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Senate Banking Committee Questions Regulators On Recent Bank Failures and Federal Rescue Efforts

Barr, Gruenberg Suggest Tougher Regulations Coming for Banks With >$100 Billion in Assets; Republicans Fault Fed, FDIC for Not Catching SVB's Problems, Calling New Rules Unnecessary

The Senate Banking Committee today (Tuesday, March 28) held a hearing on "Recent Bank Failures and the Federal Regulatory Response." The hearing concerned the recent failure and federal rescue of Silicon Valley Bank in California and Signature Bank in New York. The witnesses were Michael Barr, Vice Chair for Supervision, Federal Reserve Board of Governors; FDIC Chairman Martin Gruenberg; and Nellie Liang, Treasury Undersecretary for Domestic Finance. Materials from the hearing are posted here.

Statements

In his opening statement, Chairman Sherrod Brown (D-OH) said the government's rescue of Silicon Valley Bank's (SVB) depositors, including venture capitalists and large tech companies, had caused "justified anger" among many Americans. "I understand why many Americans are angry, even disgusted, at how quickly the government mobilized, when a bunch of elites in California were demanding it," Brown said. "The scene of the crime does not start with the regulators before us," he said. "Instead, we must look inside the bank, at the bank CEOs and at the Trump-era banking regulators, who made it their mission to give Wall Street everything it wanted." Brown said the committee "must consider how these banks exploded in size, in a way that was clearly unsustainable. Some explanations will focus on complicated-sounding concepts like: balance sheet risk, moral hazard, stress tests, liquidity ratios. Really though, it comes down to more basic concepts – hubris, entitlement, greed. And always with big paydays for the executives at the top." Brown said bank executives "face less accountability than a cashier who miscounts the cashbox. That's why I'll be introducing legislation to strengthen regulators' ability to impose fines and penalties, claw back bonuses, and ban executives who caused bank failures from working at another bank ever again." He said the committee also needs to "look at bank regulators' ability to not only identify risks and problems at banks, but to also be empowered to actually make the banks fix them."

In his statement, Ranking Member Tim Scott (R-SC) said, "The secretary of the Treasury and the chairman of the Federal Reserve are… not here to testify. I don't mean to offend the witnesses that are here, but it is hard to believe the Biden administration seriously is concerned about the failure that we're seeing when they themselves are shielding the top official at the Department of Treasury." Scott called the decision to name Barr as the person to review what happened at SVB and Signature "an obvious, inherent conflict of interest and a classic case of the fox guarding the henhouse." Scott said regulators have described SVB "as unique and highly 'idiosyncratic' – meaning the warning signs should have been flashing red and SVB should have stood out as what it was – absolutely a problem child. Clear as a bill were the warning signs." Scott said the disproportionate amount of low-earning bonds in SVB's portfolio should have triggered action: "Of all our supervisors, the Federal Reserve should have been keenly aware of the impact its interest rate hikes would have on the value of these securities, and it should have been actively working to ensure the banks it supervises were hedging their bets and covering their risk accordingly." Scott turned to a familiar villain to explain why the Fed was distracted, saying, "Recent reports confirm what we already know, your priorities and your work with the San Francisco Federal Reserve Bank President, Mary Daly, centered on climate change—an issue wholly unrelated to the Federal Reserve's dual mandate and role as supervisor."

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In his statement, Federal Reserve Board Vice Chair for Supervision Michael Barr said regulators "will continue to closely monitor conditions in the banking system and are prepared to use all of our tools for any size institution, as needed, to keep the system safe and sound…. The events of the last few weeks raise questions about evolving risks, and what more can and should be done so that isolated banking problems do not undermine confidence in healthy banks and threaten the stability of the banking system as a whole." Barr said that after the collapse of SVB, regulators should strengthen bank stress testing to capture a wider range of risks and potential avenues for financial contagion, saying the bank's failure "illustrates the need to move forward with our work to improve the resilience of the banking system." Barr said the Fed's bank stress tests will be enhanced with multiple scenarios to uncover a variety of channels of contagion, and that the Fed will propose "a long-term debt requirement" for larger banks that aren't big enough to be designated as global systemically important (G-SIBs), "so that they have a cushion of loss-absorbing resources." Along with stress testing, Barr said the Fed must look into changing its liquidity rules and "other reforms," and he cited the "critical" need to revamp capital requirements and bolster loss-absorbing buffers at large banks that are smaller than the group of G-SIBs. In addition to capital and liquidity, Barr said the review will also consider whether supervisors have the tools needed to follow up on their warnings.

