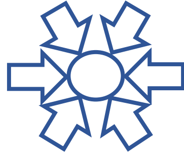

FedFin Client Report

Monday, May 1, 2023

FedFin Assessment: Fed Contemplates Supervisory Reform, Promises Regulatory Rewrite

Client Report: REFORM221

Executive Summary

In this and subsequent reports, we build on our initial reactions to SVB/SBNY reports from the Fed, FDIC, and GAO, focusing in more depth on the agencies' plans for near-term action with strategic consequence and key points in the GAO's report that will strongly influence Hill reactions on both sides of the aisle. Informed by today's rescue of First Republic – on which more is to come from us shortly – FedFin starts here with the Fed, not going into detail on the results of its extensive fact-finding unless new facts are likely to influence near-term policy and political response. As previously noted, the Fed's report acknowledges serious supervisory shortcomings, with the detailed analysis concluding that the "root cause" of this is "difficult to ascertain, especially given the impact of the pandemic on remote supervision in 2020 and 2021." The Fed also lays out a series of new procedures and rules to reverse Trump-era changes to which many problems are attributed even though the report also notes that SVB was clearly no longer a "satisfactory" risk by 2017, well before the light-touch and tailoring rules were implemented. The Fed report also notes that the tougher rules it now advocates might still be insufficient to prevent SVB's failure, but argues that they would have bolstered its resilience and are warranted for banks and BHCs with assets over $100 billion to prevent widespread regional-bank failures with systemic consequence. The report also shows that SVB and SVFC would have been required to add significant additional capital and meaningful liquidity under the rules in effect before the 2019 "tailoring" (see FSM Report **SIFI34**).

One important take-away from the Barr report is the Fed's determination to do considerably more case-by-case application of tougher capital, regulatory, and compensation standards for banks subject to supervisory warnings. The Fed's analysis of other issues that might be subject to regulatory review does not suggest near-term action on matters such as how the Fed reviews financial risk in M&A applications, more restrictive anti-tying rules, or tougher Volcker Rule restrictions for covered funds despite the controversial changes that may have exacerbated SVB and SVFC's risk (see FSM Report **COVEREDFUNDS2**). However, the report goes into detail on incentive-compensation misalignment, referencing 2010 inter-agency guidance (see FSM Report **COMPENSATION29**); we expect these standards to be quickly overhauled even as broader inter-agency discussion advances of the incentive-comp rules mandated under the Dodd-Frank Act.

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Analysis

The Barr report is a preliminary one with future actions based in part on it to be accomplished either by subsequent reports and/or notice-and-comment rulemakings. Although it goes into extensive detail on SVB and SVFC, the report emphasizes the importance of setting policy for the banking system as a whole based on lessons beyond those specific to individual management, board, or supervisory actions in this case.

Key lessons derived from SVB and its parent BHC's failure include:

- Social media, concentrated depositor bases, and technology may have increased the speed of bank runs.
- Going forward, the Fed should use added capital and/or liquidity standards in enforcement actions related to capital planning, liquidity and governance to focus management attention on rapid remediation. Capital-distribution prohibitions should also be considered.
- The bank and BHC were poorly governed by a board focused on short-term profits, not resilience.
- Effective contingency-funding planning, including prepositioned collateral for discount-window advances would not have prevented failure but ensured a less disruptive resolution. The report does not say if a systemic designation might also have been averted but implies that this might have been the case. It seems likely that regulators may continue to resist calls to include discount-window advances in LCR assumptions, instead mandating it as part of resolution planning for banks of all sizes.
- As noted, the Fed is uncertain why supervision failed so dramatically. However, it nonetheless finds that one problem may have been Board-delegated authority. The board needs to play a more assertive role ensuring supervisory consensus and near-term action, ensuring also that System supervisory resources track banking-industry growth.
- Supervisors were likely cowed by Board "light-touch" expectations as well as reluctance to aggressively challenge an institution with seemingly strong earnings.
- Had SVB and/or SVFC been on the rules mandated prior to tailoring, they would have had significant liquidity and capital shortfalls, although the LCR would not have fallen into high-risk ranges because of the manner in which the current rule treats uninsured deposits.
- Even when supervisors brought SVB to Board attention in February of 2023, discussion was informational and did not convey any sense of immediate danger.
- SVB's exclusivity clauses requiring borrowers to hold deposits at the bank did not violate anti-tying provisions.
- SVB's documentation for Volcker Rule compliance, including with regard to what were likely covered funds, was so poor that the Fed could not determine whether the bank and BHC met these standards in the course of this review.

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Action steps for near-term regulation for banks with assets over $100 billion will focus on:

- A new interest-rate supervision methodology. Mr. Barr does not mention additional capital standards, suggesting the Fed is not at this time planning express standards, but Pillar 2 supervisory capital is possible (see FSM Report **IRR7**);
- new liquidity supervisory standards and regulations that better capture uninsured-deposit risk, HTM security treatment, and wider regulatory applicability. Appropriate and lengthy transition periods would accompany such standards;
- wider capital recognition of AOCI, with a transition period of "several years";
- broader mandatory stress-test applicability;
- tougher minimum incentive-compensation standards;
- continuing action on the holistic capital framework;
- final action on Basel end-game capital standards; and
- long-term debt (i.e., TLAC) standards for regional banks (see FSM Report **RESOLVE48**).

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