EXAMINING CAPITAL REGIMES FOR FINANCIAL INSTITUTIONS

HEARING

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED FIFTEENTH CONGRESS

SECOND SESSION

JULY 17, 2018

Printed for the use of the Committee on Financial Services

Serial No. 115–109

U.S. GOVERNMENT PUBLISHING OFFICE

31–508 PDF WASHINGTON : 2018

HOUSE COMMITTEE ON FINANCIAL SERVICES

JEB HENSARLING, Texas, *Chairman*

PATRICK T. MCHENRY, North Carolina, *Vice Chairman*
PETER T. KING, New York
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
STEVAN PEARCE, New Mexico
BILL POSEY, Florida
BLAINE LUETKEMEYER, Missouri
BILL HUIZENGA, Michigan
SEAN P. DUFFY, Wisconsin
STEVE STIVERS, Ohio
RANDY HULTGREN, Illinois
DENNIS A. ROSS, Florida
ROBERT PITTENGER, North Carolina
ANN WAGNER, Missouri
ANDY BARR, Kentucky
KEITH J. ROTHFUS, Pennsylvania
LUKE MESSER, Indiana
SCOTT TIPTON, Colorado
ROGER WILLIAMS, Texas
BRUCE POLIQUIN, Maine
MIA LOVE, Utah
FRENCH HILL, Arkansas
TOM EMMER, Minnesota
LEE M. ZELDIN, New York
DAVID A. TROTT, Michigan
BARRY LOUDERMILK, Georgia
ALEXANDER X. MOONEY, West Virginia
THOMAS MACARTHUR, New Jersey
WARREN DAVIDSON, Ohio
TED BUDD, North Carolina
DAVID KUSTOFF, Tennessee
CLAUDIA TENNEY, New York
TREY HOLLINGSWORTH, Indiana

MAXINE WATERS, California, *Ranking Member*
CAROLYN B. MALONEY, New York
NYDIA M. VELÁZQUEZ, New York
BRAD SHERMAN, California
GREGORY W. MEEKS, New York
MICHAEL E. CAPUANO, Massachusetts
WM. LACY CLAY, Missouri
STEPHEN F. LYNCH, Massachusetts
DAVID SCOTT, Georgia
AL GREEN, Texas
EMANUEL CLEAVER, Missouri
GWEN MOORE, Wisconsin
KEITH ELLISON, Minnesota
ED PERLMUTTER, Colorado
JAMES A. HIMES, Connecticut
BILL FOSTER, Illinois
DANIEL T. KILDEE, Michigan
JOHN K. DELANEY, Maryland
KYRSTEN SINEMA, Arizona
JOYCE BEATTY, Ohio
DENNY HECK, Washington
JUAN VARGAS, California
JOSH GOTTHEIMER, New Jersey
VICENTE GONZALEZ, Texas
CHARLIE CRIST, Florida
RUBEN KIHUEN, Nevada

SHANNON MCGAHN, *Staff Director*

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

BLAINE LUETKEMEYER, Missouri, *Chairman*

KEITH J. ROTHFUS, Pennsylvania, *Vice Chairman*
EDWARD R. ROYCE, California
FRANK D. LUCAS, Oklahoma
BILL POSEY, Florida
DENNIS A. ROSS, Florida
ROBERT PITTENGER, North Carolina
ANDY BARR, Kentucky
SCOTT TIPTON, Colorado
ROGER WILLIAMS, Texas
MIA LOVE, Utah
DAVID A. TROTT, Michigan
BARRY LOUDERMILK, Georgia
DAVID KUSTOFF, Tennessee
CLAUDIA TENNEY, New York

WM. LACY CLAY, Missouri, *Ranking Member*
CAROLYN B. MALONEY, New York
GREGORY W. MEEKS, New York
DAVID SCOTT, Georgia
NYDIA M. VELÁZQUEZ, New York
AL GREEN, Texas
KEITH ELLISON, Minnesota
MICHAEL E. CAPUANO, Massachusetts
DENNY HECK, Washington
GWEN MOORE, Wisconsin
CHARLIE CRIST, Florida

CONTENTS

EXAMINING CAPITAL REGIMES FOR FINANCIAL INSTITUTIONS

Tuesday, July 17, 2018

U.S. House of Representatives,
Subcommittee on Financial Institutions
and Consumer Credit,
Committee on Financial Services,
Washington, D.C.

The subcommittee met, pursuant to notice, at 2:02 p.m., in room 2128, Rayburn House Office Building, Hon. Blaine Luetkemeyer [chairman of the subcommittee] presiding.

Present: Representatives Luetkemeyer, Rothfus, Lucas, Posey, Ross, Pittenger, Barr, Tipton, Williams, Trott, Loudermilk, Kustoff, Tenney, Clay, Maloney, Scott, Green, Heck, and Crist.

Chairman Luetkemeyer. The committee will come to order. Without objection, the Chair is authorized to declare a recess of the committee at any time. This hearing is entitled, "Examining Capital Regimes for Financial Institutions."

Before we begin, I would like to thank the witnesses for appearing today. We appreciate your participation. And, quite frankly, everybody is jealous of our panel today. We have a very, very distinguished panel. Thank you, all, for being here, and we certainly look forward to and anticipate your testimony.

I now recognize myself for 5 minutes for purposes of delivering an opening statement.

Last April, this subcommittee held a hearing to examine the state of Federal financial regulation and the impact regulators and their perspective regimes were having on institutions, their customers and the U.S. economy. Sitting on the front row of the dais were stacks of paper representing 20,000 to 30,000 pages the average bank submits to the Federal Reserve for its annual CCAR (Comprehensive Capital Analysis and Review) review process. That is 20,000 to 30,000 pages per bank per year just for CCAR.

Fast forward a little more than a year, and I am pleased to report that the first time, in a long time, progress has been made and some relief has been granted. Thanks, in large part, to the effort of the Members of this committee and our colleagues in the Senate and a President who champions regulatory reform.

CCAR doesn't burden nearly as many institutions as it did 1 year ago. While some relief has been seen, it is widely recognized that there is more work to be done.

In a January speech, the newly minted Federal Reserve Vice Chairman for Supervision, Randy Quarles, outlined his vision by stating that, and I quote, "simplicity of regulation is a principle that promotes public understanding of regulation, promotes meaningful compliance by the Industry of Regulation," and reduces unexpected negative in synergies among regulations. Confusion that results from overly complex regulation does not advance the goal of a safe system. End quote.

Vice Chairman Quarles went on to indicate support for changes to the resolution planning process and stress-test programs, acknowledging substantial progress made by financial institutions in the last few years.

His quasi predecessor, Governor Dan Tarullo, said in his departure speech last year, and I quote, "the time may be coming when the qualitative objection in CCAR should be phased out and supervisory examination work around stress testing and capital planning completely moved into the normal, year-round supervisory process, even for G-SIBs." End quote.

While we didn't agree on much during his tenure, Governor Tarullo and I had at least one thing in common, the idea that capital is a good thing. Capital protects institutions and for—and, more importantly, consumers against loss and guards the financial system against threats of collapse. While I believe in robust capital requirements, I don't think capital should be required to the point that it consolidates risk and eliminates choice in the marketplace for commercial individual clients.

The reality is that we still live in a world where the financial regulatory regime stifles growth and limits the availability of financial products. The new crop of Federal financial regulators, in an effort to right-size regulation, are considering additional measures, including tailoring to provide relief to institutions of all sizes. As they do so, I would first urge them to implement the statutory changes, included in Senate bill 2155 without delay and do so while closely adhering to what is clear congressional intent.

It is time for the Federal Reserve to also conduct a holistic review and acknowledge that the world has changed since the enactment of Dodd-Frank and the finalization of the capital requirements on the books today. Such review should include a consideration of equal and reasonable treatment for institutions with more than $250 billion in assets and for immediate holding companies—or intermediate holding companies of international banks operating in the United States.

These institutions should be subjected to tailored regulation that reflects the risk they pose to the financial system. Such steps would not only reflect the intent of Congress but also the Administration, evidenced most clearly through the recommendations issued by the Treasury Department since President Trump took office.

It is time to take the guessing out of capital planning and regulation. I press leadership at each of the Federal financial regulatory agencies to recommit to greater transparency and adherence to the requirements in the Administrative Procedures Act. We need smarter streamlined regulatory regimes that promote not just transparencies, but also effective tax payer and systemic protections.

We have a very distinguished panel of witnesses before us today. Each of these gentlemen has an honorable background, and we appreciate their testimony.

The Chair now recognizes the Ranking Member of the subcommittee, the gentleman from Missouri, Mr. Clay, for 5 minutes for an opening statement.

Mr. CLAY. Thank you, Mr. Chair, and thank you for conducting this hearing. At this time, I am going to be going back and forth to a business meeting in the Oversight and Government Reform Committee. We are expecting votes, so I will designate Mr. Scott, of Georgia, as the ranking Democrat on the panel. And I yield to him on his opening statement.

Chairman LUETKEMEYER. Very good. We will recognize Mr. Scott for an opening statement.

Mr. SCOTT. Thank you, Mr. Chairman. Thank you, Mr. Clay.

As was pointed out by the Chairman in his opening remarks, it is important for us to remember that stress tests are an important tool that we armed our regulators with in the aftermath of the terrible financial crisis. And we did that so that regulators can test the health of our country's biggest banks.

And I was, back then, very proud of the fact that I was an original co-sponsor of Dodd-Frank. And I am proud to say this, that if it weren't for the most stringent capital leverage requirements that we put in place, our financial system wouldn't be as safe as it is today. These changes have also made our banks more resilient. And they have led to increased bank lending, which helped spur our great economic growth that we are experiencing today.

These changes also have made our banks more active in getting the necessary capital out into the marketplace. But as I have been saying for quite a while in our numerous committee meetings, no law is perfect. And that is to say Dodd-Frank is not perfect.

And we, as lawmakers, cannot be unwilling to look at these Dodd-Frank rules, simply because they are too politically difficult to discuss. Our banking system needs us to do that. That is why I became the Democratic leader of Mr. Zeldin's Stress Test Improvement Act HR4293.

We have a distinguished panel. We are looking forward to your interesting and helpful comments. And thank you, Mr. Chairman. I yield back.

Chairman LUETKEMEYER. The gentleman yields back. With that, we go to the testimony of our witnesses. Today, we welcome the Honorable Kevin Fromer, President and CEO of Financial Services Forum; the Honorable Greg Baer, President and CEO of Bank Policy Institute; Dr. Douglas Holtz-Eakin, the President of American Action Forum; Dr. Marcus Stanley, Policy Director of Americans for Financial Reform; and Mr. Keith Noreika, Partner at Simpson Thacher & Bartlett.

Each of you will be recognized for 5 minutes to give an oral presentation of your testimony. Without objection, each of your written statements will be made part of the record. Just a quick tutorial on the microphones in front of you. Please pull—that whole thing will come forward. All you do is just pull the whole thing forward. And make sure you are—the microphone is close. It is very sensitive. Red means—or green means go, yellow means you have a minute to wrap up, and red means we need to close down all together.

So, with that, Mr. Fromer, your recognized for 5 minutes. Welcome.

STATEMENT OF HON. KEVIN FROMER

Mr. FROMER. Thank you, Mr. Chairman, and Congressman Scott and Members of the subcommittee. Thank you for having this hearing and thank you for the opportunity to testify today.

My name is Kevin Fromer, and I am President and CEO of the Financial Services Forum. Our members are the eight largest and most diversified financial institutions headquartered in the United States. And we welcome the opportunity to discuss our support for a broad review of U.S. capital regulations, as well as a more targeted review of the capital planning process, the leverage ratio, and the capital surcharge which applies to only our members.

The Forum's member firms provide vital services in support of the U.S. economy. In the first quarter, Forum institutions held more than $4 trillion in loans, accounting for 44 percent of total lending to businesses and households.

Our members also underwrite nearly three-quarters of debt and equity transactions among other large U.S. institutions, providing critical services that other institutions cannot provide on a similar scale.

Our institutions have significantly enhanced their resiliency and resolvability over the past decade. And they are strongly positioned to support economic growth throughout the economic cycle. Notably, they maintain more than $900 billion in tier one capital, a more than 40 percent increase since 2009.

Our member institutions also have significantly improved their liquidity positions, holding nearly $2 trillion in high-quality liquid assets, an increase of more than 85 percent since 2010. Our members maintain strong capital levels, and they support capital standards that promote both stability and economic growth.

Since capital is a more expensive form of bank funding, unwarranted increases in capital standards lead to increased costs of borrowing and reduced availability of loans for consumers, businesses and communities. To foster economic growth, it is imperative that capital standards be appropriately calibrated to effectively balance costs and benefits.

Regulators worldwide have issued many new requirements at a significant pace in recent years, necessarily focusing on each measure individually. With nearly a decade of change and experience and data behind us, now is the time for a holistic review of the interaction of these important but separate actions. Regulators here and abroad have already begun that process of reviewing and adjusting the post-crisis regulatory system to make key rules operate with greater transparency and efficiency.

An important initial step in this regard was a series of recommendations made by the Treasury Department last year. In my testimony, we call for a broad review and highlight our views on targeted near-term steps. The Federal Reserve, this year, proposed to integrate its capital regulatory rule with its capital planning and stress testing regime, while establishing a new stress capital buffer.

In addition, two Federal banking agencies proposed to revise the enhanced supplementary leverage ratio which applies to only our members. These efforts, which we appreciate, seek to maintain strong capital adequacy while reducing the complexity, cost, and unintended consequences of the regulations.

The Forum has offered suggestions for improving these proposals. First, the Forum believes that the stress capital buffer proposal should be modified to ensure that boards of directors at financial institutions can clearly and appropriately make capital management decisions. A firm with capital in excess of the Federal Reserve's requirements should be permitted to make capital distributions in the way its board deems most productive. The Federal Reserve should also improve the transparency of its scenario and model designs by, for example, soliciting public comment on its stress scenarios.

Finally, the Federal Reserve should conduct full set analysis of the effective costs and benefits of the proposed stress capital buffer proposal that accounts for the full range of its economic costs.

Secondly, with respect to the enhanced supplementary leverage ratio proposal, we have recommended that the agencies exclude risk-free assets to eliminate the economic incentive to reduce participation in low-risk, low-return businesses.

These changes would also serve the agencies' stated goal of ensuring that leverage requirements serve as a backstop to risk-based capital as opposed to a binding constraint.

Finally, both the stress capital buffer and leverage proposals import the G-SIB (global systemically important bank) capital surcharge which, again, only applies to our members. This surcharge was finalized in 2015, 3 years ago, in the absence of several very important improvements to the regulatory system.

In conjunction with our colleagues at the Bank Policy Institute, we have analyzed the level of the G-SIB surcharge and find that it is overstated by at least 1 percent because of subsequent additional regulatory requirements, which both reduce the risk and the impact of default to the financial system.

Accordingly, we believe that the G-SIB surcharge should be reconsidered. This is an initiative that would be wholly consistent with the stated intent by regulators to reexamine and reevaluate the efficacy and efficiency of the proposed crisis regulatory regime.

We look forward to continued engagement with the Congress, with regulators, and other stakeholders to achieve a balanced system that seeks the goals of a safe and sound system with one that best supports economic growth and job creation.

Thank you.

[The prepared statement of Mr. Fromer can be found on page 67 of the Appendix.]

Chairman LUETKEMEYER. Mr. Baer, you are recognized for 5 minutes.

STATEMENT OF HON. GREG BAER

Mr. BAER. Thanks. Chairman Luetkemeyer and Members of the subcommittee, today is my first testimony on behalf of the New

Bank Policy Institute (BPI). Our new organization will conduct research and advocacy on behalf of America's leading banks, which will also serve the interest of consumers who desire innovative products at competitive prices and businesses who seek funding for their growth. The stakes are high as our members make 72 percent of all loans and 44 percent of all small business loans.

Turning to capital regulation, U.S. banks now hold substantial amounts of high-quality capital. Since the global financial crisis, BPI's 48 members have increased their collective tier one common equity from nearly $400 billion to almost $1.2 trillion.

As a barometer for just how much capital the largest banks are carrying in 2018, consider this year's CCAR results. I should note that BPI's smaller non-CCAR banks have even higher capital ratios than the largest. The scenario included a sudden increase in the unemployment rate of 600 basis points. In the stock market crash of 65 percent, housing prices plunged 30 percent. And a similar shock hit capital markets.

Using the Federal Reserve's own monetary policy projections, we calculate that such a rapid increase in the unemployment rate alone, leaving aside all the other shocks, has only about a 50-50 chance of occurring once every 10,000 years. And yet, in this year's CCAR exercise, banks ended up highly solvent, holding a ratio of tier one common equity risk-based assets ranging from 4.0 to 16.2 percent.

Over-capitalization of the bank sector matters because every major evaluation of the cost and benefits of capital requirements, including those done by the Basel Committee, the Federal Reserve, the Bank of England, and the IMF find, it is lending to clients with higher capital requirements. The only debate is how much?

Another underestimated adverse consequence of capital regulations stems from volatility. We frequently hear from bank CFOs that capital planning is extremely difficult when capital requirements vary dramatically year to year, whether from CCAR stress testing scenarios and model changes or examiner pressure.

The final overarching concern is the credit allocation inherent in today's regime. One bank CFO recently remarked to a colleague that he is no longer in the banking business but rather in the regulatory optimization business. In other words, choosing business lines not based on the bank's own estimate of the risk adjusted returns, but rather on how they are treated by capital or liquidity regulations.

At the moment, the Federal banking agencies are considering a variety of rules that could ameliorate or exacerbate these issues. One pressing concern is how the agencies will adopt the new CECL, or Current Expected Credit Loss, accountable methodology for loan loss reserving.

CECL was originally proposed by the FSB as a counter-cyclical measure. However, the strong sense of our banks, now validated by a study we have just published this week, is that it will have precisely the opposite effect. As a result, any future recession will be far less, unless the bank regulators take offsetting action.

More immediately, as 2155 revises the thresholds for imposing enhanced prudential standards in three ways. First, the institutions under 100 billion are no longer subject to enhanced prudential standards, full stop.

Second, institutions between 100 and 250 billion in assets will become exempt from most of those standards in 18 months, unless the Federal Reserve determines otherwise by rule or order. This review should include living wills. And, as Vice Chair Quarles recently indicated, the LCR.

Third, 2155 requires the Federal Reserve to differentiate how it applies any enhanced prudential standard, based on the firm's complexity. We believe that as the Fed considers how to implement 2155, it should suspend application of many of the enhanced standards while it decides what to do.

I should also note the tailoring should include international banks headquartered overseas and doing business in the United States. Their U.S. regulation presents unique issues as such a firm might be a G-SIB in Europe but a regional bank in the United States. Yet, current regulation does not consider those issues in a nuanced way.

In April, the Federal Reserve and OCC (Office of the Comptroller of the Currency) proposed to revise the enhanced supplementary leverage ratio. We generally support that proposal as it would return the leverage ratio to serving as a backstop.

We also generally support the Federal Reserve's recent proposal to simplify capital requirements whereby any stress capital buffer is added to a steady statement on capital requirement, rather than being run as an annual pass/fail exercise.

Nonetheless, we believe that before the Fed finalizes such a proposal, it must remedy fundamental problems with its stress testing regime and resolve significant methodological problems with a G-SIB surcharge.

In particular, the Fed operates CCAR using a mono-model, mono-scenario approach, which we believe produces an inaccurate picture of risk, provides—produces unjustifiable volatility, concentrates risk and allocates capital, principally away from small businesses, LMI borrowers and capital markets' activity.

All in all, it is a lot for regulators in this community to consider. We hope to help and welcome your questions.

[The prepared statement of Mr. Baer can be found on page 38 of the Appendix.]

Chairman LUETKEMEYER. Thank you, Mr. Baer. Dr. Holtz-Eakin, you are recognized for 5 minutes.

STATEMENT OF DR. DOUGLAS HOLTZ-EAKIN

Dr. HOLTZ-EAKIN. Thank you, Mr. Chairman and Congressman Scott and Members of the committee. It is a privilege to be here today. I want to applaud the committee's efforts at continuing to optimize the capital regimes that face U.S. banks. Unquestionably, Dodd-Frank produced a better capitalized banking sector and one that is safer, but it did so at some fairly well-documented costs.

It is an enormously expensive regulatory initiative. It costs about $40 billion to comply already and that tab goes up every year. In part, because of those costs, we have seen only a handful of new banks enter the market in the United States. Something that I have considered a very troubling development from the point of view of the competition in the banking sector.

On top of that, we have seen a documented decline in the access of small businesses to credit and that has a spill-over impact on the capacity of those businesses to grow, to hire people, and to provide the wages of our labor force.

At the other side of the market, we have seen a loss in some consumer benefits, like free checking accounts. And I think, overall, there is an increasing body of evidence that suggests that Dodd-Frank came at too high of a cost for the benefits that it produced.

So, I applaud the recent efforts of this committee and the Congress in the Economic Growth, Regulatory Relief, and Consumer Protection Act, which tailored the regulatory regime to take some of those costs off smaller banks, which will reverse some of the impacts that we have seen.

But I don't think that leaves us with no work left to do. I think there are some things that I have highlighted out of my written testimony. Number one, among the attributes that Dodd-Frank emphasized in thinking about capital regimes was macroprudential regulation or systemic risk issues. To my eye, there has been no real success in identifying a good measure of systemic risk that regulators can target and appropriately manage.

Instead, that regime has turned into simply a second layer of prudential regulation. I would encourage the committee to think about holistically reviewing all of those efforts, from the point of view of having only a single layer of prudential regulation that actually works.

And in that regard, I want to commend the Federal Reserve for its use of stress tests. Stress tests are a very powerful tool to look at the capacity of institutions to weather financial stress and economic downturns. When done well, that is to say with a sufficient transparency, reliance on more than a single scenario, they can accomplish great prudential regulation by allowing the stress test to reveal the complexity of a bank's activities in its capacity to weather those difficulties.

So, I would encourage them to use more stress testing as a bulwark of the regime, not less. And certainly, at least to my eye, this has the additional advantage of bringing market discipline as a complement to the regulatory regime.

If stress tests reveal that an institution is weak, markets will identify that weakness. They will price it appropriately. And they will bring pressure on that institution to correct its capital backing. And there is no substitute for good capital to survive downturns.

So, I think that is a place to focus going forward. And I also think that those tests should be conducted not as part of having the Federal Reserve tell banks how they can use their money. They should be tested to say, is this bank sufficiently capitalized to operate safely in the United States. And past that, they should be able to do with whatever dividends and other cash distributions they see fit with their money.

And so, we have made enormous progress. That progress has come with somewhat of a price, in terms of growth and benefits to consumers of small businesses. We can continue to make progress and I would encourage the committee to continue to work on that.

[The prepared statement of Dr. Holtz-Eakin can be found on page 78 of the Appendix.]

Chairman LUETKEMEYER. Thank you, Dr. Holtz-Eakin. I appreciate your comments. Dr. Stanley, you are recognized for 5 minutes. Welcome.

STATEMENT OF DR. MARCUS STANLEY

Dr. STANLEY. Thank you, Chairman Luetkemeyer and Members of the subcommittee, for the opportunity to testify today.

Today's hearing examines capital regimes for financial institutions. In thinking about regulatory capital requirements, I believe it is important to start with, first, the principles. This begins with understanding that large banks receive extensive backing from the Federal Government.

According to the Federal Reserve Bank of Richmond's latest bailout barometer, almost 80 percent of the liability of all banking institutions or $15 trillion benefits from an explicit or implicit promise of support from the taxpayer. This support ranges from deposit insurance to the kind of long-term emergency assistance that was provided by the Federal Reserve and Treasury during the financial crisis and continues to be authorized under the Dodd-Frank Act.

Public guarantees are a cornerstone of the modern financial system. I guarantee you that if any Member of this committee advanced legislation that significantly cut back on those public guarantees for the financial system, the very same people who ask you for less regulation today would be in your office tomorrow opposing that bill.

Given the government guarantees provided the for-profit entities in the financial sector, it is important to require that these private entities put up significant resources of their own, especially by investing their own private equity capital. In the absence of such capital requirements, companies could take advantage of low-cost funding made possible by guarantees—government guarantees and take the profit upside while leaving losses to be covered by the taxpayer. That is what we saw in the 2008 crisis.

Even with post-crisis regulatory capital requirements in place, banks are able to borrow much more than any other private sector business could. A private nonfinancial firm might be able to borrow an amount equal to half its assets. An aggressive financial firm outside the public safety net, like a medium-sized hedge fund, would typically borrow 60 to 80 percent of the value of its assets. But the large banks at the center of our financial system today all routinely borrow amounts over 90 percent of their total asset value.

Simple math says that the less capital these banks are required to invest, the greater their profit return on each unit of equity. So, the easiest way for large banks to increase their return on equity is to convince you, the legislators, to reduce their required levels of capital.

To do this, they make two arguments. The first argument is that you should be complacent. Because the current requirements for capital and other loss absorbency are so far in excess of any possible losses from a financial crisis that there is no way that 2008 could ever happen again. Of course, no one expected 2008 to happen before 2008 either.

The second argument is that you should be alarmed because the current regulatory capital requirements impose severe costs on the economy. Both of these arguments are mistaken. First, you should not be alarmed. Bank lending, especially business lending, is growing significantly faster than general economic growth which indicates that the banking sector is not acting as a drag on economic growth.

Capital is a resource that is actively deployed. Capital supports lending, making lending safer and more durable. Better capitalized banks lend more during downturns.

To the extent capital does increase bank costs, reasonable estimates of the economic cost of increased capital are already routinely taken account by right—into account by regulators and setting bank capital requirements.

Multiple impartial studies show that current requirements are, if anything, too low compared to their economically optimal level. You should also not be complacent. While bank loss absorbency has increased from the disastrously inadequate levels observed before the financial crisis, it is still far from clear that it is sufficient to fully protect against the risk of another financial crisis. However dramatic the microeconomic variables used by the Federal Reserve in stress test scenarios, the underlying stress test models that project scenario losses are still showing estimated loss is much less than those actually experienced by banks during the financial crisis.

And most of all, you must not be complacent because of the devastating economic impacts of financial crises. The last crisis produced some—created some $10 trillion in direct economic cost to the U.S. alone. Nine million lost jobs. Millions of families foreclosed from their homes. And shook the legitimacy of both our economic and political system. It must not be permitted to happen again.

[The prepared statement of Dr. Stanley can be found on page 101 of the Appendix.]

Chairman LUETKEMEYER. Thank you, Dr. Stanley. Mr. Noreika, you are recognized for 5 minutes. Welcome.

STATEMENT OF KEITH NOREIKA

Mr. NOREIKA. All right. Mr. Chairman, Ranking Member Scott, and Members of the subcommittee, thank you for having me here today. During 2017, I had the honor to serve as the Acting Comptroller of the Currency. Today, I hope to give you my perspective as someone recently familiar with both the concerns of the public and private sectors.

I will focus my remarks on the need for tailoring two important segments of the financial system. First, regional banks with between $100 and $250 billion in total consolidated assets. And, second, international banking organizations that have a banking and capital markets presence in the U.S.

In Dodd-Frank, Congress stated that the Federal Reserve, quote, “may differentiate among companies on an individual basis by category, taking into consideration their capital structure, riskiness, complexity, financial activity, size and any other risk-related factors.”

Despite this invitation to tailor, the vast majority of the Federal Reserve's enhanced prudential requirements have been applied to all firms based on simple asset measures. In a recent enactment of the regulatory relief legislation in May, Congress has now directed the Federal Reserve to tailor its requirements to the riskiness of the institutions that it supervises.

With respect to regional banks, the Act first presumes that all firms with less than $250 billion in total consolidated assets are no longer covered by enhanced prudential requirements. And to apply them, the Federal Reserve must affirmatively demonstrate that the requirements are appropriate to prevent risks to financial stability or to promote safety and soundness, and there have been no such risks currently identified for such firms.

Second, the Act requires that the application of any enhanced prudential requirement to a firm with at least $100 billion in total consolidated assets must take into account a statutory multi-part conjunctive test. Third, Congress has required separate analyses for assessing the application of each enhanced prudential requirement.

And, finally, as the Federal Reserve proceeds to implement the Act, the substantive requirements of each of the enhanced prudential standards should also be revisited, reexamined, and tailored to ensure that the substance of each requirement is appropriate based on the risk posed by the subject firm.

With respect to the application of enhanced prudential requirements to international banking organizations, since the passage of the International Banking Act in 1978, the regulation of international banks operating in the U.S. has been guided by a non-discrimination principle of, quote, "national treatment and equality of competitive opportunity."

Congress' commitment to national treatment was reaffirmed in Dodd-Frank. The implementation of enhanced prudential requirements has not always lived up to Congress' mandate of national treatment, most notably through the implementation of an intermediate holding company requirement on firms with more than $50 billion in U.S. non-branch assets; and a variety of prescriptive governance, risk management, capital, liquidity, stress testing, and resolution planning requirements on the U.S. operations of international banks.

The U.S. ring-fencing requirements and reactive foreign-ring fencing requirements cause a net increase in capital costs on international firms and U.S. firms operating abroad as countries apply stand-alone capital and liquidity requirements. This may have the perverse effect of making banks with cross-border activities less safe because if a crisis in one geography burns through the firm's local prepositioned resources, the firm may be precluded from using its resources located elsewhere to bolster the part of its operation under stress.

There are a number of actions that the Federal banking agencies should take to reintroduce national treatment into their regulation of the U.S. operations of international banks. First, the agencies should better account for the global resources of international firms when calibrating capital, liquidity, and stress testing requirements applied to the U.S. operations of these firms.

Second, consistent with the June 2017 Treasury Report recommendations, the requirements applicable to the U.S. operations of international banks should be commensurate with the risks posed by their U.S. footprints.

Finally, the current CCAR framework disadvantages international firms, whose U.S. operations are primarily capital markets in nature and does not take into account the benefits of global diversification that exists for these international banks.

Thank you and I look forward to your questions.

[The prepared statement of Mr. Noreika can be found on page 84 of the Appendix.]

Chairman LUETKEMEYER. Thank you, Mr. Noreika. I appreciate your testimony today and all of the gentlemen here that are on our panel today.

With that, we will begin the questioning. I will recognize myself for 5 minutes.

I guess, Mr. Noreika, we can start with you. With regards to implementing Senate Bill 2155, do you see any ambiguity in the way that the $250 billion threshold was set?

Mr. NOREIKA. Could you repeat that?

Chairman LUETKEMEYER. Yes. Do you see any ambiguity in the way that the $250 billion threshold was set or is the statute pretty clear?

Mr. NOREIKA. I think the—yes. No, thank you.

Chairman LUETKEMEYER. Because you were talking about this in your statement here just now and talking about concerns on how this should be done. Have you seen any concerns at this point with it not being done?

Mr. NOREIKA. Well, look, I think the statute is clear. The statute presumes that these banks are out unless a determination is made, both that there is a risk of financial stability of the United States or safety and soundness of the institution. And a multi-part statutory test is applied to each prudential standard to reapply to those banks.

Now, I think we heard from the Chairman of the Federal Reserve today in his testimony, in an exchange with Senator Warner, that they are working on this. And I think the effort is to urge the Federal Reserve to apply the statute as it is written to, I think, immediately lift the enhanced prudential requirements on these banks until and unless they can empirically demonstrate that there is a need for each of the prudential requirements to apply to each of the institutions in this asset range.

Chairman LUETKEMEYER. Well, and I know the procurement period on this is disclosed. And I am sure they are listening, so has anybody got a comment they would like to make to the Fed that say, hey, we suggest this? Nobody has a comment to make to the Fed today? Really? OK. I have a lot of them. But we will stop there.

With regards to—Dr. Holtz-Eakin, you were talking about the stress test and the importance of it. And I think you made a comment, something to the effect that it was—you don't think it is quite as good as it could be because it doesn't quite accurately measure the stress that banks are under. Can you elaborate a little on that?

I would agree with you, probably to a point. You can't—it is difficult to guess what kind of stress can come—where it can come from and all of the different variables so who knows what is going to happen. But what would you see as some extra things that the Fed could do or perhaps, that we could do to enable this to be a better situation?

Dr. HOLTZ-EAKIN. So, I think there are really two areas. The first is the transparency and the public nature of the information revealed by the stress test. If you think back to the first stress tests when they were done, the original plan was not to make the results public. And markets were in turmoil and there was an enormous amount of fear and uncertainty.

And when they decided to actually reveal those stress tests, it allowed market participants to identify healthier versus less healthy institutions pretty clearly. It allowed them to price those risks more effectively. And it allowed them to bring market discipline to the operation of those banks. It is important that that continue going forward.

I am concerned, my comment to the Fed, about this plan to simply move away from having stand-alone stress tests, put everything into a CCAR process that doesn't look terribly transparent to me. I think that is giving up the opportunity to have market discipline as a complement to good regulation. And you need both. So, that is point number one.

The second point is, I am not a big fan of a single scenario stress test. Stress tests are done by lots of institutions for their own purposes and they involve multiple kinds of scenarios to test, genuinely, their exposure to different kinds of downturns, different kinds of commodity price fluctuations, different kinds of housing market impacts. I would encourage the Fed to think more about bringing that kind of a regime into play.

Chairman LUETKEMEYER. Well, along that line, Governor Tarullo in my comments, I indicated that he made the comment that stress testing programs should move to the normal examination cycle. And, to me, I think that is where it needs to go. I don't know if the banks need to be filling out forms to have the regulators see if they have guessed right on whether this is actually going to work.

To me, the regulators should have a set of scenarios that they believe could happen. They go into a bank and they apply those scenarios to the business model and the actual bank members and see if it works. Is that something that makes sense to you?

Dr. HOLTZ-EAKIN. I whole-heartedly concur. I think that is exactly the right way to use them. And reveal those results and that would be a good way to do prudential regulation. In the end, you want good safety and soundness regulations and stress tests can be an important part of that.

Chairman LUETKEMEYER. My time has almost expired. With that, I will yield back the balance of time and I will go to the distinguished gentleman from Georgia. Mr. Scott is recognized for 5 minutes.

Mr. SCOTT. Thank you very much, Mr. Chairman. Mr. Baer, let me start with you. I wanted to ask your thoughts—ask you for your thoughts on stress tests because, as I mentioned earlier in my opening remarks, my bill with Mr. Zeldin makes structural changes to the stress test regime in the—in this way. Our bill made such structural changes as saying the Fed couldn't fail a bank for their qualitative portion of their test. And we also eliminated the adverse scenario from the test requirements, among other things.

But recently, from the Fed, as we all saw for the first time, handed out a passing grade when a passing grade wasn't deserved. The Fed referred to this as, quote, "a conditional nonobjection" It is interesting to know what that means.

But I also view the amendments we made in my bill with Mr. Zeldin as a way to reduce the burden without fully gutting these critical, important tests. But I viewed these recent actions from the Fed as a way to smooth out our markets negative and often overly harsh a reaction to the news of a bank receiving a Federal grade.

So, Mr. Baer, let me ask you this first part. What sort of reforms do you think are more important?

Mr. BAER. I would—thank you, Congressman. I would agree with you that the qualitative portion of the CCAR should be part of the regular examination process just the way they examine anything else from credit underwriting to the markets' businesses. The adverse scenario is proving useful because it simply never binds and it has just become an exercise that does not have a lot of benefit and is probably not as robust as some of the scenarios that Dr. Holtz-Eakin was talking about that the bank, itself, runs.

With respect to the results and pass or fail. I think where we need to get is where we have confidence that those results are actually meaningful and where the Fed can be comfortable saying there is really no way to give an exception.

Right now, and I think you have already heard it, we are in a mono-scenario, mono-model world where you have extreme stresses in certain areas and level stresses in other. That is not necessarily the result that is going to—or the process that is going to—that is going to make the banks safest. Banks should not just be testing for, and I assure you they do not, very high increases in employment. They should be looking at what happens if there is a problem with foreign debt, something in China, something in Russia, European issue, hyperinflation, deflation.

So, banks that are really managing their risk, they look at all those different scenarios and then they make a judgment about what their capital needs are. And so, we support the notion of the Fed running multiple scenarios, perhaps averaging them—averaging them over time, expressing the volatility.

Mr. SCOTT. Very good. Now, Dr. Holtz-Eakin, I hope I pronounced your name correctly.

Dr. HOLTZ-EAKIN. Exactly right, sir.

Mr. SCOTT. Thank you. You made some interesting comments in your testimony. First of all, you said that competition in the banking system is getting less. You said there are fewer and fewer banks. You said there are fewer and fewer checking accounts at these banks. You also said systemic risk regulation is now questionable.

And then you said this. You said, we need more stress testing and not less. Now, we have five distinguished gentlemen there. How many of you agree with Mr. Eakin that we need more stress testing, not less? All right, we have two out of three? Tell me, give me—those of you—somebody—one of you who disagree, tell me why? Why do you think—now, Mr. Eakin has said why we need more. One of you that raised your hand said we need less. Tell me why you disagree. Yes, Mr. Fromer.

Mr. FROMER. Yes, I will start. Let me just say that the issue is not the stress test, per se, because the stress test process is a useful process. The issue is parts of the process that have proven to be not transparent, whether it is the models, as Mr. Baer has referred to, or the economic scenarios, that Mr. Holtz-Eakin has referred to. So, the improvements that we believe are necessary are focused on the transparency of both of those components of the stress test.

So, it may involve more scenarios as they have discussed. But I think it is the quality of the scenarios and the understanding of what is inside the model of the Federal Reserve versus the real experience of the institution itself?

And then, the quality of the actual economic scenarios. Are they extreme? Are they plausibly extreme? And when do the firms experience that information for purposes of their capital planning, in order to reduce the volatility that has been mentioned?

Mr. SCOTT. All right, very good. Thank you, Mr. Chairman.

Chairman LUETKEMEYER. Thank you. The gentleman yields back. With that, we go to the Ranking—or the Vice Chairman of the committee, Mr. Rothfus. The gentleman from Pennsylvania is recognized for 5 minutes.

Mr. ROTHFUS. Thank you, Mr. Chairman. Mr. Baer, as you know, Basel III takes a fairly punitive approach to mortgage servicing rights compared to other intangible assets. This is particularly challenging for U.S. banks since our mortgage market relies on securitization while banks in other jurisdictions tend to follow the originate-and-hold model.

Can you describe how Basel III's approach to mortgage servicing rights affects U.S. banks?

Mr. BAER. Sure. Thank you, Congressman. Now, clearly, there was a very large change made post-crisis to mortgage servicing rights. The level at which a capital deduction occurred, the threshold was much lower. And then, the capital deduction, I think, rose from 100 percent to 250 percent. So, it is a substantial penalty.

It is also interesting that that came out of the Basel Committee where, really, it is the United States. This is really a uniquely U.S. issue so—because we have a large securitization market. And I think it is fair to say that most countries around the world don't really have this issue as much. So, that may not have been the best place to have it debated.

It is fair to say that during the crisis, mortgage servicing rights did not become a readily salable asset. So, clearly, there should be some restrictions on their ability to count toward capital. And I think it is a very good question whether the post-crisis reaction that came out of Basel was too extreme.

And yet, I think it would be a very good idea to recalibrate that. And, almost certainly, downward to give more credit for it. Certainly not as much credit as common equity. But more—I think it is now five times the capital deduction for residential loans.

Mr. ROTHFUS. Well, can you offer some insights on how capital rules applicable to mortgage servicing rights affect the consumers?

Mr. BAER. Sure. Well, it affects consumers in two ways. One, it increases the cost of the servicing. But, also, what you have seen post-crisis, as a result of the very high capital charge, is that a lot of this business has migrated away from regulated banks to nonbank servicers.

I think there was a time when that was considered to be a good thing. I think experience has taught us that consumers are probably better off if that is at a regulated financial institution with a lot of other relationships with that customer and a lot of incentives to do right by that customer.

Mr. ROTHFUS. Mr. Fromer, over the last decade, the Federal banking agencies have built a complex regulatory regime with wide-ranging consequences for regulated industries and the broader economy. While our committee has led the way on historic regulatory reform, we should all recognize that there is always an opportunity to build a stronger and more efficient regulatory system. In order to do that, we need an honest and thorough account—thorough accounting of the rules in place today.

In a speech earlier this year, Vice Chairman Quarles said the following. Quote, "now is an eminently natural and expected time to step back and assess past regulatory efforts. It is our responsibility to ensure that they are working as intended and given the breadth and complexity of this new body of regulation, it is inevitable that we will be able to improve them, especially with the benefit of experience and hind sight."

Do you agree with the—do you agree that the Fed should undertake a holistic review of our regulatory regime and, if so, why would this be important?

Mr. FROMER. Thank you for the question. First of all, I would wholeheartedly agree with that statement. And I believe it is a statement that is at least conceptually shared, not only here but amongst regulators outside the U.S. And that is to say, after you have a decade of experience in data, not only amongst the regulators but the firms themselves, that you—that the responsible thing to do here is to take a holistic approach.

As perfect example of why you need to do that, we have something called the G-SIB surcharge that applies to the Forum institutions. That G-SIB surcharge is put in place for the purposes of putting capital into the system, in the event that there is a heightened risk of default or failure of a large firm and the impact that could have, the social cost that could have.

But it was put in place at a time when a series of other improvements had not been implemented. Those improvements have been implemented. And as a consequence, the surcharge is, to some degree, redundant of the improvements that have been made.

So, that is an example of the kinds of things that, I think, the regulators need to take a broad look at in the context of the framework.

Mr. ROTHFUS. Mr. Noreika, in your testimony, you wrote that regulators should be transparent in rulemaking and supervisory process and not become overly reliant on unofficial rulemaking through guidance. Of course, this backdoor approach to regulation was all too common in the previous Administration.

You recently finished a stint as the Acting Comptroller of the Currency. Have you seen a shift in the attitude and actions of regulators in recent months on this topic?

Mr. NOREIKA. Well, I have, Congressman. And I think it is a welcomed change. And I think we are starting to see some of this reviewed by Congress as a congressional Review Act, such as we saw with the indirect auto lending guidance. And I think there is an effort underway at each of the banking agencies to catalogue their so-called guidance and see what needs to be put out for notice and comment. And then, also, what might be subject to a congressional review as well.

So, I think it is a welcomed guidance. I think rules will get more rules, which will get more rules in how they are implemented. And guidance, obviously, is useful up to a point but it has to remain guidance. And when it becomes a binding effect, then there are certain legal protections that are there for the—for those that are regulated and that has to be—the government has to be mindful of that.

Mr. ROTHFUS. My time has expired. I yield back.

Chairman LUETKEMEYER. The gentleman's time has expired. I call the gentleman from Texas who is recognized for 5 minutes, Mr. Green.

Mr. GREEN. Thank you, Mr. Chairman. I thank the witnesses for appearing as well. I remember when we were talking about long-term capital. Anybody remember that name, long-term capital? You—OK, thank you. And we were talking about events and how things just couldn't happen. But before there was long-term capital, we had people who were very skeptical about regulations. And nobody anticipated that long-term capital would occur but it did.

I remember when the banks would not, NOT—would not lend to each other. And I remember why we had to resort to Dodd-Frank. Dodd-Frank was necessary and, in my opinion, it has served us well. I think the living wills, the stress tests are important. For a multiplicity of reasons, I might add.

But we have two persons who have indicated that they think we should have more stress tests and didn't get a chance to hear your responses as to why. So, let me start with the first person who would like to respond. Which of you will that be, please?

Mr. BAER. I will go. It is a very broad question. I think for firms that are subject to stress testing, and I think that should include large complex firms, those that have a variety of businesses perhaps internationally, you are always going to be better off running more stress scenarios rather than fewer. You don't want them only preparing for one type of impact as opposed to a variety. That is not to say, though, that for every firm, stress testing is appropriate.

And I believe Congress got it right in 2155 when it moved from annual periodic with respect to regional firms. Those are, generally, firms that have a pretty homogenous book of mortgage loans, C&I (commercial and industrial) loans, generally not any international exposure, probably have a more complex liability structure.

So, I think it really varies, depending on the bank. But once you are saying, yes, stress testing is appropriate for this bank, I am very worried about the current regime where you have a mono-model, mono-scenario approach to determining the capital adequacy of that bank.

Mr. GREEN. Mr. Stanley, I think you were among the two.

Dr. STANLEY. Yes, I think what is going on here is that I agree, conceptually, with Dr. Holtz-Eakin and Mr. Baer that there are a wide variety of types of stresses and stress scenarios that could impact a bank. And regulators have to be—both regulators and banks have to be creative and aggressive in seeking out what might be on forecast risks or risks that are difficult to forecast that might harm the bank.

So,you have to test a greater range of scenarios. But I would just point out that this goes, in my view, completely opposite to this claim by industry that we can't have volatility in stress testing results, and stress testing impacts and stress tests can't change from year to year. The very fact that markets change so often that you have to check multiple scenarios, to me, means that there should be an unpredictable element in stress tests. They should change.

And if you have had a stress test that was totally predictable, it wouldn't really be stressful and it wouldn't really be a test.

Mr. GREEN. I think that I see someone who would like to respond to your response so I will yield to you. And give your name, if you would. Is it Mr. Baer?

Mr. BAER. Yes.

Mr. GREEN. Thank you.

Mr. BAER. I think to the extent that markets are actually changing, bank's capital requirements should change. If all that is changing is the stress test that is chosen by the regulator, that really shouldn't be causing large changes in a bank's capital position.

It is important because banks have to make long-term business plans: 1, 2, 3, 5 years out. And if you don't know what the capital charge is going to be for that business, it is very difficult to do that. And that does not help consumers or businesses.

Again, if there is a real change in the bank's risk, yes, and it is to the upside, the bank's capital prime should go up. If it is—if it is to the downside, it should go down. And this doesn't necessarily mean, I would say to Dr. Stanley, lower capital requirements. To the extent that you average them, either averaging a variety of scenarios or averaging the results over a couple of years or whatever that stress scenario is, that would still suppress volatility. It wouldn't really necessarily—

Mr. GREEN. I think Mr. Stanley would like to have a final retort so I am going to allow this debate to continue for this last round. Mr. Stanley.

Dr. STANLEY. Well, I have very little time but I guess I would just point out that we—in terms of capital planning and long-term planning, we actually don't want banks over-adjusting and trying to track the regulatory capital requirements. We—that element of unpredictability, I think, could be important, precisely so that banks don't take excessive account of regulatory requirements in their future planning, and instead look more at the business environment.

Mr. GREEN. Mr. Chairman, if I may, Ranking Member Clay has asked that I offer some materials for the record with unanimous consent.

Chairman LUETKEMEYER. Without objection.

Mr. GREEN. The Center for American Progress has a rather lengthy document and letter to be submitted; Better Markets similarly situated; the Americans for Financial Reform. I ask that, if there are no objections, that all be submitted into the record.

Chairman LUETKEMEYER. Without objection.

Mr. GREEN. Thank you.

Chairman LUETKEMEYER. The gentleman's time has expired. Now, we go to the gentleman from Oklahoma. Mr. Lucas is recognized for 5 minutes.

Mr. LUCAS. Thank you, Mr. Chairman. And I would like to revisit a couple of issues with my colleagues here. But first, I always remind folks that coming from a capital-starved region, the oil and gas industry, agriculture, Main Street in rural Oklahoma, capital is always a challenge for us. By the same token, I acknowledge to you that I come from a long line of debtors, so I have a certain perspective from that perspective.

Let us visit Mr. Baer. I have heard my constituents, in the wake of S2155, say that they are confused about legislative intent when it comes to stress testing. Some of my banks, most of which are very small and are well under the $100 billion threshold, believe that 2155 was meant to do away with all stress tests for banks under those numbers, not just the test called for in Dodd-Frank. I realize you don't speak for FDIC, but is this a view that is widely shared by—among the industry?

Mr. BAER. Yes. I think, Congressman, that if you are under that threshold, it is the assumption and the only way I would read the statute is that that is the end of having to do these types of stress tests. And I would say we are actually quite concerned that regulators these days are very fond of what we call horizontal reviews, which we sometimes call examinations management consulting, where they will look at a variety of banks and come in and say, you know what? We don't like your practices. We want you to do what some other banks are doing.

So, to the—we are very concerned that these same requirements that have been ended by 2155 will actually come back in through the examination process. And I really think that is something for this committee to keep an eye on.

Mr. LUCAS. That was my next question: How we clarify the situation so that the intent behind 2155 is obvious to everyone.

Mr. BAER. Again, Congressman, I think it is a real concern. We have a whole—we could have a whole separate hearing on the examinations as far as the regulatory process. Because I think, particularly for smaller banks, a lot of this isn't about stress testing or G-SIB surcharges or any of that. It is really about a fundamental shift, post-crisis, away from examinations focusing on safety and soundness issues that are material to the health of the firm and toward more minor criticisms and consulting and horizontal reviews.

I do think it is going to be a long process. But I hope that the new leadership of the agencies can refocus the exam teams on matters that are material to the financial institution and not just wanting them to do it a different way.

Mr. LUCAS. So, you don't disagree. When the bankers say they read what they read which is how I read the bill. It sounds like the way you read the bill.

Mr. BAER. Yes, that is what I understand. I think Mr. Noreika eluded to guidance where, for years now, banking agencies have been issuing guidance. And they say it is only guidance but every banker you talk to, every compliance department says, no, we treat that as a binding regulation in every case because that is the way the examiners treat it. So, it is a cultural thing. I think it is going to be difficult to resolve but it is an important issue.

Mr. LUCAS. Mr. Noreika, let us touch on that subject of the issue of mortgage servicing rights and the treatments under the capital rules. I have a couple of constituent institutions in Oklahoma that have been very successful in servicing things like FHA loans. There other institutions across the country that are very successful in dealing with V.A. and USDA loans.

And they are very concerned, as we have discussed earlier, that under the Basel III cap, combining with the risk of these assets hinders their ability to engage in the activity, and they tell me that they are seeing literally the business being driven to nonbank lenders where their regulation is lighter.

Could you touch on that for just a moment? Is this a legitimate concern by my constituents?

Mr. NOREIKA. Yes. And it is something that I faced at the OCC and we put out a proposed rule that hasn't yet been finalized. But certainly the capital charges for servicing rights are overly punitive. It disproportionally impacts regional community banks and reduces the availability of loans in our communities. Holding mortgage servicing rights is often part of a sound strategy for banks that originate and sell loans while retaining the right to service these loans.

The practice permits banks to make loans in our community and develop stronger customer relationships while appropriately managing risks to their balance sheets.

As I mentioned, when I was at the OCC, we put out a capital rule to streamline and loosen the punitive requirements on these requirements in, I believe, September 2017. I think the time has come for the agencies to finalize that rule, with respect to mortgage servicing rights, and take away some of the punitive effects that comes from holding these assets.

Mr. LUCAS. Thank you, sir. I yield back, Mr. Chairman.

Chairman LUETKEMEYER. The gentleman yields back. With that, we go to the distinguished gentleman from Kentucky, Mr. Barr. The Chairman of the Monetary Policy Committee is recognized for 5 minutes.

Mr. BARR. Thank you, Mr. Chairman. I will start with Dr. Holtz-Eakin. The question about the legislation that was recently signed into law, Economic Growth, Regulatory Relief, and Consumer Protection Act. What do you believe will be some of the most pronounced impacts on bank lending, now that that law has been signed?

Dr. HOLTZ-EAKIN. I think the most pronounced impacts are going to be in the relatively small loans: $50,000, $100,000, $200,000 to small businesses in the area—in those areas. We know there has been a big geographic dispersion in the quality of the economic recovery. It looks a lot like the geographic dispersion in the access to credit. And so, I think that is an important economic benefit.

Mr. BARR. Can you elaborate a little bit more on your testimony about market discipline as an additional factor in strengthening the financial system, in addition to capital requirements?

Dr. HOLTZ-EAKIN. There is nothing better than capital for honing incentives, right? The thought of losing your own money is a powerful motivator. And if you have investors who are looking at institutions carefully and correctly trying to price the risks that those institutions face, that is a tremendous source of discipline to the operation of those institutions.

So, wherever possible, it is useful to try to bring that into the process. And that is one of the reasons I, at least, think that the stress tests are so valuable. They provide information to market participants about how firms react in different situations. That is useful for pricing.

Mr. BARR. Is there a lack of transparency anywhere in the law right now that could be corrected, in terms of transmitting greater levels of information to consumers?

Dr. HOLTZ-EAKIN. I just echo a lot of the things that Mr. Baer said about the current stress testing regime not having sufficient robustness to convey all of the risks that these institutions will face and can weather or not weather. And that is what you want to know.

Mr. BARR. Mr. Noreika, thank you for your service at the OCC. And let me just ask you, now given your background in both the private sector and the public sector, your thoughts about the role and importance of regional banks in the traditional lending model and how does over-regulation contribute to curtailing lending in economic growth?

Mr. NOREIKA. Well, thank you, Representative Barr. Look, failing to properly tailor the enhanced prudential requirements, with respect to regional banks or all banks, will continue to increase the price and limit the availability of credit in the United States and, ultimately, stifle economic growth. Poorly tailored requirements also hurt access to credit, usually for those at the margin, those in underserved communities which are often served by regional banks. Poorly calibrated requirements also unintentionally incentivize unnatural and risky behavior and they make the market less safe.

Mr. BARR. Can I jump in really quickly?

Mr. NOREIKA. Yes.

Mr. BARR. Your—the thrust of your testimony was that the $50 billion asset threshold was an arbitrary threshold.

Mr. NOREIKA. Yes.

Mr. BARR. And that the new regime is a preferred approach, based on these multi-factor tests.

Mr. NOREIKA. Yes.

Mr. BARR. The presumption is that if a—if an institution has assets less than $250 billion, it is—it doesn't warrant that enhanced prudential supervision. But it does give discretion above 100 billion for that—for the application of those enhanced supervisory rules.

What is so—what is magic about the $250 billion threshold? Is there an argument to be made that that threshold should go up as long as the regulators have the discretion to apply a similar multifactor test to institutions between, say, 250 or 500 billion or, for that matter, any institution that is not categorized as a G-SIB.

Mr. NOREIKA. Sure. That is a very good question. Look, I think the way the world is divided now, in light of the regulatory relief legislation, is that everything under 250 billion is presumed to be out. And everything under 100 billion is absolutely out by statute.

Above 250 billion, Congress now has required, directed the Federal Reserve to apply its enhanced prudential standards based on this multi-par test. One of those factors is asset size. But the other factors are not asset size. And so, even for the banks above $250 billion, the Federal Reserve has to go back and they have to look at each of their—and it says any prudential standard so it is for each one. They have to look at them and they have to look at the—those factors with respect to the individual institution.

And I think this dovetails nicely with what we are hearing out of the new leadership of the Federal Reserve as far as tailoring goes. Congress has provided a roadmap for tailoring.

Mr. BARR. I have more questions but my time has expired. Thank you.

Mr. NOREIKA. Thank you.

Chairman LUETKEMEYER. The gentleman's time has expired. With that, we will go to Mr. Tipton. He is from Colorado. He is recognized for 5 minutes.

Mr. TIPTON. Thank you, Mr. Chairman. I thank the panel for taking time to be able to be here. And Mr. Noreika, maybe you would like to go back a little bit more, in terms of some of the questions that Mr. Rothfus had brought up, in regards to, are we actually seeing the needle move after 2155 is being signed into law with the regulators. Some of the comments that I have had from some of my local banks is when—you were just talking about some of the tailoring end of it.

Mr. NOREIKA. Right.

Mr. TIPTON. They said they really haven't seen any real impact. It is business as usual. So, could you drill down a little bit more in where you are seeing that movement starting to go?

Mr. NOREIKA. Sure. And, look, I am on the outside looking in now. And I was recently on the inside looking out. I don't disagree with your statement. I think that Congress has provided fairly clear guidance to the agencies.

I think that the agencies did take immediate steps for the banks below $100 billion to inform them of certain changes. Maybe that hasn't filtered out entirely. But I think that whatever those are, they should be in constant contact with their regulator to work out those issues because what Congress did was fairly clear.

I think the real issues immediately facing the agencies are with below 250 billion, this presumption that they are out, unless there is a finding made that there is a threat to financial stability or safety and soundness and the application of a multi-par test. And then, above 250 billion, there is the application of the statutory multi-par test that now is directed by statute. And I think that is one we haven't yet seen the agencies come out and talk about. And hopefully we will soon.

But I do have an appreciation for the way things work in the public sector as opposed to the private sector. I suppose 2 months in the private sector—in the public sector isn't quite as fast as perhaps I would like. But—or you would like.

But I am sure they are working on it diligently. And I think hearings like this help give valuable input on helping them to come to a formulation of how they are going to deal with these different groups of banks.

Mr. TIPTON. Right. And I think Mr. Barr's comments in terms of setting arbitrary thresholds and how that impacts. Do you have some recommendations specifically rather than just having arbitrary thresholds? I know they are working on it. But is there something more that Congress could be doing?

Mr. NOREIKA. Well, look, I think you are doing exactly the right thing like holding hearings like this. And I think you can step in with targeted legislative actions if the agencies go in the wrong direction or read the law the wrong way. Hold their feet to the fire. And that is exactly what you should be doing.

I think right now, the goal is for the agencies, and with congressional direction, to go reexamine everything they did before. And so that not only is the scope, but also the substance as well.

I think you have to also look at each of the requirements and see whether they are narrowly tailored or whether it is a broad-brush approach to applying something to one of the largest banks, then being falling downhill, if you will, as I think Senator Corker once told me toward the Main Street banks and having an overly punitive effect which has ramifications for the economy.

Mr. TIPTON. Mr. Baer, would you like to comment a little bit on this? And I thought it was interesting, you were making the comment regards to some of the horizontal type of examinations that are going on. And I came from the private sector and we were constantly doing a review in business, almost every day, had the flexibility, the nimbleness to be able to make some changes, if necessary to be able to do it.

Would you address some of that regulatory process?

Mr. BAER. Sure, Congressman. It is actually quite—I think, quite interesting, from a bank regulatory policy perspective. That clearly, and I think they would agree post—in recent years, the Fed and the OCC are going in opposite directions, in terms of how they examine. The OCC is reemphasizing the importance of the examiner in charge and having a resident team that knows and understands that bank.

The Federal Reserve is moving toward a more centralized approach with cross-reserve bank, cross-functional teams and a lot of folks in Washington. I could actually make a good argument for or against either approach. I think either could work, either could fail.

But I do think the risk of the latter approach is that you get to having the cross-functional team as, sort of, judge and jury. Where they are looking at multiple banks and they are picking the one they like the best.

I have heard this from multiple firms that they were told, well, yes, on the liquidity front, you are in compliance with the OCR. You passed CLAR. Your own work is pretty good. But we just completed a horizontal review, and we like what somebody else is doing better.

Will we give you access to that? No, we will not. That is confidential supervisory information. But we would like you to up this or change this. And I think that is very unfair to the banks and also I just think it is a bad idea.

There are real benefits—ultimately, banks compete on the ability to manage risk. And if you can have all banks manage risk the same, obviously that is something of an overstatement. But to the extent that you are pushing back some to measure risk the same way and manage it the same way, that is not a great thing.

Mr. TIPTON. Thank you. My time has expired, Mr. Chairman.

Chairman LUETKEMEYER. The gentleman's time has expired. With that, we have the Ranking Member has returned. And with that, we recognize him for 5 minutes' worth of questions. Mr. Clay.

Mr. CLAY. Thank you, Mr. Chairman. And Dr. Stanley, regulators under the Trump Administration have said that since it has been a decade since the financial crisis, and it is time to review and revisit all of the post-crisis financial rules to seek improvements, what is your early assessment of their proposals? Are their proposed modifications to post-crisis reforms one-sided with the focus on deregulating the financial industry?

Dr. STANLEY. Well, you answered the question for me. They absolutely are one-sided. And we have no problem with reviewing. We do believe that it is entirely appropriate to review our regulatory framework.

But this is a review that seems exclusively focused on weakening the regulations that came out of the financial crisis. And, in fact, in several cases, we had proposed rules that were ready to go, that would have strengthened regulation, regulation of bonus—bank bonuses, regulation of commodity activities at banks. And these rules were just dropped as though they never existed because they didn't go in that deregulatory direction.

Mr. CLAY. Yes. And do you think lessons from the financial crisis have faded in the minds of some policymakers? I know that when I look at the housing market, just like African-American borrowers were steered into high-priced loans for no reason other than the complexion of their skin, that now we have reverted back to that. That there is still a disproportionment—disproportionate number of people who are applying for 30-year mortgages that are being denied. Do you think those memories have faded already after 10 years?

Mr. STANLEY. Well, I think that memories may have faded in Washington D.C. I don't think that memories have faded outside of Washington D.C. Middle-class wealth is still significantly lower than it was before the financial crisis. Are the impacts of financial crisis, in terms of loss of housing, in terms of increases in poverty have not really—are still with us outside of Washington D.C.

Mr. CLAY. Yes. Do you believe the Fed failed, as many of us do, at implementing and enforcing our consumer financial protections lost prior to the creation of the CFPB (Consumer Financial Protection Bureau)?

Dr. STANLEY. Well, I think it is very clear that the Fed failed. The Fed was warned and the Fed did not take action on predatory subprime lending, on predatory lending that targeted minority communities. And in the case of the OCC, we had the OCC actively stepping in to preempt and reverse State laws that would have taken action against some of this predatory lending.

So, they were actually weighing in to expand predatory lending. And that is why it has been so important to create an independent consumer agency.

Mr. CLAY. And then, they knew the Countrywides and the other predators were out there preying on consumers and they enhanced it and helped them. Unbelievable.

Was it important to impose enhanced prudential standards on the Nation's largest banks as Dodd-Frank did, including requiring more capital, less leverage and regular stress tests?

Dr. STANLEY. Well, I—absolutely. Things went terribly wrong before the financial crisis. You had entities, weeks before they failed, reporting that they were perfectly fine and they exceeded regulatory capital requirements that existed before the financial—before 2008, weeks before they failed.

So, the prudential requirements before 2008 were just manifestly inadequate and permitted all kinds of abuses and really had to be reformed.

Mr. CLAY. Do you support the Volcker Rule's prohibition on proprietary trading so that banks that benefit from the Federal's safety net do not gamble with deposits?

Dr. STANLEY. Yes, we do. And a lot of people say that the Volcker Rule proprietary trading ban is somehow disconnected to the crisis. But the truth is that banks lost hundreds of billions of dollars from assets held in their trading books, firm trading inventories. They lost well over $100 billion in 2008 and that was a major contributor to the financial crisis.

And Volcker, I think, could be improved in a variety of ways but it takes that on and that is a critical issue.

Mr. CLAY. All right, thank you for your responses. And, Mr. Chairman, my time is up.

Chairman LUETKEMEYER. The gentleman's time is up. With that, we have a second round. Mr. Barr would like to ask a few additional questions. He is recognized for 5 minutes.

Mr. BARR. Thank you. And I appreciate the second round, Mr. Chairman. And to Mr. Fromer or Mr. Baer. The question is about this mono-model of stress testing. And I think, Mr. Baer, you specifically touched on this. I am interested in this because I have heard Randy Quarles talk about this as a risk for regulators to focus on a mono-model testing.

And I am curious to know your thoughts on how the Fed and other regulators can avoid—best avoid a mono-model stress testing regime. And how can we avoid a situation where banks and participants in the financial services sector are moving in the same direction, creating and concentrating risk, as opposed to allowing an organic diversification of risk that is—that is fueled by a diversity of stress testing scenarios?

Mr. BAER. Sure. You may—I think one potential answer is to provide full transparency around the model which would also allow for notice and comment, from a whole wide range of folks all on this panel, about whether that is a good model or not. It would allow backtesting and real consideration of it. I know there have been concerns expressed by some that that would let the banks know the test.

But, I think of an analogy of, if the EPA decided to regulate pollution controls and said, we are not going to tell you the regulation. We are just going to run the secret model, and, at the end of the year, we are going to tell you whether you passed or not. And if you didn't pass, then you can't operate next year. No one would think that that is a fair system. When the government has rules, we, as citizens, have the right to know the rules.

Now, if the concern is so great, though, that we aren't allowed to know the test, then I think it is a perfectly good option to allow bank models to be used as part of the stress test. Those models are not made up. They are rigorously backtested.

And the Federal Reserve now reviews and approves every one of those models. So, if they can't provide transparency, then I think there is a ready alternative.

Mr. BARR. Right. So, I think it is purposeful from the standpoint from financial stability. It is also a due process issue, of course.

Mr. Fromer, let me just shift gears, actually, to another question. In recent testimony before this committee, Randy Quarles, Vice Chairman of Supervision, testified that because of the improvement in the resolvability of firms realized over the past few years through the living will process, it is appropriate now to assess—to reassess the G-SIB surcharge calculation.

The G-SIB surcharge applied to U.S. banks has nearly doubled that of the international standard, placing our institutions at a competitive disadvantage in the global marketplace. But now, we hear about this stress capital buffer that, effectively, doubles down on what has already been acknowledged to be a miscalibrated requirement by enshrining the G-SIB surcharge in this new rule.

I know you share the same concern. Can you elaborate on why that is a problem from a—from the standpoint of international competitiveness?

Mr. FROMER. Sure. First of all, the G-SIB surcharge, as I stated earlier, was put in place to deal with the systemic risk, potential for a default, the impact of default in the system. As Governor Quarles and others have indicated, there are a number of other steps that took place after the implementation of the G-SIB surcharge of the establishment which, to some degree, have made the G-SIB surcharge redundant. And that is why we believe it is necessary—it is crucial, in fact—to go back and look at it.

The problem with the G-SIB surcharge is with respect to international competitiveness. It has to do with the fact that, in the United States, the regulators applied a higher standard, known as method two. And method two is, essentially, a higher charge for these U.S. G-SIBs.

In our view, that actually creates a built-in disadvantage for U.S. institutions vis aAE1 vis their foreign peers. First of all, if you feel like the—if you believe that the system has improved through a variety of different improvements, whether it is TLAC or clearing and margin or living wills, you should go back and look at the G-SIB surcharge. And then, specifically you need to look at method two because of the built-in disadvantages it provides for the U.S. G-SIBs versus their foreign peers.

And it is amplified, as I think you are getting to, by the fact that the G-SIB surcharge now has been imported into two other schemes, one of which is the supplementary leverage ratio for the largest banks, and the second is the stress capital buffer proposal.

Mr. BARR. And so, I think we all should be interested in the competitiveness of U.S. institutions, relative to the—to our foreign competitors. And, yet, at the same time, to Mr. Noreika's testimony, we also know that foreign banks are an indispensable conduit for foreign investment in the United States, which is a source of a lot of high-paying jobs. Frankly, higher foreign direct investments is responsible for higher paying jobs, in many cases, than domestically produced jobs.

My question to you is, according to a 2016 Federal Reserve report, a substantial percentage of loans provided in the—in—my time may have expired already. Well, I didn't get to that question but we will continue the discussion, Mr. Noreika, at another time. Thanks.

Mr. NOREIKA. Happy to.

Chairman LUETKEMEYER. The gentleman from Kentucky is full of questions. So, we can be here until midnight, and he will still be asking questions. But good questions.

The Ranking Member, Mr. Clay, has some second questions as well and he is recognized for 5 minutes.