Moving into the specifics of what happened at SVB, Barr called the bank's failure "a textbook case of mismanagement," saying, "SVB failed because the bank's management did not effectively manage its interest rate and liquidity risk, and the bank then suffered a devastating and unexpected run by its uninsured depositors." As part of the Fed's review of what went wrong at the bank, Barr said the Fed will look at 2019 regulatory changes implemented after Congress passed a law easing rules for regional banks in 2018, saying, "At the time of its failure, SVB was a 'Category IV' bank, which meant that it was subject to a less stringent set of enhanced prudential standards than would have applied before 2019." He said the Fed is committed to ensuring the central bank "fully accounts for any supervisory or regulatory failings, and that we fully address what went wrong."

In his statement, FDIC Chairman Martin Gruenberg said "the state of the U.S. financial system remains sound despite recent events." He said the "circumstances surrounding the failures of SVB and Signature Bank merit further thorough review by both regulators and policymakers," and that the "FDIC's Chief Risk Officer will undertake a review of the FDIC's supervision of Signature Bank and intends to release a report by May 1, 2023." Notably, Gruenberg said the FDIC will also "undertake a comprehensive review of the deposit insurance system, and will release by May 1, 2023, a report that will include policy options for consideration related to deposit insurance coverage levels, excess deposit insurance, and the implications for risk-based pricing and deposit insurance fund adequacy." Gruenberg appeared to suggest that tougher regulations for banks may be considered in the coming months, arguing that the failures of SVB and Signature "demonstrate the implications that banks with assets over $100 billion can have for financial stability… The prudential regulation of these institutions merits serious attention, particularly for capital, liquidity and interest-rate risk," adding that such banks warrant "serious attention" to their capital rules. "This would include the capital treatment associated with unrealized losses in banks' securities portfolios," he said. "Resolution plan requirements for these institutions also merit review, including a long-term debt requirement to facilitate orderly resolution."

In her statement, Treasury Under Secretary for Domestic Finance Nellie Liang said regulators must ensure bank regulatory policies and supervision are appropriate for the risks and challenges the industry faces today, and assured the committee that regulators will use the tools at their disposal, if warranted, to ensure the safety of Americans' deposits. "We have used important tools to act quickly to prevent contagion. And they are tools we would use again if warranted to ensure that Americans' deposits are safe," she said. Liang noted the important role that small- and mid-sized banks, including community banks, play in the financial system, saying such institutions "play a vital role in providing credit and financial support to families and small businesses." Liang said that over the weekend that followed SVB's collapse, it became clear that regulators needed to step in before business began on Monday (March 13) to calm the financial system. That led to a number of actions from Treasury, the Fed and the FDIC to stem runs on uninsured deposits and "prevent significant disruptions to households and businesses."

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QUESTIONS

Early Signs of Trouble. Barr said Federal Reserve supervisors had met with Silicon Valley Bank's chief financial officer as far back as October 2021 to convey their concerns about how the bank was managing interest-rate risks in its investment portfolio and liquidity risks. "Essentially the risk model was not at all aligned with reality," he said. "Fundamentally, the bank failed because its management failed to appropriately address clear interest-rate risk and clear liquidity risk." Fed supervisors issued six warnings "near the end of 2021," and then in May 2022 issued two more, Barr said. That was followed by a downgrade of the bank's management rating in summer 2022 and then an October meeting with SVB's senior management. The bank was served with formal notices documenting "matters requiring attention" and "matters requiring immediate attention" based on "the inaccuracy of their interest rate risk modeling," Barr said.

In February 2022, supervisors made a presentation to the Fed Board of Governors on the impact of rising interest rates on some banks' financial condition, including SVB, Barr said. Barr criticized SVB for not having a chief risk officer in place, saying the problems that caused the bank's collapse were "really basic" banking risks. "The examiners at the San Francisco Federal Reserve Bank called those issues out… and those actions were not acted upon in a timely way," he said.

