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Committee on Financial Services

Subcommittee on Financial Institutions and Consumer Credit

Examining Capital Regimes for Financial Institutions

Testimony of

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Chairman Luetkemeyer, Ranking Member Clay, and members of the Subcommittee, thank you for the opportunity to testify today. My name is Kevin Fromer and I am President and CEO of the Financial Services Forum.[1] On behalf of our members, the eight largest and most diversified financial institutions headquartered in the United States, the Forum welcomes the opportunity to discuss its support for a systematic review of U.S. capital regulations, as well as a more targeted review of the special capital surcharge required of only our members, the capital planning process, and the leverage ratio.

With nearly a decade of regulatory changes behind us, now is the time to conduct a holistic review of the post-crisis framework and to make adjustments that would foster greater efficiency and transparency and effectively balance the important goals of a safe and sound financial system with one that best supports economic growth and job creation.

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[1] The Financial Services Forum is an economic policy and advocacy organization whose members are the chief executive officers of the eight largest and most diversified financial institutions headquartered in the United States. Forum member institutions are a leading source of lending and investment in the United States and serve millions of consumers, businesses, investors, and communities throughout the country. The Forum promotes policies that support savings and investment, deep and liquid capital markets, a competitive global marketplace, and a sound financial system.

Role and Value of the Largest Financial Institutions

The Financial Services Forum's member firms provide vital services in support of the U.S. economy. They support economic growth by lending to consumers, businesses, and other financial institutions, and help foster deep and liquid capital markets that allow government and private institutions to finance public spending and investment. In the first quarter of 2018, Forum institutions held more than $4 trillion in loans, accounting for 44 percent of total lending to businesses and households.[2] Forum institutions are a primary source of all consumer loans and hold more than $685 billion in consumer loans including credit card loans, automobile loans, and student loans.

Our members are also a primary source of real estate financing and currently hold approximately $1.5 trillion in real-estate backed loans that finance both construction and home ownership.[3] Small business lending is also an important priority for our members. As of June 2017, our members held more than $83 billion in small business loans with more than $51 billion in loans that are less than $100,000.[4]

Our members also meet three-quarters of the funding needs of other financial institutions, including community banks and insurance and mortgage finance companies.[5] They underwrite nearly three quarters of debt and equity transactions, such as initial public offerings, among other large U.S. institutions, thereby providing a service that other institutions cannot provide on a similar scale.

Strength, Resilience, and Resolvability

Forum institutions have significantly enhanced their resiliency and resolvability during the past decade and are strongly positioned to support economic growth throughout the economic cycle. Importantly, Forum members have substantially improved their capital and liquidity positions, which foster their ability to continue promoting economic growth and job creation. Forum member institutions now maintain more than $900 billion in tier 1 capital, the most loss-absorbing form of capital, an increase of more than 40 percent since 2009 (Figure 1).[6]

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[2] Federal Reserve data, Assets and Liabilities of Commercial Banks in the United States – H.8, available at www.federalreserve.gov\\releases\\h8\\default.htm; FR Y-9C data, available at www.ffiec.gov\\nicpubweb\\nicweb\\HCSGreaterThan10B.aspx.

[3] Id.

[4] Federal Deposit Insurance Corporation, Quarterly Banking Profile, available at https://www.fdic.gov/bank/analytical/qbp; Call Report data, available at https://cdr.ffiec.gov/public.

[5] Federal Reserve data, Assets and Liabilities of Commercial Banks in the United States – H.8, available at www.federalreserve.gov\\releases\\h8\\default.htm; FR Y-9C data, available at www.ffiec.gov\\nicpubweb\\nicweb\\HCSGreaterThan10B.aspx.

[6] FR Y-9C data, available at www.ffiec.gov/nicpubweb/nicweb/HCSGreaterThan10B.aspx.

