Testimony submitted to the Financial Institutions and Consumer Credit Subcommittee of the House Financial Services Committee, hearing on "Examining the Designation and Regulation of Bank Holding Company SIFIs," Wednesday, July 8, 2015, 1pm (embargoed until the hearing begins).

Submitted by Simon Johnson, Ronald Kurtz Professor of Entrepreneurship, MIT Sloan School of Management; Senior Fellow, Peterson Institute for International Economics; and co-founder of http://BaselineScenario.com.[1]

A. Main Points

1) Section 165 of the 2010 Dodd-Frank Act authorizes the Board of Governors of the Federal Reserve System to establish "more stringent" standards and requirements for bank holding companies with assets over $50 billion compared with smaller bank holding companies. At the same time, the Fed is granted considerable discretion to determine exactly how to apply these standards, including what requirements are imposed on different size banks (Section 165(a)(2)(A)). (The precise wording of the Act is discussed further in Section C below.)

2) As a matter of practice since 2010, the Fed has not applied one set of standards to all banks with assets over $50 billion. There is substantial differentiation, depending in part on size, but also varying according to factors such business model, complexity, and opaqueness.

3) This differentiation, to date, seems sensible and reasonably robust – subject to the points below. It also appears completely consistent with Congressional intent, expressed through Dodd-Frank and earlier legislation that is still in effect.

4) The Federal Reserve has long had responsibility for the safety and soundness of the American financial system. This role can be traced back to the panic of 1907, which led to the founding of the Fed in 1913. The bank runs and broader economic problems of the 1930s led to a re-founding of the Federal Reserve System, with a clear mandate to prevent the financial system from getting out of control.[2]

5) In the run-up to 2007-08, the Federal Reserve had a great deal of discretion with regard to financial regulation and supervision but failed: to protect consumers, to understand the build-up of risk around derivatives, to supervise appropriately some large financial institutions then

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[1] Also a member of the Federal Deposit Insurance Corporation's Systemic Resolution Advisory Committee, the Office of Financial Research's Research Advisory Committee, and the Systemic Risk Council (created and chaired by Sheila Bair). All the views expressed here are mine alone. Underlined text indicates links to supplementary material; to see this, please access an electronic version of this document, e.g., at http://BaselineScenario.com. For important disclosures, see http://baselinescenario.com/about/.

[2] On this and broader Fed history, see Peter Conti-Brown, "The Twelve Federal Reserve Banks: Governance and Accountability in the 21st Century," Working Paper #10, Hutchins Center on Fiscal & Monetary Policy at Brookings, March 2, 2015. For the Fed's extensive supervisory mandate in the 2000s, see Heidi Mandanis Schooner, "Central Banks' Role in Bank Supervision in the United States and United Kingdom," Brooklyn International Law Journal, 2003, available at ssrn.com.

under its jurisdiction, and to keep the system from imploding.[3] These failures were not due to lack of resources or an unawareness of the changes happening within the financial system. Rather there was a deliberate strategy of noninterference, along with many instances of actually encouraging various forms of deregulation that, in retrospect, are clearly understood – including by Fed staff and governors – as having increased levels of systemic risk.[4]

6) At the time of the discussions and debates that led to Dodd-Frank, Congress had to face the facts: almost all the banking and financial sector regulators had failed in their tasks – some even more spectacularly than had the Fed. (The exception was the Federal Deposit Insurance Corporation, but a decision was taken not to promote the FDIC to the role of system regulator.)

7) With regard to bank holding companies, Congress did not create a new authority for the Fed in Dodd-Frank. Rather Congress re-affirmed the existing broad authority and set some minimum bars – specifying bright lines to define for the Fed which kinds of bank holding companies require more attention, while allowing the Fed to retain a considerable degree of discretion regarding what exactly that attention will involve.[5]

8) At the threshold of $50 billion in total assets, bank holding companies are now required to prepare resolution plans. They must also file an integrated Systemic Risk Report (FR Y-15).

