AFR Americans for Financial Reform

Education Fund

October 1, 2018

Vice Chairman Randall Quarles
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

RE: Response to letter from Senator Perdue regarding implementation of S. 2155

Dear Vice Chair Quarles:

On behalf of Americans for Financial Reform Education Fund (AFR Education Fund), we are writing in response to the recent letter from Senator Perdue and others (the "Perdue letter").[1] The Perdue letter urges you to view the implementation of S. 2155 as requiring extensive and inappropriate deregulation of large banks.[2]

We believe the Perdue letter misrepresents the substance of S. 2155, and calls for changes in regulation that are misguided and unjustified by any reasonable assessment of the Federal Reserve's responsibility to maintain adequate prudential regulation of some of the nation's largest and most important bank holding companies.

As you know, S. 2155, or the "Economic Growth, Regulatory Relief, and Consumer Protection Act", was signed into law in early 2018. Section 401 of S. 2155 removes the mandate in Section 165 of the Dodd-Frank Act for the Federal Reserve to impose enhanced prudential standards at bank holding companies with between $50 and $250 billion in assets.

The Perdue letter interprets the removal of this mandate as forcing the Federal Reserve to make major deregulatory changes in the current oversight of dozens of banks between $50 and $250 billion in size. It even interprets S. 2155 as somehow mandating the deregulation of other banks that are over $250 billion in size and not directly addressed by the legislation at all.

The arguments in the Perdue letter are based on several misrepresentations. The letter misrepresents the legal implications of S. 2155, the nature of systemic risk in the financial sector, and the risks posed by U.S. operations of large foreign banks.

The Federal Reserve Retains Discretionary Authority over Banks below $250 Billion

The Perdue letter claims that S. 2155 mandates deregulation of banks between $50 billion and $250 billion in size, as opposed to increasing the Federal Reserve's flexibility in regulation of such banks. However, the preservation of authorities in Section 401(b) of S 2155 makes clear that the Federal Reserve and other prudential agencies maintain the authority to take regulatory or supervisory actions to enhance the safety and soundness of any regulated banks and such authority is not affected by S. 2155. Section 401(a)(1)(C) of S 2155 further reiterates the Federal

[1] Americans for Financial Reform Education Fund (http://realbankreform.org/) is an unprecedented coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith-based and business groups.
[2] The Perdue Letter was sent on August 17, 2018 and is available at https://bit.ly/2DNmjpX

Reserve's flexibility to impose any prudential standard mentioned in the Dodd-Frank Act on any bank holding company between $100 billion and $250 billion in size if the Federal Reserve determines "it is appropriate to prevent or mitigate risks to the financial stability of the United States….or to promote the safety and soundness of the bank holding company". Section 401(e) of the bill also specifically requires the Federal Reserve to continue to conduct supervisory stress tests of bank holding companies between $100 billion and $250 billion in size.

In a floor colloquy discussing the intent of the legislation, Senator Mark Warner, a central drafter of S. 2155, confirmed his view that "it is prudent for the Federal Reserve to have discretion to apply the… enumerated enhanced prudential standards in section 165 to those banks [between $100 billion and $250 billion] as part of the strong and tailored regime", and that under S 2155 the Fed "can apply an enhanced prudential standard to those banks for financial stability reasons or simply to promote the safety and soundness of a bank, which is a low standard."[3] He also supported continuing existing stress test rules, stating that "Congress has not made any changes to CCAR [Comprehensive Capital Analysis and Review] in S 2155".

Beyond any debate over S 2155, the Federal Reserve also has numerous other statutory authorities for prudential regulation of bank holding companies of any size that exist completely outside of Section 165 of the Dodd-Frank Act and are unaffected by the S 2155 amendments to that legislation. For example, 12 USC 1844(b) grants the Federal Reserve authority to issue regulations relating to capital requirements for bank holding companies and mandates that such requirements be countercyclical. 12 USC 1844(e) authorizes the Board to restrict activities that pose a threat to the safety and soundness of a bank holding company. 12 USC 1467a grants similar authorities for savings and loan holding companies. Many of these authorities were cited in authorizing key post-crisis regulations. Notably, they were cited as support for the 2012 stress testing rule, which imposes differential prudential requirements based on bank size.[4]

The Perdue Letter Misrepresents Systemic Risk

Banks between $50 and $250 billion in size are among the largest few dozen banking organizations of the 6,000 total banks in the U.S. They hold some $4 trillion in assets, about a quarter of the assets held by the U.S. banking system. In addition to these banks, the Perdue letter also argues for weakening regulation on banks with over $250 billion in assets that are not designated as Global Systemically Important Banks (G-SIBs) – another seven banks holding $2.7 trillion in assets.[5] This concentration of potential risk in a tiny fraction of the largest U.S. banks amply justifies the Federal Reserve in continuing to impose stronger prudential standards on these banks than on the thousands of smaller banks with fewer than $50 billion in assets.

The Perdue letter claims that there is no need for this small group of large banks to be more stringently regulated than an ordinary community bank. It does so by deliberately confusing the issue of whether a single bank is so large, interconnected, and complex that its failure could undermine the entire global financial system, as measured under the Federal Reserve's current G-SIB scoring metric, with the issue of risks to the financial system posed by large banks in general. The consistent assumption in the Perdue letter is that unless a single individual bank is

[3] Mark Warner Colloquy, Congressional Record, Senate, March 14, 2018, S1713 and following.
[4] Federal Reserve System, "Supervisory and Company-Run Stress Test Requirements", Final Rule, 12 CFR Part 252, Federal Register Volume 77, No. 198, October 12, 2012. https://bit.ly/2Ng9T9r
[5] 2016 FR Y-15 report data, available at https://www.ffiec.gov/npw/FinancialReport/FRY15Reports

central to the global financial system as measured by the G-SIB metric the Federal Reserve is not justified in imposing enhanced prudential standards on that bank. This flies in the face of common sense and basic economics.

