

SBNY had total assets of $110 billion. The FDIC estimates SBNY's failure will cost $0.88 billion,[7] or 0.80 percent of total assets, a relatively low number for a bank of this size.

SBNY, not owned by a holding company, was a full-service commercial bank with 40 private client offices in the New York metropolitan area, Connecticut, California, Nevada, and North Carolina.[8] SBNY catered mainly to privately owned businesses, their owners, and senior management. SBNY's subsidiaries included Signature Financial (a specialty finance company), Signature Securities (brokerage, asset management, and insurance products), and Signature Public Funding (municipal finance and tax-exempt lending and leasing products to government entities). SBNY had no foreign branches or subsidiaries.

SBNY grew rapidly in the years immediately before failure, going from $51 billion in total assets as of year-end 2019 to $110 billion at the time of failure. SBNY was more than well-capitalized, despite this growth, at the end of 2022 (see Table 2).

First Republic

First Republic had total assets of $213 billion, displacing SVB as the second-largest bank failure in FDIC history. The FDIC estimates the First Republic failure will cost $16.5 billion,[9] or 7.8 percent of First Republic's total assets, making it the second most expensive failure in the FDIC's history.[10] As with SVB, First Republic's failure was costly for its size.

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[6] SVB Financial Group's 2022 10-K, page 13.
[7] See FDIC, BankFind Suite: Bank Failures & Assistance Data at https://banks.data.fdic.gov/bankfind-suite/failures?.
[8] For more information, see Signature Bank's 2022 10-K filed with the FDIC at https://efr.fdic.gov/fcxweb/efr/fcxservlet/PublicEfrFileDownload?instFlngId=11266&instFlngAtchId=1&f.
[9] See FDIC, BankFind Suite: Bank Failures & Assistance Data at https://banks.data.fdic.gov/bankfind-suite/failures?.
[10] The 2023 Failures will cost the DIF an estimated $35.2 billion. By way of contrast, from 2008 through 2022, the FDIC resolved 536 failures at an estimated cost of $72.0 billion, or just about double the estimated cost of the three 2023 Failures.

Table 2. SBNY December 31, 2022, Capital Positions[11]

	SBNY	Required To Be Well-Capitalized
Total Risk-Based Capital	12.32%	10.00%
Tier 1 Risk-Based Calital	11.20%	8.00%
Common Equity Tier 1 Capital to Risk-Weighted Assets	10.41%	6.50%
Tier 1 Leverage Capital	8.79%	5.00%

First Republic was a commercial bank and trust company not owned by a holding company. It offered high-net-worth individuals private banking, private business banking, and private wealth management, with 93 offices throughout the U.S., but mainly in California.[12]

First Republic grew rapidly in the years immediately before failure, going from $116 billion in total assets as of year-end 2019 to $213 billion at the time of failure. First Republic was well-capitalized, despite this growth, at the end of 2022 (see Table 3).

Table 3. First Republic December 31, 2022, Capital Positions[13]

	First Republic	Required Capital
Tier 1 Leverage Ratio	8.51%	4.0%
CET1 Ratio	9.17%	4.5%
Tier 1 Risk-Based Capital	11.56%	6.0%
Total Risk-Based Capital	12.60%	8.0%

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[11] Signature Bank's 2022 10-K, page 105.
[12] For more information, see First Republic Bank's 2022 10-K, pages 22 and 72 at https://ir.firstrepublic.com/filings#:~:text=February%2028%2C%202023-,2022%20Form%2010%2DK,-February%2024%2C%202023.
[13] First Republic Bank's 2022 10-K, pages 22 and 72.

Failure Actions and Timeline

On Thursday, March 9, depositors attempted to withdraw $42 billion from SVB, resulting in a failure to meet its cash letter at the Federal Reserve.[14] SVB was closed on the *morning* of Friday, March 10, 2023, due to the obvious liquidity pressures.[15]

The FDIC quickly announced the establishment of the Deposit Insurance National Bank of Santa Clara (DINBSC)[16] to assume all insured deposits of SVB.[17] DINBSC was to open for business on Monday, March 13, giving insured depositors full access to their funds, but uninsured depositors were to receive an advance dividend[18] available at some point during the week of March 13.[19] The knowledge during the business day on Friday that SVB's uninsured depositors would be subject to loss shook the financial markets significantly.[20] Also, on Friday, the FDIC's resolution groups received notification of SBNY's possible failure.

On Saturday, March 11, the FDIC began marketing DINBSC to 24 potential bidders. Bids were due the afternoon of Sunday, March 12. Also, on Sunday, SBNY was closed. As the FDIC was evaluating the SVB bids, the Secretary of the Treasury approved a systemic risk exception for SVB and SBNY, allowing the FDIC to avoid a least-cost transaction, thereby permitting it to make whole all depositors of both banks. The FDIC immediately established Silicon Valley Bridge Bank, N.A., a full-service bank operated by the FDIC, to assume SVB's deposits and certain assets pending the search for an acquiring institution. The FDIC also established Signature Bridge Bank, N.A., a full-service bank operated by the FDIC, to assume SBNY's deposits and certain assets pending the search for an acquiring institution.

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[14] Order Taking Possession of Property and Business, Silicon Valley Bank, Department of Financial Protection and Innovation of the State of California, March 10, 2023, at https://dfpi.ca.gov/wp-content/uploads/sites/337/2023/03/DFPI-Orders-Silicon-Valley-Bank-03102023.pdf?emrc=bedc09.

[15] Close of business on a Friday is the FDIC's preferred time and day of the week for a failure, as customers can conduct Friday's business, and it allows the ensuing weekend to orchestrate a resolution transaction so that insured depositors can seamlessly access their funds the following Monday. A deviation from this time or day usually indicates something is amiss.

