Center for American Progress

Tailoring Banking Regulations to Accelerate the Next Crisis

By Gregg Gelzinis May 16, 2019

When President Donald Trump took office, he promised to do "a big number"[1] on the Dodd-Frank Wall Street Reform and Consumer Protection Act. He also promised to give a "major haircut"[2] to this centerpiece of the U.S. response to the 2007–2008 financial crisis. Beyond signing into law the Economic Growth, Regulatory Relief, and Consumer Protection Act[3]—a 2018 bill that rolled back key pieces of Dodd-Frank—Trump has sought to keep his promise by appointing financial regulators intent on watering down major elements of financial reform.

These banking regulators—at the Federal Reserve Board of Governors, Office of the Comptroller of the Currency (OCC), and Federal Deposit Insurance Corp. (FDIC)—have proposed or finalized a host of changes to the big-bank safeguards put in place following the 2007–2008 financial crisis. The common refrain from these regulators is that the changes should be appropriately characterized as a commonsense "tailoring" of regulation. In fact, Federal Reserve Vice Chair for Supervision Randal Quarles used the words "tailor" or "tailoring" a staggering 25 times in a single related policy speech.[4] The phrase implies the changes are neutral tweaks. When analyzing them collectively, however, it becomes very clear that they are not.

The regulatory actions, when taken together, amount to substantial big-bank deregulation and severely increase the fragility of the financial system. Some changes implement provisions to the Dodd-Frank rollback bill in concerning ways, while others go far beyond the law. The U.S. economy and taxpayers are significantly more exposed to the risks of another crash today than they were two years ago.

Living wills

The most recent deregulatory proposal, issued by the Fed and FDIC, targets banks' living wills submissions.[5] These biennial submissions to the two regulators provide a roadmap for how the bank would be wound down in an orderly fashion if it failed. If the Fed and FDIC find deficiencies upon reviewing the resolution plans, banks must rectify them in a timely manner or face more stringent regulatory safeguards.

Regulators even have the authority to break up firms if the living wills are repeatedly deficient. During the 2007–2008 financial crisis, policymakers did not have the tools or necessary information to liquidate "too big to fail" banks and shadow banks;[6] the only options were catastrophic bankruptcies or taxpayer bailouts. Through the living wills process, banks have simplified their legal structures and have better positioned capital and liquidity throughout their firms to facilitate an orderly failure, if necessary.[7]

The latest proposed rule from the Fed and FDIC would eliminate the living wills requirement for banks with between $100 billion and $250 billion in assets.[8] If a bank of this size failed, however, it would represent one of the largest bank failures in the history of the United States.[9] These are not small banks. Absent a credible living will, regulators during the next crisis would be far more likely to resort to massive bank mergers with taxpayer assistance. The proposed rule would also decrease the frequency of submissions for all banks with more than $250 billion in assets—including the largest Wall Street banks.

Initially, living wills submissions were required annually, but over time, the process shifted to the current biennial timetable. Under the proposal, banks with between $250 billion and $700 billion in assets, as well as the U.S. operations of massive foreign banks such as Deutsche Bank, would submit full plans only once every six years. The largest Wall Street banks—the eight global systemically important banks (G-SIBs)—would be required to submit a full living will once every four years. The proposal would also require banks to submit miniresolution plans halfway between full submissions. Moreover, the proposal includes a troubling provision regarding waivers for the living wills submissions: Banks can ask the Fed and FDIC to waive certain elements of the resolution plan, and only one of the two regulators has to agree to the waiver for it to be granted.[10] Put another way, if one agency rejects the waiver and one agency agrees to it, it is granted. A tie goes to the big banks, not taxpayers.

