THORN RUN PARTNERS
GOVERNMENT RELATIONS

Hearing Summary

November 14, 2023

SENATE BANKING CONDUCTS OVERSIGHT OF PRUDENTIAL REGULATORS

EXECUTIVE SUMMARY

Today, the Senate Banking Committee held a hearing to conduct oversight of federal financial prudential regulators. Lawmakers heard testimony from Fed **Vice Chair for Supervision Michael Barr, Federal Deposit Insurance Corporation (FDIC) Chair Martin Gruenberg, National Credit Union Administration (NCUA) Chair Todd Harper,** and **Acting Comptroller of the Office of the Comptroller of the Currency (OCC) Michael Hsu.** The banking regulators fielded questions from lawmakers on a broad range of issues affecting the banking industry.

Notably, regulators faced bipartisan pushback for their Basel III endgame capital rulemaking over concerns that it will restrict lending to small businesses and minority communities. However, regulators contested that they did not believe the rule would have such impacts but would address the concerns during the public comment period. Additionally, FDIC Chair Gruenberg faced staunch criticism of the FDIC over reports of harassment and workplace misconduct at the regulatory agency. Chair Gruenberg condemned these accusations and informed lawmakers that the FDIC has enlisted a third party to investigate the claims.

OPENING STATEMENTS

Chair Sherrod Brown (D-OH) (statement) expressed concerns about recent bank failures, highlighting the need for improved bank supervision and accountability for risky behavior. He emphasized the challenges posed by banking consolidation, advocating for actions to ensure banks meet the needs of their communities. Chair Brown also discussed the finalized Community Reinvestment Act (CRA) rule and the Basel III in-game capital proposal, addressing their significance in modernizing regulations and safeguarding the financial system.

Acting Ranking Member Mike Rounds (R-SD) echoed Republican concerns about the extent of recent regulatory changes proposed and finalized by financial regulators. He highlighted the complexity and potential negative impact of these regulations on banks, businesses, and individuals, emphasizing potential compliance costs on financial institutions. Sen. Rounds particularly criticized the Basel III end game rule and climate risk management requirements, arguing that they could limit access to credit, restrict small business lending, and negatively affect retirees' savings and called for regulators to reconsider these measures.

WITNESS TESTIMONY

Fed Vice Chair for Supervision Michael Barr (testimony) asserted that the U.S. banking system remains sound and resilient, with banks reporting capital and liquidity ratios above regulatory minimums. He acknowledged challenges, including declines in asset value for some banks due to increased interest rates and the need for active risk management. Vice Chair Barr emphasized the importance of maintaining a strong banking system, particularly focusing on capital reforms to ensure banks can absorb losses.

FDIC Chair Martin Gruenberg (testimony) echoed comments that the banking industry demonstrated resilience despite stress in the second quarter. However, he noted that, while net income remained high and asset quality stable, challenges included lower net interest margins and increased funding pressures for a second consecutive quarter. Chair Gruenberg highlighted the FDIC's efforts to enhance the resilience and resolvability of large regional banks through proposed rulemakings, along with ongoing reviews and actions to address supervision concerns and ensure a safe working environment amid recent reports of sexual harassment at the FDIC.

NCUA Chair Todd Harper (testimony) asserted that despite resilience, emerging issues include rising net charge-off ratios and a drop in composite capital adequacy, asset quality, management, earnings, liquidity, and sensitivity (CAMELS) code ratings, particularly for larger and more complex credit unions. Chair Harper emphasized the importance of managing credit risks, addressing liquidity challenges through the Central Liquidity Facility, and restoring NCUA authority to examine third-party vendors to enhance system resilience.

OCC Acting Comptroller Michael Hsu (testimony) informed lawmakers that the OCC's 2024 bank supervision plan focuses on key areas, including asset liability management, credit risk, cybersecurity, operational risks, and consumer compliance. Acting Comptroller Hsu highlighted the OCC's efforts to address commercial real estate risk, update guidance on third-party relationships, and manage risks associated with artificial intelligence (AI) and digital assets, including tokenization.

DISCUSSION AND QUESTIONS

Capital Proposal

- Chair Brown echoed sentiment from several of his Democratic colleagues in asking Vice Chair Barr for the justification for regulators' enhanced capital requirement rulemaking. The Vice Chair asserted that bolstered capital requirements may aid in preventing future financial crises. Additionally, Vice Chair Barr noted that the proposal will apply only to the nation's largest banks but welcomed public comment on the rule.
- **Sens. Katie Britt (R-AL)** and Rounds inquired how long the Federal Reserve Board of Governors were given to review Vice Chair Barr's "holistic" capital review before considering the Basel III proposal and whether it will be released to the public. Vice Chair Barr stated that this review was an internal examination and not an official document. Sen. Rounds suggested that fellow Board members may have benefited from seeing the results of the holistic review.

Vice Chair Barr indicated that the collection of proposals contains detailed analysis and that Board members were given weeks to review the proposed rule.

