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EXAMINING THE REGULATORY REGIME FOR REGIONAL BANKS

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FOURTEENTH CONGRESS

FIRST SESSION

ON

EXAMINING THE IMPACT OF THE EXISTING REGULATORY FRAMEWORK ON REGIONAL BANKS

MARCH 24, 2015

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EXAMINING THE REGULATORY REGIME FOR REGIONAL BANKS

TUESDAY, MARCH 24, 2015

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Richard Shelby, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN RICHARD C. SHELBY

Chairman SHELBY. The Committee will come to order.

Last week, the Committee continued its examination of the existing regulatory framework for regional banks by hearing from the regulators. Today we will hear from a broad panel of experts, including those who have witnessed firsthand the impact of the current regulatory structure and those who have analyzed this issue in depth.

Current law subjects all banks with assets of $50 billion or more to enhanced prudential standards, regardless of whether the bank has $51 billion, $251 billion, or trillions in assets.

Five years after this threshold was fixed in statute, no legislator or regulator has properly explained where it came from, why it was deemed appropriate at the time, or what analysis supported it. I believe that 5 years is long enough to know if an arbitrary threshold is appropriate and whether or not it should be changed.

Last week, we heard from regulators that there are alternative ways to measure systemic risk instead of relying solely upon an arbitrary asset threshold.

We also heard that the existing statutory requirements limit the regulators' flexibility to tailor prudential standards based on the actual systemic risk of an institution. The current framework should address systemic risk as current law intends. I believe there is a way to do this without preventing regional financial institutions from growing, remaining competitive, and expanding into new communities.

Ironically, the arbitrary $50 billion threshold may create a competitive advantage for Wall Street institutions by imposing costly compliance barriers for region-based banks that are a fraction of their size. Instead of giving our regulators the flexibility to properly direct resources by focusing on the institutions that present the most risk, the law creates a clear line of demarcation based purely on the institution's size. Therefore, the regulators are unable to

scale regulation in a manner that reflects a bank's risk profile and activities.

I am concerned that a regulatory system that is too rigid imposes unwarranted costs without enhancing safety and soundness. These costs are then passed along to consumers and businesses by restricting credit and other financial services. Restricted lending means slower growth and fewer opportunities.

The ideal regulatory regime should allow for the maximum level of economic growth while also ensuring the safety and soundness of our financial system. It is becoming more apparent that current law has not struck the appropriate balance and that changes are in order. Today's witnesses will discuss some of those changes and give us the benefit of their expertise as we consider possible refinements to current law.

Senator Brown.

STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. Thank you, Mr. Chairman. Thanks to all four witnesses for joining us.

This hearing is important to examine the regulation of regional banks. It is the second of two hearings on this topic, and a third—an earlier one actually we had done in the Subcommittee I chaired last year. This is the second of these two under Chairman Shelby, and I appreciate the work that he is doing. I thought our discussion last Thursday was useful. I hope we can learn as much today.

It is important we advance this conversation to ensure that prudential regulations for regional banks are crafted appropriately. It is an important topic to me personally and my State because three of our large regional banks—Fifth Third, the largest, followed by Key, followed by Huntington in my State, and as I pointed out last week, we had a fourth, larger than any of the three, that was unable to survive the 2008 financial crisis, partly for management reasons, largely the economy but other things. Congress directed agencies through Dodd-Frank to institute standards like capital and liquidity and risk management and stress testing to lower the likelihood and the costs of large bank holding company failures. It called for heightened rules for large bank holding companies, but it directed regulators not—and I emphasize "not"—to take a one-size-fits-all approach so that a $50 billion bank or a $100 billion bank would not be treated the same way, logically, as a $2 trillion bank.

We all agree that regional banks are not systemic in the same way that money center banks are, so we need to understand that the SIFI designation at 50 does not mean—we sometimes conflate this. It does not mean that Congress and the regulators think that they are systemic in the same way that money center banks are. The failure of one regional bank, assuming it is following a traditional model, will not, in fact, threaten the entire system. But the rules were not meant to cover only systemically important or too-big-to-fail banks.

