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GAO

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Highlights

Highlights of GAO-10-100, a report to congressional committees

FEDERAL DEPOSIT INSURANCE ACT

Regulators' Use of Systemic Risk Exception Raises Moral Hazard Concerns and Opportunities Exist to Clarify the Provision

Why GAO Did This Study

In 2008 and 2009, the Federal Deposit Insurance Corporation (FDIC) provided emergency assistance that required the Secretary of the Department of the Treasury (Treasury) to make a determination of systemic risk under the systemic risk exception of the Federal Deposit Insurance Act (FDI Act). The FDI Act requires GAO to review each determination made. For the three determinations made to date, this report examines (1) steps taken by FDIC, the Board of Governors of the Federal Reserve System (Federal Reserve), and Treasury to invoke the exception; (2) the basis of the determination and the purpose of resulting actions; and (3) the likely effects of the determination on the incentives and conduct of insured depository institutions and uninsured depositors. To do this work, GAO reviewed agency documentation, relevant laws, and academic studies; and interviewed regulators and market participants.

What GAO Recommends

To better ensure transparency and accountability, Congress should consider amending the FDI Act to require Treasury to document reasons for not making a determination for an announced action and to clarify the requirements and exception. As Congress considers financial regulatory reform, it should ensure greater regulatory oversight of systemically important institutions to mitigate the effects of weakened market discipline from use of the systemic risk exception. The Federal Reserve and Treasury generally agreed with our findings.

View GAO-10-100 or key components.
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What GAO Found

Treasury, FDIC, and the Federal Reserve collaborated before the announcement of five potential emergency actions that would require a systemic risk determination. In each case, FDIC and the Federal Reserve recommended such actions to Treasury, but Treasury made a determination on only three of the announced actions. Although two recommendations have not resulted in FDIC actions to date, their announcement alone could have created the intended effect of increasing confidence in institutions, while similarly generating negative effects such as moral hazard. However, because announcements without a determination do not trigger FDI Act requirements for documentation and communication, such as Treasury consultation with the President and notification to Congress, such de facto determinations heightened the risk that the decisions were made without the level of transparency and accountability intended by Congress. Further, uncertainties can arise because there is no requirement for Treasury to communicate that it will not be invoking a systemic risk determination for an announced action.

Two of Treasury's systemic risk determinations—for Wachovia and Citigroup—were made to avert the failure of an institution that regulators determined could exacerbate liquidity strains in the banking system. A third determination was made to address disruptions to bank funding affecting all banks. Under this latter determination, FDIC established the Temporary Liquidity Guarantee Program (TLGP), which guaranteed certain debt issued through October 31, 2009, and certain uninsured deposits of participating institutions through December 31, 2010, to restore confidence and liquidity in the banking system. While there is some support for the agencies' position that the statute authorizes systemic risk assistance of some type under TLGP facts and that it permits assistance to the entities covered by the program, there are questions about these interpretations, under which FDIC created a broad-based program of direct assistance to institutions that had never before received such relief—"healthy" banks, bank holding companies, and other bank affiliates. Because these issues are matters of significant public interest and importance, the statutory requirements may require clarification.

Regulators' use of the systemic risk exception may weaken market participants' incentives to properly manage risk if they come to expect similar emergency actions in the future. The financial crisis revealed limits in the current regulatory framework to restrict excessive risk taking by financial institutions whose market discipline is likely to have been weakened by the recent use of the systemic risk exception. Congress and regulators are considering reforms to the current regulatory structure. It is important that such reforms subject systemically important financial institutions to stricter regulatory oversight. Further, legislation has been proposed for an orderly resolution of financial institutions not currently covered by the FDI Act. A credible resolution regime could help impose greater market discipline by forcing participants to face significant costs from their decisions and preclude a too-big-to-fail dilemma.