

January 21, 2020

## The Next Frontier: Fed Vice Chair Quarles’ Proposals to Reform Banking Supervision

---

On January 17, the Federal Reserve Board’s Vice Chair for Supervision Randal Quarles outlined an ambitious planned reform of the Federal Reserve’s approach to banking supervision in remarks before the American Bar Association Banking Law Committee.<sup>1</sup> While many of the concepts have been percolating for some time, the speech is notable for spelling out publicly a list of concrete proposals to implement principles the Vice Chair has advocated during his tenure. The most significant proposals relate to reforming the Large Institution Supervision Coordinating Committee (“LISCC”) framework, additional transparency for the Comprehensive Capital Analysis and Review (“CCAR”), and limitations on issuing “matters requiring attention” (“MRAs”) in examination reports. The proposals would enhance “transparency, accountability and fairness in bank supervision” and were characterized by Vice Chair Quarles as “rooted in common sense with a view towards maintaining firm and fair supervision.”

The proposed changes could increase the transparency of the Federal Reserve’s supervision and impose meaningful constraints on the now relatively unfettered discretion of Federal Reserve examiners to determine supervisory ratings. The proposed changes are particularly significant in light of the adverse consequences firms face following a management ratings downgrade (which can jeopardize a banking organization’s status as a financial holding company and increase its deposit insurance fund assessments, among other implications). While the scope and the timeline for implementation of these reforms remains unclear, the Vice Chair indicated that implementing this slate of reforms will be a “very high priority.”

---

<sup>1</sup> Randal K. Quarles, Vice Chair for Supervision, Federal Reserve, Spontaneity and Order: Transparency, Accountability, and Fairness in Bank Supervision (Jan. 17, 2020).

### **Large Institution Supervision Coordinating Committee**

Vice Chair Quarles endorsed two important changes to the LISCC framework, and described these changes as improving the transparency of supervisory practices without compromising the effectiveness of supervision.

- The Vice Chair suggested limiting the firms in the LISCC portfolio to those that fall in Category I of the Federal Reserve’s recent tailoring framework (i.e., the eight U.S. global systemically important banks (“G-SIBs”)). This change would mean that inclusion in the LISCC portfolio would be based on clear, predictable and publicly available criteria.
  - This change would have the practical effect of removing the four foreign banking organizations (“FBOs”) currently in the portfolio (Barclays, Credit Suisse, Deutsche Bank and UBS, each of which is projected to be in Category II or III in the new tailoring framework) from the LISCC portfolio. As support for this change, Vice Chair Quarles noted the significant shrinking and de-risking of the LISCC FBOs’ U.S. operations since the framework was created and the differential in systemic risk scores between the U.S. G-SIBs and the LISCC FBOs.
  - Inclusion in the Federal Reserve’s LISCC portfolio has significant consequences for affected firms, including annual horizontal reviews such as the Comprehensive Liquidity Analysis and Review (“CLAR”) and the Supervisory Assessment of Recovery and Resolution Preparedness. In response to Congressional concerns that these supervisory expectations (among others) imposed on LISCC firms have become binding in practice, the Government Accountability Office determined in October 2019 that two of the Federal Reserve’s supervisory letters laying out LISCC expectations are “rules” under the Congressional Review Act and should have been submitted to Congress for review in order to become effective.
- Vice Chair Quarles also suggested that the Federal Reserve consider publishing the program manual that describes the Federal Reserve’s supervisory processes for identifying and addressing risks posed by LISCC firms. Publication of the LISCC manual could provide meaningful insights into the CLAR process in particular. In contrast to the CCAR program, the CLAR process has not been included in the Federal Reserve’s recent actions to increase the transparency of its supervisory stress tests.

### **Supervisory Process**

Vice Chair Quarles also proposed reforms to the way the Federal Reserve supervises all firms.

- Modifying communication of supervisory findings. Vice Chair Quarles suggested that the Federal Reserve could limit future MRAs to violations of law, violations of regulation and “material” safety and soundness issues. This materiality standard would be intended to limit MRAs to those issues that are significant enough to affect a bank’s supervisory rating. Lesser safety and soundness concerns would instead be addressed through supervisory observations, a category of findings that would be reinstated in reports of examinations. The Federal Reserve

had eliminated this supervisory tool in 2013, while the FDIC and OCC retained it. The practical effect of distinguishing between MRAs and supervisory observations could depend in part on whether firms would be more likely to decline to follow a supervisory observation, including one that recommended a remediation measure or change in practice, because it did not rise to the level of an MRA.

