Testimony of Jeremy Newell
General Counsel
The Clearing House Association

Before the U.S. House Financial Services Committee

At the Hearing Making a Financial Choice: More Capital or More Government Control?

July 12, 2016
Chairman Hensarling, Ranking Member Waters, and members of the Committee, my name is Jeremy Newell and I am Executive Managing Director, General Counsel and Head of Regulatory Affairs for The Clearing House Association. Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. The Clearing House Association is a nonpartisan advocacy organization dedicated to contributing quality research, analysis and data to the public policy debate.

The Clearing House is owned by 24 banks which provide commercial banking services on a regional or national basis, and in some cases are also active participants in global capital markets as broker-dealers and custodians. Our owner banks fund more than 40 percent of the nation’s business loans held by banks, including almost $200 billion in small business loans, and more than 75 percent of loans to households. Reflecting the composition of our membership, throughout my testimony I will focus on the effects of capital regulation on U.S. globally systemically important banks (“G-SIBs”), U.S. regional banks of all sizes, and the U.S. operations of foreign banking organizations with a major U.S. presence.

One might assume that eight years after the financial crisis would be a good time to assess the consequences of the established post-crisis regulation of bank capital. As I will discuss, however, the pace of regulatory change is not slowing, and U.S. and global regulators continue to pursue pending or anticipated proposals – most never envisioned by the Dodd-Frank Act – that would fundamentally rework what has already been done.

These pending regulatory efforts to introduce additional capital and other reforms are difficult to reconcile with the current capital position and resilience of the U.S. banking industry, which is extraordinarily robust, and the existing regulatory framework, which is extensive and stringent. Rather, we believe that now is the appropriate time to pause before considering additional changes and evaluate the effectiveness and real-world consequences of capital reforms that have already been enacted with a view towards identifying: (i) reforms (or aspects thereof) whose benefits do not justify their costs, and (ii) ways in which post-crisis capital rules can be better tailored to the specific risk profiles and business models of different types of banks.

In an effort to illustrate these issues, my testimony will have four parts:

First, an overall description of both the benefits and costs of bank capital, which provides important context for the evaluation of enacted and still-pending capital reforms.
Second, a description of the core post-crisis capital reforms that clearly have made commercial banks more resilient and resolvable, yielding benefits that are worth their economic costs. These benefits are sizeable and quantifiable.

Third, a description of pending or recently enacted reforms that impose meaningful impediments to economic growth and access to credit by consumers and smaller companies, but provide few if any marginal benefits beyond what has already been achieved by the core reforms. In some cases these regulations are flawed conceptually or operationally; in others, their marginal benefit is small because they are duplicative (or triplicative) of other rules. And in many cases, a reform that might be reasonable for some has been applied on a one-size-fits-all basis to banks whose activities pose few if any relevant risks.

Fourth, a description of several key considerations that should inform any effort to reevaluate and better rationalize existing capital requirements and post-crisis bank regulation more broadly.

I. The Benefits and Costs of Bank Capital Regulation

The financial crisis demonstrated that robust capital levels are essential to the resiliency of both individual banks and the larger financial system. The post-crisis regulatory response has rightfully focused on measures intended to improve and sustain the capital strength of the U.S. banking system. Although not a panacea, there is widespread consensus that capital is among the very best tools to protect the safety and soundness of banks, since capital acts as an all-purpose cushion that can absorb any potential losses that a bank might experience, whatever their cause or circumstances. For this reason, The Clearing House has and continues to support robust capital requirements for all banks.

At the same time, just as there are benefits to higher bank capital, there are also costs. In particular, because equity is more expensive than debt funding, capital requirements constrain the extent to which a bank can make loans or engage in other financial activities that serve the needs of customers and businesses and support and drive economic growth. The more capital that must be maintained per dollar of lending or other activity, the less such activity may be supported per dollar of capital. This dynamic affects not only the amount of lending or other activity a bank may do, but also the type of lending or activity. This is because when capital and other costs of an asset exceed the return on that asset, it will become uneconomic for banks to engage in the activities that involve that asset. In other words, and simply put, the capital regulation of banks has real
and substantial power to determine how credit is allocated to the U.S. economy – both in terms of who and how much.\(^1\)

Given this interplay, it is important that capital regulation balances both the benefits and the costs of higher capital; at a certain point the incremental benefits of increasingly higher capital requirements for safety and soundness become attenuated at best, while the negative impact on lending and other key activities that support the economy become substantial and pronounced. It is in the context of finding that appropriate balance in capital regulation that I focus my remarks today.

II. Core Post-Crisis Banking Reforms

Core post-crisis banking reforms have generally sought to achieve two goals: resiliency and resolvability. The former significantly reduces the chance of bank failure through heightened capital, liquidity and other resiliency measures. The latter goal establishes a legal and operational framework that ensures that any bank can fail without systemic impact or taxpayer assistance. Each of these is described in detail below.

a. Improvements to Resiliency through Enhanced Capital

A key lesson of the financial crisis is the critical importance of maintaining sufficient capital and liquidity levels to ensure that banks can absorb outsize losses and heightened liquidity demands that typically accompany periods of financial stress. Responding to that key lesson, banks have significantly increased the amounts of high-quality capital and liquid assets they maintain, and regulators have enacted a range of reforms that require these heightened levels of capital and liquidity to remain in place over time.

i. Current Capital Levels

The numbers speak for themselves. The aggregate tier 1 common equity ratio of TCH’s 24 owner banks rose from 4.6 percent at the end of 2008 to 12.1 percent at the end of last year. In dollar terms, common equity tier 1 capital nearly tripled from about $326 billion to $956 billion over the past seven years.

