Legal Studies and Business Ethics Department
The Wharton School
University of Pennsylvania
600 Jon M. Huntsman Hall
3730 Walnut Street
Philadelphia, PA 19104.6340
215.898.7689 phone
215.573.2006 fax

Peter Conti-Brown
Class of 1965 Associate Professor of Financial Regulation
Co-Director, Wharton Initiative on Financial Policy & Regulation
petercb@wharton.upenn.edu
215.898.6516 phone

Testimony before US Senate Committee on Banking, Housing, and Urban Affairs
Subcommittee on Economic Policy

"Strengthening Accountability at the Federal Reserve: Lessons and Opportunities for Reform"

Peter Conti-Brown
Class of 1965 Associate Professor of Financial Regulation
Co-Director, Wharton Initiative on Financial Policy and Regulation
The Wharton School of the University of Pennsylvania

Biographical Statement

Peter Conti-Brown is the Class of 1965 Associate Professor of Financial Regulation and Co-Director of the Wharton Initiative of Financial Policy and Regulation at The Wharton School of the University of Pennsylvania. A financial historian and a legal scholar, Conti-Brown studies central banking, financial regulation, and public finance, with a particular focus on the history and policies of the US Federal Reserve System. He is author of the book *The Power and Independence of the Federal Reserve* (Princeton University Press 2016), co-author of a leading textbook on financial regulation (The Law of Financial Institutions), and author and editor of several other books and articles on central banking, financial regulation, and bank corporate governance. He received a law degree from Stanford Law School and a PhD in history from Princeton. He and his wife Nikki are the parents of four children.

Over the past two months, three of the roughly twenty banks with assets between $100 billion and $250 billion have failed. Of the remaining seventeen, we do not know how many would have failed but for the extraordinary interventions of the government related to the other three. Since March 12, 2023, we have been in a roiling banking crisis, a fact acknowledged by the very interventions that the Fed, Treasury, and FDIC have made to prevent this crisis from spiraling into a financial cataclysm.

Responsibility for the failure of these banks relies primarily with the bankers that mismanaged them. But the failures of so much of this market segment also invites important questions. The extraordinary powers used over the last two months were designed or redesigned after the 2008 financial crisis, especially through Congress's passage of the 2010 Dodd-Frank Act. At the time, it was the hope of Congress, the US President, and the American people that such unusual and extraordinary government interventions would be rare: rare because individual bank failures would be preventable through robust regulation and supervision and rare because even if unprevented an individual bank's failure would not a systemic crisis make.

March 12 was the realization that those efforts did not work. The questions we must ask ourselves, among many others, are these: (1) what did we fail to do in the years leading up to March 2023; (2) what changes does this crisis invite us to ponder that can strengthen us against future crises; and (3) what changes must we make to restore the confidence of the American people in our government's ability to ensure that our financial system stays robust, resilient, and fair for all members of our society and not just the wealthiest among us.

More specifically, I will focus on the consequences of a change in supervisory culture, regulatory framework, and legislative context since 2017; the need for a better information-gathering system than currently exists within the Federal Reserve System, especially with respect to an independent, Senate-confirmed Inspector General for the System; and removing the stain of special interest from the Fed's governance structure, a stain placed by compromise during a different time that has long outlasted any useful purposes.

Wharton
UNIVERSITY *of* PENNSYLVANIA

I. The Consequences of Legislative, Regulatory, and Supervisory Changes since 2017

A. The Dodd-Frank Context for Regulation and Supervision

Dodd-Frank made several vital changes to our financial system as relevant to banking crises. In many cases, it was responsive to the idiosyncrasies of 2008, including by overhauling the way that derivatives are traded and creating a new financial regulatory body focused on financial products that consumers may not need or may not understand.[1] In other ways, it sought to create a system that would make the financial system more resilient to financial crises of all kinds, no matter the specific cause.

