



**Testimony of Greg Baer
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**“Fostering Economic Growth: Midsized, Regional and Large Institution
Perspective”**

**U.S. Senate Committee on
Banking, Housing and Urban Affairs**

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Chairman Crapo, Ranking Member Brown, and members of the Committee, my name is Greg Baer and I am the President of The Clearing House Association and General Counsel of The Clearing House Payments Company. Established in 1853, we are 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 25 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 owners fund more than 40 percent of the nation's business loans held by banks, which include 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 regulation on U.S. global systemically important banks, U.S. regional banks of all sizes, and the U.S. operations of foreign banking organizations with a major U.S. presence.

After nearly a decade of fundamental and continuing changes to financial regulation, now is an opportune time to review the efficacy of our current bank regulatory framework. My testimony will focus on reforms that could directly and immediately enhance economic growth. Certainly, there are many other areas where reform is urgently needed – for example, the regulatory regimes for anti-money laundering, cybersecurity, the Community Reinvestment Act, and corporate governance, as well as a general breakdown in transparent administrative procedure at the regulatory agencies – but those involve other priorities, and have a more indirect effect on the economy.

I should emphasize at the outset that if the goal of regulatory reform is to prompt economic growth, that goal cannot be achieved while excluding regulation of large and regional banks from that effort. As the Treasury Department noted in its report this week, community banks hold only 13% of U.S. banking assets, so reform limited to those firms will not have a significant economic impact. And large banks – defined as those in holding companies with at least \$50 billion in assets – originated 54 percent small business loans in 2015 by dollar amount and 86 percent by number.

I. THE CASE FOR REFORM OF BANK REGULATION

Room for reform. The starting point for any review of post-crisis regulation is an American banking system that is extraordinarily resilient. U.S. banks now hold substantial amounts of high-quality capital; since the crisis, the aggregate tier 1 common equity ratio of TCH's 25 owner banks nearly tripled to 12.2 percent at the end of last year. In absolute, dollar terms, that is an increase in tier 1 common equity from \$331 billion to over \$1 *trillion*. Similarly, U.S. banks now hold unprecedented amounts of high-quality liquid assets (HQLA) to ensure that they can survive a period of persistent liquidity stress (a run, in other words): today, nearly a quarter of U.S. large bank balance sheets consists of cash, U.S. Treasury bonds, and similarly low-risk and highly liquid assets.

Moreover, we now have in place a comprehensive legal and operational framework that ensures that even the largest and most complex banks can go bankrupt

like any other company, without taxpayer support and without risk to the broader financial system, ending too-big-to-fail and replacing moral hazard with market discipline. Markets clearly have recognized as much, as bank holding company debt is now priced on the assumption that bondholders will not be bailed out, and rather will be bailed in in order to recapitalize the institution.¹

As discussed below, there is considerable evidence that bank capital and liquidity levels have now been pushed beyond what is reasonably necessary for safety and soundness and financial stability purposes. And other restrictions on banking activity have been imposed without sufficient analysis or evidence – and without regard to current capital and liquidity levels. Here, and generally, when I refer to “banks,” I am including their non-bank affiliates, which increasingly are now subject to the same restrictions (while providers of financial services that are not affiliated with banks are effectively unregulated).

Need for reform. While much has been gained in fortifying the nation’s largest banks, it is also clear that the banking system is playing an unnecessarily diminished role in fostering economic growth and vibrant capital markets, and that systemic risk is building up outside of the banking system, which has been the sole focus of many post-crisis reforms. A key driver here is the recent sea change in banking whereby large and regional banks generally no longer allocate capital and make business decisions based on their own assessment of economic risk, with regulatory capital as a backstop; rather, because regulatory capital requirements are so high and prescriptive, *regulation* often dictates how capital -- and therefore credit to the economy – is allocated.² A similar phenomenon is occurring with respect to post-crisis liquidity requirements.

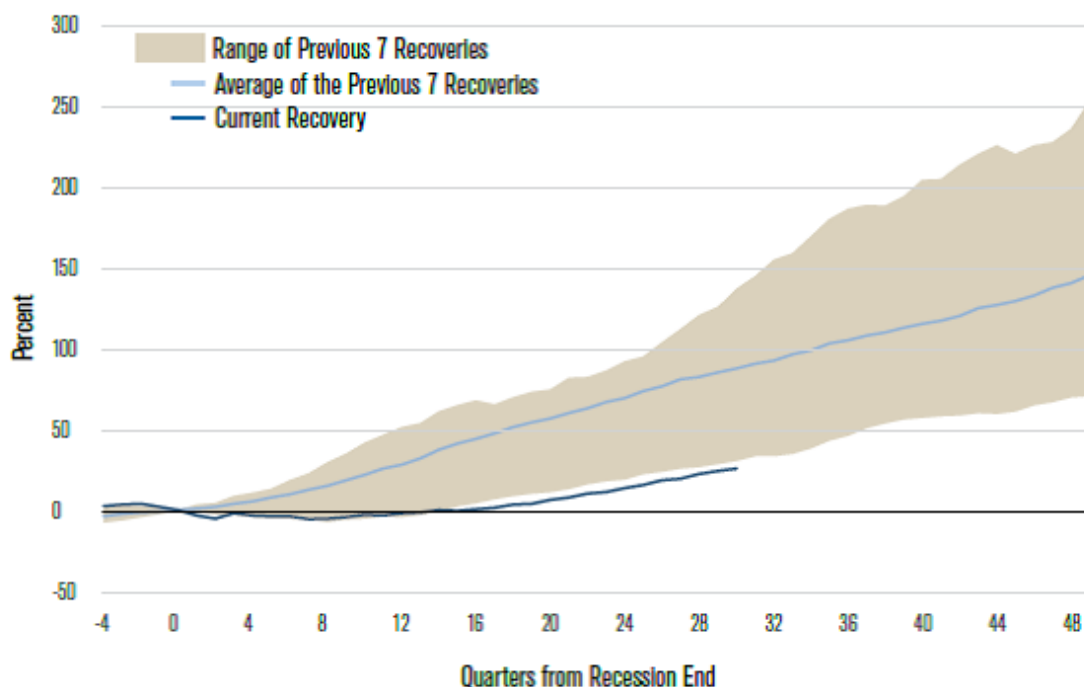
As described in detail below, there are numerous opportunities to better align existing capital and liquidity requirements with the goal of economic growth – without jeopardizing, and likely enhancing, the strength and resiliency of the financial system. Three areas of regulatory impact highlight the significant potential for reform.

Small business lending. As demonstrated in the chart below from the recent Treasury report, bank lending has lagged significantly in the current recovery.

¹ See The Clearing House eighteen53 Blog, *The Canard That Won't Go Away: Correcting the Record (Again)* (April 21, 2017), available at <https://www.theclearinghouse.org/eighteen53-blog/2017/april/21%20-%20icba>.

² For example, the recent research by Viral Acharya et al. finds that banks subject to stress tests have reduced the supply of credit to relatively risky borrowers. In particular, the supply of credit is reduced to large corporate borrowers that exhibit high risk, commercial real estate, credit card, and small business borrowers who also tend to be relatively risky. See Acharya, Viral V. and Berger, Allen N. and Roman, Raluca A., *Lending Implications of U.S. Bank Stress Tests: Costs or Benefits?* (May 23, 2017). Available at SSRN: <https://ssrn.com/abstract=2972919>

Figure 7: Growth in Bank Lending Since End of Recession



Source: Financial Accounts of the United States, Federal Reserve

As Of: 2017 Q1

Much of the lag is attributable to small business lending. In April 2017, the Federal Reserve published an inaugural nationwide survey of small business credit conditions, the *Small Business Credit Survey* (SBCS), which reports widespread evidence of tight credit conditions for small businesses.³ In particular, according to the results of the SBCS, approximately 36 percent of small businesses reported not having all of their borrowing needs satisfied. More specifically:

- About 60 percent of small businesses reported having faced financial challenges over the past 12 months.
 - Of those, approximately 45 percent cited lack of credit availability or ability to secure funds for expansion as a reason.
 - About 75 percent of those firms facing financial challenges said they used owners' personal funds to address this problem.
- About 45 percent of small businesses applied for financing over the past 12 months. Of those that applied for credit, 24 percent received none of the funds requested and 36 percent received only some portion of what they requested.

³ See Federal Reserve Banks of Atlanta, Boston, Chicago, Cleveland, Dallas, Kansas City, Minneapolis, New York, Philadelphia, Richmond, Saint Louis and San Francisco, *Small Business Credit Survey* (April 2017), available at www.newyorkfed.org/medialibrary/media/smallbusiness/2016/SBCS-Report-EmployerFirms-2016.pdf.