---

\(^1\) The Bank of England’s recent decision to reduce the U.K.’s countercyclical capital buffer (CCyB) to spur economic activity in the wake of Brexit is a good, real-world example of the overall relationship between capital requirements and the ability of banks to lend and support the economy.
As a benchmark for just how resilient large banks’ capital positions have come post-crisis, consider the results of the Federal Reserve’s stress test exercise (the “Comprehensive Capital Analysis and Review,” or CCAR), which attempts to measure the ability of banks to withstand a severe economic downturn. For the 2016 exercise, banks were required to demonstrate how they would perform under a sudden and severe recession and coincident market crisis that featured the following:

- A sudden jump in the unemployment rate of 4 percentage points (from 5 percent to 9 percent) during the first 4 quarters of the scenario, which is nearly twice as severe as the increase that occurred during the 2007-2009 financial crisis (when unemployment increased only 2 percentage points over the first year);
- A sudden decrease in GDP of more than 6 percentage points;
- An abrupt rise in the BBB corporate bond spread;
- A 50 percent drop in the equity market over four quarters, an 11,000 point loss on the Dow;
- For banks with substantial trading and processing operations, the abrupt failure of their largest counterparty; and
- The emergence of negative short-term interest rates.²

After this stress, the 33 banks currently subject to CCAR must meet a series of capital requirements, including a 4.5 percent common equity tier 1 ratio.³ And they must do so assuming they take no action to shrink balance sheets, reduce dividends, or postpone planned share repurchases – almost certainly deeply counterfactual assumptions. Thus, a bank that passes the CCAR exercise must not only have sufficient capital to avoid failure under historically unprecedented conditions – it must have enough capital to emerge from such an event resilient and doing business as usual.

The results of the 2016 CCAR exercise, announced just a few weeks ago, make emphatically clear just how strong the capital position of the U.S. banking system has become. On a quantitative basis, after taking into account the extreme hypothetical downturn and banks’ planned capital actions, every single one of the

---


³ The quantitative assessment of a bank’s capital plan also requires a tier 1 risk-based capital ratio above 6 percent, a total risk-based capital ratio above 8 percent and a tier 1 leverage ratio above 4 percent.
banks subject to CCAR met their post-stress minimums. And they did so with substantial loss absorbency to spare. In the aggregate, on a post-stress basis, the CCAR banks held $275 billion in common equity tier 1 capital over and above their required post-stress minimums. Given the extraordinary amount of capital now held in the U.S. banking system, it is difficult to imagine on what basis one might conclude that either more capital or other regulatory intervention in the balance sheets of our nation’s banks is needed at this time.

ii. Core Capital Regulations

The level of capital that now exists in the U.S. banking system is not merely a transitory trend; a series of regulatory requirements has helped to drive these changes and will sustain them over time.

*Increases in the quality of required capital.* The financial crisis taught us that common equity should be the predominant component of tier 1 capital, the strongest class of capital, as it is most effective at absorbing losses. Accordingly, the Basel III capital standards and U.S. implementing rules establish common equity as the predominant component of capital.

*Increases in the quantity of required capital.* The quantity of required bank capital has also increased substantially. This has been accomplished in two key ways – first, through a significant expansion of the denominator for capital ratios, and second, through a considerable increase in the minimum ratios themselves. In particular, Basel 2.5 more than doubled capital requirements for capital markets assets, and Basel III and U.S. implementing rules require banks to maintain a minimum risk-based common equity tier 1 ratio of 4.5 percent, as well as a “capital conservation buffer” of an additional 2.5 percent – plus an additional capital surcharge for G-SIBs ranging from 1 to 4.5 percent.4

*Emphasis on stressed rather than static measures of capital adequacy.* Capital regulation now emphasizes stress testing to measure banks’ capital adequacy. The first stress test deployed by the Federal Reserve was its Supervisory Capital Assessment Program (SCAP) exercise in 2009, which played a crucial role in ending the financial crisis. SCAP was subsequently codified in the form of the Dodd-Frank Act Stress Tests (DFAST) and the CCAR process described above. Although, as noted below, we have serious concerns about how CCAR is applied in practice along with the strong possibility that it may be revised in the near term, we nonetheless believe that it is a core reform as stress testing is an important and necessary tool for assessing the health of the banking

In particular, stress testing represents a key improvement in capital regulation and supervisory practices because it incorporates a forward looking, dynamic assessment of capital adequacy, and is less reliant on static measures and recent historical performance. It also helps to address one of the key criticisms of a risk-based capital framework – which is the concern that risk weights might underestimate the risk of an asset – particularly in a crisis. Stress testing provides a strong and dynamic backstop to guard against that potential worry.

b. Resolvability: A Successful Legal & Operational Framework to Resolve Large Banks without Taxpayer Support

Title I and Title II of the Dodd-Frank Act are core reforms that ensure that any banking organization can be resolved in a way that requires no taxpayer assistance and does not destabilize the broader financial system. For U.S. global systemically important bank holding companies (G-SIBs) engaged in substantial non-banking activities, this required a new framework, described below. For more traditional commercial banks that hold substantially all of their assets with an insured depository institution, the crisis showed that the FDIC possessed the necessary authority and expertise to resolve them, and major changes were not required.

i. The Legal Framework: Titles I & II and Single-Point-Entry Resolution

The Dodd-Frank Act established a legal framework for the resolution of a large banking organization, which the Federal Reserve and FDIC have implemented in a thoughtful way. For most U.S. G-SIBs, this progress includes the single-point-of-entry (SPOE) resolution strategy. Under the SPOE strategy, all of the losses across a U.S. G-SIB would be absorbed by shareholders and creditors of its parent holding company – which would fail and be put into a Chapter 11 bankruptcy. Bankruptcy should always be the preferred method of resolution – or, where circumstances require, an FDIC receivership under Title II of the Dodd-Frank Act.