9) Bank holding companies with more than $10 billion in total assets must conduct annual company-run stress tests. Bank holding companies with more than $50 billion in total assets must conduct semiannual company run stress tests and also participate in stress tests run by the Federal Reserve.[6]

10) The Fed already had authority to establish regulatory capital requirements, liquidity standards, risk-management standards, and concentration limits (including single-counterparty credit limits). All of these can be and have been tailored as the Fed deems appropriate.[7]

11) There are, of course, costs with running any sensible risk management program. Many of these so-called "compliance costs" are very much in the interests of shareholders – it was deficiencies in or the complete lack of such programs that resulted in heavy losses and significant financial firm failures in the crisis. For example, the Dodd-Frank requirement

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[3] The Federal Reserve System's own mission statement has four bullet points. The Fed disappointed along almost every dimension of these stated goals in 2007-08, with the exception that it kept the payments system functioning.

[4] For the history of deregulation and the role of the Fed, see Simon Johnson and James Kwak, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown*, Pantheon 2010, particularly chapter 4. Fed chairman Alan Greenspan was a leader in this push for deregulation in the 1980s, 1990s, and into the 2000s but, to be fair, there was a considerable degree of bipartisan consensus on this policy direction.

[5] Dodd-Frank did create a new authority for the Fed vis-à-vis nonbank financial companies that are designated as systemic by the Financial Stability Oversight Council (FSOC).

[6] Section 165(i)(2) of Dodd-Frank is quite specific on these requirements. However, as applied by the regulators, there is a "substantially abbreviated data reporting template" for the smaller banks; see Thomas J. Curry, written testimony submitted to the Senate Banking committee, March 19, 2015.

[7] *Better Markets*, a pro-financial reform group, has produced a very useful fact sheet that shows the main thresholds and how the Fed has chosen to apply them.

(Section 165(h)) of risk committees for bank holding companies with more than $10 billion in assets seems entirely consistent with the best interests of shareholders.

12) Shareholders could, in principle, speak for themselves regarding how much risk management they want and how they would like this to be organized. But we must recognize the limits imposed on shareholder influence over bank holding company management, including through the extensive rules on ownership of banks. These restrictions are, ironically, administered by the Federal Reserve itself.[8]

13) Some recent legislative proposals could increase our deference to the Financial Stability Board (FSB), with regard to either criteria or actual designation of banks (or nonbanks) as systemically important. This would be unwise. The FSB plays an important role in facilitating communication between regulators, but not all major countries share our concern for or general approach to limiting systemic risk. Relying too much on the FSB would excessively cede US sovereignty to a body with limited accountability. It could also create the possibility of a "race to the bottom", as happened with capital requirements before 2007.

14) Other proposals suggest that the Financial Stability Oversight Council (FSOC) should have to designate banks as systemic in order for them to receive heightened scrutiny from the Fed. This would be a strange arrangement, as FSOC by design includes nonbank regulators, such as the chairs of the Securities and Exchange Commission and the Commodity Futures Trading Commission. Allowing or requiring nonbank regulators to tell a bank regulator which banks to regulate (and potentially how to regulate them) does not seem wise.

15) It would be helpful to require bank holding companies with at least $10 billion in total assets to file a Systemic Risk Report (FR Y-15). This report is concise and provides data on the systemic footprint of a financial institution. Hopefully, bank holding companies put together such data for their own management and investors in any case. Publishing such reports provides a clearer perspective, for regulators and for market participants, on differences in activities and risks across bank holding companies just below and just above $50 billion in assets.

16) Should some bank holding companies with less than $50 billion in total assets be subject to heightened scrutiny, for example due to various off-balance sheet activities, such as derivatives? Without seeing Systemic Risk Reports for those firms, it is hard to know.

17) The available Systemic Risk Reports also suggest that, at all size levels, it would be sensible to think of bank holding company size more in terms of total exposure (on-balance sheet plus off-balance sheet) as defined in those reports, rather than the more narrow measure of total consolidated assets. (More on this in Section B below.)

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[8] See for example, the Fed's 2008 "Policy statement on equity investment in banks and bank holding companies". On the "many activity restrictions and regulatory intrusions" involved with becoming a bank holding company – owning or controlling a bank – see Saule T. Omarova and Margaret E. Tahyar, "That Which We Call a Bank: Revisiting the History of Bank Holding Company Regulation in the United States," *Review of Banking and Financial Law*, Vol. 31, 2011-2012, available at ssrn.com.

B. The Critical Threshold Issue

What if the threshold for enhanced prudential standards were lifted, for example, to $100 billion?

