AFR Americans for Financial Reform

Education Fund

TESTIMONY TO HOUSE FINANCIAL SERVICES COMMITTEE

Subcommittee on Financial Institutions And Consumer Credit

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Chairman Luetkemeyer, Ranking Member Clay, and members of the subcommittee, thank you for the opportunity to testify before you today on behalf of Americans for Financial Reform. AFR is a coalition of more than 200 national, state and local organizations who have come together to advocate for stronger and more effective oversight of the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, and faith based groups.[1]

Today's hearing examines capital regimes for financial institutions. It takes place against the background of a relentless lobbying effort by major banks to lower capital requirements. Since bank capital is a fairly technical issue to start with, and much bank lobbying takes place in regulatory back rooms, it is easy to miss the full scope of this effort. But it is impressive to say the least. Large banks are lobbying to weaken stress testing, reduce leverage capital and risk-based capital add-ons for the largest systemically significant banks, cut capital requirements for cleared derivatives almost to zero, weaken the capital regime for dozens of banks between $100 and $250 billion in size using the implementation of the recent Economic Growth, Regulatory Reform and Consumer Protection Act (EGRRCPA), and more. These efforts are reflected both in appeals to regulators and in numerous bills that have come before this committee.

Many of these efforts are already meeting with success, as we can see in recent regulatory proposals to slash the supplementary leverage ratio for large banks and to weaken stress testing requirements. If this pattern continues, it will represent a very substantial weakening of a post-crisis capital regime that many experts across the political spectrum believe is already dangerously inadequate.

Below, I offer some additional comments on current bank capital controversies and lobbying. But it's worth first taking a moment to consider why this effort is taking place. Why are banks so eager to reduce capital requirements?

It's not because the banking sector is doing badly economically. The FDIC recently reported that, aided by large tax cuts, commercial banks earned a remarkable $55.9 billion in profits in the first quarter of 2018, shattering previous records. Over 96 percent of banks were profitable. This

[1] A list of AFR members is available at http://ourfinancialsecurity.org/about/our-coalition/

follows five consecutive years of record and near-record profits. Between 2012 and 2017 the annual profits of commercial banks ranged from $150 to $170 billion, comparable in real terms with the record profits earned in the banking boom just before the 2008 financial crisis.

It's not because banks can't lend. Since the passage of the Dodd-Frank Act in the third quarter of 2010, total economic output (GDP) has grown by 33 percent, but total commercial bank loan portfolios have grown by 39 percent and bank business lending books have grown by a remarkable 79 percent. Commercial banks have added an additional $1 trillion to their business loan portfolios over the years in which Dodd-Frank was implemented, representing a real annual growth rate in business lending far higher than the pre-Dodd Frank growth rate.[2]

To understand why slashing equity capital requirements is such a consistently high priority for banks, we need to take a brief detour into what bank capital is and what it does.

As in other industries, bank equity capital represents the private assets of the private owners (shareholders) of the bank that are held at risk in the organization, in excess of the liabilities the bank owes to others. But unlike other industries, banks enjoy the unique benefit of large-scale public backing for their liabilities. Bank retail deposits (debt owed to depositors) are directly insured by the Federal government.[3] The experience of the 2008 financial crisis, along with the continued availability under the Dodd-Frank Act of various forms of emergency assistance to the financial sector, demonstrates that non-deposit liabilities of the nation's largest and most systemically significant banks may also receive public backing. Since a bank becomes insolvent once shareholders' equity is exhausted, bank capital can be understood as the layer of private sector funding that protects the public from another taxpayer bailout of banks.

