BETTER MARKETS

SPECIAL REPORT

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The Agenda for the Fed’s Next Vice Chair for Supervision

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Randal Quarles, vice chairman of supervision at the Federal Reserve, right, speaks as Jerome Powell, chairman of the Federal Reserve, listens during a Federal Reserve Board meeting in Washington, D.C., U.S., on Monday, April 8, 2019. Photographer: Andrew Harrer/Bloomberg via Getty Images.

Although currently there is tremendous focus on who President Biden will nominate as the next Chair of the Federal Reserve, and appropriately so, another critical role on the Federal Reserve Board that must be filled is the Vice Chair for Supervision (VC Supervision). The four-year term of the current VC Supervision, Randal Quarles, is expiring on October 13, 2021.

This position has significant importance for financial stability and the safety of the U.S. banking system. That is particularly the case given the need to quickly and dramatically re-regulate after the last four years of dangerous Trump-era deregulations that were pushed by VC Supervision Quarles with the support of Fed Chair Jay Powell and others.[1] Moreover, while too many ignore it, strong financial regulation is critically interconnected with the execution and effects of monetary policy. In particular, while "loose monetary policy" can helpfully promote economic growth and full employment, it may also contribute to excessive risk-taking, market bubbles, and moral hazard, which increases the overall risks within the financial system.

The VC Supervision is the head of the Fed's Committee on Supervision and Regulation and can have tremendous influence[2] over the setting of rules and standards for the U.S. banking system, as well as on the intensity and ultimately the effectiveness of the Fed's supervisory oversight of banks. The VC Supervision is also an important member of the Financial Stability Board, an international body that coordinates on policy direction for global financial stability, and is a key U.S. representative to the Basel Committee on Banking Supervision, which sets global standards for prudential regulation and supervision of banks.

The next VC Supervision must use all of these platforms to pursue an agenda of "re-regulating" the banking system to promote a safer and fairer financial system. The too-big-to-fail problem (TBTF)

[1] Unsupported claims and assertions that the deregulation under Powell and Quarles was insignificant or modest fail to recognize or acknowledge (1) the breadth and scope of the deregulation across the most material and meaningful regulations and (2) the certain increase in probability of exacerbated crises and taxpayer bailouts from that deregulation. The deregulation was significant and dangerous, as we have detailed in two reports.

[2] It is, however, important to understand that, while the VC Supervision role has influence over rulemakings and has largely been left by Fed Chairs to manage the supervision and regulation portfolio in the past, it cannot be assumed that history will be repeated in the future. One must remember that if a Chair opposes something, it is probably unlikely to happen regardless of what the VC Supervision wants. In the current case one wonders if a Chair that has overseen and approved deregulation over the past four years would take a hands-off approach if the new VC Supervision wanted to restrengthen supervision and regulation. This is why it is critical that the President engage in a thorough, robust and comprehensive process to select the next Chair of the Fed: that choice will not only impact monetary policy, but every other action of the Fed including financial regulation.

targeted by the Dodd-Frank Act and other post-2008 Financial Crisis (2008 Crash) banking reforms is not only alive and well, it has grown even larger, more dangerous, and harder to address. The incoming VC Supervision must more fully address the challenges of TBTF by:

(1) further reducing the likelihood of large bank failure through the strengthening of capital and liquidity standards; and
(2) enhancing requirements around bank resolution preparedness so large banks can be shut down and/or be taken apart and sold off piece-by-piece more easily in the event they do fail.

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The consequences of a failure of a large bank are potentially devastating to the entire economy, which is why the largest banks are referred to as TBTF and why they were bailed out in 2008, and likely would have had to be again in 2020 if not for the trillions of economic and market support provided by the Federal Reserve and the U.S. government to address the crisis of the COVID-19 pandemic. Because the size of these firms could result in economic catastrophe and precipitate taxpayer-backed bailouts, it is essential to minimize to the greatest extent possible the TBTF problem, including by increasing the confidence of the American people that large banks won't fail, or, if they do, that failure will be handled properly. The efforts to address TBTF must also be complemented by regulations that work to protect against emerging and opaque risks, including those from climate change and an evolving financial system.

The VC Supervision must work both within the Fed and with the other national banking agencies to ensure we have a banking system that better serves all Americans. Achieving greater equity in our banking system for low-income communities and communities of color is more than simply the right thing to do. It would help millions of people that are almost systematically poorly served by banks and other institutions in the financial services industry. And it could also provide a boost to the U.S. economy more broadly while taking at least a small step on the path toward greater economic equality. In fact, a report from Citigroup estimated that if four key "racial gaps" between black and white Americans are closed today, $5 trillion can be added to U.S. GDP over the next five years.

