Americans for Financial Reform

Quarles Testimony on Big Bank Regulation

As the single most important regulator of the largest banks in the U.S. financial system, Federal Reserve Vice-Chair Randy Quarles is required to testify this week on the supervision and regulation of the banking system.

While this mandated testimony gets less publicity than the testimony of the Federal Reserve chair on the state of the U.S. economy, it is in some ways just as important. Large banks are only a subset of the broader economy, but the Federal Reserve has much more direct control over the conduct of major financial institutions than it does over the economy as a whole. The regulatory choices made by Vice-Chair Quarles will have a crucial impact on the vulnerability of the U.S. economy to another disastrous financial crisis.

In that context, it's disturbing to see that the Federal Reserve under Quarles leadership has been acting to weaken the regulation of the largest banks in the country, such as Goldman Sachs, JP Morgan, Wells Fargo, and Bank of America. Although the details are often technical, the aggregate impact of Federal Reserve actions is significant and growing. Below are several areas we recommend Congress should question Mr. Quarles about.

Weakening Big Bank Regulation Even Though the Economy is Strong

In Mr. Quarles testimony, he correctly characterizes the overall financial situation of American banks as very strong, noting strong profitability and loan growth.

Classically, this is the point in the economic cycle where it would be easiest for banks to raise capital, and the most appropriate time to ensure that banks hold enough equity capital to do safe and sound lending. Making sure banks are well capitalized now is the right kind of counter-cyclical policy to ensure that the financial system has the capacity to continue to serve the economy during any future downturn and to absorb losses without a public bailout.

Yet the Federal Reserve does not seem to be doing this kind of countercyclical regulation. Instead, we are seeing regulation of the very largest banks become weaker, allowing them to fund more of their activities with borrowed money and pay out capital to benefit their executives and shareholders that should instead be reserved to ensure that they do not endanger the economy during the next recession. Examples include:

- Goldman Sachs analysts just calculated that the recent Federal Reserve proposal changing stress testing procedures will allow the eight largest banks to reduce their equity capital by $54 billion.

- The proposed change in leverage ratio requirements at the largest banks will also significantly reduce minimum required capital, especially as banks change their balance sheets to take advantage of it.

- The stress test forecasts of potential bank losses that are at the heart of the Federal Reserve's capital regime have become significantly weaker over recent years. Estimated losses in the event of a future recession, as projected by the Federal Reserve's models, dropped by over one-third in the past three years, allowing banks to pay tens of billions in additional capital. These estimates are much lower than the losses observed in the financial crisis.

- Quarles testimony and responses to questions hint at additional future weakening of bank rules in numerous areas. For example, in his Tuesday House testimony Quarles was highly critical of the Volcker Rule, implied he would reduce the risk-based capital surcharge for the nation's largest banks, and also indicated the Federal Reserve would end limits on capital distributions at big banks due to weaknesses in risk management.

If we are seeing regulations being weakened so sharply even at a time when the banking sector is very strong economically, what will we see during a weaker economy, where banks will find it much harder to make profits or raise capital?

Weakening Leverage Capital Requirements

The Federal Reserve's proposal to reduce leverage capital ratios at major banks deserves special attention. The proposal would slash the required leverage capital ratios at the nation's largest banks by about 20 to 40 percent. The proposal states that leverage capital requirements at the largest depository banks will drop by over $120 billion if this proposal is finalized as is. Capital required by the leverage ratio at the overall holding company will also drop sharply.

The proposal is and should be highly controversial. The FDIC refused to join the rule proposal because of its sharp cuts in required leverage ratios, and the agency's belief that strengthening leverage ratios was "among the most important post-crisis reforms". Federal Reserve Governor Lael Brainerd also dissented from the proposal. Such dissents are a very rare if not unprecedented action for supervisory rules.

