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FEDERAL RESPONSES TO RECENT BANK FAILURES

HEARING

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND MONETARY POLICY

OF THE

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FEDERAL RESPONSES TO RECENT BANK FAILURES

Wednesday, May 10, 2023

U.S. House of Representatives,
Subcommittee on Financial Institutions
and Monetary Policy,
Committee on Financial Services,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:04 p.m., in room 2128, Rayburn House Office Building, Hon. Andy Barr [chairman of the subcommittee] presiding.

Members present: Representatives Barr, Posey, Luetkemeyer, Williams of Texas, Loudermilk, Rose, Timmons, Norman, Fitzgerald, Kim, De La Cruz, Ogles; Foster, Velazquez, Sherman, Beatty, Vargas, and Casten.

Ex officio present: Representative Waters.

Also present: Representative Emmer.

Chairman Barr. The Subcommittee on Financial Institutions and Monetary Policy will come to order.

Without objection, the Chair is authorized to declare a recess of the subcommittee at any time.

Today's hearing is entitled, "Federal Responses to Recent Bank Failures."

I now recognize myself for 5 minutes to give an opening statement.

Thank you to our witnesses for appearing before us today. Because of economic mismanagement under the Biden Administration, and failures of bank supervision, we now face increased odds of recession. Following the bipartisan CARES Act, a partisan, reckless, nearly-$2 trillion American Rescue Plan Act was enacted by the President, which fueled runaway inflation. While the Administration and the Federal Reserve tried to convince the American people that inflation was transitory, it definitively was not.

Inflation skyrocketed and persisted, and Americans were hammered by rising costs in grocery aisles and at the pump and saw their wages rapidly eroding in real terms. Despite warnings from my Republican colleagues and myself, the Federal Reserve was late to the game in responding to inflation, and therefore had to raise interest rates at one of the fastest paces in modern history. The precipitous interest rate increases put heightened interest rate risks into the system, and regulators and supervisors at the Fed were, again, late to react. All of the context in which these bank failures occurred has to be looked at in the context of this historical set of facts.

These risks were not attended to by Federal or State regulators and supervisors, but were recognized by depositors. This led to bank runs and systemic stress. We now face increasing odds of a credit crunch, as banks of all sizes anticipate more-onerous regulations and market scrutiny. If recent events are not dealt with productively, we also run a risk of ending up with a banking system with a small number of too-big-to-fail banks and a scattering of very small banks. Such a barbell banking system is not good for communities across the country.

The Vice Chair for Supervision at the Federal Reserve has signaled his desire to go beyond reviewing supervisory failures that contributed to the recent bank runs. He continues to signal his desire to increase capital charges and impose more-stringent regulations on already well-capitalized banks that are not to blame for recent stresses in the system.

Following the failures of Silicon Valley Bank and Signature Bank, which were caused by bank runs, key regulators decided to issue their own self-referential, self-assessment reports on those failures to set a narrative. The Chair of the FDIC ordered a review of Signature Bank's failure, taking some blame for inadequate supervision, but the review mostly blamed the banks and internal FDIC vacancy issues. The full Board of the FDIC did not adequately participate in the review. The FDIC also issued a term paper on deposit insurance and what it believes Congress should focus on before responding to multiple inquiries from this committee for information, so Congress could arrive at our own conclusions.

The Federal Reserve Vice Chair for Supervision, Michael Barr, led his own self-serving politicized review of the failure of Silicon Valley Bank and made regulatory recommendations. The full Board of the Fed did not participate in the review. The review, by the way, said nothing about the monetary policy errors and the late-to-the-game of monetary normalization that contributed mightily to the problem. In the face of a need to inform Congress and respond to multiple requests from this committee for timely information, the Fed and the FDIC decided to devote resources to a hasty, self-serving review of their own supervisory failures to set a narrative.

To be clear, the Board of the Federal Reserve System and the Board of the FDIC should not view their recent narratives about the failures of Silicon Valley Bank and Signature Bank as precedents for how Congress is informed in the future. Rather than being responsive to Congress so that we may consider potential legislative needs, Federal agencies and officials have slow-walked us. Instead, they have spent their time writing their own narratives to cover their mistakes and injecting politicized calls for more regulation into the public sphere. That is simply unacceptable. And it clearly shows why we need to change emergency authorities for the Fed and the FDIC, and Treasury to at least obtain accountability and transparency.

We need to ensure that the full Boards at the Fed and the FDIC are adequately consulted in important decision-making and that a single regulatory actor cannot act unilaterally to inject their political preferences into regulations. The bills noticed today get at the heart of increasing accountability and transparency at our Federal

financial regulators and emergency actions. The bills are not intended to be partisan, and their provisions would apply independent of what party is in power. They are simply about accountability to the American people and Congress of financial regulatory actors who take actions that affect trillions of dollars of resource flows. I look forward to discussing these issues today.

The Chair now recognizes the ranking member of the subcommittee, the gentleman from Illinois, Dr. Foster, for 5 minutes for an opening statement.

Mr. FOSTER. Thank you, Mr. Chairman, and I will not use my whole 5 minutes, as I think this is the time where Congress is best served by and the people are best served by listening instead of speaking.

There are a couple of new factors and old factors that we see in this. The new factor is the internet-driven runs that, when we had our first emergency Zoom meeting with the FDIC, caused them to look kind of shell-shocked at the speed at which these runs occurred. And that is a risk that everyone recognizes, and we are going to have to understand what kind of emergency liquidity support will be needed to defend against those. And for anyone providing that emergency liquidity, they will have to be able to tell at a glance that the entity they are providing that liquidity to will ultimately become solvent. And that is the difficulty with what we are going to be facing here.

I see the value of both internal and external reviews, and I think they were valuable. The reports produced were, in fact, valuable as starting points to this. I also think we have much to learn with a comparison of the Credit Suisse failure and the recent effects of the bank failures of banks of the order of 1 percent of U.S. GDP, which were not in and of themselves systemically crucial and they wouldn't have brought down the economy if they, by themselves, failed.

In contrast, the Credit Suisse was over 100 percent of Swiss GDP. It was truly too-big-to-fail. And when it failed, it failed gracefully without really a whiff of contagion and without leaving the Swiss taxpayer so far on the hook. I think the difference there is contingent capital, the contingent capital that was insisted upon by the Swiss banking regulators. As Credit Suisse failed, they allowed a mechanism to have a mandatory capital injection into the carcass of Credit Suisse that made it something worth buying, and took the value of Credit Suisse from roughly negative-$14 billion to plus-$3 billion and allowed a white knight to step in and take it over. So, I think we should look hard at that as a model. And I know I share with Chairman McHenry an enthusiasm for this general approach on a contingent capitalism market-based approach to have another set of eyes on the books of these banks, and at the risk posture.

Anyway, I am eager to get on with this hearing, and with that, I will yield back the rest of my time.

Chairman BARR. The gentleman yields back. We will now hear from our witnesses.

First, Ms. Margaret Tahyar. Ms. Tahyar is a partner at Davis Polk & Wardwell and a member of their fintech practice. Her practice focuses on providing strategic bank and financial regulatory

advice. In addition to her full-time practice, she teaches financial regulation as an adjunct lecturer in law at Harvard Law School.

Second, Mr. Jonathan Gould. Mr. Gould is a partner at Jones Day in Washington, D.C., where he provides bank and financial regulatory and strategic advice to financial services providers of all types. Previously, Mr. Gould served as the Senior Deputy Comptroller and Chief Counsel of the Office of the Comptroller of the Currency.

Third, Mr. Thomas Michaud. Mr. Michaud is president and CEO of Keefe, Bruyette & Woods, an investment bank specializing in the financial services sector, where he began his career in 1986. He was named chief executive officer in October of 2011 and is responsible for directing all of the firm's business lines in both the United States and Europe.

And finally, Professor Kathryn Judge. Professor Judge is the Harvey J. Goldschmidt Professor of Law and vice dean for intellectual life at Columbia Law School. Ms. Judge currently serves as an editor of the Journal of Financial Regulation and a research member of the European Corporate Governance Institute. She previously served on the Financial Stability Task Force and the Financial Research Advisory Committee to the Office of Financial Regulation.

We thank each of you for taking the time to be here. Each of you will be recognized for 5 minutes to give an oral presentation of your testimony. And without objection, each of your written statements will be made a part of the record.

Ms. Tahyar, you are now recognized for 5 minutes for your oral remarks.

STATEMENT OF MARGARET E. TAHYAR, PARTNER, DAVIS POLK & WARDWELL LLP

Ms. TAHYAR. Thank you, Chairman Barr, and Ranking Member Foster. The banking crisis is like a burning house. Just watching it, we know that mistakes were made, there are lessons to be learned, and changes are coming. Think of it as three stages. In the emergency stage, heroic firefighters are rushing to the flames to save the house and the people. Dedicated agency staff have been working around the clock. I have personally received a message at 2:45 a.m., asking if I am available to talk right then.

The reliance on firefighting is not a path to a better way. Once the flames died down, it is the what-happened stage, the time to think about the very different people who were living in the house when it caught fire. That was management and the supervisors, what did they do or not do to let this fire happen? The final stage we need to ask is, did something in the construction of the house cause the fire? If the problem was the electricity, let's not focus on how people felt about the plumbing.

For each stage, we need fact-based lessons learned and policy changes that encourage a strong, multi-tiered banking sector. So far, there are many suggestions based on political priors, which assume regulatory changes without proof of any links to the burning house. We also need much more transparency. It is not possible for the firefighters to be transparent in real time when the house is burning. But afterwards, there needs to be a full accounting.

Here are some preliminary thoughts. There should be independent reports by professional investigators. There are many good elements in the report you have before you, but they are drastically incomplete. They are only a first step in any fact-based exercise. There should be a structurally-independent investigation by trained professional investigators done on a bipartisan basis.

There is a deep red flag in the reports that Congress should not ignore. They point to severe resource challenges for examiners, lacunae in the skill sets, weakness in the job candidates, as well as heightened turnover. It is concerning that new examiners resigned before completing their training and that fully-funded posts cannot be filled. And there are press reports of culture problems and low morale causing experienced examiners to leave. The consequence is that at critical times, examiners were slow to react, 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 are also clues that something is amiss. The Barr report hints at confusion around internal governance, escalation roles and responsibilities, and deadlines and accountability. It raises the question of whether the supervisors were well-managed. It is deeply unfair to blame overworked line examiners who were not given fully-updated training and were suffering from poor direction and management.

These red flags might be a more plausible cause, at least in part, for the supervisory failures rather than an unexplained shift in tone from the previous leadership, the tailoring or the guidance on guidance. All of the agencies need to engage in a holistic review of how the supervisory staff is hired, trained, and managed. Virtually all of banking supervision takes place in secret. The lack of transparency sits uncomfortably with the securities laws and with accountability to Congress in the public. It is impossible for Congress, academics, and the public to judge the effectiveness of the regulatory framework, supervision, or emergency actions when what the public sees is only a very small tip of a very large iceberg. We really need to ask, who is watching the watchmen?

Finally, let's be careful out there. There is one big thing where Congressional action as opposed to oversight is necessary, a hard look at reforms to the deposit insurance program. We have never seen a deposit run of such scale and speed happening overnight and on a weekend. In a world with social media, mobile banking, and when many companies and consumers are multi-banked, uninsured deposits can flee with a click. And the multi-banking is the point that hasn't gotten a lot of attention. If you are going to flee with a click, you have to have two bank accounts. And if you think about the difference, there was a reference to a barbell banking system, which we don't want. Many of the customers of regional banks are sticky; they are not necessarily multi-banked. That is something to look into.

Anyway, with instant payments, open banking, data portability, or central bank digital currency, it is going to make it worse or better. Absent deposit insurance reform and solving the red flags, the regulatory changes being suggested will be window dressing. It matters, because an impact on banking is an impact on the econ-

omy and credit, which is already fragile. For those of you who remember Hill Street Blues, "Let's be careful out there." Thank you.

[The prepared statement of Ms. Tahyar can be found on page 64 of the appendix.]

Chairman BARR. Thank you for your testimony.

Mr. Gould, you are now recognized for 5 minutes.

STATEMENT OF JONATHAN V. GOULD, PARTNER, JONES DAY

Mr. GOULD. Chairman Barr, Ranking Member Foster, and members of the subcommittee, thank you for the opportunity to discuss the Federal responses to recent bank failures. My testimony will focus on the recently-issued reports from the Fed and the FDIC on their supervision of Silicon Valley Bank and Signature Bank. 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 Federal Reserve's Office of Inspector General (OIG), "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." This statement might well summarize the report from the Fed and the 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. Agency self-reflection is appropriate, but supervisory transparency and Congressional accountability are critical.

The Fed and FDIC reports offer a starting point for further fundamental review by Congress. 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.

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. It is particularly hard to explain the Fed's failure to supervise for interest rate risks when it created that risk through its own monetary policy actions. Neither report explains the many failures of supervision, and significant portions of the reports are distractions. An independent review and disclosure of internal agency communications about SVB and Signature Bank about supervision would seem to be an obvious next step in any credible investigation. Both reports raise questions about the adequacy and allocation of resources at these agencies, but the reports give us little information as to how the agencies prioritize their resources.

Congress should request and review budgetary detail and supervisory staffing models, including those for the San Francisco Fed, to determine whether the agencies are giving short shrift to their supervisory functions or if it disagrees with their priorities. The Fed report does address changes in regulation in May following the Economic Growth Act. Others have addressed the lack of causal connection between that law and the bank failures.

I will merely add that: one, the Federal Reserve did not enforce regulations that did apply to SVB; two, the proliferation of regulations since the 2008 crisis may have reduced risk management and supervision to mirror compliance exercises, damaging both in the process; and three, overreliance on preferred regulatory tools may have blinded supervisors to risks that do not appear when viewed through that tools particular lens.

The Fed has an unique governance and structure that differ from other bank supervisors. Congress should consider whether and to what extent the Fed structure and governance is a contributing factor to its supervisory failures. A clear presentation from the Fed of roles and responsibilities within this System and between the Board and Reserve Banks is a prerequisite for basic accountability. The Fed report identifies some potential conflicts of interest between the Reserve Banks and the Board, and of 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.

The business of banking is built on trust and confidence, but that trust and confidence is currently in doubt. Competent bank supervision is a prerequisite to restoring it. Transparency into the supervisory strategies and priorities of the Fed and the 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.

[The prepared statement of Mr. Gould can be found on page 42 of the appendix.]

Chairman BARR. Thank you, Mr. Gould.

Mr. Michaud, you are now recognized for 5 minutes.

STATEMENT OF THOMAS MICHAUD, PRESIDENT AND CHIEF EXECUTIVE OFFICER, KEEFE, BRUYETTE & WOODS (KBW), A STIFEL COMPANY

Mr. MICHAUD. Good afternoon, Chairman Barr, and Ranking Member Foster. Thank you for having me here today, and thank you to the rest of the members as well.

