SULLIVAN & CROMWELL LLP

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FDIC Special Assessment for March 2023 Bank Failures

Final Rule is Substantially Similar to Proposal

SUMMARY

Late yesterday, the Board of Directors of the Federal Deposit Insurance Corporation ("*FDIC*"), in a 3 to 2 vote (with Chairman Gruenberg, Acting Comptroller Hsu, and Director Chopra voting in favor and Vice Chairman Hill and Director McKernan voting against), adopted a final rule ("*Final Rule*")[1] imposing a special assessment to recover the loss to the Deposit Insurance Fund ("*DIF*") arising from the use of the "systemic risk" exception to the least-cost resolution test ("*Systemic Risk Determination*") in connection with the resolutions of Silicon Valley Bank ("*SVB*") and Signature Bank ("*Signature*").[2] The total amount to be collected under the special assessment is equal to the DIF's losses attributable to the protection of uninsured depositors at SVB and Signature, which the FDIC now estimates to be $16.3 billion, a slight increase from the estimate in the Proposed Rule.[3] The special assessment "will be adjusted as the loss estimates change."[4]

Under the Final Rule, the "assessment base" for an insured depository institution ("*IDI*")[5] will be equal to the institution's estimated uninsured deposits as of December 31, 2022, adjusted to exclude the first $5 billion in estimated uninsured deposits.[6] The special assessment will be collected at an annual rate of approximately 13.4 basis points over eight quarterly assessment periods, and the first quarterly assessment period will begin on January 1, 2024 (with the first assessment payment due by June 28, 2024).

In adopting the Final Rule, the FDIC rejected all substantive recommendations from commenters, including those suggesting that certain types of entities and uninsured deposits be excluded from, or subject to different treatment for purposes of, the special assessment. The FDIC also rejected a recommended change to the accounting treatment that would have allowed the special assessment to be restructured as a prepaid expense that could be amortized over a multi-year period.[7]

BACKGROUND

On March 10, 2023, the California Department of Financial Protection and Innovation closed SVB. Two days later, the New York State Department of Financial Services closed Signature. In each case, the FDIC was appointed as receiver.[8] On March 12, 2023, in consultation with the President and acting on the recommendation of the FDIC's Board of Directors and the Board of Governors of the Federal Reserve System, the Secretary of the U.S. Department of Treasury made a Systemic Risk Determination, which allowed the FDIC to complete its resolution of both banks without imposing losses on any depositors.[9]

The Federal Deposit Insurance Act requires the FDIC to recover the loss to the DIF arising from actions taken in reliance upon a Systemic Risk Determination by imposing a special assessment on IDIs and their holding companies. In doing so, the FDIC must establish assessment rates "sufficient to cover the losses incurred as a result of [the Systemic Risk Determination]."[10] To that end, on May 11, 2023, the FDIC approved a notice of proposed rulemaking to impose a special assessment to cover losses to the DIF caused by the failures of SVB and Signature ("*Proposed Rule*").[11]

FINAL RULE

The Final Rule is substantially similar to the Proposed Rule. This section highlights certain key elements of the Final Rule, as well as the FDIC's responses to commenters' recommendations.

A. ESTIMATED SPECIAL ASSESSMENT AMOUNT

To determine the amount of the loss to the DIF attributable to the cost of covering uninsured deposits pursuant to the Systemic Risk Determination, the FDIC calculated the percentage of each of SVB's and Signature's deposits that were uninsured at the time the bank failed, then applied that percentage to the total cost of the failure for each bank.[12] As of the adoption of the Final Rule, the FDIC determined the total estimated loss to the DIF attributable to the protection of both banks' uninsured depositors to be $16.3 billion, which is approximately $500 million greater than originally projected.[13] The FDIC noted that this amount will be periodically adjusted and the exact amount of losses will be determined at the termination of the SVB and Signature receiverships.[14]

B. RATE FOR SPECIAL ASSESSMENT

Under the Final Rule, the FDIC will apply a special assessment rate equal to an annual rate of approximately 13.4 basis points, which is higher than the 12.5 basis point annual rate provided for in the Proposed Rule.[15] The FDIC explained that this change was due to the combined increase in the cost estimate and the lower total assessment base due to intervening amendments to reported estimated uninsured deposits filed since the Proposed Rule.[16]

C. ASSESSMENT BASE AND SCOPE OF APPLICATION

The Final Rule provides that each IDI's assessment base will be equal to its estimated uninsured deposits as such number is reported on its Call Report or FFIEC 002 for the quarter that ended December 31, 2022, after applying a $5 billion deduction. In a change from the Proposed Rule, in determining estimated uninsured deposits, the FDIC will take into account any amendments made by IDIs to correct the reporting of uninsured deposits on such Call Report or FFIEC 002 that arise from, or are confirmed through, the FDIC's review of the IDI's reporting methodology.[17]

