FedFin Client Report

Wednesday, May 16, 2023

Fed, FDIC Stand Their Ground Under Withering GOP Assault

Client Report: REFORM224

Executive Summary

In their first appearance following the reports on recent failures, FRB Vice Chairman Barr and FDIC Chairman Gruenberg were harshly criticized by Republicans for both the bank failures and recommended remedies. HFSC Chairman McHenry (R-NC) blamed the Fed for faulty monetary policy that led to inflation and unduly quick rate hikes that endangered financial stability as well as lax supervision that missed glaring failures at SVB, SBNY, and First Republic. Mr. McHenry was unconvinced by Vice Chair Barr's defense of the reports finding that Fed supervision had undergone a "cultural" shift under Vice Chair Quarles; Mr. Barr defended the finding based on interviews with the San Francisco Fed's staff. Democrats fired back, with Ranking Member Waters (R-CA) arguing that Republicans were politicizing consideration of essential supervisory and regulatory reforms. Acting Comptroller Hsu was at pains to emphasize that none of the failed banks were OCC-regulated, reiterating as we noted yesterday that supervision must be forceful and numerous rules require urgent revision. Although Mr. Hsu indicated an "open mind" to bank M&A – an issue of particular concern to Republicans – he also reiterated the need to ensure large-bank resolvability via TLAC and severability standards (see FSM Report **RESOLVE48**). Mr. Barr announced that the interagency proposal finalizing Basel III and his thinking on the holistic capital review will be released this summer. He also said that new, multiple stress-test scenarios will be released for public comment before adoption. Mr. Gruenberg indicated that revised incentive-compensation standards are likely to require a new proposal he expects sometime before year-end.

Analysis

Opening Statements

Chairman McHenry pushed back against what he described as the Administration's "one size fits all" regulatory approach, claiming that it will unduly harm regional banks while protecting TBTF. Ranking Member Waters reiterated that while regulators need to be more assertive, it is the responsibility of bank executives to operate their bank safely and soundly. She rejected the "transparency" bills that Financial Institutions Chairman Barr (R-KY) plans to bring to votes and also pushed back against GOP bills addressing the crisis, criticizing them for attempting to limit the Rep. Barr argued that increasing capital requirements and

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continuing to block mergers would cause harm to the financial system, while Rep. Foster (D-IL) focused on the need for Basel III implementation with Congressional and industry input.

Testimony

The oral testimony given by each witness did not differ from the written testimony analyzed yesterday for clients.

Q&A

- **Capital Review:** Reps. Scott (D-MO) and Nickel (D-NC) asked Vice Chair Barr if he was analyzing the impact of capital changes on LMI communities and small businesses in his review and if capital increases will limit LMI lending; Mr. Barr said that the Fed is doing so, noting that its view was that strong capital enables institutions to lend in times of stress. Rep. Timmons (R-SC) asked why Mr. Barr is conducting a capital review if he believes banks are well-capitalized; Mr. Barr said that "well-capitalized" is underjudged under current rules that do not capture recent risks. Rep. Garbarino (R-NY) asked how the Fed plans to control the impact of any sudden change of a capital increase; Mr. Barr replied that the changes will be conducted in a measured manner and through the typical comment process. Rep. Houchin (R-IN) argued that raising capital would increase borrowing costs for regional banks; Vice Chair Barr countered, noting that the capital increases will be implemented gradually and that robust capital leads to increased lending, not less.

- **Supervision** - Chairman McHenry voiced concern that Vice Chair Barr reported a cultural shift in supervision only based on anecdotal interviews with staff. Rep. Huizenga (R-MI) stated that the GAO report (see *Client Report* **REFORM223**) not only failed to find a culture shift but also reported a trend of supervisory reluctance dating back to 1993. Rep. Velázquez (D-NY) asked the Vice Chair how the Fed plans to redesign the supervision of rapidly growing banks, noting that she is considering legislation on the issue. Mr. Barr stated the Fed is currently reviewing its tiered system, noting it is looking at risk factors – such as rapid growth – in addition to asset size. Rep. Sherman (D-CA) asked if regulators have improved their supervision of interest rate risk since the failures; Chairman Gruenberg stated it was one of the agencies' top priorities. Rep. Foster asked if giving supervisors less discretion may give regulators better leverage to escalate concerns; Acting Comptroller Hsu noted the importance of balancing supervision and regulation. Rep. Foster also asked about the merits of automatic regulatory mechanisms; Mr. Hsu said they can help but it depends on the context. Reps. Nunn (R-IA) and De La Cruz (R-TX) asked Vice Chair Barr if he agreed with Governor Bowman's comments that SVB's and SBNY's idiosyncratic failures do not necessitate new regulations; Mr. Barr disagreed.

- **AOCI:** Ranking Member Waters asked Vice Chair Barr if AOCI treatment inflated SVB's capital levels; Vice Chair Barr did not directly address SVB but noted that the Fed is considering changes that would pass unrealized losses or gains to capital treatment to more accurately represent the financial position of firms over $100 billion.