Criticism of Regulators' Supervision of SVB. Despite Barr's explanations, several senators echoed Ranking Member Scott in disparaging regulators' oversight of SVB, questioning why the Fed didn't act sooner even though the bank's problems were on supervisors' radar, such as long-term securities whose value had plummeted and an abundance of uninsured deposits. Jon Tester (D-MT) said, "For over a year, regulators were saying to this bank, 'straighten up and fly right,' and they never did a damn thing about it. It looks to me like the regulators knew the problem, but nobody dropped the hammer." Tester said regulators should have made "these bankers damn miserable" once several red flags were raised in late 2021.

- When Mike Rounds (R-SD) asked how quickly a bank should act upon supervisory directives from the Fed, Barr said he didn't know the time frame for such a response, adding that he first learned about SVB's problems in February as part of a Fed presentation on how rising interest rates were affecting banks. John Kennedy (R-LA) was among Republicans who asked Barr why the Fed didn't have SVB undergo a stress test to measure its ability to deal with a future financial crisis. "You stress-tested in 2022 for the wrong thing," he said, comparing it to someone going in for a Covid test but instead being checked for cholera. Barr said the Fed's own rules prevented it from stress-testing SVB due to its size. Steve Daines (R-MT) said regulators should to lose their jobs over their failures, calling it "ridiculous" that Barr was not willing to say that if Fed employees failed to perform their jobs, he would recommend they be fired. Katie Britt (R-AL) criticized the regulators' willingness to seek tougher regulations: "You are not using the tools in your toolbox. That's what people hate about Washington. We have a crisis and you come in here without knowing whether or not you did your job, and you say you want more." Cynthia Lummis (R-WY) said the Fed already had ample authority to address SVB's shortcomings: "I can't think of another rule, or law, or regulation, that you needed."

- Mike Crapo (R-ID) said some are engaging in "blame-shifting" by asserting that SVB's collapse "was a statutory failure." Crapo pressed Barr on whether S. 2155, the 2018 law he pushed through that eased many regulations on smaller and mid-sized banks, had prevented the Fed from considering the risks being run by SVB. Barr told him that that law did give the Fed "substantial discretion." He added that the Fed will be examining whether to propose changes to the bank supervisory scheme through formal rulemaking.

- Chris Van Hollen (D-MD) said he detected hypocrisy among senators who were now faulting bank supervisors. "We've got a lot of folks that had been saying for months and years, 'Let's rein in the bank supervisors,' and now all of a sudden, it's like, 'Where were the supervisors? Why weren't they being more aggressive?' " Elizabeth Warren (D-MA) asked each of the witnesses if they agreed that banking regulations, such as standards for capital and liquidity, need to be strengthened going forward, after Congress in 2018 "burned down dozens of

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safeguards" that had been instituted by the 2010 Dodd-Frank Act. All the witnesses said yes. "I anticipate the need to strengthen capital and liquidity standards for firms [with more than $100 million in assets]," like Silicon Valley Bank, Barr said. While including SVB's executives among those who were responsible for the crisis, Warren said, "These collapses also represent a massive failure in supervision over our nation's banks." Warren is sponsoring a bill with Rick Scott (R-FL) that would require the Fed's inspector general to be appointed by the president and confirmed by the Senate.

Outside Reviews. In addition to the concerns Ranking Member Scott expressed in his opening statement, Catherine Cortez Masto (D-NV) questioned the regulators on whether there should be an independent investigation of their agencies to determine any wrongdoing. Barr said while it is important for the Fed to do its own review, which he called "a self-assessment," it would be "appropriate for outsiders to have independent reviews," and the Fed would "expect and welcome independent reviews of our actions."

