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What The 2023 Bank Failures Taught Us, And What's To Come

By **Christopher Paridon, Kristin Lee and Rebecca Raskind** (December 21, 2023, 5:12 PM EST)

This past spring we witnessed some of the most significant bank failures and financial market turmoil to occur since the 2008 global financial crisis.

Christopher Paridon

The consecutive, and some might say related, failures of Silicon Valley Bank, Signature Bank and First Republic Bank, as well as the government-arranged acquisition of Credit Suisse AG, also helped produce, or at least accelerate, what looks to be a seismic shift in the regulatory and supervisory landscape for banking organizations.

In the U.S., the consequences of these failures are continuing to be felt throughout the financial sector — along with other sectors of the economy — but they may be most pronounced for banks, bank-holding companies and other similar organizations.

Kristin Lee

So, as 2023 draws to a close and in keeping with the time-honored tradition of year-in-review articles, there's no better time to look back and offer, in no particular order, our thoughts on some key themes and lessons learned from these spring bank failures and the associated regulatory and supervisory fallout, as well as a few of our expectations for what 2024 may bring in banking regulation.

Supervision and enforcement are front and center.

Rebecca Raskind

Following the bank failures in spring 2023, we are observing a prioritization of supervision — especially examination — and enforcement by the federal banking agencies. This likely implements the view expressed by the Board of Governors of the Federal Reserve System that it needs to "improve the speed, force, and agility of supervision,"[1] the statement by the Federal Deposit Insurance Corp. that it "could have been more forward-looking and forceful in its supervision,"[2] and the testimony by Office of the Comptroller of the Currency's Michael Hsu that "awareness and identification of weaknesses [at SVB and Signature] were not the problem; rather timely and forceful supervisory action were lacking."[3]

We continue to see an uptick in the banking agencies' enforcement efforts. This includes not only an increased number of matters requiring attention, or MRAs, and matters requiring immediate attention, or MRIAs, but also multiple consent orders or similar formal enforcement actions, several related to deficient governance and oversight of third parties or affiliates (more on that below).

Lesson Learned

While examiners and other supervisors may have previously been more willing to work with banking organizations to address an issue informally or on a more flexible timeline, they can now be expected to step in faster and more forcefully, meaning banking organizations are now more likely to see the same issue resulting in an MRA or MRIA at a minimum and, potentially, resulting in a formal enforcement action.

Much ado about something: The failures brought a flurry of rulemakings and other releases.

Each year brings its own cadence of rulemakings and regulatory guidance. While the overall amount of bank regulatory issuances, not counting the many releases from the Consumer Financial Protection Bureau, was lower in 2023 as compared to both 2021 and 2022, post-March 2023 saw a significant uptick, especially related to topics such as resolvability, prudential standards and corporate governance.

The Federal Reserve, the FDIC and the OCC, individually or jointly, issued approximately 40 meaningful rulemakings, financial institution letters, supervision and regulation letters, bulletins, or guidance documents, many designed to address the risks identified or perceived in the recent bank failures.

Among other areas, the agencies have shown an increased interest in: liquidity risk and contingency planning; third-party risk management (generally and especially related to fintech partnerships); credit risk and loan underwriting standards (especially for commercial real estate); Community Reinvestment Act implementation; resolution planning; and digital asset or similar so-called novel activities.

The impact has been especially acute for those banking organizations that might be termed "mid-size" or "large regional banks," i.e., those banking organizations with $100 billion or more in total assets but less than $250 billion in total assets, and who may not have the same level of compliance and other staff as global systemically important or large banking organizations.

While generally respectful of the principle of avoiding excessive regulation on community banks, some of these releases target banks with significantly less than $100 million in total assets, such as the FDIC's proposal to apply corporate governance and risk management requirements, which are similar to those already imposed by the OCC on banks with $50 billion or more in total assets, on FDIC-regulated banks with $10 billion or more total assets.

Lesson Learned

Banking organizations, especially those above with $100 billion in total assets, can expect to continue to grapple with these rulemakings and other regulatory releases, leading to increased compliance costs and burdens.

$100 billion in total assets is the new $250 billion in total assets (which was the new $50 billion in total assets…).

In 2019, the Federal Reserve revised portions of the enhanced prudential standards, or EPS, which formed part of its framework for supervision and regulation of larger banking organizations.

These revisions largely maintained EPS requirements for global systemically important banks, but tailored and reduced (or, in some cases, eliminated) EPS requirements for other banking organizations.

Partially — but not fully — as a result of this spring's bank failures, the Federal Reserve and other federal banking agencies have shown a desire to revisit or re-tailor some of the decisions or changes previously made regarding supervision of larger banking organizations.

For instance, this holistic review of regulatory capital requirements for banking organizations is not unique to 2023, but it took on additional significance and urgency following the spring's bank failures.