The public backing for their debt liabilities, along with the unique money-like character of bank liabilities, means that banks are able to borrow far more than other companies relative to the private equity stake of their owners. As noted in the statement submitted by Professors Cechetti and Schoenholtz for today's hearing, the market typically allows non-financial corporations to borrow less than $1.50 per dollar of private equity. In contrast, large banks in the U.S. today borrow close to $14 per dollar of equity invested by the firm's owners. This is significantly more than even aggressive non-bank financial firms such as smaller hedge funds, which clearly do not

[2] Based on AFR calculations using the data from Q1 1973 to Q1 2018, sourced from the following data series available from the St. Louis Federal Reserve: Commercial and Industrial Loans, All Commercial Banks (https://fred.stlouisfed.org/series/BUSLOANS), Loans and Leases in Bank Credit, All Commercial Banks (https://fred.stlouisfed.org/series/TOTLL), and Gross Domestic Product (https://fred.stlouisfed.org/series/GDP).
[3] A nominal premium is paid for this insurance but it is far lower than the amount that would be needed to properly compensate the public for the relevant risk. See e.g. Acharya https://voxeu.org/article/systemic-risk-and-deposit-insurance-premiums

have either official or implicit public backing for their liabilities. Typically such smaller hedge funds borrow $5 or less per dollar of equity.[4]

One would think that as a matter of ideological principle supporters of capitalism and free markets would favor high levels of private equity investment in large banks. Capital is after all essential to capitalism. The only reason that bank shareholders can get away with holding very low levels of their own capital relative to the firm's debt is the various government guarantees provided by the public. Before the existence of Federal deposit insurance and the Federal Reserve, banks held much higher levels of private equity capital than they do now, levels more comparable to what hedge funds hold today.[5]

However, in Washington ideological principle often comes in a distant second to economic interests. And bank insiders have a very large economic interest in reducing mandatory bank capital. A public backstop for bank borrowing combined with low levels of capital is a great deal economically for big bank shareholders, including top bank executives who are paid in stock. In practice, every dollar of reduction in mandatory capital requirements is a dollar that can be paid out to shareholders in the form of dividends or stock buybacks. Since shareholder equity is the private funding that stands between the public and another government bailout of banks, this represents an implicit transfer of wealth from the general public to the financial insiders who hold major ownership stakes in banks.

Not only is this unfair, but the incentive effects of such capital reductions can be extremely dangerous. Given the economic centrality of banks and their support through the public safety net, equity holders are in a position to take the profit upside from risk while imposing many of the losses on taxpayers and society at large through the economic fallout from the failure of a large bank. The less of their own capital bank owners are required to invest in order to claim the profits of the bank, the more extreme these lopsided incentives become and the greater the incentive to take irresponsible risks. The moral hazard issue becomes particularly dangerous when a bank is in imminent danger of failure. When a highly leveraged bank experiences significant losses, profits must be very large in order to accrue to equity shareholders rather than creditors. In such a case equity holders may favor outright gambles that are harmful to other stakeholders in the bank.

[4] See Form PF private fund statistics available from the Securities and Exchange Commission at https://www.sec.gov/divisions/investment/private-funds-statistics.shtml . These are averages and a few highly leveraged hedge funds do come closer to typical bank levels of leverage

[5] Lawmakers also supplemented these high capital levels with a regime of double liability for bank shareholders, which made them liable for twice their capital stake in case of a bank failure. This provided additional private sector protection against bank abuse of their central role in the economy. Double liability was phased out as public support for the banking sector grew. Macey and Miller, 1992. http://digitalcommons.law.yale.edu/fss_papers/1642/

General Bank Arguments for Lowering Capital Levels

Bank shareholders are not disposed to directly argue their economic interest in lower capital requirements. Instead, they typically deploy a number of more facially acceptable arguments.

