BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

JEROME H. POWELL
CHAIR

May 28, 2020

The Honorable Brian Schatz
United States Senate
Washington, D.C. 20510

Dear Senator:

Enclosed are my responses to questions 1, 3, 4, 5, 6, and 7 you submitted following the February 12, 2020,[1] hearing of the Committee on Banking, Housing, and Urban Affairs. A copy also has been forwarded to the Committee for inclusion in the hearing record. My response to your remaining question will be forthcoming.

Please let me know if I may be of further assistance.

Sincerely,

Jerome H. Powell

Enclosure

[1] Questions for the record related to this hearing were received on February 21, 2020.

<u>Questions for The Honorable Jerome H. Powell, Chair, Board of Governors of the Federal Reserve System from Senator Schatz</u>:

1) According to the Federal Reserve's annual supervisory report for 2019, approximately 40-45% of financial holding companies (FHCs) with more than $100 billion in assets have a less than satisfactory rating, and thus are not meeting the Bank Holding Company Act standard of "well-managed." This is a trend that has spanned more than the last ten years. While we cannot know from aggregated supervisory data whether which firms are falling below the statutory standard year after year, it is a troubling trend. It suggests both a wide-spread failure of large FHCs to manage themselves well, as well as a persistent failure to correct their deficiencies. In addition, more than half of the Federal Reserve's supervisory findings have related to deficiencies in the governance and risk management of these large banks.

Wells Fargo is one of the most recent and high-profile examples of poor management. Wells Fargo has been responsible for a string of egregious consumer abuses in several business units, including (a) opening over 3.5 million fake accounts; (b) illegally repossessing military members' cars; (c) charging auto loan borrowers for insurance without their knowledge; (d) improperly levying fees for extending mortgage rate-locks; (e) failing to offer mortgage modifications because of a software glitch that resulted in several hundred foreclosures; and (f) charging wealth management services for inappropriate add-on products and steering them into investments that generated larger commissions for Wells. According to a report commissioned by Wells' independent directors, the firm's sprawling organizational structure inhibited effective risk management.

The Fed has responded by imposing an unprecedented asset cap until the company fixes its governance problems. But the Fed has the authority to require Wells Fargo, and other poorly managed FHCs, to make themselves smaller and less complex in order to regain control over their management.

A. Do you see any benefits to institutions like Wells Fargo being smaller and less complex?

Since the financial crisis, the Federal Reserve has subjected larger, more complex firms to more stringent regulatory requirements (such as the GSIB surcharge, which increases with size and complexity) and comprehensive, intense examination focused on key risks. The Federal Reserve will continue to appropriately tailor its regulatory and supervisory regime to calibrate stringency and severity to the risks a firm poses to the financial system.

B. What is the Fed doing to improve governance at large, poorly managed firms?

Since the financial crisis, the Federal Reserve has taken a number of regulatory and supervisory steps to improve governance at large firms in general and firms that are not well managed in particular. These steps built on the existing regulatory and supervisory framework that has for many years restricted firms that are not well managed.

For example, large firms are subject to specific governance requirements in Regulation YY (12 CFR part 252). In addition, the Federal Reserve has articulated governance expectations for large firms in Supervision and Regulation (SR) Letter 12-17 (*Consolidated Supervision Framework for Large Financial Institutions*), and that governance is a fundamental aspect of each of the three component ratings assigned to large firms (see SR 19-3, *Large Financial Institution (LFI) Rating System*). The supervisory programs for large financial institutions, which culminate in ratings assigned under the LFI rating system each year, include examinations and other activities that focus on governance. If governance issues are identified, supervisors direct the board and senior management to address them through supervisory findings and formal and informal enforcement actions, as appropriate. If a firm fails to address these issues, such actions may be escalated and lead to more stringent limitations on their operations, as in the case of Wells Fargo.

C. Has the Fed considered exercising its divestment authority under Section 4(m) of the Bank Holding Company Act of 1956 to require large FHCs that are poorly managed to shrink themselves until they are better able to manage themselves?

When a financial holding company (FHC) falls out of compliance with section 4(l) of the Bank Holding Company Act, by becoming less than well-managed or well-capitalized, the noncompliant FHC enters into a confidential 4(m) agreement with the Federal Reserve Board (Board) requiring, among other things, that they remedy the identified deficiencies. This agreement is an enforcement action that permits the FHC to continue operating while it addresses its deficiencies. The agreement is approved by the Board and may be modified or terminated by the Board.