- **Deposit Insurance Reform**: Rep. Meeks (D-NY) asked Chairman Gruenberg for the appropriate level for raising deposit coverage for business payments accounts; Mr. Gruenberg replied that this change would require legislation but is attractive because it addresses financial stability risks while minimizing moral hazard. In a later exchange with Rep. Flood (R-NE), Chairman Gruenberg noted that the tradeoff of this change would be increasing assessments. Rep. Torres (D-NY) argued that the banking system is now two-tiered, where “too-big-to-fail” banks have implied unlimited deposit coverage and “too-small-to-succeed” banks are experiencing deposit flights. Mr. Barr disagreed with this assessment and noted that deposit flight stabilized following the introduction of the bank term funding program.

- **S. 2155:** Ranking Member Waters asked Vice Chair Barr if the Fed had proper supervisory flexibility following S. 2155. Mr. Barr replied that it did and did not need new legislation going forward. Rep. Hill (R-AR) argued that this admission countered Democratic attacks on the law and stressed the need to protect bank diversity. Rep. Meuser (R-PA) asked if Vice Chair Barr agreed with arguments blaming S. 2155 or if the Fed has the discretion to investigate “red flags”; Vice Chair Barr replied that the law gives significant discretion, but it did inhibit prompt supervisory responses by lowering prudential standards. The Fed is looking also at how best to improve standards under current law.

- **Incentive Compensation:** Rep. Velázquez strongly pressed the regulators to finalize the longstanding incentive compensation rules. In response, Chairman Gruenberg noted that the agencies will likely have to reissue an NPR, which may come before the end of the year. Rep. Tlaib (D-MI) asked the regulators if the finalized rule should include clawbacks, also noting that she is working on legislation on this issue. Each regulator replied that it should, although Vice Chair Barr said the Fed has not reached a determination. Rep. Green (D-TX) reiterated that the liability of the crisis should fall on the bankers rather than the supervisors and pushed for executive clawbacks.

- **Holding Companies**: Rep. Sherman argued that banks can avoid regulation by not having a holding company; Vice Chair Barr stressed the importance of same risks, same regulations.

- **Community Banks:** Rep. Scott voiced concerns about community banks holding large amounts of community real estate, with Mr. Barr reiterating the importance of banks understanding and mitigating their risks. Noting that it is common for regional banks to make investments and deposits in community banks, Rep. Meeks asked if the special assessment would have a "trickle-down effect;" the Vice Chair only stated that the Fed was committed to maintaining a diverse banking system.

- **Resolutions**: Rep. Velázquez asked Chairman Gruenberg how the FDIC is working to maximize the preservation of LMI housing in the Signature Bank resolution. Mr. Gruenberg replied that the FDIC is working closely with NY State and City officials to ensure that outcome. Rep. Huizenga asked if the FDIC inhibited the participation of nonbanks in the recent bank resolution; Chairman Gruenberg stated the FDIC made a significant effort to invite both banks and nonbanks. Rep. Fitzgerald (R-WI) stated that some banks are concerned that they will be assigned an incorrect bank category under the joint FDIC-FRB resolution proposal; Mr. Barr stated that individual bank risk profiles will be taken into account.

- **Commercial Real Estate**: Stating that a large proportion of CRE mortgages will reach maturity in 2023, Rep. Torres asked the Vice Chair how much of a financial stability risk this posed. Mr. Barr stated that this is a key issue that the Fed is currently reviewing. When asked if loan restructuring should be done, Mr. Barr replied that he believed banks already are doing so as part of their risk management.

- **CRA**: Rep. Cleaver (D-OH) pushed his CRA reform bill that would subject independent mortgage companies to CRA exams, codify community reinvestment agreements, and require disclosures of deposits to LMI communities, asking if it aligns with the agencies' CRA trajectory. Acting Comptroller Hsu said that any effort to modernize and strengthen the CRA is welcome and pledged to engage with the Representative's staff.

- **"Golden Chair" Proposal:** Rep. Pressley (D-MA) compared banks to public-private partnerships due to public support and deposit insurance, but argued it was a skewed partnership due to banks earning the profits but the public bearing the losses. Thus, she proposed a "Golden Chair," which is a guaranteed government seat on bank boards, which could have acted as an early warning sign in the cases of SVB and SBNY.

- **Mergers**: Rep. Rose (R-TN) asked Acting Comptroller Hsu if Sen. Warren's (D-MA) letter demanding the rejection of the TD Bank merger had any impact; Mr. Hsu stated that the agencies follow the letter of law regarding mergers.

- **Stablecoins**: Rep. Torres asked Acting Comptroller Hsu if his comments in January comparing stablecoins to private money prior to the Civil War ignored the fact that stablecoins are pegged to the dollar. Mr. Hsu said that, while that is an important distinction, the comparison still applies due to the lack of standardized chartering or regulation.

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- **Stress Testing**: In response to Rep. Kim (R-CA) saying that stress tests assumed low interest rates, Vice Chair Barr stated that stress test scenarios should include a tightening environment, noting that the Fed will conduct a pilot test including such conditions and release a proposal regarding multiple shocks.

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