Immediately after beginning the four-year term, the new VC Supervision needs to publicly reset the tone of Federal Reserve bank oversight by making it clear that assertive supervision and strong regulation, especially for the very largest banks, are critical to promoting financial stability and protecting the public interest. While seemingly obvious, this is necessary to quickly reverse the messaging and approach of VC Supervision Quarles and other leaders of banking regulatory agencies in the Trump era, who promoted a "kinder, gentler" approach to regulating and overseeing large banks. This reset should include a clear and public communication of the Fed's priorities in this area.

New VC Supervision Should Address Trump-era Deregulation

The first of the priorities should be to undo the most dangerous deregulation caried out since 2017. The Fed's supervisory stress test, which is now part of real-time capital requirements for large banks through the implementation of the stress capital buffer (SCB) in 2020, must be strengthened and made more dynamic. Two key elements that had made the Fed's pre-Trump era version of the stress test effective and meaningful must be reinstated:

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(1) the assumption that banks will make all planned capital distributions over the full nine quarter stress test timeframe, rather than the current assumption they will only payout four quarters of dividends, and
(2) the assumption that banks' balance sheets can grow under stress.

These changes would help ensure that banks have sufficient capital to withstand severe unexpected stress that could come at any time and would align with the observed reality that balance sheets can grow tremendously during stress, as they did during the pandemic for many large banks. In fact, the largest six banks' balance sheets grew by an aggregate 23% between the end of 2019 and the first quarter of this year.

In addition, the requirement that banks be able to meet minimum post-stress leverage targets—*i.e.*, meet minimum leverage requirements even after accounting for the losses estimated in the stress test—should be restored. Prior to its removal, the post-stress leverage requirement had at times resulted in the highest level of required capital for many large banks compared to the post-stress capital requirements that remain in place. Restoring the requirement could be done relatively easily by finalizing the previously proposed—but never implemented—stress leverage buffer.

The "stress" in the test must be increased, and the scenarios used should be more dynamic to capture varying salient and emerging risks. Based on recent results, the stress test and associated capital requirements have become too predictable for banks and not stressful enough. Indeed, in 2021, many of the largest banks' capital requirements were not dictated by the stress test results at all but rather by the minimum 2.5 percent floor required in the SCB rule. The result of insufficiently rigorous and increasingly less dynamic stress tests is an unacceptably higher likelihood that TBTF banks will fail under stress and have to get bailed out by taxpayers yet again.

Second, the previous regulatory requirements for liquidity at some large banks must be reinstated. Specifically, the unnecessary weakening of liquidity requirements for large banks with between $250 and $700 billion in assets should be reversed. While justified by claims of "tailoring" requirements to make them strongest for the largest banks (those designated as globally systemically important), banks in the $250-$700 billion range are also systemically important, and sufficient liquidity for them is necessary to prevent an accelerated decline into failure in times of stress. Also, the Net Stable Funding Ratio liquidity regulation should be reverted to its originally proposed form, prior to the exclusions, limitations, and other unnecessary modifications included in the final rule passed in the Trump era.

Third, the Fed must reverse the unfounded weakening of regulations around large bank trading and derivatives activities. The components of the Volcker Rule, which are supposed to prohibit banks from trading on their own behalf (so-called "proprietary trading") and from investing in or owning certain types of potentially unsafe funds, were seriously weakened through definition changes and exclusions. The original form of the Volcker Rule should be adopted and made broader and stronger. Separately, the Fed should reinstate the requirement for the posting of collateral—*i.e.*, so-called initial margin requirements—on derivative transactions between a bank with deposit insurance coverage and its affiliates.

Other key regulations should be strengthened to go even further than they had in their initial form. For example, making large banks prepare for possible resolution is critical to addressing the TBTF problem. The submission of so-called "living wills" should return to a two-year cycle from the four to six-year cycle currently required under the weakened regulation. This would increase their relevancy. Even more importantly, many of the Fed's resolution plan expectations—particularly including those for certain capital and liquidity needs as well as for simpler bank structure—should be made part of legally constraining rules, rather than only being articulated through non-binding "supervisory guidance." This would ensure that all large banks are required to meet a minimum level of standards. It would also address the oft-repeated concerns of banking industry advocates who have criticized the Fed for using supervisory guidance and a "principles-based" approach to overseeing banks' resolution planning. Given the importance of making large banks more resolvable, a rules-based approach is needed.