Moreover, the FDIC has begun the rule-making process for weakening the resolution plan requirements for taxpayer-insured, deposit-taking subsidiaries, also known as insured depository institutions (IDI).[11] These IDI plans are separate from the living wills. The living wills submissions cover the resolution of the entire banking conglomerate, while the IDI plans only cover the taxpayer-insured commercial banking subsidiaries.[12]

Less stringent living wills requirements decrease the likelihood of orderly failures and increase the chances that policymakers will again resort to taxpayer bailouts during the next crash.[13]

Bank capital

The lack of strong equity-capital buffers was one of the key vulnerabilities in the banking system before the financial crisis.[14] Bank capital is essentially a cushion of funding, which, unlike debt, does not need to be repaid and can therefore absorb losses. In the past decade, postcrisis efforts have substantially strengthened bank capital levels. But research shows there is more work to be done.[15] Instead of building on this progress, Trump-appointed regulators have taken steps to lower equity buffers at the largest banks in the country.

The Fed and OCC issued a proposal that would lower the capital buffers at the taxpayer-backed commercial banking units of the eight Wall Street G-SIBs by $121 billion, or 20 percent.[16] Additionally, the proposal could lead to an $86 billion reduction over time at their holding companies, as banks seek to optimize their other capital requirements.[17]

Furthermore, regulators issued a proposal that would allow banks with between $250 billion and $700 billion in assets to opt out of a new capital requirement called the accumulated other comprehensive income (AOCI) capital treatment. The AOCI requirement ensures that banks' capital levels reflect their up-to-date losses on certain assets.[18] During the crisis, banks did not have to immediately write down their capital levels when the values of certain securities were deteriorating. This treatment painted an unrealistically rosy picture of the loss-absorbing capacity at banks.[19]

Risks tend to build under the surface during strong economic times. For centuries, a damaging cycle of booms and busts has been driven, in part, by financial deregulation during positive economic times. Yet, despite clear evidence that the economy is moving toward the end of the business cycle, the Fed refused in March to activate a postcrisis capital buffer that was created to improve the loss-absorbing capacity at the largest banks during economic booms.[20] With elevated asset prices and sky-high corporate debt levels, the countercyclical capital buffer, as it is called, was designed to be activated in moments like this.[21]

These actions on bank capital leave the core banking system more vulnerable to another crash.[22]

Stress testing

The Fed proposed or finalized several changes to the bank stress-testing regime that would fundamentally weaken this important regulatory tool. Stress tests are meant to ensure banks have sufficient capital buffers to handle a severe financial shock and economic downturn, while still serving the credit needs of the real economy.[23] The first stress tests were conducted in 2009 and have played an important role in improving both the capital levels and internal capital planning capabilities at big banks.

First, the Fed proposed watering down certain assumptions used in the stress tests, which would make the tests less rigorous.[24] Banks would have to prefund only four quarters of their planned dividends instead of nine quarters of planned dividends and share repurchases. Moreover, the Fed would assume that bank balance sheets do not grow during the stress-testing time horizon, further limiting the amount of capital required by the tests.[25]

Second, the Fed proposed removing the supplementary leverage ratio (SLR)—an important capital requirement—from the stress tests.[26] The SLR does not take the riskiness of a bank's assets into account and serves as a complement to the risk-weighted capital requirements that also apply to banks.[27] This is one of the measures that prevented some Wall Street banks from initially passing the 2018 stress tests, and its removal certainly makes the tests less challenging for big banks.[28] Fed Vice Chair for Supervision Quarles even suggested the Fed may remove all leverage measures from the tests.[29] Third, the Fed is now publicly releasing detailed information on its own internal models used in the stress tests.[30] Providing this information to banks helps them game the tests and could lead to correlated risk taking, as banks adapt their balance sheets to limit their stress-testing losses based on the Fed's models. Releasing this information is akin to giving banks the tests in advance. The stress tests are supposed to shock bank balance sheets and test them in a robust manner. This change turns stress testing into a simple open book exam.

Fourth, the Fed eliminated its qualitative objection in the stress tests.[31] Under the qualitative objection, the Fed could stop big-bank shareholder distributions if the firms had deficiencies in their internal capital planning processes. The threat of this powerful tool is a major reason why banks have improved their internal controls, governance, and capabilities around capital planning.[32] And this decision runs counter to the Fed's purported desire to provide more "transparency" surrounding the tests.[33] In reality, the Fed is only advancing transparency when it serves banks. Finally, the Fed proposed reducing the frequency of stress tests from annually to biennially for banks with $100 billion to $250 billion in assets, as well as for massive foreign banks with U.S. operations of that size.[34]

These changes would make the stress tests easier for banks and reduce the utility of this vital tool. As a result, bank balance sheets and internal capabilities would be less resilient to a financial shock.