Notably, credit availability for small businesses is tighter at large banks that are subject to the highest capital and liquidity regulations. At these banks, approval rates were just 45 percent for small businesses with less than \$1 million in revenues. In contrast, community development financial institutions and small banks reported approval rates of 77 percent and 60 percent, respectively. This fact is significant because, as noted, large banks originate a sizable share of small business loans that cannot realistically be replaced by smaller banks: 54 percent by dollar amount and 86 percent by number of loans.⁴

Moreover, our own research has shown that the U.S. stress tests are constraining the availability of small business loans secured by nonfarm nonresidential properties, which accounts for approximately half of small business loans on banks' books. Our analysis indicates that subjecting a bank to the U.S. supervisory stress tests leads to a reduction of more than 4 percentage points in the annual growth rate of its small business loans secured by such properties, which translates to a \$2.7 billion decrease in the aggregate holdings of these small business loans each year on average.

Mortgage lending. Another example of an asset class unnecessarily burdened by post-crisis regulation is home mortgage lending, and here again, capital regulation is a major driver. As demonstrated in our own research, the Federal Reserve's Comprehensive Capital Analysis and Review (CCAR) stress test is imposing dramatically higher capital requirements on residential mortgage loans than bank internal (Federal Reserve-approved) models and the standardized approach to risk-based capital developed by the Basel Committee on Banking Supervision.⁵ Indeed, for first-lien mortgage loans, CCAR capital requirements are 45 percent higher than under banks' own projections and 95 percent higher than under the Basel III standardized approach. Because smaller banks are subject to less stringent capital requirements, they can act as a control group in assessing the impact of new regulations on the supply of credit. Between the fourth quarter of 2010 and the end of 2016, residential real estate loans declined 0.5 percent on average on an annual basis at banks subject to the CCAR stress test, while they rose 4.0 percent on average over the past six years on an annual basis at banks not subject to that test.

Capital markets. In the United States, much of the lending to the private nonfinancial sector and most of the borrowing by the government sector occurs outside the banking system, in capital or money markets. Indeed, banks provide only about one-third of credit in the United States. Large bank holding companies facilitate financial market intermediation both by making markets in securities traded in those markets and by providing funding to other market participants who transact in those markets.

⁴ See The Clearing House eighteen53 Blog, *Myth versus Reality on Small Business Lending* (March 24, 2017), available at www.theclearinghouse.org/eighteen53-blog/2017/march/24-small-business-lending.

⁵ See The Clearing House: *The Capital Allocation Inherent in the Federal Reserve's Capital Stress Test*, https://www.theclearinghouse.org/~media/TCH/Documents/TCH%20WEEKLY/2017/20170130_WP_1_mpllicit_Risk_Weights_in_CCAR.pdf.

Interestingly, post-crisis regulation by *banking* regulators has affected securities markets more than regulation by *securities* regulators. In particular, bank regulations have made it significantly more expensive for broker-dealers affiliated with banks – which includes, post-crisis, all of the largest dealers – to hold, fund and hedge securities positions. Higher capital charges make holding of inventory more expensive, and the Volcker Rule makes holding such inventory a potential legal violation. The surcharge for global systemically important banks (GSIBs) and liquidity rules make securities financing more expensive. It has become more difficult for dealers to hedge the risk associated with holding the inventories of the bonds using credit default swaps.⁶

The greatest impact has been felt by smaller companies, as the capital rules impose lower capital charges on more liquid securities, which tend to be issued by larger companies; broker-dealers, forced to ration their balance sheets, are serving their largest customers first. As shown in the chart below, issuance of corporate bonds by small and midsized nonfinancial firms has fallen over the past few years while issuance by larger firms has risen.

Assessing the impact of new regulations Market liquidity



As another example, the efficiency and liquidity of financial markets are maintained by the ability of asset managers to take leveraged positions in mispriced

⁶ Recent research by economists at the Federal Reserve Bank of New York has found that CDS have become much more costly to hold in large part because of the capital that dealers are required to hold against the transaction. Boyarchenko, Nina, Pooja Gupta, Nick Steel, Jacqueline Yen, (2016) “Trends in Credit Market Arbitrage,” Federal Reserve Bank of New York Staff Reports No. 784, July 2016, p. 18.

assets to earn a profit when the asset price returns to normal. Such positions are financed in the market for repurchase agreements. Broker dealers are often the intermediary between two financial institutions, engaging in a repo with one and an identical matched repo with another. While such matched transactions are nearly riskless, the leverage ratio requirement forces banks to hold considerable capital against their reverse repos. Moreover, if the net stable funding ratio were adopted as proposed, banks would be required to finance the loans with a material amount of longer-term funding rather than a matched repo borrowing. As explained in a recent TCH research note, these types of requirements make such transactions more expensive, and dealers are passing those costs along.⁷

Thus, more than four-fifths of the respondents to the Federal Reserve's Senior Credit Officer Opinion Survey in June 2015 indicated that liquidity and market functioning in Treasury markets had deteriorated. Over 80 percent of those respondents reporting a deterioration indicated that the most important cause was a decreased willingness of securities dealers to expand their balance sheet for market-making purposes as a result of regulatory change.

II. REFORMING CAPITAL REGULATION

A. Stress Testing

When enough should be enough. Certainly, a key lesson of the financial crisis is the critical importance of maintaining capital levels sufficient to absorb outsized losses that typically accompany periods of financial stress. Responding to that lesson, banks have significantly increased the amounts of high-quality capital they maintain, and regulators have enacted a range of reforms that require these heightened levels of capital to remain in place over time.

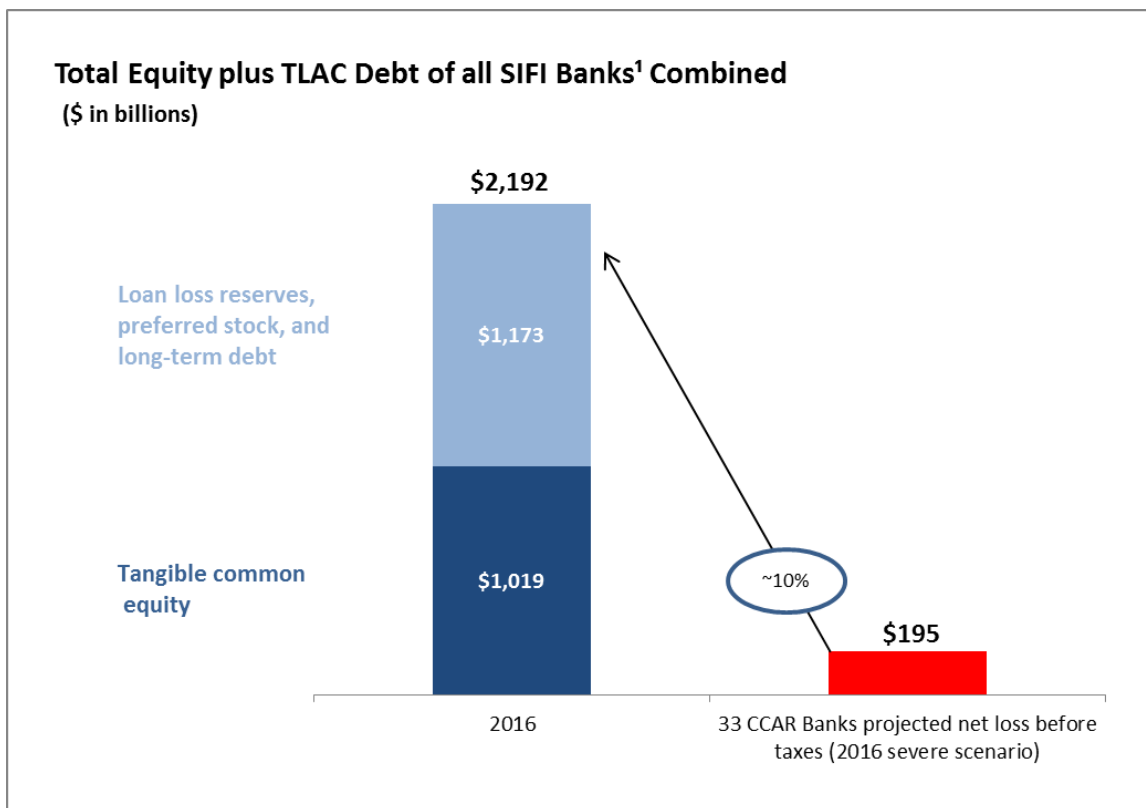
Implementation of Basel III changes has increased the quality of capital, focusing on common equity as opposed to hybrid debt/equity instruments. In the United States, there is an increased and wise emphasis on stressed rather than static measures of capital adequacy – in particular, the Federal Reserve's CCAR exercise and the banks' own internal stress tests. These are important improvements to the bank capital framework that resolve key shortcomings revealed by the financial crisis, and we support them.