Mr. CLAY. Thank you, Mr. Chairman. And, Mr. Noreika, during your tenure as Acting Comptroller of the Currency, you moved to weaken the agency's examination policy for the Community Reinvestment Act (CRA) with respect to discriminatory or other illegal credit practices. Can you explain to the committee how this policy helps combat discriminatory lending?

Mr. NOREIKA. Well, first of all, no, I didn't. Second, what I did do was we instituted guidance that put the Community Reinvestment Act back in—

Mr. CLAY. Hope that is not an omen—

Mr. NOREIKA. Hopefully it is not for one or the other of us, right? Exactly. So, what I did do was reinstituted a policy so that, basically, community reinvestment is evaluated for community reinvestment purposes. So, there had been a trend in the prior Administration toward penalizing banks for things that had nothing to do with investment in their communities and the type of lending activities that they used to claim credit for their CRA exams.

And so, what we did was we went back to basics of the Community Reinvestment Act. So, at the outset, each bank is reviewed, under the current rule at least, for its lending operations, its service activities, and its investment activities.

And what we did is we said, with respect to the activities for which a bank claims lending credit, if those activities are done in a way that harms consumers, then that will be the basis for a downgrade. There has to be a logical nexus for the noncompliant consumer-harming activities to affect the CRA rating. Because, again, CRA, the whole purpose of it is to make sure banks are lending in their communities.

We don't want to be overly punitive because then a bank might decide, hey, we have such big problems. We are not going to do anything. We are going to get our problems settled and not invest in the communities. I did not want that to happen.

And what I worried about was that the so-called downgrades, which expanded more broadly than the activities that were used to claim credit, would actually act as a deterrent to investment on communities.

Mr. CLAY. And thank you for that response but I was—I am wondering, did you dig into the numbers to see that, OK, in economically disadvantaged parts of that service area, did they do 30-year mortgages? Did they expand 30-year mortgages? Did they do home improvement loans? Did they do small business loans? And did that data help you determine the grade?

Mr. NOREIKA. Well, look, I think you can never decide something going forward. Obviously, afterwards, you have to look back and see how it did. And I think that is the general context of this entire hearing is looking back at things that may have been perfectly reasonably put in place at the time but may have a deleterious effect or just the market changes over time.

With respect to Community Reinvestment Act. Look, I think the original purposes of the Act were, again, clearly to get banks to not abandon their local communities. A very laudable effect. I think the worry was that a lot of other baggage was getting placed on that that, ultimately, would deter lending in communities.

And that is what, frankly, concerned me the most in why I instituted that examination guidance was to, again, get back to the basics and encourage banks to lend in their community and not deter them from doing that.

Mr. CLAY. But think about the challenges that impact economically disparate communities, economically disadvantaged communities. Those are the ones that need the financial stimulus the most.

Mr. NOREIKA. Oh, I absolutely agree with you.

Mr. CLAY. And so, I mean, that is what—

Mr. NOREIKA. I absolutely—

Mr. CLAY. I always thought the CRA was.

Mr. NOREIKA. No, I absolutely agree with you. And I do somewhat worry CRA was getting highjacked as just another way to penalize banks for general things they did wrong to consumers. And I think there has to be that absolute laser focus of CRA on the underserved communities, themselves, and getting banks to invest in them. And that was why I did what I did.

Mr. CLAY. And that is why we have the CFPB as to be the cop on the beat, I would think. Thank you. I yield back.

Chairman LUETKEMEYER. The gentleman's time has expired. With that, we have the gentleman from Georgia. Mr. Loudermilk has returned and he is recognized for 5 minutes.

Mr. LOUDERMILK. Thank you, Mr. Chairman. And I would like to start off by yielding a portion of my time to my friend from Kentucky, Mr. Barr, so he can continue that very intriguing and interesting line of questioning that he was—

Mr. NOREIKA. You are not going to get me out of the question here are you?

Mr. BARR. I want to thank my friend. And I will be brief since I have already consumed too much time.

But to follow up to Mr. Noreika. Just as the G-SIB surcharge could put U.S. banks at a competitive disadvantage, what I was getting at in my question was that, similarly, unfair treatment of U.S. subsidiaries of foreign banks could also be a problem, from the standpoint of U.S. economic growth. Because it could in—could incentivize those foreign banks to decrease their U.S. operations and could lead to a withdraw of foreign funds. Many of which are contributing to foreign direct investments which, again, is a source of a lot of jobs and economic growth.

So, the question is, from a competitive equity standpoint, how can we approach regulations to make sure that U.S. subsidiaries of foreign banks operate on a level playing field with our counterparts?

Mr. NOREIKA. Sure. And that is the statutory directive. But I must say, from my time in office, having seen these foreign banking organizations come talk to me, they were dramatically pulling outside—out of the United States, especially with respect to the capital markets' type activities. That before the intermediate holding company requirement had been the subject of functional regulation under the Gramm-Leach-Bliley Act. Due to the international—intermediate holding company act had been pulled into banking regulation and subject to these enhanced prudential standards. The cost of doing business apparently went through the roof and drove that capital outside the United States.

And I think, to the detriment of our country, as you are pointing out, in the sense of the markets are less liquid, the activity is pushed out into less-regulated spheres. And, obviously, there is the real-world impact on people who may be employed or not employed anymore by these institutions.

Mr. BARR. And I better reclaim Mr. Loudermilk's time. Thank you, my friend.

Mr. LOUDERMILK. All right, thank you. And, Mr. Noreika, we will continue with you since we have you there. My question really is around the SIFI (systemically important financial institution) designation. And under Dodd-Frank, it specified between $100 and $250 billion in assets. Those financial institutions are entitled to complete relief from regulation as a SIFI institution after an 18-month transition period.

My understanding is, also, that after that period, that the law gives the Fed the ability to restore the regulations if the bank becomes a systematic risk. But under the current conditions, the recent CCAR results and G-SIB surcharge risk data shows that banks with less than 250 billion in assets do not present this type of risk. I, as well as others, think they should be exempt from all the regulations associated with being SIFI unless there is significant change to risk profile.

My question is, do you agree that these banks do not currently pose that type of systemic risk?

Mr. NOREIKA. I do, Congressman. Certainly, if those are the Fed's own findings, with respect to systemic risk, I don't think there is any reason to wait to exempt them from the enhanced prudential standards while the Fed then goes and reviews how the standards need to be revised in light of the new law.

Mr. LOUDERMILK. OK, thank you. Mr. Baer, with the short time that I have remaining. I understand that some of the biggest challenges of the CCAR stress test, in addition to the sheer burden of these Dodd-Frank requirements, is the fact that the stress test models used by the Fed are relatively secret. In a 2016 GAO report, it showed that CCAR process is overly qualitative, offered too little communication for regulated banks, and that the scenarios were designed without appropriate analysis. Can you shed light on why that is such a problem for institutions such as yours?

Mr. BAER. Sure. It is difficult even to explain how complicated the CCAR process has become. What a data drain it is. What a resource drain. I think even for banks in the 100 to 250 billion who we expect to no longer be doing this, there are probably dozens of people, maybe up to 100 at the bank doing this full time. At the larger institutions, it is hundreds of people doing this full time. It is a very intensive data exercise.

And then, of course, as I got to earlier, they really don't know a lot about the model that they are trying to manage to them. You can try to reverse engineer some things and we have actually tried to derive the implicit risk weights from what that model produces. And you can get some indications.

But it is a very difficult process. Again, I do support stress testing for large complex institutions that have really complex risks. But, particularly for a $100 to $250 billion institution, we have traditional supervision. Without that, it is unnecessary, I believe.

Mr. LOUDERMILK. Thank you. With that, I yield back.

Chairman LUETKEMEYER. If you have some additional questions, gentlemen, you can be certainly recognized because we have a little time here.

Mr. LOUDERMILK. In other words, I am the only one left, Mr. Chairman, is that right?

Chairman LUETKEMEYER. It is raining outside and the game hasn't started yet tonight so we are OK with it.

Mr. LOUDERMILK. Well, I think with the last thunder clap, everybody ran. I don't—I hope they are not going two by two to a big wooden boat somewhere. Maybe we should—

Well, then, I do have—I will also defer to Mr. Fromer to answer the same question if you would like.

Mr. FROMER. I think what I will add to what Mr. Baer said was that for banks of all sizes, it is a difficult process. It is a complex process. It is resource consumptive. But the other thing is that it makes it extraordinarily difficult for the boards and the management of these institutions to go through this thoughtful process of planning the deployment and the distribution of their capital.

And to the extent that you have opacity in the models, and to the extent that you get scenarios presented to you in February for a process that is supposed to conclude and does conclude in June, and then you live with the results for the next quarters and have no flexibility in terms of your further distribution of capital. Even though there may be things going on in your firm or things going on in the economy at large which affect the operation of your firm, affect the plans that you have made and your ability to dynamically change the nature of your business with those events.

The process right now is very constraining. And, in effect, it says, even though you have met your minimum requirements, even though your institution is safe and sound, you have all your minimum requirements in place, you as a board, you as a management are still restricted, in terms of the way you can deploy and distribute your capital.

And that is sort of an erosion of fiduciary responsibility that we think needs to be addressed as part of the overall review.

Mr. LOUDERMILK. So, does this inhibit your ability to properly serve your customers?

Mr. FROMER. Inevitably, it does. If you have gone through a thoughtful planning process, as our institutions all do, and you are constrained by information that you do not have, because you just don't have access to it. None of us can sit here and tell you what goes on, with respect to these models and how the scenarios are actually put together. Because it is opaque.

So, the degree that you can't make decisions about the operation of your institutions, it inevitably affects the kinds of services that you are going to provide to your customers and the pricing as well.

Mr. LOUDERMILK. And Mr. Baer?

Mr. BAER. If I could just say, there is also a really important credit allocation component to this. We did—our research team went back and looked and derived the implicit risk weights for CCAR compared to the standardized approach and then compared to the bank's own modeled approach through DFAS. And what they showed was that the implicit risk weights, that is the capital charge, were dramatically higher for certain asset classes. Most notably, small business, prime mortgage, and market making.

It is actually about the same for C&I. But, so, implicitly in this, though, is that it is driving banks in certain directions and driving all the banks in the same directions. And it is interesting, we, then, took the next step and said, well, can we see that in the actual data in how banks behave?

And what you know, if you look, and I think some of this is in my testimony, which I know some of this is in my testimony, if you compare banks subject to CCAR banks versus banks not subject to CCAR, and look at their behavior, you will see the banks that are subject to the test are moving out of the asset classes that are most affected by the test.

Mr. LOUDERMILK. OK, thank you. Mr. Chairman, I don't have any further questions. I could—be glad to yield to you or I yield back.

Chairman LUETKEMEYER. We are already on our second round, so you get your second round of questions. So, if you are done, well, we will move on.

Mr. LOUDERMILK. I am done.

Chairman LUETKEMEYER. The gentleman yields back. OK. I have just one comment which is, the reason for the stress test, originally because of Dodd-Frank, was because of the systemically important institutions that could bring down the economy.

And I think we have talked about in the bill that—2155 that set thresholds. And while I am not a big fan of thresholds, I think anybody would recognize that $250 billion bank, while that is a big bank, it is not big enough to bring down the economy of the United States.

And so, I think you have to remember why that part of Dodd-Frank is there and why—what kind of implications it could have and should have. And most banks now that are exempt under 250, I—we have—I guess we will watch the actions of the Fed. But I know the regulators. But we—they should not be considered systemically important the part where they are going to be negatively impacted by overburdenedsome regulations of additional tests.

One thing we haven't talked about yet, we have discussed pretty thoroughly everything else, is—and, Mr. Baer, I think you brought this up, is CECL. Can you comment, and Mr. Fromer perhaps as well, with regards to the impact of CECL loan capital accounts and if you have seen any kind of impact at this point yet.

Mr. BAER. Certainly. Thank you, Congressman. I think it is a terrifically important issue, and I appreciate the opportunity. I think CECL began with a very good idea. The Financial Stability Board recommended to the Fed that they look at the accounting for reserves. The concern was that reserving can be quite cyclical. That is in the midst of a crisis, banks are having to add reserves. And that means they are shrinking lending.

A fundamental mistake, though, I think was made in projecting what the effect of this would be. The change was made from the incurred loss methodology which basically said, you set up your reserve when loss is estimable and probable. That has been the standard for 40 years. The new requirement says that you have to set up a reserve at the time you make the loan for all projected losses over the life of the loan, even if the chances of those are small.

Meanwhile, you cannot book any potential income from that loan over the course of the loan—of its life. So, that is a fairly significant change. But the idea was, OK, well, let us have them take the reserve at the beginning. And then, when things go bad, they won't have to restrict and build a big reserve.

The fundamental problem with that, though, is it presumed and, I think, the analysis done by economists on it, presumed, as economists like to presume, perfect knowledge. So, they presumed that everybody got it right at the start.

What our team did, after hearing a lot of nervousness from the CFOs about this, is we actually went back and we ran the 2007 to 2009 financial crisis. And we said, let us not presume perfect knowledge. Let us actually look at what the macroforecasts actually were at the time. Stand in the economic community and see what happened.

And what happened was they didn't have the perfect knowledge. And what happened is you got into 2008. That is when all the forecasts went bad or assumed that there was going to be a very large recession.

And so, what would have happened if CECL had been in place is there would have been massive reserves taken. Not just reserves on the loans for which losses were already estimable and probable. But loans for every need, a reserve for all loans. And particularly for loans for low- to moderate-income people.

So, what our review shows is if CECL had been in place, it would not have been countercyclical, it was not of built reserves in 2006 and 2007. It would have been profoundly procyclical and would have met massive bank reserves in 2008, which almost certainly would have dramatically heightened the recession. So ours shouldn't be the last word on this.

And we are trying to encourage more research, not discourage more research. But it is certainly the gut sense of the folks in finance that we have talked to at the bank so we think it is a terrifically important issue.

Chairman LUETKEMEYER. Anybody else want to comment on that? No, OK. Basically, we are finished here. Would anybody like to have a closing comment? I can go down the line here and I can give everybody about a minute, minute and a half to just make a couple closing comments on issues that came up that you would like to talk about that maybe weren't thoroughly discussed or reiterate one specific point. Mr. Fromer.

Mr. FROMER. Thank you, Mr. Chairman. I think the point that I would make is that simply a reiteration of the view that there is an opportunity now and a lot of experience that, I think, regulators here and abroad can use now to do a complete review, specifically around these individual actions and the interaction among them because there is an interdependency. And in doing so, I would also add that we obviously went through a tumultuous time 10 years ago and we have done an enormous amount of work to address the results of the crisis.

And these are extremely highly capitalized institutions, as we have talked about. I think no one really wants to go back and turn the clock on that. We are not looking at going back to the future, if you will. But we do think it is important to take stock of what we have done and make sure that we are doing it in the most cost-effective way possible.

Chairman LUETKEMEYER. Thank you. Mr. Baer.

Mr. BAER. Just a couple thoughts. First, I do think it is important to acknowledge how tough capital regulation is. If the regulators come up with something very granular, we criticize them for credit allocation. If they give up and go to a leverage ratio and say every asset has the same risk, we criticize them for not thinking things through. So, it—I am sure there is some medium in there but it is not so easy and happy to find. And so, they deserve our empathy and they also deserve our notes and comment on that.

I think we touched on it a little bit today but I do think the unseen world of bank examination is as important as the overt world of bank regulation. And that there are a lot of requirements going on out there that we don't even know about, and that it is very important for this committee and others to focus on.

I would also just say, although I share the enthusiasm about equity, I did want to put in a word for debt, particularly for larger institutions that issue debt to the markets. That now, post-crisis, the way resolutions are conducted is actually quite loss absorbent and protects taxpayers.

And there is about a trillion dollars of it out there, at least for our members. It also brings into play a group of investors and analysts who are quite worried about losing their money and also exert a significant amount of market discipline. So, I think that is a benefit.

And I would also add that post-crisis, I think there have been—at least a GAO study and a couple of other academic papers looking at post-crisis debt pricing spreads. And there is no evidence that large banks are receiving a premium in the market or a discount, however you want to look at it. But they are being able to issue cheaper, as a result of some too-big-to-fail premium.

So, that is really market debt. Of course, the easiest way to figure out its market debt is to turn on a Bloomberg machine and see that it is priced the same way market debt is for other large institutions in other industries.

Chairman LUETKEMEYER. OK. All right, thank you. Dr. Holtz-Eakin.

Dr. HOLTZ-EAKIN. Well, I applaud the committee for holding this hearing. And I think it is a good time to do a holistic review of the regulatory apparatus. And I would encourage the committee, the regulators, to look at these institutions holistically. I think the thing I find most troubling in many discussions is the notion that we can separate systemic risk over here and get a capital charge for that. Sort of a prudential regulation over here and an enhanced prudential regulation up here. Liquidity regulation over here. That is not the way the world works.

And one of the reasons I think a more robust stress testing regime is desirable is it takes a holistic look at the performance of the institution through the stress. And I think that should be the focus.

Chairman LUETKEMEYER. Very good. Dr. Stanley.

Dr. STANLEY. Yes, a couple thoughts. One is I think there tends to be this trend or pattern that whenever we see a change in behavior, by banks in response to new capital requirements, that this is somehow a cost or a bad thing. And I don't think that is true.

Mr. Noreika talked about how U.S. subsidiaries of foreign banks have decreased some of their capital markets' activities in the U.S. because of the intermediate holding company rule. Well, I don't think that Credit Suisse or Deutsche Bank, CBO desks activities before the crisis were doing any favors for the U.S. economy, nor were there enormous credit lines where they pulled all—borrowed all these dollars in the U.S. and then couldn't pay them back without Federal Reserve assistance. That—those capital markets' activities were not doing anybody any good. And the idea that they might have become more responsible about those activities I think might be a positive impact of the IHC rules.

And also, just in terms of this competitiveness, the argument about competitiveness with Europe. And I think it is pretty clear that the U.S. banking sector is in a lot better shape than the European banking sector. There are still major concerns about the weakness of that sector. And, to some degree, I think the higher prudential requirements in the U.S. have been a competitive advantage of our banks because people know that our banks are safer and sounder and better to deal with.

Chairman LUETKEMEYER. Mr. Noreika.

Mr. NOREIKA. Well, thank you, Mr. Chairman, and thank you for having me here today. I just want to conclude by saying, look, I am very optimistic about the banking sector, about the regulation of the banking sector.

I think with the passage of the new law and the new regulated—regulatory heads finally in place, we have a real opportunity to take stock, to look at all the regulations that have been put in place and how they have been enforced over the past 10 years. I think when we talk and we hear the—particularly the Vice Chairman for Supervision at the Fed, talk about tailoring and transparency. Those are welcome thoughts in the bank regulatory sphere.

And I think now the devil is in the details. And, to me, the details are a soup-to-nuts review of how all of the cumulative effects of these regulations have impacted the various segments of the financial system. In particular, I think are the subsets that I talked about today. Those in the $100 to $250 billion range, which is going to merit a review by the Federal Reserve and those in the foreign banking realm.

But, again, I think we have the approach here now to take a look and to tailor and to make more rational our regulation of these banks. And I think, hopefully in a few years, we will reap the results from that.

Thank you.

Chairman LUETKEMEYER. Thank you. And thank all of the witnesses today for the testimonies. It has been great. You guys are fantastic.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

With that, this hearing adjourned.

[Whereupon, at 3:50 p.m., the subcommittee was adjourned.]

A P P E N D I X

July 17, 2018

The Bank Policy Institute

Testimony before the Financial Institutions and Consumer Credit Subcommittee of the House Financial Services Committee

Examining Capital Regimes for Financial Institution

July 17, 2018

Chairman Luetkemeyer, Ranking Member Clay, my name is Greg Baer, and I am the CEO of the Bank Policy Institute. It is a pleasure to appear before you today.

At the outset, I should note that today is my first testimony on behalf of BPI, a product of the combination of the former Clearing House Association and Financial Services Roundtable. We will conduct research and advocacy on behalf of America's leading banks, which we believe will also serve the interests of bank customers: consumers who desire innovative products at competitive prices, and businesses who seek funding for their growth. Our focus will be prudential regulation of banking, and how it affects not only safety and soundness and financial stability but also innovation and credit availability. The stakes are high, as our members make 72% of all loans and 44% of the nation's small business loans.

Turning to the subject of today's hearing, capital requirements are both very important and very difficult to design and calibrate. We approach the subject with humility, and empathy for regulators charged with a complex mission. The current capital regime has some clear attributes but also some fundamental and important flaws.

In the first section of my testimony, I will review current bank capital levels and try to give a sense of just how high they are. In the second section, I will describe three general problems with current requirements: (i) they require banks to hold too much capital; (ii) they are volatile, and for no good reason; and (iii) they allocate credit in a way that is very real but that regulators have been reluctant to acknowledge. In the third section, I will describe how these concerns can be reduced through specific regulatory reforms.

I. <u>CURRENT CAPITALIZATION OF THE BANKING SYSTEM</u>

A. <u>Capital</u>

U.S. banks now hold substantial amounts of high-quality capital. Since the global financial crisis, the aggregate tier 1 common equity ratio of BPI's 48 member banks has more than doubled to 12.1 percent at the end of last year. In dollar terms, that is an increase in tier 1 common equity from nearly $400 billion to almost $1.2 trillion.

We now take for granted two of the most important post-crisis reforms. First, capital requirements now focus heavily on common equity rather than hybrid capital instruments that did not prove sufficiently loss absorbing in crisis. Second, off-balance-sheet exposures are now much better captured and capitalized. One could argue that these two changes alone would have been sufficient to prevent a recurrence of the stress on the banking system seen in the last financial crisis. Obviously, regulators did not stop there.

B. Total Loss Absorbency: Long Term Debt as Bail-in/Gone Concern Capital

During the financial crisis, we learned a valuable lesson about what types of non-deposit liabilities absorbed loss before shareholders, and what types did not. This lesson was especially important with respect to the largest institutions the failure of which could pose risks to the larger financial system – so-called global systemically important banks, or GSIBs. Legally, debt issued to the market by GSIBs took losses before the deposit insurance fund. In the event, however, regulators recognized that much of that debt was short-term debt, and that imposing losses on it would create major systemic risk, because short-term debt holders, including corporate uninsured depositors, would run at the first hint of trouble – and not only from a firm experiencing trouble, but also other firms. Those firms would then be required to sell assets to fund the run, causing a further depreciation in asset values. So, in many cases, GSIB debt holders were protected against loss. Note that this included long-term debt holders; while by definition they could not run, because their debt was not maturing, resolution authorities were legally prohibited from discriminating against one class of debt holders (long-term) to favor another (short-term). So, it was bail out all or none.

Perhaps the greatest untold story in post-crisis regulatory reform is a regulatory solution to this problem.[1] On one level, the solution was remarkably simple: effectively ban GSIBs from issuing short-term debt. (There was also a very large amount of legal work done (including some by me) to determine the tenor and terms of that debt to ensure its loss absorbency; regulators also sensibly limited each large bank's ability to hold long-term debt of another, to prevent one firm's failure from spreading.) So, with long-term creditors unable to run, and no legal issues about differential treatment of creditors, long-term debt is now fully absorbent in a bankruptcy or resolution. It absorbs loss only once the firm has failed – or, under bank living wills, is close to failing. But at that point, it unambiguously takes losses before other types of liabilities, most notably federally insured deposits held at any of the GSIB's bank subsidiaries. It is now frequently and aptly described as "gone concern" capital, and markets and rating agencies appropriately treat it as carrying substantial risk. While equity will always be a preferred source of loss absorbency from a regulatory perspective, because it keeps the firm afloat, long-term debt now protects taxpayers to an equal extent.

---

1 *See* Oliver Ireland, Anna Pinedo, and Jeremy Jennings-Mares, *The Resurgence of Debt as Capital, Banking Perspectives* (1Q2018), *available at* www.theclearinghouse.org/banking-perspectives/2018/2018-q1-banking-perspectives/articles/resurgence-of-debt-capital.

So, when one combines capital and long-term debt at the holding company level, one gets a firm's total loss absorbing capacity – better known in the regulatory area as TLAC.

C. The Unseen Connection: Liquidity

The focus of this hearing is capital, and regulators generally treat capital and liquidity like church and state. They are, however, interrelated: a liquid bank requires less capital (and an illiquid bank, more), and a well-capitalized bank requires less liquidity (and an undercapitalized bank, more). As our research team recently wrote, "[a]s a result of the introduction of Basel III liquidity requirements, large banks hold a sizable stock of liquid assets that can be easily liquidated if a financial crisis (and resulting run of liabilities) were to occur. These large stockpiles of highly liquid assets make fire sales of illiquid assets much less likely to occur, thereby decreasing the potential magnitude of a large bank's losses during a crisis and the probability of the bank's failure."[2]

The link of liquidity to capital is especially strong with respect to capital ostensibly directed to systemic risk (the so-called GSIB surcharge). In recent research, we take the methodology used by the Federal Reserve in setting that surcharge, specifically the historical return on risk-weighted assets, and adjust for the impact of current liquidity requirements. Intuitively, had banks been subject to liquidity requirements during past financial crises, banks would have been able to sell those liquid assets during the stress period, thereby reducing the likelihood of fire sales of less liquid assets and the size of their resulting losses. Our findings indicate that the favorable impact of liquidity requirements on bank losses lead to approximately a 25 percent haircut on the GSIB surcharge; put another way, the GSIB surcharge is now requiring affected banks to hold approximately 50-100 basis points more capital than its own ostensible goal would require.[3]

D. Perspective on Current Capital Levels: CCAR 2018

We will discuss its benefits and costs later, but for now it is worth identifying CCAR as a good barometer for just how much capital the largest 18 banks are carrying in 2018. (BPI members that are not among the top 18 banks in CCAR have *even higher* common equity Tier 1 capital ratios.)

---

2 *See* Francisco Covas, Bill Nelson, and Robert Lindgren, *Estimating the LCR Haircut to the GSIB Surcharge* (Jun. 13, 2018), *available at* https://bpi.com/estimating-the-lcr-haircut-to-the-gsib-surcharge/.

3 These results are obtained under the assumption that banks are subject to a 100 percent LCR requirement, and thus understate the impact, as all GSIBs maintain an LCR well over 100 percent in practice

This year's stress tests featured a downturn in the U.S. economy significantly more severe than the 2007-2009 financial crisis. The scenario included a sudden increase in the unemployment rate of 600 basis points and a stock market crash of 65 percent; housing prices plunged 30 percent; a global market shock of similarly dramatic proportions simultaneously hit firms with a capital markets business; and operational risk losses occurred as well. Using the confidence interval the Federal Reserve provides around its own quarterly projections, we calculate that such a rapid increase in the unemployment rate – let alone the simultaneous deterioration of all the other variables – has only about a fifty-fifty chance of occurring once in 10,000 years.[4]

And yet, in this year's CCAR exercise, all but three banks would have weathered this financial apocalypse and still held more than a 4 percent ratio of Tier 1 capital to total assets. Three institutions that failed to meet that requirement ended up at 3.4, 3.5 and 3.9 percent.

One might think that failing CCAR meant suffering a loss large enough that it would require taxpayer assistance. It absolutely does *not* mean that, not even close. One could think that it meant suffering a loss large enough to make the bank insolvent, imposing losses on equity holders (but not debt holders and, of course, therefore not the deposit insurance fund). Again, no, not even close. As the Federal Reserve has structured the test, failing means that after a dramatic increase in unemployment, plunge in housing prices, and market crash, the bank does not have enough capital to remain over the relevant thresholds: in other words, enough capital to continue lending as if nothing much had happened.

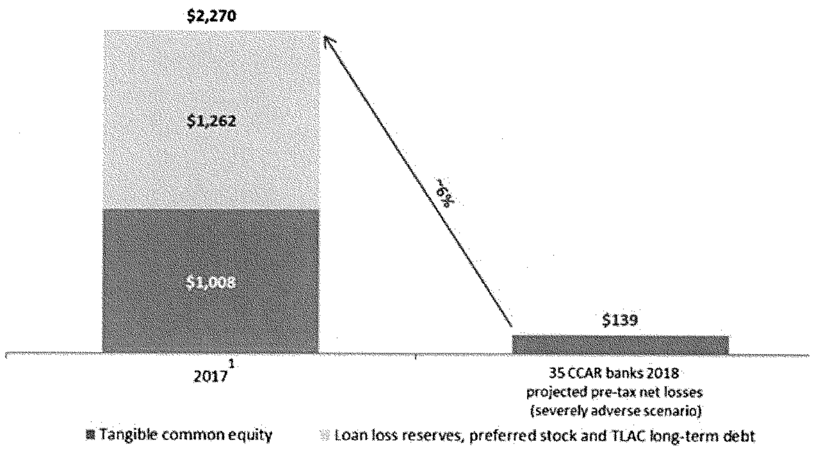
In the auto world, it would mean requiring sufficiently large bumpers such that a 60 mile per hour crash would not only keep the passengers alive, not only keep them unharmed, but also would have no effect on the car.

As a benchmark, consider the loss absorbency currently held by the largest banks shown in the following chart. Specifically, the 18 largest banks in CCAR hold more than $1 trillion in tangible common equity. Under the Federal Reserve's severely adverse scenario, projected net losses before tax for the 35 banks that participated in CCAR 2018 were $139 billion. Thus, collectively, the largest 18 banks in the 2018 CCAR exercise could have taken all the losses of the apocalyptic scenario and still suffered an additional *$870 billion* in losses prior to being insolvent.

---

4 *See* Francisco Covas and Bill Nelson, *Cracks in the Fed's stress tests* (Mar. 2, 2018), *available at* https://bpi.com/cracks-in-the-feds-stress-tests/.

Loss Absorbing Resources of the Largest U.S. Banks Combined ($ billions)



[1] Includes only the 18 banks participating in CCAR 2013
Source: SNL Financial, Federal Reserve Board
CCAR = Comprehensive Capital Analysis & Review
TLAC = Total Loss Absorbing Capacity

Even then, under post-crisis rules, the deposit insurance fund would not be tapped. Rather, debt holders of the bank holding company would be "bailed in" to absorb loss. Collectively, the 18 CCAR banks hold $1.05 trillion in TLAC. So, collectively, after this unprecedented stress event, taxpayers would still be *$2.13 trillion* in losses away from having the deposit insurance fund reimburse a depositor, as the amount of projected net losses in CCAR accounts for approximately 6 percent of the aggregate amount of loss absorbing resources of the largest 18 banks. Put another way, the 18 largest banks are currently capitalized sufficiently to suffer the losses of a financial crisis substantially worse than the last one, and still be prepared to lose more than an additional $2 trillion prior to the FDIC paying out an insured depositor. (And larger banks not among that group hold even higher levels of capital relative to risk-weighted assets.)

E. <u>The "Records Profits" Canard</u>

One sees little analysis based on any absolute or historical standard that argues that U.S. banks are undercapitalized, or not overcapitalized. The most frequent argument – if it could be called that – that we hear is that large banks are making "record profits" and therefore should have higher capital requirements, or at the very least not object their current levels.

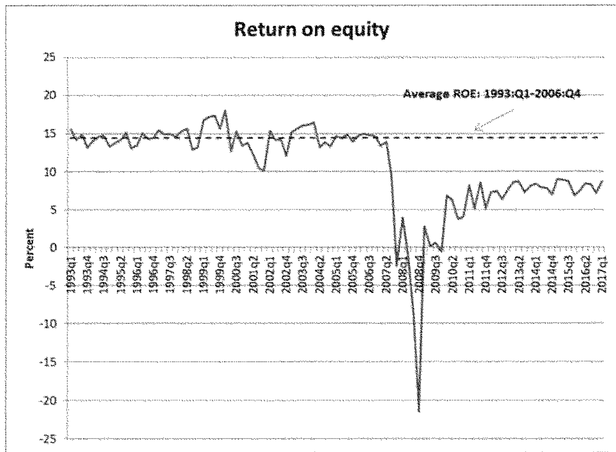
Just for starters, step back and think just how counterintuitive the "record profit" canard really is. Suppose the government adopted a rule that every power plant had to be painted yellow, or that every car had to have a bumper on the roof, or that every restaurant had to include a pet bathroom. All of those would be really dumb regulations, but all of those industries would remain profitable. Indeed, they might even report "record profits" after those regulations were promulgated. Does that mean that those regulations would then be vindicated, and constitute smart regulations?

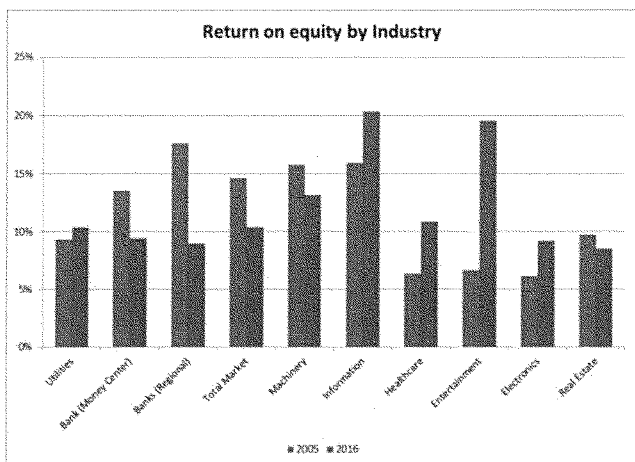
Of course, the converse is also true: if an industry were suffering record losses, that fact would not necessarily suggest that smart regulations should be relaxed.

But with more particularity, let's consider four more specific problems with the "record profits" canard.

First, "profits" is an odd and misleading metric to evaluate the health of an industry. After years of economic growth and some inflation, almost every U.S. industry is earning "record profits." (Hyperinflation would be a wonderful recipe for record profits.) However, no investor or analyst decides whether to invest in a company based simply on its profits. They generally look at return on equity (ROE) and related measures, both on an absolute and relative basis. So, "profits" tell us little about how attractive an industry is for investment purposes.

So what has happened to banks' ROEs? (Note these charts do not reflect the impact of 2018 tax reform.)





Thus, we see that bank ROEs remain below historical averages, and about average with respect to other industries.

Second, this argument implicitly suggests that profits are a bad thing for an industry to earn, and merit heightened regulation to reduce them. That is a very strange idea.

Third, the largest profit center for almost all banks is lending. Give or take, the more loans banks make, the more money they make. So, when banks are making more money on lending, that generally means that more people are getting loans. Those arguing that current profits are satisfactory are effectively saying that loan availability is sufficient, and that borrowers should be satisfied. That, apparently, is not currently true. According to the Fed's small business credit conditions survey, 61 percent of startups (small businesses with 5 years or less) reported not having their borrowing needs satisfied.[5]

Fourth, the profits argument elides an important question: how do *particular* regulations affect the profits (really, ROE) of *particular* bank businesses? More on this later, but as our previous research indicates, banks are enhancing profit by shifting assets out of certain activities that draw the largest capital charges in relation to true economic risk – for example, small business lending, mortgage lending, and market-making.[6] Instead, they are investing in less capital intense businesses, like asset management, including private wealth management. Is that a reason to feel sanguine about current levels of regulation?

F. The Nature of Buybacks

Relatedly, it has been puzzling in this CCAR cycle to see large banks criticized by some for paying dividends or making share repurchases. As demonstrated, that capital is not needed to meet any regulatory capital requirement, and thus is not serving any safety and soundness or financial stability purpose. When a company – whether bank or bakery – cannot earn a return on its capital in line with its ROE target and its shareholders' expectations, it returns capital to its shareholders, who then redeploy it in a higher and better use. An institutional investor might invest in another bank or another industry. An individual might reinvest as well, or use the money to buy a home or pay a bill.

One could say that the government should require banks to retain the capital, impose a significantly lower return to their shareholders, and just allow their share prices to drop. Of course, one could say the same of pharmaceutical companies – who could invest more in drug research – or tech companies – who could develop new products. The core concept of capitalism, however, is that capital should flow to companies that can offer the highest return. For that reason, the government today has not nationalized any of these sectors, dictating the returns their shareholders can receive. And wisely so.

---

5 Federal Reserve Banks, *Small Business Credit Survey: Report on Employer Firms* (2017), *available at* www.fedsmallbusiness.org/medialibrary/fedsmallbusiness/files/2018/sbcs-employer-firms-report.pdf.

6 *See* Francisco Covas, *The Capital Allocation Inherent in the Federal Reserve's Capital Stress Test* (January 2017), *available at* http://pushbpi.wpengine.com/wp-content/uploads/2018/07/20170130_tch_research_note_implicit_risk_weights_in_ccar-final-4.pdf.

It is also worth noting, with considerable irony, that CCAR 2018 actually represented a substantial *increase* in bank capital requirements. (Thus, affected banks were paying lower dividends and making fewer share repurchases than they would have been allowed under the previous year's exercise.) The overall increase in the severity of the hypothetical set of stressful economic and market conditions developed by the Federal Reserve, has resulted in a significant tightening of large banks' capital requirements – approximately 0.93 percent of banks' risk-weighted assets. It would seem to be a mark of how poorly understood the CCAR process is that there has been very little notice paid to the fact that it served this year as a very significant capital increase – on the order of 10 percent – for the banks subject to it.

Lastly, it is worth noting that all the leading banks that are members of BPI are publicly traded companies. The shareholders who benefit from higher dividends or share repurchases are pension funds, individual retirement accounts, large mutual funds, and millions of individual investors. They are the principal beneficiaries of capital distributions.

II. OVERVIEW OF CURRENT CAPITAL REQUIREMENTS

I will now provide general observations about current capital levels, and then proceed in the next part to address particular rules shaping these outcomes.

A. <u>Too High</u>

In general

As the numbers above suggest, there is strong evidence to suggest that banks are holding significantly greater capital and total loss absorbency than can be justified on any historical experience or current analysis. Furthermore, there is no dispute that an increase in capital requirements reduces lending, and ultimately economic growth. Every evaluation of the cost and benefits of capital requirements —including those done by the Bank for International Settlements[7] (the parent of the Basel Committee on Banking Supervision), the Federal Reserve,[8] the Bank of England,[9] the International Monetary Fund[10] – begins by estimating the decline in lending and economic activity caused by

---

[7] *See* Bank for International Settlements, *An assessment of the long-term economic impact of stronger capital and liquidity requirements* (August 2010), *available at* www.bis.org/publ/bcbs173.pdf.

[8] *See* Simon Firestone, Amy Lorenc and Ben Ranish, *An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the US* (2017), *available at* www.federalreserve.gov/econres/feds/files/2017034pap.pdf.

[9] *See* Jihad Dagher, Giovanni Dell'Ariccia, Luc Laeven, Lev Ratnovski, and Hui Tong, *Benefits and Costs of Bank Capitol* (March 2016), *available at* www.imf.org/external/pubs/ft/sdn/2016/sdn1604.pdf.

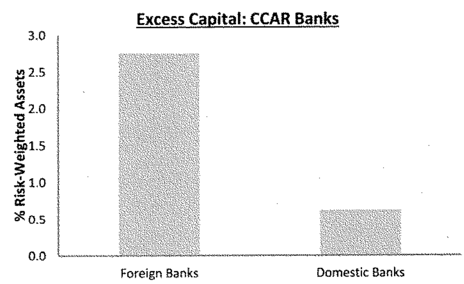
[10] *See id.*

higher capital requirements. The only debate is how much lending and economic activity decrease for a given increase in capital.

Foreign banking organizations

The U.S. operations of international banks headquartered overseas present difficult questions about how to measure capital adequacy, given that they are owned abroad, and most capital of the consolidated company is held at the overseas parent. By our analysis, they also are holding significantly more capital for their U.S. operations than can be justified by data or analysis.

The figure below shows that foreign banking organizations (FBOs) operating in the U.S. are extremely well capitalized. The two bars in the chart depict the amount of excess capital of foreign-owned subsidiary banks in the U.S. and domestic banks relative to risk-weighted assets. The amount of excess capital is defined as the maximum amount of capital those banks could pay out without breaching any of the existing capital requirements.[11] The bar to the left shows the capital buffer of FBOs under the current set of capital requirements and the bar to the right shows the capital buffer of domestic banks. The capital buffer of foreign-owned subsidiary banks operating in the United States and subject to the U.S. stress tests is equal to 2.8 percent of risk-weighted assets, while the capital buffer of domestic-owned U.S. banks is 0.6 percent of risk-weighted assets.

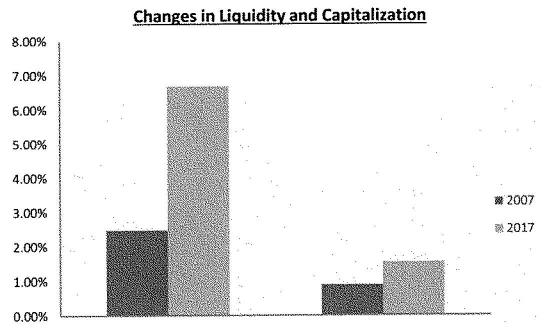


Note: Excess capital is calculated as a percentage of risk-weighted assets under the standardized approach. Excess capital is defined as the maximum amount of capital banks could return to shareholders without breaching any of the current capital requirements. These include 8 non-stressed capital requirements and 10 stressed capital requirements.

---

[11] *See* Francisco Covas, Brett Waxman, and Robert Lindgren, *The Fed Increases Large Banks' Capital Requirements* (Jun. 29, 2018), *available at* https://bpi.com/the-fed-increases-large-banks-capital-requirements/.

As shown in the chart below, U.S. broker-dealers of foreign banks increased their resilience significantly over the past 11 years. Specifically, the broker-dealers have roughly tripled their capital relative to total assets and approximately doubled their cash holdings as a proportion of total assets.[12]



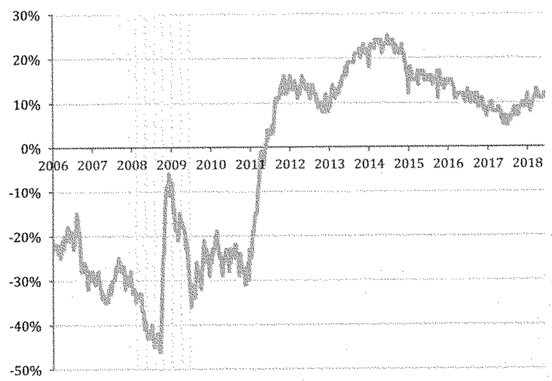
Source: SEC Form X-17A-5 and BPI calculations

Lastly, foreign-headquartered banks also operate in the United States through branches. In the post-crisis period, the assets and liabilities of the branches and agencies have also experienced profound changes. As shown in the chart below, branches were using U.S. funding to support their overseas operations, which was a valid concern for the Federal Reserve. Beginning in early 2011, however, this pattern reversed, and branches now see much of their funding coming from their foreign parents.

---

12 We included the following eleven broker-dealers in our sample: Barclays Capital, Inc., BMO Capital Markets Corp., BNP Paribas Securities Corporation, Credit Suisse Securities (USA), LLC, Deutsche Bank Securities, Inc., HSBC Securities (USA), Inc., MUFG Securities Americas, Inc., RBC Capital Markets, LLC, RBS Securities, Inc., UBS Securities, LLC.

Net Due to Head Office



Source: Federal Reserve H8 and BPI calculations

In summary, our analysis shows that the U.S. operations of these banks are extremely resilient.

B. Too Volatile

One underestimated adverse consequence of CCAR stress testing is the volatility it injects into bank capital requirements. We frequently hear from bank CFOs and treasurers that capital planning is extremely difficult when capital requirements vary dramatically year to year, making long term investments in businesses more difficult. Imagine, for example, if the National Highway Transportation Safety Agency changed auto safety tests each year, and what chaos that would bring to auto design and innovation.

Of course, there would be no problem with volatility in capital requirements if it corresponded to actual volatility in risk. This is manifestly not the case, however. This year's CCAR post-stress capital requirement rose about 10 percent, yet no one believes that the relevant banks had a corresponding increase in risk. Rather, the Federal Reserve simply changed its stress scenario and, for all we know, its black box forecasting model, to produce that result. As earlier noted, by the Fed's own forecasts, there is approximately a 50-50 chance of that scenario occurring over the next 10,000 years, yet it has driven a substantial increase in capital requirements this year, which could change again next year – up or down.

This does not make a lot of sense.

C. Too Prescriptive

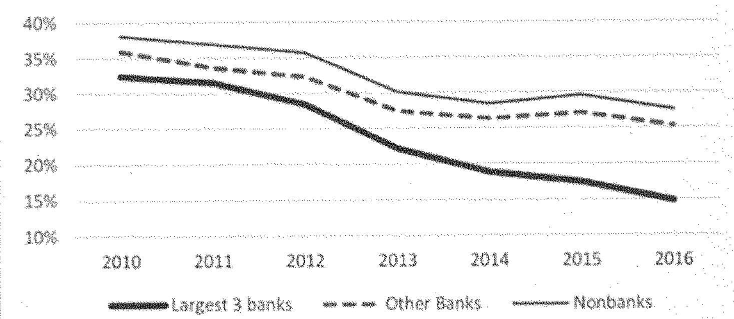
Capital adequacy measurement can really proceed along three possible paths: the first is for the government to determine the risk of each asset; the second is for each bank to determine the risk of each asset; and the last is to give up and simply assume that each asset has the same risk. For the first two options, there is also the choice of how granular the assessment should be: at one extreme, all loans of a very general type (mortgage, corporate) treated as having the same, standardized risk; at the other, each loan receiving its own unique capital charge.

The clear push of the Federal Reserve post-crisis has been towards the government determining the risk of assets, generally through standardized risk models developed at the Basel Committee, coupled with its own (secret) CCAR model and its own stress scenario design. A leverage ratio, assuming all assets have the same risk, serves as a backstop. And a bank's modeling of its own risk (using models approved by the Federal Reserve) is on course to play little to no role in capital requirements. There is great irony in this approach, as the Global Financial Crisis occurred under a Basel I regime where governmental, standardized approaches governed. Basel III, which allowed banks to model risk for capital purposes, was adopted post-crisis and been generally successful; nonetheless, it is being discarded in the push to implement what is popularly known as Basel IV, which returns to standardized approaches.

Having the government determine capital allocations, and indirectly, which assets banks will choose (because they choose based on ROE), has profound implications for credit allocation. For example, at BPI, and formerly at the Clearing House, we have been particularly interested in the effect of regulation, particularly stress testing, on low and moderate-income borrowers. In effect, when the Federal Reserve projects the effects of CCAR's scenario's unprecedentedly sudden and severe increase in unemployment, an unsurprising result is that loans to low-income borrowers default at high rates. As a result, banks subject to CCAR must hold very high levels of capital against those loans, making them more expensive. The results can be seen in a recent note from Federal Reserve economists, several academic papers, and our own research demonstrated the same effect, both for mortgage and small business lending, as illustrated in the following chart.[13]

[13] *See* Neil Bhutta, Steven Laufer, and Daniel R. Ringo, *The Decline in Lending to Lower-Income Borrowers by the Biggest Banks* (September 2017); The Clearing House, *The Capital Allocation Inherent in the Federal Reserve's Capital Stress Tests* (January 2017); Viral V. Acharya, Allen N. Berger, Raluca A. Roman, *Lending Implications of U.S. Bank Stress Tests: Costs or Benefits?*, J. OF FINANCIAL INTERMEDIATION (Aug. 18, 2017); Cortés, Kristle, Yuliya Demyankyk, Lei Li, Elena Loutskina, Philip Strahan, *Stress Tests and Small Business Lending*, NBER Working Paper No. 24365 (March 2018); and Michael Bordo and John Duca, *The Impact of the Dodd-Frank Act on Small Business*, NBER Working Paper No. 24501 (April 2018).

Figure 1: Share of Mortgages to LMI Borrowers



Note: The nonbank category excludes lenders identified as subsidiaries or affiliates of depository institutions. Source: Federal Financial Institutions Examination Council (U.S.)

Accessible version

III. Recent and Possible Future Changes to the Capital Regime

With these concerns as background, I will now discuss some current regulatory proposals, and some others that it would be wise for regulators to pursue in the capital arena.

A. CECL

In 2016, despite serious controversy, the Financial Accounting Standards Board decided to replace the existing incurred-loss accounting method for calculating the allowance for loan losses. The new standard is CECL, the "current expected credit loss" method, which becomes effective in 2020. CECL constitutes a dramatic departure in how loan losses are estimated by the banking industry, and an important debate about CECL's impact on bank capital is now commencing.

We believe that CECL is a major threat to economic stability in a financial crisis. Our analysis shows that it will be profoundly procyclical in its application to bank capital, likely increasing significantly the severity of any future recession.

CECL will also represent yet another capital increase on all banks. To some extent that was the goal, as the hope was that by having large reserves in good times, banks would not have to constrict lending in recession. As our research will show, however, the effect will be the opposite, and the cost in diminished economic growth from higher capital at all times will have no corresponding benefit.

First, some brief background. U.S. GAAP currently bases the loan loss allowance on a so-called "incurred loss" model: under this method, an allowance for loan losses, or reserve, is provided when a bank estimates that a loss is *probable* of having been incurred, and the bank can *reasonably estimate* the amount of the loss. In sharp contrast, under the new CECL model, banks will be required to estimate the losses that are expected to occur over *the entire life of the loan*. That is, a reserve must be provided if a loss can be predicted to occur *at any time in the future*. The allowance under CECL therefore will be based on each bank's projected estimates of future economic conditions, and how those future conditions will influence the loan portfolio.

Furthermore, although CECL will require banks to provide for future *losses* expected to arise on loans immediately upon being made, CECL will not permit banks to record expected future *income* from those loans until interest is actually earned in future periods. Because the regulatory capital framework uses GAAP, the U.S. banking agencies have acknowledged that implementation of CECL in 2020 will require a downward adjustment to bank regulatory capital levels (CET1). But because the CECL provisions represent a reserve for future, not just incurred, credit losses, they essentially represent additional loss absorbency capacity for banks. Therefore, requiring banks to hold capital against CECL accounting losses without a corresponding recalibration downward of the regulatory capital minimums, would appear to misstate the actual financial condition of each bank.

Of far greater, systemic, concern, CECL also will provide a strong incentive for banks to reduce lending to riskier customers such as households with less than perfect credit histories. Furthermore, because borrower risk goes up in a downturn, that disincentive will intensify in a recession, potentially amplifying economic weakness. CECL also may affect the pricing, terms and availability of longer-dated credit products (e.g. residential mortgage loans) and increase liquidity risk for companies outside the banking sector as a result of obtaining loans with a shorter tenor (i.e., lower durability of funding and increased spread and refinancing risk for banks' clients). The irony here is extreme, as CECL was originally proposed by the Financial Stability Board with the opposite goal in mind.

We had heard this concern anecdotally from bank CFOs for some time. But this week, we released a study demonstrating how the banking system would have behaved had CECL been in place for the period 2007-09. Bank capital would have been sharply reduced at the height of the financial crisis, likely doubling the contraction in lending by banks that occurred, deepening the recession. While some of the procyclicality comes from the accounting *per se*, the larger impact is from its effect on bank capital. Thus, the bank regulators can and should mitigate that effect.

B. S. 2155 and Tailoring of Regulation

President Trump recently signed into law S.2155, the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA), the first significant amendment to the Dodd-Frank Act since its enactment.[14] S.2155 reflects a clear consensus that the enhanced capital, liquidity and other regulations required under the Dodd-Frank Act (DFA) for larger banks should be applied in a much more tailored fashion. However, to have their intended effect, many of its provisions depend on faithful implementation by the Federal Reserve and other banking agencies.

S. 2155 revises sections 165 and 166 of DFA, which together require the Federal Reserve to establish "enhanced prudential standards" – that is, more stringent capital, liquidity, stress testing, resolution planning and other rules – for larger banks. DFA took a simplistic approach in determining to whom the enhanced standards should apply: any bank holding company with more than $50 billion in consolidated assets.

S. 2155 revised the thresholds for imposing enhanced prudential standards in three important, complementary ways. First, institutions under $100 billion are no longer subject to enhanced prudential standards – full stop. Second, institutions with consolidated assets between $100 and $250 billion will become exempt from most of those standards in 18 months unless the Federal Reserve determines otherwise by rule or order, and will be subject only to "periodic" supervisory stress tests. Third, S. 2155 mandates that the Federal Reserve differentiate how it applies any enhanced prudential standards to covered institutions based on risk-related factors, including a firm's complexity.

We believe that the letter and spirit of S. 2155 compel a variety of implementing regulatory changes.

First, the Federal Reserve should move forward promptly to implement the stress testing changes authorized by S. 2155 for firms with $100-$250 billion in assets – prior to the CCAR 2019 cycle. S. 2155 no longer requires annual supervisory stress tests, but instead only "periodic" supervisory stress tests. Whatever time period is chosen, it obviously must be something less frequent than annual, because that is the precisely the term Congress chose to replace.

Second, and also for firms with $100-$250 billion in assets, S. 2155 creates a clear default principle for all other enhanced prudential standards (e.g., living wills, the LCR, and other requirements): they should apply only if the Federal Reserve affirmatively determines that applying that standards is "appropriate to address financial stability risks or safety and soundness concerns and has taken into consideration the firm's capital structure, riskiness, complexity and other factors." In assessing which rules (if any) may meet that standard, the Federal Reserve should engage in a public rulemaking process that (i) clearly focuses on whether there are any heightened risks to be reduced, and (ii) demonstrates that any benefits of applying any particular enhanced standard outweigh its costs.

---

[14] Economic Growth, Regulatory Relief and Consumer Protection Act. Pub.L. No. 115-174 (2018).

Third, a provision of EGRRCPA prevents the regulatory agencies from applying heightened risk-weights to high volatility commercial real estate (HVCRE) exposures unless they meet new, narrower criteria. This will resolve uncertainty about capital requirements applicable to certain acquisition, development, and construction loans. The agencies need t to update the capital rules and associated reporting form instructions (e.g., the FR Y-9C and Call Report instructions) to conform to this aspect of the EGRRCPA, and should do so swiftly.

Finally, for all firms that received regulatory relief under S. 2155 – but especially firms under $100 billion in assets, which were exempted from enhanced standards altogether – it is crucial that the Federal Reserve and other agencies not impose via the examination process what they have just been prohibited from imposing via the regulatory process. As we have written elsewhere, post-crisis, examiners, have frequently imposed unwritten requirements through the examination process, with a downgrade in rating as their leverage. There is therefore the risk that examiners may simply reimpose enhanced prudential standards through a series of Matters Requiring Attention (MRAs) or Matters Requiring Immediate Attention (MRIAs), or by conducting a horizontal review and then criticizing a firm for not following the "best practices" observed by firms that are subject to enhanced standards. Any such result would contravene the express purpose of S. 2155. Yet we have already heard banks tell us that this process has begun. Nowhere would continuing Congressional oversight be more useful than in this area.

C. <u>Tailoring More Broadly</u>

S. 2155 should also serve as a catalyst to recalibrate the larger regulatory framework for banking institutions of *all* sizes. An institution's size is not a reflection of the risk it poses to the system. The new law replaces the vague encouragement that regulators tailor, which frequently was ignored, with a firm requirement that they do so. It is no longer the case that the Federal Reserve "may" tailor each of its enhanced prudential standards; now, it "shall."

For example, Vice Chair Quarles has already noted the need for greater tailoring of enhanced liquidity standards (e.g., the liquidity coverage ratio and internal liquidity stress testing rules), emphasizing the need for "concrete steps toward calibrating liquidity requirements differently for large, non-G-SIBs."[15] Similarly, the agencies should also move quickly to finalize certain aspects of a pending September 2017 proposal to simplify regulatory capital rules. This would include increasing the CET1 deduction threshold for mortgage servicing assets, certain deferred tax assets, and investments in the capital of unconsolidated financial institutions, as well as changing the treatment of minority interests to include greater amount of subsidiary-issued capital in its consolidated capital ratios.

---

15 *See* Randal K. Quarles, *Early Observations on Improving the Effectiveness of Post-Crisis Regulation* (Jan. 19, 2018).

For foreign firms, tailoring should include a review (and explanation) of the process by which they are designated for inclusion in the Federal Reserve's Large Institution Supervision Steering Committee (LISCC). Designation as a LISCC firm effectively triggers enhanced supervision, and foreign banks report that LISCC pressure has played a role in their shrinking of capital markets businesses in the United States, which has had real but unfortunately undebated impacts of U.S. businesses. Yet the Federal Reserve process for designating firms for inclusion is opaque and the decision effectively unappealable. There is no known process for de-designation, and no example of it.

More broadly, U.S. gold-plating particularly affects foreign-headquartered banks that are often required to comply with multiple duplicative and different standards including at the home country level. As a result, the Federal Reserve should also carefully consider tailoring of the above described standards to foreign banking organizations (FBOs) in light of the mandate of S.2155. Under S. 2155, 14 FBOs are swept into enhanced standards because the $250 billion asset threshold is interpreted in terms of global assets whereas only 11 U.S.-headquartered firms are covered. For many of those foreign banks, their U.S. operation is a standard, mid-sized regional bank. The Federal Reserve should consider how to best tailor the enhanced prudential standards to the U.S. footprint of FBOs that are often on par with regional and smaller community banks than large U.S. banking organizations. The Treasury Report on banking, for example, recommends tailoring the application of enhanced prudential standards to FBOs based on their U.S. risk profile and proportionate to the risks such firms present to the U.S. financial system. Such tailoring would be consistent with S. 2155 and with long-standing principles of national treatment and deference to home country supervision, and would ensure protection of American financial interests abroad and continued foreign investment in the United States, which is substantial.

D. <u>Pending Capital Reforms</u>

There are currently pending two significant regulatory proposals that would reform important aspects of the capital framework for larger banks. The first is a long-overdue recalibration of the enhanced supplementary leverage ratio (eSLR), and the other is the Federal Reserve's proposal to better integrate its stress testing exercise into risk-based capital requirements through establishment of a stress buffer framework. Each holds significant promise to simplify and rationalize our existing byzantine capital rules, but also includes meaningful weakness that should be cured before the proposal is finalized.

Proposed changes to the eSLR

In April, the Federal Reserve and OCC proposal to revise the eSLR requirements applicable to U.S. GSIBs and their subsidiary insured depository institutions, and to make conforming changes to the TLAC and eligible long-term debt requirements applicable to

U.S. GSIBs.[16] Reflecting a broad consensus that the initial, uniform calibration of the eSLR was both insufficiently tailored and inappropriately calibrated, the eSLR proposal would replace the current uniform surcharges with specific surcharges based in part on each firm's applicable GSIB surcharge.

As we have often noted, given the significant shortcomings of a leverage ratio measure, it is critical that any leverage requirement be set as a backstop, and not as a potentially binding capital requirement in ordinary circumstances.[17] The latter would drive misallocation of capital in the economy – as any measure that ignores risk is bound to do – and discourage low-risk, low- return activities that are critical to the effective functioning of financial markets.

At the same time, and similar to our concerns with the pending stress buffer proposal, the eSLR's use of the Federal Reserve's GSIB surcharge rule to determine the size of eSLR requirements further increases the importance of a comprehensive reassessment and recalibration of the U.S. GSIB surcharge. And even as revised, the eSLR proposal would continue to use the existing, flawed leverage denominator for purposes of relevant calculation. Thus, the agencies should consider modifying the denominators for leverage requirements, including by implementing the U.S. Treasury Department's recommendations in its June 2017 report regarding the SLR denominator. In that report, the U.S. Treasury Department recommended that the total leverage exposure measure (i.e., the SLR denominator) exclude (i) central bank reserves, (ii) U.S. Treasury securities and (iii) initial margin for centrally cleared derivatives.[18]

Serious problems with the Federal Reserve's stress testing regime

To be clear, we continue to believe that stress testing is a smart way to evaluate the resiliency of a bank. More static measures are necessarily backward looking and therefore assume, for example, that if subprime mortgages have repaid consistently over a period of years, they will continue to do so. Importantly, stress testing also recognizes

---

16 *See* 83 Fed. Reg. 17317 (Apr. 19, 2018). A comprehensive analysis of the eSLR proposal is contained in our comment letter, which is available at www.bpi.com/wp-content/uploads/2018/07/8cc793eaea964573b2850373bd055335-2.pdf.

17 *See, e.g.,* Greg Baer, *The Leverage Ratio: Neither Simple Nor Sensible* (June 26, 2017), *available at* https://bpi.com/the-leverage-ratio-neither-simple-nor-sensible-2/; *see also The Clearing House Comment Letter Re: Stress Testing Transparency Proposals* (Jan. 22, 2018) at Annex A 3-5, *available at* https://bpi.com/recent-activity/tch-offers-recommendations-to-improve-stress-testing-transparency/.

18 *Id.* *See also* The Clearing House, *Submission to the U.S. Treasury Department: Aligning the U.S. Bank Regulatory Framework with the Core Principles of Financial Regulation* (May 2, 2017), at 13-15, *available at* www.theclearinghouse.org/-/media/TCH/Documents/TCH%20WEEKLY/2017/20170502_TCH_Submission_to_UST_re_Core_Principles_Study.pdf.

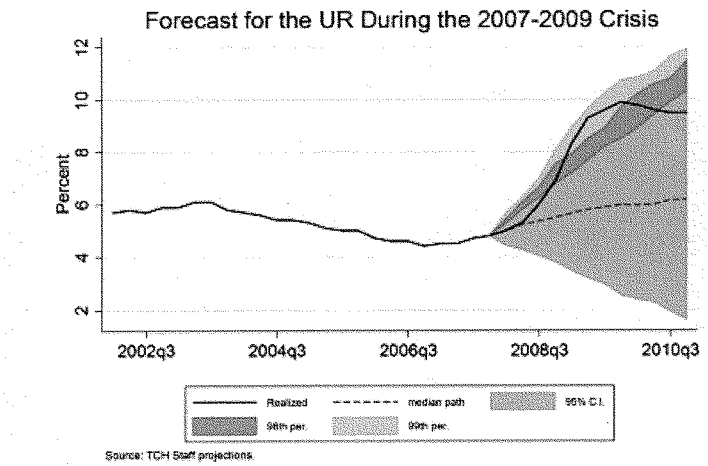
implicitly the benefits of firm diversification: a given stress might cause losses to certain divisions of a diversified firm but bring gains to others. As implemented in CCAR and the Federal Reserve's capital planning process, stress testing is also clearly countercyclical.

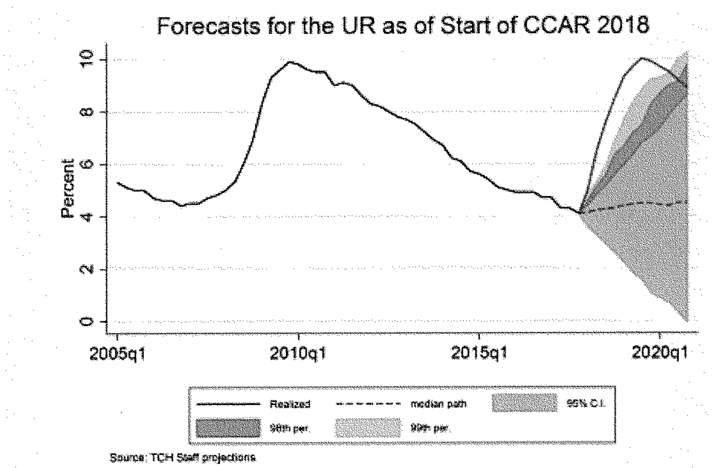
Notwithstanding these clear advantages, there are continuing concerns about the Federal Reserve's CCAR exercise – in particular about both procedural and substantive deficiencies in how it is constructed in theory and applied in practice.

Reading and watching market analysis of recent 2018 CCAR stress test results, I've been struck by how analysts and investors clearly understand something that many policymakers do not: how extreme, and thus how extraordinarily improbable, this year's stress scenario was. As I noted earlier, the stress test scenario has about a 50-50 chance of occurring once in 10,000 years, and investors appeared to have quite appropriately drawn no lessons about the financial condition of the banks based on their performance. Rather, insofar as market prices reacted to the results, the reaction reflected news about what capital distributions the Federal Reserve would allow the banks to make, or the ability of the firm to deal with the Federal Reserve, not news about the condition of the banks.

The Federal Reserve designs its stress scenarios using what it calls "a recession approach," in which the severely adverse scenario is intended to "reflect conditions that characterize post-war U.S. recessions, generating either a typical or specific recreation of a post-war U.S. recession." While we have argued for a different, probabilistic approach, this year's scenario is clearly inconsistent with both.

As an illustration of the extraordinary implausibility of this year's stress scenario, the two charts below compare density forecasts of the unemployment rate during the 2007-2009 financial crisis (first panel) with its path under the Fed's severely adverse scenario (second panel). During the first nine quarters of the 2007-2009 financial crisis, the realized unemployment rate was always less than the 99th percentile (the yellow portion of the cone). However, as can be seen in the chart below, under the severely adverse scenario in CCAR 2018, the path of the unemployment rate is almost always above the 99th percentile of our forecasts. Indeed, the unemployment rate path under the severely adverse scenario approximately corresponds to the worst path we were able to generate across thousands of simulations of our model. Moreover, the rise in the unemployment rate is assumed to take place much more rapidly than was true in the financial crisis, causing losses under the Fed's scenario to ramp up very quickly. We can find no historical antecedent for the suddenness of the stress in the unemployment rate.





Consider, then, the central, continuing problem with the Federal Reserve's CCAR stress test: *it bases its capital assessment not on a bank's current financial condition or how its assets are most likely to behave in the future, but rather on how those assets* *would behave under a single stress event of unimaginably unlikely severity.* And because regulatory capital requirements produced by CCAR are now so high as to drive bank credit allocation decisions, it means that *banks subject to CCAR are increasingly pressured to choose assets based on how well they perform under the Fed's single, apocalyptic scenario, not how they would perform under far more likely scenarios.*

Of course, to some extent, the problems above are inherent in the nature of stress testing, as any prescribed stress will be extremely unlikely to occur. Stress testing serves as a countercyclical capital buffer exactly because it presumes that current good times will turn bad at some point in the future, and rightly so. But the Federal Reserve multiplies this inherent problem exponentially by using a single scenario, and a single scenario of such extreme unlikelihood.

Any concerns about the use of a single scenario are greatly amplified when one realizes that the Fed, in addition to using only one scenario of its own devise, uses only one model of its own devise (kept secret, without public review let alone comment) to estimate each bank's losses under that model, and has proposed to use its own or a Basel-designed model for every other component of its proposed new capital standard.
In a recent article, *The Quiet Revolution in Central Banks*, I described how the Federal Reserve's recent capital proposal would combine a Basel minimum standard, CCAR results (through a so-called stressed capital buffer), a GSIB surcharge, and potentially a countercyclical capital buffer to establish what would almost certainly be the binding capital constraint for any bank subject to it:

> "All of the component parts involve either the Federal Reserve or the Basel Committee, not the bank, modeling the risk. The remarkable result of this process is that at no point is a bank's view of the risk of a loan or any other asset relevant to the capital it must hold against that asset.... There is good reason to believe this would end poorly for the U.S. economy. Governmental attempts at direct or indirect credit allocation have a dismal history. Economic growth would suffer, as diversity in risk tolerance and judgment produce greater opportunities for businesses and individuals to obtain bank credit. Furthermore, because standardized risk measures and the Federal Reserve's loss-forecasting models are necessarily crude and one-size-fits-all, relying on less data than the banks' own models, much of the capital allocation they drive is likely to be misallocation. Lastly, systemic risk would increase as large banks were forced to concentrate in asset classes favored by the governmental models. (There is also the converse risk that non-banks would concentrate in asset classes disfavored by the governmental models; because those actors operate outside the purview of the Federal Reserve and do not qualify for

lender-of-last-resort support, a collapse in prices for those assets would constitute its own systemic risk.)"[19]

In sum, leaving model variation aside for the moment and focusing just on scenario design, the Federal Reserve should seek public comment on at least three key questions: (i) how many stress scenarios to use (including the possibility of using some bank-designed, bank-specific scenarios), (ii) by what standard those scenarios should be designed (e.g., with what probability they should be likely to occur); and (iii) how their results should be combined (e.g., by averaging the losses and revenue under each scenario). Each subsequent year, it should then publish proposed scenarios for comment to ensure they meet the Fed's own previously published designed standard. Averaging across results will help reduce volatility. To further reduce volatility in outcome, it should also propose averaging the previous two to three years of results before using those results as minimum capital standard. This would reduce volatility significantly, and allow for better capital planning.