By way of background, my name is Tom Michaud, and I am president and CEO of Keefe, Bruyette & Woods (KBW), a Stifel Company. I have been with KBW for 36 years, and I have focused my career on being part of a team that delivers high-quality bank-

ing and financial services research advice, particularly to mid-sized and regional banks. We also produce the Keefe Bank Index and the Keefe Regional Bank Index, both of which are standards upon which bank performance is rated.

The current banking crisis has been driven by fear. Although each bank crisis is unique, they all have one thing in common: depositors lose confidence that their money is safe and they seek a safer haven. That is why the FDIC was created 90 years ago, and no insured deposit has ever lost value since. FDIC insurance has allowed the U.S. to have a diverse banking system of all sizes: global banks, regional banks, mid-sized banks, and community banks.

The recent bank failures have illustrated two developments since Congress last modified deposit insurance 13 years ago. First, money now moves faster than ever before. The speed of the run at Silicon Valley and Signature Banks was staggering. Second, the market has embraced that the biggest banks are likely too-big-to-fail, and that there is an implicit government guarantee that stands behind them.

Those are the two key factors that have changed since Congress last changed the rules. Left unaddressed, I believe that there will be strong forces that will restructure the banking industry, and current Fed data suggest that it is underway right now.

Having banks of all sizes is critical to the success of our economy. America's largest banks are global leaders and standout amongst their international peers. While the biggest banks have most of the deposits, they don't make most of the small business loans in America. For America's economy to prosper and benefit all Americans, not just in large financial centers, regional banks are essential. That was demonstrated when they provided 60 percent of the Paycheck Protection Program (PPP) loans during the recent pandemic.

But there is an opportunity to level the playing field since the deposit limits were last changed. I believe that the big banks can continue to operate the way they do, but that the mid-sized and smaller banks need more deposit insurance to neutralize that too-big-to-fail guarantee. The modifications I propose are on the belief that deposit insurance will continue to be an industry expense, and in no way encompass taxpayer support.

Therefore, I believe that Congress should address the problem with three actions: one, raise the debt limits for operating accounts so that small businesses and nonprofits can keep their funds in a local bank and not worry; two, allow banks to buy additional insurance directly from the debt; and three, further tailor premiums for the systemic banks to account for the too-big-to-fail implicit guarantee.

I would also encourage that, first, healthy bank mergers and acquisitions (M&A) be allowed and accepted so that banks can seek the same scale benefits that their larger competitors have. Also, we need healthy bank M&As so that healthy banks can acquire underperforming banks and save an ultimate loss possibly to the Deposit Insurance Fund.

Second, regulators should modify held-to-maturity accounting treatment, as well as modify treatment of other comprehensive income (OCI) into other regulatory ratios. And third, as a comment

that was made recently during the introduction, a review should be done to ensure that government agencies have the proper systems in place to support the financial system as real-time payments become a reality, especially with the rollout of FedNow in July.

I believe that these steps would be sufficient in addressing the current instability in banking. The stocks, again, were very weak today. I also believe that the lack of complexity of these changes reduces the risk of unintended consequences and that this approach avoids the possibility of additional regulations that could prove to be counterproductive.

Thank you for the opportunity to be in front of you today, and I look forward to hearing your questions.

[The prepared statement of Mr. Michaud can be found on page 55 of the appendix.]

Chairman BARR. Thank you, Mr. Michaud.

Professor Judge, you are now recognized for 5 minutes.

STATEMENT OF KATHRYN JUDGE, HARVEY J. GOLDSCHMIDT PROFESSOR OF LAW AND VICE DEAN FOR INTELLECTUAL LIFE, COLUMBIA LAW SCHOOL

Ms. JUDGE. Thank you, Chairman Barr, Ranking Member Foster, and members of the subcommittee. It is a pleasure to be here today, and I appreciate the opportunity to discuss the recent bank failures and the lessons that we can learn from those failures.

I want to spend my time just setting the stage with two broad points that hopefully cut across the range of different issues at stake in today's deliberations. And I want to spend a few moments just building on and responding to some of the comments from my fellow witnesses.

First, the recent bank failures reveal fundamental shortcomings in the regulation and supervision of large regional banks. Since the beginning of March, four regional banks have failed, and three of those banks failed in ways that impose significant costs on the Deposit Insurance Fund. The FDIC currently estimates the Deposit Insurance Fund will lose $20 billion in connection with the failure of SVB, it will lose $2.5 billion in connection with the failure of Signature Bank, and it will lose $13 billion in connection with the failure of First Republic.

Moreover, two of those banks failed in ways that pose such a risk to systemic stability that all of the regulators involved voted to approve the use of the systemic risk exception (SRE) to the requirement that the FDIC otherwise resolve the bank in a way that imposes the least cost on the Deposit Insurance Fund. This was not a political decision. Both the Board of Governors of the Federal Reserve and the FDIC Board, [inaudible] bodies, and there was unanimity among these bodies, that this was the correct course of action under the circumstances. The imposition of such significant costs to the Deposit Insurance Fund and the existence of such a widely-recognized threat to the stability of the financial system clearly demonstrate that the regulations currently governing large financial institutions, large regional banks are not adequate, and more needs to be done.

This episode is a powerful reminder of the ways that the digitization of finance has and will continue to change the nature

of banking, the pressures that banks face, and the structure of the financial system. It is a critical time for regulators and for Congress to stay on top of recent developments and to look broadly to identify emerging risks.

Although it might not seem directly relevant to today's hearing, the new guidance proposed by the Financial Stability Oversight Council (FSOC) for designating non-bank financial institutions is systemically significant, and a proposed analytical framework for systemic risks is a prime example of the way regulators should be using the available tools to address emerging risks before they pose a threat to the financial system.

More work could also be done to consider how best to protect the financial intermediaries and financial infrastructure that provide critical credit and financial services needed to promote a healthy and balanced economy. This could include more efforts to promote the vitality of community financial institutions, including community banks, Minority Depository Institutions (MDIs), and Community Development Financial Institutions (CDFIs), and helping to ensure that they remain focused on serving the small businesses and the wide array of families and individuals who need access to the services that they can provide.

Finally, I want to comment quickly that I agree with my fellow witnesses on the importance of supervision in the coming era. Again, digitization means that a lot of things are moving and they are moving quickly. It is often during periods of higher inflation and higher interest rates that we end up with more disruptive changes to the structure of the financial system. So, it has never been so critical to have really qualified supervisors on the ground who are willing to ask the hard questions and are willing to think creatively about what are the tail risks, what are the low-probability events that could result in things happening that we haven't seen in the past but could be incredibly destructive to the safety and soundness of an individual bank, or to the health of the broader financial system.

And I would encourage you, in trying to think about how we create the right culture and environment to attract the type of supervisors that we are going to need, that going forward, you take time to consider what is the type of environment that is going to allow those supervisors to ask hard questions and to respond in a way that is appropriately responsive and at times, when needed, aggressive in making sure the banks are attuned to the ways their actions could undermine their own safety and soundness, and even more disconcertingly, potentially undermine the health of the broader financial system.

Thank you again for the opportunity to be here, and I look forward to your questions.

[The prepared statement of Professor Judge can be found on page 47 of the appendix.]

Chairman BARR. Thank you for your testimony, and the Chair now recognizes himself for 5 minutes for questions.

Let me start with Ms. Tahyar. As I mentioned in my opening statement, the Vice Chair for Supervision at the Fed and the Chairman of the FDIC led self-assessments, self-referential re-

views. In your view, do these reports provide the impartial accountability for the Fed and the FDIC to Congress?

Ms. TAHYAR. No.

Chairman BARR. And I also alluded to the fact that we have made multiple requests for more information, supervisory information, information about the weekend of March 10th and about the events leading up to the decisions to seize the banks, and about FSOC meetings. We have nothing from the regulators in terms of visibility into those deliberations. What are the consequences of having opaque bank regulators that block the information flow to Congress?

Ms. TAHYAR. I guess I would start by having a little bit of sympathy for the firefighters, who have been working virtually 24/7, which is why I am in three stages. But I think over time, Congress, on both sides of the aisle, needs to get a lot more information and a lot more transparency. And the consequences are the consequences that we have seen here, which is we have had a failure of supervision, a failure of management, and a banking panic. There will always be banking panics, we can't prevent them, but we can mitigate them.

Chairman BARR. Mr. Gould, let me talk about that supervision piece. In the Fed's review that it just recently published, it talks about the fact—I am drawing on memory here, but I believe that Silicon Valley Bank surpassed the $100-billion asset mark sometime in early 2021. The failure, of course, was in March of 2023. There was some effort made to put a new supervisory team in place, but am I correct in saying that the bank was subject to enhanced prudential standards all the way back to February, March of 2021?

Mr. GOULD. Yes. That is correct. The bank was subject to certain enhanced prudential standards.

Chairman BARR. And this is, by the way, the Dodd-Frank Act, as amended by the bipartisan Regulatory Relief Act. So, it is not as if Silicon Valley Bank wasn't subject to enhanced standards under those regulatory regimes. Am I correct about that?

Mr. GOULD. That is correct. And some of the standards to which they were subject such as the internal liquidity and stress testing requirements, the Federal Reserve was not even actually enforcing.

Chairman BARR. Yes. This excuse for supervisors, that somehow they were psychologically impacted by the regulatory relief law, doesn't really hold water when you consider they had a charge under existing regulation, existing laws to apply those enhanced supervisory standards to this institution for well over a year before it failed.

Mr. GOULD. They did, and beyond the regulatory framework to which they were subject, the failings were so basic, so fundamental to kind of risk management one-on-one as to be glaringly obvious under any regulatory framework.

Chairman BARR. Yes. Let me just say, interest rate risk is something that bank examiners have looked at long before Dodd-Frank was ever enacted, right? You don't need Dodd-Frank to supervise interest rate risk.

Mr. GOULD. That is fundamental to the business of banking. That is how banks make money.

Chairman BARR. Yes. So, this attempt to blame regulatory tailoring or even an insufficiently-robust Dodd-Frank regime is really missing the point here. This was a classic supervisory failure; interest rate risk is the business of banking and the supervision was a failure.

Mr. Gould, if Vice Chair Barr used Silicon Valley Bank and Signature Bank failures as leverage to impose higher capital charges on banks, even though SVB and Signature were capitalized before the bank runs they experienced, would that be good for the economy and for Americans who rely on bank credit?

Mr. GOULD. I think there are others who are better-equipped to answer that question, but I don't think anyone has a monopoly on common sense. So, I would merely add that there are clear tradeoffs when you raise capital in terms of reduced availability of credit.

Chairman BARR. Mr. Michaud, for the small regional to mid-sized banks, if we were to eliminate regulatory tailoring, and to the extent there are some stresses related to deposit migration out of these mid-sized banks, should we be imposing a one-size-fits-all regulatory capital liquidity requirement on those smaller banks right now?

Mr. MICHAUD. I think it would permanently change the face of the dynamics of banking forever if that happened. I think that you would see the mid-sized banks be absorbed into the bigger banks. You need to have that tremendous bar-belling that we talked about, where there would be banks which only had clients that were smaller than $250,000, and then all of the other clients would end up in the bigger banks.

Chairman BARR. My time has expired. I wanted to get to deposit insurance, but I am sure my colleagues will. I will now recognize the ranking member of the subcommittee, Dr. Foster, for 5 minutes.

Mr. FOSTER. Thank you. Mr. Michaud, you brought up something that has been brought up by many people, which is the idea of fully insuring transaction accounts, operating accounts. Could you speak on what are the pros and cons of that? Why isn't it a good idea at this point?

Mr. MICHAUD. Let me give you an illustration, because many of us have been talking about this bar-belling of the industry. I am just going to say, for instance, assume you are the CFO or a treasurer, an employee, or a volunteer of a nonprofit in one of your communities, and you have over $250,000 in your operating account to run your nonprofit. The way things stand now with the current limits, you have to do your own credit analysis of your bank or go towards moving your money to a too-big-to-fail bank, because you need this—

Mr. FOSTER. Correct. This is, I think, well understood by many, but not all potential customers.

Mr. MICHAUD. But my view is that you need that support. I don't know if it needs to be unlimited, but I do think it needs to be raised considerably. I think it needs to be targeted, because I think it is those small businesses that will choose to be in a too-big-to-fail bank, regardless of the price of the service or the relationship

they have with their smaller bank. And that trend will happen over time if deposit insurance isn't changed, in my opinion.

Mr. FOSTER. Okay. Professor Judge, on your end?

Ms. JUDGE. I would agree that when it comes to the small businesses, it is important that they have the peace of mind to know that their transaction accounts at least are safe. And I think the FDIC did a nice job laying out the different options and showing how segmentation, a way of you saying that there is something different for individual accounts and what the appropriate cap is relative to the small and mid-sized businesses that might need meaningfully more deposit insurance in order to make things like payroll. So, trying to think about how we responsibly institute a system of segmentation could be incredibly helpful in promoting the health of community and other small banks, and also helping to promote the stability of the clients that they serve.

Mr. FOSTER. Mr. Michaud, you also mentioned using differential FDIC insurance premiums as a way to sort of level out the barbell. This strikes me as having a lot of elements of a sort of a big banks tax and a redistribution of wealth, if they are not based on actuarial risks. I was just wondering what you think of that, which I am not necessarily opposed to, but we have to sort of treat it for what it is.

Mr. MICHAUD. There is an implicit guarantee in this too-big-to-fail position that these banks are in. They get the benefit of paying less for deposits because of the tradeoff for safety, so they are actually getting value in that aspect for being too-big-to-fail. And the question is, can we have them pay more for deposit insurance for some of that value they are getting for being too-big-to-fail? That is the thinking.

Mr. FOSTER. One of the reasons that I think Chairman McHenry and I are fans of contingent capital, is a mechanism for making the big banks pay for the tail risk of their continued existence in troubled times. Are there any lessons to be learned about the market-to-market of losses due to interest rate shifts, because that is something that we struggled with during the Dodd-Frank time, with the market of mortgage-backed security losses, whether you should immediately recognize those or allow the fiction that these will be carried to maturity, which may or may not turn out to be true. Are there lessons learned there from any of the witnesses?

Mr. MICHAUD. I think there are, and actually, in my proposal to you all, I did say that there should be some adjustments and that you can put in place targets where there could be limits to a degree of how those ratios come to bear. But the market was very focused on these mark-to-market losses of Silicon Valley Bank, for example, even though it wasn't necessarily counted in certain regulatory ratios. And I think there is an opportunity to amend some of that approach that could build a safer and sounder system. Also, remember we have had a 5 basis point move in 14 months, which is extraordinary, but that is what the rules should be built for.

Mr. FOSTER. It was clear to all market participants that there was an interest rate shift coming, that was telegraphed in advance, and that it would be big, and many banks hedged appropriately and some decided that they wanted to be more profitable this quarter and not pay for the hedge. So, I personally have sort of limited

sympathy because I appreciate the moral hazard effect of this. A lot of the customers who went to Silicon Valley Bank went there because they were paying higher interest rates than their competitors, and part of that was that they had lots of uninsured deposits. So, we have to think this through carefully so that we don't inadvertently just start subsidizing the tail risk and allow those costs on smaller and smaller banks.

