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before the U.S. House of Representatives Financial Services Subcommittee on Financial Institutions and Monetary Policy

Hearing on Federal Response to Recent Bank Failures

May 10, 2023

Chairman McHenry, Ranking Member Waters, Ranking Member Barr, Ranking Member Foster and Members of the Subcommittee:

Thank you for the opportunity to be here today. Thank you as well for turning your attention to ensuring the health and vibrancy of the banking sector.

Since March of this year, we have witnessed the failure of four regional banks. Three of those banks failed in ways that imposed significant losses on the Deposit Insurance Fund. Two of those banks failed in ways that required the FDIC, the Federal Reserve Board of Governors and the Treasury Secretary, in consultation with the President, to invoke the "systemic risk exception" to the requirement that a bank be resolved in the manner that imposes the lowest cost on the Deposit Insurance Fund. To further allay panic and ensure banks had adequate access to liquidity on favorable terms, the Federal Reserve Board instituted the Bank Term Funding Program, relying on its broad authority pursuant to its Section 13(3) authority to expand the terms and counterparties of collateralized lending arrangements in "unusual and exigent circumstances."

Whether this crisis is behind us remains uncertain. What's not uncertain is that these failures reveal meaningful shortcomings in how regional banks are regulated and supervised. Alongside other bank failures and episodes of distress, they also provide important insights into ways to improve the resilience of the banking system and to hold bank leadership to account.

I. Structure of the Banking System

Recent events raise a host of policy issues regarding how to best to ensure the safety and soundness of banks and how to promote the resilience of the banking system. Yet the process of answering these questions has important ramifications not only for the health of the banking system, but also for the structure of the banking system, who it serves, and who benefits from its operation. Keeping the big picture in mind is key to answering the myriad policy issues now at play in a coherent manner and in a way that actually achieves desired aims.

For a long time, the United States had a remarkably diffuse and decentralized banking system. Rules limiting the ability of banks to open branches or operate across state lines resulted in a country awash in small banks that focused on serving their local communities. There were drawbacks to this system. Banks were often overly exposed to the health of a single economic region, rendering those banks more fragile and sometimes accentuating periods of local economic distress. Yet there were also a range of advantages. No single bank was "too big to fail." That the health of banks often went hand in hand with the health of the local economy gave bankers an incentive to support local businesses and local economic growth.[1] This is one reason that community banks have always played, and continue to play, a central role in small business lending.[2] And in working with both businesses and individuals, community banks engage in more relationship banking, which has real benefits for both the bank and the businesses and families they serve.[3]

Over the past half century, the U.S. banking system has been transformed. The total number of banks has gone down dramatically, while the proportion of bank assets held by the largest banks has gone up even more dramatically. The legal and regulatory changes that made this possible were adopted over time by a range of different actors, but—affirming the importance of vision—they often worked collectively to make this possible because they were guided by a broad (though far from universally held) belief that the country would benefit from having large, global banks that could serve increasingly large, multinational corporations, and hopes that efficiency gains would be passed along to consumers. Experience has shown that there are some benefits from having larger, more diversified banking organizations, but the drawbacks have proven to be significant, myriad and very difficult to address.

The decisions made in the coming months and years regarding how to respond to this saga and how best to promote the resilience of the banking sector, will similarly affect the structure of the banking system, who has access to credit and other financial services, and the fairness of the terms on which credit and services are provided. So far at least, the country has managed to retain a vibrant community banking sector, including community development financial institutions and minority depository institutions. These banks make up a far smaller share of banking assets today, but they continue to play an outsized role in small business and agricultural lending, and they play a particularly important role providing credit to minority-owned businesses and other minority borrowers.[4] Small businesses today also report having a much better experience when they work with a community bank than when they seek credit from a large bank or a fintech. And when Covid hit, small banks played a vital role getting money into the hands of truly small businesses and their employees.

So far, community banks seem to be weathering this storm relatively well, bolstered by the relationships they so often have with their customers. Yet the events of the past two months and the still simmering unrest in the banking sector could further accentuate the competitive challenges these banks are facing. Specifically considering how the impact of the policy issues under discussion, and the longer term policy agenda, on the vibrancy of community banks and their willingness to provide the credit small businesses need to flourish and families need to survive could prove critical to the long-term health and inclusiveness of our economy.

