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ONE YEAR LATER: LESSONS LEARNED FROM THE MARCH 2023 BANK FAILURES
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PANEL: REDUCING THE CHANCES OF A REPEAT OF MARCH 2023

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FIRESIDE CHAT

THE HONORABLE PATRICK MCHENRY (R-N.C.)
Chairman of the House Financial Services Committee
U.S. House of Representatives

Moderator: AARON KLEIN
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PANEL: RESOLVING FAILING BANKS

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David Wessel Good morning, everybody. I'm David Wessel, director of the Hutchins Center on Fiscal and Monetary Policy here at Brookings. And behalf of the Hutchins Center and the Center on Regulation and Markets. I'd like to welcome you to this event, both the people in the room and the people watching remotely.

Our subject today is what lessons we've learned from the really interesting episodes of March 2023. A year ago, the global financial system suffered the most significant banking stress since the global financial crisis of 2007 and eight. As you all probably know, if you're at this event, Silicon Valley Bank failed, prompting the FDIC to take it over in the middle of the day. Couldn't even make it into the weekend, which is unusual. Now, it's tempting to see this as a one off event. Silicon Valley was certainly, for want of a better term, unusual. Almost all its deposits were uninsured, and it was woefully unprepared for an increase in interest rates that eroded its the value of its securities portfolio. But it was followed by what some have called the panic of 2023. The failures of Signature Bank and First Republic and overseas Credit Suisse. To arrest what U.S. authorities feared was a spreading and destabilizing bank run, U.S. authorities invoked emergency powers to cover all uninsured deposits and to create an unusually generous emergency lending facility. These actions stabilize the financial system, and they shielded the economy from harm. But the recent troubles of New York Community Bank Corp and the unfortunately named Republic First Bank Corp are reminders that there are still banks that are in trouble, particularly those that have invested in commercial real estate.

So I think it's, understood that bank failures are inevitable, despite all the changes we've made to rules about capital and liquidity and regulation and risk management since the global financial crisis. But today, we ask what lessons we should learn from the March 2023 episode, including steps that policymakers, regulators, supervisors, bankers should take to reduce the risk that the failure of a couple of banks, not the biggest banks, can threaten the stability of the entire financial system and end up with taxpayers riding to the rescue once again. Somebody I'm not sure who's originally responsible for this phrase. I heard it first from Claudia Goldman, the economic historian who recently won the Nobel Prize. You don't know where you're going unless you know where you've been.

So today we're going to start with a panel that I'm moderating that will look specifically at what lessons we should learn about supervision, regulation, bank risk management, and what should be changed. And I'm pleased to have a very good panel Tobias Adrian is director of the Monetary and Capital Markets Department of the IMF, where he's been for seven years. Before that, he spent 13 years at the New York Fed, and he and his colleagues at the IMF have just today published a report on, what we learned about what happened in March 2023. And he's also going to draw on this report about supervision, which has been a concern of the IMF for a long time.

Susan McLaughlin is now at the Yale Program on Financial Stability, is a 30 year veteran of the New York Fed who, importantly for this conversation, oversaw the lender of last resort function at the New York Fed.

And as soon as the air traffic controllers allow his plane to land. We'll be joined by Bill Demchak, who's chair and CEO of PNC, which is the eighth largest bank in the US, 560 billion in assets. Bill joined PNC in 2002 and has been the CEO since, 2013.

So our plan is, I'm going to moderate a panel here. I hope we have time, we're kind of pressed for time, we have two 45 minute panels, and this panel will be followed by a conversation my colleague Aaron Klein is going to hold with Patrick McHenry, the

Republican congressman from North Carolina, who is now chair of the House Financial Services Committee but was made famous when he was the interim speaker. He's the guy with the bow tie who smiled broadly when he finally got relieved of that great job of being speaker of the House.

And Aaron's going to moderate a panel following that, on resolution.The Dodd-Frank act told us that we weren't going to have to have anymore rush rescues of banks because we set up a resolution system that was supposed to, avoid this. And it wasn't invoked for various reasons. And so what have we learned about resolving, resolving failed banks? In his panel will be Jarryd Anderson, who co-chair of financial services group at Paul Weiss, Gary Cohn, former chairman of the white House National Economic Council and now vice chair of IBM, and Alexa Philo, who's a senior policy analyst at the Americans for financial reform. Previously worked at Deutsche Bank and UBS and was for 13 years a bank examiner. So she can tell us how how it really works and why they miss all these things. Let me but we're going to do is I'm going to ask, Tobias first, to talk a little bit about bank supervision and what we learned about bank supervision and its weaknesses during the recent or the year ago crisis.

Tobias Adrian Yeah thanks so much, David, thanks for hosting this, this event. And thanks for Brookings staff to organize. So the one year anniversary for what we call the banking turmoil as opposed to the banking crisis. The banking turmoil of 2023, I think happened, about a week from now, one year ago. And, let me let me start by noting, the main culprit was the management of the institutions. That ended up in distress. You know, when you look at the business model of SVB, but also some of the other, regional banks that were in distress last year. It was highly concentrated exposures on both the asset side and the liability side of the balance sheet, the huge amount of duration risk, huge amount of liquidity risk with a large dependance on uninsured deposits, highly concentrated depositor base. Basically the Silicon Valley firms. And, it's these management failures that ultimately led to the to the failure of the institution.

I think the policy question is, could there have been more action ex ante, to contain the sort of like broader fallout from this failure, as you noted in the opening remarks? You know, banks will fail and and, you know, badly managed banks should fail, right? I mean, that is how how life goes or how corporate life goes. But there was a first of a spillover effect. So in fact, thinking back, of last year, both the Federal Reserve and the FDIC, together with the Treasury and ultimately in the White House had to take emergency measures. So they used emergency powers in the case of the Federal Reserve, the 33 lending powers. And for the FDIC, the systemic risk exception of the Dodd-Frank Act.

So those are both emergency powers that had to be deployed in order to contain the fallout of the failure of these regional banks. And exposed this was very successful, but it was a pretty heavy sledgehammer, right? I mean, they rolled out all the crisis management tools available, making uninsured depositors whole in two of those institutions lending at par with zero haircuts at the discount window. Right? These are very, very aggressive actions that worked very well, but could more have been done ex ante to prevent even going there.

And so what is interesting when you look at the history a number of reports have been written by the Federal Reserve, the bi report by the FDIC that really look in great detail as to what's happened in the run up. And the interesting thing there is that supervision. And I'm going to focus on supervision here. Supervisors did flag the issues at SVB for months and sometimes even years in advance. So they wrote supervisory letters to the

management of SVB and other institutions flagging the liquidity problems, the interest rate risk exposures, the failures in the risk management. Right? So the red flags were clearly there. The letters were being sent. What they did not do is to use their powers to get a commitment by management to remedy those issues. Right? So the way we describe it in the paper that you held up is that there was supervisory hesitation. The supervisors hesitated to act aggressively to get agreement from management to fix the shop. Right? The issues were there and management basically ignored those letters. Right? And, you know, what is striking is in the U.S., unlike in many other countries in the US, supervisors do have the legal powers to take aggressive actions. Right? So the supervisors had all the legal basis to be very, very forceful, but they were not. So the hesitation of the supervisors that I think need fixing, right? I mean, they they did see many of the problems, but they hesitated to act. And when you think about the ex ante regulation, sorry, the ex ante prudential approach. There are three pillars, right? There's regulation, and there were issues for regulation. Happy to talk about that. There's supervision. And the issue with supervision was this hesitancy. And then there's the market discipline. And I would argue all three had the issues and the supervision. It was really the hesitation as opposed to the legal powers or the autonomy or other things, which oftentimes the issues that we see in country.

David Wessel So what is the solution to addressing supervisory hesitation? What is it? Is it bad incentives? Is it politics? What what held them back and how do we change that?

Tobias Adrian So you know what is interesting when you look at the supervision in the Federal banking institutions in the U.S. after the 2008 crisis, there was a massive restructuring of supervision, focusing very much on the G-SIBs, right.

David Wessel The global systemically.

Tobias Adrian The globally systemic. So.

David Wessel This is an acronym free zone.

Tobias Adrian Oh, I didn't realize.

David Wessel Well, coming from the IMF I can understand that.

Tobias Adrian So, you know, the acronyms, like their own language that we speak. So, you know, so supervision really scaled up, the seniority of supervisors engaging with senior management at the G-SIBs, being much more forward leaning musing stress tests, for example, as a key tool to ex ante forward looking analysis, looking at liquidity mismatches as a capital issues and, asset quality issues at a very senior level with senior level engagement. But at the regional banks, that was not being done. In fact the US introduced this regulatory tail there tailoring. And it's called regulatory tailoring. But it was really both regulation and supervision that was tailored so that the smaller regional banks, between 10 million. Sorry. Between the small these regional banks, we're not, subject to the same regulations or the same supervision. So the regulation, we do think, needs fixing, but in the supervision, it's really about the culture of the supervisors, how supervision is managed. Many of the powers are already there.

David Wessel So, Susan, the lender of last resort function of central banks historically dates, you know, a hundred years more back, I guess, to Paget, Walter Paget. And the notion is that banks have, very illiquid assets, loans to mortgages and business loans and

very liquid liabilities that can run. And just like in the Mary Poppins movie, you can have a bank run where everybody wants to get their money out, and the bank has assets that are still good, but they don't have the cash to pay out. And we learned during the Great Depression that you can have bank runs that screw up the whole economy. So we set up a system of deposit insurance to discourage runs. But it's not a bailout of the banks when the central when the Fed or the ECB or the Bank of England says if you have good assets, give us your assets as collateral, lend you money so you can make your depositors whole. And I think in one fo Tobias's papers, he's talked about the synergy between liquidity and solvency. If everybody believes you're solvent, they won't take the money out. And in order to assure them that they can get their money out, the central bank steps in. So you have had a lot of experience in this lender of last resort function, the discount window and its analogs. And so, there's been some concern that it didn't work here as it should have.

Susan McLaughlin Yeah, absolutely. I mean, I think that your description of the lender of last resort is exactly right. The discount window in the U.S. is the key lender of last resort tool for the banking system, and it's really designed to provide confidence in times of uncertainty about a bank's ability, a solvent bank's ability to, continue operating. It also has value in stemming a run on one bank from, from spreading to other banks as well. So until recently, the debate on lessons from 2023 has mainly centered on supervisory reforms. And that's understandable. There's been a pretty limited discussion of the role of the lender of last resort, which I'll say discount window here out, to mean that in the U.S., the discussion of the discount window really has centered on two things, encouraging banks to be ready to use the window in times of stress and requiring banks to pre-position collateral in some proportion to their runnable liabilities. I think what's missing, though, from the debate is, the issue of stigma that accompanies the discount window. And this dates back to the 1920s. For reasons we can talk about later, if we have time. But basically, there's a lot of stigma that accompanies, the use of the discount window. So banks are reluctant to use the window when they initially have, a liquidity need that's unexpected. And this is problematic because if banks are just ready, but they're not willing to use the tool, then the tool can't do its job in stemming run and contagion risk.

