Federal Reserve Policy & Regulatory Changes Needed in Response to Silicon Valley Bank and Signature Bank Failures & Related Market Turbulence
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The Federal Reserve's deregulatory and light touch approach to regulation and supervision paved the way for the bank failures that have shaken the financial system this year and that led to extraordinary government intervention to preserve financial stability. Particularly notable were the agency's decisions during the Trump administration to implement deregulatory legislation - S.2155, the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 – in ways that went considerably beyond what the law required. But this was far from the only set of decisions that enabled greater risk taking by institutions at the expense of safety and stability for the public.

In this most recent banking crisis, faced with the possibility of dangerous spreading instability, the government stepped in to make depositors, who had deposits millions of dollars above the insurance limit, whole. It was a powerful reminder of both the public impact of the risky choices bank executives make, and the breadth of government support the system relies on and that bank executives profit from.

We need a serious reckoning with these realities and a robust response from the Fed and other regulators. They must see self-interested arguments by finance for rules that maximize short term gains and executive compensation - no matter the public cost - for what they are. Justice requires a much more robust system of regulation, oversight, accountability and affirmative obligations for financial companies – (along with public options for banking) – that fosters security and opportunity for people, communities, and the businesses that are the backbone of a more equitable economy.

The Fed must realign its policies and rules to reduce outsized risk in banks and the financial system and assert much more rigorous oversight over its supervised financial institutions, through appropriate levels of micro- and macroprudential supervision and regulation. **Below we suggest a set of changes the Fed can make without Congressional action that would increase financial stability and put the welfare of the public ahead of the narrow interests of big banks and Wall Street.**

I. Investigations

An independent investigation should be conducted of the regulatory and supervisory failings at the Fed that contributed to the recent bank failures, one that includes a probe of the role of senior leaders in Washington. The circumstances warrant a thorough evaluation by an independent party, in addition to the internal Fed investigation. We need a serious, high-level commitment from the Fed to learn from the agency's past mistakes, something that historically only materializes under strong outside pressure.

- **The Federal Reserve should modify its policies and procedures (P&P) for internal supervisory escalation** to increase the amount of escalation that takes place and track the escalated issues to remediation and closure, establishing consequences for inaction. The P&P should:
  - Define the range of issues or violations requiring escalation and the specific paths to follow for each of these, including Reserve Bank leadership and the Board of Governors.
  - Establish a robust process for prompt escalation of these issues to all accountable and responsible parties.

- Strengthen internal standards enabling the issuance of Enforcement Actions; enforcement activity regarding SVB appeared to be too little too late.

II. Sound Incentive Compensation Practices

The Fed should, along with the other relevant regulatory agencies, align executive compensation with sound practices by finalizing long-overdue rulemaking under section 956 of Dodd Frank to prevent executive compensation that encourages inappropriate risk-taking.

- A final rule should defer a significant percentage of executive compensation for up to ten years, ban stock options (as they provide executives with asymmetric incentives), and ban executives from hedging bonus pay.

The Fed should prohibit banks using the Fed's Bank Term Funding Program (BTFP) from making irresponsible stock payouts and inappropriate compensation arrangements. This ban should include attaching strict conditions on BTFP loans by applying compensation, stock buyback, and capital distribution restrictions like those the Fed attached to its Main Street Lending Program during the COVID-19 pandemic. These limitations prevent executives from profiting at the public's expense. This prohibition should also include limiting closures of branches in Low to Moderate Income (LMI) communities during a BTFP loan period. This step would extend the benefits of liquidity from the BTFP facility to underserved communities struggling to maintain local access to critical financial services.

III. Strengthened prudential regulation for all banks

The Fed should reverse rulemakings that went beyond the requirements of S.2155 at the Fed's discretion. This change would include, **for banks with total assets between $100 billion and $250 billion,** enhanced capital and liquidity requirements, an annual stress testing requirement, and annual resolution planning:

- **Increase Capital Requirements, especially for Global Systemically Important Banks (G-SIBs)**

Vice Chair of Supervision Michael Barr recently announced a holistic review of capital requirements, and the failures of SVB and Signature Bank starkly underlined the need to strengthen liquidity and capital requirements for banks with assets greater than $100 billion. But big banks have mounted a major effort to get Congress to pressure the Fed to limit additional capital requirements, using the argument for "tailoring," the now-discredited approach that produced a light touch on SVB. The Fed must instead boost requirements, including for banks above the $100 billion range, and especially for the G-SIBs. Regulators had to take extraordinary steps to stop the contagion from SVB; imagine what would happen if a company the size of JPMorgan Chase were in a crisis. The Fed should:

- Strengthen its overall prudential framework, including capital requirements.
- Increase the Supplemental Leverage Ratio (SLR) from its current level of three percent and raise the surcharge for G-SIBs.
- Implement reforms proposed by the Basel Endgame, including increased standardization for calculating risk-weighted capital requirements.
- Implement automatic triggers for the Countercyclical Capital Buffer requirements to be held in reserve. When activated, these reserves could slow the growth of credit bubbles and prevent dangerous risk-taking.

