Alert
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COZEN O'CONNOR

Cozen Currents - The Banking Crisis: What Happens Next?

The Cozen Lens

- As the dust settles on the most serious banking crisis since 2008, lawmakers and regulators are eying the policies, as well as the politics, necessary to restore stability to the banking system.

- Whether or not the crypto market collapse was one of the sparks that set off the banking crisis can be debated, but it will not change the reinforced caution with which President Biden's regulators now view the asset class.

- If you thought the banking crisis would be a moment of clarity for the debt ceiling, think again. It has reinforced the divide on both sides of the aisle. But when the debt ceiling becomes a full-blown crisis for markets and other policy priorities, dynamics are likely to change.

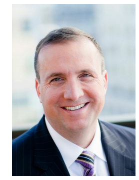
The Banking Crisis: How We Got Here and Where We're Going

How We Got Here. A bank run on Silicon Valley Bank (SVB) and the subsequent failure of Signature Bank brought the banking crisis playbook back to the forefront for the Biden administration and prudential regulators.

- The Federal Deposit Insurance Corporation took specific action for SVB and Signature Bank. Under its own systemic risk exemption and with the support of Treasury Secretary Janet Yellen and the Federal Reserve Board, it fully guaranteed the uninsured deposits of both banks.
- The Fed took broad action to provide more liquidity and reduce interest rate risks for the banking sector more broadly. It used its Section 13(3) "unusual and exigent circumstances" authority to establish the Bank Term Funding Program whereby it is providing loans for one year at par value to banks for eligible collateral despite any current mark to market discounts.
- Regulators are on guard to avoid a "Lehman moment" where regulators can't or won't step in to save a bank or its depositors. The Treasury has coordinated actions with the largest banks to help the struggling First Republic Bank from failing.

Where We Go from Here. The bank runs created near- and long-term objectives for regulators, while also complicating longer-held objectives on monetary issues like combating inflation.

- In the near term, regulators want to prevent any further bank runs and to reach a point where deposit outflows return to normal levels. However, that means relying on using the existing tools regulators have as much as possible before breaking the glass on new policies like unlimited deposit insurance for everyone.
- In the longer term, regulators want to fortify the regulatory and supervision framework so that there is no incentive for bank runs like those that have occurred over the past couple of weeks to resume and to avoid a consolidation of deposits among the largest systemically important financial institutions even after the termination of the Fed's emergency lending program.
- The battle against inflation continues as well. The Fed's yearlong campaign to raise interest



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Related Practice Areas

- Government Relations - Cozen O'Connor Public Strategies rates was a major contributor to the bank runs. But the Fed still wants a return to the stability of prices. They are balancing that with the stability of the financial system.

How We Get from Here to There. Congressional hearings, proposed legislation, and new regulations are all on the horizon. Legislators, regulators, and lobbyists all have a role to play in how things develop.

- Lawmakers are torn between making a difference and making a point. As the 2024 election cycle ramps up, good banking politics will be more important than good banking policy for some. At the same time, there are lawmakers with a genuine interest in understanding the aftermath of this banking crisis and what might be necessary to prevent another one in the future.
- Regulators want to create policies that stand the test of time, not just until a Republican administration. This means a deliberate but resolute process in investigating what happened and going through the traditional rulemaking process to make changes for banks of certain sizes.
- Just like in the aftermath of the Great Financial Crisis and the drafting of the Dodd-Frank Act, lobbying today plays a critical role with legislators and regulators in understanding the banking crisis and what the appropriate responses will be moving forward. The banking industry and other relevant players may not be speaking with one voice on what the appropriate policy response may be. Ensuring one's message doesn't get lost in the shuffle -- and can address the different political philosophies on each side of the aisle -- will be important for having a meaningful and lasting impact.

The Banking Crisis and Crypto

Uncertainty Means Caution. Whether the crypto market collapse was an incipient cause of the banking crisis can be debated, but the answer to that question will not change how federal regulators respond.

- President Biden’s regulators, especially those in charge of overseeing the banking system, have been extremely cautious with the guidance they have given to banks regarding crypto activity. The prevailing thought was that by doing so they would minimize the potential for crypto’s volatility to impact traditional financial institutions.
- With the current uncertainty in the banking sector, these prudential regulators will now be even more careful with the guidance for crypto activities that they provide banks. This could mean, among other things, that these regulators release a more forceful joint statement warning banks that they should be careful when considering working with digital asset companies.

Finding New Partners. One of the most challenging tasks for crypto companies moving forward will be finding new banking partners as two of the failed banks were among crypto’s largest banking service providers.