I see a disconnect also between current messaging from Fed officials, which is really encouraging banks to use the discount window when they need it. And the way that discount window borrowing capacity is treated and how we supervise banks with respect to liquidity risk management, I think there are a lot of opportunities here, which I'll talk about in a minute to kind of make these two tools, supervision and lender of last resort, work together and march in the same direction in a way that really enhances financial stability.

So why is stigma a problem? As I noted, if banks are not ready, are ready, but not willing to use the window, then the discount window can't do its job in mitigating systemic risk. And importantly, stigma actually undermines the cause of bank readiness. So if I'm a bank and I know my management doesn't really want me to use this, or I'm going to get criticized by my supervisors if I use it, I'm I don't want to use it, and I'm probably not going to be preparing to use it. And then when I need it, it's going to be very challenging. And in fact, we saw this last year with both SVB and Signature. So SBB had not tested the discount window, their ability to borrow, you know, for the past year before their demise. Most of their Fed eligible collateral was actually parked at their Federal Home Loan Bank. So when the time came to try to move that to their Federal Reserve Bank, there weren't arrangements in place to do that. And, there was a lack of understanding at SVB about even just the operational cut off times, they had to observe to be able to move collateral

same day. And so obviously, by the time they wanted to pivot to discount window funding, it was too late.

Signature perhaps even a more egregious case. They didn't even have discount window as part of their contingency funding plan. They hadn't tested the discount window and their ability to borrow from it for about five years before their demise. And when it came time to, try to borrow from the discount window, they were not familiar with the collateral eligibility guidelines at the Fed, and they actually spent some time in their final days trying to pledge an eligible collateral to the Fed, which obviously was not helpful for them. So I think while discount window borrowing obviously would not have saved either SVB or Signature, they were experiencing solvency issues. I think it's fairly clear to say it could have slowed down the run on those banks, and it could also have slowed or even stopped the contagion of the run to other regional banks with similar characteristics. So again, the window can only be effective if banks are actually willing to use it when they need it.

How to reduce stigma. I think, you know, this is a complicated problem. Stigma is a multifaceted, issue. No one public sector entity can really solve it on their own. I think that there are things that both the central bank and bank liquidity regulators can do to, to reduce stigma. Several things that the Fed could do, develop and execute a clear long term communication strategy to the public, to make clear that primary credit is a legitimate source of funding for solvent banks against good collateral when they need it. I think there's a lot of confusion on this point. We have a long kind of checkered history again since the 1920s, about whether this discount window tool is really something that should be used when needed or is really not okay to use.

Second, I think the Fed could explore a way to administer secondary credit, which is really akin to recovery in relation, resolution funding, kind of separately from administration of primary credit at the discount window. I think that this could help to reduce the kind of muddying the waters of having both solvent and weak banking programs, lending programs.

David Wessel Just to be clear, so secondary is for banks that are kind of in trouble.

Susan McLaughlin Well, it's for so the official language is, it's for banks that are not eligible for primary credit.

David Wessel Okay.

Susan McLaughlin So it takes the cake from that one.

David Wessel Remedial.

Susan McLaughlin Yeah. Yeah. But essentially it's it's really more akin to recovery and resolution funding I think in practice. Other central banks, interestingly in the world, have drawn a much brighter line between lending to solvent banks and lending to weaker banks. And those central banks have tended to have much more success in having a destigmatized way to lend to solvent institutions.

I think a third thing the Fed could do is improve its infrastructure and operational processes, to make the process of pledging collateral and borrowing from the window easier to access for banks. And I'm sure you have much to say about this, but I'll just give one example. Borrowing from the window is actually a pretty manual process. So a bank

calls and there's a kind of a period of time where the staff are checking to make sure you know that it's okay to approve the loan. I think that pause again for a solid bank with good collateral, sufficient collateral that's unencumbered to to secure the loan, that waiting period almost seems to signal. We don't have to say yes. And I think that that's, you know, it's kind of a legacy of this constructive ambiguity that started in the 20s. But why not automate the check, for collateral for primary credit borrowers and make it more of a straight through process? I think that would, again, be another way to kind of demonstrate this is a legitimate tool to use in times of need.

And finally, I think the Fed could probably revisit, it's probably a good time to revisit the appropriate pricing for primary credit to better balance the trade off between creating stigma, if the rate is too high for the discount window, and displacing market activity if the rate is too low. For example, what is the right spreads for the primary credit rate over the Fed funds rate? Is it 100 basis points as it was before the GFC? Is it zero basis points as we have today? I think that that would be a really useful, effort to kind of look at that. And I think also thinking about how primary credit is priced relative to credit, as extended by Federal home loan banks, would be a very useful exercise as well.

Bank regulators also have a role to to play in reducing stigma. Bank regulators could recalibrate their, requirements and guidance regarding liquidity risk management to align more with this idea that the Fed is now, really pushing that primary credit is a legitimate source of short term funding to meet unexpected needs. For example, if requiring banks to pre-position collateral. This is being discussed a lot. There are a lot of proposals for this out there. Why not consider counting some portion of the HQLA.

David Wessel High quality liquid assets

Susan McLaughlin Liquid sorry acronym violation. Yes. Non high quality liquid assets. pledged in the liquidity coverage ratio for sound banks. I think you know there's a lot of talk out of the Fed right now. Very good message of encouraging banks to use the discount window and to, use it in its contingency funding plan and to test regularly, I think. Why not require that? I think that would be a really important requirement. Rather than letting banks decide whether they're going to be ready, let's just require them to be ready. And if we're requiring the discount window to be part of a bank's contingency funding plan, why wouldn't we also count it as a source of contingent liquidity in banks internal, liquidity stress tests and resolution funding plans? So I think the bottom line is, you know, we can reduce stigma. The discount window, it's been with us for a long time. It's not going to be easy. It will require a concerted effort across the central bank and bank liquidity regulators. But it is something that we should do to ensure that we have an effective lender of last resort in the U.S.

David Wessel Thank you. Let me just pick up on two points, you said. So one is it wouldn't have saved Silicon Valley Bank because they were a mess. But the reason it's important to have it is so that other banks that are threatened, where people are panicking, can pay off their depositors and depositors.

Susan McLaughlin Yeah. It provides a source of confidence to depositors and investors, frankly, that, you know, the bank will have access to liquidity if needed.

David Wessel And the second thing is, so we tell the banks, you have to have a certain amount of liquidity. We have all these rules. We tell them you should feel free to use the discount window. It's almost like this is probably a violation of some corporate finance

principle. It's almost like a line of credit. But then we tell them, you can't count this access when we decide how liquid you are. So why don't. So then, Duh.

Susan McLaughlin I think we need in the US to decide what we're for with the discount window. Is it is it a facility that is a backstop that's legitimate for sound banks to use against good collateral when they need it? Or is it something that really shouldn't be used? And I think, you know, this constructive ambiguity doctrine that dates back to the 20s really has caused a lot of confusion. I think there's even confusion stemming from the Federal Reserve Act itself. There's a provision in the section at ten B that governs discount window lending that notes that no reserve Bank is obligated to provide a loan to a bank. And I think that dates from the era when there was not robust prudential supervision of banks around the time of the Depression. And the Fed was very worried legitimately about lending to weak banks. But I think now, we have much more robust supervision. Yes, there's opportunity for improvement, as Tobias has noted, but we have a very strong fundamental system. And I think we need to decide what are we doing with our lender of last resort tool.

David Wessel All right. So Bill, I'm glad that the weather gods and air traffic control allowed you to make it.

William Demchak So sorry.

David Wessel That's all right. You missed the glowing introduction I gave for you. Tobias started out by saying that, the banks that failed in March 2023 failed in large part because of management. And then he went on to talk about supervision. I'm interested in your responses to Susan, but I want to ask a broader question first. So as a banker, a regional bank, super regional bank, what lessons do you think we should learn from the March 2023 episode?

William Demchak My primary lesson learned was that regulation is uneven. It astounded me. What the First Republic and Silicon Valley were able to do inside of what I thought was, well, I know is inside of the FDIC handbook. Regulators didn't do their job. The management was bad and risks were, you know, lots of different things. But it just, you know, bluntly, if that was an OCC bank, that never would have happened.

David Wessel I see, so when you say regulation, you mean not the supervisors but the rules.

William Demchak The regulation is there. The supervisors didn't do their job. Silicon Valley Bank was was the day they put on their fixed rate bond position, long before the Fed started raising rates. They should have been red flagged or they had embedded leverage in their balance sheet. That was unsustainable inside of any sort of rate rise in any interest rate risk manager would have known that and stopped it. It shouldn't have happened after the Fed raised rates. It was a position that was a long term capital position. I'm going to go buy a hundred billion of bonds and fund it with hot money. Nobody in their right mind would do that. And the regulators shouldn't allow that to happen. So and you don't need new rules to tell a regulator to not allow that to happen.

David Wessel So explain what you mean about the difference between Federal Deposit Insurance Corporation regulation and the Office of the Comptroller of the Currency.

William Demchak I think there's a regulatory arbitrage in this country. I think it is uneven. I think we purposefully have allowed and, I'm sympathetic to this, smaller banks to have

lighter touch regulation. But in the course of doing so we've allowed banks to, to charter shop.

David Wessel So who are you regulated by, PNC.

William Demchak Well, everybody. We are a national bank, so like FDIC insured Fed member, which basically brings everybody into the House.

David Wessel And, in the case of New York Commercial Bank Corp, what role did that play? This whole difference in regulators in that episode?

William Demchak I don't have direct knowledge of that situation. I have more knowledge of the issues from last March. But it's not a coincidence that they merge into Flagstar. Take the OCC Charter and the new regulators in looking at an old book and saying, oh my God, I think is really telling.

David Wessel Interesting. So, can you reflect a little bit on Susan's points about the discount window? How does it look to you as a banker? Is it a facility you can count on without getting dinged by the board of directors, analysts and regulators or not?

William Demchak No, I mean, it's start with they've been the stigma behind it. It's the lender of last resort. So the day you hit it for anything other than a test you effectively have told the world you failed it, you know, and investors inspect that. Look at that number, it's disclosed because it's by district. So nobody wants to tell me.

David Wessel So just explain. So the Fed doesn't disclose the name of the bank to borrows for three years, two years.

William Demchak But you can figure it out.

David Wessel But they publish by each regional bank who's borrowing. And there's not that many banks and ones and so on. Suddenly a big thing comes up. It's kind of hard to forget.

William Demchak But even away from that, we call it the lender of last resort. There's a need in this country for regular way liquidity into the banking system, which today is served by the home loan banks, particularly for smaller banks, that has increased with the advent of money market funds and just excess reserves needed to be held as a function of liquidity ratios. The Fed should be playing that role, in my view, the Fed is not, because of all the things Susan said, it's mechanically incredibly difficult. Even when you pre-position you have to audit what Signature loans in a vault that is guarded. You call your regional Fed, somebody answers the phone, maybe. Then they'll have a meeting to see if it's actually okay for you to draw in, and they'll talk to Washington and you draw. If I draw from the home loan bank, I hit a few keystrokes and draw against Treasury. So pre-position, it's much easier. It's regular way lending. It's necessary liquidity in that system, I think, for the discount window for the Fed to play its role. First of all, you need to counter to your points is LCR. It's crazy for me to pre-position collateral and then get penalized for, having done so. You need to whatever the, the monitoring is such that you can access it easily if you have good collateral and importantly, capital. You ought to be able to do it, and it shouldn't be a lender of last resort issue. It ought to be funding into the banking system that helps in a situation where, for whatever reason, deposits are leaving an institution. But there's good collateral and capital that makes that a momentary event as opposed to a critical event.