Liquidity rules

The Fed, FDIC, and OCC issued a proposed rule that would substantially reduce the liquidity requirements for banks with between $100 billion and $700 billion in assets.[35] Liquidity requirements are important safeguards to limit the chances and effects of damaging bank runs.[36] Banks should have the liquid assets necessary to quickly meet cash demands from creditors and counterparties during a period of stress. If a bank's assets are tied up in illiquid, hard-to-sell assets, it may have to sell those assets at fire-sale prices to generate cash. Fire sales harm the bank's financial position and can have dangerous ripple effects on other firms and markets.

The regulators' proposed rule would entirely remove two important postcrisis liquidity requirements—the liquidity coverage ratio and the net stable funding ratio—for banks with between $100 billion and $250 billion in assets and would reduce these requirements by 15 percent to 30 percent for banks with between $250 billion and $700 billion in assets.[37] These changes would reduce the liquidity buffers at affected banks by $77 billion.[38]

Lower liquidity buffers at some of the largest banks in the country make it more likely that banks will resort to destructive fire sales in times of stress and increase the chances that creditors will run in the first place.[39]

Volcker rule

The five financial regulatory agencies with jurisdiction over the Volcker rule issued a proposed rule that would invite more risk into the banking system.[40] The Volcker rule prevents bank holding companies and their affiliates from making risky proprietary bets and from investing in hedge funds and private equity funds. Engaging in trading activity for the bank's own profit is highly risky and belongs outside of the core banking system, which is backed by taxpayers.

The proposal allows banks essentially to regulate their own adherence to a central provision in the Volcker rule, weakens definitions, removes certain restrictions for foreign banks, increases the size of existing loopholes, and creates new ones.[41] Despite a stated desire to advance data-driven policy, the proposal offers no data or evidence justifying the rollbacks. And recent reporting suggests Wall Street lobbying efforts have successfully convinced the regulators to make even more severe changes and reverse course on elements of the proposal banks opposed.[42]

Conclusion

Regulators call their actions regulatory "tailoring." But these actions move in one direction—weakening the big-bank regulations put in place following the financial crisis. It is deregulation, plain and simple. And the actions documented here do not cover additional recent measures, including lighter bank supervision,[43] regulatory rollbacks made by Congress that did not provide much discretion to regulators,[44] deregulation in the shadow banking sector,[45] and the dismantling of key consumer financial protections.[46]

These rules have been largely proposed or finalized on a one-by-one basis, making it easy to lose sight of the big picture. But the rules interact with and exacerbate one another, and the collective impact of these actions should trouble all Americans. Regulators are making stress in the financial system more likely while limiting the ability for banks to safely handle that stress. Regulators won't bear the burden of the next crash. That tab will be picked up, as always, by taxpayers.

Endnotes

1 Glenn Thrush, "Trump Vows to Dismantle Dodd-Frank 'Disaster'," *The New York Times*, January 30, 2017, available at https://www.nytimes.com/2017/01/30/us/politics/trump-dodd-frank-regulations.html?_r=0.

2 Jessica Dye, "Trump vows 'major haircut' for Dodd-Frank," *Financial Times*, April 4, 2017, available at https://www.ft.com/content/fb08a355-f7fc-3021-8c92-d94af9a2f35b.

3 Economic Growth, Regulatory Relief, and Consumer Protection Act, Public Law 115-174, 115th Cong., 2nd sess. (May 24, 2018), available at https://www.congress.gov/bill/115th-congress/senate-bill/2155.

4 Randal K. Quarles, "Getting It Right: Factors for Tailoring Supervision and Regulation of Large Financial Institutions: Speech at American Bankers Association Summer Leadership Meeting," Board of Governors of the Federal Reserve System, July 18, 2018, available at https://www.federalreserve.gov/newsevents/speech/quarles20180718a.htm.

