21 June 2023

House Financial Services Grills Federal Reserve Chair Powell On Monetary Policy, Inflation, Bank Capital Rules

Powell Says Rate Hikes Likely to Resume; New Capital Rules Would Be Limited to Largest Banks

The House Financial Services Committee today (Wednesday, June 21) held a hearing on "The Federal Reserve's Semi-Annual Monetary Policy Report." The only witness was Federal Reserve Chairman Jerome Powell. Materials from the hearing are posted here.

In his opening statement, Chairman Patrick McHenry (R-NC) announced that in the second week of July after the July Fourth recess, the committee will mark up the majority's digital assets market structure bill and its stablecoins regulation bill. Turning to monetary policy, McHenry said that "after keeping interest rates too low for too long, the Fed was slow to address the problem. In a stunning about-face, the Fed then raised interest rates by 5 percentage points in a little over a year – the fastest spike in modern history. This approach introduced accelerated interest rate risk for which companies, workers, and families across the country were not prepared." McHenry said the bank runs that took place earlier this year "are an example of the consequences. Now we're told these runs represent a systemic threat to the stability of our financial system," while financial institutions also face commercial real estate exposure.

McHenry said that Fed Vice Chair for Supervision Michael Barr's speech on Tuesday (June 20) represented "a new approach to stress tests that I can't quite understand. If reports are accurate, he's pursuing a massive increase in capital standards for medium and large institutions. This would limit banks' ability to lend money, exacerbating the looming credit crunch, and starving families and small businesses of the capital they need." The proposed changes would strain capital markets, he said, "as they will be forced to absorb nearly $1 trillion in new Treasuries. This has led many to believe the Fed may be called on to help, perhaps through its repo or other facilities. Clearly, our economy is in a precarious position. From inflation to a potential credit crunch to substantial balance sheet risks for financial institutions, there is a great deal of uncertainty on the horizon." Because of that., McHenry said, "It's become clear that Congress may need to again examine separating supervision and regulation out of the Fed, and gaining greater oversight and control by Congress and the elected branches."

In her statement, Ranking Member Maxine Waters (D-CA) said she has "cautioned against any approach to monetary policy that ignores the Fed's maximum employment mandate and results in a recession, with millions of people losing their homes and jobs… While we have had strong job growth thus far, experts contend that this trend will not persist with more rate hikes." Waters said that Biden administration and the Fed have made progress against inflation: "In fact, it's been 10 months since the passage of the Inflation Reduction Act and inflation has successfully been cut in half… However, the only way we will fully combat inflation is to address the primary driver of inflation, soaring housing costs." Waters said that "on the heels of almost blowing up our economy by forcing a national default," Republicans are "now picking a fight over a tiny fee of less than 1 percent of total housing costs, ignoring the costs homebuyers are paying with 7 percent interest rates, appraisal fees and title insurance," and "fighting about gas stoves." On new bank capital rules, Waters said the Fed "must act to correct the supervisory and regulatory failures identified by our committee's oversight," noting that committee Democrats had recently introduced 11 bills, "including three of my own, to strengthen the safety and soundness of our banking system and hold executives accountable for their misdeeds," and she noted the Senate Banking Committee's markup today of a bill clawing back compensation from executives of failed banks.

Andy Barr (R-KY), chairman of the Financial Institutions and Monetary Policy Subcommittee, gave a short statement about forthcoming changes to bank capital rules from Fed Vice Chair Barr, saying, "New onerous one-size-fits-all regulation by the Fed needs proper vetting and transparency. I would ask you today to commit to providing us with analysis done so far by the Fed on the vice chair's new proposals. I also respectfully ask that the chairman revisit Section 1107(a)(1) of the Dodd-Frank Act to observe that the vice chairman for supervision is authorized only to develop recommendations for the board and oversee supervision and regulation… The law does not give the vice chair special abilities to unilaterally write his own preferred regulations. It does not say that the vice chair should unilaterally write public-facing book reports on bank failures or results of climate scenario experiments."

