Remarks by Vice Chairman Travis Hill at the American Enterprise Institute
"Reflections on Bank Regulatory and Resolution Issues"

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Introduction

The past year and a half has been a pivotal time for the FDIC. With three of the four largest bank failures in U.S. history, longstanding questions have reemerged about how to address bank runs, and newer questions have emerged regarding how FDIC receiverships are funded. Today, I will offer thoughts on both of these topics, along with views on the FDIC's approach to brokered deposits and a few thoughts on the path forward for the Basel III Endgame proposal.

Bank Liquidity and the Discount Window

The bank failures last spring sparked a conversation about the Federal Reserve's discount window and bank liquidity rules, among many other topics. Many wondered how Silicon Valley Bank (SVB), with a huge stockpile of government bonds, was largely unable to borrow from the discount window before its failure.[1] Subsequent reports from the Federal Reserve and FDIC on SVB and Signature Bank, respectively, described how both institutions were unprepared to do so.[2]

The Federal Reserve was originally created to mobilize reserves, provide liquidity to banks, and reduce banking panics,[3] with varying success over time.[4] One prerequisite for this

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[1] *See, e.g.,* Bank Policy Institute, Something Happened: An Initial Try at an Explanation (Mar. 21, 2023) ("If SVB held all these Treasury and agency securities, why didn't it meet the run by converting them into cash at the Federal Home Loan Banks, the Fed's discount window, and the Fed's new Standing Repo Facility?"). According to Vice Chairman Barr, SVB was able to borrow $5.3 billion from the discount window the night before it failed, a tiny fraction of the funds it needed. *See Recent Bank Failures and the Federal Response: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, Questions for the Record from Senator Tim Scott for The Honorable Michael S. Barr, 118th Cong. (Mar. 28, 2023).

[2] Board of Governors of the Federal Reserve System, Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank (April 28, 2023), p. 60 ("[SVB] had limited collateral pledged to the Federal Reserve's discount window, had not conducted test transactions, and was not able to move securities quickly from its custody bank to the FHLB or the discount window."); Federal Deposit Insurance Corporation, FDIC's Supervision of Signature Bank (April 28, 2023), p. 15 ("[Signature] did not have sufficient collateral pledged at the Federal Reserve's Discount Window to cover pending wire requests.").

[3] *See, e.g.*, ROGER LOWENSTEIN, AMERICA'S BANK (2015) p. 218 ("No onlooker in 1913 could have predicted that one day the Fed's most well-advertised duty would be setting interest rates. The [Federal Reserve Act's] primary purpose was to mobilize reserves, the better to avert a crisis, and to modernize the banking system. Its emphasis was on the mechanics of how the Reserve Banks would provide liquidity to banks – that is, by purchasing their short-term loans.").

[4] *See, e.g.*, WILLIAM GREIDER, SECRETS OF THE TEMPLE (1987) p. 310 ("Whatever the promises and expectations, the Federal Reserve System had not brought an end to the danger of bank 'runs.' Federal deposit insurance did. During the 1920s, bank suspensions had fluctuated annually from 366 to 975 (from 1929 to 1933, they ranged from

objective to succeed is that banks must be able and willing to use the liquidity facilities available. The lack of use is a multifaceted problem, but the less banks use the discount window in aggregate, the more stigmatizing it is when banks do use it, and the more reluctant supervisors are to allow banks to rely on it as part of their contingency planning.

As an initial step to address the issue, following stories of SVB's frantic, last-minute efforts to borrow from the discount window,[5] the Federal Reserve has reportedly been working on operational improvements to modernize the discount window's antiquated[6] operations, such as by allowing banks to make funding requests electronically rather than by phone[7] and potentially expanding the hours of operation.[8] These types of operational improvements seem like a necessary but insufficient step.

Another idea that has been under consideration is a discount window prepositioning rule. This concept is a derivation of Mervyn King's "Pawnbroker For All Seasons" proposal, which would require a bank's cash and central bank borrowing capacity to exceed all runnable

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1,350 to 4,000 a year). In 1933, once the Federal Deposit Insurance Corporation was in place, the phenomenon of panic and collapse virtually disappeared from American economic life." Well, not *entirely*…).

[5] Hannah Miao, Gregory Zuckerman, and Ben Eisen, How the Last-Ditch Effort to Save Silicon Valley Bank Failed, *Wall Street J.* (Mar. 22, 2023).

[6] *See, e.g.,* Group of Thirty, Bank Failures and Contagion: Lender of Last Resort, Liquidity, and Risk Management (Jan. 2024), p. 9 ("[In the United States, there are furthermore many operational frictions that hinder the effective pledging and substitution of collateral, notably so for loans that must be collateralized through a third party or an audited borrower-in-custody arrangement. …] [T]he current US system is too cumbersome, is not fully harmonized across the regional Federal Reserve Banks, and uses outdated processes and technologies."); Brookings Institution, One year later: Lessons learned from the March 2023 bank failures (Mar. 5, 2024) ("Brookings Event") (William S. Demchek: "It's mechanically incredibly difficult. … You call your regional Fed, somebody answers the phone, maybe, then they'll have a meeting to see if it's actually okay for you to draw and then they'll talk to Washington and you draw. If I draw from the Home Loan bank, I hit a few keystrokes, and draw against Treasuries I've prepositioned. It's much easier, it's regular way lending."); Federal Reserve Bank of Atlanta, Financial Markets Conference 2024, Policy Session 1: Domestic Liquidity Provision during Potential Crises (May 20, 2024) (Bill Nelson: "One of the Treasurers grew up in Bulgaria, and she commented that working with the discount window brought up a lot of memories of dealing with institutions in her childhood.").

[7] *See, e.g.*, Lorie K. Logan, A level playing field for deposit insurance (July 18, 2024) ("[W]e've launched Discount Window Direct, an online portal that lets depository institutions more efficiently request loans"); Congressional Research Service, Federal Reserve's Discount Window: Policy Issues (May 8, 2024) ("The discount window did not have a web interface until 2024, and that interface still has limited functionality.").

