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Senate Banking Committee Grills Banking Regulators On Basel III, Bank Supervision, FDIC Harassment Scandal

Dems, Republicans Concerned that Capital Proposal May Affect Small Businesses, Mortgages

The Senate Banking Committee today (Tuesday, November 14) held a hearing on "Oversight of Financial Regulators: Protecting Main Street Not Wall Street." Materials from the hearing are posted here. The witnesses were the four prudential banking regulators:

- Michael Barr, Vice Chair For Supervision, Federal Reserve
- Martin Gruenberg, Chair, Federal Deposit Insurance Corporation
- Michael Hsu, Acting Comptroller, Office of the Comptroller of the Currency
- Todd Harper, Chair, National Credit Union Administration

Statements

In his opening statement, Chairman Sherrod Brown (D-OH) said the collapse of Silicon Valley Bank and Signature Bank earlier this year happened even though "your agencies did identify the risks at these institutions, and you called them out. But that failed to result in real action from the banks' management to actually do anything to mitigate those risks." He said those lessons should be "turned into action," including improving bank supervision, holding bank executives accountable for risky behavior and strengthening rules so banks have adequate capital during crises. Brown urged Congress to pass the RECOUP Act (S. 2190) targeting negligent bank executives, which the committee approved in June but has not yet come to the Senate floor. Brown said consolidation has left "just a handful of the largest banks" holding $14.75 trillion in assets, "more than half the nation's GDP," which he said meant less choice for consumers in the banking marketplace and customers being driven "out of the banking system, toward high-fee, predatory non-bank financial companies, like check cashers, payday lenders and fintech apps."

Brown said he was pleased to see the regulators come together to propose an overhaul of the 1977 Community Reinvestment Act rules, which required updating after the arrival of the internet and mobile phone technology. He called the CRA modernization "critical to ensuring that banks are fulfilling the promise of the [CRA] by serving and investing in their communities." He also mentioned the joint proposal to implement new bank capital standards under the Basel III "endgame." The capital proposal "recognizes the systemic importance of banks that are large, just not quite as massive as the Wall Street megabanks -- banks like Silicon Valley, before it collapsed. As we saw this spring, mismanagement and risky bets at those banks can still threaten the financial system…" Brown said the proposal has been "relentlessly attacked… with the same old, tired arguments: Compliance will cost too much, we won't be competitive, we already have enough capital, we won't be able to lend to small business. We've heard it all before. Let's be clear: The largest banks will need to redirect a tiny fraction of their enormous profits over a period of several years to get to the new capital levels. Every single bank that would be impacted by this proposal has the capacity to comply with the new capital levels and extend credit to small businesses and working-class and middle class families – all while remaining wildly profitable."

Brown closed by noting the money Hamas was able to raise to attack Israel, and asked the regulators "to be vigilant when it comes to all the risks associated with illicit finance and the banking and credit union system."

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In his statement, Sen. Mike Rounds (R-SD), substituting for Ranking Member Tim Scott (R-SC), noted the busy pace of rulemaking by the regulators, saying that "in the last few months alone, your agencies have put forth or finalized regulations and guidance that represent the biggest rewrite of banking regulations since the passage of Dodd-Frank," including regulations on bank capital, long-term debt resolution planning, the Community Reinvestment Act, debit card interchange fees and climate risk management. "These proposals collectively amount to thousands of pages, with the [CRA] alone standing at almost 1,500 pages, nearly double the length of the entire Dodd-Frank Act." He said he and his Republican colleagues found it "concerning" that the regulators "failed to consider how these rules will impact banks and businesses of all sizes, ultimately harming the American people… the cost of this rulemaking onslaught will ultimately be borne by small businesses and wage earners who are on a fixed income and rely on their local banks for loans and access to credit." Rounds mentioned a letter to the regulators criticizing the Basel III bank capital rule proposal, led by Ranking Member Scott and signed by 38 other Republican senators. Rounds said that because of the "the scale and breadth of each of these proposals, I would support having a hearing dedicated to each and every one to understand the impacts that they will have."

