THORN RUN PARTNERS GOVERNMENT RELATIONS

Hearing Summary *July 9, 2024*

SENATE BANKING COMMITTEE HOLDS SEMIANNUAL HUMPHREY-HAWKINS HEARING

EXECUTIVE SUMMARY

On July 9, the Senate Banking Committee held a hearing to receive testimony from Federal Reserve (Fed) Chair Jerome Powell on the central bank's semiannual monetary policy report. During the hearing, Democrats on the panel repeatedly raised concerns over the impact of sustained, elevated interest rates on employment and housing. Nonetheless, there was some bipartisan agreement on the need for the Fed to remain independent of political pressures. Several Committee Democrats also pressed Chair Powell on why the Fed has not yet joined other federal financial regulators on a proposed rulemaking to implement Dodd-Frank Act Section 956 on incentive-based compensation arrangements, which they contended is "long overdue." Other issues raised by individual Democratic senators included commercial real estate (CRE) risk, climate risk, the impact of recent Supreme Court decisions, liquidity standards, merger reviews, and Fed ethics, among others.

Meanwhile, Committee Republicans, led by **Ranking Member Tim Scott (R-SC)**, continued to press Chair Powell on prudential regulators' Basel III Endgame capital proposal, requesting updates on planned changes and the path forward. They contended that a modified proposal should be subject to additional public comment and that the Fed should also make available the results of its quantitative impact survey (QIS). Chair Powell in turn notably shared that the Fed, Federal Deposit Insurance Corporation (FDIC), and Office of the Comptroller Currency (OCC) are "very close" to agreeing on a set of changes to the Basel proposal. While stating that reissuance of the proposal would be consistent with past practice, the Fed Chair also indicated that regulators have yet to reach agreement on next steps. Additional matters raised by Republican senators included the Fed's long-term debt (LTD) proposal, Treasury debt issuance, and immigration.

OPENING STATEMENTS

Chair Sherrod Brown (D-OH) (statement) contended that higher interest rates do not address what he claimed is the largest cause of increased prices — namely, "corporate greed" — and stressed the impact of continued, elevated interest rates on costs, particularly housing prices. He urged regulators to finalize their Basel III Endgame proposal in the "best interest of taxpayers," not large banks. The Chair also criticized incentive-based compensation as rewarding risky behavior and pressed the Fed to join other financial regulators on their proposal to address this matter. He also urged the Fed to ensure that its merger review process is "robust" and protects consumers and communities. Chair Brown concluded by pressing Chair Powell to ensure high ethical standards at the Fed, criticizing the central bank's recent update to its trading policy as failing to establish "clear penalties" for violations.

Ranking Member Tim Scott (R-SC) (statement) attributed inflation to the Biden administration's economic policies, citing increased spending and regulations. He singled out the President's student loan debt forgiveness plans, which he claimed will only benefit individuals from households with an average income of $300,000 or more and which he said are politically motivated. Ranking Member Scott also voiced criticism of regulators' Basel III Endgame proposal, reiterating warnings that it would negatively impact access to capital. The current proposal should be withdrawn and an "appropriate" proposed rule should be re-issued only after regulators analyze and make available for public scrutiny their supporting data, he concluded.

WITNESS TESTIMONY

Fed Chair Jerome Powell (testimony) testified that, over the past two years, the U.S. economy has made "considerable progress" toward the central bank's two percent inflation goal and that, although labor market conditions have cooled, they remain strong. On monetary policy, the Chair stated that, following a lack of progress in the early part of this year, recent data indicates "modest further progress" toward two percent inflation. He reiterated the Federal Open Market Committee's (FOMC) belief that it will not be appropriate to reduce rates until there is greater confidence in sustainable progress toward that target. Nonetheless, the Chair acknowledged that, beyond inflation, the Fed risks other economic impacts if it cuts rates too late or too soon.

DISCUSSION AND QUESTIONS

Basel III Endgame & Long-Term Debt Proposals

- Ranking Member Scott prompted Chair Powell to commit to issuing a new Basel proposal with a "robust" notice and comment process. Chair Powell shared that the Fed has been holding discussions with other bank regulators on possible changes to the original proposal and regulators are "very close" to reaching agreement on the "substance" of those changes. He added that it is consistent with past practice to issue another proposal for comment when there have been "broad and material changes." When prompted by **Sen. Thom Tillis (R-NC)**, Chair Powell reiterated this intention to reopen the proposal to comment.
- The Ranking Member noted that the Fed has yet to publish the results of its QIS for the Basel proposal. Chair Powell indicated that, when regulators reach agreement on changes to the proposal, those changes will be published for comment along with the QIS and anticipated effects the proposed changes would have. The Chair also anticipated a potential 60-day period for any comments. **Sen. Mark Warner (D-VA)** also voiced his interest in seeing the quantitative analysis as part of any revisions.
- **Sen. Mike Rounds (R-SD)** asked Chair Powell whether he believes that the changes being pursued by regulators to the Basel proposal would be a "logical outgrowth" of the original proposal. The Chair declined to make that judgement as a legal consideration but reiterated his view that the changes should be issued for public comment, consistent with prior practice. He indicated that there is consensus from the Fed Board on this but added that the FDIC and OCC must also be in agreement.