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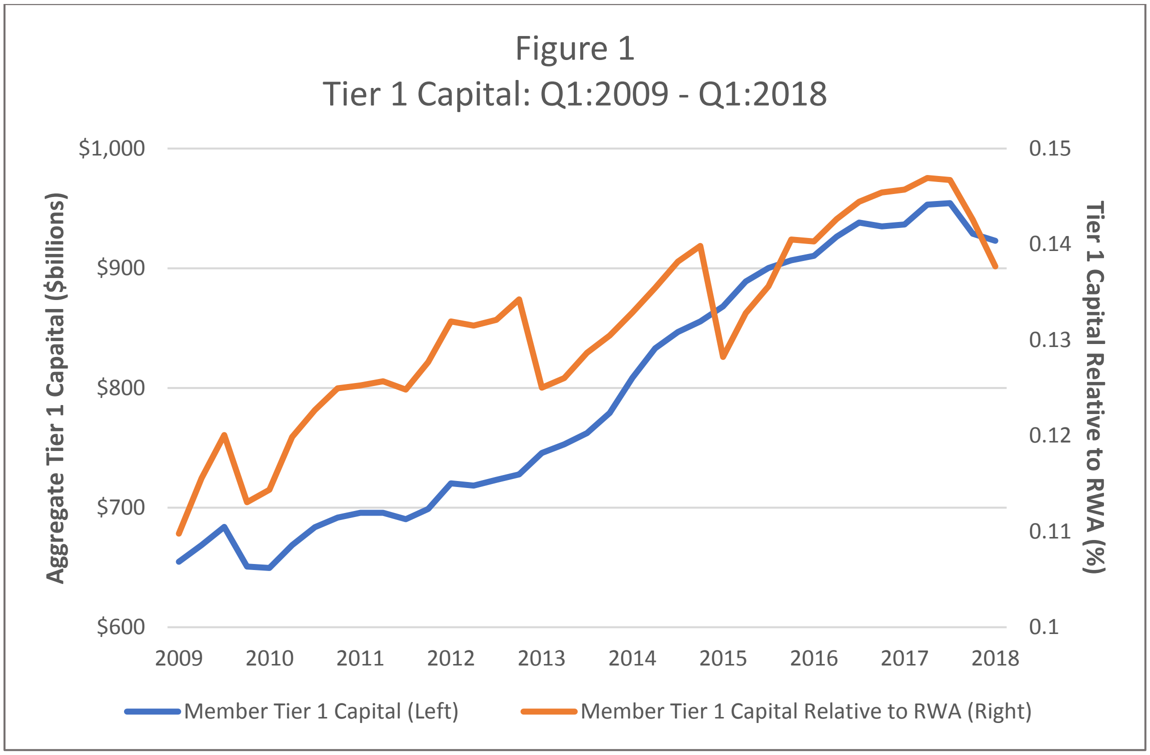
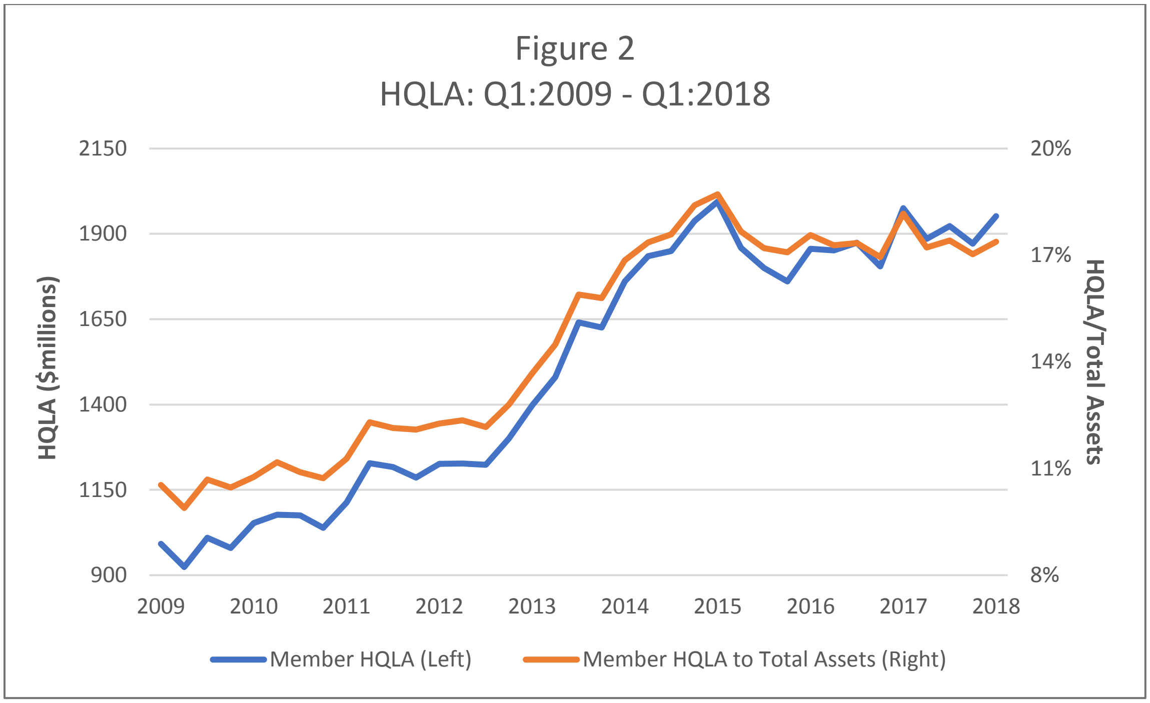


