



# *FedFin Client Report*

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Tuesday, April 17, 2018

## **Quarles Advances Ambitious, Wide-Ranging Reg Rewrite**

Client Report: **FEDERALRESERVE44**

### **Executive Summary**

In his first of two days before Congress, FRB Vice Chairman Quarles today appeared before the House Financial Services Committee in an unusually substantive and policy-setting session. In this report, we detail the areas in which Mr. Quarles broke new ground – most notably with regard to stress testing, liquidity regulation, TBTF, the GSIB surcharge, and CRA, noting also the many other issues on which new positions were laid out. These included criticism from GOP leadership not so much of the FRB’s pending rewrite of board responsibilities ([see FSM Report CORPGOV23](#)), but of what the Members termed the Fed’s already over-heavy hand sitting in on board meetings and forcing directors to resign. This view is of course directly opposed to Sen. Warren’s (D-MA) views in the Wells case as well as the Board’s enforcement action ([see Client Report CORPGOV26](#)) shortly before Chair Yellen left the Fed. As this report details, Mr. Quarles clearly has a far-reaching reform agenda, approving for example of the Treasury proposal to confine the toughest LCR only to GSIBs ([see Client Report LIQUIDITY30](#)). He is also open to retooling the GSIB surcharge, CCyB, and several other tenets of current Fed regulation. Among these also is the Board’s prior approach to bank-like regulation of insurance companies; Mr. Quarles supported the state-based approach and pledged to reflect this in international deliberations. As detailed here, the hearing also touched on technical questions such as tax definitions in TLAC, the new reference rate, and Volcker Rule specifics.

### **Analysis**

#### ***Opening Statements***

Chairman Hensarling (R-TX) argued for regulatory transparency and increased cost-benefit analysis. Reps. Luetkemeyer (R-MO) and Huizenga (R-MI) called for

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additional tailoring and applauded efforts to evaluate the current regulatory regime for unintended consequences.

Ranking Member Waters (D-CA) applauded the FRB's enforcement action against Wells Fargo, praising the decision to cap the company's growth. She was also critical of the FRB's and OCC's recent eSLR proposal ([see FSM Report LEVERAGE13](#)). Rep. Kildee (D-MI) argued that changes to CRA regulations should promote inclusion.

### **Testimony**

Mr. Quarles argued that the financial system is more resilient since the crisis and that more regulatory attention is needed regarding the efficiency, transparency and simplicity of the regime. He specifically supports moving living wills to a two year cycle and recalibrating liquidity and living will requirements for non-GSIBs. Mr. Quarles also thinks the stress-test proposals could go farther by considering comments on scenario design. The FRB is also in the process of developing a revised framework for determining "control" under the Bank Holding Company Act.

### **Q&A**

- CRA: Reps. Waters, Ellison (D-MN) and Velázquez (D-NY) pressed Mr. Quarles on the need to strengthen the CRA to prevent discrimination. Mr. Quarles is broadly supportive of Treasury's CRA recommendations ([see Client Report CRA20](#)), saying that the banking agencies are planning a joint ANPR to improve service to low- and moderate-income communities. Rep. Loudermilk (R-GA) said revisions should consider the rise of fintech, provide certainty regarding what products will receive CRA credit, and make exams timely; Mr. Quarles agreed.
- Stress Tests: Reps. Maloney (D-NY) and Scott (D-GA) were critical of suggestions that the FRB should subject stress test scenarios to public comment. Rep. Scott argued that public notice will promote gaming, noting that he successfully removed this provision from the House-passed H.R. 4293. Mr. Quarles said public input could improve scenario design although he said a full notice and comment period could be logistically difficult. Reps. Hensarling and Barr (R-KY) argued that the FRB should not object to the capital plans of any banks on qualitative grounds, with Mr. Quarles responding that a pending proposal would expand this approach to all large BHCs.