In his prepared remarks, Federal Reserve Chairman Jerome Powell said the unemployment rate has "moved up, but remained low in May at 3.7 percent. There are some signs that supply and demand in the labor market are coming into better balance. The labor force participation rate has moved up in recent months, particularly for individuals aged 25 to 54." Powell said that while the jobs-to-workers gap "has narrowed, labor demand still substantially exceeds the supply of available workers. Inflation remains well above our longer run goal of 2 percent." He said that in May, the 2-month change in the consumer price index "came in at 4.0 percent, and the change in the core CPI was 5.3 percent. Inflation has moderated somewhat since the middle of last year. Nonetheless, inflation pressures continue to run high, and the process of getting inflation back down to 2 percent has a long way to go. Despite elevated inflation, longer term inflation expectations appear to remain well anchored…"

Powell said that while the Fed has seen the effects of its tightening on demand in the most interest-rate sensitive sectors of the economy, "It will take time, however, for the full effects of monetary restraint to be realized, especially on inflation." Notably, Powell said that nearly all members of the Fed's Open Markets Committee (FOMC) "expect that it will be appropriate to raise interest rates somewhat further by the end of the year." But at last week's meeting, "we judged it prudent to hold the target range steady to allow the committee to assess additional information and its implications for monetary policy… We will continue to make our decisions meeting by meeting based on the totality of incoming data and their implications for the outlook for economic activity and inflation, as well as the balance of risks. We remain committed to bringing inflation back down to our 2 percent goal."

QUESTIONS

Interest Rates. Chairman McHenry asked Powell if the Fed will continue to raise interest rates later this year. Powell said the FOMC's "participants submitted a personal forecast suggesting that almost all of them thought there would be additional hikes…. the level to which we raise rates is actually a separate question of the speed with which we move. Earlier in the process, speed was very important. It's not very important now. The sense of the summary of economic projections and the decision really is just that, given how far we've come, it may make sense to move rates higher, but to do so at a more moderate pace. That's really it… as you get closer to your destination, as you try to find [it], you slow down even further."

Bank Capital Rules. Several Republicans questioned Powell about potential changes to bank capital standards that have been signaled by Michael Barr, the Fed's vice chair for supervision. Chairman McHenry said that in his Tuesday speech, Barr caused "complete confusion" in describing a new kind of "reverse stress test" for banks, even though Barr himself has said the banking system is sound and well-capitalized. McHenry said there have been "a lot of discussions about the amounts of capital he's talking about, the concern that this is procyclical." He asked how Powell would "interpret" Barr's remarks as someone who sits on the FOMC. Powell said, "There are a significant number of proposals that are kind of in the works. They haven't been finalized, let alone brought to the board yet. And so I can't really get into specific details today… Regulatory proposals go to the board. Every person on the board.. has an obligation to evaluate and vote on those. And I'm one of those people… I think regulation should be transparent and consistent and not too volatile, and particularly as it relates to capital requirements. I do note the central importance of capital. We want banks to be resilient to shocks. We want them to be able to lend in good and bad times. We want in particular the G-SIBs, the eight largest banks, to have very high levels of capital and liquidity. Indeed, we spent years raising those levels over a long period of time."

Powell continued, "And I think there's broad agreement that… that capital is strong. The question there would be what sorts of increases will be justified… it's going to be a question of weighing and balancing those costs." Powell added that "we want to be careful not to regulate the smaller banks to the point where really their business models are challenged for all but the largest banks." McHenry told him the committee "would expect to see a quantitative analysis [from the Fed] of whatever the capital charge is going to be."

French Hill (R-AR) said that bank capital levels had remained high throughout the Covid-19 pandemic, high unemployment and government shutdowns. He asked to what extent Powell and the other Fed governors have been involved in Fed Vice Chair Barr's "holistic review" of capital rules. Powell told him, "We've all been briefed by staff on the proposals. But as I mentioned, they're still somewhat in motion." He said the Fed's Committee on Supervision and Regulation now included Barr, Governor Philip Jefferson and Governor Michelle Bowman. When Hill asked if the U.S.-based G-SIB banks are better capitalized than their global peers in Europe or Asia, Powell said, "We're certainly at or near the top of the league table. I think there are a couple other jurisdictions that also have broadly similar levels of capital strength… I would say our banks are very strongly capitalized, and also competing quite successfully globally outside the United States."

On the Basel III reforms, Hill asked, "Wouldn't it be better if the European banks did a holistic review and actually got their capital up to American standards?" Powell said, "No one's bound by these. But they have agreed to follow the same standards. And I think they're going through the same process we're going through." Hill said capital and supervisory rules should be "consistent over time. And I think that's frustrating here. We see a change in administration, sometimes we see changes in rules, which is, I think, frustrating to the private sector and to market participants."

