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March 5, 2018

Honorable Michael Crapo
Chairman
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, D.C. 20510

Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing & Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Chairman Crapo and Senator Brown:

As we approach the tenth anniversary of the height of the financial crisis, it is critical that we not lose sight of the core concerns that rightly motivated members of both parties to seek regulatory mechanisms to guard against systemic risk and to promote financial stability. With the pending consideration of S. 2155 by the full Senate, I wanted to take this opportunity to reiterate some of the points about the regulatory structure we have discussed in the past, especially as they apply to this bill.

While S. 2155 begins from the sound premise that some refinements are desirable in the way various statutory requirements have been tailored, I have a number of disagreements with specifics of the bill. Rather than rehearse all of those, I want to focus on the three features that raise particular concerns about financial stability, in hopes that they could be omitted or at least clarified. As I will explain in more detail below, I would urge the following changes:

1. Clarification that banking organizations with assets between $100 and $250 billion will continue to be subject to the annual stress test and CCAR process of the Federal Reserve;
2. Clarification that the higher section 165 threshold established by the bill applies to the worldwide assets of foreign banking organizations; and
3. Deletion of Section 402 of the bill, which would make certain changes to leverage ratio requirements.

With respect to the first two of these changes, while there is widespread – though by no means universal – agreement that the $50 billion level is too low a threshold for many of the section 165 requirements, there is considerable disagreement over how much it should be raised. There is a case to be made for the $250 billion level chosen in S. 2155, though personally I think that is too high. In considering how to raise the threshold, the most important consideration is to align enhanced prudential standards with the risks to safety and soundness and financial stability actually associated with various groups of banks.

As you know, I have for several years advocated a limited number of changes to the statutory thresholds established in the Dodd-Frank Act for certain additional regulatory requirements. My reason for suggesting these changes was my conclusion, both from my own analysis and from discussions with supervisory staff when I was still a member of the Board of Governors of the Federal Reserve, that the benefits of some of the important prudential requirements added by Dodd-Frank were considerably less significant for the smaller banks within the range established by the different thresholds. In these instances, it seems better policy to allocate more of the risk management and compliance resources of banks, and of the supervisory resources of the banking agencies, to the important risks actually faced by banks of a certain size and activity mix. For instance, the expense incurred by small banks with minimal trading assets and liabilities just to ensure that they are complying with Volcker Rule regulatory exemptions seems quite disproportionate to any safety and soundness benefits.

When it comes to the threshold for the more stringent prudential standards mandated by Section 165 of Dodd-Frank, this same calculation should apply. That is, which of these requirements deliver significant safety and soundness benefits for particular sizes of banks? The answer, I concluded after several years of experience, is that the 165 requirements deliver relatively small benefits for the safety and soundness of banks that currently have between $50 and $100 billion in assets, and many deliver only moderate benefits for banks somewhat above that size. For example, special liquidity requirements (on top of normal supervisory assessments of liquidity management) seemed of limited prudential utility for medium-sized commercial banks engaged in the conventional business of taking deposits and making loans.

But S. 2155 calls into question the post-crisis prudential measure that *is* essential for the safety and soundness of these banks, and for the stability of the financial system in the face of major asset shocks. Section 401(e) of the bill as reported out of Committee instructs the Federal Reserve to conduct supervisory stress tests of banks with between $100 and $250 billion "on a periodic basis." This provision is obviously meant to indicate that these banks are not exempted from the stress testing requirements created by Section 165. Yet the provision is quite vague, with little indication of what kind of test is contemplated for these banks. This language might be interpreted benignly, simply to indicate that this set of banks will remain in the stress testing program even though they will have been removed from other section 165 requirements. Of more concern is an interpretation that these banks not be in the stress test every year, though the results of the test – whenever it *is* conducted -- could still be used as the analytic basis for the general authority of federal banking agencies to set capital requirements on a bank specific basis. And then there is a very troublesome interpretation that these banks not be in the current Federal Reserve stress testing process, including the Comprehensive Capital Annual Review (CCAR). Instead, they would be in some different, ill-defined kind of stress testing program.

