BANK POLICY INSTITUTE

BPI Policy Recommendations Related to the 2023 Banking Stress

Below are two sets of recommendations: first, a small number of immediate steps that should be taken to avoid a significant reduction in bank lending; second, policy changes that would over the medium to long term improve bank resiliency and financial stability while minimizing costs to economic growth.

Immediate Steps

The Federal Reserve and the federal banking agencies should immediately take these steps to improve confidence in the banking system:

- Announce at the next FOMC meeting changes to reduce the size of the Federal Reserve's overnight reverse repo (ON RRP) facility, which has served to facilitate the drain of deposits from the banking system. Such a change could be effectuated by widening the spread between the rate paid on the ON RRP and the rate paid on reserve balances. Doing so would result in higher deposit levels at banks, which are used to fund economic growth.
- Make clear to the public that an anticipated consequence of the FOMC's monetary policy strategy is an overall decline in bank deposits, and that regular reports that deposit levels are shrinking reflect that strategy and are not indicative of troubles in the banking system.
- Announce a one-year extension of the Bank Term Funding Program to reduce market uncertainty.
- Announce publicly that any regulatory or supervisory changes affecting the treatment of securities on bank balance sheets will be adopted with a five-year delayed effective date.

Policy Recommendations

Liquidity

- The banking agencies should conduct a holistic review of their liquidity rules, with notice and public comment. That review should include steps to (i) recognize borrowing capacity under central bank lending programs in assessing bank liquidity, as described below; (ii) destigmatize the use of central bank lending programs; (iii) issue examination guidance on depositor concentration risk (e.g., by region/industry and deposit size/type); (iv) revise reporting requirements consistent with these steps; and (v) revisit liquidity disclosure rules that facilitate runs and short selling. The agencies should study successful efforts by the Bank of England with respect to the interaction of liquidity regulation and central bank lending.
- The Federal Reserve should reform its existing array of balance sheet programs to better reduce bank sector liquidity risks while preserving bank lending and economic growth by (i) recognizing borrowing capacity at the discount window, Standing Repo Facility and Federal Home Loan Banks for purposes of applicable liquidity rules, internal liquidity stress tests, general liquidity examination and resolution planning expectations; (ii) encouraging or perhaps requiring a minimum amount of ordinary-course borrowing from such facilities to reduce stigma and ensure operational efficiency; (iii) entering into an MOU with the FHLBs that (a) as a policy matter, defines the respective roles of FHLB and discount window lending and (b) as an operational matter, defines collateral pledging expectations and subordination agreements in a way that ensures the timely availability of credit from the proper source under stress; and (iv) enhancing the effectiveness of the Bank Term Funding Program by extending the term of the program by one year, extending the term of the loans, expanding eligible collateral and also considering potential changes to the rate.
- The federal banking agencies and the FSOC should review the ability of banks to obtain liquidity against HTM securities through the repo market and seek to remove any accounting, regulatory or supervisory obstacles to

doing so. The FSOC should urge the FASB to review and reconsider current accounting rules that bar hedge accounting treatment for interest rate risk hedging of HTM securities.

- Any recalibration of the LCR and NSFR should await the results of the exercise above, as no accurate calibration can occur without knowing the operational framework to which it is being applied. The LCR and NSFR should also be internally consistent, which they presently are not.

Capital

- The banking agencies should release for public comment any "holistic review" of current capital rules that serves as a basis for changes in capital requirements. Such a review should include an analysis of the increase in the cost of lending and decrease in economic growth that would occur. This review should also include costs and risks that come with lending moving even more rapidly to unregulated private entities.
- The banking agencies should reduce uncertainty by promptly promising to eliminate the AOCI filter for certain banks, with a five-year delayed effective date, consistent with past precedent.
- With the AOCI filter removed for AFS securities, banks may have an incentive to move securities from AFS to HTM. However, restricting banks' ability to hold securities in HTM would have significant economic effects. The agencies should issue an ANPR seeking possible options on how banks can demonstrate their ability to hold securities in HTM to maturity, including economic and financial stability effects of any change, and in that ANPR state that any potential change would come with a five-year delayed effective date.
- The Federal Reserve could include an alternative, rising interest rate scenario in its capital stress tests while keeping the scenarios internally rational (e.g., the direction and pace of rates consistent with the macroeconomic assumptions) rather than structured to achieve a predetermined outcome.
- To the extent TLAC-like requirements are imposed on a wider set of banks, the Fed should ensure they are appropriately tailored in scope and appropriately modified from the existing requirement. Firms should be permitted to issue at either the bank or holding company level, depending on the firm's resolution strategy. The proposal should also grandfather existing long-term debt and provide for an appropriate transition period to avoid a market "crowding out" effect, particularly in the current environment.