II. Regulatory Framework for Large Regional Banks

[1] E.g., Raghuram Rajan, Communities, the State, and Markets: The Case for Inclusive Localism, Oxford Review of Economic Policy, 37(4), pp. 811-23 (2021).
[2] E.g., Marshall Lux & Robert Greene, The State and Fate of Community Banking, Harvard M-RCBG Associate Working Paper Series, No. 37 (Feb. 2015).
[3] E.g., Sumit Agarwal et al, Benefits of relationship banking: Evidence from consumer credit markets, Journal of Monetary Economics, Vol 96, pp 16-32 (2018).
[4] Letter from Rebecca Romero Rainey, President & CEO, Independent Community Bankers of America, to Rohit Chopra, Director, Consumer Financial Protection Bureau, dated Apr. 18, 2022.

The diverse array of banking organizations that constitute the United States banking system precludes any one-size-fits-all approach. A community bank with $3 billion in assets that operates entirely within a single state should not be subject to the same suite of regulations needed to promote the safety and soundness of a large, complex, multi-national banking organization. Some degree of tailoring has long been part of banking regulation in the United States, and should remain so.

This episode has served as a powerful reminder of the importance of ongoing diligence with respect to the adequacy and the appropriateness of the rules governing banks of all sizes and types, and particularly with respect to megabanks and regional banks. Although megabanks are not in the immediate spotlight, there remains room for improvement with respect to their oversight. Federal Reserve Vice Chair Michael Barr was already in the process of a holistic review of capital adequacy standards and the implementation of Basel III remains incomplete. These tasks are now more pressing than ever. Recent events also cast doubt on the credibility and adequacy of the resolution plans in place for banks of all sizes. Alongside the messy bank failures experienced in the United States, and regulators decisions to invoke the systemic risk exception, the decision overseas to allow UBS to acquire Credit Suisse suggests the work done on resolution planning is nowhere need complete and more work needs to be done.

Nonetheless, the core issue at play in the wake of the failures of four regional banks is the adequacy of the regulations governing regional banks. Although sometimes referred to as midsized banks because they sit between the globally systemic banks and community banks in the pecking order of size, many regional banks are very large banks.

How best to regulate regional banks has been hotly debated for a long time. On the one hand, large regional banks are far larger, more complex and harder to resolve than community banks, and should be subject to more robust regulation accordingly. On the other hand, even large regional banks are not as large, as complex or as globally active as the country's largest banks. Hence, for a while, it may have been reasonable to hope that they were not systemic, and any fallout that may flow from the failure of a regional bank could be contained without threatening the health of the broader financial system or forcing regulators to compromise on other important regulatory aims. Today, those beliefs are no longer tenable.

With respect to both Silicon Valley Bank and Signature Bank, every Federal Reserve Governor, every member of the FDIC Board, and the Treasury Secretary, in consultation with the President, determined that allowing either bank to be resolved in the ordinary course "would have serious adverse effects on economic conditions or financial stability."[5] This is a high burden, both substantively and procedurally. That every single policy maker with a vote thought it was clearly satisfied is a testament to the gravity of the threat to stability that almost came to pass.

This does not mean that every regional bank is too-big-to-fail, but it does demonstrate that the health of these banks can pose serious threats to the health of the banking system more broadly. And, the need to resolve a failed regional bank in a short timeframe can compel bank regulators to take actions otherwise inconsistent with promoting healthy competition and limiting

[5] 2 U.S.C. § 1823 (c)(4)(G).

the further growth of the country's largest banks.[6] These realities demonstrate why it is critical to subject these banking organizations to appropriate enhanced prudential standards. The good news is that there is already a suite of regulatory requirements readily available and well suited to address these challenges. These include enhanced liquidity risk management requirements, standardized liquidity requirements—commonly known as the Liquidity Coverage Ration and the Net Stable Funding Ration, enhanced capital requirements, supervisory stress testing, more robust bank-run stress testing and additional obligations with respect to resolution planning.

As an initial matter, the Federal Reserve and other regulators should use the discretion available under current law to ensure that the prudential regulations imposed on large regional banks and banking organizations are commensurate with the risks that they pose.[7] The path proposed by Federal Reserve Board in its report on the failure of SVB marks an important step in this direction, and the Fed should move swiftly to initiate the rulemaking process needed to implement more appropriate standards.

