



## 5 Questions for the Fed's Vice Chairman for Supervision

By Gregg Gelzinis | April 17, 2018

This week, Federal Reserve Vice Chairman for Supervision Randal Quarles will testify for the first time before the House Committee on Financial Services and the Senate Committee on Banking, Housing, and Urban Affairs.<sup>1</sup> Quarles is the first person to hold the vice chairman for supervision position at the Federal Reserve Board of Governors. The position was created by the Dodd-Frank Wall Street Reform and Consumer Protection Act to serve as the Fed's point person on the supervision and regulation of the banks and nonbank financial companies that fall under its jurisdiction.

This hearing presents a useful opportunity for members of the House and Senate to press Vice Chairman Quarles on his financial regulatory views and to gain clarity regarding the Fed's priorities for banking regulation and supervision. Unfortunately, in recent speeches, Quarles has outlined an agenda focused on easing post-crisis rules for even the largest Wall Street banks.<sup>2</sup> Topics that should be covered in the hearing include the Senate's Dodd-Frank rollback bill, bank capital requirements, the Fed's physical commodities proposed rule, and the Volcker Rule.

This issue brief outlines some potential questions that Vice Chairman Quarles should have to address in the hearings.

*1. If the Senate's Dodd-Frank rollback bill is enacted, will the Fed aggressively reapply enhanced regulations to deregulated banks and refuse to loosen regulations on foreign megabanks?*

In March, the U.S. Senate passed S. 2155, the Economic Growth, Regulatory Relief, and Consumer Protection Act—the most significant rollback of the Dodd-Frank Act since the landmark legislation was passed in the wake of the 2007–2008 financial crisis.<sup>3</sup> Under Dodd-Frank, banks with more than \$50 billion in assets are subject to a suite of enhanced regulations to limit their chance of failure and mitigate the potential impact of a failure.<sup>4</sup> Out of the 5,700 banks in the United States, these stronger rules currently only apply to the 38 largest banks.<sup>5</sup> The centerpiece of S. 2155 raises Dodd-Frank's asset threshold for enhanced regulatory scrutiny from \$50 billion to \$250 billion, which

would eliminate several of these important post-crisis rules—including living wills, stronger liquidity requirements, company-run stress testing, and enhanced risk management standards—for 25 of the largest 38 banks in the country.<sup>6</sup> These rules help ensure that banks plan for their orderly failure, have enough liquid assets to meet payments on their liabilities in times of stress, adequately manage the risks they take, and continue to provide the financial services that the real economy depends on despite a financial shock and resulting economic downturn. Moreover, the rules today are appropriately tailored—a \$75 billion bank, for example, faces less stringent regulations than a \$2 trillion bank. The 25 banks deregulated by S. 2155 hold one-sixth of the assets in the entire banking sector and received \$47 billion in Troubled Asset Relief Program bailout funds during the financial crisis.<sup>7</sup> If a handful of these banks failed during a period of stress in the financial system, it could threaten U.S. financial stability. Indeed, the Congressional Budget Office (CBO) confirmed that relaxing these rules would increase the likelihood of another financial crisis.<sup>8</sup> Policymakers and bank executives do not pay for financial crises—workers and families bear the burden through lost jobs, homes, and savings. As Congress considers rolling back Dodd-Frank, it should remember whom such an action would put at risk.

S. 2155 gives the Fed the authority to reapply these enhanced regulatory standards to the deregulated banks that have from \$100 billion to \$250 billion in assets. Vice Chairman Quarles will therefore play a key role in determining which banks will not escape Dodd-Frank’s enhanced regulations. He should aggressively reapply these standards, as the 2007–2008 financial crisis clearly demonstrated that banks of this size can contribute to financial instability.<sup>9</sup>

Currently, the Fed applies Dodd-Frank’s full suite of enhanced regulations to foreign banks based on the size of their U.S. operations. A foreign bank that has \$50 billion in U.S. nonbranch assets must form an intermediate holding company (IHC) in the United States. Under the Fed’s current rules, the IHC will face a similar regulatory regime to a U.S. bank of a comparable size.<sup>10</sup> A foreign bank with more than \$50 billion in global assets but less than \$50 billion in U.S. nonbranch assets faces a much lighter regulatory touch and does not have to form a U.S. IHC. The Fed treats a \$50 billion U.S. IHC similarly to a \$50 billion U.S. bank in part to satisfy the principle of equality of competitive opportunity—a principle codified in multiple banking laws, including Dodd-Frank.<sup>11</sup>