[16] A deposit insurance national bank (DINB) is a limited-service, temporary bank chartered by the OCC designed only to accept insured deposits from the failed institution with no power to accept assets. A DINB is structured to pay insured depositors via an operating bank rather than by issuing checks.

[17] Significant detail on the failures of SVB and SBNY was obtained from: GAO, "Preliminary Review of Agency Actions Related to March 2023 Bank Failures," April 2023, page 38 at https://www.gao.gov/assets/gao-23-106736.pdf.

[18] To alleviate the adverse liquidity implications of a bank failure, the FDIC may provide advance dividends (payments) to uninsured depositors based on its failure loss estimate. For example, if the FDIC estimates uninsured depositors are expected to receive 80 cents on the dollar, it may provide them 75 cents on the dollar at the time of failure. The FDIC allows some cushion (in this example, 5 cents on the dollar) if the loss estimate is incorrect. Absent an advance dividend, uninsured depositors may not have access to their funds for months or even years, awaiting the liquidation of the failed bank's assets.

[19] FDIC Press Release, "FDIC Creates a Deposit Insurance National Bank of Santa Clara to Protect Insured Depositors of Silicon Valley Bank, Santa Clara, California," March 10, 2023, at https://www.fdic.gov/news/press-releases/2023/pr23016.html.

[20] FDIC, *Options for Deposit Insurance Reform*, May 1, 2023, pages 6 and 7 at https://www.fdic.gov/analysis/options-deposit-insurance-reforms/index.html.

On March 20, 2023, Flagstar Bank, N.A., Hicksville, NY, took over all deposits and certain loans of the SBNY bridge bank.[21] On March 26, 2023, First–Citizens Bank & Trust Company, Raleigh, North Carolina, took over all deposits and loans of the SVB bridge bank.[22]

SBNY had a weak but not fatal liquidity position before SVB's announced failure. The SVB failure created an environment whereby the New York State Department of Financial Services believed SBNY could not safely open for business on Monday, March 13. But SVB's failure repercussions were much more spectacular as a general contagion to other regional banks was feared. This resulted in a systemic risk exception for both SVB and SBNY, suspending the least-cost resolution, thus allowing the full coverage of all depositors at both institutions. Further, the Board announced the availability of additional funding to eligible banks to meet their liquidity needs.[23]

First Republic was experiencing financial difficulties and liquidity pressures before the collapse of SVB and SBNY, but these failures compounded First Republic's liquidity needs. On Thursday, March 16, a consortium of the nation's largest banks deposited $30 billion in First Republic to show confidence in the institution. On Sunday, March 19, S&P Global cut First Republic's credit rating further into junk territory by moving it three notches from BB-plus to B-plus, warning an additional downgrade may be forthcoming and that the large-bank liquidity support may not be sufficient.[24] First Republic's liquidity continued to deteriorate throughout the remainder of March as FHLB borrowings increased from $14.0 billion to $28.1 billion and Federal Reserve discount window advances zoomed to $77.3 billion. By the end of March, First Republic's external emergency funding had far outstripped its deposit base (see Table 4). First Republic's liquidity position worsened throughout April, culminating in its closure on Monday, May 1, 2023. JPMorgan Chase Bank, N.A., Columbus, Ohio, acquired all deposit accounts and substantially all the assets.[25] No systemic risk exception was necessary.

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[21] FDIC, "Failed Bank Information for Signature Bank, New York, NY," at https://www.fdic.gov/resources/resolutions/bank-failures/failed-bank-list/signature-ny.html.
[22] FDIC, "Failed Bank Information for Silicon Valley Bank, Santa Clara, CA," at https://www.fdic.gov/resources/resolutions/bank-failures/failed-bank-list/silicon-valley.html.
[23] Joint press release, "Joint Statement by Treasury, Federal Reserve, and FDIC," March 12, 2023 at https://www.federalreserve.gov/newsevents/pressreleases/monetary20230312b.htm.
[24] Reuters, "S&P cuts First Republic deeper into junk, says $30 billion infusion may not solve problems," March 19, 2023, at https://www.reuters.com/business/finance/sp-again-downgrades-first-republic-bank-ratings-2023-03-19/#:~:text=S&P%20cut%20First%20Republic's%20credit,that%20another%20downgrade%20is%20possible.
[25] FDIC, "Failed Bank Information for First Republic Bank, San Francisco, CA," at https://www.fdic.gov/resources/resolutions/bank-failures/failed-bank-list/first-republic.html.

Table 4. First Republic's Liquidity Position ($ Billions)[26]

	Total Deposits	Deposits Minus Large Bank Support	FHLB Borrowings	Federal Reserve Advances	Total FHLB, Federal Reserve and Large-Bank Support
December 31, 2022	176.4	176.4	14.0	0.5	14.5
March 31, 2023	104.1	74.1	28.1	77.3	135.4
April 28, 2023	92.6	62.6	28.1	93.2	151.3

Lessons Learned/Observations

The 2023 Failures have meaningful implications for the LTD requirements contemplated in the NPR. Here are some points for consideration.

Regional Banks Can Be Systemically Important

The failure of SVB created significant systemic spillover effects. SBNY failed the same weekend, First Republic never recovered from the repercussions of the SVB failure, and funds moved from certain regional banks to other institutions viewed as better insulated from failure, including global systemically important banking organizations (GSIBs).[27] The SVB and SBNY failures necessitated systemic risk exceptions, allowing all depositors to be fully covered, and the Federal Reserve was forced to implement an emergency bank funding program. First Republic likely would have failed the week of March 13 without extensive support from the large banks and the Federal Reserve. The 2023 Failures could have been compressed into a one-week timespan, perhaps requiring a third systemic risk exception.

Financial institution failure compression is not new. There were six systemically important collapses in 2008: The Bear Stearns Companies Inc. (Bear Stearns), Lehman Brothers Holdings Inc. (Lehman), American International Group, Inc. (AIG), WaMu, Wachovia Corporation (Wachovia), and Citigroup Inc. (Citigroup). Four collapsed during September: Lehman, AIG, WaMu, and Wachovia. Further, Fannie Mae and Freddie Mac each were placed into conservatorship on September 7.

