BANK POLICY INSTITUTE

Will a De Facto Tightening of Regulations Cause a Recession and an Early End To QT?

Bill Nelson | Sept 6, 2023

We have heard in general terms from many banks and their advisors that there is a widespread and pronounced tightening in requirements currently being imposed by examiners. BPI, along with many other observers including the GAO and FDIC, has pointed to examination failures as important contributing factors to the failures of SVB and Signature Bank.[1] In particular, examiners failed to take action to limit the risks posed to SVB from making unhedged investments in longer-term fixed-rate securities, and the risk posed to both banks from a heavy reliance on concentrated uninsured deposits for funding. If examiners are adjusting their focus toward real financial risks to safety and soundness, based on regulations issued in accordance with the Administrative Procedure Act, such an adjustment may be appropriate. However, if examiners are imposing subjective standards that go beyond existing capital and liquidity requirements, they are engaged in *ultra vires* rulemaking, and rulemaking that might be arbitrary and capricious.

This point is an important one not just because of the value of the rule of law but because a widespread *de facto* tightening of bank regulations could tip the economy into a recession. As shown in the exhibit, reductions in credit supply from banks have been associated with the three recessions prior to the COVID-19 recession. The exhibit shows the net percentage of banks reporting having tightened lending standards on commercial and industrial loans over the preceding three months on the Fed's quarterly survey of senior loan officers, a measure that is often used as a proxy for changes in the supply of bank credit. The shaded areas are recessions. On the survey released on July 31, 2023, 51 percent of banks reported tightening standards on loans to large and medium businesses and 49 percent reported tightening standards on loans to small businesses.[2] Higher percentages were only recorded in four previous instances during the period the questions were asked, and all four were just prior to, or during, a recession.

Indeed, during the Global Financial Crisis, the staff of the Federal Reserve Board used these survey responses as a proxy for financial distress to help explain and forecast economic activity. As described in the briefing documents (Greenbook Part I) provided to the FOMC at their September (pp. I-4 to I-5) and October I-12 to I-13) 2008 meetings, elevated percentages of banks reporting tightening standards were associated with significantly lower GDP. In the October Greenbook, for example, staff projected that the

---

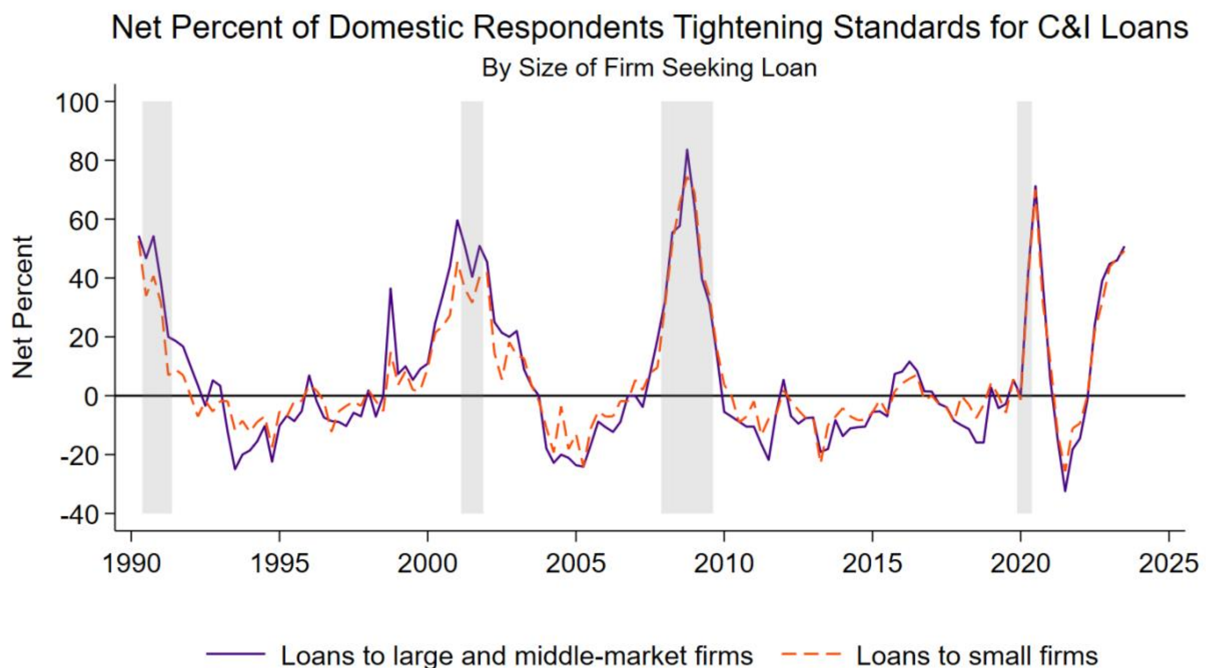
[1] https://bpi.com/something-missing-omissions-and-surprises-in-the-federal-reserves-svb-report/ and https://bpi.com/a-failure-of-self-examination-a-thorough-review-of-svbs-exam-reports-yields-conclusions-very-different-from-those-in-the-feds-self-assessment/

[2] In response to special questions on the survey, about 40 percent of respondent banks indicated that they expect to tighten C&I standards further over the remainder of the year.

tightening would lead to real GDP that was 1.3, 3.1 and 4.0 percent lower than baseline in 2008, 2009 and 2010, respectively.

What makes the current episode different, however, is that "changes in the effects of legislative changes, supervisory actions or changes in accounting standards" is an important reason for the tightening. In the July survey, 54 percent of banks indicated that these concerns were a somewhat or very important reason for tightening.[3] During the previous peak, in July 2020, only 26 percent of banks had so indicated. The reason was added in October 2010 and so was not there for the peak tightening during the GFC.

