FINANCIAL REGULATION POST-INAUGURATION

February 2021 Update

Douglas J. Elliott
January brought us major political developments and more information about the policies of the Biden Administration. The impact on financial regulation, however, should be substantially smaller than for many other policy areas. Legislation about financial regulation remains unlikely, although a tax on the largest banks could be part of any tax changes. Nominees are now likely to skew somewhat more progressive than before the Democrats took control of the Senate, but moderates will likely still play the larger role overall. Congressional oversight hearings will push regulators more in the progressive direction, now that Republican-led hearings will not occur to pull in the other direction. None of these differences are likely to be huge, nor should the major regulatory emphases shift from what was already expected.

This paper lays out the structural changes since my December 2020 paper and their implications for financial regulation, followed by an updated version of my overall views on what the new team is likely to do in this area.

THE BIG PICTURE STRUCTURAL CHANGES

The Senate elections in Georgia
Winning both US Senate seats in the run-off elections in Georgia on January 5th gave Democrats significantly more control over their own fate, although there remain strong limits on their ability to enact partisan priorities. The clearest advantages are procedural, but highly important. Democrats will now largely control which bills are considered on the floor of the Senate and House. In addition, the committee chairs will all be Democrats and they will control what investigations and oversight hearings are conducted.

This procedural power should not be underestimated. For example, it is pretty clear that if the House's bill to pay $2,000 stimulus checks had come to the floor of the Senate in December, it would have passed, given the combined support of the Democrats and President Trump. Instead, then-Majority Leader Mitch McConnell simply didn't allow a vote. Similarly, a number of Republican committee investigations designed to politically embarrass Biden or the Democrats would not have occurred under Democratic committee chairs.

Beyond that, having 50 votes, plus a tie-breaker from Vice President Kamala Harris in her constitutional role as President of the Senate, will allow the Democrats to confirm President Biden's nominees, if the party stays united. This would also hold true for any legislation that is exempt from filibuster. As a reminder, most bills can be halted through a filibuster, which allows
a determined minority to keep debate going until the proponents give up or find 60 votes to end debate. In practice, this has come to mean that most controversial legislation cannot pass the Senate with just 51 votes, but need 60. Some legislation, in particular budget reconciliation bills, cannot be filibustered. This means that tax changes, for example, could be passed with only Democratic votes. There are a number of detailed procedural restrictions limiting the extent this procedure can be used. It would, however, definitely be available for one major tax package a year.

The storming of the Capitol and subsequent impeachment of President Trump
Everyone followed this closely, so I will not attempt to recap the events. The big question is whether the net effect will be to make partisan compromise more or less likely. This breaks into three sub-questions.

First, will it change the approach of the new Administration? President Biden campaigned on finding common ground with Republicans and working to unify the country, so the post-storming revulsion against extremism works in his favor. However, he also needs the support of the progressive wing of the Democratic party which is even angrier at Republicans now and is emboldened after the Georgia elections and the weakening of the Republican party in recent weeks. On the whole, I believe that the situation will lead the new president to try even harder to find areas for compromise, such as on infrastructure spending.

Second, will it change the reactions of Senate Republicans? There has been a change in tone among many Senate Republicans to show more willingness to work with the new president. This may fade quickly given the overall polarization in the country, especially with the impeachment trial inflaming partisan feelings. Alternatively, there could be some movement by more moderate Republicans to find common ground with Democrats, at least for the next few months and possibly longer. This clearly falls into unknowable territory, given the unprecedented nature of recent events, indeed of the last four years.

Third, and related, what will former President Donald Trump do? On the one hand, he may choose to fight hard for control of the Republican party or establish his own “Patriot Party”, as he is apparently considering. If he chooses this route, it is likely that he will urge opposition to virtually every Biden Administration proposal. On the other hand, he may either calculate that he is better served by staying more in the background for a while or he may become so caught up in business activities or lawsuits that he doesn't put his energy strongly into politics. If he chooses the active political route, this will almost certainly pressure Republicans to be less willing to compromise with Democrats.

Overall, I would expect there to be some elements of compromise, but that partisan gridlock is likely to dominate, limiting the volume and importance of new legislation.
IMPLICATIONS FOR FINANCIAL REGULATION

Legislation
Prospects for legislation related to financial regulation remain slim, despite Democrats controlling both houses of Congress. First, partisan differences on financial regulation are strong and therefore not easily bridged. This matters, since very little in financial regulation would be exempt from filibuster. Second, politicians don't feel a compelling need to take action in this area, since this crisis differs from the Global Financial Crisis in that it was not triggered by the financial sector and US financial institutions are viewed as fundamentally sound.

There is now more possibility of a tax increase targeted at the largest banks, since this could be done as part of a budget reconciliation act and it may not be too difficult to unite 50 Democrats around banks as a source of revenue to fund various popular priorities. At the same time, calls to tax Wall Street through a financial transaction tax may remain a bridge too far, as some Democrats would be likely to break ranks to vote this down.

Appointments to key regulatory positions
The Georgia Senate victories have given the Biden Administration more room to nominate progressives to some of the key regulatory positions. Not surprisingly, a progressive, Rohit Chopra, has been nominated to run the Consumer Financial Protection Bureau. Further, Gary Gensler, a favorite of progressives, will be taking over as Chair of the Securities and Exchange Commission (SEC). Both of these nominations came after the Georgia results.

