Large Bank Oversight and M&A Ramifications from Recent Bank Failures

April 26, 2023

The Silicon Valley Bank ("SVB") and Signature Bank ("Signature") failures (together, the "March Failures") were the second- and third-largest commercial bank failures in U.S. history. Six weeks after the March Failures, bank stability issues continue to generate headlines, and healthy banks remain subject to depositor outflows.[1] The March Failures have raised broad-ranging questions regarding the proper calibration of U.S. bank supervision and regulation and the potential need to reconsider reforms adopted after the 2008 financial crisis and changes to those reforms introduced during the Trump administration by the Economic Growth, Regulatory Relief, and Consumer Protection Act (the "EGRRCPA"). The March Failures have brought particular attention to the oversight of the approximately two dozen non-GSIB U.S. banks with assets between $75 and $700 billion ("Large Banks").

Even before the March Failures, U.S. bank regulators[2] under the Biden administration had indicated a desire to reverse some of the tailored regulatory standards implemented during the Trump administration that were designed to alleviate regulatory burdens for GSIBs and, particularly, Large Banks. For instance, in December 2022, Federal Reserve Board (the "FRB") Vice Chair for Supervision Michael Barr discussed the need for a "holistic review" of bank capital standards.[3] Last year, the FRB and the Federal Deposit Insurance Corporation (the "FDIC") also issued an advance notice of proposed rulemaking ("ANPR") to evaluate whether large regional banks (and potentially other institutions) should become subject to total loss absorbing capacity ("TLAC") and enhanced resolution requirements more similar to those of the GSIBs to facilitate bank resolution.[4] Martin Gruenberg, now the FDIC Chair, presaged these developments when, in 2019, he spoke to the "challenges posed by the failure of a large regional bank"

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[1] *See e.g.*, Rachel Louise Ensign, *First Republic Lost $100 Billion in Deposits in Banking Panic*, Wall Street Journal (April 25, 2023, 6:02 AM), https://www.wsj.com/articles/first-republic-lost-100-billion-in-deposits-in-banking-panic-7e1bd86c.

[2] This Debevoise In Depth uses "U.S. bank regulators" to mean the FRB, FDIC and OCC (as defined herein).

[3] Michael S. Barr, *Why Bank Capital Matters*, remarks at the American Enterprise Institute (Dec. 1, 2022), *available* here.

[4] *Resolution-Related Resource Requirements for Large Banking Organizations*, 87 Fed. Reg. 64170 (Oct. 24, 2022).

and lamented the weakening or removal of many of the resolution requirements to which Large Banks were subject before the Trump reforms.[5]

U.S. bank regulators now find themselves under pressure to respond quickly and forcefully to the March Failures and ensuing industry instability with supervisory and regulatory changes. They have already made public statements pointing toward future reforms that would scale back some of the tailoring reforms implemented under the EGRRCPA.[6] In recent Senate Banking Committee testimony, Vice Chair Barr noted that the FRB is conducting a thorough review of FRB supervision and whether that supervision was sufficiently robust in light of the rapid growth of SVB (with a report scheduled for release on April 28). Barr also stated that the tailoring measures taken during the Trump administration were "in the scope of [the FRB's] review" and that the FRB is evaluating several regulatory changes (described in the discussion below) to ensure Large Bank resiliency.[7] Exhibit A illustrates how, in light of Barr's comments, the enhanced prudential standards might be revised to apply to Large Banks.[8] FDIC Chair Gruenberg also appeared before the Senate Banking Committee and, in his testimony, stated that "serious attention" was needed with regard to several aspects of Large Bank regulation, including capital treatment of unrealized losses in securities portfolios and resolvability of banks with assets of $100 billion or more, with specific consideration for enhanced resolution plans and long-term debt requirements.[9] The FDIC is also expected to issue a report concerning its supervision of Signature by May 1.

This Debevoise In Depth seeks to assist Large Banks to prepare for the anticipated changes to the regulatory landscape by discussing possible supervisory questions that may arise (and some possible responses thereto) in the immediate term, as well as longer-term regulatory and industry challenges.

The regulatory and oversight changes described herein may foster more bank and non-bank M&A. U.S. bank regulators, seeking a safe, sound and resilient banking system, may be more receptive to mergers in which the parties demonstrate that the resulting organization will be more resilient and better able to provide for the convenience and needs of its customers. From the Large Banks' perspective, the enhanced regulatory

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[5] Martin J. Gruenberg, *An Underappreciated Risk: The Resolution of Large Regional Banks in the United States*, remarks at The Brookings Institution, Center on Regulation and Markets (Oct. 16, 2019), *available* here.

[6] *See, e.g.*, *Barr* Testimony, *infra* note 7; Gruenberg Testimony, *infra* note 9; White House Fact Sheet, *infra* note 23.

[7] Michael S. Barr, *Testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs* (Mar. 28, 2023) [hereinafter "Barr Testimony"], at 8-9, *available* here.

[8] Given the breadth of the changes, it may even be possible for Category IV to be eliminated altogether, *i.e.*, consolidated with Category III. This, in turn, could obviate the need to calculate certain systemic risk metrics relevant for Category III firms, including non-bank assets and off-balance sheet exposure.