One such tactic is a kind of "argument by metaphor" which depicts bank capital as somehow economically inactive. For example, some have recently become fond of the phrase "trapped capital", claiming that regulatory capital requirements "trap" capital in the financial system that could instead be "deployed to the economy". These kind of metaphors are wildly misleading. Capital directly supports lending – it is the very opposite of economically inactive or "trapped". Banks have a profit incentive to deploy every dollar of capital they have to support economic activity. When banks cease to have capital they become insolvent and therefore cannot lend at all. The point of regulatory capital requirements is precisely to ensure that in the event of a downturn in which banks experience unexpected losses, they will still have adequate capital to continue lending. As Professors Cechetti and Schoenholtz emphasize in their statement, the evidence clearly shows that when banking systems are better capitalized going into a downturn, they are better able to support lending growth.[6]

Another argument is that higher bank capital increases the costs of lending since the greater returns demanded by equity holders as opposed to the cost of raising funds through borrowing must be passed on to bank customers. By inserting assumed increases in the cost of lending into macroeconomic models, advocates of lower bank capital generate large estimates of the supposed economic costs of capital.

This argument is also flawed in that it ignores a number of critical additional factors:

- First, regulators and analysts already take into account the potential for an increase in the cost of lending due to capital in setting their capital requirements. Extensive modeling by the Basel Committee found that these costs were much lower than the economic benefits of increased capital in preventing financial crises and bank failure.[7] Other recent studies that incorporate the cost of lending have found that current capital requirements are likely below the economically optimal level.[8]

[6] See Cecchetti, Stephen G. and Kermit L. Schoenholtz, "Better capitalized banks lend more and lend better," www.moneyandbanking.com, December 5, 2016.
[7] https://www.bis.org/publ/bcbs173.pdf
[8] Firestone, Simon, Amy Lorenc, and Ben Ranish (2017), "An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the U.S.", Finance and Economics Discussion Series 2017-034. Washington: Board of Governors of the Federal Reserve System, https://doi.org/10.17016/FEDS.2017.034; Passmore, Wayne, and Alexander H. von Hafften (2017). "Are Basel's Capital Surcharges for Global Systemically Important Banks Too Small?," Finance and Economics Discussion Series 2017-021. Washington: Board of Governors of the Federal Reserve System, https://doi.org/10.17016/FEDS.2017.021

- Second, any increase in lending costs due to bank capital at a point in time must be balanced against the fact that better capitalized lending is more sustainable through the economic cycle. Even if a mandate for higher capital during an economic boom leads to some increase in the cost of lending during good economic times, it will make lending cheaper during an economic downturn by ensuring that banks are still solvent and able to lend.

- Third, it is questionable whether increases in mandated capital lead to significant general increases in lending costs at all. Interest rates in the economy are mostly determined by Federal Reserve monetary policy. When the Federal Reserve determines to keep interest costs low it is generally able to do so regardless of bank capital mandates. We have seen this over the period following the financial crisis, which saw record low interest rates despite increases in bank capital requirements. And in the current economic environment, if lowering bank capital requirements did lead banks to cut interest rates, the Federal Reserve would likely counteract this by increasing interest rates in accordance with its preferred monetary policy.

Bank lobbyists are free to plug any estimate of lending cost increases into models of the effect of bank capital, while ignoring the positive effects of bank capital in sustaining lending during a future economic downturn. Inflated estimates can easily generate frightening figures for the economic costs of capital requirements. But those figures are only as good as the assumptions that drive them.

Another argument for lowering bank capital standards in the U.S. is that our prudential standards exceed the prudential standards for European banks. But prudential standards are lower in Europe because the European banking system is in far worse shape than the U.S. banking system. Replicating the prudential decisions that led to the current weak state of European banking is clearly not in the interests of Americans who want to rely on a sound and healthy financial system. After the financial crisis, European regulators did not act as forcefully as U.S. regulators to strengthen oversight of their banks, because European banks were in a weaker position and were far more vulnerable to the European sovereign debt crisis that followed the global financial crisis. Today the European banking system is far weaker than the U.S. system, with banks less profitable and much greater fears of a potential banking crisis.[9] The rate of non-performing assets in European banks is triple the rate for U.S. banks.[10] The greater degree of safety and soundness of American banks – including their higher levels of capital – should be understood as a competitive advantage, not a disadvantage.

