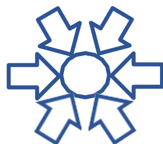

Federal Financial Analytics, Inc.

MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

DATE: May 8, 2023

The reason the FDIC sold First Republic to JPMorgan is that it didn't want to do yet another resolution that bailed out uninsured depositors. The reason the FDIC didn't want to backstop more uninsured depositors is that it would have had to say First Republic was as systemic as SVB and Signature Bank and this was nowhere near as credible. The reason the FDIC had to find these two earlier failures systemic was because it couldn't think of anything better and the reason it couldn't think of anything better in any of these resolutions is that it was wholly unprepared for them and, now, for any of the others that may come suddenly upon us. The FDIC must quickly rewrite its resolution playbook, but even a good one won't work without a new set of triggers for meaningful prompt corrective action that forces change at troubled banks and readies the FDIC for resolution – not bail-out – if change doesn't come quickly.

Last week's near-death spirals show how quickly banks with respectable earnings and deposit inflows go down for the count when market sentiment turns on them. Unlike the March failures, regional banks on the ropes since then were punched by investors, not the uninsured depositors who are now big winners on their moral-hazard bet. These investors weren't all short-sellers – many of them were equity stockholders who seemed suddenly to realize that the FDIC wouldn't protect them when a troubled regional is sold to a bigger banking organization. Why investors thought they would be bailed out is hard to say; that they did and now they don't is the risk we face.

Investors and regulators have learned the super-hard way that very well-capitalized banks as adjudged by their regulatory-capital ratios can sometimes fall quickly into a total-loss abyss. For evidence, see the enormous slide in share prices at many regional banks after JPMorgan's acquisition of First Republic. Stock prices recovered on Friday, but whether this is one of the "dead-cat bounces" Wall Street unsentimentally enjoys or a more lasting recovery is yet to be seen. Regardless, we know now that market sentiment can turn upside-down with only a whisper of risk, let alone a real indicator of a looming one.

Markets thus respond with alacrity, but regulators are ponderous at their best and often fall years behind blaring risk signals as the Fed and FDIC all-too-convincingly demonstrate. Just one example: as the Fed says, supervisors were unwilling to mess with SVB despite the bank's refusal to self-correct in part because the bank's earnings were strong. Regulators thought market confidence was a sign of bank resilience, not the yield-chasing, moral-hazard assuming gamble it turned out to be.

Another even worse reason why the banking agencies stood by as SVB and SBNY foundered is evident in the GAO's study of SVB and SBNY: The agencies' failure to rewrite prompt corrective action (PCA) triggers to capture non-capital indicators as GAO recommended in 2011 and I urged in Congressional testimony a decade before.

That the agencies need to take off their capital blinders is clear. Where more agency-reform work is needed is ensuring that PCA is indeed prompt and corrective – so far, it's been nothing of the sort. Analytical work is urgently needed to define which non-capital triggers should also be pulled by supervisors finally willing, able, and ready to pull them.

For starters, one clear risk indicator suitable for PCA schedules is market capitalization. Bank stock prices of course go up and down and sometimes round and round, so a simple drop in market-cap isn't necessarily meaningful. But, real warning signs are obvious when there are slow market-cap declines well below book value or sudden stress at institutions targeted by investors as high-risk banks.

The reasons for these bullseyes are manifold; the risk they present is manifest. As a study from former Treasury Secretary Lawrence Summers and others has shown, a bank's franchise value as measured by its market

capitalization is a vital indicator of a bank's resilience. To the extent the market believes that a bank is not worth its money, a bank becomes increasingly vulnerable to runs driven not just by depositors, but also by the panoply of counterparties on which its lifeblood depends.

What else signals trouble? Fast growth is a proven risk indicator, but one the FDIC has ignored since 1995 and with which none of the other agencies has also much troubled itself. GAO and my testimony also urged a new trigger for any bank that grows fast – say fifty percent or more in assets or liabilities over a year. This trigger should apply even if growth comes from mergers because we've seen over and over again – SVB most recently – that merger integration is a lot harder to do than promise.

Michael Barr's report suggests another risk indicator: "novelty." By this, he means a bank's decision to enter sectors such as crypto or – the report is less clear here – perhaps also venture-capital finance. What the Fed would do with innovative institutions and how it might curtail necessary market evolution is unaddressed and needs quickly to be clarified. Here, mechanical PCA triggers might be less advisable, although possible. To my thinking, novel ventures should be put in internal "sandboxes" firewalled from other bank activities under discrete risk management unless or until the bank demonstrates to supervisors who are presumably paying attention that new risks can be well managed within acceptable capital, liquidity, governance, and other parameters.

Are there other quantitative and qualitative risk indicators that should force supervisory scrutiny? For sure. Triggers based on credit delinquency, concentrated risk exposures by sector or geography, and significant equity-based board and senior management compensation are just a few that come quickly to mind. Constructing these new PCA triggers isn't easy, but going on without them is extraordinarily hazardous.

The lesson of the last few weeks and especially the last few days is that bank regulators have been living in a cocoon of capital ratios, one into which they will softly settle again if they raise all the capital ratios Mr. Barr's report also targets. Neither his report nor the FDIC's mentions what will be done about most of the other risks each agency spots beyond a few promised internal personnel and operational improvements. Worse, nothing is said about resolution beyond a repeat call by Mr. Barr for new long-term debt rules for large regional banks. These new rules will be a waste of time and money if the Fed, OCC, and FDIC do not first ensure that resolutions are unlikely because supervisors step in fast and the FDIC is alerted immediately when a PCA trigger is breached so it can ensure living-will or other resolution plans are credible and operational. Without sound PCA, banks will linger on life support; without resolution, they'll come out of their decline via bail-out. Been there, done that, let's not.