The Federal Reserve, OCC and FDIC expressly recognized that the spring bank failures influenced their July 2023 proposal to implement changes as part of the so-called Basel III endgame.[4]

That proposal is designed to standardize and generally increase capital and liquidity requirements for banking organizations with $100 billion or more in total assets. It would also require banking organizations to include unrealized gains and losses from certain securities when calculating their capital ratios, i.e., it would eliminate the accumulated other comprehensive income, or AOCI, opt-out used by a number of banking organizations.

The proposed elimination of the AOCI opt-out is notable because as has been discussed widely, both SVB and Signature utilized the AOCI opt-out, which allowed them to generally avoid taking earlier capital charges on losses from certain securities in their portfolio.

The spring bank failures also helped advance a proposed rule that would require banking organizations with $100 billion or more in total assets to issue and maintain minimum amounts of long-term debt.[5]

This proposal, related in part to an advanced notice of proposed rulemaking issued in October 2022 that highlighted risks posed by certain larger banking organizations with high levels of uninsured deposits — perhaps coincidentally describing those U.S. banks that failed in spring 2023 — is designed to improve financial stability and increase the resolvability and resiliency of such organizations.

Similarly, in connection with stress testing, Federal Reserve Vice Chair for Supervision Michael Barr has repeatedly called for revisions to the stress testing regime in light of the spring bank failures.[6]

Barr also called for — and has indicated that the Federal Reserve is in the process of developing — additional stress testing scenarios that would be "exploratory,"[7] indicating that liquidity risk, inverted interest rate risk, or other factors associated with the failures of SVB, Signature, First Republic, and even the government-arranged acquisition of Credit Suisse, may appear in future scenarios.

Lesson Learned

Banking organizations that may have previously thought they would not be subject to certain EPS or similar prudential requirements, especially those with between $100 billion and $250 billion in total assets, may need to rethink the scope and type of regulation applicable to them going forward.

Third-party risk management, BaaS and fintech partnerships are under pressure.

During 2023, the federal banking agencies continued, and if anything increased, their scrutiny of third-party risk management by banking organizations. This scrutiny seemed to intensify following the June release of the interagency guidance on third-party risk management, which set out revised — and heightened — supervisory expectations on how to manage risk throughout the life cycle of relationships

with third parties.

While covering traditional service providers, many perceived the focus of the agencies to be on fintech partnerships and banking as a service, or BaaS, models. Despite the number of challenger banks, neobanks, BaaS partnerships, and similar nonbank bank offerings, "banks are special," as Gerry Corrigan once concluded.[8]

Coincidentally, while many focused on liquidity and capital risk coming out of the spring bank failures, the OCC's semiannual risk perspective for Fall 2023 noted that 42% of outstanding MRA concerns have operational risk — which should include third-party risk — as the primary risk.[9]

This is consistent with our lived experience and the noticeable uptick of recent supervisory enforcement actions that highlight the need to make improvements to banking organizations' third-party risk management practices.

Lesson Learned

Regulators, especially examiners and supervisors, are focused on banking organizations' risk, and risk management, related to all third-party relationships, especially those involving fintechs and BaaS.

Digital asset activities remain subject to skepticism.

The collapse of FTX in November 2022 predated 2023 by several months but was notable for highlighting what some perceived as risks related to cryptocurrency, especially when it came to light that FTX had significant relationships with Moonstone Bank, a tiny bank located in Washington.

The March 2023 collapse and voluntary liquidation of Silvergate Bank and failure of Signature, both banks that had significant ties to the cryptocurrency industry, increased the already heightened level of skepticism by regulators and some others regarding crypto or digital assets.

For instance, the FDIC, OCC and Federal Reserve all require banks subject to their supervision to follow some type of approval or nonobjection process prior to engaging in "novel" activities involving digital assets, distributed ledger technologies and similar activities.

Along with the continuing pall of the U.S. Securities and Exchange Commission's Staff Accounting Bulletin 121, this skepticism hangs over banks' involvement, or lack thereof, with digital assets, despite the federal banking agencies also claiming to support innovation and recognition of the "same activity, same risks, same regulation" principle.[10]

Lesson Learned

Regulators continue to be skeptical of banking organizations being heavily involved with digital assets, and regulatory headwinds regarding these activities may be expected to continue without legislative action.

Uninsured deposits, and understanding deposit insurance, is critical.

Following the failures of SVB, Signature and First Republic, we received a significant influx of questions from clients asking about whether their deposits were insured or uninsured and, in some cases, whether

they had a deposit at all.

Following the failures, regulators have also, understandably, increased their attention on banks' uninsured deposits, in part because they viewed the level of cited uninsured deposits as a contributing factor to the liquidity issues these banks faced before their failure.