[8] *See, e.g.*, Michelle W. Bowman, Liquidity, Supervision, and Regulatory Reform (July 18, 2024) ("I would note that the Federal Reserve recently published a proposal to expand the operating hours of the Fedwire Funds Service and the National Settlement Service (NSS), to operate 22 hours per day, 7 days per week, on a year-round basis. The proposal also requested feedback on whether the discount window should operate during these same expanded hours."); Michael S. Barr, The Intersection of Monetary Policy, Market Functioning, and Liquidity Risk Management (Feb. 14, 2024) ("While banks do their part to get operationally ready, we at the Federal Reserve also need to continue to improve discount window operations."); *The Federal Reserve's Semi-Annual Monetary Policy Report: Hearing Before the H. Comm. on Fin. Servs.*, 118th Cong. (July 10, 2024) (statement of Jerome H. Powell) ("[W]e know that that the [discount window] infrastructure is a little tired and we're investing in that and making it more user friendly and all that. So that's a big, big project that's going on.").

liabilities.[9] The objective is similar to that of deposit insurance, to remove the risk of runs by removing the risk of loss, but broader (in the sense that it would apply to all short-term liabilities, rather than just a subset of deposits) and leakier (in the sense that it would not completely remove the risk of loss[10]).

More recently, in 2023, a number of institutions experiencing stress or negative attention repositioned their balance sheets so that total cash plus borrowing capacity at the Federal Reserve and Federal Home Loan Banks exceeded total uninsured deposits. This was generally a helpful approach to stem deposit outflows, as it removed the "first mover advantage" that can spark a bank run, and helped restore confidence among potentially skittish depositors. However, maintaining such a ratio, while doable in the short term for some banks, would be extremely costly to maintain over the long term for most banks, and impossible to achieve even in the short term for some banks. Moreover, moving the entire banking system to such a 100% ratio would radically reshape the role banks play in the economy.

The proposal currently being discussed is a derivation of this concept. Presumably in recognition that this type of 100% ratio is unfeasible, the new proposal under consideration would require banks to maintain a minimum ratio of cash plus discount window borrowing capacity to uninsured deposits set at some value below 100%,[11] with news reports suggesting that ratio could be set around 40%.[12]

While I think establishing some incentives or requirements for banks to establish access to, preposition collateral at, and borrow from the discount window is worth considering, setting this type of hardwired ratio seems dangerous. Whereas a ratio above 100% may remove the first mover advantage (at least temporarily), a ratio under 100% amplifies it, by shining a magnifying glass on the fact that a bank *cannot* cover every depositor. If SVB's management said to its uninsured depositors on March 8, 2023, "don't worry, we have 40% coverage of our deposits," I

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[9] MERVYN KING, THE END OF ALCHEMY, pp. 270-280 (2017); *see also* Paul Tucker, Is the financial system sufficiently resilient: a research programme and policy agenda (June 2019) ("I have suggested five concrete things central bankers could do: [The first is to m]ove towards requiring all banking-type intermediaries to cover all short-term liabilities with assets eligible for discount at the Window").

[10] For example, if there was a market crash and market values of a certain asset class plummeted, banks who had pledged such assets to the central bank could see significant decreases in their borrowing capacity to well under 100 percent of short-term liabilities.

[11] Michael J. Hsu, Building Better Brakes for a Faster Financial World (Jan. 18, 2024) (hereinafter "Hsu Speech") ("In short, I believe a new targeted regulatory requirement for midsize and large banks to have sufficient liquidity to cover stress outflows over a five-day period warrants serious consideration. The denominator should consider the potential speed and severity of uninsured deposit outflows, while the numerator should consider the liquidity value of pre-positioned discount window collateral, in addition to reserves.").

[12] Andrew Ackerman, A Century-Old Lending Lifeline for Troubled Banks Has a Major Flaw. The Fed Wants to Fix It., *Wall Street J.* (Apr. 19, 2024) ("Coming rules from the Fed and two other agencies aim to require banks to preposition billions more in collateral. The proposal could require larger banks to have enough cash and posted collateral to be able to borrow the equivalent of a significant portion of their uninsured deposits, perhaps around 40%.").

suspect the reaction from depositors would have been something like, "we better make sure we are part of the 40%, and not part of the 60%!"

Part of the motivation cited for the proposal is destigmatizing the discount window.[13] The Federal Reserve has been working to address stigma for many years,[14] an issue that has existed for nearly its entire history.[15] I tend to think that, at least for large banks, stigma will remain an issue so long as banks do not borrow from the discount window in meaningful volumes *and* markets can figure out when banks under stress are forced to borrow.[16] A fundamental challenge is encouraging banks to use the discount window, so that it is less damaging to use when really needed, but not to make it so attractive that the central bank becomes an everyday source of liquidity across the industry. In that vein, while it is helpful for regulators to do more to consistently convey that borrowing from the discount window is acceptable, what message does it send to establish a rule requiring prepositioning, but *not* incorporate discount window capacity in the Liquidity Coverage Ratio (LCR)[17] and Internal Liquidity Stress Tests (ILST)[18]?

I think it makes more sense to consider incorporating discount window capacity into the LCR, rather than creating a new liquidity metric for each stress event.[19] If a bank run unfolds at supersonic speed, as occurred at SVB, the discount window is likely to be the only game in town, as only the central bank can create liquidity at scale immediately. Even if the run at SVB had occurred over the course of days rather than hours, rapidly liquidating its huge portfolio of securities to meet outflows would have been impractical and extremely disruptive to markets – as the FDIC learned firsthand when we assumed and later sold off that same securities portfolio.[20]

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[13] Hsu Speech, *supra* note 11 ("One solution would be to explicitly give banks credit for their discount window borrowing capacity to cover ultra-short term, acute outflows like those endured by SVB and Signature. This would make clear that regulators expect banks in stress to utilize the discount window to help cover short term liquidity outflows when needed. This regulatory expectation could help de-stigmatize discount window usage.").