The FDIC rejected all comments regarding the calculation of the special assessment base, including requests that certain entities be excluded altogether (*e.g.*, community banks) and requests that certain groups of banks be exempt from, or pay a smaller portion of, the overall special assessment.[18] The FDIC also rejected comments recommending that a more recent date be used to calculate the assessment base, noting that the December 31, 2022 date "most closely approximate[s] an institution's vulnerability to significant deposit withdrawals in the absence of the [Systemic Risk Determination], and therefore reflect[s] the institutions that most benefited from such determination."[19]

A number of commenters also supported the exclusion of, or different treatment for, certain types of uninsured deposits, including (i) collateralized deposits, (ii) deposits held by custody banks and (iii) intercompany deposits.[20] Without citing any supporting empirical or historical evidence, the FDIC declined to exclude or provide different treatment for any particular type of uninsured deposits, noting that (i) the presence of collateral "does not fully mitigate run risk", (ii) custody banks "hold large amounts of uninsured deposits" and (iii) the lack of "clear evidence that intercompany deposits are more stable relative to other deposits."[21]

D. COLLECTION PERIOD FOR THE SPECIAL ASSESSMENT

The special assessment will be collected over an eight-quarter period, beginning with the first quarterly assessment period of 2024, with the first invoice payment due on June 28, 2024.[22] The FDIC rejected requests to shorten or lengthen the collection period, along with suggestions that banks be allowed to fully fund obligations prior to the end of the collection period.[23]

The FDIC will review and consider revisions to the loss estimate on a quarterly basis during the collection period.[24] If, prior to the end of the first eight quarters, the FDIC expects the loss to be lower than the anticipated special assessment collection, the FDIC will cease collection of the special assessment.[25] Alternatively, if the FDIC has yet to recover the estimated or actual loss amount after the first eight quarters, the FDIC will extend the collection period for one or more quarters, as needed, to recover any shortfall.[26]

Further, if a final loss amount is not determined until after the initial collection period plus any extension (which the FDIC considers to be a "likely event" since its receiverships are likely to continue beyond this period), the FDIC will impose a "one-time final shortfall special assessment" to collect the final shortfall amount.[27] The special assessment will be collected at the same time and in the same manner as an IDI's regular quarterly deposit insurance assessment.[28]

In response to comments, the FDIC clarified that it plans to communicate to covered IDIs any changes to the loss estimate, as applicable, and to provide updates on the collection of the special assessment to affected banking organizations.[29] The FDIC will make these communications through quarterly assessment invoices.[30] The FDIC also noted that it "publishes estimated losses and other data on bank failures and assistance on its publicly available website."[31]

E. MERGERS, CONSOLIDATIONS AND TERMINATIONS OF DEPOSIT INSURANCE

If an IDI acquires another IDI, the acquiring IDI will be responsible for the acquired IDI's remaining special assessment amount, if any.[32] If the FDIC extends the collection period or imposes a one-time final shortfall assessment, each banking organization's assessment base will not be adjusted to account for mergers and failures that occurred during the eight-quarter assessment period.[33] This is a departure from the Proposed Rule, which would have required an adjustment. This change reflects the FDIC's view that each banking organization's assessment base, calculated in this manner, will reflect its relative benefit from the Systemic Risk Determination.[34]

Additionally, as initially proposed, the Final Rule provides that if an IDI's insured status is terminated and its liabilities are not assumed by another IDI, the terminating IDI must, among other things, continue to pay assessments for the remaining assessment periods that its deposits are insured, but not thereafter.[35] In the Final Rule, the FDIC further added that it will require any bank that voluntarily terminates its insured status after the adoption of the Final Rule or during any special assessment collection period to pay the entire remaining amount of its special assessment at the same time its obligation to pay regular deposit insurance assessments would end.[36] The FDIC stated that this change was made "to avoid incentivizing banks to voluntarily terminate their insured status to avoid paying the special assessment."[37]

F. ACCOUNTING TREATMENT

Under the Final Rule, banking organizations must account for the special assessment in accordance with U.S. generally accepted accounting principles ("*GAAP*").[38] The FDIC rejected comments recommending that the special assessment be restructured as a prepaid expense that could be amortized over a multi-year period.[39] The FDIC noted that such treatment would lessen the one-time effect on income, but also reduce liquidity by the full amount of the special assessment at payment, thereby inhibiting the institution's ability to absorb unexpected setbacks while also supplying credit to the economy.[40] Instead, banking organizations will recognize the accrual of a liability and an expense from a loss contingency for the entire special assessment when the institution determines that the conditions for accrual under GAAP have been met (*i.e.*, in Q4 2023).[41]

