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FINANCIAL REGULATION UNDER BIDEN

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My overall forecast for changes in financial regulation under Biden's Administration remains largely unchanged from my pre-election views. However, there are some areas where the new team will have to be less bold than appeared likely pre-election and we have also learned some things from the early nominations to key positions. This paper provides an updated version of my views.

THE CHANGES

Significant tax changes for the financial sector are unlikely.

Some Democrats wanted to see special taxes for the largest banks and a Financial Transactions Tax (FTT) to discourage Wall Street speculation. Republican opposition would make this all but impossible unless the Democrats win both of the Georgia Senate seats in the run-off election on January 5, 2020, which is possible, but unlikely. Even if they do, it would be difficult to avoid suffering at least one Democratic defection on a controversial tax vote in the Senate, which would kill the bill. The exception might be if, in a couple of years, there is an effort at deficit reduction that gains some bipartisan support. In that case, a modest bank tax seems possible, given the continued unpopularity of the big banks. An FTT, on the other hand, would remain very difficult to pass.

Bold structural changes to the government's role in retail banking are unlikely.

Some progressive Democrats were exploring ideas to improve financial inclusion by increasing the role of the government or the Fed in retail banking. One idea was to have the US Postal Service act as a bank, similar to postal banks in Europe. Another was to allow individuals to open accounts directly at the Fed, possibly in concert with the introduction of a digital version of the US dollar. Both ideas were long shots and neither now seems possible.

Former Fed Chair Janet Yellen will be Treasury Secretary.

The new Secretary is in the mainstream of Democratic views on financial regulation, so her appointment does not significantly change the prospects for regulatory changes.

THE BIG PICTURE

Financial regulation is unlikely to be one of the top priorities for President Biden.

Covid-19, the economic recovery, healthcare, social justice, the climate transition, and troubled foreign relations will already more than occupy the new President's attention.

Major legislation in this area is therefore improbable.

Big legislation almost always takes a major push from the Administration, which appears unlikely unless a large problem develops that creates a bipartisan consensus for action. The relatively strong Republican showing in the elections means that they will retain control of the Senate unless both Georgia seats go to the Democrats on January 5, 2020, which is possible, but unlikely. Even if that happens, it is difficult to pass major legislation starting from the slimmest of all possible majorities in the Senate.

But, regulators can do a great deal without new legislation.

Capital and liquidity requirements, resolution and recovery planning, risk management procedures, disclosure requirements, and many other areas offer regulators and supervisors great leeway to mandate changes.

Who are chosen for the key positions will matter.

Any Democratic appointees will share certain priorities, but there will be important differences on other potential initiatives and in how the key priorities are executed. The shape of the new team is unclear at this point, except for Janet Yellen as Treasury Secretary and Adewale Adeyemo as Deputy Treasury Secretary.

Most changes will take time.

New regulators will not be in place for some time and then need to settle in, have their staffs initiate the analysis required to back up rule changes, put out proposed rules and receive comments, make any refinements, issue the final rules, and then wait for them to take effect.

The Biden team has not issued detailed financial regulatory proposals, but we do have a sense of their priorities. These are likely to include:

- Tougher regulation of the largest banks
- Climate transition risk management and disclosure requirements
- A social justice package
- Implementation of Basel IV and potential further changes to capital requirements

Biden appointees will also influence global regulatory initiatives.

The US has a strong influence on regulatory standards that come out of the Basel-based bodies. Fed Vice Chair for Supervision Randal K. Quarles, for example, is the current Chair of the Financial Stability Board.

THE REST OF THE STORY

Financial regulation is unlikely to be one of the top priorities for President Biden.

Realistically, a President can only successfully push a few major initiatives in their first two years, although they always start out believing they can do more at one time. The new President will already face a daunting set of challenges with Covid-19, the economic recovery, healthcare, social justice, the climate transition, and troubled foreign relations. Barring a major financial crisis, financial regulation cannot compete with these issues for the Administration's attention.

Major legislation in this area is therefore improbable.