- **Sens. Thom Tillis (R-NC)** and **Steve Daines (R-MT)** asked whether Vice Chair Barr intends to move forward with the Basel III proposal if the Fed Board does not come to a consensus. Vice Chair Barr indicated that he hopes to receive "broad" consensus but was wary that the measure would receive unanimous approval.
- **Sens. Jon Tester (D-MT)** and Britt were concerned over the potential impact of regulators' capital requirement proposal on small businesses and access to capital, asking how they are measuring its potential impact. Vice Chair Barr explained that he does not believe that the measure will have significant negative effects on small businesses or consumers, asserting that the rule's credit provisions are similar to existing standards. Sen. Tester wondered whether public comments have raised similar concerns. Vice Chair Barr noted that public discourse has raised these concerns and that the Fed will work to address any issues raised during the public comment period.
- **Sens. John Kennedy (R-LA), Cynthia Lummis (R-WY)**, and Tester worried that the capital proposal may result in banking activities shifting to the non-bank sector. Vice Chair Barr acknowledged these concerns and expressed willingness to address the issue if Fed officials and stakeholders feel as though the risk is credible.
- Sen. Britt pressed Vice Chair Barr on whether the Fed had conducted a "cumulative" analysis on the impact of the capital proposal. Vice Chair Barr welcomed public input and analysis on the subject. Sen. Britt inquired about the Fed's quantitative impact study in relation to the proposed capital requirements rule. Vice Chair Barr explained that the study was conducted in 2021 and that the Fed is in the process of updating the data for inclusion in a finalized rule.
- Sen. Britt asked whether regulators plan to extend the comment period for the long-term debt and resolutions planning rule. Vice Chair Barr indicated willingness to extending the comment period if there are sufficient concerns.
- Sen. Kennedy pressed Vice Chair Barr on whether the proposed capital requirements rule would have prevented the several regional bank failures earlier this year. Vice Chair Barr believed the proposal's focus on interest rate risk and unrealized losses may have prevented the failures.
- **Sen. Bob Menendez (D-NJ)** was concerned that the capital proposal may disproportionately impact minority homeownership. Witnesses acknowledged these concerns and reiterated that regulators welcome public input to address any potential issues.
- Citing concerns over the potential impact of the capital proposal, **Sen. Mark Warner (D-VA)** proposed the notion of requiring a degree of utilization of the Fed's Discount Window — or ability to pledge collateral. Vice Chair Barr noted that officials encourage the use of the Discount Window and programs like the Bank Term Funding Program (BTFP) in times of market liquidity stress. Chair Gruenberg echoed these remarks, noting that the use of the Discount Window should not be stigmatized and expressed openness to Sen. Warner's proposal.
- Sen. Daines asked whether the Fed has conducted a cost-benefit analysis of the proposal's public listing requirement. Vice Chair Barr reiterated that officials do not believe the proposal will negatively impact small businesses, but that regulators are willing to address issues

raised during the comment period — such as the public listing requirement. Further, Vice Chair Barr argued that the proposed rule provides greater flexibility for small businesses than under current law in the form of lower risk weights.

- **Sen. Elizabeth Warren (D-MA)** sought to dismiss concerns that the capital proposal would restrict small business lending by noting that it applies to a limited number of large financial institutions. Vice Chair Barr added that much of the increased capital provisions apply to activities other than small business lending, such as derivatives trading.
- **Sen. Chris Van Hollen (D-MD)** voiced concern over the Basel III proposal's treatment of clean energy tax credits and wondered if witnesses had echoed similar concerns. Acting Comptroller Hsu echoed all witnesses in acknowledging that the subject has been raised and that regulators will work to address them as they examine public comments.

Financial Risks

- **Sen. Jack Reed (D-RI)** questioned whether "synthetic risk transfers" (SRT) might pose a risk to the banking system, citing concerns regarding the role of similar derivatives products in the 2008 financial crises. Vice Chair Barr explained that the Fed has approved these transactions on a case-by-case basis, adding that the Fed will evaluate whether SRTs pose any risk before allowing banks to conduct such transactions on a routine basis. Sen. Reed asked how much visibility the Fed has into the private equity side of SRTs, to which Vice Chair Barr acknowledged the Fed has little insight. Chair Gruenberg urged regulators to take a "cautious" approach to such financial instruments. Acting Comptroller Hsu agreed, adding that it can be an effective risk mitigation tool if done correctly.
- Sen. Reed asked what actions regulators are taking to mitigate the potential risks posed by banks partnering with third parties in offering banking services. Chair Gruenberg acknowledged that these third-party relationships can pose a risk, particularly when used to "export" a bank's interest rates to other jurisdictions. Acting Comptroller Hsu said the OCC is focused on combating "predatory" lending practices.
- **Sen. Tina Smith (D-MN)** inquired about how regulators are adapting their regulatory approach considering how new technologies can impact risks such as bank runs. Vice Chair Barr stated that the Fed is increasing its focus on bank contingency plans and liquidity risk management, noting that many institutions have pre-positioned capital at the Fed's Discount Window. Chair Gruenberg suggested that the emergence of technology and social media presents a new form of liquidity risk. Mr. Harper added that it underscores the importance of the NCUA having an enhanced liquidity facility, calling for greater regulatory authority and ability to examine third-party vendors and technology.
- **Sen. John Fetterman (D-PA)** prompted witnesses to discuss what they believe to be the cause of Silicon Valley Bank's (SVB) failure. Vice Chair Barr pointed to mismanagement of interest rate risk and incentive structures that encouraged risky decision making regarding its hedge positions. Chair Gruenberg contended that the bank's reliance on uninsured deposits positioned itself in a way that risked contagion to other banks. Acting Comptroller Hsu added that the bank's rapid growth also played a role.