- **Countercyclical Capital:** Rep. Royce (R-CA) argued that capital levels should adjust during the business cycle; Mr. Quarles said that banks should raise their capital during good times and said that regulators can encourage this by using stress tests or other measures. However, he also said it is an open question regarding whether the CCyB balances well with the market's need for certainty.
- **Governance:** Reps. Hensarling, Huizenga, and Duffy (R-WI) were critical of the FRB's proposed guidance on the supervisory treatment of bank board of directors, saying that it could unintentionally result in increased micromanagement of bank boards. They also argued that the FRB should not force banks to allow FRB staff to attend board meetings, demand certain board members be fired, or ask about bank lobbying activities. Mr. Quarles stressed that the objective of the guidance is to reduce micromanagement. He agreed questions about lobbying were inappropriate and said that the FRB should only recommend board member removal in the most egregious cases of misconduct.
- **SLR:** Rep. Maloney asked if the proposed eSLR revisions make the Senate finreg bill's provision exempting custody bank central banks assets unnecessary. Although Mr. Quarles answered in the negative, he did say that, if this becomes law, the FRB would recalibrate its proposal (which would in fact be mandated by the pending denominator change regardless of the Fed's view on it). Rep. Velázquez argued that weakening the eSLR is a slippery slope to further capital reductions; Mr. Quarles said it is necessary to ensure that the leverage ratio is not a binding constraint. Rep. Rothfus (R-PA) emphasized his support for the Senate bill.
- **GSIB Surcharge:** Rep. Hollingsworth (R-IN) asked whether it would be appropriate to recalibrate the GSIB surcharge's coefficients to reflect recent market developments. Mr. Quarles said that this might be appropriate especially in light of possible changes to living wills.
- **Resolvability:** After repeated prodding from Rep. Sherman (D-CA) on whether any bank is TBTF, Mr. Quarles said that he does not think so "at the moment." When asked if he would support eliminating the "limited bailout provisions" that are in Dodd-Frank, presumably referring to OLA, Mr. Quarles stressed the need for regulators to be humble regarding predictions about the future. Rep. Hensarling argued that the FRB has the authority to implement the main provisions of the House-passed living will reform bill ([see FSM Report LIVINGWILL18](#)); Mr. Quarles said he agrees and supports these provisions.

- **International Standards:** Rep. Maloney asked if the U.S. should continue to participate in the Basel Committee and the FSB. While Mr. Quarles said that these organizations can be made more transparent, participation ensures that international standards are crafted with U.S. input. Reps. Duffy, Ross (R-FL), and Budd (R-NC) pressed Mr. Quarles to support the U.S. state-based insurance regime in international insurance negotiations; Mr. Quarles agreed to do so. Rep. Budd also argued that international insurance standards should consider not only capital levels in determining whether there is a level-playing field, but also consumer protection standards. Mr. Quarles agreed.
- **FRB Supervision of Insurance Companies:** Rep. Rothfus said that FRB supervision of insurance companies that own depository institutions is duplicative and asked how the FRB plans to reduce burdens on these firms. Mr. Quarles said that he support streamlining requirements, but some regulatory relationship will still be required.
- **TLAC:** Rep. Hill (R-AR) asked about the conflict between the tax law's base erosion provisions and TLAC. Mr. Quarles said that the FRB is aware of the issue, has asked banks to quantify how the changes will impact them, and then will decide with Treasury how best to address this.
- **Volcker Rule:** Rep. Lynch (D-MA) argued that changing the definition of proprietary trading should be left to Congress; Mr. Quarles disagreed. He also said that the rule has clear negative effects on capital markets. Rep. Love (R-UT) expressed concern that the Volcker rule applies to ILCs and unitary thrifts; Mr. Quarles said that he is aware of the concern but noted that the statute may limit regulators' ability to provide relief.
- **Guidance Process:** Reps. Luetkemeyer and Davidson (R-OH) argued that regulatory guidance is not binding if it does not go through a rulemaking process. Rep. Luetkemeyer also asked if the FRB is considering limiting its guidance in a way similar to the DoJ. Although Mr. Quarles said that guidance should continue to play a role, he emphasized that it is not binding. He also said the FRB is considering ways to formally articulate this.
- **Cybersecurity:** Reps. Wagner (R-MO), Tipton (R-CO) and Luetkemeyer all pressed the Vice Chairman on efforts to harmonize cybersecurity standards. Mr. Quarles said that the FRB is engaging in interagency discussion to promote harmonization and cyber resiliency.

- FRB on Appropriations: Reps. Barr and Davidson argued that putting the FRB's supervisory activities on appropriations would increase transparency and oversight. Mr. Quarles worried that future Congresses could use the supervisory budget to influence monetary policy.
- SA-CCR: Rep. Hultgren (R-IL) criticized the slow process to transition away from the current exposure method (CEM) to the standardized approach to counterparty credit risk (SA-CCR). He asked what the FRB can do immediately before a final rule is issued. Mr. Quarles said that the FRB is proceeding with its rulemaking.
- SOFR: Rep. Pittenger (R-NC) asked if the switch to this reference rate has undergone a cost-benefit analysis and if systemic effects had been considered. Mr. Quarles said the shift is voluntary and that he does not foresee any systemic risk.