Unfortunately, these sensible reforms have been accompanied by other changes to the U.S. capital framework which have introduced a significant degree of unnecessary opacity, subjectivity and uncertainty to capital regulation in the United States. Large U.S. banks today are subject to dozens of different capital requirements. Of those, the Federal Reserve's CCAR stress test and the enhanced supplementary leverage ratio

⁷ See The Clearing House, *Shortcomings of leverage ratio requirements*, (Aug. 2016), www.theclearinghouse.org/-/media/tch/documents/20160809_tch_research_note_leverage_ratio.pdf?la=en.

(eSLR) are set at such high levels that they most frequently dictate bank’s decision-making. In addition, U.S. regulators have consistently implemented capital reforms in a manner that both significantly exceeds agreed-upon international standards and is much more stringent than necessary to support safety, soundness, and financial stability.

Of course, a crucial question is how much capital is enough. TCH’s 25 owners hold roughly triple the amount of capital they did pre-crisis, but should it be quadruple, or double? We believe three benchmarks are useful here. First, consider the results of the Federal Reserve’s severely adverse scenario under CCAR, which presents for large banks a greater economic and market shock than was present in the global financial crisis. Then, compare the losses projected under that stress scenario to the loss absorbency currently held by those banks, as detailed in the following chart.



In sum, CCAR imposes a stress scenario significantly harsher than the previous financial crisis.⁸ Yet as of 2016 tangible common equity was *five times* the losses

⁸ It is worth noting that neither banks nor their regulators place exclusive focus on a single scenario; rather, banks run, and the Federal Reserve monitors, numerous stress scenarios, including ones chosen by each bank to focus on its unique vulnerabilities.

implied under that scenario. Total loss absorbency – which includes debt holders who would be “bailed in” as part of a bankruptcy under the Title I living will process or the Title II Orderly Liquidation Process, was *ten times* those losses.

Consider as a second benchmark JPMorgan Chase, which is universally considered to have had sufficient capital to have weathered the past financial crisis without need for taxpayer assistance, while making two acquisitions and continuing to lend and make markets. Thus, one could reasonably suppose that the amount of capital it held pre-crisis was sufficient (and would have been all the more sufficient if all other firms had held that amount as well). Today, JPMorgan Chase holds *double* the capital it did pre-crisis. More importantly, all large banks are now required to hold similar levels of capital (with some variation based on the size of any GSIB surcharge). And the firms subject to those capital rules today include the largest broker dealers – which is significant, because pre-crisis, monoline investment banks like Bear Stearns and Lehman Brothers were not subject to bank-like capital requirements and operated with a fraction of the capital of large banks.

And consider as a third benchmark long-term debt spreads and CDS spreads of large U.S. banks, which have remained stable over the past five years. While we have not seen a significant financial crisis during this period, we observed a large trading loss at one large U.S. bank in mid-2012, volatility around the Brexit vote in the United Kingdom in the middle of last year, a significant consumer scandal at another large U.S. bank in the second half of last year, and more generally, a fair amount of international political instability in recent months.

There is also reason to believe that higher capital standards have reached levels at which they are having a counterproductive effect. In a recent paper, Sarin and Summers (2016) point out that by several capital markets-based measures, including stock price volatility and CDS spreads, banks appear to be riskier now than they were before the crisis, even as bank capital and liquidity standards have been substantially raised over that same period of time.⁹ The authors conclude that the most likely explanation is that banks’ franchise values have declined. Specifically, a bank’s franchise value depends on its ability to generate earnings and increase those earnings over time. The tightening of regulations that has occurred since the crisis, while increasing loss absorbency, has also reduced the profitability of banks.

While no one would recommend a return to the low and uneven capital levels that existed pre-crisis, or to treating as capital hybrid instruments that did not prove to be loss absorbing, the largest U.S. banks are now overcapitalized by any objective measure. Hundreds of billions of trapped capital is not necessary to meet any quantifiable safety

⁹ See Sarin, Natasha and Lawrence H. Summers; *Have big banks gotten safer?*, Brooking Papers on Economic Activity, Fall 2016.

and soundness need, and could be redeployed to furthering economic growth – either through more lending or returning excess capital to shareholders for reinvestment elsewhere.

Potential for reform. The Federal Reserve’s stress testing framework attempts to measure the ability of banks to withstand a very severe economic downturn (and, where relevant, a market shock). Under CCAR, the Federal Reserve runs its own proprietary models to determine the effect of various supervisory scenarios on banks’ capital adequacy – that is, the estimated net losses and resulting reduction in capital under those scenarios. After this stress, a large bank must meet a series of capital requirements, including a 4.5 percent common equity tier 1 ratio. And it must do so assuming that it does nothing to shrink its balance sheet, reduce its dividend, or postpone planned share repurchases under severely adverse economic conditions – almost certainly deeply counterfactual assumptions. Thus, a large bank that passes the CCAR exercise not only has sufficient capital to avoid failure under historically unprecedented adverse conditions – it has enough capital to emerge from such an event doing business as usual, and without taking actions that would be normal (or even compelled) under the circumstances.

Stress testing is an important tool for assessing the health of the banking system because it incorporates a forward looking, dynamic assessment of capital adequacy, and is therefore less reliant on recent historical performance. However, the Federal Reserve’s CCAR stress tests are highly and unnecessarily opaque, relying upon macroeconomic scenarios that are never published for public comment and a series of unidentified models (combined in unspecified ways) that have never been subject to peer review or public comment.

To the best of our knowledge, which is necessarily limited by the opacity of the CCAR process, the accuracy of the Federal Reserve’s models, individually and collectively, has never been back-tested. The results of this non-public process continue to differ markedly from the results of the banks’ own, more robust earnings forecasting models – models that the Federal Reserve itself subjects to rigorous review. (The bank process is part of what is known as DFAST, short for “Dodd-Frank Act Stress Test.”) At this point, there is no basis to conclude that the Federal Reserve’s models do a better job of projecting losses than the banks’ own (Federal Reserve-approved) models.

Both the quantitative test of CCAR and the qualitative test described below also are needlessly complex and consume enormous resources at the largest banks, which resources could be more effectively redeployed; the CCAR annual submissions for the largest banks average in excess of 50,000 pages.

Effects on economic activity. Collectively, the opacity, subjectivity and overall stringency of the CCAR framework act as a significant constraint on lending, economic growth, and liquid capital markets. As we have demonstrated in detailed empirical research, this is largely the result of the excessively high amounts of capital banks are

required to hold against their small business lending, mortgage lending, and trading book assets to pass the test.¹⁰ Under banks' own DFAST projections, capital requirements for small business loans and home mortgage loans are 80 percent and 45 percent higher than under the Basel III standardized approach, respectively. For trading assets, the higher capital requirements under CCAR are driven by the Federal Reserve's prescribed global market shock that is part of the CCAR scenarios for banks with large trading operations. However, the market shock also applies to the DFAST stress tests that are calculated using the banks' own models, and the capital requirement for the trading book under CCAR is 20 percent higher than DFAST.¹¹

CCAR's excessively high capital requirements for small business loans and home mortgages likely reflect in large part the severity of the stress scenario used in the test. The stress test includes increases in unemployment that are more sudden in some cases more severe than seen in the global financial crisis, and other parameters that go beyond any historical experience.

The inevitable result is that banks are shifting away from cyclically sensitive sectors (where loss of employment is likely to trigger default) like small businesses and households with less-than-pristine credit. Bank behavior is consistent with this set of incentives:

- Small commercial real estate loans, which account for approximately half of small business loans outstanding on banks' books, declined about 2 percent on average over the past 5 years.¹²
- On the residential real estate lending side, home equity lines of credit declined more than 6 percent per year over the past 5 years, despite the significant appreciation in housing prices, and are about 110 basis points more expensive than they were pre-crisis.¹³
- The declines in these categories of lending have been larger at banks subject to CCAR than at banks not subject to CCAR.

Substantial benefits to economic growth could be achieved through three limited reforms to CCAR, all of which would increase banks' capacity and propensity to make these types of loans.

First, banks' more robust, Federal Reserve-approved models should be used to estimate stress losses for purposes of the CCAR quantitative assessment. The Federal Reserve should use its own, more simplified models as a check on the bank models.

¹⁰ *Capital Allocation in CCAR, supra* note 5.