Failure compression has systemic implications as it concentrates failures in a narrow band. But it also stresses the resources necessary for effective resolutions. While there were only three systemically important failures in 2023, the situation could have been much worse in the absence of systemic risk exceptions and the emergency lending facility established by the

[26] Order Taking Possession of Property and Business, First Republic Bank, Department of Financial Protection and Innovation of the State of California, May 1, 2023, at https://dfpi.ca.gov/wp-content/uploads/sites/337/2023/04/First-Republic-Order-Taking-Possession-under-FC-592-FINAL.pdf.

[27] For a more detailed discussion, see FDIC, *Options for Deposit Insurance Reform*, page 7.

Federal Reserve. Future banking crises will also experience failure compression. The LTD proposal should mitigate failure compression and, thus, potential systemic risk.

Additionally, the systemic risk posed by regional banking organizations is not new. WaMu was considered a regional institution when it collapsed in 2008. Yet, WaMu's failure triggered the immediate collapse of Wachovia, resulting in a systemic risk exception by the FDIC.[28]

Depositors Can Be a Source of Market Discipline and Systemic Contagion

The FDIC operates under a statutory $250,000 deposit insurance limit and a legal mandate to structure failure resolutions in the least costly manner. The least-cost test requires the FDIC's strict adherence to the deposit insurance limits, except with a systemic risk exception.

The threat of loss to depositors generates market discipline. Depositors will be reluctant to place their funds in poorly run institutions, causing them to shrink or not grow as rapidly as management would desire. Also, an institution undergoing severe financial stress will fail earlier than otherwise due to liquidity pressures before book equity insolvency, perhaps resulting in a lower-cost transaction for the FDIC.

But as demonstrated by the SVB and WaMu failures, depositors can also be a source of systemic contagion. Depositor discipline can be detrimental to the orderly resolution of large financial institutions, especially during severe financial stress. Depositors can be responsible for systemic contagion spreading throughout the banking system, even affecting institutions with only modest financial difficulties.

Deposit relationships tend to involve short-term funds subject to immediate withdrawal. Further, depositors typically are not in a position to readily absorb losses. For example, a corporate treasurer risks losing their job if corporate funds are lost in a bank failure. Also, bank deposits, should they not be made readily available, can have direct spillover effects on the economy, such as in payroll processing.

Market Discipline More Generally

Ultimately, oversight for any financial entity rests with the board of directors, who then provides strategic guidance to senior management responsible for implementing day-to-day decisions. However, other actors influence corporate governance, such as regulatory authorities and funding and investment capital providers.

At its finest, market discipline is the influence of market participants on any corporate organization to curtail risk-taking or encourage healthy financial behavior. However, not all market discipline involves risk reduction or actions consistent with the interests of the FDIC as an insurer or the various supervisory entities. Some market participants (especially depositors)

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[28] Wachovia Bank, N.A., total asset of $670 billion, did not fail in the traditional sense. WaMu was closed on Thursday, September 25, 2008, immediately placing Wachovia in an untenable liquidity situation. On Monday, September 29, 2008, the FDIC, the Board, and the Treasury provided open-bank assistance to Citigroup to acquire the banking operations of Wachovia. The Citigroup transaction was suspended several days later when, in a deal negotiated by Wachovia, Wells Fargo and Company agreed to acquire Wachovia without government assistance. For more detail, see FDIC, *Crisis and Response: An FDIC History, 2008–2013,* page 69, at https://www.fdic.gov/resources/publications/crisis-response/book/crisis-response.pdf.

can discipline management, but their actions may also lead to the institution's rapid liquidity failure and other systemic contagion. Other market players (especially shareholders) can encourage rather than curtail risky behavior in a search for higher returns. The effects of market participants can be varied and quite broad.

Generally, an IDI's nongovernmental market discipline comes through three groups: depositors and other short-term creditors, long-term and subordinated debt, and shareholders. Concerning larger banking organizations, the interests of the FDIC as an insurer align more closely with those of long-term and subordinated debt holders than the other two classes. Thus, a reduction in depositor discipline resulting from the LTD proposal, to be replaced by discipline from LTD, is a more optimal solution.

TLAC Guidelines for GSIBs

The NPR proposed rule is based heavily on the total loss-absorbing capacity (TLAC) requirements the Board applies to GSIBs. There are eight U.S.-based GSIBs, all of which use a single point of entry (SPOE) resolution strategy compared to the multiple point of entry (MPOE) resolution strategy preferred by covered institutions. A general understanding of the TLAC requirements and how they relate to an SPOE resolution strategy is necessary to better understand the proposed rule's requirements.[29]

Under the TLAC guidelines, a parent HC must hold funds, mainly Tier 1 capital plus eligible LTD, to absorb losses in the event of financial stress. Total TLAC requirements are the greater of 18 percent of risk-weighted assets (RWAs) plus applicable buffers or 7.5 percent of total leverage exposure plus a 2 percent buffer. Total LTD requirements are the greater of 6 percent of RWAs plus the greater of Method 1 and Method 2 GSIB surcharges or 4.5 percent of total leverage exposure.[30] There is no requirement to hold LTD at an operating subsidiary.

Given the function of TLAC funds held by the HC to absorb losses in financial stress, the SPOE resolution plan obligates the parent HC to downstream to subsidiaries the funds necessary to meet liquidity and capital demands. In the extreme case where the parent HC files for bankruptcy, virtually all funds are made available to the subsidiaries.[31] Thus, under ideal circumstances, only the parent HC enters a resolution process while all operating subsidiary entities remain open.