[9] Martin J. Gruenberg, *Testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs* (Mar. 28, 2023) [hereinafter "Gruenberg Testimony"], at 3, 21, *available* here.

burdens under the FRB tailoring rules of moving from a Category IV bank ($100 to $250 billion of assets) to a Category III bank ($250 billion to $700 billion of assets) historically provided a material disincentive to grow beyond Category IV. However, if due to the March Failures, U.S. bank regulators materially increase the regulatory burdens on Category IV banking organizations, where both SVB and Signature were resident, then Category IV banking organizations may determine that the benefits of economies of scale and diversification warrant material organic and inorganic growth, even if the growth moves them into tailoring Category III. For Large Banks in tailoring Category III, the broad asset range ($250 billion-$700 billion) may allow significant growth and the benefits growth provides, without material enhanced regulatory burden. In addition to M&A's additive benefits regarding assets and capabilities, many Large Banks also may wish to consider divestitures to reposition their balance sheets and place themselves in the best position to succeed in the coming regulatory environment.

The discussion in this Debevoise In Depth is likely also relevant to foreign banking organizations ("FBOs"), due to the similarity in the tailoring rules for FBOs and Large Banks. This discussion may be relevant to the U.S. GSIBs as well, given that they are the most highly regulated of the U.S. banking institutions.

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Please do not hesitate to contact us with any questions.

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Short Term: Preparing for Potential Supervisory Activity

Although the precise circumstances leading up to the March Failures remain subject to debate and investigation, U.S. bank regulators have cited deficiencies in risk management practices as a proximate cause of the failures. Regulators have focused on liquidity and interest rate risk management, risk governance, reporting and preparedness. In the wake of the March Failures, supervisors may probe these areas more thoroughly, escalate concerns more quickly and issue harsher sanctions more readily than they would have otherwise. Below, we outline several key areas on which supervisors may focus and suggest steps banking organizations should consider taking to prepare for enhanced scrutiny.

Assess Risk Management Practices

- **Interest Rate and Liquidity Risk Management Practices and Contingency Funding Plans.** In his testimony before the Senate Banking Committee, Vice Chair Barr focused on ineffective interest rate and liquidity risk management practices as proximate causes of SVB's failure. He suggested that SVB failed to "develop effective interest rate risk measurement tools, models, and metrics" and to properly manage its liabilities. As described in his testimony, supervisors had also found deficiencies in SVB's contingency funding.[10] Banking organizations may wish to consider whether their interest rate and liquidity risk management practices and contingency funding plans remain appropriately calibrated based on their risk profiles and activities, and whether these practices and plans are clearly documented.

- **Risk Governance**. Vice Chair Barr also described SVB's failure as a "textbook case of mismanagement" and noted SVB's supervisors had found deficiencies in board oversight and internal audit, among other areas, leading to SVB's management rating downgrade in the summer of 2022.[11] In addition to reviewing and potentially enhancing liquidity and interest rate risk management practices and documentation, banking organizations may benefit from assessing more holistically the adequacy of their risk governance, including roles and responsibility, management information systems, escalation and reporting processes, risk appetite and limits setting. We discuss considerations for banking organizations' boards of directors below.

- **Financial Institution Exposure and Connectedness.** In light of the concerns around contagion in the wake of the March Failures, banking organizations may consider reviewing their exposure and interconnectedness to other financial institutions, both in terms of the safety of client funds and the organization's access

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[10] *See* Barr Testimony, *supra* note 7, at 1-2, 5-6.

[11] *See id.* at 2, 5.

to its own funds. For example, it may be advisable for a banking organization to (i) be prepared to provide clients with a clear understanding of how it manages risk arising from other financial institutions, (ii) review its sweep agreements with other banks and (iii) be prepared to communicate with its clients about those agreements. In addition, banking organizations may want to revisit their own practices for diversifying exposure to other financial institutions in light of recent events.

Review Board Oversight

As noted above, Vice Chair Barr stated in his Senate testimony that SVB had been issued three findings related to ineffective board oversight.[12] In light of potential heightened supervisory scrutiny of board and senior management oversight and identified weaknesses in SVB's risk management practices, boards may benefit from:

- reviewing the robustness of board-level risk reporting, escalation triggers, and whether the data they receive captures critical information regarding present and emerging risks;
- engaging management in a discussion of liquidity and interest rate risk management practices, crisis preparedness plans (including the board's role) and the appropriateness of these practices and plans;
- assessing whether director engagement and challenge are adequately reflected in meeting minutes; and
- considering whether retaining outside advisors who can provide expertise and additional guidance to inform board decision-making would be helpful.

Additionally, in evaluating strategic opportunities, boards of directors may want to consider whether transactions, including bank and non-bank acquisitions, would reduce concentration risk by diversifying an organization's funding, asset and revenue mix. Boards and senior management also should take into account management's ability to manage the risks associated with the transaction, including integrating new businesses and operating a larger organization.

