FedFin Client Report

Tuesday, November 14, 2023

Capital Proposal Gets Bipartisan Bashing in Senate Banking

Client Report: REFORM229

Executive Summary

Today's Senate Banking hearing with top bank regulators showcased broad bipartisan concern over the interagency capital proposal (see FSM Report **CAPITAL230**). Although Chairman Brown (D-OH), Sen. Warren (D-MA), and Sen. John Fetterman (D-PA) staunchly defended the proposal on countercyclicality grounds, other senators on both sides of the aisle sounded the alarm over its impact on credit availability, small-business lending, and shadow-bank migration. FRB Vice Chair Barr repeatedly defended his agency's analysis while emphasizing openness to comment, also highlighting that the proposal relates primarily to non-credit activity and would apply to only 37 banks. Some Republicans also raised concerns over other recent rulemakings, with Sen. Britt (R-AL) asking Vice Chair Barr if the agencies would consider a comment deadline extension for the LTD proposal (see FSM Report **TLAC9**). Although Mr. Barr stated that the rule is far simpler than the capital proposal, he also said the agencies would consider a similar extension. FDIC Chairman Gruenberg drew bipartisan ire over reports of FDIC widespread harassment, with Republicans seizing the occasion to criticize Mr. Gruenberg's leadership. Grilled by Sen. Tillis (R-NC) about reports of a Fed leak of confidential supervisory information, Mr. Barr only said that he is deeply concerned. Separately, Chairman Brown emphasized unfinished work on bank executive accountability and urged Congress to pass the RECOUP Act (see FSM Report **COMPENSATION37**), which passed the Committee nearly unanimously in July.

Analysis

Opening Statements

In addition to applauding the agencies' recent CRA finalization, Chairman Brown defended the capital proposal on grounds that the largest banks will only need to redirect a "tiny fraction of their enormous profits" to comply over several years. He also warned that large bank M&A would result in risky NBFI activity as well as increasingly limited LMI access to traditional banking services. Sen. Rounds (R-SD), who served as Ranking Member today, sharply criticized what he said was the agencies' failure to consider the interactions and costs of their recent rulemakings, emphasizing burdensome compliance obligations and negative small business and consumer impacts. In addition to noting that he supports individual hearings on

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every recent banking agency proposal, he also excoriated the recent climate risk proposal (see FSM Report **CLIMATE17**), calling this "well outside" the agencies' Congressional mandate.

Testimony

Vice Chair Barr emphasized that the banking system is resilient and sound while noting risks due to factors such as growing reliance on high-cost funding, unrealized losses, uninsured-deposit concentrations, and heightened loan losses. Chairman Gruenberg pointed to significant downside risk from higher rates, geopolitical tension, and unrealized losses. Acting Comptroller Hsu also stated that the banking system is safe and sound, taking time to emphasize proportionality in OCC rulemaking and supervision. NCUA Chairman Harper highlighted emerging risks including rising net charge-off ratios and decreasing annualized returns at credit unions, also calling for legislation that would restore the NCUA's authority to supervise third-party vendors.

Q&A

- **Capital Proposal:** Prompted by Chairman Brown and Sen. Warren to defend the capital proposal, Vice Chair Barr emphasized its importance for banking system resilience while recognizing that it may not appropriately capture all risk. Responding to concerns from Sen. Menendez (D-NJ) that the capital proposal will exacerbate housing unaffordability, Vice Chair Barr and Chairman Gruenberg emphasized that their agencies will seriously consider comments. Sens. Tester (D-MT) and Kennedy (R-LA) raised concerns that the capital proposal will push activity into the nonbank sector; Vice Chair Barr said he shares this concern, emphasizing that his agency will revise the final rule if it finds that the proposal creates risk in this area. Responding to concerns from Sen. Daines (R-MT) on whether the proposal will restrict small business lending, Vice Chair Barr argued that small business provisions in the rule provide more risk-weight flexibility allowing banks to hold less capital against small businesses. Sen. Britt asked Vice Chair Barr if the Fed performed a thorough analysis on operational risk requirements; Mr. Barr stated that the proposal's preamble does so, also arguing that the combination of credit and operational risk components in the proposal is small compared to current rules.