Although liquidity and concentration limits beyond those applicable under pre-existing statutory requirements for insured depository institutions are only obliquely related to the risks faced by banks currently in this size range, capital shortfalls *are* a risk. Loans gone bad, with the resulting impairment of capital positions, are the principal risk associated with the traditional lending that dominates the activities of most of these banks.

A number of banks of this size received TARP funds in late 2008 in order to buttress their capital positions. While other, smaller banks also received TARP funds, the difference is precisely in the aggregate size of this group of banks. Together, just the domestically owned firms falling in this range hold $1.5 *trillion* in assets (compared to less than $300 billion in assets for those between $50 and $100 billion). There is good reason to believe that these regional

lending institutions share the risks associated with shocks to commercial real estate prices, residential real estate prices, and the financial situation of consumers. Thus there could also be systemic implications of stress among this group of banks. The current CCAR program of the Federal Reserve helps build the resiliency of banks to these serious problems, thereby decreasing the chances of systemic stress or the unavailability of lending to even creditworthy businesses and households that results when the capital positions of banks are compromised.

To remove this protective measure would be to undermine a key achievement of the post-crisis period. Accordingly, as the ***first feature of the bill that should be changed,*** I urge the Senate, should it proceed with this legislation, to remove any ambiguity as to whether these banks will remain in the quantitative side of the CCAR program on an annual basis. The Federal Reserve has already exempted these banks from the qualitative part of the CCAR and has taken steps to simplify some of the procedural and reporting requirements associated with it. I suspect the Board of Governors would be amenable to doing more along these lines. But we should not risk the improvement in the resiliency of the U.S. financial system that the stress testing program has brought about by ensuring that regulatory capital requirements take into account the changing economic and financial risks faced by sizeable banks that together provide credit to large proportions of American households and businesses.

The ***second*** feature of the bill that raises concerns of a systemic nature is also related to the $250 billion threshold, as it applies to foreign banking organizations operating in the United States. As you know, since the financial crisis the Board of Governors has required certain foreign banking organizations with more than $50 billion in assets other than branch assets to establish intermediate holding companies in the United States. (Some foreign banking organizations already had such holding companies.) In raising the $50 billion threshold to $250 billion, the bill may raise the question as to whether foreign banking organizations with less than $250 billion must now be excluded from the application of section 165 requirements.

I should say first that I do not think this is the best reading of the wording of S. 2155. That is, I think the best reading is that worldwide assets of large foreign banks are be the basis for determining if they are covered by section 165, with the Board of Governors having continuing authority to determine what level of *U.S. assets* of these large global banks is the appropriate threshold for section 165 regulatory measures promulgated in its regulations. I understand that Chairman Powell indicated something along these lines in his Senate testimony last week. However, it does appear that there are other interpretations being advanced, including by Secretary Mnuchin, whose testimony before the Senate Banking Committee in January seemed to suggest that foreign banking organizations with between $50 and $250 billion in assets in the United States would be exempted from Section 165 prudential measures by S. 2155.

This result would be a grave regulatory mistake, one that is almost incomprehensible in light of experience during the financial crisis and the profile of many large foreign banking organizations in the United States today. As I explained above, many of the special section 165 requirements are not especially relevant to nearly all the U.S. banks currently holding less than $250 billion in assets. But that is precisely because they are traditional commercial banks, taking deposits and making loans. The U.S. operations of many foreign banking organizations, on the other hand, contain substantial proportions of assets in broker dealers and other non-traditional-banking operations, where funding runs, cross-activity counterparty exposures, and resolution challenges are very significant risks. Indeed, the broker-dealer operations of many of these banks are more significant in the United States than in their home countries. They are also

susceptible to having their parents seek dollars from them in order to meet obligations of parts of the foreign banking organizations outside the United States.

Moreover, in sheer dollar terms, the group of foreign banking organizations with between $100 and $250 billion is a very important part of the U.S. financial system, holding about $1.4 *trillion* in assets. Some of the foreign banking organizations falling in this category are among those that were most affected by the financial crisis; some have encountered significant problems since then. U.S. regulators do not have a window into the global liquidity positions, or authority over the global risk management practices, of these firms.