Later in the hearing, Andy Barr (R-KY) said, "It seems like right now the vice chairman is writing personalized assessments of bank failures and the results of new Fed climate scenario experiments without a whole lot of collaboration with other governors. Given that this new scheme could raise capital requirements by as much as 20 percent in an already well-capitalized banking system, and that the cost of such changes could be $100 billion or more in lost GDP, I am concerned with your testimony that this would only be a virtual vote." When Barr asked if the Fed would provide to the committee any analysis backing changes in bank capital rules, Powell said, "We'll create a public record that supports the proposal, whatever it turns out to be. And the votes will be what they are. And it'll be subject to public comment and analysis."

Young Kim (R-CA) asked Powell if it was prudent to raise capital requirements when small businesses have complained about a lack of access to capital. Powell told her, "With capital standards, it's always a tradeoff. More capital means a more stable, more sound, more resilient banking system. But at the margin, it can also mean a little bit less credit availability and the price of credit can be affected. And there's no perfect way to assess that balance." Kim asked if increasing capital requirements might reduce liquidity in the commercial real estate loan market, where $1.5 trillion in CRE loans will mature in the next three years and work-from-home policies are straining the market. Powell said Kim was right that "a good portion of the [CRE] loans are held in smaller banks. And supervisors are very much engaged with those banks… But there's a playbook for working your way out of these loans."

In questions from Andrew Garbarino (R-NY), Powell said, "any increase above these [bank capital] levels would need to be shown to be justified… I'm going to react to whatever the proposal turns out to be in the end and give it my best assessment… If we put a proposal out this summer, let's say, it'll be quite a while before that proposal is agreed among the agencies and then voted on. And then it will take some years to come into full effect."

When Mike Lawler (R-NY) asked about changes to bank capital rules, Powell said, “We don’t have a proposal in front of us at this point. And I think any increase in capital for the large banks would need to be justified. I don’t know that there will be much in the way of capital increases proposed for banks, other than the very large banks, but we’ll have to see…. I think there will be a proposal that comes to the board sometime this summer… And we’ll obviously share whatever analysis we have.”

Causes of Inflation. When Juan Vargas (D-CA) asked if it was fair to blame the Biden administration for high inflation, given the presence of worse inflation rates elsewhere around the world, Powell said, “People are going to be unpacking the causes of this inflation. Many, many academic careers will be built on new ways to look at this… I just think you see inflation everywhere in the world. There’s a common factor here which has to do with the pandemic. There’s also room for fiscal policy. There’s room for monetary policy in the explanation. And I just think it’s very hard to unpack that. And it’s not up to us to make a judgment about on fiscal policy: we don’t support it, we don’t criticize it, we take it as something that arrives at our front door.”

S. 2155 Leading to a ‘Cultural Shift’ Among Supervisors. Nydia Velazquez (D-NY) noted that Fed Vice Chair Barr’s postmortem report on the bank failures earlier this year found that “while there was regulatory tailoring conducted in response to S. 2155,” a 2018 law providing regulatory relief to certain banks from Dodd-Frank prudential rules, “there was also… a cultural shift at the Fed under the direction of the previous vice chair for supervision, Randy Quarles,” including “pressure to reduce burdens on firms, meet a higher burden of proof for a supervisory conclusion, and a need to accumulate more evidence than in the past.” She asked if Powell was aware of this shift and its impact.

Powell told her, “I think we learned from the Silicon Valley failure and the others that there is going to be a need for stronger supervision and also regulation for banks of that size. And I’m committed to learning the right lessons from this exercise and to forthrightly implementing changes.” On his awareness of “cultural changes” among Fed supervisors, Powell said, “Certainly I was aware that we were trying to avoid excessive regulatory burden. That’s always an appropriate thing…. The way you’re describing it is not what I recall.” Powell said, “I had no part in preparing the [Barr] report. I’m confident that the staff who worked on the report reported accurately what they heard.” Going forward, Powell said, “I think there is a point to be made that there are situations in which we need to be more forceful and more proactive, not in all situations, but in some. In regulation, I think we’re learning that we need to update our thinking around liquidity regulation, which was based on a certain speed of bank runs which now looks to be outdated.”