The Federal Reserve's stress buffers proposal

In April, the Federal Reserve issued a long-awaited proposal to establish a stress buffer framework that would create a single, integrated set of capital requirements by combining the supervisory stress test results of CCAR exercise with the ongoing requirements of its Basel III regulatory capital rule.[20] This stress buffers proposal could increase the coherence and simplicity of the U.S. bank capital framework and resolve long-standing flaws in the design and mechanics of the DFAST and CCAR exercises.

For example, we strongly support the proposal to eliminate from CCAR and DFAST the currently applicable assumption that firms' balance sheets and risk-weighted assets ("RWAs") grow under stressed conditions. Under an actual stress scenario, firms' balance sheets would be affected by a combination of counterparty actions (including defaults, draw-downs on existing lines of credit and demand for new credit) as well as shocks to market-wide demand. It is unrealistic, and contrary to historical experience to assume that these effects would, in the aggregate, result in a firm's balance sheet *growing*

---

19 *See* Greg Baer, *The Quiet Revolution of Central Banks* (Jun. 7, 2018), *available at* www.theclearinghouse.org/banking-perspectives/2018/2018-q2-banking-perspectives/departments/quiet-revolution-central-banks.

20 *See* Board of Governors of the Federal Reserve System, *Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules*, 83 Fed. Reg. 18,160 (Apr. 25, 2018). As proposed, the proposal would apply to bank holding companies with $50 billion or more in total consolidated assets and U.S. IHCs of FBOs established pursuant to Regulation YY. We assume that the Federal Reserve will adjust the $50 billion threshold and scope of applicability to be consistent with the EGRRCPA.

under stress. As a result, removing the balance sheet and RWA growth assumptions from DFAST and CCAR would make the stress testing framework more realistic.

So, too, would the removal of the assumption that firms would continue making all common stock dividend payments and share repurchases in the midst of such extreme stress, particularly when regulations would prohibit those payments.

At the same time, however, further important changes to the proposal are necessary to produce more realistic scenarios and assumptions, reflect more accurate and updated measures of risk, and achieve the intended simplification and elimination of the quantitative objection to a firm's capital plan for banking organizations covered by the proposal.[21]

First, while integrating stress losses into ongoing capital requirements through the proposed stress buffers would promote the transparency and simplification of the capital and stress testing framework, it would also heighten the urgency to reform scenario design (as described above) and reduce the volatility of estimated stress losses.

Second, the Federal Reserve should significantly enhance its disclosures about supervisory models to allow for greater model transparency, which would facilitate feedback to improve the quality and credibility of supervisory models. Use of bank models should be considered where appropriate, particularly if full transparency is not provided.

Third, final stress buffer requirements should not include an additional component for four quarters of planned common stock dividends in light of the payout restrictions under the Federal Reserve's capital rule, which would prohibit such payments.

Fourth, consistent with the intended elimination of any quantitative objection to a firm's capital plan, the Federal Reserve should amend the capital plan rule to fully eliminate any residual basis for a quantitative limitation on capital distributions. This would comport with the Federal Reserve's stated expectation that a firm's board of directors and senior management should be responsible for capital planning. Of course, firms would still be required to remain in compliance with all capital requirements after a capital distribution is made.

Fifth, the proposal's effective transition of the GSIB surcharge into a post-stress minimum requirement makes it imperative to review and reassess the U.S. implementation of the GSIB surcharge, which currently suffers from conceptual and methodological flaws.

Sixth, a footnote in the proposal noted that U.S. IHC subsidiaries were excluded from the impact analysis the Federal Reserve conducted on the proposal. The proposal

---

21 A comprehensive analysis of the stress buffers proposal is contained in our comment letter, which is available at www.bpi.com/wp-content/uploads/2018/07/f751f6eaf79445b3ae744b6e02816d3d-1.pdf.

should be amended to take into account the different circumstances of the U.S. IHCs of FBOs. In any event, prior to finalization of the buffer requirements, the Federal Reserve should analyze the impact of the proposal on these firms to better inform the calibration of the stress buffer applicable to U.S. IHCs of FBOS in recognition of the different business models, risks, and exposures of those firms.

C. **Foreign Bank Regulation**

The key issue in appropriate regulation for the U.S. operations of international banks is appropriate tailoring, consistent with longstanding principles of national treatment. The enhanced prudential standards (e.g., capital, liquidity, stress testing, etc.) should be applied to the U.S. operations of foreign banks consistent with their U.S. footprint and risk profile. The development of the U.S. intermediate holding company makes it appropriate to consider the U.S. operations of international banks in what is essentially a U.S. ring-fenced entity. We would note that the Federal Reserve's recently issued single-counterparty credit limit rule starts to employ tailoring by creating a construct more deferential to equivalent home country regimes.

However, there is much room for additional forms of tailoring for the U.S. operations of international banks. Higher capital and liquidity standards should not tie to thresholds based on foreign exposure. International banks are often required to comply with higher requirements due to a $10 billion foreign exposure threshold present in a number of Federal Reserve rule's like the net stable funding ratio (NSFR). Capital and liquidity requirements more generally should take into account the fact that the IHC is supported by an international bank that can act as a source of strength.

Ring fencing

The Federal Reserve set the internal TLAC requirement for all foreign banks operating in the United States at 90% – at the highest end of the agreed-upon range, and (in violation of the FSB agreement) without any consultation with the relevant crisis management groups or other consideration of the risks posed by the individual subsidiaries.

Furthermore, the United States also imposed a standalone debt requirement on foreign banks, meaning that they are limited in how much equity can count towards meeting that 90% requirement. Not only was this action a break from an international standard, it also makes little policy sense, as equity is by all accounts more loss absorbing than debt.

The practical impacts of that decision are profound. The application of CCAR to the U.S. subsidiaries of foreign banks has dramatically raised their equity ratios, yet the standalone debt requirement means that there can be no corresponding decrease in the debt they carry. Thus, by one recent estimate, the effective average internal TLAC requirement for foreign banks operating in the United States is not 75 percent or 90 percent but rather 140 percent – a degree of ring fencing that is both unjustifiable on the merits and inconsistent with the Financial Stability Board's own standard.[22] There is also strong evidence that this action has triggered a regulatory trade war, with foreign jurisdictions preparing to require similar U.S. ring fencing of the operations of U.S. banks abroad.

Fortunately, in recent remarks, Vice Chair Quarles has indicated a willingness to revisit the race toward ring fencing.[23] And it will be just as important for U.S. regulators to pursue similar, reciprocal adjustments to internal TLAC requirements that are imposed on the overseas operations of U.S. banks.

Examination

Branches of foreign banks are extensions of their home country bank, and are supervised as such by their home country regulators. Nonetheless, the Federal Reserve increasingly, through its CISO regime, is examining these branches as if they were U.S. banks. The result is a massive resource drain, as foreign banks must set up shadow governance and risk management regimes, when the major advantage of branching is to allow consolidated management. It would be akin to requiring a U.S. bank operating nationally to have a separate Chief Risk Officer for its Arkansas branches, its North Carolina branches, etc.

Of course, the Federal Reserve had a valid concern when these branches were borrowing funds in the U.S. and using those funds to lend to their foreign parents before the crisis, creating a substantial cross-border liability. Now, however, even as those branches has moved from a "due from" to a "due to" position.

D. <u>GSIB Surcharge</u>

In the United States, the eight "global systemically important banks" (GSIBs) are required to hold more capital than other banks by an amount equal to their "GSIB surcharges," which currently range from 1.5 to 3.5 percentage points. The GSIB framework has numerous weaknesses which should be addressed over both the short and long term.

Adjustment for economic growth

In the short term, the Federal Reserve should adjust the GSIB surcharge to account for economic growth since it was initially put in place.

---

22 *See* D. Wilson Ervin, *The Risky Business of Ring-Fencing* (Dec. 12, 2017), *available at* https://ssrn.com/abstract=3085649.

23 Randal K. Quarles, *Trust Everyone--But Brand Your Cattle: Finding the Right Balance in Cross-Border Resolution* At "Ring-Fencing the Global Banking System: The Shift towards Financial Regulatory Protectionism" Symposium (2018).

In the United States, the GSIB surcharge is calculated as a fixed constant times the GSIB's systemic indicator score mapped into discrete ranges. The ranges each correspond to 50 basis point increments in the surcharge. In the Basel methodology, known as Method 1, the systemic indicator score is calculated using an equally weighted average of five measures of systemic importance—complexity, interconnectedness, cross-jurisdictional activity, substitutability, and size. However, in the U.S. implementation of the G-SIB surcharge framework, the Federal Reserve requires U.S. banks to calculate their systemic indicator scores under two different methods, with the higher of the two resulting surcharges applying. The U.S. score, known as Method 2, replaces the "substitutability" category with "short-term wholesale funding." Four of the measures under Method 2 – complexity, interconnectedness, cross-jurisdictional activity, and size – are calculated as the sum of balance-sheet and off-balance-sheet items for a GSIB at the end of each year, divided by the average over the 2012 and 2013 levels of the aggregate sum across global GSIBs of those same items. Thus, these four measures will trend up over time with both inflation and with economic growth, even if risk remains constant.[24]

In the final rule establishing the GSIB surcharge, the Federal Reserve noted:

> "Scores calculated under the fixed approach could be influenced by factors unrelated to systemic risk such as general economic growth. Method 2 does not include an automatic mechanism to adjust for such potential effects in order to avoid unintended consequences. For example, under a fixed approach scores could potentially increase over time as a result of general economic growth as the economy expands. One way to address this effect could be to deflate scores by the rate of economic growth. However, such an approach could have the unintended consequence that scores would increase procyclically in the event of an economic contraction, thereby potentially raising capital surcharges in a way that could further exacerbate the economic downturn. ...The Board will periodically reevaluate the framework to ensure that factors unrelated to systemic risk do not have an unintended effect on a bank holding company's systemic indicator scores."[25]

The Federal Reserve notes that the factors entering into the score should be adjusted for economic growth, but expresses concern that doing so would make the surcharges procyclical: if nominal GDP fell, capital requirements would go up. To

---

[24] The fifth measure, "short-term wholesale funding" (STWF) is calculated as the ratio of the GSIB's STWF divided by its average risk-weighted assets over the previous four quarters. Because the STWF measure is divided by a number that also will grow over time, it will not trend up with economic growth and inflation.

[25] *See* Board of Governors of the Federal Reserve System, *Regulatory Capital Rules: Implementation of Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies*, 80 Fed. Reg. 49082 (Aug. 14, 2015), *available at* www.gpo.gov/fdsys/pkg/FR-2015-08-14/pdf/2015-18702.pdf.

address this concern, BPI researchers used the CBO's estimate of potential nominal GDP rather than actual nominal GDP as a measure of activity. Potential GDP is essentially the trend in output after removing business cycle variation. Potential nominal GDP in 2017 was 16.4 percent higher than the average of its level in 2012 and 2013. We recalculated the GSIB surcharges adjusting the four components that are subject to a trend. As shown in the table, the adjusted systemic indicator scores fall for each bank, with the average score falling by 10 percent, with the average surcharge declining by 19 basis points. Put another way, nominal GDP growth since the GSIB surcharges were adopted has inflated the surcharges by 19 basis points on average.

Broader concerns

The GSIB surcharge also has other, more fundamental problems that we recommend the Federal Reserve resolve over time.

First, the methodology does not estimate the systemic losses that would occur if each GSIB were to fail. Instead, the losses are simply assumed to be proportional to a specific weighted sum of selected bank characteristics. Different, equally reasonable, assumptions governing the relationship between systemic loss given default and bank characteristics would deliver materially different surcharges. Because the systemic loss given default is assumed, not estimated, the GSIB surcharge has not been adequately substantiated and may not be appropriately "calibrated."

Second, although the methodology does estimate empirically the relationship between capital levels and the odds of failure, the estimate is based on historical experience, and is very sensitive to the number of banks included and the time period used, and includes banks that are in no way representative of today's GSIBs. To appreciate the impact of including unrepresentative firms, consider First City Bancorporation of Texas, a BHC that concentrated its portfolio in Texas real estate and energy lending, received FDIC open bank assistance in 1988, and later failed. Inclusion of this single bank holding company in the data set appears to increase the GSIB surcharge for a hypothetical average GSIB by 40 basis points under the Federal Reserve's methodology. Limiting the sample to a truly representative set of banks would reduce the charge significantly, and appropriately.

Third, the methodology omits highly significant factors in determining the systemic risk that would be imposed by the failure of a given GSIB – the ostensible purpose of the surcharge. Several post-crisis steps have significantly reduced the systemic impact of a GSIB default: robust new liquidity rules; the single-point-of-entry resolution strategy; the plans for resolution under bankruptcy required by Title I of Dodd-Frank; the Federal Reserve's total loss absorbing capacity (TLAC) rule which has added hundreds of billions of dollars of gone-concern loss absorbency by making it legally required and operationally feasible to "bail in" debt holders; and the ISDA protocol among derivatives dealers that prevents derivatives close-outs of the type seen with Lehman. Arguably, all of these factors are more relevant than those considered in the Federal Reserve's methodology; all have been (justifiably) touted by Federal Reserve officials as materially reducing systemic risk, and yet none have any impact on the GSIB surcharge whatsoever.

Thank you for the opportunity to testify.

FINANCIAL SERVICES FORUM

U.S. House of Representatives Committee on Financial Services

Subcommittee on Financial Institutions and Consumer Credit

Examining Capital Regimes for Financial Institutions

Testimony of
Kevin Fromer

President and Chief Executive Officer
Financial Services Forum

July 17, 2018

Chairman Luetkemeyer, Ranking Member Clay, and members of the Subcommittee, thank you for the opportunity to testify today. My name is Kevin Fromer and I am President and CEO of the Financial Services Forum.[1] On behalf of our members, the eight largest and most diversified financial institutions headquartered in the United States, the Forum welcomes the opportunity to discuss its support for a systematic review of U.S. capital regulations, as well as a more targeted review of the special capital surcharge required of only our members, the capital planning process, and the leverage ratio.

With nearly a decade of regulatory changes behind us, now is the time to conduct a holistic review of the post-crisis framework and to make adjustments that would foster greater efficiency and transparency and effectively balance the important goals of a safe and sound financial system with one that best supports economic growth and job creation.

---

[1] The Financial Services Forum is an economic policy and advocacy organization whose members are the chief executive officers of the eight largest and most diversified financial institutions headquartered in the United States. Forum member institutions are a leading source of lending and investment in the United States and serve millions of consumers, businesses, investors, and communities throughout the country. The Forum promotes policies that support savings and investment, deep and liquid capital markets, a competitive global marketplace, and a sound financial system.

FINANCIAL SERVICES FORUM

Role and Value of the Largest Financial Institutions

The Financial Services Forum's member firms provide vital services in support of the U.S. economy. They support economic growth by lending to consumers, businesses, and other financial institutions, and help foster deep and liquid capital markets that allow government and private institutions to finance public spending and investment. In the first quarter of 2018, Forum institutions held more than $4 trillion in loans, accounting for 44 percent of total lending to businesses and households.[2] Forum institutions are a primary source of all consumer loans and hold more than $685 billion in consumer loans including credit card loans, automobile loans, and student loans.

Our members are also a primary source of real estate financing and currently hold approximately $1.5 trillion in real-estate backed loans that finance both construction and home ownership.[3] Small business lending is also an important priority for our members. As of June 2017, our members held more than $83 billion in small business loans with more than $51 billion in loans that are less than $100,000.[4]

Our members also meet three-quarters of the funding needs of other financial institutions, including community banks and insurance and mortgage finance companies.[5] They underwrite nearly three quarters of debt and equity transactions, such as initial public offerings, among other large U.S. institutions, thereby providing a service that other institutions cannot provide on a similar scale.

Strength, Resilience, and Resolvability

Forum institutions have significantly enhanced their resiliency and resolvability during the past decade and are strongly positioned to support economic growth throughout the economic cycle. Importantly, Forum members have substantially improved their capital and liquidity positions, which foster their ability to continue promoting economic growth and job creation. Forum member institutions now maintain more than $900 billion in tier 1 capital, the most loss-absorbing form of capital, an increase of more than 40 percent since 2009 (Figure 1).[6]

---

[2] Federal Reserve data, Assets and Liabilities of Commercial Banks in the United States – H.8, available at www.federalreserve.gov\\releases\\h8\\default.htm; FR Y-9C data, available at www.ffiec.gov\\nicpubweb\\nicweb\\HCSGreaterThan10B.aspx.

[3] Id.

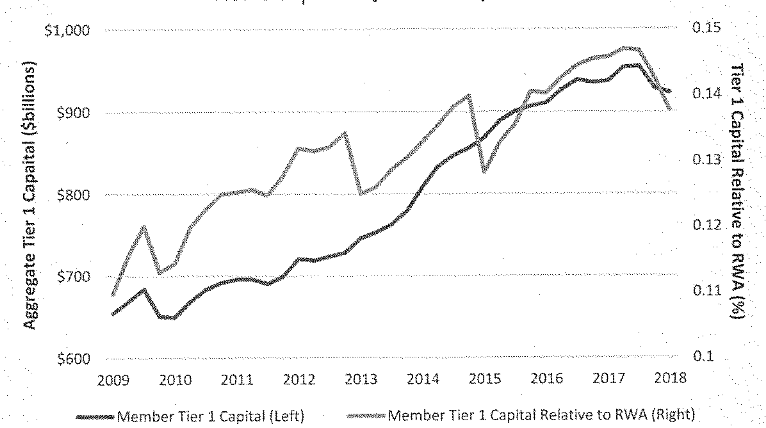
[4] Federal Deposit Insurance Corporation, Quarterly Banking Profile, available at https://www.fdic.gov/bank/analytical/qbp; Call Report data, available at https://cdr.ffiec.gov/public.

[5] Federal Reserve data, Assets and Liabilities of Commercial Banks in the United States – H.8, available at www.federalreserve.gov\\releases\\h8\\default.htm; FR Y-9C data, available at www.ffiec.gov\\nicpubweb\\nicweb\\HCSGreaterThan10B.aspx.

[6] FR Y-9C data, available at www.ffiec.gov/nicpubweb/nicweb/HCSGreaterThan10B.aspx.

FINANCIAL SERVICES FORUM

Figure 1
Tier 1 Capital: Q1:2009 - Q1:2018

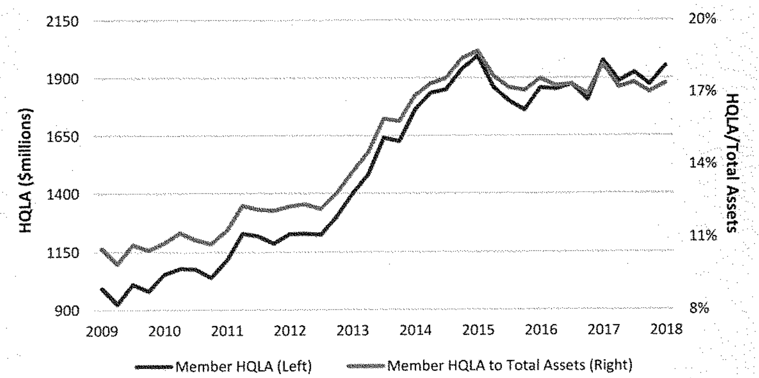


Similarly, our member institutions have significantly enhanced the quality and quantity of liquidity and now hold nearly $2 trillion in high-quality liquid assets (HQLA), an increase of more than 85 percent since 2010 (Figure 2).[7]

[7] Id.

FINANCIAL SERVICES FORUM

Figure 2
HQLA: Q1:2009 - Q1:2018



In conjunction with these meaningful improvements to capital and liquidity, several other post-crisis regulatory and supervisory reforms have led to a significant and demonstrable increase in Forum member firms' resiliency and resolvability. Through the resolution planning process—commonly referred to as the "living wills" process—Forum institutions have made significant changes to simplify their corporate structures to improve resolvability. Our members also meet new total loss-absorbing capacity (TLAC) requirements designed to facilitate a potential resolution proceeding. With respect to derivatives markets, Forum members meet new regulatory requirements for central clearing, margin, and automatic stays – all of which reduce systemic risks across the financial system.

The Importance of Appropriate Capital Standards

Our members maintain strong capital levels and support capital standards that promote a safe and sound financial system that supports economic growth. It is worth noting that capital is a more expensive form of finance than debt. Therefore, unwarranted increases in capital standards lead to increased borrowing costs and reduced availability of loans for consumers, businesses, and communities. It is therefore imperative that capital standards be appropriately calibrated.

In the context of this discussion, it is important to remember that small changes in capital standards can have large effects on the economy. Businesses and households make borrowing and investment choices on the basis of seemingly small differences in borrowing costs. A family deciding if they can afford to

FINANCIAL SERVICES FORUM

buy a home, or a small business owner deciding whether to expand, will respond to differences in borrowing rates that are measured in a quarter or a half of a percentage point.

The ability of the Forum institutions to support the U.S. economy in their unique ways critically depends on calibrating regulation that balances effective costs and benefits. Financial regulations that do not balance costs with benefits lead to an inefficient financial system in which U.S. banks are hindered in their ability to best support consumers, businesses, the economy, and job creation.

Holistic Review of Regulatory Framework

Regulators worldwide have issued new requirements at a significant pace and volume in recent years, necessarily focusing on each measure individually. With nearly a decade of regulatory changes behind us, now is the time to conduct a holistic review of the post-crisis framework and to make adjustments that would foster greater efficiency and transparency and effectively balance the important goals of a safe and sound financial system with one that best supports economic growth and job creation.

In particular, the Forum supports regulators' recent efforts to enhance capital regulation efficiency by harmonizing their capital and stress testing rules and adjusting the leverage ratio requirements. These efforts seek to maintain the underlying policy goal of ensuring capital adequacy while reducing the complexity and cost of the regulation. Moreover, while the Forum has offered suggestions for further improving proposals—such as updating the special capital surcharge applied only to our member institutions, as I will detail later—our members appreciate regulators' focus on improving regulatory efficiency. The Forum's comments on the various proposals are intended to further enhance the efficiencies while maintaining the overarching goal of each regulation.

As U.S. regulators strive to achieve greater regulator efficiency, there should be particular focus on the implementation of international regulatory standards. In several recent instances, U.S. regulators helped negotiate agreements with international counterparts, but then adopted more stringent requirements for U.S. firms, thereby diminishing the international competitiveness of U.S. banks relative to their global peers. U.S. businesses of all sizes rely on globally active banks to support their growth through the international trade of goods and services and it is important that U.S. banks are able to operate on a level playing field with their foreign peers.

Support for an overarching regulatory review is widespread. Federal Reserve Board (FRB) Vice Chairman for Supervision Randal K. Quarles last month said "A decade after the crisis, implementation of the major post-crisis reforms is largely complete, and we have entered a new phase that is aimed at reviewing and improving regulations to ensure that they are achieving their aims in the most effective

FINANCIAL SERVICES FORUM

and efficient manner."[8] Former FRB Governor Daniel K. Tarullo similarly said "...the novelty of many of the forms of regulations adopted by financial regulators, either in implementing the Dodd-Frank Act or under existing authorities, almost assures that some recalibration and reconsiderations will be warranted on the basis of experience."[9]

Further, it should be noted that the drive to evaluate the efficacy and efficiency of post-crisis reforms is a global effort that is being undertaken by the very same international standard-setting bodies that were largely responsible for originally promulgating these standards.[10] Finally, the U.S. Treasury Department has compiled a comprehensive list of specific revisions to the post-crisis regulatory regime in a series of recent reports.[11]

In conducting this review, regulators must seriously consider how different post-crisis regulations interact with each other and whether the resulting regulatory *system* is appropriately calibrated to support the U.S. economy. Policymakers in the past 10 years have created a large number of new regulations. For the most part, these regulations—capital, liquidity, derivatives reform, and resolution—were developed and considered independently to address specific issues and achieve targeted goals. In addition, many of these regulations were developed in a relatively short time frame in an effort to respond quickly to the financial crisis. At the same time, all of these regulations are interdependent and the imposition of one regulation has implications for others.

Capital and liquidity regulations provide a clear example. Banks with more liquidity are less prone to so-called fire-sales of assets and other bank run-type behavior. Accordingly, for the same level of equity capital, a bank with more liquid assets on its balance sheet is more resilient and safer than a bank with fewer liquid assets on its balance sheet. As a result, the efficacy of capital regulation must also account for the effects of liquidity regulation.

Accordingly, it is critical that regulators consider the totality of the post-crisis regulatory system and seriously assess whether these regulations are appropriately and effectively calibrated as a system rather than a set of independent and parallel regulations.

---

[8] FRB Vice Chairman Randal K. Quarles, America's Vital Interest in Global Efforts to Promote Financial Stability, Speech before the Utah Bankers Association 110th Annual Convention (June 27, 2018), available at www.federalreserve.gov/newsevents/speech/quarles20180627a.htm.

[9] FRB Governor Daniel K. Tarullo, Departing Thoughts, Early Observations on Improving the Effectiveness of Post-Crisis Regulation, Speech before The Woodrow Wilson School (Apr. 4, 2017), available at www.federalreserve.gov/newsevents/speech/tarullo20170404a.htm.

[10] Both the Financial Stability Board (FSB) and the Basel Committee on Banking supervision (BCBS) have announced work programs to evaluate the efficacy and efficiency of post-crisis reforms. See www.fsb.org/what-we-do/implementation-monitoring/effects-of-reforms/ and www.bis.org/speeches/sp180129.htm.

[11] For example, see U.S. Department of the Treasury, "A Financial System That Creates Economic Opportunities: Banks and Credit Unions" (June 2017), available at, www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf.

FINANCIAL SERVICES FORUM

Clearly, Forum members believe strongly that the regulatory adjustments that have been proposed thus far, or that might result from a broad review, should continue to support the safety and soundness of the financial system, make the system more effective, and ensure continued economic growth.

Reviewing the Capital Regime for Large Financial Institutions

Given the centrality of capital in the business of banking and financial intermediation, as well as the magnified role of capital as part of the post-financial crisis regulatory framework, it is appropriate to prioritize capital regulations, stress testing, and capital planning requirements as part of an overall review of the regulatory system.

Federal banking regulators have introduced several proposals this year to amend the capital framework. The Forum supports appropriate and coherent capital requirements that apply to banks of all sizes and welcomes efforts by regulators to improve the capital framework.

Integration of Stress Testing and Capital Rules

Earlier this year, the Federal Reserve Board proposed to integrate its regulatory capital rule with its capital planning and stress testing regime while establishing a new stress capital buffer (SCB).

Integration of the stress testing and capital regimes to achieve a more simplified and harmonized capital framework is a laudable goal. However, because this integration would establish a fundamentally new approach to setting capital requirements that would amplify the role of stress testing, it becomes even more incumbent upon regulators to review the current framework holistically. The Forum believes certain changes should be made to more effectively achieve the FRB's policy objectives.

Background

The evolution of the FRB's stress testing practices illustrates the potential to find a more appropriate balance. During the financial crisis, the FRB turned to stress testing under the Supervisory Capital Assessment Program (SCAP) to "determine potential losses at the largest firms if the prevailing stress severely worsened and to restore confidence in the financial sector."[12]

While the original SCAP program was focused on quickly restoring capital adequacy and market confidence during a time of severe economic stress, the CCAR program has evolved into something that is much broader in scope. CCAR is an annual, point-in-time exercise under which firms submit a capital plan and the FRB subsequently approves, in advance, firms' quarter-to-quarter capital distributions. The

[12] Federal Reserve System, Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules, 83 Fed. Reg. 18161, available at www.gpo.gov/fdsys/pkg/FR-2018-04-25/pdf/2018-08006.pdf.

FINANCIAL SERVICES FORUM

FRB uses processes and models that are not publicly available, thus providing neither firms nor the marketplace with transparency, a predicate to establishing confidence in their results.

Rather than relying on expanded versions of the extreme policy measures (i.e., SCAP) that may have been necessary in the depths of the financial crisis, the FRB should recognize that the ongoing capital framework can strike a more appropriate balance between the original safety and soundness rationale for supervisory stress testing and the core responsibility of boards of directors to oversee capital distributions on a dynamic basis.

Indeed, the *ex-ante* nature of the CCAR exercise means that ongoing capital distributions do not account for changing macro and firm-specific conditions, effectively removing the ability of a board of directors to engage in a dynamic, ongoing capital planning process. Instead, firms and their boards of directors should have flexibility to adjust quarterly distributions in response to changing conditions.

Recommendations

The Federal Reserve should undertake a broader review of its capital and stress testing programs to ensure that boards of directors at financial institutions can clearly and appropriately make capital management decisions.

A firm with capital in excess of the FRB's requirements—inclusive of all relevant buffers—should be permitted to make capital distributions in the way its board deems is most productive. The Federal Reserve's current capital planning process reduces the ability of a firm to attract new capital and, in turn, artificially reduces the ability to provide credit to the economy. The inability of the board to distribute capital after meeting all relevant regulatory requirements thereby stunts economic activity without any clearly justified financial stability benefit and should be avoided.

Further, the FRB should improve the transparency of its scenario and model designs. This could be accomplished through a solicitation of comments on its process, in particular on the specific stress scenarios. The FRB could also amend its existing Policy Statement on the Scenario Design Framework for Stress Testing to develop an empirically grounded framework to establish "guardrails," or outer boundaries on the severity of the supervisory stress scenarios.

Specifically, the lack of transparency into the FRB's stress testing models and scenario design methodology encourages firms to hold additional capital beyond regulatory minima to avoid "failing" the stress tests. Thus, the effective cost of the FRB's capital and stress testing framework includes the cost of retaining this additional capital, which results from the structure of the proposal and its supporting regulatory architecture. This dynamic is exemplified by the stress test results released on June 21, 2018, which show significant variability and unpredictability and should be taken into account in the FRB's quantitative assessments. According to one estimate, banks maintain an additional capital

FINANCIAL SERVICES FORUM

buffer of up to one percentage point to guard against the year-to-year volatility in stress test results.[13] Such a management buffer applied to each of our members results in approximately an additional $65 billion in capital. This increase in capital beyond required minima is solely the result of the opacity and volatility of the stress testing process and unnecessarily raises the cost of funding which is then passed onto consumers and businesses.

Finally, the FRB should conduct a fulsome analysis of the effective costs and benefits of the proposed stress capital buffer beyond the impact of minimum capital requirements. The Forum's members are concerned that the SCB proposal does not contain robust analysis of the effective costs beyond citing its potential capital impact. Simply stating the potential impact on minimum capital requirements likely underestimates the proposal's overall economy-wide costs, particularly in light of the opacity of the FRB's stress testing processes.

Leverage Ratio

The Federal Reserve and the Office of the Comptroller of the Currency (OCC) earlier this year issued a separate proposal to modify the enhanced supplementary leverage ratio (eSLR). A leverage ratio is a simplified capital requirement that compares equity capital to total assets without adjusting for the risk of the underlying assets. Large, interconnected financial institutions are subject to an additional "supplementary" leverage ratio requirement that also accounts for certain off-balance sheet exposures such as derivatives and securities financing transactions. The largest, most interconnected firms—our members—are subject to an "enhanced" or higher and more stringent version of the supplementary leverage ratio.

The Forum agrees with the agencies that leverage requirements should serve as a backstop to risk-based capital requirements, rather than as the binding capital requirement. At present, the eSLR serves as the binding capital constraint for four of the eight Forum members' top-tier bank holding companies. Under the proposed revisions, the agencies note that the eSLR would remain the binding constraint for one Forum member's holding company.

Because leverage ratios do not differentiate the amount of capital required by the relative risk of an underlying exposure, the Forum agrees with the agencies that "[l]everage capital requirements should generally act as a backstop to the risk-based requirements" rather than as a binding constraint.[14]

---

[13] See Nomura Bank Regulation Update – SCB Proposal, SCB Good for Everyone (Except the Brokers) (April 11 2018); Autonomous CCAR's Next Moves Not So Scary After All (September 30, 2016)

[14] Federal Reserve System and Office of the Comptroller of the Currency, Regulatory Capital Rules: Regulatory Capital Enhanced Supplementary Leverage Ratio Standards for U.S. Global Systemically Important Bank Holding Companies and Certain of Their Subsidiary Insured Depository Institutions; Total Loss-Absorbing Capacity Requirements for U.S. Global Systemically Important Bank Holding Companies, 83 Fed. Reg. 17317, available at www.gpo.gov/fdsys/pkg/FR-2018-04-19/pdf/2018-08066.pdf.

FINANCIAL SERVICES FORUM

Therefore, the Forum supports the proposal and urges the agencies to adopt it promptly. However, the Forum believes more needs to be done to ensure this policy objective is achieved.

Recommendations

The agencies should take additional steps to ensure that leverage capital requirements act as a backstop to risk-based capital requirements, rather than as a binding constraint. In particular, the leverage calculations should exclude risk-free to eliminate the economic incentive to reduce participation in lower-risk, lower-return businesses. For example, the Treasury Department recommends excluding central bank reserves, U.S. Treasury securities, and initial margin for centrally cleared derivatives from the leverage ratio denominator.[15]

Including risk-free assets in the leverage ratio denominator creates incentives for banking organizations to reduce participation in, or increase costs for, lower-risk, lower-return businesses and products that are essential for a vibrant and growing economy. Although the proposed recalibration of the eSLR helps to avoid some of these perverse incentives in the short run, a more durable approach would be to remove risk-free assets from the leverage ratio denominators altogether.

GSIB Capital Surcharge

Banks that are identified as global systemically important banks—or GSIBs—are required to maintain an additional capital buffer that is scaled to the regulator's estimate of the banks' systemic importance. Both the capital and leverage proposals that have been proposed this year by regulators import the GSIB capital surcharge, which heightens the need to evaluate its appropriateness in light of the entire regulatory system that has emerged since the financial crisis.[16]

In collaboration with our colleagues at The Clearing House Association (now the Bank Policy Institute), we recently analyzed the calibration of the GSIB surcharge as implemented in the United States within the context of the broader regulatory framework. We found that GSIB surcharges should be reduced significantly by at least 1 percentage point to account for TLAC requirements, which reduce the cost of resolutions, and the Liquidity Coverage Ratio, which should reduce the magnitude of future GSIB losses.[17] To put this estimate in perspective, we note that an additional percentage point in capital for our members translates into approximately an additional $65 billion in capital.

[15] U.S. Department of the Treasury, "A Financial System That Creates Economic Opportunities: Banks and Credit Unions" (June 2017), available at, www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf.

[16] In addition, when adopting the GSIB surcharge, the FRB stated it would periodically reevaluate the method 2, "gold-plated" version that it uses "[t]o ensure changes in economic growth do not unduly affect firms' systemic risk scores." Further, method 2 relies on a flawed methodology to calculate a firm's use of short-term wholesale funding, underscoring the need to reconsider method 2.

[17] Financial Services Forum, "Joint Forum, Clearing House Blog: Seeing the Forest for the Trees: GSIB Capital and Enhanced GSIB Regulation" (June 27, 2018), available at www.fsforum.com/press/blog/joint-forum-clearing-house-blog-seeing-the-forest-for-the-trees-gsib-capital-and-enhanced-gsib-regulation/.

FINANCIAL SERVICES FORUM

Simply put, if the GSIB surcharges were appropriately calibrated when they were introduced in 2015, then the surcharges are now too high in light of liquidity, resolvability, and other related regulations that were proposed and finalized after the GSIB surcharge was finalized in 2015. Such reductions would, in turn, reduce the cost of funding, and increase the supply of credit GSIBs can provide to businesses and households alike, while establishing capital levels that continue to promote safety and soundness as well as financial stability goals.

Recommendations

The Forum believes the GSIB surcharge, as implemented by the FRB for U.S. institutions, does not appropriately reflect several related enhancements to the post-crisis regulatory regime, such as advancements made in the living wills process, and should therefore be reconsidered by regulators, as acknowledged by Vice Chairman Quarles in response to a question asked during congressional testimony on April 17, 2018.[18] When doing so, the FRB should undertake, and request public comment on, a quantitative assessment of the calculation of the GSIB surcharge, including how it interrelates to the SCB and other requirements. Pending such reevaluation, the FRB should exclude the GSIB surcharge from the stress capital buffer.

Finally, it should also be noted that the specific implementation of GSIB capital surcharges that was adopted in the United States goes beyond the framework that was agreed to at the international level. As a result, GSIB capital surcharges are substantially higher for our members than their foreign competitors. This gold-plating of international standards impinges upon the international competitiveness of our members and provides a further rationale for reviewing and reconsidering the appropriate calibration of the GSIB capital surcharge.

Conclusion

Regulators in the United States and internationally have discussed the necessity of evaluating the significant regulatory changes that have been implemented during the past decade. The Forum believes these efforts are imperative and looks forward to continued engagement to ensure our regulatory system balances the important goals of a safe and sound financial system with one that best supports economic growth and job creation. I appreciate the Committee's invitation to appear today and look forward to answering any questions you may have.

---

[18] In testimony before the House Financial Services Committee, Vice Chairman Quarles discussed in particular how the living wills process had "resulted in improvement in resolvability of the firms." Further, he said: "And that means that the consequence of their default is less. And the reason for the GSIB surcharge is precisely our assessment of the heightened consequence of their default. ... a process of thinking about it is appropriate now."

Examining Capital Regimes for Financial Institutions

Testimony presented to the
U.S. House Committee on Financial Services

Douglas Holtz-Eakin, President*
American Action Forum

July 17, 2018

*The views expressed here are my own and do not represent the position of the American Action Forum. I thank Thomas Wade for his assistance.

1. Introduction

Chairman Luetkemeyer, Ranking Member Clay, Members of the Committee, it is a privilege to speak to you today on a matter of great importance – the regulatory capital regimes imposed on the U.S. banking sector. The central question posed by the committee is "the efficacy and practicality of multiple capital regimes for our financial institutions." In that regard, I hope to make three overarching points:

- The evaluation of a regulatory capital regime can be viewed along the dimensions of systemic risk, prudential regulation, and compliance costs;
- The recent passage of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) dramatically improves the efficiency of the capital regimes; and
- Especially after the recent improvements, the Dodd-Frank regulatory regimes have left banks safer, but they remain a net drag on economic performance.

Let me elaborate on each.

2. Key Elements of the Dodd-Frank Regulatory Regimes

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) imposed a series of capital regimes on financial institutions with more than $10 billion in total consolidated assets.

As a basic matter, there were increased minimum capital requirements and buffers intended to increase the quantity of regulatory capital. Banks with more than $50 billion in assets became subject to enhanced capital requirements and public disclosures. Both small and large bank holding companies (BHCs) were required to hold more capital and have higher capital ratios. There are different computations required for BHCs with less than $250 billion in assets and those with $250 billion or more in assets. Last, the largest BHCs – the Global Systemically Important Banks, or GSIBs – have a 1.5-3.5 percent capital surcharge of risk-weighted assets they must maintain on top of minimum required capital.

Dodd-Frank also introduced the stress tests and the Comprehensive Capital Analyses and Review (CCAR). The stress tests are intended to identify those banks at risk of insolvency during periods of economic downturn and financial stress. The CCAR built upon the stress tests to assess a bank's capital plan, including cash the bank intends to return to shareholders.

EGRRCPA introduced important modifications to this basic regulatory structure. In particular, it raised the threshold for application of enhanced prudential standards from $50 billion to $250 billion. Those BHCs between $50 billion and $100 billion are exempt from these standards, while those between $100 billion and $250 billion will be exempt within 18 months of the effective date of the act. It also raised the threshold for stress tests to $250 billion in assets and exempted those banks with less than $10 billion in assets from the Volcker rule.

3. Capital Regimes: Concepts

The starting point for thinking about the capital regime is prudential regulation. The oldest rule remains the best: Holding more capital is the best insulation against insolvency and provides the sharpest incentives for underwriting, risk management, and efficient operations.[1] This rule was the central tenet of the CHOICE Act considered by the Financial Services Committee in recent years. This approach seeks to marry regulation with financial market surveillance and discipline of banks' risk management.

As a conceptual – as opposed to operational – matter, there appears to be little reason for multiple regimes of increasing capital requirements. There will exist an adequate level of capital backing; markets will reward those who maintain adequate capital and punish those who do not.

One might argue that it is difficult for a regulator to pick the "right" level for the capital requirements. The balance sheets of different banks might perform differently in times of economic duress. Or the scope of activities on a balance sheet might change as size increases, requiring a different level of capital backing. This might be one rationale for a set of multiple capital regimes that would contain a set of risk-weights or special capital contingencies. Indeed, there are elements of this in the current approach.

However, there is another approach that has the characteristic of a single regime: reliance on a (well-designed) stress-testing regime.[2] Banks can choose their capital levels and business strategies; stress tests reveal whether they are capable of surviving economic hardship. To be most effective, these stress tests should be transparent and public – if a bank fails a stress test it is important information for financial markets and a regulatory regime is most effective when complemented with market discipline.[3]

As a practical matter, this strategy runs into complications as well. First, stress tests must be continually revised to reflect the realistic characteristics of economic and financial hardship that a bank might face. This challenge may give some reservations about an exclusive reliance on stress tests for prudential regulation.

Second, the compliance costs for stress tests are a significant burden for small banks. If so – and this reality underlies the EGRRCPA – then once again there would be a compelling reason that multiple regimes tailored to bank size may make the most sense.

The final consideration is the notion of systemic risk and systemically important banks. Clearly, additional capital charges in Dodd-Frank are attributed to systemic risks, and Dodd-Frank created the Financial Stability Oversight Council (FSOC) explicitly to monitor systemic risk and regulate both banks and non-banks in order to control it. The problem is that there has never been a convincing definition of systemic risk or any operational way to measure it.

For that reason, there can be no coherent strategy for the FSOC to regulate systemic risk, nor can there be a coherent set of capital charges on a BCH that offset its contribution to systemic risk. The entire enterprise has become an exercise in a second layer of prudential regulation. It should be jettisoned (and the FSOC disbanded) and the focus returned to efficient and effective prudential regulation.

In sum, there are sensible reasons to have multiple regimes tailored to bank size.

4. Impacts Beyond Banking

On balance, the Dodd-Frank capital regimes have made the banking sector safer and sounder. In and of itself, this was the objective and the outcome is good news. The issue, however, is costs that this effort imposed beyond the banking sector on the economy as a whole. Here I believe it is fair to have some concerns.

To begin, Dodd-Frank is an extraordinary regulatory undertaking and imposed significant costs. In the eight years since Dodd-Frank was signed into law, $38.9 billion in regulatory costs and nearly 83 million paperwork-burden hours have been incurred. Under the current regulatory framework, the growth in these costs shows no sign of slowing down. Just last year, newly finalized regulations added more than $2 billion in regulatory costs and 8 million paperwork hours.

In addition, higher capital requirements are a *de facto* tax on profitability – albeit in the interest of safety – that posed an additional burden on banks. As is always the case in tax analysis, those costs will be shifted to both savers (lower returns) and borrowers (higher interest rates). These are drags on economic growth.

One piece of fallout from Dodd-Frank was that only a handful of new banks have been started in the United States – a clear tribute to the regulatory burden on small banks. And existing smaller community and regional banks cut back their supply of credit.

For existing entities, the resulting costs have hit all sectors of the financial community, with a disproportionate and unforeseen effect on Main Street institutions like community and regional banks and credit unions. This has caused the institutions closest to consumers and small business owners to redirect critical resources to regulatory compliance. As a result, business owners and consumers have been left inadequately served and the economy has suffered.

One study shows that since Dodd-Frank took effect in 2010, loans up to $100,000 have fallen 13.3 percent, loans between $100,000 and $250,000 have fallen 18.4 percent, and loans between $250,000 and $1 million have fallen 13.7 percent. This decline in the access to credit feeds slower growth in gross domestic product, jobs, and wages nationally and in each state.

The upshot has been the loss of some competitive vitality in the banking sector and diminished financing for the smaller, growing Main Street business that have been the traditional source of jobs, productivity, and real wage growth.

Another manifestation of the extreme regulation was the loss of consumer benefits. For example, in 2009 76 percent of all bank accounts were free to the consumer. Fast forward to 2013 and only 38 percent of bank accounts were offered free of charge. This steep drop is the result of a number of factors. In addition to bank accounts that were no longer free, banks began requiring higher minimum balances on their free or low-fee accounts as well as charging higher card replacement and other administrative fees in response to the banks' increased regulatory compliance costs.

Finally, there are large swaths of Dodd-Frank-related regulatory costs that have nothing to do with the causes of the financial crisis. There is no evidence that proprietary trading at banks caused the crisis, yet the costly and complex Volcker rule lives on. Derivatives were not (with the sole exception of credit default swaps at AIG) involved in the crisis, but Dodd-Frank imposed an entirely new derivatives regime that raised the cost of hedging for retail customers. The FSOC and its associated bank and non-bank designations (GE, AIG, MetLife, Prudential) solved no real systemic risk problem at tremendous costs. And in those cases that had real fingerprints on the crisis – housing finance in general, and Fannie Mae and Freddie Mac in particular – the Dodd-Frank law did not address the problem.

The bottom line is that in exchange for a safer banking system, the U.S. sacrificed economic vitality and growth. It is difficult to quantify this with any precision (I took a heroic stab one time)[4], but it underlies the sentiment that Dodd-Frank simply went too far.

Thank you and I look forward to answering your questions.

Notes

[1] I focus here on capital regimes to ensure solvency. A separate and very important set of issues is adequate liquidity (the financial crisis was to a great degree a liquidity crisis).

[2] The emphasis here is on "well-designed," which means that they be forward-looking in their construction. Stress tests and regulatory action that are purely reactionary and materially delayed will not provide adequate information. A stress test written in March based on the economic challenges of the year before that leads to regulatory action in June or July may not be sufficient.

[3] In this regard, I think stress tests are most valuable when they are really tests: firms pass or fail. From this perspective, the plan to move the stress tests into the CCAR process is a step in the wrong direction.

[4] Douglas Holtz-Eakin, "The Growth Consequences of Dodd-Frank", American Action Forum, May 6, 2015, https://www.americanactionforum.org/research/the-growth-consequences-of-dodd-frank/.

TESTIMONY OF KEITH A. NOREIKA
BEFORE THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT OF THE COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES
JULY 17, 2018

The Need For Reasoned, Transparent Tailoring of Enhanced Prudential Requirements and Supervision

Chairman Luetkemeyer, Ranking Member Clay, and members of the subcommittee, my name is Keith Noreika and I am a Partner in the Financial Institutions Practice at Simpson, Thacher & Bartlett LLP. During 2017, I had the honor to serve as the Acting Comptroller of the Currency.

Thank you for the opportunity to speak today before the Subcommittee on Financial Institutions and Consumer Credit of the House Financial Services Committee about the current state of capital requirements and other enhanced prudential requirements that apply to the U.S. banking sector. The U.S. banking sector is an important segment of the economy that serves as the primary provider of credit to our communities, to consumers and small- and large- businesses alike, and is a vital engine of growth and innovation in our economy. As a former Acting Comptroller of the Currency, I have spent a significant amount of time and effort working to apply the appropriate level of regulation to financial institutions in the United States in a manner that balances the safety, soundness and stability of the financial system, while preserving room in the system for innovators to continue to efficiently allocate capital. Today, I hope to give you my perspective as someone recently familiar with the concerns of both the public and private sectors.

In my testimony, I will focus on two distinct and enduring tensions in the bank regulatory space. The first is the tension between the mandate to regulate both safety *and* soundness of the banking sector. The second is the tension between the democratic need for transparency in the creation and implementation of regulatory requirements, and the bases for any requirements, balanced against the need to preserve appropriate agency discretion to act as a day-to-day supervisor without having to go through administrative processes.

During my time leading the primary regulator of U.S. national banks, I kept front and center in my mind the principle that financial regulators are mandated to protect both the safety *and* the *soundness* of the banking sector. Soundness requires that banks are not so overburdened with regulations that they are unable to turn a profit. Soundness requires that bank management have sufficient freedom and discretion to run their own businesses. When drafting regulations to increase safety in the banking sector, it is important for regulators to consider the economic consequences of their regulations, including how their regulations may adversely impact firms' abilities to operate effectively and the price and availability of credit offered to the public, including to poor families and to our nation's underserved communities. This need for appropriate balance drives my approach to financial regulation generally and informs my comments today about the need for tailoring of enhanced prudential requirements.

The other key principle that guided me during my time leading the Office of the Comptroller of the Currency was the importance of transparency and public input into the regulatory process. The Federal Reserve, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (the "Federal Banking Agencies") have been delegated authority by the democratically elected Congress to regulate and supervise the U.S. banking system. The Federal Banking Agencies, in turn, are required by democratic principles, as well as the Administrative Procedures Act ("APA"), to publish for notice and comment any rule, which is broadly understood to include any rule, policy, or interpretation that has binding effect on the rights or obligations of affected parties, and to incorporate a statement of the basis and purpose for adopting such rule after consideration of the data, views and arguments presented by the public. During my time running the OCC, I was mindful that when focusing on the goal of increasing the safety of banking organizations, one must remain transparent in the rulemaking and supervisory process and not become overly reliant on "unofficial rulemaking" through guidance. In the banking sector, which is perhaps the most highly regulated industry in the country, there is a risk that rules will beget more rules, and for every rule published in the Code of Federal Regulations, there may be dozens of unofficial rules, often termed non-binding "guidance" or supervisory action, that could potentially have a practical binding effect on subject institutions. Such rules are suspect under the APA, and certain of these rules must also be submitted to Congress for review pursuant to the Congressional Review Act.

By the end of this afternoon's hearing, I expect that we will have heard proposals for specific changes to capital and stress testing requirements that are applied to U.S. financial institutions; this may include changes to calculations and calibrations underlying the capital surcharge applicable to the eight U.S. global systemically important banks, known as "G-SIBs," and changes to the processes and assumptions underlying the Federal Reserve's Dodd-Frank Act Stress Testing regime and its Comprehensive Capital Analysis and Review, known as "DFAST" and "CCAR" respectively, which together are capital stress tests and reviews designed to evaluate both capital adequacy in severe conditions and the quality of the internal processes that firms use to assess their own capital needs. While I strongly support many of the recommendations for tailoring of these requirements and processes that have been advanced by industry participants, academics, and others, I will focus my remarks today on the need for tailoring for two important segments of the U.S. financial system: (1) U.S. regional banks with between $100 billion and $250 billion in total consolidated assets, and (2) international banking organizations organized outside of the U.S. that have a banking and capital markets presence in the United States.

Tailoring Enhanced Prudential Requirements for Regional Banks

Before I get into specific proposals, I would like to take a step back and discuss more broadly the application of the Federal Reserve's enhanced prudential requirements to U.S. financial institutions, including stress testing and other prudential requirements, and discuss the need for the Federal Reserve to introduce further tailoring into its enhanced prudential requirements for regional banks, as has been advocated by the current Federal Reserve Vice Chairman for Supervision, Governor Randal Quarles.[1]

As we all know, if you have a requirement that is insufficiently calibrated and tailored to a known risk, the risk will continue unabated. On the other hand, if you apply an overly broad and punitive requirement, it will unnecessarily limit lending activity, inhibit economic growth, and in many cases, create artificial incentives that cause firms to take unnatural actions and behaviors that can often be more risky than the previously unregulated behavior. As we have seen time and again, whether it is poorly calibrated capital requirements that incentivize firms to hold risky assets, or liquidity requirements that incentive firms to hoard cash during a crisis rather than spend it in a way that would increase market liquidity, poorly tailored regulations can make the financial system more dangerous, not less so.

[1] *See, e.g.*, Randal K. Quarles, Speech at the Utah Bankers Association 110th Annual Convention, Sun Valley, Idaho (June 27, 2018) ("A common theme in the legislation and the Fed's steps to improve our regulation and supervision is tailoring. As the Fed continues to evaluate the effectiveness and efficiency of regulations, I expect tailoring will be a guiding principle."); *see also* Jerome H. Powell, Testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, D.C. (June 22, 2017) ("As we near completion of the major post-crisis regulatory reforms...we should continue to tailor our requirements to the size, risk, and complexity of the firms subject to those requirements...[and] we should assess whether we can adjust regulation in common-sense ways that will simplify rules and reduce unnecessary regulatory burden without compromising safety and soundness.").

Congress knew this following the financial crisis when it enacted section 165 of the Dodd-Frank Wall Street Reform and Consumer Protect Act ("Dodd-Frank Act"), which tasked the Federal Reserve, in order to mitigate financial stability risks, with establishing enhanced prudential requirements for bank holding companies with $50 billion or more in total consolidated assets, including requirements relating to capital, leverage, liquidity, risk management, governance, resolution planning, concentration limits, and stress testing, among others.

Congress invited the Federal Reserve to tailor these requirements to the risk profile of the companies subject to the enhanced prudential requirements appropriately so that these requirements would be precisely and specifically applied to firms that presented precise and specific harms that needed to be addressed. Specifically, Congress stated in section 165 that the Federal Reserve "*may*, on its own or pursuant to a recommendation by [the FSOC], 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 [it] deems appropriate" (emphasis added).

Notwithstanding this Dodd-Frank provision, the vast majority of the Federal Reserve's enhanced prudential requirements were applied to all firms based on simple asset measures or measures of on-balance sheet foreign exposures that did not specifically differentiate between the characteristics identified by Congress as the potential basis for tailoring.

For instance, if a bank holding company crossed $50 billion in total consolidated assets, it would suddenly become subject to: supervisory DFAST stress testing by the Federal Reserve and more frequent company-run stress testing (as well as the Federal Reserve's CCAR capital plan requirements, which are imposed outside of the Dodd-Frank Act framework), enhanced risk management and risk committee requirements, prescriptive liquidity risk management and stress testing requirements, standardized liquidity requirements (one currently effective and another the Federal Reserve is still working on), and resolution plan requirements. International banking organizations with more than $50 billion in U.S. non-branch assets would also become subject to the Federal Reserve's intermediate holding company requirement, a ring-fencing requirement that, as I will discuss later, has the potential to make the international banking system less safe.

By and large, a single measure meant a firm was covered by all of those requirements. To be fair, there were some other instances of tailoring. Firms with $250 billion or more in total consolidated assets or $10 billion or more in on-balance sheet foreign exposure are, for instance, subject to slightly higher liquidity requirements. More recently, the Federal Reserve exempted from the CCAR qualitative review firms with less than $250 billion in total consolidated assets and less than $75 billion in total non-bank assets, an exemption that I applaud and hope to see applied to other CCAR firms in the future. The Federal Reserve has also adopted an additional set of requirements for the largest 6 U.S. bank holding companies, and the two largest U.S. processing banks, the so-called G-SIBs. However, for the dozens of other banking organizations with more than $50 billion in total consolidated assets, to date, tailoring has been limited to simple dollar thresholds and a foreign exposure threshold that nearly everyone agrees do not accurately capture risk.[2]

[2] As part of any tailoring proposal to make the enhanced prudential requirements apply to banking organizations based on more risk-sensitive measures, as I discuss further below, the Federal Banking Agencies should consider eliminating the foreign exposure threshold entirely, given that this metric is not risk-based and impacts international banks in a disparate manner.

As a result, today, moderately-sized regional banking organizations with traditional and straight-forward business models that provide communities with their traditional banking needs, such as getting loans and having a place to make deposits, have been generally subject to the same stress testing, risk management, capital, and liquidity requirements that are applied to firms that are materially larger and more complex. These requirements have adversely impacted the lending activities of regional and community banks, and have increased the price of, and reduced the access to, credit for families, small businesses, and other job creators in our economy.[3]

With the recent enactment of the Economic Growth, Regulatory Relief, and Consumer Protection Act, which I will refer to as "the Act," Congress recognized these concerns and directed the Federal Reserve to tailor its requirements to the riskiness of the institutions that it supervises. The Act did two important things for tailoring enhanced prudential requirements. First, it raised the threshold for the applicability of enhanced prudential requirements from $50 billion to $250 billion. Second, the Act provided that the Federal Reserve may, by order or rule, apply any enhanced prudential requirement to firms with at least $100 billion in total consolidated assets, so long as the Federal Reserve *both* determines that application of the specific prudential requirement is appropriate (either to prevent or mitigate risks to U.S. financial stability or to promote the safety and soundness of the firms in question), *and* takes into consideration the firms' capital structure, riskiness, complexity, financial activities (including

[3] *See* Michael D. Bordo, John v. Duca, "The Impact of the Dodd-Frank Act on Small Business," NBER Working Paper No. 24501 (April 2018); The Effects of Increased Post-Crisis Regulation and Supervision on Regional Banks and the Economy They Serve, Regional Bank Coalition (July 15, 2018), available at regionalbanks.org/the-data; Marshall Lux and Robert Greene, "The State and Fate of Community Banking," M-RCBG Associate Working Paper No. 37, Harvard University Kennedy School (February 2015).

financial activities of subsidiaries), size, *and* any other risk-related factors that the Federal Reserve deems appropriate.

These two tailoring-related changes reflect careful drafting and policy choices by Congress. First, under the Act, the presumption is that all firms with less than $250 billion in total consolidated assets are no longer covered by enhanced prudential requirements. To apply enhanced prudential requirements to such firms, the Federal Reserve must affirmatively demonstrate that the requirements are appropriate to prevent risks to financial stability or to promote safety and soundness and are appropriately tailored to the organizations in question. That means that the Federal Reserve should provide a bottom-up review and analysis of the impact of the enhanced prudential requirements that it intends to apply to regional banks.

Prior to proposing any new thresholds, the Federal Reserve should perform and publish a comprehensive empirical analysis of the cumulative effect of all of its enhanced prudential requirements on U.S. financial stability and the safety and soundness of the regional banking sector that justifies any enhanced prudential requirements that apply going forward. Any retention of enhanced prudential requirements should reasonably be based on economic analysis that demonstrates how the benefits that such rules provide for the mitigation of systemic risk and the promotion of safety and *soundness* of the banking sector outweighs the costs of these requirements. This recommendation is consistent with the U.S. Treasury Department's conclusions in its June 2017 Report to President Trump pursuant to Executive Order 13772, in which Treasury concluded that Federal Banking Agencies should "follow the principles of transparency and public accountability by conducting rigorous cost-benefit analyses and making greater use of notices of proposed rulemakings to solicit public comment." In particular, Treasury recommended that the Federal Banking Agencies perform and make available for public comment a cost-benefit analysis with respect to at least all "economically significant" proposed regulations.[4]

Second, the Act requires that the application of any enhanced prudential requirement to a firm with $100 billion in total consolidated assets or more must take into account a firm's "capital structure, riskiness, complexity, financial activities (including financial activities of subsidiaries), size, and any other risk-related factors that the [Federal Reserve] deems appropriate." This is a conjunctive, not a disjunctive, test. As a result, under the Act, the Federal Reserve cannot continue to apply enhanced prudential requirements to firms with more than $100 billion in total consolidated assets merely based on asset size alone. To comply with the Act, any application of enhanced prudential requirements to such regional-sized firms must incorporate each and every of the following characteristics of the firm: riskiness, complexity, financial activities, size, and any other factor the Federal Reserve deems appropriate, as well as consider how the application of enhanced requirements reduce financial stability risk and promote safety and soundness.

One idea for how the Federal Reserve could accomplish this tailoring would be to adopt and apply the methodology currently used to identify G-SIBs and calculate the G-SIB surcharge, or a similar multi-factored measure, to identify those banks with more than $100 billion in total consolidated assets that pose sufficient risk to qualify them for enhanced requirements. The G-SIB surcharge calculation methodology is a measure that the Federal Reserve has already adopted, it has already gone out for notice-and-comment, and,

[4] U.S. Department of the Treasury, *A Financial System That Creates Economic Opportunities: Banks and Credit Unions* (Washington, D.C., June 2017) (hereinafter the "June 2017 Treasury Report").

notwithstanding certain areas where the G-SIB calculation should be recalibrated and improved, it is a generally understood and accepted approach for measuring a firm's systemic risk.

Third, the Act requires the Federal Reserve to apply Dodd-Frank's multi-factored, conjunctive test for determining applicability for "any prudential standard." Congress required separate analyses for assessing the application of each separate rule. In other words, there should not be a single line which, if crossed, causes a firm to be subject the entire suite of enhanced prudential requirements. And this makes sense. For instance, why should a firm be subject to enhanced liquidity requirements based on the amount of its assets, even though those assets may be highly liquid and the firm may fund itself primarily with long-term stable funding? Why subject a regional banking organization with a traditional "mom-and-pop" business model of taking deposits and making traditional loans to a number of annual stress testing requirements, which costs millions of dollars and the efforts of dozens of employees on an ongoing basis, based merely on an asset threshold? An enhanced requirement that targets a specific risk should only apply to a firm if that firm demonstrates a vulnerability to that specific risk. It should not be the case, and the Act does not permit, the Federal Reserve to continue applying a single risk-insensitive trip wire that, if tripped, causes a firm to become subject to the full panoply of enhanced prudential requirements.

As the Federal Reserve proceeds to implement the Act, the *substantive requirement* of each of the enhanced prudential requirements should also be reviewed and tailored to ensure that the substance of the requirement is appropriate based on the risks posed by the subject firm. It does not make sense for the same prescriptive governance requirements that apply to G-SIBs to be applied to smaller regional banks. It similarly does not make sense for portions of rules that were specifically designed to target broker-dealer activities to be applied to firms that do not have a significant broker-dealer. Failing to tailor properly both the scope *and* substance of the Federal Reserve's enhanced prudential requirements will inevitably result in constraints on economic growth and access to credit, and may distort incentives and ultimately cause more risk to exist in the system.

I am encouraged by statements by the Federal Reserve's leadership about the importance of improving the efficiency of regulation by carefully considering a regulation's potential adverse economic consequences, and by focusing on precise calibration of the regulation to fit the risks in need of mitigation.[5] I am also hopeful that the Federal Reserve will apply these principles as it tailors the enhanced prudential requirements, if any, that continue to apply to regional banks with above $100 billion in total consolidated assets.

Before I move on to discuss enhanced prudential requirements applicable to international banks, I would like to add one final thought on tailoring for regional banks. The Federal Reserve should immediately cease the application of the enhanced prudential requirements to firms with less than $250 billion in total consolidated assets, in the same fashion that the Federal Banking Agencies recently indicated that they would not apply these requirements to firms with less than $100 billion in total consolidated assets. Although the Act included an 18-month delayed effective date, presumably to give the Federal Banking Agencies time to consider how to tailor these regulations appropriately, every day that these burdensome requirements unnecessarily apply to regional banks that do not present significant risks, economic growth is stifled and this cost is primarily borne by consumers and small businesses.

[5] Randal K. Quarles, Speech at the American Bar Association Banking Law Committee Annual Meeting, Washington, D.C. (January 19, 2018) (noting that "[e]fficiency of regulation can be improved through a variety of means," including by achieving a given regulation's objective using fewer tools, addressing unintended adverse consequences or eliminating perverse incentives created by a regulation, calibrating a given regulation more precisely to the risks in need of mitigation, or using simpler examination procedures for bank supervisors).

In all events, applying rules until or unless they can be empirically validated puts the cart before the horse. Given the statutory mandates of Dodd-Frank and the Act, a demonstrated analysis showing systemic risk should be required before any further application of these rules to regional banks.

Tailoring Enhanced Prudential Requirements Applicable to International Banks

I would next like to discuss the application of enhanced prudential requirements to international banking organizations that are organized in countries outside of the United States. International banks represent an important segment of the U.S. banking sector, representing 20% of total U.S. banking system assets, providing one-third of U.S. business loans, and engaging in significant broker-dealer and capital markets activities in the U.S. markets.[6]

Since the passage of the International Banking Act of 1978, the regulation of international banks operating in the United States has been guided by a non-discrimination principle of "national treatment and equality of competitive opportunity." Put simply, and as explained by Congress, national treatment has meant the "parity of treatment between foreign and domestic banks in like circumstances." The policy goal of providing parity of treatment was two-fold. It was designed both to support the fair and equal treatment of U.S. and international banking organizations operating in the United States, ideally with the result of engendering fair and equal treatment of U.S. banking organizations that operate abroad. It was also designed to ensure that U.S. customers would benefit from increased competition and access to credit that would result from international firms providing services in U.S. markets.

Congress's commitment to national treatment was reaffirmed in the Dodd-Frank Act, where Congress directed the Federal Reserve, when applying enhanced prudential requirements

[6] June 2017 Treasury Report, pg. 68.

to international firms, to "(A) give due regard to the principle of national treatment and equality of competitive opportunity; and (B) take into account the extent to which the foreign financial company is subject on a consolidated basis to home country standards that are comparable to those applied to financial companies in the United States."

In some ways, the implementation of enhanced prudential requirements has been in tension with the principle of national treatment, most notably with respect to the implementation of an intermediate holding company ("IHC") requirement on firms with $50 billion or more in U.S. non-branch assets; a variety of prescriptive governance, risk management, capital, liquidity, stress testing and resolution planning requirements on the U.S. operations of international banks with $50 billion or more in total assets (measured against U.S. assets or global assets, depending upon the requirement); and for IHC subsidiaries of international banks that are G-SIBs, a requirement to maintain certain amounts of internal total-loss absorbing capacity ("TLAC") and long-term debt, in each case that is issued from the U.S. IHC to its foreign parent company.

The adverse net effect of these requirements has been well-documented, with industry participants, the Treasury Department (in its June 2017 Treasury Report), and Federal Reserve officials themselves noting that the U.S. has administratively created a system of ring-fencing, under which local U.S. capital, liquidity, and debt requirements have contributed to the balkanization and fragmentation of international financial markets that threatens the free-flow and efficient transfer of money and capital across the international financial system.