The two principal benefits of this strategy are that it: (i) makes it legally and operationally feasible to impose losses on holding company debt holders, thereby vastly expanding the loss absorbency of the relevant banks, and (ii) allows the material operating subsidiaries to remain open and operating, thereby minimizing the systemic consequences of a large banking organization failure.
Two significant developments have greatly enhanced the credibility of SPOE as a resolution strategy.

Resolution Stays on Financial Contracts. One potential shortcoming of the SPOE strategy was identified by regulators and market participants: if the parent holding company enters into a bankruptcy or resolution proceeding, then the counterparties of the holding company’s subsidiaries might exercise “cross-default” rights and terminate their derivatives and similar financial contracts with the subsidiaries, and then seize and liquidate the collateral (even though the subsidiaries remain open, solvent, and performing on their contractual obligations). This would drain liquidity from the group in resolution, and the sale of the collateral into the market at a time of stress could have systemic consequences, as it did in the financial crisis.

To prevent this outcome, each U.S. G-SIB (as well as most other G-SIBs globally) has voluntarily adhered to the ISDA 2015 Universal Resolution Stay Protocol, which provides for the explicit recognition of resolution stays on cross-default rights in financial contracts between and among the world’s largest dealer banks. In order to extend this systemic protection beyond dealer bank transactions, the Federal Reserve recently proposed a rule that would generally require G-SIBs to include resolution stays in financial contracts with all of their counterparties. The Clearing House strongly supports this proposal, as the inclusion of resolution stays in financial contracts will make it easier to implement an SPOE resolution.

Total Loss Absorbing Capacity. In order for SPOE to be effective, a firm must maintain sufficient loss absorbing capacity that can be bailed-in to recapitalize the firm even after a massive loss, and that bail-in must be operationally feasible. The former is achieved by maintaining, at the holding company level, substantial liabilities that cannot run in stress (basically, equity and long-term debt).

To ensure that sufficient loss absorbency remains in place over time, the Federal Reserve has proposed a “total loss absorbing capacity” (TLAC) rule that would require U.S. G-SIBs to maintain minimum total loss absorbing capacity equal to 21.5 percent to 23 percent of its risk-weighted assets, and 9.5 percent of

---

its total assets. The scale of this reform has not been widely appreciated: the eight U.S. G-SIBs alone will be expected to maintain, on an aggregate basis, more than $1.5 trillion in total loss absorbing capacity.

Operational feasibility is achieved by minimizing the types of other holding company creditors, thereby avoiding disputes among creditor classes in bankruptcy. The Federal Reserve’s proposed rule would prohibit nearly all short-term debt or other liabilities at the holding company, and make clear that operating liabilities of subsidiaries are senior to the bail-in/TLAC equity and debt at the holding company. Thus, a U.S. G-SIB’s losses can be imposed entirely on the private sector without inducing the holders of the group’s short-term debt or financial contracts to run, or the holders of its other operating liabilities to cut off critical services.

Clear Evidence of Success. Investors and markets appear convinced that equity and long-term debt holders are fully at risk in the event of failure, and that government assistance will not be required, or available, to resolve a large banking organization. Put another way, they appear convinced that large banks are no longer “too big to fail.” The spreads that debt markets charge large banks have risen dramatically from pre-crisis levels. A Government Accountability Office (GAO) study released in July 2014 stated, “[o]ur analysis provides only limited evidence that large bank holding companies had lower funding costs since the crisis and instead provides some evidence that the opposite may have been true at the levels of credit risk that prevailed in those years.” The GAO found that any premium in the interest rates (that is, lower rates) that banks pay to borrow in the bond market had been significantly reduced, eliminated, or even reversed. Indeed, in half of the 42 models they employed, larger banks actually pay more to borrow than mid-sized banks issuing publicly traded debt.

Similarly, the ratings agencies now rate debt in accordance with the market reality reported by the GAO. At the time of the 2014 study, two of the three large rating agencies had already eliminated any “uplift” in ratings of bank holding

---

6 I also note that while we strongly support the TLAC requirement in principle, we do have several key concerns with the specific way in which the Federal Reserve has proposed to implement TLAC in the United States. See Letter from The Clearing House et al. to the Board of Governors of the Federal Reserve System (Feb. 19, 2016), available at www.theclearinghouse.org/issues/articles/2016/02/20160219-tch-comments-on-fed-s-tlac-proposal.

company debt because of anticipated future government support. Since then, the third rating agency has also dropped any uplift for bank holding company debt.

III. Regulatory Measures that Yield Benefits Less than their Economic Costs

For the core reforms described above, it is reasonably clear that their benefits generally exceed their costs. But it is also clear that other current and anticipated regulations – or particular aspects or applications of those regulations – do not meet that test, with costs and consequences that have not been well measured or understood.

Three keys to performing a regulatory cost-benefit analysis are as follows:

First, each regulation contains mandates and incentives that, while implicit rather than explicit, are nonetheless clear. Bank regulation necessarily favors some activities over others; thus, when regulatory requirements are calibrated at high levels, they create strong incentives for banks to no longer allocate their balance sheets according to actual economic risk but rather according to regulatory requirements. There is a common misperception that banks faced with a higher capital requirement can react in only three ways: (i) accepting a lower return on equity, (ii) shrinking assets across the board, or (iii) increasing prices across the board. Under this view, regulation is agnostic or content neutral. In fact, banks identify the business lines that are causing the higher capital (or other regulatory) charge relative to actual economic risk, and then face a difficult decision of how much of that cost to require the business lines to earn back. For example, we see substantial evidence of this phenomenon in global capital markets businesses, where numerous large banks have either exited businesses entirely or dramatically reduced the amount of capital they are willing to commit to supporting market liquidity. Conversely, we have seen a strong trend globally for large banks to enter or expand private wealth management: this activity does not require significant capital or liquidity, and thus is a business smiled upon by the post-crisis regulatory regime.