Big legislation almost always takes a major push from the Administration, which appears unlikely unless a large problem develops that creates a bipartisan consensus for action. Further, Republicans will retain control of the Senate unless the Democrats win both Georgia Senate seats in the run-off election in that state on January 5, 2020. Historically, Republican candidates in Georgia have performed better in run-off elections than in the general election that precedes it, so the odds are in their favor. After all, they won more votes in the general election for these two seats, although they failed to hit the 50 percent threshold required to avoid a run-off. To quantify an intuition, I think the Democrats have only a 25 percent chance of winning both seats.

Action is made even less likely by the Senate's "filibuster" rule, which allows a minority of senators to block most legislation unless there are 60 votes to override the filibuster. Even if Democrats achieve the narrowest of majorities in the Senate (50 seats for each party, with Vice President Kamala Harris breaking the tie in her capacity as President of the Senate), Republicans will have many ways of blocking legislation. All it would take, for example, would be one Democratic defection, such as Senator Joe Manchin of West Virginia, who describes himself as a "Conservative Democrat" and represents a state that voted for President Trump in both elections by a margin of about 40 percentage points. Failing such a defection, Republicans could use filibusters in most cases to block action.

But, regulators can do a great deal without new legislation.

Congress virtually always grants financial regulators and supervisors considerable freedom to write specific rules and guidance to implement any legislation it passes, in recognition of the complexity of the issues in this area. Capital and liquidity requirements, resolution and recovery planning, risk management procedures, disclosure requirements, and many other areas provide regulators and supervisors great leeway to force changes. Some new priorities, such as dealing with the role of finance in the climate transition, could largely be tackled without new laws. Disclosures, risk management requirements, and potentially capital requirements, could all be used to focus banks on the climate transition.

Who are chosen for the key positions will matter.

Any Democratic appointees will share certain priorities, but there will be important differences on other potential initiatives and in how the key priorities are executed.

The two key roles in Treasury are now set. Former Fed Chair Janet Yellen will be Treasury Secretary and Adewale "Wally" Adeyemo will be Deputy Treasury Secretary. Yellen's views on financial regulation, and her actions as Fed Chair, place her solidly in the mainstream of Democratic views on these issues. Given the new Secretary's expertise and experience on financial regulation, the Deputy Treasury Secretary's role in this area is likely to be less influential than might otherwise be the case.

A key question is who will be Biden's choice for Chair of the Federal Reserve Board, when Jerome "Jay" Powell's term expires in February of 2022. Chair Powell could be reappointed, but the probability is that Biden would choose a Democrat to replace him. Quantifying an intuition, my current guess is that Powell has about a 25 percent chance of reappointment.

In his favor, Powell is generally viewed favorably by members of Congress of both parties and by the markets. The monetary policy he has overseen is popular and fits with approaches favored by Democratic economists. Reappointing him would provide more stability, which markets generally prefer, and would allow Biden to demonstrate bipartisanship. He would also be a shoo-in for confirmation despite a Republican-controlled Senate. In fact, there would be the potential to gain Senate Majority Leader Mitch McConnell's agreement not to oppose Biden's choices for another one or two other key positions as a package deal in exchange for Powell's reappointment.

Working against him are two big factors. First, presidents would rather appoint their own person, both for policy reasons and because it gives them an opportunity to reward one of their own with a highly coveted position. Second, there is much more focus on the Fed's regulatory role than was true when Paul Volcker, Alan Greenspan, and Ben Bernanke were each reappointed by presidents of the opposite party to theirs. There will be very strong pressure from progressives for someone viewed as tougher on bank regulation to take over. They have spent the last three years strongly attacking the Fed for purportedly undercutting financial regulation at the behest of the Trump Administration and the big banks. Finally, it is worth noting in passing that the politics that supported the reappointments of Volcker, Greenspan, and Bernanke were very different from the current situation.

I recommend Sebastian Mallaby's excellent biography of Alan Greenspan if you want an in-depth discussion of those situations ("The Man Who Knew: The Life and Times of Alan Greenspan").

The other key Fed role in this area is the Vice Chair for Supervision, held currently by Randal K. Quarles, whose term expires in October of 2021. Here the politics are different. There is no realistic possibility that Quarles would be reappointed by Biden.

There are a number of Democrats who are well qualified to step in as Fed Chair, and various names are rumored at this early point. The betting favorite remains Lael Brainard, currently on the Board of Governors of the Fed. Of course, she was the betting favorite to be Treasury Secretary too, which underlines the difficulty of making these predictions. We may get an earlier indication of Brainard's future, as the most likely alternative appointment for her would be as Vice Chair for Supervision, where a nomination would likely occur in the late spring or early summer of 2021. Nomination for this role would indicate that she will not be nominated as Fed Chair.