At the end of 2014, there were 9 bank holding companies that had consolidated assets between $50 billion and $100 billion: Deutsche Bank Trust Corporation ($56 billion), Zions Bancorporation ($57 billion), Huntington Bancshares Incorporated ($66 billion), Comerica Incorporated ($70 billion), Discover Financial Services ($83 billion), BBVA Compass Bancshares ($83 billion), Bancwest Corporation ($90 billion), KeyCorp ($94 billion), M&T Bank Corporation ($97 billion).[9] However, a better measure of potential significance in the financial system as a whole is "total exposures" of a bank holding company, as defined in the Banking Organization Systemic Risk Report form (FR Y-15, Schedule A, line 4).[10] This requires a bank to report both its on-balance sheet and off-balance sheet activities, including derivatives exposures and credit card commitments, in a comparable way.[11] As we learned in 2007 and 2008, off-balance sheet activities are important and can – particularly at a time of stress – have major impact on solvency of financial institutions and on the spillover effects from potential failures.

In the latest available Systemic Risk Reports, from the end of 2014, six of these 9 bank holding companies actually had "total exposure" (on- and off-balance sheet) over $100 billion.[12] It is hard to argue that the fate of a bank holding company with a total exposure threshold of over $100 billion is definitely inconsequential to the system as a whole.[13]

Of the three bank holding companies that had under $100 billion in total exposure, one is a subsidiary of a large non-US bank that recently failed the stress tests conducted by the Fed.[14] It

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[9] This section uses information from the Systemic Risk Reports required by the Fed of all bank holding companies with over $50 billion in total assets. The form is here: http://www.federalreserve.gov/reportforms/formsreview/FRY15_20120822_f_draft.pdf. The publicly data on consolidated assets can be accessed, by bank, from this webpage (after selecting the desired reporting period): http://www.ffiec.gov/nicpubweb/nicweb/HCSGreaterThan10B.aspx.

[10] These reports are available, by bank, from http://www.ffiec.gov/nicpubweb/nicweb/HCSGreaterThan10B.aspx.

[11] The instructions regarding the content of this form are here: http://www.federalreserve.gov/reportforms/forms/FR_Y-1520131231_i.pdf.

[12] KeyCorp had $140 billion in total exposure, while M&T Bank ($120 billion), BBVA ($108 billion), Bancwest ($112 billion), Comerica ($103 billion), and Discover Financial Services ($100 billion) had over $100 billion in total exposure at the end of 2014. Total exposures were: $80 billion at Huntington; $74 billion at Zions, and $53 billion at Deutsche. These total exposures grew at annual rates of between 5 percent (at KeyCorp) to over 23 percent (at Huntington) from the end of 2013 to the end of 2014. Total exposures shrank only at Deutsche Bank, where there have been major issues both in the US and globally.

[13] Long-Term Capital Management (LTCM), when it was on the brink of failure in 1998, had on-balance sheet assets of around $125 billion, with capital of $4 billion. "But that leverage was increased tenfold by LTCM's off balance sheet business whose notional principal ran to around $1 trillion"; David Shirreff, Lessons from the Collapse of Hedge Fund, Long-Term Capital Management.

[14] Deutsche Bank (in the US) had total exposure of over $60 billion at the end of 2013; this fell to $53 billion at the end of 2014. Another subsidiary of a major global bank, Santander USA, had total exposures of $98 billion at the end of 2013, rising to $146 billion at the end of 2014. The assets of Santander USA increased from around $77 billion at the end of 2013 to over $113 billion at the end of the third quarter of 2014 and $118 billion at the end of the fourth quarter of 2014 – an example of how quickly a large global bank can shift business into its US subsidiary. *Too Big to Fail: The Hazards of*

would seem unwise to suddenly regard those firms as no longer needing more stringent standards than required for smaller and much simpler banks.

This leaves Huntington Bancshares Incorporated and Zions Bancorporation below $100 billion in total exposure.[15]

While some regional banks have relatively simple business models, others are at least partially more complex. For example, five of the 9 bank holding companies with under $100 billion in total assets are (i.e., own) registered swaps dealers or have a significant exposure to derivatives.[16]

Regional banks, including those in the $50 billion to $100 billion total asset range, were reportedly involved in lobbying for the repeal of Section 716 of Dodd-Frank, which would have "pushed out" some swaps from their insured bank subsidiaries. The repeal of Section 716 at the end of 2014 is a further reason for the Fed and other regulators to pay close attention to regional banks.