My time is now up, and I yield back.

Chairman BARR. The gentleman's time has expired. The gentleman from Florida, Mr. Posey, is now recognized for 5 minutes.

Mr. POSEY. Thank you very much, Mr. Chairman. As I recall, this committee was told there wouldn't be any bank failures like this if we created the Consumer Financial Protection Bureau (CFPB). I am kind of shocked we are here if the CFPB was doing its job.

First, Ms. Tahyar, rates go up, capital values go down. Barron estimated that the undeclared loss on Silicon Valley Bank's bonds due to the rapid run up in interest rates, starting in March 2022, would have wiped out nearly all of the banks $16-billion equity capital base at year end 2022. Would it be fair to say that capital was not the real problem here?

Ms. TAHYAR. It was not. Capital was a lagging indicator and the banks that failed were well-capitalized upon failure. We saw the same thing with adequate capitalization during the financial crisis.

Mr. POSEY. Very good. Thank you.

Mr. Gould, is there any reasonable capital standard or level that would have protected against the interest risks of Silicon Valley Bank's asset base in the period after Fed rate hikes began in March 2022?

Mr. GOULD. No.

Mr. POSEY. Thank you.

Mr. Michaud, wasn't the rapid and massive increase that the Fed began in March 2022, to curtail our 40-year record inflation, a contributing factor in Silicon Valley Bank's lack of liquidity, given that its asset base was heavily invested in fixed-rate mortgage-backed securities?

Mr. MICHAUD. That move was significant. Correct.

Mr. POSEY. Thank you.

Professor Judge, to what extent did the Federal Open Market Committee (FOMC) anticipate the kinds of interest rate impacts we saw with Silicon Valley and prepare an alert or strategy for regulators to prepare for such impacts?

Ms. JUDGE. The overarching aim of the FOMC is to fulfill a dual mandate focusing on both employment and price stability in a period where inflation was rising rapidly, not just in the United States, but in countries around the world, and their primary focus for the health of the economy, I believe, was probably trying to make sure that we managed to promote price stability, and get that inflation under control.

And precisely because of these environments, it has never been more important to have sufficiently-robust regulatory structures in place and to make sure going forward, that we have supervisory structures that are responsive to a rapidly-changing environment. And when there are not procedural hurdles or perceptions of proce-

dural hurdles that allow people to respond quickly and appropriately in the face of such a rapidly-changing environment.

Mr. POSEY. My questions are answered, Mr. Chairman. I yield back. Thank you.

Chairman BARR. The gentleman yields back. The gentlewoman from New York, Ms. Velazquez, is now recognized.

Ms. VELAZQUEZ. Thank you, Mr. Chairman. Professor, Judge, the rescue of depositors at Silicon Valley Bank and the invocation of the systemic risk exception by Federal regulators demonstrates that regulators think regional banks can pose a systemic risk to the system. Do you think that these banks should face the same rules as the gypsy banks?

Ms. JUDGE. There continues to be some differences between large regional banks and the global systemically important banks (G–SIBs). I think all of the proposals on the table recognize some differences, but the question is the extent of the magnitude of what those differences should look like.

And one of the things that we have learned over the course of this episode is regardless of what might have seemed reasonable at an earlier point in time, these banks are so systemic that everybody involved, who was operating in real time, felt like they posed a meaningful threat to the stability of the financial system. The risks at Signature looked somewhat different than the risk at Silicon Valley Bank. So, this was not just one single bank or a whole variety of different bank models that were under strain. And what we have further learned is that the resolution of these banks is far from easy to do.

Even with respect to First Republic, where we did not actually have to invoke the systemic risk exception, we saw a $13-billion hit to the Deposit Insurance Fund, which suggests that we have a long way to go to make sure that they are regulated in a manner commensurate with the risk they pose.

Ms. VELAZQUEZ. Thank you. You note in your testimony that bank leaders can seek to game the rules and take on additional risks in order to seek higher profits. I recently wrote a letter, with Senator Van Hollen, to Federal regulators encouraging them to finalize their rulemaking under Section 956 of Dodd-Frank, which is supposed to prohibit incentive-based compensation structures that encourage excessive risk-taking. Wouldn't you agree that it is well past time for regulators to finalize this important rule?

Ms. JUDGE. It is clearly past time for that rule to be finalized. I think the letter is exactly what we need to create the pressure to try to make sure the regulators are fully using the suite of tools currently available to them, that Congress has given them to address the incentive issues that continue to arise. And that encourage bank management at times to take risks from which they could profit, but where others bear the loss.

Ms. VELAZQUEZ. Thank you. And you also note that the tools that regulators have to penalize and remove bank officers and hold them accountable remain inadequate. What additional measures should we consider to hold bad actors accountable?

Ms. JUDGE. A more robust set of callback tools will also be appropriate as the situation well demonstrates. Clawback tools are a mechanism of responding when an executive has received com-

pensation because they appeared to be earning it, but where we know with the benefit of hindsight that they were actually making decisions that undermined the safety and soundness of the institutions they were overseeing and imposing costs that ultimately hit the Deposit Insurance Fund. We want to make sure the bank executives, first of all, don't have the incentive to take the types of risks that would undermine the health of their institutions because they know they are going to have to pay the money back, and where there is a greater sense of fairness, that they are not profiting at the expense of others.

Ms. VELAZQUEZ. Thank you. In your testimony, you state that in 2019, the Federal Reserve made a choice to implement the Economic Growth, Regulatory Relief, and Consumer Protection Act in a manner that was meaningfully more deregulatory than the revised statutory scheme required. Can you further explain this statement, and how do you think Congress, not regulators, can address this issue?

Ms. JUDGE. Two points there, the first thing to note is that Congress potentially appropriately at the time gave the Fed discretion over what to do with banks of certain thresholds with the idea that the Fed was closer to the ground, so they might have better information over how risky banks, for example, in the $100-billion to $250-billion range, actually were and the appropriate suite of enhanced prudential requirements to apply in light of that. And we saw that they did not actually use that discretion in a manner that was commensurate with the risk we now know that those banks were assuming. For me, that suggests going forward, we have been back on that discretion, understanding that there might be a tendency towards excessive deregulation, because the costs are only felt in the future, and really trying to potentially hardwire standards that are more commensurate with what we have learned recently is the nature of the threat that these banks have the potential to pose.

Ms. VELAZQUEZ. In conclusion, Congress needs to act. Thank you. I yield back.

Chairman BARR. The gentlelady yields back. The gentleman from Missouri, Mr. Luetkemeyer, is now recognized.

Mr. LUETKEMEYER. Thank you, Mr. Chairman, and I thank our witnesses for being here today.

I want to start out by going to Ms. Tahyar. You mentioned in your initial remarks that the social media phenomenon of being able to get out there and get a message out there that caused, I think, in somebody's words here, a "banking panic," is very concerning, not necessarily from a bank by bank basis, but from a systemic situation. This is where I want to go with my questions here, because some individual banks are going to be well-run, and some not well-run. And in the situation we have here, I think we have a lack of regulatory oversight embankments management on the two, three banks we are talking about, but the system is what I am concerned about.

The overall system can be played with. I sit on the House China Select Committee as well, and it scares the dickens out of me when I can see that we are playing games with our own financial system now while the tweets are going on and their social media is going

on. And I just know the Chinese are sitting there watching what is going on.

So, we have another tool in our toolbox to play around with the United States economy, their banking system, and we are doing nothing about it. And it is very concerning to me because from a system standpoint, we have to be thinking in terms of what the bad guys are going to be doing to us, and to be able to prevent that from happening, or put a tool in toolbox for the regulators to be able to manage the crisis.

Mr. Gould, I think you said that the system is built on trust and confidence, and Mr. Michaud said it is driven by fear, that people lose time or lose confidence in the system, and things happen. My concern is also that we have real-time payments coming around the corner here shortly. And we saw $42 billion went off the books of Silicon Valley in less than 48 hours. And real-time payments will take 48 minutes to do $42 billion if we are not careful, and we don't understand how the system works and put some things in place to stop it.

I have a couple of ideas I want to run by you this afternoon. One is to put in place the ability for the FDIC to put—and they did this back in 2010—in place a 60-day ability to protect the transactional accounts and deposits at these institutions across the country. And now, they can do it on a bank by bank basis, but if the risk is systemic enough that we could have the whole system be under attack, I think it would be worthwhile to be able to have them go at least on a 60-day basis with just transactional accounts. What do you think about that, Ms. Tahyar?

Ms. TAHYAR. Thank you very much for those thoughts. I agree with all of them, and they terrify me as well, and I think we should all be terrified. Social media and bad state actors in this panic is a new thing and we have to grapple with it.

My own view is that providing the FDIC the power with the three keys of the systemic risk exception to temporarily guarantee deposits up to whatever level the FDIC chooses, is an important tool. Congress limited it, and Dodd-Frank was a different time, and the house was burning for a different reason. It feels to me like what Congress said is, thank you very much for the firefighting, now we are going to defund the firehouse. So, I hope that Congress really thinks about putting that back in place.

Mr. LUETKEMEYER. Mr. Michaud?

Mr. MICHAUD. I would agree. I think orderliness is important, and I think that tool could create a more-orderly moment to address the bigger picture and make important corrections.

Mr. LUETKEMEYER. I think it makes them calm, and the system gives you 60 days to settle down to figure out if you really have a threat or not.

Mr. MICHAUD. One hundred percent.

Mr. LUETKEMEYER. Can you come to Congress to do something, but you don't have a threat ticket off and off you go?

Mr. MICHAUD. What you will see is there is a lot of churn in equity and fixed-income markets and bank securities, which is a reinforcement for concern.

Mr. LUETKEMEYER. Mr. Gould, what do you think of that?

Mr. GOULD. I think you should just make sure you understand the cost and the incentive of such a mechanism with the SEC going forward. And I think as a prerequisite to informing yourself as to whether that is appropriate, I think you need to get more transparency from the Fed and the FDIC as to actually what happened during that 3-day time period, which I think, as yet, we still haven't seen. So in order for you all to make an informed decision, I think you first and foremost need to get more information from them.

Mr. LUETKEMEYER. Very good. We had SEC Chairman Gensler here a couple of weeks ago, and we asked him whether he had the authority to stop the short-selling on an industry-wide basis. In fact, today in The Wall Street, there is another article with regards to short-selling banks.

Ms. Tahyar, do you think that he has the authority right now to do it across-the-board? He kind of waffled on that.

Ms. TAHYAR. Well, the Chair of the SEC did it in September 2008 and nobody questioned the authority at that time.

Mr. LUETKEMEYER. Okay.

Ms. TAHYAR. So, he clearly has it.

Mr. LUETKEMEYER. Okay. Thank you very much. I yield back.

Chairman BARR. The gentleman's time has expired. The gentleman from California, Mr. Sherman, is recognized for 5 minutes.

Mr. SHERMAN. Thank you. I don't think we can tell the bank regulators that it is not their fault because we had different monetary policies or fiscal policies over the last few years. I am very old, and we have some other old people here. We have some young people too, some younger than myself. But as old people remember, we have had zero-percent interest rates, and we have had 16-percent interest rates. Interest rates go up, and interest rates go down. We have had fiscal budgetary surpluses under Clinton, and we had enormous fiscal budgetary deficits under Trump and others. Fiscal policy goes up, and fiscal policy goes down. We need a banking system where banks can survive not only the existing fiscal and monetary policy, but changes as they may occur.

Mr. Gould, you are wise to have pointed out the governance structure of the Fed and the whole system. First, we have forum shopping. We don't allow that and you can't say, well, I don't like this IRS; I want to go to the other IRS to audit my returns. And we have a governance structure in which the banks elect the people on their regional boards, who are then in charge of auditing them. And if we had a system where only billionaires subject to audits would determine who is running the IRS, we would have a very different tax system.

Mr. Michaud, you bring up an interesting proposal on FDIC insurance. We kind of have two proposals. One is for expanding coverage of operating accounts. When you say operating accounts, are you limiting that to non-interest bearing checking accounts?

Mr. MICHAUD. Pretty much operating transaction accounts as defined.

Mr. SHERMAN. Yes. How would you define that?

Mr. MICHAUD. Typically, I think it would be the operating accounts that businesses and nonprofits and others use for their daily business. And it could be—

Mr. SHERMAN. It is very hard to determine am I a business, or am I just an individual? Do they have a definition?

Mr. MICHAUD. In their report, the FDIC laid it out and gave you the bookends for what you could use for a definition.

Mr. SHERMAN. Okay. I would think that we would want to limit that to non- or low-interest rate accounts if people have more than a quarter million dollars to invest earned interest. That is a different circumstance.

The other policy idea is having, on occasion, temporary, systemwide unlimited insurance. And I am concerned that if we did that, people would pull their money out during that temporary period or we make it permanent and just have total FDIC insurance, which comes very close to a bailout.

Mr. Michaud and Mr. Gould, do you see unlimited insurance of all FDIC accounts either temporary or permanent as a way to go?

Mr. MICHAUD. I have been a fan of the targeted approach, which is you can pick certain types of accounts, but not necessarily insuring all accounts.

Mr. SHERMAN. I want to put up this chart here. What we see here is huge, unprecedented, unrealized losses on marketable securities. We saw our 2018 law allow the Fed to not be tough on these issues with regard to mid-sized banks.

Ms. Judge or Mr. Gould, is it standard practice as part of regulating a bank to calculate how much the bank has lost because of interest rate risk? You can do that, obviously, on marketable securities, but on portfolio loans, you say, ah, that is a 5-year loan, at the time the loan was extended rates were at 2 percent for 5-year loans. Now, they are at 6 percent for 5-year loans, so it's pretty easy to calculate back and determine how much the bank has lost. And then, compare those losses, unrealized losses, on loans and bonds to the bank's capital. Is that a standard part of regulating a bank?

Ms. JUDGE. Clearly, it is for the largest banks.

Mr. SHERMAN. But we couldn't do it with all the banks, could we?

Ms. JUDGE. As a regulatory matter going forward, we should be clear—

Mr. SHERMAN. So, you are saying that preparing a schedule, showing losses due to interest rate risk, is something we didn't bother to do on mid-sized banks, not because it is hard, but because we didn't want to know the answer?

Ms. JUDGE. I don't know what they were looking at, at the time. I believe if I am going to provide any defense that there was an expectation that you would have some type of offset, the regional banks—

Mr. SHERMAN. What you do is you blind yourself to how much money you have lost by believing your customers are willing to subsidize you by leaving the money in. If you believe that, you would probably run up a $35-billion cost to our system.

Ms. JUDGE. Which is exactly why, going forward, regardless of what was true in the past, depositors have woken up and it is very clear we need to—

Chairman BARR. The gentleman's time has expired. The gentleman from Texas, Mr. Williams, is now recognized.