5 Lalita Clozel and Liz Hoffman, "Fed Moves to Ease Living Wills, Allowing Large Banks to File Wind-Down Plans Less Frequently," *The Wall Street Journal*, April 8, 2019, available at https://www.wsj.com/articles/fed-expected-to-ease-living-wills-allowing-large-banks-to-file-wind-down-plans-less-frequently-11554731689.

6 Jun Luo, "Quicktake: Shadow Banking," *Bloomberg*, September 24, 2018, available at https://www.bloomberg.com/quicktake/shadow-banking.

7 Martin J. Gruenberg, "Statement by Martin J. Gruenberg Member, FDIC Board of Directors, Notice of Proposed Rulemaking: Title I Resolution Plans," Federal Deposit Insurance Corp., April 16, 2019, available at https://www.fdic.gov/news/news/speeches/spapr1619.html.

8 Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corp., "Agencies invite comment on modifications to resolution plan requirements; proposal keeps existing requirements for largest firms and reduces requirements for firms with less risk," Press release, April 16, 2019, available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190416a.htm.

9 Lael Brainard, "Statement on Proposals to Modify Enhanced Prudential Standards for Foreign Banks and to Modify Resolution Plan Requirements for Domestic and Foreign Banks by Governor Lael Brainard," Press release, April 8, 2019, available at https://www.federalreserve.gov/newsevents/pressreleases/3B1F641BEB4A485B994EBC38165F0F3B.htm#aboutMenu.

10 Ibid.

11 Federal Deposit Insurance Corp., "FDIC Seeks Comment on New Approaches to Insured Depository Institution Resolution Planning," Press release, April 16, 2019, available at https://www.fdic.gov/news/news/press/2019/pr19034.html.

12 Martin J. Gruenberg, "Statement by Martin J. Gruenberg, Member, FDIC Board of Directors, Issuance of a Notice of Advance Notice of Proposed Rulemaking: Resolution Plans Required for Insured Depository Institutions with $50 Billion or More in Total Assets," Federal Deposit Insurance Corp., April 16, 2019, available at https://www.fdic.gov/news/news/speeches/spapr1619a.html.

13 Center for American Progress, "Statement: Fed Proposals Leave the U.S. Financial System More Fragile and Taxpayers Exposed to Risk of Another Crash, Says CAP's Gregg Gelzinis," Press release, April 8, 2019, available at https://www.americanprogress.org/press/statement/2019/04/08/468422/statement-fed-proposals-leave-u-s-financial-system-fragile-taxpayers-exposed-risk-another-crash-says-caps-gregg-gelzinis/.

14 Eric S. Rosengren, "Bank Capital: Lessons from the U.S. Financial Crisis," Federal Reserve Bank of Boston, February 25, 2013, available at https://www.bostonfed.org/news-and-events/speeches/bank-capital-lessons-from-the-us-financial-crisis.aspx.

15 Gregg Gelzinis, Andy Green, and Marc Jarsulic, "Resisting Financial Deregulation: Progressive Banking Policies to Strengthen—Not Slash—Financial Reform" (Washington: Center for American Progress, 2017), available at https://www.americanprogress.org/issues/economy/reports/2017/12/04/443611/resisting-financial-deregulation/.

16 Jeff Stein, "Fed advances plan to weaken post-financial-crisis rule for biggest banks," *The Washington Post*, April 24, 2018, available at https://www.washingtonpost.com/news/wonk/wp/2018/04/24/fed-advances-plan-to-weaken-post-financial-crisis-rule-for-biggest-banks/.

17 Peter Eavis, "Washington Wants to Weaken Bank Rules. Not Every Regulator Agrees," *The New York Times*, April 24, 2018, available at https://www.nytimes.com/2018/04/24/business/dealbook/bank-rules-leverage-ratio.html.