TLAC LTD is viewed as loss-absorbing during financial stress. The more LTD held at the parent HC, the more funds are available to downstream to operating subsidiaries to meet their liquidity and capital needs. To protect this loss-absorbing capacity, TLAC rules require that LTD be issued from a clean HC and have other restrictions, such as being unsecured and plain vanilla.

A sufficient amount of loss-absorbing capacity at the parent HC combined with an SPOE resolution strategy fundamentally alters how a GSIB operating subsidiary (including IDIs) will be

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[29] For a detailed understanding of the TLAC requirements, see Davis Polk, "Federal Reserve's Final Rule on Total LossAbsorbing Capacity and Eligible Long-Term Debt," January 11, 2017 at https://www.davispolk.com/sites/default/files/2017-01-11_davis_polk_federal_reserves_final_rule_on_tlac.pdf.

[30] See JPMorgan Chase & Co.'s 2022 Form 10-K, page 95 at https://jpmorganchaseco.gcs-web.com/static-files/57c2ed73-8a15-47c2-94f0-e9e29ca87e2c.

[31] See, for example, the JPMorgan Chase & Co. 2023 Resolution Plan Public Filing, page 19 at https://www.federalreserve.gov/supervisionreg/resolution-plans/jpmorgan-chase-1g-20230701.pdf.

treated during financial stress. GSIB operating subsidiaries will be recapitalized by the parent HC rather than allowed to enter a resolution process. This mitigates systemic contagion as a failure, and the resulting potential losses to depositors are avoided. The FDIC does not have an IDI resolution process to deal with, nor the expense. Effectively, LTD acts as private deposit insurance willing to cover depositors fully during financial stress.

The NPR seeks to apply the same concept to covered IDIs not connected to a GSIB but with a twist. Since covered organizations use an MPOE resolution strategy, the covered IDI will hold downstreamed subordinated debt as the loss buffer during financial stress. While the NPR contemplates the covered IDI could be closed, thus entering into a resolution process, doing so invites systemic contagion. To fully guard against systemic contagion, all SIFIs should be under a system whereby the IDI does not fail.

For all systemically important IDIs, failure should be avoided as a matter of practice. This sends an essential message to financial markets that a stressed IDI will be recapitalized as a first course of action, thus protecting all depositors fully. Therefore, a consistent approach to SIFIs is established, minimizing the threat of systemic contagion.

Categorization of Financially Distressed SIFIs

For illustrative purposes, and at the risk of oversimplification, I will divide into the following three groups the possible positions of a systemically important IDI near the point of liquidity insolvency/financial collapse.

- *Level 1*—A sufficient amount of equity capital and LTD is available to offset the expected financial losses, or the parent HC possesses adequate financial resources to recapitalize the IDI. The IDI operates under an SPOE resolution plan preannounced to the public and authorized by the regulatory authorities that stipulates, at the point of severe financial stress, the IDI will be recapitalized rather than closed. Depositors and other market participants believe the IDI, parent HC, and regulators will execute the recapitalization plan as necessary.

- *Level 2*—A barely sufficient (or slightly insufficient) amount of equity capital and LTD is available to offset the expected financial losses, or the parent HC scarcely possesses sufficient (or slightly insufficient) financial resources to recapitalize the IDI. The IDI operates under an MPOE resolution plan preannounced to the public and authorized by the regulatory authorities, which stipulates that the IDI will be closed during severe financial stress. Depositors and other market participants are uncertain whether uninsured depositors will be subject to loss under standard FDIC protocols.

- *Level 3*—An insufficient amount of equity capital and LTD is available to offset the expected financial losses or the parent HC possesses inadequate financial resources to recapitalize the IDI. The IDI operates under an MPOE resolution plan preannounced to the public and authorized by the regulatory authorities, which stipulates that the IDI will be closed during severe financial stress. Depositors and other market participants believe uninsured depositors will be subject to loss under standard FDIC protocols.

In March 2023, the GSIBs generally fell into the Level 1 grouping, while SVB, SBNY, and First Republic were Level 3. Level 1 is preferred if the objective is to mitigate systemic risk, while Level 3 will have the worst possible systemic risk outcomes of these groupings. A SIFI

operating under Level 3, and most likely Level 2, invites a system risk exception in the event of its failure.

Level 1 is unique in that sufficient privately held resources are available to recapitalize the troubled IDI, and there is also agreement among market participants and regulatory authorities that the IDI will remain open. With the avoidance of failure, uninsured depositors are not at risk; thus, the threat of rapidly developing, systemically damaging runs is minimized. The contagious spread of runs to other systemically significant IDIs is mitigated if they are also Level 1. This is managed without government financial support.

Level 2 is better than Level 3 regarding systemic risk mitigation, but only by a small margin. Both have a resolution strategy calling for the IDI's failure rather than recapitalization. The outcome for uninsured depositors is uncertain under the FDIC's current rules. And depositors are not in a good position to absorb losses. Thus, the risk of runs will spread to what is viewed as similarly situated IDIs.

The NPR's LTD proposal would elevate covered IDIs out of Level 3. Of grave concern is whether the elevation will be only to the general area of Level 2 or to a much-preferred Level 1.

Recommendations

Given the previous discussion, I propose the following adjustments to the LTD proposal outlined in the NPR.

Add a Conversion Feature to IDI Subordinated Debt

Mitigation of systemic risk is a primary reason for the LTD proposal. Depositors run to escape the *failure* of their financial institution. In this regard, an MPOE strategy involving the failure of the parent company's operating subsidiaries will generate more systemic contagion than a strategy involving only the bankruptcy of the parent organization. Indeed, the 2023 Failures caused excessive funds to flow out of regional banking institutions into GSIBs, viewed by the market as safer, in part due to an agreed-upon SPOE resolution strategy.

To better mitigate systemic risk, an SPOE resolution strategy should be contemplated for covered institutions by requiring the IDI's LTD to be converted into equity at the direction of supervisory entities. Deposit runs will be mitigated if the predetermined approach to a troubled IDI is recapitalization through the conversion of subordinated debt instead of failure, hoping the existing subordinated debt will cover losses. A conversion feature would parallel what GSIBs currently contemplate in their SPOE resolution plans.