¹¹ *See id.*

¹² *Capital Allocation in CCAR, supra* note 5.

¹³ *Capital Allocation in CCAR, supra* note 5.

With the Federal Reserve models no longer binding in the first instance, no concentration of risk or “gaming” concern would prevent their being made transparent. Notice and comment or other peer review would doubtless improve their accuracy.

We note that such an approach is not a theoretical construct, but current practice at the Bank of England where banks' own models play the central role in the United Kingdom's supervisory stress tests.¹⁴ Banks use of their own models motivates them to better develop their own stress scenarios, which are than more tailored to their business models. That said, the Bank of England does not rely entirely on banks own models and has its own suite of models for peer-benchmarking and to ensure consistency of results across participating banks. In adopting the system, the Bank of England has noted that it does not want its own models to drive capital requirements at the risk of stifling stifle innovation in risk management at banks. More generally, if a set of unique models being used is overly conservative, the efficiency of the financial system would be reduced. Conversely, if those models are vulnerable to a particular source of risk, the entire system could be undercapitalized during a period of financial stress.¹⁵

Second, annual stress test scenarios should be subject to a 30-day public notice and comment period to ensure that they meet the Federal Reserve’s identified standard – consistency with post-war U.S. recessions. While we believe that standard is sensible, it should be subjected to notice and comment rulemaking.

Third, counterfactual and incorrect assumptions about how banks would behave in a crisis (e.g., continuing share repurchases and balance sheet growth under severe stress) should be corrected.

B. Leverage Ratio

A leverage ratio measures the capital adequacy of a bank by dividing its capital by its total assets (and, in some cases, off-balance-sheet exposures) without taking into account the risk of any particular asset or exposure. Requiring the same amount of capital to be held against every asset makes the holding of low-risk, low-return assets relatively more costly when compared with the holding of higher-risk assets, higher-return assets. Put another way, if a capital regulation requires a bank to hold the same amount of capital against each asset, the bank will by necessity gravitate to relatively higher-risk, higher-return assets.

A leverage ratio can still be a useful tool as a backup measure when banks collectively misunderstand the risk of a certain asset class (as they did with mortgages

¹⁴ See Bank of England (2015) *The Bank of England's approach to stress testing the UK Banking System* (October 2015). Available at <http://www.bankofengland.co.uk/financialstability/Documents/stresstesting/2015/approach.pdf>

¹⁵ See Gallardo, German, Til Schuermann, and Michael Duane (May 2016), *Stress testing convergence*, *Journal of Risk Management in Financial Institutions* 9, p. 32-45.

and mortgage-related securities in the past crisis), but serious problems have emerged for U.S. banks because U.S. regulators have set the minimum leverage ratio for the largest U.S. banks at nearly double the international standard, without adequate analysis of (i) whether such a high leverage ratio is necessary to prevent excessive risk taking or (ii) the impact of such a high leverage ratio on lending, market activity and economic growth. These are the very same banks that provide support to U.S. capital markets and ensure the safekeeping of investor assets, and in the course of doing so hold large amounts of low-risk, liquid assets like central bank placements and Treasury securities.

More specifically Basel III introduced a 3 percent supplementary leverage ratio for internationally active banks, which includes both on-and off-balance-sheet assets.¹⁶ U.S. regulators have not only applied this 3 percent supplementary leverage ratio requirement to all larger banks, but have also imposed a still-higher requirement for U.S. GSIBs – an eSLR of 5 percent at the holding company level and 6 percent at depository institution subsidiaries.¹⁷ Consequently, for several of the largest U.S. banks, the eSLR, as opposed to a risk-based requirement, that acts as a current or potential future binding constraint and therefore affects bank capital and business planning.¹⁸

The overall impact of the leverage ratio as a measure of capital adequacy, and the resulting misallocation of capital, have increased dramatically in recent years as a result of other regulatory mandates. As noted, large banks presently are required by liquidity regulations to hold about a quarter 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 requires banks to hold capital against these assets.

Banks with sizeable custody, treasury services or other businesses that employ a servicing business model or take sizeable corporate deposits are particularly affected. In practice, this means that, under the liquidity rules, these banks must hold cash or Treasury securities against these deposits, on the assumption that up to 100 percent of them will run in a crisis (although the outflow rate during the financial crisis was substantially lower) and then hold 6 percent capital against the same cash and U.S. Treasury bills that the regulators require they hold for liquidity purposes. Of systemic concern, these problems are likely to become more pronounced in periods of financial market uncertainty, as institutional investors seek to lower their risk exposure by raising

¹⁶ See Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems* (June 2011), available at www.bis.org/publ/bcbs189_dec2010.pdf.

¹⁷ See 79 Fed. Reg. 187.

¹⁸ See Federal Financial Analytics, Inc., *Mutual-Assured Destruction: The Arms Race between Risk-Based and Leverage Capital Regulation* (Oct. 13, 2016).

cash and banks must manage the resulting deposit inflows in the most conservative way possible, via placements at the Federal Reserve and other national central banks.

Another issue that has received recent notice is how the supplementary leverage ratio makes it more costly for U.S. banking organizations to provide clearing member services to clients on centrally cleared derivatives. While risk-based capital rules allows banking organizations to exclude from their denominator any initial margin posted by their clients on derivatives transaction - and rightly so, as the bank bears no risk of loss on such margin - the leverage ratio does not. As a result, the leverage ratio exaggerates the exposure amount of these derivatives and effectively requires banks to hold un-economic amounts of capital when providing clearing services to clients. Because of this, at least three major dealers have exited the business. Accordingly, former CFTC Chairman Massad called for the U.S. leverage ratio to be amended to take account of segregated margin.¹⁹

In sum, under the eSLR, U.S. GSIBs are currently required to trap approximately \$53 billion in capital against cash reserve balances deposited at the Federal Reserve, and an additional \$15 billion against U.S. Treasury securities. These are assets whose value banks are at no risk of misjudging; capital allocated to them could be far better deployed to lending or supporting market liquidity. Thus, the answer is not to dispense with the leverage ratio but rather to eliminate the enhanced supplementary leverage ratio, and to deduct from the denominator of the supplementary leverage ratio high-quality liquid assets like central bank reserves and Treasury securities, as well as segregated client margin.

It is sometimes said that deducting these assets would begin a “slippery slope.” This worry is difficult to understand – bank regulation is replete with line drawing. For example, the liquidity coverage ratio gives 100 percent credit for a central bank reserve or U.S. Treasury security as a liquid asset; this has not created a “slippery slope” whereby loans have been given 100 percent credit as a liquid asset. The Bank of England, on July 25, 2016, began deducting central bank reserves from the leverage ratio denominator for U.K. banks – and no “slippery slope” has emerged whereby it has felt the need to do so for, say, subprime loans.²⁰

C. Operational Risk

Large institutions currently are required to build and maintain models to measure operational risk for capital purposes based on a Federal Reserve-approved Advanced

¹⁹ See Timothy Massad, *Keynote Address by Chairman Timothy G. Massad before the Institute of International Bankers* (March 2, 2015), available at www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-13.

²⁰ See Bank of England, *Financial Policy Committee statement and record from its policy meeting, July 25, 2016 (August 2016)*, available at www.bankofengland.co.uk/publications/Pages/news/2016/062.aspx.

Measurement Approach. Because it is exceedingly difficult to base a capital charge on a subjective assessment of the risk inherent in a bank's current operations, these models generally look at past large litigation losses and treat them as a proxy for the risk of something going wrong in the future.

In contrast to international peers, the U.S. banks are often prohibited from excluding losses from their models even when the bank has exited the business line that caused the loss, or sold such business to another institution. (The acquirer also assumes the capital charge associated with the past event, effectively doubling the capital requirement on an aggregate basis.) U.S. banks are prohibited from using expert judgment to lower the output of their model even when factors make certain operational losses less likely in the future, while non-U.S. banks are permitted to make such adjustments. Similarly, banks may put in place a range of other risk mitigants, such as insurance or hedges, but none of these are meaningfully recognized or reflected in the current operational risk capital framework. Finally, for some banks, the regulators add to any modeled results a "supervisory overlay," which is a completely arbitrary add-on presented with no analytical or evidentiary basis.

As a result of all these factors, operational risk capital charges are inflated and extremely sensitive to any data anomalies or extreme events. At least one bank was reported in 2014 to be holding over \$30 billion in operational risk capital,²¹ and as a general matter, U.S. banks currently hold significantly more operational risk capital than their international counterparts. It is also worth noting that operational risk losses tend to be idiosyncratic and thus uncorrelated, so extraordinarily high capital is being held against a risk that is unlikely to be systemic. (Clearly, some operational risks of the mortgage business did prove correlated during the financial crisis; however, even here, those losses were experienced years after the associated credit and market losses.)