It follows logically that if Congress changes Dodd-Frank’s \$50 billion threshold for enhanced regulations, then the Fed will make the parallel change for foreign banks to preserve the principle of equal competitive opportunity. While the Senate bill contains weak clarifying language on the issue of foreign bank regulation, law firm Davis Polk agrees that a parallel change is the most likely outcome.<sup>12</sup> The U.S. Department of the Treasury has also recommended loosening the rules on foreign banks in conjunction with raising Dodd-Frank’s \$50 billion threshold for enhanced regulations—and Treasury Secretary Steven Mnuchin agreed that S. 2155 would implement that recom-

mentation.<sup>13</sup> The Senate Committee on Banking, Housing, and Urban Affairs rejected an amendment offered by Ranking Member Sherrod Brown (D-OH) that would ensure foreign banks are not deregulated by S. 2155, and the full Senate failed to consider this amendment.<sup>14</sup> Without such an amendment, S. 2155 will lead to the deregulation of the U.S. operations of foreign megabanks. Loosening the rules on these banks would decrease the resiliency of the U.S. financial system and increase the likelihood that these foreign banks bring risk to U.S. shores.

In a speech to the Institute of International Bankers, Vice Chairman Quarles suggested that further tailoring rules for the U.S. operations of foreign banks is on the Fed's agenda—a thinly veiled nod toward loosening current rules.<sup>15</sup> This hearing provides an opportunity for Quarles to state clearly how the Fed will treat massive foreign banks that have U.S. IHCs with from \$50 billion to \$250 billion in assets if S. 2155 is enacted.

*2. The Senate's Dodd-Frank rollback bill lowers the loss absorbing capital cushions at systemically important custody banks. Will the Fed refrain from providing similar treatment to the custody businesses of JPMorgan Chase and Citigroup?*

S. 2155 makes a misguided change to the calculation of an important post-crisis capital requirement. The supplementary leverage ratio (SLR) serves as a simple and transparent risk-neutral complement to more complex risk-weighted capital requirements.<sup>16</sup> Together, both types of capital requirements help ensure that the largest banks in the country have adequate loss-absorbing buffers. Section 402 of S. 2155 excludes deposits held at central banks from the SLR calculation of banks predominantly engaged in custody banking. Custody banks provide for the safekeeping of their customers' financial assets and perform clearing, settlement, and other asset servicing functions for their clients. Removing these assets from the calculation is akin to assigning them a 0 percent risk weight, which violates the principle of the SLR to not factor in the real or perceived riskiness of assets. Aside from undermining the SLR's purpose, this change would directly lower loss-absorbing capital cushions at the three custody banks that are currently subjected to the SLR: Bank of New York Mellon Corp., State Street Corp., and Northern Trust Corp.<sup>17</sup> These banks are vital to the plumbing of the financial sector, holding a combined \$77 trillion in assets under custody or administration.<sup>18</sup>

This change would be bad enough if it were strictly limited to these custody banks, but the language used in S. 2155 opens the door for other banks with significant custody businesses, such as JPMorgan Chase & Co. and Citigroup Inc., to receive the same treatment.<sup>19</sup> The CBO predicted a 50 percent chance that the federal banking regulators would in fact apply this SLR change to JPMorgan Chase and Citigroup.<sup>20</sup> Initially, this section of S. 2155 included a quantitative threshold that would certainly exclude these other banks, but the language was watered down in committee. Given this confusion, Vice Chairman Quarles should express to which banks the Fed will apply the SLR change.

