Thursday, May 18, 2023

Federal Regulators Lose Ground as Senate Banking Reviews Recent Failures

Client Report: REFORM226

Executive Summary

Describing the CEOs' statements at his last hearing as "the dog-ate-my-homework" excuses for grievous failings, Senate Banking Committee Chairman Brown (D-OH) also attacked Republicans for placing blame on monetary policy, not the culture of supervisory laxity he details with various quotes from Trump Administration officials. Still, the panel's legislative agenda seems limited to the executive-clawback measure we projected as the most likely outcome immediately after the mid-March failures (see *Client Report* **REFORM218**). Sen. John Kennedy (R-LA) countered that Vice Chairman Barr's attribution of blame to Randy Quarles is the Fed coming up with a similarly-lame excuse for its recent failings. Ranking Member Scott (R-SC) continued to lambast poor supervision, reiterating also that higher capital requirements would adversely affect economic growth. Sen. Warren (D-MA) used her questioning to blast the grounds on which Acting Comptroller Hsu agreed with JP Morgan's acquisition of First Republic, making it clear not only that she favored sale to competing regional-bank bidders, but also that her opposition to his appointment as Comptroller has not wavered. After the hearing, Sen. Warren released a letter she sent to FDIC Chairman Gruenberg and Mr. Hsu demanding answers by May 31 to numerous highly-critical questions on FRC's disposition. Answering Sen. Menendez (D-NJ), Mr. Barr said that it is difficult to downgrade CAMELS when a bank has strong earnings. Mr. Barr was joined by Chairman Gruenberg in flatly contradicting assertions SVB's CEO made earlier this week about the lack of supervisory warnings around interest-rate risk or participation in identifying possible bidders after the receivership was declared, making it clear that their agencies are reviewing grounds for additional enforcement actions and will act as quickly as possible on new incentive-compensation rules.

Analysis

Opening Statements

Chairman Brown began by excoriating the failed bank CEOs and defending the bank regulators, blaming weaker Trump-era rules for weaker oversight. He called for undoing these

Federal Financial Analytics, Inc.
2101 L Street, NW – Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com

rules and for improving capital and liquidity standards as well as stress testing. He also called for deposit insurance reform, improving merger policy, restoring supervisory culture, and revising executive compensation standards, noting that he wants legislation to hold bank executives accountable via more "meaningful punishments and deterrents." Ranking Member Scott emphasized that the bank failures were caused by bank mismanagement, supervisory lapses, and inflation, arguing that regulators had sufficient tools to maintain financial soundness via S. 2155 and that no new rules are needed. He also took issue with the description of the bank failures as idiosyncratic.

Testimony

Testimony of Messrs. Barr, Gruenberg, and Harper was the same as that delivered in the House on Tuesday (see *Client Report* **REFORM224**), although Mr. Hsu addressed Chairman Brown at the close of his testimony to make clear that the American people – not banks – are the OCC's customers. Adrienne Harris of NYDFS laid out her department's reasoning on its handling of SBNY's failure, stating that its inability to provide reliable data and a credible liquidity strategy forced it to take possession of the bank. Clothilde Hewlett of CDFPI said that changes are needed to promote safety and soundness of state-chartered banks.

Q&A

- **Clawbacks:** Chairman Brown asked if it is difficult to hold executives of large banks accountable; Chairman Gruenberg said that the FDIC has done so in the past and is prepared to do so going forward, with Acting Comptroller Hsu agreeing. Sen. Rounds (R-SD) asked Mr. Gruenberg if the FDIC can claw back SVB executive bonuses; Mr. Gruenberg said the FDIA provides this authority. The senator then asked the Chairman point blank if the FDIC is investigating the banks' executives; Chairman Gruenberg said it is.
- **Incentive Compensation:** Sen. Menendez asked the regulators if they agreed with the Fed report's criticism of SVB's incentive compensation structure; Mr. Hsu, Gruenberg, and Harper agreed. The senator then asked Vice Chair Barr if the 2016 proposed incentive compensation rule would have mitigated some of SVB's issues; Mr. Barr said it would. Sen. Menendez said the rule is ten years overdue and asked the regulators to commit to finalization; the regulators said they would. Sen. Van Hollen (D-MD) said SVB's executives profited by taking more risk; Mr. Barr said the bank's compensation structure lacked appropriate risk management, which is why it was downgraded. The senator then asked if executive compensation packages and risk management should be better aligned; Vice Chair Barr said they should, noting interagency work to achieve this.
- **Supervision:** Chairman Brown and Sen. Rounds asked the regulators if, per the bank CEOs' testimony on Tuesday, the banks fixed problems their examiners identified; all witnesses said no. Chairman Brown also asked them if they would commit to improving examination and enforcement; all said yes. Ranking Member Scott later accused the regulators of scapegoating; Vice Chair Barr said he accepts full responsibility for