An ongoing Basel Committee review of operational risk capital could rectify these problems if an improved regime could be constructed appropriately and – importantly – adopted by U.S. regulators without "gold plating." The result would be to free up billions of dollars of capital for more productive uses.

III. REFORMING LIQUIDITY REGULATION

A. Liquidity Coverage Ratio

A key lesson of the financial crisis was the need for banks to maintain sufficient liquidity to survive periods of financial stress. The regulatory response includes Basel III's liquidity coverage ratio (LCR), which requires banks to maintain a sufficient stock of liquid assets to cover a 30-day run on the bank with no access to additional funding, plus a Dodd-Frank Act requirement that large banks conduct liquidity stress

²¹ See Peter Rudegeair, REUTERS, *Trading scandals, legal fines may ramp up U.S. banks' capital needs* (June 9, 2014), available at www.reuters.com/article/us-banks-oprisk-idUSKBN0EK1M520140609.

tests on a monthly basis across at least overnight, 30-day, 90-day, and one-year time horizons, and maintain a sufficient “liquidity buffer” based on their expected liquidity needs under these stress tests. These are concrete improvements to the bank liquidity framework, which we generally support.

These regulations have dramatically increased the ratio of HQLA to total assets in the U.S. banking sector. The largest 33 banks held 12 percent of their assets in HQLA in 2008; today they hold 24 percent of their balance sheets in these assets. Compared to the onset of the crisis, this improvement is even more pronounced, with the proportion of HQLA increasing nearly five times since the end of 2006 (i.e., from 5.75 to 24 percent).²² The question, of course, is whether this large an expansion of bank balance sheets is necessary, and whether it is having unintended effects.

Although the LCR is conceptually sound, in practice it makes assumptions about which liabilities will run, and which assets can be sold, that a TCH study shows have no empirical bases and appear inconsistent with even crisis-era experience.²³ For example, while the LCR assumes that 30 percent of liquidity lines of credit provided to nonfinancial corporations in a future 30-day period of systemic and idiosyncratic stress would be drawn, the highest draw on such lines at large commercial banks (including several that failed or nearly failed) over any month in the financial crisis was 10 percent. While the LCR assumes that 100 percent of the non-operational deposits of financial institutions would be drawn, the worst experience during the crisis was 38 percent.²⁴

These seemingly arcane calibration errors have major real-world consequences. In recent years, U.S. companies of all sizes have complained that standby letters of credit are unavailable, or more expensive and difficult to obtain. A major reason is because banks must assume that in crisis those lines will be drawn in amounts three times greater than even the worst historical experience would indicate, and therefore hold cash or cash-equivalent assets to fund those draws. And, in turn, under the leverage ratio, they must hold significant amounts of capital against those riskless or low-risk assets.

B. Net Stable Funding Ratio

The net stable funding ratio (NSFR) is intended to establish a maximum safe amount of liquidity transformation that a bank can engage in by ensuring that banks have sufficient “sticky” liabilities to fund assets that would be unable to liquidate easily over a one-year horizon. When the NSFR was first proposed by the Basel Committee in 2009, the metric was designed to ensure that a bank with an NSFR greater than 100 percent would be able to weather a one-year episode of idiosyncratic liquidity stress. The NSFR

²² See The Clearing House, *State of American Banking* (2016) at exhibit 3 (updated).

²³ See The Clearing House, *The Basel III Liquidity Framework: Impacts and Recommendations* (Nov. 2, 2011), available at www.theclearinghouse.org/-/media/files/association%20documents/20111102_liquid_liquidity%20coverage%20ratio.pdf.

²⁴ *Id.*

thereby was meant to be a complement to the LCR requirement, which was designed to ensure that a banking organization could weather a shorter (30-day) but more severe period of stress.

In those initial formulations of the NSFR, the “extended stress” was defined by specific characteristics – for example, “a potential downgrade in a debt, counterparty credit or deposit rating by any nationally recognised credit rating organisation.” That benchmark was not included in the final NSFR standard released by the Basel Committee, or in the proposed rule to implement the NSFR in the United States. Nor was any other benchmark included, making it unclear what goal(s) the NSFR is intended to achieve and how it was calibrated.

Moreover, for U.S. banks already subject to the LCR, uniquely stringent liquidity stress testing under the Dodd-Frank Act requirements, a Comprehensive Liquidity Analysis and Review and a U.S.-only short-term-wholesale funding surcharge as part of the GSIB surcharge, it is unclear what additional risk the NSFR would mitigate that is not sufficiently addressed by these requirements.

The NSFR, if implemented, would significantly inhibit economic growth and liquid financial markets due to its flawed design and lack of transparency with respect to its calibration to ensure its efficiency and effectiveness. As demonstrated in our research, *The Net Stable Funding Ratio: Neither Necessary nor Harmless*, over time, the NSFR, if implemented in the United States, could be expected to significantly limit lending and capital markets activity.²⁵ If central bank reserve balances and retail deposits shrink in line with the Fed's forecast for policy normalization, and banks shift their funding toward wholesale deposits in line with historical experience many individual banks would not comply unless they took some compensating action. In particular, we show that the annual growth in bank lending would have to be cut by about 3.5 percentage points, to near zero, even to offset only half of the projected decline in the NSFR.

IV. REFORMING THE BANK LIVING WILL PROCESS

Title I of the Dodd-Frank Act requires each large bank holding company to construct a plan for its rapid and orderly resolution, and requires regulators to review the credibility of that plan.

Regulators have required bank holding companies to file living wills on an annual basis, against ever shifting, often non-public standards, even though the regulators have been generally unable to review them and provide feedback within that timeframe. Recognizing that section 165(d) of the Dodd-Frank Act requires the submission of living wills on a “periodic,” not annual, basis, an appropriate and sensible approach is to

²⁵ See The Clearing House eighteen53 Blog, *The Net Stable Funding Ratio: Neither Necessary nor Harmless* (July 5, 2016), available at www.theclearinghouse.org/eighteen53-blog/2016/july/05-research-note-nsfr.

eliminate the formal requirement for an annual submission in favor of submission cycle that is better tailored to the objectives of the living will process.

The Federal Reserve and FDIC also have required, through the living will process, substantial amounts of liquidity and capital to be pre-positioned – and therefore, trapped – at numerous subsidiaries. The most recent living will guidance issued in April 2016 states that bank holding companies must assume, counterfactually, that a net liquidity surplus in one material entity cannot be transferred to meet liquidity deficits at another material entity (even between branches of the same banking legal entity). Further, the guidance also requires bank holding companies to assume that cash balances held by material entities (including branches of the bank) within their primary nostro accounts with the main bank entity of the firm are unavailable in a stress prior to, and during resolution. The guidance imposes similar requirements with respect to pre-positioning of loss absorbing capital resources at material entities. None of this guidance has been published for notice and comment. Reform here could take the form of a statement that for any firm using the single-point-of-entry resolution strategy and in compliance with the TLAC requirement for holding company loss absorbency, the living will process should not include any incremental liquidity requirement at the operating subsidiary level; for all firms, we would recommend withdrawing the presumption that liquidity cannot be transferred among subsidiaries.

Currently, each federal (and state) banking agency is authorized to impose its own set of recovery and resolution planning requirements on different parts of a banking organization, leading to an unnecessary amount of duplicative and at times contradictory requirements. Many of these requirements were not subject to a rigorous impact analysis, and are not appropriately tailored. This may also reinforce ring fencing of entities as bank regulators focus only on the entities for which they are responsible.

We would recommend eliminating the separate insured depository institution-level resolution and recovery planning regimes.. At a minimum, the agencies should be required to coordinate among themselves to establish a single set of consistent recovery and resolution planning requirements.

V. REFORMING ACTIVITY LIMITATIONS

Post-crisis regulation has included not only capital and liquidity regulation to reduce the risk of bank failure to the taxpayer and the broader system, but also direct limits on bank activities – however well capitalized and funded they are. In some cases, these limits are unjustified.

A. Leveraged Lending

Leveraged lending is an important type of financing for growing companies, which tend to carry a lot of debt. Although these companies therefore represent a greater repayment risk than more established firms, this risk is one that banks have considerable experience managing. Banking organizations have long played a critical role in arranging, originating, and administering funding for leveraged loans as part of their

larger role as credit intermediaries. Following the financial crisis, capital requirements have increased significantly for such loans, as have requirements for modeling their risks.

