Ten Actions Necessary to Prevent Large Bank Failures, Strengthen the Financial System, and Protect Main Street Families

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The failures of First Republic Bank, Silicon Valley Bank (SVB), Signature Bank, and the ongoing banking crisis are going to directly impact and hurt Main Street families, workers, small businesses, community banks, and the entire economy. That's because it is already causing banks to reduce their lending resulting in less credit available to individuals and businesses of all sizes. Some have estimated that this will reduce the country's gross domestic product (GDP) by at least half a percentage point or likely more than $132 billion (which will be on top of the economic slowdown precipitated by the Fed's historic rate increases and quantitative tightening).

This didn't have to happen. The crisis was predictable and the causes are not a mystery: since 2017, the financial industry has been significantly deregulated and under-supervised, as captured by a 2018 headline: "Banks Get Kinder, Gentler Treatment Under Trump." The seeds of this crisis were fertilized by banking supervisors who egregiously failed to do their jobs, as detailed in recent reports by the Federal Reserve, FDIC, and GAO.

The combustible mix of weaker rules and lax oversight by the banking agencies incentivized bank executives to take excessive risks and engage in irresponsible and reckless—if not illegal—behavior because they get to enrich themselves very quickly by basically gambling with other people's money. When that leads to bank failures, those deficient (or worse) executives merely lose their jobs but get to keep the money they pocketed while shifting the losses to taxpayers, other banks, and the public. This "all upside, no downside" for bankers makes more misconduct and bank failures inevitable.

This should surprise no one. Eliminating or gutting financial protection rules and weakening banking supervision are like banks in a high crime area getting rid of their security guards, taking the locks off the doors, and removing the alarm systems while at the same time the police are reducing the number of cops patrolling the streets. There is only going to be one result: higher risk, reckless, and illegal behavior.

The good news is that the actions necessary to change this—and strengthen the banking system, prevent crises, and protect Main Street—are well known, not particularly complicated, and the least costly option. First, of the approximately 5,800 banks in the U.S., the failed regulation and supervision contributing to the current crisis relates to a relatively small number of banks, only the largest 35 with more than $100 billion in assets. Second, increased regulation and supervision are not that costly, especially when considered in relation to the costs of bank failures and crises. For example, the most recent failures are estimated to directly cost more than $40 billion in bailouts and about $132 billion in lost GDP and these costs will only increase as the banking crisis continues. And we should all remember that the 2008 financial crash cost more than $20 trillion dollars.

Preventing crashes is always much less expensive than trying to stop, mitigate or clean up after they happen. As pointed out in a March 23, 2023 Report "The Ongoing Use and Abuse of Cost-Benefit Analysis in Financial Regulation,"

> "[f]inancial rules that protect consumers, investors, and financial stability cost money for compliance, personnel, and technology to prevent reckless, illegal, and even criminal conduct. However, not having those rules in place is far more costly …. Thus, the issue is not whether there are costs associated with

> financial regulation; the issues are who is going to pay those costs and when. Will it be the financial industry or the public, and will it be before another crash or after?"

Thus, the industry's never-ending claims that the costs of effective financial regulation and supervision to them and the U.S. economy are too high are outweighed by the much higher although never mentioned costs of the potentially devastating consequences of non-regulation or under-regulation and weak oversight by the banking agencies. Additionally, the industry's always exaggerated claims should also be discounted because, as private companies, they put profit and bonus maximization above all else, thereby always subordinating the public interest and the costs to the public to their own private interests.

Unfortunately, the bad news is that the financial industry is more powerful than ever and exercises outsized influence in Washington from Congress and the banking regulatory agencies to whatever administration is in place at the time and the media. The money, access, and political power of the financial industry and its allies makes implementing even the most basic remedies very difficult to achieve. But putting big bank profits over the public interest must end. Below are summaries of the most important actions to take to address the key deficiencies and reduce the likelihood and severity of future banking crises.

Most of the proposed actions are rule changes that financial regulators can and should do immediately through interim final rules, not in a multiyear rulemaking process as proposed by the Fed in its report on SVB. Such an extended timeline for this process would greatly empower the financial industry, result in endless delay, and almost certainly lead to much weaker rules. Not only would that process inevitably be too little too late, but it may well not happen until after the next crisis. Interim final rules are a much better way to go, and there is longstanding precedent for such action. Regulators need to act now with the will and courage to prevent crashes as quickly and decisively as they respond to them once they happen.