Second, in assessing the benefit of a given rule against its cost, it is not sufficient to identify its standalone benefit. What is relevant is its marginal benefit – that is, what benefit it adds to the core reforms and others already enacted. For a rational cost-benefit analysis, it is not enough to simply say that a rule has the benefit of reducing the chances of a financial crisis like the last one: the question is what is the marginal benefit, given the presence of other rules, and how does it compare to the rule’s cost (including that it might increase the chances of a financial crisis that is unlike the last one).
Third, in assessing benefits and costs, careful attention must be paid to whom the rule applies. This is because, in many cases, regulators have applied a particular reform to a wide range of banks on a nearly uniform basis. Such an approach to regulation, and to macroprudential regulation in particular, is inappropriate and inherently fails to account for the wide variety of business models and practices that exist among individual institutions. The application of prudential standards should not simply be a function of an organization’s asset size, but should instead be based on the types of risk being run by the organization, driven largely by the types of activities it engages in. Unfortunately, it is often exactly this untailored, size-based approach that has been applied in practice – much of the post-crisis prudential framework, including the Basel III capital and liquidity framework and the enhanced prudential standards established under Title I of the Dodd-Frank Act, is not appropriately tailored to the diversity of banking organizations and business models that exist in the United States.

With these three kinds of questions in mind, we have identified a range of capital-related reforms that yield benefits incommensurate with their costs. Many involve rules and regulations already enacted, but several involve additional reforms that have been proposed or are anticipated, but have not yet been finalized. All deserve careful evaluation and, where appropriate, revision to ensure an appropriate balance between their benefits and costs.

a. Existing Capital Rules & Mandates

i. CCAR

The U.S. stress test is an important building block of the post-crisis banking regulations and we are, in principle, supportive of rigorous stress tests as a tool to assess the capital adequacy of large banks. At the same time, however, we have growing concerns about the Federal Reserve’s CCAR exercise in practice.

The stakes here are significant. CCAR is the binding constraint for most large banks and thus has tangible economic impacts. For example, by more severely stressing unemployment rate changes, the 2016 stress scenarios implicitly discourage small business lending and household lending, as these are the types of loans whose loss rates are most sensitive to increases in unemployment.

One can think of CCAR as having three main components: (i) the stress scenario provided each year; (ii) the process by which the Federal Reserve decides how much each bank will lose, and thus how much capital it will have remaining after undergoing that stress; and (iii) the minimum remaining amount of capital a
bank must have left over after that stress. We have serious concerns with the current opacity of the first two of these components.\textsuperscript{8} Because confidence that CCAR appropriately balances the benefits and costs of higher capital depends, in part, on the reasonableness of both the scenarios and models that are the core of the CCAR exercise, greater transparency and public deliberation around both is needed.

With respect to the stress scenarios, the Federal Reserve’s own self-imposed standard states that the severely adverse scenario should consist of “a set of economic and financial conditions that reflect the conditions of post-war U.S. recessions.”\textsuperscript{9} The 2016 stress scenarios assume, however, a macroeconomic shock that is considerably more severe than the 2007-2009 financial crisis or prior post-war recessions. In particular, the increase in the unemployment rate in the 2016 scenario is substantially more sudden than what was experienced during the 2007-2009 crisis, which is likely to cause credit losses to accumulate rapidly and in greater amounts over the stress period. Although these scenarios are disclosed each year, they are not subject to prior notice and comment, and therefore neither their reasonableness nor their consistency with the Federal Reserve’s own standards is subject to open debate.

Similarly, and in contrast to other jurisdictions, the Federal Reserve uses its own internal model(s) to estimate stressed credit losses and net revenues. These models are enormously important drivers of the CCAR results for each bank. Yet the Federal Reserve provides virtually no detail regarding the specifications of these models – not only are they not subject to public review and comment – they are not even publicly disclosed.

CCAR also provides a useful example of a regulation that generally has been applied uniformly across a large range of banks with differing business models and risk profiles. As a result, and particularly in light of the immense operational and administrative burden that attends participation in CCAR, the various concerns noted are more pronounced for those banks with simpler balance sheets or smaller risk profiles, for whom the benefits of CCAR are likely to be significantly less in practice, while the costs remains substantial.

\textsuperscript{8} As described below, we also have serious concerns with the anticipated future direction of the third component, the post-stress minimum capital requirements.

\textsuperscript{9} See 12 C.F.R. part 252, Appendix A.4.
ii. Supplementary Leverage Ratio

A leverage ratio measures the capital adequacy of a bank by dividing its capital by its total assets. Although the leverage ratio is seen as an alternative to risk-based measures of capital, the leverage ratio is in fact also a risk-based measure of capital, albeit a bad one. It assesses the risk of each asset to be exactly the same – akin to setting the same speed limit for every road in the world. The risk of a Treasury security is deemed the same as that of a loan to a startup with uncertain cash flows. The risk of holding a market-making portfolio of liquid, highly rated bonds is equated to the risk of holding a portfolio of illiquid loans to untested companies.