Update Crisis Response Playbooks and Enhance Operational Readiness

To respond to questions from supervisors, it may be prudent for banking organizations to consider revising or creating crisis-related playbooks to assess preparedness for

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[12] The FRB's expectations for board effectiveness are outlined in SR letter 21-3, *Supervisory Guidance on Board of Directors' Effectiveness* (Feb. 26, 2021), *available* here. For more information on SR 21-3, please see our prior Debevoise In Depth, *Federal Reserve Board Finalizes Board Effectiveness Guidance* (Mar. 10, 2021), *available* here.

liquidity and stock volatility stress situations like the one faced by SVB, whether arising from within the organization or as a result of contagion related to instability at peer banks. Banking organizations already have several existing playbooks, including those related to governance, contingency funding, recovery and resolution and crisis communication. Those could be combined or coordinated and serve as a "go-to" resource during periods of instability and could include preparation to draw on sources of funding and identification of available lines of credit and potential buyers for liquid assets in a crisis. Further, the organization should consider whether it is appropriately positioned to quickly draw on government support facilities, including the Federal Home Loan Bank system, the FRB's discount window and other available FRB facilities. This includes ensuring that the appropriate collateral is properly identified and positioned prior to a crisis. In addition, tabletop exercises could be used to simulate and review crisis responses. These exercises can help identify gaps in the organization's playbooks and operational readiness.

Potential Increase in M&A Resulting from March Failures and Expected Regulatory Changes

Large Banks are subject to the FRB's tailoring rules, which are designed to reduce the likelihood of failure of institutions as they become more systemically important by subjecting them to enhanced prudential standards ("EPS"). The majority of the FRB's tailoring rule categories use asset size as a proxy for complexity, though following the March Failures, Vice Chair Barr suggested that other factors, such as the niche nature of a bank, should also be considered. Historically, the increased EPS burdens of moving from a lower to higher tailoring category (*e.g.*, Category IV to Category III) provided a significant disincentive for a Large Bank to grow from its current tailoring category into the next larger one.

However, the changes in oversight and regulation of Large Banks currently contemplated by the U.S. bank regulators may reduce that disincentive. As both SVB and Signature were Category IV banks, U.S. bank regulators will likely seek to increase significantly the regulations and oversight of institutions in that category, as Exhibit A suggests. As the differential burden between the application of the EPS rules to Category IV and Category III banks lessens, the benefits of bank and non-bank M&A, including economies of scale to deal with regulatory costs and diversification of customer base, products and geography, increase. Moreover, once a Category IV bank moves into Category III, the broad asset range of Category III would allow further M&A and thus more of the benefits M&A provides. More generally, as the burdens of the EPS rules become more significant, economies of scale and diversification benefits may justify bank and non-bank M&A with less regard to its impact on the resultant bank's tailoring category. Comprehensive board evaluation of these issues, both when evaluating whether to pursue an M&A strategy generally and with respect to the impact of any particular deal, is even more essential in this environment.

Of course, particularly for bank M&A, the U.S. bank regulators' current negative view towards Large Bank M&A also must be evaluated. This view has dampened or delayed Large Bank M&A for much of the Biden administration. However, the U.S. bank regulators continue to discuss releasing updated M&A guidelines, which should provide some additional clarity. Additionally, the March Failures may have increased the U.S. bank regulators' concerns about the safety and soundness and resiliency of the banking system. If a Large Bank evaluates the governance and enhanced regulatory burdens raised in this In Depth and can demonstrate that the resultant bank will be both more resilient, safe and sound under the new regulatory framework, and thus able to provide inclusive benefits to a wider range of customers on an ongoing basis, that demonstration may increase regulatory receptivity to a bank deal more than it would have before the March Failures.

To maximize its chance of regulatory success, a Large Bank may want to demonstrate to its regulators how it will comply with the current or anticipated regulatory obligations that come with its increased size. Large Banks can prepare implementation plans addressing these issues and present them as part of the application process. These plans could include, for example, identifying additional applicable requirements (*e.g.*, holding company resolution plans or liquidity coverage ratio requirements) and how the bank is ensuring it will be able to meet those requirements.

Moreover, Large Banks may not engage in M&A only to add assets and capabilities. Rather, after conducting a strategic review of their environment and upcoming regulation, Large Banks also may restructure companies within their consolidated enterprise, and even divest of certain businesses or operations, to best position themselves to address their business objectives and the capital, liquidity and structuring regulations likely ahead. Given the current environment, those evaluations and divestitures may occur in the near future.[13]

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[13] *See e.g.*, Matthew Monks, *PacWest Bancorp Explores Sale of Its Lender Finance Division*, Bloomberg (Apr. 21, 2023, 7:08 PM), https://www.bloomberg.com/news/articles/2023-04-21/pacwest-bancorp-explores-a-sale-of-its-lender-finance-division?leadSource=uverify%20wall.