David Wessel Is it cheaper for you to borrow from the Federal Home Loan Bank than the Fed?

William Demchak Yeah, actually not right now because the discount window is at a zero spread and the home loan bank is, probably about the same. To be fair in today's moment. But you never, you know, they changed. They changed the price.

David Wessel Yeah. And talk to me a little bit about what it's like to be the CEO of a bank like yours and deal with supervisors. Most of us don't work in a profession. I mean, I have the good fortune to work for the Wall Street Journal because of the First Amendment. We're unregulated. We have no standards. It's total freedom. Can you run a business effectively with a bunch of supervisors who may not be as smart as the people who you employ looking over their shoulders?

William Demchak I disagree with the last statement. One of the things I would tell you about our supervisory relationships, which is almost every time true, is when they smell smoke, they are correct. They can't necessarily distinguish between a one alarm fire and a five alarm fire. But when they say, hey, what do you think of this ? We're seeing that. They're almost every time correct in my experience. And so at the end of the day, we're in the business of taking risk. That's what a bank does. Right? We transform money supply. And anybody who wants to talk to me about risks that I am taking so I can get smarter about it, it's okay by me.

David Wessel And finally, a lot of people have called attention to an interview you did or a call with analysts where you basically said that corporate depositors don't trust that U.S. regulators will keep all banks safe, so they'll likely migrate to the really big banks, the JP morgan's and Bank of America. So a bank like yours, 560 billion in assets, eighth largest bank. The only smart thing for you to do is to get bigger. So you're essentially too big to fail. That didn't seem to be the spirit of Dodd-Frank, but it seems to be the reality. \What the hell is going on here?

William Demchak Well, the benefits of scale forget about the incidents last March, but just the benefits of scale. If kind of, we had that theory forever, but it's basically has taken off and proven true where the economies of scale inside of marketing, inside of, ubiquitous brand, coast to coast technology, cyber protection, product development, delivery are finally playing out in the banking space. And you see, since the financial crisis the two largest banks by deposit B of A and JP Morgan, have grown massive organic deposits here. They grow at PNC every five years. And every other bank in the country, and I think this is correct, except for Silicon Valley and First Republic, their deposits shrunk during that same period of time as market share, unless you did an acquisition or merged. And so we already saw, you know, Mike Mayo calls it Goliath is winning. But we've already seen that big banks are pulling share. You know, one of them is public that they want to have 20% retail share within the next five years in the U.S. March accelerated it because what happened in March was away from the retail rates you have for deposits. You had corporations basically saying, I've got a problem. I can no longer trust that you, my banker, I love you like a brother, but I have no idea if your bank is safe because these two high flying great banks just blew apart. And I'm not going to, as treasurer of this company, take the risk that you're not safe. And I know if I go with B of A or JP Morgan. And by the way, at the margin PNC. So we net net benefited from this. I'm just going to move my money upstream. And that's what's happened and it's accelerated.

David Wessel I'm interesting. Tobias, Susan called my attention to an interesting speech that ECB official Frank Alderson made where he said he talked about bank culture. And he said while balance sheets are often scrutinized with a hawk's eye is often culture that whispers the first signs of trouble. Banks are complex organisms driven by sum of their human interactions and decisions, and it is a bank's culture that flavors these interactions. And he basically made the case that when supervisors focus only on the balance sheet, they miss the red flags. And I wonder if you agree with that and what we do about it.

Tobias Adrian Yeah, absolutely. So, I think it's important to keep in mind that there are culture issues in the banks and culture issues in the supervisor. And as I alluded to earlier, when you look at, the supervision of the Federal banking agencies in the U.S, there was a significant shift in the culture of banking supervision for the G-SIBs, the globally systemically important banks. So these are, 7 or 8 institutions in the U.S, after the crisis. And they're really four focus areas, of that, supervisory approach, one of which is governance. And so the culture issue is broadly captured in the oversight of governance. So there's quite a bit of effort at a very senior level from supervisors to understand governance mechanisms in the supervised institutions. For the regional banks, there hasn't been that sort of shift. In fact, there was the regulatory tailoring, that occurred, I think, in 2019, which tailored both regulation and supervision in the proportionate manner that essentially changed the culture of supervisors, of those institutions. And as I as I alluded to earlier, right. It's really the culture of the supervisors. So they did see a lot of red flags, but they didn't engage proactively with management to get the commitment of management to make change, even though they have a legal basis to do so. Right? So the US has very strong legal supervisory basis. So it is a cultural issue in the supervisory agency bill.

David Wessel Bill, you sort of you suggested that interest rate risk, it's part of the job of being a banker. And when interest rates are zero, you're pretty confident, you know, what direction they're going to go eventually. I think.

William Demchak For a while we weren't.

David Wessel Yeah. That's true. Did do you think the Fed should have told its supervisors, look, as we start to raise interest rates, you got to bear down on the banks to make sure they have adequate risk, interest rate, risk management. Or is that just not their job?

William Demchak No, I mean, it's their job and it's inside of a stress test environment. Whether a bank is subject to the official test or not, where you would test against variables and see outcomes, I think the issue of the risk positions, well, we use PNC as an example. We invest in fixed rate assets. Our fixed rate assets went underwater when interest rates went up. We owned them as a hedge against our non-interest-bearing deposits, which are marked to market. So, you know, we we basically went into this somewhat short. So rates would go up and on a calculator we made money not necessarily for gap. Had we owned massive amounts of more bonds, that would have been a negative outcome that would come through in through solvency. Regulators talk to us about that all the time. But that's common sense risk. I, I have a certain set of funding in a short in a short position, and I'm going to buy something long against it. I'm going to do my very best in a bank to run a matched book, recognizing I have a lot of unhedgeable variables on either side. That's our job. That's what banks do. And we talk to regulators all the time about that.

David Wessel We have a few minutes for questions. I have a I'm going to take. 2 or 3 questions and let the panel thing. We're really pressed for time. So when you ask the question it should a end in a question mark and b, be a short and identify yourself. Let's start here Carter.

Carter Dougherty Oh I will absolutely be short. My name is Carter Dougherty. I'm with, Americans for Financial Reform. Quick question for Tobias. What exactly changed in the culture of supervision between 2018 and roughly 2022, because supervisors were newly empowered after the crisis. But something appears to have happened in the Fed. And then I can't resist asking, Bill, it is almost four years to the day that you said that banks need to move away from gotcha fees, correctly anticipating, the Biden administration, regulators talking about junk fees. And today, the Consumer Financial Protection Bureau announced, caps on, credit card late fees. Is this a good thing? Do you see your vision being fulfilled here for a more transparent market?

David Wessel Right. So over here. I think that was two questions, Carter, but I'll let you have it.

Paul Saltzman Hi. Paul Saltzman. I'm general counsel of Eagle Bank a $12 Million Community Bank here in DC, and former president of the clearing house processor BPI. No, I'm just curious that no one mentioned deposit insurance reform in this mix of possible solutions, particularly with respect to business accounts. I was wondering if the panel can address that.

David Wessel Okay. Let's start with those. So want to take let's start with the last one, deposit insurance reform. Susan, you want it?

Susan McLaughlin I think I honestly don't know where it stands right now because the FDIC came out with a very interesting report, several options. And the discussion seems to have dried up, but, certainly that's something I think that does need to be addressed. I mean, if you think about financial stability framework in a country is supervision and regulation resolution authority, lender of last resort, deposit insurance. Deposit insurance is a key piece of that.

William Demchak The one thing I would add is we get we are afraid of uninsured deposits because they can run. If I have collateral in a right way discount window, it doesn't matter. So I don't think we need increased deposit insurance. I think that leads to bad behaviors. But I do think that you need to have access to a window with good collateral to be able to cover uninsured deposits should they run.

Susan McLaughlin And again, I just want to emphasize, you know, it's so important that all of these tools work together and are walking in the same direction. And we don't have that right now.

Tobias Adrian Yeah. So on the on the question, what happens to supervision? So, you know, we the IMF does these financial sector assessments in countries around the world. So every five years we go into every single major jurisdictions and do a very deep dive assessment a conjunction assessment of what could be the stress. That's pillar number one. Pillar number two is what is the regulatory oversight and the supervisory practices. And pillar number three is what are the emergency measures, the crisis management tools that the country has. So in the US, we did this for the last time in 2020. And, you know, when you go back to the documents. So these are extensive documents that are all

available publicly on the IMF website. You know, we clearly flag, for example, that on site supervision in, in those, regional institutions, you know, went down dramatically. We criticized the regulatory steering, which went hand in hand with the supervisory hearings. So it's not just regulation, but also supervision. And, you know, as I mentioned earlier, there was a clear shift towards improving supervision and regulation as well as resolution and crisis management of the largest institutions. But the hearing was about, you know, proportionality in a way, you know, that that lowered the standards. So I think what we said back then is very consistent with what has, unfolded, since then and again, I think that, the legal basis on regulation, things need to change, but on supervision, they're very strong legal basis. And it is the culture, the management of the supervisory process that can be enhanced, dramatically.

David Wessel Bill from your point of view as a banker. Seems to me in regulation of banks as well as many other things, we have big pendulum swings that Randal Quarles is different from Michael Barr. The FDIC is different under Biden than it was under Trump. The OCC, the comptroller is different. The whole system now, and this is true and other regulatory agencies, seems to swing from place to place with who's in the white House. Is that a problem for you?

William Demchak Yes. It's hard to plan and run a business on four year cycle, right? You know, we've been in business 165 years.

David Wessel And you want to respond to Carter's.

William Demchak I'd love to. PNC introduced something called low cash mode. I'll take your word for it, four years ago. It seems longer than that. But, basically an overdraft product that we built because I felt at the time we were hitting customers with fees almost by accident. We called them gotcha fees. They were somebody didn't intend to pay later. Overdraw. Something didn't clear. And, you know, they had plenty of liquidity somewhere else. And we charged them a fee. So low cash mode. That's how we responded in other banks put grace period in got rid of de minimis amount. So basically where overdraft is left in the moment is a place where if somebody overdrafts a PNC account, they're making a conscious choice that that is their best financial decision to do that versus be late on a car payment or not pay their school taxes or do whatever their other things are that they're going to do. That has morphed into what at least one regulator calls junk fees, which has become a popular term, which is, you know, frankly, wrong. Banks have a right to make money. We need to disclose how we're making money. And it should otherwise be fair. And by the way, if it isn't fair, there's 5000 banks. We compete, in so many a lower price. So I just want to distinguish. We shouldn't charge a fee because you didn't understand it. To me, that's a gotcha fee. People don't understand, I caught him. That's a bad thing. And that's what we stop. I think that's very different than charging legitimate fees for legitimate service. And I think one of the issues that is playing out, at least in this administration, is an attack on any fees in banking, which ultimately leads, in my view, to bad outcomes, particularly for the smaller banks who don't have many fee streams to begin with.

David Wessel Thank you. So with that, Congressman McHenry is here. So please join me in thanking the panel. And I want to thank you all for being so, succinct and thoughtful. And please don't get up off your seats because the next act is about to begin.

