STATEMENT OF

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BEFORE

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OF THE HOUSE COMMITTEE ON FINANCIAL SERVICES

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FEDERAL RESPONSES TO RECENT BANK FAILURES

MARGARET E. TAHYAR BIOGRAPHY

My name is Margaret E. Tahyar, known as Meg, and I head the Financial Institutions Group at Davis Polk & Wardwell LLP where I have been a partner for 26 years and where I have toiled in the field of banking regulation for 34 years. I am one of the co-authors of the law school textbook, *Financial Regulation and Policy* (Barr, Jackson, Tahyar, 3rd Edition, Foundation Press 2021). In addition to my day job as a partner at Davis Polk, I have in the past taught as an adjunct professor at Harvard Law School and Columbia Law School. I represent a large range of financial institution clients, but I am here today in my individual capacity and not on behalf of any client. The views I express are my own, and not necessarily those of Davis Polk, any client or any other organization with which I have been affiliated.

Introduction

A banking crisis is like a burning house. Watching the fire we know that mistakes were made, there are lessons to be learned and changes are coming. It helps to think about this banking crisis as having three stages. When the house is burning, the firefighters rush into the flames to save the house and the people inside. The firefighters are emergency heroes. Congress needs to ask if our firefighters have the right tools and equipment. The systemic risk exception was the right tool for this crisis. Once the flames die down, it is time to think more deeply about the very different people who were living in the house when it caught fire. In this situation, it was management and the direct supervisors. What did they do, or not do, to let this fire happen? There needs to be an examination of the root causes and accountability with a fair and balanced assessment of who did what when. Finally, the oversight committees should ask if something in the construction of the house made it unusually susceptible to fire. If there was a problem with the electricity, let's not focus on how the people in the house felt about the plumbing. Let's also not focus on what caused other houses 15 years ago to burn down for different reasons. Let's focus on what is new—the speed with which the fire can blaze with social media and in a digital world.

I urge Congress and the regulators to examine thoroughly and separately the different stages of the burning house. A healthy U.S. banking sector is multi-tiered with banks of different sizes and business models continuing to exist. If we want regional and community banks to continue to fulfill their roles in the economy, we need evidence-based lessons learned and policy changes that align to the realities of today's world. We shouldn't leap into a blame game based solely on political priors.

Here are some preliminary thoughts about the paths that Congress should be focusing on and the questions it should be asking the supervisors in light of the information in the reports.

1. Independent Reports by Professional Investigators

You have several reports in front of you by the state and federal regulatory agencies that supervised the failed banks. There are many good elements in these reports and the agency leadership should be commended for their critical assessments and transparency. These reports are only a first step in any evidence-based exercise. They were written quickly by people with good intentions. Those who worked on the reports, however, were not structurally independent and were not trained as professional investigators. Typically, internal investigations are designed with structural independence to avoid any institutional bias in shaping the story. Professional investigators are trained to assess the validity of what they are being told in interviews—they rely on documentary cross-checks and pull contemporaneous internal email traffic. There should be a structurally independent investigation conducted with the same level of depth and professional standards that the major federal agencies require of independent investigations in the private sector. It may be an impossible goal in today's Washington that this independent and professionally investigated report also be non-partisan, but that should be the aim nonetheless.

2. Talent, Training and Retention

There is a red flag in the reports that Congress should not ignore. Read in their totality, the reports point to severe resource challenges among examiners, lacunae in the skill sets of existing examiners and in the roster of candidates for open positions as well as problems with heightened turnover. It should be concerning to all of us that new examiners resign before completing their training, that fully funded posts cannot be filled and that there are press reports of poor culture and low morale causing experienced examiners to leave. The collateral consequence of these talent issues is that, at critical times, examiners were slow to react, not timely in their messages to the banks, did not have internal deadlines and became distracted by process and consensus. The many media leaks from the supervisors complaining about the culture or attempting to absolve themselves as well as, in recent years, data breaches are also clues that something is amiss in the culture and management.

These talent and resource challenges, which may be happening in different ways in the different agencies, are happening at a time when the financial sector is becoming more complex. It is a fair question to ask whether these talent and resource challenges are occurring across all the banking agencies, state and federal, and whether they are impacting supervision throughout the banking system. It is unfair to blame overworked line examiners not given fully updated training and suffering from a lack of direction and management. This severe talent, training and retention problem in the supervisory staff might be a more plausible reason than an unexplained shift in tone from the previous leadership, the tailoring laws and regulations or the guidance on guidance. I am doubtful that we should believe in the "disempowered supervisor" as the primary explanation.[1]

A well-trained and appropriately resourced professional cadre of examiners is critical for effective supervision. The New York Department of Financial Services has, commendably, pointed out that it will review its examiner training to see if it needs updating. All of the agencies need to engage in a holistic review of examiner hiring, training, retention and management. Is the current training still fit for purpose and how long has it been since there has been a fundamental review? It is unclear the extent to which interest-rate risk has been re-emphasized in recent years. It is also unclear the extent to which examiners are trained in separation of powers, due process and governance in addition to the traditional economic topics. Safety and soundness is not above the law—it is the law.