Mr. WILLIAMS OF TEXAS. Thank you, Mr. Chairman, and thank you all for being here today. Americans are struggling under the weight of crippling inflation and families are being forced to decide whether to put food on the table or pay the rent. The Biden Administration's massive spending spree of Executive Orders has fueled this crisis. The Democrats' partisan American Rescue Plan injected $1.9 trillion into the economy, ignoring the warnings that this plan would cause skyrocketing inflation. And as a result, the Federal Reserve has continued to increase interest rates to their highest levels since 2007.

Mr. Gould, in your testimony, you stated that the Federal Reserve's rapid interest rate hikes are a source of systemic risks to the banks. They supervise and were a cause of Silicon Valley Bank's failure. So, can you elaborate on how interest rate hikes caused these bank failures and how do you think the Fed failed to supervise the banks they oversee for this risk?

Mr. GOULD. Yes, sir. The rising interest rate risks caused the bond portfolio, the investment portfolio of banks like SVB to decrease and accrue all of these unrealized losses, which investors began to pick up on and see that there were significant unrealized losses on the bank's assets on their balance sheet.

This is a phenomenon that was well-understood, and well-known. In fact, as recently as a month before Silicon Valley Bank's failure, the Fed Board made a statement on the impact of rising interest rate risks, on banks, on their balance sheets and their investment portfolios. And literally, the case study was Silicon Valley Bank a month before it failed.

Mr. WILLIAMS OF TEXAS. The Federal Reserve's report reviewed the supervision of Silicon Valley Bank. Key findings determined that Silicon Valley Bank's board of directors—you just touched on that—failed to manage the risks. On top of that, the key findings go on to say Fed supervisors did not appreciate the extent of the bank's vulnerabilities. In 2022 alone, the Federal supervisor issued three findings on SVB's ineffective board oversight, their weakness in risk management, and the bank's flaws in their internal audit function.

So, it should raise major concerns that the Federal Reserve, which is tasked with regulating and overseeing banks' risky practices, identified vulnerabilities for more than a year but failed to take corrective actions to ensure that SVB fixed those problems. So despite there being two main causes of the SVB failure, the Fed report stated this experience emphasized why strong bank capital matters and goes on to discuss the need for stronger bank capital.

So again, Mr. Gould, in your opinion, would you think about requiring more regulatory capital above the current levels? Would that have prevented the failures of Silicon Valley Bank and Signature Bank, which were well-capitalized banks? Would high capital levels have prevented SVB mismanagement or the Fed supervisory failures?

Mr. GOULD. Sir, even under higher capital standards, it would seem that according the Fed report, Silicon Valley Bank would have remained adequately capitalized. I think there are questions around whether or how to treat unrealized losses in certain investment portfolios, and whether or not that volatility should flow

through to regulatory capital. I think those are questions that should be examined. But at least as I understand it, regulatory capital levels at SVB, even had they been higher, would have still been met.

Mr. WILLIAMS OF TEXAS. Okay. As a result of the failures of banks in California and New York, taxpayers in Texas, which is where I am from, and across the United States could be left footing the bill for these banks' mistakes and mismanagement. And now, Texas banks face possible FDIC insurance assessments for something they had no part in creating. The FDIC has an obligation to get the best pricing at failed bank auctions and to avoid having to use taxpayer funds to bail out these banks. During the auctions of SVB and Signature, the FDIC did not move fast enough to find a viable buyer, letting multiple days pass. Well, there were reports of several offerings to these banks before a bid was approved.

So finally, Mr. Gould again, could taxpayers have been spared from paying for the failures of these banks if the bidding process had moved more forcefully and swiftly, and did the FDIC leave value on the table?

Mr. GOULD. Congressman, it is certainly the case. A failed bank is often likened to a melting ice cube in that you want to move quickly to sell it, to preserve as much franchise value as possible. I think the situation is simply that we don't have all of the facts, or at least as I sit here, I don't have all of the facts about what actually occurred over these weekends. But you are not similarly limited. You can obtain from the FDIC the facts since you are their overseer.

Mr. WILLIAMS OF TEXAS. I am in the car business, and sometimes we say, your first deal is the best deal. You want to react and sell it. So with that in mind, Mr. Chairman, I yield back. Thank you.

Chairman BARR. The gentleman yields back. The gentleman from California, Mr. Vargas, is now recognized.

Mr. VARGAS. First of all, thank you, Mr. Chairman. I appreciate the opportunity to have this hearing. I want to also thank the ranking member, of course, and the witnesses here today.

I do have to say I want to challenge the premise that somehow President Biden has created all this inflation in the United States. In fact, it is interesting because it has been a worldwide phenomenon. If we look at our peers across the ocean, our European peers, they have been running harder than we are. The U.K. inflation rate is over 10 percent. The EU is still at 8.8 percent or so. Some notion that somehow miraculously or infamously, the Biden Administration created it—no, obviously it was the pandemic, and a whole bunch of other problems that we have had globally, and we have had international inflation. It has been everywhere.

Anyway, I just had to get that off my chest because every time I hear my colleagues say, I just don't think it is true. Dodd-Frank, what is a good loan? Was it the right thing to do at the right time, Dodd-Frank? Let me start with you, Professor Judge.

Ms. JUDGE. I think it seemed like a reasonable move at the time. And I think over time we are learning we probably should have gone further when we had the opportunity. Clearly, that is proven by the fact that we are sitting here, not that much later, and we are facing the magnitude of the bank failures that we are now fac-

ing and of the losses to the insurance fund that we are now facing. Again, some of that was changes in Dodd-Frank and regulatory changes that went even further than the statutory changes. But I think Dodd-Frank brought about much-needed changes. And I think there is always more work to be done. It is the nature of financial regulation.

Mr. VARGAS. Thank you.

Mr. Gould, I think that you said something like, we have passed a bunch of laws, but they haven't done much, or something of that sort. Would that include Dodd-Frank?

Mr. GOULD. Sir, I think that expectations of what Dodd-Frank could accomplish and what some of its proponents said it would accomplish were overstated. As far as I can tell, it did not end the era of boom and bust. At least based on the actions of the regulators just a couple of months ago, it would seem that at least under certain circumstances, there are banks that can fail in ways that would have systemic impact. So at least in two major areas, I think it came up short.

Mr. VARGAS. Do you think it was a good law in general or do you think we shouldn't have had a law?

Mr. GOULD. No, sir, I do not think it was a good law in general.

Mr. VARGAS. Okay. Thank you.

Ms. Tahyar?

Ms. TAHYAR. Dodd-Frank was what, 800 pages, with a dozen titles? There are good parts of it. And there are parts of it that, as Jonathan has said, were overstated. I think the paradigm shift in macroprudential regulation was a good one. I think time goes on and things change, and there is a need for adjustments in some places.

Mr. VARGAS. Okay. It would be unfair, Mr. Michaud, if I didn't ask you. Go ahead, sir.

Mr. MICHAUD. Terrific. Thank you. I think that Dodd-Frank succeeded in bringing more capital and liquidity regulation to the industry, which has been well-served. But I think that there are parts of it that might have gone a little bit too far, and still might need adjusting, but I think the preponderance of it was supported from capital and liquidity. And I don't think the banks that failed, failed because of capital or liquidity. I think they were overwhelmed by a bank run at a moment in time.

Mr. VARGAS. Let's get to that. In fact, that was one of the points that I wanted to talk about. I do believe we should have very large banks. I think that is good for the United States and good internationally. I also think that regional banks are very, very important. And of course, the smaller community banks are important, but they always seem that they would be susceptible, both the regional and the community banks to a run, especially with the digitized ability to move money so quickly, so won't they always strategically be vulnerable? Yes, go ahead?

Mr. MICHAUD. And just to finish saying, I didn't want to also not say that there were mistakes made about interest rate management to that prior question. I am not absolving those big banks that have failed.

Mr. VARGAS. Right. Let's speak about this one.

Mr. MICHAUD. I think these companies are trying to build themselves in a more diversified manner. As long as they manage their concentrations and their capital well, look, there are 4,700 other banks that are doing it successfully right now. I know that these three failures were spectacular and unfortunate, but there are over 4,700 that are doing a really good job, I believe.

Mr. VARGAS. Yes. Thank you. My time has almost expired. But I want to say it just seems that structurally, when you can move $42 billion within a few days, it is always going to be structurally problematic. Thank you.

Chairman BARR. The gentleman's time has expired. The gentleman from Georgia, the Vice Chair of the Subcommittee, Mr. Loudermilk, is recognized for 5 minutes.

Mr. LOUDERMILK. Thank you Mr. Chairman, and thank you for holding hearings on this issue, hearings that are extremely important with the things that are going on. So, it is great that we are actually able to address these types of issues now.

Mr. Gould, in hindsight, the interest rate problem should have been clear, not the least to the Federal Reserve in the case of Silicon Valley. And in Vice Chairman Michael Barr's report, he attributes the lack of concrete supervisory action in the lead-up to SVB's failure to a myriad of causes including supervisory culture under the previous Vice Chair for Supervision. Do you think this is an accurate self-assessment from the Fed or could this just be simply shifting the blame?

Mr. GOULD. Sir, it is impossible to tell, since, for example, we don't have the interview notes on which those kinds of allegations are based. So for me sitting here, it is impossible to tell, but it can certainly be the latter.

Mr. LOUDERMILK. Okay. Considering the Federal Reserve supervisors failed to anticipate obvious systemic risks directly related to their own response to rapid inflation, do you believe it is appropriate that they continue pursuing other major supervisory initiatives such as Basel Endgame or Vice Chairman Barr's holistic capital review?

Mr. GOULD. I think they should focus on their supervisory failures and enforcing the regulations that are on the books rather than pursuing additional regulations.

Mr. LOUDERMILK. Basically, do the job that you already have appropriately before you start taking on more responsibilities or you are just going to fail on those?

Mr. GOULD. That is correct.

Mr. LOUDERMILK. I agree with you on that. Thank you. One of the recommendations in Mr. Barr's report is that we work to change supervisory behavior and promote faster, more decisive supervisory action. My concern with this is that many of the supervisory recommendations made in relation to SVB were unrelated to the risks that caused the collapse. How would we guarantee that unbridled supervision wouldn't create an environment where supervisors dictate management decisions unrelated to safety and soundness?

Mr. GOULD. I think that is an excellent question, and one which I think supervisors grapple with all the time. I think internally, you obviously need to have a strong management culture. Unlike

regulation, if you are an examiner, your training is on the ground, it is based on judgment acquired over years of experience. All of the regulators will say that they apply kind of a risk-based focus to how they think about supervision and making sure that they are in fact, focused on the risks that really matter versus kind of check-the-box exercises on extraneous risks that don't actually matter, it is really tough.

And frankly, there is also always a cost from the bank management perspective, if you have several dozen MRAs, they might be distracted, rather than focusing on the MRAs that really matter. Understanding that, I think is really a function of having good leadership and good training.

Mr. LOUDERMILK. But one thing just brought up is culture. And one of the issues that I have seen with the culture of regulators, as we have seen this transition from the idea that originated in agencies is to work in partnership with industry to come up with regulations that ensure safety and soundness. But in many cases, we see a culture that is adversarial-based, where regulators are the adversaries, or at least are viewed as adversaries by the banks or financial institutions or the businesses. Is that what we are seeing in a lot of these financial regulators? Is it an adversarial relationship.

In other words, we see that a lot in management supervision, which changes depending on who is in the White House at the time. But when it comes to the regulators on the ground, is that culture an issue? Is it is more of a, "gotcha," environment, instead of, let's ensure the soundness and safety of your bank.

Mr. GOULD. I think that is a risk. The banking agencies' prudential regulation is very different from say, the SEC and the CFTC, which are market regulators and viewed more as enforcement agencies. I think there is a potentially worrisome trend of the banking agencies looking more and more like enforcement agencies over time. I don't know if that serves the larger policy interest of maintaining systemwide safety and soundness, if they adopt kind of a more, "gotcha," attitude.

Here though, at least, based on what the Fed report says about Silicon Valley Bank, I don't think the issue was a failure to be adversarial. I think there was just a lack of follow-through and allowing these issues to linger and get bigger and bigger and not be addressed.

Mr. LOUDERMILK. Thank you. That was part of the point is, in some areas it is adversarial, and in some areas it is like, let's turn our eye to this one. So thank you, Mr. Chairman, and I yield back.

Chairman BARR. The gentleman yields back. The gentleman from Illinois, Mr. Casten, is now recognized for 5 minutes.

Mr. CASTEN. Thank you to the gentleman from Kentucky and all of our witnesses. I appreciate you being here on these important issues. I also feel a little bit like that scene in Planes, Trains, and Automobiles, where you know they are you are going the wrong way, even know where we are going. Like Neal and Del, there is a lot of bad stuff in the rearview mirror, but what is coming down the pike is a lot worse right now.

Professor Judge, I want to start with you. Treasury Secretary Yellen has said that we are going to be unable to pay our bills by

June 1st, if we don't come to some agreement on the debt ceiling. Do you have any sense of what is going to happen to Treasury yields if we miss a payment?

Ms. JUDGE. Clearly, resolving the debt ceiling has to be a top priority. The Biden Administration is making it a top priority. They are looking for cooperation. We clearly are going to see adverse consequences on the ability of the U.S. Government.

Mr. CASTEN. I am asking just numerically, because I don't have a Bloomberg terminal in front of me. When I looked 2 weeks ago, there was about a 300 basis points spread between Treasuries coming through before and after the default date. I don't know if you all have seen—

Ms. JUDGE. I don't have a number off the top of my head. There are various estimates that have been out there, none of which look pretty.

Mr. CASTEN. Okay. We are talking about rapid interest rate spikes that created mark-to-market problems where it was that volume of an increase over 9 months. Do you have some sense of how many banks are about to get, "SVB'd," from a mark-to-market perspective if all of a sudden there is a roughly 300-percent increase in interest costs on Treasuries?

Ms. JUDGE. I expect a number of banks will face challenges if there is a significant change in the Treasury rate. Again, I think a lot of what banks hold are longer-term instruments that are also keyed off of the risk-free rate. So it is interesting and challenging to know, which is precisely why going back to where you started, it is never been more important for regulators and for supervisors to be engaging in these forward-looking analyses and trying to understand, what are the tail risks?

Mr. CASTEN. Second question. My colleague was talking about Dodd-Frank. We don't require banks to hold capital for risk-free assets. If Treasuries are about to not get risk-free, there is something like an 8-percent capital charge. How much capital do the nation's banks have to raise if the Treasuries are suddenly deemed to be not risk-free assets?

Ms. JUDGE. It is a great question. I don't have the number for you off the top of my head.

Mr. CASTEN. Does anybody on the panel know that? The numbers I have heard are at the low end of that as $160 billion overnight? I see heads nodding directionally. Okay.

Mr. GOULD. It depends on the risk weight to which they would be subjected.

Mr. CASTEN. Sure. But if you just look at like 8 percent of what is out there right now, it is a big number.

Mr. GOULD. Correct. It is a big number. I don't know the number, but it is a big number.

