Federal Financial Analytics, Inc.

# MEMORANDUM

**TO:** Federal Financial Analytics Clients

**FROM:** Karen Petrou

**DATE:** September 11, 2023

It's a cliché, but it's also true that one can't beat something with nothing, especially in Washington. This is an axiom well worth remembering when it comes to all of the new capital and resolution rules befalling the nation's biggest banks. I don't think they need to be beaten back in their entirety – much in the proposals fixes vital flaws. But the agencies have done a remarkably poor job conjuring the impact of each of these sweeping proposals, let alone their cumulative impact in the context of all the other rules and the grievous supervisory lapses that contributed to recent failures no matter all the rules that could well have sufficed if enforced. Thus, the most obvious problems with this new construct are opacity, complexity, and most importantly reasonable doubts that, even with all these sharpened arrows, supervisors will still fail to draw their bows and then fire early and often. All too much in the new rules is false science, as even a cursory read of the impact analyses makes painfully clear. Instead of setting standards on lofty, unproven models, safeguards should rely on an engineering axiom: use warning lights that force prompt and corrective action. Think of the ground warning in an airplane followed by urgent "pull-up" commands and then go to work on the banking dashboard with clear, enforceable rules and new PCA thresholds forcing supervisory action and accountability.

The need for new PCA triggers is even more urgent than I thought when I first outlined the importance of essential safeguards that are still missing in all of the agencies' to-do lists. As we dispiritedly noted last week, the FDIC's report on First Republic's failure followed its earlier self-exoneration of Signature's demise, essentially saying that supervisors did their best – things should have been done better, but they weren't done all that badly given what was known at the time. However, this report like all the others shows that supervisors knew a lot but did remarkably little – as at the other banks, First Republic's exemplary CAMELS rating only dropped after the bank was flat-lining.

In fact, the most useful part of the agencies' supervisory inquiries is the historical litany of missed opportunities to set a wavering bank aright. In retrospect, each agency sees blinking warning lights, but failure to force the bank to pull over is blamed largely on supervisory unwillingness to discipline banks which by two measures – regulatory capital and earnings – seemed in the pink. Will this change now?

There are few – if any – specific plans laid out by either the Fed or FDIC to ensure prompt corrective action if capital seems robust and profits seem plentiful. The FDIC is instead busy "exploring opportunities" to do better and the Fed is, with the singular exception of novel activities, confining itself to working with the other agencies on lots of new rules. Whether these will be followed any better than all the ones that came before is unclear because regulators have promised that supervisors would do better in all the crises that came before and they have yet to do so other than when their hesitant hands are forced by PCA's capital thresholds.

Thus, the new rules are for naught if supervisors do nothing and more than a little in the complex, burdensome rules is unnecessary were supervisors to do more and act a lot faster. As the GAO has made clear, nothing in current law bars the banking agencies from setting additional quantitative and qualitative thresholds that every bank understands and each supervisor learns by heart. Those fearful of mussing a profitable bank's hair are far more likely to do so when other express indicators require intervention.

Here are specific ways to update PCA and make it not only prompt, but also meaningfully corrective.

In my last PCA foray, I suggested triggers based on unrealized loss. The capital proposal would now bring some of these into the capital framework for most large banks, likely making a specific trigger unnecessary because big-bank deposit runs are far less likely if investors are convinced that a bank will remain solvent even if it recognizes losses to meet unanticipated demand.

However, nothing in the capital standards addresses another obvious cause of each recent bank failure: helter-skelter growth. In May, I recommended a fast-growth trigger, still essential since no regulator has yet suggested doing anything concrete about this. The FDIC abandoned fast-growth warning standards in 1995 thinking that no bank could fail again thanks to PCA. Maybe if we had workable PCA, banks could grow as their animal spirits dictate, but better if PCA throttles unduly rapid expansion in the absence of similarly-heightened safeguards.

The recent bank-failure reports reiterate many other hard lessons supervisors seem to need to learn over and over again the very hard way. For example, interest-rate risk – unaddressed in any of the new standards – is one grievous flaw in bank failures going back to the S&L crisis, if not before. PCA thresholds can and should set sanctions based on widening asset/liability mis-matches, forcing rapid-fire strategic realignment if the bank doesn't have the good sense to heal itself.

And there's more. Capital rules capture credit delinquencies in some cases, but a PCA trigger based on overall delinquencies and defaults requiring a capital buffer make at least as much sense as hoping stress tests capture risks thanks to whatever scenario the Fed fancies at the time.

The FDIC First Republic report also suggests that some triggers it calls reputational risk that are actually franchise-value threats may warrant monitoring. One of these is the market price of a bank's equity. This isn't a reputational risk – it's a real one given the challenges facing any bank when stock prices head to and then below book value. This is of course the worst possible time to demand that a bank issue new equity or debt instruments, but it's a very, very good time for regulators to impose capital-distribution restrictions and double-check the resolution plan.

Another warning bell is a sharp uptick in short selling. This is of course a volatile business with rumors spread just for the awesome profits a keen short can gather before markets wise up. Nonetheless, supervisors should develop a trigger to monitor short-selling volume and then look very hard at the shorts' rationale to ensure that there isn't something to it. The FDIC also suggests watching social media for early warning signs, but I fear little other than a looming run can be discerned from all the competing interests and half-truths that populate even the most disciplined threads.

Are these the right PCA triggers? Maybe not, but there's no question that new automatic trip-wires are needed not only because supervisors haven't ever taken true heed of hard lessons, but also because the raft of new rules has so many evident internal contradictions and perverse consequences. Some added regulatory burden and even some damage to U.S. bank comparative advantage is necessary because current standards have touched big banks too lightly in areas where tough love would have served them far better. However, the new rules would institute corporal punishment in lieu of the old light-touch approach, a brutal spanking doing undue damage easily avoided if supervision is made far better not by promises, but instead by clear, accountable standards.