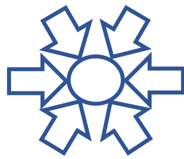

FedFin Client Report

Monday, March 13, 2023

FedFin First Take: Failure Fall-out

Client Report: RESOLVE49

Executive Summary

As we noted last night, the President concurred with Treasury, the Fed, and FDIC in deciding that SVB's Friday failure and imminent runs on Signature Bank and, most likely, others posed a systemic risk. This determination permits the FDIC to override all the efforts to end the moral hazard feared when uninsured depositors are fully protected in bank resolutions and came with a new Fed facility making it still easier for banks to obtain liquidity from the Federal Reserve. As we also observed, much effort is being made to assert that none of these backstops is a bailout, a conclusion sure to draw considerable discussion and dissent even from those who concur that the scale of potential run risk Monday morning could not otherwise have been averted. With this risk hopefully now resolved, much policy and political debate will begin about the Administration's decision; why Silicon Valley Bank was so vulnerable; whether rules or enforcement are to blame for its failure, that of Signature Bank, and systemic fragility; and – even if rules are generally robust – which revisions to them are needed. The overall construct of reactions to this emergency and then the likelihood of substantive response beyond the Congressional statements and President's commitment to new rules this morning will emerge in more specific form over the next few days if market strains continue to ease. FedFin will of course continue to apprise clients of key considerations.

Among the most lasting consequences of this crisis with both policy and market impact is the extent to which it has meaningfully damaged public confidence in the banking system. Growing conclusions that recent runs are in part an artifact of greater liquidity risk due to social media will also have far-reaching impact not only on bank regulation, but also the SEC's pending MMF and OEF rules. We will thus also monitor individual statements, actions, and related events with this in mind in terms of policy consequence. We turn in this report to considerations warranting immediate attention.

Analysis

Despite the Fed's decision this afternoon to launch an internal inquiry concluding by May 1, is certain that HFSC and Senate Banking will very quickly convene hearings at which Treasury, the Fed, and FDIC are called to explain what was done after SVB's

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failure, why risk seemed so grave, and what should have been done to avert it. We expect the agencies to be roundly criticized from both sides of the aisle and across the political spectrum even though Democrats will go a bit easier in order to give the agencies a chance to lay out how rules will soon be revamped.

However, Republicans are sure to demand accountability for supervisory lapses trying to hold Fed Vice Chairman Barr accountable despite his relatively-recent arrival to blunt his calls for tougher rules. The GOP will also attack decisions by the White House and banking agencies sure to be characterized as a "bailout," and why the FDIC could not find a buyer for SVB and thus work out a less costly, private-sector resolution. Reasons Republicans will surely cite here are merger constraints, past instances of successor-bank legal liability for a failed bank's violations, and FDIC unpreparedness.

Democrats are sure to argue that rules for all large banks should be tougher, pointing to the exemption SVB and Signature had from liquidity rules that might have prevented the need for sudden assets sales and capital losses; seek to end exemptions from capital recognition of AOCI; explore the benefits of unlimited deposit insurance in a new system funded at greater cost to banks; along with Republicans, reconsider restricting Fed emergency-liquidity powers; demand tougher capital standards; renew calls for tougher, faster resolution plans for all but the smallest banks; and demand tough enforcement by the FRB and SEC for failed-bank senior management and directors.

Similar lines of argumentation on each side of the aisle are likely in hearings also by the Senate Permanent Investigations Committee, although we expect these to take longer to convene and go more deeply into supervisory issues, bringing the Fed in for particularly harsh questioning given its role as the led federal supervisor for both SVB and Signature.

What will the agencies do to forestall a high political price for this weekend's contentious, if necessary, actions? Treasury, the Fed, and FDIC are sure to insist that nothing they have done is a bailout even as they contemplate ways to reinstate market discipline, perhaps by a mandatory uninsured-deposit haircut, calls for an end to the Home Loan Bank super lien, and – from the FDIC – demands for higher firewalls between IDIs and holding-company activities or even a ban on some of the unconventional capital-markets and investment activities evident at Silicon Valley Bank and its parent company. The extent to which customers of the bank's VC-financing and similar activities were required to redeposit all funds at the bank may come under review not only as a potential anti-tying violation, but also as a practice barred at all banking organizations to prevent funding concentrations and resulting illiquidity and even macroeconomic risk.

As more is learned about each bank's failure and the agency's decisions, many more issues for policy debate, regulatory, action, and political acrimony will surely emerge. We will thus continue to monitor all developments, analyze them as quickly as possible, and

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advise clients of key developments and our forecast for what's to come after this most considerable shock to the financial system and public confidence in banks and their regulators.

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