

Randal K Quarles: Jet flight, mail bags, and banking regulation

Speech (via webcast) by Mr Randal K Quarles, Vice Chairman for Supervision of the Board of Governors of the Federal Reserve System, at the Prudential Regulation Conference, 3 June 2021.

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As many of you know, I am speaking to you from Salt Lake City, which, among its myriad other virtues, was the home of one of the earliest passenger airlines—Western Air Express, which ran its first passenger flight in the spring of 1926: Eight hours in a Douglas M2 between Salt Lake City and Los Angeles, with one stop in Las Vegas for fuel. Two of the first passengers sat on the mail sacks in the back, and those early plane travelers were adventurers in other ways as well. That year there were 12 fatal commercial airplane crashes and that number rose to 59 a year by 1930. That's not total deaths—that's fatal crashes, with many people on each plane. Comparing hours flown and number of flights, that would be as if we had 7,000 fatal airplane crashes in a typical year today, with hundreds of thousands dead.

But we did not have 7,000 fatal crashes last year. We had five in the entire world. The year before we had eight. Air travel is famously the safest way to get from point A to point B, as a result of decades of innovation in technology and operating processes. Importantly, however, even as the airline industry was improving safety, it was equally focused on improving efficiency—especially as we moved into the era of jet travel in the 1960s. The eight-hour trip between Salt Lake and Los Angeles now takes an hour and a half even counting all the nosing around on the ground (although an argument can be made that a typical coach seat may not be that much more comfortable than sitting on the mail bags). Yet average fuel burn has been falling every year since 1960 and continues at a strong pace—in the first decade of the 21st century, fuel efficiency on domestic flights increased by another 40 percent. The airlines recognized that the public has a strong interest in safety, but that it also has a strong interest in other values as well. A more efficient airline is easier on the environment, cheaper for the consumer, and a stronger contributor to the overall economy. And, obviously, these continuing improvements in operation have been achievable without any compromise in safety.

I think you can see where I am going with this. In the aftermath of the Great Financial Crisis, the Federal Reserve, the international regulatory community, and the banking industry took action to radically improve the safety of the banking system: new capital and liquidity rules, new stress testing requirements, a new resolution framework. Together, these have greatly strengthened the safety of the financial system. Actual common equity capital ratios for large banks have roughly doubled since the crisis (and are at least six times as great as the pre-crisis requirements).

But in implementing these safety requirements, we did not pay as close attention to efficiency. Yet the public interest in efficiency is also strong, so over the last four years we have comprehensively sought ways to improve the efficiency of the system while maintaining its safety—which is every bit as possible in the financial system as it has been for the airlines. While this has been a broad project, today I want to focus on four examples of measures that illustrate this phenomenon. These measures have enjoyed support across the political spectrum because they have brought measurable benefits to the American people.

Tailoring Regulation

The first that I would cite is our broad work since 2018 on tailoring our bank regulatory framework. That year, a bipartisan majority in Congress passed the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA), which made modifications to the Dodd-Frank Act and called on the banking agencies to further tailor regulation to better reflect the business models and activities of the different banking firms that we supervise. The legislation

recognized that it is possible to keep the system just as safe while allowing the financial system more capacity to support the real economy and more flexibility in doing so.

As I have said before, one of my goals as Vice Chair for Supervision has been to make our regulatory framework as simple, transparent, and efficient as possible. In particular, we must always ask whether the cost of regulation—whether in reduced economic growth or in increased frictions in the financial system—is outweighed by the benefits of the regulation. If we have a choice between two methods of equal effectiveness in achieving a goal, we should choose the one that is less burdensome for the system.

This principle guided our activity in differentiating among firms based on their risk profile and applying tailored standards accordingly. In keeping with the intent of EGRRCPA, the Fed adopted a revised tailoring framework for the application of our enhanced standards to large firms. That framework rightly differentiates standards, including capital and liquidity requirements, based on the risk profile of an individual firm. Our previous framework relied heavily on a firm's total assets to determine the stringency of our regulatory requirements. However, the tailoring framework relies on a broader array of indicators—size, as well as measures of short-term wholesale funding, non-bank assets, off-balance sheet exposures, cross-jurisdictional activity—to better align our prudential standards with the risk of a firm. Under the tailoring framework, the most complex, systemically important firms are subject to the most stringent requirements, while less complex firms are subject to commensurately reduced requirements. This allows firms to focus resources more on their core lending function to support the real economy, which was certainly in evidence during the booming economy in the run-up to COVID.