The inherent inaccuracy of the leverage ratio – and the resulting misallocation of capital – has increased dramatically in recent years as a result of other regulatory mandates. In particular, liquidity rules (principally the liquidity coverage ratio, or “LCR”) now effectively require large banks to hold approximately 30 percent of their balance sheets in high-quality liquid assets (“HQLA”) – predominantly cash, Treasury securities and other government securities. Large banks now hold approximately three times as much of these assets as they did pre-crisis. Those assets rightly receive a zero or low risk weight in risk-based capital measures – but the leverage ratio completely ignores their actual risk – and creates a powerful disincentive to hold low risk assets beyond those required by regulation.

To put this in practical terms, consider the combined effects of regulation on the decision to make a small business loan. That loan must be funded, and unless it is funded with retail or other very “sticky” deposits, the LCR requires the bank to hold HQLA (cash or cash equivalents) against that funding. While this treatment under the LCR may be appropriate, the supplementary leverage ratio requires banks to hold capital against the HQLA – five or six percent in the case of G-SIBs, and three percent in the case of other large banks. This is not appropriate, and unnecessarily increases the cost of making the loan.

The impact of the U.S. supplementary leverage ratio is especially pronounced on bank holding companies’ capital markets activities, which are not funded by insured deposits. U.S. capital markets are the deepest, most liquid, and most efficient in the world, allowing U.S. companies as well as the government to finance growth and borrow more cheaply. At the heart of those markets are broker-dealers, which facilitate the issuance and trading of securities, and provide funding to other financial institutions. The broker-dealer business model involves holding well-hedged temporary inventories in low risk assets, as well as standing between borrowers and lenders in offsetting and well-collateralized repo transactions. Both activities earn only narrow margins; promote the liquidity and
efficiency of financial markets; and entail little or no risk. However, both are balance-sheet sensitive; that is, they create assets on the books of broker-dealers – assets that banks now have to fund in material part with expensive equity because of the supplementary leverage ratio requirement. Because of the thin margins earned in financial intermediation, the added cost from the supplementary leverage ratio requirement has a substantial impact on the amount of the activity.

The impact of the U.S. supplementary leverage ratio is also pronounced for those banks that provide custody services, such as the operation of cash management accounts for investment funds and other institutional investors. Such banks are finding it increasingly challenging to accept certain cash deposits from customers, because the U.S. leverage ratio requires substantial capital against the low-risk, liquid assets in which those deposits are temporarily invested – generally cash and U.S. Treasuries. And current and future regulatory focus on this essentially riskless activity may not only impede custody banks’ ability to provide traditional custody services – it could also have an adverse impact on financial stability by preventing banks from being able to accept cash deposits from their custodial clients during a crisis, denying those clients a safe haven to preserve their capital and potentially worsening a run on the banking system.

Another problem with the supplementary leverage ratio is the way in which it works in opposition to the regulatory push for central clearing of derivatives. In particular, the leverage ratio requires banks to hold capital against client margin collected and held in a segregated account that unquestionably reduces the exposure of the bank, which ignores the fact that such margin not increases a bank’s risk. As a result, it effectively requires banks to hold un-economic amounts of capital when they trade with a client and then clear the trade. Because of this, at least three major dealers have exited the business. Accordingly, CFTC Chairman Massad has called for the U.S. leverage ratio to be amended to take account of segregated margin.

Notwithstanding these significant weaknesses a leverage ratio can, if calibrated appropriately, form a useful part of the larger bank capital framework. As we saw during the crisis, there will be times when banks (and other actors) seriously misjudge the risk of an asset class, and therefore undercapitalize it. Furthermore, if that asset class is illiquid and opaque to the markets (e.g., mortgages or mortgage-backed securities), then market confidence in risk-weighted measures will fall, and markets may resort to leverage measure themselves.

Thus, there is reason to establish a minimum leverage ratio below which a bank cannot fall as a failsafe measure in the event of a widespread failure to measure risk. However, this ratio should be set as a backstop, and not as the
predominant capital standard in ordinary circumstances; the latter would drive
daily misallocation of capital in the economy, as any measure that ignores risk is
bound to do if made a binding constraint. Here, the Basel Committee on Banking
Supervision (the “Basel Committee”) appears to have struck a fair balance by
adopting a minimum leverage requirement of three percent. For U.S. G-SIBs,
however, the U.S. banking agencies have set the ratio at six percent for bank
subsidiaries and five percent for the consolidated bank holding company. Thus,
banks subject to both the LCR and supplementary leverage ratio are currently
required to hold $53 billion in capital against cash reserve balances deposited at
the Federal Reserve, and an additional $19 billion against Treasury securities.
These are assets whose value banks are at no risk of misjudging; the capital
allocated to them could be far better deployed to lending or supporting market
liquidity.

iii. G-SIB Surcharge

The capital surcharge for G-SIBs is designed to reduce the likelihood of
failure such that the expected social cost of a G-SIB’s failure is approximately
equal to that of a large, but non-systemically important bank holding company.
The Federal Reserve has established a complex methodology to calculate the
G-SIB capital surcharge, which The Clearing House has studied in detail. As we
summarize in a recently released research paper, the G-SIB surcharge’s calibration
has major shortcomings.\textsuperscript{10} For example:

The Federal Reserve’s white paper includes the largest 50 banks each
quarter…. a sample size that extends to banks that are so small that their
experience may not be relevant. For example, at the end of the sample
period, the set of 50 banks whose earnings were used to calculate the G-SIB
surcharge had assets as low as $24 billion. However, in a 2014 response to
a GAO study, the Federal Reserve expressed the view that it is
inappropriate to compare such small banks to G-SIBs. Specifically, the
Federal Reserve noted, that “a bank holding company with $10 billion in
assets is too small to make a meaningful comparison to a bank holding
company with $1 trillion in assets... A bank holding company of $50 billion
in assets would provide a more relevant comparison...” For example, the
now defunct First City Bancorporation of Texas, one of the ten smallest
banks in the sample at $11.2 billion in assets, failed in the late 1980s
because of its concentrated exposure to energy and agricultural markets. It
was also geographically highly concentrated, with 59 of its 60 subsidiaries

