Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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In the wake of recent bank failures, much has rightly been said about how supervisors failed to act even though warning claxons blared. Nothing that happened to Silvergate, SVB, or Signature is due to forces beyond supervisory control, but there are deep, structural weaknesses in how banks have long been supervised. How long? I went back to my 2001 Senate Banking testimony about what was then the largest-ever failure to find that many of the lessons that should have been learned never sunk in.

Given that this hearing was in 2001, a good deal of what I said about bank capital requirements was about Basel I and is thus long out of date. However, one key point isn't: the capital triggers used to spark prompt corrective action (PCA) were and are an unduly-simplistic way to identify the need for rapid supervisory intervention.

Silvergate, SVB, and Signature were all "well" capitalized right up to the brink of collapse because each of the banks in its own way arbitraged the capital rules to enormous – and obvious – advantage. Nothing in law or rule bars bank supervisors from stepping in well before PCA ratios sink but nothing seems to stir supervisors to do so. 1991's PCA requirements were an important advance at the time, but it was outdated only a decade later. Now, it's a dangerous supervisory distraction.

What else noted in 2001 remains an urgent fix? Over two decades ago, I urged the FDIC to reinstate the high-growth early-warning system it put in place during the S&L crisis it then quickly retracted in 1995. SVB tripled in size in just three years and many other failed or fragile banks did the same. Regardless of where "tailoring" thresholds for enhanced regulation reside, supervisors can and should read the call reports. If a bank is growing past the size or complexity at which current supervisory processes suffice, then supervision needs to change – fast.

I also thought then and believe now that supervisors need to be held to account to avert failure instead of just conducting an autopsy. Supervisory reports are of course almost entirely proprietary, but there is nothing about the inferences supervisors draw from them that must be kept under the wraps that cocoon supervisors at least as much as troubled banks. Supervisors are forced to bail out banks because supervisors are consistently too late with too little. The supervisory CAMELS ratings of each bank's resilience can and should be made public, possibly on a quarter's lag time. If we want market discipline and supervisory acumen, then counterparties and policy-makers need to know when problems arise and ask questions before answers come in the form of yet another bailout.

Seven years after I testified in 2001 came the great financial crisis, one I think might have been considerably less severe or even averted had there been supervisory improvements after the S&L debacle, 1991 banking crash, and 2001's warning shot of another problems soon to strike down so many banks in 2008. In addition to structural supervisory lapses, my testimony also points to the complex financial instruments on the books of the big, failed thrift outside meaningful capital requirements which supervisors also overlooked. These residuals and structured investment vehicles were systemically disastrous in 2008 in part because the banking agencies failed to heed 2001's obvious warning and did nothing to curtail them until Congress made them do so.

The great financial crisis of course led to the Dodd-Frank Act that demanded many new rules and structural changes. Among these is Title II creating the orderly liquidation authority (OLA) Congress established so no bank failure would ever again force a taxpayer bailout. Yet that's just what we had on March 16 no matter the plaintive denials in the bailout announcement.

Why didn't the FDIC deploy OLA? Quite simply, it still doesn't know how to do so nor is it ready to resolve a large regional banks despite all the powers Congress gave it. Instead, the FDIC and Fed have issued a proposal demanding a new regional-bank resolution tool: TLAC. In my view, they shouldn't get it unless or until the agencies show that they have all the processes in place and any living wills they need and thereafter determine that these for some reason still do not suffice.

The 2023 rulebook is already full of complex, burdensome standards that would be wholly unnecessary if supervisors do what they can and should do. In the absence of meaningful accountability, bank regulators seem always to blame failure on their stars and then seek statutory change. The banking system would be healthier and the shadows shorter if supervisors did their jobs faster and without fear or favor. Perhaps we need some new rules, but even the toughest new rules satisfying the most ardent critics are to no avail if they remain unenforced.