Rounds said the regulators' mandate that banks engage in climate scenario analysis is an example of "regulators operating well outside the mandates given to them by Congress… banks are being told that they will be supervised to make sure they have such programs in place… Not a single bank has failed because they have failed to account for climate risk." He said that in their desire to "worship at the altar of climate change," regulators are "sacrificing the economic well-being and capabilities of hard-working Americans. None of these regulations exist in a vacuum. And collectively, these rules paint a devastating picture for consumers, especially low- and moderate-income communities."

Federal Reserve Vice Chair of Supervision Michael Barr said that during the financial crisis, "the effects of woefully undercapitalized banks had a devastating impact on our economy, resulting in the worst recession since the Great Depression." Barr said that it took six years for employment to recover, while "more than 10 million people fell into poverty, and 6 million families lost their homes to foreclosure. And these costs occurred even with substantial support from the government." The Fed then adopted a set of capital reforms that "greatly strengthened our banking system…" But he said that while capital ratios at the largest banks have more than doubled since 2009, "the U.S. banking system has grown from $12 trillion in assets in 2009 to $23 trillion today….The reforms to the capital requirement framework that the banking agencies proposed earlier this year are the last stage of these post-crisis capital reforms."

Barr said the proposed rules "would apply to banks with at least $100 billion in assets, fewer than 40 of the over 4,000 banks in our banking system. Community banks would not be affected by this proposal…. The increases would be the most substantial for the largest and most complex banks, the G-SIBS, and the bulk of the estimated rise is attributed to trading and other non-lending activities." Barr noted that regulators are giving the public "nearly six months to review the proposal, so they can provide meaningful comments." He mentioned the long-term debt proposal the Fed released in August, "which would expand long-term debt and resolution planning requirements to additional large banks," with the goal of "increasing the potential options available for resolving depository institutions and to enhance overall financial stability," with requirements "calibrated at a lower level relative to the largest and most complex banks."

FDIC Chairman Martin Gruenberg said the banking industry "continues to face significant downside risks from the effects of inflation, rising market interest rates, and geopolitical uncertainty. The economic outlook remains uncertain despite relatively solid growth and low unemployment so far this year. These risks could cause credit quality and profitability to weaken, loan growth to slow, provision expenses to rise, and liquidity to become more constrained." He said commercial real estate loan portfolios, "particularly loans backed by office properties, face challenges when loans mature, as demand for office space remains weak." Gruenberg said banks have "tightened underwriting standards over the past year across a range of household and business loans, and they may continue to tighten further."

Gruenberg said the regulators' joint Basel III bank capital proposal "is a continuation of the federal banking agencies' efforts to revise the regulatory capital framework for our nation's largest most systemic financial institutions following

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the global financial crisis of 2008. Notably, it does not apply to community banks." He said the proposal "would make important changes to address capital weaknesses identified in the 2008 financial crisis and enhance the resilience and stability of the banking system." Gruenberg said the FDIC is also undertaking "a comprehensive review of its supervision program, with a focus on interest rate risk, unrealized losses on securities and loans, uninsured deposits, rapid growth, and the need (when necessary) to escalate supervisory matters and take actions to compel compliance."

Gruenberg closed by saying he was "personally disturbed and deeply troubled" by the *Wall Street Journal*'s report this week on incidents of sexual harassment and misbehavior at the FDIC. He said the FDIC is "conducting a comprehensive review, including engaging an independent third party, to ensure that we understand the nature of these issues and take all appropriate actions to address them."

OCC Comptroller Michael Hsu said that in response to increasing risks in commercial real estate, the OCC and other regulators published "a policy statement on prudent commercial real estate loan accommodations and workouts, which updates existing interagency supervisory guidance on CRE loan workouts and reminds banks to work prudently and constructively with creditworthy borrowers during times of financial stress." Hsu said the final Community Reinvestment Act rules "modernize the CRA by recognizing banking activities that take place beyond physical branches and ATMs being significantly more data-driven and objective and providing for greater transparency," and addresses "concerns related to 'grade inflation' inflation in CRA ratings by better incentivizing CRA lending and investments in [low- and moderate-income] communities. The rule tailors evaluations and data collections to bank size so that community banks do not have additional burdens."