- **Supervision:** Chairman Brown asked each regulator how they have revised their supervisory approaches. Acting Comptroller Hsu reiterated that none of this year's bank failures were at national banks but noted efforts to identify areas where the OCC can implement faster supervision. Acknowledging "hard lessons" from this year's bank failures, Chairman Gruenberg and Vice Chair Barr emphasized their agencies' focus on faster supervisory escalation as well as IRR, concentration of unrealized losses, rapid growth, and uninsured deposit concentration. Flagging a recent uptick in bank MRAs and MRIAs, Sen. Tillis argued that the Fed is already able to escalate its supervision via S. 2155.

- **Fed Consensus:** Speared by Sen. Rounds' concerns that other Fed Board members were not privy to Mr. Barr's holistic review, several Committee Republicans grilled the Vice

Chair about his expectations for Board consensus on the final capital rule. Sen. Tillis asked Mr. Barr point blank if he intends to move forward with a final rule if full Board consensus is unachievable; Vice Chair Barr said the Board will strive for full consensus but does not expect unanimous support, here explaining that "broad" consensus would entail most of the board believing the proposal is appropriate. Highlighting testimony from Gov. Cook indicating that she had yet to review the capital proposal before mid-July, Sen. Britt grilled Mr. Barr on whether Board Members had sufficient time to review the proposal before voting on it; the Vice Chair said that they had, stating that each Governor also may request detailed briefings. Sen. Daines also argued that the Fed should be a consensus-driven organization.

- **Credit-Risk Transfer:** Sen. Reed (D-RI) asked the regulators to summarize the financial stability risks of credit risk transfers as well as the guardrails in place to mitigate them; Vice Chair Barr said that the Fed looks carefully at these transactions and approves them on a case-by-case basis, noting that the Fed intends to base future decisions on their use for capital mitigation on future performance. Sen. Reed also asked the Vice Chair about the extent of the Fed's visibility into the hedge fund and private equity side of these transactions; Mr. Barr said that the lack of nonbank transparency is a longstanding supervisory issue. Mr. Gruenberg said the issue creates considerable uncertainty requiring great caution and regulatory attention, while Acting Comptroller Hsu noted that the transactions can be a helpful part of risk management.

- **Rent-a-bank Arrangements:** Sen. Reed also asked the regulators for an update on their approach to "rent-a-bank" arrangements; Chairman Gruenberg acknowledged that third party relationships are an important risk management issue, stating that the FDIC is monitoring circumvention of state usury laws. Mr. Hsu said there is no place for predatory lending within the financial system.

- **CRA:** Although Sens. Cortez-Masto (D-NV), Van Hollen (D-MD), and Smith (D-MN) praised the agencies' CRA rule, Sen. Menendez asked about what the agencies are doing to ensure effective implementation as well as supervision under new guidelines; Mr. Barr emphasized that Fed will take steps to ensure strong examiner guidelines and training as well as bank and community partnerships, with Messrs. Gruenberg and Hsu also assuring that implementation work has already begun.

- **Discount Window:** Sen. Warner (D-VA) suggested some sort of mandated use of the discount window. Mr. Barr agreed that the window is an effective tool and banks must ensure readiness to draw on it when needed.

- **AI:** Sen. Warner raised concerns over AI's propensity for manipulation, encouraging FSOC to focus on this issue, while Sen. Butler (D-CA) called for greater regulatory scrutiny of AI-driven lending bias.

- **Liquidity risk:** Highlighting recent bank failures, Sen. Smith asked the regulators to explain their regulatory approach to novel technology-driven liquidity risks; Vice Chair Barr emphasized the importance of strong bank contingency planning and discount window

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usage, noting that the Fed will look broadly at liquidity rules and say more about them in the coming months. Chairman Gruenberg added that banks and regulators must regularly monitor bank social media commentary.

- **FedNow:** Sen. Van Hollen called the country's delayed implementation of real-time payments a $100 billion tax on lower-income Americans, asking Vice Chair Barr to describe the Fed's progress on FedNow; Mr. Barr said he expects full bank participation to take time but believes FedNow will be an attractive option, also emphasizing the Fed's active outreach program to banks and third-party service providers.

- **Deposit Lags:** Sen. Warnock (D-GA) took serious issue with lagging consumer deposit rates and asked Mr. Barr about what the Fed is doing to address them; the Vice Chair only said that current rates are about in line with historical patterns, repeatedly stressing that deposit rates are bank decisions outside of the Fed's purview.

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