SVB Run Larger Than Previously Known. In describing the days that led up to SVB's collapse, Barr said that after the bank experienced $42 billion of customer withdrawals on Thursday, March 9, more than double that figure that was expected to be withdrawn the following day. "That morning, the bank let us know that they expected the outflow to be vastly larger based on client requests and what was in the queue," Barr said. "A total of $100 billion was scheduled to go out the door that day… That's an extraordinary pace and scale." The Fed first tried to help SVB obtain the cash through its emergency-lending facility, in the belief that the bank could meet the withdrawals and continue operating, Barr said. But by the morning of March 10, the scale of additional withdrawals scheduled for that day made that approach impossible, he said, and regulators seized the bank before it could open. The FDIC's Gruenberg said that the top 10 depositors at Silicon Valley held $13.3 billion in their accounts, an outsize proportion reflecting the wealth of many of its customers, which included large companies like streaming video company Roku, which held about $500 million in an SVB account, the Associated Press reported.

Scenario of Selling SVB Before Its Collapse. Ranking Member Scott suggested the collapse of SVB "could have been avoided" if a private-sector entity had acquired the bank on March 10, but Gruenberg said the FDIC did not have an acceptable bid at that time. "When you hear rumors that this process was delayed because the White House doesn't like mergers in any shape, form, or fashion, it makes you wonder what actually is going on," Scott said. An acquisition would have prevented the government from having to back uninsured depositors, he said. Bill Hagerty (R-TN)said, "In spite of all the preparation and tools at your disposal, the FDIC failed to do its job. There was obviously enough demand to orchestrate a sale…. Throughout the course of that weekend I was inundated with phone calls telling me legitimate bidders were being waved off," Hagerty told Gruenberg. "If ideology had anything to do with this, this committee is going to be deeply concerned about that."

But in questions with Chairman Brown, Gruenberg said the FDIC, Fed and Treasury intervened to prevent a broader bank run. If they had not stepped in, he said, "I think there would have been a contagion, and I think we would have been in a worse situation today." Gruenberg said the FDIC had received two bids to buy SVB the weekend it failed, one of which was not valid because it had not been approved by the board of the potential buyer. He said the FDIC had determined that the other offer was "more expensive than a liquidation of the institution would've been," whereas the FDIC has a legal duty to minimize losses to the deposit insurance fund.

Assessment on Banks. Gruenberg said the FDIC in May will propose a special assessment on banks to cover the costs to the Deposit Insurance Fund (DIF) of the SVB and Signature failures. Those costs amount to an estimated $22.5 billion, the largest single hit to the DIF in its history, with $20 billion of that attributable to SVB. The prospect of such an assessment was troublesome for some senators, such as Sen. Lummis, who said, "Wyoming's community banks may end up paying for this… Will you exempt community banks?" Gruenberg told her that "regulators have a lot of leeway" in how those costs are divided up among different categories of banks, and the FDIC is "considering" not making community banks pay to replenish the DIF, adding that the agency will recommend a formula in early May.

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Executive Compensation. Chairman Brown, Sen. Van Hollen and others expressed frustration at reports that SVB executives had sold stock and received bonuses shortly before the bank's collapse. "Almost every American would agree it's simply wrong for the CEO and top executives to profit from their own mismanagement and then leave FDIC holding the bag," Van Hollen said. Recent SEC filings showed that former SVB CEO Greg Becker sold more than $2 million in bank stocks in late February and $1.1 million in stocks in January, ahead of the bank's failure, *CNN* reported. Barr said, "The board does have authority to pursue actions against individuals who engage in violations of the law, who engage in unsafe or unsound practices who have engaged in breaches of fiduciary duty… We retain this authority even after a bank fails, and we stand ready to use this authority to the fullest extent based on the facts and circumstances." Barr said potential consequences include prohibition from banking, civil money penalties or paying restitution. Gruenberg said the FDIC is already conducting investigations into the conduct of board members, executives and other affiliated parties of the failed banks.

Crypto Problems Afflicting Banks. Gruenberg said high levels of uninsured deposits and rapid growth were common factors in the collapse of the two banks, and tracing a narrative that began with the closing of Silvergate Bank on March 8, a San Diego-area bank that focused on the digital assets business. The bank lost 68% of its deposits in the aftermath of FTX's bankruptcy. "The troubles experienced by Silvergate Bank demonstrated how traditional banking risks… when not managed adequately, could combine to lead to a bad outcome." Gruenberg said SVB, like Silvergate, had concentrated its activities in venture capital firms, and that both used digital platforms that allowed round-the-clock transactions. They were "the only two known platforms of this type within U.S. insured institutions," he said.

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