Hsu touched upon the OCC's interagency guidance on third-party relationship risk management, and "the considerable interest by the banking industry in artificial intelligence." On digital assets, he said "attention is shifting from crypto to the tokenization of real-world assets and liabilities. In contrast, a crypto tokenization is driven by solving real-world settlement problems and can be developed in a safe, sound and fair manner." On the principles for climate-related financial risk management for large banks recently approved by the OCC, Fed and FDIC, Hsu said the principles "do not tell bankers what customers or businesses they may or may not bank, but clarify how large banks can maintain effective risk management and keep their balance sheets sound, so they can continue to be a source of strength to their customers and communities through a range of severe weather scenarios."

QUESTIONS

FDIC Sexual Harassment Allegations

Chairman Brown noted the reported allegations of "pervasive sexual harassment, misogyny and lack of accountability" at the FDIC creating "a toxic environment for female bank examiners." He said the FDIC's own inspector general had highlighted these problems more than three years ago. Gruenberg repeated that the *Wall Street Journal* story was "deeply disturbing and troubling…. it's quite clear that we've had employees at the FDIC subjected to horrendous experiences that simply are unacceptable, and can't be tolerated." To address the allegations, he said the FDIC has engaged "an independent third party to do an agency-wide review both of Washington… and our regional and field offices, to inform us on the nature of the challenge here and how we may be able to address it effectively." He said changes to policies and procedures were coming, and that it would be management's responsibility to "give employees the sense of confidence that they can actually utilize these mechanisms to protect themselves if they're treated improperly, and also to have processes to hold individuals accountable who engage in misconduct."

Sen. Rounds asked Gruenberg if he had been aware of any of these allegations before they were reported on Monday; he said he was not. When Rounds asked if any future reporting on the scandal would mention Gruenberg personally, he said he didn't think so.

Cynthia Lummis (R-WY) noted that she had previously criticized Gruenberg for working with CFPB Director Rohit Chopra to "oust" the previous FDIC chair, Jelena McWilliams, in December 2021. "She was a highly qualified woman.

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So you ousted her and now you're the chairman. You've been there for 18 years at an agency that now has been exposed as having a hostile work environment towards women, that women are denied opportunities for advancement… so this disgusting behavior can continue among your colleagues, people who work for you. We know that some of the employees who harassed women at the FDIC found employment at other agencies -- great, send them elsewhere instead of ousting them from the system." Gruenberg told her that the earlier inspector general report "had 15 recommendations, all of which the agency resolved to the satisfaction of the IG. Did it change the culture? No, I think it probably didn't. And I think candidly, that's the underlying issue here." Lummis said, "If that happened in my office, I would be doing a lot more than looking at it. That's so far beyond the pale of what would be acceptable human behavior anywhere, let alone in what is supposed to be a respected federal agency, that just looking at it, or having a third party come in and evaluate that, is bureaucratic mumbo-jumbo for 'We're doing nothing, and nothing is going to improve'… I'm just going to say you sure as heck better do something about this."

Basel III Endgame Bank Capital Proposal

When Chairman Brown asked the Fed's Barr why the bank capital proposal was needed, Barr said the new standards would only apply to "to the largest banks, fewer than 40 out of the more than 4,000" U.S. banks. Barr said the proposal "focuses on having stronger capital rules for trading and other non-lending activities where banks have had large losses," while the changes to credit and operational credit risk "are very small compared to the current rules. Overall, the proposal makes our capitalist system more consistent, more transparent, and more-risk sensitive." But he said the Fed "recognizes that the rule may not appropriately capture all risks," and the Fed would take all comments seriously "to improve the rule going forward."