### *3. Will the Fed work with other banking regulators to increase capital requirements for the largest banks or at least activate the countercyclical capital buffer?*

A lack of sufficient equity capital buffers across the banking sector was one of the main vulnerabilities of the financial system prior to the 2007–2008 financial crisis. Banks funded themselves with too much debt and too little equity capital. When losses started piling up, banks either failed or were bailed out. Policymakers made, both domestically and internationally, a concerted effort after the crisis to improve the quantity and quality of bank capital requirements. Recent research shows that despite the significant progress made on increasing bank capital levels, policymakers must further increase capital requirements for the largest banks to achieve the socially optimal level of capital—the capital level that maximizes the economic benefits of lowering the chances of future financial crises while limiting the slight increase in bank funding costs associated with higher capital. A 2016 International Monetary Fund (IMF) study concluded that equity capital requirements set from 15 percent to 23 percent of risk-weighted assets would be optimal, avoiding most previous financial crises.<sup>21</sup> Researchers at the Fed concluded in 2017 that equity capital requirements set from 13 percent to 26 percent of risk-weighted assets would maximize economic benefits, while limiting the costs.<sup>22</sup>

Current equity capital requirements, depending on the systemic profile of the institution, range from 7 percent to 11 percent of risk-weighted assets. Bank capital levels are typically a few points above the required levels, meaning that current capital levels are at or below the low end of the socially optimal range. As former Fed Governor Daniel Tarullo stated, based on the cost-benefit trade-off of ratcheting up capital requirements, it is better to be on the higher end of the optimal range.<sup>23</sup> Former Treasury Secretary Timothy Geithner agrees that current bank capital requirements are likely too low.<sup>24</sup> Countless academics have performed research similar to that of the IMF and the Fed, coming to similar conclusions.<sup>25</sup> Based on this mounting evidence, Vice Chairman Quarles should work with the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency to increase bank capital requirements accordingly. While it is highly unlikely that regulators will significantly increase capital requirements, the Fed could activate the countercyclical capital buffer (CCyB).<sup>26</sup> This modest policy tool is an additional bank capital buffer, currently set at 0 percent, that can be ratcheted up to 2.5 percent during positive economic times when risk appears to be building in the financial system.<sup>27</sup> This additional capital buffer would apply to banks with more than \$250 billion in assets, or \$10 billion in on-balance-sheet foreign exposure. Given high asset valuations within this late stage of the economic cycle, Eric Rosengren, president and CEO of the Federal Reserve Bank of Boston, agrees that activating the CCyB may be appropriate.<sup>28</sup>

Instead of increasing capital requirements, the Fed and other banking regulators appear to be on the verge of reducing them, rejecting the principle of countercyclicity—the idea that financial regulations should be strengthened later in the business cycle as asset

valuations increase and the risk of future losses builds. Regulators have proposed lowering the enhanced supplementary leverage ratio requirements that apply to the most systemically important banks, in addition to the SLR changes included in S. 2155.<sup>29</sup>

The Fed also recently released its stress capital buffer proposed rule.<sup>30</sup> The concept of the rule—to harmonize regulatory capital requirements with the stress testing regime—is sound. If appropriately crafted, this proposal would lead to an increase in the aggregate capital levels at banks subject to stress testing. But the specific stress test assumptions loosened by the Fed’s proposal—including the assumptions regarding balance sheet growth and the time horizon for expected dividend payouts—would reduce aggregate bank capital levels. According to the most recent stress testing data, this proposal would reduce required capital at these banks by \$30 billion.<sup>31</sup> Reducing loss absorbing buffers during positive economic times, at a time when capital levels nonetheless remain below socially optimal levels, is the exact opposite of prudent regulation.

Quarles should address his stance on the capital levels at systemically important banks and discuss whether the Fed is considering activating the CCyB.

*4. Do you support the Fed’s 2016 recommendations for repeal of the provisions in applicable banking laws that permit banks to engage in merchant banking and other high-risk activities, as well as the Fed’s proposed rule that would tighten restrictions on these activities under existing authorities?*

Section 620 of the Dodd-Frank Act required federal banking regulators to review and analyze the risks associated with the range of activities in which banks are currently permitted to engage. Regulators were also required to issue a report recommending actions to enhance the safety and soundness of the banking sector stemming from this review.<sup>32</sup> In the report, the Fed recommends that Congress repeal merchant banking authorities that permit banks to make investments in nonfinancial companies, the grandfathered authorities that permit some banks to engage in a wide range of physical commodities activities, and additional exemptions.<sup>33</sup> These recommended changes would improve the safety and soundness of the banking sector by strengthening the traditional separation between banking and commerce, limiting the chance that risks associated with commercial operations lead to bank losses. The Volcker Rule certainly made progress on this front by banning banks from investing in hedge fund and private equity funds above a de minimis amount—and the final Volcker Rule written by regulators arguably should have covered some of these other risky activities.<sup>34</sup> The Fed’s recommendations would prudently build on this progress.