Through the 4(m) agreement, the FHC is required to seek prior approval from the Board to engage in any new financial activities or to make nonbank investments or acquisitions.[1] The Board may also impose other restrictions on the FHC as appropriate. This approach incentivizes the firm to focus on fixing its supervisory issues.

If a noncompliant FHC fails to address the identified deficiencies within the specified period of time then the Board may require the institution to divest its depository institutions unless the FHC chooses to voluntarily cease all of its FHC-only permissible activities. The Board regularly assesses a noncompliant FHC's progress in remediation of identified issues and as part of this review considers whether it would be appropriate to implement other limitations or ultimately exercise authority to require divestiture.

D. Why has the Fed never used this authority before?

We have found that the broad range of supervisory and enforcement tools that Congress as conferred on the Board have generally been effective in motivating institutions to remediate issues. These tools include the ability to issue examination findings that highlight Matters Requiring Attention and Matters Requiring Immediate Attention, as well as ratings downgrades. If a problem requires a more detailed resolution or is more pervasive at an institution, the Board can impose informal enforcement actions (typically in the form of

[1] 12 CFR 225.83(d).

Memorandums of Understanding) and formal enforcement actions, such as Written Agreements and Cease and Desist Orders, which may carry civil money penalties, are available tools. In addition, there is a range of restrictions the Federal Reserve may impose through 4(m) agreements short of requiring divestiture, such as limits on particular nonbank businesses.

Enforcement measures may escalate depending on the severity or difficulty of the problem. Indeed, the decision to force divestiture of a depository institution or cessation of nonbank financial activities would be one of the most severe penalties that would be considered if the informal and formal enforcement tools exercised throughout the supervisory process did not result in corrective action, or if circumstances otherwise warrant a heightened response.

E. Under what circumstances would the Fed use this authority going forward?

As discussed above, because of the severity of the action and the potential for unintended consequences, the Board would consider ordering divestiture only in severe cases where other options would not be feasible or effective. The risk of unintended adverse consequences to the broader economy would be a primary consideration, as would the severity and duration of the issues giving rise to the consideration.

The supervisory process is focused on addressing the issues you have identified, including ensuring that large and complex organizations have robust risk management practices to ensure safety and soundness and compliance with consumer compliance laws and regulations. I welcome further discussion on ways to improve our current approach to this important issue.

3) During the hearing, you stated that in a future recession, the Federal Reserve would use tools that it used for the first time during the 2008 financial crisis, including quantitative easing through purchases of long-term assets and Treasury bills. Quantitative easing was successful in increasing the money supply and pushing down interest rates. But even with almost $2.6 trillion in quantitative easing, one quarter of American families lost at least 75% of their wealth and more than half lost at least 25% of their wealth.[1] And the pace of economic recovery was historically slow, averaging just 2% instead of the average of 3-5% typical of other economic recoveries.

The problem for households who lost their homes and for the broader economy was that not enough of the money that the Fed pumped into the financial system made it into the hands of American households and businesses. Instead, much of the extra supply of money remained within the financial system and was poured back into the stock market. Two years after the start of the financial crisis, the Fed cleared the largest banks to pay out dividends and buy back shares. Since then, stock buybacks in the financial sector—and economy-wide—have surged. In the past ten years, the financial sector spent $860 billion in stock buybacks, and in 2019, S&P 500 companies spent a record $1 trillion in stock buybacks. These data suggests that the Fed's reliance on using the financial system as its intermediary for stimulating the economy in a crisis was inefficient.

[1] https://www.ncbi.nlm.nih.gov/pmc/articles/PMC4200506/

A. Do you think the financial system made the best use of the additional money supply from quantitative easing?

The Federal Reserve's asset purchase programs were mainly intended to place downward pressure on longer-term interest rates to reduce the cost of funding to business and households. Academic research suggests that the purchases programs were successful in achieving this goal.[2]

In addition to reducing the cost of funding, the Federal Reserve's asset purchase programs also appeared to have boosted the availability of funding to business and households through increased bank lending—though these effects are difficult to estimate precisely, as banks raise funds from various sources and those funds are all fungible. Nonetheless, recent academic research provides evidence that the asset purchase programs did increase bank's risk tolerance and their lending to customers. For example, several studies find that following the first round of large-scale asset purchases (LSAP) and the third round of LSAPs, which involved Federal Reserve purchases of agency mortgage-backed securities (MBS), banks with higher initial holdings of MBS increased lending more than banks with little initial MBS exposure, and were more likely to reorient their lending activities towards riskier loans and easier lending standards.[3]

B. In the case of a future recession, do you think the economy would benefit more if the Fed used its tools to increase the money supply in a way that put money directly into the hands of American households?