18 Gregg Gelzinis, "Danger lurks in latest deregulatory push," *American Banker*, November 13, 2018, available at https://www.americanbanker.com/opinion/danger-lurks-in-latest-deregulatory-push.

19 Lael Brainard, "Statement on Proposals to Modify Enhanced Prudential Standards for Large Banking Organizations by Governor Lael Brainard," Press release, October 31, 2018, available at https://www.federalreserve.gov/newsevents/pressreleases/brainard-statement-20181031.htm.

20 Board of Governors of the Federal Reserve System, "Federal Reserve Board votes to affirm the Countercyclical Capital Buffer (CCyB) at the current level of 0 percent," Press release, March 6, 2019, available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190306c.htm.

21 Gregg Gelzinis, "It's time for the Fed to activate safeguards against financial bubbles," MarketWatch, August 2, 2018, available at https://www.marketwatch.com/story/its-time-for-the-fed-to-activate-safeguards-against-financial-bubbles-2018-07-31.

22 Gregg Gelzinis, "This is not the time to loosen rules on bank capital," MarketWatch, May 2, 2018, available at https://www.marketwatch.com/story/this-is-not-the-time-to-loosen-rules-on-bank-capital-2018-05-02.

23 Gregg Gelzinis, "The Fed's Proposed Stress Testing Changes Are a Mixed Bag" (Washington: Center for American Progress, 2018), available at https://www.americanprogress.org/issues/economy/reports/2018/03/20/448041/feds-proposed-stress-testing-changes-mixed-bag/.

24 Board of Governors of the Federal Reserve System, "Federal Reserve Board seeks comment on proposal to simplify its capital rules for large banks while preserving strong capital levels that would maintain their ability to lend under stressful conditions," Press release, April 10, 2018, available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180410a.htm.

25 This proposal would wisely include the G-SIB surcharge as a poststress requirement. But even when factoring in this change, the watering down of the stress testing assumptions would lead to a net reduction of capital for all firms subjected to the stress tests.

26 Ibid.

27 Gregg Gelzinis, "3 Flawed Banking Industry Arguments Against a Key Postcrisis Capital Requirement," Center for American Progress, October 27, 2017, available at https://www.americanprogress.org/issues/economy/news/2017/10/27/441413/3-flawed-banking-industry-arguments-against-a-key-postcrisis-capital-requirement/.

28 Peter Eavis, "Wells Fargo Sailed Through Its Stress Test. Goldman Sachs and Morgan Stanley, Not So Much," *The New York Times*, June 29, 2018, available at https://www.nytimes.com/2018/06/29/business/dealbook/fed-stress-tests.html.

29 Randal K. Quarles, "Beginning Stress Testing's New Chapter: Speech at 'An International Perspective on the Future of Bank Stress Testing' Symposium sponsored by Harvard Law School Program on International Financial Systems," Board of Governors of the Federal Reserve System, November 16, 2018, available at https://www.federalreserve.gov/newsevents/speech/quarles20181116a.htm.

30 Board of Governors of the Federal Reserve System, "Federal Reserve Board releases document providing additional information on its stress testing program," Press release, March 28, 2019, available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190328a.htm.

31 Michelle Price and Pete Schroeder, "Federal Reserve scraps 'qualitative' test for U.S. banks in 2019 stress tests," Reuters, March 6, 2019, available at https://www.reuters.com/article/us-usa-fed-stresstests/federal-reserve-scraps-qualitative-test-for-u-s-banks-in-2019-stress-tests-idUSKCN1QN2PX.

32 Board of Governors of the Federal Reserve System, "Comprehensive Capital Analysis and Review 2016: Assessment Framework and Results" (Washington: 2016), p. 9, available at https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20160629a1.pdf.

33 Jeff Cox, "Changes coming to bank stress tests, Fed's Powell says," CNBC, June 1, 2017, available at https://www.cnbc.com/2017/06/01/changes-coming-to-bank-stress-tests-feds-powell-says.html; Quarles, "Beginning Stress Testing's New Chapter: Speech at 'An International Perspective on the Future of Bank Stress Testing' Symposium sponsored by Harvard Law School Program on International Financial Systems."