Similarly, our member institutions have significantly enhanced the quality and quantity of liquidity and now hold nearly $2 trillion in high-quality liquid assets (HQLA), an increase of more than 85 percent since 2010 (Figure 2).[7]

[7] Id.



In conjunction with these meaningful improvements to capital and liquidity, several other post-crisis regulatory and supervisory reforms have led to a significant and demonstrable increase in Forum member firms' resiliency and resolvability. Through the resolution planning process—commonly referred to as the "living wills" process—Forum institutions have made significant changes to simplify their corporate structures to improve resolvability. Our members also meet new total loss-absorbing capacity (TLAC) requirements designed to facilitate a potential resolution proceeding. With respect to derivatives markets, Forum members meet new regulatory requirements for central clearing, margin, and automatic stays – all of which reduce systemic risks across the financial system.

The Importance of Appropriate Capital Standards

Our members maintain strong capital levels and support capital standards that promote a safe and sound financial system that supports economic growth. It is worth noting that capital is a more expensive form of finance than debt. Therefore, unwarranted increases in capital standards lead to increased borrowing costs and reduced availability of loans for consumers, businesses, and communities. It is therefore imperative that capital standards be appropriately calibrated.

In the context of this discussion, it is important to remember that small changes in capital standards can have large effects on the economy. Businesses and households make borrowing and investment choices on the basis of seemingly small differences in borrowing costs. A family deciding if they can afford to buy a home, or a small business owner deciding whether to expand, will respond to differences in borrowing rates that are measured in a quarter or a half of a percentage point.

The ability of the Forum institutions to support the U.S. economy in their unique ways critically depends on calibrating regulation that balances effective costs and benefits. Financial regulations that do not balance costs with benefits lead to an inefficient financial system in which U.S. banks are hindered in their ability to best support consumers, businesses, the economy, and job creation.

Holistic Review of Regulatory Framework

Regulators worldwide have issued new requirements at a significant pace and volume in recent years, necessarily focusing on each measure individually. With nearly a decade of regulatory changes behind us, now is the time to conduct a holistic review of the post-crisis framework and to make adjustments that would foster greater efficiency and transparency and effectively balance the important goals of a safe and sound financial system with one that best supports economic growth and job creation.

