AFR Americans for Financial Reform

A Roadmap for the Federal Reserve

The Federal Reserve is one of the most critical players in the goal to reorient financial regulation towards serving as a tool for economic and racial justice. Now that the Fed has a full board, including a long-awaited Vice Chair of Supervision, bold action should immediately be taken to both undo the harmful policies implemented by the Trump Administration and set policy that will lead to a more inclusive economy.

The Federal Reserve's priorities should be to:

1) Reverse deregulatory actions under the Trump Administration
2) Complete Dodd-Frank rulemaking
3) Reimagine a more equitable and sustainable financial system

Reverse Deregulatory Actions

Stress Testing

The stress testing process has been greatly weakened over the years and effectively gutted by the Trump Administration.[1] The previous administration reduced the amount of capital distributions that banks are required to prefund in the stress test, and it eliminated the assumption that large banks' balance sheets expand during downturns.[2] The Federal Reserve should revert to the stress tests' original design and modeling.

The stress tests should also integrate risks related to inequality, racial injustice and climate change into stress test modeling. Until the tests become more rigorous, the Fed should pause outstanding disbursals of bank dividends and review stress test results as part of broader review of all outstanding agency action. These tests are done to ensure big banks can maintain sufficient capital and resiliency during severe economic downturns without a taxpayer bailout. If they are not dynamic, rigorous, and comprehensive their efficacy greatly diminishes and ultimately hurts taxpayers who are stuck with the bill after yet another round of bailouts.

Restore Bank Supervision

The Fed should restore the capacity and authority of bank supervisors to properly oversee and, if necessary, demand change in irresponsible bank practices, a tool which has been

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[1] Jeanna Smialek. The New York Times. "The Fed Simplifies Capital Rules, a Change Sought by Big Banks" March 2020.

[2] Board of Governors of the Federal Reserve System, "Federal Reserve Board approves rule to simplify its capital rules for large banks, preserving the strong capital requirements already in place," March 2020

seriously weakened under the Trump Administration.[3] The Fed should strengthen internal processes that incentivize supervisory staff to identify and demand changes in irresponsible bank practices. Using the tools at the Fed's disposal such as the ability to limit or stop dividends or stock buybacks is an effective way to punish bad practices by banks and should be used more often. Additionally, formal, public enforcement actions should be issued more often against repeated bad actors. This enhances the effectiveness of regulation and acts as a deterrent to future harmful practices.

Volcker Rule

The Fed needs to restore and strengthen the Volcker Rule to limit banks' speculative activity. In the immediate there should be stepped up oversight and enforcement against bank trading that runs afoul of Volcker restrictions, and dramatically improved public disclosure. Right nowhere is almost no data available on bank trading and covered funds activity that would make it possible to understand how or whether the Volcker Rule is enforced. Regulators and banks should provide public data listing the individual trading desks at major banks, including the types of instruments traded, the aggregate inventories at the desk level, and how Volcker trading limits are set.

The Fed should also undertake further rulemaking to undo the Trump Administration's weakening of the Volcker rule, but also to address weaknesses and gaps in the rule finalized in June 2020.

Re-propose and Improve the Leveraged Lending Guidance

The Fed should also look at re-proposing the Leveraged Lending Guidance, which aimed to limit a bank's ability to sell new debt for corporate borrowers if that debt would bring the issuers' leverage above 6.0x debt to its earnings. That guidance was rolled back in 2019.[4] In its re-proposal the Fed has a second opportunity to design the guidance in a way that addresses the widespread inflation of corporate earnings (and thus artificially lowering its leverage) that occurred in response to its original 2013 guidance.[5]

Complete Dodd-Frank Rulemaking

Prudential Regulation of Non-banks

The Fed has not finalized a comprehensive prudential regulatory framework for nonbanks with assets greater than $50 billions, as required by Section 165 of the Dodd-Frank Act.[6] Furthermore, under the Trump administration the Financial Stability and Oversight Council

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[3] Lalita Clozel. The Wall Street Journal. "Banks Get Kinder, Gentler Treatment Under Trump" December 2018.
[4] Ropes & Gray. "OCC Head Says Banks Need Not Comply with Leveraged Lending Guidance" March 2018.
[5] Sandra Montgomery and Michelle Iodice. Los Angeles and San Francisco Daily Journal. "Pulling back the curtain on close leverage." May 2019.
[6] Aaron Nicodemus. Compliance Week. "A decade later, Dodd-Frank remains unfinished. Will Gary Gensler's SEC close it out?" June 2021.

