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Impacts of the 2023 Banking Crisis on Mid-sized & Regional Banks

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In the spring of 2023, the US banking sector experienced greater disruption than at any time since the 2008 financial crisis. In March 2023, two mid-sized banks failed as a result of liquidity issues stemming from unexpected and rapid loss of depository confidence: Silicon Valley Bank and Signature Bank. To avoid an industry contagion, the federal banking regulators, together with the Department of the Treasury, were forced to take extraordinary action to protect the uninsured depositors of those two institutions. Just a few months later in May, another mid-sized bank, First Republic Bank, failed for similar reasons and was acquired by JPMorgan in a receivership transaction with the Federal Deposit Insurance Corporation (FDIC).

In responding to the spring 2023 bank failures, the banking regulators are relying largely on the playbook developed and deployed in response to the 2008 financial crisis, although somewhat tailored to the circumstances of the recent failures—measures to increase capital, increase liquidity, require long-term debt, and expand resolution planning requirements. We have already seen a more cautious approach by examiners and heightened day-to-day scrutiny, particularly of mid-sized and regional banks, which were the institutions most impacted by the recent banking stress.

Federal Reserve Chair Jerome Powell reinforced this idea at a banking conference in June when he noted that regulators missed the threats in the recent crisis partially because of the "natural human tendency to fight the last war." In other words, regulators were focused on what caused the 2008 crisis, namely credit and liquidity issues resulting from the 2008 housing bubble burst, as opposed to what caused this most recent crisis, specifically mid-sized institutions' inadequate management of interest rate risk and a very rapid escalation of events caused by social media and digital banking. Powell noted that recent "events suggest a need to strengthen our supervision and regulation of institutions of the size of [Silicon Valley Bank]" and that the Federal Reserve would "try to find ways to be more agile and, where appropriate, more forceful" in its supervision.

More forceful regulation and supervision of regional banks could have a number of effects within the industry, including the likelihood of more M&A activity.

Recent Rulemakings & Guidance Proposed by Agencies

While it is unlikely that new banking legislation will be enacted in the near term, the federal banking regulators have already proposed several rulemakings that will impact regional banks.

Capital Requirements

In July 2023, the regulators proposed substantial revisions to the regulatory capital framework for banking organizations with total assets of $100 billion or more, as well as banking organizations with significant trading activity. The proposal:

- replaces internal models-based capital requirements with new, more risk-sensitive standardized requirements for banking organizations with $100 billion or more in total assets;
- requires banking organizations with $100 billion or more in total assets to calculate regulatory capital in a consistent manner, including by reflecting unrealized gains and losses from certain securities in their capital ratios and complying with the supplementary leverage ratio requirement and the countercyclical capital buffer, if activated; and
- requires certain smaller firms with significant trading activities to comply with the proposal's market risk provisions.

The proposal, along with a second proposal that would revise the calculation of the global systemically important banks (GSIB) risk-based capital surcharge, are estimated to result in an aggregate 16 percent increase in common equity tier 1 capital requirements for impacted bank holding companies.

Liquidity Risk Management & Contingency Funding Plan

The banking regulators also issued an Addendum in July updating their guidance on liquidity risks and contingency planning (Addendum). The Addendum notes that the events of this spring are a "reminder . . . that depositor behavior and broader market conditions may evolve . . . without warning," implying that institutions may need to be agile and act quickly to maintain liquidity.

- The Addendum notes that depository institutions should assess the stability of their funding and maintain a broad range of funding sources that can be accessed in adverse circumstances, including the Federal Reserve's discount window.
- Depository institutions should focus on operational readiness, which would include being aware of the practical, operational steps required to obtain funding from contingency funding sources and regularly testing any contingency borrowing lines.

- Depository institutions should review and revise contingency funding plans periodically and more frequently as market conditions and strategic initiatives change to address evolving liquidity risks.

Long-Term Debt Requirements

In August, the banking regulators issued a proposed rule that would require banks with total assets of $100 billion or more to maintain a minimum amount of long-term debt (LTD)—both at the holding company and depository institution level—that could be used to absorb losses in the event of failure. The regulators noted that “the failure of three large banks in spring 2023 underscored the importance of supplementary, loss absorbing resources that regulators can use to resolve banks in a way that reduces costs and risk of disruption to the banking system.” The regulators' position is in line with that of the Biden Administration, which has renewed calls to apply the LTD requirement to banks below the $250 billion asset threshold.