Mr. CASTEN. Are you concerned about any banks that might not be able to raise that volume of capital overnight?

Ms. TAHYAR. I don't see how banks can raise capital in the middle of a debt default.

Mr. CASTEN. Me, neither. What happens to repo markets, if the Treasuries that are used as the swap on the risk-free premium are no longer risk-free?

Mr. MICHAUD. This would be a new moment for the markets. And I think there would be a lot of big concerns in a variety of areas to deal with, if that happens.

Mr. CASTEN. Okay. If we allow the United States economy and the global economy to go into freefall, what happens to long-term U.S. structural deficits, as the American people are looking for us to provide social services that the banks can no longer lend money to provide up or down? Do tax revenues go up? Can they go up?

Ms. JUDGE. A range of bad things can happen, which is why it is all the more important that we are having this hearing and really trying to figure out, how do we make sure the banks, but also non-bank financial institutions, are prepared for the range of risks that might hit at any point in time?

Mr. CASTEN. Okay. Last question. Moody's did an analysis of the proposal that my colleagues across the aisle have put forward, in exchange for not committing suicide, we would thank the economy. Moody's analysis is that it would increase the likelihood of recession and result in 780,000 fewer jobs. If we go into recession and spike the unemployment rate, do long-term structural deficits go up or go down? It is not a trick question.

Ms. TAHYAR. They go up.

Mr. CASTEN. Thank you. Like I said, we are going the wrong way. And my colleagues across the aisle would have us believe that the only choice before us is, how we would like to die? There are more choices that we have. And I hope we can take this issue seriously and move forward and not kill the entire U.S. economy over some pettiness because somebody doesn't like a prior tax vote or a prior spending vote.

I yield back.

Chairman BARR. The gentleman yields back. The gentleman from Tennessee, Mr. Rose, is now recognized.

Mr. ROSE. Thank you, Chairman Barr, and thank you Ranking Member Foster, for holding the hearing, and thank you to our witnesses for being here.

At the start, I want to respond quickly to Mr. Vargas' opening comments about inflation and what I would call the Biden inflation. Years ago, my professors at Tennessee taught me that inflation is caused when you have too many dollars chasing too few goods and services. So, I reflect back to a couple of years ago when many of us in this room were sounding the alarm, as the Biden Administration was kind of doubling down on the COVID relief funds at a point when even people like former Treasury Secretary Larry Summers was saying, "This is going to be inflationary."

The fact that other countries made the same mistake does not excuse the bad policy choices that the Administration put in place, of not only putting too many dollars in the economy, but also, at the same time, restricting production, which dealt with the other side of that equation so that we ended up with that classic situation that causes inflation. And we got it in just as former Treasury Secretary Summers predicted. And unfortunately, we oftentimes have to repeat the mistakes of the past. I just wanted to answer that.

So, the Administration's own policies, I think, got us to where we are today. I think that is important because then the response, the

policy response to that from the Fed has been to dramatically raise interest rates in such a short period of time as part of what has created the stresses that we see that are leading to the bank failures that we have seen in recent weeks.

Mr. Michaud, First Citizens Bank's stock has nearly doubled since acquiring Silicon Valley Bank, but the FDIC kept its potential gain, our gain on First Citizens stock at $500 million. In your opinion, do you think the FDIC got a raw deal?

Mr. MICHAUD. It is very hard for me to know all the features that went into the bid that First Citizens made. And I think typically what happens in these whole bank acquisitions, is there a variety of tradeoffs in terms of what a bank may pay to acquire a failed bank. So I don't know what tradeoff they may or may not have gotten as part of that stock appreciation.

Mr. ROSE. Why not allow the Federal Government to recoup or the FDIC, in this case, to recoup more of its losses and share in those gains?

Mr. MICHAUD. I think that question would be best for the FDIC to know exactly what the alternatives were at the time, which unfortunately is not something that I know.

Mr. ROSE. Sure. Thanks for your insights there. Last year, Senator Elizabeth Warren sent a letter urging Comptroller of the Currency Hsu to block the TD Bank-First Horizon deal. And the deal fell apart just last week, because they were not given a timetable for regulatory approvals. And First Horizon stock was down nearly 40 percent last week.

So Mr. Gould, do you believe the OCC's actions of being influenced by members of the Democratic Party, like Senator Warren, specifically as it relates to bank mergers, do you believe that their actions are being influenced?

Mr. GOULD. I would certainly hope not.

Mr. ROSE. Do you think it is appropriate for regulators, like Comptroller Hsu, to give weight to any one Member of Congress?

Mr. GOULD. I think it is appropriate for independent regulators to look to the statutory factors that Congress as a whole as a body has required them to do so. And that is where their analysis should begin and end.

Mr. ROSE. Mr. Gould, we have seen this not only at the OCC, but at the SEC, the FDIC, the FTC, and the CFPB. The list goes on and on. So my question is, is it important for regulators to be apolitical and to make judgments based on objective criteria? I think you have already answered that, but in his report, the Fed Vice Chair for Supervision, Michael Barr, touched broadly on the type of regulations that the Fed may consider in their review of the recent bank failures. According to Barr, actions might include increasing capital requirements and adding early triggers to required stress testing when a bank crosses the threshold from one category to the next. The bottom line is that the incremental costs to the banking industry are likely to fall upon that tier of banks below the G-SIBs.

Mr. Gould, my question is, won't these actions just further entrench the G–SIBs and make it harder for the regionals to compete?

Mr. GOULD. Sir, I think that the imposition of additional kind of regulations on regional banks will have an impact on the specific markets that they serve, including the availability of credit. The comparative analysis, as between one type of bank and another, I think is a little hard to tell. And I would hope that the Fed is thinking that through before they put forward any proposals.

Mr. ROSE. Thank you. Mr. Chairman, I yield back.

Chairman BARR. The time has expired. The gentlewoman from Ohio, Mrs. Beatty, is now recognized for 5 minutes.

Mrs. BEATTY. Thank you, Chairman Barr, and Ranking Member Foster, and to all of our witnesses, thank you for being here today. I am sorry my colleague, Congressman Vargas, has left for another hearing, but let me say that I want to be on the record as associating myself with his opening statements on inflation.

And certainly, if we look back, and I think a report that the President gave just a month or so ago in March talked about looking over the last 12 months at how inflation had actually reduced. And certainly, we know gas and food had contributed to it. Gas prices also came down. My colleague mentioned COVID. Certainly, there were a lot of dollars and things put in place. Over a million people had died because of COVID. Small businesses and the economy was affected. So for those things that he did in that space, I support Mr. Vargas and his opening statements.

Now, let me start with Professor Judge. In the resolution of Silicon Valley Bank and Signature Bank, do you think that the Federal Government took the appropriate steps to intervene and prevent contagion by invoking the systemic risk exception and insuring all deposits of both banks?

Ms. JUDGE. Yes, I defer to the policymakers who had the information. But what we see is policymakers of both parties were unanimous in their perception that this posed a threat to the stability of the financial system. And we have seen that actually, no such disruption subsequently materialized, and instead, we managed to maintain a relatively resilient banking system despite major losses.

Mrs. BEATTY. Some of my colleagues on the other side of the aisle are proposing legislation that would place additional requirements on the President, Treasury, and Federal banking agencies before they can take action to respond to the bank failure.

Would those additional requirements, in your opinion, slow down the ability of those agencies to respond to a bank failure?

Ms. JUDGE. Yes. I am very concerned about the way that they might impede the ability for them to respond appropriately. I think that Ms. Tahyar did a great job in her comments earlier comparing the situation to a house on fire, and the first rule is for the firefighters to put out the fire. And I think anything that impedes their ability to make sure the fire is contained, could have adverse consequences on the health of the economy.

Mrs. BEATTY. Okay. Thank you. We have already spent a lot of time talking about the FDIC and the change to the $250,000 limit on deposit insurance. But let me go back to our hearing, I believe it was on March 1st, when I asked Chair Gruenberg about this. And he didn't make a comment on it or declined to make a com-

ment on any particular proposal until the whole review was completed.

But earlier this month, I think it was in the FDIC report that they released, they outlined three options for reforming the deposit insurance: it was unlimited; it could be targeted; or it could be limited coverage. And stated that the FDIC believes that targeted coverage will be the most promising option to improve financial stability. Do any of these options resonate with you? And I will ask each one of you.

Ms. JUDGE. Yes, I thought the report was exceptionally well-done. And the notion that we might want more targeted approaches to deposit insurance that allow small business owners to have the additional protection they need and to also maintain that close relationship that they so value with their local community bank, makes a lot of sense.

Mrs. BEATTY. That prompts me to ask the other Members, do you think Congress should focus on expanding coverage to small-business payment accounts?

Mr. MICHAUD. I, 100 percent agree. I think the targeted approach is the right approach. And I think that is the right cohort to focus on.

Mrs. BEATTY. Mr. Gould?

Mr. GOULD. I was a Congressional staffer here in 2005, when Congress raised the deposit insurance limits from $100,000 to $250,000 for examiner accounts, and I have seen them go up since then. One thing that I think Congress should really look at is historically, what have the levels been? What problem are you trying to solve? And make sure whatever you do in deposit insurance reform, if you do anything, that it addresses specific problems. And then, you also understand that it is not just deposit insurance reform; you also have other mechanisms to reduce the risk of runs, including from incompetent supervision.

Mrs. BEATTY. Thank you for reminding all of us or many of us that we raised it recently. And I will end with you, Ms. Tahyar.

Ms. TAHYAR. I thought the FDIC report was very well-done. I think deposit insurance reform is something Congress has to look at. I have nothing to add except to say that unlimited insurance—we would be the only country in the world to do that, so I would have—

Mrs. BEATTY. Thank you.

Chairman BARR. The gentlelady's time has expired. The gentleman from South Carolina, Mr. Timmons, is now recognized.

Mr. TIMMONS. Thank you, Mr. Chairman. I just want to begin by saying it is shocking to me that some of my colleagues across the aisle are still living in a fantasy land, where they believe that the $7 trillion of extraordinary spending did not cause the highest inflation environment in my life. I just don't understand. I guess, let's just start here. I just want to say that pandemic spending needed to happen. But I would say that number was between $1 trillion and $2 trillion, and that was bipartisan. There was $5 trillion on top of that, that was largely partisan. So I guess just as a show of hands, well, let's just do yes-or-no questions each.

Ms. Tahyar, do you believe that the $7 trillion of spending done in the last 3½ years caused inflation? Just yes or no?

Ms. TAHYAR. Yes.

Mr. TIMMONS. Mr. Gould?

Mr. GOULD. Yes.

Mr. TIMMONS. Mr. Michaud?

Mr. MICHAUD. Yes.

Mr. TIMMONS. Professor Judge?

Ms. JUDGE. I look across the Atlantic, and I see the U.K. sitting there, and they engage in—

Mr. TIMMONS. We are going to that next year. You can say no; it is fine.

Ms. JUDGE. It does not seem like it was the perfect—

Mr. TIMMONS. Okay. So, I guess this is the next thing. The dollar is still the global reserve currency until this President undoes that, and he just nominated somebody to lead his Economic Council who believes that we should actively go off the dollar as the reserve currency, which is insane.

Mr. Gould, I will start with you. Do you see a relationship between the inflationary environment that we experience in the United States, the reserve currency, and that impacting other countries' inflation and causing hyperinflation in certain countries; is there a relationship there?

Mr. GOULD. I assume if the value of the dollar is not stable over time, it will lose its appeal as a global reserve currency.

Mr. TIMMONS. And many believe that the inflation being experienced in other countries can be partially blamed on the United States.

But let's just go to the issue at hand, SVB. Mr. Michaud, do you think it is best practice to have a chief risk officer for a bank?

Mr. MICHAUD. Yes, I do.

Mr. TIMMONS. Okay. So the fact that SVB didn't have a chief risk officer from April of 2022 until January 2023, that is a problem.

Mr. MICHAUD. I don't know the specifics. But it's something I would look into, given those facts.

Mr. TIMMONS. What do you think is the appropriate ratio of diversity officers to risk officers? Is it at least one-to-one? Fair enough? You don't have to answer that.

So, 11 of the 12 branches of the Federal Reserve System were warning banks about stress testing higher interest rate environments, while the San Francisco Fed was beating the ESG drum. They were not communicating in the same way that the other 11 were.

Ms. Tahyar, is that a problem? Do you think that the San Francisco Fed should have been telling the banks to stress test higher interest rate environments? Would that be best practice?

Ms. TAHYAR. I don't know what was going on at the San Francisco banks because we don't have the facts. In theory, in a vacuum, all of the Reserve Bank's should have been focusing on interest rate risks.

Mr. TIMMONS. I have spoken to a number of people who are aware of what they were doing and they were not encouraging that.

Let's go to Congress's role in all this. We delegated our authority to bail out future banks because of the Troubled Assets Relief Program (TARP). If Treasury and the FDIC did not have the authority

to invoke the systemic risk exception, do you think Congress would have done it? Mr. Gould, what are your thoughts?

Mr. GOULD. I'm sorry, sir. Do I think—

Mr. TIMMONS. Do you think Congress would have bailed out SVB and Signature, if not for Treasury and the FDIC having the statutory authority to invoke the systemic risk exception?

Mr. GOULD. That is tough to predict. I recall back in 2008, the first time TARP was up for a vote, it did fail. My guess is it would be tough.

Mr. TIMMONS. Probably not. And the President and the Treasury Secretary said that this was not a bailout. It did not impact citizens all over the country. But unfortunately, with them ignoring the quarter-million-dollar FDIC max and just saying, well, we are just going to insure everybody, that creates risk, which results in initial premiums, which my constituents are going to pay, so that was a lie. It was just a lie.

The President focused on this concern about payroll, which would have been met, and the President and the Treasury Secretary focused on the fact that it wasn't a bailout and it wouldn't affect anybody. I don't think that the Federal Government should have bailed out banks which made poor decisions. I think that those banks should have made their customers 90 percent whole, and the shareholders should have lost everything. I think that is what needs to happen when you lose. The free market has corrections. And when Congress gets involved and bails people out, the free market ceases to exist. I do not believe they should have been bailed out, and I am sick and tired of my constituents being stuck with the bill for failed Democrat policies. With that, Mr. Chairman, I yield back.

Chairman BARR. The gentleman yields back, and just a reminder to Members not to engage in personalities. With that, the ranking member of the Full Committee, the gentlewoman from California, Ms. Waters, is now recognized.

Ms. WATERS. Let me thank our witnesses for being here today and sharing the information that you have shared. I have been looking at some of the reports that have been coming out, not only from GAO, but from the Fed, et cetera. And based on what I am seeing, everybody is to blame.

You have management at the banks that was not taking care to do what they should be doing, particularly when we look at Silicon Valley Bank. And I don't know who was examining their balance sheets, but they didn't seem to know or understand that many of the securities that they were holding had much less value than when they were acquired, which is one of the problems. I don't know whether, because they were the go-to bank for the young creative business people or the startups, they cared whether or not they had insurance. I don't know a lot about some of the issues that we are beginning to hear something about.