34 Gelzinis, "Danger lurks in latest deregulatory push."

35 Board of Governors of the Federal Reserve System, "Federal Reserve Board invites public comment on framework that would more closely match regulations for large banking organizations with their risk profiles," Press release, October 31, 2018, available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20181031a.htm.

36 Ibid.

37 Ibid.

38 Ibid.

39 Brainard, "Statement on Proposals to Modify Enhanced Prudential Standards for Large Banking Organizations by Governor Lael Brainard."

40 Board of Governors of the Federal Reserve System, "Federal Reserve Board asks for comment on proposed rule to simplify and tailor compliance requirements relating to the 'Volcker rule'," Press release, May 30, 2018, available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180530a.htm.

41 Gregg Gelzinis, "Hollowing Out the Volcker Rule: How Regulators Plan to Undermine a Pillar of Financial Reform" (Washington: Center for American Progress, 2018), available at https://www.americanprogress.org/issues/economy/reports/2018/10/03/458638/hollowing-volcker-rule/.

42 Jesse Hamilton and Benjamin Bain, "Wall Street Nears a Big Win in the Latest Revamp of Volcker Rule," *Bloomberg*, April 25, 2019, available at https://www.bloomberg.com/news/articles/2019-04-25/wall-street-nears-a-big-win-in-the-latest-revamp-of-volcker-rule.

43 Lalita Clozel, "Banks Get Kinder, Gentler Treatment Under Trump," *The Wall Street Journal*, December 12, 2018, available at https://www.wsj.com/articles/banks-get-kinder-gentler-treatment-under-trump-11544638267?mod=searchresults&page=2&pos=6.

44 For example, Section 402 of S.2155, or the Economic Growth, Regulatory Relief, and Consumer Protection Act, weakened the SLR for custody banks. This change is significant, but regulators have implemented the statute directly without exercising any discretion. Moreover, S.2155 did not afford the banking regulators discretion over banks with $50 billion to $100 billion in assets. The deregulation for these banks was automatic. These changes dampen the resilience of the financial system, but Congress, not regulators, is to blame.

45 Gregg Gelzinis, "Deregulating AIG Was a Mistake" (Washington: Center for American Progress, 2017), available at https://www.americanprogress.org/issues/economy/reports/2017/10/11/440570/deregulating-aig-mistake/; Center for American Progress, "Statement: CAP Statement on FSOC's Vote to Deregulate Prudential Financial: Decision 'Decreases the Resiliency of the U.S. Financial System'," Press release, October 17, 2018, available at https://www.americanprogress.org/press/statement/2018/10/17/452160/statement-cap-statement-fsocs-vote-deregulate-prudential-financial-decision-decreases-resiliency-u-s-financial-system/; Lalita Clozel, "Court Drops Government's Appeal of MetLife Case," *The Wall Street Journal*, January 23, 2018, available at https://www.wsj.com/articles/court-drops-governments-appeal-of-metlife-case-1516742046.

46 Robert O'Harrow Jr., Shawn Boburg, and Renae Merle, "How Trump appointees curbed a consumer protection agency loathed by the GOP," *The Washington Post*, December 4, 2018, available at https://www.washingtonpost.com/investigations/how-trump-appointees-curbed-a-consumer-protection-agency-loathed-by-the-gop/2018/12/04/3cb6cd56-de20-11e8-aa33-53bad9a881e8_story.html; Aimee Picchi, "Debt collector rules could allow unlimited texts and emails to consumers: 'We are horrified'," CBS News, May 8, 2019, available at https://www.cbsnews.com/news/debt-collector-rules-proposed-by-consumer-bureau-may-soon-allow-unlimited-texting-and-emails-to-be-sent-to-consumers/; Anne Fleming, "The government move that threatens to keep Americans trapped in debt," *The Washington Post*, May 2, 2019, available at https://www.washingtonpost.com/outlook/2019/05/02/government-move-that-threatens-keep-americans-trapped-debt/?noredirect=on&utm_term=.b8cd515ab34c.