In 2016, the Fed also proposed a rule that would tighten restrictions on risky physical commodities activities.<sup>35</sup> The Fed has yet to finalize this rule, and Vice Chairman Quarles has not provided an updated timetable for the rule’s completion. During the hearing, Quarles should address his view on the Fed’s Dodd-Frank Section 620 recommendations and commit to finalizing the physical commodities rule in a timely manner.

*5. On what objective, data-driven grounds are regulators looking to rewrite the Volcker Rule when all evidence suggests it is reining in swing-for-the-fences trading bets without any detrimental side effects for capital markets?*

The Volcker Rule ensures that banks and their affiliates do not engage in speculative trading for their own profit and become overly exposed to risky hedge fund and private equity activities. This sensible rule directs banks to focus on client-centered functions such as lending, market-making, and underwriting, while limiting the chances of taxpayer losses. More than two years since its effective date in 2015, the Volcker Rule appears to be working as intended. Banks have shuttered their proprietary trading desks, reined in their market-making and hedging desks to ensure that they do not hide proprietary trading, and made progress toward unwinding their investments in hedge fund and private equity funds.<sup>36</sup> These changes have not come at the expense of U.S. capital markets. Research by academics and regulators has found that most liquidity metrics are well within historical norms and that bond issuance has hit record levels over the past few years.<sup>37</sup> Data released by the Fed also show that the bank trading desks that it oversees are primarily making money off of new positions from fees, spreads, and commissions, as opposed to the price appreciation of existing positions.<sup>38</sup> Far more transparency on the Volcker Rule's implementation, impact, and enforcement is needed, but it seems to be working.<sup>39</sup> The Volcker Rule has not impaired market functioning, and banks now have far less exposure to these highly risky activities, so it is unclear why a full rewrite of the rule is a top priority for Vice Chairman Quarles.<sup>40</sup>

Quarles' stated justification for this rewrite is the "burdensome" nature of the Volcker Rule.<sup>41</sup> But while regulatory efficiency, or accomplishing the mission of a regulation in the least cumbersome way, is a worthy goal, simplification is often code for loosening the Volcker Rule and driving loopholes through the heart of it. Any changes made to the Volcker Rule must not open the door for these risky activities to creep back onto the balance sheets of bank holding companies and their affiliates. If Vice Chairman Quarles wants to improve the Volcker Rule, he should focus first on closing some loopholes that found their way into the final Volcker Rule regulation and establish a heightened public disclosure regime for compliance and enforcement.<sup>42</sup>

As regulators are looking to rewrite the Volcker Rule, Congress is considering legislation that would concentrate the rulemaking authority for the Volcker Rule at the Fed, cutting out the other four financial regulators that currently have jurisdiction.<sup>43</sup> This would make it easier for Vice Chairman Quarles to swiftly and severely roll back the rule. In addition, it makes little sense to remove the Federal Deposit Insurance Corporation from the process, as the Deposit Insurance Fund is on the hook for losses if big trading bets tear down a bank. Moreover, the U.S. Securities and Exchange Commission and the Commodity Futures Trading Commission have extensive trading and financial markets expertise that the other banking regulators do not possess. Given these developments, Quarles' stated views on the Volcker Rule carry increased significance.

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## Conclusion

The vice chairman for supervision is the Fed's point person on the supervision and regulation of financial institutions. Therefore, the House and Senate hearings this week will provide some clarity on the Fed's regulatory and supervisory agenda. Vice Chairman Quarles has made it clear that he plans to re-examine the post-crisis regulatory regime—from capital and liquidity rules to the Volcker Rule. Members of the House and Senate should use these hearings to underscore the importance of financial reform efforts and to question Vice Chairman Quarles on how he will use his authority. A financial system with strong safeguards and vigorous regulatory oversight will ensure resilience, which is vital for long-term sustainable economic growth. Past financial crises clearly demonstrate that workers and families suffer when risks on Wall Street that undermine the economy's resilience go unchecked; it is therefore important that Quarles keeps workers and families in mind when exercising his authority.

*Gregg Gelzinis is a research associate for Economic Policy at the Center for American Progress.*

## Endnotes

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