1. Capital Requirements Must be Strengthened.

If a bank does not have enough capital to absorb the losses it experiences, then it fails regardless of the reasons; if it's a systemically important bank, then that failure will almost certainly lead to the failure of other financial institutions, threatening the collapse of the financial system and, ultimately, the economy itself (which is why they are called "too-big-to-fail" or "TBTF"). To avoid that calamity, the government bails out (or "rescues") the banks by de facto providing the capital after the fact that the bank did not have in the first place to prevent it from failing.

Thus, a bank's capital is what protects banks, depositors, taxpayers, the banking system, and the economy from the damage that results from the potential failure of a large TBTF bank. This is well-known for Wall Street's largest banks, but, as the three recent bank failures proved (which are estimated to cost more than $30 billion dollars), it is equally true for many other large banks, even if they are not the very largest, globally systemically important banks (GSIBs). These banks (those with more than $100 billion in assets) should be thought of as domestically systemically important banks (DSIBs). That's why it must be a priority for the banking regulators to reverse the recent needless and baseless weakening of capital and other regulatory requirements for such banks. They simply must be required to have enough of their own capital pre-failure so the taxpayer doesn't have to de facto provide that capital to prevent their failure.

2. Liquidity Requirements Must be Restored.

Another key part of the post-2008 crash reforms was requiring banks to have sufficient readily available liquid funds to cover unexpected outflows of cash, like depositors leaving or losses on assets, both of which happened at the three recently failed large banks. That's why minimum liquidity requirements for large banks were enacted through the net stable funding ratio (NSFR) requiring adequate stable funding for twelve months and the liquidity coverage ratio (LCR), which requires them to hold enough high-quality liquid assets (HQLA) like cash, Treasury securities or other securities that can be quickly turned into cash. These rules enable the banks to which they apply to withstand 30 days to 12 months of substantially increased liquidity outflows as might occur in periods of severe stress.

These requirements are key because a bank can theoretically have enough capital but not be sufficiently liquid to quickly pay depositor or creditor demands. That will cause the bank to immediately sell all sorts of assets, resulting in "fire sales" which result in realizing capital-eroding losses, asset prices to collapse, and bank runs as happened at SVB.

3. Resolution Plans/Living Wills Must be Robust and Workable.

A foundational pillar of capitalism and a free market is the real possibility of a company failing: reap the rewards of successful business creation but suffer the consequences of business failure. While that applies to every other business in America, policymakers have created an exception for the largest banks, which, because of the potentially disastrous consequences for society should they fail, have been insulated from failure by the creation and tolerance of too-big-to-fail and taxpayer supported government bank "rescues." That violates and overrides the fundamental market discipline of potential bankruptcy; it also hands those banks unfair subsidies and enables unfair competition (as seen by the recent depositor flight from so-called regional banks to TBTF banks based on the belief that the uninsured deposits there would unquestionably be protected at those TBTF banks). That's wrong and must end.

While people can debate whether Wall Street's gigantic, global, complex, multi-trillion-dollar, derivatives and capital markets driven banks can ever be resolved in bankruptcy like other businesses, that cannot be true for these three banks or DSIBs generally. While large, they were relatively small with straightforward operations and balance sheets. They could have and should have had workable living wills allowing them to be resolved in an orderly bankruptcy process. If the regulators had done their job, those banks would have had robust, workable living wills and the banking crisis of the last two months could very well have been avoided. Among other things, one very important way to do that is to require banks to prove their resolvability before any bank merger is approved.

4. End Bankers' "All Upside, No Downside" Incentive Compensation Schemes.

It is routine for financial executives and traders to pocket million-dollar bonuses and often even tens of millions of dollars in a single year. That prospect of unimaginable, immediate riches causes too many bankers to take outsized and unjustified risks. Worse, while those bankers get the upside if their unreasonable and unconstrained risk taking pays off, the financial institution ends up covering the downside when they lose, which ends up being covered by others if, as just happened, the losses are so big that the bank fails.