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The pandemic-caused financial and economic stress, as well as the 2008 Crash, have highlighted issues that should lead to further enhancements of regulatory requirements. For example, in both events money market funds (MMFs) proved to be a source of fragility and material risk to financial markets and the banking system. Many MMFs are sponsored by large banks, and some have repeatedly provided their MMFs with funding and other critical support during periods of stress. But large bank-sponsored MMFS—like non-bank-sponsored MMFs—are not currently required to hold capital. That has materially contributed to the MMF industry having to be bailed out both times and why this needs to change. Such issues highlight that capital requirements for large banks should be higher and that the Fed should be rethinking its capital requirements more broadly. The VC Supervision also should work with the Securities and Exchange Commission to address issues with MMFs themselves, including MMFs that are not bank-sponsored.

The supplementary leverage ratio (SLR) requirement, which aims to prevent large bank balance sheets and risks from growing too large relative to capital levels, also requires consideration. The Fed provided relief on this requirement during the pandemic, with the stated intention of enabling banks to support the economy, by temporarily excluding the deposits of banks that are held with the Fed (so-called "Fed reserves") from the SLR.[3] The Fed is now considering making permanent modifications to the SLR. This decision must not be made until the new VC Supervision has been confirmed. The Fed should carefully consider all the options and engage in an open public process that includes full public input. That maximizes the likelihood that intended and unintended consequences get identified and considered before action is taken. For example, any permanent exclusion of reserves could incentivize banks to put money into reserves rather than lending in times of stress. Assessing the costs and benefits of such tradeoffs should be a high priority.

More generally, the next VC Supervision should assess what other modifications could be made to the regulatory framework to enhance the safety and soundness of the banking system. Consideration should

[3] The Fed should undertake an analysis of the extent to which this requested policy relief achieved its stated purpose. Did this enable the largest banks "to support the economy" and, if so, how and in what amounts? Too often the Fed and other regulators provide regulatory relief for all sorts of stated reasons, but almost never thereafter analyze what happened and if those actions were in fact merited. That needs to change.

be given to the entire regulatory landscape. The assessment must address changes that have occurred in the financial system, particularly the growth of the nonbank sector (the so-called "shadow banking system"), its interconnectedness with and the potential vulnerability it represents for the banking sector, and other systemic risks associated with non-bank financial firms.

The Fed should utilize lessons learned from the pandemic, which can provide a good case study on the resiliency of the banking system, especially if it is assumed the level of support from the Fed's trillions of dollars of liquidity and regulatory relief as well as the fiscal and other support from the CARES act had not been there to the same extent. The VC Supervision should be leading the charge on this analysis and insist on public disclosure of the results as part of a broader pandemic-related review of the state of financial markets and the costs and benefits of various Fed crisis-fighting actions.

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Systemic risk also has increased due to the massive consolidation in the banking industry and the continued creation of new megabanks. The two largest bank mergers since the 2008 Crash—each at over $500 billion—have occurred in the last three years. Such mergers can increase financial stability risks and reduce availability and increase the cost of consumer banking services. The Fed must strengthen its merger review process to ensure that future mergers enhance the public interest—such as increased access to credit—while reducing, or at the very least not increasing, the level of risk in the system.

The New VC Supervision Must Restrengthen Large Bank Supervision

On the bank supervision front, the effective elimination of the so-called "CCAR qualitative objection" to bank capital distributions significantly weakened large bank supervision by getting rid of a meaningful negative consequence that could be used when large banks exhibited dangerously bad practices. As a result of a qualitative objection, the Fed previously could limit or prevent dividends and share buybacks, directly affecting shareholders and thereby providing a strong incentive for boards of directors and senior management to prioritize risk management and governance practices.

This type of tool should be used more often not less. Like most profit-maximizing businesses, banks will not tend to incur costs that even marginally cut into their profits unless they are required to by strong rules and assertive supervision. As was proved in the years before the 2008 Crash, banks will externalize the costs of systemic risks on society to maximize their profits, leaving significant dangers and risks unaddressed and thereby shifting them to the public. The early success of the CCAR program at promoting a safer banking system by making banks address woefully deficient risk management and governance practices (by forcing banks to incur the costs to do so) demonstrates the effectiveness of the tool.

The Fed's supervisory assessments should be expanded at the largest banks to include a greater explicit focus on the effectiveness of boards of directors, and consideration should be given to requiring independent board chairs rather than allowing CEOs to also be board chairs. Boards of directors are ultimately responsible for ensuring banks have strong and effective management that works to prevent dangerous practices and comply with existing laws and rules. While proposed guidance from 2017 on the responsibilities of boards of directors was quietly finalized this February, it also suffers from the same issue as living wills of being reliant on non-binding guidance, a problem made more acute through a rule finalized by the Fed and other agencies earlier this year. When a bank repeatedly demonstrates ineffective practices, the board of directors must be held accountable through the supervisory process. An assessment of boards, or actions taken to hold ineffective boards accountable, should be made public.