- Finalizing later this year the Federal Reserve’s proposal to improve the ability of firms to share confidential supervisory information with employees, affiliates, service providers and other agencies.<sup>2</sup>
- Codifying in a rule the non-binding nature of guidance.
  - The rule would codify the interagency “guidance on guidance” from September 2018, establishing that guidance may not form the basis for an enforcement action or supervisory criticism in an examination report. In remarks on the same topic the following day, other Federal Reserve staff indicated that an interagency effort to formalize the interagency statement has been underway for more than six months and release of a proposed rule is expected shortly.
  - Vice Chair Quarles also endorsed an independent review of guidance and a proactive assessment of future guidance. These reviews would focus on removing mandatory language and bright lines from guidance. In addition, the review would focus on ensuring that guidance keeps pace with rulemaking. For example, the scope of guidance on stress testing and capital planning would be reviewed to align with the recent tailoring framework.

### **Comprehensive Capital Analysis and Review**

Vice Chair Quarles previewed three proposals that he would support to further improve the transparency of stress tests conducted under CCAR.

- Continuing to share substantial details of key models and economic scenarios, particularly for the global market shock component. This approach would build on a package of policy statements released over two years ago to provide some transparency around the design of models and scenarios, which Vice Chair Quarles described at the time as “early steps.”<sup>3</sup> Friday’s remarks suggest that additional transparency measures may indeed be forthcoming, but also suggest that the Federal Reserve would stop short of subjecting its models and economic scenarios to public notice and comment—an approach that the Treasury Department and the banking industry have supported.
- Providing CCAR firms with the ability to review their stress capital buffer before completing their full capital plan and determining their likely dividends and distributions. In response to a

---

<sup>2</sup> “Rules Regarding Availability of Information,” 84 Fed. Reg. 27976 (June 17, 2019).

<sup>3</sup> Randal K. Quarles, Vice Chair for Supervision, Federal Reserve, Early Observations on Improving the Effectiveness of Post-Crisis Regulation (Jan. 19, 2018).

question on whether the stress capital buffer would be finalized in time for the 2020 CCAR exercise, the Vice Chair noted the Federal Reserve could finalize some elements that were part of the original proposal, and then propose other elements later. These other elements could include a non-zero counter-cyclical capital buffer or a greater-than-2.5% stress buffer floor.

- Reducing the volatility predicted in the stress capital buffer arising from the change each year in CCAR scenarios and input metrics. Options include averaging stress testing outcomes over multiple years or averaging the current year with one or more previous years.

### **Transparency Improvements**

Consistent with the principle of transparency in the Federal Reserve’s regulatory approach, Vice Chair Quarles proposed two actions to improve the supervisory process for all banks.

- Subjecting “significant” supervisory guidance to both public notice and comment and to Congress for purposes of the Congressional Review Act. These steps would have the practical effect of treating significant guidance as a rule. Vice Chair Quarles suggested that guidance would be considered “significant” if it can have a “material impact on bank behavior.”
- Creating a searchable database of Federal Reserve interpretations, guidance, FAQs and commentary, which would include the “oral history” of informal guidance colloquially referred to as “the Talmud” by Federal Reserve staff. Other Federal Reserve staff at the American Bar Association meeting also endorsed this project. Similar transparency concerns have motivated recent rulemakings, such as the Federal Reserve’s proposal on the control framework.

### **Large Financial Institutions Ratings Framework**

Vice Chair Quarles described several aspects of the large financial institutions (“LFI”) ratings framework that would be adjusted. The LFI framework focuses on three components of a firm’s operations: capital, liquidity, and governance and controls. The Vice Chair suggested monitoring the following two practices, implying that changes may be forthcoming.