The IHC requirement predictably spurred IHC proposals in other jurisdictions. For international firms operating in the United States and U.S. banks operating abroad, ring-fencing requirements make it significantly more expensive to operate. This has and will continue to result in international firms retreating from U.S. markets, thereby harming competition and decreasing the availability of credit and capital markets activities in the United States, which will ultimately hurt the U.S. consumer.[7] Moreover, the U.S. ring-fencing requirements, and reactive foreign-ring fencing requirements, will cause a net increase in capital costs on international firms, and U.S. firms operating abroad, as countries apply stand-alone capital and liquidity requirements. This may have the perverse effect of making banks with cross-border activities less safe, because if a crisis in one geography burns through the firm's local prepositioned resources, the firm may be precluded from using its resources located elsewhere to bolster the part of its operations that is under stress.[8]

There are a number of actions that the Federal Banking Agencies can and should take to reintroduce national treatment into their regulation of the U.S. operations of international banks. The first is that the Federal Banking Agencies should better take into account the global resources of international firms when calibrating capital, liquidity, and stress testing requirements applied to the U.S. operations of these firms. International firms are often more diversified and safer on a global basis than would appear from just a narrow focus on their U.S. operations, and this should be reflected in the Federal Banking Agencies' regulation of such firms. Further, any current or future plans to increase or further solidify ring-fencing, such as in the area of liquidity regulation or resolution planning requirements, should be carefully tailored to prevent further fragmentation of the financial system. The new leadership at the Federal Reserve has indicated a willingness to reconsider the calibration of its ring-fencing requirements,

[7] *See, e.g.*, Institute for International Bankers, Submission to U.S. Treasury Department Regarding Executive Order 13772; Financial Stability Oversight Council 2016 Annual Report; Oliver Wyman, Enhanced Prudential Standards for Foreign Banking Organizations: An Impact Assessment, April 30, 2013.

[8] *See* Wilson Irving, "Understanding 'ring-fencing' and how it could make banking riskier," Brookings Center on Regulation and Markets (February 7, 2018).

and I urge the Federal Reserve to focus on the safety and soundness of international firms on a global basis when it proposes future tailoring of these requirements.[9]

Second, consistent with the June 2017 Treasury Report recommendations, the requirements applicable to the U.S. operations of international banks should be commensurate with the risks posed by their U.S. footprints (with due consideration to the benefits arising from these firms' global resources and diversification). For instance, U.S. IHC subsidiaries of certain international banks are subject to certain heightened standards that, with respect to U.S. banking organizations, only apply to the largest and most complex firms. In this regard, certain IHCs are subject to enhanced capital planning requirements, additional and punitive market shock scenarios in their CCAR stress testing, as well as the CCAR qualitative assessment, and enhanced liquidity stress testing and risk management requirements, each of which are otherwise applied only to the largest and most complex U.S. banking organizations. Further, certain international banks have been grouped with the U.S. G-SIBs in the Federal Reserve's Large Institution Supervision Coordinating Committee ("LISCC") supervisory portfolio, under which they are subject to heightened supervisory standards and expectations and are judged in horizontal reviews against U.S. G-SIBs that have much more significant U.S. footprints. This creates an unequal playing field.

Any tailoring of requirements, as well as the finalization of any current proposals for new requirements, should take into account the economic impact that such rules would have on international banks operating in the United States.[10] It is vital for the transparency and due

[9] Randal K. Quarles, Speech at "Ring-Fencing the Global Banking System" Symposium, Harvard Law School, Cambridge, Massachusetts (May 16, 2018) ("We are interested in views from the firms and the public on how the [ring-fencing] regimes can be improved, and we expect to invite public comment on our living will guidance for U.S. and foreign firms in the near future.").

[10] Notably, the stress capital buffer proposal contained no analysis of the impact of the proposal on international banks.

process of our regulatory process for administrative agencies to measure and analyze the impact of their rules on affected parties, and that obligation should not be ignored merely because a U.S. entity has a foreign parent.

Finally, there are numerous opportunities for tailoring that should be performed that take into account the unique global operations of international firms. The Federal Reserve should, for example, consider whether there is a need for both U.S. capital requirements and internal TLAC requirements for IHCs of G-SIBs. In stress, capital and internal TLAC, which can be converted into equity, are functionally similar, which raises the question of whether both of these requirements are necessary. The internal TLAC requirement also raises international tax issues that are unique to international firms that should be addressed. There are numerous changes that should be made to the CCAR process as it applies to domestic and international firms, including introducing more transparency, stronger processes, and a reconsideration of scenarios and supervisory models. With respect to international firms in particular, the current CCAR framework disadvantages firms whose U.S. operations are primarily capital markets in nature, and does not take into account the benefits of global diversification that exist for international banks. These disadvantages would be further exacerbated if the CCAR results are engrained in a spot capital requirement through the proposed Stress Capital Buffer. This disparate treatment should be addressed in connection with a broader rethink of the CCAR process, one that includes significantly more transparency, public input, and due process into what is most firms' binding capital constraint.

I am optimistic that with the passage of the Act, and new heads of the Federal Banking Agencies, that our financial system will benefit from a regulatory framework that is more appropriately tailored to the risks posed by regulated financial institutions, particularly regional and international banking organizations. In particular, I look forward to working with the Federal Banking Agencies to promote a regulatory regime for regional banks in which each rule is appropriately tailored to the risk profile of any bank subject to such rule, based on a multi-factor analysis of the bank's risk characteristics and a rigorous cost-benefit analysis of the intended and unintended economic consequences of each rule (beginning with an immediate moratorium on compliance with enhanced prudential requirements for any banking organization with less than $250 billion in total consolidated assets). And I look forward to the economic benefits that the U.S. financial system would enjoy through a recalibration of the current ring-fencing requirements and a regulatory approach to international banking organizations that gives more consideration to the strength of the firm's global operations, which will ultimately result in a more robust U.S. financial market.

Thank you for allowing me to appear before you today to present my views on these important issues.

Americans for Financial Reform

Education Fund

TESTIMONY TO HOUSE FINANCIAL SERVICES COMMITTEE

Subcommittee on Financial Institutions And Consumer Credit

July 17, 2018

Chairman Luetkemeyer, Ranking Member Clay, and members of the subcommittee, thank you for the opportunity to testify before you today on behalf of Americans for Financial Reform. AFR is a coalition of more than 200 national, state and local organizations who have come together to advocate for stronger and more effective oversight of the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, and faith based groups.[1]

Today's hearing examines capital regimes for financial institutions. It takes place against the background of a relentless lobbying effort by major banks to lower capital requirements. Since bank capital is a fairly technical issue to start with, and much bank lobbying takes place in regulatory back rooms, it is easy to miss the full scope of this effort. But it is impressive to say the least. Large banks are lobbying to weaken stress testing, reduce leverage capital and risk-based capital add-ons for the largest systemically significant banks, cut capital requirements for cleared derivatives almost to zero, weaken the capital regime for dozens of banks between $100 and $250 billion in size using the implementation of the recent Economic Growth, Regulatory Reform and Consumer Protection Act (EGRRCPA), and more. These efforts are reflected both in appeals to regulators and in numerous bills that have come before this committee.

Many of these efforts are already meeting with success, as we can see in recent regulatory proposals to slash the supplementary leverage ratio for large banks and to weaken stress testing requirements. If this pattern continues, it will represent a very substantial weakening of a post-crisis capital regime that many experts across the political spectrum believe is already dangerously inadequate.

Below, I offer some additional comments on current bank capital controversies and lobbying. But it's worth first taking a moment to consider why this effort is taking place. Why are banks so eager to reduce capital requirements?

It's not because the banking sector is doing badly economically. The FDIC recently reported that, aided by large tax cuts, commercial banks earned a remarkable $55.9 billion in profits in the first quarter of 2018, shattering previous records. Over 96 percent of banks were profitable. This

[1] A list of AFR members is available at http://ourfinancialsecurity.org/about/our-coalition/

follows five consecutive years of record and near-record profits. Between 2012 and 2017 the annual profits of commercial banks ranged from $150 to $170 billion, comparable in real terms with the record profits earned in the banking boom just before the 2008 financial crisis.

It's not because banks can't lend. Since the passage of the Dodd-Frank Act in the third quarter of 2010, total economic output (GDP) has grown by 33 percent, but total commercial bank loan portfolios have grown by 39 percent and bank business lending books have grown by a remarkable 79 percent. Commercial banks have added an additional $1 trillion to their business loan portfolios over the years in which Dodd-Frank was implemented, representing a real annual growth rate in business lending far higher than the pre-Dodd Frank growth rate.[2]

To understand why slashing equity capital requirements is such a consistently high priority for banks, we need to take a brief detour into what bank capital is and what it does.

As in other industries, bank equity capital represents the private assets of the private owners (shareholders) of the bank that are held at risk in the organization, in excess of the liabilities the bank owes to others. But unlike other industries, banks enjoy the unique benefit of large-scale public backing for their liabilities. Bank retail deposits (debt owed to depositors) are directly insured by the Federal government.[3] The experience of the 2008 financial crisis, along with the continued availability under the Dodd-Frank Act of various forms of emergency assistance to the financial sector, demonstrates that non-deposit liabilities of the nation's largest and most systemically significant banks may also receive public backing. Since a bank becomes insolvent once shareholders' equity is exhausted, bank capital can be understood as the layer of private sector funding that protects the public from another taxpayer bailout of banks.

The public backing for their debt liabilities, along with the unique money-like character of bank liabilities, means that banks are able to borrow far more than other companies relative to the private equity stake of their owners. As noted in the statement submitted by Professors Cechetti and Schoenholtz for today's hearing, the market typically allows non-financial corporations to borrow less than $1.50 per dollar of private equity. In contrast, large banks in the U.S. today borrow close to $14 per dollar of equity invested by the firm's owners. This is significantly more than even aggressive non-bank financial firms such as smaller hedge funds, which clearly do not

---

[2] Based on AFR calculations using the data from Q1 1973 to Q1 2018, sourced from the following data series available from the St. Louis Federal Reserve: Commercial and Industrial Loans, All Commercial Banks (https://fred.stlouisfed.org/series/BUSLOANS), Loans and Leases in Bank Credit, All Commercial Banks (https://fred.stlouisfed.org/series/TOTLL), and Gross Domestic Product (https://fred.stlouisfed.org/series/GDP).

[3] A nominal premium is paid for this insurance but it is far lower than the amount that would be needed to properly compensate the public for the relevant risk. See e.g. Acharya https://voxeu.org/article/systemic-risk-and-deposit-insurance-premiums

have either official or implicit public backing for their liabilities. Typically such smaller hedge funds borrow $5 or less per dollar of equity.[4]

One would think that as a matter of ideological principle supporters of capitalism and free markets would favor high levels of private equity investment in large banks. Capital is after all essential to capitalism. The only reason that bank shareholders can get away with holding very low levels of their own capital relative to the firm's debt is the various government guarantees provided by the public. Before the existence of Federal deposit insurance and the Federal Reserve, banks held much higher levels of private equity capital than they do now, levels more comparable to what hedge funds hold today.[5]

However, in Washington ideological principle often comes in a distant second to economic interests. And bank insiders have a very large economic interest in reducing mandatory bank capital. A public backstop for bank borrowing combined with low levels of capital is a great deal economically for big bank shareholders, including top bank executives who are paid in stock. In practice, every dollar of reduction in mandatory capital requirements is a dollar that can be paid out to shareholders in the form of dividends or stock buybacks. Since shareholder equity is the private funding that stands between the public and another government bailout of banks, this represents an implicit transfer of wealth from the general public to the financial insiders who hold major ownership stakes in banks.

Not only is this unfair, but the incentive effects of such capital reductions can be extremely dangerous. Given the economic centrality of banks and their support through the public safety net, equity holders are in a position to take the profit upside from risk while imposing many of the losses on taxpayers and society at large through the economic fallout from the failure of a large bank. The less of their own capital bank owners are required to invest in order to claim the profits of the bank, the more extreme these lopsided incentives become and the greater the incentive to take irresponsible risks. The moral hazard issue becomes particularly dangerous when a bank is in imminent danger of failure. When a highly leveraged bank experiences significant losses, profits must be very large in order to accrue to equity shareholders rather than creditors. In such a case equity holders may favor outright gambles that are harmful to other stakeholders in the bank.

---

[4] See Form PF private fund statistics available from the Securities and Exchange Commission at https://www.sec.gov/divisions/investment/private-funds-statistics.shtml . These are averages and a few highly leveraged hedge funds do come closer to typical bank levels of leverage

[5] Lawmakers also supplemented these high capital levels with a regime of double liability for bank shareholders, which made them liable for twice their capital stake in case of a bank failure. This provided additional private sector protection against bank abuse of their central role in the economy. Double liability was phased out as public support for the banking sector grew. Macey and Miller, 1992. http://digitalcommons.law.yale.edu/fss_papers/1642/

General Bank Arguments for Lowering Capital Levels

Bank shareholders are not disposed to directly argue their economic interest in lower capital requirements. Instead, they typically deploy a number of more facially acceptable arguments.

One such tactic is a kind of "argument by metaphor" which depicts bank capital as somehow economically inactive. For example, some have recently become fond of the phrase "trapped capital", claiming that regulatory capital requirements "trap" capital in the financial system that could instead be "deployed to the economy". These kind of metaphors are wildly misleading. Capital directly supports lending – it is the very opposite of economically inactive or "trapped". Banks have a profit incentive to deploy every dollar of capital they have to support economic activity. When banks cease to have capital they become insolvent and therefore cannot lend at all. The point of regulatory capital requirements is precisely to ensure that in the event of a downturn in which banks experience unexpected losses, they will still have adequate capital to continue lending. As Professors Cechetti and Schoenholtz emphasize in their statement, the evidence clearly shows that when banking systems are better capitalized going into a downturn, they are better able to support lending growth.[6]

Another argument is that higher bank capital increases the costs of lending since the greater returns demanded by equity holders as opposed to the cost of raising funds through borrowing must be passed on to bank customers. By inserting assumed increases in the cost of lending into macroeconomic models, advocates of lower bank capital generate large estimates of the supposed economic costs of capital.

This argument is also flawed in that it ignores a number of critical additional factors:

- First, regulators and analysts already take into account the potential for an increase in the cost of lending due to capital in setting their capital requirements. Extensive modeling by the Basel Committee found that these costs were much lower than the economic benefits of increased capital in preventing financial crises and bank failure.[7] Other recent studies that incorporate the cost of lending have found that current capital requirements are likely below the economically optimal level.[8]

---

[6] See Cecchetti, Stephen G. and Kermit L. Schoenholtz, "Better capitalized banks lend more and lend better," www.moneyandbanking.com, December 5, 2016.
[7] https://www.bis.org/publ/bcbs173.pdf
[8] Firestone, Simon, Amy Lorenc, and Ben Ranish (2017), "An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the U.S.", Finance and Economics Discussion Series 2017-034. Washington: Board of Governors of the Federal Reserve System, https://doi.org/10.17016/FEDS.2017.034; Passmore, Wayne, and Alexander H. von Hafften (2017). "Are Basel's Capital Surcharges for Global Systemically Important Banks Too Small?," Finance and Economics Discussion Series 2017-021. Washington: Board of Governors of the Federal Reserve System, https://doi.org/10.17016/FEDS.2017.021

- Second, any increase in lending costs due to bank capital at a point in time must be balanced against the fact that better capitalized lending is more sustainable through the economic cycle. Even if a mandate for higher capital during an economic boom leads to some increase in the cost of lending during good economic times, it will make lending cheaper during an economic downturn by ensuring that banks are still solvent and able to lend.

- Third, it is questionable whether increases in mandated capital lead to significant general increases in lending costs at all. Interest rates in the economy are mostly determined by Federal Reserve monetary policy. When the Federal Reserve determines to keep interest costs low it is generally able to do so regardless of bank capital mandates. We have seen this over the period following the financial crisis, which saw record low interest rates despite increases in bank capital requirements. And in the current economic environment, if lowering bank capital requirements did lead banks to cut interest rates, the Federal Reserve would likely counteract this by increasing interest rates in accordance with its preferred monetary policy.

Bank lobbyists are free to plug any estimate of lending cost increases into models of the effect of bank capital, while ignoring the positive effects of bank capital in sustaining lending during a future economic downturn. Inflated estimates can easily generate frightening figures for the economic costs of capital requirements. But those figures are only as good as the assumptions that drive them.

Another argument for lowering bank capital standards in the U.S. is that our prudential standards exceed the prudential standards for European banks. But prudential standards are lower in Europe because the European banking system is in far worse shape than the U.S. banking system. Replicating the prudential decisions that led to the current weak state of European banking is clearly not in the interests of Americans who want to rely on a sound and healthy financial system. After the financial crisis, European regulators did not act as forcefully as U.S. regulators to strengthen oversight of their banks, because European banks were in a weaker position and were far more vulnerable to the European sovereign debt crisis that followed the global financial crisis. Today the European banking system is far weaker than the U.S. system, with banks less profitable and much greater fears of a potential banking crisis.[9] The rate of non-performing assets in European banks is triple the rate for U.S. banks.[10] The greater degree of safety and soundness of American banks – including their higher levels of capital – should be understood as a competitive advantage, not a disadvantage.

---

[9] The Economist, "American Banks Have Recovered Well, Many European Banks Much Less So", Economist Special Report, May 6, 2017; available at https://econ.st/2sek3hJ ; Davies, Paul, "Europe's Investment Banks Suffer America Envy", Wall Street Journal, July 28, 2017. Available at https://on.wsj.com/2uD1HJa

[10] Wackerbeck, Phillip, Benjamin Baur and Thornton Wegner, "The 1 Trillion Euro Challenge to European Banking", Price Waterhouse Coopers, November 8, 2017. Available at https://pwc.to/2mkD5Rz

Specific Controversies in Bank Regulatory Capital

Beyond these general arguments for lower capital, there are a host of specific controversies related to bank capital. Since banks have no incentive to point out cases in which regulators do not mandate enough capital relative to risks, these controversies almost invariably concern claims that regulators require too much capital relative to bank risk. Lowering capital through a host of specific challenges to particular rules has the advantage of obscurity. While some might contest whether banks in general should be less capitalized, very few people are equipped to argue whether the lookup tables under the Current Exposure Method (CEM) lead to excessive capital charges for cleared out-of-the-money options.

AFR has offered comments to regulators in many of these areas, including comments on proposed changes to stress testing requirements, on stress test principles, on leverage ratio requirements, on G-SIB surcharges and their relationship to cleared derivatives, on derivatives exposure measures, on the implementation of CECL accounting standards, and others. A selection of the most relevant comments are attached to this testimony and I will not reproduce their arguments here.[11]

However, I would like to offer some broad comment on the current direction of these controversies. Congress should be concerned that the current direction of bank lobbying and the regulatory response to it is leading to an excessive reliance on risk-based capital. Under the system of risk-based capital, banks are only required to hold capital against the regulators estimates of the specific risks of bank activities. This seems sensible in principle, but the problem is that both regulators and markets are often wrong about the future risks of bank activities. Indeed, it is rarely the expected and properly forecast economic risk that leads to a major downturn or crisis, but the unexpected and underestimated economic risk.

An overreliance on risk based capital requirements had disastrous consequences prior to the 2008 financial crisis. For example, regulators slashed risk-based capital requirements to negligible levels for the private mortgage backed securities that were at the heart of the financial crisis, which created a large incentive for banks to hold large amounts of these "toxic" securities.[12] Regulatory decisions like this fueled the creation of systemic risk before the crisis, showing the dangers of excessive reliance on regulatory judgements of risk.

There are two major elements of the post-crisis capital regime that could counterbalance the dangers of an excessive reliance on risk-based capital. These are the leverage ratio and an active

[11] Links to these comments as well as other AFR comments to regulatory agencies are available at http://ourfinancialsecurity.org/category/regulatory-comment-letters/

[12] OCC, Federal Reserve System, FCC, and Office of Thrift Supervision, "Risk Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitization", Federal Register, November 29, 2001. Available at https://bit.ly/2IvqLqw

and rigorous stress testing regime. I am concerned that both of these are being targeted for weakening by bank lobbying and that regulators have been overly responsive to this lobbying.

Leverage requirements for the most part do not use regulatory risk weights and thus guarantee that banks have a minimum level of equity capital even if their activities may currently be judged as "low risk". During the 2008 financial crisis, it was leverage ratios and not risk-based capital that forecast bank failure. To get a sense of the significance of the leverage ratio, note that at the end of 2017, the six largest U.S. banks had $13 trillion in exposures under the supplementary leverage ratio metric, but just $6.3 trillion in exposures subject to risk weighted capital requirements.[13] In other words, over half of potential risk exposures were not covered at all by risk weighted capital requirements.

Unfortunately, regulators have recently proposed to cut the already low leverage ratio requirement of 5 percent for major banks, on the argument that the leverage ratio should not be "binding" on bank activities because it does not incorporate regulatory risk judgements. This of course ignores the possibility that regulatory judgements could be wrong. As we saw prior to the financial crisis, incentivizing banks to put more weight on regulatory calculations of risk and allowing them to slash their equity capital by changing their balance sheet in accordance with such calculations is a dangerous course.

A rigorous and active stress testing regime could also counterbalance an excessive reliance on risk-based capital. However, stress testing is not easy to implement properly. As we saw with the OFHEO stress testing of the housing GSEs prior to the financial crisis, poorly implemented stress tests can be useless.[14] For stress tests to be effective, regulators must be willing to change scenarios frequently and test the impact of failures in assumptions that currently drive financial markets (such as the assumption before the 2008 crisis that there could not be a large nationwide drop in housing prices). Doing this is politically difficult and will inevitably be challenged by banks who do not wish to prepare for possibilities that they consider unlikely.

As discussed extensively in AFR comments on stress testing, it appears that regulators may be moving in the opposite direction, emphasizing stability and predictability in stress testing.[15] Banks are urging them in this direction as well, claiming that excessive "volatility" in stress testing results is somehow illegitimate. But a stress test that is fully stable and predictable is neither stressful nor a true test. Instead, such a "stress test" simply replicates the weaknesses of risk based capital by inducing banks to align their balance sheets with predictable regulatory expectations. The combination of more predictable stress tests and other cuts in stress test capital

[13] Data taken from December, 2017 Basel Pillar Three disclosures for Bank of America, Citigroup, Goldman Sachs, JP Morgan, Morgan Stanley, and Wells Fargo.
[14] For an analysis of what went wrong with these pre-crisis stress tests, see Frame, W. Scott and Gerardi, Kristopher and Willen, Paul, "The Failure of Supervisory Stress Testing: Fannie Mae, Freddie Mac, and OFHEO" (March 2015). FRB Atlanta Working Paper No. 2015-3. Available at https://ssrn.com/abstract=2593492http://dx.doi.org/10.2139/ssrn.2593492
[15] See AFR comment on Federal Reserve stress test principles and modeling, available at http://ourfinancialsecurity.org/wp-content/uploads/2018/02/AFR-Comment-on-Stress-Test-Proposal-Package.pdf

requirements proposed in the Federal Reserve's April proposal on Stress Capital Buffers threatens to undermine the protective value of the stress testing process.[16]

Finally, Congress should also be concerned about the adequacy of capital requirements for derivatives, including cleared derivatives. By their nature, derivatives are a contingent liability whose full risks are difficult to predict. Derivatives that can look very low risk in calm markets can create substantial losses in situations of market volatility and turbulence. A major and unpredicted increase in derivatives risk exposures in the months prior to the 2008 financial crisis – an increase in credit exposure of over $1 trillion in the second half of 2008 alone – was a major contributor to the financial crisis.

Banks are currently arguing for extremely low exposure measures and therefore extremely low capital requirements for derivatives, particularly cleared derivatives. These low capital requirements will encourage possibly excessive derivatives activities by banks and leave the public unprotected if derivatives risks again materialize in an unexpected way. In the specific case of cleared derivatives, while clearing represents a step forward in risk management, it does not obviate the need for capital to back clearing member positions. Clearinghouses are a risk management mechanism, not a way to make risk disappear. Derivatives risks continue to exist even when derivatives are cleared.

Congress should reject attempts to cut derivatives capital requirements, and should encourage regulators to keep these requirements strong as they write new rules to measure derivatives risk exposures.

[16] AFR comments on the Stress Capital Buffer proposal are available at http://ourfinancialsecurity.org/wp-content/uploads/2018/06/AFR-Education-Fund-Stress-Capital-Buffer-Comment-Letter.pdf

AFR Americans for Financial Reform

February 2, 2018

Ms. Ann Misback, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Docket No. OP-1586; OP-1587; OP-1588

Re: Federal Reserve Board request for comment on the package of proposed changes to the supervisory stress testing framework

Dear Ms. Misback,

On behalf of Americans for Financial Reform (AFR), thank you for the opportunity to comment on this package of proposals, which include a proposal on enhanced disclosure of stress test models (OP-1586), a proposed revision of the stress testing policy statement (OP-1587), and a new policy statement on the scenario design framework for stress tests (OP-1588).[1]

Below, we first offer a general assessment of stress testing, and then comment in more detail on each proposal.

<u>**Overview of Stress Testing**</u>

This comprehensive package of proposals offers the opportunity for a broader assessment of stress testing, its strengths and weaknesses as a central element of capital regulation, and how it might be improved going forward.

There is general agreement that the original Federal Reserve 2009 crisis-era Supervisory Capital Assessment Program (SCAP) stress tests were a successful supervisory exercise. These stress tests, conducted during the worst of the crisis and coupled with a promise of government support to banks linked to stress test findings, were successful in restoring market confidence by providing better information regarding unrecognized losses on bank portfolios.

However, as many have pointed out since then, such "wartime" stress tests conducted during a financial crisis are quite different than the challenges presented by ongoing "peacetime" stress tests used as a supervisory tool in normal times.[2] In stress tests conducted during a financial crisis, there is some understanding of the specific market pressures causing the financial crisis,

[1] Americans for Financial Reform is an unprecedented coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups. A list of AFR members is available at http://ourfinancialsecurity.org/about/our-coalition/

[2] Schuermann, Til, "Stress Testing in Wartime and in Peacetime", January 24, 2016. Available at SSRN: https://ssrn.com/abstract=2735895 or http://dx.doi.org/10.2139/ssrn.2735895

and the issue is credibly sizing the losses that could eventually occur from this scenario. Furthermore, there is usually strong political support for forcing banks to recognize losses from the emerging or ongoing crisis. As shown by the less successful European banking stress tests conducted in 2009 and 2010, these factors are not always enough to guarantee a successful "wartime" stress test, but they certainly make such stress tests more likely to be effective.

In contrast, using "peacetime", non-crisis stress tests as a standard tool of capital regulation raises more complex issues. Scenario selection becomes critical, including specific assumptions about how asset or trading markets are likely to be affected by broad macro scenarios. But the enormous range of possible scenarios means there is an unavoidably arbitrary aspect to such selection. There is less political support for aggressive scenarios that create significant losses for banks, and more pressure to make loss forecasts for stress tests routine and stable so that banks can engage in predictable capital planning.

Yet if stress test loss modeling becomes routine and predictable, stress testing becomes less dynamic and more similar to other forms of static capital regulation such as capital charges on risk-weighted assets. A stress test that was substantively unchanging from year to year, and where transparent and predictable loss factors were applied to assets in a routine stress scenario, would simply lead banks to hold capital in line with well-understood stress test model predictions for their portfolio. Such model predictions would be equivalent to known risk weights on portfolio assets. Just as banks do with risk weights, they would adapt their portfolios to regulatory stress testing models, investing more heavily in assets that are predicted to have lower losses and taking on tail risks that do not materialize in typical stress scenarios.[3] The benefits of stress testing as a dynamic forward-looking process that could reflect changes in financial risks over the economic cycle would be lost.

Demands by banks that stress tests be made "fully" transparent and predictable to the companies they affect are effectively demands that stress testing be downgraded into another form of static risk-based capital regulation. The Board should not accede to the desire for predictability in capital planning and agree to make stress tests a routinized compliance exercise. Stress tests should remain "surprising". Both macro scenarios and modeling choices down to the asset level should change from year to year to reflect current market vulnerabilities. Regulators should fully exploit the potential of stress testing to "lean against the wind" in sometimes unexpected ways and counter-balance the inherently pro-cyclical nature of capital regulation. Providing a form of counter-cyclical regulation that moderates destabilizing financial cycles of boom and bust should be an explicit goal of a stress test regime.

These are not simply theoretical concerns. There are some disturbing signs that in recent years banks have begun to adapt to CCAR stress testing, and that testing has become more routinized and projected losses have declined. In a 2015 paper, the economist Til Schuermann found that

---

3 Jarrow, Robert A., "Capital Adequacy Rules, Catastrophic Firm Failure, and Systemic Risk", Johnson School Research Paper Series No. 5-2012, June 14, 2012 Available at https://ssrn.com/abstract=2084200. This paper describes the mathematical similarities between stress tests, capital adequacy ratios, and value-at-risk models where stress test scenarios do not incorporate tail risks.

banks were managing capital buffers more closely to projected stress test results, which were becoming more predictable.[4]

Over the years since, the level of CCAR stress on bank capital, as measured by stress test losses, has visibly declined. An AFR analysis performed after the 2017 stress tests, the first in which all banks passed the test, found a long term decline in the stringency of the CCAR tests. (The full AFR analysis is attached as an appendix to these comments).

Specifically, our analysis found that:

- Between 2015 and 2017, projected CCAR losses due to the stress scenario have steadily declined, from 510 basis points of risk-based capital in 2015 to 330 basis points in 2017.

- Over this period, capital distributions permitted to shareholders have also steadily increased.

- Average and peak losses projected under the stress scenario in 2017 were significantly lower than the losses observed during the 2008-10 financial crisis.

Notably, these shifts occurred even as the macroeconomic scenario for the stress tests become more stringent, with greater declines in GDP and greater increases in unemployment in 2017 than 2015.[5]

There could be a number of reasons for the decline in the "stressfulness" of the stress tests relative to past years and to financial crisis losses. These include changes in bank portfolios, either as a result of optimizing to predicted stress test capital charges or due to shifts in the economic cycle, changes in regulatory modeling decisions that are not reflected in the overall macro scenario, or both. But the apparent decline in the stringency of stress tests is concerning.

It is especially noteworthy that projected capital losses due to the stress tests have been declining as the economic cycle is turning up and economic growth is increasing. This implies that there may be some pro-cyclicality in elements of stress test models or policy decisions that are not reflected in the overall macro scenario, which has not become more lenient.

Below, we provide more detailed comments on each proposal.

---

[4] Gutierrez Gallardo, German and Schuermann, Til and Duane, Michael, "Stress Testing Convergence", July 28, 2015. Available at https://ssrn.com/abstract=2636984

[5] For details of macroeconomic scenarios, see Table 1 of the Scenario Design proposal for stress testing, Docket Number OP – 1588.

Americans for Financial Reform
1620 L Street NW 11th Floor Washington, DC 20006 | 202.466.1885 | ourfinancialsecurity.org

Comments on Enhanced Disclosure of Stress Test Models – Docket OP-1586

Costs and Benefits of Stress Test Discloosures

Stress test modeling disclosures create both costs and benefits. A potential cost of very detailed disclosures is that banks may over-adjust their portfolio decisions to the parameters of stress test models. This would exacerbate the problem of "model mono-culture" in which banks are encouraged to invest excessively in assets or strategies whose risks have been underestimated by regulatory models, and under-invest in situations where risks are overestimated by regulators.

Excessive disclosures may also compromise the independence of stress tests and create opportunities for banks to lobby to change specific model parameters to prevent modeling decisions that would project losses on their balance sheets. In the case of stress tests performed at the Federal Housing Finance Agency (FHFA) prior to the financial crisis, the effect of such politicization was disastrous, as it basically prevented stress tests of the GSEs from adjusting to changing market conditions.[6]

Permitting stress test models to be issued as proposals under notice and comment rules in the Administrative Procedures Act would be particularly harmful to stress test independence. Such a process would permit regulated banks to get extensive advance notice of model details and also to challenge specific parameters in court. This would create what would almost amount to veto power for regulated institutions as regards specific parameters and decisions in stress test models, or at least empower regulated to institutions to procedurally delay the implementation of model elements they disapproved of for a very significant period.

But there are also significant benefits to public transparency around stress test models. Without such transparency, it will be difficult or impossible for the public to understand whether stress testing is genuinely "stressful", in the sense of using scenarios and modeling assumptions that test the durability of the financial system to unexpected but plausible shocks to asset prices and trading strategies. Transparency may also lead to valuable informational input and feedback for regulators from academics, market analysts, and other unbiased observers. Managed correctly, public transparency for a variety of stakeholders can also assist in creating public and political support for rigorous stress testing.

We believe the benefits of stress test model disclosures are maximized and the costs are minimized when:

1) such disclosures take place after stress tests are completed (post-test as opposed to pre-test disclosures), and

2) stress test modeling assumptions vary from year to year to reflect current market conditions, and test the durability of bank portfolios to unexpected shocks.

---

[6] Frame, W. Scott, Kristopher Gerardi, and Paul Willen, "The Failure of Supervisory Stress Testing: Fannie Mae, Freddie Mac, and OFHEO", Federal Reserve Bank of Atlanta Working Paper 2015-3, March, 2015. Available at https://www.frbatlanta.org/research/publications/wp/2015/03.aspx

Americans for Financial Reform
1620 L Street NW 11th Floor Washington, DC 20006 | 202.466.1885 | ourfinancialsecurity.org

Post-test transparency minimizes opportunities for banks to either adjust their portfolios or attempt to change specific model parameters or assumptions using political pressure. Post-test transparency may of course also be mined for predictions of the next year's modeling practices. But if modeling assumptions tend to shift from year to year, post-test disclosure will be less informative as to next year's modeling assumptions, and banks will adapt less to the model. In contrast, if stress test modeling assumptions are very stable, then post-test disclosure of each year's model assumptions will be highly informative as to the next year's model assumptions.

Recommendation for Annual Stress Test Disclosure Conference / Convening

We also believe that the net benefits of stress test disclosures are maximized when such disclosures are not directed solely at regulated entities, but are designed for maximum inclusion of the public and unbiased experts who are not tied to regulated entities. The costs of stress test disclosures are due to the ways in which they can distort decision making by regulated entities, or compromise stress test independence by empowering regulated entities to manipulate the tests. Many of the benefits are created by public involvement, including independent feedback on analytic decisions and enhanced political support for more rigorous stress testing.

In practice, stress testing is far more visible to the regulated entities subject to it, as regular contact and discussion with regulators concerning the details of stress tests is necessary during the testing process. Unless regulators choose to engage in active outreach to the public to counterbalance this structural advantage, stress tests will be far more transparent to regulated insiders than the public.

We recommend that the Board convene an annual stress test conference to discuss current and upcoming scenario and modeling choices in stress testing, as well as the role of stress testing in financial regulation more broadly. The goal of such a conference should not simply be to discuss technical modeling issues, but to discuss with the public and interested experts the policy choices made in stress testing and how these choices can make the financial sector and indeed the broader economy more stable and less vulnerable to damaging financial instability.

Currently, the Boston Federal Reserve holds an annual conference on stress test modeling, with a focus on technical presentations regarding current cutting edge techniques in the field. This conference is valuable, and could serve as the nucleus for the kind of convening suggested here. But a broader conference on stress test transparency would involve outreach to a broader range of invitees and would include a more general discussion of the policy and modeling choices involved in stress testing.

Assessment of Specific Proposed Disclosures

In our view, the model disclosures laid out in this proposal are likely to be beneficial in the aggregate and do not risk significant costs of the type discussed above.

As we understand the proposal, these disclosures would be given on a post-test basis. The disclosures regarding the structure of the loan loss modeling are fairly generic and do not contain an excessive level of detail. The proposal to disclose post-test projected loan losses by category of loan, either through hypothetical portfolios or through other means, are more detailed. However, they are critical in helping the public understand whether macro scenarios lead to realistic levels of loan losses. Overall, we believe that the proposed disclosures would be helpful to organizations like ours, to analysts, and to academics in understanding whether stress tests have been well conducted.

Recommended Additions to Proposed Disclosures, Including Market Shock Disclosures

The usefulness of the projected loan loss disclosures would be enhanced if the Board also disclosed two additional items of information with them:

- The first would be aggregated portfolio information for major banks by type of loan, so that the public could understand which types of loans were most important drivers of projected stress test losses. Many banks voluntarily disclose portfolio loss rates for different types of loans already, so this should not be a major step.

- It would also be useful if the Board accompanied projected loan loss rates with historical data on actual loan loss rates for each class of loan in previous historical stress periods. This would be useful in assisting the public in interpreting the results, and does not raise any confidentiality concerns.

We also recommend that the Board expand the kind of disclosures laid out for loan loss modeling to other areas of stress testing where we believe disclosures are inadequate.

In particular, we recommend expanded disclosures for the results of the aggregate market shock, which determines trading losses at banks with significant trading books. Currently market shock disclosures are limited to the risk factor changes that compose the market shock. Banks also disclose their total aggregate losses for the trading and counterparty shock combined.

However, the conversion of the market shock risk factors to projected monetary losses is performed by the bank itself using its own internal models, as the Board apparently does not have the resources to model the impact of risk factor changes on bank trading positions. The exclusive use of these internal models would seem to clash with the principle of stress test independence and create what is effectively a "black box" process from the public perspective. This disclosure proposal does not appear to recommend any additional disclosure regarding the market shock calculation.

We realize that it would probably be impractical and would raise confidentiality concerns to release the actual internal bank models. However, disclosures for the market shock could still be significantly improved in the following manner:

- Bank trading losses should be reported separately from the counterparty shock losses, so that the public can understand which losses come from the counterparty shock and which from the trading scenario.

Americans for Financial Reform
1620 L Street NW 11th Floor Washington, DC 20006 | 202.466.1885 | ourfinancialsecurity.org

- Bank trading losses should be disclosed at the trading desk level. The current practice of releasing a single aggregated figure does not give any information as to which trading markets were most severely impacted by the shock. Banks are already required to gather information at the trading desk level to comply with the Volcker Rule, and release some information as to the desk structure of their trading operations in the Basel Pillar 3 disclosures.[7] We would suggest a fairly detailed mapping of trading desk structure corresponding to earlier Basel Pillar 3 disclosure proposals, and also that losses be reported at the trading desk level both as an absolute figure and as a percentage of inventory.[8]

- Although it is impractical to release actual bank models, some qualitative information as to the type of internal bank model used to project losses should be shared with the public. It is especially important to have some understanding of how tail risk losses were modeled. For example, was an expected shortfall approach used? How conservative was the loss modeling approach?

In addition, information should be shared as to the treatment under the Market Shock scenario of available-for-sale securities that are typically marked to market by banks. There is an argument that the Market Shock or a similar scenario should apply to all securities that are marked to market, unless it is clear that banks will be permitted to diverge from mark to market accounting in a time of economic stress.

Reliance on Credit Ratings Should Be Avoided in Projecting Losses for Securitized Products

The model descriptions in this disclosure proposal make clear that the Board relies on credit ratings issued by companies such as Moodys and Standard and Poors (National Recognized Statistical Ratings Organizations, or NRSROs) as an important independent variable in projecting losses for both corporate bonds and securitized products.

As is well known, the failure of NRSROs (credit rating agencies) to properly assess the risks of securitized products was a major driver of the 2008 financial crisis. As the Financial Crisis Inquiry Commission (FCIC) stated in its report conclusions:[9]

> "credit rating agencies were essential cogs in the wheel of financial destruction. The three credit rating agencies were key enablers of the financial meltdown. The mortgage-related securities at the heart of the crisis could not have been marketed and sold without their seal of approval. Investors relied on them, often blindly. In some cases, they were

[7] Bank for International Settlements, Standards: Pillar 3 Disclosure Requirements, Consolidated and Enhanced Framework, March, 2017. Available at https://www.bis.org/bcbs/publ/d400.pdf
[8] Bank for International Settlements, Consultative Document: Pillar 3 Disclosure Requirements, Consolidated and Enhanced Framework, March, 2016, https://www.bis.org/bcbs/publ/d356.pdf
[9] The Financial Crisis Inquiry Commission, The Financial Crisis Inquiry Report, January, 2011. Available at http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf . See also Permanent Subcommittee on Investigations, Wall Street and the Financial Crisis: Anatomy of a Financial Crisis, United States Senate Committee on Homeland Security and Government Affairs, April 13, 2011.

Americans for Financial Reform
1620 L Street NW 11th Floor Washington, DC 20006 | 202.466.1885 | ourfinancialsecurity.org

> obligated to use them, or regulatory capital standards were hinged on them. This crisis could not have happened without the rating agencies."

In fact, the performance of the NRSROs was so unreliable that Section 939A of the Dodd-Frank Act required regulatory agencies to remove references to commercial credit ratings and to instead substitute an independent standard for credit worthiness.

Whether or not the use of credit ratings in stress test models violates Section 939A, we believe that the Board should modify its procedures to reduce reliance on ratings as a predictor of performance, particularly for securitized products. While Dodd-Frank nominally introduced a number of reforms in the oversight of NRSROs, these reforms have been implemented in a flawed and incomplete manner.[10] Furthermore, none of the reforms implemented address the fundamental issue of the conflicts in the business model of ratings agencies, who are paid by the issuers of the securities they rate. Issues concerning ratings are especially salient in the area of securitized products, both due to the complexity of these products and the fact that individual issuers may issue numerous securitized products, making the business relationship with the issuer critical to the future revenue stream of the NRSRO.

We recommend that the Board significantly reduce its reliance on credit ratings, and increase internal capacity to understand features of securitized products that influence how such products respond to market stress. Had such capacity been in place prior to the financial crisis, then supervisors might have been able to better understand, for example, the flawed correlation assumptions in pre-crisis MBS and CDOs. The possibility of triggering liquidity backstops for supposedly off balance sheet products might also have been predicted.

This knowledge should be used to increase the sophistication of loss projections for securitized products. Currently, such projections appear to simply forecast impairment based on historical losses in products with similar asset classes and ratings. However, changes in the design and terms of complex securitized products could limit the applicability of such historical projections. While we realize that the Board does not have the resources for individually rating all securities, there could be significant benefits from research on the design of securitized products, supported by more detailed information gathered from banks on the features of such products.

Comments on the Stress Testing Policy Statement – Docket OP-1587

There are several broad principles included in the stress testing policy statement that we strongly support, several that we have concerns about, and we would also recommend adding an additional principle (counter-cyclicality) to stress test model policies.

We Support the Principles of Independence, Conservatism, and Credit Supply Maintenance

We strongly support the maintenance and aggressive implementation of these principles.

[10] Gaillard, Norbert and William J. Harrington, "Efficient, Commonsense Actions to Foster Fair Credit Ratings", *Capital Markets Law Journal*, Volume 11, No. 1, 2016.

Principle 1.1. Independence. The striking failure of bank internal models during the financial crisis showed the need for better model risk governance and for a strong independent check on bank models.[11] The abuse of internal model governance seen in the JP Morgan London Whale trades in 2012 showed that some of these issues continued after the crisis.[12] Although regulatory models are not perfect, regulators do not face the immediate profit-related conflicts of interest that banks may face in validating their own internal models. The discipline of doing independent regulatory modeling of bank risks and losses is also beneficial to regulators in helping them perform supervisory oversight of bank internal modeling.

Even given the Board's efforts to maintain the principle of independence, stress testing is still heavily reliant on bank internal modeling. In the previous section we discussed the reliance on bank internal modeling in determining market shock losses. Analysts have also observed that there are some 200 line items in the data reported to the Board in the FR Y-14A for CCAR analysis that require model estimation by reporting banks.[13] Such reliance is probably to some degree unavoidable. But absent a strongly held principle that stress testing should be a truly independent check on internal bank risk assessments it would become even more significant.

Principle 1.6. Conservatism. The massive economic costs of a financial collapse, as well as the strong political pressure from powerful industry interests for more lenient tests, argue for a commitment to erring on the conservative side in assessing risks to bank solvency. Serious and independent cost-benefit analyses consistently show that, based on current levels of bank capital, there is little to no risk of creating large net social costs by practicing conservative risk assessments during stress testing.[14] We strongly endorse the principle of conservative risk assessment.

But as discussed in the introductory section above, the decline in the projected stress test losses during recent years raises questions as to whether this principle is being fully observed in practice.

Model Policy 2.7. Credit Supply Maintenance. As the Proposal observes, the Board's goal of ensuring that banks continue to perform crucial credit intermediation functions during a downturn requires the assumption that banks will not meet capital ratio goals by shrinking their balance sheets. The requirement that banks maintain or increase their current balance sheet size during the projected stress test period is certainly a necessity to enforce this assumption. Absent this requirement, the Board would essentially be building a credit crunch into its stress test projections. The experience of stress tests before this requirement was put in place in 2014 shows

[11] Brown, Jeffrey, Brad McGourty and Til Schuermann, Til, "Model Risk and the Great Financial Crisis: The Rise of Modern Model Risk Management", Wharton Financial Institutions Center Working Paper No. 15-01, January 7, 2015. Available at SSRN: https://ssrn.com/abstract=2557213

[12] United States Senate Subcommittee on Investigations, "JP Morgan Chase Whale Trades: A Case History of Derivatives Risks", March 15, 2013. http://online.wsj.com/public/resources/documents/JPMWhalePSI.pdf

[13] Brown, *op. cit.*, p. 7

[14] Firestone, Simon and Lorenc, Amy and Ranish, Benjamin, "An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the US" FEDS Working Paper No. 2017-034, March 31, 2017. Available at https://ssrn.com/abstract=2946814

Americans for Financial Reform
1620 L Street NW 11th Floor Washington, DC 20006 | 202.466.1885 | ourfinancialsecurity.org

that banks will frequently attempt to meet capital minimums by projecting that their balance sheets will shrink during a recession.[15]

However, we do not believe that simply requiring that banks maintain current asset size during a projected stress period is sufficient to ensure that banks are sufficiently capitalized to properly serve their credit intermediation function during severe stress. First, total commercial bank asset size has typically increased even over recessionary periods, indicating that some increase in bank portfolios is necessary to fuel economic growth.[16] Second, a number of factors may lead to unplanned increases in bank portfolio size during a downturn, including greater use of undrawn loan commitments and the sudden shutdown in markets for the sale and distribution of loans. It would thus be safer and more conservative to assume some increase in asset size during a recession.

Further, the failure to include capital buffers, such as the G-SIB buffer, in stress tests also calls into question the commitment to the principle of credit supply maintenance. In an actual economic downturn, banks will have an incentive to maintain capital buffers in order to continue paying out dividends and bonuses, as well as encourage market confidence. A bank which is only able to maintain a capital ratio below the full buffer requirements based on a stable balance sheet will therefore have a significant incentive to reduce its balance sheet in an actual recession. Including capital conservation buffers in stress test requirements will encourage credit supply maintenance. The Board should include capital buffers in its stress test scenarios, as the failure to maintain such a buffer in an actual stress scenario would create significant incentives to reduce the balance sheet.

Principles Involving Stability, the Phasing in of Material Model Changes, and Limiting Reliance on Past Outcomes May Lead to Excessively Static Stress Tests

We are concerned that several of the policy principles here will hamper the ability of the Board to use stress testing to respond rapidly to changes in economic cycles, even if such response is called for. While these principles are reasonable in many circumstances, in others they may not be. Stating them as overarching principles could reduce needed flexibility and lead to stress tests that are too static and not responsive to changes in market conditions.

Principle 1.5. Robustness and Stability. In this principle, the Board states its intent that supervisory model projections should be stable and should not vary according to "transitory factors" or "temporary changes". It also states that newly available data should not be the "principal driver" of changes in results.

However, the financial system and the economy are not stable. Financial risks can emerge rapidly and single years of data can provide important advance warning of changes in model relationships. For example, FICO scores for subprime borrowers increased between 2000 and 2006. But the performance of the later loan cohorts was radically worse than earlier cohorts, and

[15] Federal Reserve Board of Governors, "Federal Reserve Independent Balance Sheet and RWA Projections", December 16, 2013. Available at https://www.federalreserve.gov/bankinforeg/independent-projections-letter-20131216.pdf
[16] See bank assets time series available at https://fred.stlouisfed.org/series/TLAACBW027SBOG

Americans for Financial Reform
1620 L Street NW 11th Floor Washington, DC 20006 | 202.466.1885 | ourfinancialsecurity.org

FICO scores became significantly less predictive of loan performance.[17] If a stress testing system had been in place prior to the financial crisis, the ability to rapidly incorporate e.g. 2006 loan performance data could have been very important in ensuring that banks retained earnings against upcoming stress losses.

Principle 1.5 is stated in a fairly general way, and, all other things equal, stability might be a desirable quality in stress testing. But especially combined with other supervisory model policies stated in the Proposal elevating stability to a central principle is likely to reinforce a tendency toward excessively static stress tests.

Modeling Principle 2.3, Phasing in of Highly Material Model Changes and elements of **Modeling Principle 2.4, Limiting Reliance on Past Outcomes** would both delay the incorporation of material new data into the modeling process. Principle 2.3 requires that any change that affects model results in a significant way, apparently including the incorporation of newly available data, be phased in over a two year period. During the first year, only half the impact of the change would be included in the projection, and the full impact would be incorporated in the second year. Principle 2.4 limits reliance on past outcomes, including outcomes in the recent past, by sharply restricting the use of modeling techniques that reflect recent changes in asset level performance (e.g. loan vintage fixed effects).

Policies that limit reliance on data from the recent past can be of value insofar as they prevent over-adjusting stress test models to recent periods that show low volatility in asset prices and benign market conditions. However, we are concerned that the blanket application of these policies may lead to stress tests that are too static and are delayed in reflecting turns in the economic cycle. Had a stress test regime been in place in 2007, the combination of these policies would have made it significantly more difficult to incorporate the 2006 indicators of a severe approaching downturn.

Contrary to the emphasis on static stress testing in these principles, there are indications in other proposals that the Board recognizes that it may in some cases be necessary to rapidly incorporate new information and significantly change stress tests in a short period of time. Most notably, the proposal on Scenario Design states that it may be necessary to "add salient risks to the severely adverse scenario" based on current market conditions.[18] The Scenario Design proposal discussion of formulating market shocks also mentions the need to introduce hypothetical elements based on current market conditions.

It is unclear how these elements would work with the emphasis on stability in the proposal on Stress Test Principles. For example, would a new salient risk added to the severely adverse scenario have to be phased in over two years, as required by Modeling Principle 2.3? Does the Robustness and Stability Principle 1.5 imply that such a new salient risk could not be the "principal driver of a change in results?" In any case, the fact that the various elements mentioned as part of scenario design are not elevated to the status of principles governing overall

[17] Sengupta, Rajdeep and Bhardwaj, Geetesh, "Credit Scoring and Loan Default", International Review of Finance, Vol. 15, Issue 2, pp. 139-167, June, 2015. Available at SSRN: https://ssrn.com/abstract=2613721
[18] Section 4.2.4 of the Proposal, in the discussion of "Approach for Formulating the Macroeconomic Assumptions for Scenarios", CFR 59543.

Americans for Financial Reform
1620 L Street NW 11th Floor Washington, DC 20006 | 202.466.1885 | ourfinancialsecurity.org

stress testing indicates that they will be given lower priority than principles which require more static stress test projections. We believe this would be a mistake. Stress test principles should give greater weight to the need to reflect emerging market risks.

The Board Should Add an Explicit Commitment to Counter-Cyclical Policy in Its Stress Test Policy Statement and Its Model Policies

There is broad consensus that financial system pro-cyclicality was a major contributor to the 2008 economic and financial crisis, and that the system of capital regulation contributed to that pro-cyclicality.[19] Accounting-based capital measures, and many measures used to set market risk capital such as Value at Risk (VAR), are inherently pro-cyclical. Such metrics are heavily influenced by current asset prices, which are systematically overstated in boom periods. Static risk weights on capital do not reflect such overpricing.

A major potential benefit of stress testing is that it can act as a counterweight to cyclicality, requiring banks to raise capital in boom times when it is easier to do so and ensuring that banks are adequately capitalized to provide financial intermediation during downturns and recessions. But doing so requires stress test scenarios and models that are dynamic and that actively incorporate assumptions that currently elevated asset prices and trading markets may revert to long-term historic trends or mean values.

Almost all the explicit discussion of counter-cyclicality in stress testing in these Proposals occurs in the Scenario Design proposal, which discusses the issue in the context of setting macro scenario variables such as unemployment and economic growth. The approach seems to be to ensure counter-cyclicality by choice of macro scenario variables, for example by assuming a greater increase in unemployment in periods where unemployment is low. However, the key question is how macro variables are converted into predicted stress losses at the asset level. As documented in the attached appendix, projected stress capital losses have declined steadily between 2015 and 2017, even though the projected unemployment rate increase grew over that period from 4 to 5.3%, and the projected decline in GDP increased from 4.7 to 6.6%.

We suggest incorporating counter-cyclicality as a stated principle governing stress testing policy as a whole, and also a stated policy governing model design. The explicit commitment to counter-cyclicality would help make clear the Board's commitment to dynamic stress testing that ensures that the financial system is robust to even rapid and unexpected economic downturns. It would also legitimate departures from more stable modeling assumptions at times when such departures were justified due to extremes in the economic cycle.

The inclusion of counter-cyclicality in modeling principles would encourage the design of models that incorporate counter-cyclical assumptions directly at the asset level. The models presented in the various proposals appear to model asset losses simply as a function of changes in macro scenario variables. Such models do not incorporate counter-cyclical assumptions. Absent adjustment, they would project that the impact of a change in a macro scenario variable will have a similar effect on asset values regardless of the current state of the asset market.

[19] Financial Stability Forum, "Report of the Financial Stability Forum on Addressing Pro-Cyclicality in the Financial System", April 2, 2009. Available at http://www.fsb.org/wp-content/uploads/r_0904a.pdf

In contrast, there are many examples of stress test models that directly incorporate counter-cyclicality into model design by assuming some form of mean reversion to historical trends in asset prices. For example, the Federal Housing Finance Administration (FHFA) has experimented for years with models that include countercyclical house price assumptions.[20] Another, more complex, example is the recent work on explicitly incorporating market valuation bubbles into credit risk assessment, with projected stress losses being greater during a market bubble.[21]

These models have the feature of automatically projecting greater losses when particular asset classes diverge from historical trends or appear to have particularly inflated values. This would encourage more capital to be raised during overheated markets, when it is easier to raise capital, and work to correct inflated measures of accounting capital during such periods. We suggest that the Board explore such counter-cyclical modeling options.

Comments on Stress Testing Scenario Design – Docket OP-1588

A number of issues related to scenario design have already been discussed in the previous section on stress testing principles. In particular:

- We support the principle of counter-cyclicality in scenario design. This principle mandates larger shocks to the macro variables for stress test scenarios conducted in a strong economy when cyclical systemic risks are high, and possibly smaller shocks when the economy is already weak or contracting. This approach appears to be included in the Scenario Design proposal.

  However, we believe that to ensure counter-cyclicality it is necessary to look beyond the broadest macro variables such as unemployment and economic growth and consider trend reversion in asset and trading markets in a more detailed way. We urge incorporating counter-cyclical principles into overall stress testing and model policy in order to do this.

- We support the inclusion of currently salient market risks in adverse scenarios, and indeed believe that such inclusion is critical if stress tests are to be sufficiently dynamic. As stated above, we believe that some modification to the proposed stress testing principles that strongly emphasize stable models and outcomes is needed to ensure that currently salient market risks are incorporated into stress tests as often or as forcefully as may be necessary.

---

[20] Smith, Scott and Jesse Weiher, "Countercyclical Capital Regime: A Proposed Design and Empirical Evaluation," *Federal Housing Finance Agency*, Working Paper No. 12-2, April, 2012. https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2151484

[21] Jacobs, M., Jr.."The Impact of Asset Price Bubbles on Credit Risk Measures". *Journal of Financial Risk Management* 4, 251–266 , November 30, 2015, http://doi.org/b4w7; Jacobs, M. Jr, "Asset Price Bubbles and the Quantification of Credit Risk Capital with Sensitivity Analysis, Empirical Implementation, and an Application to Stress Testing", *Journal of Risk Model Validation,* 11(4), December, 2017.

Americans for Financial Reform
1620 L Street NW 11th Floor Washington, DC 20006 | 202.466.1885 | ourfinancialsecurity.org

We Strongly Support the Proposed Inclusion of Changes in Wholesale Funding Costs in Stress Test Scenarios

There can be no doubt that changes in the cost and availability of funding, especially short-term wholesale funding, is a major feature of market stress on banks in the real world. Adding to an immense amount of previous descriptive and academic evidence, recent empirical research has found that challenges to bank solvency have a strong and rapid impact on bank funding costs, which in turn increase capital losses in a vicious cycle.[22] The current practice of simply not including these funding cost effects in stress scenarios is a glaring omission and one that is long overdue for correction.

Question number three asks which variables specifically should be used to represent changes to funding costs or availability in stress test scenarios. There is an extensive empirical literature on this, much of it summarized or referenced in the article cited in the previous paragraph. We will not attempt to analyze it here. But a sensible place to start would be with the various liquidity classifications used for the Liquidity Coverage Ratio (LCR) and the Net Stable Funding Ratio (NSFR), which classify funding sources based on their stability under stress.

Supervisors could assume that liquidity sources with limited residual maturity that are classified as particularly likely to "run" – especially funding provided by other financial entities that monitor their counterparties closely – will increase in cost or become unavailable as capital losses increase. It would be reasonable to introduce some non-linearity in funding availability as a bank comes close to insolvency, meaning that banks with projected capital positions close to the regulatory minimum could experience a sharper increase in funding costs.

Modeling House Prices in the Macro Scenario

The proposal requests comment on the use of the ratio of house prices to per capita income as a metric for housing prices in the macro scenario. The use of per capita income does not assess the affordability of a home for the average family, as per capita income is not a distribution sensitive measure. It would be better to use the ratio of house prices to median income, or else a price to rent ratio in order to assess housing price costs relative to the costs of housing services.

Thank you for the opportunity to comment on these proposals. If you have questions, please contact AFR's Policy Director, Marcus Stanley, at marcus@ourfinancialsecurity.org or 202-466-3672. Thank you for your attention to this letter.

Sincerely,

Americans for Financial Reform

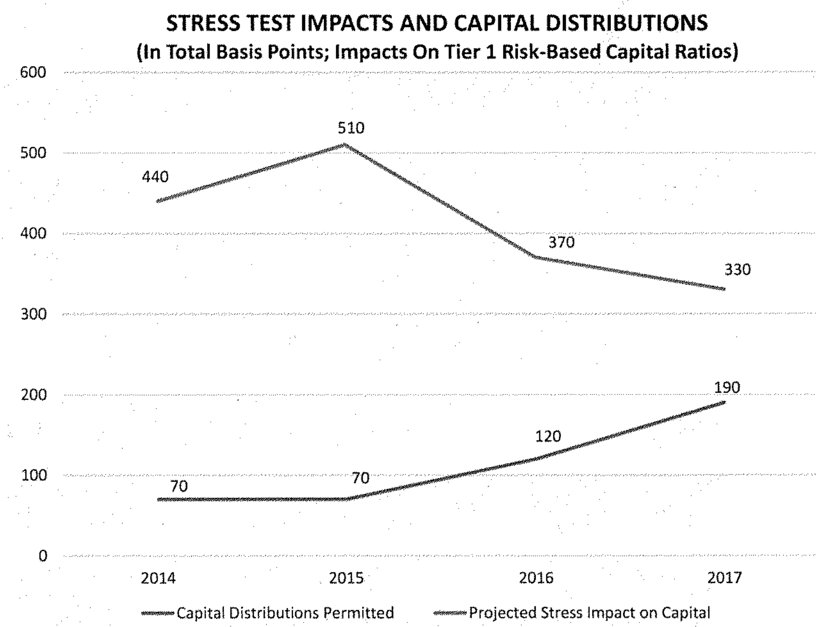
---

[22] Schmitz, Stephan, Michael Sigmund and Laura Valderrama, "Bank Solvency and Funding Costs: New Data and New Results", IMF Working Paper WP/17/116, May, 2017. Available at https://www.imf.org/~/media/Files/Publications/WP/2017/wp17116.ashx . Also, Dent, Kiernan, Sinem Hoke and Apostolos Panegiotopoulos, "Solvency and Funding Costs: Interactions at U.K. Banks", Bank of England Working Paper 681, October 13, 2017. Available at https://www.bankofengland.co.uk/working-paper/2017/solvency-and-wholesale-funding-cost-interactions-at-uk-banks

Appendix To Stress Test Disclosure Comment: AFR Assessment of 2017 Stress Test Results

The 2017 Stress Tests Appear Less Stressful Than Ever

- 2017 stress tests permitted banks to return more capital than ever before (190 basis points of risk-based capital).
- Stress models also had the lowest impact on bank capital recorded in recent years. The stress scenario reduced bank capital by just 330 BP.



Source and impacts: DFAST and CCAR releases from Federal Reserve, 2014-2017. Capital returns estimated by comparing projected DFAST risk-based ratios without capital distributions to CCAR ratios with capital distribution. Stress test impacts estimated by comparing starting risk-based ratios to minimum projected risk-based ratios during stress periods.

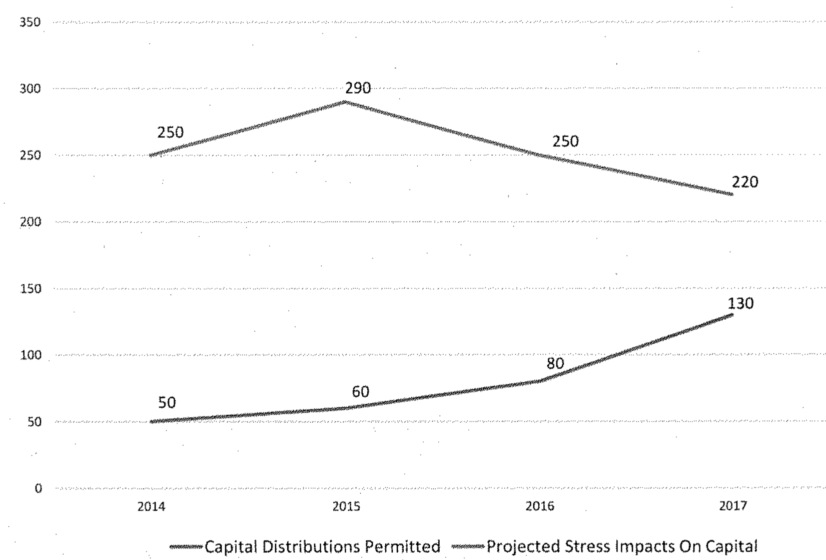
AFR Americans for Financial Reform

Similar Impacts for Leverage Ratios

- Findings are not due to changes in risk weights over the period.
- Returns as a fraction of leverage capital were at an all-time high (130 BP) and modeled stress was less "stressful" than ever (220 BP).

SOURCES AND NOTES: DFAST and CCAR releases from Federal Reserve, 2014-2017. Capital returns estimated by comparing projected DFAST leverage ratios without capital distributions to CCAR ratios with capital distribution. Stress test impacts estimated by comparing starting leverage ratios to minimum projected risk-based ratios during stress periods.

STRESS TEST IMPACTS AND CAPITAL RATIOS
(In Total Basis Points; Impact on Tier 1 Leverage Ratios)



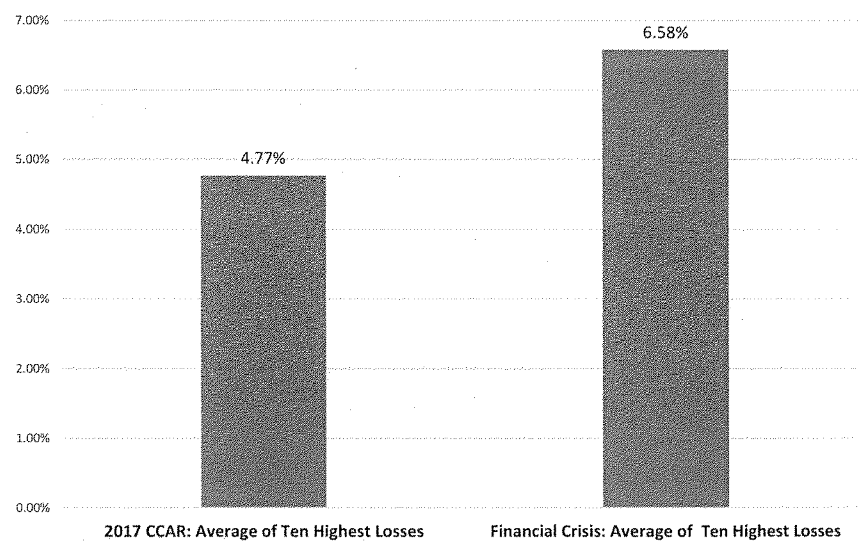
Americans for Financial Reform

2017 CCAR Model Losses Lower Than Financial Crisis Losses

- The average 2017 CCAR modeled loss of 3.3% was far below the 6.58% average loss at the top ten largest banks in the 2008 financial crisis, as estimated by the Boston Fed.
- Comparing the average of the top ten largest losses in the CCAR to the top ten estimated losses in the 2008 financial crisis also gives a far lower figure.
- The Boston Federal Reserve estimates of are likely a ***significant underestimate*** as they do not take into account all government assistance.

SOURCES: 2017 Federal Reserve CCAR Release; Strah, Scott, Jennifer Hynes and Sanders Shaffer, "The Impact of the Recent Crisis On The Capital Positions of Large Financial Institutions", Working Paper, Federal Reserve Bank of Boston, July 16, 2013. See chart on page 17

Average of Highest Losses: 2017 CCAR Compared to Financial Crisis
(Risk Based Capital; Estimated Crisis Loss From Boston Federal Reserve Study)

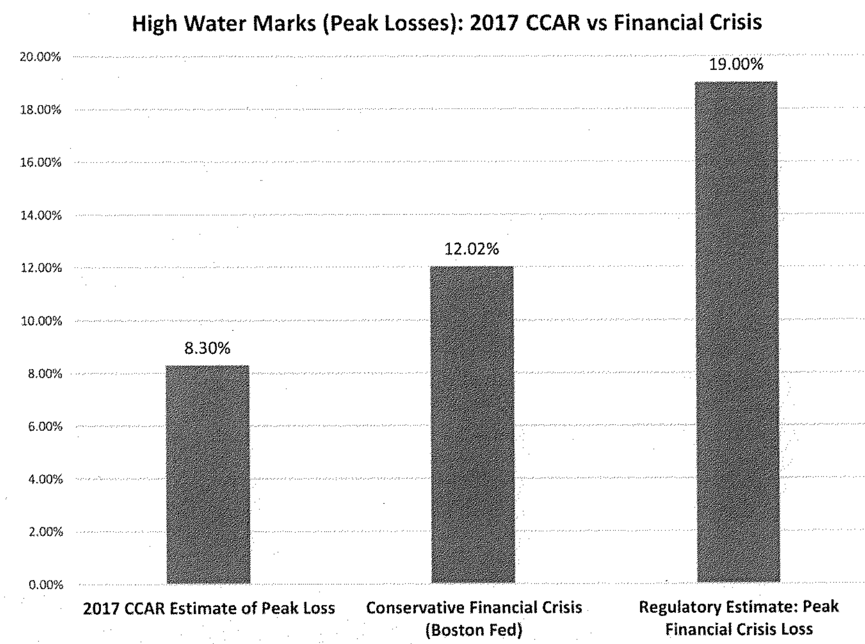


AFR Americans for Financial Reform

2017 CCAR Model Losses Lower Than Financial Crisis Losses

- 2017 CCAR estimate of the highest financial crisis loss (peak loss at any major bank) is much lower than financial crisis peak loss.
- Regulators' best estimate of 2008 financial crisis peak losses, including effects of government assistance, is 19 percent. (Calibration exercise performed for the TLAC rule)

SOURCES AND NOTES: 2017 Federal Reserve CCAR Release; Strah, Scott, Jennifer Hynes and Sanders Shaffer, "The Impact of the Recent Crisis On The Capital Positions of Large Financial Institutions", Working Paper, Federal Reserve Bank of Boston, July 16, 2013. CFR 8274 in Federal Reserve Board of Governors, "Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements", Final Rule, Federal Reserve System 12 CFR 252, Federal Register Volume 82, Number 14, January 24, 2017. Peak losses estimated as highest loss in risk-based capital at any major bank.