Our tailoring of regulation was not limited to just large banks. The banking agencies worked on a range of measures to better reflect the risk profile of smaller banking organizations. These include expanded eligibility for our small bank holding company policy statement, and an increased scope of banks eligible for longer examination cycles. Most prominently, we also adopted a simple measure of capital adequacy for qualifying community banks—the community bank leverage ratio. These measures also made our regulatory framework more efficient, tailoring the regulation of community banks to their risks.

Another key change to improve the efficiency of our framework was the introduction of the stress capital buffer requirement, which integrated our stress testing and regulatory capital frameworks. The stress capital buffer requirement is a firm-specific capital requirement that is calibrated based on the results of the stress test and was designed to provide a through-the-cycle, unified approach to capital distribution restrictions. This change enhanced our framework by better differentiating between firms that posed the most systemic risk and other large banks. Additionally, this change contributed to simplifying our capital framework by reducing the number of capital requirements to which large banks are subject from 18 to 8 without reducing its resiliency—a material improvement in efficiency, and thus in the ability of banks to focus on service to customers rather than duplicative compliance

Foreign Banks

In addition to tailoring regulation, we have tailored supervision. As an example, the Large Institution Supervision Coordinating Committee (LISCC) portfolio was adjusted in scope so that it now encompasses all Category I firms, or U.S. GSIBs, and only those foreign banks with U.S. operations that would be identified for Category I standards if they were housed within a bank holding company. The adjustment resulted in certain foreign banks being moved out of the LISCC portfolio and into a separate supervisory portfolio with all other foreign banks along with domestic banks of similar sizes and risk profiles. The removal of these foreign banks from the LISCC portfolio reflects their significantly reduced risk profile and size in the United States—since 2008, the size of their combined U.S. assets has shrunk by about 50 percent and they have reduced the assets at their broker-dealers from a peak of \$1.9 trillion in 2008 to \$360 billion,

a reduction of more than 80 percent. As a result of these substantial changes, it has clearly become appropriate to supervise the present-day U.S. operations of these foreign banks alongside domestic and foreign banks with a similar risk profile in our Large and Foreign Banking Organization (LFBO) portfolio.

This means that these organizations will be horizontally assessed against other foreign banks. By grouping foreign banks together, this portfolio reassignment enhances the ability of supervisors to take into account, in a comprehensive fashion, of the structural features and specific risks associated with the cross-border character of foreign banking operations in the United States. It is obviously incorrect to say that this is “weaker” supervision: these banks are subject to the same capital and liquidity requirements that they were before and the supervisors in our LFBO portfolio are expert public servants. Indeed, this approach may be more effective in identifying risks unique to foreign banks. For example, the Archegos exposures in foreign banks outside the United States that resulted in recent losses outside the United States—losses that could not have been picked up by LISCC supervision—might have benefited from a supervisory structure that was more focused on foreign-bank-specific risks.

The Countercyclical Capital Buffer

The third example of a decision we have made to improve the ability of the banking system to provide support to a strong economy has been our treatment of the countercyclical capital buffer, or CCyB. Large banks are subject to a potential CCyB, which is a macroprudential tool that allows the Board to dynamically adjust capital levels of large banking firms when the risks to financial stability have meaningfully changed. There were many calls from outside the Fed for us to activate the CCyB in the years before the COVID event. It is clear now that those calls were mistaken.

The Board’s CCyB policy statement details the range of financial system vulnerabilities and other factors the Board may take into account as it evaluates settings for the buffer, including but not limited to, leverage in the financial sector, leverage in the nonfinancial sector, maturity and liquidity transformation in the financial sector, and asset valuation pressures. Our policy has been to maintain a 0 percent CCyB when vulnerabilities are within the normal range and, when they rise to a level meaningfully above normal, to increase the CCyB to a level that compensates for the rising vulnerabilities.

As you no doubt have noticed, we did not increase the CCyB in the strong economy before the COVID event. That is because we have a consistent, disciplined, and comprehensive framework that lays out the proper factors to evaluate when deciding to turn the CCyB on or off, and the framework did not suggest vulnerabilities were particularly high. That framework has guided our decisions over the past few years and provided clear and transparent guidance to the public.