[14] *See, e.g.*, Joint Press Release, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Office of Thrift Supervision, National Credit Union Administration, Agencies Issue Guidance on Appropriate Use of Discount Window (July 23, 2003); *see also* Joint Press Release, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Federal Banking Agencies Encourage Banks to Use Federal Reserve Discount Window (Mar. 16, 2020).

[15] *See, e.g.*, Brookings Event, *supra* note 6 (Susan McLaughlin: "[The issue of stigma] dates back to the 1920s.").

[16] *See, e.g.*, Steven Kelly, Weekly Fed Report Still Drives Discount Window Stigma, Yale School of Management, Program on Financial Stability (Apr. 3, 2024).

[17] 12 C.F.R. § 329.20.

[18] 12 C.F.R. § 252.35(b)(3). There are also limitations on firms' ability to assume reliance on the discount window as part of resolution plans. *See, e.g.*, Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation, Final Guidance for the 2019 [sic], 84. Fed. Reg. 1438 (Feb. 4, 2019).

[19] The Federal Reserve could also consider incorporating discount window access into the ILST.

[20] The FDIC deliberately sold most of the securities over many months to avoid disrupting markets.

And even First Republic, which suffered a run that lasted several weeks, primarily[21] met its deposit outflows with Federal Reserve borrowings,[22] and was finally forced into receivership when it dropped to secondary credit[23] and lacked the borrowing capacity to continue to meet outflows. Furthermore, selling large stockpiles of a security craters the value of that security and harms any other banks who own those securities.

Allowing banks to count loans that are monetizable through the discount window in the LCR could also reduce the trend of forcing large banks to buy increasingly large quantities of securities, and operate increasingly like bond funds,[24] particularly if the agencies are also planning on ratcheting up HQLA demands through other LCR changes.[25] From a stigma perspective, this would achieve a similar goal of incentivizing banks to preposition more collateral at the discount window, while delivering a more consistent message regarding supervisors' expectations of discount window use under stress.

In addition to improvements to the discount window, we should continue to think about other ways that regulators can better manage future liquidity stresses. One example is better access to real-time data. I have spoken in the past about the FDIC's rapid phase prototype

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[21] In addition to Federal Reserve borrowings, *see infra* note 22, First Republic met some early withdrawals with Federal Home Loan Bank borrowings, and on March 16, 2023 received $30 billion in deposits from an industry consortium of large banks. *See* Federal Deposit Insurance Corporation, FDIC's Supervision of First Republic Bank (Sept. 8, 2023). But neither an industry rescue nor FHLB borrowing are anticipated by the LCR either.

[22] First Republic's discount window borrowing reached a peak of $109 billion. *See* Federal Deposit Insurance Corporation Office of Inspector General, Material Loss Review of First Republic Bank, p. 24 (November 2023). The bank also had outstanding borrowings from the Bank Term Funding Program (BTFP) of approximately $14 billion at failure.

[23] Banks with poor supervisory ratings, very weak capital ratios, or otherwise deemed to not be in sound financial condition are only eligible to borrow from the discount window on secondary credit, which is typically overnight and applies a higher penalty rate and higher haircuts to collateral than primary credit. *See* Board of Governors of the Federal Reserve System, Discount Window Lending.

[24] *See, e.g.*, Samuel G. Hanson, Victoria, Ivashina, Laura Nicolae, Jeremy C. Stein, Adi Sunderam, Daniel K. Tarullo, The Evolution of Banking in the 21st Century: Evidence and Regulatory Implications, Brookings Papers on Economic Activity (Mar. 2024) ("Specifically, and this is especially true for the larger banks that have been most impacted by competition from non-bank lenders, the share of securities in their portfolios has increased significantly in recent decades. These securities consist primarily of U.S. Treasuries and agency mortgage-backed securities (MBS) whose payments are insured by the government sponsored enterprises. Thus, these securities are free of credit risk, so the only risk that banks face in holding them is interest-rate risk. In this sense, the larger banks are beginning to look more like long-term bond mutual funds than they did at the beginning of the century, albeit bond funds that have uninsured liabilities that can be withdrawn on demand at par, rather than being equity financed.").

[25] *See, e.g.*, Michael S. Barr, On Building a Resilient Regulatory Framework (May 20, 2024) ("Second, we are considering a restriction on the extent of reliance on held to maturity (HTM) assets in large banks' liquidity buffers, such as those held under the liquidity coverage ratio (LCR) and the internal liquidity stress test (ILST) requirements, to address the known challenges with their monetization in stress conditions. Third, we are reviewing the treatment of a handful of types of deposits in the current liquidity framework. Observed deposit withdrawals from high-net-worth individuals and companies associated with venture capital or crypto-asset-related businesses suggest the need to re-calibrate deposit outflow assumptions in our rules for these types of depositors.").

competition, which was initiated in 2020 and discontinued by the current Chairman, to develop technologies to provide more granular and frequent data, which could eventually have given the FDIC access to real-time deposit flow data.[26] Another option, on potentially a much shorter time horizon, arises from a recent paper by researchers at the Federal Reserve Bank of New York. The paper analyzed which banks suffered runs in March 2023 by looking at interbank payments through Fedwire and ACH.[27] The weekend after SVB failed, I asked officials at the Federal Reserve whether this type of data was available to see deposit movements, and I was told it was not.[28] It would be very helpful if the Federal Reserve can find a way to make this data available in real time for key decision-makers, along with capabilities to rapidly analyze it. Among other benefits, better visibility into real-time deposit movements across the system could significantly improve our ability to monitor for runs and contagion, and reduce the risk of unnecessarily invoking the system risk exception (and vice versa).

Receivership Funding

Much like the bank failures last year raised questions about banks' contingency funding plans (or lack thereof), so too did the failures raise similar questions about the FDIC's. Bank failures can occur suddenly and involve significant short-term liquidity demands, particularly in the event of large bank failures, or a large number of bank failures. The FDIC faced such a situation last spring, when the failures of SVB and Signature (and subsequently, but to a lesser extent, First Republic) placed substantial liquidity demands on the FDIC. The FDIC initially met these demands through borrowings from the Federal Reserve,[29] and did not pay off the borrowings in full until nearly nine months later. The unprecedented nature of these borrowings, and the substantial cost incurred, have raised a number of questions.