Potential Regulatory Changes to Come

Because of their broad rulemaking authority, the U.S. bank regulators likely will not need any congressional action to implement many of the changes highlighted in agency statements thus far. Consistent with statements made by Vice Chair Barr and other agency principals, we expect U.S. bank regulators to focus on rule revisions both to enhance resolvability and to prevent the likelihood of failure, including revisions to resolution planning requirements, the imposition of TLAC requirements on large regional banks, enhancements to the liquidity coverage ratio and net stable funding ratio and changes to stress testing requirements, among others. Though not at the forefront of recent statements from U.S. bank regulators, regulatory changes on related fronts, such as incentive-based compensation[14] and discount window access[15] may also be on the horizon as a consequence of the March Failures.

For certain actions, the U.S. bank regulators may be able to enact change without a notice and comment period, such as by issuing new guidance outside of the formal rulemaking process. For other changes, the U.S. bank regulators would need to issue a proposal and seek public comment. It is critical for stakeholders, particularly any affected banking organizations, to weigh in during the comment period of such a proposal. It may also be advantageous for banking organizations to begin to assess how these anticipated changes would impact them and how they can begin to marshal the internal resources needed to address the changes.

Resolution Planning

As a result of the March Failures, there will likely be a refocus by the FRB and FDIC on resolution planning. Although we expect regulators to be focused on addressing the resolution of Large Banks, some changes based on lessons learned from the March Failures could affect other banking organizations as well, including U.S. GSIBs and FBOs.

Background

The Dodd-Frank Act requires large bank holding companies ("BHCs") and non-bank systemically important financial institutions (though none are currently designated) to submit resolution plans to the FRB and FDIC to prepare for a rapid and orderly

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[14] *See* Antoine Gara, Parick Temple-West and Tabby Kinder, *Executive pay at Silicon Valley Bank soared after big bet on riskier assets*, Financial Times (Mar. 24, 2023), https://www.ft.com/content/02ff2860-2d5b-4e21-96af-cef596bff58e (describing how executive compensation at SVB was tied to risky asset bets).

[15] *See* Hannah Miao, Gregory Zuckerman and Ben Eisen, *How the Last-Ditch Effort to Save Silicon Valley Bank Failed*, Wall Street Journal (Mar. 22, 2023, 5:30 AM), https://www.wsj.com/articles/how-the-last-ditch-effort-to-save-silicon-valley-bank-failed-89619cb2 (documenting how technical and systematic failures with the discount window system prevented SVB from receiving loans).

resolution under the Bankruptcy Code. The plans require the submission of a resolution strategy for how to resolve all of the institution's material legal entities without serious adverse effects on U.S. financial stability.

These resolution plans used to be required for financial institutions with $50 billion or more in assets. In 2018, the EGRRCPA raised the threshold to $250 billion and gave the U.S. bank regulators discretion to apply the requirement to firms with total consolidated assets of between $100 billion and $250 billion. In 2019, the FRB and FDIC revised the implementing regulations (the "165(d) Rule") so that financial institutions with total consolidated assets of less than $100 billion would no longer be required to file these holding company resolution plans, and only certain firms (based on tailoring factors) with total assets between $100 and $250 billion would be required to file plans.[16] In addition, the resolution plan filing requirement moved from an annual to a two- or three-year submission cycle, depending on the firm's category under the FRB's tailoring rules, with the largest firms being required to alternate between filing a full and "targeted" resolution plan. Under these revisions, as a Category IV bank, SVB was not required to submit a resolution plan under the 165(d) Rule.

The FDIC has issued a separate rule (the "IDI Rule") requiring insured depository institutions ("IDIs") with more than $50 billion in assets to submit bank-level resolution plans to the FDIC. In 2019, the FDIC issued an ANPR seeking comment on potential changes to the IDI Rule and indicated that the submission of IDI resolution plans would not be required until the rulemaking process was completed. A revised rule, however, was never proposed, but in June 2021, the FDIC issued a statement as guidance modifying its approach to implementation of the IDI Rule. The statement confirmed that it would resume the requirement of resolution plan submissions under the IDI Rule for IDIs with $100 billion or more in assets and extend the resolution plan submission frequency for these institutions to a three-year cycle. It also laid out the FDIC's modifications to the process for IDI resolution planning, the expectations for the contents of IDI resolution plans and exemptions to content requirements for IDI resolution plans. SVB had submitted its first plan pursuant to the IDI Rule in December 2022; Signature had never submitted a resolution plan.[17]

Potential Changes

Following the March Failures, the FRB and FDIC seem likely to reverse course and intensify regulations and guidance regarding different elements of resolution planning. In fact, as discussed above, even before the March Failures, these agencies had already issued an ANPR to solicit comment on whether Large Banks should be required to

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[16] For more information on the 165(d) Rule, please see our prior Debevoise In Depth, *Agencies Finalize Changes to Resolution Planning Requirements* (Jan. 21, 2020), *available* here.

[17] *See* Signature Bank, Annual Report (Form 10-K) (Mar. 1, 2023), at 23, *available* here.

enhance their resolvability primarily by holding "an extra layer of loss-absorbing capacity," which "could improve optionality in resolving a large banking organization or its insured depository institution."[18] Future reforms are likely to be informed not only by the ANPR but also by what type of resolution planning information proved useful in the resolution of SVB and what critical pieces of information or planning were missing.