AFR Americans for Financial Reform

AFR Americans for Financial Reform
Education Fund

June 25, 2018

Ann E. Misback, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

RE: Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules (RIN 7100-AF 02)

Dear Ms. Misback:

On behalf of Americans for Financial Reform Education Fund ("AFR"), we are writing to comment on proposed changes (the "proposal") by the Federal Reserve Board of Governors (the "Board") that would modify regulatory capital and stress test rules to merge the current stress testing process with regulatory capital rules by instituting a Stress Capital Buffer (SCB) .[1]

AFR has previously commented extensively on stress test rules.[2] Many of the issues and concerns raised in the previous comment are relevant to questions in this proposal and we will refer back to them in this comment where relevant.

We generally support the core structural change in this proposal -- converting the capital stress generated from regulatory stress testing into a new SCB that is incorporated into the regulatory capital rules and replaces the current capital conservation buffer. We also support the requirement that the new SCB be floored at the current 2.5% level of the capital conservation buffer, so that the shift to a SCB could not reduce current capital requirements as compared to the current capital conservation buffer.

However, we are concerned about several changes proposed in this rule that would have the effect of reducing total capital requirements. We are also concerned about questions in the proposal that seem to indicate additional measures could be added in the final rule which would also represent effective cuts in capital requirements.

This proposal estimates that based on 2015-2017 data, the aggregate effect of the proposed changes would represent an increase of from $10 billion to $50 billion in capital for U.S. Globally Systemically Important Banks (G-SIBs), and a decline of up to $45 billion in non-G-SIB capital. In the proposal to change the enhanced supplementary leverage ratio (eSLR), there is another estimate of capital impacts, which claims that the combination of this SCB proposal and the proposed cuts to the eSLR would reduce aggregate G-SIB capital by $400 million. We

[1] The Americans for Financial Reform Education Fund brings together an unprecedented coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups. A list of AFR members is available at http://ourfinancialsecurity.org/about/our-coalition/.

[2] Americans for Financial Reform, "Comment on Stress Test Proposal Package", February, 2018. Available at https://bit.ly/2Is44n7

would note that an independent analyst report by Goldman Sachs runs counter to these estimates, and calculates that this SCB proposal alone would increase aggregate distributable capital by $54 billion for G-SIBs (i.e. reduce G-SIB capital by $54 billion).[3]

The difference in these estimates shows the range of impacts this proposal could have, and also the potentially very significant effect of the elements of the proposal that reduce capital for the nation's largest and most systemically significant banks. These elements include:

1) The assumption of a stable balance sheet (constant risk weighted assets) through the stress period.

2) The change from prefunding nine quarters of dividends and share buybacks to pre-funding just four quarters of dividends.

3) The shift from requiring banks to meet Supplementary Leverage Ratio (SLR) requirements under stress to meeting Tier 1 Leverage requirements under stress.

We oppose all three of these changes and, for the reasons explained below, believe all three are analytically unjustified. We are also concerned that other parts of the proposal, most notably Question 23 in the proposal, seem to suggest that additional changes could be made in the final rule that would further reduce stressed capital requirements, perhaps significantly.

Assumption of a stable balance sheet: As we noted in our previous comment on stress test modeling and disclosures, we do not believe that the assumption of a stable balance sheet is stringent enough for the Board to meet its stated goal of ensuring that banks are sufficiently capitalized to continue their credit intermediation function during a recession. First, as noted in the proposal itself, total commercial bank asset size has typically increased even over recessionary periods, indicating that some increase in bank portfolios is necessary to fuel economic growth.[4] Second, a number of factors may lead to unplanned increases in bank portfolio size during a downturn, including greater use of undrawn loan commitments and the sudden shutdown in markets for the sale and distribution of loans.

We would also note that increases in regulatory risk weights may take place during an extended recession which would have the effect of increasing total risk weighted assets.

It would thus be far safer and more conservative to assume some increase in asset size during a recession. Without such an assumption, banks may not have sufficient capital to address unplanned increases in the balance sheet and new demands for credit while maintaining regulatory capital minimums.

[3] Ramsden, Richard et. al, "CCAR Stress Capital Buffer Proposal Expected to be Constructive for Large Banks", Goldman Sachs Equity Research, April 11, 2018.
[4] See bank assets time series available at https://fred.stlouisfed.org/series/TLAACBW027SBOG

Americans for Financial Reform Education Fund
1615 L Street NW Suite 450 Washington, DC 20006 | 202.466.1885 | ourfinancialsecurity.org

Shift from prefunding nine quarters of dividends and share buybacks to prefunding just four quarters of dividends. During the financial crisis period, dividend payments for most banks were interrupted for a period of at least three full years while banks rebuilt their capital buffers.[5] Dividends for some large systemically significant banks were interrupted even longer. This points to the sensible and properly conservative nature of extending the scope of stress test modeling to at least nine quarters of dividends, as opposed to the four quarters proposed here. This is especially true since the payment of dividends may be helpful in maintaining investor confidence during a crisis.

The proposed rule would also end the pre-funding of share buybacks, on the argument that banks voluntarily halted share buybacks prior to and during the financial crisis, while they did not halt dividends.[6] However, the research cited in the proposal (Hirtle, 2016) does not support the conclusion that it is entirely unnecessary to pre-fund share repurchases.[7] Figure 2 in the cited paper shows that, while share repurchases were halted prior to dividend payments, banks continued share repurchases well into what should have been understood as a period of financial stress. For example, Figure 2 shows that share repurchases actually exceeded dividend payments for large bank holding companies during the first half of 2007, and repurchases remained at a significant level through the first quarter of 2008.

Perhaps even more important, the exclusion of share repurchases in this proposal would represent a significant change from the circumstances that prevailed during the 2005-2009 period covered by the cited research. The exclusion of share repurchases from strict capital planning would give banks an incentive to return money to shareholders through repurchases rather than dividends. The research cited in the proposal hypothesizes that the difference between bank behavior with respect to dividends and behavior with respect to share repurchases is due to the fact that at the time dividends were more expected by the market than share repurchases, and were thus the preferred route to signal credibility to investors. But market expectations can clearly change.

We believe the Board should continue to require banks to prefund share buybacks and should extend the four quarters of prefunding required in this proposal.

Shift from Supplemental Leverage Ratio (SLR) to Tier 1 Leverage Ratio: In the current stress test and capital planning process, banks are required to meet the required SLR of 3 percent after projected stress losses. This proposal does include a Stress Leverage Buffer along with the SCB to represent the requirement that banks meet leverage capital requirements as well as risk-

[5] Schwartz, Nelson and Eric Dash, "Banks Poised to Pay Dividends After Three Year Gap", New York Times, January 13, 2011. Available at https://nyti.ms/2KlAG3w
[6] CFR 18163 and footnote 20.
[7] Hirtle, Beverley, "Bank Holding Company Dividends and Repurchases During the Crisis", Federal Reserve Bank of New York Staff Report 666, Revised April, 2016. https://nyfed.org/2KapUBd

weighted capital requirements when under stress. However, the relevant leverage buffer is based on Tier 1 leverage instead of the supplementary leverage ratio.

The difference between Tier 1 leverage and the SLR is very significant. The Tier 1 leverage ratio includes only on-balance sheet assets, while the SLR includes exposures that are technically off balance sheet but may result in risk exposure to the bank (e.g. may return to the balance sheet under stress). Many of the risks that materialized during the 2008 financial crisis were technically off balance sheet but in fact returned to create losses to the bank.

By effectively removing the stressed SLR requirement and replacing it with a stressed Tier 1 leverage requirement, the proposal would significantly reduce stress leverage requirements. Of course, banks must still meet the SLR requirement on a spot basis (they must still be in excess of the SLR and relevant eSLR in order to meet capital distribution pre-requisites). However, technically off balance sheet risk exposures would no longer be subject to stress test modeling under this proposal. Not only would this reduce the effective stress on the bank, it reduces regulatory flexibility in stress test scenario design and stress test modeling. We strongly oppose this change.

Responses to Questions

Question 5: How should the Board contemplate the appropriate level of the countercyclical capital buffer in light of the proposal?

When set, the countercyclical capital buffer should be incorporated directly into the spot capital requirements as an additional add-on to the base capital requirement and the stress capital buffer. We strongly disagree with the idea that the countercyclical capital buffer is repetitive or redundant when combined with the stress capital buffer. The stress capital buffer is a modeling exercise while the countercyclical capital buffer is a direct add-on intended to force banks to hold additional capital at peak periods of the economic cycle. As discussed in AFR's previously submitted comment on stress testing (*supra* note 2), it is far from clear that the current stress testing process is fully effective as a counter-cyclical measure. Furthermore, the difference between the methods of calculation and application of the countercyclical capital buffer and the stress buffer would render them complementary in any case.

Question 6: What aspects of the calculation of the stress buffer requirements could be modified to increase the effectiveness of the proposal in ensuring that firms maintain stress buffer requirements that are appropriately sized to withstand stressful economic and financial conditions while permitting such firms to continue lending and supporting the real economy?

See the discussion above. We suggest that the Board assume at least some growth of risk-weighted assets during a stress period, incorporate share repurchases into capital planning and extend the capital planning period beyond four quarters, and base the Leverage Capital Buffer on the SLR instead of the Tier 1 leverage ratio.

Question 23: What, if any, other changes to CCAR or the capital plan rule should the Board consider? For example, what advantages or disadvantages would be associated with:

- *i.* *Removing or adjusting the provisions that allow the Board to object to a large and complex or LISCC firm's capital plan on the basis of qualitative deficiencies in the firm's capital planning process;*
- *ii.* *Publishing for notice and comment the severely adverse scenario used in calculating a firm's stress buffer requirements;*
- *iii.* *Providing additional flexibility for a firm to exceed the capital distributions included in its capital plan if its earnings and capital ratios are above those in its BHC baseline; or*
- *iv.* *Providing additional flexibility to a firm to increase the planned capital actions above what was included in its original capital plan based on the results of the supervisory stress test or request for reconsideration?*

Taking these questions in order:

- i. It is crucial that the Board maintain the capacity to object to LISCC firm's capital for qualitative deficiencies in capital planning. Numerous elements of the stress test modeling process depend directly on the capacity of large banks to aggregate and model their risks. If such capacity is deficient, the balance sheet data and (especially) the trading loss data submitted to the Board may be false and misleading, rendering results of the stress test doubtful at best. A qualitative assessment of the firm's planning capacities is therefore a critical part of the stress testing process.

- ii. We do not believe it would be helpful to subject key elements of the stress test to direct lobbying and possible legal challenge as would occur through the notice and comment process. This issue is discussed in our previous comment on stress testing. Opening the detailed scenario or the details of the stress test models to notice and comment challenge is likely to lead banks to delay or overturn changes in the stress tests that reflect current market conditions, as occurred for GSE stress tests prior to the financial crisis. It is also likely to lead to a "model monoculture" where banks align their risk decisions closely to Federal Reserve models.

- iii. This proposal already substantially increases the flexibility granted to individual bank holding companies to interact with the Federal Reserve and either lobby to change its stress capital buffer or to adjust its capital plan. Increasing such flexibility still further by permitting the firm to exceed planned capital distributions would be entirely inappropriate.

Thank you for the opportunity to comment on these proposals. If you have questions, please contact AFR's Policy Director, Marcus Stanley, at marcus@ourfinancialsecurity.org or 202-466-3672. Thank you for your attention to this letter.

Sincerely,

Americans for Financial Reform Education Fund

Americans for Financial Reform
Education Fund

June 25, 2018

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street SW, Suite 3E-218
Washington, DC 20219

Ms. Ann Misback, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Docket ID OCC-2018-0002; Docket No. R-1604

Re: Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for U.S. Global Systemically Important Holding Companies and Certain of Their Subsidiary Insured Depository Institutions; Total Loss-Absorbing Capacity Requirements for U.S. Global Systemically Important Bank Holding Companies

To Whom It May Concern:

On behalf of the Americans for Financial Reform Education Fund ("AFR"), thank you for the opportunity to comment on these proposed changes to regulatory capital rules (the "proposal").[1] For reasons made clear below, AFR opposes this proposal to cut the minimum required leverage ratio at systemically critical banks.

If implemented, this proposal would represent a major shift in the current capital regime for the largest U.S. banks. It would cut the current required enhanced supplementary leverage ratio (eSLR) from its current level of five percent at the holding company level and six percent at the insured depository to a new level of three percent plus half of the risk-based capital surcharge for each global systemically important bank (G-SIB). Current G-SIB surcharges range from 1 to 3.5 percentage points, so this proposal would slash the eSLR at all of the largest U.S. banks. It would cut minimum required leverage at the bank holding company level between 5 percent (JP Morgan) and 25 percent (BNY Mellon and State Street). More significantly, it would cut required leverage ratios by 21 percent to 38 percent at the insured depository subsidiaries of these companies.

These cuts are likely to have a major impact. The leverage ratio is the only capital requirement that applies fully and directly to all bank activities, as opposed to just those activities that regulators judge to be risky. This makes the leverage ratio particularly critical. There is a long

[1] The Americans for Financial Reform Education Fund brings together an unprecedented coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups. A list of AFR members is available at http://ourfinancialsecurity.org/about/our-coalition/

Americans for Financial Reform Education Fund
1615 L Street NW Suite 450 Washington, DC 20006 | 202.466.1885 | ourfinancialsecurity.org

history of failures in regulatory judgement of risk. Such failures were a major contributor to the 2008 financial crisis. By the time of the 2008 crisis regulatory risk measurements had diverged so far from the reality of market risks that risk-based capital ratios were completely uncorrelated with bank failure, while unadjusted leverage capital ratios were strongly correlated with bank solvency.[2] Investors lost faith in risk-based regulatory capital figures, hardly surprising since banks like Lehman Brothers were reporting Tier 1 capital ratios of over ten percent just weeks before their failure.

In the years prior to the financial crisis, regulators specifically acted to slash risk-based capital requirements to negligible levels for the private mortgage backed securities that were at the heart of the financial crisis, encouraging banks to hold large amounts of these "toxic" securities.[3] Regulatory decisions like this fueled the creation of systemic risk before the crisis, showing the dangers of excessive reliance on regulatory judgements of risk and how such reliance can actively create additional systemic risk.

Current market data continues to show that leverage capital plays a critical role in controlling bank risks. At the end of 2017, the six largest U.S. banks had $13 trillion in exposures under the supplementary leverage ratio metric, but just $6.3 trillion in exposures subject to risk weighted capital requirements.[4] In other words, over half of potential risk exposures were not covered at all by risk weighted capital requirements. Cutting leverage requirements for G-SIBs thus means that the majority of exposures at the largest and most complex banks will have lower equity requirements in their funding.

The proposal offers impact estimates that minimize the effect of the cuts in leverage requirements. It estimates that were this proposal to be implemented today in combination with the Stress Capital Buffer rules also recently proposed, affected bank holding companies would only be able to return $400 million to shareholders.[5] However, this estimate appears to reflect only the effect of cutting required leverage capital based on the current composition of bank balance sheets. As the proposal itself makes clear, the point of cutting the leverage ratio is

---

[2] Some of the research that establishes this finding includes International Monetary Fund (IMF), 2009, "Global Financial Stability Report, Chapter 3, Detecting Systemic Risk", Washington, April 2009; Detragiache, Enrica, Asli Demirguc-Kunt, and Ouarda Merrouche, 2010, "Bank Capital: Lessons from the Financial Crisis", IMF Working Paper 10/286, Washington: International Monetary Fund, December 2010; Haldane, Andrew G., 2012, "The Dog and the Frisbee", Bank of England Speech 596, presented at the Federal Reserve Bank of Kansas City's 36th economic policy symposium, Jackson Hole, Wyoming; Mayes, David G. and Stremmel, Hanno, 2012, "The Effectiveness of Capital Adequacy Measures in Predicting Bank Distress" , 2013 Financial Markets & Corporate Governance Conference; Brealey, Richard A., Ian A. Cooper, and Evi Kaplanis, 2011, "International Propagation of the Credit Crisis" , SSRN Working Paper, April, 2011; Berger, Allen N., and Christa H.S. Bouwman, 2013, "How Does Capital Affect Bank Performance During Financial Crises?", Journal of Financial Economics (JFE), Volume 109, Issue 1, July 2013 Blundell-Wignall, Adrian and Caroline Roulet, 2013, "Business models of banks, leverage and the distance-to-default", OECD Journal No. 103: Financial Market Trends, Vol 2012-2; Hogan, Thomas L., Neil Meredith, Zuhao Pan, 2013, "The Failure of Risk-Basked Capital Regulation," Fairfax: Mercatus Center at George Mason University

[3] OCC, Federal Reserve System, FCC, and Office of Thrift Supervision, "Risk Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitization", Federal Register, November 29, 2001. Available at https://bit.ly/2IvqLqw

[4] Data taken from December, 2017 Basel Pillar Three disclosures for Bank of America, Citigroup, Goldman Sachs, JP Morgan, Morgan Stanley, and Wells Fargo.

[5] CFR 17321 and footnote 27.

precisely to facilitate banks changing their balance sheets by adding more so-called "low risk" activities and funding such activities with more borrowed money than they are currently permitted to. Thus, while current aggregate capital may decline by only $400 million, the ratio of aggregate capital to aggregate bank exposures may decline by significantly more.

Furthermore, the proposal also cites the estimate that equity held at insured depository institutions (IDI) within the holding company will decline by over $120 billion due to the proposed changes in the proposal.[6] This is a truly major decline. The IDI should not be viewed as interchangeable with the rest of the bank holding company, so that capital can freely be shifted throughout the bank as needed. The depository institution is directly within the Federal safety net in a way that other parts of the holding company are not. Since IDI depository liabilities are directly insured by the Federal government, it is far more difficult to resolve the IDI without public subsidy.

AFR believes that the effects of these cuts would be significant, and that they are not justified by arguments set out in the proposal. Specifically, the claim in the proposal that the leverage ratio must be calibrated as a "backstop" to the current risk-based capital ratio does not justify cuts in the current leverage ratio. First, the proposal fails to properly assess the costs of a "binding" leverage ratio at major banks and also fails to demonstrate that these costs exceed the costs of having a lower leverage ratio requirement. Second, even if the leverage ratio should be used as a backstop, the proposal fails to examine the alternative of simply raising the risk-based capital ratio. There is extensive evidence that risk-based capital ratios, particularly for G-SIBs, are likely too low. Below, we discuss these points in more detail.

Calibration of the Leverage Ratio to the Risk-Based Capital Ratio

The major justification given for cutting the leverage ratio in the proposal is that the leverage ratio should be a "backstop" to the risk weighted capital ratio and should not be "binding" on bank decision making. The leverage ratio is binding in cases where the total amount of capital required for a bank holding company's portfolio under the leverage ratio requirement exceeds the total amount of capital required under risk-weighted capital requirements. In such cases, a bank's marginal investment decision will be made based on the leverage ratio metric of risk, which applies an equal capital charge to all investments. Conversely, if the total amount of capital required under risk-weighted charges exceeds leverage capital requirements, then the leverage ratio is not binding and marginal investment decisions will be made based on regulatory risk weights.

The proposal claims that a binding leverage ratio will impose significant costs because banks will be risk insensitive when they make marginal decisions based on the leverage ratio metric, but will be properly risk sensitive when they choose based on the regulatory risk weights incorporated in risk-weighted capital. Specifically, the proposal states that a binding leverage ratio will create "incentives for firms to reduce participation in or increase costs for low-risk, low-return businesses, which may have an adverse effect on safety and soundness". The Board

[6] CFR 17321 and footnote 29.

Americans for Financial Reform Education Fund
1615 L Street NW Suite 450 Washington, DC 20006 | 202.466.1885 | ourfinancialsecurity.org

and the OCC are therefore cutting the supplementary leverage ratio to "help ensure that leverage ratio requirements generally serve as a backstop to risk-based capital requirements".[7]

No quantitative analysis is given to back the assertion that leverage ratio requirements must play a subordinate, backstop role to risk-based capital requirements. There are several reasons to believe that the assertion is at least significantly overstated. Some of the reasons are laid out in a recent (2017) study by the European Central Bank, which, unlike this proposal, directly examined the effects on bank risk-taking of a binding leverage ratio.[8] The study found that banks newly subject to a binding leverage ratio increased their risk-weighted assets to total assets ratio by around two percentage points more than they otherwise would without a leverage ratio, but that this relatively positive minor effect was outweighed by the effect of holding more capital. On net, the study found that introduction of the supplementary leverage ratio significantly lowered the risk of failure for banks affected by a binding leverage ratio.

The authors give several reasons why the leverage ratio still worked to improve bank safety and soundness in this case. First, banks' marginal incentives to take on investments with high risk weights under a binding leverage ratio are not unlimited. They operate only on the margin. As banks increase their investments in assets with high risk weights, the absolute level of capital required under the risk-weighted charges will increase and eventually the leverage ratio will no longer be binding. The claim in this proposal that cuts in the leverage ratio would only permit bank holding companies to release $400 million in capital indicates that, at least at the holding company level, banks are already close to the crossover point and have limited scope to take on investments with a higher risk weight at the current level of the eSLR.

Second, the absolute increase in overall required capital under the leverage ratio itself acts to constrain bank risk taking, by ensuring that bank equity holders have more "skin in the game" than they would under a less stringent capital regime.

While the ECB study examines the European capital rules, it is conceptually highly applicable to the U.S. situation. The ECB study findings imply that despite the unsupported claims in the proposal, lowering leverage ratios could and likely would increase bank risk of failure. It is puzzling that the agencies have not performed a similar analysis for U.S. banks.

Beyond the issues laid out in the ECB study, the proposal also does not take seriously the likelihood that the leverage ratio will restrict activities that are in fact risky and, as in the 2008 financial crisis, risk-based capital will again fail to properly assess such activities. There is only one mention in the proposal of the possibility that the leverage ratio could protect "against underestimation of risk both by banking organizations and by risk-based capital requirements". Beyond this single mention, the assumption in the proposal is that the leverage ratio constrains banks from "lower-risk, lower return businesses". This is despite the fact that during the financial

---

[7] CFR 17320

[8] Smith, Jonathan Acosta, Michael Grill, and Jan Lang, "The Leverage Ratio, Risk-Taking, and Bank Stability", European Central Bank, Working Paper No, 2079, June, 2017. Available at https://bit.ly/2N0kEhp

crisis the activities that showed the greatest losses were precisely those that were expected to carry the least risk and were treated as low-risk under risk based capital rules.[9]

The specific examples given in the proposal of so-called "lower risk" businesses that would be facilitated by cutting the leverage ratio are "secured repo financing, central clearing for market participants, and taking custody deposits for clients". It is ironic that the agencies would call these businesses "lower risk", since these markets in fact pose significant systemic risk.

Many economists believe that breakdowns in the system of secured repo financing were critical during the financial crisis. A post-crisis white paper by the New York Federal Reserve stated that breakdowns in the tri-party repo market "had the potential to destabilize the financial system", and that the Federal Reserve was forced to take "extraordinary actions" such as providing large amounts of direct financial assistance to primary dealers in order to "avert a collapse in confidence in the tri-party repo market".[10]

As for derivatives central clearing, no one disputes that the failure of a bank that was a clearing member of a major derivatives central counterparty (CCP) would create enormous risk to the financial system, and that this risk increases with the volume of cleared derivatives. As a recent report by the Commodity Futures Trading Commission (CFTC), puts it, "A clearinghouse will incur market risk only if and when a clearing member fails to meet a payment obligation to the clearinghouse. The credit risk that a clearinghouse takes is thus also that of its members....clearing members are essential to the functioning of a clearinghouse".[11] A failure of a major derivatives CCP would in turn have enormous implications across the financial system. A recent Treasury report on capital markets stated that "CCPs are critical infrastructures...that continue to pose systemic risks...and are uniquely interconnected with other U.S. financial institutions".[12]

It may be that regulators view individual repo or cleared derivatives transactions as lower risk even though the overall infrastructures for repo transactions and derivatives clearing are clearly systemically risky and their failure could have catastrophic consequences. We suggest that this is a short-sighted view. The solvency of the private banks at the heart of the system of derivatives clearing and repo transactions is directly connected to the stability of the relevant infrastructures. At the very least, regulators owe the public a detailed explanation of how and why they believe that reducing capital requirements for derivatives clearing, secured repo transactions, and other similar activities would not increase risk to the systemically critical infrastructure for these activities. Such an explanation could, for example, explain whether and how margin requirements in the relevant markets were adequate to protect against the public despite the significant cut in underlying equity capital that backs them which is proposed here.

---

9 See page 6 and following in Hannoun, Herve, "The Basel III Capital Framework: A Decisive Breakthrough", Speech at Seminar on Financial Regulation, Hong Kong, December 22, 2010. Available at https://www.bis.org/speeches/sp101125a.htm

10 https://www.newyorkfed.org/medialibrary/media/banking/nyfrb_triparty_whitepaper.pdf

11 Commodity Futures Trading Commission, Supervisory Stress Test of Clearinghouses. A Report By Staff, November, 2016. http://bit.ly/2Aozueg

12 U.S. Department of the Treasury, A Financial System That Creates Economic Opportunites: Capital Markets, October, 2017. http://bit.ly/2fPPMR3

Risk Based Capital Requirements are Too Low

Even if one were to accept that a binding leverage ratio has significant social costs – and as discussed above, we do not believe this is supported by compelling evidence – an alternative way to ensure that the risk based capital ratio is binding is simply to increase risk-based capital requirements. This would change the relationship between leverage and risk-based capital requirements while increasing or at least maintaining overall capital ratios.

There is ample analytical evidence that current risk-based capital levels are too low from a cost-benefit perspective. Cost-benefit analyses of capital requirements are highly model and assumption dependent, and we realize that such estimates can be questioned. But there is by now a large and impressive academic literature finding that current risk based capital levels, including the G-SIB surcharges at the largest systemically critical banks affected by this proposal, are either at the low end or clearly below the range of socially optimal levels. This literature includes several academic papers from Federal Reserve staff.[13] An extensive literature review from the Peterson Institute finds that current equity capital requirements are about one-third too low.[14] Other research by expert and reputable sources such as the Federal Reserve Bank of Minneapolis finds that current capital requirements are even farther below the socially optimal level and should be drastically increased to avert the costs of potential financial crisis.[15] The clear indication from this research is that the optimal way to align leverage ratios with risk based capital ratios is not to slash leverage ratio requirements, but to increase risk-based capital requirements.

The weight of the literature points clearly to the conclusion that cutting the absolute ratio of capital to total exposures, as this proposal would do, is not justified by the evidence and would be socially harmful. It is striking that the Agencies appear not even to have considered the option of increasing capital requirements or to have analyzed the research on this issue.

Other Questions

Question 1: To what extent would the proposed eSLR standards appropriately balance the need for regulatory standards that enhance systemic stability with the long-term goal of credit availability, efficiency, and business growth? What alternatives, if any, should the Board and the OCC consider that would more appropriately strike this balance?

---

[13] Firestone, Simon, Amy Lorenc, and Ben Ranish (2017), "An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the U.S.", Finance and Economics Discussion Series 2017-034. Washington: Board of Governors of the Federal Reserve System, https://doi.org/10.17016/FEDS.2017.034; Passmore, Wayne, and Alexander H. von Hafften (2017). "Are Basel's Capital Surcharges for Global Systemically Important Banks Too Small?," Finance and Economics Discussion Series 2017-021. Washington: Board of Governors of the Federal Reserve System, https://doi.org/10.17016/FEDS.2017.021

[14] Cline, William, The Right Balance for Banks: Theory and Evidence on Optimal Capital Requirements, The Peterson Institute, May, 2017.

[15] https://www.minneapolisfed.org/research/staff-reports/capital-requirements-and-bailouts ; https://www.minneapolisfed.org/~/media/files/publications/studies/endingtbtf/the-minneapolis-plan/the-minneapolis-plan-to-end-too-big-to-fail-2016.pdf?la=en

Americans for Financial Reform Education Fund
1615 L Street NW Suite 450 Washington, DC 20006 | 202.466.1885 | ourfinancialsecurity.org

If the Board and the OCC wish to change the calibration of the leverage ratio to risk-based capital, they should consider the option of increasing risk-based capital rather than cutting leverage ratio requirements.

Question 2: How would the proposed calibtration of the eSLR standards affect business decisions of GSIBs and covered IDIs?

As the proposal indicates, the change in the eSLR standards would increase incentives for GSIBs and covered IDIs to expand businesses that have low equity funding requirements under risk-based capital rules. These businesses range from cleared derivatives to dealing in sovereign debt with a zero risk weight. The Federal Reserve and OCC should consider whether these businesses are truly "low risk" as described in the proposal, particularly when funded with larger amounts of leverage.

Question 5: Should the Board and the OCC consider alternative approaches to address the relative bindingness of leverage requirements to risk-based capital requirements for certain firms? Specifically, what are the benefits and drawbacks of excluding central bank reserves from the denominator of the supplementary leverage ratio as an alternative to the proposal?

We would be concerned that the exclusion of central bank reserves would undermine the purpose of the leverage ratio as a guarantee that all exposures of the bank are backed with equity capital. While central bank reserves are government-backed and are not exposed to immediate risk of loss, we would be concerned that such reserves could be re-deployed rapidly in ways that would not be reflected immediately in leverage ratio calculations.

We also urge the Federal Reserve and the OCC to take steps to address the interaction of this proposal with recently passed legislation (S 2155) that would exclude central bank reserves associated with activity by custody banks from the leverage ratio. In combination with the very large reduction in the eSLR that would be created by this proposal, the implementation of S 2155 would reduce leverage ratios at custody banks well below the 3 percent requirement faced by non-GSIB banks. Since custody banks play a systemically critical role in finance, this would be entirely inappropriate. In light of the passage of S 2155, this proposal should at least be significantly modified to reduce or eliminate the leverage ratio reductions for custody banks.

Thank you for the opportunity to comment on these proposals. If you have questions, please contact AFR's Policy Director, Marcus Stanley, at marcus@ourfinancialsecurity.org or 202-466-3672. Thank you for your attention to this letter.

Sincerely,

Americans for Financial Reform Education Fund

AFR Americans for Financial Reform

Education Fund

July 13, 2018

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street SW
Washington, DC 20219

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

Ms. Ann E. Misback
Secretary Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Docket ID OCC-2018-0009; Docket No. R–1605 and RIN 7100–AF04; and RIN 3064-AE74.

RE: Regulatory Capital Rules: Implementation and Transition of the Current Expected Credit Losses Methodology for Allowances and Related Adjustments to the Regulatory Capital Rules and Conforming Amendments to Other Regulations.

To Whom It May Concern:

Americans for Financial Reform Education Fund (AFR) appreciates the opportunity to comment on the above referenced proposed rule (the proposed rule or the proposal) by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (together, the agencies).[1]

We generally support the manner in which this proposal provides for the implementation of the Current Expected Credit Losses (CECL) methodology. We particularly support the agencies decision to properly reflect the impact of CECL implementation on Tier 1 equity capital, without artificially reducing required equity capital in a manner that would reduce the effect of CECL implementation on the total resources banks set aside in advance to absorb losses.

[1] Americans for Financial Reform is an unprecedented coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith-based and business groups. A list of coalition members is available at: http://ourfinancialsecurity.org/about/our-coalition/

Americans for Financial Reform
Education Fund
1615 L Street NW, Suite 450, Washington, D.C. 20036 | 202.466.1885 | ourfinancialsecurity.org

The new CECL accounting standards will replace the current approach, commonly known as the "incurred loss" methodology, to shift the way banking organizations estimate and record their credit losses. Under CECL, upon recording a loan, banks will be required to recognize the expected credit losses over the entire lifetime of the loan, forecasting these losses using a combination of historical data and the impact of current and predicted future economic conditions. This is a change from the current method of recognizing credit losses that have actually been incurred or that have crossed a probability threshold for recognition.

With these methodological changes, the CECL framework will result in earlier recognition of credit losses. If effectively implemented, CECL should have a significantly countercyclical effect compared to the incurred loss accounting used over the past several decades. The negative effects of incurred loss accounting was clearly observed during the 2008 financial crisis, when loan loss allowances did not begin to build up until provisions were sharply increasing and the crisis-induced recession had already begun (and allowances did not peak until 2010).[2] These allowances thus provided no advance funding for loan losses and were useless in buffering the impact of the recession on financial intermediation.

The failure to do advance recognition of loan losses also contributed to the large scale collapse of confidence by investors in bank financial data, which contributed centrally to the failure of financial markets. As Stefan Ingves, the then-chair of the Bank of International Settlements, later explained:[3]

> "...under existing accounting standards, bank provisioning for credit losses on their loan books was backward-looking. The incurred loss model that underpinned IFRS and US GAAP prevented banks from making forward-looking assessments of likely losses. So provisions had not been adequately built up in good times, and there was considerable uncertainty about what additional provisioning might be needed. All of this meant that, when confidence in banks was most needed, the key regulatory metric of financial health - the regulatory capital ratio - was increasingly discounted because it potentially overstated a bank's true loss-absorbing capacity."

Indeed, the initial SCAP stress testing efforts were in part driven by the need to provide trustworthy information to the market about the potential "hole" in bank balance sheets that could be created by future loan losses.[4]

---

[2] See Figure 1 in Chae, Sarah, Robert F. Sarama, Cindy M. Vojtech, and James Wang (2018). "The Impact of the Current Expected Credit Loss Standard (CECL) on the Timing and Comparability of Reserves," Finance and Economics Discussion Series 2018-020. Washington: Board of Governors of the Federal Reserve System, https://doi.org/10.17016/FEDS.2018.020 .

[3] Ingves, Stefan, "Restoring Confidence in Banks", Keynote Address to the 15th Annual Convention of the Global Association of Risk Professionals, New York, 4 March 2014. https://www.bis.org/speeches/sp140304.htm

[4] Wall, Larry, "Measuring Capital Adequacy", Federal Reserve Bank of Atlanta Working Paper 2013-15, December, 2013.

Americans for Financial Reform
Education Fund
1615 L Street NW, Suite 450, Washington, D.C. 20036 | 202.466.1885 | ourfinancialsecurity.org

If properly implemented, CECL should also increase incentives to restructure troubled debt by providing needed loan modifications in recessionary period, since potential losses from troubled debt restructurings should be incorporated into forecasts in advance.[5]

In sum, replacing the backward-looking incurred loss accounting for loan losses with the forward looking CECL methodology offers macroeconomic benefits and a greater potential for the understanding of risks and losses by regulators, investors, the public, and banks own credit risk managers.

CECL and regulatory capital ratios

One immediate effect of introducing CECL will be to reduce banks Tier 1 equity capital. As of the beginning of the first reporting period after adoption of CECL, banks will have to record an adjustment to their allowances for credit losses equal to the difference between its pre- and post-CECL amounts of credit loss allowance. This adjustment to credit loss allowances will be recorded in banks financial statements with offsetting adjustments to retained earnings. Since retained earnings are included in common equity tier 1 (CET1) capital, the one-time adjustments to allowances for credit losses, retained earnings, and DTAs will affect the calculation of a banking organization's regulatory capital ratios. Specifically, the increased allowances contemplated in CECL are expected to generally reduce banks retained earnings and consequently their measured CET1 capital.

Banking organizations and industry groups are objecting vociferously to this increase in required capital, arguing that current bank capital standards are "calibrated" to previous incurred loss accounting and bank capital minimums should somehow be reduced through an ongoing and continuous "adjustment" to eliminate any effects of CECL introduction on required capital.[6] However, current minimum capital requirements are not calibrated to past accounting standards, but instead to macroeconomic estimates of the costs and benefits of capital.[7] Furthermore, as AFR has mentioned in previous letters, there is extensive evidence that current minimum capital requirements are below the range of socially optimal levels from a macroeconomic cost-benefit perspective and are therefore calibrated at too low a level.[8] This literature suggests that the

[5] Whether this potential benefit of CECL is fully realized will depend in part on technical issues in loss forecasting.
[6] For example see: David Wagner, "Arrival of CECL triggers new bank capital debate," The Clearing House, Blog post, February 8, 2018, available at: https://bit.ly/2mhfFfK; or the letter from the American Bankers Association on this rule proposal, dated July 13, 2018 and available at https://www.regulations.gov/document?D=OCC-2018-0009-0013
[7] See e.g. Bank of International Settlements, "An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements", August, 2010. Available at https://www.bis.org/publ/bcbs173.pdf
[8] Firestone, Simon, Amy Lorenc, and Ben Ranish (2017), "An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the U.S.", Finance and Economics Discussion Series 2017-034. Washington: Board of Governors of the Federal Reserve System, https://doi.org/10.17016/FEDS.2017.034; Passmore, Wayne, and Alexander H. von Hafften (2017). "Are Basel's Capital Surcharges for Global Systemically Important Banks Too Small?," Finance and Economics Discussion Series 2017-021. Washington: Board of Governors of the Federal Reserve System, https://doi.org/10.17016/FEDS.2017.021; Cline, William, The Right Balance for Banks: Theory and Evidence on Optimal Capital Requirements, The Peterson Institute, May, 2017; Fabrizio Perri and Georgios Stefanidis, "Capital Requirements and Bailouts," Federal Reserve Bank of Minneapolis, August 21, 2017, available

Americans for Financial Reform
Education Fund
1615 L Street NW, Suite 450, Washington, D.C. 20036 | 202.466.1885 | ourfinancialsecurity.org

introduction of an accounting standard that would lead to some decline in measured Tier 1 capital would be completely appropriate.

In addition, continuously adjusting capital requirements to essentially negate the effect of CECL on equity capital could undo many of the benefits for which CECL was designed. As loan loss forecasts under CECL led to increases in advance loan loss reserves and declines in retained earnings, regulators would simultaneously reduce the amount of equity the bank would have to hold, therefore permitting continued payouts of retained earnings to shareholders. The increase in advance loss provisions in one area of the bank balance sheet would simply be counterbalanced by the decline in advance provision for losses in another area. It hardly seems reasonable to require the effort to implement the new CECL accounting standard while at the same time negating many of its practical effects.

Banks are also arguing that although CECL on the face of it appears to be clearly counter-cyclical, it could in practice be pro-cyclical if expected loss modeling is systematically and significantly mistaken in predicting the severity of loan loss experience in recessions.[9] No doubt a wide variety of negative effects could occur if expected loss modeling under CECL is systematically flawed. However, this should be addressed through proper supervision of such loss modeling, not by dropping the CECL concept or by blunting its effects through adjustment of bank capital. Conceptually, the advance loan loss reserving that is created by CECL accounting is clearly counter-cyclical if properly implemented and can hardly be more pro-cyclical than simply failing to reserve against loan losses until such losses have already happened, as occurred during the 2008-2010 financial crisis and recession.

Agency Proposal

To addresses the potential reduction in CET1 capital, the agencies propose giving banking institutions the option to phase-in the day-one effects of the CECL standards over a three-year transitional period. If an eligible bank does not elect to use the transition option in its first regulatory reporting period after implementing CECL, it will not be permitted to elect it on subsequent periods. Upon electing the phase-in option, banks would calculate the difference between pre- and post-CECL allowance for credit losses, retained earnings, and DTAs and would be able to adjust their regulatory capital calculations by transitional amounts for three years.

We support the proposal to phase in CECL impacts on capital. However, we strongly believe that such impacts should be fully reflected and that their recognition should not be excessively

at: https://bit.ly/2um03wf; "The Minneapolis Plan To End Too Big To Fail," Proposal by The Federal Reserve Bank of Minneapolis, November 16, 2016, available at: https://bit.ly/2mcIdHo.

9 ABA Letter

Americans for Financial Reform
Education Fund
1615 L Street NW, Suite 450, Washington, D.C. 20036 | 202.466.1885 | ourfinancialsecurity.org

delayed. Any further delay beyond the already generous three year phase-in period provided in this proposal would not be appropriate.

Additionally, we believe it is important that the forthcoming rule maintain the proposed increase to total leverage exposure by the respective CECL transitional amount, for the purposes of the supplementary leverage ratio calculation during the three-year transition period. Adjusting the denominator of the supplementary leverage ratio (i.e., total leverage exposures) to align it with the adjustments to the numerator (Tier 1 capital) is essential to maintain consistent, effective leverage buffer requirements that take into account risk exposures that could materialize as losses for the a bank.

Specific questions in the proposal

Question 3: The agencies seek comment on the sufficiency of the proposed three-year transition period. Would a different time period be more appropriate? If so, why?

The three-year phase-in period is an appropriate amount of time for banking organizations to smooth out the potential day-one adverse effects on regulatory capital of adopting the new CECL methodology. This period should be sufficient for these organizations to transit to the new standards and to bring their regulatory capital ratios into compliance with the agencies' capital rules. In fact, and as noted in the proposed rule, since the Financial Accounting Standards Board issued the new accounting for credit loss methodology in 2016, banking organizations will have had four years to prepare for CECL in addition to the three contemplated in the transition period.

The transition adjustment already effectively allows banks to postpone recapitalization for three years—for those banks which would need to under the new CECL standards. It would be worrisome if the agencies were to grant any extension of the three-year period to phase-in immediate reductions in regulatory capital as a result of the new accounting standards. Not only we oppose a longer transition period, but requests of such nature, this late in the game, should be taken as representative of inadequate capital planning by a banking organization.

Implementing a forward-looking model of credit loss recognition is a significant strength of the CECL framework vis-à-vis the incurred loss methodology—and delaying full compliance would be inappropriate.

Question 7: The agencies are requesting comment on the proposed CECL transitional amount limitation for certain advanced approaches banking organizations that have an ECR shortfall. What, if any, are the associated advantages and disadvantages of the alternatives provided by the agencies?

We are concerned that banks with eligible credit reserves (ECR) shortfalls could experience a fictitious increase in their core loss-absorbing capital requirements. Under current rules, banking organizations using the advanced approaches capital framework (and that have completed the parallel run process) can include in their adjusted total capital any amount of ECR in excess of

Americans for Financial Reform
Education Fund
1615 L Street NW, Suite 450, Washington, D.C. 20036 | 202.466.1885 | ourfinancialsecurity.org

their regulatory expected credit losses, up to 0.6 percent of credit risk-weighted assets. While if their ECR are lower than the expected credit losses—i.e., they have an ECR shortfall—they are required to deduct the shortfall from CET1 capital. We believe this is an appropriate deduction from the CET1 capital to provide a more accurate picture of the core loss-absorbing capital a bank has to weather rainy days.

The changes contemplated in the proposal would allow an additional transitional amount in the calculation of the ECR, to phase-in the immediate increase of these reserves upon adoption of CECL. However, even with the phase-in method, the ECR increase would close the shortfall gap between those reserves and the expected credit losses. In other words, the ECR increase carries a concurrent reduction in the ECR shortfall that can be deducted from CET1 capital. As a result, and ceteris paribus, advance approaches banking organizations that have ECR shortfalls pre-CECL would end with greater post-CECL CET1 capital.

The agencies' joint proposal clearly states that the "CECL transition provision is designed to phase in the day-one *adverse* [emphasis added] impact on a banking organization's regulatory capital ratios resulting from its adoption of CECL."[10] Specifically, the stated objective of the proposal is alleviating the CET1 capital reductions that banks would generally experience as a result of the increased credit loss allowances and subsequent reduction in retained earnings, immediately after implementing CECL. We support the transitional amount limitation and believe it is important to avoid contradictory, "undue" benefits to banking organizations with an ECR shortfall prior to adoption of CECL and that may experience an increase in CET1 capital instead of a reduction.

Concluding comments

Thank you for the opportunity to comment on these proposals. If you have questions, please contact AFR's Policy Director, Marcus Stanley, at marcus@ourfinancialsecurity.org or at 202-466-3672. Thank you in advance for your attention to this letter.

Sincerely,
Americans for Financial Reform Education Fund

[10] Proposal, at p. 22317.

AFR Americans for Financial Reform

November 22, 2017

Ann E. Misback, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

RE: Proposed Agency Information Collection Activities (FR Y-15; OMB No. 7100-0352)

Dear Ms. Misback:

On behalf of Americans for Financial Reform, we are writing to express our support for proposed changes (the "Proposal") by the Federal Reserve Board of Governors (the "Board") to the FR Y-15 systemic risk reporting form ("FR Y-15") regarding the treatment of cleared over-the-counter ("OTC") derivatives transactions.[1]

On August 24th of this year the Board released a Proposal to revise the FR Y-15 reporting form to make clear that all cleared derivatives transactions, including those in which the bank acted as an agent guaranteeing the client's performance to the derivatives central counterparty (CCP), should be fully included in Schedules B and D of the FR Y-15 reporting form. The effect of this inclusion is to ensure that all derivatives activity by banks that are CCP members is incorporated into the interconnectedness and complexity scores used in determining the G-SIB capital surcharge. According to industry sources and outside analyses, the full inclusion of this activity will increase G-SIB surcharges significantly, possibly requiring major clearing banks to raise over $10 billion in additional capital.[2]

Industry groups have vociferously protested this change and urged the Federal Reserve to withdraw the proposed changes in the G-SIB scoring process.[3] Their objections fall into two broad categories, substantive and procedural. Substantively, they argue that it is inappropriate to fully include agency cleared derivatives activity in determining the interconnectedness and complexity of a systemically important bank. Procedurally, they argue that this Proposal contains too little analysis and discussion and should be re-issued in a more extensive rulemaking.

As discussed further below, we believe industry's substantive objections are self-serving and misguided. Agency clearing services by a CCP member are a perfect example of the type of activities that should be included in systemic risk metrics and should be associated with a higher G-SIB surcharge. The substantive industry objections rely on arguing that the Board should turn its back on its responsibility to ensure the stability of the most systemically significant institutions and instead embrace different goals such as reducing the cost to CCP members of

[1] Americans for Financial Reform is an unprecedented coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups. A list of AFR members is available at http://ourfinancialsecurity.org/about/our-coalition/.
[2] Woodall, Louie, "Banks Prepare for Battle With Fed Over G-SIB Rules", Risk Magazine, November 3, 2017.
[3] Futures Industry Association and International Swaps and Derivatives Association, "Letter To Federal Reserve Board Re Proposed Agency Information Collection Activities", October 11, 2017. http://bit.ly/2A2V3Ak

clearing derivatives. In cases where industry raises real issues, such as the need to transfer derivatives positions during a CCP recovery process, it would be entirely counterproductive to address such issues by reducing ordinary course of business G-SIB surcharges for the largest and most active clearing members.

We have more sympathy with some of the procedural objections to the current form of the proposal, However, these procedural objections do not go to the issue of whether the surcharge increase is called for substantively, which we strongly believe it is, and we do not believe they are sufficient to justify not proceeding with this change.

Below we discuss these issues further and respond to some industry claims as reflected in the October 11th letter on this issue from the Futures Industry Association (FIA) and the International Swaps and Derivatives Association (ISDA), or "FIA/ISDA Letter".[4]

Agency Clearing Activities Should Be Fully Counted in G-SIB Surcharges

When the G-SIB surcharge rule was finalized, then Federal Reserve Chair Janet Yellen clearly stated its purpose:[5]

> "A key purpose of the capital surcharge is to require the firms themselves to bear the costs that their failure would impose on others...In practice, this final rule will confront these firms with a choice: they must either hold substantially more capital, reducing the likelihood that they will fail, or else they must shrink their systemic footprint, reducing the harm that their failure would do to our financial system. Either outcome would enhance financial stability."

Chair Yellen's statement is inherent in the "expected impact" framework used to calculate the G-SIB surcharge, described by the Board as "the harm it [a G-SIB] would cause to the financial system were it to fail multiplied by the probability that it will fail."[6]

Agency clearing of derivatives is a paradigmatic example of an activity which increases the expected impact of the failure of a firm on other financial institutions and on the financial system as a whole. The default of a firm doing large amounts of agency clearing would greatly increase risks to both the firm's customers and to the CCP itself.[7] This is non-controversial and referenced by organizations such as ISDA itself in its own publications on clearing.[8]

---

[4] Futures Industry Association and International Swaps and Derivatives Association, "Letter To Federal Reserve Board Re Proposed Agency Information Collection Activities", October 11, 2017. http://bit.ly/2A2V3Ak

[5] Federal Reserve Board of Governors, "Federal Reserve Board Approves Final Rule Requiring Largest, Most Important US Bank Holding Companies To Strengthen Their Capital Positions", Press Release, July 20, 2015. http://bit.ly/2AqrFoq

[6] Board of Governors of the Federal Reserve System, Calibrating the G-SIB Surcharge, July 20, 2015. http://bit.ly/2iKICR0

[7] Ruffini, Ivana, "Central Clearing: Risks and Customer Protections", Economic Perspectives, Federal Reserve Bank of Chicago, Q4 2015. http://bit.ly/2Bi2L7G

[8] Pirrong, Craig, "The Economics of Central Clearing: Theory and Practice", ISDA Discussion Paper Series Number One, May, 2011. http://on.wsj.com/2ArMKyZ

With respect to CCPs, the failure or default of a clearing member would expose the CCP to market risk and to the need to rebalance positions, greatly increasing the CCP's own risk of failure. As the CCP stress test report by the Commodity Futures Trading Commission (CFTC), puts it, "A clearinghouse will incur market risk only if and when a clearing member fails to meet a payment obligation to the clearinghouse. The credit risk that a clearinghouse takes is thus also that of its members....clearing members are essential to the functioning of a clearinghouse".[9] A failure of a major CCP would in turn have enormous implications across the financial system. The recent Treasury report on capital markets stated that "CCPs are critical infrastructures...that continue to pose systemic risks...and are uniquely interconnected with other U.S. financial institutions".[10] This concern was later underlined by NEC chair Gary Cohn in recent public remarks.[11]

With respect to a customer, the failure of a clearing member would expose customers to the direct risk of loss of margin, and to the risk that the clearinghouse would no longer be able to perform on their derivatives positions.[12]

This is precisely the type of externality risk referred to by Chair Yellen and meant to be taken into account in the "expected impact" framework for determining a G-SIB surcharge. These risks operate both through the increased operational complexity created by customer clearing relationships and the responsibilities of membership in a CCP, and through the increased interconnectedness of a firm doing agency clearing to numerous other financial entities, including customers, CCPs, and indirectly to other clearing members of a CCP and customers of those members which may be affected by the default of a major clearing member.[13] It is thus entirely appropriate and indeed necessary to include agency clearing in G-SIB surcharges and to require additional capital for major clearing intermediaries in order to take into account the increased externality risks of their failure.

Industry's Substantive Arguments Against the Proposal Are Misguided

Arguments in the FIA/ISDA letter against the inclusion of agency clearing volume in the determination of G-SIB surcharges are misguided and only serve to distract from the points laid out above.

---

[9] Commodity Futures Trading Commission, Supervisory Stress Test of Clearinghouses, A Report By Staff, November, 2016. http://bit.ly/2Aozueg

[10] U.S. Department of the Treasury, A Financial System That Creates Economic Opportunites: Capital Markets, October, 2017. http://bit.ly/2fPPMR3

[11] Smialek, Jeanna, "Gary Cohn Calls Clearinghouses a New Systemic Problem", Bloomberg News, October 15, 2017. https://bloom.bg/2hYM8cD

[12] Ruffini, Ivana, "Central Clearing: Risks and Customer Protections", Economic Perspectives, Federal Reserve Bank of Chicago, Q4 2015. http://bit.ly/2Bi2L7G

[13] Indeed, recent research finds that the interconnectedness of risks of clearing member failure are not properly incorporated into current systemic risk management techniques such as CCP stress tests and bank capital stress tests. See Paddrick, Mark and H. Peyton Young, "How Safe Are Central Counterparties in Derivatives Markets?", Office of Financial Research Working Paper, November 2, 2017. http://bit.ly/2A3BvM7

Encouraging Central Clearing Is Not the Goal of Capital Regulation: One industry argument is that central clearing itself reduces systemic risk and interconnectedness as compared to bilateral derivatives transactions, and that therefore the Board must seek to lower capital charges connected with central clearing in order to encourage greater volume of such clearing. Industry also makes the related argument that the Board must refrain from any capital regulations that would lead derivatives market intermediaries to increase their prices or market participants to reduce their cleared derivatives activity.

This is a misrepresentation of the entire Dodd-Frank regulatory framework and the Board's responsibility under that framework. The Dodd-Frank Act encourages central clearing by mandating central clearing where such clearing is appropriate. This mandate is the strongest possible way to encourage central clearing. Capital, liquidity, and margin regulation is then intended to reflect systemic risks of derivatives transaction responsibilities, including the systemic risks associated with CCP membership and agency clearing.

By requiring participants in derivatives markets to internalize these risks through holding loss absorbency resources such as capital and margin, systemic risk regulation leads to derivatives pricing that properly reflects the risks to the broader economy of derivatives activities. This may in some cases lead to lowering the level of derivatives activities, including cleared derivatives activities. If capital regulation leads market participants to internalize the costs of derivatives risks that were previously assumed to fall on the rest of society through "too big to fail" support by the public safety net, it would be economically appropriate for derivatives activity to decline.

Further, as has frequently been pointed out by many observers including ISDA itself, central clearing does not inevitably reduce systemic risk and interconnectedness, but instead changes the location of that risk and the way it is managed.[14] When CCPs are well managed and clearing members can be relied on not to default, clearing can be expected to reduce systemic risk and interconnectedness. But this depends on, among other things, the solvency and capital position of clearing members, which are impacted by capital regulation.

The question of the proper relationship between total capital charges for bilateral derivatives transactions and cleared derivatives transactions is also frequently raised by industry in efforts to reduce capital charges for cleared derivatives. This ratio is an entirely separate question from whether major participants in the cleared derivatives markets are properly capitalized. Should regulators feel that the ratio between capital charges in bilateral and cleared derivatives markets do not reflect the relative risks of these activities, they can raise capital charges in bilateral markets rather than reducing capital that supports clearing. In addition, given the many regulatory advantages that already exist for cleared derivatives, we are skeptical that the aggregate costs of clearing derivatives are higher than those of bilateral derivatives, and have seen no comprehensive analysis to that effect.

CCP Recovery and Clearing Capital Charges: Industry also argues that capital charges associated with agency clearing will make it more difficult to transfer derivatives positions to

[14] Pirrong, Craig, "The Economics of Central Clearing: Theory and Practice", ISDA Discussion Paper Series Number One, May, 2011. http://on.wsj.com/2ArMKyZ

solvent clearing members in the event of a clearing member default. Such transfers, or "porting", are a key element of the CCP recovery process. Industry argues that solvent clearing members will be more reluctant to accept porting of customer positions if accepting such positions mean that they will have to raise more capital.

This ignores the key point that better capitalization of agency clearing will reduce the likelihood of clearing member default in the first place. Indeed this is a central goal of capital requirements. Better capitalization of agency clearing also means that all clearing members, including those which do not default, will be more solvent and better capitalized in an absolute sense, meaning that they will be better positioned to contribute to the CCP recovery process.

It is true that during the specific time period around the default of a clearing member, regulators may wish to facilitate porting of client positions by temporarily relaxing associated capital requirements, including related G-SIB surcharges. Such a temporary accommodation, which could for example involve giving clearing members that accept new client positions an extended time period to raise additional capital, could address any concerns around porting of client positions during CCP recovery. Regulators could easily pre-plan for such a process by specifying in advance their regulatory policies during the period immediately following a clearing member default.

This kind of temporary accommodation is entirely different than permitting agency clearing activities to be systematically undercapitalized during normal times. Permitting such undercapitalization would increase systemic risk, contribute to the mispricing of derivatives activities, add to the risk of clearing member default, and reduce the total resources available to clearing members during the recovery process.

Industry's Procedural Arguments Should Not Lead the Board to Withdraw the Proposal

The FIA/ISDA letter also raises a broad range of procedural arguments against the Proposal. These include arguments that the public has not been given adequate analysis or explanation of the proposal and that the proposal does not reflect previous iterations of the G-SIB surcharge.

The Board Must Ensure That the G-SIB Surcharge Reflects Systemic Risk: The FIA/ISDA letter points out that the initial G-SIB surcharge set forth by both U.S. and international regulators did not clearly reflect agency clearing activities. It argues that therefore the Board should refrain from including such activities now.

However, the Board is not obligated to ignore risk-related activities simply because such activities were not previously included in the relatively new G-SIB surcharge framework. Such a commitment would mean that the G-SIB surcharge could never be updated to reflect new considerations concerning financial risk. The Board's judgement should be entirely based on the risks of agency clearing activity and whether the amount of such activity is reasonably related to the expected systemic disruption and external costs that would be created by the failure of a financial institution.

The Board is also not required to conform the U.S. G-SIB surcharge to the exact surcharge definition used by international regulators. Basel regulatory standards are explicitly intended as a floor, not a limitation, on regulatory stringency. If the Board feels that stronger standards are necessary to protect the U.S. economy then the Board must put such standards in place. The entire U.S. G-SIB surcharge framework reflects this commitment, as it substantially diverges from the base BIS framework due to the Board's concern that the international framework was inadequate.

Furthermore, in this case the proper regulation of agency clearing activities is of special concern to U.S. regulators, as the agency clearing model is mostly used by U.S. CCPs. CCPs in other countries are more likely to use the "principal" model which involves explicit contractual commitments to both customers and the CCP.[15] Principal-model clearing is already reflected in G-SIB surcharge scoring.

The Board Should Ensure Adequate Public Communication of Significant Changes in the G-SIB Surcharge Calibration: The FIA/ISDA letter also argues that the Board has not adequately explained this G-SIB surcharge change and its implications to the public, and did not provide sufficient notification by making this change through an alteration in reporting forms.

We agree that the Board should clearly communicate to the public all major changes in the G-SIB surcharge calibration. This includes any future changes that act to reduce the G-SIB surcharge or reflect the removal of potentially systemically risky activities from surcharge scoring. We agree with the Board's decision to extend the comment period for this change. We also believe that the Board should have issued a press release in connection with the initial Proposal which made clear to the public that the seemingly technical changes in the FR Y-15 reporting form would have substantial capital implications.

However, we would point out that significant information is already available to the public concerning this change. The Board has filed with OMB the precise edits to the FR Y-15 form that are under consideration, and these edits are available to the public. The Board also provided a brief public justification of these changes. While it would be reasonable to expand upon this justification, we believe it is substantially self-explanatory and directly reflects the underlying "expected impact" framework for the G-SIB surcharge. This framework was extensively analyzed and explained in the White Paper accompanying the final G-SIB surcharge rule.[16]

Thank you for the opportunity to comment on this Proposal. Should you have any questions, please contact Marcus Stanley, AFR's Policy Director, at marcus@ourfinancialsecurity.org or (202) 466-3672.

Sincerely,

Americans for Financial Reform

[15] LCH Clearnet, "Interest Rate Swap Clearing: Client Access to OTC Derivatives Clearing", Presentation at Nordic Capital Markets Conference, November 21, 2011. http://bit.ly/2B7xcfN

[16] Board of Governors of the Federal Reserve System, Calibrating the G-SIB Surcharge, July 20, 2015. http://bit.ly/2iKJCR0

BETTER MARKETS

July 16, 2018

Chairman Jeb Hensarling
2129 Rayburn House Office Building
Washington, DC 20515

Ranking Member Maxine Waters
4340 Thomas P. O'Neill, Jr. Federal Office Building
Washington, DC 20024

Dear Chairman Hensarling and Ranking Member Waters:

Through our many years of engagement on policy and rulemaking regarding capital regimes and stress tests for prudentially regulated financial institutions, Better Markets Inc. has produced extensive evidence-based assessments of what works and doesn't in capital requirements and testing.

The available data provides real-time, real-life evidence that vitally important financial protection rules have not damaged the banks or the economy; rather, they have created the conditions for sustained economic growth and prosperity. As former Federal Reserve Board Chair Paul Volcker remarked in April 2017:

> [C]laims that Dodd-Frank and other regulatory approaches have somehow gravely damaged the effective functioning of American financial markets, the commercial banking system, and prospects for economic growth simply do not comport with the mass of the evidence before us. Here we are in 2017 with a near fully employed economy, close to stable prices, bank profits at a new record, and the return on banking assets again exceeding one percent. Loans at both large and small banks are at new highs, double the pre-crisis years. In fact, loan growth has again been exceeding growth in nominal GDP.[1]

The importance of increased capital has been definitively established by recent robust data-driven academic work, establishing that better capitalized banks have higher rates of lending and a lower cost of capital throughout the business cycle. In particular, Morris Goldstein's recent book, *Banking's Final Exam: Stress Testing and Bank-Capital Reform* undertakes a rigorous review of all the data and analysis, demonstrating that 14% to 18% capital levels for the 8 U.S. G-SIBs (and a sliding scale for smaller banks) would be appropriate with negligible impact on lending. The understated summary of the analysis is worth considering in full:

---

1 https://www.volckeralliance.org/sites/default/files/attachments/Paul%20Volcker_Bretton%20Woods%20Speech_19Apr2017.Pdf

1825 K Street, NW, Suite 1080, Washington, DC 20006 TELEPHONE (1) 202.618-6464 FAX (1) 202.618.6465 WEBSITE bettermarkets.com

At the heart of the banking industry's opposition to much higher capital requirements is the assertion that higher bank capital requirements will depress bank lending and thereby reduce output and employment in the economy. This assertion is increasingly at odds with the empirical evidence – as well as with the appraisals of senior bank supervisors....Better capitalized banks lend more, not less, than weakly capitalized ones. One recent impressive study, which looked at 105 large banks from advanced economies over the 1994-2012 period, finds that after holding other factors constant, a 1%-point increase in the equity to total assets ratio (i.e., the leverage ratio) is associated with a 0.6% increase in total lending growth. With this empirical finding, a key pillar of the case against much higher capital requirements is taken away.[2]

Additionally, as you consider making significant changes to capital requirements, we encourage you to review the attached comment letters, which provide greater detail of Better Markets' perspective on capital requirements, and the appropriate role of federal regulators in the oversight and monitoring of systemic risk in national and global finance. The capital, leverage, and stress testing requirements for banks and other financial institutions set forth in the Dodd-Frank are among the most important regulatory reforms adopted in almost a century. They are critical for maintaining the financial stability of the domestic and global financial markets and ultimately the world-wide economy. Any changes to those rules and regulations must be undertaken with the utmost care and only for the most compelling reasons. Above all, they must not be weakened.

Sincerely,

Dennis M Kelleher

Dennis M. Kelleher
President & CEO

Better Markets, Inc.
1825 K Street, NW
Suite 1080
Washington, DC 20006
(202) 618-6464
dkelleher@bettermarkets.com
www.bettermarkets.com

[2] Goldstein, Morris. *Banking's Final Exam: Stress Testing and Bank-Capital Reform*, Peterson Institute for International Economics, 2017; citing Gambacorta and Shin, *Why Bank Capital Matters for Monetary Policy*, Working Paper 558. Basel: Bank for International Settlements; see also Admati and Hellwig, *The Bankers' New Clothes: What's Wrong with Banking and What to Do About it*, Princeton University Press, 2013; and Admati and Hellwig *The Parade of Bankers' New Clothes Continues: 31 Flawed Claims Debunked*, Revised December 2015.

Enclosures:

Re: Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules, Docket No. R-1603 and RIN 7100-AF 01;

Re: Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for U.S. Global Systemically Important Bank Holding Companies and Certain of Their Subsidiary Insured Depository Institutions; Total Loss Absorbing Capacity Requirements for U.S. Global Systemically Important Bank Holding Companies; Joint Notice of Proposed Rulemaking; OCC Docket ID OCC-2018-0002; Board Docket No. R1604; Board RIN 7100 AF-03

BETTER
MARKETS

June 25, 2018

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
Suite 3E-218
400 7th Street, SW
Washington, DC 20219

Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for U.S. Global Systemically Important Bank Holding Companies and Certain of Their Subsidiary Insured Depository Institutions; Total Loss Absorbing Capacity Requirements for U.S. Global Systemically Important Bank Holding Companies; Joint Notice of Proposed Rulemaking; OCC Docket ID OCC-2018-0002; Board Docket No. R-1604; Board RIN 7100 AF-03

Ladies and Gentlemen:

Better Markets[1] appreciates the opportunity to comment on the notice of proposed rulemaking captioned above ("Proposal" or "Release"),[2] issued jointly by the Office of the Comptroller of the Currency ("OCC") and the Board of Governors of the Federal Reserve System ("Board"), regarding revisions to the enhanced supplementary leverage ratio ("eSLR") for top-tier bank holding companies and their subsidiaries.[3]

The Proposal is unwise, as it will weaken the regulatory framework that protects our financial system from instability and crisis, without any empirical basis and without conferring

1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system, one that protects and promotes Americans' jobs, savings, retirements, and more.

2 83 Fed. Reg. 17317 (Apr. 19, 2018).

3 In this comment letter, we use the term "Agencies" to refer to the Board and the OCC collectively.

any discernable, countervailing benefits. Absent a reasonable, data-driven basis for the Proposal, including any specific benefits it would confer, the Agencies should withdraw it.

INTRODUCTION AND SUMMARY

The only thing that stands between a failing bank and a taxpayer bailout is the bank's capital cushion. As we saw just ten short years ago, insufficient capital can be catastrophic for the banks, the financial system, the taxpayers, and the entire country. The sheer scale of the bailouts, backstops, and credit facilities provided to the GSIBs during the financial crisis was staggering, totaling over ten trillion dollars, as detailed on the attached Addendum.

Those bailouts were only a part of the costs of the 2008 crash and the massive effort to mitigate the consequences, which we have calculated to exceed $20 trillion in lost GDP.[4] Many of those costs continue today as economic dislocation, distress, and anxiety remain all too familiar at the kitchen tables of tens of millions of Americans who were not bailed out.

While the crash and its devastating consequences had numerous causes, the lack of adequate bank capital was most prominent, and the subsequently enacted capital rules were key reforms designed to prevent the recurrence of such a crisis. The goal was not only to prevent bank failures or a systemic crisis, but also to avoid the human devastation inflicted on so many American families. Those goals must be the prism through which policy decisions about capital are viewed, particularly if those decisions will result in reduced capital levels and, therefore, fewer protections for American families who have already suffered so much.

Notwithstanding this compelling history and context, the Board and the OCC are now proposing to modify the enhanced SLR ("eSLR") for top-tier U.S. bank holding companies identified as global systemically important bank holding companies ("GSIBs"). The Proposal would make similar modifications to the SLR for the insured depository institution subsidiaries ("IDIs") of those GSIBs.

Specifically, for the GSIBs, the proposal would replace the 2% eSLR buffer (which is added to the baseline 3% leverage ratio) with a new, variable amount equal to 50% of the firm's GSIB risk-based capital surcharge. And for the IDI subsidiaries of those GSIBs, the proposal would replace the 6% supplementary leverage ratio (used to determine whether those subsidiaries are deemed "well-capitalized") with a formula comprised of a 3% SLR plus 50% of the GSIB surcharge applicable to the covered subsidiary's GSIB holding company.