Aaron Klein Good morning. I'm Aaron Klein. Senior fellow Center for Regulation and Markets. And it's my pleasure. Join me in introducing Chairman Patrick McHenry. If you don't know who the chairman is, you're probably in the wrong room. But, for those of you,

who need an an introduction and those of you watching at home are online. Chairman McHenry is served as chairman of the House Financial Services Committee. He served as acting speaker. This is wrapping up his 10th term in Congress representing, North Carolina's 10th district.

Aaron Klein North Carolina's 10th district, ten terms, rising to be chairman of the Financial Services Committee. Acting Speaker and, now this is your swan song. You will not be standing for reelection. That's right. And so now we can tell it like it is, right?

Patrick McHenry I've been doing that for a while, you know. Everybody says, well, it's because you're not running for reelection. I'm like, no.

Aaron Klein It's it's it's true. So, so I mean, you have an amazing reputation for being a straight shooter and a town that's getting a little, some would argue more crooked, as time goes on.

Patrick McHenry Squirrely.

Aaron Klein Solet's start right with, with, the real question. A year ago, we had a bunch of banks failing and the government, Treasury, the FDIC, the Fed broke the glass, rang the alarm bell, invoked systemic risk authority. Some, including myself, would say, bailed out uninsured depositors. Did they do the right thing?

Patrick McHenry So there are two elements to this. One is in the moment of crisis, and then the other is what comes thereafter. Right? So two elements . And the first, they did well, because it calmed the crisis. In the second, not so good. So let me dive into this.

The FDIC, should have an informative time, been able to take quick and effective action. Number one. Number two, the Fed should have provisioned for the discount window much more quickly. So I agree with, Chairman Powell when he says the Fed Response was clunky. Right? And an immediate piece of it. But when Secretary Yellen stepped in, that calmed the waters significantly. And eventually we got to a good place. I think in the immediate question there, it was to calm the waters and stem the tide. And I think that happened, it was way too much drama, for what we're, now a major banking crisis of two banks, right? Without any great contagion beyond this. They had an obvious hole in their balance sheet that was visible to everyone. So to me, as a policymaker, transparency was the key there. And we've got some takeaways on, on the discount window, the operations of the FDIC and the Fed, where they obviously failed in that moment in those days. They did not, act in an appropriate fashion commensurate with the rules that they had. And because they didn't do that, it had to then graduate up to, really, Chairman Powell and Secretary Yellen stepping in to calm things when it should have been done at lower levels.

Now, the second piece of it. So, in the immediate piece, we all rallied to say, let's just be calm. We can get through this thing. The long term question is the regulatory response to that, which was a failure of two banks with a hole in their balance sheet visible to all investors. Right? Actually, one hole in the balance sheet. And that, Silicon Valley bank being the shrapnel and the projectiles taking out other banks. Right? A total of two other banks they took out. But the response to that is additional capital, which was not the issue at stake. Not the issue of regulatory reform and not the proper learning from the crisis. So that part, I think, is a we get a failing grade for the response. And the response is to raise more capital for institutions that were not affected by this and actually performed quite well in the moment of, trepidation crisis in March last year.

Aaron Klein So on the prior panel, PNC CEO Demchak was pretty clear in saying that at an OCC regulated bank, the hole in the balance sheet that you're referring to on SVB would just not have allowed to happen. Immediately after the crisis, the Federal Reserve promised, quote, an unflinching, end quote review of its regulatory practices both at the San Francisco Federal Reserve Bank, which regulated SVB, and at the board, which had regulatory authority delegated to the San Francisco. How would you grade a year later, that unflinching review.

Patrick McHenry Self-referential. It is my review of of how restrained I was at my third trip to the salad bar. Actually, not the salad bar, but I view that initial response, of their review. This is the reason why we have checks and balances in our government. This is the reason why we have other people do after action review, not the people that actually committed the action. And I think it was, a self-serving report, with a conclusion that is disconnected from the reality of the situation. So I don't grade the Fed and Barr's report, very, very highly. I think it is an attempt to justify what Barr otherwise wanted to do.

Aaron Klein What steps do you think the Fed hasn't done that it should in the years since the failure to reform itself, because the Fed says it answers to Congress and you, being the Chairman of one of the two committees of Congress that it it answers to.

Patrick McHenry Okay, so let's separate this out. So Congress has created the Federal Reserve through law. We created the Federal Reserve. We gave themthe ability to take on monetary policy. We gave a substantial amount of governmental control that was done poorly in America, for well over a century. And we actually created a monetary body for that purpose. So I think independent rate setting and monetary policy is a very good, very good thing. Number one.

Number two, independent regulatory policy is really stupid and not conforming with law in any country on the globe. So we have to have proper oversight of regulatio. In this question of functionality in March, there are a couple of things we know. And some of this matches regulation. Some of it touches monetary policy. But, Silicon Valley Bank should not have failed on a random day of the week. We've not seen this in America. And, it's got we've got to go back, many generations for us to see something like that happen. So why? Well, the discount window closing at a time that didn't conform to the reality of the stress in the market. Well, this is kind of an obvious thing. Can't you open up the discount window? Well, in the reports we get, and we're trying to dive in a little more here, but they said, well, we picked up the phone and we had we had assets over here because we've got these folks that hold mortgages through home and banks, and we thought of them as the discount window for fast provision of capital. That's not what they do. So you're using these systems in an inappropriate way then the discount window. Well, I'm sorry, we didn'tactually have our capital positioned to use the discount window. Excuse me. And you're on a phone. Wait, so you're telling me this is not technology enabled? So on the front side of this, you have a fast bank run based off consumer tech, which is how we live. And on the back end, the banks are getting provisions of capital at the way they did in the 1940s. Well. They're using the phone a little bit better now, right? And it's cheaper to use the phone, but they're still using a phone. You're kidding me, right? So why don't you have bank capital provisioned with the discount window? And they know what's on your balance sheet and saying, we can take care of this. Should be a push of a button rather than phone calls, and it should be done in an instant rather than days. And so that piece they didn't fix, and this is an operational question of operational competence. The FDIC in resolving this institution, they had a weakened and they dithered. They delayed. They couldn't make a

big decision in that first weekend. We should have been done with this bank run. We should have been done. It shouldn't have taken Secretary Yellen and Chairman Powell to step in in the second week. This should have been done by the operations of the Fed and the regional banks. Number one. Number two the FDIC being competent and capable in resolving institutions, that's not a complex resolution. This is not a complex resolution of those two banks. This is something that could have been done in the 60s or 70s with less drama than we just had, and in a tech era. So we've got to update technology. We have to make sure there's operational proficiency and excellence at these institutions of government that are very key and vital. So technology operational effectiveness are key takeaways. And what was completely lacking in that moment.

Aaron Klein So it's right because it wasn't just SVB, Signature Bank almost failed on a random day of a week because when they went to wire money Fed wire was closed. And you say, well, what do you mean it's closed? Well, we decided to close at 7 p.m. or 6 p.m.. You know, others have said, well, why isn't this thing open 24/7? Why isn't it open longer? I wrote a piece with George Selden from Cato in 2020 saying, run a third batch of these systems, don't close. And that almost tripped a totally different bank. So it's not just that, but starting down the path to real time payments makes me become insane. So I'm going to resist the temptation and stick with the different point you raised, which was over the weekend. People forget that initially, the FDIC announced a bridge bank, which is a standard resolution, which meant the uninsured depositors, which was basically all the money at the bank, which was basically, big tech firms that weren't retail people. Silicon Valley Bank had four branches. This is not a regional bank like PNC or the other big regional banks they usually have, M&T, I'm a Maryland guy, that used to be the old Maryland bank, about the same size SVB, a thousand branches. This were fancy VCs with big dollar amounts. The largest depositor was Circle, a stablecoin, $3.3 billion. Ironically, the biggest risk to their stablecoin that weekend was the money they had at the bank. In fact, if you look at the market because there's a really weird thing that the largest depositor was running a stablecoin, so you could actually see what the market was thinking in terms of losses was down to $0.87. Not very stable over the weekend. That being said, then they got bailed out. They got the $3 billion of taxpayer money will come out of deposits, which will come out of fees paid by all of us. So you've been deep in this stablecoin world. What do you think of the fact that in the stablecoin world, the money was in the bank, and the bank was a source of risk? And how did that play into the fact that it was over that weekend? Then the bail out came. Had that bail out not come? I don't know what would have happened.

Patrick McHenry But let me say there are two items here that are vital. And then a third kicker that I'm just going to take the opportunity to throw in. Thank you. It's good to be here. So, number one, you have a regulatory issue here. You have the Fed putting out to member banks that they have to have an affirmative yes, before a bank can hold digital asset related items. So, and this is their novel products piece. What they're saying to member banks is do not touch this. So for stablecoins that are very narrow market of where they could actually put cash. I mean we're talking about deposits, this is not some novel digital new product, it is cash right? So they have very few places to put it which then enhance risk. So that Fed decision actually narrowed the number of banks which made it riskier, which meant that Circle, instead of spreading that 3.3 billion over 100 institutions, could have only spread it over a handful of institutions across the country. So that is a regulatory question primarily, number one. Number two, this is the reason why we need a Federal law. We have no Federal law on what is a stablecoin. There's no definition under Federal law. The only thing we have is a money transmission license. That's the only thing that relates to digital assets to repurpose, for digital assets. So that is not conforming with

a great country, the greatest economy in the world, with the safest banking system in the world, the most diverse and deepest capital markets in the world. It is stupid policy. So we're trying in a bipartisan way, trying to fix what is a stupid set of policy we currently have.

Let me go into the kicker here, which is SAB 121, an accounting rule by the Securities Exchange Commission that is saying, those folks that are engaged in digital assets have to hold digital assets on their balance sheet rather than in custody. That is a very bad policy. It is not safe for consumers, number one. So if the institution fails, that puts at risk their product that they think is being held in custody for them. Number one. Number two, this doesn't conform to long running, accounting rules. Not that people broadly care about that, but care about the effects of it. And so we've got to fix that bad, securities exchange law that has a bad effect, across financial institutions and taking digital assets, many of which have been around for a decade. And taking them out of mainstream finance and making them in a riskier set of finance. So there are things that we should resolve as Congress. And with stablecoins, we can resolve the regime specifically. But the Fed has to resolve the issue of institutions that can touch those deposits.

Aaron Klein Let's pick up on this concept of deposits and also the rule of law, because that really is Congress's authority is the rule of law. The rule of law is that deposits on over $250,000 are uninsured. And if your bank fails, those are potentially at risk. Since this turmoil of the three banks in March and then First Republic, there have been two small banks that failed. Both of which were purchased in assumption, resolved at pretty large loss risks. But the rule of law still out there. When is the next depositor uninsured depositor going to lose money in a bank failure?

