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Client Alert

March 2020

Will the FDIC Revive the Temporary Liquidity Guarantee Program Under The CARES Act?

Introduction

On March 27, the President signed into law the Coronavirus Aid, Relief and Economic Security Act ("CARES Act"). Section 4008 of the CARES Act authorizes the FDIC to establish liquidity guarantee programs for insured depository institutions and their holding companies. In light of the current financial crisis, we expect the FDIC will implement liquidity guarantee programs in the near future. But what will those programs look like?

During the previous financial crisis in 2008, the FDIC established the Temporary Liquidity Guarantee Program (the "TLGP"). The TLGP was considered an integral part of the broad government response to systemic risk in the banking system at that time, and it was the first time in the FDIC's history that it systemically protected bank debt. At its height, the FDIC guaranteed approximately $350 billion in newly issued bank debt and $800 billion in deposits under the program.[1] As a result of changes in applicable law as part of the Dodd-Frank Act, the FDIC's authority to implement liquidity guaranty programs similar to the TLGP was limited until the CARES Act became effective.

This client alert revisits the TLGP implemented by the FDIC from 2008-2012. While the FDIC has not yet announced any liquidity guaranty programs under the CARES Act, we believe it likely that the FDIC would follow the model of the TLGP in establishing any liquidity guaranty programs during the current crisis. When the FDIC formally announces liquidity programs under the CARES Act, we expect to issue another client alert describing the programs.

The TLGP consisted of two components, the Debt Guarantee Program and the Transaction Account Guarantee Program. Let's look at each of those programs separately.

Debt Guarantee Program

The Debt Guarantee Program ("DGP") guaranteed new senior unsecured debt issued by financial institutions and their holding companies. Under the DGP, in addition to debt issued by their subsidiary depository institutions, US bank and thrift holding companies (other than "unitary thrift holding companies" that were engaged in nonfinancial activities) were eligible to take advantage of the program and issue indebtedness guaranteed by the FDIC. Certain affiliates of depository institutions were also eligible as determined by the FDIC on a case-by-case basis. Eligible entities (both depository institutions and their parent companies) were required to inform the FDIC if they desired to opt out of the program. The table below shows the amount of debt that was guaranteed by the FDIC under the DGP during the previous financial crisis.

[1] https://www.fdic.gov/bank/historical/crisis/chap2.pdf

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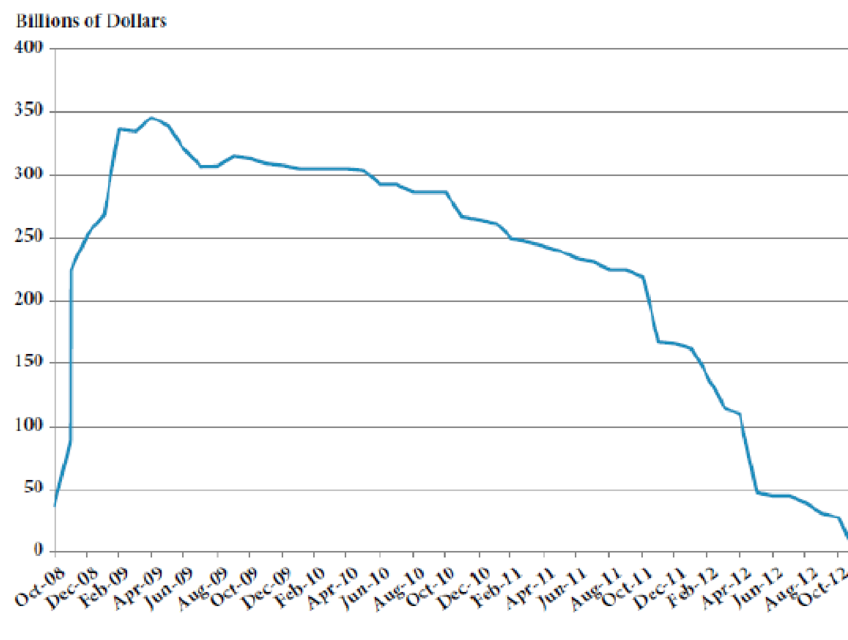
DGP Debt Outstanding, October 2008-December 2012



Source: FDIC

<u>Pricing and Limits on Participation</u>

Under the DGP, entities that issued debt were assessed fees in order to compensate for the FDIC's risk. The agency initially proposed an annualized 75 basis point flat fee, but ended up implementing a sliding fee schedule ranging from 50 to100 basis points in response to industry comments. Eventually, the FDIC also added an additional surcharge to the guarantee fee on any debt with a maturity of one year or greater. Looking back, the FDIC has acknowledged that a more discriminating pricing method might have been better. Accordingly, a more sophisticated pricing method may be used under a new program, building on the FDIC's prior experience with the DGP.