SVB's failure also reduced franchise value compared to an open solution. For example, SVB owned a subsidiary bank in the UK, which the Bank of England closed on March 10 (ring-fenced). This subsidiary had total loans of £5.5 billion and total deposits of £6.7 billion but was purchased by HSBC for only £1 on March 13, 2023.[32] SVB's failure, which prompted the ring-fencing, resulted in losing any franchise value associated with this subsidiary. SVB also had

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[32]HSBC, "Strategic acquisition to strengthen HSBC's banking franchise in UK," March 13, 2023 at https://www.hsbc.com/news-and-views/news/media-releases/2023/hsbc-acquires-silicon-valley-bank-uk-limited#:~:text=HSBC%20Holdings%20plc%20announces%20that,of%20around%20%C2%A36.7bn.

foreign offices in Germany, Canada, and the Cayman Islands. This is only one of many instances where franchise value can be impaired in an IDI failure, thus increasing resolution costs and exacerbating systemic contagion.

Base IDI Subordinated Debt Requirement on Expected Failure Costs

The proposed rule would base covered IDI LTD requirements on capital levels. As stated:

> Under the proposal, a covered IDI would be required to maintain outstanding eligible LTD in an amount that is the greater of 6.0 percent of the covered IDI's total risk-weighted assets, 3.5 percent of its average total consolidated assets, and 2.5 percent of its total leverage exposure if the covered IDI is subject to the supplementary leverage ratio.[33]

This calibration is based on the theory that should the IDI's equity be depleted in the failure, the available LTD should be sufficient to recapitalize the resulting bridge institution adequately.

None of the 2023 Failures were subject to a supplementary capital charge; thus, had they still been in operation, their proposed LTD requirements would have been either 6 percent of risk-weighted assets or 3.5 percent of total assets, whichever is greater. Table 5 shows the estimated losses to the FDIC in each of the 2023 Failures. In each case, there was an estimated loss to the FDIC, indicating total failure losses exceeded the bank's equity capital. In the cases of SBNY and First Republic, failure losses also exceeded their outstanding

Table 5. 2023 Failures: Assets, Capital and FDIC Estimated Losses ($ Billions)[34]

	Total Assets	Risk-Weighted Assets	Total Equity Capital	Estimated FDIC Loss	FDIC Loss as a % of Total Assets	FDIC Loss as a % of RW Assets	3.5% of Total Assets	6% of Risk-Weighted Assets
SVB	209.0	111.3	15.5	17.8	8.5%	16.0%	7.3	6.7
SBNY	110.4	89.8	8.0	0.9	0.8%	1.0%	3.9	5.4
First Republic	212.6	151.8	17.4	16.5	7.8%	10.9%	7.4	9.1
Aggregate	532.0	352.9	40.9	35.2	6.6%	10.0%	18.7	21.2

[33] NPR, pages 64529 and 64530.
[34] Various year-end 2022 Call Reports, FDIC, BankFind Suite: Bank Failures & Assistance Data at https://banks.data.fdic.gov/bankfind-suite/failures?, and FDIC, "FDIC's Supervision of First Republic Bank," September 8, 2023, page 2, footnote 1 at https://www.fdic.gov/news/press-releases/2023/pr23073a.pdf.

subordinated debt ($572 million and $776 million, respectively). For SVB, which held no subordinated debt, estimated FDIC losses are $17.8 billion, greater than its $15.5 billion in equity capital.

For SVB and First Republic, the proposed level of LTD would not have resulted in an adequately capitalized bridge bank. Indeed, the LTD would have been insufficient to cover estimated FDIC losses. For these two institutions, the proposed level of LTD would have resulted in an insolvent bridge bank.

To mitigate systemic risk to the maximum extent possible, the LTD should be convertible into equity capital in such an amount that the institution remains solvent and, importantly, remains open. Failures promote systemic contagion. For the institutions to have remained open, the required level of LTD for SVB and First Republic should have been much greater than the proposed 3.5 percent of total assets or 6 percent of risk-weighted assets.

Calibrating LTD requirements is complex, involving tradeoffs between mitigating systemic risk, the impact on LTD markets, expected industry cost, and other factors. Data from past failures is limited but can be helpful. Three additional elements are essential. If the LTD rule is implemented, covered institutions will move funds from surplus capital into LTD instruments. All 2023 Failures held more capital than required. Relatively speaking, bank failure losses are inversely related to bank size, so expected losses at a much larger covered institution would be lower.[35] Finally, it is likely the losses presented in Table 5 would have been lower had an LTD requirement been in place for several years due to market discipline.

In addition to the 2023 failures, we know the FDIC had no loss in the WaMu failure, which held subordinated and senior long-term debt of 4.5 percent of total assets or 5.8 percent of risk-weighted assets. Thus, the proposed rule would have been consistent with WaMu's holdings. However, WaMu would have needed more LTD to recapitalize the institution, thereby avoiding failure. With the failure came the Wachovia collapse and the resulting systemic risk exception. Likewise, without a significantly higher LTD requirement, SVB would have failed, resulting in a systemic risk exception.

The proposed LTD requirements appear substantially inadequate to avoid future systemic risk exceptions, not nearly enough to put them in the Level 1 arena along with GSIB IDIs. However, the proposed requirements would significantly lower the DIF's loss exposure.

Phase In IDI Subordinated Debt Requirements

The proposed LTD requirements would start when an IDI reaches $100 billion in total assets without any phase-in. This creates an enormous cliff effect for institutions approaching $100 billion. There would be an incentive for institutions to stop growing after reaching $99 billion or to take actions to game the system through activities such as asset sales, for example. Also, a troubled IDI just above the $100 billion threshold could shrink under the threshold before failure, thus allowing it to cancel its LTD to the detriment of the FDIC and the mitigation of systemic risk.