- **Extend the Liquidity Coverage Ratio (LCR) beyond G-SIBs**

Stressed liquidity coverage measurement and monitoring should be incorporated into the safety and soundness programs of all banks. The primary regulators should require all U.S. banks to measure and monitor the LCR and to maintain an appropriate liquidity cushion for stressed conditions. Banks with $50 billion in total assets or more should also be required to monitor their Net Stable Funding Ratio, to ensure sufficient structural liquidity.

- **Strengthen Stress Tests**

The Fed should restore stress testing requirements in place prior to S.2155 and re-establish the qualitative section of the tests used by bank supervisors. It should bring back the pre-funding of capital distributions and strengthen Stress Test assumptions about large banks' balance sheets expanding during downturns. Rising interest rates, one of the main factors that led to SVB's downfall, should be included in stress test scenarios.

IV. Volcker Enhancements

The Fed should reverse the Trump era Covered Funds Rule that weakened information and reporting and strengthen Volcker Rule implementation and enforcement. A stricter Volcker Rule would have gone farther to limit the venture capital concentrations and de-hedging activity contributing to SVB's failure.

The Federal Reserve, along with the OCC, FDIC, and SEC, should swiftly improve Volcker-related information collection and reporting to enforce the law more effectively and should revisit the whole Volker Rule regulation to implement the statute more robustly. This should include:

- **Reversal of the Volcker Covered Funds Rule passed in July 2020**, which allowed banks to invest in some credit funds and either sponsor or take ownership stakes in venture capital funds. Many of the current federal financial regulators, including FDIC Chair Martin Gruenberg and CFTC Chair Rostin Behnam, objected to the rule. NEC Chair Lael Brainard, then a Fed Governor, also dissented against the changes, stating that the "proposed changes will weaken hard core protections in the Volcker Rule and enable banking firms again to engage in high-risk activities". The proposal opens the door for firms to invest without limit in venture capital funds and credit funds.
- **Swiftly improving information collection and reporting** to enforce the law more effectively.
- **A review of the appropriateness of the Fed granting SVB a five-year exemption from the Volcker Rule**. The review should be undertaken from a safety, soundness, and consistency perspective, as well as considering any impacts of such multi-year exemptions on the reliability of the Rule for protecting the financial system, individuals, and businesses from poor decisions on the part of bank executives.

V. Closure of Anti-Tying Loopholes

The practice of tying loans to deposits likely contributed, at least in part, to SVB's build-up of uninsured deposits. While the tying of products is restricted under Section 106 of the Bank Holding Company Act (BHCA), the Fed used its regulatory discretion to allow a range of tying relationships to exist with 16 exceptions to the anti-tying statute. These have contributed to the build up of risky concentrations in banking organizations. The Fed needs to either remove or reduce these exemptions to avoid build up of dangerous risk concentrations.

- **The Fed should withdraw some or all of its exemptions to the anti-tying law,** including the exemption for BHCs and their nonbank subsidiaries and the sixteen other exemptions for tying by banks, including for credit derivatives.
- **The Fed should work to offset the leverage the largest banks** with commercial and investment banking arms **have over corporate borrowers,** particularly since mergers among large banks have reduced the number of institutions with sufficient balance sheet capacity to handle the credit needs of large corporations.
    - **The Fed should not require borrowers to show that they were coerced** into purchasing a tied product. A more suitable requirement is only to have to show that purchasing the tied product had been required of the client.

Congress should also introduce legislation to prohibit or at least place a quantitative cap on banks' ability to tie traditional bank products.

VI. Strengthen supervisory requirements for Available for Sale (AFS) and Held to Maturity (HTM) Securities

The Fed permits some supervised banking organizations (with total assets under $250 billion) to not include unrealized losses on their holdings of securities designated as "available for sale" in their regulatory capital disclosures. This loophole enabled SVB and other mid sized banks to disclose regulatory capital numbers that made their capital position appear stronger than it was. Unrealized losses on AFS and HTM securities were a key factor in SVB's sudden collapse. The Fed should:

- **End the exemption that permits some banks to conceal losses on securities they hold.**
- **Require supervised firms to provide full transparency related to unrealized gains and losses** on securities in their risk reporting to senior management and the board of directors and in the firm's public disclosures.
- **Require supervised firms to have in place robust risk management and independent oversight ALM**, particularly unrealized losses in the firm's securities portfolio.