The Federal Reserve is committed to using its full range of tools to support the economy, thereby promoting its maximum employment and price stability goals. For example, in the current economic downturn, the Federal Open Market Committee (FOMC) has moved quickly to cut the policy rate to near zero and stated that it intends to keep the rates at that level until it is confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals. To support the flow of credit to households and businesses, foster smooth market functioning, and promote effective transmission of monetary policy to broader financial conditions, the Federal Reserve has been purchasing large amounts of Treasury and agency mortgage-backed securities. Federal Reserve policies to lower short- and longer-term interest rates are helping—by reducing the interest payments that households pay on their mortgages and other loans—to put more money in the hands of American households. Additionally, by providing support for economic activity and jobs in this challenging time, our actions will also help to put more money—in the form of labor income—into the hands of American households.

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[2] See Gagnon, Joseph E. 2016. "Quantitative Easing: An Underappreciated Success," Policy Briefs PB16-4, Peterson Institute for International Economics; and Kuttner, Kenneth N. 2018. "Outside the Box: Unconventional Monetary Policy in the Great Recession and Beyond." Journal of Economic Perspectives, 32 (4): 121-46.

[3] See Rodnyansky, Alexander and Olivier M. Darmouni (2017). "The Effects of Quantitative Easing on Bank Lending Behavior," Review of Financial Studies, vol. 30, pp. 3858-3887; Chakraborty, Indraneel & Goldstein, Itay & MacKinlay, Andrew, 2020. "Monetary stimulus and bank lending," Journal of Financial Economics, Elsevier, vol. 136(1), pages 189-218; and Kurtzman, Robert, Stephan Luck, and Tom Zimmermann (forthcoming). "Did QE lead banks to relax their lending standards? Evidence from the Federal Reserve's LSAPs," Journal of Banking and Finance.

The Federal Reserve is also undertaking programs to provide stability to the financial system and to more directly support the flow of credit in the economy—for households, for businesses of all sizes, and for state and local governments. Many of these programs rely on emergency lending powers that are available only in very unusual circumstances. The Federal Reserve is deploying these lending powers to an unprecedented extent, enabled in large part by the financial backing and support from Congress and the Treasury. However, these are lending powers, and not spending powers. The Federal Reserve cannot grant money to particular beneficiaries, but can only make loans to solvent entities with the expectation that the loans will be repaid.

C. If American households had been able to keep up with their rent and mortgage payments, pay their bills, and maintain financial stability during the recession, do you think it would have enabled the U.S. economy to recover faster from the crisis? What do you think the impact would have been on household wealth today?

During and after the 2007-2008 financial crisis and the Great Recession the Board and the FOMC indeed exercised their statutory authority to undertake a wide range of aggressive and unprecedented conventional and unconventional policy actions, including large-scale asset purchases. Although those actions did mitigate to a considerable extent the consequences of severely adverse and widespread pressures and difficulties facing families and businesses all across the country, very many American families fell behind on their rent payments or mortgage payments, and fell into a fragile financial state. Moreover, there were other government programs, such as the Home Affordable Refinance Program, that allowed mortgagors to either lower their monthly mortgage payments or to pay down their loan faster by lowering their interest rates, and allowed them to build more equity. Such programs were more effective because the Federal Reserve purchases of mortgage-backed securities helped improve conditions in the secondary market for mortgages.

Had families been able to maintain their incomes, home values, and other financial resources throughout that extremely difficult period, household wealth would likely have been higher than its record level at the end of 2019, but one cannot know just how much.

D. What tools could the Fed use to make sure that any increase in the money supply in a crisis gets into the hands of American households, rather than remaining in the hands of banks or shareholders?

As mentioned above, Federal Reserve policies to lower short- and longer-term interest rates—by reducing the interest payments that households pay on their mortgages and other loans—help to put more money in the hands of American households in a crisis. Additionally, by providing support for economic activity and jobs in this challenging time, lower interest rates will also put more money—in the form of labor income—into the hands of American households.