- Developing these relationships will take time and, given the warnings from federal regulators, banks will be more cautious about what businesses they take on. Furthermore, while banks may still be interested in exploring relationships with some firms that come to them, it is doubtful that many will actively seek new business in the crypto sector.
- Some companies may look to move operations overseas in search of banking partners, but this will not remove them from the US’s jurisdiction as seen in the case of FTX. In addition, with the US dominance in the financial markets, it will likely be influential in global regulatory standards for crypto, meaning companies will not be able to just ignore America’s approach to digital assets.

Not So Stable Stablecoins. One of the most destabilizing parts of the banking crisis for the crypto industry was the depegging of Circle’s USDC stablecoin.

- Circle found itself caught in the crisis, as $3.3 billion reserves for its stablecoin were located at Silicon Valley Bank. The company has seen nearly $3 billion worth of net outflows from USDC since the crisis began with investors moving their money to other stablecoins, primarily Tether.

- After losing its peg, Circle has been outspoken in urging for stablecoin regulation and calling for legislation from Congress. The pitch from the company to lawmakers has been that with proper legislation, USDC would not have depegged.
- Whether true or not, stablecoin legislation is not moving quickly in Congress. It appeared closest to coming to fruition last summer with an apparent agreement between the bipartisan leaders of the House Financial Services Committee, but was undone by opposition from rank-and-file members on both sides of the aisle. There is still some optimism that if there were to be meaningful crypto legislation, stablecoins may be the most feasible area to address, but no new progress has developed yet. It simply has not been a priority to date for lawmakers amidst many other competing priorities as the banking crisis has unfolded.

Debt Ceiling Dynamics Unchanged Despite Banking Crisis

Debt Ceiling Impasse Remains. The banking crisis has not publicly changed the dynamics of the debt ceiling standoff.

- Republicans are blaming the banking crisis on a broader fiscal crisis. "Why are we having a banking crisis? Because government spent too much and created inflation," House Speaker Kevin McCarthy (R-CA) said last week. "Should we do exactly what the president is saying, just lift the debt ceiling and create more inflation and more banking problems? I mean, this should be a wake-up call to everybody."
- Democrats are pointing to the banking crisis and saying it's exactly why Congress shouldn't mess around with lifting the debt ceiling. "Instead of calling for calm, House Republicans are sowing chaos by threatening a default at a time when banks need stability," Senate Majority Leader Chuck Schumer (D-NY) said. "The right answer is for Republicans in the House to stop saber-rattling, drop the hostage-taking and brinkmanship and work together, work in a bipartisan way, to extend the debt ceiling without strings attached."
- There's no breaking of ranks on either side of the aisle from the respective leadership positions.Senate Minority Whip John Thune (R-SD) this week said GOP senators remain behind McCarthy. Senator Jon Tester (D-MT), who faces a challenging re-election, continued to say, "I don’t think we should be negotiating on the debt ceiling."

House Republicans Need to Show, Not Just Tell. After President Biden released his FY24 budget proposal earlier this month and with a banking crisis riling markets, the onus is on McCarthy to show what Republicans actually want.

- It's an important signal of McCarthy's relative strength in negotiations if he can deliver 218 votes on certain policy markers. That's not just an important signal to Biden but also to Senate Republicans and moderate House Republicans who will have to play a bigger role, along with moderate Democrats, if the speaker can't deliver the votes.
- Republicans are eying spending cuts. TBD if it's in a full 10-year budget. Some cuts being discussed include a $130 billion reduction for FY24 spending and strengthening work requirements on mandatory programs like SNAP benefits (SNAP will be a big fight in the upcoming Farm Bill reauthorization as well)
- Republicans are eying non-spending cuts. A plurality of conservative House Republicans say "energy independence" is their most important policy priority for the debt ceiling. They are looking to pass The Lower Energy Costs Act, which received the coveted H.R. 1 designation demonstrating that it’s a centerpiece of the House GOP legislative agenda, later this month.

When the Debt Ceiling Becomes a Full-Blown Crisis. Right now, there's still a range of estimates for the "X date," or when the Treasury can no longer pay all its obligations. When there's more clarity, the debt ceiling dynamics will enter a new stage.

- Most estimates have an X date range between July and September. There will be greater clarity from tax season next month and the new revenue available to pay obligations. With a more definitive X date, it will not just get the attention of lawmakers but also of the financial markets.
- A market reaction, in turn, will also get the attention of lawmakers, just as it did in previous crises. "Fiscal principles" can often take a back seat to a market crash.
- House Republicans are looking at spending and policy changes that could impact other

negotiations. This includes FY24 spending and the Farm Bill. There are appropriators and agriculture lawmakers and interests who will push back against the debt ceiling encroaching on their own negotiations.