(FSOC) voted to restrict the Council's future ability to designate non-banks as systemically important.[7] We urge the Board as an influential voting member of FSOC to advocate for a swift reversal of the 2019 SIFI designation rules.

FSOC then needs to then be prepared to analyze and designate as Systemically Important Financial Institutions (SIFIs) a number of non-banks that by virtue of their size and risk of their investments could pose a threat to the entire financial system. In the meantime, the Federal Reserve should urgently begin work developing a supervisory approach for these institutions.

Executive Compensation

Section 956 of Dodd-Frank required the Federal Reserve and other agencies to engage in rulemaking within nine months of the law's passage to prohibit incentive-based compensation in certain financial institutions that "encourages inappropriate risks." Twelve years later, we do not have a final rule even though there is widespread agreement that the structure of incentive-based compensation was a central contributor to the 2008 financial crisis.[8]

The Federal Reserve should work with the other agencies to propose a strong rule as soon as possible. The rule should at least include the following: 1) long compensation deferral periods; 2) a minimum level of forfeiture in the case of wrongdoing or inappropriate risk-taking to minimize the regulated institutions' discretion; 3) a ban on hedging or offsetting any decrease in the value of incentive-based compensation; and 4) 5) restrictions on stock options and equity-based compensation that mimics stock option incentives; and 6) a requirement that deferred compensation continue to be deferred even if it is bought out by a new employer.

Reimagine a More Equitable and Sustainable Financial System

Revisit Bank Merger Guidelines

The Federal Reserve, along with the other banking agencies, have not revised the bank merger guidelines since 1995. The Fed needs to follow through on President Biden's executive order on competition and join the FDIC in revitalizing the merger review process.[9] The Fed, and all the banking agencies, needs to improve the merger guidelines by a) expanding their review of products beyond deposit concentration; b) incorporating the effect of a merger on systemic risk and thus as a competition issue; and c) taking a more holistic approach to assessing a merger's benefit to the public instead of narrowly focusing on CRA ratings. The shortcomings of the current bank merger review process have failed to protect the public from mega-banks imposing higher costs on consumers, reducing the volume or quality of banking services, or to prevent the biggest banks from becoming so large that they pose a risk to the entire financial system and

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[7] Alan Rappeport. The New York Times."Former Top Financial Regulators Warn Against Move to Ease Oversight of Firms." May 2019.

[8] Financial Crisis Inquiry Commission, "Financial Crisis Inquiry Report," Feb. 2011; United States Senate, Permanent Subcommittee on Investigations, "Wall Street and the Financial Crisis: Anatomy of a Financial Collapse," April 2011; Financial Stability Forum, "FSF Principles for Sound Compensation Practices," Apr. 2009, 4 n.2.

[9] President Joseph R. Biden. "Executive Order on Promoting Competition in the American Economy" July 2021.

real economy. Any merger review should also revamp how regulators evaluate if a merger serves the convenience and needs of a community and not simply assess this through the merging parties' CRA ratings.[10]

Finalize New Rules Under the Community Reinvestment Act (CRA)

The Fed, along with the other banking agencies, issued an interagency rule to revamp CRA regulations. This was long overdue, as the CRA was designed as a tool meant to drive investment into redlined communities, but has inadequately done so. Improvements to the CRA should start by explicitly prioritizing race as a factor in CRA exams, alongside the low- and moderate-income communities that it currently prioritizes. The final rule should consider climate-related impacts from banks, incorporate more opportunities for resilience or green investment credits, enhance data collection, and improve the examination process to provide a more accurate reflection of how banks are meeting the needs of underserved communities through greater community participation. We support the Fed's current efforts to rewrite these rules and urge the Fed, along with its counterparts, to swiftly issue a final rule that addresses the concerns outlined above.

Create a Framework for Climate Supervision and Examinations

Chair Powell has acknowledged climate change as an emerging systemic risk to the financial system and endorsed the 2021 FSOC climate report.[11] These actions are consistent with the findings of other central banks; recent reports from the ECB[12] and Bank of England[13] have confirmed that climate change presents an urgent and growing threat to banks. To address this, we encourage the Fed and its bank examiners to incorporate climate risk into the agency's regular supervision and examinations. As an immediate step, we encourage the Fed to adopt the FDIC's proposed climate supervision principles for large banks.[14] Within the next six months, the Fed, FDIC, and OCC should issue further detailed supervisory guidance on climate scenario analysis,[15] fair lending[16] aspects of climate risk mitigation–including racial and economic justice implications–and transition plans, and begin training supervisors and examiners. The Fed should act swiftly to complete and publish the results of a system-wide climate stress test and also publish climate scenarios for bank supervision and exams.