An initial question is when and to what extent the FDIC should have drawn from the Deposit Insurance Fund (DIF), rather than the Federal Reserve, to fund these receiverships. The FDIC invests the DIF's funds in nonmarketable Treasury securities,[30] which earn a return for the

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[26] *See* Travis Hill, Recent Bank Failures and the Path Ahead (Apr. 12, 2023) ("In 2020, the FDIC initiated a 'Rapid Phased Prototyping' competition to develop technologies to provide the FDIC with more granular and frequent data from banks that chose to participate. This type of tool not only could help expedite populating a data room for a failed bank, it also would give the FDIC access to much higher quality data to monitor broader trends, such as deposit flows in times of stress. Unfortunately, this project was discontinued.").

[27] Marco Cipriani, Thomas M. Eisenbach, and Anna Kovner, Tracing Bank Runs in Real Time, Federal Reserve Bank of New York (May 2024).

[28] My impression was that this data was also not available that weekend to the individuals with whom I spoke.

[29] For brevity, I will generally use the term "FDIC" to describe both actions taken by the FDIC in its corporate capacity (*e.g.*, allocating funding from the DIF) and in its capacity as receiver. Similarly, I use the term "Federal Reserve" to refer collectively to the Board of Governors of the Federal Reserve System, the Federal Reserve Bank of New York, and the Federal Reserve Bank of San Francisco.

[30] The FDIC invests DIF funds in "cash and cash equivalents" and nonmarketable Treasury securities. Cash equivalents are short-term, highly-liquid investments consisting primarily of U.S. Treasury Overnight Certificates.

DIF but cannot be traded in the market. In order to access cash from the DIF, the FDIC must redeem securities[31] with the Treasury Department in exchange for cash.[32] The average yield on the DIF's portfolio last March was slightly over 3 percent,[33] meaning borrowing at market rates (much less at a penalty rate) was a much costlier option than spending DIF funds.[34]

On March 10, 2023, the day SVB failed, cash in the Treasury General Account (TGA) amounted to $208 billion,[35] several hundred billion dollars lower than usual due to the fact that the outstanding debt of the United States reached its statutory limit on January 19, 2023.[36] The FDIC was able to access some funds from the DIF, but there were significant challenges and frictions in doing so because of sensitivities related to the debt ceiling and Treasury's cash position. The FDIC ultimately withdrew approximately $52 billion[37] from the DIF in multiple installments between March and May, amounting to approximately 40 percent of the funds in the DIF when SVB failed.

I will offer three observations on this point. First, it seems the FDIC could have accessed more cash than Treasury provided, given the level of the TGA in March, and perhaps the FDIC should have insisted on it. Second, in the event Treasury could not have provided more cash (or, in a future event, the level of the TGA is smaller[38]), the FDIC and Treasury could have devised a plan for Treasury to, at one or more upcoming auctions, (1) redeem the FDIC's securities for cash and, on the same day, (2) issue new securities into the market. As others have pointed

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Last spring, the FDIC in effect ran into the same issue in monetizing cash equivalents when overnight securities matured and in monetizing nonmarketable Treasury securities.

[31] Here, and throughout, I use the phrase "redeem securities" as a shorthand to refer both to redeeming securities for cash and withdrawing cash from the DIF when securities mature.

[32] *[Errant footnote]*

[33] Federal Deposit Insurance Corporation, First Quarter 2023 CFO Report to the Board, p. 8.

[34] When the FDIC sells underwater securities, the losses are realized for purposes of net income, but the unrealized losses are already reflected in the DIF balance. More generally, whether the DIF is more economical than borrowing from an outside source depends on a range of factors, including the rate environment, the composition of the FDIC's securities portfolio, and the borrowing terms available. For example, it is possible in a different environment that the earnings on the DIF's securities portfolio might exceed the interest expense of available borrowings.

[35] *See* Daily Treasury Statement. Note this number fluctuated on a daily basis but was generally above $200 billion throughout March. For example, on March 8, the TGA balance was $312 billion, and on March 13, it was $227 billion.

[36] *See* Letter from Treasury Secretary Janet Yellen to Speaker of the House Kevin McCarthy (Jan. 19, 2023).

[37] This figure does not include the $40 billion that the FDIC withdrew the day SVB failed that was returned to the Treasury Department several days later. The $40 billion was intended to fund the payoff of depositors through a Deposit Insurance National Bank (DINB), but was returned after the systemic risk exception was invoked and the FDIC instead opened a bridge bank.

[38] On June 1, 2024, for example, the TGA balance fell to $23 billion, the lowest level in recent years. *See*, Daily Treasury Statement, *supra* note 35.

out,[39] redeeming securities from the DIF lowers the national debt and creates more space under the debt limit for the Treasury Department to issue new securities. Under this scenario, the FDIC would need to borrow from the Federal Reserve (or another outside source) for a few *days* until the cash proceeds from the securities issuance(s) arrived.

Third, and most fundamentally, the FDIC should have unfettered access to funds in the DIF. Perhaps, rather than rely on the Treasury Department's ability to redeem the DIF's securities for cash, another option might be for the FDIC to leave funds in a deposit account at a Federal Reserve Bank.[40] This would ensure the FDIC could access and deploy DIF liquidity on very short notice, including after business hours and over a weekend. While many government agencies spend much larger sums than the FDIC, I am unaware of any that has the same potential for very large, *unexpected* liquidity needs that must be met immediately, with the one possible exception the Federal Reserve itself, which serves as the lender of last resort precisely because it can create its own liquidity.

