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Financial Institutions and Monetary Policy
hearing on
"Federal Responses to Recent Bank Failures"

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Chairman Barr, Ranking Member Foster and Members of the Subcommittee: thank you for the opportunity to discuss Federal responses to recent bank failures.

My testimony will focus on the recently-issued reports from the Federal Reserve and FDIC on their supervision of Silicon Valley Bank ("SVB") and Signature Bank, respectively. My testimony is my own. I am speaking today solely in my personal capacity; I am not speaking on behalf of any clients or my law firm.

According to the Fed's Office of Inspector General (and I quote):

> …examiners identified key safety and soundness risks, but did not take sufficient supervisory action in a timely manner to compel the Boards of Directors and management to mitigate those risks. In many instances, examiners eventually concluded that a supervisory action was necessary, but that conclusion came too late to reverse the bank's deteriorating condition.[1]

This statement might well summarize the voluminous reports from the Fed and FDIC. But it was actually issued in 2011 in connection with the OIG's review of Fed supervision of the 35 state member banks that failed in the aftermath of the 2008 financial crisis. In the years following this assessment, Congress has enacted major banking reforms, and the banking agencies have promulgated a host of new regulations and revised their supervisory approaches. And yet we seem to have made little progress in improving supervisory outcomes without recourse to extraordinary interventions like guaranteeing uninsured deposits.[2] Agency self-reflection is appropriate, but supervisory transparency and Congressional accountability are critical given the limited progress made since 2008. The Fed and FDIC reports offer a starting point for further fundamental review by Congress. My testimony will address several areas: supervision; regulation; and Fed governance, structure and conflicts of interest.

[1] *Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank* (April 2023), https://www.federalreserve.gov/publications/review-of-the-federal-reserves-supervision-and-regulation-of-silicon-valley-bank.htm ("Fed Report"), at 95 (quoting Fed Office of Inspector General, Summary Analysis of Failed Bank Reviews (September 2011)).

[2] The goal of supervision is not to prevent all bank failures, but rather to safeguard the overall stability of the system, minimize moral hazard, and ensure failures occur in an orderly fashion.

Supervision and regulation are complementary but worth distinguishing. Regulation is broadly applicable and implements statutory imperatives; supervision is the practical art of applying that regulatory framework to individual banks through the exercise of examiner judgment.[3] In the case of SVB, the Fed acknowledges that its supervision failed to identify, much less address, some of the most basic safety and soundness risks applicable to a bank, including liquidity and interest rate risks. Risk management, which ***is*** the business of banking (not an outgrowth thereof), appears reduced to a mere compliance process by both failed banks and their supervisors. It is particularly hard to explain the Fed's failure to supervise for interest rate risk, when it created that risk through its own monetary policy actions.[4] Neither report explains the many failures of supervision,[5] and significant portions of the reports are simply distraction.[6] An independent review and disclosure of internal agency communications about SVB and Signature supervision would seem an obvious next step in any credible investigation.

Both reports raise questions about the adequacy and allocation of resources at these agencies. Neither agency is limited to the General Schedule pay scale, and their headcounts materially exceed their fellow Federal bank supervisor, the OCC.[7] And, yet, the Fed Report notes that "[o]nly one examiner was responsible for reviewing [interest rate risk] and the investment portfolio, and, in some cases, would also review liquidity and model risk management (MRM) during a two-to-three-week timeframe."[8] Likewise, the FDIC Report complains about examiner shortages and difficulty filling key roles.[9]

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[3] For more on the differences between bank regulation and supervision, see then Fed Vice-Chairman Randy Quarles's "Spontaneity and Order: Transparency, Accountability, and Fairness in Bank Supervision" (Jan. 17, 2020), https://www.federalreserve.gov/newsevents/speech/quarles20200117a.htm.

[4] SVB was literally the case study for a Board briefing on February 14, 2023, entitled "Impact of Rising Rates on Certain Banks and Supervisory Approach." Fed Report, at 70.