But also important, smaller institutions would not be subject to the market discipline afforded by LTD until they reach the $100 billion threshold. SBNY had total assets of $51 billion as recently as year-end 2019 but quickly grew into a systemically important institution within only

[35] This suggests LTD requirements for covered institutions need not be similar to those for GSIFs, in fact, they should be higher everything else being equal.

three years. Additionally, SVB had total assets of $56 billion at year-end 2018. Had an LTD requirement been in place for them in 2018 or 2019, their growth may have been slowed, and perhaps they never would have failed, or their failure costs would have been diminished.

I suggest applying 50 percent of the LTD requirement to IDIs with total assets of $50 billion and then increasing the requirement by one percentage point for every billion dollars of new asset growth until the requirement completely phases in at $100 billion in total assets. Such a system would avoid the cliff effect and more carefully apply market discipline to up-and-coming systemically important institutions.

Implement a Rolling Requirement for LTD Maturities

To maximize market discipline, a covered institution should go to the market regularly to purchase new externally issued LTD, say every one or two years. This will ensure market participants a consistent opportunity to exercise judgment on the condition of the issuing institution.

Reconsider Requirements for Externally Issued LTD

As of mid-2023, the proposed NPR LTD requirements would encompass 18 covered HCs, one covered intermediate holding company (IHC), and one permitted externally issuing IDI.[36] Thus, in almost all cases, LTD would be externally issued by a parent HC, while the covered IDIs would issue internal LTD to their parent HC.

The proposed rule treats external and internal LTD the same, for the most part. The calibration requirements for a covered HC are the same as for the covered IDI, based on identical percentages of risked-based assets or total consolidated assets. The restrictions and requirements of externally issued LTD are outlined in the NPR with the statement that internally issued LTD instruments essentially have the same structure. The limits and conditions typically are justified in the NPR by the need for the LTD to absorb losses. The language in the NPR borrows heavily from the TLAC LTD requirements, viewing the externally issued LTD as needed to absorb losses.

Should a covered IDI issue internal LTD to its covered parent company, which then issues external LTD, the primary objectives and functions of internal and external LTD are very different; to think of the internal and external LTD identically risks suboptimal results.

The primary objective of internal LTD issued by a covered IDI is to absorb losses during severe financial stress to serve as a buffer for depositors and general creditors. This buffer protects the DIF and may allow the troubled IDI to remain solvent by converting to equity, thus mitigating systemic risk. The internal LTD should be subordinated, unsecured, and generally plain vanilla.

The primary objective of external LTD issued by a covered parent HC is to provide a source of funds to be downstreamed as internal LTD to subsidiary entities. Market pricing and other mechanisms will provide market discipline to the parent HC and, therefore, to the subsidiary entities. The features of this debt should not be unnecessarily destabilizing to the parent company during financial stress, should not compromise the loss-absorbing function of the

[36] NPR, page 64549.

downstreamed LTD, should not be unduly expensive to the parent HC, and finally, the LTD holders should feel protected in the event of bankruptcy to the extent possible.

In this case, internally and externally issued LTD are connected primarily because the externally issued LTD can be the source of funds for the internally issued LTD. The interest-earning features, maturities, or other features of these two types of debt need not be the same; in fact, they should not be if they are to fulfill their different objectives optimally. Indeed, long-term debt currently issued by a parent HC for general purposes can be downstreamed to subsidiaries into various instruments, each with different maturities and other investment features, including deposits, general-creditor debt, subordinated debt, and equity.

To minimize overall funding costs, a parent HC will likely issue its external LTD in various tranches, some with more risk exposure than others. For example, some LTD issuances could be subordinated while others have a general creditor status. In this regard, a great deal of flexibility in issuing LTD would be beneficial.

The Agencies may wish to revisit some of the proposed restrictions on externally issued LTD to make it less expensive to the parent HC. Here are several issues for review.

Security. Indeed, the externally issued LTD should not be secured by assets held by an operating subsidiary. But could it be secured by parent company assets? Subsidiary losses at the level where the internally issued LTD is needed to absorb these losses will likely result in a parent HC bankruptcy or other stresses. Would such security place the LTD holders in a better position, thus resulting in a lower debt cost upon issuance?

Plain vanilla, generally. The NPR argues for plain vanilla externally issued notes, stating:

> Eligible external LTD instruments would be required to be "plain vanilla" instruments. Exotic features could create complexity and thereby diminish the prospects for an orderly resolution of the external issuer. These limitations would help to ensure that eligible external LTD represents loss-absorbing capacity with a definite value that can be quickly determined in resolution. In a resolution proceeding, claims represented by such "plain vanilla" debt instruments are more easily ascertainable and relatively certain compared to more complex and volatile instruments. Permitting exotic features could engender uncertainty as to the level of the issuer's loss-absorbing capacity and could increase the complexity of the resolution proceeding and potentially result in a disorderly resolution.[37]

But, again, the internally and externally issued LTD are separate instruments. An exotic feature in an externally issued LTD instrument does not alter or complicate the valuation of the internally issued debt (which itself would be subordinated, unsecured, and plain vanilla); its total value would be available to absorb losses or convert into equity if necessary.

Structured notes. Structured notes would be prohibited. The NPR defines a structured note as:

> a debt instrument that: (i) has a principal amount, redemption amount, or stated maturity that is subject to reduction based on the performance of any asset, entity, index, or embedded derivative or similar embedded feature; (ii) has an embedded derivative or similar embedded feature that is linked to one or more equity securities, commodities, assets, or entities; (iii) does not have a minimum principal amount that

[37] NPR, page 64535.

becomes due and payable upon acceleration or early termination; or (iv) is not classified as debt under U.S. GAAP.[38]

A parent HC may issue LTD in tranches, each with a different level of risk. The financial market, if allowed, will develop instruments suitable as LTD but with features consistent with a structured note. These features could make LTD issuance less expensive yet still meet the objectives outlined in the proposed rule.

