FedFin Client Report

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FedFin Forecast: Prudential Regulatory Framework Set for Structural Change Largely Built on Current Standards

Client Report: REFORM211

Executive Summary

As promised, FedFin begins our 2022 forecasts with this in-depth report on bank regulation. In general, we conclude that the context of decisions in 2022 and beyond will shift from a focus on tailoring efficiencies and burden relief to one emphasizing risk mitigation, fairness, equity, and -- for the very biggest banks -- a smaller systemic footprint. This report looks at the impact of pending personnel decisions as well as the outlook for climate-risk, new capital rules, FBO standards, and other key issues. The only rule we think might get a near-term substantive rewrite is the stress capital buffer (see FSM Report **CAPITAL225**) via tougher CCAR standards and a reversal of the prior decision to end qualitative objections. The odds of a leverage rewrite are smaller, but not negligible.

Future reports will assess crypto assets and payment-system decisions. This report, like those to come, presumes no substantive statutory changes to the law governing rulemakings in these areas.

Analysis

Key Policy-Makers

Although perhaps the most decisive individual voice on these standards -- that of the Fed's supervisory vice chair -- is unknown, we reiterate that Fed policy will change even if the confirmed nominee is not Sarah Bloom Raskin. Although Chairman Powell's and Gov. Brainard's nominations are not without peril (see *Client Report* **FEDERALRESERVE66**), it is likely that they will be confirmed. As vice chair, Ms. Brainard will support a more progressive Fed regulatory approach; Chairman Powell may differ, but he has committed that the supervisory vice chair will lead policy, giving him a still-powerful but no longer necessarily decisive, role in the face not only of the new supervisory chief and Vice Chair Brainard, but also the majority of new Governors.

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Acting Comptroller Hsu and Acting FDIC Chairman Gruenberg strongly support the new regulatory paradigm and, even if they are replaced by others as long-term agency heads, their successors will surely also share these views. CFPB Director Chopra has a direct role setting bank regulation only via his vote on the FDIC board, but his strong views on many questions will influence public debate, Congressional consideration, and agency action.

Key Rules

The following is a brief summary of probable action on key prudential rulemakings likely in 2022 for the banking sector:

- Climate Risk: Although all the banking agencies are independent and thus need not necessarily adhere to President Biden's climate-risk order (see FSM Report **GREEN8**),the views of key policy-makers and Congressional Democrats will drive the actions detailed in our recent analysis of the OCC's open shot (see FSM Report **GREEN12**). Indeed, Chairman Powell stated at his confirmation hearing yesterday that the Fed will follow FSOC's lead (see *Client Report* **FEDERALRESERVE67**). We thus expect the Fed and FDIC quickly to issue similar statements that would then permit final action early this year on high-level principles for the largest banks. Whether these retain the OCC's environmental-justice edict may be the most controversial aspect of inter-agency negotiations along with the extent to which the discussion of scenario analysis can be accelerated into requirements for at least the biggest of the big banks.
- Basel IV: Although the banking agencies suggested that they would advance the 2017 "Basel IV" capital rewrite last summer, nothing came of it even though the Basel Committee is putting increasing pressure on laggards. We expect the situation to be resolved as quickly as possible when the FRB has a slate of confirmed senior members. The issue was on hold as Mr. Powell sought to win his renomination and feared that any action on Basel IV might be deemed to relax current capital rules. Mr. Powell has long pledged that any capital charges will be neutral in terms of their cost, but neutrality across a wide range of companies hides significant business-model differences. Now, we expect what one trade association has called the "Basel premium" in order to continue Basel compliance with the "gold-plating" on which U.S. regulators have long insisted.
- SLR Relief: The Basel IV construct is focuses on credit-, market-, and operational-risk requirements, but the question for the U.S. leverage ratio remains outstanding since the banking agencies withdrew their 2020 liberalization. Although Mr. Powell rested his openness to SLR relief at the confirmation hearing, we see little chance of renewed SLR relief on a permanent basis from the Fed once its new team is in place or from the OCC and FDIC.
- Tailoring: Although press suggests that the tailoring rules will be withdrawn, we think that unlikely. However, we do expect the FRB at some point to revisit the provisions in the final rule (see FSM Report **SIFI34**) omitting a liquidity requirement for foreign-bank branches and agencies. This is not a high priority and the rule may thus be left as is,

but any short-term funding market challenges or repo-market volatility will bring it back to the fore.

- Stress Testing: In his parting remarks, Vice Chairman Quarles suggested numerous changes to the stress-testing process (e.g., averaging). We continue to believe any such changes are moot, with the Board instead considering changes to the next SCB round such as tougher scenarios and higher approval thresholds perhaps by reinstating qualitative review or, more easily, revising the administrative thresholds for approving capital distribution.
- GSIB Surcharge: Mr. Quarles also suggested significant changes to the surcharge to prevent sharp increases as Basel IV comes into effect. We expect the surcharge methodology instead to stay as is which, even in the absence of Basel IV rules, will result in higher surcharges for most banks after 2023.
- Additional Issues: If the banking agencies have the bandwidth to review and rewrite controversial rules, then they may turn to the final covered-funds rule (see FSM Report **COVEREDUFNDS2**), broader revisions to the Volcker Rule (see *Client Report* **PROPTRADE26**), and inter-affiliate swap margin relief (see FSM Report **DERIVATIVES35**). However, while new officials -- especially those who, like Ms. Brainard and Mr. Gruenberg, who opposed these rules -- may wish to tackle them, we expect new priorities to take all the time regulators have for action unless a controversial case or broader industry volatility leads them to do so. The one exception to this may be the FDIC's final brokered-deposit rule (see FSM Report **DEPOSIT INSURANCE 111**), which lies solely in the FDIC's jurisdiction and which incoming Acting Chairman Gruenberg strongly opposed.

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