Without a strong leverage ratio, banks can manipulate regulatory risk classifications to reduce their holdings of equity capital and load up on assets that regulators wrongly believe are low risk. Banks need to hold significant amounts of their own equity capital in order to support healthy lending and absorb potential losses if the economy slows down. At its current level, the leverage ratio requirement guarantees that a trillion dollar bank will have at least $50 billion in equity capital in the overall organization (and $60 billion within the depository bank). That's a level which seems minimal, but would be severely reduced by this proposal.

The Federal Reserve justifies this sharp cut in leverage requirements as simply "recalibrating" the leverage ratio, and claims that the current leverage ratio requirement is too high relative to the risk based capital requirements determined by regulators. But these are the same risk based capital requirements that failed us in the 2008 financial crisis, when regulators mischaracterized subprime mortgage backed securities as "low risk" and allowed banks to hold massive amounts without adequate capital backing. Today, regulatory risk models class assets ranging from many types of complex derivatives to Greek government bonds as having limited or no risk. Without the security of an adequate leverage ratio, banks will once again be free to increase their borrowing to purchase large amounts of supposedly "low risk" assets.

Pulling Back From Regulation of Bank Bonuses

We recently learned from a NY State Comptroller report that Wall Street bonuses showed a dramatic 17% increase last year. Bonuses have increased by 34% over the last two years, and the average bonus for Wall Street traders is now at the second highest level ever recorded – behind only 2006, the year before the financial crisis began.

We also know, from the Financial Crisis Inquiry Commission and other sources, that out-of-control bonus practices were a major driver of the 2008 financial crisis. Top executives at Bear Stearns and Lehman took out almost $2.5 billion in bonuses in the years before those two companies failed, and never had to repay a dime. After the crisis, multiple surveys showed that over 80% of financial market participants agreed that irresponsible bonus practices were a major contributor to the short-term risk taking that brought down the financial system.

Section 956 of the Dodd-Frank Act instructed bank regulators to reform bonuses at financial institutions, by eliminating "take the money and run" bonus practices that encourage irresponsible risk-taking. Prior to Mr. Quarles confirmation, regulators had proposed rules that would have placed new limits on big bank bonuses. Specifically, regulators would have banned some of the worst practices such as compensation based on volume, and required that bonuses be deferred and placed at risk over a longer period of time in case unforeseen risks, misconduct, or fraud caused future losses. By doing so, compensation practices could have become more similar to compensation under traditional partnership arrangements that prevailed for centuries on Wall Street, where partnership stakes remained at risk for the long term. Strong rules on bank bonuses have already been finalized in the UK and some other European jurisdictions.

Yet over the past 18 months, the Federal Reserve and other U.S. regulators seem to have completely abandoned the effort to regulate bonuses at financial institutions, even as bonuses skyrocket back to pre-crisis levels. The Congressionally mandated requirement to control the potential risks created by bank bonuses needs to be completed and implemented.

Pulling Back From Limitations on Commodity and Non-Banking Activities at Major Banks

In late 2016, the Federal Reserve and other banking agencies came out with a forceful report recommending major changes in the financial activities permitted at major banks. The report called on Congress to repeal authorities for large-scale commodities activities at banks, as well as authority for merchant banking activities that allow banks to own non-financial companies. (It also recommended that Congress eliminate bank charters that did not allow consolidated supervision, such as the Industrial Loan Corporation charter). The report documented the major threats to bank safety and soundness created by permitting banks to engage in such activities.

Many of the recommendations in that report required Congressional action. But the Federal Reserve followed up on the report's findings by also proposing a rule limiting the ability of big banks to invest in physical commodities and putting in place additional risk safeguards when they did. This rule was aimed at the "catastrophic" risks that extensive commodity activities posed to major banks. It would also have had the effect of preventing the manipulation of physical commodity markets by big banks.

Despite the strong statements in both the report and the proposed rule that commodity activities posed major risks to bank safety and soundness, this rule also appears to have been completely abandoned by the Federal Reserve. No public activity has taken place on the proposal and there appear to be no plans to complete it.