The Federal Reserve should only turn on the CCyB in times of significant irrational exuberance; for example, in the face of a self-reinforcing cycle of borrowing and asset prices of the kind we saw in 2004–06. Yet, in my view, our through-the-cycle capital levels—that is, our fixed capital requirements—in the United States have been set so high, that our CCyB is effectively already “on.” As a result, existing capital requirements for banks in the United States were already at a high enough level to maintain financial stability. When capital levels are sufficiently high, it would needlessly reduce the ability of firms to provide credit to their customers to turn on an additional capital requirement like the CCyB. Indeed, as I said at the time, the problem under our framework would instead be finding ways to turn down the CCyB thus embedded in our through-the-cycle capital requirements when the system was hit by a shock. Although the Fed had no formal CCyB to release when the COVID event struck, the U.S. banking system played a major role in taking deposits from, and extending credit to, households and businesses in 2020, and we did indeed have to take temporary measures to “turn down” our implied CCyB through limited exemptions to some of our capital requirements. The U.S. banking system performed very well in the COVID

event compared to other jurisdictions that did have a CCyB that they released.

The Volcker Rule

Finally, a fourth example: changes to the implementation of the Volcker rule that have had the effect of providing greater ability for banks to support dynamism and innovation through venture capital funds, including incentives for banks to make investments in low-income areas, benefitting different groups, including minority entrepreneurs.

Over the past four years, the agencies responsible for implementing the Volcker rule have broadly simplified the rule's compliance requirements. We have adhered to the intent of the rule while providing greater clarity and certainty for permissible activities. In particular, the most recent revisions opened up opportunities for banks to invest in the communities they serve through a variety of fund structures without running afoul of the Volcker rule restrictions.

Our clarification of the definition of "covered funds" in the Volcker rule has allowed banks to make a broader range of fund investments that support communities, with the confidence that they are permissible. In passing the Community Reinvestment Act, Congress found that regulated financial institutions have a continuing obligation to help meet the credit needs of their local communities, so it is eminently sensible that the Volcker rule regulations allow banks to meet these important obligations.¹

Other changes finalized last year allow banks to make investments in rural business investment companies and qualified opportunity funds. Rural business investment companies promote economic development and job creation in rural areas, while qualified opportunity funds support long-term investments in economically distressed communities.

Together, these changes have given greater certainty to banks about what is permissible and what is not under the Volcker rule—a clear efficiency gain—while also allowing them to make a broader range of investments that support innovative growth and benefit local communities.

The COVID Event

These are just a few examples of changes we have made over the last four years that have bettered the ability of the system to perform its function of providing credit to households and businesses. But have we been as successful as the airlines in making efficiency improvements while continuing to make the system safer? That proposition faced a significant test in the spring of 2020, with the arrival of COVID-19 and the severe effects that measures to contain it had on the economy and financial system. It allowed us to gauge not only the resilience of our regulatory framework but the effectiveness of our efforts over the last four years to ensure that our framework did not hamper banks' ability to perform their critical function to lend to households and businesses and serve as financial intermediaries.

When the COVID event began last year, the magnitude of the economic and financial disruptions was staggering. Voluntary and mandated quarantines, lockdowns, and social distancing efforts hammered aggregate demand, caused unfathomably large job losses clustered in certain service sectors, and sharply increased uncertainty. Workplaces closed, travel was curtailed, and global supply chains were disrupted. Large sectors of the global economy, such as tourism and transportation, came to an abrupt stop. As concerns about the virus and measures to contain it spread, these effects grew.

At the same time, certain critical financial markets seized up or ceased to function effectively. Short-term liquidity markets were strained as investors "dashed for cash," focusing on their own liquidity. The commercial paper market, where companies raise cash by issuing short-term debt, seized up to an extent similar to the fall of 2008. And as in the financial crisis, investors in certain prime and tax-exempt money market funds with immediate cash needs submitted redemption

requests that resulted in significant outflows from these funds. Equity prices plunged and yields on corporate bonds widened significantly. Perhaps I can simply underscore the peril of the time by noting that the Treasury market—the lifeblood of the financial system—became highly dysfunctional, something that didn't even happen in 2008 or 2009. This was truly a massive global shock.

As businesses closed and consumers stayed home, 22 million jobs were lost in scarcely two months. The unemployment rate soared from 3.5 percent in February 2020 to 14.8 percent in April 2020, well above the highest rates experienced in the United States since the Great Depression.² In addition to the immediate and apparent impact of the COVID event, there was also tremendous uncertainty regarding the path of future government responses. Macroeconomic experts, both at the Federal Reserve, and elsewhere, constructed many different plausible scenarios for how the economy would fare, and this was reflected in scenario-writing related to stress tests. Our June 2020 stress tests included a sensitivity analysis, designed in April 2020, that used three alternative downside scenarios that spanned the wide range of projections made at that time by professional forecasters. Those scenarios included peak unemployment rates ranging from 16 percent to 19.5 percent and assumed no additional fiscal measures to support the economy.

