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"Examining Legislative Proposals to Reduce Regulatory Burdens on Main Street Job Creators"

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Examining Legislative Proposals to Reduce Regulatory Burdens on Main Street Job Creators

Chairman Neugebauer, Ranking Member Clay, and distinguished members of the Subcommittee, thank you for convening today's hearing and for inviting me to testify.

My name is Paul Kupiec and I am a resident scholar at the American Enterprise Institute. My research interests focus on banking, banking regulations, risk measurement and financial stability. To satisfy committee requirements, I have included my resume as an appendix to this testimony. The following remarks represent my own personal views on the bills that the subcommittee is examining today. It is an honor for me to be here and testify before this distinguished subcommittee.

In my testimony, I consider the merits of seven separate bills that are currently under consideration. Four of these bills seek to rectify specific shortcoming in existing legislation. Two bills attempt to improve government administrative processes. And the final bill instructs bank regulatory agencies to change an existing regulation.

To the extent that I correctly understand what each of these bills are attempting to accomplish, in my judgment, none of them will magnify existing financial sector risks. Nor will any of these bills contravene the Dodd-Frank Act's requirement for heightened supervision and regulation of systemically important financial institutions.

H.R. 2121, the "SAFE Transitional Licensing Act of 2015," creates a 120-day grace period during which a licensed mortgage loan originator (MLO) retains the right to continue mortgage loan originations when they change jobs.[1] The amendment is necessary because of the administrative delay in processing new license applications. The grace period allows an MLO in good standing to remain employed as a MLO while he or she applies for a new license. A new license may be required when an MLO movers to a new institution or a new state.

[1] The 120-day grace period begins when: (i) a state-licensed MLO who has not been required to register with the Nationwide Mortgage Licensing System and Registry registers with the Registry and reflects the new employer; or (ii) when the new licensed employer of an MLO already registered in the National Mortgage Licensing System and Registry records the MLO's new place of employment in the Registry.

These amendments to the SAFE Act remedy unnecessary job mobility restrictions on MLOs that have been created unintentionally by existing legislation. Since the required MLO information must be available on the National Mortgage Licensing System and Registry during the full 120-day grace period, I do not see any negative consequences associated with this legislation.

H.R. 2287, the ''National Credit Union Administration Budget Transparency Act'' seeks to improve the public accountability and management of the National Credit Union Administration (NCUA). This bill would require the annual NCUA budget process to include as part of the preparation process: (1) a "detailed business-type" annual budget; (2) the publication of this detailed budget in the Federal Register; (3) a public hearing to receive public comments on the NCUA's proposed budget; and, (4) the requirement to modify the proposed budget to account for public comments. The amendments proposed in this bill seem reasonable and appropriate. Aside from the additional time this will add to the NCUA budget process, I do not see any downside from increasing the public accountability of the NCUA.

H.R. 2987, the "Community Bank Capital Clarification Act," changes the Dodd-Frank Act § 171 small institution exemption. Section 171 imposes minimum leverage and minimum risk-based capital requirements on Bank Holding Companies (BHCs).[2] The current language in § 171 exempts BHCs from these requirements if an institution had less than $15 billion in consolidated assets as of December 31, 2009. H.R. 2987 proposes to amend the § 171 exemption to include all BHCs with less than $15 billion in consolidated assets at the end of a reporting quarter, not just those with less than $15 billion in consolidated assets as of December 31, 2009.

The Community Bank Capital Clarification Act would create an incentive for some BHCs larger than the $15 billion threshold to shrink in order to avoid the additional regulations imposed by § 171 regulations. BHCs under $15 billion in consolidated assets were not seen as a threat to financial stability by Congress and they were explicitly excluded from BHC minimum leverage and risk-based capital requirements at the time the Dodd-Frank Act was drafted. This proposed amended exemption is fully consistent with the original intent of the Dodd-Frank Act.

H.R. 2473, the "Preserving Capital Access and Mortgage Liquidity Act of 2015'' will allow credit unions under a certain asset size limit, as measured by the institution's average assets over

[2] These capital requirements also include a phase out of the use of hybrid capital instruments.

the prior three years, to join the Federal Home Loan Bank System.[3] I have no issue with this amendment. It is consistent with the mission of the Federal Home Loan Banking System.

H.R. 3340, the ''Financial Stability Oversight Council Reform Act,'' would place the Office of Financial Research and the staff of the Financial Stability Oversight Council under the Congressional appropriations process. The proposed law would also require the Office of Financial Research to file quarterly reports to various committees and subcommittees handling oversight of federal agencies in the House of Representatives and the Senate.