In the ANPR, the FRB and FDIC expressed concern about the challenges associated with the acquisition of a large, failed IDI and the difficulties of executing a purchase and assumption transaction given "the universe of potential acquirers is limited."[19] This concern had previously been raised by current FDIC Chair Gruenberg, who noted back in 2019 that "the limited number of banks with the capability to acquire a failed regional bank" should indicate that federal regulators needed to prepare for resolution of these banks by other means and that enhanced resolution planning could prove useful.[20] To some extent, this fear was borne out by the failures of SVB and Signature—in each case, the lack of immediately available buyers required the FDIC to create a bridge bank and, after running a bidding process, the FDIC was unable to execute a clean purchase and assumption transaction for the entire bank.

It will likely be easier for the FDIC to make changes to the IDI plan requirements through issuing guidance, so it may make sense for Large Banks to focus on changes to the IDI plan requirements in the near term. However, it remains to be seen precisely which changes will be pursued. Below, we provide some elements of resolution planning the agencies could change without notice and comment:

- Requiring interim updates of holding company resolution plans pursuant to the 165(d) Rule;
- Requiring resolution plans or updates in connection with merger approvals;[21]
- Lowering the submission threshold for IDI plans to include banks with $50 billion or more in assets;

[18] 87 Fed. Reg. at 64170.

[19] *Id.* at 64171.

[20] *See* Gruenberg, *supra* note 5, at 4-5, 8-9.

[21] Federal regulators had already started requiring this as a condition of approval for certain bank mergers before the March Failures. For example, in October 2022, the FRB and the Office of the Comptroller of the Currency ("OCC") imposed additional resolution planning-related requirements as a condition to approving U.S. Bank's acquisition of MUFG Union Bank. FRB and OCC, *Letter Re: Application to merge MUFG Union Bank, National Association, San Francisco, California with and into U.S. Bank National Association, Cincinnati, Ohio* (Oct. 14, 2022), at 4-6, *available* here.

- Expanding IDI plan requirements to include additional content and removing existing exemptions; and
- Returning to the original submission frequency contained in the IDI Rule before the 2021 changes.

Resolution planning changes that would require notice and comment rulemaking include:

- Revising the IDI Rule to provide for engagement and capabilities testing or additional financial reporting that may have been useful in the resolutions of SVB and Signature (although it is possible this could be done through guidance or the supervisory process);[22]
- Revising the 165(d) Rule to apply in all cases to smaller regional banks, such as those with assets between $100 and $250 billion;[23]
- Increasing the frequency of 165(d) plan submissions; and
- Removing the concept of targeted plans and reduced plans for certain FBOs.

TLAC

In light of recent regulator statements discussed above, the March Failures appear very likely to cause the FRB to impose some sort of TLAC requirement on Large Banks and potentially on non-GSIB FBOs.

Background

Currently, under the FRB's 2017 final TLAC rule, TLAC requirements apply to U.S. GSIB BHCs and U.S. intermediate holding companies of non-U.S. GSIBs with $50 billion or more in U.S. (non-branch) assets.

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22 In a recent speech, FDIC Vice Chairman Travis Hill stated that "[t]he SVB failure also reinforces the importance of a bank's capability to quickly populate a data room so that potential bidders can perform due diligence" and "[a]nother key capability is a firm's ability upon failure to immediately produce a list of key employees for the FDIC, and to ensure those employees remain in their positions post-failure." Travis Hill, *The Recent Bank Failures and the Path Ahead*, remarks at the Bipartisan Policy Center (Apr. 12, 2023), *available* here.

23 The Biden administration, in a recently released fact sheet responding to the March Failures, asserted that Trump administration regulators took the wrong approach in "remov[ing] the [living will] requirement for bank holding companies in the $100 to $250 billion size range," further stating that "banks and bank holding companies of this size" should have to submit these resolution plans. White House Fact Sheet, *President Biden Urges Regulators to Reverse Trump Administration Weakening of Common-Sense Safeguards and Supervision for Large Regional Banks* (Mar. 30, 2023), *available* here.

Pursuant to the TLAC rule, U.S. GSIBs must hold a minimum amount of external eligible long-term debt ("LTD") and a minimum amount of LTD plus Tier 1 capital (together comprising TLAC). Eligible LTD must have certain characteristics that make it loss-absorbing, such as having a maturity of one year or more, not having certain acceleration rights, not being structured notes and other features. U.S. GSIBs also must abide the "clean holding company requirements," which restrict the types of liabilities and other instruments that can be held at the parent holding company. For example, the parent holding company is prohibited from issuing short-term debt or entering into qualified financial contracts with third parties.[24]

Potential Changes

In October 2022, the FRB and FDIC (the "Agencies") issued an ANPR to solicit comment on a potential TLAC requirement to facilitate resolving a large banking organization or its insured depository institution that is not a GSIB, with a particular focus on large regional banks.[25] The Agencies were concerned about an increased reliance among large banking organizations on uninsured deposits, which can be less stable in a stress scenario. They felt that a TLAC requirement could help to resolve this challenge, noting that "[t]he availability of sufficient loss-absorbing resources at the depository institution would preserve franchise value and support stabilization of the firm to allow for a range of options for the restructuring and disposition of the reduced firm in whole or in parts."[26] This could be particularly useful, they noted, for a bridge bank strategy.[27]