Nonetheless, the federal banking agencies have issued guidance setting arbitrary limits on such lending, based on no empirical evidence – in particular, any evidence that the capital supporting such activity is somehow inadequate. It is a classic example of bank regulators substituting their judgment for lenders and markets without any meaningful analysis or evidence. For example, regulators require banks, in evaluating whether a company is leveraged for purpose of the new restrictions, to assume that all lines of credit are drawn, and to ignore cash held by the company. As a result, some Fortune 500 companies with investment grade debt are now deemed by the regulators to be highly leveraged, and thus subject to limits on their bank borrowing.

It also appears that this guidance has been supplemented by further direction, from examiners to banks, to limit lending activities in the area – although the precise details of such direction are unknown as they are deemed by the agencies to be “confidential supervisory information,” and therefore immune to public scrutiny.

Of course, these loans are subject to capital requirements, and the regulators have not identified any flaws in those standards (including, in the case of the Federal Reserve, its own CCAR models) that would cause these types of loans to be uniquely undercapitalized. Nor have the agencies presented any data to show that there is an unhealthy concentration of these loans in the banking system. Also, consistent with post-crisis behavior in a range of areas, the banking agencies have implemented these substantial new limits on bank lending through guidance and “frequently asked questions,” rather than formal notice-and-comment rulemaking and regulation. They have nonetheless deemed the guidance binding, and enforced it just as if it were a rule.

As a result of the leveraged lending guidance and examiner pressure, banks have been forced to turn away hundreds of millions, perhaps billions, of dollars of loans to growing businesses. Furthermore, there is scant evidence that leveraged lending guidance and subsequent direction have constrained the risk perceived by the federal banking agencies. Despite any potential concerns regarding poorly underwritten or low-quality loans, a bank-centric approach is simply shifting risk rather than limiting it, and increasing the cost to borrowers, as banks tend to be lower cost providers of credit. Recent research by a team of Federal Reserve Bank of New York economists illustrates that the guidance has had the effect of reducing bank activity in this area, but has also increased nonbank activities, demonstrating limited effectiveness from a macroprudential view.²⁶ Notably, those non-banks do not appear to be experiencing the outsized losses that the bank regulators implicitly predicted in forcing banks to abandon much of this lending.

²⁶ Sooji Kim et al., Liberty Street Economics, *Did the Supervisory Guidance on Leveraged Lending Work?* (May 2016), available at <http://libertystreeteconomics.newyorkfed.org/2016/05/did-the-supervisory-guidance-on-leveraged-lending-work.html>.

We recommend that the guidance be rescinded immediately and in its entirety, which would provide an immediate boost to economic growth as a large number of growing companies once again became eligible for bank credit..

B. The Volcker Rule

Section 619 of the Dodd-Frank Act (commonly referred to as the “Volcker Rule”) generally prohibits U.S. insured depository institutions, U.S. operations of foreign banks and their affiliates from engaging in “proprietary trading” and sponsoring or investing in hedge and private equity funds subject to some limited exceptions, including exceptions for customer-related activities such as market-making. Prior to the enactment of the Volcker Rule, very few of the firms now subject to the Rule engaged in proprietary trading activities. Of those that did, many of them were in the process of divesting or ceasing their proprietary trading activities. Today, trading businesses of covered financial institutions are focused solely on serving client needs and hedging the attendant risk.

The final regulations implementing and interpreting the Volcker Rule are voluminous and complex, contained in 964 pages, including an 893 page preamble. Under these rules, the five U.S. federal financial agencies charged with implementing and enforcing the Volcker Rule have interpreted it in a highly restrictive way, with a broad spectrum of trading activity (i.e., not only short-term, speculative activities that the Volcker Rule was intended to target) presumed to be prohibited proprietary trading unless proven otherwise.

Market-making. Under the rules, a covered banking entity is required to go to extraordinary lengths to prove that its routine market making and underwriting activities (included related hedging) do not constitute “proprietary trading.” The agencies have adopted a broad definition of proprietary trading with strict requirements for permissible activities that could potentially captures legitimate market making in less liquid securities, particularly when markets are under stress and there is less demand. For example, banking organizations are required to strictly limit their inventory to the reasonably expected near-term demand of customers or counterparties. For debt of smaller companies, which may trade only weekly or even monthly (especially during times of stress), banking organizations may be required to unduly limit their positions, thus prohibiting them from taking any action to stabilize markets.

Recent research has begun to bear out longstanding reports from market participants that the regulations that implement the Volcker Rule are inhibiting economic growth and reducing market liquidity by constraining the ability of banking groups to buy, sell and underwrite securities, including corporate bonds that could help finance the operations of corporate customers. A Federal Reserve staff study released in December 2016, *The Volcker Rule and Market-Making in Times of Stress*, finds that the illiquidity of stressed bonds has increased after the Volcker Rule, as dealers regulated by the rule

have decreased their market-making activities.²⁷ Other research indicates that with many brokers constrained in their ability to hold inventory as a result of the Volcker Rule and other post-crisis regulations, the secondary market for smaller issuers' debt has tightened. The impact is that since the enactment of the Dodd-Frank Act in 2010, new debt issuances by smaller firms has generally declined. When lower liquidity puts debt markets out of reach of smaller firms, it impedes their ability and the economy at large to grow.

Notably, Congress specifically exempted market making from the Volcker rule. Fault here thus lies not with the statute but the regime chosen to implement it.

Funds. The Volcker Rule also prohibits banks from engaging in proprietary or speculative trading by investing in private equity or hedge funds, notwithstanding the absence of evidence that such investments contributed to the financial crisis or have otherwise caused outsized losses. While the agencies must implement the statute as Congress has enacted it, they have extended its reach to numerous other types of funds that bear little in relation to either private equity or hedge funds. This has created enormous and unnecessary compliance challenges for institutions with asset management businesses serving customers seeking to save and build wealth, as well as for market making in a number of asset classes, including securitized products, covered bonds and non-U.S. public funds.

More specifically, the regulation's overly broad definitions of "hedge fund" and "private equity fund" (so-called "covered funds" under the regulations) include vehicles that are not traditionally considered to be hedge funds or private equity funds and require extensive analysis and documentation of a banking entity's determination of whether a particular vehicle is a covered fund or qualifies for an exclusion or exemption. Moreover, the Volcker Rule regulations restricts banking entities from engaging in activities that could promote lending, capital formation and job creation, through investing in vehicles such as certain types of credit funds, infrastructure funds, energy funds, real estate funds and REITs. In addition, the Volcker Rule, as implemented, makes it difficult for a bank-owned asset manager to seed and test new asset management strategies for customers as a result of the 3 percent statutory limits on ultimate bank ownership after an initial one-year seeding period, the unduly burdensome process for extending the temporary seeding period, and the lack of clarity on use of bank assets to fund separate account seeding structures under the proprietary trading rules. Making the rule more rational through appropriately tailored definitions of "hedge fund" and "private equity fund" and more reasonable ancillary requirements would lead to more efficient regulations, promote lending, capital formation and job creation, and enhance customer offerings and financing opportunities.

²⁷ See Jack Bao, Maureen O'Hara, and Alex Zhou (2016), The Volcker Rule and Market-Making in Times of Stress, Finance and Economics Discussion Series 2016-102. Washington: Board of Governors of the Federal Reserve System, available at <https://doi.org/10.17016/FEDS.2016.102>.

Asset-liability management. Firms use portfolios of liquid assets to hedge firm-wide risk. These positions are managed by the corporate treasury, not traders in the investment bank; are not short-term trading positions; and are not engaged in to benefit from short-term price movements. Nonetheless, the regulators have imposed the same compliance obligations on this activity.

Enforcement. Five U.S. federal financial agencies are tasked with examining and enforcing compliance with the Volcker Rule, thereby complicating efforts by financial institutions to comply with its requirements on an enterprise-wide basis and to receive interpretive guidance relating to its restrictions.

The whole approach to Volcker Rule compliance differs radically from the standard supervisory paradigm, whereby firms are charged with compliance and subject to enforcement action if they fail to comply. Only with the Volcker Rule have the agencies set themselves on a “pre-crime” mission, performing constant monitoring for compliance.

This “pre-crime” approach is even odder and more unnecessary given a GAO report on proprietary trading during the financial crisis, which demonstrated that proprietary trading was not a cause of the financial crisis.²⁸ Given the idiosyncratic nature of proprietary trading’s losses (and gains), it does not represent a systemic risk, and the prudential risks that both trading and fund activities pose are now subject to significantly higher capital charges under the Basel 2.5 and Basel III reforms. Notwithstanding the relatively low demonstrable risk profile of the activities in question, the regulations have nonetheless implemented a wide-ranging and highly-complex set of requirements that have and will continue to impair markets and slow the real economy. These consequences are only exacerbated by the extra-territorial manner with which the agencies have implemented the Volcker Rule’s restrictions.