VII. Decisive Action Against Too-Big-To-Manage Banks

The Federal Reserve should protect consumers and businesses and preserve financial system stability by strengthening action against large banks with a repeat history of disregard for laws, rules, and regulations.

In January 2023, Acting Comptroller Michael Hsu laid out a four-tier escalation framework for "Too Big to Manage" banks in which he proposed breaking up banks that "had multiple opportunities to address the problem and been publicly motivated to do so, yet fallen short, again."

Wells Fargo has clearly reached the final escalation level of Acting Comptroller Hsu's framework: the asset cap (imposed by the Fed) and fines (imposed by numerous regulators) have not deterred Wells Fargo's lawbreaking. The Fed and other regulators should be using a next set of tools, such as capping certain businesses and potentially shrinking them, divestitures, and more as discussed in a recent speech by CFPB Director Chopra.

Senator Elizabeth Warren has noted that separating asset management and investment banking — which can include managing investment funds and providing financial market sales and trading services — from the bank would also ensure that Wells Fargo's everyday customers did not continue to suffer. The Fed could accomplish this goal by revoking Wells Fargo's financial holding company license, essentially making it impossible for the company to operate any nonbank businesses.

VIII. Strengthened Bank Merger Review Framework

The Fed should also update the Bank Merger Review Framework (BMRF) and Guidelines. The current administration has made combating anti-competitive business practices a priority, and in 2021, issued an Executive Order that directed the agencies and the DOJ to strengthen the Bank Merger Guidelines. However, almost two years later, the agencies have yet to do so. In recent mergers, including SVB and BP Bank, the Fed assessed the risk to financial stability qualitatively and did not disclose any quantitative metrics used.

The Fed, together with other prudential regulators, should design a BMRF to robustly incorporate financial stability into their merger evaluations, along with more deeply and effectively considering the convenience and needs of diverse communities. The framework should include bright-line qualitative and quantitative metrics and tests for assessing threats that a merger would present to financial stability and transparent disclosure of the results of the merger assessment.

The BMRF should include provisions to protect consumers and small businesses from the well-documented, harmful effects of mergers by including reasonable standards for merged banks to maintain comparable levels of credit and other services, and protection from excessive fees post-merger.

- **A Community Benefits Assessment** could fulfill regulators' statutory obligation to determine how a proposed merger will benefit the needs of its community. This assessment should consider other relevant factors in addition to a bank's CRA rating such as: guaranteeing that a merger is in the public interest by requiring CFPB approval if consumer products are involved; requiring disclosure of discussions between the institutions and regulators pre-filing of a merger application; requiring regulators to examine the anticompetitive effects on individual products; and requiring an evaluation of merger impact on product quality or potential exploitation of consumers.
- **Community Benefits Agreement** - The BMRF should require provisions in merger agreements to ensure that Diversity Equity and Inclusion commitments are enforceable and protected from post-merger decisions that result in curtailed lending or increased branch closures in Black and Hispanic communities.

IX. Regulation of Non-Banks

The FSOC has issued a new proposed rule for a SIFI designation, and now the Fed needs to act swiftly to develop frameworks for non-bank supervision.

- **The Fed should develop and finalize a comprehensive supervision and regulation framework for systemically significant non-banks** with assets greater than $50 billion, as required by Section 165 of the Dodd-Frank Act.
- The Fed needs to exercise leadership in the FSOC process to swiftly apply the SIFI designation framework.

X. Strengthened Oversight of Crypto Market

The recent Signature Bank failure underscored the safety and soundness concerns with business models that are concentrated in crypto activities or have concentrated exposures to crypto assets. The Fed, along with the other financial regulators, should strengthen oversight of crypto assets, actors and activities, as well as oversight and control of banks' exposure to crypto. The Fed should move swiftly to:

- **Draw bright lines between the crypto sector and depository financial institution groups and markets.** Other policy measures would also contribute to better oversight and accountability for the crypto industry, and additional protection for consumers.
- **Use existing authorities to establish oversight of stablecoins, applying the same standards** of supervision and regulation as applied in pre-existing banking and securities products and markets. Treating stablecoin in a unique or permissive manner and applying different supervisory and regulatory standards for comparable products creates regulatory arbitrage and dangerously invites the flow of investment further into the unregulated shadow banking sector. Such actions would be particularly reckless considering recent lessons learned the speed of runs on liabilities among increasingly digitally savvy market participants and investors.