Barr noted that the Federal Reserve is "going to evaluate how [it] supervise[s] and regulate[s] liquidity risk, starting with the risks of uninsured deposits" and suggested that "[l]iquidity requirements and models used by both banks and supervisors should better capture the liquidity risk of a firm's uninsured deposit base."[11]

Similarly, in July, the FDIC published a financial institution letter clarifying its expectations of how insured depository institutions should report uninsured deposits and noted that some insured depository institutions are not reporting estimated uninsured deposits in accordance with — and much go back and amend any existing call reports to be consistent with — the FDIC's position regarding instructions for the consolidated reports of condition and income, more commonly known as call reports.

The FDIC also finalized its "special assessment" related to the costs to the deposit insurance fund from protecting uninsured depositors during the spring bank failures, where the costs would be based on an insured depository institution's estimated uninsured deposits as of Dec. 31, 2022 (the last day of the last quarter before the spring bank failures).

Lesson Learned

Regulators are likely to continue to focus on the level of, and risks posed by, uninsured deposits at banking organizations, and bank customers are likely to increasingly focus on the extent to which their deposits are uninsured.

Our Crystal Ball for 2024

Recognizing that predictions and these days, thanks to inflation, it takes $5-plus to buy you a cup of coffee, we offer the following thoughts regarding bank regulation, and our best wishes, in the New Year:

- Supervisors and examiners will continue to show an increased willingness to take formal and informal supervisory actions, and they will do so sooner and more forcefully than in recent years.

- Regulatory compliance obligations on banking organizations will increase, especially those in the $100 billion-$250 billion total asset range.

- Third-party risk management, especially related to BaaS, will remain a key regulator focus. Expect increased compliance and supervisory expectations in this area.

- Banking organizations will continue to cautiously explore digital asset activities, but without legislative action we are pessimistic that much of consequence will change.

- Uninsured deposits will receive increased attention from regulators, especially related to liquidity risk, and from customers, especially related to FDIC insurance coverage.

- Commercial real estate lending risk, in general and especially for concentrated exposures, is similarly likely to receive increased attention.

- The federal banking agencies will continue their march to implement existing proposals regarding Basel III endgame and other significant matters, being mindful of any Congressional Review Act deadlines.

- Speaking of politics, 2024 is an election year, which means regulators may be more hesitant to act the closer we get to November 2024. It also means that a change in administration, and therefore potential change in agency principals, can alter the regulatory and supervisory landscape yet again.

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[1] Board of Governors of the Federal Reserve System, Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank (Apr. 28, 2023) ("SVB Report"), https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf, at 2.

[2] https://www.fdic.gov/news/press-releases/2023/pr23033a.pdf.

[3] https://www.occ.gov/news-issuances/congressional-testimony/2023/ct-occ-2023-45-written.pdf.

[4] See, e.g., Martin J. Gruenberg, Chairman of the Federal Deposit Insurance Corporation, Remarks at the Peterson Institute for International Economics (June 22, 2023), https://www.fdic.gov/news/speeches/2023/spjun2223.html?source=govdelivery&utm_medium=email&utm_source=govdelivery ("[t]he agencies are considering whether to apply the proposed new rule to banks with assets over $100 billion. This consideration has certainly been influenced by the recent experience with three bank failures of institutions with assets between $100 billion and $250 billion. If we had any doubt that the failure of banks in this size category can have financial stability consequences, that has been answered by recent experience.").

[5] See, e.g., Martin J. Gruenberg, Chairman of the Federal Deposit Insurance Corporation, Statement on the Notice of Proposed Rulemaking on Long-Term Debt (Aug. 29, 2023), https://www.fdic.gov/news/speeches/2023/spaug2923a.html ("[T]he experience of the three large bank failures this spring should focus our attention on the need for meaningful action to improve the likelihood of an orderly resolution of large banks under the Federal Deposit Insurance Act, without the expectation of invoking the systemic risk exception. The long-term debt requirement put forward in this [proposal] would be a meaningful step in that direction.").

[6] See, e.g., Michael S. Barr, Federal Reserve Vice Chair of Supervision, Multiple Scenarios in Stress Testing (Oct. 19, 2023), https://www.federalreserve.gov/newsevents/speech/barr20231019a.htm ("The failures of three large banks last spring showed that acute banking strains can emerge even without a severe recession.").

[7] Id.

[8] E. Gerald Corrigan, "Are Banks Special?", Federal Reserve Bank of Minneapolis Annual Report 1982, https://fraser.stlouisfed.org/title/annual-report-federal-reserve-bank-minneapolis-473/annual-report-1982-18309.

[9] OCC, https://www.occ.gov/publications-and-resources/publications/semiannual-risk-perspective/files/pub-semiannual-risk-perspective-fall-2023.pdf.

[10] See, e.g., Michael S. Gibson, https://www.federalreserve.gov/newsevents/testimony/gibson20231205a.htm .

[11] SVB Report at 3.