Impact on asset-liability management. The risk of proprietary trading in a corporate treasury function, where assets are held in available-for-sale or held-to-maturity accounts, is remote at best. But the Volcker compliance regime is not tailored to the risk that proprietary trading will actually occur, and therefore corporate treasuries face high burdens in defending business-as-usual activity.

Needed reforms. Given the breadth and scope of these problems, the financial regulators should revise their Volcker Rule regulations to establish simpler criteria for identifying what trading and fund activities are impermissible and a simpler and more reasonable process for conducting examinations and issuing interpretive guidance. They should eliminate the regulation’s odd presumption that *all* trading activity is illegal unless it can be proven to supervisory satisfaction, through detailed analysis and continuous monitoring, to meet a laundry list of specific criteria. Proprietary trading can be easily

²⁸ Government Accountability Office, *Proprietary Trading: Regulators Will Need More Comprehensive Information to Fully Monitor Compliance with New Restrictions When Implemented* (July 2011), available at www.gao.gov/assets/330/321014.pdf.

distinguished by just a few key features. These regulatory changes should be complemented with a shift in the compliance regime from real-time enforcement to traditional reliance on bank compliance and internal audit functions, with examiners reviewing their results; specialized compliance program requirements and unnecessary metrics should be eliminated. The result would be a substantial improvement in market liquidity and investment in funds that promote capital formation and job creation.

VI. REFORMING SUPERVISION, EXAMINATION & ENFORCEMENT

We believe that bank supervision (as opposed to regulation) has lost its way post-crisis, and requires a comprehensive reexamination. While the link to economic growth in this area is less direct than in the others cited, it is very real.

In sum, three developments have converged to restrict or even halt the ability of many banks to open branches, invest, or merge to better meet the needs of their customers. First, even as banks have dramatically improved their financial condition by increasing their capital, liquidity, and asset quality positions, supervisors have transformed the supervisory scorecard (the CAMELS rating system) from a measurement of financial condition to a measurement of compliance. Second, supervisors have adopted a series of unwritten rules that produce lower CAMELS ratings. Third, supervisors have adopted another series of unwritten, or in some cases written, rules (albeit none with any basis in statute) that translate those low ratings and other supervisory issues into a bar on expansion. The result is a regime, effectively invented by bank supervisors without notice and comment or Congressional input, that makes an examiner's expectations regarding bank compliance matters a fundamental determinant of whether banks can invest and grow.

For perspective, consider that we routinely see serious compliance violations across a wide range of American industries. Those companies are subjected to enforcement proceedings and are required to pay fines and remediate their practices, but no one ever suggests that while those proceedings are pending they should be stopped from opening new franchises, building new plants, developing new drugs, designing new cars, or launching new apps. Yet somehow we have reached the point in banking where the punishment for a compliance problem routinely includes, in addition to a vast array of civil and criminal liabilities imposed by a wide array of federal and state authorities (often by multiple authorities for the same underlying conduct), a prohibition on any type of expansion by the bank. The opportunity lost is not just for the bank but for its customers, and ultimately an economy that relies on its banking system for financing.

Of course, banking is different in the sense that bank deposits are insured by the FDIC. But that gives government a special interest in the *financial condition* of banks. As a result, Congress has in limited instances linked expansion to financial condition. As we will see, though, financial condition is no longer what banks are being graded on, and the penalties for a bad grade now vastly exceed what Congress has authorized.

Another result is simply a massive cost, which must be passed along to consumers, as described in M&T Bank's most recent annual report message to shareholders:

At M&T, our own estimated cost of complying with regulation has increased from \$90 million in 2010 to \$440 million in 2016, representing nearly 15% of our total operating expenses. These monetary costs are exacerbated by the toll they take on our human capital. Hundreds of M&T colleagues have logged tens of thousands of hours navigating an ever more entangled web of concurrent examinations from an expanding roster of regulators. During 2016 alone, M&T faced 27 different examinations from six regulatory agencies. Examinations were ongoing during 50 of the 52 weeks of the year, with as many as six exams occurring simultaneously. In advance of these reviews, M&T received more than 1,200 distinct requests for information, and provided more than 225,000 pages of documentation in response. The onsite visits themselves were accompanied by an additional, often duplicative, 2,500 requests that required more than 100,000 pages to fulfill—a level of industry that, beyond being exhausting, inhibits our ability to invest in our franchise and meet the needs of our customers.²⁹

A. CAMELS Ratings

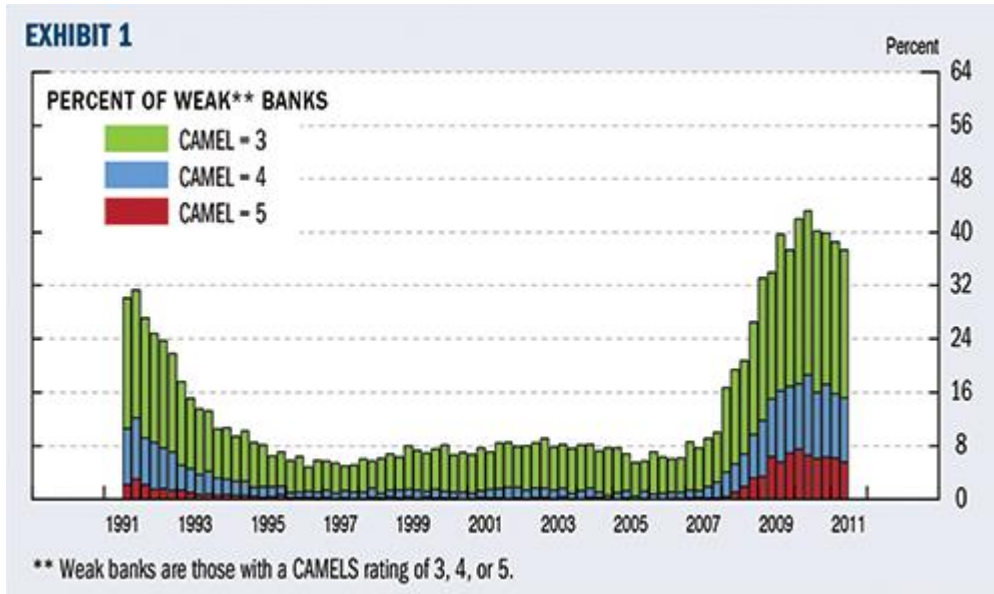
The centerpiece of bank supervision is the CAMELS rating system. It was created by examiners in 1979 as a scorecard to evaluate an institution’s “financial condition and operations” – in other words, its safety and soundness. (Interestingly, the creation of the CAMELS system was not specifically mandated by any statute or regulation.) The CAMELS system evaluates a bank across six categories – Capital, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk, especially interest rate risk – and assigns a composite rating, all on a scale of 1 (best) to 5. With the sole exception of a few small changes in 1996 (most notably, the addition of the “S” component), the CAMELS standards have not been materially updated in the almost 40 years since their adoption – not after adoption of the original Basel Accord on capital in 1988, the Basel III regime in 2010, the Comprehensive Liquidity Analysis and Review in 2012, or the Liquidity Coverage Ratio in 2014.

The result is a system that is hopelessly out of date. Detailed capital, liquidity, and other rules have been expressly designed and carefully calibrated to evaluate the key components of the CAMELS ratings: capital, liquidity, and, less obviously, earnings and asset quality, which are now evaluated through stress testing for certain banks. Thus, for example, the published standards that examiners apply in deciding the capital component of the rating do not include consideration of any post-1978 regulatory capital standards – or any market indicators, which also have grown in sophistication over the past 40 years. There is no mention of CCAR, the self-described *Comprehensive Capital Analysis and Review*. Rather, the published standards speak vaguely of factors like “the ability of management to address emerging needs for additional capital.” This is not to say that there cannot be cases where a bank that is deemed well-capitalized under the current 35-

²⁹ M&T Bank Chief Executive Office Robert G. Wilmers, *2016 Annual Report Message to Shareholders* (Mar. 9, 2017), available at <https://newsroom.mtb.com/document-archive/annual-report-letters/2016-annual-report-message-to-shareholders.htm>.

plus different capital tests could not, in theory, still require more capital. It is, however, pretty unlikely.

It is worth examining the predictive ability of CAMELS ratings. Consider the number of banks rated as weak (CAMELS 3, 4, or 5 in Exhibit 1).



This chart seems to demonstrate little predictive ability for CAMELS ratings, even when they were focused on financial condition. In 2007, a small percentage was rated as weak, but hundreds failed.

