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The politics of the banking turmoil

Political division will limit legislative efforts to respond to pressure on US regional banks, turning attention to regulators.

Key Takeaways

- The collapse of two regional lenders in the US, Silicon Valley Bank (SVB) and Silvergate Bank, will have important economic and political consequences.
- In the near term, political divisions over the root causes of the collapse of SVB prevent a substantial legislative response. President Biden will therefore rely on regulators to make smaller piecemeal changes.
- It is likely that only significant market pressure would incentivise Congressional action. A narrowly divided, highly partisan Congress raises the risk of failed legislative efforts. This is similar to the failure to pass the Troubled Assets Relief Programme on the first attempt in 2008.
- Legislative efforts have already begun in the Senate with the 'Failed Bank Executives Clawback Act'. But the focus is on the regulators who are set to release reports into SVB's collapse on 1 May.
- The economic spillovers of the banking turmoil could have implications for the debt ceiling negotiations. A more rapid slowing of the economy may bring forward the so-called x-date, when the US can no longer meet all its obligations.
- This raises the likelihood of a short-term extension to the debt ceiling as the negotiations to deliver a more lasting solution may take longer to complete. This could end up creating multiple x-dates in a short period of time, which could cause rolling volatility in markets.

quickly to declare that both SVB and Silvergate Bank fell under the 'systemic risk exception'. This allowed the authorities to provide support for these specific institutions and expand deposit insurance above the \$250k limit.

In addition to this, the Fed announced additional liquidity for the banking sector with the creation of the Bank Term Lending Facility and changes to the existing Discount Window.

These measures stemmed immediate systemic risks, but credit conditions will likely still tighten. The fallout from this is hard to quantify but it does increase our confidence that the US will enter a recession later this year.

Politicians have mostly been playing the blame game

Washington's initial response to the collapse of SVB was broadly along party lines. Democrats were keen to put the root cause of the failure on Trump-era regulatory rollbacks, calling for a full restoration of the Dodd-Frank Act. This is unlikely to get through the Republican-controlled House, where Representatives argue that regulators had all the right tools but failed to use them.

Some Republicans, particularly existing or presumptive presidential candidates, have instead fixated on the perceived role of ESG-focused policies in the downfall of SVB. Republican messaging on ESG, including proposed legislative changes, will continue to be a key issue to watch in the run up to the 2024 election. For now, legislative efforts will be blocked while there is still a Democrat president.

Centrist Republicans have blamed the collapse on high inflation, which they in turn attribute to government spending.

Recent bank turmoil will see credit conditions tighten

The Federal Reserve (Fed), along with the Federal Deposit Insurance Corporation (FDIC) and the Treasury, stepped in



This argument would provide further backing to the Republican desire to cut government spending as part of the debt ceiling and budget negotiations later this year, particularly if further banking failures were to occur.

For now, polling data indicates there has not been a backlash against Biden in response to the banking sector turmoil, indicating Republican efforts may not have been effective. This may also blunt Republican attempts to use inflation and tightening credit conditions as a means of extracting concessions from the government during fiscal negotiations around the debt ceiling.

One thing that both parties seem to agree on is that the decisions of the banks' executives have played a significant role. After Biden requested legislative action, the bipartisan Failed Bank Executive Clawback Act of 2023 was introduced to the Senate. This would require regulators to claw back from bank executives all or part of the compensation they received over the five-year period preceding a bank's insolvency or FDIC-resolution.

Both parties are keen to avoid recreating the perception following the 2008 crisis that policy favoured bank executives. This means the bill is likely to pass in some form.

Regulators are on the back foot, but action is likely

It is likely that we see further changes to the regulatory system because of this episode. The Fed had been monitoring SVB for over a year, issuing numerous citations around the bank's risk management, interest rate risks, and the inadequacy of its internal stress-testing procedures. Republicans, who favour lighter changes to regulation, argue regulators have the right tools but didn't use them.

Both the Fed and the FDIC are conducting inquiries into what went wrong at SVB, with final reports expected on 1 May. These reports are likely to set out how regulators can change their approach within their existing legal powers. Lighter touch changes could include making the stress-testing procedures more rigorous, increasing the accountability of the Fed themselves when regulated banks fail.

Democrats, including President Biden, would favour a more robust response, such as rolling back changes made to Dodd-Frank in 2018 with regards to supervision of medium-sized banks to make sure that those with more than \$50bn in assets are subjected to more rigorous stress testing and possibly even greater capital requirements.

A near-term increase in deposit insurance would only be introduced in the event of a greater crisis

Under Dodd-Frank, the Federal Deposit Insurance Corporation can make limited changes to the deposit insurance ceiling, but making an increase "widely available" requires congressional approval.

An increase to deposit insurance has been promoted as a measure to protect depositors by some politicians, including Senator Elizabeth Warren.

Beyond progressives, the principle of deposit insurance is more divisive. The House Freedom Caucus are opposed to universal deposit insurance and they claim this may increase irresponsible behaviour in the banking sector. Moderate Republicans are likely to vote for the measure only in the event of more widespread banking failures. Even in this scenario, there is a risk that a divided House fails to pass legislation despite market stress, generating further turbulence. This would be similar to what happened when the Troubled Asset Relief Programme failed to pass in 2008.

In the absence of a majority in favour of change, Biden will work within the bounds of what can be achieved without Congress. Regulatory proposals announced by the White House would reverse some of the deregulatory efforts made under Trump. Under these plans, banks with between \$100 billion and \$250 billion in assets would hold more liquid assets, increase their capital, submit to regular stress tests and write "living wills" that detail how they can be wound down.

Should deposit insurance eventually be increased, which does seem to be the logical end of the recent policy response of all but implicitly guaranteeing all deposits, this will likely come with much more substantial regulatory reform. The expectation of this reform would likely weigh on bank equity prices today in anticipation of certain bank business practice becoming less profitable.

Earlier recession would complicate debt ceiling talks

A weaker economic outlook would also complicate the debt ceiling negotiations. An earlier recession would increase government spending on automatic stabilisers, bringing the x-date – the date by which the US will be unable to meet all its obligations – forward.

While the x-date is still unlikely to be hit before late June, it still carries risks, principally if Republicans are unprepared to begin substantive negotiations. After having originally promised a budget proposal by 15 April, Republicans have pushed back publication to May, indicating that it is proving harder than anticipated to find a majority position.

An x-date at the earlier end of expectations would leave little time for substantive negotiations. The perception of political unpreparedness for the x-date may increase market volatility before a resolution is found. In a 'Congress is unprepared' scenario, the most likely outcome would be a short suspension of the debt ceiling to allow for more negotiating time. As we have highlighted [before](#), a short-term extension would run the risk of creating rolling market volatility.

Authors

Lizzy Galbraith and Abigail Watt



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