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Reflections on Recent Turmoil in the Banking and Financial Services Industry

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LUNCHEON KEYNOTE

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Six questions regarding the current banking crisis

1. Why do banks fail?
2. What was unusual about the failure of SVB and what takeaways does it leave?
3. What tools does the Federal Government have available to prevent bank failures and stabilize the banking system?
4. What are "Stress Tests" and how do they work? Why didn't they trigger earlier action in the case of SVB, Signature and New Republic?
5. What has happened to the $250,000 statutory depository insurance limit?
6. What are some measures that should be considered to help prevent or better manage banking crises in the future?

Why do banks fail?

- Crises typically preceded by rapidly rising interest rates and a decline in value of assets
- First banks to fail are those with the greatest interest rate exposure due to high duration assets
- Losses at earliest banks trigger "runs on the bank" among their depositors
- "Run on the bank" is a function of the mismatch between the long-term assets on and short-term liabilities of demand deposits
- Depository Insurance is a strong protection against bank runs and failures
  - *Facilitates transformation of short-term deposit liabilities into longer term, more permanent liabilities against which long-term assets can be held*
  - *Alleviates cyclical impact of interest rate fluctuations and enables banking rules and regulators to focus largely on credit quality, defaults and loan losses*
- Current system is vulnerable because it does not protect large uninsured deposits

What was unusual about the failure of SVB and what takeaways does it leave?

- Speed of a "run on the bank" has accelerated
- Focus at SVB was largely on losses from long-duration, high quality investments that were interest rate sensitive, NOT from poor credit decisions and increased defaults
- Banks with large percentages of uninsured deposits are the most vulnerable

What was unusual about the failure of SVB and what takeaways does it leave?

- Current capital rules and stress tests focus on credit risk and how portfolios may degrade in a down cycle
    - *They do a poor job of accounting for interest rate risk*
- Bank supervision of large regional banks has been lax
- Systemic risk is not limited to "SIFIs" and includes major regional banks

What tools does the Federal Government have available to prevent bank failures and stabilize the banking system?

- FDIC can guarantee ALL the deposits of an individual bank by invoking "systemic risk" exception
  - *Bank must fail first*
- Fed Reserve Discount Window provides liquidity as "lender of last resort"

What tools does the Federal Government have available to prevent bank failures and stabilize the banking system?

- FRA Section 13.3 programs can be created with the approval of the Treasury Secretary, but only in an emergency
  - *Bank Term Funding Program established after SVB failure, creating additional liquidity and even allowing Fed to lend under circumstances where it could prove undercollateralized*

What tools does the Federal Government have available to prevent bank failures and stabilize the banking system?

- FRA Section 14 authority to buy/sell assets interpreted to permit repo facilities as extension of credit
- "Treasury-suasion " as in the case of First Republic

What are the "Stress Tests" and how do they work?

Why didn't they trigger earlier action in the case of SVB, Signature and New Republic?

What are the "Stress Tests" and how do they work?

- Developed for "SIFIs" after 2008 to help restore confidence in banking system
- Annual tests under "Baseline" and "Severely Adverse" Scenarios to test whether banks have sufficient capital to survive one or more bad economic scenarios
- Trump era changes increased bank size required for testing: SVB was never tested
  - *BUT if SVB had been tested under the 2021 and 2022 scenarios it likely would have passed because scenarios assumed continued low interest rates*

What are the "Stress Tests" and how do they work?

- Current stress test (2023) does not include a scenario with further significant interest rate increases
  - *Nine rate increases by Fed from March of '22 through March of '23, from almost nothing to 5%: nobody considered the impact?*
- In addition to stress testing, banks subject to capital requirements using "risk-based capital rules" – amount of capital required depends on risky bank assets
  - *Because Treasuries bear no credit risk they are not discounted in calculating required capital.*

What has happened to the $250,000 statutory depository insurance limit?

- The cap is unlikely to be applied except in isolated instances of smaller community banks
- System-wide assurances used in 2008 were eliminated
- Insurance guaranty can be extended for individual banks under "systemic risk exception"
  - *Exception can only be applied after bank failure*
  - *Exception was triggered to protect SVB's and Signature's "non-SIFI" large depositors*

What has happened to the $250,000 statutory depository insurance limit?