Second, in time, Congress may seek to reduce the amount of discretion that the Federal Reserve has to lower the prudential standards for banks or other banking organizations with assets in excess of $100 billion. In 2019, the Federal Reserve made a choice to implement Economic Growth, Regulatory Relief, and Consumer Protection Act in a manner that was meaningfully more deregulatory than the revised statutory scheme required. With the benefit of hindsight, it is clear that decision was in error. Moreover, because the adverse impact of deregulation on the health of banks and the banking system are often only felt in future periods, there is a risk that even if standards are tightened now, future regulators may again seek to weaken standards despite the harms that could result. Given the direct costs of bank failures, and the way such failures can undermine faith in the banking system and bank regulators, Congress should consider expanding the statutorily required enhanced prudential standards applicable to banking organizations with over $100 billion in assets.

Third and relatedly, recent events suggest that there may also be room for other improvements in where and how to impose heightened prudential standards. This should include reviewing when banks, not just bank holding companies, should be subject to enhanced prudential standards. It may also be worth expanding the ability of the Fed and other bank regulators to impose an appropriate mix of enhanced prudential standards to banks and banking organizations with assets between $50 and $100 billion.

III. Supervision

The regional bank failures this spring, and the reports from the FDIC, the Federal Reserve, the New York Department of Financial Services examining those failures, also reveal significant shortcomings in the adequacy of the supervisory structures currently in place at the Federal Reserve and FDIC. The Federal Reserve has gone further and has voluntarily provided its recent SVB examination reports and other supervisory materials relating to SVB. Let me briefly thank the staff members of each of those agencies for the incredible effort they invested

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[6] Congress has limited the ability of banks with more than ten percent of the deposit base to grow via acquisition absent exceptional circumstances. J.P. Morgan was already well above this threshold before being allowed to acquire substantially all of the assets and liabilities of First Republic Bank.
[7] See generally Board of Governors of the Federal Reserve System, Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank (2023).
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putting those reports together in such limited time, and let me also express my deep appreciation to Vice Chair Barr, FDIC Chair Gruenberg and Superintendent Harris for their leadership in choosing to be so forthcoming and proactive.

Although questions remain, the reports collectively provide a critical first step in unpacking what went wrong and what needs to fixed with respect to bank supervision. Given the amount of information available in those reports, I will limit my comments to key issues and matters not fully flushed out in those reports.

Bank culture and repeat offenders: Even prudently run banks will sometimes make mistakes. They may expand into a new domain without adequately understanding and addressing the attendant risks or make personnel decisions that contribute to compliance failures in a particular division. Supervisors can help banks identify such missteps and may appropriately want to give bank management an opportunity to rectify the shortcoming.

Other times, however, supervision reveals more than isolated missteps. It may reveal persistent shortcomings in risk management, chronic issues with respect to compliance or other patterns of misbehavior. Similarly, banks often respond in a prompt and appropriate manner when a supervisor brings a shortcoming to their attention, via a supervisory letter or otherwise, some banks routinely fall short in their willingness to devote adequate attention and resources to addressing identified deficiencies.

Some bank regulators are already taking steps to focus in on the problem of repeat offenders. At a Brookings event in January, Acting Comptroller Hsu explained how the OCC is using escalation frameworks to address this challenge, and the reality that some banks may be too big to manage well. Escalation frameworks both give banks a chance to take corrective actions, and provide them an extra incentive to take corrective action because the penalties for not doing so go up the longer misbehavior or deficiencies persists. As he explained, "when a bank is on notice that certain deficiencies need to be fixed and they don't get remediated on time or new things break, the OCC will actively consider imposing growth restrictions." And if a bank has had "multiple opportunities to address the problem and been publicly motivated to do so, yet fallen short… supervisors would consider the fourth level of escalation – simplification via divestiture."[8]

Although it was a long time in coming, and far too many consumers were harmed in the interim, the decision by the Federal Reserve to cap the growth of Wells Fargo is a prime example of appropriate escalation. CFPB Director Chopra has also highlighted the importance of prioritizing and addressing recidivism, and he is similarly using escalation plans to address the challenge. More widespread and consistent use of appropriate escalation frameworks should be a cornerstone of efforts to improve bank supervision.