Examination

- The banking agencies should amend the tailoring rules to allow for heightened examination of banks that grow materially faster than peers.
- The banking agencies should provide that MRAs, which have become effectively a regulatory mandate, be issued only for conditions that create a risk to the safety and soundness of the bank. Concerns about process and documentation should take the form of observations or recommendations. "Governance" should be grounds for an MRA (or a downgrade in rating of the Management component of CAMELS or the Governance and Controls component of the LFI rating) only if there is materially deficient behavior by the board or senior management – as opposed, for example, to failing to adhere to examiner preference in how management constitutes committees, defines the so-called "lines of defense," manages vendors, manages its IT, structures and staffs internal committees, drafts policies and procedures or keeps minutes of meetings. No MRA should be based on "reputational risk" unless that risk can be shown to be having a material financial impact.
    - An emphasis on material financial risk should not prevent agency examiners from providing recommendations or observations based on their experience and expertise, or based on horizontal reviews that identify best practices. But to avoid a world where "when everything is important, nothing is important," the reaction of bank management to those items should not drive examination ratings, and bank management should not be expected to devote the same resources on the same remediation timelines to those items as they are to remediating MRAs focused on material financial or other material safety and soundness risk. And disagreements about those recommendations or observations should not drive CAMELS or LFI ratings.
- The banking agencies should revise their supervisory ratings frameworks to make them more transparent, better integrated with existing rules, and focused primarily on financial condition and material financial risk as

opposed to process, documentation and micro-governance. The Management component of the CAMELS regime and the "Governance and Controls" component of the LFI rating system are currently subjective and often driven by immaterial governance and process issues. Those components should follow the other ratings except in extreme cases. (In other words, a management team that produces satisfactory capital positions, asset quality, earnings, liquidity positions and sensitivity to market risk should presumptively be rated Satisfactory or better.)

- For banks with assets exceeding a specified threshold, all MRAs should be reviewed on a quarterly basis by agency principals (the Comptroller of the Currency, the Federal Reserve Board or a committee thereof, the board of directors of the Federal Deposit Insurance Corporation or a committee thereof).
- The banking agencies should desist from the practice of issuing *ultra vires* "industry MRAs" which are clearly rules that legally require public notice and comment under the Administrative Procedure Acct but are issued to large numbers of banks under the cloak of examination secrecy to avoid public review and debate.
- The banking agencies should conduct a comprehensive review of current examination practices for interest rate risk and issue updated guidance.

Other

- ***Industry consolidation.***
    - The banking agencies should repair bank M&A by eliminating the concept of "informational completeness" as grounds for indefinitely delaying bank mergers. This practice does serious harm to both acquirer and target, as well as their employees and customers, and is now chilling a market that should be active.
        - Thus, at the Federal Reserve, applications that are still materially incomplete as of the 90-day statutory deadline should be denied rather than delayed. While the statutory deadline is more extended under the Bank Merger Act, the Federal Reserve should act consistent with its statutory duty, and thereby challenge other relevant agencies to act more promptly.
    - In addition, the agencies should amend their policies to:
        - Permit delegation of authority notwithstanding a protest of the application unless that protest raises serious substantive issues, particularly if the protestant has a history of raising spurious issues;
        - Permit the acquiring and target institutions to share confidential supervisory information;
        - Provide that a deficiency at an acquired institution will not be grounds for denial absent a determination that the acquiring institution lacks the ability or intent to remediate it.
    - The Departments of Treasury and Justice should publicly support such steps.
- ***Resolution practices*.**
    - The FDIC should improve its approach to resolving failed banks by seeking public comment on ways to meet the least-cost test while simultaneously providing more appealing transaction terms to potential acquirers and preserving the franchise value of the failed bank.
    - The FDIC should have outside investment banking advisory firms pre-positioned to assist in any possible resolution, and engage those firms early in the process.
- ***Short selling.*** The SEC should adopt a rule on short selling, as mandated by the Dodd-Frank Act in 2010. Leveraging reports that it currently receives, the SEC should also reallocate resources to investigating market manipulation in bank stocks.
- ***Securitization.*** The government should revitalize securitization markets: (1) the federal banking agencies should revise the regulatory treatment of securitizations (traditional and synthetic) to recognize true economic risk transfers and allow for appropriate capital relief commensurate with the transfer of credit risk and (2) the SEC should establish an alternative public disclosure framework to Reg AB II based to enable public offerings of RMBS and increase participation of private investors in the U.S. mortgage market. Such steps would allow banks to lend more and thereby expand credit availability and economic growth. The movement of lending into shadow finance not only increases the cost and decreases through-the-cycle availability of mortgage and other forms of credit but also reduces the chances of a troubled borrower having an

opportunity to work out loans, as banks are equipped for workouts but nonbank lenders generally proceed to seize collateral.

Policy Recommendations BPI Opposes

- Any industry-wide recalibration of the ILSTs through "horizontal reviews" or "industry MRAs" which would effectively subsume the LCR and NSFR without public notice and comment through a rulemaking process.
- Any reflexive changes to S.2155 or the banking agencies' 2019 tailoring rule inconsistent with the above recommendations, or that fail to recognize the risk, complexity and activities of the bank, following an appropriate notice and comment period.
- Any general increase in capital requirements (e.g., pursuant to implementation of the 2017 Basel Accord) that is predicated on spring 2023 events; those events focused on "bread and butter" interest rate and liquidity risk, whereas the 2017 Basel Accord focused on market, credit and operational risk.
- Any shift in supervisory approach that eschews necessarily core reforms and notice-and-comment rulemaking in favor of greater and more frequent use of enforcement actions and capital/activity restraints for management, governance and controls issues.
- Conversion of the U.S. capital rules to an *ultra vires*, non-transparent, process-free, European "Pillar 2" system.

Policy Recommendations BPI Currently Neither Supports nor Opposes But Will Study Further

Changes in the scope of deposit insurance coverage.