But evidently, there were management problems. They grew too fast to begin with, and perhaps they were too lenient in the way that they made loans, too many uninsured depositors and all of that, but the regulators also had problems. Now, some of those problems were created by S.2155, which certainly did, as I remember, reduce the prudential oversight, particularly as it related to stress testing, for example. Now, those who said, we will say that

the regulators had options, they could have exercised some of the regulation that was created by S.2155, they didn't have to.

But I want to direct this question to Ms. Tahyar. I appreciate that you are knowledgeable in your testimony that the White House and Fed Vice Chair Barr raised constructive ideas to strengthen the regulatory framework for regional banks, some of which you agree with and some you may not specifically. Which prudential standards did they highlight that you think should be improved?

Ms. TAHYAR. I think the long transition period moving from one category to another is something that ought to be looked at. I also think that the not passing through OCI in capital, which is something that has been on the books since 2013, should be revisited, and I think Vice Chair Barr's statement that size alone is not what makes an institution risky is, in fact, a good one.

Ms. WATERS. Thank you. Let me just touch on something that is always controversial as we deal with this oversight. Should regulators look to strengthen the stress testing and liquidity requirements, among other prudential standards? When we talk about additional capital, everybody goes crazy. What do you think?

Ms. TAHYAR. I think there are likely some improvements that could be made there, but I would be reluctant to put the same amount of Liquidity Coverage Ratio (LCR) or high-quality liquid assets (HQLA) requirements on regionals as we have on the G–SIBs. I really hope that the regulators will look at that carefully, and be fact-based in the policy changes they make.

Ms. WATERS. Well, since you are going there, let me just ask you, as I look at our regionals now, I am a bit concerned, and I want to make sure that we can do everything to ensure that they are functioning and that they are safe. But why is it that I keep hearing so much about protection for regionals when, in fact, we know that we would be better off keeping a close eye on them now?

Ms. TAHYAR. I think I am influenced here, Congresswoman, by the fact that I am from a small town in Michigan, so I know what it is like for small and mid-sized businesses that aren't in major coastal cities. I think our regional banks are the banks that are providing small and mid-sized enterprises with the most credit they can get. When I teach classes, I talk a lot about Joe's Auto Body Shop. He has 25 auto body shops in the Tri-County region. Joe isn't somebody who changes his bank at a click.

Ms. WATERS. Thank you very much. I yield back.

Chairman BARR. The gentlewoman's time has expired. The gentlewoman from California, Mrs. Kim, is now recognized.

Mrs. KIM. Thank you, Chairman Barr and Ranking Member Foster, for organizing this timely hearing to discuss the recent bank failures. And I would like to say on the record that I believe the Biden Administration's American Rescue Plan's $1.9-trillion injection into the economy helped spur inflation to 9.1 percent in 2022, an inflation rate that we haven't seen in 40 years. And to tame that inflation, the Fed was forced to act swiftly by raising interest rates at a pace also not seen in decades.

Unfortunately, in the State of California, where I am from, we have seen firsthand how partisan economic policies can lead to the failure of two of its biggest banks, wiping out nearly half a trillion

dollars in assets in just a matter of days. So, this is why we are having this hearing to get to the bottom of those bank failures, and we are trying to strengthen our financial system and protect the backbone of our economy. Those are the small and mid-sized financial institutions, because they are the ones who provide much-needed capital for our small businesses.

Let me ask the first question to Mr. Gould. A lot has been discussed regarding the FDIC's actions to resolve and sell SVB. Do you think it was a mistake by the California Department of Financial Protection and Innovation to close SVB by midday on March 10th?

Mr. GOULD. Congresswoman, based on what I know from the reports, SVB lost something on the order of over $40 billion in deposits on Thursday. And I think at least based on, again, what I read in reports, regulators anticipated another $100 billion was going to flow out the next day. That is, as I understand it, a deposit run of huge magnitude. So, I think the decision to close them was really all that was left to do. They had no other options. I think there are good questions that can be asked about what led up to those events. I think the time Thursday, Friday, looking at those kinds of deposit offloads, I think that gave them great falls.

Mrs. KIM. Do you think there could have been other things the California regulator and the FDIC could have done differently in the resolution of SVB?

Mr. GOULD. Again, I think it is a little hard for us to judge simply because we don't have all of the information of what went on in the period immediately preceding the closures by California. But also, over that weekend, and then in the kind of week or so that elapsed until the FDIC found a buyer or at least a partial buyer.

Mrs. KIM. Let me follow up, and then I will ask another question. I know this has already been discussed by previous Members who asked the question, and my understanding is that the regulators have the tools, like S.2155, to prevent bank failures. Can you elaborate on that, because I wasn't here when that conversation took place. Can you elaborate on your thinking on the argument that S.2155 caused the bank failures?

Mr. GOULD. Sure. The discretion that S.2155 afforded the Fed in particular, but the regulators in general gave the ability to tailor enhanced prudential standards based on the asset size of the banks. They did so over the course of 2018, 2019, and 2020. Had SVB been subject to the enhanced prudential standards that would have existed, but for S.2155, with the exception of the LCR, which they would have failed, they would have passed every single other test.

And even failing the LCR, it is important to note they were already failing the more important internal liquidity stress testing, and the Fed was not enforcing the existing regulations on the book. And if they had in order to pass the LCR or to pass an internal liquidity stress testing, they would have had to bulk up on even more high-quality liquid assets, which are themselves ironically subject to interest rate risk. So, they would have bought more government obligations, thus increasing their exposure to interest rate risk. That is a perverse and ironic impact of regulation in this particular case.

Mrs. KIM. Okay. I only have 9 seconds, so maybe I will just ask that, and hopefully you can follow up with that last question that I was going to ask. I will yield back. Thank you.

Chairman BARR. The gentlelady yields back. The gentlewoman from Texas, Ms. De La Cruz, is now recognized.

Ms. DE LA CRUZ. Thank you, Chairman Barr, for holding this hearing today, as this committee seeks to continue to uncover facts around the recent bank failures at Silicon Valley Bank and Signature Bank, and most recently, First Republic Bank. It is critical that this body continues to investigate the circumstances around these bank failures and how the Biden Administration and the financial regulators responded to these events. I am the Congresswoman in South Texas, and most of my community is rural. And a lot of my constituents rely very heavily on smaller institutions or regional banks. So, this is an area of particular focus to me.

When the bank failures occurred, I got on the phone and I spoke with those smaller banks, those community banks, and regional banks to ask, how are you all doing? And they said, "Congresswoman, we have adequate capital, we are fine, we will be able to get through this period. But what we are most worried about is that because of the lack of good management in these banks, and the failure of the regulators, that we are going to bear the consequences as small community banks and regional banks."

So, my question really goes to all of you. Should the Federal Reserve call for stronger regulatory tools, as appears to be implied by the Vice Chair for Supervision? And what consequences could this have on our small community and regional financial institutions in districts like mine, that by the way, serve a large population of Hispanics? In fact, we are one of the largest Hispanic communities in the entire nation. Yes, sir?

Mr. MICHAUD. Maybe, I will take the first shot at that. My view is that the regulators do already have the tools they need to adequately supervise. And what you speak about, I think speaks to tailoring, which is the approach that has been done very recently. So, I believe that the tools are in place and it is a matter of how it is supervised, rather than needing new rules or laws for the Federal Reserve at this moment.

Ms. TAHYAR. I agree with that, and I think we have a multitiered banking system because we are a large and complex country. And we need to continue to have different sizes of banks serving different communities. I think that the agencies need to focus on supervision, and they need to clean house more than they need to focus on regulatory change.

Ms. DE LA CRUZ. Thank you. Yes, Professor?

Ms. JUDGE. For me, there is a need to do both. There is clearly a need to ramp up supervision. At the same time, I loved your framing and the attention that you are paying to the community banks, and the important roles that they are playing in your district and in local communities across the country. I actually believe that appropriately regulating very large regional banks, banks with over $100 billion in assets that we have learned cannot be resolved in an orderly fashion, would actually help to encourage people to focus on those true community banks and the smaller regional banks that really are focused on serving their community.

Ms. DE LA CRUZ. Let me ask you a question, ma'am. Where do you live?

Ms. JUDGE. I live in New York City, but I actually grew up in Ann Arbor. The community bank that I worked with most is the State Bank of Graymont, which is based in Pontiac, Illinois. We have some farmland exposure to Illinois and they are actually doing an amazing job with agriculture lending.

Ms. DE LA CRUZ. You live in New York. How many years have you lived there?

Ms. JUDGE. I have lived there about 11 years.

Ms. DE LA CRUZ. Eleven years now. So, when was the last time you went to rural America and spoke with community and regional banks about what you are proposing?

Ms. JUDGE. The last time I went to rural? I spent a lot of time all around the country. I gave the inaugural—

Ms. DE LA CRUZ. In the last 3 months?

Ms. JUDGE. Yes, I gave the inaugural family and small business lecture at the University of South Carolina, because I could not be more dedicated or supportive of small businesses. And I went to South Carolina and I traveled at lot—

Ms. DE LA CRUZ. I yield back. In the last 3 months speaking after this failure, I think that being among community and regional banks, we will hear the same thing over and over again, which is exactly this, and I think it has been repeated several times. The Fed was not enforcing current regulation on the books, and if they did just that, we would not be in this situation, and community and regional banks would not have the fear that they have now.

Chairman BARR. The gentlelady's time has expired. The gentleman from Tennessee, Mr. Ogles, is now recognized.

Mr. OGLES. Thank you, Mr. Chairman, and witnesses. I know it has been a long afternoon, but thank you, and thank you for indulging us. Mr. Chairman, I reject the premise that small to mid-sized banks are somehow a problem in our economy. Mr. Michaud, you said that roughly 4,700 of the small to mid-sized banks are getting it right. So, the three banks that failed were poorly run, they were poorly managed, and they were poorly supervised.

This is an either/or question for—we can go down the line. We will start with you, Ms. Tahyar. What is more important: for banks to examine their liquidity risk or their climate risk?

Ms. TAHYAR. Sorry. Was that liquidity risk?

Mr. OGLES. Liquidity versus climate?

Ms. TAHYAR. Liquidity.

Mr. GOULD. Liquidity.

Ms. JUDGE. Liquidity and both.

Mr. OGLES. Okay. Same premise, interest rate risk or climate risk?

Ms. TAHYAR. Interest rate risk.

Mr. GOULD. Interest rate.

Mr. MICHAUD. Interest rate.

Ms. JUDGE. Interest rate doesn't have to be a choice.

Mr. OGLES. We are stating the obvious, right? But when we look at these banks, when we look at SVB in particular, which was so focused on climate risk versus their deposit structure—you want to

think of actuarial tables. When I think of liquidity risk and I think of interest rate risk, I think of dollars and cents. I think of numbers.

But the problem was, these banks were putting polar bears and penguins above their fiscal responsibility. So, any effort to target or impede or to increase the cost structures of our small to mid-sized banks will face a strong headwind from this committee, in particular from me, because I represent rural areas, and it is the small businesses in the communities that are the backbone of my communities. And it is the small to mid-sized banks that are lending to those small businesses.

Mr. Chairman, I will also reject the premise that Biden's policies are not to blame here. Econ 101, when the government puts more money into the economy than the economy can produce itself, the back side risk of that is always going to be inflation. So, when you force an omnibus bill on the American people that is an additional $2 trillion that doesn't need to be had, at a time when retail prices are going up, and when underlying commodities are screaming, stop the madness, and we did nothing other than spend more money.

Biden's policies were reckless, they were feckless. And I am appalled at the idea that he is not to blame. At the same time, he is creating choke points in production, choke points in energy production. So with that, according to the FDIC report, unlimited coverage of deposits, Mr. Gould, would increase the size of the Deposit Insurance fund just to retain basic ratios of insured deposits to the Fund itself. And the estimates could be increased 70 percent more, which is going to lead to increased assessments on the banks. Is that a good or a bad thing?

Mr. GOULD. That, in and of itself, is a bad thing, whether or not it is justified by whatever benefit it provides.

Mr. OGLES. Again, when I think of the increased assessments and the impact that is going to have on my small to mid-sized banks in my district and all of the rural districts across the country, isn't that an argument against unlimited deposit coverage?

Mr. GOULD. That is certainly an argument. Yes.

Mr. OGLES. When I think about where we are and how we got here, it is easy to armchair-quarterback. It is easy, quite frankly, to lay blame. I have said this before, and I will say it again, Ronald Reagan says the scariest phrase in the American language is, "I am from the government and I am here to help," So, what should we not do as we move forward? Ms. Tahyar?

Ms. TAHYAR. We should look at fact-based evidence and then make policies. We shouldn't just be with our political priors.

Mr. OGLES. That is right.

Mr. GOULD. We should examine the efficacy of the regulations on the books and see whether they are out there performing as promised, including resolution or recovery planning,

Mr. MICHAUD. We should make sure the solution is targeted for the need, but also something we haven't spoken about yet, which is, there has been a real headwind to healthy bank M&A and that has been the message that has been sent to the industry. I think ultimately, the industry would be healthier, the mid-sized banks would be healthier, and the industry would be able to resolve

weaker banks in that manner without the defund if there was a more efficient way to consolidate than there is right now.

Mr. OGLES. Right.

Ms. JUDGE. I completely agree that we should look at the facts and we should look at the efficacy of the current regulatory scheme. And in light of recent events, we had three major bank failures imposing massive losses, so I think we have to see that the current scheme is coming up wanting.

Mr. OGLES. Mr. Chairman, I have just a few seconds left to give you the last word.

Chairman BARR. I appreciate the gentleman yielding. I think we are running out of time. We may do just another quick round. And so, I will take that time the gentleman yielded and I appreciate him yielding.

And with that, without objection, we are going to go to just one additional round with the indulgence of the witnesses and the ranking member. And we have agreed that each one of us will ask one more round of questions.

Let me just follow up the question about M&A to Mr. Michaud. On resolutions, if there is a need for additional resolutions, is it important to avoid more industry consolidation for regulators if there are additional failures to give regional banks as opposed to G–SIBs the opportunity to acquire or merge with failing institutions to preserve that diversity within our financial ecosystem that you talk about?

Mr. MICHAUD. I very much support the Congressional limits where banks with more than 10 percent of the deposits in the country should not be acquiring other banks. And I think the industry needs to build competitors for the 4 banks that have 40-percent market share. I think the economy would be better off if we had other banks that were able to compete with them more.

Chairman BARR. So, an FDIC reluctance to approve mergers, particularly among regional banks or small banks, can actually be quite anticompetitive?

Mr. MICHAUD. Right now, it is not the FDIC as much as the Fed. The amount of time it takes to complete a merger in the United States has doubled in the last 2 years. Not only that, but there is uncertainty as to the process and the outcome, should you look to undertake consolidation. The consolidation that has been happening is regional banks have been trying to combine to create these regional champions to serve their regions and compete with the bigger banks.