Complete Rulemaking on Oversight on Third-Party Relationships

As the financial industry landscape continues to evolve towards open banking, the rise of financial technology (fintech) firms, and as banks seek to engage in cryptocurrency markets, it is critical the Fed, along with the other relevant agencies, complete its rulemaking on third-party

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[10] AFREF's Letter to the Federal Reserve on the Community Reinvestment Act Proposed Rulemaking. August 2022; AFREF's Letters on Incorporating Climate Supervision into Community Reinvestment Act Regulation. August 2022.

[11] Financial Stability Oversight Council, "Report on Climate-Related Financial Risk," Oct. 2021.

[12] European Central Bank, "2022 climate risk stress test," July 2022; Wall Street Journal, "Eurozone Banks Fail to Factor In Climate Risks, ECB Says," July 2022.

[13] Bank of England, "Results of the 2021 Climate Biennial Exploratory Scenario (CBES)," May 2022; Reuters, "Bank of England tells banks to take climate action now or face profit hit," May 2022.

[14] Federal Deposit Insurance Corporation, "Request for Comment on Statement of Principles for Climate-Related Financial Risk Management for Large Financial Institutions," March 2022.

[15] Americans for Financial Reform Education Fund, *Letter to FDIC*, June 2022.

[16] Americans for Financial Reform Education Fund *et al.*, *Joint Fair Lending Joint Letter to FDIC*, June 2022.

risk management. Any final rule should guide banks on how to identify and address the risks associated with any given third-party; select and oversee the third-party; and monitor the third-party throughout the life of the relationship. The Fed should also have regulatory oversight authority over third-parties as long as the third-party, through its relationship with a bank, is capable of injecting systemic risk into the banking system (e.g. a stablecoin issuer or a credit risk management company that performs CECL calculations).

Assess the Rising Risks Associated with Non-Banks and Cryptocurrencies

Following a similar theme as above, as banks increasingly partner with fintech firms or seek to enter the cryptocurrency and stablecoin markets, the threat to financial stability rises, as do the risk for cyberattacks. The Federal Reserve, along with the other banking agencies, should jointly study the new threats these companies inject into the financial system. Additionally, as a greater variety of firms gain access to the Federal Reserve's services, including master accounts, the Fed should comprehensively study what effect non-banks or narrow banking charters will have on our financial system. Lastly, the banking agencies should use its considerable powers to regulate the stablecoin markets without waiting on legislation and study, not only the risks stablecoins pose to the greater financial system, but how their potential collapse can affect marginalized communities.

Evaluate the Effects of the Fed's COVID Emergency Facilities on Racial and Economic Equity

During the COVID-19 pandemic, the Fed announced six new facilities, financed by taxpayer equity investment, meant to support at least $2.3 trillion in "real economy" lending.[17] The facilities were notably lacking in requirements that would link funding to the public's benefit, the maintenance of employment, or response to the Coronavirus pandemic. Public financing from these facilities could be used for leveraged buyouts or dividend recapitalizations, and there were few requirements for companies that benefited from these facilities to maintain employment or limit executive compensation. While the Fed provided relief to the debt markets and indirectly aided speculative activity, it is not clear to what extent communities of color and low-to-moderate income communities were provided similar relief. We urge the Fed to study how these emergency facilities contributed to inequities across race and income and how they could be improved for future crises.

Leverage the Extraordinary Braintrust at the Fed to Study Broader Economic Risks

The independent nature of the Fed, along with the unique role it plays in our economy, has led to an infrastructure consisting of world-leading economists and access to a trove of data sets. This unparalleled apparatus should be used to study some of the most pressing questions of our time such as the rise of financialization in the last few decades and the effect it has on our economy; economic concentration; and the various facets of the racial wealth gap. As the Fed is being pushed to disaggregate its employment data by race, it should also seek to find novel ways to analyze its data to better serve the greater economy.

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[17] AFREF's Letter on the Emergency Fed Reserve Facilities. April 2020.