Fed’s Balance Sheet. Mike Flood (R-NE) told Powell that the Fed’s balance sheet had “seen an alarming increase from around $800 million to today’s $8.3 trillion in assets. While the Fed had managed to offload about $700 billion in assets by August 2019, the economic shocks of the pandemic led the Fed to resume quantitative easing as a form of relief. “The scale involved here, to me, is startling,” Flood said. “How can we avoid an environment where any effort to unwind the… balance sheet is undone any time there’s an economic shock?” Powell said, “This time the balance sheet roll-off is much, much faster than it was back in the first episode. We also know more. We hadn’t grown our balance sheet like that and we hadn’t shrunk it before. Now we have experience with that. So we are moving back down to a level that will be appropriate for our new framework…. It is important that the balance sheet not just grow with every cycle.”

When Frank Lucas (R-OK) asked Powell to describe “the levels of securities that the Fed would look to maintain in the long term,” Powell said, “The way the process works is, securities mature and they roll off our balance sheet… and there’s a cap for mortgage backed securities and also for Treasuries, so it doesn’t get too large. And if you hit that cap month upon month, it works out to roughly a little less than $1 trillion a year in shrinkage, which is a whole lot faster than what we did in the last cycle. But then again, the balance sheet is that much bigger In terms of the level we’re thinking about [which] will allow us to operate our abundant reserves regime with enough of a buffer on top of it so that reserves won’t accidentally become scarce.”

Stablecoins Bill. Ranking Member Waters said the Republicans’ bill regulating digital asset stablecoins “would create 58 different licenses, with federal regulatory approval over only two of the licenses. The remaining 56 licenses can be issued by each state, territory, and D.C. with little or no federal oversight, regulation, and enforcement." She said the proposal "takes state pre-emption into a whole new level," effectively allowing "every state to pre-empt another state… even the Fed would be severely hamstrung in providing any oversight." Waters said she has argued that while "we should allow states to be part of this process, we must have a strong, enforceable federal floor with a role for the Federal Reserve to approve and provide oversight of payment stablecoins issued by non-banks" to protect consumers. She asked if Powell agreed that "it is important for the Fed… to have a chance to approve or decline any state licensed non-bank entity before it starts issuing payment stablecoins nationwide."

Powell told her, "We do see payment stablecoins as a form of money. And in all advanced economies, the ultimate source of credibility in money is the central bank. And we believe that it would be appropriate to have quite a robust federal role in what happens in stablecoins going forward, and that leaving us with a weak role and allowing a lot of private-money creation at the state level would be a mistake." He said he appreciated that the committee had given the Fed an opportunity to be heard on the issue.

Central Bank Digital Currency. Zach Nunn (R-IA) said, "It's been brought up by a number of my banks back home relating to a central-bank digital currency or any federal issued coin… If the Fed were to offer direct individual accounts to citizens, wouldn't this be a direct threat to the financial privacy of many Americans?" Powell told him, "It's not something we support. We would not support… accounts at the Federal Reserve [held] by individuals… If we were to support, at some point in the future, a CDBC, it would be one that we're intermediated through the banking system and not directly at the Fed.

Asset Managers Controlling Banks. Bill Huizenga (R-MI) said he wanted to follow up on a previous exchange he had with Powell about the Fed's legal opinions outlining how asset managers can operate without being deemed "in control" of a regular bank or a bank holding company. "It's no secret that this percentage of ownership held by asset managers will constantly fluctuate as shares are purchased and sold on a on a daily basis," Huizenga said. "Someone must ensure asset managers are complying with not only these opinion letters… but also with the statutory and regulatory framework that the letter outlined." He asked if the Fed taking any steps to assess or monitor whether Vanguard, BlackRock and others are complying with commitments they made in November 2019 and December 2020. After conferring with staff, Powell said, "We're broadly monitoring the situation. I don't know that we have a particular focus on the asset managers." He said the Fed's General Counsel's Office is monitoring compliance with the letters, adding "We don't have any reason to think that they're not in compliance, by the way… We'll check, but I think we know what we're going to find." Huizenga said he would follow up with a letter to including more detailed questions on this question.

If you have questions, please contact Will Heyniger or Bob Schellhas at (202) 293-7474 or wcey@ey.com.

Links embedded in this alert:

- Hearing page - https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=408872
- McHenry statement - https://financialservices.house.gov/news/documentsingle.aspx?DocumentID=408878
- Waters statement - https://democrats-financialservices.house.gov/news/documentsingle.aspx?DocumentID=410578
- Powell statement - https://docs.house.gov/meetings/BA/BA00/20230621/116127/HHRG-118-BA00-Wstate-PowellJ-20230621.pdf