Among these changes is a kind of theory of financial risk espoused in Dodd-Frank. That theory is one of supervisory discretion. As in other areas of legislation, Congress deemed financial risk too idiosyncratic, too ephemeral and changeable to be managed exclusively by legislative fiat. Instead, Congress created a system that gave the important decision-making authority to bank supervisors, on the ground. These supervisors would be able to monitor financial stress as it occurred, in real time, with the ability and authority to intervene aggressively when financial risks changed from the necessary and tolerable to the unnecessary and intolerable. Supervisors would work mostly in secret – indeed, Congress criminalized the supervisors' disclosure of this "confidential supervisory information" so that the exchange of information between banks and government could be candid, free-flowing, and productive.[2] Regulators like the Federal Reserve, FDIC, and Comptroller of the Currency would oversee these supervisors, but the real work of accomplishing congressional priorities for managing financial risk would belong to these quiet bureaucrats toiling in obscurity with the full weight of governmental authority behind them.[3]

---

[1] See Titles VII (Derivatives and Swaps) and X (Consumer Financial Protection Bureau) of the Dodd-Frank Act, Pub. L. 111-203, 124 Stat. 1367 (2010)
[2] See 18 USC § 1906. For more, see Peter Conti-Brown, "The Curse of Confidential Supervisory Information," Brookings Institution Report, Friday, December 20, 2019.
[3] This discussion draws from my work with Sean Vanatta, including in the article "Risk, Discretion, and Bank Supervision," available here, and our longer history of bank supervision, *The Banker's Thumb: A History of Bank Supervision in America* (under contract, Princeton University Press).

The theory of this focus on bank supervision was not new to Dodd-Frank. It is a theory older than our federal banking laws. What Dodd-Frank did was expand the reach of supervision. Supervisors would be able to take idiosyncratic risks and look at the entire system. They would be able to use new tools to gather more information to identify risks with greater lead times.

The cost of such supervision is not small, either for the government or for the banks themselves. Reflecting a long-standing enthusiasm for protecting smaller banking institutions from the full brunt of these costs, Dodd-Frank drew a line – banks with assets below $50 billion would not be subject to the enhanced prudential standards that would give supervisors even more tools to spot systemic and idiosyncratic concerns before they became cataclysmic. Those banks above that threshold would, on the other hand, be subject to precisely these tools.

The tools came in a few varieties, some regulatory, most supervisory.[4] On the regulatory side, among many other requirements, banks above the $50 billion threshold had to present clear plans for how they would fail in an orderly way, without triggering the more dramatic interventions that we have seen this year. They would be subject to higher liquidity standards to ensure that they could manage large withdrawals.[5] They would be subject to higher capital requirements, meaning that they would have to rely on the equity markets to fund themselves more extensively than the flighty funding they would find in credit markets, including from depositors. And they would be subject to annual "stress tests" to see how the banks' balance sheets would withstand deteriorating economic conditions.

These legislative and regulatory changes were not the most important consequence of the 2008 financial crisis. The more important change was in the change to bank supervision, the management of the public-private relationship that undergirds our financial system. Even without these regulatory changes, the supervisory apparatus expanded and reformed after 2008 meant that there would be forward-leaning systems in place to catch idiosyncratic risks not anticipated by either legislative or regulatory changes.

[4] Enhanced Prudential Standards are found in the Dodd-Frank Act, § 165, *supra* note 1.
[5] See Section 165 of Dodd-Frank, *supra* note 1.