- Embedding qualitative risk management standards in the capital and liquidity components. Vice Chair Quarles’ focus on this topic raises the question whether the Federal Reserve would move toward relying on more quantitative measures of capital and liquidity adequacy.
- Determining “well-managed” status based on a firm’s lowest component rating, no matter the others. While the Federal Reserve has unilateral discretion to make changes to the LFI framework in its role supervising bank holding companies, it remains unclear whether the Federal Reserve intends to initiate a joint-agency process to revise the CAMELS framework for depository institution ratings, given that downgrades of the “M” component in a CAMELS rating can trigger similar adverse consequences.

## **Observations**

- *Focus on Supervisory Reform.* With these remarks, Vice Chair Quarles has publicly turned his attention for 2020 from rulemaking to supervision. The Federal Reserve’s agenda for the second half of 2018 and most of 2019 focused heavily on implementing Congressional rulemaking mandates imposed by the Economic Growth, Regulatory Relief, and Consumer Protection Act and the Federal Reserve’s own tailoring initiatives. Now that the Federal Reserve has largely finished that work, the speech signals an intention to shift focus towards reforming how supervisors implement those rules through engagement with specific firms.
- *Building Inter- and Intra-Agency Consensus.* While these remarks represent Vice Chair Quarles’ own ideas, suggestions and preferences, they are likely to be accorded significant weight by the various stakeholders necessary to implement his agenda. Support from his Federal Reserve colleagues is necessary for some proposals (*e.g.*, reforming the LISCC criteria), while support from his eventual successor is necessary for others (*e.g.*, subjecting significant guidance to public notice and comment and to Congress). Building consensus will therefore be a necessary condition to implementing and sustaining these proposals.
- *Limitations on MRAs.* The proposal to limit MRAs to violations of law, violations of regulation and “material” safety and soundness issues, together with reduced reliance on guidance, may help address longstanding concerns at supervised firms about firms suffering ratings downgrades for shortcomings that previously were simply the subject of exam commentary. These downgrades can have significant business consequences, including on a firm’s ability to acquire or invest in financial companies.
- *Transparency for Guidance.* Subjecting “significant” guidance to the public rulemaking process and to Congressional review is indeed likely to improve transparency and accountability. While this is likely to limit examiners’ use of guidance as the explicit basis for criticism in an exam, it is also possible that this more burdensome process will result in less guidance. As a result, firms may have less visibility into supervisory expectations, and examiners may rely on a set of unwritten and not well-publicized standards.
- *Relief for the LISCC FBOs.* Vice Chair Quarles stated that his preference to remove the four FBOs from the LISCC portfolio would have “no effect on the regulatory capital or liquidity requirements that currently apply to the four LISCC FBOs.” If ultimately adopted, these changes could nonetheless reduce burden by releasing these FBOs from LISCC-specific compliance requirements, including the CLAR, an annual supervisory stress test with quantitative and qualitative elements. These changes would be justified by Vice Chair Quarles’ observations about the de-risking of FBOs.<sup>4</sup>

...

CLEARY GOTTLIB

---

<sup>4</sup> See James DiSalvo, Federal Reserve Bank of Philadelphia Research Department, “How Foreign Banks Changed After Dodd-Frank,” *Banking Trends* (Sept. 2019).

# Contacts

If you have any questions concerning this memorandum, please reach out to your regular firm contact or the following authors:



**Michael H. Krimminger**  
Partner  
Washington, D.C.  
+1 202 974 1720  
mkrimminger@cgsh.com



**Derek M. Bush**  
Partner  
Washington, D.C.  
+1 202 974 1526  
dbush@cgsh.com



**Katherine Mooney Carroll**  
Partner  
Washington, D.C.  
+1 202 974 1584  
kcarroll@cgsh.com



**Hugh C. Conroy, Jr.**  
Partner  
New York  
+1 212 225 2828  
hconroy@cgsh.com



**Jack Murphy**  
Senior Counsel  
Washington, D.C.  
+1 202 974 1580  
jmurphy@cgsh.com



**Allison H. Breault**  
Senior Attorney  
Washington, D.C.  
+1 202 974 1532  
abreault@cgsh.com



**Patrick Fuller**  
Senior Attorney  
Washington, D.C.  
+1 202 974 1534  
pfuller@cgsh.com



**Zachary L. Baum**  
Associate  
Washington, D.C.  
+1 202 974 1873  
zbaum@cgsh.com