[9] The Economist, "American Banks Have Recovered Well, Many European Banks Much Less So", Economist Special Report, May 6, 2017; available at https://econ.st/2sek3hJ ; Davies, Paul, "Europe's Investment Banks Suffer America Envy", Wall Street Journal, July 28, 2017. Available at https://on.wsj.com/2uD1HJa

[10] Wackerbeck, Phillip, Benjamin Baur and Thornton Wegner, "The 1 Trillion Euro Challenge to European Banking", Price Waterhouse Coopers, November 8, 2017. Available at https://pwc.to/2mkD5Rz

Specific Controversies in Bank Regulatory Capital

Beyond these general arguments for lower capital, there are a host of specific controversies related to bank capital. Since banks have no incentive to point out cases in which regulators do not mandate enough capital relative to risks, these controversies almost invariably concern claims that regulators require too much capital relative to bank risk. Lowering capital through a host of specific challenges to particular rules has the advantage of obscurity. While some might contest whether banks in general should be less capitalized, very few people are equipped to argue whether the lookup tables under the Current Exposure Method (CEM) lead to excessive capital charges for cleared out-of-the-money options.

AFR has offered comments to regulators in many of these areas, including comments on proposed changes to stress testing requirements, on stress test principles, on leverage ratio requirements, on G-SIB surcharges and their relationship to cleared derivatives, on derivatives exposure measures, on the implementation of CECL accounting standards, and others. A selection of the most relevant comments are attached to this testimony and I will not reproduce their arguments here.[11]

However, I would like to offer some broad comment on the current direction of these controversies. Congress should be concerned that the current direction of bank lobbying and the regulatory response to it is leading to an excessive reliance on risk-based capital. Under the system of risk-based capital, banks are only required to hold capital against the regulators estimates of the specific risks of bank activities. This seems sensible in principle, but the problem is that both regulators and markets are often wrong about the future risks of bank activities. Indeed, it is rarely the expected and properly forecast economic risk that leads to a major downturn or crisis, but the unexpected and underestimated economic risk.

An overreliance on risk based capital requirements had disastrous consequences prior to the 2008 financial crisis. For example, regulators slashed risk-based capital requirements to negligible levels for the private mortgage backed securities that were at the heart of the financial crisis, which created a large incentive for banks to hold large amounts of these "toxic" securities.[12] Regulatory decisions like this fueled the creation of systemic risk before the crisis, showing the dangers of excessive reliance on regulatory judgements of risk.

There are two major elements of the post-crisis capital regime that could counterbalance the dangers of an excessive reliance on risk-based capital. These are the leverage ratio and an active

[11] Links to these comments as well as other AFR comments to regulatory agencies are available at http://ourfinancialsecurity.org/category/regulatory-comment-letters/
[12] OCC, Federal Reserve System, FCC, and Office of Thrift Supervision, "Risk Based Capital Guidelines; Capital Adequacy Guidelines; Capital Maintenance: Capital Treatment of Recourse, Direct Credit Substitutes, and Residual Interests in Asset Securitization", Federal Register, November 29, 2001. Available at https://bit.ly/2IvqLqw

and rigorous stress testing regime. I am concerned that both of these are being targeted for weakening by bank lobbying and that regulators have been overly responsive to this lobbying.

Leverage requirements for the most part do not use regulatory risk weights and thus guarantee that banks have a minimum level of equity capital even if their activities may currently be judged as "low risk". During the 2008 financial crisis, it was leverage ratios and not risk-based capital that forecast bank failure. To get a sense of the significance of the leverage ratio, note that at the end of 2017, the six largest U.S. banks had $13 trillion in exposures under the supplementary leverage ratio metric, but just $6.3 trillion in exposures subject to risk weighted capital requirements.[13] In other words, over half of potential risk exposures were not covered at all by risk weighted capital requirements.