B. *Changes in 2018: The Consequences of the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018*

In 2018, after many months of debate, President Trump signed the Economic Growth, Regulatory Relief, and Consumer Protection Act.[6] In an era of omnibus bills, often hundreds or thousands of pages long, one of the most impressive feats of the EGRRACPA (or S. 2155, as it is more commonly known), is its length: the entire bill is just 75 pages long. The part that is relevant to the present banking crisis, Title IV of that act, is just five pages long. In those five pages, entitled "Tailoring Regulations for Certain Bank Holding Companies," Congress changed the $50 billion threshold to $250 billion. For those largest banks – of which there are currently thirteen – nothing would change on a regulatory and legislative level. For banks with assets of $100 billion to $250 billion, Congress instructed the Fed to make specific determinations about the appropriateness of all enhanced supervisory standards before proceeding. The Act did not require a specific conclusion on these questions, but at a stroke Congress did require that all pre-existing regulations be evaluated all over again.[7]

Over the last two months, three of the twenty banks within that band of $100 billion to $250 billion have failed. (In the somewhat absurd vernacular of banking, we call these banks "regional banks."). We do not know how many of the remaining seventeen would have failed but for the emergency declarations and concomitant liquidity support that the federal government's extraordinary actions facilitated thereafter.

Thus, while the focus is often on Silicon Valley Bank, the fact is that we have had an intolerable failure of a market segment – when 15% of banks fail within the very class that Congress deregulated in 2018, we have enough smoke to inquire about the presence of fire.

One fundamental question for Congress in whether to revisit the "regulatory relief" provided by S 2155 is to inquire into the counter-factual: if the threshold for enhanced prudential supervision had stayed at $50 billion, rather than be raised to $250 billion (with mandatory evaluations for the "regionals" between $100 billion and $250 billion), would we have avoided the banking crisis of 2023?

Counter-factuals, we know, are thought experiments. We cannot answer them definitively. But based on the information we have, I believe that the answer to this question is yes. In a world without 2155, we would not have seen such aggressive

[6] Pub. L. 115-174 (May 18, 2018).
[7] *Id.* Title IV.

expansion by the three failed banks, we would not have seen such aggressive risk mismanagement, we would have seen more red flags in time to resolve these banks in a more orderly way, and we would have sustained a supervisory culture in this specific context that would have overridden bank objections when supervisors flagged these concerns.

That is a long list of conclusions that require unpacking. It is clear, now as in 2018, that discontinuities in regulatory treatment change bank behavior. The very fact that bankers now at the center of this crisis lobbied hard for a change in treatment reflects that desire. What 2018 did was give a green light for dramatic expansion. In the low-interest rate environment of the pandemic, with its clientele awash in liquidity, Silicon Valley Bank – to cite one of the three examples – decided to pour rocket fuel on its business model, but without adequate risk management to prepare for the consequence of such growth. If that decision had meant costlier enhanced prudential supervision, we can be sure that bankers would have responded with at least some caution, some modicum of cost-benefit analysis. Instead, they plunged full steam ahead.

Even if these bankers had made the determination that growth at all costs was appropriate, they would have then been subject under the original Dodd-Frank to the enhanced liquidity and capital requirements that would have presented speed bumps along the way. By early 2023, the cake was baked, so to speak. Silicon Valley Bank was a failed institution. No amount of liquidity coverage ratios, living wills, capital requirements, or stress tests could have prevented it. What would have been different was the liquidity and capital context of 2021 and 2022. In that world, when the cake was still the batter, we would have had many more tools and many more warnings to prevent such wild, amateurish, and irresponsible risk taking from building into the rush of failure.

This is a point worth emphasis. Rapid growth in banking is almost always a dangerous phenomenon, because it reflects a failure of diversification in both liability and assets. A sudden influx of funding will usually come from one source: a very large client, a very large group of brokered deposits, a single sector of the economy enjoying a surge in funds. That lack of diversification means the failure of that single source can result in the sudden failure of liquidity. And with the influx of that funding, banks must make rapid-fire decisions about where to put that money. In such an environment, they are likely to invest without diversification, which takes time. A failure in the asset class designated to hold this rapid growth will, in turn, be a failure of the newly large bank.

Dodd-Frank was meant to put brakes on precisely this growth by imposing liquidity and capital requirements that would either check that growth completely or

throw red flags to bankers and supervisors in the face of it. For the banks no longer subject to those early warning systems, the red flags would be fewer.