Again, like Chairman Powell I believe the best reading of S. 2155 is that it does not affect the authority of the Federal Reserve to apply section 165 standards, as appropriate, on foreign banking organizations with over $250 billion in worldwide assets -- the change from current law being that it would not be required to do so for foreign banking organizations with between $50 and $250 billion in worldwide assets. But, given the enormous gap in the regulation of systemically important foreign banking operations in the United States that would result from a different interpretation by a regulator or court in the future, it is very important that this ambiguity be clarified. In an environment in which judicial deference to the interpretation of a possibly ambiguous statute by the administering agency is no longer so predictable, it is incumbent on Congress to eliminate such ambiguity wherever possible.

The ***third feature*** of the bill that raises potentially systemic concerns is section 402, which contains an oddly and, I think, inappropriately targeted change in the leverage ratio applied by the banking agencies. Removing funds deposited with central banks from the denominator of the leverage ratio only for banks "predominantly engaged" in the custody business is troublesome for at least two reasons.

First, removing any assets from the denominator risks sliding down the slippery slope of removing others. While central bankers may argue their interests in not having monetary policy affected at all, treasuries and finance ministries may then argue their interests in not having sovereign debt included. And, as we have already seen in the Treasury Department's report in June 2017, some will go even further, such as by arguing that margins posted in central clearing facilities should be excluded, presumably to encourage more central clearing. While these proposed exclusions may be justified on the ground that the assets in question are utterly risk-free (a clearly incorrect proposition for central clearing margin), that argument misconstrues the rationale of a leverage ratio, which is precisely to serve as a backup mode of capital regulation by measuring and controlling *total leverage,* not riskiness. Going down this path of excluding assets from the denominator would, in addition to being ill-advised legislative policy, threaten the post-crisis improvement in the leverage of major U.S. banks.

Second, it is hard to see the rationale for excluding a particular type of asset from the denominator of the leverage ratio only by reference to a bank's dominant form of activity in "custody, safekeeping, and asset servicing." Banks other than custody banks engage in this activity. Taking this kind of approach is very much out of keeping with the traditional – and wise – practice of Congress in avoiding legislating the details of capital requirements. It will invite lobbying efforts for changing other details and, thereby, risk both the coherence and the integrity of regulatory capital requirements.

As I think you know, I am sympathetic to the situation of State Street and Bank of New York. But, as I have suggested previously, there is a much sounder way to address that situation.

Their difficulties stem from the fact that the 2% enhanced supplemental leverage ratio add-on is applicable to all eight systemically important U.S. banks, whereas the risk-weighted capital surcharge varies based on the systemic importance of each bank. Thus State Street and Bank of New York have, in effect, higher leverage ratio "surcharges" than they do risk-weighted surcharges. This reverses what should be, and has been, the traditional role of the leverage ratio as a back-up to guard against excessive leverage build up in good economic times that can come to grief in bad ones (though the crisis revealed the pre-crisis leverage ratio requirement, like risk-weighted capital requirements, to be insufficiently robust). Modifying the enhanced supplemental leverage ratio requirement by stipulating that it would not exceed the risk-weighted surcharge, or by making it proportional to that surcharge would be a much more defensible policy approach.

My understanding, based on public statements from Federal Reserve officials, is that the banking agencies are planning to make changes to the leverage ratio. I anticipate that those changes will relieve the State Street and Bank of New York situations, though I hope without going so far as to erode the value of the leverage ratio more generally by encouraging the untrammeled growth of repo and other short-term, runnable funding back closer to pre-crisis levels. In any case, this anticipated action by the regulatory agencies should address the situation of the clearings banks without the damage to the framework for capital regulation which that Section 402 would entail.

To recapitulate: In the interests of protecting financial stability and guarding against systemic risk, I would urge the Senate to:

1. Make clear that banks with between $100 and $250 billion in assets will continue to subject to CCAR stress testing and resulting capital distribution constraints;
2. Make clear that foreign banking organizations with $250 billion or more in worldwide assets are subject to more stringent prudential restraints within the discretion of the Board of Governors; and
3. Remove Section 402.

Thank you for your consideration of these admittedly lengthy comments on S. 2155. As always, please let me know if I can be of any further assistance.

Sincerely,

Daniel K. Tarullo