FedFin Client Report

Tuesday, February 6, 2024

Yellen Ducks Capital Question, Further Threatening Finalization

Client Report: FSOC30

Executive Summary

As anticipated, today's HFSC hearing with Treasury Secretary and FSOC Chair Yellen showcased sharp Republican criticism of the Council's nonbank designation authority (see FSM Report **SIFI36**), with Chairman McHenry (R-NC) and Financial Institutions Subcommittee Chairman Barr (R-KY) citing the guidance as yet another example of regulatory politicization, calling FSOC a "rogue" and "roving" regulator. Digital asset regulatory gaps were a top GOP concern, with Chairman McHenry also joined today by Reps. Hill (R-AR), Johnson (R-SD), and Thompson (R-PA) in sending a letter to Ms. Yellen requesting much greater attention to SEC and CFTC collaboration on digital asset oversight. The hearing also continued to raise doubts about the viability of the agencies' capital proposal (see FSM Report **CAPITAL230**), with Ms. Yellen repeatedly refusing to endorse it and emphasizing that the rule's final form is the purview of the banking agencies. Democratic opposition to the proposal was most starkly captured by Rep. Scott (D-GA), who said not only that it would be economically "terrible," but that the majority of Committee members shared this opinion. Ranking Member Waters (D-CA) strongly countered this view, but Democratic support today was muted. Rep. Waters was also joined last night by Reps. Green (D-TX), Lynch (D-MA), Cleaver (D-MO), and Foster (D-IL) in sending a letter to Chairman McHenry requesting a hearing examining what they argue are racial disparities in mortgage approval rates at Navy Federal Credit Union.

Analysis

Opening Statements

Chairman McHenry accused FSOC of straying from its mission order to meet the Biden Administration's political priorities and argued that the Council has failed to offer a transparent account of last year's bank failures. Systemic supervision was also disputed on grounds that broader FDIC and Fed oversight responsibilities are inconsistent with what he called their "gross incompetence" as supervisors. In addition to touting robust macroeconomic conditions under the Biden Administration, Ranking Member Waters countered Mr. McHenry by praising FSOC's updated designation procedures. While Financial Institutions Subcommittee Chairman Barr called FSOC a "partisan body and rogue regulator," Subcommittee Ranking Member Foster (D-IL) praised the Council for its new focus on AI and encouraged it to remain vigilant to other emerging risks.

Testimony

Secretary Yellen's statement largely revisited the Council's 2023 report (see *Client Report* **FSOC29**), emphasizing its support for banking system capital review, stronger resolution standards, and efforts to address uninsured deposit concentration. Other top FSOC priorities include NBFI risk, climate-related financial stability risks, cybersecurity, AI, and digital assets, with Ms. Yellen calling for improved climate disclosure standards as well as legislation to regulate stablecoins and spot-markets for non-security cryptoassets.

Q&A

- **Nonbank Designation Authority:** Chairman McHenry asked if FSOC has identified any nonbank firms for designation; Ms. Yellen declined to comment on any specific firms, noting that the Council has not taken any action or received any recommendations on which firms to designate. Ms. Yellen also emphasized that designation is only one of many tools and that is by no means its preferred tool. Chairman McHenry called the guidance "opaque." Rep. Sherman (D-CA) asked why FSOC would consider designating entities such as mutual funds and money managers if their liabilities are insubstantial; Ms. Yellen said FSOC would only consider designating an entity that poses a financial stability threat. Rep. Beatty (D-OH) raised concerns about whether the designation guidance sets sufficient due process standards; Ms. Yellen emphasized that companies would have ample opportunity to provide FSOC with information germane to the decision. Rep. Wagner asked if Secretary Yellen stands by a prior statement that activities-based regulation is the appropriate approach for asset management; Ms. Yellen reiterated that there is "no preferred approach." Rep. Meuser (R-PA) criticized the agencies' lack of cost-benefit analyses, particularly for nonbank SIFI designations. Ms. Yellen responded that cost-benefit analysis is something the agencies could have done but chose not to, expressing the difficulty of properly quantifying financial crises.

- **Capital Reform:** Although Ranking Member Waters strongly defended the capital proposal, Rep. Scott argued that stronger capital requirements would diminish credit availability and stated that the implementation of stronger capital requirements would be economically "terrible." He also emphasized that the "majority" of the Committee shares this view, a claim Rep. Velasquez (D-NY) later challenged; Ms. Yellen only emphasized the importance of credit availability but would not opine on the capital proposal. Rep. Barr asked if a "barbell" banking system would strengthen financial stability; Ms. Yellen said that a diverse banking system is beneficial. Rep. Lucas (R-OK) raised concerns that the proposal would undermine US capital markets resilience; Ms. Yellen declined to take a position on this, saying it was up to the banking agencies to analyze the specifics of the rule. Rep. Wagner (R-MO) asked if Ms. Yellen still believes that US banks have sound levels of regulatory capital; Ms. Yellen said she does, leading Rep. Wagner to sharply question how this is compatible with stronger capital requirements.