Patrick McHenry This is a bad take away from the lack of proper operational control at the FDIC. And, what I think is Chairman Gruenberg not being willing to make the big decision the first weekend, he eventually made the big decision. I think he did did well in the following couple of weeks. That initial weekend, though, he clearly failed. But in the following 2 to 3 weeks, he did make very difficult decisions. For somebody with his record. To fix the, then resolve these institutions. So, the bad takeaway here is that a failed institution is completely backstopped based off some arbitrary line in the sand that the Treasury and the FDIC just dreamed up. That is a very bad take away from this crisis. We have to make it clear that uninsured deposits are uninsured. Number one. Number two, we also have to make it clear that usually all depositors are made whole. In bank resolutions. It's a rare exception where you have account losses. But we've had zero account losses for those that are insured. So I think we have to ensure that, the customer actually knows, what's at risk. There's a lot of discussion with the FDIC about and getting data flows on what is the proper level of FDIC insurance. 250 is an arbitrary number, completely arbitrary. The 250 number, the origin of the $250,000 deposit number. You know this.

Aaron Klein I do, I lived it .

Patrick McHenry A pay for for Dodd-Frank. It is Congress burping this up because the CBO gave us a score that 250 could help pay for the regulatory costs of implementing Dodd-Frank. Number one, they undershot the regulatory cost. The CBO did. And they've overshot. Well, it's just an accounting game. A shell game for the CBO on 250. So there is no science behind 250. There's no art of measuring this against risk. I am happy to review this. I'm happy to understand this, but it needs to be data driven rather than the instant reflex that many policymakers had to ensure everyone ad infinitum, which would then nationalize our banking system, which is an absurd take away.

Aaron Klein It's against, I've written about this, the principles of FDR were to protect the little guy, not the venture capitalists with 500 million bucks in the bank. I'm sorry, Bill Ackman. Your money is at stake. If you don't want to add stake my treasuries and companies in corporate treasuries. I'm sorry if that's your job. That's that's your job. When when 250 was made final under Dodd-Frank and it was first proposed, as a as part of a vote sweetener for TARP when TARP originally went down, in the House, you were there it wasn't a pretty day, and there was no plan B, and over a weekend, what do you do to get more votes? Well, small banks tend to like deposit insurance, and people are afraid. And they're, you know, reports of runs. So which is why. And, you know, Reagan moved it from 40 to 119 80. So that's 2.5 X hadn't moved since then. Paul Saltzman asked the first panel what prospects there are for deposit insurance reform in Congress, and there was a lot of chatter a year ago after all of this. Chatter seems to have died down. Is it fair to say there's not going to be deposit insurance reform this Congress?

Patrick McHenry Highly unlikely.

Aaron Klein And then when will it be?

Patrick McHenry Well, let's let the data drive this. So we don't have we don't actually have economic analysis to dictate a term. We have this idea that we're going to have, payroll accounts protected. Well, how do you do that? How do you judge what is a payroll account and what's not? What type of business account? All these other questions of of basic implementation, which look, as policymakers, we usually don't get into the practical question until very late. But on this we need to start with a practical question. Like what is the effect? And we need to let economic analysis drive that question rather than just, reflexive politics.

Aaron Klein Economic analysis may drive the number lower rather than higher. I don't know if politics could could withstand that. Let me ask you. You brought up the home loan bank system, and it's incredibly important for people to realize the single largest borrower of the San Francisco Federal Home Loan Bank was SVB. The second largest borrower was First Republic. These folks rapidly ramped up their borrowing as the first panel. I think Susan, mentioned they in collateral pledged there, etcetera. That bank that failed in Kansas, one of the two tiny ones where the CEO got scammed by a crypto scammer went from 0 to $20 million, which is a huge amount in 30 days. They'd never touched a home loan bank loan. They're cratering because the CEO stealing money, they're run into the home loan bank, right? For advances. Nobody seems to think this is an issue.

Patrick McHenry It's as if they don't have regulators. Well, but I mean, there's this great discussion in March, April, May of last year. The tailoring is bad. Well, tailoring is this. You have regulators, they go this looks questionable. We're going to go ask questions here. This is seems to me like maybe part of our job. So if you have a rapidly increasing size of an institution, Silicon Valley Bank met that metric, they should be looked at. The Fed had that authority to look at them in an enhanced way, they did not.

Patrick McHenry So to say Congress needs to change these authorities. Well, wait a second. You actually had these authorities. You didn't use them. So let's go talk to the person who made the decision like, oh they're fine. You have a you have an institution that triples in size in a very short period of time, in Silicon Valley Bank, and there's not a second look. this this is absurd. So the threshold questions that we've been debating in Washington. Is it 50, is it 100. Is it 250? What's the right size? That is not conforming with risk. You can have an institution that is, there's doing very unsafe, very unsound things.

That is smaller. They should be looked at in an enhanced way and in larger institutions, as we saw in March. Some of them performed pretty damn well. Not the takeaway I had in 2009 and ten of the effect of Dodd frank. But in one way it was that the largest banks were assumed to be bailed out. So those depositors from smaller institutions went to where they could get the bailout. We shouldn't have the takeaway that all institutions over some thresholds have that same government guarantee. I think that's a bad takeaway.

Aaron Klein That was the logic when we were doing Dodd Frank, of putting the number at 50 so that folks over the threshold would be allowed to fail without bailouts.

Patrick McHenry Yeah, but on this, Congress always comes up with some art. They said, look, economic analysis said it's 50, right? They don't come up with an economic analysis. Congress never does this, where they come up with economic analysis and they say it's 37.5. 39. We always do. We says it's 10, 25, 50, 100. Well, maybe I'm dealing with my pre-K child who's doing skip counting. But that's what Congress comes up with. We need to let the economics drive that question rather than some arbitrary threshold.

Aaron Klein Do we? I'm going to turn to the audience here because I'm sure there are a lot of folks that have other questions. But on this point, on the home loan banks, do we need to reform how the home loan bank are regulated? I mean that the Federal Housing Finance Agency has come out with some proposals. The home loan bank system has been at the heart of multiple failures. If you look at the bar, the top bars from the home on bank in 2006, it was Countrywide, WAMU, Bank of America. You look it up a year ago as SVB, First Republic. I mean, I'm noticing a trend here.

Patrick McHenry But it's the only GSE that did not fail during the financial crisis.

Aaron Klein Well, so failure is an interesting definition when you're first in line in the creditor queue. Do you think do you think Congress needs to revisit the statutory reform system for the home loan banks?

Patrick McHenry I don't think that's the priority right now. I think we have to make sure that the Fed, the FDIC, those you see are functioning at the highest levels with the greatest capacity possible. Look at the scandals of the FDIC of supervision. We've not updated our view of supervision. We've not pushed these regulators to use technology rather than deploying people into conference rooms to go do data pools sitting on site. What do you have to do? A data pool sitting on site when we have this thing called the internet? Right? So we have to have a holistic review of supervision to make sure that's right. And along the way we'll see how we have to move these things. The idea that we have this competing set of regulators, to do, in essence, the same thing, but one consistently has failures. We've got to review that and make sure that you actually have consistent regulation of our banking industry. So you don't have a barbell banking system, which is the current take away of the regulatory regime, only small and only large. And everything in between is you're dead man walking.

Aaron Klein And I wrote that, I thought, and the consequence of the failure of supervision at SVB should be moving the authority to the SEC. That was my that was my opinion. But I'm sure folks in the room have opinions and questions. No opinions, only questions.

Patrick McHenry Oh, please. It's Washington.

Audience member Hey, Aaron. It's it's on. You've mentioned a couple of times that, you know, uninsured depositors were were bailed out, which sort of, implies taxpayer bailout. But the losses associated with the bank failures were covered by the deposit insurance fund which is funded by the bank. So can you sort of square that for me?

Patrick McHenry Oh, I didn't say. I didn't say taxpayer bailout. I said bailout.

Aaron Klein No, I did. He's yelling at me because the deposit insurance fund is on the US budget. It's reviewed in the Congressional Budget Office. It's like saying the highway Trust fund, which we all pay by gas taxes, isn't tax. Taxpayers don't build the roads, only drivers build the roads. I mean, it's a shell game. Banks are taxpayers. We're all taxpayers. Banks pay that by taking the fees because we all need a bank to live in America. You need a bank account, if you don't have a bank account, life in America is really hard and really expensive. The cost of those things get passed back on to bank people who are taxpayers. So.

Patrick McHenry Well, we also have something we've got to get to the bottom of which is the FDIC tapping the Fed, to bail out the FDIC. And we need more information from the Fed and the FDIC on that decision making.

Aaron Klein So the American Bankers Association just came out with a really interesting paper this morning talking about why was there a 100 basis point penalty that the FDIC loaned. I personally think this had a lot to do with the fact that we were looking in extraordinary measures, and folks don't appreciate, having worked in the Treasury Department in the debt ceiling crisis, you don't get that extraordinary measures are not meant to be normal. And the dysfunction and no offense to Congress, but the dysfunction in Washington and the administration has created a situation where people think you can live in extraordinary measures without creating other ancillary problems that we've never seen in the fact that these failures happened during that period with the debt ceiling. The deposit insurance fund isn't liquid cash, it's in treasuries.

Patrick McHenry I went I went from the bank response to the debt ceiling negotiation. So I had a joyful spring of 23.

Eli Asdourian Hi, Eli Asdourian. I'm a research assistant in the Hutchins Center. Is there a reason that we couldn't index the deposit insurance limit to inflation rather than revisiting it? Every generation?

Eli Asdourian It has been. It is.

Eli Asdourian It's an it's indexed like it sounds like it's been 250 for a while what does it mean to be indexed.

Aaron Klein So we indexed it in the Deposit Insurance Act of 2005 or 6 when we merge the diff and the safe. And if you are the biff in the safe to create the diff, and you wouldn't even believe as a research assistant, there used to be a thing called thrifts. They had different insurance policy. But I swear to God that's true. And so, but but Congress.

Patrick McHenry Has done a very nice job of remodeling the former thrift supervision office. You know, but he went from biff to diff to safe and all this stuff. So, you know, you got your work cut out for it to make sense of this.

Aaron Klein John.

John Holman Hi. John Holman with American banker. So you mentioned that you didn't think that deposit insurance reform was happening. This Congress were highly unlikely, I think was how you put it. I'm wondering whether is that, because is that just a matter of kind of nailing down logistics of kind of the operational questions that you mentioned? Or is there, is there actually is there durable desire, bipartisan desire to actually address, deposit insurance? And a sort of second question is there's also operational problems with the discount window that I think have been discussed at length. Might those go a long way towards solving the kinds of problems that deposit insurance reform would be designed to solve?