Also, I believe, even as we sit here today, there are banks that are willing to take on other banks that may be underperforming. But the banks would be unwilling to take that action because they don't know if the regulatory response would allow them to do it and they can't afford that risk.

Chairman BARR. Mr. Gould, your testimony was interesting when you said the proliferation of regulation since the 2008 crisis may have reduced risk management and supervision to mere compliance exercises, damaging both in the process. Can you elaborate?

Mr. GOULD. Yes, sir. I think sometimes regulation, particularly in the absence of competent supervision, provides the illusion that we are addressing risks. And I think that is a problem. I think we

should not be overly reliant on mere regulation. I think supervision is what matters. And I think supervisors have all of the tools, most fundamentally of which is just examiner judgment, to ensure the safety and soundness of banks.

Chairman BARR. Yes. An overreliance on regulatory tools such as some stress testing may have blinded supervisors to risks that are hiding in plain sight, like basic interest rate risk. I also thought it was very interesting that you pointed out that the one regulation that Silicon Valley Bank was not subject to as a result of S.2155 and regulatory tailing was a requirement that hadn't been imposed on them, that would have actually increased their interest rate sensitivity. The requirements, had the Fed enforced it on the liquidity coverage ratio and shifting holdings to high quality liquid assets.

Final question to Ms. Tahyar, thank you. Professor Judge claimed a regulator transparency legislation would impede supervisory responsibilities. I would note that nothing in these bills takes away any regulatory supervisory or emergency powers. They are only transparency and reporting requirements. Would that in any way impede the firefighting that you talked about in your analogy?

Ms. TAHYAR. Mr. Chairman, I haven't had a chance to look at the specifics of the legislation. I would be happy to put something in the record. But in general, we are living in an environment where there is not enough transparency from the banking agencies, and that makes it more difficult for Congress and others to do their oversight.

Chairman BARR. Let me just stipulate that nothing in this collection of bills takes away any emergency powers of the regulators. And let me just stipulate for the record, that the goal of these bills is to give the American people, through their Representatives in Congress, greater visibility into decision-making at the time of the house fire, and after the house fire. In that scenario, does that in any way impede the ability of regulators to do their job?

Ms. TAHYAR. No, it doesn't, Mr. Chairman.

Chairman BARR. And with that, I yield 5 minutes to the ranking member, Dr. Foster.

Mr. FOSTER. Thank you. I was wondering if any of you have at this point any general after-thoughts about the systemic risk exception? Did it function as designed? Was this an appropriate use of it? Are there any changes that we might kind of play on that? Obviously, it is a big issue with a lot of the Members here as to how the special assessment is going to land. If you have any advice on if you were to craft the special assessment, what would it look like?

And if I remember correctly, only the first two banks had the systemic risk exception and the third did not. So, most of the hit actually will come through the special assessment. Does anyone want to venture any thoughts on how that—

Mr. MICHAUD. I will start with the systemic exception. I think it was a good decision to do that. Because if I think it hadn't happened, I think more banks would have failed. And it was due to the sudden nature of the bank runs. I think in that moment, it was important to do.

The other thing is that closing a bank in the middle of the day is highly unusual. It makes things disorderly. I know that Mr.

Gould spoke earlier about how it would be interesting just to learn what we can do better in the future as to what happened in those hours. I think the impact after that was dramatic. So, I think it is best if this resolution happens when the markets are not open.

Mr. FOSTER. Any other thoughts, Ms. Tahyar?

Ms. TAHYAR. The systemic risk exception should be rare, but it is there for a reason, and this time, it was used wisely. I think the three keys do provide some political checks and balances, but, again, I think we still need to have after-action reports with transparency and accountability around what happened, when, and how.

Mr. FOSTER. Are there any aspects that give you heartburn? For example, there is a lot of freedom in the special assessment. And there is a lot of danger that it will be very politicized and unavoidable?

Ms. TAHYAR. Yes. Thank you, Ranking Member Foster. The special assessment is we already have the White House Fact Sheet, which is saying that it shouldn't fall on community banks. I think that is appropriate, given the need to protect community banks. But other than that, I think there needs to be a fairness about how that special assessment is allocated among the bigger banks and among the regional banks.

Mr. FOSTER. And what sort of factors, if you were to write it, would be considered the fraction of uninsured deposits? In terms of fairness, what you would want is banks, which had a similar business profile as Silicon Valley Bank or Signature and so should be preferentially hit with the assessment. Are there reasonable ways to do that?

Ms. TAHYAR. You are thinking if you have a higher proportion of uninsured deposits.

Mr. FOSTER. Whatever the risk factors? You want to punish banks that had similar risk factors, in some sense?

Ms. TAHYAR. That particular point makes sense to me. I have to say that I feel like there is still a lot to learn on how that special assessment should happen. So, I would prefer to wait and see what the FDIC proposes and then react to that.

Mr. MICHAUD. And Ranking Member Foster, I would just do what we talked about earlier, I think there is a lot of value in being too-big-to-fail, that these banks just because of their size, are receiving more deposits as we speak. And so I believe that those banks should bear a higher proportion of this assessment. Not all, but should bear a higher proportion than they do today.

Mr. FOSTER. And any thoughts on the extraordinary support that was provided to banks holding Treasuries, and using them as collateral, I guess, for loans at par, which seemed like maybe a significant intervention?

Mr. MICHAUD. My view on that is that they are the lender of last resort and the market needed that moment, and it brought stability. We can figure out all of these things if the market is stable and orderly. It wasn't, and I think that facility helped bring stability so we could have this conversation.

Ms. JUDGE. I would just note that Dodd-Frank did make very significant changes to the systemic risk exception and to Section 13(3). I think those changes helped, but I think this was an episode of actually both instruments being used very prudently by regulators

to help maintain a stable and healthy financial system in the face of significant bank failures.

Mr. FOSTER. Okay. Any further thoughts you have, we are going to have to be pondering this for a while, and I really appreciate your thoughtful comments. Thank you. I yield back.

Chairman BARR. The gentleman yields back. And I would like to thank our witnesses for your testimony today on this very illuminating and timely topic.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

This hearing is now adjourned.

[Whereupon, at 4:10 p.m., the hearing was adjourned.]

A P P E N D I X

May 10, 2023

Testimony of Jonathan V. Gould
Partner, Jones Day
Before the U.S. House Financial Services Subcommittee on
Financial Institutions and Monetary Policy
hearing on
"Federal Responses to Recent Bank Failures"

May 10, 2023

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.

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[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.

Written Testimony of Kathryn Judge, Harvey J. Goldschmidt Professor of Law and Vice Dean for Intellectual Life, Columbia Law School

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.

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[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.

Testimony

Before the U.S. House Financial Services Subcommittee on Financial Institutions and Monetary Policy

Hearing on “Federal Responses to Recent Bank Failures”

Thomas Michaud

President and CEO

Keefe, Bruyette & Woods (KBW), *A Stifel Company*

May 10, 2023

Good morning, Chairman Barr and members of the Financial Services subcommittee, and thank you for inviting me to speak with you as part of this important hearing.

By way of background, Keefe, Bruyette & Woods (KBW) is a 61 year old firm that specializes in investment research, equity brokerage and investment banking services for financial institutions. Given the firm's breadth of focus, the firm has a unique expertise in understanding not only the largest institutions in the financial services industry, but also the mid and small company universe as well. KBW has one of the most extensive franchises of its kind in the world, with a widely recognized research department, covering more than 450 US financial institutions and approximately 150 European and Japanese institutions.

KBW was an employee owned firm until 2006 when it went public on the New York Stock Exchange. The firm was acquired by Stifel Financial (Stifel) in 2013 and today operates as a subsidiary of Stifel (NYSE: SF). Stifel is a 132 year old company, headquartered in Saint Louis, MO and is the nation's 7th largest retail brokerage firm, based upon the number of registered investment advisors. KBW, once headquartered in the World Trade Center, has been very active in the 911 community. In particular, the firm helped establish 911Day.org (www.911day.org) as an organization that has responded to Congressional action dedicating 911 as a National Day of Remembrance and Service.

I have been with KBW for 36 years and have been President and CEO for the past 11. I started my career as a bank credit analyst before moving to equity research where I specialized in bank research. Over my career, I have been responsible for businesses in the US and Europe. I often represent the firm as an expert on the banking and financial services industry and my views are consistently sought by industry leaders, corporations and journalists. My parent company is also a Member of the Mid-Sized Bank Coalition and I have worked closely with Members of Congress on matters impacting financial services and banking.

Banking crises, driven by depositor fear, have happened before and are why the FDIC was created.

Over the past 150 years, the United States has undergone approximately 10 periods of bank unrest or turmoil. Most of these periods led to a lack of confidence (or were created by a lack of confidence) in the banking system and undermined the ability of banks to perform their essential contribution to economic functioning and prosperity. Or said a different way, what is happening now is not unprecedented, but thankfully only happens about once every 15 years in modern American history. Each of these banking panics has had plummeting confidence as a key element. In 1933, upon the creation of the FDIC and following a bank panic that led to a bank holiday, President Roosevelt said "there is an element in the readjustment of our financial system more important than currency, more important than gold and that is the confidence of the people… You people must have faith, you must not be stampeded by rumors or guesses. Let us unite in banishing fear." While today's banking stress is nothing like the panic in 1933, fear

played a central role in leading to three bank failures over the past two months. These three failures represent three of the four largest in American history.

As many economists see a slowdown and possible recession on the horizon, the nation should know that the fundamentals of the banking industry are sound. The United States has one of the strongest, if not the strongest, banking systems in the world and more than a few of this industry's practices set the global standard. Changes in liquidity and capital requirements following the Global Financial Crisis and as directed by Dodd Frank, have helped position the industry to better weather the pending economic slowdown. However, recent declining depositor confidence has emerged as a critical variable in 2023 and needs to be addressed or the complexion of the industry will change dramatically. While the recent apex of the crisis appears to be behind us, confidence in the banking system remains very fragile and volatility in the stocks and bonds of banking companies continue to exhibit and contribute to this wariness.

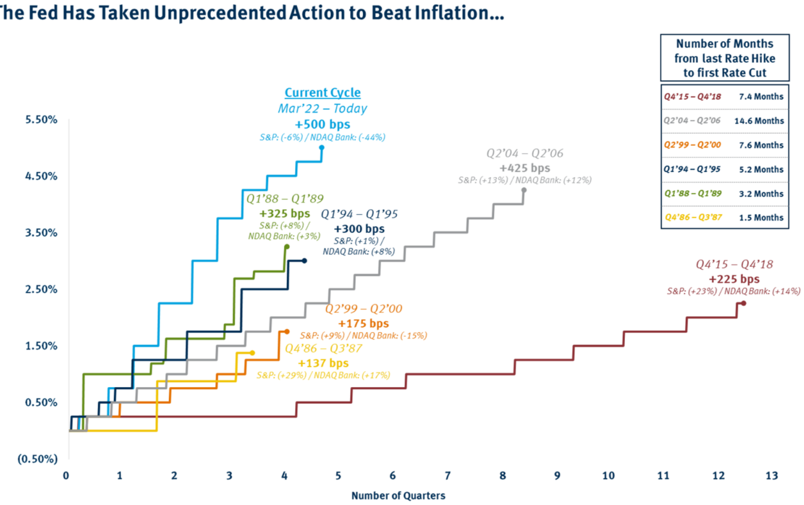
The March bank failures show how the speed of money has accelerated and the impactful role that social media can play.

During Congressional Hearings following the collapse of Silicon Valley Bank it was disclosed that depositors withdrew 20+% of deposits on Thursday, March 9th and had initiated withdrawal requests for 55+% of deposits on Friday, March 10th. If the bank had been open all day it may have, in fact, lost more than 55% of deposits on Friday. The size and speed of this run was unprecedented and reflects the technological advancement that has happened in payments and banking. It is now easier for depositors to move their money between banks than ever before. This increases the chance of a bank run, should a sudden drop in confidence occur. Silicon Valley Bank was primarily a business bank and not a typical bank with branches, and its depositors were more concentrated and larger than a typical bank. Social Media played a role in the bank run when well-known depositors used social networking to communicate that they were withdrawing funds from the bank, and encouraged others to do the same. This might have been the first all-electronic run on a bank of meaningful size. When the FDIC on Friday, March 10th did not protect all of the depositors of Silicon Valley Bank the run quickly spread to other banks. To mitigate risk, depositors took a "who's next" mentality and, increasingly, depositors started to judge the safety of their bank on its size and the degree of its uninsured deposit concentration. This judgement applied particular pressure on mid-sized commercial banks (versus consumer banks), where median deposit balances are larger and included a slightly higher proportion of uninsured deposits. During this period and continuing to today, bank stock volatility has increased significantly with heightened speculation about the health of banks. This market action has further pressured depositor confidence, creating a feedback loop between deposits and stock prices. In the coming months, the Federal Reserve will expand its FedNow real-time payments system. This new program is designed to increase the speed of payments. As these developments roll out, it is critical that the regulatory apparatus and support system for banks keep up.

The recently failed banks had concentrations that made depositors nervous and Held to Maturity Accounting was not a safe harbor during a period of record Fed tightening.

In hindsight, it appears that interest rate exposure is what made Silicon Valley and First Republic riskier in the eyes of depositors. Both banks grew at fast speeds during the pandemic and used the COVID deposit surge to invest in long-dated fixed rate assets, creating a significant duration mismatch on their respective balance sheets. As the Federal Reserve started raising interest rates at a historic pace (see chart below); market commentary, social network communications and volatile stock prices all negatively impacted depositor confidence, which ultimately led to three bank failures. Also, in the case of Silicon Valley Bank, the bank had an unusual degree of concentration in its deposit base, as the top 10 depositors had $13 Billion of total deposits. Suggestions for the future include modifying rules surrounding Held to Maturity securities and placing limits for the use of this accounting treatment as a percentage of bank capital. Or, building in circuit breakers if exposures exceed certain thresholds. Even without regulatory action on this point, I expect market forces to require a greater accounting of concentration in a bank's core business and more limited use of Held to Maturity accounting.

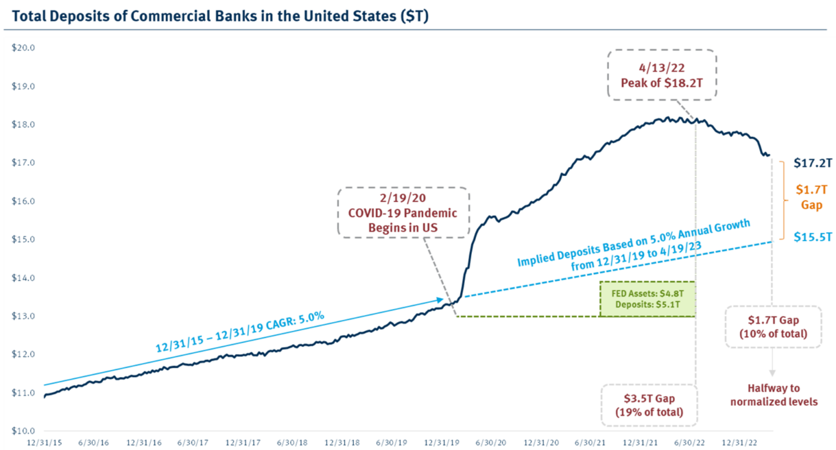
The Fed Has Taken Unprecedented Action to Beat Inflation…



Source: KBW, S&P Global Market Intelligence; Market data as of 5/3/2023
Note: Historical rate hikes since 1985; Rate hikes based on the Fed upper bound

Deposits have been shrinking since April 2022, as COVID surge deposits exit the banking system. This is a headwind for credit extension in the United States.