\textsuperscript{10} See The Clearing House, Overview and Assessment of the Methodology Used to Calibrate the U.S.
GSIB Capital Surcharge (May 2016).
located in Texas. …I]nclusion of this bank in the sample accounts for 36 basis points of the G-SIB surcharge for an average G-SIB.\textsuperscript{11}

As noted, the Federal Reserve has stated that the G-SIB surcharge is “designed to reduce a G-SIB’s probability of default such that a G-SIB’s expected systemic impact is approximately equal to that of a large, non-systemic bank holding company.”\textsuperscript{12} Thus, by definition, regulatory changes that reduce the systemic impact of a G-SIB’s failure should reduce its G-SIB surcharge, but they do not. A company that holds sufficient TLAC to effectuate a SPOE strategy, agrees to the ISDA protocol, and increases its margin against uncleared swaps and security-based swaps – all measures that regulators have justifiably stated have materially decreased systemic risk – would incur the same G-SIB surcharge as one that did not.

Furthermore, the overstatement of the G-SIB surcharge also contains an implicit mandate: reduce the activities that add to the score, namely, capital markets activities. This mandate derives from the five factors that determine a G-SIB’s surcharge under the binding U.S. standard:

- The \textit{complexity} factor includes almost exclusively securities and derivatives assets held in market making;
- The \textit{inter-connectedness} factor includes almost exclusively dealer-to-dealer trading assets held in order to hedge customer positions held in market making;
- The \textit{cross-jurisdiction} factor includes almost exclusively cross-border dealer-to-dealer trading of the type captured by the interconnectedness factor;
- The \textit{short-term wholesale funding} factor includes almost exclusively the funding of securities positions; and
- The \textit{size} factor is not so exclusively focused on securities activities, but for the largest banks those assets constitute a large percentage of their total assets.

\textsuperscript{11} Id. at 11.

Thus, the only effective way for a firm to reduce its G-SIB surcharge is to reduce its market making and other activities that provide market liquidity and generally support capital markets.

Another fundamental shortcoming of the G-SIB surcharge calculation is the simplistic assumption that the social cost of a large bank’s failure is a multiple of a firm’s “systemic risk indicator score”—the score determined by the five factors listed above without providing any meaningful empirical evidence or analysis that these scores reflect the actual or relative systemic losses that the financial system would suffer upon a particular firm’s failure. Not only would different plausible relationships between the score and the cost of failure lead to substantially different surcharges, as shown by the research paper, but other accepted methods of calculating the systemic importance of a bank yield noticeably different results. For instance, a recent IMF study that assessed the largest bank holding companies’ contribution to systemic risk found a different ranking of, and less difference between, the largest banks.13

iv. Countercyclical Capital Buffer

Perhaps the best example of a post-crisis capital requirement that would fail even the most basic cost-benefit analysis is the countercyclical capital buffer. The countercyclical capital buffer was developed by the Basel Committee and contemplates an additional capital requirement for larger U.S. banks of up to 2.5 percentage points so as to “protect the banking system from the systemic vulnerabilities that may build-up during periods of excessive credit growth.”14 The Federal Reserve has recently issued a proposed policy statement describing when and why it might impose this buffer.15 That proposal has serious legal and procedural problems, but I will emphasize here its fundamental conceptual problems. This untested capital requirement is simultaneously both too broad and too narrow to be effective as a macroprudential tool to limit the build-up of risks in a credit bubble—too broad, because it would levy a hefty capital charge against all bank activities, not just the ones posing heightened risk, and too narrow, because it would do nothing to address any risks that arise outside of the banking system. Indeed, one can imagine that such a capital charge would only

13 See “Germany Financial Sector Assessment Program,” International Monetary Fund (June 2016).
serve to accelerate the build-up of systemic risks by creating strong incentives for risk-taking to migrate outside the banking system.\textsuperscript{16}

\hspace{1cm} \textit{v. Ring Fencing for Foreign Banks}

Most of the post-crisis reforms have been applied, appropriately, to the U.S. operations of foreign banks. In some cases, however, foreign banks have received treatment that has unnecessarily and adversely affected their ability to assist U.S. customers. Specifically, foreign banks with significant U.S. operations have been required by the Federal Reserve (but \textit{not} the Dodd-Frank Act) to ring-fence their U.S. non-branch assets, place them into a U.S. intermediate holding company (IHC), and then ensure that the IHC meets a variety of capital, liquidity, and other standards. The proposed TLAC rule makes it very difficult to fund the IHC, and other rules have imposed duplication of back office functions.

For foreign banks that largely structure and manage their U.S. operations on a standalone basis and have adopted a multiple-point-of-entry strategy to resolution, such ring-fencing is generally consistent with their business operations and approach to resolution.\textsuperscript{17} But many foreign banks manage and operate their U.S. and other subsidiaries on a global, consolidated basis; subjecting such foreign banks to this U.S.-style of mandatory, \textit{ex ante} ring-fencing that has two principal shortcomings.