Sen. Rounds engaged in a long exchange with Barr about the "holistic review" of existing capital rules the Fed's Board of Governors conducted before issuing its proposal. This included how much time the Board had for the review ("an extensive period of time," Barr said) and whether the review would be released to the public or to the committee (Barr said the review was internal and had been conducted by his predecessor as vice chair for supervision, Randal Quarles). Barr often appeared to be referring to how the Board had reviewed the actual draft proposal before its release, not the previous "holistic review" of existing rules, saying, "There is not a document that is the holistic review" when Rounds pressed him for scenarios in which that review could be released. Barr said the proposed rule itself "contains a detailed written analysis" of both the capital proposal and the long-term debt proposal.

Thom Tillis (R-NC) said the Fed's Board of Governors "clearly… at this point does not have consensus" on the capital proposal, noting criticisms made by Vice Chair Philip Jefferson and Chairman Jerome Powell. He asked Barr if the Fed would still move forward on the proposal without a consensus on the Board. Barr told Tillis he "would like to get broad consensus. I don't know whether I'll be able to get full consensus… A broad consensus would be that most of the board believes that this is an appropriate step." Barr said most of the actions the Fed Board has taken over the last 15 months have been "full consensus items" backed by a strong majority. Tillis said it seemed "odd" to him that critics have blamed S. 2155 (the Economic Growth, Regulatory Relief and Consumer Protection Act, a bank-deregulation bill enacted in 2018) for the failure of SVB and Signature, even though the same law gave the Fed the "optionality" of revising capital rules upward on mid-size banks if necessary – authority the Fed is now using to propose its new rules.

Katie Britt (R-AL) also asked about the amount of time Barr had allowed the Fed's Board of Governors to review the draft capital rules before they were proposed. Britt noted that as late as two weeks before the Basel III proposal was released, Fed Governor Lisa Cook had testified to the committee that she had not reviewed it. Barr told her that "every governor was given the opportunity to meet with staff and to be briefed on the proposal and in detail."

Britt said the capital proposal "assumes that banks are significantly undercapitalized for operational risks, yet cites no evidence to support this assumption. Not only are these risks already accounted for in stress testing, but the new standardized approach is not tailored to the varying business models of various banks." She asked Barr if the Fed had analyzed the potential impacts of the proposed operational risk requirements, and their effect on the availability of mortgages for small businesses, small-business loans, and retail credit. Barr said the proposal's analysis covers those

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items, but he said its new language on credit risk and operational risk "is very, very small in relation to current rules." Britt said that "over the last several months, we've seen a wholesale attempt to fundamentally alter our banking system. Not only do your agency's recent proposed rules undermine the proven strength of our banking sector, but they risk making it weaker… I have spoken directly with dozens of banks and credit unions of all sizes; it is clear that your proposed rules are so wide-reaching that they leave no financial institution untouched. Even more concerning, the lack of effort from you as regulators to engage these institutions is startling, along with the absence of any stated rationale for making these key decisions."

Britt also asked Barr if the Fed may grant an extension of the comment period for the capital proposal's language on long-term debt and resolution planning. Barr said that was "a pretty straightforward rule compared to the Basel proposal, but if there are concerns… we're happy to consider such matters."

Jon Tester (D-MT) said that while the proposed capital rules "don't affect any banks in Montana, they do affect the big guys that affect Montana. And if you look at our system, it has worked incredibly well, especially when you compare it to what folks in other countries have access to…. I will just tell you that from a small-business standpoint, if this rule doesn't work, it's going to raise hell with the economy of my state… I have also had a conversation about how potentially this could push activities into the nonbank sector. That's not regulated." Barr told him, "We expect most comments to come in in mid-January. But we already have heard, in the public discourse, a concern in this regard [for consumers and small businesses]. And we're paying very, very close attention to that… The way we've analyzed this rule, we do not believe that this will have significant negative effects on small businesses. The credit provisions in the rule are quite similar to existing binding provisions."

Mark Warner (D-VA) noted that some of the regulators had argued that "a number of the major G-SIBs are already meeting those new capital requirements. But I do feel like this could be the moment of a perfect storm, where you've got the challenges around rising interest rates; you've got quantitative tightening; you have the challenge… that this may actually push more lending outside the regulatory perimeter. On top of that, we've got a lot of geopolitical risks… I worry a little bit about the schedule, that the comments may not come in until after the rule gets close to finalization."