In particular, the Forum supports regulators' recent efforts to enhance capital regulation efficiency by harmonizing their capital and stress testing rules and adjusting the leverage ratio requirements. These efforts seek to maintain the underlying policy goal of ensuring capital adequacy while reducing the complexity and cost of the regulation. Moreover, while the Forum has offered suggestions for further improving proposals—such as updating the special capital surcharge applied only to our member institutions, as I will detail later—our members appreciate regulators' focus on improving regulatory efficiency. The Forum's comments on the various proposals are intended to further enhance the efficiencies while maintaining the overarching goal of each regulation.

As U.S. regulators strive to achieve greater regulator efficiency, there should be particular focus on the implementation of international regulatory standards. In several recent instances, U.S. regulators helped negotiate agreements with international counterparts, but then adopted more stringent requirements for U.S. firms, thereby diminishing the international competitiveness of U.S. banks relative to their global peers. U.S. businesses of all sizes rely on globally active banks to support their growth through the international trade of goods and services and it is important that U.S. banks are able to operate on a level playing field with their foreign peers.

Support for an overarching regulatory review is widespread. Federal Reserve Board (FRB) Vice Chairman for Supervision Randal K. Quarles last month said "A decade after the crisis, implementation of the major post-crisis reforms is largely complete, and we have entered a new phase that is aimed at reviewing and improving regulations to ensure that they are achieving their aims in the most effective and efficient manner."[8] Former FRB Governor Daniel K. Tarullo similarly said "…the novelty of many of the forms of regulations adopted by financial regulators, either in implementing the Dodd-Frank Act or under existing authorities, almost assures that some recalibration and reconsiderations will be warranted on the basis of experience."[9]

Further, it should be noted that the drive to evaluate the efficacy and efficiency of post-crisis reforms is a global effort that is being undertaken by the very same international standard-setting bodies that were largely responsible for originally promulgating these standards.[10] Finally, the U.S. Treasury Department has compiled a comprehensive list of specific revisions to the post-crisis regulatory regime in a series of recent reports.[11]

In conducting this review, regulators must seriously consider how different post-crisis regulations interact with each other and whether the resulting regulatory *system* is appropriately calibrated to support the U.S. economy. Policymakers in the past 10 years have created a large number of new regulations. For the most part, these regulations—capital, liquidity, derivatives reform, and resolution—were developed and considered independently to address specific issues and achieve targeted goals. In addition, many of these regulations were developed in a relatively short time frame in an effort to respond quickly to the financial crisis. At the same time, all of these regulations are interdependent and the imposition of one regulation has implications for others.

Capital and liquidity regulations provide a clear example. Banks with more liquidity are less prone to so-called fire-sales of assets and other bank run-type behavior. Accordingly, for the same level of equity capital, a bank with more liquid assets on its balance sheet is more resilient and safer than a bank with fewer liquid assets on its balance sheet. As a result, the efficacy of capital regulation must also account for the effects of liquidity regulation.

Accordingly, it is critical that regulators consider the totality of the post-crisis regulatory system and seriously assess whether these regulations are appropriately and effectively calibrated as a system rather than a set of independent and parallel regulations.

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[8] FRB Vice Chairman Randal K. Quarles, America's Vital Interest in Global Efforts to Promote Financial Stability, Speech before the Utah Bankers Association 110th Annual Convention (June 27, 2018), available at www.federalreserve.gov/newsevents/speech/quarles20180627a.htm.

[9] FRB Governor Daniel K. Tarullo, Departing Thoughts, Early Observations on Improving the Effectiveness of Post-Crisis Regulation, Speech before The Woodrow Wilson School (Apr. 4, 2017), available at www.federalreserve.gov/newsevents/speech/tarullo20170404a.htm.

[10] Both the Financial Stability Board (FSB) and the Basel Committee on Banking supervision (BCBS) have announced work programs to evaluate the efficacy and efficiency of post-crisis reforms. See www.fsb.org/what-we-do/implementation-monitoring/effects-of-reforms/ and www.bis.org/speeches/sp180129.htm.

[11] For example, see U.S. Department of the Treasury, "A Financial System That Creates Economic Opportunities: Banks and Credit Unions" (June 2017), available at, www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf.