<u>Nature of Guaranteed Debt</u>

The 2008 DGP covered newly issued unsecured debt that met certain other requirements, including that the debt was evidenced by a written agreement or trade confirmation, had a specified and fixed principal, was non-contingent and contained no embedded options, forwards, swaps, or other derivatives, and was not, by its terms, subordinated to any other liability. Senior unsecured debt included federal funds purchased; promissory notes; commercial paper; unsubordinated unsecured notes, including zero-coupon bonds; US dollar-denominated certificates of deposit owed to an insured depository institution, insured credit union or foreign bank; US dollar-denominated deposits in an international banking facility of an insured depository institution or a foreign bank; and US dollar-denominated deposits on the books of foreign branches of US-insured depository institutions, which were owed to an insured depository institution or a foreign bank.

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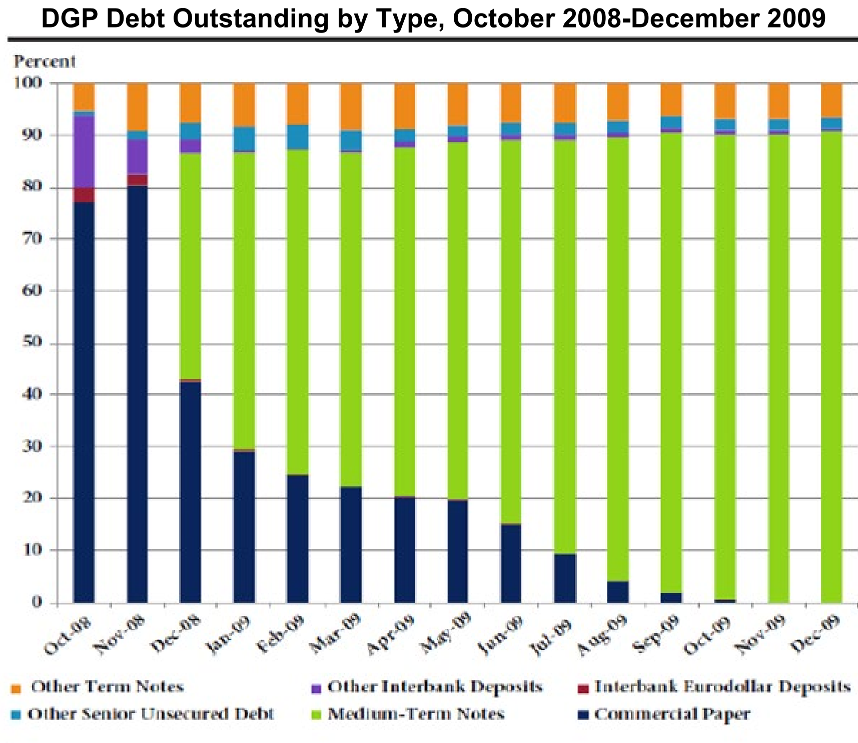
The following table breaks out DGP debt outstanding by type.

DGP Debt Outstanding by Type, October 2008-December 2009



Source: FDIC

Debt-Guarantee Limit

Through the DGP, the FDIC guaranteed an amount of debt issued by an entity on or after October 14, 2008, based on the outstanding indebtedness of the entity as of September 30, 2008. For entities that had indebtedness outstanding on September 30, 2008, the maximum amount of newly issued senior unsecured debt that the FDIC guaranteed was up to 125% of the outstanding senior unsecured indebtedness that was outstanding on September 30, 2008, with less than nine months remaining to maturity. The majority of banks and holding companies had no qualifying unsecured indebtedness outstanding (other than Fed funds and trade payables). As a result, the FDIC issued a final rule that participating depository institutions with little or no indebtedness outstanding could have a guarantee limit equal to 2% of total liabilities as of September 30, 2008. Holding companies with little or no senior unsecured debt outstanding on September 30, 2008, that wished to participate had to apply to have some amount of indebtedness covered by the program. The FDIC evaluated requests for such guarantees on a case-by-case basis. All requests for establishing the debt guarantee limit had to include the details of the request, a summary of the applicant's strategic operating plan and describe the proposed use of the debt proceeds.

In determining the amount of the guarantee, the FDIC considered the financial condition and supervisory history of the proposed borrower, the strength from a ratings perspective of the issuer of the obligation that was to be guaranteed, and the size and extent of the activities of the organization. The FDIC had the discretion to consider any other factors that it deemed relevant. The FDIC also made exceptions to an entity's debt guarantee limit or imposed other requirements on the entity after consultation with the entity's primary federal banking regulator.

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An insured depository institution was permitted, with prior written notice to and no objection from the FDIC, to increase its own senior unsecured indebtedness that was guaranteed by using part of its parent's limit. If an insured depository institution did so, however, the debt guarantee limit of the holding company was reduced by the amount of guaranteed debt that the subsidiary issued over its limit.