The Agencies' concerns in the ANPR seemed prescient during the March Failures, as a run on uninsured deposits appeared to be a major factor in the collapse of both SVB and Signature, and bridge bank strategies were pursued for both. As a result, and based on recent statements by Vice Chair Barr and others, a proposed TLAC rule for Large Banks and perhaps other institutions seems significantly more likely. Both Chair Gruenberg and Vice Chair Barr stated in their respective testimonies on the March Failures before the Senate Banking Committee that one of the lessons learned from the crisis is that LTD requirements should be expanded to a wider range of banks.[28] Further, the Biden administration's fact sheet called for regulators to "move forward expeditiously" and, based on the ANPR, expand LTD requirements to "a broader range of banks."[29] While the resolution of both SVB and Signature, through a bridge bank strategy, proved

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[24] Non-U.S. GSIBs subject to the TLAC rule have similar requirements, but we focus here on U.S. GSIBs for simplicity.

[25] 87 Fed. Reg. 64170.

[26] *Id.* at 64171.

[27] *Id.* at 64172.

[28] *See* Barr Testimony, *supra* note 7, at 9 ("We plan to propose a long-term debt requirement for large banks that are not G-SIBs, so that they have a cushion of loss-absorbing resources to support their stabilization and allow for resolution in a manner that does not pose systemic risk"); Gruenberg Testimony, *supra* note 9, at 3, 21.

[29] White House Fact Sheet, *supra* note 23.

complicated and expensive to the Deposit Insurance Fund, Swiss regulators wiped out $17 billion of junior Credit Suisse Group AG's ("CS") debtholders by writing down CS's additional tier 1 capital securities ("AT1s") (Europe's TLAC equivalent) to facilitate UBS Group AG's buyout of CS.

The precise nature of the TLAC requirement that would be applicable to Large Banks still remains to be seen. In the ANPR, the Agencies considered imposing a TLAC or LTD requirement at either the insured depository institution level and/or the holding company level for a large regional bank. They also considered some form of internal TLAC between the IDI subsidiary and its holding company parent, clean holding company requirements similar to those that apply to the U.S. GSIBs and recovery planning guidance. Following the March Failures and recent statements, it may be prudent for banking organizations to start to consider what a TLAC requirement might look like and what sorts of comments should be made to the Agencies.[30] Particularly, banking organizations with multiple point-of-entry ("MPOE") resolution strategies may want to consider where debt may be held if TLAC requirements are imposed.

Liquidity Risk and Short-Term Wholesale Funding

As mentioned further above, Vice Chair Barr's testimony to the Senate Banking Committee identified liquidity risk mismanagement as a key contributor to the March Failures and pointed out that SVB specifically was not subject to certain quantitative liquidity regulations. To the extent that the FRB's forthcoming April 28 report suggests that SVB would have had higher levels of liquidity under those standards, and that those higher levels would have forestalled the bank's failure, we may expect the regulators to broaden the scope of those regulations to Category IV firms. Even if the report concludes that imposition of those standards would not have prevented any of the March Failures, the U.S. bank regulators still may conclude that enhancements to the scope and calibration of those requirements would be beneficial because they would have "provided further resilience."

Background

The 2007-2008 financial crisis highlighted the risks associated with short-term wholesale funding. Indeed, many of the reforms that the U.S. bank regulators implemented in the response to the crisis focused on measuring and limiting banking organizations' reliance on such funding, including the liquidity coverage ratio ("LCR"),[31]

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[30] The CEOs of two Large Banks, U.S. Bancorp and PNC Bank, both stated on recent earnings calls that they believed new TLAC requirements for Large Banks were a "certainty" in the aftermath of the March Failures.

[31] The LCR requires firms to hold "high quality liquid assets" sufficient to meet projected cash needs over a forward-looking 30 day period of stress. Essentially, the LCR is a more risk-sensitive, broadly applicable form of a traditional bank reserve requirement.

the net stable funding ratio ("NSFR")[32] and calculation of weighted short-term wholesale funding ("wSTWF").[33]

Notably, however, these regulations focus specifically on the systemic risks associated with such funding and intra-financial system vulnerability. This focus is reflected in a number of places:

- Category IV firms are not subject to the LCR or NSFR unless they have at least $50 billion in wSTWF and, even if they do, are subject to modified versions that include less stringent stress assumptions. Similarly, Category III firms are subject to a modified version of the LCR and NSFR (and are subject to less frequent FR 2052a reporting) to the extent that they have less than $75 billion in wSWTF.
- For purposes of determining wSTWF, unsecured wholesale funding (including uninsured deposits) obtained outside of the financial sector is weighted many multiples less than funding obtained within the financial sector.
- For purposes of the LCR and NSFR, unsecured wholesale funding, including uninsured deposits and "operational deposits"[34] from outside of the financial sector, is assumed to be far stickier (under the LCR) and more stable (under the NSFR) than such funding obtained from "financial sector entities."