C. *What Bank Supervision Got Right, 2021-2023*

Fewer red flags, perhaps, but not missing entirely. Perhaps the most frustrating part of the story of the banking crisis of 2023 is the fact that these were not esoteric risks that these regional banks were taking. In the 2008 crisis, banks invested in such exotic instruments that even the bankers and policymakers themselves could not keep up. The world sat anxiously by as journalists, central bankers, and many others sought to explain the arcana of synthetic collateralized debt obligations and naked credit default swaps.

In 2023, the risks that failed bankers at failed banks say caught them by surprise were the most garden-variety risks that any bank faces at any time. The basic business model of banking is to lend money out through deposits at rates lower than banks receive by investing those loaned funds into longer-term assets. In times of tightening financial conditions, this means that banks have to make changes – interest rates are going up, which means that the money they will have to pay to depositors will go up, while that same action will make the assets banks hold go down in value. There is an entire vast bank accounting apparatus meant to capture these risks, but the overwhelming majority of banks and bank supervisors caught this problem early on. As the Federal Reserve started aggressively hiking interest rates in 2022, banks had to scramble to fix their balance sheets so that they could stay solvent.

Nearly all of them did. In an important study, economists have determined that of 4,700 banks in the United States, about 190 of them got this basic banking problem wrong and are effectively insolvent because they could not change their balance sheet in the long leadoff given by the Fed in this period of tightening financial conditions.[8] That is barely 4%, meaning 96% of banks have successfully managed these period of remarkable monetary transition. Another question for us to ask about the banking crisis, then, is not why did these banks fail, but why didn't *more* of these banks fail?

One important reason for this lack of failure is probably because bank supervision largely still works with incredible efficacy. Because the details of nearly every interaction between bank and bank supervisors is cloaked in secrecy, there is a fundamental

[8] See Erica Xuewei Jiang, Gregor Matvos, Tomasz Piskorksi, and Amit Seru, "Monetary Tightening and US Bank Fragility in 2023: Mark-to-Market Losses and Uninsured Depositor Runs?", 24 Mar 2023, available here.

asymmetry in bank supervision. Bank supervisors' failures become extremely public and often demoralizing. Bank supervisors' successes are wrapped in secrecy.

D. What Supervision Got Wrong, 2021-2023

A 96% success rate in these monetary conditions is an enormous credit to the US banking system, including the US bank supervisory system. But the fact that the three major failures were enough to tilt us into a costly, unjust, and inefficient bailout of banks and bank depositors is extremely troubling. What, then, went wrong?

The basic discretionary activities of bank supervisors who monitor the simple, predictable, and predicted blunders of failed bankers did not go wrong, at least not in general. According to the postmortem conducted by the Federal Reserve after the failure of Silicon Valley Bank, bank supervisors *did* anticipate the very concerns, on both the liability and the asset sides of the balance sheets. It was a relief to read this supervisory fact, but not a surprise. Again, the failures at these banks were so basic as to be mystifying. The efforts by these bankers to displace blame to the macroeconomic, monetary, and even – perhaps most alarmingly – the social media context is sheer codswallop.[9] None of these factors comes anywhere near explaining why these failed bankers did so poorly at their work. Bankers knew that they were taking these breathtaking risks. Even when they didn't know because their business talents were wanting they soon learned because they received warnings from bank supervisors.

Here, then, is perhaps the most important legacy of S. 2155. Supervisors, even after the passage of that Act, retained discretion to *warn* bankers of their misbegotten behavior. What they lacked was a fast and nimble institutional apparatus to *change* that banker behavior. For that, supervisors need support from regulators, who need support from Congress.