There is no reason that the Office of Financial Research should be an off-budget agency. Its budget and expenditures should be approved by Congress through the normal appropriations process. There is absolutely no downside risk in passing this legislation. It will promote transparency and oversight of Office of Financial Research budget and expenditures.

H.R. 2896, "Taking Account of Institutions with Low Operation Risk Act of 2015", or the "The TAILOR Act of 2015," will require the bank regulatory agencies to modify their supervision and regulation practices so that they are appropriate for the risk profile of an institution. In particular, there is a legitimate concern that the Dodd-Frank Act includes new heightened standards for supervision and regulation that are being applied unnecessarily to all regulated depository institutions, regardless of their risk profile.

The TAILOR Act of 2015 will require bank regulatory agencies to,

> "[T]ailor such regulatory action applicable to such institutions or class of institutions in a manner that limits the regulatory compliance impact, cost, liability risk, and other burdens as is appropriate for the risk profile and business model involved."

When "tailoring" regulations, the banking agencies must not consider a specific regulation in isolation, but instead must consider the impact of the regulation in the context of all the other regulations placed on small institutions. The cost of new regulations and processes created by the Dodd-Frank Act may not be justified by the financial system risk posed by smaller institutions.

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[3] I have been unable to find any credit union size limit explicitly mentioned in law. I have seen reports that claim that credit unions up to a size limit is $1 billion in average assets are eligible for FHLB membership as community investment institutions. However, the only limit I have been able to find in existing law is a $500 million asset size limit set in legislation passed in 1999. This size limit was indexed to the consumer price index. Based on the 1999 size limit and the subsequent changes in the CPI, credit unions up to approximately $710 million in average assets would be eligible to join the FHLB.

Banking agencies must assess the financial stability benefits of a regulation against its impact on an institution's ability to meet customer needs. Regulators must explicitly recognize the need to "tailor" regulations and supervisory processes in their examination manuals and notices of proposed rulemakings.

The TAILOR ACT also requires, within the next three years, that agencies revisit the rules they have implemented since the passage of the Dodd-Frank Act. They must amend these rules to reflect this new "tailoring" requirement. Banking agencies and the Federal Financial Institutions Examination Council will be required to report to Congress annually on the progress they have made in meeting these new requirements.

The goals of H.R. 2896 are fully appropriate. There is a pressing need to modify the one-size-fits all regulations and processes that are burdening smaller institutions with unnecessary and unproductive compliance costs. There is an inherent tendency for banking regulators to apply so-called "best practice" supervision and regulation—the rules and processes designed for the largest institutions—to all the institutions they supervise. The complex solutions used in the largest banks are implicitly encouraged by examination processes and procedures even when simpler, more cost-effective solution are available.

Consumers, businesses, and bankers have much to gain if Congress can eliminate the waste created by over-regulation of smaller financial institutions. Regulators must be required to move toward simpler, "tailored" supervision and regulation that is better aligned with the magnitude of the risk typically posed by a modestly-sized depository institution.

H.R. 2209 requires the banking agencies to amend the Liquidity Coverage Ratio (LCR) rule to give low risk, highly liquid municipal bond obligations more favorable treatment. The LCR is a post-crisis regulation that requires large banks and BHCs to hold a sufficient quantity of liquid assets to enable them to survive a bank "run" lasting roughly 30 days.[4] Each covered bank and BHC must estimate the volume of short-term liabilities that might "run" in a 30-day crisis period.

[4] The LCR must be satisfied by: (1) BHC with consolidated assets greater than $250 billion; (2) BHCs with more than $10 billion in on balance sheet foreign exposure; bank subsidiaries with more than $10 billion in consolidated assets that are owned by BHCs that satisfy condition (1) or (2); nonbank financial institutions designated by the FSOC for Federal Reserve Board (FRB) supervision for which the FRB has determined must meet the LCR.

The bank must hold enough high quality liquid assets (HQLA) so that the bank or BHC can sell these assets and use the proceeds to replace the funding shortfall caused by the "run."

The LCR has specific requirements that determine which assets count as HQLA. These requirements include value limits on the types of assets that can be included in HQLA, and limits on the share of specific asset carrying values that can be counted as HQLA.

Level 1 assets, the most liquid classification,[5] can be used to satisfy the LCR without limit at full market value without any "haircut." Level 2A assets[6] can be used to satisfy the LCR, but they must be valued at 85 percent of their market value (a 15 percent haircut), and may only be used in limited amounts. Level 2B assets[7] can be used to satisfy the LCR in limited amounts, but they must be valued at 50 percent of their market value (50 percent haircut).