4 Better Markets, The Cost of Crisis, $20 Trillion and Counting (July, 2015), *available at* https://www.bettermarkets.com/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis.pdf.

The Proposal is a step in the wrong direction. It will weaken, in at least two respects, the capital buffers that are essential for maintaining the stability of our financial system. First, and according to the analysis in the Release itself, the Proposal will reduce the dollar amount of capital held by our largest banks and their insured depository subsidiaries. In addition, it will alter the formula for calculating the eSLR in a way that makes the capital buffer less reliable and more vulnerable to evasion.

And it does all of this without a clear or credible justification. The Release makes vague assertions that banking organizations have expressed "concerns" regarding the current eSLR standards and their role as "constraints," yet it provides no details let alone robust data or empirical analysis of these claims. In reality, banks—especially the massive GSIBs—require no relief from the capital requirements currently in place, as evidenced by the record-setting prosperity that banks currently enjoy and the exceptionally strong lending markets we see today.[5] Further undercutting the Proposal is the reality that any capital it frees up is unlikely to be devoted to increased lending or to other valuable banking services; instead, it will find its way into the bonus pool or into the pockets of shareholders in the form of dividends or buybacks.

So unwise is the Proposal, in fact, that one of the three principal prudential regulators, the Federal Deposit Insurance Corporation ("FDIC"), took the extraordinary step of declining to join in its issuance. The public statement from FDIC Chairman Martin Gruenberg first observes that the Proposal would reduce the required capital across the lead IDI subsidiaries by $121 billion, then it simply and clearly explains the *im*prudence of the Proposal:

> Given these reductions in capital requirements, the FDIC did not join the Federal Reserve and OCC in issuing the proposed rule. . . . Strengthening leverage capital requirements for the largest, most systemically important banks in the United States was among the most important post-crisis reforms. In April 2014, the [FDIC], OCC, and Federal Reserve jointly finalized a rule that required the eight U.S. GSIBs to satisfy a supplementary leverage ratio capital requirement of 5 percent at

5 In fact, this data along with other factors, including the current stage of our business cycle, should have caused the Board to consider imposing countercyclical measures and requiring increased capital. As Governor Lael Brainard has cautioned, at a time when cyclical pressures are building, "we should be calling for large banking organizations to safeguard the capital and liquidity buffers they have built over the past few years. . . . Indeed, if cyclical pressures continue to build and financial vulnerabilities broaden, it may become appropriate to **ask the largest banking organizations to build a countercyclical buffer** (CCyB) of capital to maintain an adequate degree of resilience against stress." *See* Lael Brainard, Member of the Board of Governors of the Federal Reserve, Remarks at the Global Finance Forum, Safeguarding Financial Resiliencies Through the Cycle, at 7, 10 (Apr. 19, 2018) (emphasis added), *available at* https://www.federalreserve.gov/newsevents/speech/files/brainard20180419a.pdf.

> the holding company and 6 percent at their insured depository institutions. This simple approach has served well in addressing the excessive leverage that helped deepen the financial crisis.[6]

In short, the Proposal will weaken our financial system and increase the risk or severity of another financial crisis, without conferring meaningful benefits on the public, the markets, or the economy at large.

COMMENTS

1. The proposal will weaken critical safeguards designed to protect the stability of the U.S. financial system.

The Release itself highlights the lessons of the financial crisis of 2008 and the essential role that bank capital plays in protecting and preserving the stability of our financial system:

> The 2007-08 financial crisis demonstrated that robust regulatory capital standards are necessary for the safety and soundness of individual banking institutions, as well as for the banking system as a whole.[7]

As further evidence of the crucial role played by capital buffers in safeguarding our financial system, the Release canvasses the successive layers of protection that the prudential regulators have implemented, including the 2013 capital rule (including the SLR for advanced approaches banking organizations), the 2014 eSLR rule for the largest and most interconnected and complex bank holding companies and their subsidiaries, and the 2015 risk-based capital surcharge rule for the GSIBs.[8] It goes on to highlight the important role that these post-crisis measures collectively play:

> [These reforms] were designed to improve safety and soundness and reduce the probability of failure of banking organizations, as well as to reduce the consequences to the financial system if such a failure were to occur. For large banking organizations in particular, the Board's and the OCC's objective has been to establish requirements at a level that not only promotes resilience at the banking organizations and protects financial stability but also maximizes long-term through-the-cycle credit availability and economic growth.[9]

---

6 Statement of Martin J. Gruenberg, Chairman, FDIC, on Notice of Proposed Rulemaking on Supplementary Leverage Ratio by the Federal Reserve and OCC (Apr. 11, 2018), *available at* https://www.fdic.gov/news/news/speeches/spapr1218.pdf.

7 Release, *supra* note 2, at 17319.

8 *Id.* at 17318.

9 *Id.* at 17319.

The Release also highlights the need for a balanced combination of risk-based capital measures and leverage ratios. It explains that while risk-based capital requirements have the virtue of correlating capital requirements with the specific levels of risk undertaken by specific banks, leverage ratios perform a critical back-stopping role by imposing a "simple and transparent lower bound on banking organization leverage."[10]

Unfortunately, the Agencies essentially disregarded these important precepts of post-crisis financial regulation in making the Proposal. The Release concedes that the anticipated impact of the Proposal will be to *reduce* the dollar amount of the capital buffers. For example, the Release estimates that, based on third quarter 2017 data, the Proposal "would reduce the amount of tier 1 capital required across the GSIBs by approximately $400 million."[11] Over time, the capital levels permitted by the Proposal could fall by much greater amounts, by some estimates approaching $100 billion.[12] For the covered IDIs, the Release estimates that, again based on third quarter 2017 data, the reduction would be $121 billion less than the level currently required for the IDIs to be considered "well-capitalized."[13] This represents an average reduction of 20% across the IDIs of the GSIBs.[14] This decrease is significant by any measure, and it is cause for special concern because it threatens the stability of the insured, taxpayer-backed banks, those which should be protected with the most robust capital buffers.

Moreover, the Proposal would effect a fundamental change in the approach to calculating the eSLR by placing greater emphasis on the difficult, subjective, and shifting calculations tied to the risk-based, "multi-factor methodology" applicable under the capital surcharge rule.[15] Thus, in terms of the actual dollar reduction in capital buffers, as well as the methodology, the Proposal will markedly reduce safety and soundness and increase risk to the financial system.

These concerns about decreases in required capital buffers for the largest bank holding companies and their banking subsidiaries deserve special weight because even at current levels, the capital requirements are still inadequate: They cannot ensure financial system stability in the face of stresses like those seen during the financial crisis. As Better Markets has demonstrated,

10 *Id.* at 17319; *see also* Aaron Klein, Opinion, *Risk Weights or Leverage Ratio? We Need Both,* BROOKINGS (Dec. 22, 2016), https://www.brookings.edu/opinions/risk-weights-or-leverage-ratio-we-need-both/.

11 Release, *supra* note 2, at 17321.

12 *See* Peter Eavis, *Washington Wants to Weaken Bank Rules. Not Every Regulator Agrees,* N.Y. TIMES (Apr. 24, 2018) (positing an $86 billion reduction in required capital at the GSIBs if the Proposal is finalized), https://www.nytimes.com/2018/04/24/business/dealbook/bank-rules-leverage-ratio.html.

13 Release, *supra* note 2, at 17321.

14 *See* Gregg Gelzinis, *Opinion: This Is Not the Time to Loosen Rules on Bank Capital,* MARKETWATCH (May2, 2018), https://www.marketwatch.com/story/this-is-not-the-time-to-loosen-rules-on-bank-capital-2018-05-02.

15 Release, *supra* note 2, at 17318.

empirical evidence measuring the devastating impact of the crisis on just four banks (Washington Mutual, Wachovia, Citigroup, and Bank of America) shows that "banks require equity well in excess of 10 percent of their tangible assets to survive financial crises of the severity" witnessed in 2008. Losses alone can exceed this amount, and to reassure counterparties and account for rapid asset devaluations during a crisis, banks must actually have equity equal to 20-25% of assets to protect against failure.[16] Other analyses conducted by academics, the Financial Stability Board, and the Board itself, which are based on data reflecting actual losses incurred during the financial crisis, all support the conclusion that a capital cushion of at least 20% is appropriate and necessary to protect banks against the ravages of a financial crisis.[17]

Under these circumstances, a robust, factual, detailed, objective, independently confirmed, and data-driven empirical analysis supporting the changes in the Proposal is all the more important. Without such a basis, the Proposal lacks the most rudimentary foundation. That is not only bad policy but also arbitrary and capricious rulemaking.[18]

2. The Proposal lacks transparency and a credible basis.

The Proposal suffers from other important flaws because it lacks a vital measure of transparency and a persuasive rationale. The Release offers the cursory explanation that "over the past few years, banking organizations have raised concerns that in certain cases, the standards in the eSLR rule have generally become a binding constraint rather than a backstop to the risk-based standards."[19] It adds that "banking organizations have stated that the SLR standard as applied at the IDI subsidiary level may create disincentives for firms bound by the eSLR standard to provide certain banking functions, such as secured repo financing, central clearing for market participants, and taking custody deposits."[20]

---

16 *See* Comment Letter from Better Markets to the Board *et al.* on Regulatory Capital Rules, RIN 1557-AD46, at 3-5 (Oct. 22, 2012), *available at* https://bettermarkets.com/sites/default/files/documents/FRS%2C%20OCC%2C%20FDIC-%20CL-3nprs-%2010-22-12.pdf.

17 *See* Comment Letter from Better Markets to the Board of Governors of the Federal Reserve System on Total Loss-Absorbing Capacity, Docket No. R-1523 (Feb. 19, 2016), *available at* https://bettermarkets.com/sites/default/files/FRS%20-%20CL%20-%20Total%20Loss-Absorbing%20Capacity%20-%20Long%20Term%20Debt%20and%20Clean%20Holding%20Company%20Requirements%20 2-19-2016.pdf.

18 Under the Administrative Procedure Act, an agency rule is arbitrary and capricious if the agency "has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise." *See Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983).

19 Release, *supra* note 2, at 17319.

20 *Id.* at 17320.

These skeletal, unsupported, and conjectural "concerns" do not serve as an adequate or appropriate explanation for the material and systemically destabilizing changes in capital requirements set forth in the Proposal. Nowhere does the Release provide any detail regarding the banks who have lodged these "concerns," their empirical basis, or any specific examples. They appear on their face to be ad hoc and purely speculative, since the Release frames the issue solely in terms of negative effects that "may" transpire from continued adherence to the eSLR in its current form. Thus, the Proposal fails to substantiate the existence of any "constraints" or provide any evidence for the highly questionable claim that the current capital requirements are inhibiting those activities in the first place.

Nor *could* such concerns justify the Proposal. Charitably read, they amount to the contention that if the Proposal were adopted and the applicable capital restrictions were relaxed, then banks would actually engage in more lending activity or provide other important banking services. But embedded in this rationale are two false premises: First, that banks and borrowers need more lending, and second, that the Proposal would in fact generate more lending.

As to the first assumption, there is in fact no need to increase lending for the purpose of enabling banks to amass even more wealth or to promote economic growth. The banking sector across the board, and especially at the top tier, is undeniably thriving by every measure—from huge profits and bonuses to full lending portfolios. And the credit needs of the real economy are being fully met. [21]

A review of the data confirms the point and shows that far from stifling bank activity, financial regulation has created the conditions for a sustained period of economic growth and prosperity, just as the banking and securities laws did following the crash of 1929. Many prominent policymakers and market watchers have been highlighting the ever-increasing profits in the financial sector, the presence of healthy liquidity in our markets, and the overall strengths of our economy.

For example, FDIC data from 2017 shows that the financial sector has seen record profits, the rate of loan growth for the industry has exceeded the growth rate of GDP, and loan balances for community banks have been up a robust 7.7 percent year-over-year.[22] The FDIC Chairman

21 Former FDIC Vice Chairman Thomas Hoenig and former FDIC Chair Sheila Bair recently confirmed that there is no evidence of a shortage of credit: "Surveys of small businesses show that their credit needs are being met; leveraged loans to large companies are up; and the residential real estate market is hot. There may even be too much debt buildup in certain sectors." Thomas M. Hoenig & Sheila C. Bair, Opinion, *Relaxing Bank Capital Requirements Would Risk Another Crisis*, WALL ST. J. (Apr. 26, 2018), https://www.wsj.com/articles/relaxing-bank-capital-requirements-would-risk-another-crisis-1524784371. They also express the fear that the effect of the Proposal would be "to make the financial system less resilient and to make another financial crisis likelier and more severe." *Id.*

22 Federal Deposit Insurance Corporation, Quarterly Banking Profile: First Quarter 2017, https://www.fdic.gov/bank/analytical/qbp/2017mar/qbp.pdf.

reviewed this data in testimony before the Senate Banking Committee and noted that "annual increases in industry net income have averaged 7.8 percent per year since 2011. FDIC-insured institutions reported a record $171.3 billion in net income in 2016, marking a net increase of 44 percent over the prior five years."[23] The American Banker, a trade publication, also reviewed the evidence and concluded:

> Republicans have repeatedly asserted that the 2010 financial reform law has increased the cost of consumer lending and cut off access to credit. . . . Yet the available data indicates otherwise. Consumer credit has roared back in the six years since Dodd-Frank, with a 46% jump in outstanding consumer credit to $3.8 trillion. . . . [T]he fact remains that mortgage, auto and credit card lending have all gone up since 2010. [Mortgage] lending standards are as loose as they've been since the downturn. . . . Auto lending has been on a tear since the financial crisis . . . . Credit card lending has returned to pre-crisis levels with total lending hitting an all-time high of $996 billion. . . .[24]

Analysts at Bloomberg reached a similar conclusion:

> Lending declined initially after 2008, when the entire banking industry was almost wiped out by the collapse of the U.S. housing market. But it's grown steadily since then, expanding by 6 percent a year since 2013, far faster than the economy. Banks now have a record $9.1 trillion of loans outstanding.[25]

All of these trends from 2017, showing a remarkably robust financial services industry, have continued into 2018.[26] Recent assessments of the state of the banking sector again show that "U.S. bank lending has been healthy over recent years and profits are strong. . . . The current level of capital is a sign of strength."[27] Those assessments have also cautioned that at a minimum, the capital and liquidity framework must be tested through an entire economic cycle before any "judgments" are made about its performance or changes considered.[28] In short, there is no need

---

23 Statement of Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation, on Fostering Economic Growth: Regulator Perspective before the Committee on Banking, Housing, and Urban Affairs, United States Senate, June 22, 2017, *available at* https://www.fdic.gov/news/news/speeches/spjun2217.pdf.

24 Kate Berry, *Four Myths in the Battle over Dodd-Frank*, AMERICAN BANKER (March 10, 2017), https://www.americanbanker.com/news/four-myths-in-the-battle-over-dodd-frank (emphasis added).

25 Zeke Faux, Yalman Onaran, and Jennifer Surane, *Trump Cites Friends to Say Banks Aren't Making Loans. They Are*, BLOOMBERG, Feb. 4, 2017, https://www.bloomberg.com/news/articles/2017-02-04/trump-cites-friends-to-say-banks-aren-t-making-loans-they-are (emphasis added).

26 *See* Federal Deposit Insurance Corporation, Quarterly Banking Profile: First Quarter 2018, https://www.fdic.gov/bank/analytical/quarterly/2018-vol12-1/fdic-v12n1-4q2017.pdf. Record profits would likely have been achieved again in 2018 but for the anomalous effects of the tax cuts.

27 *See* Lael Brainard, *supra* n. 5, at 6.

28 *Id.*

to liberate banks from the current and relatively modest eSLR requirements, and it is surely unwise to do so at this early stage of implementation.

Other data-driven, academic analysis confirms the point that far from suppressing bank activity, capital requirements actually promote it. The evidence shows that better capitalized banks have higher rates of lending and a lower cost of capital throughout the business cycle. In particular, Morris Goldstein's new book, BANKING'S FINAL EXAM: STRESS TESTING AND BANK-CAPITAL REFORM, undertakes a rigorous review of all the data and analysis, demonstrating that 14% to 18% capital levels for the 8 U.S. G-SIBs (and a sliding scale for smaller banks) would be appropriate with negligible impact on lending. The understated summary of the analysis is worth considering in full:

> At the heart of the banking industry's opposition to much higher capital requirements is the assertion that higher bank capital requirements will depress bank lending and thereby reduce output and employment in the economy. This assertion is increasingly at odds with the empirical evidence – as well as with the appraisals of senior bank supervisors. . . . Better capitalized banks lend more, not less, than weakly capitalized ones. One recent impressive study, which looked at 105 large banks from advanced economies over the 1994-2012 period, finds that after holding other factors constant, a 1%-point increase in the equity to total assets ratio (*i.e.*, the leverage ratio) is associated with a 0.6% increase in total lending growth. With this empirical finding, a key pillar of the case against much higher capital requirements is taken away.[29]

Turning to the second false assumption underlying the Proposal, relaxing the capital standards as proposed in the Release will not actually lead to increased lending to any significant degree. The recent commentary of Former FDIC Vice Chairman Thomas Hoenig and former FDIC Chair Sheila Bair, cited above, addressed the point:

> The idea that lowering bank capital requirements boosts lending is urban legend. Ample research shows that banks with higher capital levels lend more, not less, through business cycles. . . . In fact, the proposals would likely have only a small impact on bank lending. Banks are likely simply to transfer the newly released capital to their parent companies. . . . In our experience, bank holding companies lower their capital to correspond to any new minimum requirement. They distribute the "excess" to shareholders, or use it to subsidize the expansion of their trading and other nonbank activities, rather than to increase commercial lending.[30]

---

29 MORRIS GOLDSTEIN, BANKING'S FINAL EXAM: STRESS TESTING AND BANK-CAPITAL REFORM (2017).

30 Hoenig and Bair, *supra* note 21.

In fact, this pattern of bank behavior has been garnering headlines. Stock buybacks have been climbing for years, and in mid-2017, when the capital plans of 34 of the leading banks were approved following stress tests, 26 banks immediately announced plans to buy back almost $100 billion in stock (and boost dividends), setting a single day record.[31] The trend continues with yet another high-water mark just announced in the Financial Times:

> Large U.S. banks are poised to hand over more capital to investor than they are generating from their businesses for the first time since the 2008 crisis, lowering their defenses against another catastrophic shock to the financial system. Shareholders in 22 of the country's biggest listed banks are in line for a record haul of $170 billion in dividends and stock buybacks over the coming year.[32]

All of this is money that could have been used not only to protect and preserve a capital buffer against future downturns, but also to increase lending and other socially useful banking activities—including the various services cited in the Proposal as on the wane.

In summary, the Proposal offers neither a clear and credible rationale nor a realistic benefit. And its ultimate effect will be to increase the likelihood and severity of another financial crisis. In light of these gaps in the Proposal and its adverse effects, it should be withdrawn.[33]

---

31 Chris Dieterich, *Banks Unleash Record Stock Buyback Plans,* Wall Str. J., June 30, 2017, https://blogs.wsj.com/moneybeat/2017/06/30/banks-unleash-record-stock-buyback-plans/; Christina Rexrode, *Bank Stocks Throw a Dividend Party,* Wall St. J., June 29, 2017, https://blogs.wsj.com/moneybeat/2017/06/29/bank-stocks-throw-a-dividend-party/.

32 Alistair Gray and Ben McLannahan, *US Banks Poised for $170bn in Shareholder Payouts,* FINANCIAL TIMES (June 18, 20018).

33 The Proposal also includes parallel amendments to the total loss-absorbing capacity ("TLAC") standards. It would similarly shift those standards from a fixed 2% SLR-based buffer (on top of the 7.5% TLAC requirement) to one based on the same metric the Proposal would apply to the eSLR: 50% of the firm's GSIB surcharge. Release, *supra* note 2, at 17322. The TLAC requirements represent another important set of reforms designed to address major financial system disruptions by ensuring that a GSIB has sufficient private capital to support the firm's critical operations during bankruptcy or orderly resolution. This aspect of the Proposal is objectionable for essentially the same reasons articulated above with respect to the proposed modifications to the eSLR. *See also* Comment Letter from Better Markets to the Board on TLAC proposals, Docket No. R-1523 (Feb. 19, 2016) (arguing, *inter alia*, that the Board should set *higher* minimum levels of TLAC), *available at* https://bettermarkets.com/sites/default/files/FRS%20-%20CL%20-%20Total%20Loss-Absorbing%20Capacity%20-%20Long%20Term%20Debt%20and%20Clean%20Holding%20Company%20Requirements%202-19-2016.pdf.

CONCLUSION

We hope these comments are helpful as the OCC and the Board decide whether to implement the Proposal.

Sincerely,

Dennis M. Kelleher
President & CEO

Stephen W. Hall
Legal Director and Securities Specialist

Better Markets, Inc.
1825 K Street, NW
Suite 1080
Washington, DC 20006
(202) 618-6464

dkelleher@bettermarkets.com
shall@bettermarkets.com
www.bettermarkets.com

Addendum

GSIB	TARP Funds	Non-TARP Funds	TARP Mortgage Funds	Total Bailout funds
JP Morgan Chase	$25,000,000	$391,000,000	$2,940,110	$418,940,110
Bank of America	$45,000,000	$1,344,000,000	$2,118,070	$1,391,118,070
Citigroup	$45,000,000	$2,518,000,000	$719,000	$2,563,719,000
Deutsche Bank		$354,000,000		$354,000,000
HSBC		$4,000,000		$4,000,000
Bank of China				$0
Barclays		$868,000,000		$868,000,000
BNP Paribas		$175,000,000		$175,000,000
China Construction Bank				$0
Goldman Sachs	$10,000,000	$814,000,000		$824,000,000
Industrial and Commercial Bank of China Limited				$0
Mitsubishi UFJ FG		$84,000,000		$84,000,000
Wells Fargo	$25,000,000	$159,000,000	$3,050,000	$187,050,000
Agricultural Bank of China				$0
Bank of New York Mellon	$3,000,000	$12,900,000		$15,900,000
Credit Suisse		$262,000,000		$262,000,000
Groupe Credit Agricole				$0
ING Bank				$0
Mizuho FG		42,300,000		$42,300,000
Morgan Stanley	$10,000,000	$2,041,000,000		$2,051,000,000
Nordea				$0
Royal Bank of Canada				$0
Royal Bank of Scotland		$541,000,000.00		$541,000,000
Santander			$26	$26
Societe Generale		$124,000,000		$124,000,000
Standard Chartered				$0
State Street	$2,000,000	$103,300,000.00		$105,300,000
Sumitomo Mitsui FG		$56,000,000		$56,000,000
UBS		$287,000,000.00		$287,000,000
Unicredit Group		$97,000,000		$97,000,000
Total	**$165,000,000**	**$10,277,500,000**	**$8,827,206**	**$10,451,327,206**

(Dollars in Thousands)

Sources:

Sources:

https://projects.propublica.org/bailout/list/index (TARP)

https://www.gao.gov/new.items/d11696.pdf (Non-TARP)

BETTER
MARKETS

June 25, 2018

Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules, Docket No. R-1603 and RIN 7100-AF 01

Ladies and Gentlemen:

Better Markets[1] appreciates the opportunity to comment on the notice of proposed rulemaking captioned above ("Proposal" or "Release"),[2] issued by the Board of Governors of the Federal Reserve System ("Board"), regarding amendments to various rules governing bank capital, capital planning, and stress testing.

INTRODUCTION AND SUMMARY

The capital, leverage, and stress testing requirements for banks and other financial institutions set forth in the Dodd-Frank Act and implemented by the Board and other prudential regulators since the financial crisis are among the most important regulatory reforms adopted in almost a century. They are critical for maintaining the financial stability of the domestic and global financial markets and ultimately the world-wide economy. Any changes to those rules and regulations must be undertaken with the utmost care and only for the most compelling reasons. Above all, they must not be weakened.

Unfortunately, the net effect of the Proposal will be to undermine these critical reforms. While some of the elements of the Proposal are conceptually sound, the inescapable fact is that it would materially alter several important assumptions underlying the supervisory stress tests,

1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system, one that protects and promotes Americans' jobs, savings, retirements, and more.

2 83 Fed. Reg. 18160 (Apr. 25, 2018).

resulting in a decrease in the amount of capital that most large banks with over $50 billion in assets would have to maintain to avoid limits on their capital distributions.

This weakening of prudential safeguards is unwise on its face. As a general matter, bank capital requirements are still too low to adequately protect our financial system and our economy from crisis and meltdown. Moreover, when economic growth is strong, as it is today, regulators should be applying additional, countercyclical capital buffers, not shrinking existing capital requirements. And the Proposal is at a minimum premature, as any amendments to the bank capital requirements should await at least the completion of a full business cycle, a point in time that we have not yet reached.

Turning to the specifics of the Proposal, the Release fails to provide concrete and persuasive reasons for the proposed changes. The ostensible justification for the Proposal is essentially two-fold: A desire to simplify the capital buffer framework, and a desire to accommodate banks by liberalizing their ability to distribute capital in the form of dividends, repurchases, and bonuses—a practice that is already thriving under existing capital standards.[3] Such benefits, conferred on a relatively small class of bank shareholders and executives, can hardly justify the proposed thinning of capital reserves, which would undoubtedly increase the risk and severity of another financial crisis. And, as we have seen over the last ten years, such a crisis would impose widespread and crushing burdens not just on a select few but on virtually every one of America's 325 million citizens.

This is a poor trade-off and one that is especially unwise given the predominantly de-regulatory trend in bank oversight that is now underway. Alone, and even more so in combination with other de-regulatory measures that have recently been advanced in the banking arena, the Proposal represents an unnecessary and unwarranted threat to the stability of our financial system.

<u>OVERVIEW OF THE PROPOSAL AND ITS IMPACT</u>

<u>Elements of the Proposal</u>

The Proposal would materially alter some of the current requirements governing bank capital, capital planning, and stress testing. The net effect would be to reduce the amount of capital that the large banks—excepting only the GSIBs—must maintain to ensure their financial stability and avoid restrictions on their capital distributions. While the Proposal is expected to maintain or in some cases increase the required capital buffers at the GSIBs—a positive impact to be sure---it is unwise and unnecessary to do so at the expense of the capital buffers maintained at the more numerous and still systemically important banks outside the GSIB category.

- <u>Establish a new "stress capital buffer."</u> The Proposal would create a new component of the standardized approach capital conservation buffer, known as the "stress capital buffer." The new stress capital buffer would replace the current fixed "2.5% of risk-weighted assets" element of the standardized approach capital buffer. The stress capital buffer would

3 Alistair Gray and Ben McLannahan, *US Banks Poised for $170bn in Shareholder Payouts*, FINANCIAL TIMES (June 18, 20018).

be based on the results of the annual supervisory stress tests, but would have a floor or minimum of 2.5% of a firm's risk-weighted assets. According to the Release, the stress capital buffer would be "forward-looking, risk-sensitive, and firm-specific."[4] As a result of this change, a bank's required standardized approach capital conservation buffer would be comprised of the new stress capital buffer, any applicable GSIB surcharge, and any applicable countercyclical capital buffer amount.

- Preserve the advanced approaches buffer. Due to complexities and costs, the Proposal would not inject the stress-testing element into the advanced approaches capital conservation buffer, which would remain equal to the sum of 2.5% of risk-weighted assets plus any applicable GSIB surcharge and countercyclical buffer.

- Establish a new "stress leverage buffer." The Proposal would also create, again using the annual supervisory stress tests, a new "stress leverage buffer," which would not have a floor or minimum amount.

- Eliminate the quantitative basis in CCAR for limiting distributions, while preserving the qualitative criteria. The Proposal would eliminate the quantitative assessment in CCAR as the basis for objecting to a bank's capital distributions. However, banks would still be required to submit their capital plans to the Board and describe their intended capital distributions. The Board would continue to have the authority to object to the capital plans of large and complex firms on **qualitative** grounds.

- Apply the most stringent standard. Under the Proposal, firms would continue to have to maintain capital ratios above all minimum capital levels plus buffer requirements to avoid restrictions on their capital distributions and discretionary bonus payments. The Release also makes clear that a firm would be subject to the most stringent distribution limitations, as determined by the firm's standardized approach capital conservation buffer requirement as amended by the Proposal; the firm's stress leverage buffer requirement; and any applicable advanced approaches capital conservation buffer requirement or enhanced supplementary leverage ratio standard.

- Materially alter the stress testing assumptions. The Proposal would change a number of assumptions that the Board currently uses in the supervisory stress tests, rendering those tests decidedly less rigorous. Under the Proposal,

  (1) the Board would no longer assume that a firm makes any repurchases or redemptions of any capital instrument;

  (2) the Board would scale back the assumption relating to dividend payments and assume that the firm will make only four quarters of planned common stock dividend payments (in quarters four through seven, which would be added to the

---

4 Release at 18163.

> firm's projected decline in capital under stress), as opposed to the current level of payments, which assumes dividends are paid through the entire planning horizon of nine quarters;
>
> (3) the Board would assume that the firm does not make any planned issuances of regulatory capital instruments, in parallel with the assumption that the firm would not repurchase any regulatory capital instruments;
>
> (4) the Board would dispense with the assumption that any capital plan implying a common stock dividend payout above 30 percent warranted heightened scrutiny in the qualitative assessment of the firm's capital planning process; and
>
> (5) the Board would no longer assume that the credit supply remains unconstricted and that a firm's balance sheet grows throughout the planning horizon; instead, the Board would adopt the "no growth assumption" that firms take action simply to maintain their current levels of assets, including loans, securities, and trading assets.
>
> These changes in the assumptions are significant in part because they represent amounts that would no longer be added to the reductions in capital predicted by the stress tests, thus making the stress tests less rigorous.

It is fair to say that some of these proposed changes are unobjectionable. For example, the proposed stress capital buffer is a sound concept, as is the stress leverage buffer. Furthermore, it is certainly prudent for the Board to establish a floor or minimum, as proposed for the stress capital buffer. And it is critically important to preserve the GSIB surcharge and any future countercyclical capital buffers as components of the overall capital conservation buffer, which the Proposal does. However, the overriding effect of the Proposal is negative, since, as shown in the impact analysis, it will reduce the size of the capital buffer for most banks, and liberalize their ability to distribute capital freely to shareholders and executives.

Impact Analysis

The Release sets forth the results of the Board's impact analysis. For that exercise, the Board reviewed the levels of capital required under the current regime—compliance with which is necessary to avoid limitations on capital distributions—and compared those amounts to the levels of capital that would be required under the Proposal.[5]

The Board concludes that for most banks i.e. firms with over $50 billion in assets that are not GSIBs, "the proposal would generally result in a **reduction** to a firm's required level of capital to avoid capital distribution limitations relative to what is required today."[6] For example, based on the most recent data from 2017, the Release estimates that the reduction in required capital for

[5] *Id.* at 18167.
[6] *Id.* (emphasis added).

non-GSIBs would amount to **$45 billion**. The Release attributes these reductions to the modified assumptions regarding capital distributions and balance sheet growth. Those assumptions would lower the amount of Tier 1 capital that a firm would need to maintain, and those lower amounts would not be offset by any other cushioning requirements, since the new stress capital buffer applicable to the non-GSIB banks would not include a GSIB surcharge buffer (nor would it be affected by a countercyclical capital buffer amount, which is currently set at zero).

For the GSIBs, the Board estimates that the Proposal would generally maintain or in some cases increase the CET 1 capital requirements. For example, again using the recent 2017 data, the Board estimates the Proposal would lead to an increase in required capital in the range of $10 billion. Such increases could be expected to occur because the GSIB's capital conservation buffer under the Proposal would include not only the new "stress capital buffer" but also the GSIB surcharge currently in place. In combination, those requirements could exceed the levels of capital required under the current supervisory post-stress capital assessment. This effect of the Proposal is of course a positive one, and as the Board crafts the final version, it should ensure that this feature is preserved.

In addition to the problematic decrease in required capital for many large banks, the Proposal would also create uncertainty. The Release explains that these impact assessments can be expected to vary through the economic and credit cycle, depending on "the risk profile and planned capital distributions of individual firms, as well as on the specific severely adverse stress scenario used in the supervisory stress test."[7] Thus, to the extent that the stewards of future tress testing scenarios make the tests less rigorous, the decrease in required capital resulting from the Proposal would be correspondingly larger and more destabilizing.

COMMENTS

I. Bank capital standards and stress testing requirements are critically important in protecting the stability of our financial system, and the lessons of the 2008 financial crisis should guide the Board as it revises and finalizes the Proposal.

Any proposed changes to the current capital and stress testing framework must be evaluated with the critical role of those regulatory reforms foremost in mind. The Release appropriately reviews the enormous importance of bank resiliency in preserving the stability of the financial sector, and the key role of capital requirements in achieving that goal:

> The resiliency of large financial institutions is critical to the stability of the financial sector. As shown in the 2007-2008 financial crisis, problems at large financial institutions can lead to significant market disruptions, spread rapidly throughout the financial system, and cause a credit crunch, worsening economic downturns. To be resilient, a financial institution must maintain sufficient levels of capital to support the risks associated with its exposures and activities. In the years leading

7 *Id.*

> up to the financial crisis, neither the regulatory capital regime nor financial institutions' own models sufficiently captured the actual risk exposures of financial institutions, resulting in a level of capital that was inadequate to cover losses as conditions deteriorated.[8]

In reality, the only thing that stands between a failing bank and a taxpayer bailout is the bank's capital cushion. As we saw just ten short years ago, insufficient capital can be catastrophic for the banks, the financial system, the taxpayers, and the entire country. The sheer scale of the bailouts, backstops, and credit facilities provided to the GSIBs during the financial crisis was staggering, totaling over ten trillion dollars, as detailed on the attached Addendum.

Those bailouts were only a part of the costs of the 2008 crash and the massive effort to mitigate the consequences, which Better Markets has calculated to exceed $20 trillion in lost GDP.[9] And although the economy in general is much stronger, those costs continue to overshadow the financial lives of many Americans, who received no bailout.

While the crash and its devastating consequences had numerous causes, the lack of adequate bank capital was most prominent, and the subsequently enacted capital rules were key reforms designed to prevent the recurrence of such a crisis. The goal was not only to prevent bank failures or systemic crises, but also to avoid the human devastation inflicted on so many American families. Those goals must be the prism through which policy decisions about capital are viewed, particularly if those decisions will result in reduced capital levels and, therefore, fewer protections for American families who have already suffered so much.

It is no wonder then, that Congress and the financial regulators constructed a multi-layered framework of regulatory safeguards designed to protect the stability of our financial system. The Release canvasses many of those reforms, which are appropriately scaled to the size of a bank or other financial institution. Among them are capital requirements, including capital buffers as well as surcharges for the largest banks; leverage requirements, including the supplementary leverage ratio ("SLR") and the enhanced SLR for the largest banks; and supervisory and company-run stress tests, including the Comprehensive Capital Analysis and Review ("CCAR") process which the larger banks must undergo.

The Release also appropriately acknowledges the efficacy of these reforms:

---

8 *Id.* at 18160.

9 Better Markets, The Cost of Crisis, $20 Trillion and Counting (July, 2015), *available at* https://www.bettermarkets.com/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis.pdf.

> Strengthening the regulatory capital regime, including the introduction of capital planning and stress testing requirements, has been an important supervisory response to the financial crisis. . . . As a result of this program and the enhancements made to the Board's regulatory capital regime, large U.S. bank holding companies are much more resilient to stress than in the past.[10]

Given this backdrop, commendably laid out in the Release, it should be evident that any proposal to alter these bank capital requirements and related reforms must be accompanied by a robust, evidence-based justification clearly showing that the serious risks attending lower capital requirements are offset by exceptionally clear, broad-based, and tangible benefits not just to the banks themselves but to the real economy and the American public at large. Here, the case has not been made.

II. <u>The Proposal is premature and unwise, especially at a time when bank capital buffers should be increased, not scaled back.</u>

The Proposal conflicts with three basic principles that must govern bank regulation, especially in the aftermath of a financial crisis of historic proportions.

First, lowering the existing bank capital requirements to any degree is unwise because those requirements, while much improved since the financial crisis, are still inadequate. At current levels, they cannot ensure financial system stability in the face of stresses like those seen during the financial crisis. As Better Markets has demonstrated, empirical evidence measuring the devastating impact of the crisis on just four banks (Washington Mutual, Wachovia, Citigroup, and Bank of America) shows that "banks require equity well in excess of 10 percent of their tangible assets to survive financial crises of the severity" witnessed in 2008.[11] Losses alone can exceed this amount, and to reassure counterparties and account for rapid asset devaluations during a crisis, banks must actually have equity equal to 20-25% of assets to protect against failure.[12] Other analyses conducted by academics, the Financial Stability Board, and the Board itself, which are based on data reflecting actual losses incurred during the financial crisis, all support the conclusion that a capital cushion of at least 20% is appropriate and necessary to protect banks against the ravages of a financial crisis.[13] Lowering capital requirements to **any** degree is a step in the wrong direction.

---

10 Release at 18161.

11 *See* Comment Letter from Better Markets to the Board of Governors of the Federal Reserve System, *et al.*, on Regulatory Capital Rules, RIN 1557-AD46, at 3-5 (Oct. 22, 2012), *available at* https://bettermarkets.com/sites/default/files/documents/FRS%2C%20OCC%2C%20FDIC-%20CL-3nprs-%2010-22-12.pdf.

12 *Id.*

13 *See* Comment Letter from Better Markets to the Board of Governors of the Federal Reserve System on Total Loss-Absorbing Capacity, Docket No. R-1523 (Feb. 19, 2016), *available at* https://bettermarkets.com/sites/default/files/FRS%20-%20CL%20-%20Total%20Loss-

Second, when the economy and the banking sector in particular appear to be strong and stable, regulators should be considering and imposing countercyclical measures that would fortify banks against the economic downturn that will inevitably follow. As Board Governor Lael Brainard has cautioned, at a time when cyclical pressures are building, "we should be calling for large banking organizations to safeguard the capital and liquidity buffers they have built over the past few years. . . . Indeed, if cyclical pressures continue to build and financial vulnerabilities broaden, it may become appropriate to ask the largest banking organizations to build a countercyclical buffer (CCyB) of capital to maintain an adequate degree of resilience against stress."[14] Former FDIC Vice Chairman Thomas M. Hoenig has also highlighted the importance of staying the regulatory course throughout the business cycle: "We know that when the business cycle shifts and losses materialize, the absence of capital intensifies the downturn as the market suspects there is not sufficient capital to absorb the shock and it worries about bank insolvency suddenly becoming real."[15] And he made the broader point that we must not succumb to amnesia:

> Another common element of most crises is the aftermath, in which new laws and regulations are enacted with the intent to prevent new crises. But memories are short and with an improving economy, these laws and regulations—which early in the recovery are viewed as essential—are eventually recast as burdensome constraints that need to be eased or ended. . . . I caution against eroding the post-crisis capital standards that have contributed to the strength of the U.S. banks and the long-awaited recovery of the U.S. economy. Weakening those standards will undermine the long-term resilience of not only the banking system, but the broader economy as well.[16]

Third and finally, even setting aside these axioms of prudential regulation, it is simply too early to be altering the bank capital requirements that were so painstakingly and incrementally instituted over a period of years following the financial crisis. Leading policy-makers have recently confirmed that post-crisis reforms under the Dodd-Frank Act relating to capital and liquidity should not be re-visited until they have been tested through an entire business cycle. As Board Governor Brainard has explained:

> I support efforts to identify improvements that make regulations less burdensome. But it is vital to be prudent regarding any material changes to the core capital and

Absorbing%20Capacity%20-%20Long%20Term%20Debt%20and%20Clean%20Holding%20Company%20Requirements%202-19-2016.pdf.

14 *See* Lael Brainard, Member of the Board of Governors of the Federal Reserve, Remarks at the Global Finance Forum, *Safeguarding Financial Resiliencies Through the Cycle*, at 7, 10 (Apr. 19, 2018) (emphasis added), *available at* https://www.federalreserve.gov/newsevents/speech/files/brainard20180419a.pdf.

15 Thomas M. Hoenig, *Finding the Right Balance,* Keynote Speech, Peterson Institute for International Economics, at 2 (Mar. 28, 2018).

16 *Id.*

> liquidity framework, and not lose sight of the need to safeguard financial resilience through the cycle. Prudence would argue for waiting until we have tested how the new framework performs through a full cycle before we make judgments about its performance. At this point in the cycle, it is premature to revisit the calibration of core capital and liquidity requirements for the large banking institutions. [17]

Of course, we have not yet experienced a complete business cycle since the crisis, and it is therefore premature to be modifying the capital buffer requirements as proposed in the Release.

III. The Release offers no persuasive rationale for reducing the size of the capital buffer.

The Proposal fails to provide a convincing justification for a measure that will weaken capital standards by allowing banks even more leeway in making capital distributions. Such relief is unnecessary, as banks are thriving and distributions are already robust. In addition, the new assumptions that underlie the Proposal are based on flawed reasoning, and it is those questionable assumptions that ultimately account for the projected decrease in capital buffer levels.

The Release offers a number of reasons for the Proposal. It generally explains that "the Board has reviewed the CCAR program to assess its effectiveness and to identify any areas that should be refined."[18] The Release further notes that in light of the review process, which involved both internal assessment and external "feedback," "the Board has identified several areas where the capital plan rule and CCAR could be further refined or improved." The Release describes the principal purpose of those changes as "reducing burden for non-GSIBs," "addressing inconsistencies," and "simplifying certain supervisory stress test assumptions."[19] Elsewhere, the Release focuses on the multiple regulatory limitations that restrict a bank's ability to make capital distributions, and it explains that the Proposal would "simplify and integrate these requirements, eliminating the need for firms to manage to both potential sources of limitations on capital distributions."[20]

In reality, the ultimate impact of the Proposal would be "a reduction to a firm's required level of capital to avoid capital distribution limitations relative to what is required today."[21] Thus, the Proposal would weaken a critically important component of the bank capital regime for the purpose of simplifying and easing regulatory burdens and freeing up bank capital for the benefit of shareholders and bank executives.

Neither justification is persuasive. With respect to the notion of easing burdens, with each passing quarter, we see the banking industry's already record-breaking profits soar even higher.

17 *See* Brainard, *supra* note 14, at 6.
18 Release at 18161.
19 *Id.* at 18162.
20 *Id.* at 18167.
21 *Id.*

The trend over the past year and half is clear. The banking sector across the board, and especially at the top tier, is undeniably thriving by every measure—from huge profits and bonuses to full lending portfolios. And the credit needs of the real economy are being fully met.[22] For example, FDIC data from 2017 shows that the financial sector has seen record profits, the rate of loan growth for the industry has exceeded the growth rate of GDP, and loan balances for community banks have been up a robust 7.7 percent year-over-year.[23] The former FDIC Chairman Martin J. Gruenberg reviewed this data in testimony before the Senate Banking Committee and noted that "annual increases in industry net income have averaged 7.8 percent per year since 2011. FDIC-insured institutions reported a record $171.3 billion in net income in 2016, marking a net increase of 44 percent over the prior five years."[24] The American Banker, a trade publication, also reviewed the evidence and concluded:

> Republicans have repeatedly asserted that the 2010 financial reform law has increased the cost of consumer lending and cut off access to credit. . . . Yet the available data indicates otherwise. Consumer credit has roared back in the six years since Dodd-Frank, with a 46% jump in outstanding consumer credit to $3.8 trillion. . . . [T]he fact remains that mortgage, auto and credit card lending have all gone up since 2010. [Mortgage] lending standards are as loose as they've been since the downturn. . . . Auto lending has been on a tear since the financial crisis . . . . Credit card lending has returned to pre-crisis levels with total lending hitting an all-time high of $996 billion. . . .[25]

Analysts at Bloomberg reached a similar conclusion:

> Lending declined initially after 2008, when the entire banking industry was almost wiped out by the collapse of the U.S. housing market. But it's grown steadily since

---

22 Former FDIC Vice Chairman Thomas Hoenig and former FDIC Chair Sheila Bair recently confirmed that there is no evidence of a shortage of credit: "Surveys of small businesses show that their credit needs are being met; leveraged loans to large companies are up; and the residential real estate market is hot. There may even be too much debt buildup in certain sectors." Thomas M. Hoenig & Sheila C. Bair, Opinion, "*Relaxing Bank Capital Requirements Would Risk Another Crisis*, WALL ST. J. (Apr. 26, 2018), https://www.wsj.com/articles/relaxing-bank-capital-requirements-would-risk-another-crisis-1524784371.

23 Federal Deposit Insurance Corporation, Quarterly Banking Profile: First Quarter 2017, https://www.fdic.gov/bank/analytical/qbp/2017mar/qbp.pdf.

24 Statement of Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation, *Fostering Economic Growth: Regulator Perspective before the Committee on Banking, Housing, and Urban Affairs, United States Senate*, June 22, 2017, *available at* https://www.fdic.gov/news/news/speeches/spjun2217.pdf.

25 Kate Berry, *Four Myths in the Battle over Dodd-Frank*, AMERICAN BANKER (March 10, 2017), https://www.americanbanker.com/news/four-myths-in-the-battle-over-dodd-frank (emphasis added).

> then, expanding by 6 percent a year since 2013, far faster than the economy. Banks now have a record $9.1 trillion of loans outstanding.[26]

All of these trends from 2017, showing a remarkably robust financial services industry, have continued into 2018.[27] Recent assessments of the state of the banking sector again show that "U.S. bank lending has been healthy over recent years and profits are strong. . . . The current level of capital is a sign of strength."[28] This collection of data belies any claim that banks need further relief from the supposed burdens of regulation.

Nor is there any need to ease restrictions on banks' ability to distribute capital. Indeed, this represents an even less convincing rationale for the Proposal. Banks are **already** free to bestow vast sums upon their shareholders and executives, and they are taking full advantage of that opportunity. Recent reports illustrate the trend:

> Large U.S. banks are poised to hand over more capital to investor than they are generating from their businesses for the first time since the 2008 crisis, lowering their defenses against another catastrophic shock to the financial system. Shareholders in 22 of the country's biggest listed banks are in line for a record haul of $170 billion in dividends and stock buybacks over the coming year.[29]

Easing limits on the distribution of bank capital is not only unnecessary but also extremely unwise, given the prominent role of such distributions in exacerbating the financial crisis. The Release itself repeatedly makes the point by reviewing some of the relevant history:

> The risks to the ability of the financial system to support economic growth were exacerbated by actions taken by firms during the crisis. Rather than conserve loss-absorbing resources, many firms continued to distribute capital to shareholders in an attempt to reassure the market of their health and resiliency. . . . The capital rule and the capital plan rule each place separate limitations on firms' capital distributions to address the fact that many firms made significant distributions of capital in the lead up to and during the financial crisis without fully considering the effects that a prolonged economic downturn could have on their capital adequacy.[30]

It follows from these incontrovertible facts about the financial crisis that any effort to shrink the capital buffer and allow greater distributions of capital would **weaken** the ability of

---

26 Zeke Faux, Yalman Onaran, and Jennifer Surane, *Trump Cites Friends to Say Banks Aren't Making Loans. They Are*, BLOOMBERG, Feb. 4, 2017, https://www.bloomberg.com/news/articles/2017-02-04/trump-cites-friends-to-say-banks-aren-t-making-loans-they-are (emphasis added).

27 *See* Federal Deposit Insurance Corporation, Quarterly Banking Profile: First Quarter 2018, https://www.fdic.gov/bank/analytical/quarterly/2018-vol12-1/fdic-v12n1-4q2017.pdf. Record profits would likely have been achieved again in 2018 but for the anomalous effects of the tax cuts.

28 *See* Lael Brainard, *supra* note 14, at 6.

29 *See* Alistair Gray and Ben McLannahan, *supra* note 3.

30 Release at 18160, 18192.

individual firms and the banking system to weather another financial crisis. Because the Proposal would indeed thin the capital buffer for most large banks, it is imprudent.

Finally, the specific changes in the assumptions underlying the supervisory stress tests set lack a satisfactory rationale. Consider the two most important alterations. First, the Proposal would dramatically scale back the assumptions regarding capital actions. Currently, the Board assumes that a firm will make all of its planned capital actions, including dividends, repurchases, and issuances of capital instruments, throughout the planning horizon.[31] The purpose of this assumption was to bring rigor to the test and to enable the Board "to assess whether a firm could meet minimum capital requirements during severe stress conditions even if the firm did not reduce its planned capital distributions."[32] Under the Proposal, however, the Board would no longer assume that a firm makes **any** repurchases or redemptions of any capital instrument, and it would cut by more than half the assumed level of dividend payments.[33] These payouts would no longer be added to the projected decline in the firm's capital under stress, rendering the test less effective.

This new assumption suffers from a number of flaws. First, it discounts lessons learned during the financial crisis. The Release itself notes that assuming a firm will make all planned capital distributions "reflect[s] the historical experience from the financial crisis in which the largest banking organizations **continued to repurchase shares and pay dividends** to shareholders well after the financial system came under severe stress."[34] Second, this new assumption conflicts with an important regulatory objective acknowledged in the Release. The Release explains that the Proposal would continue to include at least four quarters of planned common stock dividends (cut back from nine) in the capital buffer "to preserve the current incentives for a firm to engage in disciplined, forward-looking dividend planning."[35] But if incentivizing such "disciplined, forward-looking planning" is necessary and appropriate, then the same approach should apply to assumptions about repurchases and redemptions, not just dividends. Finally, the decision to eliminate or dramatically scale back the current assumptions about capital actions appears to be arbitrary. Even if some adjustments might be deemed appropriate, the Release offers no empirical basis for the specific choices that the Board has made.

Similar concerns surround another major change in the stress testing assumptions. Currently the Board assumes "that a firm's credit supply does not contract, resulting in growth in the firm's balance sheet in stress scenarios."[36] Under the Proposal, however, the Board would adopt a "no-growth" assumption, stipulating only that a firm will maintain its current level of assets, including securities, trading assets, and loans, over the planning horizon.[37]

31 Release at 18165.
32 *Id.*
33 *Id.*
34 *Id.* at 18162.
35 *Id.* at 18165.
36 *Id.* at 18166.
37 *Id.*

This new assumption is also flawed. It conflicts with one of the Board's guiding principles for strengthening the financial system against instability and crisis. As explained in the Release, the existing, more robust assumption—

> furthered the Board's macroprudential objectives by evaluating whether firms could pass the supervisory post-stress capital assessment while continuing to lend and support the real economy. In implementing this assumption, the Board used a model calibrated to historical data that tended to project that a firm's balance sheet and risk-weighted assets would grow over the planning horizon, even in the severely adverse scenario.[38]

Thus, the test was designed to ensure not just that firms could survive conditions of extreme stress but also that they could continue to serve the real economy in a meaningful way, thus avoiding the tightening of credit markets, the crisis of confidence, and the downward spiral that perpetuate and intensify the early stages of a financial crisis. The Proposal dramatically alters this assumption, and it does so without a persuasive justification, merely noting that it would "simplify the current stress test assumptions" and at least prevent firms from planning to reduce credit supply and shrink their balance sheets in a period of stress.[39] This compromised approach to an important prudential safeguard mistakenly exalts "simplicity" over substance.

IV. **The Proposal is especially dangerous in the current de-regulatory climate, because it will act in concert with other de-regulatory initiatives to further weaken our defenses against another financial crisis.**

The Proposal is just one in a series of initiatives that will weaken important financial reforms adopted in the wake of the financial crisis. Because it would operate in conjunction with those other de-regulatory initiatives, it would pose a comparatively greater threat to the regulatory framework that helps protect and preserve the stability of our financial system. Just as the benefits of a single new regulation must be evaluated not only in isolation but also in terms of the larger benefits of the entire framework of which it is a part, the threats and risks of a single de-regulatory measure must be viewed in terms of the overall impact of a collection or series of related de-regulatory measures.

Unfortunately, the new Administration has ushered in a new era of financial de-regulation. The prime example at the legislative level is the so-called "Economic Growth, Regulatory Relief and Consumer Protection Act," signed into law on May 24, 2018, [40] which will scale back a number of the basic reforms embodied in the Dodd-Frank Act. Within the executive branch and at the independent agencies, de-regulatory measures abound. The President has issued a series of executive orders and memoranda sharply curtailing the ability of executive branch agencies to promulgate important regulations to protect the health, safety, and economic welfare of the

---

38 *Id.* at 18162.
39 *Id.* at 18166.
40 S. 2155, Public Law No. 115-174.

American public.[41] The Treasury Department has issued several extensive reports setting forth blueprints for altering, and in most cases weakening, the regulatory framework that was established to maintain the stability, fairness, and transparency of our financial markets.[42] And recently, the Board and other prudential regulators have issued rule proposals that will reduce capital requirements[43] and weaken critical limits on the ability of insured banks to engage in high-risk proprietary trading.[44]

This de-regulatory context intensifies the threat of any single proposal that seeks to unwind, rollback, or dilute the measures that were carefully put in place to prevent and mitigate any future financial crisis. For this reason, as well those articulated above, the Board should re-consider the

---

41 Executive Office of the President, Presidential Memorandum for the Secretary of the Treasury on the Orderly Liquidation Authority (Apr. 21, 2017) (requiring the Treasury Secretary to review the orderly liquidation authority); Executive Office of the President, Presidential Memorandum for the Secretary of the Treasury on the Financial Stability Oversight Council (Apr. 21, 2017) (requiring the Treasury Secretary to review the FSOC designation processes); Enforcing the Regulatory Reform Agenda, Exec. Order No. 13,777, 82 Fed. Reg. 12285 (Feb. 24, 2017) (requiring agencies to appoint Regulatory Reform Officers and Task Forces to oversee implementation of regulatory reform initiatives); Core Principles for Regulating the United States Financial System, Exec. Order No. 13,772, 82 Fed. Reg. 9965 (Feb. 3, 2017) (requiring the Treasury Secretary to review all financial regulations); Executive Office of the President, Presidential Memorandum for the Secretary of Labor on the Fiduciary Rule (Feb. 3, 2017) (requiring the Labor Secretary to examine the fiduciary duty rule to determine if it may adversely affect the ability of Americans to gain access to advice); Reducing Regulation and Controlling Regulatory Costs, Exec. Order No. 13,771, 82 Fed. Reg. 9339 (Jan. 30, 2017) (requiring the repeal of two regulations for every new regulation that is promulgated and that any cost to the industry be balanced by the repeal of other regulations, regardless of the benefits of the new or rescinded rules).

42 U.S. Department of the Treasury, A Financial System That Creates Economic Opportunities, Capital Markets, Oct. 2017, https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-Capital-Markets-FINAL-FINAL.pdf; U.S. Department of the Treasury, A Financial System That Creates Economic Opportunities, Asset Management and Insurance, Oct. 2017, https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-That-Creates-Economic-Opportunities-Asset_Management-Insurance.pdf; U.S. Department of the Treasury, A Financial System That Creates Economic Opportunities, Banks and Credit Unions, June 2017, https://www.treasury.gov/press-center/press-eleases/Documents/A%20Financial%20System.pdf.

43 Office of the Comptroller of the Currency and the Board of Governors of the Federal Reserve System, Joint Notice of Proposed Rulemaking re modifications to the enhanced supplementary leverage ratio, OCC RIN 1557-AE35, Federal Reserve RIN 7100 AF-03, 83 Fed. Reg. 17317 (Apr. 19, 2018), and Better Markets comment letter in response thereto, *available at* www.bettermarkets.com.

44 *See, e.g.,* Notice of Proposed Rulemaking, Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, Board of Governors of the Federal Reserve System (May 30, 2018), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180530a1.pdf.

Proposal and the assumptions in particular to ensure that it does not reduce the capital buffers that our large banks must maintain.

CONCLUSION

We hope these comments are helpful as the Board finalizes the Proposal.

Sincerely,

Dennis M. Kelleher
President & CEO

Stephen W. Hall
Legal Director and Securities Specialist

Better Markets, Inc.
1825 K Street, NW
Suite 1080
Washington, DC 20006
(202) 618-6464

dkelleher@bettermarkets.com
shall@bettermarkets.com
www.bettermarkets.com

Addendum

GSIB	TARP Funds	Non-TARP Funds	TARP Mortgage Funds	Total Bailout funds
JP Morgan Chase	$25,000,000	$391,000,000	$2,940,110	$418,940,110
Bank of America	$45,000,000	$1,344,000,000	$2,118,070	$1,391,118,070
Citigroup	$45,000,000	$2,518,000,000	$719,000	$2,563,719,000
Deutsche Bank		$354,000,000		$354,000,000
HSBC		$4,000,000		$4,000,000
Bank of China				$0
Barclays		$868,000,000		$868,000,000
BNP Paribas		$175,000,000		$175,000,000
China Construction Bank				$0
Goldman Sachs	$10,000,000	$814,000,000		$824,000,000
Industrial and Commercial Bank of China Limited				$0
Mitsubishi UFJ FG		$84,000,000		$84,000,000
Wells Fargo	$25,000,000	$159,000,000	$3,050,000	$187,050,000
Agricultural Bank of China				$0
Bank of New York Mellon	$3,000,000	$12,900,000		$15,900,000
Credit Suisse		$262,000,000		$262,000,000
Groupe Credit Agricole				$0
ING Bank				$0
Mizuho FG		42,300,000		$42,300,000
Morgan Stanley	$10,000,000	$2,041,000,000		$2,051,000,000
Nordea				$0
Royal Bank of Canada				$0
Royal Bank of Scotland		$541,000,000.00		$541,000,000
Santander			$26	$26
Societe Generale		$124,000,000		$124,000,000
Standard Chartered				$0
State Street	$2,000,000	$103,300,000.00		$105,300,000
Sumitomo Mitsui FG		$56,000,000		$56,000,000
UBS		$287,000,000.00		$287,000,000
Unicredit Group		$97,000,000		$97,000,000
Total	**$165,000,000**	**$10,277,500,000**	**$8,827,206**	**$10,451,327,206**

(Dollars in Thousands)

Sources:

Sources:

https://projects.propublica.org/bailout/list/index (TARP)

https://www.gao.gov/new.items/d1169f6.pdf (Non-TARP)

Center for American Progress

1333 H Street, NW, 10th Floor
Washington, DC 20005
Tel: 202 682.1611 • Fax: 202 682.1867

www.americanprogress.org

The Honorable Blaine Luetkemeyer
Chairman
House Financial Services Subcommittee on Financial Institutions and Consumer Credit
2230 Rayburn HOB
Washington, D.C. 20515

The Honorable Wm. Lacy Clay
Ranking Member
House Financial Services Subcommittee on Financial Institutions and Consumer Credit
2428 Rayburn HOB
Washington, D.C. 20515

July 17, 2018

Dear Chairman Luetkemeyer and Ranking Member Clay:

The Center for American Progress ("CAP") is pleased to submit the below statement, and attached materials, to be included in the record for today's hearing entitled, "Examining Capital Regimes for Financial Institutions," in the House Financial Services Subcommittee on Financial Institutions and Consumer Credit.

In the lead-up to the 2007-2008 financial crisis, the banking sector was drastically undercapitalized. Banks relied too heavily on debt and did not have enough equity capital to absorb losses when the financial sector came under severe stress after the collapse of the subprime mortgage market. As losses cascaded across bank balance sheets, the banking sector and U.S. economy teetered on the brink of collapse. Even with extraordinary levels of public support, including taxpayer bailouts, the near-collapse of the financial sector triggered the most severe economic downturn since the Great Depression. Unemployment soared to 10%, 10 million families lost their homes to foreclosure, and $19 trillion in household wealth was wiped out.[1]

Accordingly, improving both the quality and quantity of bank capital was at the top of the post-crisis financial reform agenda. Policymakers re-tooled risk-weighted capital requirements, implemented new leverage capital requirements that account for off-balance sheet exposures, and established a robust stress testing regime with both quantitative and qualitative components. As a result of these and other efforts, the largest 35 bank holding companies have increased their highest quality capital buffers by over $800 billion, more than doubling their common equity risk-weighted capital ratios, since 2009.[2]

[1] Annalyn Kurtz, "U.S. soon to recover all jobs lost in crisis," CNN Money, June 4, 2014, available at http://money.cnn.com/2014/06/04/news/economy/jobs-report-recovery/index.html; U.S. Department of the Treasury, *The Financial Crisis Response In Charts* (2012), available at https://www.treasury.gov/resource-center/data-chart-center/Documents/20120413_FinancialCrisisResponse.pdf; National Center for Policy Analysis, "The 2008 Housing Crisis Displaced More Americans than the 1930s Dust Bowl," May 11, 2015, available at http://www.ncpathinktank.org/sub/dpd/index.php?Article_ID=25643.
[2] Board of Governors of the Federal Reserve System, "Comprehensive Capital Analysis and Review 2018: Assessment Framework and Results" (2018), available at https://www.federalreserve.gov/publications/files/2018-ccar-assessment-framework-results-20180628.pdf.

Despite this significant progress, substantial research from the Federal Reserve Board, the Federal Reserve Bank of Minneapolis, the International Monetary Fund, and several academics provides convincing evidence that current equity capital levels are still too low.[3] The overwhelming conclusion of this research is that policymakers must increase bank capital requirements to maximize the net economic benefits that come with further lowering the chances of future financial crises. Moreover, the U.S. economy's position in the business cycle makes it imperative that policymakers raise bank capital requirements promptly. Asset valuations are inflated, corporate debt is sky-high, and underwriting standards are loosening. Policymakers must take a counter-cyclical approach by strengthening financial safeguards, like bank capital buffers, during positive economic times as risks build under the surface.

The GOP-led Congress and Trump-appointed financial regulators have instead taken several steps to undermine bank capital requirements. The Federal Reserve Board and Office of the Comptroller of the Currency recently issued a proposed rule that would lower the stronger leverage capital requirements, known as the enhanced supplementary leverage ratio, that apply to the 8 most systemically important banks in the U.S.[4] These changes, if finalized, would immediately enable the FDIC-insured subsidiaries of these banks to reduce their capital levels by $121 billion—an average of 20% per bank.[5] At the holding company level, these changes could allow banks to reduce their capital buffers by more than $80 billion over time.[6] The Federal Reserve Board also released a proposal that would make the stress tests less stressful for banks by loosening certain assumptions used in the tests and by removing a key capital hurdle that has tripped up banks in the past. The Fed estimates that this stress testing proposal would reduce aggregate capital levels across the banks subject to stress testing by $30 billion.[7] On top of these regulatory actions, the U.S. Congress passed, and President Trump recently signed into law, the Economic Growth, Regulatory Relief, and Consumer Protection Act—otherwise known as the Dodd-Frank rollback bill.[8] The bill undermines the resilience of the banking sector by removing 25 of the largest 38

---

[3] Simon Firestone, Amy Lorenc, and Ben Ranish, "An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the US" (Washington: Board of Governors of the Federal Reserve System, 2017), available at https://www.federalreserve.gov/econres/feds/files/2017034pap.pdf; Jihad Dagher and others, "Benefits and Costs of Bank Capital" (Washington: International Monetary Fund, 2016), available at https://www.imf.org/external/pubs/ft/sdn/2016/sdn1604.pdf; Federal Reserve Bank of Minneapolis, "The Minneapolis Plan to End Too Big To Fail," (2017), available at https://www.minneapolisfed.org/~/media/files/publications/studies/endingtbtf/the-minneapolis-plan/the-minneapolis-plan-to-end-too-big-to-fail-final.pdf?la=en.

[4] Board of Governors of the Federal Reserve System, "Rule proposed to tailor 'enhanced supplementary leverage ratio' requirements," Press Release, April 11, 2018, available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180411a.htm.

[5] Jeff Stein, "Fed advances plan to weaken post-financial-crisis rule for biggest banks," *The Washington Post*, April 24, 2018, available at http://www.washingtonpost.com/news/wonk/wp/2018/04/24/fed-advances-plan-to-weaken-post-financial-crisis-rule-for-biggest-banks/.

[6] Peter Eavis, "Washington Wants to Weaken Bank Rules. Not Every Regulator Agrees." *The New York Times*, April 24, 2018, available at https://www.nytimes.com/2018/04/24/business/dealbook/bank-rules-leverage-ratio.html?rref=collection%2Fbyline%2Fpeter-eavis.

[7] Board of Governors of the Federal Reserve System, "Federal Reserve Board seeks comment on proposal to simplify its capital rules for large banks while preserving strong capital levels that would maintain their ability to lend under stressful conditions," Press Release, April 10, 2018, available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180410a.htm.

[8] *Economic Growth, Regulatory Relief, and Consumer Protection Act*, S.2155, 155 Cong. 2 Sess. (Government Printing Office, 2017).

banks in the U.S. from enhanced regulatory standards.[9] The bill also works to undermine some regulations that apply to the very largest banks, including changes to certain capital requirements and the stress testing framework.[10]

One key fallacy that undergirds many of these attacks on the post-crisis bank capital regime is the notion that capital is somehow set aside or locked in a vault and can't be used for lending. Thus, the higher the bank capital requirements, the less cash a bank can use for lending. This framing is just wrong. Bank capital is a source of funding—just as deposits or other forms of debt are sources of funding. Equity capital funds loans to small businesses, entrepreneurs, and households. It is not cash that sits in a vault. Banking industry claims that higher post-crisis capital requirements have held back their ability to lend are directly contradicted by their own actions and significant research. Instead of choosing to retain earnings to fund more loans, banks have decided to return record levels of funds to shareholders through stock buybacks and dividends.[11] Also, research demonstrates higher levels of capital lead to higher levels of lending throughout the business cycle.[12] Nor have higher bank capital requirements slashed profitability in the banking sector. Indeed, bank profits are at all-time highs.[13] Strong bank capital requirements are vital for long-term, sustainable economic growth. The post-crisis capital regime has made the financial sector more resilient to future stress, but more work needs to be done. The Committee should focus on raising bank capital requirements further, instead of devising ways to chip away at the post-crisis capital regime.

Attached to this statement, please find CAP materials relevant to the topic of today's hearing.

Sincerely,

Gregg Gelzinis
Research Associate, Economic Policy
Center for American Progress

---

[9] Gregg Gelzinis and Joe Valenti, "Fact Sheet: The Senate's Bipartisan Dodd-Frank Rollback Bill," (Washington: Center for American Progress, 2018), available at https://www.americanprogress.org/issues/economy/reports/2018/02/28/447264/fact-sheet-senates-bipartisan-dodd-frank-rollback-bill/.
[10] Ibid.
[11] Matt Egan, "Tax cut triggers $437 billion explosion of stock buybacks," *CNN*, July 10, 2018, available at https://money.cnn.com/2018/07/10/investing/stock-buybacks-record-tax-cuts/index.html; Wallace Witkowski, "Banks hike dividends, buybacks after Fed stress test," *MarketWatch*, June 28, 2018, available at https://www.marketwatch.com/story/banks-hike-dividends-buybacks-after-fed-stress-test-2018-06-28.
[12] Thomas M. Hoenig, "A Capital Conflict," Federal Deposit Insurance Corporation, May 23, 2016, available at https://www.fdic.gov/news/news/speeches/spmay2316a.pdf.
[13] Federal Deposit Insurance Corporation, "Quarterly Banking Profile: First Quarter 2018" (2018), available at https://www.fdic.gov/bank/analytical/qbp/2018mar/qbp.pdf.

