THORN RUN PARTNERS
GOVERNMENT RELATIONS

Hearing Summary

November 15, 2023

HOUSE FINANCIAL SERVICES COMMITTEE CONVENES HEARING TO CONDUCT OVERSIGHT OF BANKING REGULATORS

EXECUTIVE SUMMARY

On November 15, the House Financial Services Committee held an oversight hearing with testimony from leaders of the Federal Reserve, Federal Deposit Insurance Corporation (FDIC), National Credit Union Administration (NCUA), and Office of the Comptroller of the Currency (OCC). Discussion during the hearing focused on the rulemakings and guidance from the regulators — including the Basel III Endgame proposal, joint principles for climate-related financial risk management, long-term debt proposal, and Community Reinvestment Act (CRA) modernization — as well as reports of sexual harassment at the FDIC. Notably, **Chair Patrick McHenry (R-NC)** indicated that he is requesting a Government Accountability Office (GAO) investigation into whether the joint principles for climate-related financial risk management should have been issued as a rulemaking and are subject to the Congressional Review Act (CRA).

Republicans and some Democrats were concerned about the potential impacts of the Basel proposed rule, especially as it relates to access to and cost of credit for consumers, small businesses, and first-time home buyers. Additionally, some Democrats were worried about how the Basel proposal might hinder the implementation of federal clean energy tax credits. However, most Democrats generally supported measures to increase the resilience of the banking sector in light of the spring bank failures. Other issues discussed during the hearing included the impact of the Basel proposal on small farmers and derivatives transactions, supervisory efforts, third-party vendors, and digital assets.

OPENING STATEMENTS

Chair Patrick McHenry (R-NC) was critical of the Basel III Endgame proposal, arguing that the proposed reforms would not address the causes of the spring bank failures and would hinder lending. He also expressed concerns about regulators' joint principles for climate-related financial risk management, arguing that they are based on international standards rather than economic and climate realities in the U.S. Chair McHenry said that he is requesting a GAO investigation into whether the joint principles are subject to the CRA. He also criticized prudential regulators' handling of digital assets, claiming that they are not protecting consumers.

Ranking Member Maxine Waters (D-CA) applauded the agencies' efforts to stabilize the banking sector after the bank failures and she expressed support for the proposed Basel capital requirements. The Ranking Member promoted legislation that she believed would help to shore up the banking sector, urging House Republicans to take up the Recovering Executive Compensation Obtained from

Unaccountable Practices (RECOUP) Act (S.2190). Ranking Member Waters touted regulators' final rule to strengthen and modernize the CRA. Finally, she was concerned about recent reports about sexual harassment and a toxic workplace culture at the FDIC.

Rep. Bill Foster (D-IL) observed emerging risks to financial stability, including geopolitical tension, cybersecurity, new technologies, and climate change. He noted prudential regulators' proposals to address these new risks, stressing Congress' responsibility to examine them.

WITNESS TESTIMONY

Fed Vice Chair for Supervision Michael Barr (testimony) stressed that the banking sector is stable and resilient, though he noted challenges related to high interest rates and concentrations of uninsured deposits. Vice Chair Barr stated that the Fed is working to improve its supervision considering recent bank failures, such as by conducting targeted reviews and exhibiting high interest rate and liquidity profiles. Vice Chair Barr promoted the proposed Basel capital requirements and risk adjustments, highlighting the importance of ensuring that banks are well-capitalized. Vice Chair Barr also touted banking agencies' long-term debt proposal, arguing that it would improve options to resolve financial institutions.

FDIC Chair Martin Gruenberg (testimony) referenced indicators of the stability of the banking sector, but noted challenges such as lower net interest margins and deposit outflows. The FDIC Chair promoted both the long-term debt proposal and the Basel reforms, remarking that they would increase the resilience of banks. Chair Gruenberg touted regulators' recently finalized reforms aimed at modernizing the CRA, commenting that the reforms adapt the regulations to digital banking and promote financial inclusion. The Chair also stated that the FDIC is conducting a comprehensive review of reports of sexual harassment at the agency.