Use of Outside Information: Just like banks sometimes make mistakes, bank supervisors sometimes miss risks that they should spot or fail to appreciate the seriousness of risks that they do identify. Just as with banks, experience suggests time-tested tools for reducing these risks. Adequate staffing, a culture that encourages supervisors to ask hard questions of the banks they oversee, mechanisms for ensuring timely follow up when concerns are communicated to a

[8] Acting Comptroller of the Currency Michael J. Hsu, Remarks at Brookings "Detecting, Preventing, and Addressing Too Big To Manage" January 17, 2023.

bank and for escalating issues when they are not adequately addressed, and appropriate oversight within bank supervisory structures can go a long way in helping to reduce these risks. Nonetheless, experience suggests that these steps cannot be taken for granted, and they may not always suffice. To further enhance the probability that bank should also have structured mechanisms for tracking and responding to indicia that a bank may be facing distress.

Consider just one example: Borrowings from the Federal Home Loan Banks. The Federal Home Loan Bank (FHLBank) system serves as an important source of funding for many banks and insurance companies, in good times and bad. Even healthy banks may include collateralized loans, known as advances, from their regional FHLBank as a way of diversifying their funding sources or reducing the maturity mismatch between their assets and liabilities. Time and again, however, when banks get into trouble, they turn to the FHLBanks, and the FHLBanks all too often continue to provide troubled banks the liquidity they need to limp along as underlying weaknesses grow.

During the S&L debacle, failed thrifts were far more likely to have relied on FHLBank advances than their healthy counterparts, and borrowed far more relative to their total asset.[9] Back in 2008, Washington Mutual, Wachovia, IndyMac, and other problem banks all tapped their regional FHLBank for new loans en route to their own messy failures. And the same pattern has once again been at play in this messy crisis. At year end 2021, SVB had no outstanding advances from the FHLBank of San Francisco. By the end of 2022, it was the number one biggest borrower from the FHLBank of San Francisco. Like other leading indicators of distress, this is not a red flag that a bank is necessarily in trouble, but it is a yellow flag—one that supervisors should actively monitor so they can ask the hard questions about why a bank is having a hard time funding its activities through genuine market-based mechanisms.

Excessive Caution and Procedural Hurdles: Transparency, accountability and due process are all important aims, and each plays an important role shaping bank regulation and supervision—and administrative law more generally. When taken to an extreme or imposed without regard to circumstances, these virtues can become vices that undermine the ability of regulators and supervisors to carry out the important tasks that Congress has assigned to them. The Report from the Federal Reserve on the failure of SVB suggests that among the reasons supervisors were too slow and too weak in addressing the identified deficiencies in SVB's risk management were the layered processes and excessive concern with ensuring banks were provided adequate notice. Although these virtues should not be discarded, they also should not trump responsive and appropriate supervision and supervisory responses to identified deficiencies.

Supervision as a complement to regulation: Appropriately robust regulatory standards are key to promoting the safety and soundness of banks, but they are inevitably incomplete. Absent a significant overhaul of the banking system, banks remain in the business of taking risks. And even robust guardrails can fail, particularly if and when bank leadership seek to find ways to game the rules in order to take additional risk and reap the additional profits such actions can yield. It is critical for bank supervisors have and feel able to exercise judgment in assessing and responding to emerging risks and deficiencies at the banks they supervise.

[9] Lisa Ashley, Elijah Brewer III & Nancy E. Vincent, Access to FHLBank advances and the performance of thrift institutions, Economic Perspectives, Vol. 22, 2nd, No. 2, June 1998.

IV. Bank Leadership

Bank regulators and supervisors already have some tools available to hold bank leadership to account when a bank fails. For example, as receiver for a failed bank, the FDIC can and sometimes has sued directors and officers for breaching the fiduciary obligations they owed to the bank in the period leading up to its failure. Bank supervisors also have the authority to remove bank officers and directors from their positions, to ban them from further work at a depositary institution and to impose civil monetary penalties under certain circumstances.[10] Nonetheless, as my financial regulation colleagues Da Lin and Heidi Mandanis Schooner explored in some detail in their testimony before the Senate Committee last week, these tools remain inadequate.[11]

Nonetheless, the current episode raises questions about the adequacy of the toolset available to prevent bank executives walking away from a failed bank flush with retained compensation, even as the Deposit Insurance Fund and other stakeholders suffer as a result of their bad decisions. Clawbacks help mitigate the inherent unfairness that such situations pose, and they also help to mitigate the likelihood of such bad outcomes by reducing the incentive of bank managers to engage in excessive risk taking.