[5] Unexplained delays in downgrading supervisory ratings, such as CAMELS ratings, allowed SVB and Signature to continue operating in a "business as usual" mode. Had downgrades in accordance with the supervisory records of these two banks proceeded in timely fashion, the banks would have been subject to immediate consequences, including restrictions on expansionary activities and higher deposit insurance assessments, among other things. *See, e.g.*, Federal Reserve Supervision & Regulation Letter 14-2 (Feb. 24, 2014), https://www.federalreserve.gov/supervisionreg/srletters/sr1402.htm; 12 CFR §327.16. Downgrades also pave the way for formal enforcement actions. *See, e.g.*, GAO, *Preliminary Review of Agency Actions Related to March 2023 Bank Failures* (April 2023), https://www.gao.gov/assets/820/819616.pdf, at note 39 and accompanying text.

[6] *See, e.g.*, the discussion of the Volcker rule in the Fed Report.

[7] The OCC had 3,508 employees (2022), compared to 23,517 at the Federal Reserve System (2021) and 5,612 at the FDIC (2022). See https://occ.treas.gov/publications-and-resources/publications/annual-report/index-annual-report.html; https://www.federalreserve.gov/publications/files/2021-annual-report.pdf; and https://www.fdic.gov/about/financial-reports/reports/2022annualreport/2022-arfinal.pdf, respectively.

[8] Fed Report, at 65.

[9] "From 2017 to 2023, the FDIC was not able to adequately staff an examination team dedicated to SBNY (Dedicated Team)." *FDIC's Supervision of Signature Bank* (April 28, 2023), https://www.fdic.gov/news/press-releases/2023/pr23033a.pdf ("FDIC Report"), at 4.

The reports give us little information as to how the agencies prioritize their resources. The topics of the Fed's semiannual *Supervision and Regulation Reports*[10] are not a substitute for budgetary detail and supervisory staffing models and metrics, including those for the Federal Reserve Bank of San Francisco. Congress should request and review these materials to determine whether the agencies are giving short shrift to their supervisory functions or it disagrees with their supervisory priorities.

The Fed Report does address changes in regulation it made in 2019 following the discretion granted it by Congress in the Economic Growth, Regulatory Relief, and Consumer Protection Act. It concludes that these changes created a weaker regulatory environment and may have contributed to SVB's failure. Others have addressed the complete lack of causal connection between the failure of SVB and the Economic Growth Act with the level of response it deserves.[11] I will merely add that: (1) the Federal Reserve did not enforce regulations that did apply to SVB;[12] (2) the proliferation of regulations since the 2008 crisis may have reduced risk management and supervision to mere compliance exercises, damaging both in the process; and (3) over-reliance on preferred regulatory tools, such as the Fed's regulatory capital stress testing program known as CCAR, may have blinded supervisors to risks that do not appear when viewed through that particular lens.

Congress would be better served evaluating the efficacy of regulations already on the books. Resolution and recovery planning might be a good place to start.[13] And Congress might consider reassigning agency resources from those functions to basic supervision activities, particularly in light of the alleged supervision staffing constraints noted in the reports and their direct causal connection to recent bank failures. Regulations can also have perverse consequences. For example, had SVB been subject to the liquidity coverage ratio (and had the Fed enforced it), SVB would have been incentivized to increase or shift its holdings of high-quality liquid assets, which, ironically, may have increased its exposure to interest rate risk.[14]

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[10] Fed Report, at 71.

[11] *See, e.g.*, Remarks by FDIC Vice Chairman Travis Hill at the Bipartisan Policy Center on the Recent Bank Failures and the Path Ahead (April 12, 2023), https://www.fdic.gov/news/speeches/2023/spapr1223.html. *See also* "How Did Regulatory Tailoring Affect SVB's Capital Requirements?," Bank Policy Institute (May 3, 3023), https://bpi.com/how-did-regulatory-tailoring-affect-svbs-capital-requirements/; "Something Missing: Omissions and Surprises in the Federal Reserve's SVB Report," Bank Policy Institute (May 5, 2023), https://bpi.com/something-missing-omissions-and-surprises-in-the-federal-reserves-svb-report/.

[12] *See, e.g.*, the Fed's failure to enforce Regulation YY requirements, including that SVB have a chief risk officer and hold a sufficient liquidity buffer under its internal liquidity stress test. Fed Report, at 49 and 56.