Acting Comptroller Michael Hsu (testimony) echoed assurances that the banking system is sound. Mr. Hsu highlighted regulators' efforts to provide guidance to address emerging risks, such as the policy statement on commercial real estate loan accommodations and workouts. He spoke positively of both the CRA reforms and the interagency guidance on third-party risk management. He encouraged banks to manage the risks of artificial intelligence (AI) appropriately, observing both the potential risks and benefits. Mr. Hsu highlighted the increasing attention on the tokenization of real-world assets, adding that the agency plans to hold a symposium on the topic in February of next year. Finally, he stressed the importance of the agencies' joint principles for climate-related financial risk management.

NCUA Chair Todd Harper (testimony) noted growing liquidity, interest rate, and credit risks to the credit union system. In response, he urged Congress to restore the Central Liquidity Facility's (CLF) corporate credit unions and allow them to purchase CLF capital stock on behalf of their members. Chair Harper also recommended that Congress grant NCUA authority to examine third-party vendors, which he viewed as a regulatory "blind spot."

Discussion and Questions

Basel III Endgame

- In his line of questioning, Chair McHenry generally expressed frustration with what he viewed as a lack of transparency into U.S. regulators' participation in international financial bodies, such as the Basel Committee.
- Chair McHenry asked Vice Chair Barr to describe economic analysis to support the Basel capital requirements. The Fed Vice Chair pointed to the preamble of the proposed rule, indicating that it discusses the analysis that went into each provision. Chair McHenry maintained his view that the Basel proposal lacks sufficient quantitative backing to justify its reforms.
- **Rep. Brad Sherman (D-CA)** asked whether prudential regulators are considering requiring banks to recognize unrealized losses. Vice Chair Barr explained that the Basel proposal would apply the available-for-sale securities approach for Global Systemically Important Banks (GSIB) to other large banks. Rep. Sherman characterized this as a "tiny" step forward.
- **Rep. David Scott (D-GA)** expressed concerns that the Basel capital requirements would negatively impact the ability of small farmers to access credit and increase the cost of derivatives transactions. Vice Chair Barr argued that the derivatives proposal would improve the resilience of banks. Later in the hearing, **Rep. Frank Lucas (R-OK)** echoed Rep. Scott's concerns that the Basel proposal would increase the cost of derivatives transactions.
- **Rep. Bill Huizenga (R-MI)** asked whether the Fed has researched the cumulative economic and credit impact of proposed and recently finalized banking regulations. Vice Chair Barr was unable to answer the full question but stated that the central bank does not anticipate that the Basel proposal would have a significant effect on credit conditions.
- **Rep. Ann Wagner (R-MO)** asked Vice Chair Barr what analysis they conducted on the impact of the Basel proposal on securities underwriting. Vice Chair Barr answered that the Fed's analysis indicates that the proposal would support a better risk calibration of trading activities. Rep. Wagner spoke against the proposed capital requirements for trading activities.
- Rep. Wagner contended that U.S. implementation of the Fundamental Review of the Trading Book (FRTB) along with the global market shock component of the Fed's stress tests are a "double count" of capital requirements. Vice Chair Barr countered that the Basel proposal does not double count risks in the banking system, with the capital requirements setting minimum levels and the stress test setting a stress capital buffer.
- **Rep. Sean Casten (D-IL)** was generally supportive of the Basel capital requirements, but raised concerns that the risk weight for tax equity would hinder federal funding to support clean energy projects. Both Vice Chair Barr and Chair Gruenberg expressed openness to public comments regarding this issue, with Vice Chair Barr recognizing that clean energy tax equity generally has lower risk than other equity investments.
- Rep. Sherman alleged that prudential regulators are undermining the Biden administration's clean energy efforts since the risk weight for tax equity investments would increase from 100 to 400 percent under the proposal.
- **Rep. Roger Williams (R-TX)** echoed other Republican lawmakers' criticisms that the economic analysis underpinning the Basel proposal is insufficient.