Patrick McHenry Yes. Yes. Let's just start with that. I mean, the the discount window, the provision of assets for using the discount window. Has to. The speed has to increase. That doesn't mean the Fed needs to hold additional capital. The Fed has a way to engage the market as it is now in my view. But they should know what member banks have. And member banks should have a strong understanding of how they can quickly and I mean within, within hours, at a minimum, within hours. But actually it should be much faster. Within minutes, they should be able to, have, their assets and the discount window linked up and the Fed should know. Now, we do this all the time, right? We do this all the time in the financial markets. And real world players do this. The Fed has to keep up. And they're a generation behind here. Maybe more. The conversations around deposit insurance, are not intense. They have not been intense since the spring of last year. What I focused on is making sure that we understood the facts as they were before we actually took action. Let's measure twice and cut once. And and I think I've been I think that has been borne out. I think we have regulators that have enormous capacity granted to them. Some they didn't use correctly. We need to understand why they didn't utilize their powers. And in a moment of crisis, let's understand that that question. And if it's the wrong person in the seats making the decision, if it's an operational question of somebody, making a bad decision. Well, look, I mean, unfortunately, we still are in the people business here. We have to put people in in positions of power. I have to say this to my Republican colleagues in the House all the time. Well, the administration, you know, elections have consequences. And the consequence here is the president gets, the offer to the Senate. The point is, he or she wants and they get to go run those departments. They may do well and they may be competent, and we may have a nice regime. There's some examples in this administration of that. And there are also some examples in this administration of folks that are, who are deeply incompetent, running important agencies of government. That's the risk. The president is the one who has to answer for that stuff. And, that's the reason why I think having somebody like Janet Yellen at the Treasury Department, who has enormous experience, enormous capacity, has been a great benefit to this administration on that financial stability question. And I think that that sent the right, like, send the right message to folks like me that they're serious about, about, you know, about making sure that we have a well-protected, financial, marketplace.

Aaron Klein Well, Chairman McHenry, let me, on that note, thank you for your great service to your constituents in North Carolina, to the U.S. House, to the entire country. As you point out, you've been at the helm of the Financial Services Committee and a major leader in the House through some very difficult periods, you've shepherded the nation with your best judgment and wisdom. And on behalf of myself and everyone at Brookings, thank you for coming here and sharing both of those with your your service.

Patrick McHenry Thank you. Thank you. Thank yall.

Aaron Klein So as the chairman departs, I'm going to move over further to my right. You see, his his wisdom has already infiltrated me. And invite the rest of our panelists, up, for the, next conversation. We're going to be joined by Jarryd Anderson, who's a co-chair for financial services at Paul Weiss. And, importantly, here, was first counsel to First Republic, as it was being purchased by, JP Morgan Chase. One of the major, situations, ramifications of our of our bank failure system. Alexa Philo, who's a senior policy analyst at Americans for Financial Reform and who spent 12 years as a examiner at the Federal Reserve. So we talk about supervision and what it means to actually, regulate banks on the ground. And we have a we have a real life former, supervisor, an examiner, and Gary Cohn, who is vice chairman of IBM, but, as well known to everyone, from having served as chairman of the National Economic Council, under President Trump. So thank you all here for joining us. And so let me start, by setting the framework, what actually happened a year ago when these banks failed? Jarryd, you were in the room. You we're in the room where it happened. What what what went down?

Jarryd Anderson Yeah. So, first of all, Aaron and, the Brookings Institution just want to thank you all for for having me this morning. I think this is a really timely, conversation to have. And as we approach the one year anniversary of the, failure of Silicon Valley Bank and Signature, I think it's important to reflect on, a lot of the lessons learned. You know, the first thing I want to say iis the regulators performed incredibly well during very challenging circumstances. Being in the room and part of the boots on the ground. Folks in Washington, folks on site examination teams, worked around the clock and trying to address a lot of, the challenges and, calm some of the stress in markets and among depositors. So I just want to recognize our efforts at the outset, I think just a level set for the audience. So from March through May of 2023, we saw the three largest bank failures, or the second, third and fourth largest bank failures. And MassMutual obviously was the largest one, in the history of the country. So First Republic was $213 billion, Silicon Valley Bank, was $209 billion and then Signature was $109 billion bank. So that that sort of leads us to, the events that took place, in the lead up to the failure on March 10th, we had Silicon Valley bank attempt to, do a capital raise that was was unsuccessful. We saw a failure of credit rating downgrade and then $42 billion of deposit outflows on that on that Thursday. On Friday morning, the California Department of Consumer Protection and Innovation and the FDIC, well, it appointed the FDIC as receiver and then they closed the doors on the bank. Now, what makes that quite interesting is that in the ordinary course, you closed banks on Friday afternoons at the end of the banking day. And the reason for that is to limit anxiety and contagion and lines outside of bank branches for consumers who were clamoring to have access to their deposits now because of the significant outflows on Thursday, evening of 40 plus billion and the expected, withdrawal of another $100 billion of depositors, the FDIC and the CDFPI made the difficult decision to close the bank on Friday morning. So then you have all this sort of confusion. People don't have access to deposits, what you generally would like to avoid. And then you have a resolution weekend in the ordinary course where, the FDIC actively looks for buyer of that failed institution, and if not, then they just stand up a bridge bank, and the bank is under the management, and oversight of the FDIC. But the bank continues to run and operate in the ordinary course of business on Monday. So there's no real gap in a customer's experience with the bank. That didn't happen as smoothly as it ordinarily does because of a closure on Friday morning. And then the FDIC stood up a depository institution, National Bank, which is like a separate entity that only holds the deposit and then Signature failed that weekend as well. And then they set up a separate bridge bank for Signature. And, I think that leads us to why the government invoked the systemic risk exception, to sort of, limit the fear and contagion and to sort of stop the large deposit outflows. And the way that that normally

happens is the Treasury secretary gets a recommendation from the Board of governors of the Federal Reserve System, a majority of the board and a majority of the FDIC board, in consultation with the president, and then waves a magic wand, and then all deposits are protected. So the three keys, or or I don't know if you're turning a key with your finger or not. And then on the same day, on Sunday, when they announced a systemic risk exception was invoked, the Federal Reserve established a term bank funding program, which is emergency, liquidity facility. But the two big policy issues, just to round out my comments that, folks in Washington were most concerned about was, are people going to have access to their cash deposits on Monday? And are people going to get paid on Friday? And with a $250,000 cap and deposit insurance, that raises a lot of interesting policy questions.

Alexa Philo Yeah. I just, I just wanted to put out there that in the sequence of events, that led up to where we are today in the use of the systemic risk exception. There was an important dynamic going on that created the run. And part of that was with the sale of those securities, and then.

Aaron Klein Available for.

Alexa Philo Available for sale securities, which, by the way, I don't think they would have sold as quickly and readily and taken the profit if Volcker had been robust. And, and what you have when you have, a sale of securities, taking the losses and then immediately going out and looking for capital, that's a real signal there. And I just want to call out that when things get tough, depositors and investors look for simple measures. Simple, simple, simple. What do they look for? They look for common equity. What do they look for? They look for that leverage ratio. So we can talk about the failures of the, you know, the sequence of events and where it broke down and the failures of the systemic risk perception. But I also want to put out that criticality of capital with those regional banks, particularly around those underwater securities.

Aaron Klein The I mean, the bank was dead in November. The Wall Street Journal had a front page story showing that this thing was totally dead. Yeah. Nobody ran. Yeah. Nobody ran. Then some VC slacked six companies to head out and everyone went for the door. And then that VC went on Twitter and begged to be bailed out.

Alexa Philo I mean, if you have trouble raising capital. You have a capital problem. It's just that's, you know, and that triggers those runs. And until we address that fundamental fact, I believe those runs are a fact of life, no matter how hard we try with that systemic risk and orderly liquidation.

Aaron Klein Yeah. So let's stay on that because I, I'm old enough to have worked on, Dodd-Frank and Dodd-Frank promised to end these bailouts, to end these open bank assistance where all depositors were were bailed out out of the taxpayer funded deposit insurance fund. They set up this whole title, two regime for Orderly Liquidation Authority, which you just referenced, and there was all these new tools in the toolkit, and they sat there less opened then the like worst gift my kid ever got at a birthday party that just got put on the shelf and never touched. Does what happened show that Dodd-Frank didn't work?

Alexa Philo My single answer is no. Dodd-Frank had many, many important, contributions to where we are today, and we are better off. Is that enough? No. We have a longer way to go, including with capital. And yet, what we find is, is that without that, long term debt has

not solved the problem. These other, you know, a better resolution plan has not solved the problem. What I'd like to suggest is that, that Dodd-Frank introduced key pieces, systemic risk framework, orderly liquidation, a barrier to the non-bank sector. Whereas now we have our banks, our largest banks have $1 trillion of exposure. What does that mean when we backstop our banks now? Are we backstopping that shadow bank sector as well? So I feel that Dodd-Frank put us in the right direction. But you needed that long term commitment, long term commitment to make that orderly liquidation authority work. I know this is probably blasphemy, but it may be, expensive to fund it in advance, but if it was funded in advance, it probably would have a greater chance of working. And I find similarly, in, some of the resolution plan strengthening, there's still not enough, there's still not enough capital and liquidity in that resolution scenario, whether it's single point of entry or multiple.

Aaron Klein Gary, so you know, implicit is, is we didn't stick with Dodd-Frank enough. We heard, in the first panel criticism of, of the, Dodd-Frank rollback or the tailoring often known as S - 2155. I don't know why some bills get names and other bills stick with numbers, but that was a signature achievement of the Trump administration. And people are pointing the finger at it is, is S-2155 to blame.

Gary Cohn Well, that would be wrong. You mean the bipartisan 67 vote piece of legislation? I don't think anything else got 67 votes in that two year period. That piece of legislation to tailor regulation based on a bank's activities, saying that if you're a small bank in Iowa and you don't trade securities, you don't underwrite securities, you don't market make, and all you do is take deposits, make mortgages, and have credit cards, you should have a different set of regulation than Goldman Sachs, JP Morgan and, you know, you name your favorite G-SIB. All that did is make it so that the small regional banks could have a tiered set of regulation. There was nothing in that piece of legislation that had to do with capital. And I think anyone that wants to blame this on that piece of legislation would just be wrong. I mean, it's just it's just a false statement. So I was going to say and listen as long as I could because it's more entertaining to listen and to speak. You know, I think I think people conflate liquidity and capital. And there's a big difference in banks. Very few banks ever run out of capital. Every bank gets close to or does run out of liquidity. Even if you go back to the Lehman Brothers days of 08. If you had capital, you've got you basically got all your capital return to you. Even though they had no liquidity, they had capital. So this is an issue of how much liquidity you have and how much liquidity you have at the moment. My other comment as we're sitting here arguing Dodd-Frank or not. Like I think Dodd-Frank is really interesting, a pretty good piece of legislation if you're dying of old age. Dodd-Frank knows how to deal with dying of old age. If you just fell out of a helicopter and you need a trauma one center and you need immediate care and the body can be saved. I don't think Dodd-Frank deals with trauma one care. It deals with death and dying, and it deals with, you know, how we do orderly liquidation. It doesn't deal with, okay, can we, you know, glue the bones back together? Can we put screws through the legs? Can we attach the arms and we can we keep the body functioning?

Jarryd Anderson Yeah. I generally tend to agree with Gary on this one. I don't see at all that, that that's S-2155 or the tailoring rules are really to blame for the failure of Silicon Valley Bank or Signature. And I think it's just also really important a level set on like, what's S-2155 is for the audience. So in Dodd-Frank, the SIFI threshold was a solid dotted line at $50 billion of of assets.S-2155, raise that solid line from 50 billion up to 250 billion, with a dotted line at 100 billion, which granted the Fed, discretion to subject those banks between 100 and 250 billion to these enhanced prudential standards requirements, which are automatically triggered at that new $250 billion threshold. So, you know, I think the questions, and issues that have sort of come up in this ongoing debate around would the

tailoring rules have made a difference for a Silicon Valley Bank and it's available for sale portfolio, and regulatory capital requirements, the LCR.

Aaron Klein Liquidity Coverage Ratio.