By way of illustration, property and casualty insurance companies, reinsurers, and state insurance funds routinely issue catastrophe (CAT) bonds with some or all of the principal amount subject to cancellation based on an agreed-upon, clearly defined event.[39] For example, insurance Company X may issue $50 million in CAT securities whereby, on a dollar-for-dollar basis, the principal amount of the securities is reduced if property and casualty losses for Company X are greater than $Y in any given year the debt remains outstanding; otherwise, the principal amount remains payable in full at maturity. Externally issued LTD could have similar features related to losses in an affiliated IDI's loan portfolio, for example. Such LTD would be prohibited under the NPR's proposed framework but could be a valuable component of an external issuer's LTD portfolio. While the principal value of the externally issued LTD could be compromised, the total value of the underlying internally issued LTD of the IDI remains available to absorb losses or convert to equity, if necessary.

As mentioned previously, the NPR's LTD proposal effectively implies the parent HC offers and funds its own form of private deposit insurance. In this regard, it would be optimal for the parent HC to use financial tools available to other private insurance organizations.

Contractual provisions for conversion into or exchange for equity. Conversion or exchange features would be prohibited. I have already proposed a conversion feature for the internally issued LTD. A similar feature for externally issued LTD may be attractive to some LTD holders, thereby reducing the cost of the debt relative to what it would be otherwise.

Credit-sensitive features. Credit-sensitive features would be prohibited. Yet these features could reduce the cost of the externally issued LTD and instill greater market discipline. For example, the return on the externally issued LTD could be tied to the credit rating of the parent or its subsidiary entities.

Minimum remaining maturity and amortization. The proposed rule would disallow the counting of LTD instruments with a remaining maturity of less than one year. It would discount by 50 percent an instrument with a remaining maturity of between one and two years. Such a requirement could leave a significant portion of the LTD uncounted and would force longer-maturity debt issuances than otherwise. Alternatively, the rule could allow counting all LTD but require the parent HC to extend the maturity of any internally issued LTD instrument if not doing so would breach the subsidiary's required LTD holdings. In other words, internally issued LTD could not mature, and the funds leave the subsidiary unless LTD requirements are met. This would guarantee the loss-absorbing capacity at the subsidiary level. Counting LTD with a short remaining maturity at the parent company is less of an issue. Suppose externally issued LTD is due to be replaced, and the parent HC cannot do so, presumably due to significant financial stress. In that case, remedies such as parent company bankruptcy may be necessary.

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[38] *Ibid*.
[39] For more information on CAT securities, see Andy Polacek, "Catastrophe Bonds: A Primer and Retrospective," Chicago Fed Letter, No. 405, 2018, at https://www.chicagofed.org/publications/chicago-fed-letter/2018/405.

Externally issuing IDI. One of the covered IDIs does not have a holding company through which to issue external LTD. In this case, its externally issued IDI LTD would have similar characteristics to externally issued HC LTD discussed above, except it would be subordinated, unsecured, and subject to a minimum-maturity requirement.

A market will develop for LTD based on the external issuer being a parent HC instead of an IDI. This will place the externally issuing IDI at a distinct disadvantage. One possible outcome would be for the IDI to form a parent HC to issue LTD externally.

Remove LTD Dollar Requirement for Covered HCs

I support a requirement that covered IDIs hold a specified amount of LTD. Is a companion requirement for the parent HC necessary? The covered IDI requirement is essential for keeping the IDI solvent during financial stress and protecting the FDIC from extreme losses. Indeed, the parent HC must issue some LTD to provide enough funds to meet the requirements imposed on its covered IDIs, but not necessarily on a dollar-for-dollar basis. For example, a well-capitalized parent holding company could fund some of its covered IDIs LTD with equity. However, it must not be financed by short-term debt issued by the parent holding company, as already contemplated by the NPR proposal.

Allow Covered Institutions to Use the GSIB Approach?

The NPR proposes that covered IDIs maintain a specified amount of LTD, but no such requirement exists for GSIB IDIs. This allows GSIBs to allocate more flexibly financial resources to operating subsidiaries, providing an advantage relative to institutions covered by this NPR. Should a covered institution be allowed to follow the LTD requirements of GSIBs with no IDI-required debt?[40]

The NPR's IDI LTD requirement stems from the MPOE resolution strategies used by covered institutions contrasted with the SPOE strategies used by GSIBs. An SPOE resolution approach requires the GSIB parent HC to downstream liquidity and capital to operating subsidiaries as necessary to maintain their financial health. As an MPOE resolution approach does not have this support requirement, the NPR contemplates a pre-funded amount of subordinated LTD held at all times at the IDI.

As I have already discussed, an SPOE resolution strategy is necessary to mitigate systemic contagion effectively. Thus, all institutions required to hold LTD should also be required to implement an SPOE resolution strategy. Is the NPR's IDI LTD requirement desirable if this is the case? Here are some issues for consideration.

The adoption of an SPOE resolution strategy and the abandonment of IDI LTD requirements have consequences, both good and bad. On the one hand, a GSIB-type resolution approach is more flexible and, in this regard, less costly to the institution. On the other hand, requiring subordinated LTD to be held by the IDI ensures a more certain outcome if needed to cover losses. With the SPOE strategy (yet to be tested in the U.S.), the parent HC is legally obligated to support its operating subsidiaries. Still, it is uncertain this will always happen under financial stress. The SPOE resolution strategy is quite complex, with numerous moving parts. Legal

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[40] As mentioned previously, failure costs are inversely related to bank size. Therefore, LTD requirements for institutions covered by this NPR should be higher than those applied to GSIBs.

challenges could interfere with the provision of support. Even a brief delay could be fatal in a fast-moving financial crisis.[41] Holding subordinated LTD in the IDI at all times is a more certain guarantee that funds will be available if needed. Thus, the market may view the IDIs required to hold the subordinated LTD more favorably.