At the same time, it appears very likely that Michael Barr will take over as Comptroller of the Currency, regulating all federally chartered banks. (Bank holding companies are regulated by the Federal Reserve, so the Fed is also a key regulator for all large banking groups). Barr was generally viewed as tough on banks under the first Obama Administration, when he was at the Treasury Department, but the center of gravity of the Democratic party continues to shift left. There is currently very vocal opposition to Barr, primarily because progressives have their own candidate, Mehrsa Baradaran. (One progressive reportedly went so far as to email 8,000 contacts and the entire Biden Transition team to announce he would go on a hunger strike if Barr were nominated). Thus far, Biden's team does not seem to back off once they have decided on a candidate, so the betting is pretty heavily in Barr's favor, but this may be something of a test case. And, of course, Janet Yellen is well-liked and respected by moderates and progressives alike, so the selection of the Treasury Secretary has not been controversial.

Priorities for financial regulation
The events of January do not appear to have affected the new team's choice of top priorities for financial regulation. Key issues for finance remain: Climate-related risks; social justice; capital requirements; regulation of non-bank financial institutions and markets; and cryptocurrencies. The latter priority is primarily because there are a host of policy decisions to be made about
cryptocurrencies. There is also likely to be some further toughening of regulation and supervision on foreign banking operations (FBOs) in the US, although this won't be a top priority.

That all said, “Personnel Is Policy” as people in Washington often say, so the choices of the key regulators will affect financial regulation and supervision going forward even if the broad outlines of policy priorities have not changed during January.

**UPDATED SUMMARY OF LIKELY DEVELOPMENTS IN FINANCIAL REGULATION**

**Financial regulation will not 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 already faces 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, Democrats have the narrowest possible majority in the Senate (50 seats for each party, with the Vice President breaking the tie in her capacity as President of the Senate). Legislation could be voted down with a single Democratic defection, if Republicans stay united. As an example of the challenge, one key senator will be 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. 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.

**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 is chosen for the key positions matters

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 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 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 between a one in three and a one in two chance of reappointment. I had initially placed his odds lower, but a number of influential Democrats in this area have convinced me that his chances are closer to 50-50.

In his favor, Powell is generally viewed positively 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.

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 Lael's future, as the most likely alternative appointment for her would be as Vice Chair for Supervision, where a choice would likely occur in the late spring or early summer of 2021. Nomination for this role would indicate that she will not be chosen as Fed Chair.

She 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 with the current Fed team's thinking. 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.

The Consumer Financial Protection Bureau (CFPB) and SEC will be headed by progressives, under Rohit Chopra and Gary Gensler, respectively. The Office of the Comptroller of the Currency (OCC), however, looks to be going to Michael Barr, as opposed to Mehrsa Baradaran, who is a favorite of the progressives. Barr is in the mainstream of Democratic thinking on financial regulation, so it has been surprising to see the fierceness of the pushback from some progressives when it was reported that he was likely to be nominated.

All in all, President Biden has been choosing a mix of moderates and progressives for the key financial regulatory roles, with some tilt towards moderates when one includes what we know of likely sub-cabinet appointees. The mix continues to support my views on what topics will be the highest priority for the new team, as explained below.

**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. There is also one existing vacancy on the Federal Reserve Board. The Federal Deposit Insurance Corporation (FDIC) Chair does not turn over until 2023 and Jelena McWilliams has indicated she will remain until that point. Despite her public and private statements to this effect, there is still some speculation 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).

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. This is less of an issue now that Democrats (barely) control the Senate, but problems could still arise unexpectedly.
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 in November 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 a good 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 the 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.

Please see my paper on *The Fed and Climate Risk* for a detailed discussion of the Fed's likely approach.

**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 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.

Please see my paper on *Social Justice, Financial Regulation, and the Biden Administration* for a more comprehensive discussion of likely actions.
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. So far, the appointees do not fall into this camp.

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.

Regulation of non-bank financial institutions (NBFIs)
There is a global consensus among bank regulators, and some markets regulators, that there needs to be more stringent regulation and supervision of NBFIs. In particular, money market funds are viewed as creating systemic risks that need to be curbed. Treasury Secretary Yellen has highlighted this as a concern and many others among the new team appear to share this view. There is also a belief that some types of NBFIs really can be considered “shadow banks” and that this crisis has demonstrated that they are considerably more pro-cyclical economically than banks are. This leads to pressure for the placement of bank-like capital and liquidity requirements on certain NBFIs.
Some actions would require legislation, which is unlikely. However, there is a great deal that the SEC could do under current law with regard to money market funds and mutual funds. They are likely to be prodded to take action by the Financial Stability Oversight Council (FSOC), the council of heads of financial regulatory bodies, which is chaired by the Treasury Secretary. Other regulators will also have at least limited authority over various types of non-banks.

Proponents of change will run into significant political opposition. Money market funds, other mutual funds, and some other types of NBFIs provide services that millions of consumers/voters value. Anything that appears likely to strongly limit their activities or to raise costs, and therefore pricing to consumers, will spur extensive lobbying against it.

My read is that there will be some significant regulatory action, particularly as regards money market funds, but that any tightening of regulation on NBFIs will be softened considerably by political opposition. That said, there is a fairly wide range of potential outcomes here and the final results may also be affected by whether there are failures of any significant NBFIs that are undertaking bank-like activities.

CONCLUSION

The core of financial regulation will remain the same under the new team brought in by President Biden, but there are key areas where we should expect significant change. The strongest contrast will be in financial regulation and supervision of climate-related risks, but the other areas discussed here will also see changes in direction.

Douglas Elliott is an Oliver Wyman partner focused on the intersection of Finance and public policy. He is the author of the book, Uncle Sam in Pinstripes: Evaluating US Federal Credit Programs. Prior to his current position, he was a scholar at the Brookings Institution and a Visiting Scholar at the IMF. Before that, he was the founder and principal researcher for the Center On Federal Financial Institutions. He began his career with two decades as an investment banker, primarily at JP Morgan.
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AUTHOR
Douglas J. Elliott
Partner
douglas.elliott@oliverwyman.com