Supervisors raised red flags at Silicon Valley Bank. They almost certainly raised similar flags at other banks. Those other banks made important changes to their funding and assets in 2021-2022; Silicon Valley Bank (and perhaps others) did not. If those failed banks had paid the same heed to their supervisors that the successful banks did, there would have been no banking crisis in 2023. That the failed banks felt they could ignore their supervisors with impunity tells us something that is broken within bank supervision. Banks mostly do a very good job working productively with bank supervisors. What becomes problematic is when they don't. Silicon Valley Bank did not work well with

[9] See Greg Becker, Testimony before the US Senate Committee on Banking, Housing, and Urban Affairs, May 16, 2023, available here

supervisors. It didn't work well at almost anything. We need a system for that kind of misbehavior, too.

Perhaps more than anything, this is the legacy of S. 2155. Regulatory relief meant, even sometimes explicitly, pulling back on the ability of supervisors to force bankers to wake up to the risks that they had taken.

When we encounter a crisis of an entire asset class rendered recently insulated from enhanced regulatory scrutiny, we should ask ourselves not only whether that scrutiny would have prevented the crisis. I think the counterfactual suggests that increased scrutiny would have made all the difference, but recognize that scholars will continue to analyze the banking crisis of 2023 for years to come. The question, then, is slightly different. We should ask ourselves whether these regulatory and supervisory changes are good in themselves. That debate should be clear: so-called regional banks controlling more assets than the GDP of the country of Greece do indeed impose systemic risk to the rest of us. We should design our regulatory and supervisory strategies not only for the outstanding majority of banks that either spot their own risks or work well with supervisors to do so when they have been slow at that basic task. We need a system that will require banks to make those changes before their misbehavior triggers a financial crisis for us all.

II. The Need for Better Information from Within the Fed

I present my main conclusions about the legislative, regulatory, and supervisory changes we should see as a result of the banking crisis of 2023 in Part I above. But there is more to learn. One of the most important questions, given the discretion that S 2155 still provided to it, is why and how it exercised that discretion during the critical period leading up to the crisis. This includes two full years during the Biden Administration when the President of the United States made clear a set of regulatory and supervisory priorities that the Fed appeared not to follow. It includes, too, the answers to the questions posed above: why did supervisory warnings not turn into supervisory actions?

Almost immediately after the March 12 triggering of extraordinary federal authority, Fed Chair Jerome Powell and Vice Chair for Supervision Michael Barr announced a "careful and thorough review" of the supervisory and regulatory failings that preceded the collapse of Silicon Valley Bank.[10] The subsequent report contained the

[10] Federal Reserve Board announces that Vice Chair for Supervision Michael S. Barr is leading a review of the supervision and regulation of Silicon Valley Bank, in light of its failure, March 13, 2023, available here.

Wharton
UNIVERSITY *of* PENNSYLVANIA

Fed's overview of these failures, including detailed excerpts of examination reports usually subject to restrictions on confidential supervisory information.[11]

These disclosures are laudable. The conclusions of this report in some respects make good sense. But in my view, the investigation should never have occurred in public. The Federal Reserve and the extraordinary public servants who work therein are good at many things. They are not good at self-investigation for purposes of public accountability.

Nor should we expect them to be so.[12] The Fed, through its history, has been among the very best institutions at navigating political complexity to its favor. Congress, even in the face of financial crisis or scandal, has expanded the Fed's authorities, sometimes even over the Fed's own objections. It has rarely removed that authority.[13] This is not an accident: the Fed fiercely manages its own reputation; cultivates politicians, journalists, and academics; and otherwise seeks to protect its own interests.

I do not fault the Fed for this role. Its institutional character and policy prerogatives are important. But these very facts, these very principles, mean that it provides too much of its own oversight. This cannot be. The Fed cannot supervise itself. That is Congress's job.

Congress did create Inspectors General in 1978 to provide some of this oversight.[14] The inspector general for the Federal Reserve, however, is appointed by consultation between the Fed and the CFPB, which shares a single individual inspector general. To be more precise still, this inspector general oversees *only* the Fed's Board of Governors, not the Federal Reserve System.