MarketWatch

Opinion: This is not the time to loosen rules on bank capital

By Gregg Gelzinis
Published: May 2, 2018 12:46 p.m. ET

Regulators foolishly join the late-cycle push to deregulate Wall Street

STAN HONDA/AFP/Getty Images
Financial (de)regulators seem to have forgotten the headlines of 2008 already.

As the House of Representatives considers amending the bipartisan Dodd-Frank rollback bill passed by the Senate, the federal banking regulators have moved forward with their own proposals to loosen post-crisis rules for the largest banks.

The Federal Reserve Board (Fed) and the Office of the Comptroller of the Currency (OCC) recently proposed revisions to the enhanced Supplementary Leverage Ratio (eSLR) — a post-crisis capital requirement that applies to the eight most systemically important banks. The Fed also proposed further revisions to its stress-testing framework.

The two proposed rules — to the eSLR and stress-testing framework — amend different aspects of the capital regime for big banks, but the impact is the same: Lower loss-absorbing capital cushions and a less resilient banking sector. Undoing post-crisis financial reforms is unacceptable, especially as Wall Street profits soar.

The undercapitalization of large banks was one of the primary vulnerabilities of the banking sector in the run-up to the

2007-08 financial crisis. Banks loaded up on too much debt and couldn't survive mounting losses without turning to taxpayers for a bailout.

Regulators also relied too heavily on a certain type of capital requirement: risk-weighted capital. These capital requirements were highly complex and relied on regulators' judgments on the riskiness of different assets. Unfortunately, regulators were wrong at times, assigning lower risk-weights than were appropriate to assets like mortgage-backed securities.

Moreover, banks gamed the risk-weighted capital calculations through financial engineering. By structuring assets in certain ways or by moving them off their balance sheets, banks could take the same risks while receiving lower risk-weights.

In the wake of the financial crisis, regulators made an effort to improve the quantity and quality of bank capital. Those efforts included an enhanced role for strong leverage capital requirements.

In contrast to risk-weighted capital requirements, leverage requirements do not take into account the real or perceived riskiness of different assets. Strong leverage requirements complement risk-weighted capital requirements, and serve as a simple and transparent backstop. A 3% Supplementary Leverage Ratio (SLR) applies to banks with over $250 billion in assets or more than $10 billion in on balance-sheet foreign exposure. The SLR calculation takes into account both on-balance sheet and off-balance sheet exposures. The eSLR adds an additional 2% leverage buffer to the SLR requirement at the eight most systemically important U.S. banks, known as G-SIBs.

Currently the G-SIBs face a 5% eSLR requirement at the holding-company level and a 6% eSLR requirement for their taxpayer-insured banking subsidiaries.

The leverage requirement is higher for the part of the firm insured by the Federal Deposit Insurance Corp. (FDIC) because taxpayers stand behind the insured deposits at the banking subsidiary. The Fed's proposal would decrease that 2% leverage capital buffer at both the holding-company level and the bank subsidiary.

Instead, the buffer would be equal to one half of the risk-weighted capital surcharge that also applies to the G-SIBs. This risk-weighted surcharge is calculated based on the bank's systemic footprint, factoring in variables like its size, interconnectedness, and complexity.

This change would lower the eSLR buffers at most of the G-SIBs. For example, Bank of New York Mellon BK, +0.60% faces a risk-weighted capital surcharge of 1.5%, meaning its new leverage buffer will be 0.75% percent instead of 2%. The resulting total eSLR leverage requirement for both the holding company and the FDIC insured subsidiary would be 3.75% -- instead of 5% and 6% respectively.

At the holding-company level, lowering the leverage requirements erodes a vital capital backstop and would enable these Wall Street firms to reduce their loss-absorbing buffers over time — potentially by $86 billion, according to one New York Times estimate.

As banks attempt to minimize their risk-weighted requirements by shifting assets into lower risk-weighted activities or by using financial engineering, the lower leverage requirements will give these banks more leeway to reduce capital through those actions. The more immediate impact of this change is at the taxpayer-backed bank subsidiaries. The

Fed estimates that its proposed rule would lower the capital cushions at the banking subsidiaries of these systemically important firms by $121 billion, or by an average of 20% at each bank.

Diminishing the capacity of these banks to absorb losses increases their chances of failure and the chances that taxpayers would suffer losses accordingly.

The Fed also recently proposed a rule to revise its stress-testing framework.

The goal of the rule — to harmonize the regulatory-capital requirements with the stress-testing regime — is sound. Unfortunately, the rule waters down certain stress-testing assumptions. The change in assumptions for both the growth of balance sheets during an economic downturn and the time horizon of expected dividend payments lower the aggregate capital required by the big banks subject to annual stress testing.

In addition, the proposal uses a weaker leverage measure compared to the Supplementary Leverage Ratio. Based on the most recent data, the Fed estimates that the stress-testing changes would lower required capital cushions by $30 billion.

Lowering capital requirements is especially dangerous as the economy moves towards the end of the business cycle, when the potential for future losses increases. By several measures, asset valuations are high and nonfinancial sector debt is significantly elevated. This is the exact time regulators should be tightening financial regulations to ensure resiliency when the economy experiences the next downturn.

Moreover, extensive research on the appropriate level of bank capital requirements — including from the Fed and International Monetary Fund — demonstrates that capital requirements are still too low. Regardless of the current business cycle, capital needs to be higher to maximize the benefits that come with limiting the chances of future financial crises, while minimizing the downsides to slightly higher bank funding costs.

Regulators' efforts to reduce the loss-absorbing capacity at the largest banks in the country, coupled with congressional efforts to roll back Dodd-Frank, do not bode well for those who bear the immense burden of financial crises: workers and families.

Gregg Gelzinis is a research associate for economic policy at the Center for American Progress.

Center for American Progress

1333 H Street, NW, 10th Floor
Washington, DC 20005
Tel: 202 682.1611 • Fax: 202 682.1867

www.americanprogress.org

June 14, 2018

Ms. Ann Misback, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street, SW
Washington, DC 20219

Docket Nos. R–1604; OCC–2018–0002

Re: Federal Reserve Board and Office of the Comptroller of the Currency request for comment on a rule proposed to tailor 'enhanced supplementary leverage ratio' requirements

Dear Ms. Misback:

The Center for American Progress ("CAP") welcomes the opportunity to comment on the Federal Reserve Board's ("Fed") and the Office of the Comptroller of the Currency's ("OCC") proposed rule to revise the enhanced supplementary leverage ratio ("eSLR") requirement for certain bank holding companies and their insured depository subsidiaries. CAP is an independent nonpartisan policy institute that is dedicated to improving the lives of all Americans, through bold, progressive ideas, as well as strong leadership and concerted action.

The importance of robust bank capital requirements

One of the central vulnerabilities of the financial system in the lead up to the 2007-2008 financial crisis was the lack of adequate equity capital buffers across the banking sector. The largest institutions funded their assets with far too much debt and too little capital. After the subprime housing market collapsed, losses cascaded across the financial sector and the fragility of the system was laid bare. Systemically important banks were unable to sustain losses during this period of stress without relying on unprecedented levels of government support, including taxpayer-funded bailouts. More than 500 banks[1] failed during the crisis and U.S. taxpayers spent $245 billion[2] to recapitalize the banking system, while regulators put trillions more at risk through

[1] Martin J. Gruenberg, Testimony before the U.S. Senate Committee on Banking, Housing and Urban Affairs, "Fostering Economic Growth: Regulator Perspective," June 22, 2017, available at https://www.banking.senate.gov/public/_cache/files/7ea46c04-a030-4bba-bb90-741e36ee1978/0156DC39EAA99E3C4D1E9D26D9805EF1.gruenberg-testimony-6-22-17.pdf.
[2] U.S. Department of the Treasury, "Bank Investment Programs," November 15, 2016, available at https://www.treasury.gov/initiatives/financial-stability/TARP-Programs/bank-investment-programs/Pages/default.aspx.

emergency liquidity facilities, guarantees, and capital injections at systemically important nonbank financial companies like AIG.[3] Moreover, research from the Federal Reserve Bank of Boston underscores just how quickly capital positions at the largest banks deteriorated during the crisis.[4] Data on bank losses during the crisis does not fully capture the actual undercapitalization of the banking sector, however, as bank losses would have been even more severe had the U.S. government not stepped in to buttress the financial system.[5]

One of the main regulatory objectives following the crisis was to increase both the quality and quantity of bank capital cushions. Regulators also put an emphasis on strong leverage requirements, to complement risk-weighted capital requirements. Prior to the crisis, bank capital requirements primarily relied on regulatory risk-weighting. For these requirements, regulators make a judgement on the relative riskiness of different asset classes. At times, regulators have misjudged asset riskiness and assigned lower than appropriate risk-weights to certain assets. For example, senior tranches of mortgage backed securities and Greek sovereign debt were both treated as low risk assets. Moreover, prior to the crisis, banks found ways to game complex regulatory risk-weights through financial engineering. Banks structured assets to minimize the risk-weights while assuming similar risk exposures, in part by using derivatives and other off-balance sheet constructs.

The need for strong complementary leverage requirements—which do not factor in the real or perceived riskiness of assets—was clear in the wake of the crisis. Leverage requirements are a simple and transparent complement to risk-weighted requirements. They are not vulnerable to gaming and do not rely on the potentially-flawed determinations of regulators. In 2013, the federal banking regulators finalized a new 3% supplementary leverage ratio ("SLR") requirement for bank holding companies with at least $250 billion in assets or $10 billion in on-balance-sheet foreign exposure.[6] The SLR calculation includes both on-balance-sheet and off-balance-sheet exposures. In 2014, the federal banking regulators finalized the enhanced supplementary leverage ratio ("eSLR"), an additional 2% leverage buffer for bank holding companies with at least $700 billion in assets or $10 trillion in assets under custody.[7] The definition of a covered bank holding company was later revised to apply to banks that qualified as G-SIBs.[8] The insured depository institution ("IDI") subsidiaries of these firms are subjected to a 3% leverage buffer on top of the

[3] U.S. Government Accountability Office, "Government Support for Bank Holding Companies" (2013), available at https://www.gao.gov/assets/660/659004.pdf.
[4] Scott Strah, Jennifer Haynes, and Sanders Shaffer, "The Impact of the Recent Financial Crisis on the Capital Positions of Large U.S. Financial Institutions: An Empirical Analysis" (Boston: Federal Reserve Bank of Boston, 2013), available at https://www.bostonfed.org/publications/supervision-and-credit/2013/capital-positions.aspx.
[5] Pietro Veronesi and Luigi Zingales, "Paulson's Gift," October 2009, available at http://faculty.chicagobooth.edu/brian.barry/igm/p_gift.pdf.
[6] Board of Governors of the Federal Reserve System, "Federal Reserve Board approves final rule to help ensure banks maintain strong capital positions," Press Release, July 2, 2013, available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20130702a.htm.
[7] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency, "Agencies adopt enhanced supplementary leverage ratio final rule and issue supplementary leverage ratio notice of proposed rulemaking," Press Release, April 8, 2014, available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20140408a.htm.
[8] Board of Governors of the Federal Reserve System, "Federal Reserve Board approves final rule requiring the largest, most systemically important U.S. bank holding companies to further strengthen their capital positions," Press Release, July 20, 2015, available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20150720a.htm.

SLR, bringing the total eSLR requirements for covered firms to 5% and 6% at the holding company and IDI respectively.[9]

Current capital levels are still too low

The new SLR and eSLR requirements, in addition to the Fed's stress testing regime and strengthened risk-weighted capital requirements, have gone a long way to improve the capital positions at the largest banks in the U.S. Since the crisis, banks have added over $750 billion in common equity capital—more than double the 2009 levels.[10] But extensive research conducted by the Fed and International Monetary Fund ("IMF") demonstrate that capital levels at the largest banks are currently at the low end—or below—the socially optimal range.[11] Research from an array of academics bolsters the Fed and IMF conclusions.[12] Former Federal Reserve Governor Daniel Tarullo and former Secretary of the Treasury Timothy Geithner have both suggested that moving further into the socially optimal capital range would benefit financial stability.[13]

Put simply, current levels of capital at the largest banks are not tailored to achieve the maximum economic benefits of minimizing the chances of future financial crises, while factoring in the minor increase in bank funding costs associated with ratcheting up capital requirements.

The time to bolster bank stability is during good times and before the next adverse economic shock puts them under stress. The countercyclical capital buffer ("CCyB")—a maximum 2.5% risk-weighted capital buffer that would apply to advanced approaches banks—is a new post-crisis tool that the Fed should activate given the current economic climate. Fed Governor Lael Brainard and Federal Reserve Bank of Boston President Eric Rosengren have suggested that activating the CCyB at some point in the near future may be appropriate, and their suggestion should be followed.[14]

---

[9] Ibid.

[10] Board of Governors of the Federal Reserve System, "Comprehensive Capital Analysis and Review 2017: Assessment Framework and Results" (2017), available at https://www.federalreserve.gov/publications/files/2017-ccar-assessment-framework-results-20170628.pdf.

[11] Simon Firestone, Amy Lorenc, and Ben Ranish, "An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the US" (Washington: Board of Governors of the Federal Reserve System, 2017), available at https://www.federalreserve.gov/econres/feds/files/2017034pap.pdf; Jihad Dagher and others, "Benefits and Costs of Bank Capital" (Washington: International Monetary Fund, 2016), available at https://www.imf.org/external/pubs/ft/sdn/2016/sdn1604.pdf.

[12] For example, see Anat R. Admati, "The Missed Opportunity and Challenge of Capital Regulation" (Stanford, CA: Stanford University Graduate School of Business, 2015), available at https://www.gsb.stanford.edu/sites/gsb/files/missed-opportunity-dec-2015_1.pdf.; Simon Johnson, "The Old New Financial Risk," Project Syndicate, April 28, 2015, available at https://www.project-syndicate.org/commentary/us-bank-low-equity-ratio-by-simon-johnson-2015-04?barrier=accessreg; Morris Goldstein, Banking's Final Exam: Stress Testing and Bank-Capital Reform (Washington: Peterson Institute for International Economics, 2017); William R. Cline, The Right Balance for Banks: Theory and Evidence on Optimal Capital Requirements (Washington: Peterson Institute for International Economics, 2017).

[13] Daniel K. Tarullo, "Departing Thoughts," Board of Governors of the Federal Reserve System, April 4, 2017, available at https://www.federalreserve.gov/newsevents/speech/tarullo20170404a.htm; Timothy F. Geithner, "Are We Safer? The Case for Strengthening the Bagehot Arsenal" (Washington: International Monetary Fund and World Bank Group, 2016), available at http://www.perjacobsson.org/lectures/100816.pdf.

[14] Lael Brainard, "Safeguarding Financial Resilience through the Cycle," Board of Governors of the Federal Reserve System, April 19, 2018, available at https://www.federalreserve.gov/newsevents/speech/brainard20180419a.htm; Reuters Staff, "Fed may need to adjust policy framework to respond to financial shocks -Rosengren," March 23, 2018,

Unfortunately, the eSLR proposal issued by the Fed and OCC would lower capital requirements at the most systemically important banks in the country—despite the body of research on optimal bank capital requirements, the current stage of the economic cycle, and soaring Wall Street profits.[15]

Concerns with the eSLR proposed rule

The proposed rule changes the calibration of the eSLR requirements for covered bank holding companies and their insured depository subsidiaries. Currently, bank holding companies that qualify as G-SIBs face a 5% eSLR requirement, while their IDIs face a 6% eSLR requirement. Under the proposed rule, the holding company eSLR would be the sum of 3% and one-half of the company's G-SIB surcharge. In a serious break from current practice, the IDI eSLR requirement would match the holding company requirement. The Fed and OCC claim this change would only lower holding company capital by $400 million, as other elements of the capital regime—including risk-weighted requirements and stress testing—would quickly bind. This is not the appropriate figure. Over time, banks will lower their risk-weighted assets by shifting assets towards lower risk-weights and through financial engineering. Banks could use these methods to lower capital at the holding company by around $86 billion before bumping into the new, lower eSLR requirement.[16] Moreover, Federal Reserve Vice Chairman for Supervision, Randal Quarles, suggested that the Fed may revisit the G-SIB surcharge rule.[17] Any effort to lower the G-SIB surcharge would result in an automatic decrease in the eSLR for firms, based on the proposed rule.

The more immediate impact on capital requirements, however, is at the IDI. The Fed and OCC project that capital levels at the IDI of covered bank holding companies would decrease by $121 billion—an average decrease of 20%.[18] The proposed rule eliminates the sound principle that the IDI requirements should be even stronger than the holding company requirements because taxpayers stand behind the FDIC-insured part of the firm. Such a significant decrease in capital makes it far more likely that an IDI will fail, increasing the likelihood that taxpayers suffer losses. The Fed has argued that because the capital will not leave the firm, it could be infused back into the IDI during times of stress.[19] Unfortunately, if the IDI is experiencing stress, it is highly likely that other parts of the firm will also be wavering. It may not be possible to easily infuse capital in the IDI when doing so would threaten the solvency of other subsidiaries. Strong levels of capital should be prepositioned to absorb losses at the IDI to avoid that uncertainty.

---

available at https://www.reuters.com/article/us-usa-fed-rosengren/fed-may-need-to-adjust-policy-framework-to-respond-to-financial-shocks-rosengren-idUSKBN1GZ3B6.

[15] Matt Egan, "Big banks are minting money right now," *CNN*, April 18, 2018, available at http://money.cnn.com/2018/04/18/investing/big-banks-earnings-record-profits/index.html.

[16] Peter Eavis, "Washington Wants to Weaken Bank Rules. Not Every Regulator Agrees." *The New York Times*, April 24, 2018, available at https://www.nytimes.com/2018/04/24/business/dealbook/bank-rules-leverage-ratio.html?rref=collection%2Fbyline%2Fpeter-eavis.

[17] Securities Industry and Financial Markets Association, "HFSC Hearing with Fed's Quarles," April 17, 2018, available at https://www.sifma.org/resources/general/hfsc-hearing-with-feds-quarles/.

[18] Jeff Stein, "Fed advances plan to weaken post-financial-crisis rule for biggest banks," *The Washington Post*, April 24, 2018, available at http://www.washingtonpost.com/news/wonk/wp/2018/04/24/fed-advances-plan-to-weaken-post-financial-crisis-rule-for-biggest-banks/.

[19] Ibid.

This proposed rule has a particularly concerning impact on custody banks subjected to the eSLR. The two custody banks that currently face the eSLR both have a 1.5% G-SIB surcharge. The proposed rule would therefore change their current eSLR requirements from 5% and 6% at the holding company and IDI, respectively, to 3.75% for the holding company and IDI. This is a steep drop in leverage requirements for institutions collectively holding over $65 trillion in assets under custody and administration.[20] Custody banks are critical to the plumbing of the financial sector and a major custody bank failure could have catastrophic consequences. The proposed rule is not the only proposal that would impact leverage requirements for custody banks. Section 402 of S.2155—which was signed into law by President Trump in May—directs regulators to exclude central bank deposits from the denominator of the SLR for banks predominantly engaged in custody banking.[21] This change violates the principle of the leverage ratio by essentially assigning this specific category of assets a 0% risk-weight. The combined effect of the eSLR proposed rule and the legislative change to the SLR calculation would be a precipitous drop in custody bank capital. Not only would the topline leverage requirements fall significantly, but the calculation to reach those topline requirements would be less stringent.

This proposed rule has also received an unprecedented level of opposition from current and former regulators. The Federal Deposit Insurance Corporation ("FDIC") refused to join the Fed and OCC in issuing the proposed rule due to the negative impact on bank capital levels.[22] In addition, current Fed Governor Lael Brainard dissented when the Fed voted to issue the proposed rule—the first such dissent on a regulatory proposal since the Fed started releasing such votes publicly.[23] Former FDIC Chair Sheila Bair and Vice Chair Tom Hoenig have also publicly opposed the proposed rule, warning that it increases the likelihood of another financial crisis.[24]

Recommendations

There is ample evidence that capital levels are too low at the largest banks in the country—especially given the economy's current position in the business cycle—and regulators should rectify this problem instead of exacerbating it. Both leverage and risk-weighted capital requirements should be significantly increased at the most systemic banks in the country.

Regulators have noted that leverage requirements are currently the binding capital requirement for several G-SIBS. Shifting the binding constraint to risk-weighted requirements is one of the

---

[20] Calculation based on U.S. Securities and Exchange Commission, "Form 10-K for State Street Corp." (2017), available at http://investors.statestreet.com/Cache/392404025.PDF?O=PDF&T=&Y=&D=&FID=392404025&iid=100447; U.S. Securities and Exchange Commission, "Form 10-K for The Bank of New York Mellon Corp." (2017), available at https://www.bnymellon.com/_global-assets/pdf/investor-relations/form-10-k-2017.pdf.

[21] *Economic Growth, Regulatory Relief, and Consumer Protection Act*, S.2155, 155 Cong. 2 Sess. (Government Printing Office, 2017).

[22] Martin J. Gruenberg, "Statement of Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation (FDIC), Notice of Proposed Rulemaking on Supplementary Leverage Ratio Issued by the Federal Reserve and OCC," Federal Deposit Insurance Corporation, April 11, 2018, available at https://www.fdic.gov/news/news/speeches/spapr1218.html.

[23] Board of Governors of the Federal Reserve System, "Board Votes," April 10, 2018, available at https://www.federalreserve.gov/aboutthefed/boardvotes.htm.

[24] Thomas M. Hoenig and Sheila C. Bair, "Relaxing Bank Capital Requirements Would Risk Another Crisis," The Wall Street Journal, April 26, 2018, available at https://www.wsj.com/articles/relaxing-bank-capital-requirements-would-risk-another-crisis-1524784371.

reasons regulators have provided for advancing this proposed rule.[25] If regulators wish to achieve that goal, they should increase risk-weighted requirements for G-SIBs instead of eroding leverage requirements.

Furthermore, if the Fed and OCC do move forward with this rulemaking, the stronger eSLR requirement for a covered bank holding company's IDI should be reinstated. The leverage requirements for the portion of the firm with taxpayer-backed liabilities should be higher than those for the holding company. If the IDI fails, taxpayers are on the hook. Stronger capital requirements limit the chances of that occurrence. The Fed has argued that because the capital released from the IDI will remain within the company, it could be redeployed to the IDI if it's in trouble. If the IDI is experiencing financial trouble, it is likely that other parts of the firm are also experiencing stress. It may not be possible for the company to redeploy significant capital to the IDI in a stressed environment, making it important to preposition strong capital levels. Regulators should maintain the 1 percentage point disparity between eSLR requirements for the holding company requirements and IDI.

Finally, the eSLR proposal must account for legislative changes that revised the calculation of the SLR for banks predominantly engaged in custody banking. Regulators should ensure that G-SIB custody banks do not receive both the S.2155 SLR calculation treatment and the eSLR proposed rule reduction in capital levels. Both changes together would dangerously deplete capital levels at G-SIB custody banks.

While considering changes to this proposed rule, regulators should keep in mind the worker who will lose her job, the family that will lose their home, and the retiree whose hard-earned savings will be wiped away in the next financial crisis. Amidst high bank profits and building risk in the financial sector, it is unwise to make such a crisis more likely.

Any questions on this comment letter or on related issues should be directed to Gregg Gelzinis at ggelzinis@americanprogress.org.

Sincerely,

Gregg Gelzinis
Research Associate, Economic Policy
Center for American Progress

[25] Randal K. Quarles, Testimony before the Committee on Banking, Housing, and Urban Affairs, "The Semiannual Testimony on the Federal Reserve's Supervision and Regulation of the Financial System," April 19, 2018, available at https://www.banking.senate.gov/imo/media/doc/Quarles%20Testimony%204-19-18.pdf.

Center for American Progress

The Fed's Proposed Stress Testing Changes Are a Mixed Bag

By Gregg Gelzinis March 20, 2018

This issue brief has been adapted from a regulatory comment letter submitted to the Board of Governors of the Federal Reserve System.[1]

In December, the Federal Reserve released a package of proposed changes to its framework for supervisory stress testing.[2] The Fed's stress tests for large bank holding companies and systemically important nonbank financial companies have been arguably the most important prudential regulatory tool implemented following the 2007-2008 financial crisis. In a stress test, a regulator uses economic models to project an institution's net income, capital ratios, and overall balance sheet given some hypothetical specified shock and resulting economic downturn. A robust stress testing regime helps regulators limit the chance and severity of future crises by ensuring that the banking sector has enough loss-absorbing equity capital to continue lending and providing financial intermediation through a severe economic downturn.

The Fed's package of proposed revisions includes the affirmation of some important existing stress testing principles as well as one material improvement to the scenarios currently used in stress tests. However, one prong of the package of proposals—as well as recent comments made by Federal Reserve Vice Chair for Supervision Randal Quarles—foreshadow a concerning shift in the level of stress testing information that is made public.[3] Moreover, this package does not include several potential proposals that would strengthen the stress testing regime and that should take precedence over this package of revisions.

With the Senate's passage of S.2155—the Economic Growth, Regulatory Relief, and Consumer Protection Act—the Fed's proposed package of stress testing revisions is likely only the first in what will be a series of changes to its stress testing regime. S.2155 contains many unfortunate provisions that could undermine the stress testing framework, so this will be a critical issue to monitor moving forward.[4]

This issue brief highlights the importance of an effective stress testing framework and analyzes certain aspects of the Fed's recent package of proposed changes to the stress testing framework.

Stress testing reduces risk across the U.S. economy

Stress tests are an important, forward-looking supervisory tool that enables regulators to analyze hypothetical scenarios and helps them to evaluate whether individual banks—and the banking sector in aggregate—are a source of resiliency for the U.S. economy in the face of a severe downturn. In 2009, the 19 banks with more than $100 billion in assets took part in the first stress tests conducted by the Fed.[5] The Supervisory Capital Assessment Program (SCAP), in conjunction with other crisis-era initiatives, helped to efficiently recapitalize the banking sector and gave markets confidence in the banking sector's ability to provide credit and financial intermediation in the wake of the crisis.

Based on the SCAP's success, the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 required supervisory stress testing for banks with more than $50 billion in assets; company-run stress testing for banks with more than $10 billion in assets; and both supervisory and company-run stress testing for systemically important nonbank financial companies supervised by the Fed.[6] The Fed also used existing supervisory authority to formalize a parallel stress testing framework known as the Comprehensive Capital Analysis and Review (CCAR). The Dodd-Frank Act Stress Test (DFAST) assumes a standardized capital plan for banks based on recent dividend levels and does not include any share buybacks.[7] The CCAR, however, incorporates individual capital plans submitted by banks that include both dividends and share buybacks. In addition to the quantitative analysis, the CCAR has a qualitative component—which is not included in DFAST—for banks with more than $250 billion in assets. The qualitative analysis evaluates the banks' capital planning processes to ensure that banks have reliable practices for determining their capital needs relative to the risks they face.[8] Both the DFAST and CCAR have continued to strengthen the capital positions and capital planning processes at the largest firms. Since the first stress tests in 2009, banks with more than $50 billion in assets have doubled their common equity capital, increasing their loss-absorbing cushions by more than $750 billion.[9] Stressing bank balance sheets through this supervisory exercise further improves the internal risk management frameworks at banks and ideally helps to prevent the sort of complacency that can enter markets, institutions, and even regulatory agencies as memories of the previous crisis fade.

The Fed's stress testing proposal contains some benefits

Stress testing principles

The package of proposals released for comment by the Fed includes a statement of principles for stress testing as well as a list of policies and procedures meant to implement those principles.[10] Several principles outlined in the proposal are appropriately strong and must be preserved. Stress testing in particular must remain independent, forward-looking, and conservative. Supervisory stress tests rely on models and assumptions developed by the Fed and do not rely on the internal models developed by the firms being tested. This regulatory independence is an important principle to maintain. Firms' own internal stress testing models may be designed, to the greatest extent possible, to limit their capital requirements. As a prudential regulator tasked with maintaining financial stability and the safety and soundness of the financial sector, the Fed clearly has different motivations—making true independence vital.

The stress tests conducted by the Fed must also be forward-looking. Repeating the same scenarios and shocks year after year would rely too heavily on historical data and would allow banks to easily predict the following year's exercise design. While incorporating historical data is necessary, the shocks and stress in stress test scenarios should reflect how the financial sector and the economy writ large is changing over time. They should also include emerging threats such as cybersecurity or financial technology-related stresses.

Furthermore, it is crucial that stress test scenarios are conservative. Prior to the 2007-2008 financial crisis, both regulators and financial market participants lacked imagination regarding the types of shocks that could rattle the financial sector as well as the impact that those shocks could have on the financial sector's ability to serve the real economy. Accordingly, the possibility of severe shocks was significantly discounted. Few thought a sharp national downturn in the housing market was possible or that financial engineering could magnify risk instead of strictly limiting it. Robust stress testing scenarios must ensure that the financial sector is resilient to both normal and severe downturns. Recent stress test results have led to concern as to whether this principle is being fully carried out in practice.[11]

One important element of stress testing assumptions outlined by the Fed is maintenance of the credit supply. The point of stress testing is to ensure that firms have adequate capital to absorb losses during a period of severe stress, while still fulfilling the credit provision and financial intermediation roles the real economy needs to thrive. Resilient firms must be able to lend during times of stress. If firms simply pulled back on their lending and deleveraged in order to survive, the financial sector may only have limited firm failures, but the economy as a whole will experience the sharp pains of a credit contraction. The Fed correctly highlights the importance of keeping the aggregate credit supply constant or increasing in the stress testing framework.

Short-term funding risk

In addition to outlining stress testing principles, the Fed's package of proposals includes the addition of short-term funding risk to the supervisory scenarios.[12] Adding this risk factor by including a significant increase in the cost of short-term funding would be a positive addition to the stress testing framework, particularly because an overreliance on runnable, short-term funding was a key factor in the 2007-2008 financial crisis. Before its downfall, for example, Lehman Brothers Holdings Inc. was funding as much as $200 billion of its balance sheet through overnight repurchase agreements.[13] Firms that rely heavily on short-term funding put themselves at significant risk to runs, as creditors may not roll over short-term loans during a period of stress. A run on short-term funding markets, in which the cost of said funding would increase significantly, can force a firm to liquidate assets at fire-sale prices—leading to steep losses and potentially pushing down asset prices across certain markets.

Stressing this source of funding during the supervisory stress tests would help regulators determine which firms might be overly reliant on less stable forms of funding and would rightfully require additional capital buffers to protect against that run risk. The Fed has already recognized the importance of higher capital buffers for firms with heightened funding vulnerability in other rulemakings. In the Fed's global systemically important bank (G-SIB) capital surcharge—an additional required capital buffer for the most systemically important banks in the United States—firms with a higher reliance on short-term debt face a higher capital requirement.[14] Adding a short-term funding component to the stress testing framework would simply harmonize the Fed's approach to short-term funding in the G-SIB surcharge with its stress tests.

The Fed's stress testing proposal has some shortcomings

Transparency

An appropriate level of transparency surrounding stress testing is an important goal. The public, including policymakers and academics, should have enough information to judge the robustness and execution of stress tests—from the stressfulness of the scenarios to the projected losses experienced by each individual bank. Over the past seven years, the Fed has significantly improved the transparency surrounding the stress tests. The Fed's public release of the 2011 CCAR results, for example, was 21 pages and did not include a bank-by-bank breakdown of pre- and post-scenario capital levels.[15] The 2017 CCAR public release, however, was 100 pages and included detailed bank-by-bank information with an explanation of the adverse and severely adverse economic scenarios.[16]

The Fed's package of proposed stress testing changes includes revisions to the amount of publicly disclosed information. The proposed changes, set forth in the name of transparency, include releasing the modeled loss rates on different groupings of loans and the estimated loss rates on hypothetical portfolios of loans.[17] In making any changes to the stress testing transparency regime, however, the Fed must be cautious of revealing too much. Making too much information on loss projections and the Fed's models public might enable firms to reverse engineer the stress tests.[18] And providing detailed information on the scenarios in advance of the tests—as well as projected loss estimates for certain portfolios—may give banks the opportunity to tailor their balance sheets in advance of the test in order to minimize their projected losses and in turn their required capital cushions.[19] Balance sheet tailoring ahead of stress testing periods would increase the correlation risk across the banking sector and undermine the effectiveness of the stress tests. When issuing its final rule on this package of policies, the Fed must clearly demonstrate that its proposal to disclose projected loss rates on categories of loans and hypothetical portfolios of loans does not cross that line. Again, the Fed should be sure that the disclosure of this information in no way weakens the efficacy of the stress tests.

While the proposed transparency-related changes to the stress testing framework may not cross the line, recent comments from Vice Chair for Supervision Quarles suggest that he may push for even more extensive disclosures in the future. In a January speech at the American Bar Association's annual Banking Law Committee Meeting, Quarles stated, "Finally, as I mentioned earlier, an enhanced stress testing transparency package was released for public comment last month. I personally believe that our stress testing disclosures can go further."[20] In the speech, Quarles did at least recognize that there are risks associated with disclosing too much information. It's unclear what additional elements of the stress testing framework Quarles would like to see disclosed beyond those included in the recent package of proposals. It is clear, however, where the Trump administration stands on this issue. A June banking regulation report released by the Treasury Department recommends that "the Federal Reserve should subject its stress-testing and capital planning review frameworks to public notice and comment, including with respect to its models, economic scenarios, and other material parameters and methodologies."[21] The Treasury Department's recommendation would severely undermine the stress testing regime and allow banks to engage in regulatory capital arbitrage by tailoring their balance sheets to the Fed's models. The recommendation would also allow banks to influence the stressfulness and design of the macroeconomic scenarios through the public notice and comment process.[22] The benefits of the current proposed transparency changes likely outweigh the negatives—but more concerning changes could be on the horizon.

The Fed's proposal should address higher priorities

An appropriate level of transparency is a worthy goal, but it should not be the Fed's top stress testing priority under the leadership of Chair Jerome Powell and Vice Chair Quarles. Proposing a rule to incorporate the G-SIB capital surcharge into the post-stress capital minimums is a policy that has long been discussed at the Fed and should be at the top of the Fed's to-do list.[23] The largest banks currently have the same post-stress minimum capital requirements—or the required minimum capital ratios after accounting for stress test-induced losses—as smaller firms, despite different regulatory capital requirements. The most systemically important firms should internalize the potential systemic costs associated with their failure both in regulatory capital requirements and in stress testing. Increasing the post-stress minimums for the largest firms was previously discussed as part of a move to propose a stress capital buffer as a replacement for the capital conservation buffer.[24] Put simply, the stress capital buffer concept would integrate stress test losses with regulatory capital requirements. These potential changes would likely increase the loss-absorbing capital cushions at the largest banks and would further harmonize the overall bank capital regime. Since former Fed Governor Daniel Tarullo—the point person for banking regulations under former Chair Janet Yellen—stepped down, there have been no additional updates on these potential proposals.

The Fed should also prioritize evolving its stress testing regime to better reflect financial sector interconnectedness—how individual financial institutions react to and transmit stress throughout the system. Current stress tests examine the potential losses at individual banks given a severe shock and economic downturn, which is a useful but imperfect representation of how the financial system works. The tests do not analyze what happens after the banks experience those losses nor how nonbank firms fit into the picture of financial sector stress. Are certain banks likely to sell off particular assets at fire-sale prices? How will selloffs impact other banks and nonbanks that hold those assets? How will certain funding markets, including funding provided by nonbank firms, react to the stressed environment? These second-order effects to the initial bank balance sheet losses are not currently captured by stress testing, but over the past several years research has been conducted on how stress tests can evolve to address the intricacies of financial sector interconnectedness.[25] Agent-based modeling—a useful modeling approach in nonfinancial fields such as epidemiology—is one promising area of research.[26]

Ensuring stress test transparency, affirming stress testing principles, and including short-term funding market stress in the scenarios are all important. However, increasing post-stress capital minimums for G-SIBs, implementing a stress capital buffer, and developing a new era of stress test models should all be higher priorities for the Fed.

Gregg Gelzinis is a research associate for Economic Policy at American Progress.

Endnotes

1 Letter from the Center for American Progress to the Board of Governors of the Federal Reserve System, January 22, 2018, available at https://cdn.americanprogress.org/content/uploads/2018/01/22115353/CAP_FRB_Stress_Testing_Letter.pdf.

2 Board of Governors of the Federal Reserve System, "Federal Reserve Board requests comment on package of proposals that would increase the transparency of its stress testing program," Press release, December 7, 2017, available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20171207a.htm.

3 Randal K. Quarles, "Early Observations on Improving the Effectiveness of Post-Crisis Regulation (January 19, 2018)," available at https://www.federalreserve.gov/newsevents/speech/files/quarles20180119a.pdf.

4 Gregg Gelzinis and Joe Valenti, "Fact Sheet: The Senate's Bipartisan Dodd-Frank Rollback Bill" (Washington: Center for American Progress, 2018), available at https://www.americanprogress.org/issues/economy/reports/2018/02/28/447264/fact-sheet-senates-bipartisan-dodd-frank-rollback-bill/.

5 Board of Governors of the Federal Reserve System, "The Supervisory Capital Assessment Program: Design and Implementation" (2009), available at http://www.federalreserve.gov/bankinforeg/bcreg20090424a1.pdf.

6 *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Public Law 111–203, 111th Cong., 2d sess. (July 21, 2010), 165.

7 Board of Governors of the Federal Reserve System, "Dodd-Frank Act Stress Test 2017: Supervisory Stress Test Methodology and Results" (2017), available at https://www.federalreserve.gov/publications/files/2017-dfast-methodology-results-20170622.pdf.

8 Board of Governors of the Federal Reserve System, "Comprehensive Capital Analysis and Review 2017: Assessment Framework and Results" (2017), available at https://www.federalreserve.gov/publications/files/2017-ccar-assessment-framework-results-20170628.pdf

9 Ibid.

10 Board of Governors of the Federal Reserve System, "Policy Statement on the Scenario Design Framework for Stress Testing Policy Statement," *Federal Register* 82 (240) (2017), available at https://www.gpo.gov/fdsys/pkg/FR-2017-12-15/pdf/2017-26857.pdf.

11 Marcus Stanley, "Stress Tests: Less Stressful Than Ever," Americans for Financial Reform, June 29, 2017, available at https://medium.com/@RealBankReform/stress-tests-less-stressful-than-ever-fbe68b8e161a.

12 Federal Reserve System, Policy Statement on the Scenario Design Framework for Stress Testing, Proposed Rules to 12 CFR Part 252, Federal Register, Vol. 82, No. 240, December 15, 2017, available at https://www.gpo.gov/fdsys/pkg/FR-2017-12-15/pdf/2017-26858.pdf.

13 Linda Sandler, "Lehman Had $200 Billion Overnight Repos Pre-Failure," Bloomberg, January 27, 2011, available at https://www.bloomberg.com/news/articles/2011-01-28/lehman-brothers-had-200-billion-in-overnight-repos-ahead-of-2008-failure.

14 Board of Governors of the Federal Reserve System, "Calibrating the GSIB Surcharge" (2015), available at https://www.federalreserve.gov/aboutthefed/boardmeetings/gsib-methodology-paper-20150720.pdf.

15 Board of Governors of the Federal Reserve System, "Comprehensive Capital Analysis and Review: Objectives and Overview" (2011), available at https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20110318a1.pdf.

16 Board of Governors of the Federal Reserve System, "Comprehensive Capital Analysis and Review 2017: Assessment Framework and Results."

17 Board of Governors of the Federal Reserve System, "Enhanced Disclosure of the Models Used in the Federal Reserve's Supervisory Stress Test," *Federal Register* 82 (240) (2017), available at https://www.gpo.gov/fdsys/pkg/FR-2017-12-15/pdf/2017-26856.pdf.

18 Daniel K. Tarullo, "Departing Thoughts (April 4, 2017)," available at https://www.federalreserve.gov/newsevents/speech/tarullo20170404a.htm (last accessed March 2018).

19 Ibid.

20 Randal K. Quarles, "Early Observations on Improving the Effectiveness of Post-Crisis Regulation."

21 Steven T. Mnuchin and Craig S. Phillips, "A Financial System That Creates Economic Opportunities: Banks and Credit Unions" (Washington: U.S. Department of the Treasury, 2017), available at https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf.

22 Nellie Liang, "What Treasury's financial regulation report gets right—and where it goes too far," June 13, 2017, The Brookings Institution, available at https://www.brookings.edu/blog/up-front/2017/06/13/what-treasurys-financial-regulation-report-gets-right-and-where-it-goes-too-far/.

23 Daniel K. Tarullo, "Next Steps in the Evolution of Stress Testing (September 26, 2016)," available at https://www.federalreserve.gov/newsevents/speech/tarullo20160926a.htm (last accessed March 2018); Janet L. Yellen, "Supervision and Regulation," Testimony before the U.S. House of Representatives Committee on Financial Services, September 28, 2016, available at https://www.federalreserve.gov/newsevents/testimony/yellen20160928a.htm.

24 Ibid.

25 Rick Bookstaber and others, "Stress Tests to Promote Financial Stability: Assessing Progress and Looking to the Future." Working Paper 0010 (Office of Financial Research, 2013), available at https://www.financialresearch.gov/working-papers/files/OFRwp0010_BookstaberCetinaFeldbergFloodGlasserman_StressTeststoPromoteFinancialStability.pdf; Rick Bookstaber, Mark Paddrik, and Brian Tivnan, "An Agent-based Model for Financial Vulnerability." Working Paper (Office of Financial Research, 2014), available at https://www.financialresearch.gov/working-papers/files/OFRwp2014-05_BookstaberPaddrikTivnan_AgentbasedModelforFinancialVulnerability_revised.pdf; Ron Anderson and others, "Macroprudential Stress Tests and Policies: Searching for Robust and Implementable Frameworks" (2018), Systemic Rick Center at the London School of Economics and Political Science, available at http://www.systemicrisk.ac.uk/sites/default/files/downloads/publications/Macroprudential%20Stress%20Tests%20and%20Policies%20Stretching%20for%20Robust%20and%20Implementable%20Frameworks%20%282018%29_0.pdf.

26 Rick Bookstaber, Mark Paddrik, and Brian Tivnan, "An Agent-based Model for Financial Vulnerability."

Center for American Progress

5 Questions for the Fed's Vice Chairman for Supervision

By Gregg Gelzinis April 17, 2018

This week, Federal Reserve Vice Chairman for Supervision Randal Quarles will testify for the first time before the House Committee on Financial Services and the Senate Committee on Banking, Housing, and Urban Affairs.[1] Quarles is the first person to hold the vice chairman for supervision position at the Federal Reserve Board of Governors. The position was created by the Dodd-Frank Wall Street Reform and Consumer Protection Act to serve as the Fed's point person on the supervision and regulation of the banks and nonbank financial companies that fall under its jurisdiction.

This hearing presents a useful opportunity for members of the House and Senate to press Vice Chairman Quarles on his financial regulatory views and to gain clarity regarding the Fed's priorities for banking regulation and supervision. Unfortunately, in recent speeches, Quarles has outlined an agenda focused on easing post-crisis rules for even the largest Wall Street banks.[2] Topics that should be covered in the hearing include the Senate's Dodd-Frank rollback bill, bank capital requirements, the Fed's physical commodities proposed rule, and the Volcker Rule.

This issue brief outlines some potential questions that Vice Chairman Quarles should have to address in the hearings.

1. If the Senate's Dodd-Frank rollback bill is enacted, will the Fed aggressively reapply enhanced regulations to deregulated banks and refuse to loosen regulations on foreign megabanks?

In March, the U.S. Senate passed S. 2155, the Economic Growth, Regulatory Relief, and Consumer Protection Act—the most significant rollback of the Dodd-Frank Act since the landmark legislation was passed in the wake of the 2007–2008 financial crisis.[3] Under Dodd-Frank, banks with more than $50 billion in assets are subject to a suite of enhanced regulations to limit their chance of failure and mitigate the potential impact of a failure.[4] Out of the 5,700 banks in the United States, these stronger rules currently only apply to the 38 largest banks.[5] The centerpiece of S. 2155 raises Dodd-Frank's asset threshold for enhanced regulatory scrutiny from $50 billion to $250 billion, which would eliminate several of these important post-crisis rules—including living wills, stronger liquidity requirements, company-run stress testing, and enhanced risk management standards—for 25 of the largest 38 banks in the country.[6] These rules help ensure that banks plan for their orderly failure, have enough liquid assets to meet payments on their liabilities in times of stress, adequately manage the risks they take, and continue to provide the financial services that the real economy depends on despite a financial shock and resulting economic downturn. Moreover, the rules today are appropriately tailored—a $75 billion bank, for example, faces less stringent regulations than a $2 trillion bank. The 25 banks deregulated by S. 2155 hold one-sixth of the assets in the entire banking sector and received $47 billion in Troubled Asset Relief Program bailout funds during the financial crisis.[7] If a handful of these banks failed during a period of stress in the financial system, it could threaten U.S. financial stability. Indeed, the Congressional Budget Office (CBO) confirmed that relaxing these rules would increase the likelihood of another financial crisis.[8] Policymakers and bank executives do not pay for financial crises—workers and families bear the burden through lost jobs, homes, and savings. As Congress considers rolling back Dodd-Frank, it should remember whom such an action would put at risk.

S. 2155 gives the Fed the authority to reapply these enhanced regulatory standards to the deregulated banks that have from $100 billion to $250 billion in assets. Vice Chairman Quarles will therefore play a key role in determining which banks will not escape Dodd-Frank's enhanced regulations. He should aggressively reapply these standards, as the 2007–2008 financial crisis clearly demonstrated that banks of this size can contribute to financial instability.[9]

Currently, the Fed applies Dodd-Frank's full suite of enhanced regulations to foreign banks based on the size of their U.S. operations. A foreign bank that has $50 billion in U.S. nonbranch assets must form an intermediate holding company (IHC) in the United States. Under the Fed's current rules, the IHC will face a similar regulatory regime to a U.S. bank of a comparable size.[10] A foreign bank with more than $50 billion in global assets but less than $50 billion in U.S. nonbranch assets faces a much lighter regulatory touch and does not have to form a U.S. IHC. The Fed treats a $50 billion U.S. IHC similarly to a $50 billion U.S. bank in part to satisfy the principle of equality of competitive opportunity—a principle codified in multiple banking laws, including Dodd-Frank.[11]

It follows logically that if Congress changes Dodd-Frank's $50 billion threshold for enhanced regulations, then the Fed will make the parallel change for foreign banks to preserve the principle of equal competitive opportunity. While the Senate bill contains weak clarifying language on the issue of foreign bank regulation, law firm Davis Polk agrees that a parallel change is the most likely outcome.[12] The U.S. Department of the Treasury has also recommended loosening the rules on foreign banks in conjunction with raising Dodd-Frank's $50 billion threshold for enhanced regulations—and Treasury Secretary Steven Mnuchin agreed that S. 2155 would implement that recommendation.[13] The Senate Committee on Banking, Housing, and Urban Affairs rejected an amendment offered by Ranking Member Sherrod Brown (D-OH) that would ensure foreign banks are not deregulated by S. 2155, and the full Senate failed to consider this amendment.[14] Without such an amendment, S. 2155 will lead to the deregulation of the U.S. operations of foreign megabanks. Loosening the rules on these banks would decrease the resiliency of the U.S. financial system and increase the likelihood that these foreign banks bring risk to U.S. shores.

In a speech to the Institute of International Bankers, Vice Chairman Quarles suggested that further tailoring rules for the U.S. operations of foreign banks is on the Fed's agenda—a thinly veiled nod toward loosening current rules.[15] This hearing provides an opportunity for Quarles to state clearly how the Fed will treat massive foreign banks that have U.S. IHCs with from $50 billion to $250 billion in assets if S. 2155 is enacted.

2. The Senate's Dodd-Frank rollback bill lowers the loss absorbing capital cushions at systemically important custody banks. Will the Fed refrain from providing similar treatment to the custody businesses of JPMorgan Chase and Citigroup?

S. 2155 makes a misguided change to the calculation of an important post-crisis capital requirement. The supplementary leverage ratio (SLR) serves as a simple and transparent risk-neutral complement to more complex risk-weighted capital requirements.[16] Together, both types of capital requirements help ensure that the largest banks in the country have adequate loss-absorbing buffers. Section 402 of S. 2155 excludes deposits held at central banks from the SLR calculation of banks predominantly engaged in custody banking. Custody banks provide for the safekeeping of their customers' financial assets and perform clearing, settlement, and other asset servicing functions for their clients. Removing these assets from the calculation is akin to assigning them a 0 percent risk weight, which violates the principle of the SLR to not factor in the real or perceived riskiness of assets. Aside from undermining the SLR's purpose, this change would directly lower loss-absorbing capital cushions at the three custody banks that are currently subjected to the SLR: Bank of New York Mellon Corp., State Street Corp., and Northern Trust Corp.[17] These banks are vital to the plumbing of the financial sector, holding a combined $77 trillion in assets under custody or administration.[18]

This change would be bad enough if it were strictly limited to these custody banks, but the language used in S. 2155 opens the door for other banks with significant custody businesses, such as JPMorgan Chase & Co. and Citigroup Inc., to receive the same treatment.[19] The CBO predicted a 50 percent chance that the federal banking regulators would in fact apply this SLR change to JPMorgan Chase and Citigroup.[20] Initially, this section of S. 2155 included a quantitative threshold that would certainly exclude these other banks, but the language was watered down in committee. Given this confusion, Vice Chairman Quarles should express to which banks the Fed will apply the SLR change.

3. Will the Fed work with other banking regulators to increase capital requirements for the largest banks or at least activate the countercyclical capital buffer?

A lack of sufficient equity capital buffers across the banking sector was one of the main vulnerabilities of the financial system prior to the 2007–2008 financial crisis. Banks funded themselves with too much debt and too little equity capital. When losses started piling up, banks either failed or were bailed out. Policymakers made, both domestically and internationally, a concerted effort after the crisis to improve the quantity and quality of bank capital requirements. Recent research shows that despite the significant progress made on increasing bank capital levels, policymakers must further increase capital requirements for the largest banks to achieve the socially optimal level of capital—the capital level that maximizes the economic benefits of lowering the chances of future financial crises while limiting the slight increase in bank funding costs associated with higher capital. A 2016 International Monetary Fund (IMF) study concluded that equity capital requirements set from 15 percent to 23 percent of risk-weighted assets would be optimal, avoiding most previous financial crises.[21] Researchers at the Fed concluded in 2017 that equity capital requirements set from 13 percent to 26 percent of risk-weighted assets would maximize economic benefits, while limiting the costs.[22]

Current equity capital requirements, depending on the systemic profile of the institution, range from 7 percent to 11 percent of risk-weighted assets. Bank capital levels are typically a few points above the required levels, meaning that current capital levels are at or below the low end of the socially optimal range. As former Fed Governor Daniel Tarullo stated, based on the cost-benefit trade-off of ratcheting up capital requirements, it is better to be on the higher end of the optimal range.[23] Former Treasury Secretary Timothy Geithner agrees that current bank capital requirements are likely too low.[24] Countless academics have performed research similar to that of the IMF and the Fed, coming to similar conclusions.[25] Based on this mounting evidence, Vice Chairman Quarles should work with the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency to increase bank capital requirements accordingly. While it is highly unlikely that regulators will significantly increase capital requirements, the Fed could activate the countercyclical capital buffer (CCyB).[26] This modest policy tool is an additional bank capital buffer, currently set at 0 percent, that can be ratcheted up to 2.5 percent during positive economic times when risk appears to be building in the financial system.[27] This additional capital buffer would apply to banks with more than $250 billion in assets, or $10 billion in on-balance-sheet foreign exposure. Given high asset valuations within this late stage of the economic cycle, Eric Rosengren, president and CEO of the Federal Reserve Bank of Boston, agrees that activating the CCyB may be appropriate.[28]

Instead of increasing capital requirements, the Fed and other banking regulators appear to be on the verge of reducing them, rejecting the principle of countercyclicality—the idea that financial regulations should be strengthened later in the business cycle as asset valuations increase and the risk of future losses builds. Regulators have proposed lowering the enhanced supplementary leverage ratio requirements that apply to the most systemically important banks, in addition to the SLR changes included in S. 2155.[29]

The Fed also recently released its stress capital buffer proposed rule.[30] The concept of the rule—to harmonize regulatory capital requirements with the stress testing regime—is sound. If appropriately crafted, this proposal would lead to an increase in the aggregate capital levels at banks subject to stress testing. But the specific stress test assumptions loosened by the Fed's proposal—including the assumptions regarding balance sheet growth and the time horizon for expected dividend payouts—would reduce aggregate bank capital levels. According to the most recent stress testing data, this proposal would reduce required capital at these banks by $30 billion.[31] Reducing loss absorbing buffers during positive economic times, at a time when capital levels nonetheless remain below socially optimal levels, is the exact opposite of prudent regulation.

Quarles should address his stance on the capital levels at systemically important banks and discuss whether the Fed is considering activating the CCyB.

4. Do you support the Fed's 2016 recommendations for repeal of the provisions in applicable banking laws that permit banks to engage in merchant banking and other high-risk activities, as well as the Fed's proposed rule that would tighten restrictions on these activities under existing authorities?

Section 620 of the Dodd-Frank Act required federal banking regulators to review and analyze the risks associated with the range of activities in which banks are currently permitted to engage. Regulators were also required to issue a report recommending actions to enhance the safety and soundness of the banking sector stemming from this review.[32] In the report, the Fed recommends that Congress repeal merchant banking authorities that permit banks to make investments in nonfinancial companies, the grandfathered authorities that permit some banks to engage in a wide range of physical commodities activities, and additional exemptions.[33] These recommended changes would improve the safety and soundness of the banking sector by strengthening the traditional separation between banking and commerce, limiting the chance that risks associated with commercial operations lead to bank losses. The Volcker Rule certainly made progress on this front by banning banks from investing in hedge fund and private equity funds above a de minimis amount—and the final Volcker Rule written by regulators arguably should have covered some of these other risky activities.[34] The Fed's recommendations would prudently build on this progress.

In 2016, the Fed also proposed a rule that would tighten restrictions on risky physical commodities activities.[35] The Fed has yet to finalize this rule, and Vice Chairman Quarles has not provided an updated timetable for the rule's completion. During the hearing, Quarles should address his view on the Fed's Dodd-Frank Section 620 recommendations and commit to finalizing the physical commodities rule in a timely manner.

5. On what objective, data-driven grounds are regulators looking to rewrite the Volcker Rule when all evidence suggests it is reining in swing-for-the-fences trading bets without any detrimental side effects for capital markets?

The Volcker Rule ensures that banks and their affiliates do not engage in speculative trading for their own profit and become overly exposed to risky hedge fund and private equity activities. This sensible rule directs banks to focus on client-centered functions such as lending, market-making, and underwriting, while limiting the chances of taxpayer losses. More than two years since its effective date in 2015, the Volcker Rule appears to be working as intended. Banks have shuttered their proprietary trading desks, reined in their market-making and hedging desks to ensure that they do not hide proprietary trading, and made progress toward unwinding their investments in hedge fund and private equity funds.[36] These changes have not come at the expense of U.S. capital markets. Research by academics and regulators has found that most liquidity metrics are well within historical norms and that bond issuance has hit record levels over the past few years.[37] Data released by the Fed also show that the bank trading desks that it oversees are primarily making money off of new positions from fees, spreads, and commissions, as opposed to the price appreciation of existing positions.[38] Far more transparency on the Volcker Rule's implementation, impact, and enforcement is needed, but it seems to be working.[39] The Volcker Rule has not impaired market functioning, and banks now have far less exposure to these highly risky activities, so it is unclear why a full rewrite of the rule is a top priority for Vice Chairman Quarles.[40]

Quarles' stated justification for this rewrite is the "burdensome" nature of the Volcker Rule.[41] But while regulatory efficiency, or accomplishing the mission of a regulation in the least cumbersome way, is a worthy goal, simplification is often code for loosening the Volcker Rule and driving loopholes through the heart of it. Any changes made to the Volcker Rule must not open the door for these risky activities to creep back onto the balance sheets of bank holding companies and their affiliates. If Vice Chairman Quarles wants to improve the Volcker Rule, he should focus first on closing some loopholes that found their way into the final Volcker Rule regulation and establish a heightened public disclosure regime for compliance and enforcement.[42]

As regulators are looking to rewrite the Volcker Rule, Congress is considering legislation that would concentrate the rulemaking authority for the Volcker Rule at the Fed, cutting out the other four financial regulators that currently have jurisdiction.[43] This would make it easier for Vice Chairman Quarles to swiftly and severely roll back the rule. In addition, it makes little sense to remove the Federal Deposit Insurance Corporation from the process, as the Deposit Insurance Fund is on the hook for losses if big trading bets tear down a bank. Moreover, the U.S. Securities and Exchange Commission and the Commodity Futures Trading Commission have extensive trading and financial markets expertise that the other banking regulators do not possess. Given these developments, Quarles' stated views on the Volcker Rule carry increased significance.

Conclusion

The vice chairman for supervision is the Fed's point person on the supervision and regulation of financial institutions. Therefore, the House and Senate hearings this week will provide some clarity on the Fed's regulatory and supervisory agenda. Vice Chairman Quarles has made it clear that he plans to re-examine the post-crisis regulatory regime—from capital and liquidity rules to the Volcker Rule. Members of the House and Senate should use these hearings to underscore the importance of financial reform efforts and to question Vice Chairman Quarles on how he will use his authority. A financial system with strong safeguards and vigorous regulatory oversight will ensure resilience, which is vital for long-term sustainable economic growth. Past financial crises clearly demonstrate that workers and families suffer when risks on Wall Street that undermine the economy's resilience go unchecked; it is therefore important that Quarles keeps workers and families in mind when exercising his authority.

Gregg Gelzinis is a research associate for Economic Policy at the Center for American Progress.

Endnotes

1 House Committee on Financial Services, "Hearing entitled 'Semi-Annual Testimony on the Federal Reserve's Supervision and Regulation of the Financial System,'" April 17, 2018, available at https://financialservices.house.gov/calendar/eventsingle.aspx?EventID=403293.

2 Randal K. Quarles, "Speech: Early Observations on Improving the Effectiveness of Post-Crisis Regulation," Board of Governors of the Federal Reserve System, January 19, 2018, available at https://www.federalreserve.gov/newsevents/speech/quarles20180119a.htm; Randal K. Quarles, "Speech: The Federal Reserve's Regulatory Agenda for Foreign Banking Organizations: What Lies Ahead for Enhanced Prudential Standards and the Volcker Rule," Board of Governors of the Federal Reserve System, March 5, 2018, available at https://www.federalreserve.gov/newsevents/speech/quarles20180305a.htm.

3 Andrew Ackerman, "Senate Passes Bill Easing Banking Rules," *The Wall Street Journal*, March 14, 2018, available at https://www.wsj.com/articles/rollback-of-crisis-era-banking-rules-clears-senate-1521067499; Gregg Gelzinis and Joe Valenti, "Fact Sheet: The Senate's Bipartisan Dodd-Frank Rollback Bill" (Washington: Center for American Progress, 2018), available at https://www.americanprogress.org/issues/economy/reports/2018/02/28/447264/fact-sheet-senates-bipartisan-dodd-frank-rollback-bill/.

4 *Dodd-Frank Wall Street Reform and Consumer Protection Act*, H. Rept. 4173, 111 Cong. 2 sess. (Government Printing Office, 2010).

5 Gelzinis and Valenti, "Fact Sheet: The Senate's Bipartisan Dodd-Frank Rollback Bill."

6 Ibid.

7 National Information Center, "Holding Companies with Assets Greater Than $10 Billion," available at https://www.ffiec.gov/nicpubweb/nicweb/HCSGreaterThan10B.aspx (last accessed April 2018); ProPublica, "Bailout Recipients," available at https://projects.propublica.org/bailout/list/index (last accessed April 2018).

8 Congressional Budget Office, "Cost Estimate: S. 2155, Economic Growth, Regulatory Relief, and Consumer Protection Act" (2018), available at https://www.cbo.gov/system/files/115th-congress-2017-2018/costestimate/s2155.pdf.

9 Elizabeth A. Warren, "Elizabeth Warren: Don't Let Big Banks Escape the Fed's Scrutiny," Bloomberg View, October 26, 2017, available at https://www.bloomberg.com/view/articles/2017-10-26/elizabeth-warren-don-t-let-big-banks-escape-the-fed-s-scrutiny.

10 Federal Reserve System, "Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations," 12 CFR Part 252, *Federal Register* 79 (59) (2014): 17240-17338, available at https://www.gpo.gov/fdsys/pkg/FR-2014-03-27/pdf/2014-05699.pdf.

11 See, for example, *Dodd-Frank Wall Street Reform and Consumer Protection Act*, Sec. 165 (b)(2)(A).

12 Luigi L. De Ghenghi and others, "Senate Passes the Bipartisan Banking Bill," Davis Polk, March 15, 2018, available at https://www.finregreform.com/single-post/2018/03/15/senate-passes-bipartisan-banking-bill/.

13 U.S. Department of the Treasury, *A Financial System that Creates Economic Opportunities: Banks and Credit Unions* (Executive Office of the President, 2017), available at https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf; Office of Sen. Sherrod Brown, "Mnuchin Confirms Dodd-Frank Rollback Bill Will Benefit Foreign Mega Banks, Shadow Banks," Press release, January 31, 2018, available at https://www.brown.senate.gov/newsroom/press/release/mnuchin-confirms-dodd-frank-rollback-bill-will-benefit-foreign-mega-banks-shadow-banks.

14 U.S. Senate Committee on Banking, Housing, and Urban Affairs, "Executive Session to consider the nomination of The Honorable Jerome H. Powell and S. 2155, the Economic Growth, Regulatory Relief and Consumer Protection Act," December 5, 2017, available at https://www.banking.senate.gov/hearings/executive-session-to-consider-the-nomination-of-the-honorable-jerome-h-powell-and-s-2155-the-economic-growth-regulatory-relief-and-consumer-protection-act.

15 Quarles, "Speech: The Federal Reserve's Regulatory Agenda for Foreign Banking Organizations."

16 Gregg Gelzinis, "Treasury wants to weaken a crucial post-crisis capital requirement," *American Banker* BankThink, June 20, 2017, available at https://www.americanbanker.com/opinion/treasury-wants-to-weaken-a-crucial-post-crisis-capital-requirement?feed=00000158-080c-dbde-abfc-3e7d1bf30000.

17 Gregg Gelzinis, "3 Flawed Banking Industry Arguments Against a Key Postcrisis Capital Requirement," Center for American Progress, October 27, 2017, available at https://www.americanprogress.org/issues/economy/news/2017/10/27/441413/3-flawed-banking-industry-arguments-against-a-key-postcrisis-capital-requirement/.

18 Calculation based on U.S. Securities and Exchange Commission, "Form 10-K for State Street Corp." (2017), available at http://investors.statestreet.com/Cache/392404025.PDF?O=PDF&T=&Y=&D=&FID=392404025&iid=100447; U.S. Securities and Exchange Commission, "Form 10-K for The Bank of New York Mellon Corp." (2017), available at https://www.bnymellon.com/_global-assets/pdf/investor-relations/form-10-k-2017.pdf; U.S. Securities and Exchange Commission, "Form 10-K for Northern Trust Corp." (2017), available at https://www.northerntrust.com/documents/earnings/Y9C/10q/ntrs-10k-2017.pdf?bc=25378244.

19 Jeff Stein, "Senate bill could allow 2 top banks to hold billions less in reserves, reducing buffers against collapse," *The Washington Post*, March 9, 2018, available at http://www.washingtonpost.com/news/wonk/wp/2018/03/09/senate-bill-could-allow-2-top-banks-to-hold-tens-of-billions-less-in-reserves-reducing-buffers-against-collapse/.

20 Congressional Budget Office, "Cost Estimate: S. 2155, Economic Growth, Regulatory Relief, and Consumer Protection Act."

21 Jihad Dagher and others, "Benefits and Costs of Bank Capital" (Washington: International Monetary Fund, 2016), available at https://www.imf.org/external/pubs/ft/sdn/2016/sdn1604.pdf.

22 Simon Firestone, Amy Lorenc, and Ben Ranish, "An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the US" (Washington: Board of Governors of the Federal Reserve System, 2017), available at https://www.federalreserve.gov/econres/feds/files/2017034pap.pdf.

23 Daniel K. Tarullo, "Speech: Departing Thoughts," Board of Governors of the Federal Reserve System, April 4, 2017, available at https://www.federalreserve.gov/newsevents/speech/tarullo20170404a.htm.

24 Timothy F. Geithner, "Are We Safer? The Case for Strengthening the Bagehot Arsenal" (Washington: Per Jacobsson Foundation, 2016), available at http://www.perjacobsson.org/lectures/100816.pdf.

25 Anat R. Admati, "The Missed Opportunity and Challenge of Capital Regulation" (Stanford, CA: Stanford University Graduate School of Business, 2015), available at https://www.gsb.stanford.edu/sites/gsb/files/missed-opportunity-dec-2015_1.pdf; Simon Johnson, "The Old New Financial Risk," Project Syndicate, April 28, 2015, available at https://www.project-syndicate.org/commentary/us-bank-low-equity-ratio-by-simon-johnson-2015-04?barrier=accessreg; Morris Goldstein, "Banking's Final Exam: Stress Testing and Bank-Capital Reform" (Washington: Peterson Institute for International Economics, 2017); William R. Cline, "The Right Balance for Banks: Theory and Evidence on Optimal Capital Requirements" (Washington: Peterson Institute for International Economics, 2017).

26 Board of Governors of the Federal Reserve System, "Federal Reserve Board announces it has voted to affirm Countercyclical Capital Buffer (CCyB) at current level of 0 percent," Press release, December 1, 2017, available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20171201a.htm.

27 Board of Governors of the Federal Reserve System, "Regulatory Capital Rules: The Federal Reserve Board's Framework for Implementing the U.S. Basel III Countercyclical Capital Buffer," *Federal Register* 81 (180) (2016): 63682–63688, available at https://www.gpo.gov/fdsys/pkg/FR-2016-09-16/pdf/2016-21970.pdf.

28 Reuters Staff, "Fed may need to adjust policy framework to respond to financial shocks -Rosengren," Reuters, March 23, 2018, available at https://www.reuters.com/article/us-usa-fed-rosengren/fed-may-need-to-adjust-policy-framework-to-respond-to-financial-shocks-rosengren-idUSKBN1GZ3B6; Office of Financial Research, "Financial System Vulnerabilities Monitor," available at https://www.financialresearch.gov/financial-vulnerabilities/#/ (last accessed April 2018).

29 Board of Governors of the Federal Reserve System, "Rule proposed to tailor 'enhanced supplementary leverage ratio' requirements," Press release, April 11, 2018, available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180411a.htm.

30 Board of Governors of the Federal Reserve System, "Federal Reserve Board seeks comment on proposal to simplify its capital rules for large banks while preserving strong capital levels that would maintain their ability to lend under stressful conditions," Press release, April 10, 2018, available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180410a.htm.

31 Memorandum from Staff to Board of Governors, "Proposed rule regarding the stress buffer requirements," April 5, 2018, available at https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180410a1.pdf.

32 Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency, "Report to the Congress and the Financial Stability Oversight Council Pursuant to Section 620 of the Dodd-Frank Act" (2016), available at https://www.occ.gov/news-issuances/news-releases/2016/nr-ia-2016-107a.pdf.