Changing the subject: The move from financial condition to compliance. The appropriate response to the diminished value of CAMELS as a measure of financial condition would have been to decrease its importance in the supervisory process or incorporate better measures of financial condition. To their credit, the Federal Reserve and other banking agencies adopted several crucial post-crisis reforms to improve bank resiliency: most notably, CCAR stress testing, Basel III, and the LCR. However, exactly because more objective, analytically sound standards have overtaken the CAMELS system as a gauge of financial condition, examiners have shifted their emphasis to the one entirely subjective component: management. And not management as viewed through the lens of maintaining sound financial condition, but rather through the lens of “compliance” – not just with laws, but with examiner guidance and criticisms too.

Various “unwritten rules” reportedly have been adopted as part of this shift:

- All components do not count equally toward the composite rating; the management rating counts the most, and it increasingly appears that the composite rating cannot be higher than the management rating. This elevation of management as the “super component” has never been subject to public comment. A 1996 update to the CAMELS standards stated that “the

management component is given special consideration when assigning a composite rating.” Over time, it has become the dominant consideration.

- The management rating does not depend primarily on the financial condition of the bank (because, if it did, it would track the other ratings), but rather on compliance with banking agency rules and guidance. In practice, any compliance problem resulting in enforcement action or penalty, regardless of its materiality, can result in a downgrade of management; so, too, can unresolved “Matters Requiring Attention” (a confidential examiner criticism).
- Management ratings increasingly are driven by the results of a consumer compliance rating that was adopted as an independent evaluation.

Thus, the examination system has changed from primarily an evaluation of the safety and soundness of an institution to, increasingly, an evaluation of routine compliance matters and the readiness with which management accedes to examiner criticism. And this change has been accompanied by a substantial increase in the consequences of a low rating, with supervisors raising the stakes dramatically. While compliance matters are important, they are not uniquely and exclusively important, and should not pollute a system designed for an altogether different, and vital, safety and soundness purpose.

Consequences. Bankers now routinely refer to being in the “penalty box,” where they cannot expand through investment, merger, or adding a branch. Mid-size and regional banks are particularly affected. There are various ways into the penalty box:

- As described above, a “3” rating for management operates as a halt on expansion. Under section 4(k) of the Bank Holding Company Act, a financial holding company whose bank receives a “3” rating for management must receive Federal Reserve approval to expand certain non-banking activities. Regulators now extend that to almost any type of expansion, or at least to any expedited review of branching or other applications.
- Any AML consent order operates as a multiyear ban on expansion for any purpose, regardless of the seriousness of the conduct motivating the order or the progress made by the firm in remediating it. While consent orders bring to mind large banks in highly publicized cases, small and midsized banks routinely receive such orders.
- A “Needs Improvement” CRA rating also operates as a multiyear ban, regardless of what triggered it or how it is being remediated. While some statutes governing expansion require an assessment of management (for example, the Bank Holding Company Act, governing bank acquisitions), many do not. And of those that do, each speak in particular to “management resources” – presumably, the ability of management to oversee an integration – and not compliance issues. Large banks have sufficient resources to remediate problems in one area while expanding in another area – for

example, to remediate an AML issue at an overseas subsidiary while opening a new branch in the Midwest United States.

The results of this new supervisory regime are significant:

- Many banks -- of all sizes, but particularly midsized banks -- have been blocked from branching, investing, or merging to meet their customers' needs.
- Bank technology budgets often are devoted primarily not to innovation but to redressing frequently immaterial compliance concerns.
- Board and management time is diverted from strategy or real risk management and instead spent remediating frequently immaterial compliance concerns and engaging in frequent meetings with examiners to ensure that they are fully satisfied. Numerous banks report that their boards now spend a majority of their time on regulation and compliance.

Of course, for examiners interested in having their compliance criticisms acknowledged and immediately remediated, this system works well. But as we note, it is not a tool that regulators in any other industry feel they need, and it has important economic consequences.

Recommendations. A few core reforms are necessary. The first is an unequivocal statement that the purpose of a CAMELS rating is to assess the financial condition of the bank from the perspective of its potential risk to the Deposit Insurance Fund. The second is the withdrawal of the Federal Reserve's SR Letter 14-02 and all other restrictions on bank expansion that do not have a basis in statute or a regulation adopted pursuant to the Administrative Procedure Act. The third is a complete overhaul of the CAMELS regime (including its potential replacement) that emphasizes clear, cogent, and objective measures of financial condition over vague, arbitrary, and subjective ones.

B. Tailoring of Enhanced Prudential Standards

As we have described above, post-crisis regulatory reforms have established a myriad of new prudential requirements for banking organizations. The scope of application varies by requirement, but in many cases new regulations have been applied in a uniform fashion to large and diverse cohorts of banks of differing sizes, business models and risk profiles. For example, the Federal Reserve has implemented a number of so-called "enhanced prudential standards" under section 165 of the Dodd-Frank Act (including capital, liquidity, and other requirements) on the basis of asset size thresholds.

While the Federal Reserve has made some effort to tailor its enhanced prudential standards (e.g., by providing for a modified LCR for some firms and recently eliminating the CCAR qualitative assessment for others), it has generally done so based on arbitrary size thresholds rather than careful consideration of the scope and type of regulation warranted by different business models, risk profiles and other more meaningful criteria. And in many cases, the Federal Reserve has established one-size-fits-all rules that are not tailored at all. The result is insufficiently tailored regulatory regime for many banks that imposes unnecessary burdens and unduly limits their ability to lend to and otherwise

support businesses and consumers. There is therefore a clear need to review all enhanced prudential standards established under section 165 of the Dodd-Frank Act in order to identify and implement more appropriate and robust tailoring of their scope and extent of application; doing so would better enable banks unduly and unnecessarily burdened by the current regime to lend and otherwise serve customers and the economy.

C. Regulation of Foreign Banking Organizations

Generally outside the notice of policymakers, foreign bank operations in the United States have decreased somewhat in recent years.

Certainly, one cause of this retrenchment has been a delay in foreign banks' recapitalization post-crisis, global economic instability, and a general need to reduce balance sheet size. However, U.S. requirements have been another key driver, as recent years have also seen extensive revision to the rules and regulations governing foreign banking organizations (FBOs) that have U.S. operations. In particular, the Federal Reserve has required that, on the basis of asset size thresholds, many FBOs operating in the United States establish intermediate holding companies (IHCs) through which their U.S. activities must be operated and managed. These IHCs in turn are now subject to a wide range of new prudential requirements, including capital, liquidity, stress-testing, resolution planning and other rules. The resulting regime is one that is simply not appropriately tailored to the varying sizes, business models, and risk profiles of different types of FBOs and the inherently sub-consolidated nature of their U.S. operations.

For example, the stand-alone capital and liquidity requirements applied to the U.S. IHC of an FBO effectively hinder the foreign parent's ability to allocate capital and liquidity across its entire global business. All internationally active banks (whether foreign or domestic) manage their capital and liquidity on a consolidated, global basis, oftentimes acting nimbly to allocate financial resources to geographic locations or business operations where it is needed in a time of stress. Stand-alone U.S. capital and liquidity requirements effectively trap those resources in the FBO's U.S. IHC, making them unavailable for use elsewhere. The U.S. regime, which also mandates stress testing at the IHCs, ignores (and duplicates) similar consolidated requirements imposed on the FBOs by their home country authorities. And of course, for the various U.S. capital and liquidity rules that are applied to the U.S. IHC of FBOs, the general concerns and recommendations that we have highlighted earlier in this paper are just as relevant, and apply equally.

On top of these capital, liquidity and stress test requirements, the Federal Reserve also has required foreign GSIBs to "pre-position" extraordinarily high amounts of internal TLAC. This stands in contrast to the process described in the FSB's term sheet on TLAC, which the Federal Reserve developed in coordination with foreign supervisors; that process identifies a range of potential internal TLAC requirements, with the precise requirement to be established on an institution-specific basis through collective dialogue among that institution's home and host country supervisors. Instead, the Federal Reserve imposed internal TLAC requirements at the top end of the FSB range, unilaterally. Here, too, the result is insufficiently tailored regulatory regime for many FBOs that imposes

unnecessary burdens and unduly limits their ability to lend to and otherwise support businesses and consumers.

VII. CONCLUSION

Our banking system now stands on a solid foundation of capital and liquidity. That foundation affords us the opportunity to consider whether particular components of the regulatory and supervisory regime are unnecessary, duplicative or more stringent than necessary to achieve safety and soundness and financial stability goals. Considerable economic benefits can be achieved through such a reexamination.