V. Deposit Insurance

Deposit insurance was one of an array of important regulatory innovations adopted during the New Deal era. The rampant bank failures contributed both directly and indirectly to the suffering of ordinary Americans during the course of the Depression. Many saw their hard-earned savings diminished as a result of having deposited in their money in one bank rather than another, and fear of such losses created anxiety for many. That fear also motivated many people to withdraw their money from their bank, whether they needed or not, causing problems in the bank sector to spread.

Deposit insurance helps to address both of these problems. It helps protect consumers and small businesses from enduring what can seem like arbitrary losses on money they thought was safe. And it enhances the stability of the banking system by reducing the propensity of depositors to run. Over time, the deposit insurance cap has gone up, as have the array of accounts insured, but the overall structure of providing the same amount of deposit insurance to all comers has remained remarkably static. Rather than serving as a hard cap on how much anyone can have in insured accounts, however, this has inspired the creation of services that help some businesses and wealthy individuals distribute their funds across banks and thereby increase the aggregate value of funds they hold in insured accounts. Recent events have prompted a healthy rethinking of this overall regime.

Most obviously, not all depositors are created equal. Even some modest-sized businesses often need to hold amounts far in excess of the current cap of $250,000 in order to make payroll. Moreover, recent events have served as a reminder that depositors rarely think of themselves as creditors, and thus even large depositors may pay little heed to the health of their bank. And

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[10] 12 U.S.C. § 1818(e).

[11] U.S. Senate Committee on Banking, Housing, and Urban Affairs, Hearing on Holding Executives Accountable After Recent Bank Failures, May 4, 2023.

when demand depositors withdraw their funds en masse, the effects can be stabilizing not just for that bank but for the broader banking system. Given the range of policy proposals already on the table, I will not add to them but instead contribute a few considerations that should inform the path forward.

First, the appropriate structure for deposit insurance and the ultimate cost of providing it will depend not only on the cap, or lack thereof, on the value of deposits insured, but also on the structure and rigor of bank regulation and bank supervision. The more tools in place to credibly monitor and limit bank risk taking, the more flexibility there may be to increase the amount of insurance provided. Significant changes to the deposit insurance scheme could require meaningful changes in the regulation and supervision of banks and their affiliates.

Second, one of the most significant changes in the history of deposit insurance in the United States was the elimination of Regulation Q which limited, and often banned, the paying of interest on insured deposits. This was a critical feature of the initial scheme as it precluded banks from competing for deposits; and, in particular, it prevented banks that had taken excessive risk from being able to fund further risk taking by using high yields to attract fresh deposits. Once Regulation Q was removed, and weak banks and thrifts were not shuttered in a timely way, this was precisely what happened.

During the S&L debacle, for example, Texas had the most troubled S&Ls. To stay afloat, those S&Ls offered depositors exceptionally high yields even on insured products. Because many consumers were naturally drawn to the ability to get a higher rate of return, while still enjoying the assurances of a government backing, even healthy banks had to offer substantially higher rates of interest just to retain deposits.[12] Subsequent research shows that at the height, in 1987, healthy banks in Texas has to pay a "Texas Premium" of 50 basis points relative to banks elsewhere just to retain deposits.[13] In today's world, where banks across the country compete for deposits in a digitized environment, the ability of higher risk banks to offer higher rates of return could have even more far-reaching effects. This is not a reason to keep deposit caps where they are, but it does suggest that it may be prudent to couple any significant change in the deposit insurance with potentially adjustable caps on the amount banks can pay to insured depositors.

Third, it may be appropriate to restore, albeit in modified form, the ability of the FDIC to lift the cap on value of deposits insured, at least for certain types of accounts, during periods of widespread distress. In other words, any effort to increase or remove deposit caps should likely be coupled

[12] EUGENIE D. SHORT & JEFFERY W. GUNTHER, THE TEXAS THRIFT SITUATION: IMPLICATIONS FOR THE TEXAS FINANCIAL INDUSTRY (1988); Texas Marketers Battle High Rates and Bad Publicity, SAVINGS INSTITUTIONS, September 1988, at 84; Alane Moysich, The Savings and Loan Crises and Its Relationship to Banking, in HISTORY OF THE EIGHTIES: LESSONS FOR THE FUTURE, VOL. 1 167, 168 (1997).
[13] Moysich at 181.