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Making the Financial System Safer and Fairer

Remarks by

Michael S. Barr

Vice Chair for Supervision

Board of Governors of the Federal Reserve System

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Thank you, David, and thank you to the Brookings Institution for the invitation to speak to you today.¹ On July 19, I had the honor of being sworn in as the Vice Chair for Supervision of the Board of Governors of the Federal Reserve System. This job was created after the Global Financial Crisis to lead the Fed’s work overseeing the safety and soundness of banks and in support of its financial stability mandate. In the 12 years since then, great progress has been made in strengthening the banking system, and in strengthening oversight. I look forward to building on that work by helping to make the financial system safer and fairer, in support of an economy that serves the needs of households and businesses.

On behalf of those who may wonder what “building on that work” means, I will speak about some of my near-term goals and how I will approach achieving them. Starting with that word “building,” which to me means more than just “maintaining.” Success in financial regulation and supervision does not mean standing still because finance does not stand still. The regulatory and supervisory framework adopted after the crisis recognizes that innovation and change are constant in finance, that our understanding of existing and emerging risks can and should deepen over time, and that regulation and supervision must evolve to be effective. Many issues at the forefront of banking regulation today were not prominent five years ago, and some of them scarcely even existed. “Building” means staying ahead of changes, evaluating how banks are managing risks, and making the financial system safer and fairer for households and businesses.

When I say that one of my top goals is to make the financial system safer, it is because keeping it safe involves an active and never-ending effort to analyze risks and make necessary

¹ I am grateful to Laura Lipscomb of the Federal Reserve Board for her assistance in preparing this text. The views expressed here are my own and do not necessarily reflect those of the Federal Reserve Board or the Federal Open Market Committee.

adjustments. There is no responsible alternative to this approach because the stakes are far too high to do otherwise. The Global Financial Crisis caused a terrible recession and brought the United States to the brink of an economic collapse that could have been worse than the Great Depression of the 1930s. A significant cause was excessive risk-taking by banks and inadequate regulation and supervision by the Fed and other bank regulators. A hard-won lesson from the crisis is that the savings of every retiree, the job of every worker, the payroll of every business, and the well-being of every individual depend on a safe and stable financial system.

In addition to making the financial system safer, I am also committed to making it fairer. Fairness is fundamental to financial oversight, and I am committed to using the tools of regulation, supervision, and enforcement so that businesses and households have access to the services they need, the information necessary to make their financial decisions, and protection from unfair treatment. Safety and fairness may seem like distinct goals, but they are intertwined. Financial instability unfairly harms those who are economically vulnerable, so making the financial system safer is making it fairer.

Capital

Nothing is more basic to the safety and soundness of banks and the stability of the financial system than capital. Capital enables firms to serve as a source of strength to the economy by continuing to lend through good times and bad. To continue to perform these functions, banks must have a sufficient level of capital to ensure that they can absorb losses and continue operations during times of stress in the financial system when losses may be significant.²

² The financial crisis showed that pre-crisis bank capital requirements and levels were far short of this standard. Since then, capital requirements have increased substantially and banks have accordingly increased their capital and greatly improved their ability to understand their risks and plan for their capital

An important principle of the capital framework is that it must evolve through a continuous process of incorporating new risks that may emerge. While history is a guide to identifying the range of stresses that a bank may face, capital policy must also be forward-looking and responsive to changes in macroeconomic conditions, market structure, and financial activities.

A second principle is that the capital framework should be risk focused. Different activities pose different potential for loss, and the capital regime should calibrate requirements to account for the risks of specific activities. At the same time, simpler, non-risk-based approaches can serve as important backstops, given the complexity of risk-based approaches and evidence that these approaches can be gamed. As such, leverage ratios also serve an important role in this framework.