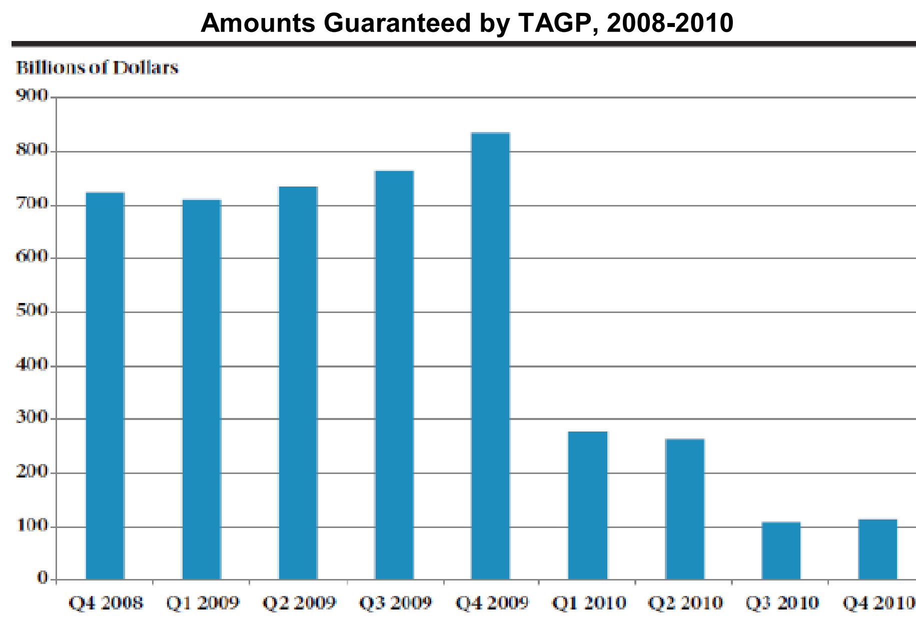
Payment on the Guarantee

The FDIC's obligation to pay under the guarantee arose upon a timely demand by the debtholder after a payment default. The FDIC satisfied its guarantee by making scheduled payments of principal and interest pursuant to the terms of the debt instrument. The FDIC, in its discretion, was permitted to make a one-time payment at any time after June 30, 2012, as a final payment of principal and interest under a guaranteed instrument with a maturity beyond that date. Upon payment of the guarantee, the FDIC stepped into the shoes of the borrower and was subrogated to the rights of each debtholder in bankruptcy.

Transaction Account Guarantee Program

The other key aspect of the TLGP was the Transaction Account Guarantee Program ("TAGP"). The TAGP fully guaranteed certain non-interest-bearing transaction deposit accounts at FDIC-insured financial institutions and was intended to comfort depositors in order to avoid runs at healthy banks. The TAGP was the first instance where the FDIC had ever extended unlimited deposit insurance protection to a class of bank deposits. Small-business accounts were specifically targeted since the FDIC found these types of accounts frequently exceeded the standard $250,000 insurance limit.

Amounts Guaranteed by TAGP, 2008-2010



Source: FDIC

The TAGP covered all non-interest-bearing transaction deposits above the FDIC's standard insurance limit, generally $250,000. Based on industry comments, the FDIC extended the TAGP to cover accounts considered important to sole proprietorships and charitable organizations and permitted participating institutions to maintain rates up to an initial 50 basis points (eventually lowered to 25 basis points as part of the second extension of the program). As with the DGP, the TAGP imposed fees for participating in the program consisting of a 10 basis point annual assessment rate surcharge on qualifying accounts for

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amounts over $250,000. The FDIC credits the TAGP for preventing disruptive shifts in deposit funding for participating institutions.

The CARES Act specifically authorizes the FDIC to guarantee non-interest bearing transaction accounts, and we expect the FDIC to exercise that authority. Several of our clients have seen an increase in cash demands from customers who are wary of having uninsured funds at their financial institution. While there are widespread efforts to avoid all in-person activities, making it more difficult to use cash, and businesses as well as individuals are increasingly leveraging electronic payment solutions, the FDIC's implementation of an unlimited guaranty of non-interest bearing deposit accounts may comfort depositors and encourage them to leave funds on deposit. This would likely increase funding available for lending by financial institutions and protect customer deposits.

Conclusion & Next Steps

The TLGP was the first time the FDIC undertook a guarantee of debt issued by financial institutions and suspended the FDIC deposit insurance limit for any type of deposits. In light of the current financial crisis, and as statutory authority for any liquidity guarantee program issued under the CARES Act requires the programs and any guarantees thereunder to terminate no later than December 31, 2020, we believe the FDIC will move quickly to exercise its authority and issue a new liquidity guaranty program in the near future. We expect, however, that the FDIC will use its wisdom gained from practical experience during the 2008 financial crisis to develop "TLGP 2.0". We intend to update this client alert when more information is available.

Resources:

- FDIC Temporary Liquidity Guarantee Program Frequently Asked Questions
- Crisis and Response, An FDIC History, 2008-2013, Chapter 2 – The Temporary Liquidity Guarantee Program
- Hunton Andrews Kurth Coronavirus (COVID-19) Resource Center

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