Clearly, Forum members believe strongly that the regulatory adjustments that have been proposed thus far, or that might result from a broad review, should continue to support the safety and soundness of the financial system, make the system more effective, and ensure continued economic growth.

Reviewing the Capital Regime for Large Financial Institutions

Given the centrality of capital in the business of banking and financial intermediation, as well as the magnified role of capital as part of the post-financial crisis regulatory framework, it is appropriate to prioritize capital regulations, stress testing, and capital planning requirements as part of an overall review of the regulatory system.

Federal banking regulators have introduced several proposals this year to amend the capital framework. The Forum supports appropriate and coherent capital requirements that apply to banks of all sizes and welcomes efforts by regulators to improve the capital framework.

Integration of Stress Testing and Capital Rules

Earlier this year, the Federal Reserve Board proposed to integrate its regulatory capital rule with its capital planning and stress testing regime while establishing a new stress capital buffer (SCB).

Integration of the stress testing and capital regimes to achieve a more simplified and harmonized capital framework is a laudable goal. However, because this integration would establish a fundamentally new approach to setting capital requirements that would amplify the role of stress testing, it becomes even more incumbent upon regulators to review the current framework holistically. The Forum believes certain changes should be made to more effectively achieve the FRB's policy objectives.

Background

The evolution of the FRB's stress testing practices illustrates the potential to find a more appropriate balance. During the financial crisis, the FRB turned to stress testing under the Supervisory Capital Assessment Program (SCAP) to "determine potential losses at the largest firms if the prevailing stress severely worsened and to restore confidence in the financial sector."[12]

While the original SCAP program was focused on quickly restoring capital adequacy and market confidence during a time of severe economic stress, the CCAR program has evolved into something that is much broader in scope. CCAR is an annual, point-in-time exercise under which firms submit a capital plan and the FRB subsequently approves, in advance, firms' quarter-to-quarter capital distributions. The

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[12] Federal Reserve System, Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules, 83 Fed. Reg. 18161, available at www.gpo.gov/fdsys/pkg/FR-2018-04-25/pdf/2018-08006.pdf.

FRB uses processes and models that are not publicly available, thus providing neither firms nor the marketplace with transparency, a predicate to establishing confidence in their results.

Rather than relying on expanded versions of the extreme policy measures (i.e., SCAP) that may have been necessary in the depths of the financial crisis, the FRB should recognize that the ongoing capital framework can strike a more appropriate balance between the original safety and soundness rationale for supervisory stress testing and the core responsibility of boards of directors to oversee capital distributions on a dynamic basis.

Indeed, the *ex-ante* nature of the CCAR exercise means that ongoing capital distributions do not account for changing macro and firm-specific conditions, effectively removing the ability of a board of directors to engage in a dynamic, ongoing capital planning process. Instead, firms and their boards of directors should have flexibility to adjust quarterly distributions in response to changing conditions.

Recommendations

The Federal Reserve should undertake a broader review of its capital and stress testing programs to ensure that boards of directors at financial institutions can clearly and appropriately make capital management decisions.

A firm with capital in excess of the FRB's requirements—inclusive of all relevant buffers—should be permitted to make capital distributions in the way its board deems is most productive. The Federal Reserve's current capital planning process reduces the ability of a firm to attract new capital and, in turn, artificially reduces the ability to provide credit to the economy. The inability of the board to distribute capital after meeting all relevant regulatory requirements thereby stunts economic activity without any clearly justified financial stability benefit and should be avoided.

Further, the FRB should improve the transparency of its scenario and model designs. This could be accomplished through a solicitation of comments on its process, in particular on the specific stress scenarios. The FRB could also amend its existing Policy Statement on the Scenario Design Framework for Stress Testing to develop an empirically grounded framework to establish "guardrails," or outer boundaries on the severity of the supervisory stress scenarios.