A related question is how far the FDIC should deplete the DIF's liquidity to meet short-term receivership needs. Even after the debt ceiling was resolved, the FDIC continued to pay the Federal Reserve's penalty rate for six more months,[41] before finally using the DIF to fully pay off the Federal Reserve at the end of November 2023.[42] In the immediate aftermath of the March 2023 failures, I think it was understandable to be cautious, but the justification for caution decreased significantly over the ensuing weeks, and was mostly gone by the summer. More generally, I suspect we may overestimate the impact that the DIF's temporary liquidity position has on depositor confidence, and if the FDIC is reluctant to use funds in the DIF for bank failures, what would this mean for our entire assessment framework?[43]

Even if the FDIC had been able and willing to use all the funds in the DIF, the FDIC still would have needed to access additional liquidity. (I should underscore that this was solely a liquidity issue, as the FDIC's assets also included all the loans, securities, and other assets assumed from the failed banks that we would subsequently sell or monetize to pay off

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[39] *See* Shai Akabas, U.S. Banking Sector Developments and the Debt limit, *Bipartisan Policy Center* (May 31, 2023) ("When making payouts to depositors, those securities are redeemed, creating room under the debt limit (since government trust funds also count towards total debt). Then, an equivalent amount of debt is issued to the public, raising the cash to pay out depositors. The entire transaction is a wash as far as the debt limit is concerned."); Jeff Huther, The FDIC's unusual loan from the Federal Reserve, *ABA Banking Journal* (May 5, 2024) ("[L]iquidation of the DIF's holdings of Treasury securities reduces the amount of Treasury debt outstanding, making an increase in Treasury bill issuance to offset the cash outflows debt-neutral").

[40] The FDI Act generally requires the FDIC to invest funds in obligations of or guaranteed by the United States, but also authorizes the FDIC to, with the approval of the Treasury Secretary, place funds in an account at a Federal Reserve Bank. 12 U.S.C. § 1823.

[41] The FDIC did pay off some of the outstanding borrowings over this time through monetizing assets.

[42] Two months later, in January 2024, the FDIC monetized approximately $47 billion of assets through the FFB to replenish the DIF's liquidity.

[43] With echoes of discussions around banks' capital buffers…

borrowings.) The most obvious places the FDIC could turn are the Federal Financing Bank[44] (FFB) and the Treasury Department,[45] which would have charged a cheaper rate than the Federal Reserve's penalty rate. Before the debt ceiling limit was raised, the Treasury Department could not have issued new debt to finance any FDIC borrowings from the FFB or Treasury – but, as noted above, the Treasury Department still had considerable cash in March, which, in addition to being used to redeem the DIF's securities, also could have been used to lend to the FDIC. Nonetheless, the FDIC chose to continue paying the Federal Reserve's penalty rate for months even after the debt ceiling was raised, rather than borrow from the FFB or Treasury.

The decision of whether to borrow from the FFB or Treasury is one the FDIC has faced before. From 1991 to 1993, the FDIC borrowed from the FFB,[46] without any adverse market reaction, while in 2009, the FDIC chose *not* to borrow from the FFB or Treasury, due to fears around the optics of borrowing from Treasury.[47] In 2023, the FDIC made the same choice for similar reasons as 2009.[48] Of course, every circumstance is unique, but I suspect we overestimated the negative consequences of borrowing from the FFB or Treasury in 2023, particularly after the debt ceiling was resolved in June,[49] and especially given the DIF's net worth was nowhere near zero.[50]

A related option is to securitize assets through the FFB, a process in which the FDIC, in effect, sells the right to future cash flows (with an FDIC guarantee) to the FFB in exchange for cash, while retaining ownership of the assets. This allows the FDIC to monetize the assets faster than selling them into the market, particularly for illiquid assets, and avoids the risk of disrupting

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[44] 12 U.S.C. § 1824(b).

[45] 12 U.S.C. § 1824(a).

[46] *See* Federal Deposit Insurance Corporation, 1993 Annual Report ("In August 1993, we also fully repaid the BIF's borrowings of working capital from the Federal Financing Bank. This borrowing authority was granted by Congress in 1990 so that the costly bank failures of the past would not severely limit our options in dealing with future bank failures. We first tapped this borrowing authority in 1991 eventually reaching a high of $15.1 billion in June of 1992. But as the pace and cost of bank failures declined, and as our deposit insurance assessment income increased, we repaid all borrowings, with interest.") The Resolution Trust Corporation also borrowed from the FFB.

[47] *See, e.g.,* Diane Ellis, Deposit Insurance Funding: Assuring Confidence (November 2013) ("During the most recent crisis, the banking industry had been beneficiaries of extraordinary government assistance, and the industry and public were suffering from what was termed bailout fatigue. It was believed that drawing on a borrowing line with the Treasury, which is backed by the U.S. taxpayer, would exacerbate matters, even though the borrowing would be only for liquidity purposes and would be repaid with interest."). Instead the FDIC required the banking industry to prepay assessments, in effect borrowing from the industry (though by rule rather than on market terms). 74 Fed. Reg. 59056 (Nov. 17, 2009); FEDERAL DEPOSIT INSURANCE CORPORATION, CRISIS AND RESPONSE: AN FDIC HISTORY, 2008-2013, p. 161 ("One reason the FDIC turned to prepaid assessments was that prepaid assessments ensured that the DIF remained industry funded, whereas borrowing from the Treasury would not. Another reason was that, unlike the prepaid assessments, borrowings from the Treasury would bear interest, which the banking industry would have had to pay eventually through higher assessments.").

[48] At least after the debt ceiling was resolved in June.

[49] Conditions in the industry were also considerably more settled by then.

[50] By contrast, in both 1991 and 2009, while the FDIC in each case considered borrowing from FFB to satisfy its *liquidity* needs, the insurance fund's net worth was negative, which may have magnified the potential downsides.

markets. The FDIC securitized approximately $50 billion in assets through the FFB in September 2023 and an additional $47 billion in January 2024.[51] This could be a useful option in the future – if the FDIC and FFB can execute such transactions *much* more quickly, ideally over resolution weekend, or if not within a few days of failure.