During the 2007-2008 financial crisis and more recently in response to the COVID-19 crisis, the Federal Reserve purchased agency MBS in order to support the transmission of changes in policy rates to mortgage rates, which are the key interest rates that households face when they buy a house or refinance an existing mortgage. Additionally, in both of these crisis episodes the Federal Reserve established the Term Asset-Backed Security (ABS) Loan Facility (TALF) to support the flow of credit—in the form of auto loans, credit card loans, student loans, and other loans—to households. The Federal Reserve took these actions to alleviate significant dislocations in agency MBS and in private label ABS markets that were impeding the flow of credit to households.

4) Can you provide an update on what the Fed is doing to address the financial risks from climate change in its supervisory and financial stability responsibilities? Please be specific about the steps you are taking. What does the Fed hope to accomplish in the next year?

The Federal Reserve is focused in the near term on mitigating economic disruptions and supporting the efficient functioning of the financial system during recovery from the COVID-19. However, we expect to continue a number of longer-term supervisory and financial stability projects in the year ahead, including on climate-related risks. We continue to participate actively in analytic efforts by the Basel Committee, the International Association of Insurance Supervisors, and the Financial Stability Board, focused on assessing the impact of climate-related risks on the financial system. Federal Reserve researchers are continuing pre-existing efforts to procure additional climate-related data and to pursue projects on the intersection of climate-related risks with supervisory policy. We also continue to engage externally and to identify and draw on expertise from other fields relevant to the assessment of climate-related risks. To the extent the Network for Greening the Financial System (NGFS) continues to hold meetings during the ongoing public health crisis, we also anticipate participating in those as a guest.

5) Does the Fed have the data it needs to assess climate financial risks?

For the Federal Reserve's near-term analysis of economic and financial activity, the staff use a variety of data sources to measure the economic effects of weather events. These include, for example, data from the Federal Emergency Management Agency and the Department of Energy used to gauge the disruptions to oil and gas extraction, petroleum refining, and petrochemical and plastic resin production in the wake of hurricanes that have affected the Gulf region. Our staff regularly uses daily measures of temperatures and snowfall from the National Oceanic and Atmospheric Administration weather stations to better understand how severe weather may be affecting measured and real economic activity in specific areas.

Our understanding of what economic activities will be affected by a severe weather event depends critically on data produced by the federal statistical agencies, such as the Census Bureau's County Business Patterns data, as those data provide information on economic activity in different geographic locations. In addition, our staff uses credit and debit card transactions data for gauging how specific types of severe weather might be affecting consumer spending in areas affected by those events.

Data remains a significant challenge in identifying, assessing, and managing climate-related financial risks, for the Federal Reserve and for other organizations, such as financial institutions. In addition to data on economic activity described above, understanding financial risks from climate change requires different types of data, including climatic, geospatial, and financial data. The challenges in meeting these data needs are faced by central banks and supervisors around the world, as well as by private financial institutions, researchers, and the public. The Federal Reserve is engaged in efforts to help bridge these gaps through investigating public and private data sources and through its work with international groups such as the Basel Committee on Banking Supervision.

6) Could you provide an update on the Fed's work to join the NGFS? Is there an estimated timeline for when the Fed would join, if it is going to? If the Fed joins as an observer, what would that mean?

While the timeline of the NGFS's activities is in flux as a result of COVID-19, the Federal Reserve remains engaged with the NGFS secretariat and its members, continues to participate in its meetings, and is following its work closely. We continue to explore how the Federal Reserve will be allowed by the NGFS to participate further in a way that is consistent the full range of the Federal Reserve's responsibilities.

7) Do you see value in conducting scenario analyses or stress tests, either of individual institutions or the financial system as a whole, to gauge resilience to climate financial risk?

The innovative and exploratory work of central banks on "climate stress-testing" is valuable, precisely because of the novel challenges that such an exercise poses. While scientific research on climate change is well developed, research on the specific transmission channels between climate change and financial risk is novel and emerging in ways that specifically affect many elements of traditional supervisory stress tests.

As climate-related risks manifest themselves over long horizons, stress testing for those risks involves the challenge of formulating scenarios and projecting outcomes over periods that stretch well beyond the current stress tests. Most supervisory stress tests today project losses with granularity at horizons of three to five years. A granular analysis of the effects of climate on banks over a timeframe relevant for climate change would require predictions of output, employment, and the structure of the economy and financial system over a 60-year period. The uncertainty of such long-horizon economic forecasts would dramatically reduce the plausibility and relevance of the results.