Potential Changes

Recent events have drawn significant scrutiny to uninsured deposits that originate from outside of the financial sector and at least superficially called into question the risks arising from these funding sources. In his March 28 testimony to the Senate Banking Committee, Vice Chair Barr noted that SVB was not subject to either the liquidity coverage ratio or the net stable funding ratio and noted that both the LCR and NSFR "are in the scope of [the FRB's] review," including by "assessing whether SVB would have had higher levels of [...] liquidity under those standards, and whether such higher levels of [...] liquidity would have forestalled the bank's failure or provided further resilience to the bank."[35] Even if the May 1 report concludes that higher levels of liquidity as a result of being subject to the rules would not have prevented SVB's failure,

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32 The NSFR focuses on longer term funding risks by ensuring that a banking organization has sufficient "available stable funding" to meet "required stable funding" arising from its activities.

33 wSTWF contributes to a large banking organization's systemic risk score and, post-EGRRCPA, impacts a firm's enhanced prudential standards categorization and application of the LCR and NSFR, and the frequency of FR 2052a liquidity reporting.

34 These include deposits necessary for the provision of operational services, including payroll.

35 Barr Testimony, *supra* note 7, at 9.

such a finding could pave the way for an aggressive re-calibration of the LCR, the NSFR and the regulatory approach to short-term wholesale funding.

Potential changes to the scope and calibration of liquidity requirements through notice and comment rulemaking may include:

- Lowering or removing the wSTWF thresholds for Category IV firms to be subject to the LCR and NSFR or for Category III or IV firms to be subject to less stringent forms of the LCR, NSFR and FR 2052a reporting.

- Modifying the calculation of wSTWF by increasing the weighting for unsecured wholesale funding obtained outside the financial sector (*e.g.*, from venture capital portfolio companies), increasing the weighting for unsecured wholesale funding (including uninsured deposits) generally or requiring private equity and venture capital portfolio companies to be treated as "financial sector entities" (subject to a higher weighting).

  - This could have a similar effect as the first bullet above, making a broader range of firms subject to the LCR/NSFR by inflating their wSTWF metrics and causing them to cross the relevant thresholds even if the numerical thresholds themselves are not changed.

  - This also could have knock-on effects for larger firms by increasing their systemic risk scores.

- Technical changes to the LCR and NSFR, including:

  - Changing operational requirements for high-quality liquid assets (*e.g.*, to the extent that the May 1 report concludes that SVB had liquid assets that it was not able to monetize quickly enough).

  - Increasing haircuts (under the LCR) or required stable funding factors (under the NSFR) for longer dated "level 1" (U.S. Treasury bonds) or "level 2A" (GSE) securities.

  - Raising outflow rates (under the LCR) and lower available stable funding factors (under the NSFR) for uninsured deposits from outside of the financial sector and "operational deposits" or increasing the scope of deposits considered to be from financial sector entities (*e.g.*, private equity and venture capital portfolio companies).

- Removing "tailored" liquidity stress testing and liquidity risk management requirements for Category IV firms by reverting to pre-2018 standards.

Regulatory Capital and Stress Testing

Vice Chair Barr's testimony to the Senate Banking Committee also identified capital and related stress testing requirements as potential contributors to the SVB failure, specifically noting that SVB was not subject to stress testing or the supplementary leverage ratios and flagging the fact that its capital levels did not have to reflect unrealized losses on available-for-sale securities. To the extent that the April 28 report suggests that these measures may have contributed to the March Failures, we may expect the federal banking agencies to impose these requirements on Category IV firms, which may include going beyond simply scaling back some of the EGRRCPA tailoring.

Background

Currently, firms with $100 billion or more in total consolidated assets are subject to capital and stress testing requirements depending on their enhanced prudential standards categorization. SVB and Signature were both Category IV firms, which meant that among other things:

- Each was subject to biennial rather than annual supervisory stress testing.
  - SVB only became a Category IV firm in 2021 around the time of its acquisition of Boston Private and did not have to comply with any supervisory stress testing until 2024 by virtue of applicable transition periods.
- Neither had to include certain elements of accumulated other comprehensive income ("AOCI") (specifically, unrealized gains and losses on available-for-sale securities) in regulatory capital.
  - Category III firms are also able to benefit from this exclusion, commonly referred to as the "AOCI filter" or "AOCI opt-out."
- Neither was subject to the supplementary leverage ratio.

Potential Changes

In the weeks following the March Failures, there has been significant focus on SVB's investment securities portfolio, which was highly sensitive to increasing rates (due to its relatively long average duration) and had accumulated significant unrealized losses that, although disclosed, were not reflected in SVB's regulatory capital ratios. Vice Chair Barr's testimony also drew attention to the fact that, as a Category IV firm, SVB was

subject to "less frequent stress testing,[36] […] no bank-run capital stress testing requirements, and less rigorous capital planning and liquidity risk management standards" and was not subject to the supplementary leverage ratio ("SLR").[37]

As with the LCR and NSFR, Vice Chair Barr has flagged these items within the scope of the FRB's review, including by assessing "whether SVB would have had higher levels of capital … under those standards, and whether such higher levels of capital … would have forestalled the bank's failure or provided further resilience to the bank." As mentioned above, even if the May 1 report concludes that imposition of these requirements would not have prevented SVB's failure, the FRB may conclude that these may have provided "further resilience" or resulted in more aggressive recalibration such that those requirements could have prevented SVB's failure.