Ultimately, the Federal Reserve funded the receiverships. More specifically, the two bridge banks borrowed extensively from the Federal Reserve to satisfy deposit outflows, with those borrowings guaranteed by the FDIC, while First Republic, as mentioned above, borrowed extensively from the Federal Reserve prior to failure. The three receiverships assumed those borrowings, which, combined, amounted to $273 billion in total,[52] which the FDIC ultimately paid off in November 2023.

When the bridge banks were dissolved, and when First Republic was sold, the Federal Reserve viewed the advances as in default, which, under the Federal Reserve's Operating Circular, results in a 500 basis point increase in the interest rate charged.[53] After some negotiation, the Federal Reserve reduced the penalty rate to 100 basis points. Yet, the FDIC fully guaranteed the borrowings, and, as banks are required by law to tell their customers,[54] the FDIC is backed by the full faith and credit of the U.S. government.[55] The 100 basis point penalty rate was extremely costly given the volumes involved and the time it took to pay it off, ultimately costing the FDIC roughly $1 billion.[56] In effect, this was a shadow tax on the banking industry, primarily charged through the special assessment, that in the short run decreases the Federal Reserve's losses and in the long run increases the "earnings" the Federal Reserve sends to Treasury.

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[51] *See* Federal Deposit Insurance Corporation, 2023 Annual Report pp. 141, 147.

[52] *See* The Federal Regulators' Response to Recent Bank Failures: Hearing Before the H. Comm. on Fin. Servs., Questions for the Record from Rep. Bryan Steil for The Honorable Martin J. Gruenberg, 118th Cong. (Mar. 29, 2023) (stating that SVB had borrowings from the Federal Reserve of $126.5 billion when it failed and Signature had borrowings from the Federal Reserve of $53.6 billion when it failed); State of California, Department of Financial Protection and Innovation, In the Matter of First Republic Bank, Order Taking Possession of Property and Business (May 1, 2023) (stating that First Republic had borrowings from the Federal Reserve of $93.2 billion when it failed).

[53] Federal Reserve System, Operating Circular No. 10 at 4.2 ("If all or any portion of an Advance Repayment Amount is not paid when due (whether by acceleration or otherwise), interest on the unpaid portion of the Advance Repayment Amount shall be calculated at a rate 500 basis points higher than the applicable rate then in effect until the unpaid Advance Repayment Amount is paid in full."), 5.1(b)(ii) ("An Advance Repayment Amount is immediately due and payable … upon the occurrence of any Event of Default [including the insolvency of the Borrower].").

[54] 12 U.S.C. § 1828(a)(1)(B).

[55] 12 U.S.C. § 1825(d).

[56] This estimate, which refers only to the interest expense added by the 100 basis point penalty rate, understates the overall cost to the FDIC – and, ultimately, the banking industry – given the other alternatives available to the FDIC discussed above. Estimating that cost is difficult and depends on a variety of factors, including which options were selected, precisely when, and on what terms.

The FDIC could have considered additional options, such as borrowing from the private sector or from the Federal Home Loan Banks, neither of which it appears the FDIC seriously considered or had ever prepared to do. It is clear there are a number of lessons to be learned from this experience, perhaps chiefly the importance of doing much more advance work for this type of scenario. Given that this was not the first, and is unlikely to be the last, time the Treasury Department has dealt with debt ceiling issues, and given the possibility we could have much larger banks fail in the future, we should have a plan in place to immediately access DIF funds when the debt ceiling is in play, and we should have other backup options in place. The FDIC has an obligation to minimize losses when resolving failed banks, and it is hard to argue we did that here.

Brokered Deposits

Next, I will offer a few thoughts on brokered deposits. The brokered deposits framework was first put in place by Congress in 1989.[57] 35 years later, I believe that the regime is no longer fit for purpose.

Brokered deposits are deposits that are placed with a bank through, or with the involvement of, certain types of intermediaries ("deposit brokers").[58] The principal consequences of a deposit being classified as brokered are (1) a "tax" in the form of higher deposit insurance assessments[59] and more punitive treatment under liquidity rules, (2) limitations on the ability of a bank to accept such a deposit if the bank falls below well-capitalized,[60] and (3) in some cases, a reflexive judgment by examiners that the deposit is "risky." The first is provided by rule, the second required by statute, and the third varies by examiner and agency.

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[57] *See* Pub. L. 101-73, § 224, 103 Stat. 183 (1989).

[58] More precisely, a brokered deposit is a deposit placed by or through a deposit broker. *See* 12 U.S.C. § 1831f(a). The FDI Act primarily defines a deposit broker as "any person engaged in the business of placing deposits, or facilitating the placement of deposits, of third parties with insured depository institutions," subject to certain exceptions, the most significant of which is the primary purpose exception. 12 U.S.C. § 1831f(g). The primary purpose exception provides that a person is not a deposit broker if the person's primary purpose is not the placement of funds with depository institutions. 12 U.S.C. § 1831f(g)(2)(I).

[59] In the case of "small banks" (generally, those with less than $10 billion in assets), brokered deposits generally only impact assessments if total brokered deposits exceed 10% of total assets, except in some cases in which brokered deposits only impact assessments if total brokered deposits exceed 10% of domestic deposits. *See* 12 C.F.R. § 327.16(a)(1)(ii)(A) and 12 C.F.R. § 327.16(e)(3). All brokered deposits impact assessments for the remaining banks, regardless of amount.

[60] For purposes of the FDIC's brokered deposit rule, a bank is considered "well-capitalized" if it has a total risk-based capital ratio of 10 percent or more; a tier 1 risk-based capital ratio of 8 percent or more; a common equity tier 1 risk-based ratio of 6.5 percent or more; a leverage ratio of 5 percent or more; and the institution is not subject to any written agreement, order, capital directive or prompt corrective action directive issued pursuant to the section 8 of the FDI Act (in the case of FDIC-supervised institutions), the International Lending Supervision Act, or the Home Owners' Loan Act, or any regulation thereunder, to meet and maintain a specific capital level for any capital measure. 12 C.F.R. §§ 324.403(b)(1) and 337.6(a)(3)(i).