Supervisory Practices

- Chair Brown pressed witnesses to elaborate on how each regulator has changed its approach to supervision following the failure of several regional banks earlier this year. Acting Comptroller Hsu noted that the OCC has made several changes to its supervisory practice. Chair Harper explained that the NCUA has increased its focus on liquidity and commercial real estate, adding that credit unions have not seen the same level of instability as other financial institutions. Chair Gruenberg said that the FDIC has issued updated guidance for bank examiners that focuses on: (1) interest rate risk; (2) concentration of unrealized losses; (3) uninsured deposit concentration: (4) rapid growth; and (5) when to escalate issues of noncompliance. Vice Chair Barr noted that the Fed has also revised its supervisory approach to focus on issues such as interest rate risk, rapid growth, liquidity risk, and cyber risk.
- Sen. Tillis expressed concern over a potential leak of supervisory information — including Matters Requiring Attention (MRA) and Matters Requiring Immediate Attention (MRIA) — and asked whether the Fed is investigating the issue. Vice Chair Barr voiced his disappointment that this information was reported in the press but did not directly confirm whether an investigation has taken place.
- Sen. Menendez inquired how regulators will ensure bank supervisors are fully trained on the updated Community Reinvestment Act (CRA) requirements. Vice Chair Barr asserted that regulators will use the two years leading up to the CRA's effective date to ensure supervisors are well-trained on the new guidance. Chair Gruenberg and Acting Comptroller Hsu agreed with Vice Chair Barr's approach.

Other Topics

- Chair Brown expressed bipartisan concern in prompting Chair Gruenberg to comment on allegations of workplace harassment and misconduct at the FDIC. Chair Gruenberg acknowledged the public reporting on the subject and noted that the FDIC has sought an investigation into the allegations by a third party. In similar questioning with **Sen. Catherine Cortez Masto (D-NV)**, Chair Gruenberg stated that he hopes the investigation will be concluded within 90 days.
- Sen. Cortez Masto asked how the revised CRA rulemaking will improve access to lending in moderate-and-low-income (LMI) communities. Acting Comptroller Hsu noted that the finalized CRA modernizes the CR implementing rules by factoring in activities that occur outside traditional branch banks. Chair Gruenberg added that it allows banks to engage in community development financing. Vice Chair Barr asserted that it would provide additional transparency and consistency for all stakeholders, echoing Chair Gruenberg's remarks regarding community development financing through Community Development Financial Institutions (CDFI).
- Sen. Cortez Masto inquired how the OCC's Project REACH will benefit minority communities. Acting Comptroller Hsu said that it focusses on bringing together various industry stakeholders to gather feedback on homeownership issues in minority communities.
- **Sen. Rapheal Warnock (D-GA)** questioned why banks have kept interest rates paid to customers low, insinuating it is not at parity with interest rates charged for lending activities.

Vice Chair Barr noted that banks do not typically pass through rising interest rates to customers, but added that these have been increasing.

- Sen. Warnock asked who was responsible for the direct deposit processing error that occurred at several large banks earlier this month. Vice Chair Barr suggested that a private clearing house was responsible for the error and that Fed officials have encouraged banks to work with their customers to remedy the issue. Sen. Warnock worried that this may have resulted in consumers facing overdraft fees or insufficient funds fees and asked whether regulators were encouraging banks to waive the fees for affected customers. Witnesses indicated that they believe banks are doing so.
- **Sen. Laphonza Butler (D-CA)** questioned what steps regulators are taking to examine its risk management practices ensuring banks are not willingly or unwillingly closing the accounts of customers due to flawed algorithms. Acting Comptroller Hsu suggested that the issue highlights the need to promote sound risk management practices as technology evolves, noting that the OCC has existing guidance about risk management practices. Chair Gruenberg echoed the importance of addressing unintended consequences of algorithmic lending.
- Sen. Smith wondered if regulators have considered a process to make updating the CRA more frequent. Vice Chair Barr stated that regulators are primarily focused on the implementation of the rule for the time being.
- **Sen. Chris Van Hollen (D-MD)** asked what steps are being taken to encourage banks to adopt FedNow. Vice Chair Barr noted that the Fed is conducting outreach to banks to encourage participation but acknowledged that officials are not expecting full participation at the launch.