Industrywide, bank deposits have been a very reliable form of funding for the industry as a whole. Pre-COVID, FDIC deposits were growing at about a 5% annual pace, which makes sense given the pace of GDP growth and the impact of compound interest. As seen in the chart below, the size of the FDIC insured deposit base swelled considerably once the government took necessary monetary and fiscal policy action to offset the impact of the pandemic. Zero interest rate policy, quantitative easing and fiscal stimulus all accounted for this growth in deposits. FDIC insured deposits grew 37% over a 26 month period from February 2020 to April 2022, making it a historic moment in the growth of the nation's deposits. The banking industry had the capital and systems to accept these deposits without any disruption to the economy. Now that government policy has changed, interest rates have gone through the fastest tightening cycle in 40 years and deposits have been declining at a rapid pace. FDIC data suggests that April 2022 was the peak in FDIC deposits during this cycle. Also, if a 5% baseline growth estimate is used, it appears that the percentage of COVID Surge Deposits in the industry peaked at 19% in April 2022 and today stands at 10%, implying that we have more to go for the size of the deposit base to normalize. This is not a perfect science and there are multiple factors that impact this analysis so it will be hard to say exactly how much of the surge deposits are left, but implications are the same. Banks have been managing, and will continue to manage this shrinkage in the deposit base while keeping their institutions sound and open for business. For example, banks have been carrying additional liquidity on their balance sheets and have been raising depositor interest rates in an effort to retain deposits. This is a challenging, but manageable moment in the industry's history. Importantly, having banks fail while COVID surge deposits leave the system only makes the process more challenging. I believe this moment of shrinking deposits and depositor unease, due to the recent failures, is likely to cause banks to be more conservative and this will likely further limit credit availability. This is why I think it is important to increase confidence in the system right now, it will enhance banks' ability to serve their clients and to extend credit more readily as the nation heads into an economic slowdown.



Source: KBW, FRED St. Louis Federal Reserve; Deposit data as of 4/19/2023

The United States needs successful banks of all sizes. The biggest banks have been gaining deposit market share. This trend accelerated in early March, exacerbated by the implicit Too Big To Fail (TBTF) guarantee.

Over the past 12 years and since the largest banks were designated as Systemic as part of the Dodd Frank reforms, the largest U.S. banks have been gaining market share. As of year-end 2022, 3% of U.S. banks have 77% of the industry's deposits, and the nation's largest four banks collectively control 40% of the deposits. Since the crisis began in early March, the trend towards deposits concentrating in the largest banks has accelerated. According to Federal Reserve data, banks have realized nearly $400 billion of deposit outflows since early March. The largest 25 domestically chartered banks have taken less of a hit, with $140 billion of outflows compared to the smaller banks with nearly $240 billion of outflows. It appears that depositors are placing even more value on the implicit guarantee that the largest banks have and that the market share shift is accelerating.

The United States needs banks of all sizes, especially the mid and small sized. Of note, over 60% of the deposits in the country are in banks with over $100 Billion in assets. Yet, these banks don't make 60% of the loans to main street America. Many of these loans are made by mid-sized and smaller banks. Deposit flows to banks based on size will ultimately disrupt the availability of credit in smaller communities. Deposits are the fuel that power loan growth. If the deposits aren't there, then lending capability will shrink, or shadow banks will step in to fill the void. These shadow banks are typically outside any regulatory barrier and supervisors will have less knowledge about what is happening in the credit markets for smaller businesses. As a reminder, close to half of all working Americans are employed by firms that have 100 or fewer employees and

mid-sized banks themselves employ approximately 292,000 people in the U.S. Getting credit to these borrowers is essential for economic growth. Additionally, it is important to recall that it was the mid-sized and smaller banks that drove the government's Payroll Protection Program (PPP) during the pandemic. Statistics show that 60% of the loans distributed were made by community banks. These banks were essential to the program's success and demonstrate these banks' importance to the economy.

While the largest banks in the nation are continuing to grow their market share in the United States, these banks also perform an important role in the global economy, which benefits the nation. Compared to their global peers, the American banks have shown better financial strength which has allowed these banks to better support their clients and the economy. The eight American Global Systemically Important Banks (G-SIBs) dominate the global rankings in fundamental performance of the 28 globally designated G-SIBs. Because of their success, the American banks have had resources to grow and to invest in the future. The largest American banks have been innovators in bringing new technology and products to market. They are also Fintech leaders, which will help ensure that American finance continues to be a global leader. The proposals that I will make later in this written testimony will be to level the playing field between the largest banks in the nation by modernizing FDIC insurance and not by eroding the current success that these banks have had. I believe it is important for mid and small sized banks to not lose market share to these larger banks just because of their size and the implicit counterparty guarantees by the government.

It is also important to allow healthy bank M&A as an important element in strengthening the banking system and allowing banks of all sizes to improve their position via scale. Currently, there are four banks that dominate the landscape with 40% of deposits. Current legislation prohibits banks with more than 10% of deposits to acquire other banks, which is an appropriate policy that should not be altered. The best policy is to allow for mid-sized and smaller banks to combine in order to create more capable competitors. More sufficiently sized regional bank competitors will lead to more choice for banking customers and will power more pricing competition and innovation. Mid-sized banks exist to focus on their local regions and communities. As technology demands grow and the cost of regulation increases with every incremental new rule, mid and small sized banks need the benefit of scale, just like the bigger banks. The marketplace is demanding more services from banks and banks of all size feel pressure to modernize. Consolidation allows for these banks to be more competitive as they grow. With scale, these banks can build the services necessary to compete with the largest banks in their region. Consolidation can also be a tool for regulators to ensure that well run institutions take over banks that need stronger risk management practices, creating a more stable industry overall.

What To Do Now? – Modernize Deposit Insurance Coverage

The last time significant change was made to the deposit insurance limits was when Congress passed the Dodd Frank Act. Since that time the speed of moving money has accelerated and protecting depositor confidence has become more important. Silicon

Valley Bank proved that bank runs can happen fast. No longer will regulators be able to see lines at branches growing, as was the case in previous bank cycles. Also, the nation's biggest banks have grown much larger as a percentage of the industry than what was probably considered when the law was passed. The larger the biggest banks become, the more value depositors will think that they get from the Too Big To Fail implicit government guarantee. Therefore, I think the time is now for modernization of bank deposit coverage. The current deposit insurance system, while successful over the past decades, is an analog system in a digital world. I believe the right answer is in the Targeted Approach as was submitted in the FDIC policy response report on May 1. I support the following for consideration:

1. **Raise deposit account coverage limits**
   Operating accounts (also known as transaction accounts) are the life blood of businesses and non-profits. These are the accounts that entities use to fund payroll and run their businesses on a daily basis. These are the entities that understand their fiduciary obligation to keep their deposits safe and many of them do not have the skills to perform credit analysis on their banks (please recall that both Silicon Valley Bank and Signature Bank were both Investment Grade rated when they failed). For this reason, to enable mid-sized banks to compete more fairly, I support raising the insurance limit for transaction accounts. Congress may also wish to consider increasing the general account limit as well.

2. **Allow additional purchases of FDIC insurance by banks**
   I propose that banks be given an opportunity to purchase additional coverage for other accounts they feel is necessary. Currently, banks are using private sector solutions to establish joint ventures with other banks to maximize deposit coverage. This is done to level the playing field with larger banks, but has added friction to the client relationship and additional cost to the bank. A more direct solution to level the playing field with larger banks is to allow these banks to buy extra insurance from the Deposit Insurance Fund for a fee. This would be in addition to raising the transaction account insurance limit.

3. **Further tailor deposit premiums by size**
   I propose further tailoring deposit premiums to place more of the annual premium on the largest banks that benefit from the Too Big To Fail implicit guarantee. The biggest banks enjoy significant benefits and advantages from this implicit guarantee, and should pay increased insurance premiums to compensate for this guarantee.

4. **Consider new rule change**
   I would investigate limiting Held to Maturity amounts as a percentage of capital or to put in place supervisory limits where regulators will take action to require additional capital if an unrealized loss in a HTM portfolio pierces a certain threshold. I believe this authority already rests with the supervisors and does not require Congressional action.

Conclusion

In conclusion, I would like to leave the Committee with the following points…

- The banking industry is sound, but depositor confidence has been shaken.
- Technology has allowed deposits to flow faster, making bank runs more rapid. As witnessed this past March, bank runs can be contagious, and both depositors and public markets investors tend to look for the next weakest bank when a bank run happens.
- TBTF is real. It is an implicit guarantee that the biggest banks enjoy. A fix for this is to modernize deposit insurance to allow mid and smaller sized banks to compete on equal footing.
- Modernizing deposit insurance will also create additional stability that will enhance the banking industry's ability to raise capital. The proposals discussed today should not change the industry-funded nature of the Deposit Insurance Fund.
- Act now or depositors may redesign the industry while reform is pending. Mid-sized and community banks play an important role at the local and regional level.
- Recognize the difference in the Moral Hazard that exists between Depositors and Investors. Moral Hazard is risky for investors because investors typically lose everything when a bank fails. Don't make depositors feel the same way or they will gravitate to the larger banks due to the implicit guarantee. Small businesses and consumers don't typically have the resources to perform credit analysis on their banks.
- Healthy bank M&A can be a productive process to build more capable regional banks and to fold underperforming banks into stronger banks.

Thank you again for the opportunity to share KBW's views as part of the Subcommittee's May 10, 2023 Hearing.

STATEMENT OF

MARGARET E. TAHYAR

BEFORE

THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND MONETARY POLICY
OF THE HOUSE COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

WASHINGTON, D.C.

MAY 10, 2023

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.

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[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.

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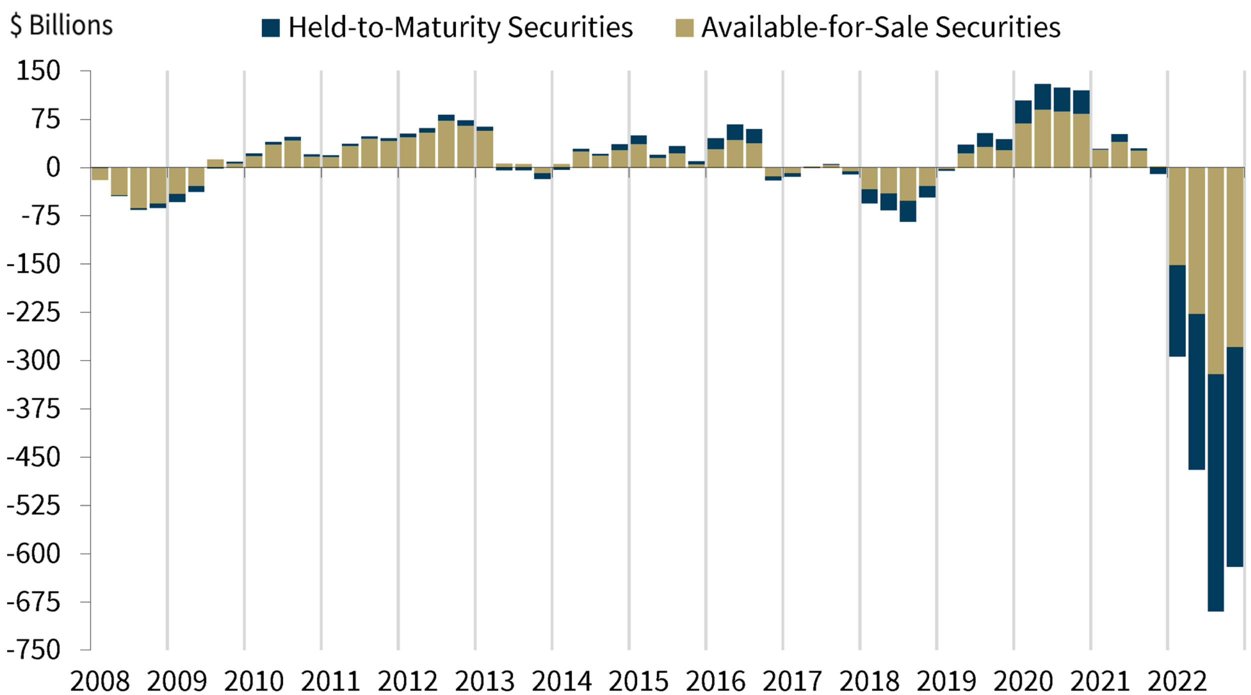
[3] *See* Alice Cho and Robert E. Litan, *Rethinking bank oversight in the wake of recent banking turmoil*, BROOKINGS (April 21, 2023), https://www.brookings.edu/opinions/rethinking-bank-oversight-in-the-wake-of-recent-banking-turmoil/.

Unrealized Gains (Losses) on Investment Securities



Source: FDIC.
Note: Insured Call Report filers only.

Questions for the Record from Ranking Member Maxine Waters
Subcommittee Hearing, entitled "Federal Responses to Recent Bank Failures"
Wednesday, May 10, 2023 2:00 PM

Mr. Jonathan Gould

1. Which of the following options best describes your self-identified race? (you may choose more than one)
    a. White or Caucasian
    b. Black or African American
    c. Hispanic/Latinx
    d. Asian
    e. Middle Eastern/North African
    f. Choose not to answer
2. Which of the following options best describes your gender identity?
    a. Woman
    b. Man
    c. Non-binary
    d. Transgender Man
    e. Transgender Woman
    f. Choose not to answer
    g. Prefer to self-describe (please specify)

<u>Mr. Thomas Michaud</u>

1. Which of the following options best describes your self-identified race? (you may choose more than one)
    a. White or Caucasian
    b. Black or African American
    c. Hispanic/Latinx
    d. Asian
    e. Middle Eastern/North African
    f. Choose not to answer
    g. Prefer to self-describe (please specify)
2. Which of the following options best describes your gender identity?
    a. Woman
    b. Man
    c. Non-binary
    d. Transgender Man
    e. Transgender Woman
    f. Choose not to answer
    g. Prefer to self-describe (please specify)

Professor Kathryn Judge,

1. Which of the following options best describes your self-identified race? (you may choose more than one)
    a. White or Caucasian
    b. Black or African American
    c. Hispanic/Latinx
    d. Asian
    e. Middle Eastern/North African
    f. Choose not to answer
    g. Prefer to self-describe (please specify)
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