- **Digital Assets:** Chairman McHenry asked Ms. Yellen to explain why she believes legislation is needed to regulate digital assets; Ms. Yellen noted regulatory gaps such as limitations on CFTC authority as well as the need to address potential stablecoin financial stability risks. Chairman McHenry asked if the NY state regime could be used to model a federal digital assets regime; Ms. Yellen emphasized the need for a regulatory floor and also noted that regulatory protections are needed for holders of crypto-wallets. Rep. Hill asked Ms. Yellen if she has taken action to encourage SEC and CFTC cooperation on stablecoin and digital assets regulation; Ms. Yellen only said she has often talked to the Chairmen of each agency about stablecoins. Rep. Davidson raised concerns that a lack of a federal US digital asset framework is driving the industry offshore.

- **OCC Merger Policy:** Rep. Barr argued that the OCC's merger policy (see FSM`Report **MERGER14**) will increase systemic risk and disorderly bank failures while decreasing GSIB competition; Ms. Yellen only said that this question would be better addressed by the Acting Comptroller. Rep. Fitzgerald (R-WI) noted frustrations banks are having with M&A turnaround times and the high degree of uncertainty regarding M&A outcomes.

- **Custody Reform:** Rep. Hill asked if Ms. Yellen supports the SEC's custody proposal (see FSM Report **CUSTODY5**); Ms. Yellen said she has expressed concerns to Mr. Gensler about the proposal's impact on banks.

- **Nonbank Payment Platforms:** Raising concerns about the CFPB's NPR to supervise nonbank payment platforms (see FSM Report **PAYMENT27**), Rep. Hill asked Ms. Yellen if she would support the designation of nonbank payment platforms; Ms. Yellen said FSOC has not taken a position.

- **SAR Surveillance:** Following GOP letters last month, Reps. Wagner and Luetkemeyer (R-MO) raised concerns that FinCEN and other regulatory agencies have instructed banks to surveil customers' transaction-level data; Ms. Yellen only promised a "thorough look" into the allegations.

- **Treasury Market Resilience:** Raising concerns that the interaction between the SEC's central clearing requirements and the capital proposal would cause banks to pull back from treasury market-making activity, Rep. Lucas asked Secretary Yellen if she is concerned about treasury market turbulence; Ms. Yellen only emphasized that an interagency working group is focused on ensuring treasury market resilience.

- **De-dollarization:** Rep. Fitzgerald raised concerns that Saudi Arabian oil trading in non-dollar-denominated currencies combined with Russian and Iranian sanctions evasion efforts could lead to de-dollarization, asking Ms. Yellen for her opinion on what Congress can do to address this issue; Ms. Yellen emphasized that while sanctions create incentives for de-dollarization, she has not seen anything she believes poses a deep threat to the dollar.

- **CRE:** Reps. Scott and Cleaver (D-MO) raised concerns that spillover effects from CRE loan portfolios could lead to reduced lending; Ms. Yellen emphasized FSOC's focus on CRE risk, noting that office properties in some cities are a special concern.

- **GSE Conservatorship:** Rep. Fitzgerald raised concerns that GSE conservatorship could be used to further politicize the entities. Rep Davidson (R-OH) asked about the plan to end the GSE conservatorship, to which Ms. Yellen stated she is committed to working with Congress to clarify a reasonable strategy.

- **CSPs:** Rep. Velasquez asked if FSOC's CSP steering committee has progressed in its work to tackle third-party CSP risk; Ms. Yellen said it has, noting that the steering group will release recommendations later this year.

- **China:** Rep. Gottheimer (D-NJ) asked if Chinese sanctions were appropriate due to its ties to Iranian oil; Ms. Yellen said that is a question for the State Department, noting that Treasury is focused on cracking down on illegal shipments of Iranian oil. Rep. Timmons (R-SC) criticized what he called FSOC's and the Biden Administration's lack of concern regarding China, stating that the US is allowing the CCP to be too involved in the US economy.

- **AI:** Rep. Lynch (D-MA) raised concerns about AI-explainability and asked if Ms. Yellen believes the financial industry is capable of onboarding the technology; Secretary Yellen agreed that AI poses important risks which FSOC is addressing. Rep. Lynch asked if the acquisition of an AI-company by a financial services firm would make the company a covered entity; Ms. Yellen said she was unsure. Once again raising concerns about gen-AI and deepfakes, Rep. Foster reiterated his call for digital IDs.

- **Shadow-bank Migration:** Rep. Torres (D-NY) raised concerns that intensive banking regulation has led to a deregulated shadow banking system, noting that stronger capital requirements could accelerate the trend; Ms. Yellen said this was a conceivable outcome, but that FSOC is focused on nonbank risk. Rep. Tlaib (D-MI) emphasized the role of nonbanks in the GFC, arguing that more must be done to address nonbank financial stability threats; Ms. Yellen assured that nonbank financial stability risks are high on FSOC's agenda.

- **IRR:** Rep. Luetkemeyer asked Ms. Yellen about what FSOC has done to address interest-rate risk at OCC-supervised national banks; Ms. Yellen emphasized the OCC's independence and that IRR and liquidity risk are the responsibility of the banking agencies.

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