We need better accountability than this system provides. In particular, I recommend three changes. First, the CFPB and Federal Reserve should be separated for these purposes. Their functions, structure, and purposes are all different. The oversight Congress requires for each agency should reflect those differences. Second, the Inspector General for the Federal Reserve should be for the full Federal Reserve System, including the Federal Reserve Banks and not just the Fed's Board of Governors. Much of the policymaking as relevant to banking crises (and much more) includes the participation

[11] Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank, April 28, 2023, available here
[12] I make these arguments in a forthcoming comprehensive political history of the Federal Reserve, *The Federal Reserve: An American History* (forthcoming, WW Norton).
[13] An exception is in Title X of Dodd-Frank, which removed most consumer financial protection oversight from the Fed and deposited it at the Consumer Financial Protection Bureau.
[14] Pub. L. 95-452, 92 Stat. 1101 (October 1, 1978).

of the Federal Reserve Banks. They require congressional oversight too. And finally, the Inspector General for the Fed should be a separate presidential appointment, confirmed by the Senate. This is all the more important because other forms of accountability and oversight, principally through the courts, is mostly foreclosed when it comes to the Fed. A presidential appointment will enhance the independence and credibility of the Inspector General in a way the position does not currently enjoy.

III. Restoring the Fed's Credibility by Removing Bankers from Federal Reserve Bank Boards

The Federal Reserve Act, signed into law by Woodrow Wilson on December 23, 1913, created a somewhat circuitous institution. It is a mélange of institutions and individuals sometimes with ambiguities about who holds responsibility and to what end. Even when Congress rewrote that structure in 1935 to place most authority for the Fed's functions in Washington DC, it left the curiosities largely in place.

The most nefarious of these is the presence, by law, of private bankers and those appointed by private bankers on the boards of directors of the twelve Federal Reserve Banks. The role of these private bankers has changed over time, but crises like the present invite opportunity to reflect on a more basic question: what business do these bankers have with formal, institutionalized seats at the table of their own regulators?

No business, is the answer. Their presence invites mischief. Either their presence matters, which means they have influence over their own supervisors, whatever that influence may be. Or their presence doesn't matter, in which case they give us the appearance of conflicts that invite conspiracies and destabilize confidence in the entire System.

This mischief is not mere conjecture. Until days before Silicon Valley Bank's collapse, its now disgraced former CEO Greg Becker sat on the board of directors of the Federal Reserve Bank of San Francisco. We do not know what role, if any, his presence played in the supervisory failures that preceded SVB's collapse. I doubt he manipulated the Fed through this formal role. The very fact that we are asking the question and having this discussion – which, to be clear, requires investigation to confirm these doubts – is a tragic waste of resources and Fed credibility.

For this reason, I support efforts to render these boards of directors advisory only, to give to the Board of Governors plenary appointment authority over the individuals who will hold these advisory positions, and remove from all banks the franchise to vote in their own to supervise their supervisors. The political compromises and context of the United States during the Wilson Administration no longer apply. The

time is far past to render these important public institutions fully public, to avoid both the appearance and fact of these conflicts.

To be clear, I do not wish to overclaim and assert that if Mr. Becker had not been on the board of the San Francisco Fed that the supervisory failures associated with SVB would not have occurred. We have no evidence about what Mr. Becker's role did or did not mean to those supervisory processes. My point is only that every minute we spend wondering about this conflict is a minute that takes away from the Fed's credibility as a public institution endowed with protecting all interests, not just the special ones.

Conclusion

To conclude, the banking crises of 2023 were preventable. Government intervention to the spectacular degree that we have seen should not have occurred. There were failures of bankers, bank supervision, bank regulators, and a legislative regime altered too far, too fast, too soon after the last avoidable financial crisis. Some of the reforms I advocate here – enhancing prudential supervision for banks with assets between $100 billion and $250 billion, for example – are directly responsive to these challenges. Others are about information and accountability (changes to the Fed's inspector general) and perception (removing bankers from Federal Reserve Bank governance). I hope we can take advantage of the lessons learned and the future crises we hope to avoid from these unfortunate two months.