Elizabeth Warren (D-MA) led Barr through a series of questions designed to show that the bank capital proposal would affect only the largest banks. "Wall Street executives don't want to have to put up more capital. Higher capital standards make banks safer, but they also nip into profits and make it harder for CEOs to pull in multimillion-dollar bonuses. So the CEOs and their big-time investors have hired an army of lobbyists to stop the new capital standards from ever seeing the light of day… The lobbyists for the big bank CEOs claim that stronger capital standards will really hurt lending, which just isn't true. But where are the lobbyists for the American people? Remember, if we don't get tougher capital requirements, the next time there's a problem, it's taxpayers who will be forced to pick up the slack. As I read the new capital standards, they apply, for example, to trading in risky financial products like derivatives, they also apply to things like operational risks for fraud or processing errors…. The Fed is focused with surgical precision on raising capital standards for the 1 percent of banks that pose the biggest risk to the economy, and on the specific banking activities that pose substantial risks… I understand that the lobbyists for that 1 percent of banks don't like it, but we don't work for them. The proposed rule is now 15 years overdue. I urge you to finalize it and put strong capital requirements in place as soon as possible."

Robert Menendez (D-NJ) expressed concern that the Urban Institute's analysis of the capital proposal "further indicates that the proposal will disproportionately increase costs for Black, Hispanic and low- and moderate-income borrowers… I would encourage you to ensure that we keep enough capital flowing so hard-working borrowers can become homeowners."

Post-SVB Bank Supervision

Chairman Brown asked the regulators how their approach to supervision has changed since the bank failures earlier this year. The OCC's Hsu told him that none of the bank failures year were national banks; "that being said, we've

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carefully reviewed the postmortems of those and identified areas where we can strengthen the agility and the speed with which we supervise, and the intensity of our supervision." The NCUA's Harper said they had increased assessments of liquidity within individual credit unions and were looking closely at commercial real estate, but he noted that 90 percent of credit union deposits are insured. The FDIC's Gruenberg said the FDIC has issued new guidance for examiners on managing interest rate risk, "concentrations of unrealized losses on loans and securities, uninsured deposit concentrations, rapid growth, and the need -- when necessary -- to escalate matters in regard to an institution and to compel compliance if an institution is not responsive." Barr said the Fed has been focused on "improving the speed, force and agility of supervision as appropriate for the institutions we supervise" and on "ensuring that we have appropriately intensified our supervision of the highest-risk firms," while making sure that supervisory findings and enforcement actions are issued in a timely way, giving bank management and boards "incentives to remediate deficiencies quickly."

'Synthetic Risk Transfers'

Jack Reed (D-RI) noted that the Fed has recently approved synthetic risk transfers, in which "banks use derivatives to reduce their capital requirements by shifting the risk of losses onto private equity funds and hedge funds." Reed said use of the word "synthetic" has made him nervous since the financial crisis, and he asked Barr what risks these transactions pose to financial stability and what "guardrails" would be appropriate for them. Barr said such transactions "are different from [those] that we permit by rule under the existing authorities to offset credit risks that banks might face. We wanted to take a careful and cautious approach with respect to these transactions, so we have approved them on a case-by-case basis subject to limitations… If they perform as intended, then they might be more generally available. If we see risks arising in those transactions, then we would limit their use for capital mitigation."

Reed asked how much "visibility" the Fed has into the private equity and hedge funds involved in these transactions; Barr said the Fed had strong visibility into the bank's side of the transaction, but "much less" into the PE and hedge fund side. Reed warned that it's possible one of the PE firms "could be undercapitalized or mismanaged, and the transactions would fail." Barr said that in the transactions the Fed approved, "the cash is actually provided up-front to the bank, and then it diminishes over time as the credit continues to perform." Gruenberg told Reed that such transfers pose "considerable uncertainty, and we need to approach it with great caution and attention." The OCC's Hsu said such transfers "require heightened attention, especially when risk transfer is thought of as risk elimination, which it is not. However, when done appropriately in a safe and sound manner with controls, it can help to be part of an effective risk management program."