A third principle is that requirements should be tiered. As firms increase in systemic importance, the social cost of their failure grows. Regulations should be designed to require firms to internalize the costs that their potential failure would impose on the broader financial system and thus on businesses and households. This means that firms face higher costs through more stringent regulations as they grow in complexity, size, and interconnectedness. And rightly, that community banks face simpler regulations.

We are looking holistically at our capital tools to understand how they are supporting the resilience of the financial system, individually and in combination. When calibrating requirements, we will work to minimize unintended consequences, limit opportunities for gaming, and avoid excess compliance costs that do not result in risk reduction. Taking a holistic view will help us consider adjustments, if any, to the supplementary leverage ratio,

needs, in concert with a greatly improved regulatory framework for capital that more accurately assesses risks to individual institutions in a complex, dynamic, and interconnected financial system.

countercyclical capital buffer, and stress testing. Within this context, I am also committed to implementing enhanced regulatory capital requirements that align with the final set of “Basel III” standards or the so-called the “Basel endgame.” This process will involve working with other federal banking agencies and soliciting public input, and I’ll have more to say about this later this fall.

Resolution

Sufficient capital in the financial system helps support the resiliency of individual banks, but it is still important to ensure that, if a large firm gets into trouble, it can be resolved without a costly bailout. The Dodd-Frank Act established the framework necessary to end bank bailouts. It provides the Federal Deposit Insurance Corporation (FDIC) with the authority to resolve any firm whose failure would pose substantial risks to our financial system, in a way that will protect the economy while ensuring that large financial firms—not taxpayers—bear any costs. In addition, the Fed and FDIC require large banks to develop living wills to demonstrate that they can be resolved in an orderly way.

Many gains have been made from this process. While recognizing these gains, we need to continue to analyze whether firms are taking all appropriate steps to limit the costs to society of their potential failure. As such, we will continue to work with the FDIC to rigorously review firms’ plans, making clear when firms do not meet our expectations and when remediation is necessary. In addition, beyond globally systemically important banks, or G-SIBs, we will be looking at the resolvability of some of the other largest banks as they grow and as their significance in the financial system increases. As we consider future policy actions in this area, the Fed will work with our colleagues at other banking regulatory agencies and seek public comment.

Bank Merger Policy Review

Mergers are a feature of vibrant industries, but the advantages that firms seek to gain through mergers must be weighed against the risks that mergers can pose to competition, consumers, and financial stability. Another priority of mine is to evaluate our approach to reviewing banks' proposed acquisitions.³ The Board is required to consider a range of factors when reviewing proposed mergers. A merged institution may be able to provide more competitive products and services, but it could also have the potential to reduce competition and access to financial services in a geographic area by raising prices, narrowing the range of services offered, and reducing the supply of small business or community development loans that rely on local knowledge. Assessing these risks is a crucial component of reviewing proposed mergers. In addition, we review the potential effects on the convenience and needs of the communities to be served by the merged entity, particularly low-income communities.⁴ Under the Dodd-Frank Act, we are also required to consider financial stability risks. These risks may be difficult to assess, but this consideration is critical. I am working with Federal Reserve staff to assess how we are performing merger analysis and where we can do better.

Stablecoins as Private Money

³ The relevant statutes with respect to proposed acquisitions include the Bank Holding Company Act (BHCA), Bank Merger Act (BMA), Dodd-Frank Act, and the Home Owners' Loan Act.

⁴ The Board must take into consideration the convenience and needs of the community to be served by the resulting institution. *See* 12 U.S.C. § 1842(c)(2): <https://www.govinfo.gov/content/pkg/USCODE-2020-title12/pdf/USCODE-2020-title12-chap17-sec1842.pdf> 12 U.S.C. § 1828(c)(5)(B): <https://www.govinfo.gov/content/pkg/USCODE-2020-title12/pdf/USCODE-2020-title12-chap16-sec1828.pdf> 12 U.S.C. § 1467a(e)(2): <https://www.govinfo.gov/content/pkg/USCODE-2020-title12/pdf/USCODE-2020-title12-chap12-sec1467a.pdf> 12 U.S.C. § 2903(a): <https://www.govinfo.gov/content/pkg/USCODE-2020-title12/pdf/USCODE-2020-title12-chap30-sec2903.pdf>. In addition, the Community Reinvestment Act (**CRA**) requires the Board to assess a depository institution's record of helping to meet the credit needs of its entire community, including low- and moderate-income (**LMI**) neighborhoods, in evaluating proposals under the BMA or section 3 of the BHCA. *See* 12 U.S.C. § 2903(a).