So how did the bank regulatory system do? By any measure, quite well.

Entering the COVID event, the banking system was fortified by over 10 years of work to improve safety and soundness, both by regulators and by banks themselves. Higher levels of capital and liquidity, better risk management, and more robust systems enabled the banking system to absorb an unprecedented shock—while providing refuge from market instability, delivering essential public aid, and working constructively to support borrowers and communities. In short, the full set of post-2008 reforms—as refined and recalibrated by the work of the last four years—ensured that this time would truly be different than the last. With respect to capital, banks actually *built* capital during the COVID event, thanks to actions from regulators and their own voluntary actions, even despite setting aside close to \$100 billion in loan loss reserves. The aggregate common equity tier 1 capital ratio for the banking system in the second half of 2020 materially exceeded its pre-COVID-event level. Capital ratios remain well above regulatory minimums for all firms. Banks also strengthened their liquidity positions during the COVID event, primarily due to an influx of deposits and their reinvestment in reserves. The share of bank liquid assets as a share of total assets far exceeds the pre-COVID-event metric.

Banks also served as a source of strength to the economy. With respect to lending, businesses were able to draw on pre-existing credit lines to meet the massive demands for cash. Banks of all sizes also funded the bulk of the more than \$795 billion in Paycheck Protection Program loans. According to our weekly data, commercial and industrial loans increased \$715 billion between the week of February 26th and their peak on May 13th. For millions of struggling households, interest and principal payments on loans were delayed. In addition, through May 2021, more than \$2.2 trillion of central bank reserves and roughly \$3.7 trillion of deposits had been absorbed by banks.

Overall, the regulatory framework for banks constructed after the financial crisis, with the refinements and recalibrations we have made over the last few years, has held up well. The banking system remained strong and resilient, and banks served as a source of strength to the economy, and our stress tests indicated this would have been the case even without the substantial fiscal assistance provided to the rest of the economy. We have already learned many new lessons regarding our financial system during this experience. One lesson in particular I wanted to highlight is that our rigorous, forward-looking capital framework, which includes the stress capital buffer, works very effectively. Beginning in the third quarter of 2020, we required large banks to resubmit their capital plans and restricted their capital distributions. Those restrictions are slated to end following this quarter if large banks perform well on the upcoming

stress test. While it was sensible at the time, given that this was the first real world test of our system, for us to use the belt and suspenders approach of additional, temporary capital distribution restrictions, we now know that we can have particular confidence in the stress capital buffer framework, as it is informed by a real-time stress testing regime. In the future, having learned the lessons of this test, we will be able to rely on the automatic restrictions of our carefully developed framework when the stress test tells us the system will be resilient, rather than using ad hoc and roughly improvised limitations.³

We cannot say, however, that the entirety of the financial system performed well, even parts that were subject to reforms following the financial crisis. As I have mentioned previously, the run on prime money funds and commercial paper were particularly concerning, as they resembled the runs faced during the financial crisis, despite subsequent reforms to those markets. The government had to step in yet again to stem the outflows from the prime money funds to stabilize financial markets. Addressing the shortcomings we saw among non-banks continues to be a focus of both domestic policymakers and the international community, particularly under my chairmanship of the Financial Stability Board. We cannot afford to allow the same things to happen again.

In the end, our banking system performed well over the challenges of the last year. U.S. banks remain in good condition. First-quarter data showed that aggregate capital ratios increased, and banks continued to maintain ample levels of liquidity. We must, of course, remain vigilant in safeguarding our banking system. New threats can, and will, emerge. In a few weeks, we will learn the results of our annual stress test and will publicly release an update on the health of large banks, evaluating their balance sheets against a quite severe hypothetical recession. The COVID event did, however, serve to reinforce that the safeguards we have built and maintained since the financial crisis have passed the strictest stress test of all.

¹ 12 U.S.C. 2901(a)(3).

² Board of Governors of the Federal Reserve System, [Monetary Policy Report – February 2021](#) (Washington: Board of Governors, February 2021).

³ The stress capital buffer requirement imposes increasingly strict automatic limits on capital distributions as a firm's capital ratios decline toward the minimum requirements, and if a firm were to be within its buffer would be more stringent than the restrictions the Board imposed over the last year.