Potential changes to the scope and calibration of capital and stress testing requirements may include:

- A reversion to annual supervisory stress testing for Category IV firms.
    - The FRB may consider introducing different and additional stress scenarios (permanently or on an ad hoc basis as it did following COVID) to address a wider range of potential failure scenarios, including rising interest rates.
    - The FRB may revisit transition periods associated with firms that cross into higher enhanced prudential standard categories, either generally or by specifically imposing additional stress testing requirements in connection with an acquisition (as SVB almost doubled in size following its acquisition of Boston Private in 2021).
- Application of the SLR to Category IV firms.
    - Given SVB's significant portfolio of U.S. Treasury securities, the federal banking agencies may be resistant to industry calls to exclude U.S. Treasury securities from the SLR denominator.
- Removing the AOCI opt-out for Category III and IV firms.

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[36] In fact, Vice Chair Barr notes that due to transition periods and the timing of biennial stress testing, SVB would not have been subject to stress testing until 2024—three years after it crossed the $100 billion asset threshold. Barr Testimony, *supra* note 7, at 8.

[37] Barr Testimony, *supra* note 7, at 8-9. The SLR is a modified form of leverage ratio that is the ratio of tier 1 capital to total assets and certain off-balance sheet items.

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Exhibit A

Potential Enhanced Prudential Standards for Large Banks

Regulatory Requirement	Category I BHC	Category II BHC	Category III BHC	Category IV BHC	Other BHC
Resolution Planning					
165(d) Resolution Planning[38]					
Capital Requirements					
TLAC/Long-term debt					
GSIB surcharge					
Enhanced Supplementary leverage ratio					
Advanced approaches					
AOCI opt-out not available					
Supplementary leverage ratio					
Countercyclical capital buffer					
Standardized approach					
Tier 1 leverage ratio					
Capital Stress Testing					
Supervisory stress testing	Annually	Annually	Annually	Annually[39]	
Company-run stress testing	Annually	Annually	Biennially[40]	Annually or Biennially	
Annual capital plan	Annually	Annually	Annually	Annually	
FR Y-14					
Liquidity and Related Requirements					
LCR and NSFR			If wSTWF <$75b: Reduced (85%), else full (100%)[41]	Applicability of LCR/NSFR regardless of wSTWF, with potential modifications (full vs. reduced, daily vs.	

Legend

- Requirement Applies
- Requirement Does Not Apply
- Potential Changes

[38] Currently, Category IV U.S. firms are not required to submit 165(d) resolution plans; rather, any FBO with at least $250 billion in global consolidated assets but not within Category II or III must submit a 165(d) plan as a triennial reduced filer. To the extent that a banking organization has an insured depository institution subsidiary with $100 billion or more in total consolidated assets, that entity would need separately to file an IDI resolution plan with the FDIC.

[39] Currently only applies biennially.

[40] Such banking organizations are still required to conduct an internal stress test, and report the results on the FR Y-14A in connection with its annual capital plan submission. To the extent Category IV firms are required to do annual company-run stress testing, we would expect a corresponding change for Category III firms.

[41] To the extent Category IV standards are increased beyond those that currently apply to Category III firms, these also would be revised.

Regulatory Requirement	Category I BHC	Category II BHC	Category III BHC	Category IV BHC	Other BHC
				monthly) based on wSTWF.[42]	
Internal liquidity stress testing	Monthly	Monthly	Monthly	Monthly[43]	
Liquidity risk management				Untailored[44]	
Liquidity Buffer					
FR 2052a	Daily (T+2)	Daily (T+2)	Daily (T+2) if wSTWF ≥$75b, otherwise monthly (T+2)	Daily/Monthly T+2/T+10 based on wSTWF.[45]	
Other Enhanced Prudential Standards					
Single counterparty credit limits	More stringent GSIB to GSIB limit applies				
Risk Committee Requirement					Applies to U.S. BHCs with total consolidated assets of $50 billion or more
Risk Management Requirements					
FR Y-15					

Legend

- Requirement Applies (blue)
- Requirement Does Not Apply (white)
- Potential Changes (pink)

[42] Currently, neither the LCR nor NSFR would apply to a Category IV BHC to the extent its wSTWF was less than $50 billion, and then is only required to calculate its LCR on a monthly basis. Other possibilities could be to revise the wSTWF metric with more stringent risk weights for uninsured corporate deposits (which would affect all firms), or maintaining the current thresholds but requiring a higher outflow multiplier and/or moving to a daily calculation.

[43] Currently, this only applies quarterly.

[44] Currently, this is tailored.

[45] Currently applies to Category IV firms on a monthly (T_10) basis. Although Vice Chair Barr did not mention this in his testimony, the FR 2052a is likely to change to match any changes in the LCR.