Examining Capital Regimes for Financial Institutions

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

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## 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

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[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/.