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The supervisory assessment framework must also include assessments of climate change-related issues. As the key supervisory agency of the banking system and the agency charged with maintaining financial stability, the Fed must move its climate-related efforts along substantially. At the very least it should be publicly communicating to banks that their ability to appropriately identify, measure, control, and monitor all of their material climate-related risks will be an important part of the Fed's supervisory assessments. Stress testing scenario analysis should also be used to inform supervisors of banks' climate risks. This is not, as some have claimed, the Fed going beyond its mandate or engaging in social policymaking. The Fed is specifically charged with not just supervising the banking industry, but also doing what is necessary to maintain financial stability and limit financial crashes. The climate crisis materially threatens to impact every aspect of the economy and financial system. The Fed has to start taking those threats seriously.

The supervisory process must be made more transparent, particularly for large banks. A lack of transparency prevents public accountability not only of the banks but undermines the public's ability to hold the Fed itself accountable for working in the public interest. The American people deserve to know when the largest banks have serious deficiencies in managing their risks, or complying with laws and rules, and what the Fed is doing about it. The argument often used against this type of transparency is that letting the public know about weak practices at a bank could undermine the bank and ultimately create a potential risk to financial stability. This argument has it backwards. Dangerous practices at banks threaten financial stability, and forcing banks to fix their issues makes them safer. With prior knowledge that supervisory assessments will be made public, large banks will have greater incentives to ensure they have strong practices, ultimately enhancing financial stability.[4]

To enhance transparency and provide incentives that support the effectiveness of bank supervision, the Fed should more frequently use formal, public enforcement actions both for safety and soundness issues and for issues related to compliance with other rules and laws, including consumer protection rules. Rather than the informal, private actions that the public never knows about, this would provide the public with valuable information about what the banks and the Fed are doing. Where formal actions are not used, at a minimum more information should be disclosed about the banks and their identified issues.

[4] It is worth noting that this same argument was used to push against the idea of publicly releasing the results of the Fed's supervisory stress test. The Fed has now been running its stress test and publicly releasing results for nearly a decade. Banks that have been publicly shown to have inadequate capital to withstand severe stress have not collapsed. Rather, they have been required to take action to ensure their capital is sufficient. This has made them stronger, made the system safer, and significantly enhanced transparency and public accountability.

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The Fed Needs to Better Address Racial Justice Issues

In addition to promoting a safer banking system, the next VC Supervision must work to improve the economic well-being of low- to moderate-income (LMI) communities, including communities of color, by promoting increased access to credit and other financial services. This can work to close the wealth gap by enabling individuals of color to purchase wealth-building assets such as homes. A key way this can be accomplished is by improving, strengthening and broadening Community Reinvestment Act (CRA)-related regulation. The CRA assessment and rating system of banks' performance in meeting the needs of LMI communities must be less subjective, and these assessments should have more meaningful consequences. If a bank has a poor CRA rating, these consequences could include rejections of bank mergers and branch modification applications and rejections of applications to offer new or remove existing services. Also, community reinvestment must be more closely linked to the sources of funding, especially for online banking, to ensure that communities providing deposits are actually benefiting from banks' CRA-related activities.

Another way to improve the economic well-being of LMI communities and communities of color is for the Fed to more closely monitor the fees charged by banks for various financial services and other factors that prevent ready access to financial services, such as required checking account minimums. These have been shown to affect low-income households and communities of color disproportionately. Bank fees add up as do fees associated with nonbank financial services, such as check cashing. For example, there were $31 billion in total overdraft fees across big and small banks in 2020. The Fed should work with the other regulatory agencies to determine the best way to encourage banks to make banking fair and accessible for all Americans. Progress on this and the state of access to lending and financial services in LMI communities should be discussed in detail in the semiannual Supervision and Regulation report.