Brainard would play a key role in financial regulation in either capacity and even were she to remain simply as a member of the Board of Governors. Her views are in the broad mainstream of thinking at the Fed, but substantially more closely aligned with those of former Fed Governor Daniel K. Tarullo than of the current team. She has dissented on most of the changes to capital requirements over the last couple of years, stating that they were too lenient for the largest banks, and had supported moving to a positive counter-cyclical capital buffer prior to the pandemic.

There are a number of other important financial regulatory roles at the various agencies, but there is too little clarity on the likely choices to discuss them further at this point.

Most changes will take time.

New regulators will not be in place for some time and then need to settle in, have their staffs initiate the analysis required to back up rule changes, put out proposed rules and receive comments, make any refinements, issue the final rules, and then wait for them to take effect.

As noted, the Fed Chair role turns over in February 2022. The role of Vice Chair for Supervision comes up earlier, in October of 2021. It also appears likely that there will be one other vacancy on the Federal Reserve Board when Biden takes office. The Federal Deposit Insurance Corporation (FDIC) Chair does not turn over until 2023 and Jelena McWilliams could choose to remain until that point. However, it is quite possible that she would not want to remain once the FDIC Board has a Democratic majority. (A combination of law and tradition allows the President to have a majority on the FDIC Board of his/her own party.) The head of the Consumer Financial Protection Bureau (CFPB) can now be replaced at the will of the President, based on a Supreme Court ruling that overrode the Dodd-Frank Act on this point on constitutional grounds. Similarly, the President appears to have the legal right to fire the Comptroller of the Currency without cause, although this has not previously happened and some legal challenge might be mounted.

It should be noted that all of these key roles require Senate confirmation, which can add a bit more time and the possibility of a confirmation problem if issues arise. A key question is how aggressive Senate Republicans will be in opposing Biden's nominees.

Biden appointees will also influence global regulatory initiatives.

The US has a strong influence on regulatory standards that come out of the Basel-based bodies. In particular, Fed Vice Chair Quarles is the current Chair of the Financial Stability Board (FSB). It has already been agreed that he will be replaced at the end of 2021 by Klaas Knot, the head of the Dutch Central Bank, who is currently Vice Chair of the FSB. Nonetheless, Quarles' successor under a Biden Presidency would have considerable influence, as would the US members of the Basel Committee on Banking Supervision and other international standard-setting bodies.

The Biden team has not issued detailed financial regulatory proposals, but we do have some sense of their priorities.

These are likely to include the following.

Tougher regulation of the largest banks

Many Democrats, especially in the progressive wing, feel strongly that the largest US banks are coddled, despite the regulatory reforms put in place after the global financial crisis. Further, there is strong support for this view from the media and most of the public. Therefore, all moves by the current regulators that are viewed as favoring the largest banks have a high probability of being rolled back. The one area with less chance of such a change is the ability of the custodian banks to exclude reserves held at the Fed from their leverage ratio calculations. This has more bipartisan support and is enshrined in legislation.

Some of the areas that could see changes are:

Implementation rules for the Volcker Rule. The so-called Volcker Rule is a misnomer, being part of a law, the Dodd-Frank Act, rather than being a rule created by regulators. As such, it requires implementation rules to give it effect. This has been both hard and controversial and consequently took a very long time. Progressives generally view the ultimate outcome as something of a sell-out to the larger banks that makes it too easy to bypass the intended effects of the law. Regulators and banks, not surprisingly, view the implementation rules more positively. The instinct of many Democrats will be to force a toughening of the standards, however there is some chance that Biden's appointees may choose not to revisit an immensely complicated area that most regulators do not view as central to the risks in the financial system.