If the discussion turns to considering lifting the scrutiny and reporting requirements for banks having over $100 billion in total assets, then looking at total exposures remains important. In the Systemic Risk Reports for the end of 2013, all of the bank holding companies with over $100 billion in assets actually had total exposure of at least $140 billion.[17]

C. Regulatory Interpretation of Dodd-Frank

Some recent prominent discussion of the Dodd-Frank Act suggests that bank holding companies with over $50 billion are "designated" as "systemic". But this is not what the legislation actually says and this is not how the law has been interpreted by regulators.

Section 165(a)(1) of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act reads,

> "In order to prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected financial institutions, the Board of Governors shall, on its own or pursuant to

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Bank Bailouts, by Gary H. Stern and Ron J. Feldman (Brookings, 2004) highlights, among other points, the potential dangers posed by foreign banks operating in the United States.

[15] Zions has had repeated problems with the Fed-run stress tests, barely passing in 2015. Part of the issue appears to be its large portfolio of Collateralized Debt Obligations. See Julie Steinberg, "Zions, Regulators Still at Loggerheads," *Wall Street Journal*, March 22, 2015.

[16] This CFTC list was checked on July 6, 2015: http://www.cftc.gov/LawRegulation/DoddFrankAct/registerswapdealer. The OCC latest derivative report shows activities by bank in the third quarter of 2014, http://www.occ.gov/topics/capital-markets/financial-markets/trading/derivatives/dq314.pdf.

[17] It is hard to know what will or will not be regarded as systemic as the next crisis develops. IndyMac Bancorp, which failed in 2008, had assets of just over $30 billion; in retrospect, its problems should have been seen at least as an early warning for the rest of the system. Continental Illinois, which failed in 1984, was one of the top ten banks in the US, but its assets were only around $40 billion. US Gross Domestic Product in 1984, in current prices, was around $4 trillion, so Continental Illinois's balance sheet assets had a book value of about one percent of the size of the US economy. In modern terms, with U.S. GDP now over $17 trillion, this further confirms the notion that we should pay close attention as a bank's size (i.e., total exposures) reaches $150 billion.

recommendations by the Council under section 115, establish prudential standards for nonbank financial companies supervised by the Board of Governors and bank holding companies with total consolidated assets equal to or greater than $50,000,000,000 that—

(A) are more stringent than the standards and requirements applicable to nonbank financial companies and bank holding companies that do not present similar risks to the financial stability of the United States; and

(B) increase in stringency, based on the considerations identified in subsection (b)(3)."

Section 165(a)(2) stipulates that the Board of Governors may "differentiate among companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities (including the financial activities of their subsidiaries), size, and any other risk-related factors that the Board of Governors deems appropriate." And the threshold for applying some standards may be set above $50 billion.

The Federal Reserve appears to have interpreted this and related sections of Dodd-Frank exactly as intended, i.e., as requiring additional scrutiny for bank holding companies over $50 billion, compared with smaller bank holding companies, but not as requiring that all bank holding companies over $50 billion be treated the same way.[18]

Martin J. Gruenberg, chairman of the FDIC, confirms that this is how regulators have interpreted the law.[19]

> "In implementing the requirement for resolution plans, the FDIC and the Federal Reserve instituted a staggered schedule for plan submissions to reflect differing risk profiles".

And,

> "The FDIC's stress testing rules, like those of other agencies, are tailored to the size of the institutions consistent with the expectations under section 165 for progressive application of the requirements."

Overall, the Dodd-Frank financial reforms told the Fed to be more careful in its regulation of bank holding companies with more than $50 billion in total assets, but there was definitely no one-size-fits-all requirement. The Fed and other regulators seem to have followed both the letter and spirit of this instruction.

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[18] Governor Daniel K. Tarullo discussed the Fed's "tiered approach to prudential oversight" most recently in his testimony before the Senate Banking Committee on March 19, 2015: http://www.federalreserve.gov/newsevents/testimony/tarullo20150319a.pdf.

[19] These quotes are from his recent testimony to the Senate Banking Committee, March 19, 2015.