That's why the post-2008 crash reforms of the "Dodd-Frank Act" had multiple provisions aimed at executive compensation and reducing this risk, including clawing back compensation and prohibiting compensation arrangements that encourage inappropriate risk taking. Regulators must strengthen those provisions and finalize related rules that inexcusably remain unimplemented. In addition, the administration's recent call to broaden regulator's powers to punish reckless bank executives should be enacted as soon as possible.

5. Stress Testing Has to Be More Stressful.

One of the most objectively successful financial protection rules put in place since the 2008 crash are required bank stress tests. In 2009, the stress test greatly reduced the panic in the financial markets by providing a transparent view into the condition of the banks and their ability to survive the ongoing crisis. Since this success, stress testing of large banks has been a key feature of ensuring the safety and soundness of the banking system. Unfortunately, the frequency (for some large banks) and stressfulness of the measure of capital needs under the stress tests have been significantly weakened since 2017 and that must be reversed.

6. Strengthening Supervision and Banks' Risk Management Practices or Prohibit Shareholder Distributions.

A key to the Federal Reserve's approach to large bank supervision in the wake of the 2008 financial crisis was the so-called CCAR qualitative objection. This enabled the Fed's bank regulators to restrict a firm's capital distributions to shareholders if the firm was found to have dangerously weak practices in risk management and capital planning, as was clearly evident at SVB and elsewhere. This was a very powerful tool because any impact on such distributions immediately gets the attention of shareholders and the media, which means that it quickly becomes a priority for a bank's board and senior executives. It gets their attention like nothing else. Unfortunately, the Fed irresponsibly gutted this after 2017. It can and must be restored quickly.

Similarly, banking supervisors must be re-empowered after the post-2017 weakening and supported when there are conflicts between them and bank executives, particularly in the face of bank noncompliance. Numerous rules and signals from the Fed that undermined the effectiveness of banking supervisors after 2017 are well-documented and need to be reversed.

7. Restore Volcker Rule Prohibitions on Bank Gambling.

Before the 2008 crash, large banks routinely used depositors' money to make high-risk bets in the hope for gigantic bonuses. This was called "proprietary trading" and it was banned by the Dodd-Frank Act in provisions known as the "Volcker Rule." The industry, including in particular Silicon Valley Bank, fought these limitations and, in response, regulators after 2017 gutted those provisions. Those actions must be reversed.

8. FSOC Must Police Systemically Significant Nonbanks.

While the most recent three bank failures are appropriately getting most of the attention, there are nonetheless serious threats lurking in nonbank financial firms (collectively known as the shadow banking system). Those threats are potentially as grave, but much less well known because nonbanks are less regulated and are even less transparent than banks. Thus, they have the potential to cause unexpected surprises like AIG and others in 2008. Here again, the Dodd-Frank Act addressed these risks by, among other things, creating the Financial Stability Oversight Council (FSOC) to focus on threats from nonbank financial firms, supported by the Office of

Financial Research (OFR).

Unfortunately, FSOC has never lived up to its mission and was effectively decommissioned in 2017. Indeed, it is stunning that there is currently not a single nonbank financial firm designated as systemically important by the FSOC. This is preposterous. Thankfully the administration just proposed actions to revive and revitalize FSOC so that the risks in nonbanks, which are deeply interconnected to the banking system, can finally be properly assessed and addressed. This must be done as quickly as possible.

9. Regulators Have to Prepare Better for the Inevitable Bank Failures.

The process followed by regulators in connection with the three recent failures was a failure in itself. In addition to having failed to ensure that these banks had workable living wills, the regulators failed to preplan to conduct a process that best served the banking system and the economy. Even after weeks of knowing First Republic Bank was on the precipice of failing and, indeed, getting worse over those weeks, the regulators, once again, engaged in an ad hoc, nontransparent, over-the-weekend, time-pressured, and panicky-looking auction process that inevitably favored the largest banks such as JPMorgan Chase. As a result of the failure to adequately plan for these potential bank failures, banking band aids are being applied in the middle of a banking panic, which guarantees lurching from crisis to crisis.

