FedFin Client Report

Tuesday, March 28, 2023

Senate Banking Demands Supervisory Accountability, Transparency, Reform

Client Report: REFORM217

Executive Summary

Today's Senate Banking hearing was extremely well-attended by senators on both sides of the aisle clearly looking first to understand what precipitated recent bank failures, who is to blame, and what should be done next. Republicans argued that current law gives the Fed considerable discretion without the need for statutory change. Although FRB Vice Chairman Barr initially sought to emphasize the need for new rules without blaming old ones, he ultimately admitted that the Fed indeed could and can govern risky banking organizations regardless of size. While Sen. Warren (D-MA) and others will surely continue to press for statutory changes to the 2018 law at issue here, Mr. Barr's admission makes this legislation still less likely to advance even as it increases the heat on the Board. Democrats agreed with Republicans that Fed supervision missed many warning signs, leading Mr. Barr and FDIC Chairman Gruenberg to reiterate that investigations to be concluded by May 1 will evaluate this issue and recommend change as needed. Mr. Gruenberg also affirmed as our report today anticipated (see *Client Report* **RESOLVE50**) that new special assessments may not apply to community banks. Mr. Barr and Mr. Gruenberg also outlined significant regulatory changes they will consider once their reviews are released. After the hearing, Sens. Menendez (D-NJ), Rounds (R-SD), and bipartisan colleagues released a letter to Chairman Powell sharply criticizing him for the Fed's failure to use current authority to intervene at any banking organization over $100 billion that poses a systemic risk, a move that they suggest would have prevented subsequent problems and the systemic designation on March 12 that protected uninsured depositors; a reply is due by April 10, reinforcing the urgency in many recent letters for quick answers before additional Congressional action after the holiday recess.

Analysis

Opening Statements

The Chairman largely castigated evil elites that permitted bank management to take undue risks without placing direct blame on supervisors. Instead, he noted that "some" were sympathetic to "arrogant" bank executives as recently as Chairman Powell's last appearance

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before the committee (see *Client Report* **FEDERALRESERVE72**), where they urged more relaxed capital standards. These he strongly opposes, but Mr. Brown is open to deposit-insurance ceiling rewrites to insulate small businesses. He and other Democrats have also asked GAO to reopen a 2019 report assessing supervisory effectiveness. Ranking Member Scott (R-SC) did blame supervisors, arguing that federal regulators had the existing authorities and clear warning signs to intervene before the banks collapsed. He also suggested that SVB's climate investments may have influenced regulators not to intervene and that the FDIC may have ideologically denied offers to buy the troubled bank before its woes became systemic. Thus, he countered calls to expand the agencies' authorities by arguing that they cannot responsibly exercise those they currently possess.

Testimony

While neither Vice Chair Barr nor Chairman Gruenberg strayed from the written testimony FedFin analyzed yesterday, Vice Chair Barr's oral testimony emphasized that the Fed is prepared to use all of its tools for any sized institution as needed. Though he forcefully blamed SVB's failure on poor interest rate risk management, he also noted that the Fed's investigation will focus on whether supervisory warnings were sufficient, whether tools were appropriate, and whether the Fed acted appropriately. Chairman Gruenberg emphasized that the banks were allowed to fail, as its leadership was removed and its investors lost their money. He also pledged that the FDIC will review the deposit insurance system and its supervision of Signature Bank and publish a proposal regarding the special assessment needed to replenish the DIF. Under-Secretary Liang's written testimony was brief and largely factual; she did, however, reaffirm the need to review bank capital and liquidity rules in concert with ongoing FRB and FDIC supervisory assessments. Treasury Under-Secretary Liang's oral testimony was largely confined to factual description of actions taken after March 9 and the reasons for them.

Q&A

- **Supervisory Lapses:** Several Republican senators pitted blame for SVB's failure on supervisory lapses and grilled Vice Chair Barr about why interest rate risks at the bank were not detected earlier or not acted upon with greater force. Sen. Rounds asked Vice Chair Barr if managing interest rate risk was listed in SVB's MRIA; Mr. Barr said that his understanding is that the MRIA flagged SVB's problematic interest rate risk modeling and called it "not aligned with reality," later confirming that the Fed's investigation will include SVB's reports of examination. Sen. Tester (D-MT) asked Vice Chair Barr to confirm that the Fed flagged concerns over SVB's financial viability for two years prior to its collapse; the Vice Chair said that he did not know if financial viability was directly addressed, emphasizing the supervisory focus on interest rate risk. Sen. Tester also grilled Vice Chair Barr on why supervisors did not apply greater pressure on the bank; Vice Chair Barr emphasized that the Fed's review will address this and that it should be held accountable if it failed. A number of Republican senators also joined Ranking Member Scott in criticizing Fed supervisors for unduly prioritizing ESG at the expense of interest rate risk monitoring; Vice Chair Barr repeated his argument that interest rate risk management failures were the reason for SVB's failure, but that the Fed's review will be broad in scope.