[13] The FDIC has required insured depository institutions with $50 billion or more in total assets to submit resolution plans since 2012. *See* 12 CFR Part 360.10. Congress should assess the level of agency resources dedicated to these efforts and what value, if any, such requirements and associated planning and agency review provided in the supervision or resolution of Signature and SVB.

[14] The liquidity coverage ratio requires banks to hold a minimum amount of high-quality liquid assets ("HQLA") to meet total net cash outflows in a 30-day stress period. HQLA comprises government obligations like Treasuries and agency (*e.g.*, Fannie Mae, Freddie Mac or Ginnie Mae) mortgage-backed securities. Although these assets have little to no credit risk, they are subject to interest rate risk. Their market value drops as interest rates rise, resulting in unrealized losses, the very same losses that contributed to SVB's failure. *See* Bank Policy Institute, "Did S.2155 Allow SVB's Failure?" (May 1, 2023), https://bpi.com/did-s-2155-allow-svbs-failure/.

The Fed has a unique governance and structure that differ from other bank supervisors, including the FDIC and the OCC. Given the fundamental failure of supervision at SVB and previous failed attempts at reform by the Fed,[15] Congress should consider whether and to what extent the Fed's structure and governance is a contributing factor. The report does not answer this question, although it raises some obvious areas for exploration. For example, the Fed report references various delegated authorities that the report failed to explore. Although these delegations are public,[16] disclosure of internal Fed communications would provide insight into how such delegations were applied in connection with the supervision of SVB. Similarly, the Fed Report hints that governance issues may have delayed an enforcement action for seven months but fails to reach any conclusion.[17] The sheer complexity of the Fed's supervisory processes is difficult to fathom and frustrates accountability.[18] A clear presentation from the Fed of roles and responsibilities within the System and between the Board and Reserve Banks is a prerequisite for basic accountability.[19]

The Fed Report identifies some potential conflicts of interest between the Reserve Banks and the Board.[20] An even greater concern is the inherent conflict of interest between the Fed's monetary policy and bank supervision functions. The Fed's rapid interest rate hikes are a source of systemic risk to the banks it supervises and were a cause of SVB's failure. Congress should explore how the Fed's monetary policy decisions, including its macroeconomic outlook, affect its supervisory strategies in general and its supervision of SVB in particular.

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The business of banking is built on trust and confidence.[21] But that trust and confidence can ebb and flow. Although our current predicament differs from 2008, trust and confidence in the banking system is ebbing now. Competent bank supervision is a prerequisite to restoring that trust and confidence. Transparency into the supervisory strategies and priorities of the Fed and

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[15] *See* Fed Report, at 93-95.

[16] *See* 12 CFR Part 265.

[17] *See* Fed Report, at 8. SVB failed before the enforcement action was delivered.

[18] Even the authors of the Fed Report are flummoxed: "The root cause of these delays around supervisory actions is difficult to ascertain. Governance issues related to the Board's approach to delegated authority may play a role." Fed Report, at 9. *See, also,* Division of Supervision & Regulation organizational chart (March 13, 2023), https://www.federalreserve.gov/aboutthefed/files/sandr-org-chart.pdf.

[19] Among other things, it appears there was an extended period of time in which the Board's Committee on Supervision and Regulation, which oversees the Division of Supervision & Regulation, lacked a chair. *See* "Fed announces Quarles to step away from internal regulatory lead role as vice-chair term expires" (Oct. 12, 2021), https://www.reuters.com/world/us/fed-announces-quarles-step-away-internal-regulatory-lead-role-vice-chair-term-2021-10-12/ (noting "that panel will meet as needed on an unchaired basis, and any regulatory projects will only advance if there is 'broad consensus' among Fed officials, according to a Fed spokesperson").

[20] *See* Fed Report, at 44 (noting the role of Board staff as both participant and Reserve Bank overseer in the supervisory process).

[21] *See*, *e.g.*, "Safeguarding Trust in Banking," Remarks by Acting Comptroller of the Currency Michael Hsu (September 15, 2021), https://www.occ.gov/news-issuances/speeches/2021/pub-speech-2021-97.pdf.

FDIC, particularly as they were applied to these failed banks, is a critical first step in understanding what went wrong. Given past failures at self-reform, Congress can and should exercise its full oversight authorities to ensure a different outcome this time.

Thank you again for the opportunity to testify. I look forward to your questions.