As indicated by its name, the G-SIB scoring metric is specifically designed and intended to measure the systemic significance of a bank to the ***global*** financial system, not the U.S. economy or the economy of regions within the United States. Basel regulators specifically recommend that national regulators assess banks for their domestic significance not with G-SIB metrics, but using an entirely different process for designating domestic systemically important banks (D-SIBs).[6]

Numerous factors of significance to U.S. citizens and taxpayers are completely missing from the G-SIB scoring metric, such as the amount of publicly insured retail deposits held by a bank or the concentration of a bank's activities in specific U.S. regions. Furthermore, the G-SIB surcharge is designed only to assess one specific prudential requirement, namely an additional surcharge to the minimum capital requirement. The repeated claims in the Perdue letter that all enhanced prudential standards should be limited to the eight banks designated using the G-SIB metric make no sense except as an effort to force deregulation of large banks.

The Perdue letter is also misguided in claiming that asset size metrics or thresholds are "arbitrary" guides to regulatory focus. Far from being arbitrary, bank asset size is the single best guide to the economic importance of a bank. Every dollar of commercial bank assets represents a loan or extension of credit to a consumer, business, or government. If a bank fails, it will be unable to continue this economic activity. The single best guide to the potential economic fallout from a bank failure is thus the size of the bank. Concentrating regulatory resources on larger banks maximizes the efficiency of those resources.

If the Federal Reserve is to be an effective macro-prudential regulator of the banking system it must continue to focus enhanced regulatory scrutiny on the larger banks in the system. To do otherwise would be to risk the same catastrophic regulatory failures as occurred before the 2008 financial crisis, when regulators failed to detect the major risks created by the activities of large regional banks such as Countrywide Financial ($211 billion asset size in 2007) or Washington Mutual ($327 billion asset size in 2007).

The Perdue Letter Misrepresents the Risks Posed by U.S. Operations of Foreign Megabanks

The Perdue letter closes by claiming that U.S. operations of giant foreign banks pose similar risks to U.S. regional banks of similar size as the US operations, and calls on you to treat them in a similar manner. This is a particularly misguided request. The U.S. operations of large foreign banks (Foreign Banking Organizations or FBOs) are obviously fundamentally different than U.S. banks of similar size. U.S. FBOs are simply a subsidiary of a much larger international bank. Regardless of the current size of their U.S. operations they can easily draw on their international parent for additional resources. In contrast, U.S. banks of the same size cannot draw on an international parent and cannot gain additional financial resources without organic growth.

For this reason, counterparties will undertake financial commitments to a U.S. FBO that they would never undertake with a U.S. bank which had similar assets under U.S. regulation. This can

[6] Basel Committee on Banking Supervision, "A Framework for Dealing with Domestic Systemically Significant Banks", October 12, 2012. Available at https://www.bis.org/publ/bcbs233.pdf

easily be seen in public metrics of financial activity. To take one example, in 2016 Deutsche Bank U.S.A did $95 trillion in payments activity, almost triple the payments activity of Wells Fargo, even though Wells Fargo had almost ten times the U.S. asset size ($2.3 trillion vs $245 billion for Deutsche Bank U.S.A).[7] U.S. operations of foreign banks such as Credit Suisse and Barclays also had significantly more payments activity than Wells Fargo and other U.S. banks that were much larger than they were in asset size, such as Goldman Sachs, Morgan Stanley, and US Bank.

This is just one example of the way in which U.S. FBOs of foreign megabanks can play a much larger role in economic activity than their U.S. asset size alone would indicate. Research demonstrates that in the years prior to the 2008 financial crisis, U.S. FBOs were used as conduits for much greater financial flows than a U.S. bank of similar size could ever have supported, and that this activity contributed substantially to systemic risk.[8] In calling on the Federal Reserve to deregulate these FBOs and treat them as though they were simply U.S. regional banks, the Perdue letter flies in the face of common sense and asks you to turn your back on an important lesson of the financial crisis.

In sum, we urge you to reject the misguided and irresponsible recommendations in the Perdue letter, which misrepresent both your authority under S. 2155 and your responsibilities as a macro-prudential regulator of the banking system. You should instead maintain enhanced prudential standards for the nation's largest banks as measured by asset size. You should also continue to regulate U.S. operations of the largest foreign banks in a manner that recognizes their fundamental differences from U.S. banks of similar size, for example by maintaining Intermediate Holding Company (IHC) requirements for U.S. subsidiaries of foreign G-SIBs.

Thank you for your attention to this letter. If you have questions, please contact the AFR Education Fund's Policy Director, Marcus Stanley, at marcus@ourfinancialsecurity.org or at 202-466-3672.

Sincerely,
Americans for Financial Reform Education Fund

[7] 2016 FR Y-15 report data, available at https://www.ffiec.gov/npw/FinancialReport/FRY15Reports
[8] Goulding, William and Daniel Nolle, "Foreign Banks in the U.S.: A Primer", Board of Governors of the Federal Reserve System International Finance Discussion Paper No. 164, November, 2012, Available at https://bit.ly/2Ica8B3