- Rep. Williams asked the Fed to abandon the provisions calling for the elimination of banks' use of supervised internal models in determining capital requirements. In response, Vice Chair Barr stated that the proposal would not impact small banks and mostly focuses on non-lending activities.
- **Rep. Nydia Velázquez (D-NY)** was generally supportive of the Basel reforms, but she raised concerns about the proposal's potential impact on small businesses' access to capital. Vice Chair Barr argued that the Basel rule would not make significant changes with respect to the cost of credit for small businesses, explaining that small businesses would generally maintain the same risk weight.
- **Rep. Jim Himes (D-CT)** expressed uncertainty as to the need for the Basel proposal given the strength and stability of the banking system. Vice Chair Barr emphasized the importance of ensuring that banks are well-capitalized, adding that the Basel proposal focuses on non-lending activities where banks have seen large losses.
- Rep. Lucas asked why the banking agencies are engaging in the Basel rulemaking if they believe the sector to be stable. Vice Chair Barr stated that the risk calibration used for certain non-lending activities — namely trading — does not match the risks seen historically, particularly during extreme financial events.

Mortgages

- Rep. Sherman criticized the Basel proposal, asserting that it discriminates against clean energy efforts, first-time home buyers, and small businesses. When Rep. Sherman asked whether the witnesses would support having a zero value for mortgage insurance, Vice Chair Barr clarified that the proposal would not alter the treatment of private mortgage insurance.
- Rep. Wagner asked whether the Basel proposal would increase the cost of and decrease access to credit for low-income communities. Chair Gruenberg indicated that the agencies plan to address concerns related to credit cost and access in the final rule, especially as it relates to the risk weights for mortgages.
- **Rep. Gregory Meeks (D-NY)** expressed concerns about the potential impact of the Basel proposal on access to mortgage options for first-time, minority, and low-to-moderate income home buyers. Vice Chair Barr welcomed suggestions to address this issue during the public comment period.
- Rep. Meeks argued that banks that make affordable mortgages and sell them to government-sponsored enterprises (GSE) would be "punitively" treated by operational risk capital requirements. Vice Chair Barr responded that the underlying credit with respect to mortgages sold to GSEs would not change from current law.

Long-Term Debt, Debit Interchange, CRA, Third Parties, & Credit Unions

- **Rep. Pete Sessions (R-TX)** was critical of the long-term debt proposal, arguing that the proposed rule is "overly prescriptive." When questioned by Rep. Sessions, Chair Gruenberg indicated that prudential regulators had been considering the long-term debt proposal before the spring bank failures.

- Regarding the debit interchange fee limit, **Rep. Blaine Luetkemeyer (R-MO)** asked whether the Fed is concerned about cost savings not being given back to consumers and small banks being forced to merge or close. Vice Chair Barr answered that the rule only pertains to large banks.
- **Rep. Emanuel Cleaver (D-MO)** expressed gratitude for the prudential regulators' efforts to modernize the CRA, highlighting his concerns that the previous iteration of CRA regulations were not suited to address technological developments in the sector.
- Rep. Williams was worried about the compliance costs of CRA modernization for community banks. Chair Gruenberg explained that community banks with assets under $600 million will not be affected by the CRA update.
- Rep. Foster asked Comptroller Hsu to speak to his calls for increased visibility into third-party vendors and other entities. Comptroller Hsu explained that banks are now partnering with fintech firms, who often also have their own partners. He remarked that there is good visibility into the bank-fintech partnerships themselves, but that regulators are lacking insights into the rest of the banking service supply chain.
- **Rep. French Hill (R-AR)** noted that 16 banks have been purchased by credit unions in the last year. Chair Harper committed to providing a memo detailing the implications of the acquisitions.
- Vice Chair Barr answered no when **Rep. Warren Davidson (R-OH)** asked whether there are plans to give privately insured credit unions access to the Bank Term Funding Program.