The regime suffers from a number of flaws. First, whether a deposit comes to a bank through an intermediary is not the key test in determining what type of risks it presents. For example, SVB suffered a deposit run in part because it relied heavily on large, concentrated, closely networked, uninsured depositors.[61] Whether any such deposits came in through intermediaries was not a relevant factor. In fact, when SVB failed, not a single one of its deposit was reported as brokered.[62]

Second, the deposit landscape now encompasses a broad range of deposit arrangements, many of which involve third parties that bear little resemblance to traditional deposit brokers. In the 1980s, the term "brokered deposit" was commonly understood to refer to a specific market in which third-party brokers gathered and pooled funds and placed them into "brokered" certificates of deposit (CDs) issued by banks.[63] At the time, Congress could use a broad definition of "deposit broker," and could broadly exclude those whose primary purpose was not the placement of deposits,[64] because "deposit brokers" represented a well-understood universe, and few others were "engaged in the business of placing and facilitating the placement of deposits" at the time. Most deposits came into a bank when customers walked into a local branch. However, since then, the internet, smartphones, and other innovations have revolutionized how banks interact with customers, with many types of deposit arrangements now involving intermediaries.

The emergence of new deposit arrangements over the years has continually put pressure on the brokered deposit framework. Prior to the 2020 rule, the FDIC addressed each new arrangement on a one-off basis, resulting in an unwieldy, opaque regime inconsistently applied across the industry. The 2020 rule brought structure, process, and order to a disorderly regime, but a fundamental problem still exists: it is incredibly difficult to make sweeping judgments on which side of the line every new arrangement falls in a fair and risk-sensitive way.

Today, different types of deposits currently classified as "brokered" present, in certain respects, diametrically opposite characteristics. Some types of brokered deposits raise safety and soundness concerns out of fears that they are volatile, unstable, or otherwise likely to be

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[61] *See, e.g.*, Board of Governors of the Federal Reserve System, Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank, p. 7 (Apr. 2023) ("[T]he standard liquidity risk metrics in the [Regional Banking Organization] portfolio were likely not appropriate for a bank like SVB. For example, a commonly used metric was the ratio of core deposits, which excludes large time deposits and brokered deposits, to total assets. By this metric, SVB appeared to have a comparatively stable source of funding despite the fact that SVB's deposits were concentrated in large, uninsured accounts that proved to be quite volatile.").

[62] *See* Silicon Valley Bank, Consolidated Reports of Condition and Income for A Bank With Domestic and Foreign Offices - FFIEC 031 (last updated Feb. 16, 2023). As of December 31, 2022, SVB had $161.5 billion in total domestic deposits, of which none were reported as brokered.

[63] *See, e.g.*, FEDERAL DEPOSIT INSURANCE CORPORATION, HISTORY OF THE EIGHTIES, p. 119 (1997) ("Brokered deposits are certificates of deposit issued by a financial institution and purchased by an investor through a third-party intermediary; the third party receives a fee or commission from the issuing institution."). I use the term "traditional brokered deposits" to refer to these brokered CDs, which still represent a sizeable portion of brokered deposits today.

[64] *See supra* note 58.

withdrawn if the bank experiences turmoil or negative attention. On the other hand, traditional brokered deposits present the opposite concern – the deposits have no franchise value because the depositors have no relationship with the bank, earn high rates, are fully insured, generally cannot withdraw before maturity, and thus are generally indifferent to the condition of the bank, but are incredibly stable.[65]

Meanwhile, as discussed above, regulators have been trying to encourage more discount window borrowing for banks experiencing funding stress, but yet the FDIC may push further to prohibit the use of brokered deposits for essentially the same purpose. From a contingency funding perspective, each has tradeoffs: the discount window can provide funds faster and at unlimited volume, but suffers from greater stigma. Yet both are generally high-rate liabilities for the bank, and are more or less equally costly to the DIF if the bank subsequently fails – in either case, the funding generally has no franchise value and gets paid off in full upon failure.[66]

Additionally, deposits gathered through a listing service website have never been treated as brokered, meaning a bank that falls below well-capitalized has no regulatory restrictions on its ability to obtain deposits through such a website by offering the highest rate – essentially the problem the brokered deposits law was initially intended to address. Banks are sometimes encouraged by supervisors to seek out listing service deposits once they become subject to brokered deposits restrictions, which I think demonstrates that this whole regime does not work.

That all said, we should not view the deposit franchise of a bank that funds itself entirely with traditional brokered deposits the same as that of a bank that funds itself entirely with, for example, retail deposits from a diverse branch network. But I do think we should make an effort to modernize how we think of a bank's funding mix, and to think more holistically about how we view a bank's deposit franchise. We could consider doing a new study on deposits similar to the FDIC's 2011 study,[67] though hopefully with a more open mind about brokered deposits.[68] And I continue to be skeptical[69] of sweeping policies restricting a bank's access to certain sources of

[65] *See* Travis Hill, Insights on the FDIC's Agenda (September 21, 2023) ("From the FDIC's perspective, the main downsides to brokered CDs are that they are costly for the bank and have no value in resolution. The flipside is that because the depositors have no relationship with the bank, earn high rates, are fully insured, and generally cannot withdraw before maturity, the deposits are extremely sticky, and the depositors are indifferent to whether the bank has a future or not. Far from being "hot money," these deposits are so cold they are virtually frozen in place.").

[66] The FDIC pays the Federal Reserve up to the value of the collateral, but I am unaware of any instance in which the FDIC has not paid off the Federal Reserve in full. (And of course, if the FDIC does not pay off the borrowings immediately in full, read above for what might happen). As noted above, traditional brokered deposits are generally fully insured; more generally, brokered deposits are paid off in full unless they are uninsured *and* the depositor class takes a loss.

[67] Federal Deposit Insurance Corporation, *Study on Core and Brokered Deposits* (July 8, 2011).

[68] I would also consider retiring the use of the term "brokered deposits" to refer to deposits beyond traditional brokered certificates of deposit.