The NPR proposal splits LTD into internal and external issuances for IDIs with a parent HC. In this case, I have recommended a relaxation of the plain vanilla and other requirements of the external LTD, a move designed to reduce debt costs. Thus, doing away with the IDI LTD requirement may disallow this flexibility.

Allow a Covered IDI That Is a Member of an HC to Issue External LTD?

The NPR asks whether to allow a covered IDI that is a member of an HC to issue external LTD to fulfill the LTD requirements. Thus, some or all of an IDI's LTD could be held by third parties rather than the parent HC. I have previously suggested a feature for IDI LTD that would allow conversion into equity in times of financial stress. The IDI's LTD should be held to provide financial support so the IDI does not fail; instead, it remains open during financial stress. The IDI may benefit if the terms of its LTD were renegotiated for an unforeseen reason. In this case, it would be enormously beneficial if the LTD had only one holder, the parent HC.

Deposit Insurance Impact

Moving covered IDIs from Level 3 to Level 1 fundamentally changes how these institutions are treated under financial stress. Rather than an IDI failing, thus entering into a resolution process, it is recapitalized using funds supplied by the private sector, not the FDIC. Therefore, depositors are protected fully without a systemic risk exception.

For IDIs covered by the NPR's proposed LTD requirements, who hold total assets of $5.3 trillion,[42] resolution costs would shift from the FDIC's DIF to the LTD holders, as with GSIBs. The total assets of the eight U.S.-based GSIB IDIs plus those of the proposed covered IDIs total almost $16 trillion, or 72 percent of all banking assets in the U.S. As a consequence, deposit insurance premiums for covered IDIs should be lowered. Further, it seems plausible to argue for a substantially lower DIF, which stood at $116 billion as of the end of the first quarter of 2023. This reserve amounts to 1.11 percent of insured deposits. However, the FDIC operates under a plan to increase this ratio to 1.35 percent, the statutory minimum, by September 2028.[43] The FDIC Board, in the long run, seeks to move the ratio to 2.0 percent.[44]

The failure of SVB resulted in a systemically important flow of deposits out of regional banking entities to GSIBs and other IDIs viewed as more failure-resistant. A substantial LTD requirement for regional banks moving them into Level 1 would place them on a similar footing to GSIBs, if not on higher ground. Funds could shift to covered IDIs from smaller banking organizations in a future banking crisis.

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[41] For more detail on potential legal impediments see Warton Financial Institutions Center, "Resolution of Global Systemically Important Financial Institutions Under the Bankruptcy Code," December 7, 2016, at https://wifpr.wharton.upenn.edu/wp-content/uploads/2022/12/Wharton-SPOE-Resolution-under-Bankruptcy-Code-12-2016-Public-Version65.pdf.
[42] NPR, page 64549.
[43] FDIC, *Quarterly*, First Quarter 2023, pages 31 and 32, at https://www.fdic.gov/analysis/quarterly-banking-profile/fdic-quarterly/2023-vol17-2/fdic-v17n2-1q2023.pdf.
[44] FDIC, *Options for Deposit Insurance Reform*, page 39.

Concluding Comments

Systemic risk is not new. Bank of the Commonwealth ($1.2 billion in total assets) was bailed out by the FDIC in 1972, followed by Franklin National Bank ($5 billion) in 1974, followed by First Pennsylvania Bank ($8 billion) in 1980, and so on.[45] Electronic bank runs are not new. Continental Illinois National Bank and Trust experienced a rapid electronic run in 1984 before being bailed out by the FDIC.[46]

Also not new is that depositors are ill-suited to absorb losses and thus will run to avoid the risk of a bank failure. The failure must be avoided to prevent the systemic consequences of a large bank collapse so that depositors are not subject to loss.

Throughout this paper, I have focused on mitigating systemic risk as the primary objective of an LTD requirement. Of the objectives listed in the NPR, systemic risk is the most challenging to tackle but also the most beneficial.

The TLAC requirements placed on GSiBs, in conjunction with their SPOE resolution strategies accepted by the Agencies, help assure the markets that, under severe financial stress, their subsidiary banks will remain open as only the parent HC will enter a resolution process. This approach minimizes the threat of systemic contagion. By effectively using LTD requirements and the SPOE resolution strategy, these standards could be applied to systemically important, non-GSiB banking organizations. Thus, market participants will view regional banking organizations equally with the GSIB organizations from a safety standpoint.

As long as a systemically important IDI is subject to the failure process as a first choice, depositors and other market participants will believe losses to depositors are highly likely. Thus, systemic contagion will be difficult to contain under financial stress. The first choice should be an open solution. Also essential is that the required level of LTD should be sufficient to cover expected financial losses at the IDI, with an adequate remainder used to recapitalize the IDI until further stability options are exercised.

With an effective LTD program, the deposit insurance scheme for larger IDIs will be amended meaningfully as a layer of private financial resources will absorb losses ahead of the FDIC. These changes should be reflected in the deposit insurance premiums paid by covered IDIs and the size of the necessary DIF.

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[45] George C. Nurisso and Edward Simpson Prescott, "The 1970s Origins of Too Big to Fail," *Economic Commentary*, Federal Reserve Bank of Cleveland, October 18, 2017, at https://www.clevelandfed.org/publications/economic-commentary/2017/ec-201717-origins-of-too-big-to-fail.

[46] Jonathan Rose, "Understanding the Speed and Size of Bank Runs in Historical Comparison," *ECONOMIC SYNOPSES,* Federal Reserve Bank of St. Lewis, May 26, 2023, at https://research.stlouisfed.org/publications/economic-synopses/2023/05/26/understanding-the-speed-and-size-of-bank-runs-in-historical-comparison.