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- **Regulatory Limits:** Chairman Brown (D-OH) asked Vice Chair Barr if the Fed's 2019 regulatory "rollbacks" contributed to risks leading to SVB's failure; Vice Chair Barr reiterated that SVB's failure to address interest rate and liquidity risks caused it to fail, noting that Fed supervisors brought these issues forward and the bank failed to respond. Sen. Warner (D-VA) argued that basic prudential regulation should have detected risks at SVB but that the scale and speed of its bank run could not have been prevented by the current regime. Sens. Menendez and Warren asked Vice Chair Barr if he agreed with Chairman Powell's statement that supervision and regulation should be strengthened; the Vice Chair agreed and said to Sen. Warren that he anticipates strengthening capital and liquidity standards for firms with over $100 billion. Sen. Britt (R-AL) asked if the Vice Chair can state definitively if the Fed used all of its tools to prevent SVB's failure; Vice Chair Barr said that the Fed's review will address this question in detail.

- **Statutory Rewrite:** Sen. Menendez asked Vice Chair Barr if he believed Congress should strengthen rules making bank failures similar to SVB less likely; Vice Chair Barr emphasized the importance of strengthening capital and liquidity rules, noting that the Fed's Basel III reforms and holistic capital review incorporate these issues and that a long-term debt requirement at regional banks could provide an additional capital cushion. Refuting Democratic attacks on the 2019 tailoring standards, Sen. Crapo (R-ID) cited statutory language he said gave the Fed broad discretion, and asked Vice Chair Barr if there were any statutory restrictions that prevented it from applying the strictest prudential standards necessary. Vice Chair Barr agreed that the Fed has substantial discretion and that there is room to change the rules in support of financial stability. Sen. Lummis (R-WY) argued that the Fed had sufficient tools to prevent SVB's collapse and that no further regulation is necessary; Vice Chair Barr reiterated that the Fed has substantial discretion to change its rules for firms in the $100 billion - $250 billion range and noted that the Fed's internal review will provide recommendations should it determine changes are needed.

- **Systemic Risk Exception:** Chairman Brown asked Chairman Gruenberg what impact small banks and businesses would have suffered without regulatory actions to protect depositors; Mr. Gruenberg said he believed that action was necessary to prevent financial contagion, explaining that concerns over knock-on effects led the FDIC board and FRB recommendations to the Treasury Secretary. Asked later by Sen. Menendez if he believed SVB's failure posed systemic risk, Vice Chair Barr said their best assessment was that contagion risk was a serious threat to depositors but would not directly say that SVB was systemically important.

- **Executive Compensation Clawbacks:** Sens. Cortez-Masto (D-NV), Van Hollen (D-MD), Warnock (D-GA), and Sinema (I-AZ) pushed hard for executive compensation clawbacks, asking the banking regulators what authority they have to implement them. Chairman Gruenberg said that the FDIC has some clawback authority under Title II of the DFA but that additional authority under the FDIA would have value. Vice Chair Barr said that the Board has this authority and that it stands ready to use it to the fullest extent. Sens. Van Hollen and Warnock also called for investigations into potential executive insider trading.

- **Banking Sector Risks:** Sen. Smith (D-MN) asked Vice Chair Barr how the Fed is monitoring interest rate risk at other banks; Vice Chair Barr argued that most banks are managing this risk soundly but that the Fed is monitoring them to flag where banks might do better, also emphasizing that the banking sector is strong and resilient. Sen. Smith also asked how interest rate risk might affect mortgage and loan companies; Vice Chair Barr noted that the Fed is looking broadly across the financial landscape to see how these risks might propagate into the banking system, including by looking at hedge funds. Sen. Lummis asked if fractional reserve banking is overly risky in the age of online banking; Vice Chair Barr only emphasized his belief that the banking sector is safe and sound.

- **Banking Agency Internal Review:** Democratic Senators asked both Chairman Gruenberg and Vice Chair Barr if they thought an internal review was appropriate. Both regulators defended their internal review while also welcoming outside investigations. Sen. Smith asked if Vice Chair Barr's review will assess whether the banks would have failed without the 2019 rule-changes and will advise about what new rules could have prevented the failures; Vice Chair Barr said the review would do both.

- **Deposit Insurance Threshold:** Sen. Vance (R-OH) asked the regulators if their actions resulted in uninsured deposits being effectively insured. Chairman Gruenberg noted the issue's importance and pledged to address it in the upcoming FDIC report. Sen. Vance took serious issue with the moral hazard implications of invoking the systemic risk exception for SVB, urging the regulators to extend their protection to smaller banks.

- **Community Banks:** Chairman Brown defended the agencies' intervention by arguing that the cost to community banks would have been far greater if no systemic actions were taken. Sen. Menendez took the opposite line, claiming that the actions are causing a flight from community banks to TBTF companies. Vice Chair Barr responded by stating that the goal was to preserve the diverse banking system. Sen. Lummis directly asked Chairman Gruenberg if he would exempt community banks from the special assessment; he replied that the FDIC has not made that determination yet.

- **FDIC Resolution Process:** Republican Senators led by Ranking Member Scott pressed Chairman Gruenberg on why the FDIC did not seek a private sale of SVB prior to its receivership. Mr. Gruenberg stated that the FDIC received two offers to buy SVB, but one was more expensive than receivership and the other was invalid because the bank's board had not approved the bid. When asked if the FDIC engaged with the bank's board to facilitate a sale, he said he would need to check FDIC records. Sen. Hagerty (R-TN) argued that banks will pass down costs from the FDIC's special assessment to consumers. He also criticized the systemic risk exception, calling the banking regulators' decision to invoke this a potential "disgrace."

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