Banks Partnering with Nonbanks

Sen. Reed asked about "rent-a-bank" situations in which banks partner with nonbanks to provide deposits and loans, which he said could "facilitate evasion of state usury limits" and other consumer protections. The FDIC's Gruenberg told him such third-party relationships "carry a lot of risk," because the bank is "accountable" for what the nonbank does. "The challenge here… is the ability of states to export their interest rates to other states, and circumvent usury laws," he said. The OCC's Hsu said "predatory lending has no place in the national banking system, whether done directly by banks, or in partnership with fintechs, and we've made sure of that."

Possible Leak of Confidential Supervisory Data

Sen. Tillis said he had written a letter to the Fed in September seeking information about a news story that reported "seven different financial institutions" had received a "dramatically increased" number of Matters Requiring Immediate Attention, or MRIAs, from their supervisors. "I can't imagine that those seven banks just went to the press and said, 'Hey, we're getting a lot more…' That sounds like someone from the Fed or the supervisor had to have leaked confidential supervisory information." He asked Barr if an investigation is under way "to determine how that information got out." Barr said he was also upset by the article: "I didn't think that it was appropriate. We do have strict rules on confidential supervisory information. I'm not aware of the source of that article, but I do find it upsetting." Tillis said, "Somebody needs to be tracked down and terminated for doing it."

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Encouraging Use of the Discount Window

Sen. Warner said that "back when the Federal Reserve was created, we created the discount window. And in many cases, usage of that by banks could have potentially alleviated this crisis, particularly SVB -- it was clear they didn't even know how to do it." He said that while many banks might choose to go to Federal Home Loan Banks, "that's just not a good enough alternative... Should we go beyond this encouragement of using the discount window, and actually require some level of mandating how you do that?" Warner asked "how much further could we go" to make sure the discount window is used more to relieve liquidity issues.

Barr told Warner, "We really are encouraging banks to use the discount window as well as the Bank Term Funding Program that we set up during the March banking stress. Both of those kinds of programs are really essential for providing liquidity to the system. And use of the discount window and the BTFP really calmed the situation down in March, and prevented... massive liquidity flows. We're looking broadly at our liquidity rules to see whether we might make improvements. We are looking at the kinds of issues you raised with respect to making sure that banks are prepared to use the discount window: they have good contingency funding plans, they test those plans, and they use the discount window." Gruenberg called the discount window "a reliable source of liquidity. For short-term liquidity under stress, we want to try to address any stigma attached to it. A prepayment management of collateral and timely management of collateral to access the window is critical. And the notion that you raised about either prepositioning collateral, or requiring some periodic use to demonstrate the capability to utilize the discount window, is something we might take."

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://www.banking.senate.gov/hearings/oversight-of-financial-regulators-protecting-main-street-not-wall-street
- Chairman Brown's opening statement - https://www.banking.senate.gov/download/brown-statement-11-14-23
- RECOUP Act summary - https://www.banking.senate.gov/imo/media/doc/recoup_act_one-pager_-_2456869.pdf
- Sen. Rounds' statement - https://www.rounds.senate.gov/newsroom/press-releases/rounds-slams-burdensome-regulations-in-opening-remarks-at-banking-hearing-emphasizes-negative-impact-on-local-communities
- Senate GOP letter on Basel III bank capital proposal - https://www.banking.senate.gov/imo/media/doc/basel_iii_banking_gop_letter.pdf
- Fed's Barr testimony - https://www.banking.senate.gov/imo/media/doc/barr_testimony_11-14-23.pdf
- FDIC's Gruenberg testimony - https://www.banking.senate.gov/imo/media/doc/gruenberg_testimony_11-14-23.pdf
- *Wall Street Journal* story on sexual harassment allegations at FDIC - https://www.wsj.com/us-news/fdic-toxic-atmosphere-strip-clubs-lewd-photos-boozy-hotel-12c89da7
- Comptroller Hsu's testimony - https://www.banking.senate.gov/imo/media/doc/hsu_testimony_11-14-23.pdf

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