Jarryd Anderson Quality control, liquidity coverage ratio. One thing you get at Brookings is a big bowl of alphabet soup whenever they host a panel. So there are, acronyms and initial isms galore. But, yeah, the liquidity coverage ratio and and based on the tailoring rules, even if Silicon Valley Bank had been subject to them, which I think the LCR was around 75%, the tailoring rules would have required 100. But to be able to stop the run, and fix the bleeding of, of the outflow of deposits. So their LCR would have had to be twice the regulatory limit, which was was 100%. So they would have to have a 200% LCR. So, I think to suggest that like these, these problems are too complicated, there are multiple points of view on these things. But to zero in on the, the tailoring rules or S-2155 as being the culprit for the series of bank failures we had last year I think is a little inaccurate.

Alexa Philo Yeah, sure. Well, first of all, I want to just clarify that the Fed did have risk-based supervision before the framework was introduced. And the banks in the band, that was the same as SVB. They're not small regional banks. They're large banks. And if one of them were to fail and you were to combine two of them, that could very easily go into the higher categories of supervision. So you had these large regional banks that have have experienced challenges in the past. And you had liquidity and capital not sufficient for the systemic risk that they actually had an impact on the system. If you have 3 or 4 regional banks with the same vulnerabilities or similar vulnerabilities, that high reliance on uninsured mdeposits, that, lack of clarity what's on their balance sheet, whether it's VC, venture capital, they probably wouldn't have built up to those concentrated levels if Volcker hadn't been rolled back, or whether it was that intensive reliance on those concentrated uninsured deposits. Irrespective when you have a number of regional banks, some of them large regional banks with similar patterns, that's where investors and depositors pulled back because of the similar patterns of increased excessive concentration due to reduction of those barriers that separated banks and shadow banks and allowing them to get outsized concentrations. So it's hard not to talk about capital when you have those outsized concentrations and so on that resulted from some of those rollbacks.

Gary Cohn All right. So as I understand it, the high concentration of systemic risk at SVB was too many deposits. I think we all know. They had too many deposits. Were coming out of Covid. Companies had to shut down. The government had put a lot of money into savings accounts. SVB had a huge deposit bank account. If you're running a bank, and I ran one for a lot of years, and you have a massive, inordinate amount of deposits, your Federal regulator tells you to do one thing buy zero risk weighted assets. There's zero risk rated because they have no risk. Zero risk weighted assets, for those you who don't know, are U.S. Treasury bills because they're full faith and credit of the U.S. government. What did SVB buy? Zero risk weighted assets. They bought U.S. Treasury bills. Now, then we have this. I would say I won't say once in lifetime. I'd say second in my lifetime event because I lived through the Volcker days. We had, I'm older than most of you, we had a second in a lifetime event. But in a absolute percentage move, probably a bigger interest rate move where we go from 0 to 500 basis points in six month Treasury bills and one year Treasury bills. And all of a sudden you take that zero risk weighted asset that your regulator told you you're supposed to buy. And we're going to tell you to hold no capital against it because it has no chance of failing. And all of a sudden, because of some quirky circumstances of not being able to raise capital because some people want their money out, you have to start selling Treasury bills at a loss that you know if you can hold the

maturity of $110, you have to start absorbing losses. And when you absorb losses, that's when you go to the capital account. The capital account at a bank is there to absorb losses. And so I think we really have to understand they bought these Treasury bills because they had to pay their depositors something, and they needed to get an equal and opposite rate of return. So I think the regular regulatory reports, if you read them, it clearly admits that the SVB management was asleep at the wheel. But equally, equally, the regulators were asleep at the wheel. You know, it's okay to buy the Treasury bills. You should buy the Treasury bills, but you should put an interest rate hedge on them. They forgot one of the major components, which was hedging the interest rate risk.

Aaron Klein So let me be clear because you say zero risk. You mean zero credit risk.

Gary Cohn There was zero risk weighted assets when you look at your Federal Reserve reporting requirements and for risk weighted balance.

Aaron Klein Right. But when we're saying risk for the audience, we're meaning, there's zero chance there's going to be a default. It doesn't mean there's zero chance the value of that asset, if you go to sell it, will have gone down. There are two different types of risk and often we use the word risk, like bank. There's a commercial bank, investment bank, we just use the word bank right? Zero risk from the Treasury department, as you said, you get paid back plus interest stated on the note. There is a risk that if interest rates go up, the value of your asset will fall. And that's the risk that existed was not in the regulation, was not hedged by the bank. Actually the bank had a hedge and then sold it. Because hedging is expensive and and they needed some bonuses and some returns for shareholders. So we just focus on.

Gary Cohn They also had no risk manager. He or she was their climate czar at the time. That was more important.

Aaron Klein You're talking for the SVB?

Gary Cohn SVB. Their climate czar was more important than risk.

Aaron Klein So let me ask you a question about for the depositors, because that's the other thing, right? The depositors that were a wash at these banks were corporations, not people. There were 90 plus percent of uninsured depositors. Was heavily corporate.

Gary Cohn I don't want to pick a fight, but corporations are people.

Aaron Klein I'm with you. The question I want to ask is when will the next uninsured depositors lose money? I asked this to the chairman. He said we have a structural problem here because the law says that they will. But he wasn't quite sure when. You guys, I mean, it's 2024. It's a year after SVB, how long will be till the next uninsured depositor loses money?

Jarryd Anderson Yeah, I think I think this is a really tough question. Chairman McHenry mentioned on during the last session that the answer to this should really be data driven. And I think that there's a fair amount of empirical research that just sort of hasn't been done yet. Because to make a determination as to whether or not you cover all deposits or just uninsured deposits. And revise a system is really a determination on how much that actually costs. And who should be responsible for bearing that cost. So I think, part of the confusion amongst the American public and even some policymakers in Washington is

when you have, a double digit billion dollar loss to the deposit insurance fund like you did with Silicon Valley Bank and Signature. Right? A $16.3 billion loss. The the bank's paid the price for that. Large banks, all above $10 billion, they didn't impose a deposit assessment on smaller community banks for policy reasons. But the largest banks who hold the most deposits in the country pay that cost. So around the time when the bank failed, I heard policymakers even saying that deposit insurance itself, that $250,000 limit, is a bailout, right? Which is a policy position that the U.S. government made following the Great Depression and standing up the FDIC in 1933 to ensure that customers have faith in the financial system. And when stress impacts banks, they don't run to their bank, and contagion doesn't exist. So there are a lot of variables that are at play. And what the, the best structure for deposit regime moving forward is, I think is, is a complicated question. With, a lot of interesting answers. But I think that the economists and, the researchers, that focus on these issues, particularly at the central bank or other agencies, it would be good to spend time, on developing that empirical research to support those policy positions.

Alexa Philo I think that makes sense. And I think what I want to do is I actually want to get back to, speaking a little bit about how this time it's different. We talk about how interest rates went from 0 to 5, and that was indeed extraordinary. And yet we hear this often. In fact, we hear all the time. Well, this time it's different. So you can't say we need more capital because this really wasn't about capital. Well, but next time it's going to be AI or next time it's going to be climate. It's always different. We don't know what's around the corner. And that's the point. And to be measuring ourselves against these outdated capital measurements. I would challenge my colleagues, do those internal models for capital markets and trading work. I think some of us have experience in that area. And if we had a firm grasp on how much capital is actually needed with reliable and consistent models, we might we might be in a better position today.

Aaron Klein When will the next depositor lose uninsured depositors?

Alexa Philo I don't believe they can now because of this systemic challenge we have, the structural challenge, and we end up backstopping part of the shadow bank system because of the largest banks being enmeshed so much.

Aaron Klein Do you think every deposit is insured in America effectively?

Alexa Philo No, but I think the signaling is and the situation is because of the similar vulnerabilities, the risk of, run on, confidence across a number of banks. The agencies aren't in a position to let it happen. The orderly liquidation authority and that systemic risk exception didn't go far enough for it to be viable and strong enough and robust enough. And we can do that but there's a resistance to pre funding, for example, doing the difficult work that takes more money. I'm not really concerned right now with the largest banks bottom line. They have have done pretty well over the last ten years in the period after Dodd-Frank, and I believe that they were set up strong because of the good robust stress test and the elements of Dodd-Frank that were there, did inspire confidence. And, yeah, I feel we lost touch with that as certain things got eroded in that space.

Aaron Klein Gary do you think all uninsured depositors are effectively insured? You've been in the seat of power. Banks failed. Banks failed every year in American history up until 2005 was the first year not a single bank failed in America, 2006 was the second. And the regulators told us what a great system that they devised. It was the pinnacle of bank regulation I remember them telling us, no failures means we're doing a great job. Failures are a natural part of business, right?

Gary Cohn It is.

Aaron Klein When do you think the next uninsured depositor will fail?

Gary Cohn I'm not sure. I'm not sure. We'll see one.

Aaron Klein Do you think we have a de facto blanket system?

Gary Cohn Even I could portray a scenario that's possible, but I think it's. We'd have to portray a scenario. It won't be an obvious answer where the where the failed deposit will come from.

Aaron Klein So does that mean we should change the law and ensure all deposits?

Aaron Klein No, I don't think so. I actually think that would be a horrible outcome. I mean, then you'd have a race to the bottom, then you would have a massive race to the bottom. So then you as a depositor would not care what the size or capital of your bank was. You would only care on the rate of return. So I, as a depositor, would put my money in the bank that paid me the highest rate of return, regardless of the financial solvency of that bank. And I have no burden put on myself. That to me would be a really bad outcome. And I think the extent that you saw banks paying inordinately high rates of return and regulators said, look, there's a substantial fundamental problem with this bank. Now, the regulation should force that bank out of those deposit businesses, and they should make it clear that people will lose their money. That should happen. So we should never allow that to happen. We can't have a race to the bottom. That would be the ultimate worse outcome for everyone.

Jarryd Anderson I think one of the upshots from the banking stress last year is really small and medium sized enterprises, who generally tend to be the primary commercial customers for regional banks. Before Silicon Valley Bank failed, they had one bank. Now they're multi banked. Right? So Joe's Body Shop or the dry cleaners, the family that owns the dry cleaners and they have, they have six different, shops or the landscaping company that has a half dozen trucks, those business relationships that were initially tied to one bank because they processed their payroll and all their business expenses, and they got commercial loans from that institution. I think more and more today, you're seeing, the CFOs and the treasurers who previously had not lived through a high interest rate environment, get smart and in thinking through contingency and ensuring that, their payroll continues to be processed and their business continues to function and operate in the ordinary course do have other banking relationships that they would not have had prior to Silicon Valley Bank.

Aaron Klein So Damien Moore from Moody's Analytics wrote an interesting question. He said, what does a successful failure resolution of a bank look like? I like the turn of phrase, what's a successful failure?