- Banks impacted by the proposal would be required to maintain a minimum amount of eligible LTD equal to the greater of 6 percent of risk weighted assets, 3.5 percent of average total consolidated assets, and, for banks subject to the supplementary leverage ratio, 2.5 percent of total leverage exposure under the supplementary leverage ratio.

- Under the proposal, a holding company would issue LTD and would generally not be permitted to engage in certain activities that could complicate resolution —known as the “clean holding company requirements.”

- The proposal would also generally require that depository institutions with $100 billion or more in assets and any affiliated depository institutions issue minimum amounts of LTD to their parents.

- The proposal would also disincentivize banks from holding LTD issued by other banks to reduce interconnectedness.

The LTD requirement covered in this proposal is separate from and does not impact the total loss-absorbing capacity rule that was issued for GSIBs in 2016. The regulators estimate that the banking organizations covered by this proposal would need to issue approximately $70 billion in new LTD, equivalent to about 27 percent of the new total LTD requirement for these institutions.

Resolution Planning Requirements

In August, the Federal Reserve Board (FRB) and the FDIC issued proposed guidance to help certain bank holding companies further develop their resolution plans. The guidance would generally apply to bank holding companies and foreign banking organizations with more than $250 billion in total assets, other than GSIBs, which are already subject to guidance on resolution planning. The FRB and FDIC noted that, “as evidenced by recent events, the failure of a banking organization that is not a GSIB can affect US financial stability.”

The guidance lays out regulatory expectations relating to key areas of potential vulnerability to resolvability, including, among other issues, capital, liquidity, governance, operational capabilities, legal entity rationalization and separability, and derivatives and trading activities.

Heightened Day-to-Day Supervision by the Agencies

Independent of the proposed rulemakings and guidance described above, the banking regulators have already begun to subject the activities of banks to higher scrutiny in their routine supervision of these institutions.

- ***Capital***. Any transactions by a bank, including returns of capital or dividends, that could impact a bank's capital position would be highly scrutinized.

- ***Liquidity***. There likely will be continued enhanced focus on banks' liquidity positions and risk management, including with respect to uninsured deposit balances and interest rate and other forms of portfolio risk. And, given that technology and social media exacerbated stress on the banking system earlier this year, the regulators are likely to examine whether banks have the operational capability to maintain adequate liquidity and to respond efficiently in a potential situation where deposit outflows are occurring or a bank's financial condition is otherwise deteriorating rapidly.

- ***Resolution Planning and LTD***. The FRB and FDIC are also more likely to challenge and scrutinize the stress scenarios, assumptions, data, modeling, and capabilities outlined in banks' resolution plan submissions. These agencies also will be focused on a bank's compliance with the LTD requirement and the manner in which that increased requirement is woven into the bank's resolution plan. Banks likely will be expected to perform independent testing of their resolution capabilities.

Conclusion

In response to the recent crisis, the industry can certainly expect enhanced regulation and supervision in the name of consumer protection and safety and soundness, which will result in increased costs for individual institutions. There is also a possibility that banking regulators will subject institutions with less than $250 billion in total assets to some of the requirements that currently apply to those institutions with at least $250 billion in total assets—such as the liquidity coverage ratio or the requirement to undergo Dodd-Frank stress tests annually, as opposed to every two years.

Surprisingly, these more burdensome operational and compliance costs may lead to an increase in M&A to achieve economies of scale. While the Department of Justice and Federal Trade Commission may take a more aggressive approach in their antitrust review of such M&A deals, banking regulators may be more receptive to some of this M&A activity for the following reasons:

- A combination of two institutions could potentially reduce overall risk in and complexity of the financial system.

- A combination involving smaller regional institutions and community banks likely would better ensure these institutions' long-term viability and competitiveness.

- In the recent crisis, there was a perception among consumers that their deposits would be most secure at the largest institutions, given their size and the fact that they are subject to enhanced regulation and supervision by the banking regulators. So, a larger bank resulting from an M&A transaction may be more in line with consumer expectations and more likely to prevent sudden deposit outflows.

- A combination may allow the regulators that supervise the resulting institution to subject the institution to greater regulatory scrutiny if the combination would cause the resulting institution, based on the new amount of its total assets, to be in a higher category of regulatory supervision, *i.e.*, greater than $250 billion in assets.