- Banking observers increasingly believe systemic risk exception will now be consistently invoked for large regional banks, but very existence of the cap ensures that bank runs will continue
- Depository insurance cap creates "moral hazard" paradox: burden is on the wrong party
- Eliminating or significantly increasing the insurance cap would protect against future bank failures

What are some measures that should be considered to help prevent or better manage banking crises in the future?

Depository Insurance

- Eliminate depository insurance cap
- Raise the cap, but restrict banks' ability to take excess deposits
  - *Excess deposits not to exceed a percentage of insured deposits*
  - *Excess deposits invested in Treasuries, MMFs or "narrow banking" accounts at Fed*
  - *Facilitate the ease with which small banks can move customer deposits to and from MMF/Treasury accounts without becoming fully regulated as brokers*

Depository Insurance

- Change depository insurance funding rules to enhance DIF solvency and share burden
    - *Charge additional fees for holding excess deposits*
    - *Pay minimum amounts each year even when DIF is fully-funded to flatten funding cycle*
    - *Share the cost with "shadow banks" that benefit from more stable system*
        - Provide them with access to Discount Window and Bank Term Funding Program

Providing Liquidity

- Give non-banks access to the Fed Discount Window
- Continue to make available lending/liquidity tools other than the Fed discount window
    - *Make the Bank Term Funding Program permanent*
    - *Eliminate "systemic risk requirement"*
    - *Allow both banks and "shadow banks" to preposition collateral with the program to ensure liquidity when needed*

Providing Liquidity

- Reinstate the Fed's ability to provide assistance to individual open banks without placing them first under receivership or supervision
  - *Mandate that such assistance, even in the form of loans, would mean taking a major stake in the company diluting existing shareholders*
  - *Companies could be required to supplement their boards with Fed-nominated directors; they could be required to modify executive pay packages*

Limiting or Discouraging Risk-Taking

- Encourage banks to reintroduce adjustable-rate lending
  - *Consider changing weightings of risk-based capital requirements to reflect that adjustable-rate loans have less risk than fixed-rate loans*
  - *Encourage hedging by applying reduced capital requirements to hedged loans*
- Modify stress testing so at least one scenario includes appropriate flexing of interest rates
- Revisit loan securitization as a potential way community banks and regional banks could both reduce risk and increase profitability

Limiting or Discouraging Risk-Taking

- Revisit "cost" vs. MTM treatment of "Held to Maturity" loans
  - *Contrary to goal of banking system that makes loans?*
  - *Better depository insurance plus permanent access to expanded Bank Term Funding Program should ensure that loans can be held to maturity, rather than sold, in a liquidity crisis*
  - *If the depository base is made more like a longer-duration liability, MTM treatment is more appropriate, just like insurance companies*

Limiting or Discouraging Risk-Taking

- Revisit bank executive pay and incentive packages to align with public policy
  - *Who is in the best position to monitor and control risks taken by banks?*
  - *Legislation mandating rulemaking was never implemented*
  - *Focus on retention of risk by executives in connection with stock or profit-based incentive compensation*
  - *Make bank executives ride out stock performance through most of an economic or credit cycle with lockups or look-backs*

Questions?

Faculty

David I. Pauker is CRO of Archegos Capital Management, LP in New York and has more than 30 years of experience advising public and private companies in financial services, consumer products, energy, manufacturing, media, telecom, real estate, retail, professional services and other industries. He previously headed the national advisory practice of a leading turnaround and restructuring advisory firm. Mr. Pauker has overseen, advised or investigated the affairs of more than two dozen financial service companies, including bank and insurance holding companies, stock and commodity broker/dealers, hedge funds and investment managers. He was CRO of Refco, a diversified financial services company that was one of the largest-ever U.S. bankruptcies. He also was appointed to the board of directors of reorganized Lehman Brothers pursuant to its bankruptcy plan and was chairman of Lehman's Legal Affairs Committee, overseeing the resolution of more than a trillion dollars of claims asserted against and on behalf of Lehman. He spent a year as Lehman's board chairman. Mr. Pauker is responsible for liquidating Archegos's assets, negotiating its out-of-court resolution plan and making distributions to creditors. He is also chairman of the board of the Government Development Bank Debt Recovery Authority of Puerto Rico and is an independent member of the board of several additional companies. Mr. Pauker received his undergraduate degree from Cornell University and his J.D. from Columbia University School of Law.