- Chair Powell confirmed to Sen. Rounds that, while it is difficult to be precise, a "good guesstimate" is that the final Basel III reforms will not come until the beginning part of next year.
- When asked by Sen. Tillis to commit to releasing the results of the Basel QIS, Chair Powell said that the Fed plans to release those results "as soon as possible" and that he does not imagine any other agencies being concerned about their release.
- Sen. Tillis urged the Fed not to overlook "second-order issues" important to foreign banking organizations (FBOs) and certain regionals as it considers changes to the Basel III Endgame proposal. He cited, for example, the original proposal's "outsized" operational risk costs. Chair Powell assured him that the Fed is "very conscious" of comments from all stakeholders.
- Chair Powell answered affirmatively when asked by **Sen. Katie Britt (R-AL)** whether he believes the 2018 regulatory tailoring law (S.2155) applies to the Fed's LTD proposal. However, he declined to agree that it would be "inappropriate" for the Fed to finalize this proposal or others before first finalizing Basel III.
- Sen. Britt raised concerns over the Basel III Endgame proposal's impact on commodities markets, noting how it would increase hedging costs by 80 percent. Chair Powell assured her that the Fed is paying close attention to concerns in this area.
- **Sen. Steve Daines (R-MT)** voiced his view that the Basel III Endgame proposal should be scrapped altogether. He asked what changes regulators plan to make to the original proposal. Chair Powell reiterated that regulators are close to reaching agreement on a set of changes but still need to agree on a process for moving forward, adding that he hopes this will occur "very soon."

Executive Compensation, Liquidity Standards, & Fed Supervision

- Citing how incentive-based compensation was found to have encouraged "excessive risk taking" by Silicon Valley Bank (SVB), Chair Brown urged the Fed to join other financial regulators on their "long overdue" rulemaking on executive compensation.
- Sen. Warner inquired about what aspect of liquidity standards are under review and how the Fed is thinking about these standards. Chair Powell replied that the failure of SVB — including the speed of the run on the bank — indicated a need to update assumptions about liquidity, noting that the Fed is working on a proposal to this end. Sen. Warner spoke of a need to think about internet-driven runs and invited input on the matter.
- Noting the Government Accountability Office's (GAO) findings on the Fed's supervisory procedures, Sen. Warner asked how the central bank is thinking about changes to supervisory standards in light of these findings and the 2023 bank failures. Chair Powell noted that Fed Vice Chair for Supervision Michael Barr is currently leading a process to evaluate how the Fed supervises banks and determine how it can be "faster and more forceful" when appropriate.
- **Sen. Elizabeth Warren (D-MA)** sharply criticized the Fed's refusal to join other regulators on their proposal pertaining to incentive-based compensation arrangements, noting that the last time the central bank issued guidance on this matter was back in 2010.
- **Sen. Chris Van Hollen (D-MD)** also expressed his frustration with the Fed's delay in implementing Dodd-Frank Section 956 on incentive-based compensation. Chair Powell

pointed out that the Fed already put out a guidance in 2010 and supervises based on that guidance, which he said appears to have "largely worked" for large firms.

Housing, Appraisals, & Commercial Real Estate

- **Sen. Jon Tester (D-MT)** wondered how current housing challenges fit into the Fed's evaluation of economic conditions, particularly in terms of the impact of housing scarcity on economic growth. Chair Powell acknowledged that tighter monetary policy is impacting activity in the housing sector but asserted that the "best thing" the Fed can do for housing is to get inflation down to two percent sustainably so that rates can decrease. The Chair reiterated this view when asked by **Sen. Raphael Warnock (D-GA)** how the Fed is working to encourage more home construction.
- When prompted by Chair Brown, Chair Powell conceded that the volume of housing sales has decreased, the median home price has increased, and monthly mortgage payments have become less affordable since the Fed started raising rates in 2022.
- **Sen. Tina Smith (D-MN)** raised concerns over CRE risk — in particular a concern that default risk may disproportionately fall on smaller banks. She asked Chair Powell how he views this risk and whether it might lead to more concentration in the banking system. **Sen. Laphonza Butler (D-CA)** also raised concern over CRE as a "future challenge." Chair Powell pointed to the Fed's recent stress tests as evidence that large banks can manage CRE risks, along with most small banks. He added that supervisors and regulators are in touch with smaller banks that tend to have local concentration in CRE to ensure they can manage the risk.
- Sen. Butler noted that a lack of affordable housing combined with high interest rates is pushing young individuals into the rental market, thereby driving rental prices up. She asked Chair Powell about the impact of the Fed' policies on future generations. Chair Powell contended that the "best thing" the Fed can do for younger individuals is to restore price stability, asserting that, while higher interest rates may make it harder to buy homes in the short-term, elevated rates now will have a positive impact in the long-term.
- Sen. Warnock touted his Downpayment Toward Equity Act (S.3930), which would provide grants to assist eligible first-generation homebuyers in purchasing their first homes.
- Sen. Warnock applauded the Consumer Financial Protection Bureau's (CFPB) finalization of a rule on home appraisals and asked why the Fed has not also finalized the rule. Chair Powell replied that he was unsure this is a rule that the Fed must also finalize but agreed to verify and follow up with the senator at a later time.