[69] *See, e.g.*, Travis Hill, Banking's Next Chapter? Remarks on Tokenization and Other Issues (March 11, 2024) ("If a bank is insolvent or does not have a viable future, authorities should move swiftly and decisively to put the institution into receivership. But weak banks can and often do survive and recover and we should be thoughtful in

liquidity as its condition deteriorates. I am generally supportive of the proposal suggested by Chairman McWilliams in 2019 to replace the brokered deposits restrictions with a growth cap, which would ensure banks in poor condition could not attempt to grow out of their problems,[70] but would allow them to meet deposit outflows in an orderly way.[71]

I also think it would be a mistake for the FDIC to substantively reopen the brokered deposits rule. Doubling down on the pre-2020 brokered deposits regime in 2024 is like doubling down on stone castles after the invention of cannons.[72]

Capital

Finally, I would like to briefly address the Basel III Endgame proposal. It's clear that the proposal – issued almost exactly a year ago – lacked appreciation for its real-world impacts,[73] and I appreciate the widespread acknowledgment that "broad and material changes" are necessary.

I agree with calls from many others that a re-proposal is necessary.[74] Given the nature, complexity, and extent of changes needed, we should allow the public an opportunity to provide

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considering policy choices that may further cripple wounded institutions and reinforce the procyclicality of our current system.").

[70] *See* Itzhak Ben-David, Ajay Palvia, René M. Stulz, How Important is Moral Hazard for Distressed Banks? (July 2020) p. 32 ("We find that distressed banks, on average, deleverage and reduce their risk.").

[71] *See* Jelena McWilliams, Brokered Deposits in the Fintech Age (December 11, 2019) ("One option to consider is replacing Section 29 of the FDI Act altogether with a simple restriction on asset growth for banks that are in trouble. This would be a far easier regime for the FDIC to administer, would at the very least limit the size of the FDIC's potential exposure, and would more directly address the key goal of preventing troubled banks from using insured deposits to try to grow out of their problems. A simple limitation on asset growth would also be more durable and should retain its effectiveness as the industry evolves and as banks change the way they attract deposits over time.").

[72] *See, e.g.,* JOHN KEEGAN, A HISTORY OF WARFARE (1993), p. 321 ("In February of [1495], having overwhelmed in eight hours the Neapolitan fortress of San Giovanni, which had once withstood a siege by traditional military means lasting seven years, [Charles VIII] rode into Naples. The whole Italy quaked at his passage. His guns [*i.e.*, mobile cannons] had brought a true revolution in warmaking. The old high-walled castles against which both siege-engines and scaling-parties had so often failed were hopelessly vulnerable to the new battering-instrument.").

[73] I expressed an extensive list of concerns when the proposal was issued last summer. *See* Travis Hill, Statement on the Proposal to Revise the Regulatory Capital Requirements for Large Banks (July 27, 2023).

[74] *See, e.g.*, *The Semiannual Monetary Policy Report to the Congress: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 118th Cong. (July 9, 2024) (testimony of Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System) ("I will just say again from my standpoint, my view and strongly held view of some of my colleagues on the Board, is that it will be appropriate for us to put out the changes again for a period of comment just because it's the right thing to do. It's what we would do typically in a situation where there are material changes to a proposed rule."); SIFMA Basel III Endgame Roundtable (April 18, 2024), p. 13 (Randal K. Quarles: "I don't think this proposal can be changed enough to make it workable without it being changed enough to require re-proposal under the Administrative Procedure Act."); Post by Jonathan McKernan (July 9, 2024) ("Count me in agreement with the strongly held view of others that we need to repropose the Endgame proposal with broad and material changes.").

feedback on what the agencies are considering. In particular, the proposed operational risk and market risk frameworks rest on a complicated set of formulas and metrics that would be challenging to amend in a broad, material, *and rational* way without receiving additional feedback. Addressing the services component of the operational risk framework, for instance, could have a profound impact on various business lines at banks, depending on how the agencies choose to modify the formula, and seeking additional comments would help ensure the agencies understand the consequences of any such modifications.

I am skeptical of re-proposing only parts of the rule. While some changes may be relatively straightforward and, in isolation, may benefit less from additional feedback, everything in the framework is related. For example, commenters might react differently to certain changes to the operational risk framework if they know the agencies plan to adopt other changes to the credit risk framework (and vice versa), given that both frameworks impact the capital charge associated with the same exposures. Additionally, I strongly believe any re-proposal should be issued jointly by all three banking agencies.[75] For just one agency to re-propose – but with an expectation that a future final rule will be issued jointly by the three agencies – would be unprecedented, sow confusion, and lead to a number of practical and legal questions.[76]

In addition to broad, material, rational changes to the Basel III Endgame piece of the proposal, I also think any re-proposal should fully reverse the proposed reversal of tailoring of the capital framework for large banks. At a minimum, the agencies should not reverse the 2019 capital simplifications rule,[77] and Category IV banks should not be subject to the new market risk framework (unless they have material trading activities), SA-CCR, or the proposed expanded risk-based approach. The extreme volatility of a two-stack approach, in which a bank might ricochet back and forth from one standardized framework to the other, does not make sense for Category IV banks,[78] especially given that the expected capital impact is quite small.

Conclusion

Thank you for your time today. I am happy to answer questions.

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[75] *See, e.g.*, Basel Plan Takes Shape as Fed Readies Major Changes for Public Review, *Capitol Account* ("Still, it's not known if the [FDIC and OCC] will join in releasing what they view as a Fed-driven document. Regardless, it seems likely that all three will come together to approve a final rule, the sources emphasize.").

[76] For example, under such a scenario, if the final rule were challenged, and a court determined the final rule lacked logical outgrowth from the original proposal, would the court strike down the FDIC and OCC rules but uphold the Federal Reserve rule?

[77] Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, Final Rule: Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996, 84 Fed. Reg. 35234 (July 22, 2019).

[78] And it is debatable whether it makes sense for any banks.