Another priority for me as Vice Chair is the regulation and oversight of new forms of private money created through stablecoins. Stablecoins, like other unregulated private money, could pose financial stability risks.⁵ History shows that in the absence of appropriate regulation, private money is subject to destabilizing runs, financial instability, and the potential for widespread economic harm. In the nineteenth and early twentieth centuries, before the advent of prudential bank regulation and deposit insurance and before action was taken to ensure private money creation by banks was appropriately regulated, repeated crises did substantial damage to the U.S. economy. I believe Congress should work expeditiously to pass much-needed legislation to bring stablecoins, particularly those designed to serve as a means of payment, inside the prudential regulatory perimeter. I look forward to continued partnership with other regulatory agencies and Congress to address the risks of stablecoins.

Financial Risks from Climate Change

Before I move away from the discussion of making banks safer, let me say a few words about the potential risks to banks posed by climate change. As our nation, and the world, grapple with how to respond to climate change, banks are increasingly focused on the risks that climate change brings to their balance sheets. The Federal Reserve is working to understand how climate change may pose risks to individual banks and to the financial system. The Federal Reserve's mandate in this area is important, but narrow, focused on our supervisory responsibilities and our role in promoting a safe and stable financial system. In the near-term, we intend to work with the Office of the Comptroller of the Currency (OCC) and the FDIC to provide guidance to large banks on how we expect them to identify, measure, monitor, and

⁵ See the President's Working Group on Financial Markets, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency, *Report on Stablecoins* (Washington: PWG, FDIC, and OCC, November 2021) https://home.treasury.gov/system/files/136/StableCoinReport_Nov1_508.pdf.

manage the financial risks of climate change. In addition, we are considering how to develop and implement climate risk scenario analyses. In that regard, next year we plan to launch a pilot micro-prudential scenario analysis exercise to better assess the long-term, climate-related financial risks facing the largest institutions.

Innovation, Access, and Consumer Protection

These are a few of my near-term priorities to help make the financial system safer. I'll have more to say about these, and other priorities for safety and soundness, in the coming weeks and months. Let me turn now more directly to my other major objective as Vice Chair, which is to make the financial system fairer. In the past, I have described the three essential elements of fairness in the financial system as a three-legged stool because all three are necessary for any aspect of fairness to work. The three are (1) financial capability, (2) financial access, and (3) consumer protection. In terms of financial capability, an important component is transparency in the cost of services, which means making sure consumers have the information they need to make good decisions. Along with other bank regulatory agencies, the Federal Reserve has a role to play in ensuring banks disclose the costs and explain the conditions on the services they provide. More broadly, though, it means basing policy on a deeper understanding of human decision-making, and the contexts in which households and businesses make those choices.⁶ Under financial inclusion, one example would be promoting access to low-cost and safe banking services for low- and moderate-income (LMI) consumers, such as through local Bank On initiatives.⁷ And consumer protection involves using supervision and regulation to fully

⁶ See Michael S. Barr, *No Slack: The Financial Lives of Low-Income Americans* (Washington: Brookings Press, 2012).

⁷ Deposit products also play a critical role in providing an entry point to the banking system for low- and moderate-income individuals, including those who are considered unbanked. Having a bank account provides the means to receive, transact, and safely save funds. It is also a pathway for a bank customer to

implement laws to promote fair lending, consumer protection, and transparency in the consumer financial services marketplace.