Specifically, the lack of transparency into the FRB's stress testing models and scenario design methodology encourages firms to hold additional capital beyond regulatory minima to avoid "failing" the stress tests. Thus, the effective cost of the FRB's capital and stress testing framework includes the cost of retaining this additional capital, which results from the structure of the proposal and its supporting regulatory architecture. This dynamic is exemplified by the stress test results released on June 21, 2018, which show significant variability and unpredictability and should be taken into account in the FRB's quantitative assessments. According to one estimate, banks maintain an additional capital buffer of up to one percentage point to guard against the year-to-year volatility in stress test results.[13] Such a management buffer applied to each of our members results in approximately an additional $65 billion in capital. This increase in capital beyond required minima is solely the result of the opacity and volatility of the stress testing process and unnecessarily raises the cost of funding which is then passed onto consumers and businesses.

Finally, the FRB should conduct a fulsome analysis of the effective costs and benefits of the proposed stress capital buffer beyond the impact of minimum capital requirements. The Forum's members are concerned that the SCB proposal does not contain robust analysis of the effective costs beyond citing its potential capital impact. Simply stating the potential impact on minimum capital requirements likely underestimates the proposal's overall economy-wide costs, particularly in light of the opacity of the FRB's stress testing processes.

Leverage Ratio

The Federal Reserve and the Office of the Comptroller of the Currency (OCC) earlier this year issued a separate proposal to modify the enhanced supplementary leverage ratio (eSLR). A leverage ratio is a simplified capital requirement that compares equity capital to total assets without adjusting for the risk of the underlying assets. Large, interconnected financial institutions are subject to an additional "supplementary" leverage ratio requirement that also accounts for certain off-balance sheet exposures such as derivatives and securities financing transactions. The largest, most interconnected firms—our members—are subject to an "enhanced" or higher and more stringent version of the supplementary leverage ratio.

The Forum agrees with the agencies that leverage requirements should serve as a backstop to risk-based capital requirements, rather than as the binding capital requirement. At present, the eSLR serves as the binding capital constraint for four of the eight Forum members' top-tier bank holding companies. Under the proposed revisions, the agencies note that the eSLR would remain the binding constraint for one Forum member's holding company.

Because leverage ratios do not differentiate the amount of capital required by the relative risk of an underlying exposure, the Forum agrees with the agencies that "[l]everage capital requirements should generally act as a backstop to the risk-based requirements" rather than as a binding constraint.[14]

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[13] See Nomura Bank Regulation Update – SCB Proposal, SCB Good for Everyone (Except the Brokers) (April 11 2018); Autonomous CCAR's Next Moves Not So Scary After All (September 30, 2016)

[14] Federal Reserve System and Office of the Comptroller of the Currency, Regulatory Capital Rules: Regulatory Capital Enhanced Supplementary Leverage Ratio Standards for U.S. Global Systemically Important Bank Holding Companies and Certain of Their Subsidiary Insured Depository Institutions; Total Loss-Absorbing Capacity Requirements for U.S. Global Systemically Important Bank Holding Companies, 83 Fed. Reg. 17317, available at www.gpo.gov/fdsys/pkg/FR-2018-04-19/pdf/2018-08066.pdf.

Therefore, the Forum supports the proposal and urges the agencies to adopt it promptly. However, the Forum believes more needs to be done to ensure this policy objective is achieved.

Recommendations

The agencies should take additional steps to ensure that leverage capital requirements act as a backstop to risk-based capital requirements, rather than as a binding constraint. In particular, the leverage calculations should exclude risk-free to eliminate the economic incentive to reduce participation in lower-risk, lower-return businesses. For example, the Treasury Department recommends excluding central bank reserves, U.S. Treasury securities, and initial margin for centrally cleared derivatives from the leverage ratio denominator.[15]

Including risk-free assets in the leverage ratio denominator creates incentives for banking organizations to reduce participation in, or increase costs for, lower-risk, lower-return businesses and products that are essential for a vibrant and growing economy. Although the proposed recalibration of the eSLR helps to avoid some of these perverse incentives in the short run, a more durable approach would be to remove risk-free assets from the leverage ratio denominators altogether.