Unfortunately, regulators have recently proposed to cut the already low leverage ratio requirement of 5 percent for major banks, on the argument that the leverage ratio should not be "binding" on bank activities because it does not incorporate regulatory risk judgements. This of course ignores the possibility that regulatory judgements could be wrong. As we saw prior to the financial crisis, incentivizing banks to put more weight on regulatory calculations of risk and allowing them to slash their equity capital by changing their balance sheet in accordance with such calculations is a dangerous course.

A rigorous and active stress testing regime could also counterbalance an excessive reliance on risk-based capital. However, stress testing is not easy to implement properly. As we saw with the OFHEO stress testing of the housing GSEs prior to the financial crisis, poorly implemented stress tests can be useless.[14] For stress tests to be effective, regulators must be willing to change scenarios frequently and test the impact of failures in assumptions that currently drive financial markets (such as the assumption before the 2008 crisis that there could not be a large nationwide drop in housing prices). Doing this is politically difficult and will inevitably be challenged by banks who do not wish to prepare for possibilities that they consider unlikely.

As discussed extensively in AFR comments on stress testing, it appears that regulators may be moving in the opposite direction, emphasizing stability and predictability in stress testing.[15] Banks are urging them in this direction as well, claiming that excessive "volatility" in stress testing results is somehow illegitimate. But a stress test that is fully stable and predictable is neither stressful nor a true test. Instead, such a "stress test" simply replicates the weaknesses of risk based capital by inducing banks to align their balance sheets with predictable regulatory expectations. The combination of more predictable stress tests and other cuts in stress test capital

[13] Data taken from December, 2017 Basel Pillar Three disclosures for Bank of America, Citigroup, Goldman Sachs, JP Morgan, Morgan Stanley, and Wells Fargo.
[14] For an analysis of what went wrong with these pre-crisis stress tests, see Frame, W. Scott and Gerardi, Kristopher and Willen, Paul, "The Failure of Supervisory Stress Testing: Fannie Mae, Freddie Mac, and OFHEO" (March 2015). FRB Atlanta Working Paper No. 2015-3. Available at https://ssrn.com/abstract=2593492http://dx.doi.org/10.2139/ssrn.2593492
[15] See AFR comment on Federal Reserve stress test principles and modeling, available at http://ourfinancialsecurity.org/wp-content/uploads/2018/02/AFR-Comment-on-Stress-Test-Proposal-Package.pdf

requirements proposed in the Federal Reserve's April proposal on Stress Capital Buffers threatens to undermine the protective value of the stress testing process.[16]

Finally, Congress should also be concerned about the adequacy of capital requirements for derivatives, including cleared derivatives. By their nature, derivatives are a contingent liability whose full risks are difficult to predict. Derivatives that can look very low risk in calm markets can create substantial losses in situations of market volatility and turbulence. A major and unpredicted increase in derivatives risk exposures in the months prior to the 2008 financial crisis – an increase in credit exposure of over $1 trillion in the second half of 2008 alone – was a major contributor to the financial crisis.

Banks are currently arguing for extremely low exposure measures and therefore extremely low capital requirements for derivatives, particularly cleared derivatives. These low capital requirements will encourage possibly excessive derivatives activities by banks and leave the public unprotected if derivatives risks again materialize in an unexpected way. In the specific case of cleared derivatives, while clearing represents a step forward in risk management, it does not obviate the need for capital to back clearing member positions. Clearinghouses are a risk management mechanism, not a way to make risk disappear. Derivatives risks continue to exist even when derivatives are cleared.

Congress should reject attempts to cut derivatives capital requirements, and should encourage regulators to keep these requirements strong as they write new rules to measure derivatives risk exposures.

[16] AFR comments on the Stress Capital Buffer proposal are available at http://ourfinancialsecurity.org/wp-content/uploads/2018/06/AFR-Education-Fund-Stress-Capital-Buffer-Comment-Letter.pdf