EXPECTED EFFECTS

The FDIC estimates that 114 banking organizations will be subject to the special assessment, including 48 banking organizations with more than $50 billion in total assets and 66 banking organizations with between $5 billion and $50 billion in total assets.[42] After analyzing the effect of the Final Rule on banking organizations' capital and earnings, the FDIC estimates that the after-tax impact of the special assessment will reduce the dollar amount of Tier 1 capital of affected banking organizations by 62 basis points, but that no banking organizations will fall below the minimum 4 percent Tier 1 leverage capital requirement as a result of the assessment.[43] In addition, the FDIC estimates that the special assessment will result in an average one-quarter reduction in income of 20.4 percent for banking organizations subject to the special assessment.[44] However, as indicated by the FDIC's own data,[45] some banks will experience substantially higher reductions, and the average reduction in income would be higher if calculated based on assets rather than number of banks.

OBSERVATIONS AND IMPLICATIONS

As described in our memo on the Proposed Rule,[46] the FDIC has wide discretion to design the special assessment under the statutory framework, after considering the three enumerated factors. Notably, because the Final Rule marks the first time that the FDIC has proposed a special assessment following a Systemic Risk Determination, there was no precedent from which the FDIC could draw in designing the assessment methodology.[47]

In this context, the FDIC sought comment with respect to all aspects of the Proposed Rule; however, it rejected all comments recommending substantive changes. The most frequent recommendation was for the exclusion of collateralized municipal deposits from the assessment base on the basis that such deposits have limited "run risk."[48] The FDIC did not deny the fact that collateralized municipal deposits have limited run risk, but stated only that the presence of collateral "does not fully mitigate run risk."[49] The FDIC did not cite any empirical or historical evidence supporting its rejection of this recommendation.

Ultimately, it may be important to place the FDIC's promulgation of the Final Rule in the context of other recent supervisory actions and statements from regulators, in particular statements from Chairman Gruenberg, who earlier this week expressed a preference for banking organizations to hold fewer uninsured deposits, noting that the regional bank failures were due, at least in part, to "overreliance on uninsured deposits" and that the FDIC was "updating examiner guidance to be more explicit about analyses of uninsured deposit concentrations."[50] Efforts by the FDIC to reduce what Chairman Gruenberg views as "overreliance" on uninsured deposits could have major ramifications for the banking industry and its customers.

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ENDNOTES

1 *Special Assessment Pursuant to Systemic Risk Determination*, *available at* https://www.fdic.gov/news/board-matters/2023/2023-11-16-notice-dis-a-fr.pdf (hereinafter "Final Rule").

2 12 U.S.C. § 1823(c)(4)(G). Absent a Systemic Risk Determination, the FDIC is required to resolve an IDI in the manner that is "least costly" to the DIF. *Id.* § 1823(c)(4)(A). In order to make a Systemic Risk Determination, the FDIC's Board of Directors and the Board of Governors of the Federal Reserve System must determine that (i) resolution under the FDIC's least-cost resolution test would have "serious adverse effects on economic conditions or financial stability" and (ii) action or assistance by the FDIC not authorized under the least-cost resolution test would "avoid or mitigate such adverse effects." *Id.* § 1823(c)(4)(G)(i).

3 Final Rule at 8.

4 *Id*. at 10.

5 Insured branches of foreign banking organizations are also subject to the Final Rule. *See* 12 U.S.C. § 1813(c)(2) (defining "insured depository institution" to include "any bank or savings association the deposits of which are insured by the [FDIC]").

6 Final Rule at 18. The $5 billion deduction is applied at the banking organization level to the extent that an IDI is party of a holding company with one or more subsidiary IDIs. *Id*. at 19.

7 Instead, banking organizations will recognize the accrual of a liability and an estimated loss (*i.e.*, expense) from a loss contingency for the special assessment when the institution determines that the conditions for accrual under U.S. GAAP have been met (*i.e.*, in Q4 2023). *See id.* at 47.

8 Press Release, *FDIC Creates a Deposit Insurance National Bank of Santa Clara to Protect Insured Depositors of Silicon Valley Bank, Santa Clara, California*, (Mar. 10, 2023), *available at* https://www.fdic.gov/news/press-releases/2023/pr23016.html; Press Release, *FDIC Establishes Signature Bridge Bank, N.A., as Successor to Signature Bank, New York, NY*, (Mar. 12, 2023), *available at* https://www.fdic.gov/news/press-releases/2023/pr23018.html.

