MEMORANDUM

To: Members of the Committee on Financial Services

From: FSC Majority Staff

Date: July 20, 2015

Subject: July 23, 2015, Hearing Titled "Ending 'Too Big to Fail': What is the Proper Role of Capital and Liquidity?"

The Committee on Financial Services will hold a hearing at 10 a.m. on Thursday, July 23, 2015, in Room 2128, Rayburn House Office Building, entitled "Ending "Too Big to Fail": What is the Proper Role of Capital and Liquidity?" This will be a one-panel hearing with the following witnesses:

- Charles W. Calomiris, Professor, Columbia University Business School
- Sujit "Bob" Chakravorti, Managing Director and Chief Economist, The Clearing House
- Norbert J. Michel, Research Fellow in Financial Regulations, Heritage Foundation
- John E. Parsons, Senior Lecturer, Sloan School of Management

Since the 2008 financial crisis, U.S. banks have raised more than $400 billion in new capital, and regulators in the United States and elsewhere, working under the aegis of the Basel Committee on Banking Supervision and the G-20's Financial Stability Board, have required those institutions to maintain higher capital buffers than they did before the crisis. Regulators have also—for the first time—adopted liquidity regulations that require financial institutions to maintain "high quality liquid assets" that they can use to satisfy their funding needs if markets seize up as they did in 2008 and 2009. In several instances, U.S. regulators have gone beyond the standards set by the Basel Committee and imposed more stringent capital and liquidity requirements on U.S. firms, a practice which has come to be known as "gold-plating."

Many government officials believe that the Basel Accords as well as regulations promulgated under the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203) have made financial institutions significantly stronger than they were before the financial crisis – and that these institutions are therefore less likely to fail catastrophically and impose losses on taxpayers. Others have argued that the regulators have gone too far – that the new capital standards and liquidity requirements have over-regulated financial institutions to the point that whatever "stability" has been gained has come at the expense of economic growth because these new standards have constricted lending and investment. Still others believe that the regulators have not gone far enough, and that the latest iteration of Basel leaves banks undercapitalized and vulnerable to external shocks like the ones that laid the economy low in 2008.

The challenge, then, for regulators is to find the Goldilocks level – not too high, and not too low – at which to set bank capital and liquidity standards. But determining the correct equilibrium is complicated by the role that the regulators themselves play in determining the riskiness of a bank's assets. Under the Basel regime, regulators use "risk weighting" to assign different levels of risk to different classes of assets – riskier assets require higher capital cushions and less risky assets require smaller capital cushions. The lower the risk assigned to an asset by the regulators, the lower the amount reported on the balance sheet, which means that the bank can fund that asset using more debt than is permitted for a higher-risk asset.

In theory, risk-weighting allows regulators to carefully calibrate assets, capital, and risk so that banks are not concentrating all of their lending in risky assets in the pursuit of high returns. In practice, risk-weighting has proven to be a less-than-successful strategy for managing risk, for several reasons. One is complexity: risk-weighting a bank's assets requires millions of calculations, both by the bank itself and its regulator. A second is that regulators have proven far from infallible in administering this complex capital regime, assigning low risk weights to subprime mortgage-backed securities and European sovereign debt, and thereby encouraging banks to crowd into these assets, which proved highly destabilizing during the recent financial crises in the U.S. and Europe.

The deficiencies in the risk-based capital regime exposed by the financial crisis have led some regulators and banking experts to advocate jettisoning that approach in favor of a more straightforward leverage ratio, in which a bank's capital adequacy is measured as a percentage of its total assets, without weighting those assets according to regulatory assessments of their relative risk. Others have urged policy-makers to consider specific forms of capital – such as contingent convertible (or CoCo) bonds – that rely less on the judgment and infallibility of regulators to achieve the goal of financial stability, and more on market discipline.

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