33 Ibid.

34 Gregg Gelzinis, Andy Green, and Marc Jarsulic, "Resisting Financial Deregulation" (Washington: Center for American Progress, 2017), available at https://www.americanprogress.org/issues/economy/reports/2017/12/04/443611/resisting-financial-deregulation/.

35 Board of Governors of the Federal Reserve System, "Federal Reserve Board invites public comment on proposed rule that would strengthen existing requirements and limitations on the physical commodity activities of financial holding companies," Press release, September 23, 2016, available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20160923a.htm.

36 Gelzinis, Green, and Jarsulic, "Resisting Financial Deregulation."

37 Marc Jarsulic, "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors, and Job Creation," Testimony before the U.S. House of Representatives Subcommittee on Capital Markets, Securities and Investment, "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors, and Job Creation," March 29, 2017, available at https://financialservices.house.gov/uploadedfiles/hhrg-115-ba16-wstate-mjarsulic-20170329.pdf.

38 Office of Rep. Carolyn B. Maloney, "Analysis of Quantitative Trading Metrics Collected Under the Volcker Rule," available at https://maloney.house.gov/sites/maloney.house.gov/files/Fed%20-%20Analysis%20of%20Quantitative%20Trading%20Metrics%20Collected%20Under%20the%20Volcker%20Rule%20%2802.14.17%29.pdf (last accessed April 2018).

39 Gelzinis, Green, and Jarsulic, "Resisting Financial Deregulation."

40 Quarles, "Speech: The Federal Reserve's Regulatory Agenda for Foreign Banking Organizations."

41 Ibid.

42 Gelzinis, Green, and Jarsulic, "Resisting Financial Deregulation."

43 *Volcker Rule Regulatory Harmonization Act*, H. Rept. 4790, 115 Cong. 2 sess. (Government Printing Office, 2018).

Center for American Progress

FACT SHEET

The Senate's Bipartisan Dodd-Frank Rollback Bill

By Gregg Gelzinis and Joe Valenti February 28, 2018

In the coming weeks, the U.S. Senate will likely vote on the Economic Growth, Regulatory Relief, and Consumer Protection Act, or S. 2155.[1] This piece of legislation, which is supported by the Senate Republican Conference and 13 members of the Senate Democratic Caucus, has been touted as a community bank bill.[2] Make no mistake, S. 2155 is the second part of a massive corporate giveaway. The corporate tax cuts passed in December 2017 were a windfall for big banks—and big banks are again winners in this legislation.[3] The bill would deregulate 25 of the largest 38 banks in the United States and would undermine some key protections for homeowners and homebuyers, while offering crumbs for consumers.[4] The devastating effects of the financial crisis were felt in every state, so it is hard to believe that the Senate would vote to undo critical postcrisis protections.[5]

If enacted, the bill would make the U.S. financial system—and key regional economies—more vulnerable to another financial crisis, potentially putting taxpayers back on the hook to bail out the same banks once again. The failure of several of these banks during a period of significant stress in the financial sector could threaten financial stability and starve the economy of the credit and financial intermediation it needs to thrive. Moreover, this bill is a solution in search of a problem. Bank profits and lending are both at all-time highs.[6] There is absolutely no reason to deregulate a large swath of the banking sector, especially while the Trump administration is already dismantling financial regulatory tools from within.[7]

Banking provisions

- This bill raises the Dodd-Frank Wall Street Reform and Consumer Protection Act's threshold for enhanced regulatory standards from $50 billion to $250 billion, meaning 25 of the 38 largest banks in the United States would no longer be subject to stronger capital and liquidity rules, enhanced risk management standards, living-will requirements, some stress testing requirements, and more.[8] These rules are vital tools to protect the safety and soundness of banks and the stability of the financial sector.

- These 25 banks collectively hold $3.5 trillion in assets, or roughly one-sixth of the assets in the entire banking sector.[9]

- These banks took $47 billion in Troubled Asset Relief Program (TARP) bailout funds during the 2007–2008 financial crisis.[10]

- Even more stunning, the bill is not just about regional banks. The 25 banks deregulated include the U.S. holding companies of massive, scandal-plagued foreign banks—such as Deutsche Bank, BNP Paribas, UBS, and Credit Suisse—the last banks on earth that should be deregulated.[11]

- The bill also lowers the loss-absorbing capital cushions at two of the eight most systemically important banks in the United States, State Street Corp. and The Bank of New York Mellon Corp., which play a systemic role in the plumbing of the financial sector—holding a combined $60 trillion in assets under custody and administration.[12] Lower capital cushions make these banks less resilient and more vulnerable to a financial shock.

- The bill exempts from the Volcker Rule all banks with less than $10 billion in assets that also have limited trading assets. That means these banks can engage in risky, speculative activities with taxpayer-insured deposits. Although most of these banks do not trade for their own profit, the bill would allow them to invest in hedge funds and private equity funds—putting local economies that depend on these banks at risk.[13]

Housing provisions

- Despite the central role of the housing market leading up to the financial crisis[14] and the Great Recession, a number of the bill's so-called community bank relief measures would reintroduce risk to the housing market at a time when the national homeownership rate is at decades-long lows.[15] These provisions would only increase risk to consumers and taxpayers, rather than sustainably expanding ownership.

- By permitting steering by manufactured-home companies to their affiliated lenders—in other words, directing borrowers toward the company's preferred lender—the bill makes a laughingstock of Congress' commitment to rural Americans, especially those of modest means. As a particular carveout for the manufactured-home industry regardless of the size of the lender, it increases the costs and risk to borrowers who are already often lower-income and more financially vulnerable.[16] Minimal consumer protections included in the bill are less than what exists today, which means they are not strong enough.

- The bill also eliminates escrow requirements for higher-cost mortgages made by banks and credit unions with assets of up to $10 billion, up from $2 billion currently.[17] Escrow is an essential borrower protection, an arrangement that prominently identifies the full cost of a mortgage loan for a prospective homebuyer and prevents the likelihood of losing a home due to an unpaid tax lien or subjection to expensive force-placed insurance, in which the lender, not the borrower, picks the insurance on the home.[18]

- Rather than being packaged and sold to investors in the secondary market, some of the riskiest mortgage loans made prior to the financial crisis were held in portfolio—in other words, kept on the lender's books.[19] Yet for banks and credit unions that have from $2 billion to $10 billion in assets, the bill would newly exempt loans held in portfolio from requirements under the Qualified Mortgage rule,[20] in which lenders ordinarily must assess the borrower's ability to repay. This dramatically expands what was a carveout for the smallest lenders, as well as gives lenders a major safe harbor for nontraditional underwriting practices reminiscent of those that caused the crisis.

- For more than 40 years, the Home Mortgage Disclosure Act (HMDA) has been at the center of fair lending research and enforcement.[21] Dodd-Frank requires mortgage lenders to collect new data points about borrowers, including age, credit score, and detailed racial and ethnic breakdowns, in order to better monitor discriminatory or predatory practices.[22] Yet S. 2155 would exempt approximately 85 percent of lenders from these reporting requirements, taking away an essential tool to ensure that homebuyers are not unfairly denied or overcharged.[23]

- The bill also rolls back appraisal requirements for higher-risk mortgages in rural areas, further risking dangerous mortgage practices. This and many other provisions ignore the causes of the crisis and are solutions in search of a problem. Instead of narrowly tailoring rules to address specific concerns in the marketplace, the bill creates massive new risks in the housing market.

Consumer protection provisions

- As a whole, the bill violates a core tenet of the Dodd-Frank Act and its consumer-facing regulations—regulating financial products not based merely on who offers them but on what the products do. For a homebuyer, the size of the originating bank should not determine whether he or she obtains a fair deal and a safe mortgage.

- There are some modest consumer provisions in the bill, including the right to free credit freezes and protections for veterans' medical debt. On balance, however, these are mere crumbs relative to the rewards given to large and small banks under this bill.

- The bill does nothing to address the Wells Fargo and Equifax scandals[24] that brought needless costs and risk to the American people, nor does it address the nation's nearly $1.5 trillion[25] in student debt.

- These so-called protections are largely inconsequential in light of the major deregulation efforts underway by Trump appointees at federal financial regulators. For instance, the Office of the Comptroller of the Currency has weakened bank assessments under the Community Reinvestment Act[26] and blessed a form of payday lending by banks,[27] while the Consumer Financial Protection Bureau (CFPB) has delayed a long-awaited rule on high-cost payday loans.[28] The CFPB recently dropped its investigation into the Equifax scandal[29] and also dropped an investigation into a payday lender charging 950 percent interest that donated to Acting CFPB Director Mick Mulvaney's 2014 and 2016 congressional campaigns.[30]

- If Congress truly wanted to support consumer protections, it would expand its oversight of these and other regulators and direct them to take action on key consumer concerns.[31] It would also expand private rights of action and end the practice of forced arbitration, so that victims could seek justice in the courts should financial regulators fail to protect them.[32] Instead, President Donald Trump and Congress overturned the CFPB's arbitration rule, which would have restored consumers' right to band together to take financial companies to court.[33]

Rebutting key claims made by S. 2155 supporters

Supporters of S. 2155 have advanced several arguments as to why progressive critiques of the bill are off base. These arguments, however, fall short. Here is a closer look at why some arguments in support of the bill miss the mark.

Claim: The bill only increases Dodd-Frank's $50 billion threshold to $100 billion

Bill supporters claim that because the Federal Reserve retains the authority to reapply Dodd-Frank's enhanced prudential standards to banks with from $100 billion to $250 billion in assets, the legislation essentially only increases the threshold from $50 billion to $100 billion. It is highly irresponsible to trust that Trump-appointed financial regulators keen on financial deregulation will aggressively use the Federal Reserve's authority to reapply these enhanced regulatory standards to banks with from $100 billion to $250 billion in assets. If anything, Federal Reserve Vice Chair for Supervision Randal Quarles has signaled that he wants to go even further in easing regulations for the biggest banks.[34]

Claim: Banks with from $50 billion to $250 billion in assets should not be regulated like the largest banks

The current regulatory regime already sensibly tailors the enhanced regulations based on the size and risk profiles of different banks. The $50 billion threshold is simply a clear and straightforward way to identify the 40 largest banks in the United States that merit heightened scrutiny. It is not a one-size-fits-all threshold. Banks with from $50 billion to $250 billion in assets are not subject to at least nine enhanced regulations to which the largest banks must adhere. A $50 billion bank faces far less stringent regulations than the most systemically important banks in the United States that have trillions of dollars in assets. Banks with between $50 billion and $250 billion in assets should, however, face a minimum level of heighted regulations that includes enhanced capital and liquidity requirements, stress testing, and a requirement to plan for their orderly failure through living wills.

Claim: The bill focuses on community and regional banks and does not affect the regulation of the largest Wall Street banks

While significantly rolling back regulations for 25 of the 38 largest banks in the United States, which include the U.S. holding companies of foreign megabanks, the bill also weakens some regulations for the largest Wall Street banks. The bill eliminates one of the two stress testing scenarios, potentially undermining how severe future stress test scenarios will be. The bill also places a new requirement on the Federal Reserve to tailor the enhanced regulations—beyond the latitude Dodd-Frank already gives regulators to tailor these regulations sensibly—opening the door for the Federal Reserve to water down rules for the largest Wall Street banks under the guise of tailoring. Finally, by changing the calculation of the supplementary leverage ratio (SLR), the bill lowers the required loss-absorbing capital cushions for two of the eight most systemically important banks in the United States.

Claim: Consumers would benefit from expanded access to credit and new protections

Most of the types of lending permitted by the bill based on a desire to expand access are potentially predatory in nature,[35] such as manufactured-housing loans with indirect kickbacks, mortgage loans not requiring a determination of the borrower's ability to repay, and loans outside of escrow in which borrowers may be confronted with costly tax liens or force-placed insurance. This is the wrong kind of access and would only introduce new risk to consumers and taxpayers, ignoring the lessons of the financial crisis.[36] Meanwhile, the new proposed protections fail to address the many real harms consumers face in the marketplace.

Conclusion

If enacted, the Economic Growth, Regulatory Relief, and Consumer Protection Act would represent the most significant rollback of financial reform since Dodd-Frank was passed in the wake of the 2007–2008 financial crisis. At a time when the banking sector is thriving—and just received a massive windfall through the recent corporate tax cut giveaway—it makes no sense to loosen the regulations on the largest banks in the country or to weaken important protections for homebuyers and homeowners. History makes clear that bankers and policymakers are not the ones who bear the immense burdens of a financial crisis. That cost inevitably falls on the shoulders of everyday workers and families, some of whom still have not fully recovered from the previous crisis. Policymakers should keep that in mind before supporting this misguided legislation.

Gregg Gelzinis is a research associate for Economic Policy at the Center for American Progress. Joe Valenti is the director of Consumer Finance at the Center.

Endnotes

1 *Economic Growth, Regulatory Relief, and Consumer Protection Act*, S. 2155, 115 Cong., 2 sess. (Government Printing Office, 2018), available at https://www.congress.gov/bill/115th-congress/senate-bill/2155.

2 Zachary Warmbrodt, "A decade after meltdown, Senate moves to roll back bank rules," *Politico*, February 20, 2018, available at https://www.politico.com/story/2018/02/20/senate-bank-rules-rollback-meltdown-416158.

3 Jim Tankersley, "Banks Are Big Winners From Tax Cut," *The New York Times*, January 16, 2018, available at https://www.nytimes.com/2018/01/16/us/politics/banks-are-big-winners-from-tax-cut.html?mtrref=www.google.com&gwh=FBA004A0057E8C758DA284BFC6BE45A6&gwt=pay.

4 Letter from the Center for American Progress to Sen. Mike Crapo and Sen. Sherrod Brown, November 27, 2017, available at https://cdn.americanprogress.org/content/uploads/2017/11/26123637/CAP-Letter-on-Economic-Growth-Regulatory-Relief-and-Consumer-Protection-Act.pdf.

5 Joe Valenti, "10 Years Later: The Financial Crisis State by State," Center for American Progress, February 22, 2018, available at https://www.americanprogress.org/issues/economy/news/2018/02/22/447031/10-years-later-financial-crisis-state-state/.

6 Gregg Gelzinis, Andy Green, and Marc Jarsulic, "Resisting Financial Deregulation" (Washington: Center for American Progress, 2017), available at https://www.americanprogress.org/issues/economy/reports/2017/12/04/443611/resisting-financial-deregulation/.

7 Gregg Gelzinis, "Don't put SIFI designations on the back burner," *American Banker*, January 29, 2018, available at https://www.americanbanker.com/opinion/dont-put-sifi-designations-on-the-back-burner?brief=00000160-700b-dbf5-a562-788b36110000; Gregg Gelzinis, "The Trump Administration Is Quietly Slashing Financial Stability Funding," Center for American Progress, December 7, 2017, available at https://www.americanprogress.org/issues/economy/news/2017/12/07/443709/trump-administration-quietly-slashing-financial-stability-funding/; Gregg Gelzinis, "Deregulating AIG Was a Mistake" (Washington: Center for American Progress, 2017), available at https://www.americanprogress.org/issues/economy/reports/2017/10/11/440570/deregulating-aig-mistake/; Gregg Gelzinis, "Hedge Funds and Systemic Risk Missing from the FSOC's Agenda" (Washington: Center for American Progress, 2017), available at https://www.americanprogress.org/issues/economy/reports/2017/09/21/437726/hedge-funds-systemic-risk-missing-fsocs-agenda/.

8 Gregg Gelzinis, "Senate's Bipartisan Dodd-Frank Rollback Proposal Is a Raw Deal," Morning Consult, December 8, 2017, available at https://morningconsult.com/opinions/senates-bipartisan-dodd-frank-rollback-proposal-is-a-raw-deal/.

9 National Information Center, "Holding Companies with Assets Greater Than $10 Billion," available at https://www.ffiec.gov/nicpubweb/nicweb/HCSGreaterThan10B.aspx (last accessed February 2018).

10 ProPublica, "Bailout Recipients," available at https://projects.propublica.org/bailout/list/index (last accessed February 2018).

11 Office of Sen. Sherrod Brown, "Mnuchin Confirms Dodd-Frank Rollback Bill Will Benefit Foreign Mega Banks, Shadow Banks," Press release, January 31, 2018, available at https://www.brown.senate.gov/newsroom/press/release/mnuchin-confirms-dodd-frank-rollback-bill-will-benefit-foreign-mega-banks-shadow-banks.

12 Calculation is based on U.S. Securities and Exchange Commission, "Form 10-K for State Street Corp." (2016), available at http://investors.statestreet.com/Cache/38179223.PDF?O=PDF&T=&Y=&D=&FID=38179223&iid=100447; U.S. Securities and Exchange Commission, "Form 10-K for The Bank of New York Mellon Corp." (2016), available at https://www.bnymellon.com/_global-assets/pdf/investor-relations/form-10-k-2016.pdf.

13 Thomas M. Hoenig, "Volcker Rule rollback is not the kind of reg relief small banks need," *American Banker*, August 24, 2017, available at https://www.americanbanker.com/opinion/volcker-rule-rollback-is-not-the-kind-of-reg-relief-small-banks-need?feed=00000158-080c-dbde-abfc-3e7d-1bf30000.

14 Colin McArthur and Sarah Edelman, "The 2008 Housing Crisis" (Washington: Center for American Progress, 2017), available at https://www.americanprogress.org/issues/economy/reports/2017/04/13/430424/2008-housing-crisis/.

15 U.S. Census Bureau, "Quarterly Residential Vacancies and Homeownership, Fourth Quarter 2017," January 30, 2018, available at https://www.census.gov/housing/hvs/files/currenthvspress.pdf.

16 Sarah Edelman and Michela Zonta, "A New Bill in Congress Would Make Mobile Home Loans Even More Predatory," Talk Poverty, November 30, 2017, available at https://talkpoverty.org/2017/11/30/new-bill-congress-make-mobile-home-loans-even-predatory/.

17 Letter from the Center for Responsible Lending, the National Community Reinvestment Coalition, and the National Consumer Law Center to Members of the U.S. Senate, December 1, 2017, available at http://www.responsiblelending.org/sites/default/files/nodes/files/research-publication/letter_opposition_s2155_rollbackofdoddfrank.pdf.

18 Justin Pritchard, "What is Escrow?", The Balance, February 14, 2017, available at https://www.thebalance.com/what-is-escrow-315826.

19 Letter from Americans for Financial Reform and others to Members of Congress, July 27, 2015, available at https://www.nclc.org/images/pdf/legislation/letter-oppose-hr-1210-barr-portfolio.pdf.

20 Consumer Financial Protection Bureau, "Ability-to-Repay and Qualified Mortgage Standards Under the Truth in Lending Act (Regulation Z)," 78 *Federal Register* 6407, 6620 (revising 12 CFR 1026), January 30, 2013, available at https://www.federalregister.gov/documents/2013/01/30/2013-00736/ability-to-repay-and-qualified-mortgage-standards-under-the-truth-in-lending-act-regulation-z.

21 Federal Financial Institutions Examination Council, "History of HMDA," available at https://www.ffiec.gov/hmda/history2.htm (last accessed February 2018).

22 Consumer Financial Protection Bureau, "Home Mortgage Disclosure (Regulation C)," 80 *Federal Register* 66127, 66340 (revising 12 CFR 1003), October 28, 2015, available at https://files.consumerfinance.gov/f/documents/201708_cfpb_final-rule_home-mortgage-disclosure_regulation-c.pdf.

23 Letter from the Center for Responsible Lending, the National Community Reinvestment Coalition, and the National Consumer Law Center to Members of the U.S. Senate.

24 Elizabeth Dexheimer, Jesse Hamilton, and Jennifer Surane, "Equifax Is Taking Over From Wells Fargo as the Financial Industry's Villain," Bloomberg, October 2, 2017, available at https://www.bloomberg.com/news/articles/2017-10-02/wells-fargo-cedes-most-hated-rank-to-equifax-in-dueling-hearings.

25 Board of Governors of the Federal Reserve System, "Consumer Credit – G.19," available at https://www.federalreserve.gov/releases/g19/current/ (last accessed February 2018).

26 Office of the Comptroller of the Currency, *Impact of Evidence of Discriminatory or Other Illegal Credit Practices on Community Reinvestment Act Ratings* (U.S. Department of the Treasury, 2017), available at https://www.occ.treas.gov/publications/publications-by-type/other-publications-reports/ppms/ppm-5000-43.pdf.

27 Office of the Comptroller of the Currency, "Acting Comptroller of the Currency Rescinds Deposit Advance Product Guidance," Press release, October 5, 2017, available at https://www.occ.treas.gov/news-issuances/news-releases/2017/nr-occ-2017-118.html.

28 Julia Horowitz, "CFPB says it will reconsider its rule on payday lending," CNN, January 16, 2018, available at http://money.cnn.com/2018/01/16/news/cfpb-payday-rule/index.html.

29 Patrick Rucker, "Exclusive: U.S. consumer protection official puts Equifax probe on ice – sources," Reuters, February 5, 2018, available at https://www.reuters.com/article/us-usa-equifax-cfpb/exclusive-u-s-consumer-protection-official-puts-equifax-probe-on-ice-sources-idUSKBN1FP0IZ.

30 Kate Berry, "CFPB drops probe into lender that gave to Mulvaney's campaigns," *American Banker*, January 23, 2018, available at https://www.americanbanker.com/news/cfpb-drops-probe-into-lender-that-gave-to-mulvaneys-campaigns.

31 Joe Valenti, "7 Ways Congress Could Give More Leverage to Consumers and Small Businesses in the Financial Marketplace," Center for American Progress, December 4, 2017, available at https://www.americanprogress.org/issues/economy/news/2017/12/04/443706/7-ways-congress-give-leverage-consumers-small-businesses-financial-marketplace/.

32 Joe Valenti, "The Case Against Mandatory Consumer Arbitration Clauses" (Washington: Center for American Progress, 2016), available at https://www.americanprogress.org/issues/economy/reports/2016/08/02/142095/the-case-against-mandatory-consumer-arbitration-clauses/.

33 Lorraine Woellert, "Trump to sign legislation overturning arbitration rule," *Politico*, October 31, 2017, available at https://www.politico.com/story/2017/10/31/trump-consumer-arbitration-rule-244396.

34 Randal K. Quarles, "Early Observations on Improving the Effectiveness of Post-Crisis Regulation," Board of Governors of the Federal Reserve System, January 19, 2018, available at https://www.federalreserve.gov/newsevents/speech/quarles20180119a.htm.

35 Joe Valenti, Sarah Edelman, and Julia Gordon, "Lending for Success" (Washington: Center for American Progress, 2015), available at https://www.americanprogress.org/issues/economy/reports/2015/07/13/117020/lending-for-success/.

36 McArthur and Edelman, "The 2008 Housing Crisis."

Bank capital requirements

Capital requirements are the most fundamental tool that banking regulation has to lower the likelihood of bank failures, financial crises, and taxpayer-funded bailouts. This section provides an overview of what capital is and why it is a pillar of banking regulation. It then details the severe undercapitalization of the banking system prior to the financial crisis and highlights the progress made to increase capital following the crisis. It also outlines the current proposals set forth by Congress and the Trump administration to undermine postcrisis capital requirements. Finally, this section presents a review of research showing that while current bank capital levels are significantly improved, they are not yet high enough, and it outlines an affirmative proposal to increase capital requirements accordingly.

What is bank capital?

In most news articles or research reports, banks are referred to as "holding" a certain amount of capital. This gives the false impression that capital is essentially cash that banks set aside in a vault that is used to absorb losses but that cannot be used for loans or other productive purposes. It is worth briefly addressing this confusion by explaining what capital actually is and why it is important.[26]

Essentially, bank capital is the difference between the value of a bank's assets—what the bank owns—and the value of its liabilities—what the bank must pay back to its creditors or depositors. For example, if a bank has $100 in assets, such as loans, and $90 in liabilities, such as deposits and other debt, then it has $10 in equity capital. That $10 is crucial for the bank, as it serves as a loss-absorbing buffer because capital is a category of funding that does not require repayment when the value of a bank's assets declines. While debt payments are due on a fixed schedule, equity holders are not entitled to regular repayment—they merely receive distributions if a company has excess profits. If the value of the bank's $100 in assets drops to $95, then it still has $5 of capital. But if the assets were to drop by more than $10 in value, the capital would be wiped out and the bank would not have enough value to pay off its liabilities—a scenario referred to as insolvency. Absent support from the government to prop up the bank, insolvency would result in the bank's failure.

A key element of this description is that this equity—which is provided by shareholders when a bank issues stock or by retained earnings when a bank keeps its excess profits—is in no way set aside in a bank vault. The $100 in loans from the example is funded by the $90 in liabilities and the $10 in equity. Understanding this loss-absorbing function of capital and dispelling the notion that it is not used to fund loans and other assets is crucial to understanding the current bank capital debate. Other more nuanced misconceptions about bank capital and its impact on lending and economic growth will be addressed throughout this section.

Undercapitalization during the financial crisis

One of the banking system's many problems in the lead-up to the 2007-2008 financial crisis was that it was severely undercapitalized. Regulatory capital requirements were too low, which allowed banks to rely heavily on debt, leaving them unable to absorb their substantial losses during the crisis. Examples of two distressed banks, Wachovia and Washington Mutual, are instructive.

At the start of the financial crisis in June 2007, the $300 billion commercial bank Washington Mutual had a tangible common equity capital-to-tangible assets ratio of 4.8 percent.[27] Tangible common equity refers to the highest quality of capital that is available to fully absorb losses. There are other categories of capital, referred to as other tier one capital or tier two capital, both of which for nuanced reasons have some debtlike features that make them less adequate for absorbing losses.[28] After booking roughly $6 billion in losses, Washington Mutual's tangible common equity ratio dropped to 3.6 percent, meaning the bank was leveraged at almost 30-to-1.[29] With this extremely low capital level and more trouble on the horizon, the Federal Deposit Insurance Corporation (FDIC) took over the bank and sold it to JPMorgan Chase. After acquisition, JPMorgan Chase wrote down $29 billion more in losses on Washington Mutual's portfolio.[30] When comparing the total losses of $35 billion with the bank's assets at the start of the crisis, it equates to an 11.5 percent loss—meaning that the bank's 4.8 percent common equity at the time was much too low to withstand the coming crisis.[31]

The failure of Wachovia, a much larger commercial bank with $700 billion in assets, reveals a similar picture of inadequate equity capital prior to the crisis. In the second quarter of 2007, Wachovia's common equity capital ratio was 4.3 percent.[32] By the end of 2008—when Wells Fargo acquired the failing bank and booked losses stemming from the acquisition—the losses totaled almost 9 percent of Wachovia's second-quarter 2007 assets.[33] As demonstrated by these two developments, and by research conducted on capital erosion by the Federal Reserve Bank of Boston, these losses occurred rapidly.[34] When such losses piled up and left banks insolvent or close to it, lending in the banking sector plummeted—severely contracting economic growth.

The losses across the banking sector overwhelmed capital ratios, necessitating hundreds of billions of dollars in government bailout funds to replenish capital, as well as trillions of dollars of additional support in guarantees and liquidity facilities.[35] More than 500 banks failed during this period.[36] In 2009, 19 banks with more than $100 billion in assets—accounting for two-thirds of the assets and more than one-half of the loans in the U.S. banking system—were selected to take part in the first stress tests.[37] Ten of the 19 participating firms were a combined $74.6 billion short of the stress test's required capital ratios.[38] The low level of regulatory capital requirements was not the only cause of the undercapitalization. Banks were also able to count the type of capital securities with debtlike qualities mentioned earlier as a higher portion of their capital requirements than was appropriate. This type of instrument—preferred stock, for example—could not absorb losses as well as common equity due to its contractual features. Counting hybrid securities toward primary capital ratios made banks look more well-capitalized than they actually were, because only common equity could be completely trusted to absorb losses. Moreover, banks and other financial institutions used derivatives and other off-balance-sheet vehicles to take on risk while avoiding the capital requirements that would accompany the same types of activities if they occurred on the balance sheet. Low capital requirements, the loose definition of what counted as capital, as well as the use of off-balance-sheet instruments, left the banking sector extremely leveraged and vulnerable to a negative financial shock.

Bank capital positions have improved

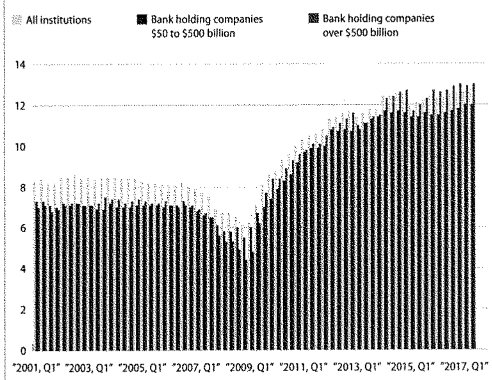
Since the financial crisis, much progress has been made to address the banking sector's capital shortcomings. Internationally, regulators worked together at the Basel Committee on Banking Supervision (BCBS)—a consensus-driven standard-setting body that brings together regulators from around the world to negotiate banking policies—and agreed upon the Basel III framework. At the time, U.S. regulators played a leading role in driving the Basel process. In the framework, capital requirements—including the definition of what qualifies as capital and the treatment of off-balance-sheet exposures—were significantly strengthened.

In the Dodd-Frank Act, U.S. regulators were directed to set minimum capital requirements and leverage requirements for consolidated bank holding companies that were no lower than those that applied to banks and were authorized to subject banks with more than $50 billion in assets to enhanced capital and leverage requirements tailored to their size and risk profiles.[39] Through public rule-makings, U.S. regulators implemented a modified Basel III capital framework and Dodd-Frank capital-related provisions, including enhanced leverage ratios and capital surcharges for the largest, most systemic U.S. banks. Since the first quarter of 2009, the 34 largest bank holding companies—which constitute more than 75 percent of the banking sector's assets—have raised their common equity capital-to-risk-weighted assets ratio from 5.5 percent to 12.5 percent by the first quarter of 2017.[40] To put those figures in context, these 34 banks have increased their highest quality capital buffers by $750 billion.[41] According to the FDIC, the banking industry's aggregate risk-based equity capital ratio has exceeded 11 percent every quarter since mid-2010—a level that the industry had previously never surpassed.[42] Furthermore, there were fewer than 10 bank failures in both 2015 and 2016, compared with the more than 500 banks that failed during the crisis.[43] Thanks to Basel III and the Dodd-Frank Act, the banking sector has come a long way in improving its capital positions.

FIGURE 3

Banks have improved their loss-absorbing capital positions since the financial crisis

Tier 1 common equity capital, as a percentage of risk-weighted assets



Source: Federal Reserve Bank of New York Research and Statistics Group, "Quarterly Trends for Consolidated U.S. Banking Organizations Second Quarter 2017," available at https://www.newyorkfed.org/medialibrary/media/research/banking_research/quarterlytrends2017q2.pdf?la=en.

Recent efforts to loosen capital requirements

In June, the Treasury Department released a report on banking regulations in response to President Trump's February executive order on financial regulation.[44] While the report included some reasonable policy recommendations regarding simplifying capital requirements for small community banks, it also included recommendations to loosen bank capital requirements, which would increase risks to financial stability. The report recommends an esoteric change to the calculation of the supplementary leverage ratio (SLR), one of the new capital requirements included in Basel III that applies to the largest banks.

Banks are required to adhere to two types of capital requirements—risk-weighted capital and leverage limits. Risk-weighted capital requirements assign weights to different types of assets based on their riskiness. Safe Treasury securities receive a zero percent risk weight, for example, while a corporate bond will receive a much higher percentage weighting. Leverage requirements such as the SLR, on the other hand, are risk-blind. Assets do not receive a risk weight and are all treated the same, making this a more holistic standard. It is a simpler way to calculate leverage and does not rely on regulators to calibrate risk weights appropriately. As a result, leverage ratios are lower than capital ratios.

Both risk-based capital requirements and leverage requirements have their pros and cons; making use of both is therefore crucial. Leverage requirements do not penalize banks for increasing the riskiness of their assets. Risk-based capital requirements are more complex and have been gamed in the past through financial engineering, and regulators are not perfect at predicting the riskiness of entire assets classes, so the risk weights can be improperly calibrated, leaving banks vulnerable. Therefore, risk-weighted capital and leverage ratio work in tandem.

The Treasury report recommends removing certain assets—cash, Treasury securities, and margin held against centrally cleared derivatives—from the denominator of the leverage ratio calculation. This is the functional equivalent of assigning a zero percent risk weight to these assets, undermining the entire purpose of the leverage ratio. This change would lower the leverage capital requirement for the largest banks by tens of billions of dollars each. Unfortunately, market regulators such as the U.S. Commodity Futures Trading Commission have also advocated for some of these weakening proposals.[45] And oddly enough, even the Treasury report's appendix disagrees with this recommendation. When describing the importance of the leverage ratio, the appendix states, "Leverage capital requirements are not intended to adjust for real or perceived differences in the risk profile of different types of exposures. ... As such, the leverage ratio requirements complement the risk-based capital requirements that are based on the composition of a firm's exposures."[46]

A narrower version of the Treasury proposal is included in the bipartisan Senate banking bill. That provision would require regulators to exclude cash held at central banks from the denominator of the SLR only for custody banks. Custody banks are vital for the U.S. economy. Combined, the largest custody banks, which are subject to the SLR, are the custodians of roughly $65 trillion in assets for their clients, which include pension funds, endowments, insurance companies, and other institutions.[47] These banks also provide clearing, settlement, and execution services to their clients—essential plumbing services for the financial sector. The proposed change to the SLR for custody banks aims to address a potential problem that may arise during a financial crisis. When their institutional clients liquidate securities—which are held in custody by the custody banks off balance sheet—en masse during a crisis to flee to cash, it is possible that cash will be deposited quickly at the custody bank on balance sheet. The custody bank would likely put this influx of cash into central bank deposits. The bank's risk-weighted capital level would be unchanged, as central bank deposits receive a zero percent risk weight, but the leverage ratio would decline. Changing the calculation of the SLR for these banks, which would lower their capital requirements today, to address this quirk that would likely last one or two weeks at the height of a financial crisis, is far too broad an approach to the problem. Providing regulators with additional emergency authority to exclude a rapid influx of deposits parked at central banks during a crisis from the calculation or further clarifying regulators' existing authority to deal with this issue may be appropriate. Moreover, regulators should explore other avenues for where these large institutional investors could park their cash during a crisis. Undermining the principle of the leverage ratio through a change in the calculation is unwise and would open the door to further erosion of the SLR, representing the "thin end of a thick wedge," as elegantly put by the Systemic Risk Council.[48]

In addition to the statutory risk-weighted capital and leverage requirements for banks, the annual stress tests conducted by the Federal Reserve serve as an additional dynamic capital requirement for banks. The Dodd-Frank Act Stress Tests (DFAST) and the Comprehensive Capital Analysis and Review (CCAR) conducted by the Federal Reserve test the balance sheets of banks with more than $50 billion in assets to ensure that they can withstand adverse and severely adverse scenarios while maintaining the minimum applicable capital cushions.[49] The CCAR also includes a qualitative component for banks with more than $250 billion in assets, in which the Federal Reserve analyzes a bank's internal risk-management and capital-planning processes. Through the CCAR, the Federal Reserve can restrict the amount of capital a bank can distribute through share buybacks and dividends. The Treasury Department report recommended that the Federal Reserve open the CCAR process, models, scenarios, and other aspects of the exercise to public notice and comment in the name of transparency.[50] Federal Reserve Vice Chair for Bank Supervision Randal Quarles and Federal Reserve Board Chair nominee Jay Powell have signaled interest in pursuing this recommendation.[51] This change would undermine the effectiveness of the annual stress tests and in turn could limit the eventual capital cushions that the Federal Reserve requires banks to maintain. If a bank knows what the adverse and severely adverse scenarios are prior to the stress test, it may modify its balance sheet accordingly to limit its projected losses and consequently, required capital.[52] Once the stress testing is over, the bank would likely then shift its balance sheet back to its prestress-testing composition. During the stress tests, this would likely increase the correlation risk between institutions—as their balance sheets would be tailored to the given scenario and economic models used by the Federal Reserve.

Financial shocks are by their very nature surprises. Banks should not be given the test beforehand, as Sen. Elizabeth Warren (D-MA) correctly argued during Vice Chair Quarles' confirmation hearing.[53] Moreover, allowing the banks to comment on the scenarios and economic models gives them an opportunity to influence the substance of the exercise. Banks will likely lobby for lax macroeconomic scenarios and more favorable economic model assumptions that line up with their business incentives. Genuine transparency on stress testing that does not undercut the entire purpose of the testing is a worthy goal—and the Federal Reserve has significantly improved transparency over the past seven years. The Fed's public release of the 2011 CCAR results was 21 pages and did not include a bank-by-bank breakdown of pre- and post-scenario capital levels.[54] By contrast, the 2016 CCAR public release was 100 pages and included detailed bank-by-bank information with an explanation of the adverse and severely adverse economic scenarios.[55] Changes to the stress-testing regime must not undermine the utility of the annual exercise.

Finally, the Treasury report also recommended that U.S. regulators delay implementation of the fundamental review of the trading book (FRTB), which refers to a revised minimum capital standard for the market risk posed by a bank's trading activities.[56] The BCBS released its final update on the FRTB in January 2016.[57] U.S. regulators have not yet implemented the rule. The revised requirement would have the net effect of increasing the capital requirements for bank trading activities to more accurately account for the riskiness of those activities.[58] Further delaying implementation of these enhanced standards for some of the riskiest activities at the largest banks would be a mistake.

Justifications to lower capital fall short

The conservative and industry-driven justification given for rolling back capital requirements is that strong capital requirements hamper banks' ability to lend and in turn, dampen economic growth. Opponents of increased capital argue that stronger requirements drive up the funding costs of banks, because equity, commensurate with the increased risk of being in a first-loss position, demands a higher rate of return than debt. The cost is then passed to consumers. Opponents assert that more expensive lending means less lending, which in turn means slower economic growth.

For example, this past February, President Trump claimed that his friends could not get loans because of Dodd-Frank. The Clearing House, a trade association for the largest global commercial banks, also claims that increased capital requirements, namely the leverage ratio, increase the cost of banking services—and in turn significantly limit lending and economic growth.[59] In 2015, the U.S. Chamber of Commerce warned that increased risk-weighted capital requirements on the largest banks—known as the globally systemically important bank (G-SIB) capital surcharge—would "create a drag on our financial services sector, and raise the costs of capital for all businesses."[60] In similar terms, the American Bankers Association claimed that the G-SIB surcharge "would be detrimental to U.S. bank customers and the institutions that serve them."[61] The Treasury Department report repeatedly talks about the costs of bank capital—the burdens bank capital places on certain loan asset classes—and it argues that lending has been historically slow to recover, in part due to excessive regulations.[62]

The evidence simply does not back up these claims. Lending has rebounded significantly since the financial crisis and is currently higher than ever.[63] The economy has added more than 16 million jobs since the Dodd-Frank Act was signed into law on July 21, 2010, while the unemployment rate dropped from 9.4 percent in July 2010 to 4.1 percent in October 2017.[64] This lending growth and economic recovery all occurred as the banking sector doubled its capital levels—not to mention the fact that bank profits are at record levels and that banks are choosing to return even more capital to their shareholders instead of using it to fund more loans.[65] In the FDIC's Quarterly Banking Profile for the third quarter of 2017, banks reported a combined net income of $47.9 billion, and the industry's average return on assets remained strong after hitting a 10-year high in the second quarter.[66] Lending continues to climb, with total loans and leases up 3.5 percent in the past 12 months.[67] Community banks, which have been subject to a trend of consolidation since the 1970s, have had sustained loan and profitability growth since the financial crisis.[68] A safe and sound financial sector is a source of strength for economic growth.

Significant research bolsters the previously outlined prima-facie case that bank capital requirements have not harmed economic growth. Research from Leonardo Gambacorta and Hyun Song Shin at the Bank for International Settlements (BIS) shows that an increase in a bank's equity capital lowers the cost of that bank's debt and is associated with an increase in annual loan growth.[69] This empirical study supports a theoretical claim about bank funding costs, known as the Modigliani-Miller theorem. It is true that equity investors demand a higher rate of return than debt investors—reflecting equity's higher risk, as it is in a first-loss position. But the Modigliani-Miller theorem holds that when a bank shifts its funding more toward equity, the increase in funding cost is offset by equity investors and debt investors both demanding a lower return because the bank has more equity and is therefore safer.[70] The mix of debt and equity do not affect a bank's total funding costs. This theorem is somewhat skewed in practice by the tax treatment of debt versus equity, making debt cheaper than it otherwise would be. As demonstrated in the BIS study, however, the offset does exist to some extent. Research on the exact impact of increased capital on funding costs and lending differs, but the clear majority of studies show a negligible or modest impact.[71] Further research from the BIS showed that banks with higher capital coming out of the financial crisis expanded lending more quickly.[72]

Furthermore, former Director of the Office of Financial Stability Policy and Research at the Federal Reserve Board Nellie Liang concludes that there is no evidence that higher capital requirements have constrained lending.[73] Thomas Hoenig, the vice chair for the FDIC, agrees with this research, stating in a 2015 *Wall Street Journal* op-ed, "Banks with stronger capital positions maintain higher levels of lending over the course of economic cycles than those with less capital."[74] Hoenig also concluded in a 2016 speech at a Federal Reserve Bank of New York (FRBNY) conference, "Strong capital levels support growth over the business cycle and are good for the economy."[75]

And to be fair, not all conservatives are opposed to higher capital. Scholars at the conservative think tanks American Enterprise Institute and the Mercatus Center have argued that current capital requirements are too low.[76] Moreover, in the comprehensive summary for the Financial Choice Act, Chairman Hensarling combats the claim that increased capital requirements hurt lending and economic growth.[77] The summary cites several of the sources referenced above. Unfortunately, the Financial Choice Act calls for only modestly higher capital, while allowing banks that choose the higher capital off-ramp to opt out of a suite of other crucial financial regulatory requirements, such as liquidity rules, stress tests, and counterparty credit limits. While some well-respected academics agree that higher capital can replace some or all of the additional prudential regulations included in the Dodd-Frank Act, the Financial Choice Act's capital increase is significantly lower than what those academics suggest. For example, Stanford Graduate School of Business professor and financial regulatory expert Anat Admati recommends a leverage ratio of 20 percent to 30 percent, which is substantially higher than the Financial Choice Act's 10 percent requirement.[78] Even with higher capital requirements, liquidity requirements, stress testing, living wills, and other prudential measures serve as complements to ensure the safety and soundness of the banking sector.

While improved, current capital levels are still too low

Recent research from the International Monetary Fund (IMF), the Federal Reserve, the Federal Reserve Bank of Minneapolis, and some academics has challenged the idea that current capital requirements are calibrated to socially optimal levels, suggesting that an increase in capital requirements at the largest banks is appropriate. The concept of the socially optimal level of capital refers to the calibration of capital requirements that maximize the economic benefits of lowering the chances of financial crises, while limiting an increase in bank funding costs that could increase the cost of lending.

The 2016 IMF study concludes that capital in the range of 15 percent through 23 percent of risk-weighted assets would have been sufficient for banks in advanced economies to absorb losses and avoid most previous financial crises.[79] The study takes a global view and looks at losses across countries, particularly ones classified as advanced economies. The Federal Reserve released a paper in 2017 using a similar methodology to the IMF study but made specific tweaks to reflect the U.S. financial sector and the fact that additional financial regulations such as liquidity requirements also lower the probability of a financial crisis. The paper found that the level of capital that maximizes net economic benefits is slightly more than 13 percent to more than 26 percent of risk-weighted assets.[80] With current equity capital levels around 12.5 percent, and regulatory requirements at less than that, the U.S. banking system is at best on the low end of this range and at worst below it.

In his farewell address in April 2017, former Federal Reserve Board of Governors member Daniel Tarullo stated:

> *In fact, one might conclude that a modest increase in these requirements—putting us a bit further from the bottom of the range—might be indicated. This conclusion is strengthened by the finding that, as bank capital levels fall below the lower end of ranges of the optimal trade-off, the chance of a financial crisis increases significantly, whereas no disproportionate increase in the cost of bank capital occurs as capital levels rise within this range.*[81]

Tarullo explains what the data clearly show: For the sake of U.S. economic security, it makes sense to err on the side of too-high capital requirements rather than too low.

Former Treasury Secretary Timothy Geithner is also concerned about current capital requirements. He argued in an October 2016 speech at the IMF and World Bank annual meetings that current capital requirements look high compared with the actual losses experienced during the 2007-2008 financial crisis, but those losses would have been much higher had the government not intervened extensively to prop up the withering financial sector.[82] Academics including Anat Admati, Simon Johnson, William Cline, and Morris Goldstein have researched the question of adequate bank capitalization levels and have argued for years that more capital is needed.[83] While the specific levels of capital that they prescribe differ, most fall within the general bounds of the IMF and Federal Reserve studies previously referenced.

The Treasury report even seems to agree on this point, despite offering a recommendation to loosen capital requirements. The report states, "While some modest further benefits could likely be realized, the continual ratcheting up of capital requirements is not a costless means of making the banking system safer."[84] While additional tools, such as long-term bail-in-able debt, are important and can play a role especially in the resolution of a complex firm, common equity capital has proved to be the best loss-absorbing option.

Policy recommendation

CAP recommends that regulators increase current capital and leverage ratio requirements to place the loss-absorbing capital cushions at the largest banks squarely within the socially optimal range. Moreover, these new capital requirements should be incorporated into the Federal Reserve's annual CCAR stress-testing exercise.

Increase risk-based capital and leverage ratio requirements

First, the appropriate banking regulators should initiate a rule-making to amend the risk-based capital requirements and leverage ratio requirements for all banks with more than $250 billion in assets in a tiered manner. Through this rule-making, the regulators should institute a new risk-weighted common-equity systemic risk capital buffer for banks with more than $250 billion in assets, with an even higher buffer for banks designated as G-SIBs to put capital requirements squarely in the middle of the socially optimal capital range.

Along with this risk-based capital increase, the regulators should raise the SLR and enhanced supplementary leverage ratio (eSLR) requirements for these institutions to be proportional with their new risk-weighted capital requirements. For example, a 5 percent risk-weighted buffer for banks with more than $250 billion in assets and an 8 percent buffer for G-SIBs would accomplish this goal. Using these numbers for the sake of argument, the new common-equity risk-weighted capital requirements for banks with more than $250 billion in assets, but not designated as G-SIBs, would be 12 percent. The new common-equity risk-weighted capital requirements for G-SIBs would be 16 percent to 18.5 percent or more, depending on the respective firm's G-SIB surcharge.

Risk-based capital requirements will always be higher than leverage requirements to ensure that no one type of capital requirement is always binding. In this example, the supplementary leverage ratio would increase from 3 percent at the holding company level across banks with more than $250 billion in assets to roughly 7.5 percent, depending on the conversion factor chosen by regulators to keep the risk-weighted assets and leverage ratios in proportion. Currently, the eSLR does not vary across banks depending on their respective risk profiles, like the G-SIB surcharge does. Regulators should change that treatment and keep the leverage and risk-weighted capital requirements proportional at each bank. At G-SIBs, the new eSLR—currently at 5 percent at the holding company level—would increase in this example to roughly 10 percent through 12 percent depending on the conversion factor, as well as each individual firm's new risk-weighted capital requirement.

The actual additional capital buffers need not be 5 percent and 8 percent exactly, but the capital requirements should accomplish the goal of moving the largest banks further away from the lower bound of the socially optimal range of capital. Banks typically fund themselves with capital exceeding the regulatory requirements, so when fully capitalized after phase-in, it is expected that banks would be a few percentage points above these new minimums. Banks should have five years to implement changes fully and should be able to do so primarily through retained earnings. Current requirements should not change at banks with $50 to $250 billion in assets, and the regulators should exercise discretion to subject or exempt banks within $50 billion above and below the $250 billion cutoff depending on a bank's risk profile. Consideration should also be given to proposals to simplify capital requirements for community banks with less than $10 billion in assets. If regulators fail to act on this proposal, Congress should pass legislation directing regulators to increase both risk-weighted capital and leverage ratio requirements for banks with more than $250 billion in assets.

TABLE 1

Example of a capital increase that would put banks squarely within socially optimal range

Risk-weighted capital and leverage ratio requirements for different categories of banks

Bank Size	Current common equity risk-weighted capital requirement	Current supplementary leverage ratio requirement	Example of a tiered common equity systemic risk buffer	Example of a socially optimal common equity risk-based capital requirement	Example of a socially optimal proportional supplementary leverage ratio
$50 to $250 billion	7%	N/A	N/A	7%	N/A
Over $250 billion	7%	3%	5%	12%	7.5%*
G-SIB	8%–10.5%**	5%	8%	16%–18.5%**	10%–12%*

*The new suppementary leverage ratio requirement would depend on regulators' calibration of the risk-weighted assets and leverage ratio proportion.

**The G-SIB surcharge for a given firm is determined based on the firm's size, interconnectedness, complexity, cross-jurisdictional activity, and reliance on short-term funding. Currently, the eight G-SIBs have surcharges ranging from 1% to 3.5%; however, the upper bound can increase based on the aforementioned factors.

Integrate increased capital requirements into the CCAR

These new risk-weighted capital and leverage requirements for banks with more than $250 billion in assets and G-SIBs should be integrated into the post-stress capital minimums in the Fed's annual CCAR stress-testing exercise. Currently, the additional capital buffers for the most systemically important banks, such as the G-SIB surcharge, are not integrated into the minimum post-stress capital requirements in the CCAR. Despite multiple intimations by former Federal Reserve Board of Governors member Tarullo and Federal Reserve Board Chair Janet Yellen, no rule to do so has yet been proposed.[85] For example, a bank with $50 billion in assets and a G-SIB must both have a minimum of 4.5 percent common equity tier one capital after the adverse and severely adverse scenarios, despite having different regulatory capital requirements. If the G-SIB surcharge and the additional systemic risk capital buffers proposed in this section are integrated into the CCAR minimums, then the G-SIBs and banks with more than $250 billion in assets would have higher post-stress minimums than a bank with $50 billion in assets. In the context of integrating the G-SIB capital requirements into the stress tests, Tarullo and Yellen outlined the concept of a stress capital buffer, which would essentially incorporate the projected stress test losses for a given bank into the regulatory capital requirement for the following year. This is a sensible proposal that the Federal Reserve should proceed with and would be compatible with the additional systemic risk buffer proposed in this section. The integration of the G-SIB surcharge and the new systemic risk buffer into CCAR would align the regulatory capital requirements with the stress tests, reflecting the fact that the failure of a G-SIB would have higher costs to the system compared with the failure of a smaller institution.

Larger, more systemically important banks should have to internalize the cost of their potential failure and should face more stringent capital requirements accordingly. That principle should ring true in both the regulatory capital requirements and in stress testing.

MON€¥ $
BAN£ING
www.moneyandbanking.com

Stephen G. Cecchetti
cecchetti@brandeis.edu
Kermit L. Schoenholtz
kschoenh@stern.nyu.edu

Statement of Stephen G. Cecchetti and Kermit L. Schoenholtz
to the
Subcommittee on Financial Institutions and Consumer Credit
of the Committee on Financial Services
U.S. House of Representatives
July 17, 2018

We appreciate the opportunity to submit the following statement on the occasion of the hearing entitled "Examining Capital Regimes for Financial Institutions." We welcome the Subcommittee's further examination of the existing regulatory approach for prudentially regulated financial institutions.

We are academic experts in financial regulation with extensive knowledge of the financial industry. Our experience includes working with private sector financial institutions, government agencies and international organizations. In our view, a strong and resilient financial system is an essential foundation of a thriving economy. The welfare of every modern society depends on it. The bedrock of this foundation is that banks' capital buffers are sufficient to withstand significant stress without recourse to public funds. Furthermore, it is our considered view that the benefits of raising U.S. capital requirements from their current modest levels clearly outweigh the costs.

To explain this conclusion, we start with a definition of bank capital, including a discussion of its importance as mechanism for *self-insurance*. We then turn to capital regulation and a discussion of stress testing.

What is bank capital? There are several consistent definitions of a bank's *capital* (or, equivalently, its *net worth*). First, capital is the residual that remains after subtracting a bank's fixed liabilities from its assets. Second, it is what is owed to the banks' owners—its shareholders—after liquidating all the assets. Third, it is the buffer that separates the bank from insolvency: the point at which its liabilities exceed the value of assets.

Importantly, capital is a source of funds that the bank uses to acquire assets. This means that, if a bank were to issue an extra dollar worth of equity or retain an additional dollar of earnings, it can use this to increase its holding of cash, securities, loans, or any other asset. Put differently, equity is *not* a wasted resource. When a bank finances additional assets with capital, its ratio of equity to total assets—the leverage ratio—rises.

Banks (and many other financial intermediaries) finance their assets with a far larger proportion of debt (relative to equity) than nonfinancial firms. Recent data show that *nonfinancial* firms typically issue between $0.80 and $1.50 worth of debt for each dollar of equity, implying a leverage ratio of 40 to 55 percent.[1] By contrast, the largest banks in the United States issue an average of roughly $14 in debt for each dollar of equity. That is, the eight global systemically important U.S. banks (G-SIBS) have a leverage ratio of roughly 7 percent.[2] This high reliance on debt boosts both the expected return on and the riskiness of bank equity, and makes banks vulnerable to even moderately adverse events.

Role of bank capital. Bank capital acts as self-insurance, providing a buffer against insolvency and, so long as it is sufficiently positive, giving bank management an incentive to manage risk prudently. Standard automobile insurance creates a similar incentive: auto owners bear part of the risk of accidents through *deductibles* and *co-pays*, which also motivate them to keep their vehicles road-ready and to drive safely.

When capital is too low relative to assets, however, bank managers have an incentive to take risk. The reason is straightforward. Shareholders' downside loss is limited to their initial investment, while their upside opportunity is unlimited. As capital deteriorates, potential further losses shrink, but possible gains do not. Because shareholders face a one-way bet, they will encourage bank managers to *gamble for redemption*. They also will discourage managers from issuing more equity, because that would dilute the value of existing shares, while the primary benefit would accrue to debtholders through reduced risk of bankruptcy. This incentive problem goes away as the level of capital rises. That is, when shareholders have more *skin in the game*, exposing them to greater losses, bank managers will be encouraged to act more prudently.[3]

Finally, a banking system that is short of capital can damage the broader economy in three ways. First, an undercapitalized bank is less able to supply credit to healthy borrowers. Second, weak banks may evergreen loans to *zombie firms*, adding unpaid interest to a loan's principal and further undermining their already weak capital position to avoid the realization of losses. Finally, in the presence of an aggregate capital shortfall in the banking system, the system as a whole is more vulnerable to contagion and panic. Even a small spark can ignite such dry and fragile tinder.

Capital requirements. Minimum capital requirements are the leading regulatory tool for ensuring the resilience of banks (and bank-like intermediaries). In addition, regulators use stress tests to limit concealed leverage and to measure the capital adequacy of banks in adverse scenarios where asset prices are assumed to plunge precipitously, markets cease to operate and funding evaporates. The combination of higher capital requirements and rigorous stress tests has led to a welcome rise in banking system capital in the decade since the financial crisis. But, how much capital is enough?

If we let the banks choose, they typically minimize reliance on equity funding, which they perceive as expensive. That is, raising capital requirements will raise a bank's *private* costs. But, to the extent that higher capital requirements compensate for banks' ability to conceal risk and reduce the distortions from public subsidies that come through the government safety net, *social* cost will decline. As one

---

[1] See the Federal Reserve's Financial Accounts of the United States, Table L. 103, www.federalreserve.gov/releases/z1/current/html/l103.htm; and the Internal Revenue Service Statistics of Income, Historical Table 13, www.irs.gov/statistics/soi-tax-stats-historical-table-13.
[2] See the FDIC's Global Capital Index: www.fdic.gov/about/learn/board/hoenig/global.html.
[3] For a discussion of this *debt overhang* problem, see Myers, Stewart C., "Determinants of corporate borrowing," Journal of Financial Economics, Elsevier, vol. 5(2), pages 147-175, November 1977.

indicator of the scale of public support, the Federal Reserve Bank of Richmond estimates that 60 percent of the liabilities of the U.S. financial system are protected by the safety net.[4]

However, there is a clear drawback to raising bank capital requirements. Because banks view equity financing as expensive, higher requirements encourage a shift of risk-taking to non-banks—beyond the regulatory perimeter. One solution to this is to focus regulation on the *economic function* rather than the *legal form* of an intermediary.[5] Absent such activities-based regulation, there will be a point where higher capital requirements, while making banks more resilient, will make the *financial system* less safe because of risk shifting.

Estimating the appropriate level for capital requirements requires balancing the benefits and the costs. In principle, this is straightforward. Larger capital buffers reduce both the frequency and severity of financial crises. But this improved resilience comes at the cost of reduced levels of lending. And, since credit fuels economic activity, growth may be lower. What level of capital equates social benefits and costs?

There is a range of views. At the top end, proponents of narrow banking call for all risky assets to be 100 percent financed by equity. Others advocate a leverage ratio in the range of 15 to 30 percent.[6] The CHOICE Act proposed 10 percent as a threshold for exempting banks from strict scrutiny.[7] Notably, all these proposals far exceed current capital requirements, which are in the range of 3 to 6 percent. In contrast, the Treasury argued in June 2017 that capital requirements for the largest U.S. banks should be "recalibrated" in cases where they exceed international standards.[8]

Our view is that requirements should be strengthened, not weakened. We base our conclusion on a number of facts. First, banks' increased reliance on equity funding over the past decade has *not* diminished the supply of credit. Bank capital requirements (measured on a consistent risk-weighted basis) have gone up by at least a factor of 10. Furthermore, capital ratios today are several times higher than they were before the crisis.[9] Yet, relative to GDP, commercial bank credit remains robust, having surpassed its pre-crisis peak.

Second, strong banks lend to healthy borrowers, weak banks don't! This conclusion is based on the simple observation that countries with better capitalized banking systems in 2006, prior to the start of the crisis, experienced stronger lending growth during and after the crisis. Not only that, but decades of

---

[4] See the Federal Reserve Bank of Richmond's Bailout Barometer: www.richmondfed.org/research/national_economy/bailout_barometer.
[5] See Cecchetti, Stephen G. and Kermit L. Schoenholtz, "Form vs. Function: Regulating Money Market Funds," www.moneyandbanking.com, May 1, 2014.
[6] In their 2013 book, "The Bankers' New Clothes: What's Wrong with Banking and What to Do about It," Anat Admati and Martin Hellwig advocate numbers in the range of 20 to 30 percent; the Federal Reserve Bank of Minneapolis in their Minneapolis Plan advocates levels between 15 and 25 percent; while the March 2015 IMF Staff Discussion Note by Dagher, Dell'Ariccia, Laeven, Ratnovski and Tong (SDB/16/05) concludes that 15 percent would be sufficient to absorb the losses in 90 percent of past OECD banking crises.
[7] See NYU Stern Center for Global Economy and Business, Regulating Wall Street: CHOICE Act vs. Dodd-Frank, bit.ly/SternCHOICE, 2017.
[8] See United States Treasury, "A Financial System That Creates Economic Opportunities: Banks and Credit Unions," June 2017.
[9] See Cecchetti, Stephen G. and Kermit L. Schoenholtz, "Regulatory Reform: A Scorecard," CEPR Discussion Paper DP12465, December 2017.

experience in Japan (and more recent activity in the euro area) show that poorly capitalized banks tend to evergreen loans—increasing loan principal to include unpaid interest from non-performing loans. That is, in their zeal to avoid recognizing loan losses, zombie banks lend to zombie firms.[10]

Third, higher bank capital levels are associated with higher share prices. Investors at least partly reward banks in jurisdictions where regulators and supervisors promote social welfare through tougher capital standards.[11] As a result, the private cost of imposing socially optimal capital requirements may be smaller than critics fear.

While we cannot say precisely how much higher capital requirements should be, our recommendation is that authorities gradually raise them at least until we see some of the claimed detrimental side effects—namely, a diminished supply of credit to healthy borrowers, a shift of risk-taking to bank-like intermediaries beyond the regulatory perimeter, or both.

Stress tests. It is notoriously difficult to measure the size of a capital buffer. How risky are assets? What are the consequences of off-balance sheet exposures? What portion of capital is truly loss-absorbing when a severely adverse shock hits? What will happen to capital levels in the event of a severe recession that causes widespread distress? We can use stress tests to answer these questions.

Today, these tests have three primary objectives: guaranteeing that banks have rigorous internal risk management processes; ensuring that banks' management and boards of directors are attentive to the risks their enterprises face; and providing the authorities with a comprehensive map of the risks and vulnerabilities in the financial system.[12]

We can summarize any stress testing regime by measuring three of its attributes: transparency, flexibility and severity. The mix of these characteristics determines the regime's effectiveness.

To understand the tradeoffs and pitfalls, consider the case of Fannie Mae and Freddie Mac, the government-sponsored mortgage lenders (the GSEs). Unlike banks, the GSEs were subject to an annual government stress test *before* the financial crisis. Following a decade of development, the Office of Federal Housing Enterprise Oversight (OFHEO) began conducting tests in 2001. The GSEs always passed—until they collapsed at the height of the crisis in September 2008. We can trace the ineffectiveness of these early stress tests to their mix of transparency, flexibility and severity. First, there was complete transparency: OFHEO published the models and scenarios in the Federal Register prior to initiating the tests. Second, there was no flexibility: from year to year, neither the parameters nor the macroeconomic conditions changed. And third, the stress applied was insufficiently severe: house prices *rose* for the first 10 quarters of the scenario, before falling only modestly over the full 8-year horizon.[13]

---

[10] See Cecchetti, Stephen G. and Kermit L. Schoenholtz, "Better capitalized banks lend more and lend better," www.moneyandbanking.com, December 5, 2016.
[11] See Cecchetti, Stephen G. and Kermit L. Schoenholtz, "Tougher capital regulation pays off," www.moneyandbanking.com, March 19, 2018.
[12] For a discussion of the history and uses of stress testing, see Cecchetti, Stephen G. and Kermit L. Schoenholtz "Transparent stress tests?" www.moneyandbanking.com, September 26, 2016.
[13] See Frame, W. Scott, Kristopher S. Gerardi, and Paul S. Willen, "The failure of supervisory stress testing: Fannie Mae, Freddie Mac, and OFHEO," FRB Atlanta Working Paper, March 2015.

Is any of these three dimensions (transparency, flexibility and severity) more critical than the others? The answer is yes. First, if the scenarios are insufficiently dire, there is no point to the test. Second, flexibility is essential. Without it, the tests are useless. Third, there is considerable room for transparency, but there are limits. Because models change slowly, and banks can glean considerable information about the Fed's models from past tests, disclosure of these models is unlikely to be a problem. Premature disclosure of the scenarios is another matter: in contrast to the GSE tests, and in line with the Fed's current Comprehensive Capital Analysis and Review (CCAR) practice, scenarios should change frequently with disclosure only *after* the banks' portfolios are determined. The alternative invites gaming.[14]

In our view, the Federal Reserve has developed a broadly effective framework for carrying out its all-important stress tests of the largest U.S. banks. Yet, having started in 2011, the Fed has now completed only the seventh CCAR exercise. That means that everyone is still learning how to best structure and execute the tests.

With this same goal in mind, we make the following proposals for enhancing the stress tests and preserving their effectiveness:

1. Change the scenarios more aggressively and unexpectedly, continuing to disclose them only *after* banks' fix their balance sheet (and off-balance sheet) exposures.
2. Introduce an experimental scenario (that will not be used in "grading" the bank's relative performance or capital plans) to assess the implications of events outside of historical experience and to probe for weaknesses in the financial system.
3. As a way to evaluate banks' internal models, require publication of loss rates or risk-weighted assets (RWA) for a range of hypothetical portfolios.
4. Stick with the annual CCAR cycle.

Finally, in line with the goals of the Dodd-Frank Act and the recent Economic Growth, Regulatory Reform and Consumer Protection Act (EGRRCPA) regulators should tailor capital and other regulatory requirements, including stress tests, to the riskiness of financial institutions. Having fewer than $10 billion in assets, the vast majority (5,474 out of 5,606) of U.S. depositories pose virtually no risk to the system. For these relatively small institutions, the self-insurance requirements should aim primarily at avoiding taxpayer losses through deposit insurance. At the other end of the size spectrum, the U.S. G-SIBs, scale serves as a reasonable proxy for the risks to the financial system.

However, for the two dozen or so medium-sized institutions with assets from $100 billion to $250 billion, scale alone is a poor indicator of risk. The EGRRCPA raised the asset threshold for strict regulatory scrutiny from $50 billion to $250 billion, but left the Federal Reserve with an option to maintain close oversight for those banks with at least $100 billion in assets. To improve risk-management incentives for these banks, and to limit legal disputes with the Federal Reserve, it would be

[14] For an analysis of recent Federal Reserve proposals to change their stress-testing regime, see Cecchetti, Stephen G. and Kermit L. Schoenholtz, "Ensuring Stress Tests Remain Effective," www.moneyandbanking.com, January 22, 2018.

better to flip the legal default by allowing the central bank the option to exempt those medium-sized banks that demonstrate their safety using an agreed-upon array of risk indicators.[15]

Conclusion. Our conclusions are clear. First, U.S. regulators should consider raising capital requirements significantly further, albeit at a gradual pace. Second, ensure that stress tests remain flexible and stressful.

We close with a quote from Sir Paul Tucker, Chair of The Systemic Risk Council and former Deputy Governor of the Bank of England:

"The history of bank regulation in the United States is of progressive dilutions of core regulatory requirements over a number of years, leaving the banking system as a whole vulnerable to crisis."

We hope that the Congress and the federal agencies to which it has delegated authority for financial regulation and supervision take this experience to heart, remaining diligent in protecting the public interest.

Stephen G. Cecchetti is Rosen Family Chair in International Finance at the Brandeis International Business School. From 2008 to 2013, he was Economic Adviser and Head of the Monetary and Economic Department at the Bank for International Settlements in Basel, Switzerland. During his time at the Bank for International Settlements, Cecchetti participated in the numerous post-crisis global regulatory reform initiatives, including working with the Basel Committee on Banking Supervision and the Financial Stability Board in establishing new international standards for ensuring financial stability. He also served as Director of Research at the Federal Reserve Bank of New York from 1997 to 1999, taught at the New York University Leonard N. Stern School of Business in the mid-1980s, and was a member of the Department of Economics at The Ohio State University. In 2016, he received an Honorary Doctorate in Economics from the University of Basel.

Kermit L. Schoenholtz is Henry Kaufman Professor of the History of Financial Institutions and Markets in the Department of Economics of New York University's Leonard N. Stern School of Business, where he teaches courses on money and banking and on macroeconomics. He also directs NYU Stern's Center for Global Economy and Business and serves on the Financial Research Advisory Committee of the U.S. Treasury's Office of Financial Research. Previously, he was Citigroup's global chief economist from 1997 until 2005. Schoenholtz joined Salomon Brothers in 1986, working in their New York, Tokyo, and London offices, eventually becoming chief economist at Salomon and Salomon Smith Barney, prior to the formation of Citigroup.

---

[15] See Cecchetti, Stephen G. and Kermit L. Schoenholtz, "Size is overrated," www.moneyandbanking.com, March 26, 2018.