\textsuperscript{16} These flaws are becoming an increasing focus of public discussion: for example, Federal Reserve Bank of Cleveland President Loretta Mester has publicly noted the shortcomings of the proposed countercyclical capital buffer approach in terms of both its unpredictability and uncoordinated nature. \textit{See} Loretta J. Mester, \textit{Five Points about Monetary Policy and Financial Stability} (June 4, 2016), available at www.clevelandfed.org/newsroom-and-events/speeches/sp-20160604-five-points.aspx (noting that “the need to coordinate countercyclical macroprudential policy actions across multiple regulators in the U.S. adds a complication to effectively using such tools in a timely way” and describing the need to “devise ways to make the macroprudential tools more systematic and less discretionary.”) Similarly, Office of Financial Research Director Richard Berner has noted that “[t]argeted policies with clear, direct effects on a financial stability threat … are preferable to general policies with diffuse effects (such as activating a countercyclical capital buffer).” \textit{Richard Berner, Remarks at the Conference on the Interplay Between Financial Regulations, Resilience, and Growth} (June 16, 2016), available at www.financialresearch.gov/public-appearances/2016/06/16/conference-on-the-interplay-between-financial-regulations-resilience-and-growth.

\textsuperscript{17} The multiple-point-of-entry resolution strategy is designed to reduce interconnectivity and facilitate resolution at the host level – a resolution strategy under which the IHC should be resolved separately from its parent financial group, under a process largely led by U.S. regulators.
First, to the extent that foreign banks manage their capital and liquidity on a consolidated basis, these banks retain and rely on the flexibility to shift financial resources within the organization to their location of highest and best use, including – most crucially – to a particular geographic or business operation in times of financial or market stress. Their ultimate strength resides in the ability to obtain support from the necessarily larger consolidated resources of the global enterprise. U.S.-style ring-fencing significantly undercuts this benefit and therefore could actually undermine financial stability. Second, ring-fencing has an undesirable effect of layering multiple capital and liquidity requirements on banking organizations, thereby increasing the regulatory burden and complexity.

At a minimum, should U.S. policymakers unfortunately continue down their current path, they should abide by Congress’ explicit direction in law to give due regard to the principle of national treatment and equality of competitive opportunity. They should also take into account the extent to which each FBO is subject on a consolidated basis to home country standards that are comparable to those applied to financial companies in the United States. In addition, we would urge policymakers to heed Congress’ specific direction to take into account differences among financial institutions based on their systemic footprints and risk profiles.

b. Additional Capital Reforms Pending

Given the extraordinary stringency and complexity of post-crisis regulation, it is somewhat surprising that the pace of regulatory change continues at a high, and continuously more burdensome level. In particular, two additional sets of changes to capital regulation are pending or anticipated, both of which would entail costs well in excess of any potential benefits.

i. Basel IV Changes to Capital Regulation

The Basel Committee has undertaken a new effort, Basel IV, that is directed at further and extensive changes to nearly all aspects of the international capital framework. This ambitious undertaking may be surprising to some, given that the Basel Committee just completed an extensive overhaul of its capital framework – Basel III, finalized by the Basel Committee in 2010 and implemented in the United States beginning in 2013.
Basel IV has not been presented for debate in the U.S., but is currently being finalized on an international basis. This is disconcerting as the breadth and scope of the proposed Basel IV revisions is difficult to overstate. For example, Basel IV includes the following separate proposals issued by the Basel Committee over the past year or so:

- Revisions to the standardized approach for credit risk,\(^\text{18}\) including:
  - Calibration of new risk weights for exposure classes based on QIS data;
  - Calibration of revised credit conversion factors, which a major determinant of the capital requirements for commitments to lend to both consumers and businesses;\(^\text{19}\)
- Revisions to the leverage ratio framework;\(^\text{20}\)
- Revisions to the standardized measurement approach for operational risk;\(^\text{21}\)
- Fundamental review of the trading book, which includes revisions to the boundary between the banking book and the trading book;\(^\text{22}\)
- The possible imposition of a step-in risk capital requirement;\(^\text{23}\)
- Incorporation of minimum haircuts into the capital requirements for certain securities financing transactions;\(^\text{24}\)

---


\(^{19}\) The Basel SACR’s revised CCFs will necessarily lead to increased risk-based capital requirements for certain off-balance sheet commitments. If these same CCFs are ultimately incorporated into the current Basel III internationally agreed upon leverage ratio denominator exposure measure, leverage ratio capital requirements would necessarily increase. We are deeply concerned that this increase would be unjustified and would make the already blunt leverage ratio instrument more of a binding constraint and further depart, as a practical matter, from the Basel Committee’s stated policy of the leverage ratio acting as a supplementary, back-stop measure to risk-weighted asset calculations.


Incorporation of “simple, transparent and comparable” securitization criteria into the capital framework;\(^{25}\)

Introduction of three potential capital floors methodologies to the internal ratings-based approach, including one based on the Standardized Approach as a whole;\(^{26}\)

Review of the credit valuation adjustment risk framework;\(^{27}\)

Revisions to Pillar 3 disclosures requirements;\(^{28}\) and

Implementation of rules relating to the treatment of total loss absorbing capacity holdings.\(^{29}\)

Taken together, these changes would effect a near wholesale revision of the Basel III capital framework, and are being undertaken in a series of separate steps where different elements are finalized at different times rather than through a deliberate, comprehensive and synchronized review.

Both the substance and process of Basel IV present numerous concerns, and The Clearing House believes that there are compelling reasons for the United States to opt out of any changes agreed to as part of Basel IV. For example, although neither the Basel Committee nor U.S. regulators have yet undertaken an analysis of the effectiveness and consequences (intended and unintended) of the Basel III changes, the Basel IV process would substantially reshape, yet again, a large part of that framework. Clearly, it would be more appropriate to meaningfully assess and come to an informed view of the impact of these recent and extensive reforms before proceeding to make any further changes.