One idea to consider, which I state tentatively because I am not an examiner and so few of the training materials are public, is replacing the current fragmented training split among many agencies with one efficient core training program for both federal and state examiners. There should also be discussions about whether to speed up the timescale of the training and whether remote or hybrid training is effective.

[1] This wonderful phrase was coined by the anonymous author of the widely admired Bank Reg Blog. *The Fed's Report on the Failure of Silicon Valley Bank*, BANK REG BLOG (April 28, 2023), https://bankregblog.substack.com/p/the-feds-report-on-the-failure-of.

3. Who Watches the Watchman?

Another area Congress should look into is how the examination staff has been organized, managed and supervised and how much secrecy is justified about the information they receive and provide in the course of their supervisory activities. Much of banking supervision takes place behind the curtain of confidential supervisory information. That lack of transparency is traditionally justified by the risk of bank runs, although it sits uncomfortably with the requirements of the securities laws and with public accountability, including accountability to Congress.[2] Given the lack of transparency, an important check and balance is that the line examiners be accountable, within their own agency structure, to more senior supervisory staff and to the appointed principals, and that senior supervisory staff and principals be accountable to Congress.

In a well managed institution, more senior supervisory staff should provide clear direction to line examiners with shifts in emphasis and tone as the risk environment changes. The Barr report, in particular, hints at confusion around internal governance, escalation, roles and responsibilities, deadlines and accountability. At the Federal Reserve, if there was a shift in supervisory tone under the previous regime, which ended in October 2021, before the interest rate increases began in March 2022, what directions had the senior supervisory staff been giving in the very changed circumstances since the rise in rates? How was the supervisory staff managed during the long hiatus between Vice Chairs for Supervision and Enforcement? There were many MRAs and MRIAs, but did they focus on the right topics at the right time, or did the quantity distract examiners and management from the major risks? As interest rates shifted, what was the guidance from senior supervisory staff on how to focus on the right issues? It does not seem right to call out examiners from the pool if there was not clear direction from senior supervisors in a timely manner.

Who is supervising the supervisors? Or, as the ancient Roman saying has it—who was watching the watchman?

4. Updating the Tools and Technology

Congress and the agencies need to examine whether the firefighters and the supervisory staff have the right technology, tools and resources. I've recently had the occasion to see dedicated public servants fighting the fire over weekends and all night long. It's not often that one sees agency staff, at multiple agencies, working all night long to make things happen. I have personally received messages at 2:45 AM asking if I am available to talk at that moment. Reliance on the goodwill and extraordinary effort of the firefighters speaks to individual heroics, but is not a path to a better way.

[2] *See* Margaret E. Tahyar, *First Thing We Do, Let's Exclude All the Lawyers*, AMERICAN BAR ASSOCIATION: BUSINESS LAW TODAY (Sept. 17, 2019), https://businesslawtoday.org/2019/09/first-thing-lets-exclude-lawyers/.

The agencies and the banking sector need to work together to think about how to transition to more real time information in more automated ways. Call reports are available only with a 30- or 45-day lag. Ad hoc daily reporting in a crisis is an interim bandaid, not a long-term solution.[3]

5. Let's Be Careful Out There

As is only natural immediately after a crisis, many different people have many different ideas on how to improve the regulatory framework. There are the reforms urged in the White House Fact Sheet and the recommendations of the Barr report. Both of these are thoughtful starts and provide much more sophisticated recommendations than those who want to simplistically push an on/off switch around the 2018 tailoring. Some of the recommendations make sense and some may go too far. Some need to be vetted against an evidence-based review. Many of them are pre-existing ideas that were already being discussed. All of them are tweaks to the existing system of banking regulation and supervision that can be done by the regulators without Congress, subject to being accountable to Congress. None of them deal with the supervisory topics I have focused on today.

There is one big thing where congressional action, as opposed to oversight, is necessary: a hard look at reforms to the deposit insurance program. Nothing can happen without Congress doing its duty to legislate in that arena. As a sometime professor, I am assigning each of you and your staff the homework of reading the FDIC's most excellent and balanced report on deposit insurance reform. It lays out pros and cons in a sober, reflective way.

My own view is that we have entered a new era. We have never seen a deposit run of such scale and speed happening overnight and on a weekend. In a world with social media and mobile banking, and one where many companies and consumers are multi-banked, uninsured deposits can flee with a click. Will instant payments, open banking, data portability or a central bank digital currency make it worse or better? Congress, and the regulators, need to grapple seriously with this one big thing—bank runs. The tweaks to regulation and supervision might work together with deposit insurance reform but, absent some kind of deposit insurance reform, the tweaks will not be enough.

It matters because an impact on banking is an impact on the economy and credit—already fragile. For those of you who remember Hill Street Blues—let's be careful out there.

[3] *See* Alice Cho and Robert E. Litan, *Rethinking bank oversight in the wake of recent banking turmoil*, BROOKINGS (April 21, 2023), https://www.brookings.edu/opinions/rethinking-bank-oversight-in-the-wake-of-recent-banking-turmoil/.