That's inexcusable given that bank failures are not uncommon and should be effectively planned for long before they actually happen. Doing otherwise fails to protect the public interest, damages public confidence, erodes Congressional support, and is a disserve to the country. Regulators must (1) regularly "war game" bank failures of different sizes, types, and amounts, including identifying other financial institutions or consortiums that could meaningfully participate in a future auction process, and (2) establish guidelines that are publicly disclosed for exactly how they are going to conduct such auctions in the future for banks of all sizes. Given how consequential these actions are, not only must there be much more planning, but there has to be much more transparency and accountability.

10.Thoughtful Consideration of Restructuring Financial Regulation and Supervision.

While the political process is stalemated and too often toxic, elected officials simply must hold hearings on the structure and effectiveness of financial regulation and supervision in the U.S. Not in the middle of a crisis or directly in its wake like 2008-2010, but when things seem to be working and there is no particular urgency or panic. Thoughtful, thorough, and careful consideration involving all stakeholders, importantly and prominently including independent nonpartisan experts, of what has and has not worked, along with recommended changes, is imperative.

The most recent Fed, FDIC and GAO reports make this all the more important. Regardless of who is at fault, regulation and supervision is ***still*** not working as well as it needs to be. Remember that the banking regulators, particularly the Fed, failed abysmally before the catastrophic 2008 crash and those many failures materially contributed to that crash. Yet, the post-crash "reforms" actually increased the power, authority, and importance of the Fed, in large part due to the view that there was no better regulator readily available. With no better options, the Fed was viewed as the least bad option.

While that arguably may have been appropriate given the time, circumstances, and political realities, that is no excuse for elected officials to not engage in a deeper analysis once Dodd-Frank was enacted. Indeed, one could make the argument that uncritically rewarding the Fed after the 2008 crash notwithstanding its failures before the crash sowed the seeds of its current failures and the 2023 crisis. Regardless, the system is not working again and a focused, unbiased review of that system, structure, and participants is overdue.

Given that may not be possible within the prevailing political climate, the country's leading foundations should consider a jointly funded, independent undertaking. That project should include nonpartisan organizations with substantive expertise who not only understand financial regulation, but who have also participated extensively in the Dodd-Frank Act regulatory process and understand how regulatory agencies work with Congress and the Executive branch. This would be a great public service. After all, virtually every one of their priorities are negatively impacted by financial crashes and the economic fallout.

Conclusion

While the recent failures resulted primarily from gross mismanagement and irresponsible conduct by the directors and officers of the banks that failed, there's always going to be mismanagement, incompetence, bad judgments, overly aggressive behavior, unreasonable risk taking, and bankers who put profits over safety and soundness. That's why regulators and supervisors exist: to police banks and bankers to minimize the extent to which bank safety and soundness, broader financial stability, and the wellbeing of the American people are threatened by poorly or dangerously run large banks.

Similarly, while restoring more assertive banking supervision with meaningful, public consequences for large banks is essential, there are also always going to be regulators and supervisors who are incompetent, ineffective, or fail for other reasons such as political, ideological, or cultural change in leadership as happened after 2017. That's why it is essential to also have particularly strong, clear, non-evadable baseline requirements for capital, liquidity, living wills, and related resilience measures, as discussed above.

Unfortunately, there is no single rule or action that anyone can take that will completely prevent costly financial crashes. There are no silver bullets. However, there are a number of important and interrelated actions that can be taken that will, together, materially strengthen banks and reduce the likelihood and severity of crashes. They will also simultaneously reduce the consequences for hard-working Americans when bankers behave badly as well as when regulators and supervisors are deficient. Importantly, there is nothing radical being proposed here; actually, just the opposite: these actions have been discussed and debated extensively since the 2008 crash and most for many years before then. That's why almost everyone, other than those directly or indirectly on the banks' payrolls, would agree that they are necessary and appropriate.

Collectively, that's why the actions summarized above (and elsewhere) must be done quickly. They will together materially improve the resilience of the banking system, reduce the likelihood and severity of bank failures, and better protect Main Street families and the economy.

To talk to one of our experts, contact Anton Becker, Communications Director, at 201-675-8049 or abecker@bettermarkets.org.

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