Jarryd Anderson Yeah, I think that's an interesting question. I mean, the the framework that we have today I think works relatively well. I mean, we saw that in the spring. The regulators, the Federal government, has a variety of different powers and tools that they're able to exercise to sort of limit contagion and broader financial stability risk. You mentioned this yourself, Aaron, that, through healthy business cycles, you will have some businesses that do exceptionally well and succeed, and you will have other businesses

that take risks or they don't, engage in appropriate risk management. And they fail. And that's what should happen in America. You have winners and losers. So long as we have, a rapid and orderly resolution system, we have resolution plans for the largest institutions on how you would unwind them in the case of, of a failure scenario. We have emergency triggers that the Federal government collectively can pull to backstop deposits. I think that all of those are really useful tools to exercise in a crisis. And the backstop of the orderly liquidation Authority and title one, I think establishes an even more robust framework for how you would potentially resolve even the largest, most systemic institutions. So, you know, I'm not sure of how much more you can do from a resolution perspective to be able to resolve banks without having an outstretched impact on financial stability.

Alexa Philo Yeah. Thanks. For, in my view, an orderly resolution is one where, to the extent there are core business lines that are healthy, that should be maintained for their value and for the customers that rely on those core businesses, critical services, payments and other critical services, making sure they're open for business. All of these, aspects of keeping that SIFI open in bridge.

Aaron Klein Systemically important financial institution, which is code word for big bank.

Alexa Philo Yeah. Keeping that open in the in the post period in the bridge period. It's unrealistic to think that you can fund and with the liquidity in the capital simply from the long term debt, you know, t lack. So it comes back to a lot of these features would be great, but they fall down, I think, because there isn't a prearranged solution for the amount of liquidity and capital it really would take to sustain the critical services and those core business lines in that post period, which is oftentimes in a vulnerable period, period, frankly, and where there is risk of other, contagion.

Gary Cohn So two points, I'll make the first one quick. Let's not go down the in the new Basel three applied. But if we go down that path, your solution is going to get more difficult because we're gonna throw more things out of the systemically important banks. So that gets more complicated. But I'm going to throw a complete curveball at you. We keep having bank failures. Look, I'm not saying we will ever stop bank failures, but the definition of insanity is keep doing the same thing, expecting different outcomes. Why don't we stop doing the same thing and let's stop expecting same outcomes? We have technology today that could help us. Why don't we start using analytics on predictive human analytic behavior. Like, there's tools today that you can use, in certain industries use, that look at the way people with inside institutions react and act to certain things. There are companies that can monitor banks and see how employees are reacting and are acting on a real time basis. The way that banks tend to work is they tend to work. Once something happens, they tend to react to it. We tend to react to the crisis when it hits. Why don't we try something really revolutionary? And why don't we monitor people's behavior on a real time basis and try and monitor bad behavior and catch things before they happen? So something like Silicon Valley Bank, we would catch the fact that the risk manager wasn't managing risk, that would have shown up in predictive human analytic behavior. We would see that the end of day report that showed risk management reports wasn't going out. There are ways to circumvent a lot of these things. That technology exists. Companies exist today. So my whole view is we're never going to stop a bank failure. There's a there's reasons why banks fail. But we could stop a lot of the the process much earlier and the earlier you stop at the easier it is to resolve.

Jarryd Anderson So can I just follow up on on that point, Gary? How how much of, the data and potential analytics do regulators already have access to and they're not being

forceful enough or historically they haven't. And I think Michael Barr, who's the vice chair for supervision at the Fed, as well as acting Comptroller Hsu, have sort of signaled that we're in a heightened enforcement environment. There's a sort of fast and furious notion behind bringing enforcement actions, documenting them, particularly amongst banks, and that 100 billion to $250 billion bucket. But in the, postmortem reports from the FDIC and the Fed, they pointed to, you know, obviously a failure of management, but also emphasize a failure of supervision. So how much of this is already at the fingertips of regulators and them not acting versus, needing to gather additional information and data to make more informed decisions?

Gary Cohn So the quick answer is I don't think they have any real time, it's all after the fact. What I'm suggesting is there are real time ways to get this data today, and there are real time companies that are providing this data today. And when I used to run a bank, I didn't realize I was doing it, but I was doing it real time. Yeah, like to me, if I got PNL reports or risk reports from every desk by 430 and I knew if I didn't get one by 430, there was a problem. Nothing good coming if I didn't get it by 430.

Alexa Philo Yeah. I think these are, interesting points to be made improved technology. And indeed, I think the Federal Reserve has pursued a lot of the improved data, improve technology. I haven't been there for a while, but I do believe. One challenge I have is that with the changes that were made in the prior administration and, supervision, there was this sort of look away, look away. If it's not illegal to look away, if you're coming on too hot and heavy and too aggressive, look away.

Aaron Klein Do you mean the prior administration or do you mean the San Francisco Fed.

Alexa Philo I mean, the agency heads that were .

Aaron Klein When you say agency or do you mean the the Fed Board of governors, the regional bank, the comptroller? Who exactly do you mean?

Alexa Philo I think that's a really great question. So, just let's be clear. You had, tone from the top, clearly, you had the tone from the top coming from the Board of governors, whether it was tone reflected down to the New York Fed or to the San Francisco was.

Gary Cohn Not Isn't that the same person. Isn't that Jerome Powell.

Alexa Philo Correct. So Jerome Powell influencing the tone from the top. And, you know, what we saw was that there wasn't this close monitoring. There was some sort of suggestion that if there wasn't a ruler that made something illegal, that examiners really should not be looking at it. And that was the tone coming from the top, both with regards to regs. Don't look at it, if it's not illegal. And then internally telling examiners to cool their jets. Those type of cultural changes can take years to remedy.

Aaron Klein Well, I'll say this. I've published in real time a long set of banks that have relied on overdraft revenue for their entire source of revenue. Woodforest Bank has lost money on everything other than overdrafts for a decade through multiple comptrollers real time information, and should close it? I mean, if you had all this magic, this real time information. Should a regulator go in and close a bank that is operating at a profit, but in a way that is clearly unsustainable? Because it's a more muscular government if you have it. I will turn to audience questions in this situation. Pat and Justin, I saw Pat from behind, and we'll work our way front.

Audience member I actually have two. Can I try two. Jared, you were in the room. I read reports, after the weekend that by Friday afternoon, Silicon Valley Bank had found a way to make the payroll payments, which was initially the main source of concern. I thought, was there a way to put a stop to the overkill of the resolution at that point? Or were things just way too far advanced. And the second is, we've talked about no uninsured depositor ever, facing a loss. Would it be credible? Would it would an act of Congress do it, to say that next time the systemic risk exception is used, not insured depositors must face at least a 5% loss or some lower number that covers the FDIC losses. Is that a feasible thing to do?

Aaron Klein You guys can pick which one of the two since Pat asked you.

Jarryd Anderson I can go for the first one. So, like I mentioned earlier, when Silicon Valley Bank and Signature failed on Friday. And I think there's a fair amount of press releases and public statements from members of Congress and particularly the California delegation. Because a lot of those sort of stresses and the bank failures, just so happened to be California West Coast institutions that the question of will people have access to their deposits on Monday morning or people get paid on Friday was a really complicated one because all deposit accounts, regardless of whether they're used for your mortgage or to pay your car insurance or to pay a 1000 employees, are capped at $250,000. So, when you have a bank failure, there are a lot of outgoing deposit requests, particularly when you stand up a bridge bank. So you signal to the public that the FDIC is now in charge, you install a temporary CEO. So the bank continues to run and function in the ordinary course, and the banks and the FDIC says the bank is open business as usual as it was on Friday. Now, a lot of customers don't necessarily take that on face value and say, I know this bank is sort of probably not long for this world. It will either be acquired or be wound down and resolved. Let me take my cash and let me move my business relationship to another institution that's more stable. And I think we saw a fair amount of deposit outflows, not even just from the bridge banks, but from other similarly situated regional banks. And they went, upstream to G-SIBs and

Aaron Klein Globally systemic important banks. These are the, the handful of banks that are even larger.

Jarryd Anderson Correct. So there were deposit inflows following those bank failures. But I think ultimately the question of how you pay people in a bridge bank scenario because there's a lot of money moving out of the bank. People are changing business relationships. Most of that is done, through wires. And you're conducting payroll effectively in a cue from this increased demand of everyone wanting to move cash out and payroll in the ordinary course being sandwiched within. So that creates, a lot of challenges. And I don't think we have a really good structure for how to address those in a future bank stress. But I'll leave the second question for others to answer.

Aaron Klein Justin? do you guys have another question or you can ask two questions but you get one answer.

Justin Chardon Justin Chardon. One question is about the reason for the supervisory failure. The consensus seems to be that the supervisors saw the issues, but they didn't act or didn't act quickly enough. What is the reason for that? The lady from AFR seems to think that the overhead culture might be part of it. But what do you all think? And then the other question real quick, sorry, is, is whether, one potential reform would be to

incorporate interest rate risk into, treasuries, as written on. No longer is your risk weighted asset.

Alexa Philo I just wanted to thank you for giving me the opportunity to say what I really think. What I really think is we're focusing a bit on some complex and important issues, but not the big elephant in the room. To me and to us and importantly, to the public, what you see, is you see an industry, particularly on the largest banks and their capital markets and trading activities, that they're undercapitalized because of their reliance on their internal models and not fixing issues that were identified during the crisis, during the Great financial crisis. Until that's fixed and until an incentive comp is fixed, so that the executives incentives where their comp is tied to return on equity, they have these incentives to build out outsized concentrations, and they have these incentives to boost their comp and boost share price. In that environment with relatively low capital for capital markets and trading and comp not aligned incentive wise, we're not going to be able to have a resilient financial system that's stable. We're going to be in this cycle of boom and bust and bailout. And so for me, you focus on the capital, the liquidity and the comp. And I we haven't heard about comp in this in the whole discussion. Thanks.

Gary Cohn I completely disagree with that, just so you know. I don't think we don't need to spend time, but I think the G-SIBs in the United States are well capitalized and are going to go even farther capitalized to the point where to get an adequate return for shareholders, they're probably going to take more risk than they want to take. At some point, you force banks to hold so much capital to get a rate of return. To attract shareholder capital, you have to take risk farther than you'd want to take to be able to get a return on capital. I think that you've got to balance the those needs. And the last point I would make is I think this is one of these things in Silicon Valley, when you sit in the glass house of regulatory Washington DC, you just write rules, and you just write rules, and you just write rules. When there's a thousand rules on the piece of paper that you have to follow, you can't follow a thousand. So you try and pick the two or 3 or 4 that you think are most important and you follow them. And that's literally what happens. And so you end up migrating your business to run to the rules that you think are the most important, to protect your shareholders, to protect your customers, to protect the capital and do those things. And I think that every bank manager today runs their bank in the most unbelievably prudent fashion to, number one, a protect depositors and b protect their franchise and the integrity and to protect their employees. And they're not thinking about taking risks. They're thinking about growing our economy. And our economy is the biggest economy in the world, because we have banks that are willing to commit capital.

Aaron Klein So we're we're at time. And as I close, just just a couple of facts. America had bank failures repeatedly as our economy grew to be the world's biggest. The one thing that terrifies me more than a world of bank failures is a world of no bank failures. Of the 4800 banks existing in perpetuity with charters never to fail, no matter what they did or not. The other thing I would note is, the bank failures were in March, near Saint Patrick's Day. In 2008, Bear Stearns failed in March, near Saint Patrick's Day. And so, everybody, come March 16th, happy Saint Patrick's Day. And thank you all very much for being with us here today at Brookings. And we appreciate it very much. Thank you.