9 12 U.S.C. § 1823(c)(4)(G); *see also* Press Release, *Joint Statement by the Department of the Treasury, Federal Reserve, and FDIC*, (Mar. 12, 2023), *available at* https://www.fdic.gov/news/press-releases/2023/pr23017.html.

10 12 U.S.C. § 1823(c)(4)(G)(ii)(III).

11 88 FR 32694 (May 12, 2023) (hereinafter "Proposed Rule"); *see also FDIC Proposed Special Assessments for SVB and Signature Bank Resolutions*, Sullivan & Cromwell LLP (May 12, 2023), *available at* https://www.sullcrom.com/insights/memo/2023/May/FDIC-Proposed-Special-Assessments-for-SVB-and-Signature-Bank-Resolutions.

12 Final Rule at 9.

13 *Id.* at 9-10.

14 *Id.* at 10.

15 *Id*. at 10-11.

16 *Id.* at 11.

17 *Id.* at 27. The FDIC notes that it is conducting a review (the "*Assessment Reporting Review*") of the reporting methodology for estimated uninsured deposits and related items on the Call Report "because of the importance of these items as indicators of safety and soundness." *Id.* at 28.

18 *Id.* at 12.

19 *Id.* at 19.

ENDNOTES (CONTINUED)

20 *Id.* at 20-24.

21 *Id.* at 21-23.

22 *Id.* at 31. The FDIC notes that the two-year collection period mitigates the risk of overcollecting, which is important for banking organizations given the FDIC's statutory requirement to place any excess funds collected through the special assessment in the DIF. *Id.*

23 *Id.* at 31-32.

24 *Id.* at 32.

25 *Id.*

26 *Id.* at 33-34.

27 *Id.* at 34.

28 *Id.* at 36. The Final Rule states that an IDI is required to take any actions necessary to allow the FDIC to debit its special assessment and any shortfall special assessment from the bank's designated deposit account used for payment of its regular assessment. *Id.* at 37.

29 *Id.* at 36-37.

30 *Id.* at 37.

31 *Id.*

32 *Id.*

33 *Id.* at 37-38.

34 *Id.* at 39-40.

35 *Id.* at 38.

36 *Id.* at 40 (citing 12 C.F.R. § 327.6(C)).

37 *Id.*

38 *Id.* (citing FASB ASC ¶ 450-20-25-2).

39 *Id.* at 41.

40 *See id.*

41 *See supra* note 7.

42 *Id.* at 26.

43 *See id*. at 47-48.

44 *See id*. at 49.

45 *See id*. at 51. The FDIC estimates that the special assessment would result in a one-quarter reduction in income of more than 30 percent for 15 banking organizations with approximately $5.8 trillion in total assets and a one-quarter reduction in income of between 20 percent and 30 percent for 23 banking organizations with approximately $6.3 trillion in total assets. By contrast, the FDIC estimates that the special assessment would result in a one-quarter reduction in income of 20 percent or less for 73 banking organizations with approximately $7.3 trillion in total assets.

46 *See supra* note 10.

47 *See* Cong. Research Serv., IF12378, *Bank Failures: The FDIC's Systemic Risk Exception* (Apr. 11, 2023), *available at* https://crsreports.congress.gov/product/pdf/IF/IF12378. Although the FDIC made or planned to make a Systemic Risk Determination five times following the enactment of this authority in 1991, only one instance resulted in losses to the DIF; a special assessment was not

ENDNOTES (CONTINUED)

levied in that case because these costs were considered jointly with another program that resulted in positive net income. *See id*.

48 Final Rule at 20-21.

49 *Id.* at 21.

50 *See, e.g.*, Remarks by Chairman Martin J. Gruenberg on Oversight of Prudential Regulators before the Committee on Financial Services, United States House of Representatives (Nov. 15, 2023), *available at* https://www.fdic.gov/news/speeches/2023/spnov1523.html. The next day at a conference, Chairman Gruenberg also remarked: "On the relationship between long-term debt and uninsured deposits, I very much agree with [the remarks of a fellow panelist], we don't want more uninsured deposits, we want less uninsured deposits, quite frankly, in terms of concentrations. I think we are going to be looking to address that as a supervisory matter." Remarks by Chairman Martin J. Gruenberg on the Panel Discussion: Banking Sector Turbulences: Lessons Learnt for Supervision and Regulation at the Seventh Annual Conference of the European Systemic Risk Board (Nov. 16, 2023), *available at* https://www.youtube.com/watch?app=desktop&v=M5naHjaV2Fw (remarks appear at 1:19:38-1:20-18). There appears to be no regulatory definition of "concentration."

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