Let me say a bit about where innovation fits into this goal of making the financial system fairer. We should welcome financial innovation as a positive force that can increase access and lower costs for individuals and businesses. That said, innovation can also introduce new risks for consumers. We have already seen occasions when uses of new technologies and data can raise serious concerns about violations of fair lending laws.⁸

As innovative financial products develop and grow rapidly, excitement can outrun the proper assessment of risk. As we have seen with the growth of crypto assets, in a rapidly rising and volatile market, participants may come to believe that they understand new products only to learn that they don't, and then suffer significant losses. Crypto-asset related activity, both outside and inside supervised banks, requires oversight so that people are fully aware of the risks they face.

We plan to work with other bank regulatory agencies to ensure that crypto activity inside banks is well regulated, based on the principle of same risk, same activity, same regulation, regardless of the technology used for the activity. I plan to make sure that the crypto activity of banks that we supervise is subject to the necessary safeguards that protect the safety of the banking system as well as bank customers. Banks engaged in crypto-related activities need to have appropriate measures in place to manage novel risks associated with those activities and to ensure compliance with all relevant laws, including those related to money laundering.

establish an ongoing relationship with a bank. Moreover, a bank account provides the cash flow data that some financial companies use to underwrite credit. One important way the Fed encourages greater access to deposit products is by giving banks credit under the Community Reinvestment Act (CRA) for offering low-cost deposit accounts to low- or moderate-income individuals. In addition, several Reserve Banks also participate in the Bank On initiative, a nationwide effort (with 90 local coalitions) to move the unbanked into the banking system by promoting access to safe, standardized low-cost transactional accounts.

⁸ United States v. Meta Platforms, Inc., No. 1:22-cv-05187 (S.D. New York, June 21, 2022).

At a more basic level, we need to focus on access to fast, efficient digital payments. This is a matter both of efficiency and of fairness. Low-income households can ill afford to wait days for their income checks to clear, nor can small businesses. A three-day payment delay is an annoyance to someone with savings and ample credit, but it is a costly burden, and sometimes a serious problem for others. And overdraft and insufficient funds fees hit LMI households hard. I have been working on issues of financial inclusion for a significant portion of my career as a public official and as an academic. I am so pleased with the progress made toward instant payments under the leadership of Vice Chair Brainard and Chair Powell, and I am looking forward to doing whatever I can to support this work, including the launch of the FedNow Service. The Federal Reserve has a responsibility to facilitate payments that work well for everyone, and we are committed to doing so.

Community Reinvestment

Rounding out my discussion of access to financial services, I will end my remarks today by touching on the importance of the Community Reinvestment Act (CRA). The CRA, first passed in 1977, encourages insured depository institutions to meet the credit needs of the communities in which they are chartered, including LMI neighborhoods, consistent with the safe and sound operation of such institutions.⁹ The CRA was designed to address past abuses of financial institutions, such as redlining. The CRA sends the unequivocal message that there is no place for discrimination in the financial system, and that every community and every borrower deserve to be treated fairly. Earlier this year the OCC, the Fed, and the FDIC jointly invited comment on a proposal designed to strengthen and modernize CRA regulations to achieve the

⁹ “What is the Community Reinvestment Act (CRA)?” Board of Governors, last modified August 24, 2022, https://www.federalreserve.gov/consumerscommunities/cra_about.htm.

objectives of the law. I strongly support the goals of the proposal and look forward to contributing to the important work underway, again led by Vice Chair Brainard.

So, to wrap up, I have tried to lay out my approach and a bit of my near-term agenda, as Vice Chair for Supervision, for making the financial system safer and fairer for households and businesses. As I said at the outset, I believe these goals are related and mutually reinforcing, so that progress in one area will advance efforts in the other. I have discussed a number of specific issues to illustrate these principles, but I'll have more to say about these ideas, and other important reforms, in the coming weeks and months. Thank you.