Inflation, Employment, & Interest Rates

- Chair Powell acknowledged to **Sen. Jack Reed (D-RI)** that recent data indicate that labor market conditions have "cooled considerably" and that the labor market appears to be "fully back in balance." He assured the senator that the Fed is aware of the "two-sided risks" it now faces and is balancing the risk of loosening monetary policy too little or too late. Chair Powell reiterated this when Chair Brown and Sen. Van Hollen also voiced their concerns over the potential impact on employment of waiting too long to lower rates.

- Chair Powell agreed with Sen. Rounds that there is both a supply and demand side to the inflation rate. However, he declined to estimate what percent of inflation is attributable to either side, citing a lack of certainty.
- Sen. Warner echoed Chair Brown's concerns over the impact of high interest rates on housing and the need for a rate cut, saying that he hopes cuts will come "sooner rather than later."
- When **Sen. John Kennedy (R-LA)** noted that roughly three-quarters of new jobs created last month were in government, health care, and social assistance, Chair Powell agreed that this reflects a "concentration" and that it would be preferable to see broader job creation.
- When prompted by Sen. Kennedy, Chair Powell declined to comment on whether he believes inflation has been caused by "corporate greed," instead contending that the Fed views inflation as an imbalance between supply and demand.
- Chair Powell declined to provide **Sen. Bill Hagerty (R-TN)** with any sense of when the Fed might cut interest rates, saying that that decision will continue to depend on inflation data and conditions in the labor market.
- Sen. Hagerty voiced concerns over the impact of Treasury's current rate of short-term debt issuance on interest rates, and he asked whether this debt issuance is at odds with the Fed's goal of bringing down inflation. Chair Powell declined to comment on Treasury's debt management but said that he does not believe it has "important" inflation implications.
- **Sen. J.D. Vance (R-OH)** drew a connection between immigration — in particular illegal immigration — and inflation. Chair Powell expressed his view that immigration is inflation "neutral" in the long-run and may help in the short-run insofar as it serves to increase the labor supply.

Additional Matters

- Sen. Reed questioned the viability of a proposal by former President Donald Trump to increase tariffs and eliminate the federal income tax, predicting that this would lead to higher prices. Chair Powell declined to comment on this matter when prompted.
- Sen. Reed asked about the cumulative effect of the Supreme Court's recent decisions in *Loper Bright v. Raimondo* and *Corner Post v. Fed* on the Fed's regulatory decision-making. Chair Powell shared that the Fed is in the process of studying these decisions and intends to follow the law as the Court has read it. Sen. Reed asserted that, if it determines that these decisions are "detrimental" to its ability to regulate, the Fed has an obligation to voice this publicly.
- Chair Brown urged Chair Powell to use the Fed's supervisory authority to ensure that Evolve Bank — one of the partner banks of the recently bankrupt fintech company Synapse — is ensuring access to funds for account holders impacted by the bankruptcy. Chair Powell assured him that the Fed is "strongly encouraging" Evolve to do whatever it can to make funds available to those affected.
- When prompted by Sen. Tillis, Chair Powell agreed that the Fed's 2024 stress test results indicate that the U.S. banking system is strong "from every measure."
- Several senators – including Sens. Tester, **Catherine Cortez Masto (D-NV)**, and **Kevin Cramer (R-ND)** – expressed their support for the independence of the Fed. However, Sen. Cramer advised against cutting rates before the November election, and Sen. Daines similarly

urged Chair Powell not to be influenced by political pressure to lower rates. For his part, Chair Powell voiced his view that there is generally bipartisan support for the Fed's independence.

- Sen. Warner proposed that, before considering additional regulations, the Fed should look at usage of its discount window, which he called an "underused tool."
- Sen. Butler brought up the Fed's pilot climate scenario analysis exercise and asked how the central bank intends to invest in expanding modeling resources for banks implementing climate-related financial disclosures. Chair Powell responded that the Fed is currently looking at what it learned from the exercise and has not yet made any decisions on what it will do with the information gathered or whether it will repeat the exercise.