GSIB Capital Surcharge

Banks that are identified as global systemically important banks—or GSIBs—are required to maintain an additional capital buffer that is scaled to the regulator's estimate of the banks' systemic importance. Both the capital and leverage proposals that have been proposed this year by regulators import the GSIB capital surcharge, which heightens the need to evaluate its appropriateness in light of the entire regulatory system that has emerged since the financial crisis.[16]

In collaboration with our colleagues at The Clearing House Association (now the Bank Policy Institute), we recently analyzed the calibration of the GSIB surcharge as implemented in the United States within the context of the broader regulatory framework. We found that GSIB surcharges should be reduced significantly by at least 1 percentage point to account for TLAC requirements, which reduce the cost of resolutions, and the Liquidity Coverage Ratio, which should reduce the magnitude of future GSIB losses.[17] To put this estimate in perspective, we note that an additional percentage point in capital for our members translates into approximately an additional $65 billion in capital.

[15] U.S. Department of the Treasury, "A Financial System That Creates Economic Opportunities: Banks and Credit Unions" (June 2017), available at, www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf.

[16] In addition, when adopting the GSIB surcharge, the FRB stated it would periodically reevaluate the method 2, "gold-plated" version that it uses "[t]o ensure changes in economic growth do not unduly affect firms' systemic risk scores." Further, method 2 relies on a flawed methodology to calculate a firm's use of short-term wholesale funding, underscoring the need to reconsider method 2.

[17] Financial Services Forum, "Joint Forum, Clearing House Blog: Seeing the Forest for the Trees: GSIB Capital and Enhanced GSIB Regulation" (June 27, 2018), available at www.fsforum.com/press/blog/joint-forum-clearing-house-blog-seeing-the-forest-for-the-trees-gsib-capital-and-enhanced-gsib-regulation/.

Simply put, if the GSIB surcharges were appropriately calibrated when they were introduced in 2015, then the surcharges are now too high in light of liquidity, resolvability, and other related regulations that were proposed and finalized after the GSIB surcharge was finalized in 2015. Such reductions would, in turn, reduce the cost of funding, and increase the supply of credit GSIBs can provide to businesses and households alike, while establishing capital levels that continue to promote safety and soundness as well as financial stability goals.

Recommendations

The Forum believes the GSIB surcharge, as implemented by the FRB for U.S. institutions, does not appropriately reflect several related enhancements to the post-crisis regulatory regime, such as advancements made in the living wills process, and should therefore be reconsidered by regulators, as acknowledged by Vice Chairman Quarles in response to a question asked during congressional testimony on April 17, 2018.[18] When doing so, the FRB should undertake, and request public comment on, a quantitative assessment of the calculation of the GSIB surcharge, including how it interrelates to the SCB and other requirements. Pending such reevaluation, the FRB should exclude the GSIB surcharge from the stress capital buffer.

Finally, it should also be noted that the specific implementation of GSIB capital surcharges that was adopted in the United States goes beyond the framework that was agreed to at the international level. As a result, GSIB capital surcharges are substantially higher for our members than their foreign competitors. This gold-plating of international standards impinges upon the international competitiveness of our members and provides a further rationale for reviewing and reconsidering the appropriate calibration of the GSIB capital surcharge.

Conclusion

Regulators in the United States and internationally have discussed the necessity of evaluating the significant regulatory changes that have been implemented during the past decade. The Forum believes these efforts are imperative and looks forward to continued engagement to ensure our regulatory system balances the important goals of a safe and sound financial system with one that best supports economic growth and job creation. I appreciate the Committee's invitation to appear today and look forward to answering any questions you may have.

[18] In testimony before the House Financial Services Committee, Vice Chairman Quarles discussed in particular how the living wills process had "resulted in improvement in resolvability of the firms." Further, he said: "And that means that the consequence of their default is less. And the reason for the GSIB surcharge is precisely our assessment of the heightened consequence of their default. … a process of thinking about it is appropriate now."