Leverage ratios. The current team of regulators has taken three sets of actions to make the leverage ratio less binding for banks. The first was to implement the mandate of new legislation that changed the leverage ratio calculation for the custodian banks by excluding reserves at the Fed. This is the least likely to be revised, since it is in law, not just regulation. The second was to change the enhanced supplementary leverage ratio that applies to the largest banks. Formerly, the required ratio was 6 percent for depository institutions and 5 percent for the banking group

as a whole. The 6 percent was dropped to 5 percent. Governor Brainard voted against this change and it could easily be reversed eventually by Biden's appointees. The third was a change to yet another version of the leverage ratio, the supplementary leverage ratio.
This revision temporarily excludes from the calculations reserves held at the Fed and holdings of US Treasury Securities. This was taken in response to the crisis in Treasury securities early in the Coronavirus Recession. It was always intended to be temporary, but some banks have hoped that it might become permanent, perhaps in modified fashion. It appears unlikely that Biden appointees would support this. Were they to do so, they might well increase the required minimum leverage ratio as a rough offset, as the Bank of England did several years ago.

Supervision of the largest banks. Vice Chair Quarles has vowed to make the Fed more transparent in its supervision and to emphasize "rule of law" approaches. This would give banks a clearer idea of what was required of them, how it ties back to law and regulation, and would give them a stronger ability to push back on demands. (See his January 2020 speech on the topic for more information.) This emphasis has the wholehearted support of most banks, especially the largest ones.

Parts of this approach would likely survive a change at the top, but most of this could fizzle out or be retracted under different leadership. Many progressives view Quarles' shift as likely to weaken the ability of supervisors to force actions on banks that they believe have excessive political influence and access to thousands of high-priced lawyers.

The CCAR stress tests also fall under the Fed's supervisory powers. The Fed has very wide leeway to make changes in this area and it is likely capital requirements driven by these tests would be raised for the largest banks. Similarly, the calibration of various capital buffers lies within the Fed's control and could be toughened.

Climate transition

This area would see a major shift. Political constraints have hampered any impulse the Fed or other regulators may have had to take action in this area. In a Biden Administration, this will reverse and there will clearly be pressure to include climate transition as a significant factor in regulation and supervision. This would be unlikely to swing as far as the European approaches, but would certainly spur regulations on risk management standards, reporting requirements, and a climate transition stress test.

Social justice

The new team will almost certainly produce a raft of proposals to ensure that financial regulation reflects an overall push for greater social justice. The Office of the Comptroller of the Currency (OCC) recently revised the regulations under the Community Reinvestment Act, a law intended to ensure that low-income and minority neighborhoods are not unfairly disadvantaged in lending and other bank activities. Many activists were opposed to these changes and it is therefore likely that some or all of these would be reversed. Beyond that, it's likely that the Administration,

Congress, and/or the new regulators would sponsor a wider effort to promote social justice in finance. The exact shape of such an initiative is unclear for now.

Capital requirements

Discussion of capital levels does not engender the same gut reactions from the public as these other topics, but many Democrats, especially progressives, believe that big banks remain too risky. It's possible that this sentiment may be tamped down if US banks comfortably handle the loan losses created by this pandemic and recession. Even that might not do it, though, as some observers on the Left view the aid provided to businesses as a disguised form of bank rescue. This all said, any appreciable increase in capital requirements is likely a couple of years out, as there will be reluctance to take actions that might potentially choke off lending during a difficult economic recovery.

There are multiple ways that new regulators could raise capital requirements. The easiest in many ways would be for the Fed to simply make stress tests harder, since they have almost complete control over this process. However, they could also: change how they calculate G-SIB buffers; add a countercyclical capital buffer; increase minimum leverage ratios; etc.

There is also the possibility that the key newly appointed regulators could have a different view of the right approach to capital requirements. For example, there is a minority of people in the policy community who place much greater emphasis on leverage ratios, out of suspicion that risk weights are flawed by complexity and gaming. Were one or more of those people appointed to key positions, they could appreciably alter capital requirements, with major effects on bank business models. Similarly, there are proponents of an active use of countercyclical capital buffers. Were they in charge, this buffer could come into play once we got sufficiently past the current crisis.

Basel IV

For similar reasons, and because of a desire to conform to international agreements, Biden appointees would be highly likely to finish the implementation of the final changes to the Basel capital accords. (Known by the industry as "Basel IV" and by the regulators as the "Basel III end-game" or similar names.) Completing this implementation is actually in line with the policy of the current Fed Chair and Governors, and other regulators as well. Therefore, this does not fundamentally represent a change, although it would put paid to the hopes of some in the banking industry of obtaining more favorable conditions in the implementation rules.

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