The two specific limits that apply to Level 2A and Level 2B assets are: (1) no more than 15 percent of the required LCR may be met using Level 2B assets (after the 50 percent haircut); and, (2) no more than 40 percent of the required LCR may be met using Level 2A and Level 2B assets (after the appropriate haircuts).

Level 2A assets must exhibit certain characteristics. These include: (i) the market price of the security must not decline by more than 10 percent during a 30-day calendar period of significant stress; (ii) the market haircut demanded by lenders in repurchase or securities lending transactions must be less than 10 percent during any 30-day calendar period of significant stress; and, (iii) the security is not an obligation of a financial sector entity or subsidiary of a financial sector entity.

Level 2B assets must exhibit the following characteristics: (i) they must be a corporate debt security that is investment grade (under 12 CFR part 1); (ii) the market price of the security must not decline more than 20 percent during a 30-day calendar period of significant stress; (iii) the

[5] Level 1 assets include: balances at the Federal Reserve; foreign central bank reserves that can be withdrawn; all securities issued with principle and interest guaranteed by the US government; high quality liquid debt issued by sovereigns, international organizations and multilateral development banks.
[6] Level 2A assets include assets issued by US government sponsored enterprises and debt issued by sovereigns and multilateral developments banks that are not included in Level 1 assets.
[7] Level 2B assets include investment grade corporate bonds and equity shares of publically traded companies that are included in the Russell 1000 Index or included in a foreign stock index with specific liquidity characteristics specified in the final LCR rule.

market haircut demanded by lenders in repurchase or securities lending transactions must be less than 20 percent during any 30-day calendar period of significant stress; (iv) the security is not an obligation of a financial sector entity or subsidiary of a financial sector entity; or, (v) the security is a publicly traded common stock included in the Russell 1000 Index or a foreign stock index that meets specific requirements described in the final rule.

The final LCR rule does not recognize state or municipal bonds as HQLA, so they have no value toward satisfying the LCR requirement. Many public comment letters recommended that investment grade liquid state and municipal bonds be included in the definition of HQLA. The reasoning behind the public comments recommending inclusion were many including:

- State and municipal bonds are at least as liquid as corporate bonds that are eligible as Level 2B HQLA
- Many states and some municipalities have far higher ratings and better liquidity than some of the foreign bonds that are eligible as Level 1 and Level 2A assets
- There are many liquid investment grade state and municipal bond issues that meet the specific characteristics specified for Level 2A and Level 2B assets.
- Many foreign countries are implementing the Basel LCR regulation and allowing the securities equivalent to their domestic state and municipal bonds to qualify as HQLA
- The exclusion of state and municipal bonds from the definition of HQLA will damage their market liquidity as banks will no longer favor holding these issues.

In May 2015, the Federal Reserve Board (FRB) issued a Federal Register Notice of Proposed rulemaking[8] to amend the LQR rule which applies to FRB-supervised institutions. The proposed amendment would allow state and municipal bonds that meet the specific characteristics required for Level 2B assets to be included in the definition of HQLA as Level 2B assets. Public comments were requested by late July.[9]

The bill under consideration, H.R. 2209, would require the Federal banking agencies to revise the final LCR rule to include state and municipal bonds in the definition of HQLA. Specifically, it would require that investment grade (under the definition in 12 CFR part 1) state and municipal bonds that exhibit the specific characteristics required by Level 2A assets (listed above) be recognized as Level 2A assets in the definition of HQLA. The bill would give the

[8] Federal Register, Vol. 80, No. 102, May 28, 2015, pp. 30383-30389.
[9] I am not aware of any additional FRB public information since the NPR.

Federal banking agencies 3 months to amend their individual LCR rules to recognize this change.

The change mandated by H.R. 2209 is appropriate and consistent with the public interest. There is no reason why high quality liquid bonds issued by US states and municipalities should receive a lower standing than foreign sovereign debt with equivalent (or even lesser) credit quality and market liquidity. Moreover, I would argue that US state and municipal bonds that are investment grade and also satisfy the liquidity characteristics required by Level 2B assets should also be required to receive recognition as Level 2B HQLA as proposed by the FRB. As many public comment letters have noted, numerous state and municipal bonds issues are more liquid than some investment grade corporate bonds, and therefore better suited for Level 2B HQLA.

Thank you, and I look forward to your specific questions.