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No guarantee systemic risk exception will save the next bank

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Introduction

As observed with the rescue of Silicon Valley Bank (SVB) and Signature Bank, the systemic risk exception allows the Federal Deposit Insurance Corporation (FDIC) to intervene in situations where the stability of the financial system is at risk. Although it was deployed in the 2008 financial crisis and more recently in the latest banking turmoil, there is no guarantee it will be applied again, if another bank fails.

An understanding of the systemic risk exception can help depositors and bank counterparties set their expectations and prompt protective actions as vulnerability in the banking system persists.

The exception and its creation

Under the Federal Deposit Insurance Act (FDIA), the FDIC must act to protect insured depositors in the event of an insured institution's failure using a method of least cost to the federal government. The systemic risk exception, however, permits the FDIC to override the restrictions on cost under the FDIA, if the risk of an institution's failure would create risk for the financial system's stability. *See* 12 U.S.C. § 1823(c)(4)(G)(i).

Historically, the FDIC had the power to step in when troubled banks were deemed "essential" in providing banking services to their community. After the savings and loan crisis of the 1980s, however, the FDIC's authority was criticized and subject to review. In response, in 1991, the systemic risk exception to the FDIA was created through the Federal Deposit Insurance Corporation Improvement Act.

The result was an overall shift that reformed the FDIC's authority from the broad "essential" services framework to protecting insured depositors at the least cost, allowing an exception to be made only under extreme circumstances.

Enter the 2008 global financial crisis. It demonstrated that the failure of a single institution could lead to a domino effect, causing widespread disruption and negatively impacting the overall economy. As a result, the systemic risk exception was employed several times in response to the crisis.

But the federal government's broad grants of funds and guarantees of obligations for solvent institutions created further concerns, including the potential for moral hazard. Consequently, under the Dodd-Frank Act, further reforms were made to the FDIC's authority, including limiting use of the exception to the wind down of a federally insured institution. *See* Dodd-Frank Act, Title XI, Sec. 1106(b) (amending FDIA).

Invoking the exception

A determination to use the systemic risk exception must run a gauntlet of approvals.

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Under the Dodd-Frank Act, upon approval of its Board of Directors, the FDIC must submit a written recommendation to the Secretary of the Treasury that includes, among other statutory requirements:

- whether the financial company at issue is in or near default, and the effect of such default on the nation's financial stability;
- recommended actions; and
- the likelihood of private sector alternatives to prevent the default.

The Secretary of the Treasury, in consultation with the President, must also make a determination of systemic risk. That determination must earn the support of two-thirds of the members of the Board of Governors of the Federal Reserve System.

Upon completing all levels of review, the FDIC is granted additional powers to protect creditors of a bank placed into receivership, including uninsured depositors, without regard to the statutory cost restrictions. The cost of protecting uninsured depositors is repaid through a special assessment on the banking industry.

Recent use of extraordinary measures

Putting aside any failures of investment strategies and risk policies, both SVB and Signature Bank were marked by a relatively

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large amount of uninsured deposits. This made them especially vulnerable to rapid email and text communications among anxious depositors. A traditional "bank run" ensued, and the banks lacked liquidity to respond.

As a result, the FDIC stepped in as receiver. A systemic risk determination was made, resulting in the FDIC guaranteeing deposits at both banks, even those over the $250,000 insured limit.

Further, the FDIC created bridge banks operated by FDIC-appointed management to help the failing entities continue to operate while the FDIC worked to find new buyers. The bridge banks provided depositors access to their accounts, and counterparties access to loans and letters of credit, preserving enterprise value. To date, the actions have paid off, as buyers have been found for significant assets of SVB and Signature Bank.

The FDIC did not protect the banks' shareholders or unsecured debt holders. The board and senior management were removed, and the FDIC will conduct investigations related to bank management.

Challenging a systemic risk determination

Use of the systemic risk exception has not been without criticism. And given its discretionary nature, plaintiffs may attempt to challenge the FDIC's determination to apply, or not to apply the exception in the future given the precedent set with SVB and Signature Bank.

Although Congress has provided that the FDIC can "sue and be sued," 12 U.S.C.S. § 1819, any party seeking damages from the FDIC for a determination not to invoke the exception may face significant hurdles.

It is uncertain whether a systemic risk exception challenge would be subject to the Federal Tort Claims Act ("FTCA"). But if so, the claim would have to be brought against the United States and would be subject to a mandatory administration process. *See* 28 U.S.C. §§ 2675, 2679(a). It is possible a claim falling within an exception to the FTCA, for example the "discretionary function" exception in § 2680, may not be pursued.

If a claim is permitted, a further issue is whether a private right of action may be permitted. Although there is limited direct authority regarding the systemic risk exception, courts reviewing other provisions of the FDIA have often determined that no such right exists. For example, in *Deutsche Bank National Trust Company v. FDIC*, the Central District of California in 2011 found no private right of action for § 1821(d)(13)(E), requiring the FDIC to maximize value in a disposition of bank assets.

The Administrative Procedures Act and Section 1821(j) of the FDIA may pose further complications, limiting judicial review at least with respect to certain actions constituting final agency actions and to restrain or affect the FDIC's receiver powers, respectively.

Finally, a plaintiff successful in proceeding to the merits must overcome the discretionary latitude given to the FDIC. In *Hale House Center, Inc. v. FDIC* in 1992, the Southern District of New York was asked to determine whether the FDIC's determinations to reimburse depositors beyond the FDIC insurance cap only in some circumstances violated equal protection. Declining to reach procedural issues regarding whether the suit could be maintained, the court applied the deferential "rational basis" test to the FDIC's actions and found no violation had occurred.

Conclusion

The systemic risk exception is a powerful tool, but its recent use for SVB and Signature Bank may have given depositors at other banks a false sense of assurance. The Treasury Secretary has warned the public not to assume the federal government's actions have created any guaranty of deposits beyond FDIC-insured amounts. Should another bank fail, and depositors argue the FDIC has created an expectation they will be fully protected, there would be significant challenges to a claim against the FDIC.

The best course of action is proactive and protective cash management to prevent from happening that which seemed so imminent in the early days of the SVB and Signature Bank failures, before the systemic risk exception was invoked.

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