Stablecoins, Crypto, CBDCs, and Custody

- Rep. Hill explained that, under existing law, a national trust bank can issue stablecoins. Mr. Hsu agreed that the OCC has the authority to charter such a bank and added that the agency's staff would be capable of supervising stablecoin issuance.
- Regarding the Fed's novel activities supervision program, Rep. Hill asked whether the non-objection status would disincentivize member banks from participating in stablecoin activities. In response, Vice Chair Barr remarked that the Fed wants to promote innovation while ensuring that there are clear guardrails for banks participating in novel activities.
- Rep. Davidson asked Vice Chair Barr to provide an update on the status of the Fed's work on central bank digital currencies (CDBC), to which he remarked that the central bank is merely exploring a CBDC but has not decided whether to recommend a retail CBDC.
- Rep. Davidson noted that conditional approvals made under OCC Interpretive Letter 1179 — which clarifies that banks already engaged in crypto activities do not need to obtain supervisory non-objection — have expired, and he asked Mr. Hsu to comment on these expirations. Mr. Hsu stressed OCC's focus on ensuring that any crypto-related activity in the banking system is safe, sound, and fair.
- Rep. Hill criticized the SEC's proposed safeguarding rule, arguing that requiring banks to hold client funds off balance sheet would be a departure from standard practice. Mr. Hsu agreed, indicating that the OCC has some concerns with the proposal. Vice Chair Barr agreed that it would be a "significant" change in custody practices at banks.

Bank Failures

- Rep. Velázquez asked whether a rulemaking on Section 956 of Dodd-Frank — which relates to limitations on incentive-based compensation at financial firms — would be released by the end of the year. Chair Gruenberg was unsure that the agencies will be able to issue the rulemaking in this timeframe.

- **Rep. John Rose (R-TN)** contended that use of the systemic risk exception for the spring bank failures creates "moral hazard" by encouraging other banks to take more risks. Chair Gruenberg agreed that the decision to invoke the system risk exception was "consequential," though he countered that there were concerns at the time about contagion in the banking system.
- Chair Gruenberg noted increased supervisory attention to interest rate risk, uninsured deposits, rapid growth, and unrealized losses when asked by Rep. Rose about lessons from the bank failures.
- Rep. Luetkemeyer was worried about the possibility of China invading Taiwan and the resulting economic fallout. Mr. Hsu indicated that there are regular conversations at different levels to assess such risks, and he assured Congress that banks — especially those with global operations — are prepared for a range of scenarios.
- When Rep. Cleaver asked about the state of the banking sector, Vice Chair Barr reiterated his assessment that the banking system is sound, though he pointed to the Basel proposal as identifying areas where banks can be made more resilient.

FDIC Sexual Misconduct Reports

- When prompted by Chair McHenry, Chair Gruenberg stated that he has never been investigated for inappropriate conduct. However, later in the hearing, Chair Gruenberg corrected the record and stated that there was a review opened against him at one time after complaints were raised about his temperament.
- Ranking Member Waters reiterated her concerns about the reports of sexual harassment at the FDIC. Chair Gruenberg responded that addressing the reports of sexual harassment is the FDIC's top priority. He stated that the FDIC is reexamining associated policies and procedures and is engaging with an independent third-party to conduct an agency-wide review. The FDIC Chair committed to providing the third-party's report to Congress when its review is concluded.
- Ranking Member Waters also secured commitments from Vice Chair Barr, Chair Harper, and Mr. Hsu to provide their sexual harassment policies and procedures to Congress and consider next steps to improve them.
- Rep. Huizenga asked if Chair Gruenberg was made aware of the sexual harassment cases during his time at the FDIC, to which he answered in the negative.