There is already a material possibility that tighter bank lending standards could lead to a recession. In the minutes to the July Federal Open Market Committee meeting released last week, FOMC participants noted two sources of downside risks to the economy. One was that the substantial tightening of monetary policy that has occurred over the past year could lead to "a sharper slowdown in the economy than expected." The other was that "the effects of the tightening of bank credit conditions could prove more substantial than anticipated."



One especially relevant historical episode is the recession of 1990-91, which was accompanied by a severe credit crunch. Basel (1) was formally approved in 1989 and phased in starting at year-end 1990. The U.S. banking agencies also adopted a new leverage ratio requirement in 1990. Joe Peek and Eric

[3] Banks put even more emphasis on other reasons for tightening in the current survey: less favorable or more uncertain economic outlook, reduced tolerance for risk, deterioration in their liquidity positions, and worsening of industry-specific problems, but large fractions of respondents always cite these reasons.

Rosengren, both then researchers at the Boston Fed (Rosengren went on to be President of the Bank), wrote a series of papers on the recession, the credit crunch and the role of new, tighter capital requirements as well as the effects of examiner guidance.[4] Peek and Rosengren show 1) capital concerns contributed to the credit crunch, 2) banks subject to examiner enforcement actions shrank a further 3.2 percent even after controlling for their capital position; 3) banks subject to enforcement actions reduced lending to bank dependent borrowers; and 4) a reduction in bank lending to small businesses in the Northeast likely contributed to a record business failure rate.

Questions about the reasons for tightening credit standards were included in the senior loan officer surveys during the credit crunch, and the answers were similar to the those reported in 2023. “Bank Capitalization, Regulation, and the Credit Crunch, a Critical Review of the Research Findings,” FEDS working paper 95-20, May 1995, (available here) reports that the most frequently cited reasons were the current economic outlook and industry specific problems, “…nonetheless, during several quarters between 15 and 25 percent of respondents cited regulatory pressures or loan portfolio quality as influential and about 10 percent pointed specifically to capital pressures.” p. 6.

Another potential consequence of a *de facto* tightening of regulations by examiners is the Fed having to end its balance sheet runoff earlier than anticipated, and thus with the balance sheet correspondingly larger. During the last round of QT, according to Tealbook B, in December 2017, the most recent available, the staff projected that the Fed should be able to shrink until the third quarter of 2021 when reserve balances equaled $500 billion. In the event, the Fed encountered significant turmoil in money markets in September 2019 when reserve balances were $1.4 trillion, nearly triple the projected amount. At a discussion at the Hoover Institute on May 4, 2018, then Vice Chair Quarles indicated that some examiners were telling banks that they needed to maintain reserve balances at the Fed despite not being required by regulation, and that such guidance could impede the Fed’s efforts to get smaller.

Such a process may currently be underway. In the New York Fed’s most recent balance sheet forecast, QT continues until mid-2025 and reserve balances reach their minimum in 2026 at $2.4 trillion. In response to a Fed survey conducted in May (but only recently released), 31 percent of banks reported that their “lowest comfortable level of reserve balances” had risen by over 10 percent since November 2022, with 16 percent reporting an increase of over 50 percent. Only 3 percent of banks stated that their lowest comfortable level had decreased more than 10 percent. Nearly three-quarters of the survey respondents indicated that satisfying liquidity stress-test metrics was a very important factor determining their target minimum level of reserves, the most important factor cited by a wide margin. Because examiner stringency has reportedly tightened further since May, these results have probably strengthened.

As a result, the lowest level of reserve balances consistent with well-behaved money markets could be well above the New York Fed’s assumption of $2.4 trillion. Reserve balances are currently $3.2 trillion. QT reduces reserve balances by about $80 billion a month. Perhaps QT may have to end near the end of

[4] Peek, Joe, and Eric S. Rosengren. "The capital crunch in New England." New England Economic Review May (1992): 21-31. ___ "The capital crunch: Neither a borrower nor a lender be." Journal of Money, Credit and Banking 27.3 (1995): 625-638. ___ "Bank regulation and the credit crunch." Journal of Banking & Finance 19.3-4 (1995): 679-692. ___ Banks and the availability of small business loans. No. 95-1. 1995.

this year because money market conditions become tight, assuming it doesn't end sooner if a contraction in bank credit causes a recession.

Views vary on whether it matters how large the Fed is. Before the GFC, the size of the Fed was for the most part limited by the demand for currency, and the Fed was consistently about 6 percent of GDP. Currently, the Fed is 32 percent of GDP. Before the GFC, the Fed only really interacted with the financial system through occasional relatively small repos with a few broker dealers. Now, 8 percent of U.S. bank assets and 29 percent of money funds assets are loans to the Fed, and the Fed has loans outstanding to medium-sized businesses and hedge funds having sold its investments in junk bonds and ETFs. Before the GFC, the Fed made a modest income for taxpayers of about $2.8 billion a month. Now the Fed is losing $10.1 billion a month, losses that have to be financed with higher taxes, reduced government spending or larger deficits.

Conclusion

There is widespread agreement that recent bank failures demonstrated shortcomings in Fed and FDIC bank supervision, and that supervision needs to be more tightly focused on issues that pose real risks to bank safety and soundness. However, examiners may not legally impose a *de facto* tightening of bank regulation without notice-and-comment rulemaking. Moreover, such a tightening risks upending the Fed's soft-landing and tipping the economy into recession, just as the implementation of Basel I led to a recession in the early 1990s. Furthermore, a tightening of liquidity requirements could prevent the Fed from continuing its efforts to get smaller and less entangled with the financial system, just as happened in 2019.

Disclaimer: The views expressed do not necessarily reflect those of the Bank Policy Institute's member banks, and are not intended to be, and should not be construed as, legal advice of any kind.