supervisory failures and promised a thorough review of the Fed's supervisory structure. Sens. Rounds and Tillis (R-NC) asked Vice Chair Barr if the Fed gave initial feedback on SVB's interest rate risk, why a MRA was issued rather than a MRIA, and how responsive SVB was compared to its peers; Vice Chair Barr said that Fed staff could have pushed faster for remediation and that SVB was comparatively slow. Sen. Tillis raised concerns over reports of increased MRA issuance since SVB's collapse; Mr. Barr said he would look into it. Sen. Sinema (I-AZ) asked Vice Chair Barr how he is defining cultural and operational change at the Fed; Vice Chair Barr said an agile and forcefully acting workforce is crucial but noted that cultural change is difficult to accomplish. Although he does not currently have a timeline for this project, he also noted that the Fed will eventually implement detailed, metric-based workplans. Sen. Sinema also took issue with regulatory turnaround time at the Fed, calling regulators "fatally late" to respond to risks and asking Vice Chair Barr what the median turnaround time is for Fed regulatory responses; Vice Chair Barr said SVB was "fatally late" in responding to regulatory concerns but that supervisors failed to escalate fast enough. Sens. Smith (D-MN) and Menendez also called for rule changes as well as stronger enforcement and accountability for supervisors and banks.

- **FRC Disposition:** As noted, Sen. Warren grilled Acting Comptroller Hsu on factors that the OCC must consider when approving a bank merger. When the Acting Comptroller answered that it must consider financial stability risks but did not list additional factors, Sen. Warren raised serious alarm that he failed to mention its obligation to also consider "an increase in size of the combined institutions." She thus asked how he could explain rejected bids by PNC and First Citizens despite significantly smaller GSIB scores compared to JPM; Mr. Hsu said that if his office had followed a strict GSIB methodology in considering the merger, it would have heightened financial stability risks. Sen. Warren said that concentration risk poses the single biggest banking system threat and said Mr. Hsu's chosen route exacerbated this. Sen. Cramer (R-ND) asked Mr. Gruenberg whether more could have been done to improve the sale of FRC to JPM; Mr. Gruenberg said its only consideration under the law is a least cost resolution. Sen. Cramer then asked Mr. Hsu if the OCC has additional leeway around systemic safety and soundness that can be considered; Mr. Hsu said timeliness and preventing contagion risk are critical to the OCC's resolution objectives. Sen. Hagerty (R-TN) asked Chairman Gruenberg about Mr. Becker's claims that the FDIC did not contact him for assistance with SVB's sale; Chair Gruenberg said the FDIC did in fact meet with him and gathered his input on the bank sale. Sen. Hagerty also said that FRC should have been auctioned before it failed, asking Mr. Gruenberg if this outcome is generally better for the American taxpayer; Mr. Gruenberg said yes.
- **Liquidity Requirements:** Sen. Reed (D-RI) called for stronger liquidity stress tests and stronger liquidity rules. Sen. Warner (D-VA) said he does not think anything within the current regulatory framework could have prevented SVB's run and advocated for a "fulsome" look at short selling by the SEC. Vice Chair Barr affirmed that the speed of the run was unprecedented and new policy is being considered. Chairman Gruenberg argued that SVB's deposit profile exacerbated its run risk but acknowledged that online banking and social media represent new realities that must be dealt with.

Federal Financial Analytics, Inc.
2101 L Street, NW – Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com

- **Reserve Bank Governance:** Sen. Reed asked Vice Chair Barr if former SVB CEO Becker's tenure on the Federal Reserve Bank of San Francisco Board influenced supervision of the bank; Vice Chair Barr said the Fed's review found no evidence of this, but that it still represents a structural issue. Sen. Reed encouraged Vice Chair Barr to consider reforms to address this. Sen. Vance (R-OH) argued that the FRB-SF's focus on ESG distracted it from traditional supervision; Vice Chair Barr said the report found no evidence of this. Sen. Vance also asked the Vice Chair if he is worried that progressive politicization of risk-assessment harms supervisory review; Mr. Barr said there was no evidence of this in the record but agreed that risk-assessment should not be political. Sen. Britt (R-AL) also took issue with what she described as an undue shift to supervisory focus on climate risk and ESG.
- **Systemic Risk Designation:** Sen. Cortez-Masto (D-NV) raised concern over moral hazard, asking Mr. Gruenberg for his opinion on bank "bailouts"; Mr. Gruenberg acknowledged that the agencies' judgment over what to do in the aftermath of SVB's failure was difficult, noting that the systemic risk exception was made only when SBNY failed and systemic liquidity risks indicated contagion threats.
- **Deposit Concentration:** Chairman Brown asked the regulators what tools they have to manage uninsured deposit risk; Chair Gruenberg said uninsured deposit concentration poses a liquidity risk that must be looked at.
- **Independent Review:** Following a joint letter this morning, Sens. Tester (D-MT) and Tillis called for an independent review of the bank failures and asked if the regulators supported one; Mr. Barr and Gruenberg said they did.

Federal Financial Analytics, Inc.
2101 L Street, NW – Suite 300, Washington, D.C. 20037
Phone (202) 589-0880
E-mail: info@fedfin.com www.fedfin.com