The Fed Needs to Focus on Emerging Sources of Risk

There are also new and emerging risks to assess and address. The rise of financial technology (FinTech) companies has altered the dynamics of the banking system and introduced competition that is broadly unregulated. And where rules may constrain activities, FinTech companies often seek to partner with banks (or apply for their own charters) to avoid what may be more stringent state regulation than the national rules that many banks follow. The presence of these companies can provide benefits, such as increased access to financial products and services, but they also raise serious customer protection issues as well as potentially create market distortions and increase systemic risk. For example, FinTech companies have been partnering with smaller banks to offer debit cards, banks that are small enough to avoid the regulatory limit on debit card interchange fees, which could eventually drive up interchange fees overall. The banking regulatory agencies, with the Fed as lead, must study the risks and market distortions arising from the growth in FinTech in a closely coordinated way and modify regulations to reduce potential risks and maximize potential benefits to hardworking Americans. "FinTech" can't be allowed to be the latest label to obscure yet more creative ways to extract money from financial

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consumers while increasing systemic risk. FinTech should be forced to live up to its promise of providing financial products and services quicker, easier and of higher quality.

Additionally, the pandemic-induced financial market crash of March 2020 led to large-scale support from the Fed through non-traditional monetary policy actions and emergency lending programs. As a result, the Fed's balance sheet has grown rapidly and massively, doubling since then from $4.2 trillion to $8.4 trillion and counting, and significantly increased the level of reserves in the banking system and liquidity in financial markets. The VC Supervision must play a key role in the identification and management of any existing risks this currently poses for the banking system and any developing risks that unfold as the balance sheet is eventually unwound.

Conclusion

The next VC Supervision has a substantial agenda to undertake over the coming four years. The nominee must be carefully selected and be someone who appreciates the need to re-regulate and assertively oversee the banking sector. He or she must also carefully consider the new and emerging risks as well as any potential benefits from the changing financial system landscape. The right set of actions will get back on the path of finishing the job started by DFA to address the TBTF problem, helping to promote greater resiliency of our financial system, and can promote an economy that works better for all Americans.

DENNIS M. KELLEHER
Co-Founder, President & CEO of Better Markets

Dennis Kelleher co-founded Better Markets in October 2010, where he is the President and Chief Executive Officer. He is an internationally sought expert on financial reform, financial markets, economics, regulation, legal issues, and their intersection with political matters. In addition to testifying in the U.S. Senate and House of Representatives, he also speaks frequently in the U.S. and Europe on these matters at conferences, seminars and symposiums as well as on all media platforms. Mr. Kelleher recently served as a member of the Biden-Harris Transition team on the Federal Reserve, Banking and Securities Agency Review Team. Prior to Better Markets, Mr. Kelleher worked for almost eight years in senior staff positions in the United States Senate, including as General Counsel and Deputy Staff Director on the Labor and Human Resources Committee (now known as the HELP Committee) and as Chief Counsel and Senior Leadership Advisor to the Chairman of the Senate Democratic Policy Committee, a member of Senate leadership. Earlier in his career, Mr. Kelleher was a partner with the international law firm Skadden, Arps, Slate, Meagher & Flom, where he specialized in crisis management, financial markets, securities, and complex corporate matters.

TIM P. CLARK
Distinguished Senior Banking Advisor

Tim Clark is the Distinguished Senior Banking Advisor for Better Markets. Prior to joining Better Markets, Mr. Clark was Deputy Director of the Division of Supervision and Regulation for the Federal Reserve Board until he retired in late 2017. He joined the Federal Reserve in 1995 as a bank examiner in New York and moved up the ranks there until 2008 when he was recruited to join the staff of the Board of Governors in Washington. He was the chief architect of the Federal Reserves' capital stress tests and liquidity stress tests. Mr. Clark also was Chairman of the Operating Committee of the Federal Reserves' Large Institution Supervision Coordinating Committee (LISCC), which was created after the crash to coordinate oversight of the biggest, riskiest banks. As such, he was a crucial voice on virtually all decisions regarding bank oversight, particularly regarding the to-big-to-fail banks and global systemically important banks. Mr. Clark was also the Federal Reserves' key contact with the senior executives at the largest banks.

PHILLIP BASIL
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Phillip Basil is Director of Banking Policy for Better Markets where he covers all aspects of the banking sector. Specifically, he works on economic and financial matters that are crucial to Main Street families, workers, investors, consumers and community banks, and that support financial and banking reforms to prevent crashes and bailouts. Mr. Basil has more than 15 years of experience in both the public and private financial sectors, primarily focused on the trading and investment portfolios of large and complex banks. Most of his career has been with the Federal Reserve Board, starting in the Division of Research and statistics (R&S) and moving to the Division of Supervision and Regulation (S&R). During his time in S&R, he was responsible for developing and executing aspects of the supervisory stress test as well as portfolio-specific risk analytics and reports for the largest, most complex banking institutions. His time in R&S primarily involved working to develop a framework to assess the systemic impact and risks of mergers and acquisitions within the banking industry.

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