Similarly, although the Basel Committee has stated that it does not intend for the changes to effectively raise capital requirements in practice, the substance of the various proposals that constitute Basel IV suggest that they would do


If bank capital requirements are to be further increased, it would seem that should be done explicitly, and not by accident.

Perhaps mostly concerning, rather than present its Basel IV changes holistically, such that commenters (and the Basel Committee itself) could assess the cumulative impact of these changes in the aggregate, the Basel Committee has issued its proposals and final standards in a piecemeal fashion, with little meaningful assessment or explanation of how they may interact in practice.

### ii. Increased Minimum Capital Requirements through CCAR

A second, very significant anticipated change to bank capital regulation is the Federal Reserve’s stated plans to substantially raise minimum capital requirements for U.S. G-SIBs by incorporating its G-SIB capital surcharge into CCAR’s post-stress minimum capital requirements. Although several Federal Reserve Board members have announced this forthcoming change in rather definitive terms, no formal proposal has yet been issued for notice-and-comment, and therefore the Federal Reserve has not yet provided any detail about either its rationale or how it would effectuate such a change.

Whatever the stated objective or method of implementation, however, The Clearing House believes that any such move would be inappropriate and unjustified at this time. As we have noted in a recent letter to the Federal Reserve, there are multiple reasons that caution against doing so:

- **First**, incorporating the G-SIB surcharge into CCAR would undermine its credibility and integrity as a stress test. According to the Federal Reserve, “[t]he Comprehensive Capital Analysis and Review (CCAR) is an annual exercise by the Federal Reserve to assess whether the largest bank holding companies operating in the United States have sufficient capital to continue operations throughout times of economic and financial stress....” As such, it is both a core safety and soundness protection and an important assurance to the investing and voting public about the resilience of the banking system. The incorporation of the

---


31 See The Clearing House, Incorporation of the GSIB Surcharge into CCAR, (June 2, 2016).

G-SIB surcharge into CCAR would fundamentally alter its objective, which is to test a bank’s resiliency under stress, such that CCAR results for U.S. G-SIBs would provide less meaningful information to banks, investors, and the public about banks’ capacity to withstand stress. This outcome would be very unfortunate, as it would undermine a key post-crisis regulatory innovation that has been highly successful in enhancing the resiliency of the banking system and public confidence therein.

- **Second**, incorporating the G-SIB surcharge into the existing CCAR framework would effectively result in “double taxation” of G-SIBs, as the existing CCAR framework already includes unique, incremental assumptions that increase stress loss estimates that apply only to G-SIBs. In particular, all eight U.S. G-SIBs are required to assume a counterparty failure scenario, and six of the eight G-SIBs are required to assume an instantaneous global market shock. No non-G-SIB is subjected to either additional stress.

- **Third**, as described above, the Federal Reserve’s methodology for calibrating the G-SIB surcharge itself contains significant weaknesses and limitations, and the G-SIB surcharge rule fails to account for continuing regulatory developments that have substantially decreased the systemic risk of GSIBs making its calibration increasingly inaccurate and overstated. Each of these problems in the G-SIB surcharge itself makes its incorporation into CCAR particularly inappropriate.

- **Fourth**, given the substantial real world impact of the G-SIB surcharge itself, particularly as a tax on capital markets activities, incorporating it into CCAR would amplify the current deterioration of market liquidity and the increased likelihood of market volatility associated with the continuing shift from principal- to agency-based intermediation.

Finally, at a more general level, it is difficult to identify the incremental benefits to safety and soundness or financial stability of higher capital requirements for G-SIBS – after all, the Federal Reserve announced just a few weeks ago that all of the U.S. G-SIBs had substantially more capital than necessary to weather, largely unaffected, a recession significantly worse than the recent financial crisis. On the other hand, the potential costs are quite clear – the negative impact to lending and credit availability of increasing G-SIB capital requirements by up to $222 billion would be substantial. Indeed, it is perplexing to juxtapose, on the one hand, the Bank of England’s recent decision to reduce its countercyclical capital buffer requirement, as a means to spur its economy, and on the other, an anticipated decision in the United States to substantially increase its
capital requirements notwithstanding continuing concerns about the strength of the U.S. economy.

IV. Key Considerations in Rationalizing and Tailoring the Regulation of Bank Capital

We support efforts to carefully evaluate the current regulatory framework, including capital, to identify areas in which the regulation of banks can be improved and their benefits and costs better balanced. We would suggest that any effort to do so take into account the following key considerations:

- First, the importance of identifying areas in which further changes are pending or anticipated, and ensuring that no further action is taken until the cumulative impact and consequences of the very large body of post-crisis rules already enacted are evaluated and understood. We have identified two key examples as pertains to bank capital in Part III (e.g., Basel IV and the increase of minimum capital requirements through CCAR), but there are likely to be others.

- Second, the need to identify aspects of those capital regulations already enacted that should be adjusted or improved, so as to ensure that their incremental benefits, relative to the post-crisis framework as a whole, are worth their costs. We have identified a number of these in Part III (e.g., CCAR, the leverage ratio, etc.), but again, there are likely to be others.

- Third, the importance of identifying existing capital and other prudential rules that can better tailored to the differing risk profiles and business models of various banks. Opportunities for further tailoring are likely to exist across the broad spectrum of bank types and business models, including community banks, regional banks of various sizes, G-SIBs, and the U.S. operations of foreign banks. And indeed, to the extent that a key objective of that exercise is to ensure that U.S. banks are in a position to efficiently meet the needs of their customers and the U.S. economy as a whole, it is crucial that steps to rationalize and better tailor the regulatory regime across the entire U.S. banking system.

* * * * *

Thank you for the opportunity to testify before the Committee today. I look forward to answering your questions.