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FRB Governor Randal Quarles Offers Parting Thoughts

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Former Vice Chair for Supervision Randal K. Quarles covered a broad range of topics in his farewell remarks. He celebrated the overall strength of the banking system and suggested areas where there is latitude for regulatory change or recalibration.

Mr. Quarles addressed a number of areas, including, among other things:

- **General Strength of Banks.** Mr. Quarles stated that the COVID-19 pandemic demonstrated the overall strength of the banking system, given that banks had performed well on stress tests throughout the pandemic. He added: "the resilience of banks during the COVID event, coupled with the results of [the FRB's] stress tests, demonstrate that the overall level of capital in the banking system is more than ample."
- **Leverage Ratio.** Mr. Quarles stressed that the leverage ratio requirement was too often becoming the binding constraint on banks, with the perverse result being that banks have incentive to invest in riskier assets as opposed to, for example, U.S. government securities.
- **Non-U.S. Banks.** Governor Quarles suggested that the level of capital or total loss-absorbing capacity of non-U.S. banks doing business in the United States may be too high, and that the requirements should be re-examined.
- **Stress Tests**. Mr. Quarles praised the performance of the FRB's stress testing during the pandemic, but cited excessive volatility in banks' capital requirements as an area for reform to enable firms to manage their capital effectively without large year-over-year shifts in regulatory required capital. Mr. Quarles recommended that such excessive volatility be addressed by averaging "the results of the current year's stress test with the corresponding stress test results from the previous two years." He argued that this would allow firms that "hold the risk profile of their balance sheets relatively constant" to maintain the same relative level of required capital from year to year.
- **Supervision.** Mr. Quarles proposed reforms with respect to the FRBs supervisory framework. He emphasized that the greatest focus should be on "improving our supervisory communications process" and outlined a three-pronged approach for such improvement. Mr.

Quarles stated that the FRB should: (i) restore the "supervisory observation" category for items of concern that have not yet risen to the level of a matter requiring attention ("MRA"); (ii) ensure that MRAs are limited to either violations of law or regulation, or material safety and soundness issues; and (iii) establish a "routine practice of independent review of important supervisory communications and guidance documents."

- **Digital Assets.** Governor Quarles expressed concern that undue regulation would discourage assets such as stablecoins. He noted his disagreement with one conclusion in the recent report of the President's Working Group on Financial Markets that recommended that only insured depository institutions should be issuers of stablecoins. However, he agreed with the concept that the assets backing any stablecoins should be held by an insured depository institution.

- **Lending by the Federal Reserve During the Pandemic.** Governor Quarles differentiated the two types of Federal Reserve loans made during the pandemic: one type to support institutional liquidity and another type to provide credit to needy borrowers, including households, businesses and local governments. As to these two types, he indicated that the Federal Reserve, in its traditional role as lender of last resort, should continue to be the agency responsible for providing what he called liquidity facilities to support liquidity during a financial crisis, but he did not believe that the Federal Reserve should be the provider of what he called broadly used credit facilities that support the extension of long term credit to the real economy – households, businesses, and governments.

- **Financial Stability Board Activities and Non-U.S. Banks.** Mr. Quarles argued that addressing weaknesses in the financial system related to non-bank financial intermediation ("NBFI") remains "one of the most important tasks" for the Financial Stability Board ("FSB"). He highlighted the progress of the FSB on this issue, including the FSB's policy proposals addressing "structural vulnerabilities in money market mutual funds."

Commentary by Steven Lofchie

A number of Chairman Quarles' remarks indicate that there should be some modest decrease of bank capital calibration, particularly as to the treatment of foreign banks and as to the leverage ratio. It is unlikely that those suggestions will be priorities for the current administration.

The most significant "big picture" remarks made by Mr. Quarles were as to the role of the Federal Reserve in extending credit following the pandemic. In particular, he asserted that the Federal Reserve's role in extending credit should be limited to supporting liquidity; it should not be a supplier of general credit to needy borrowers (a role he described as more appropriate to agencies that are directly controlled by Congress).

Commentary by Sebastian Souchet

Mr. Quarles' comments on digital assets are intriguing, if for no other reason than his somewhat surprising praise of such assets as a "welcome innovation." Previous comments by Mr. Quarles expressed significant caution with respect to a Federal Reserve-issued central bank digital currency, and may have been interpreted by some as a general skepticism of the digital asset space overall. Yet, his farewell remarks make clear his view that financial regulators should "welcome responsible innovation...[and] create a regulatory environment that not only allows for such innovation, but encourages it." Query how much Mr. Quarles' remarks on digital assets are a reflection of prudential regulators' growing acceptance of the view that digital assets are here to stay.

Mr. Quarles also raises some interesting policy questions for digital asset regulation. He argues that regulation limiting custodial wallet providers' affiliation with commercial entities is unwarranted and that "[i]t is not at all clear what regulatory interest would be furthered by such a limitation, which is much more restrictive than we require for nondigital assets." These comments reflect a recurring fundamental question for financial regulation: to what extent, if any, should there be a separation of commercial activities from the provision of financial services? Acting OCC Comptroller Hsu posed essentially the same question in recent remarks on prudential regulation of digital assets, stating that "the rapid expansion and mixing of wholesale and retail activities at some crypto firms raise the question of whether there ought to be Glass-Steagall-like separation of activities in the crypto space." (Notably, Acting Comptroller Hsu left that question unanswered.)

Setting aside the question of whether it is prudent for current financial regulations to not more fully separate a banking entity's commercial activities from its provision of financial services regarding nondigital assets (arguably due to the repeal of certain provisions of the Glass-Steagall Act), digital assets and digital asset-related activities pose rather novel regulatory concerns regarding systemic risk, conflicts of interest, and excessive concentration of market power. As noted by Acting Comptroller Hsu in his recent remarks, many of the larger digital asset firms—especially those receiving the economic benefits of economies of scale and scope, as well as first-mover advantages—aim to "become 'universal' (*i.e.*, offering everything from crypto custody to retail brokerage to market making to asset management to prime brokerage)." To the extent that such a "universal" digital asset firm exists, its presence in the market may have anti-competitive implications and may pose systemic issues due to concentration of market power. Affiliation of custodial wallet providers with commercial firms, in particular with respect to such "universal" firms (where digital asset custodial services and commercial services are provided by essentially the same entity), may only exacerbate any anti-competitive effects and further concentrate such a firm's market power. Relatedly, as emphasized by the report on stablecoins published by the President's Working Group on Financial Markets, such affiliation of wallet providers with commercial firms may lead to "advantages in accessing credit or using data to market or restrict access to products...[and] [t]his combination could have detrimental effects on competition and lead to market concentration in sectors of the real economy" (pg. 14 of the report).

Cadwalader's Steven Lofchie contributed to this comment.

Primary Sources

1. FRB Speech, Randal Quarles: Between the Hither and the Farther Shore: Thoughts on Unfinished Business

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