We heard from Governor Tarullo that systemic importance is about the failure of the institution creating a crisis, but it is also about the importance of an institution to homeowners and small businesses and the economic footprint where that bank operates.

Go back again to National City Bank in Cleveland and the damage that came to that community and to thousands of employees because of what happened with that bank. Chairman Gruenberg told us that IndyMac's failures, of course, had huge consequences for its community, its region, and the mortgage market as a whole. Again, a smaller bank, but not systemically important in that sense, but important in its community and beyond.

I look forward to hearing more from today's witnesses about these rules and their implementation for banks your size, especially the size of Regions, for example. I continue to believe we will not be successful this Congress in providing regulatory relief to institutions of any size if we do not have broad bipartisan consensus—and I underscore "broad bipartisan consensus"—to do the kind of regulatory relief that most of us or almost all of us on this Committee want to do. But it needs to be bipartisan, and it needs to be consensus; otherwise, we will fail, I think, our financial system and we fail taxpayers. Our prospects are even less likely if we try to undermine or roll back central elements of Wall Street reform.

Let me give you an example. Legislation that Senator Collins and Senator Johanns and I sponsored to tailor insurance capital standards provides a useful model on how we should address these issues. We started with the agencies—in that case it was the Federal Reserve—to see if they could address the issue without regulation. This was when a large insurance company owns a smaller bank and how the capital standards would apply. That was the issue.

When that process faltered, going to the Fed and asking to change—asking for change, when that process faltered, we introduced legislation. We held hearings on the legislation. We considered input from supporters and skeptics, and there were a number of skeptics, including people who had helped to write the Collins provision initially—the skeptics initially of those that helped to write the Collins provision.

After that sort of arduous task but very important to the legislative process, the final product of a 2-year process reflected a pragmatic compromise between industry and consumer groups that would receive the support of 100 Members of the U.S. Senate. That is the way to do legislation. That is what I hope our Committee this year will learn from our Committee last year. We did not allow other provisions, even though there were attempts, to be added to our legislation.

I am open to solving real problems affecting actual institutions without undermining the safety and the soundness of the financial system or of any individual financial entity or without undermining consumer protection.

Last week, we talked with regulators about the enhanced prudential standards are being applied to regional banks above $50 billion, which Regions and a number of other banks represent. Today I hope we can answer other questions, and here is where I think the importance of this hearing comes in.

Are there specific standards that are inappropriate for regional banks and why? What standards, if any, are inappropriate for regional banks? And why are they inappropriate?

Do the concerns being raised stem from implementing regulations which require no legislation to fix or from the law itself?

Which concerns can be addressed by using the flexibility that the law applies to the—that the law provides the Federal Reserve with prompting by the FSOC to limit thresholds for some of these standards? In other words, we know that Dodd-Frank gave flexibility to FSOC to make determinations working through the Fed or working through one of the others sitting on the FSOC on regulation issues, and they are empowered to do that.

Regulation is necessary. It is our job to ensure that regulations are appropriate. It is also important we do not make it difficult to monitor potential sources of risk or to encourage unsafe practices. Lending is inherently risky. We know that. Enhanced prudential standards are important not just as a response to the last crisis, but to prevent the next one.

Thank you, Mr. Chairman.

Chairman SHELBY. Thank you, Senator Brown.

Without objection, I would like to enter into the record at this time statements from the following organizations: the Regional Bank Coalition; the Fifth Third Bank; the Silicon Valley Bank; the Mid-Size Bank Coalition; the M&T Bank Corporation CEO Robert Wilmers' 2014 Annual Report to Shareholders, pages 8 through 14, which discuss a regulatory regime for regional banks; the April 2014 report from the Bipartisan Policy Center entitled "Dodd-Frank's Missed Opportunity: A Road Map for a More Effective Regulatory Architecture"; and a 2014 Banking Perspective article from Venable LLP entitled "Section 165 Revisited: Rethinking Enhanced Prudential Regulations." Without objection, it is so ordered.

Chairman SHELBY. Our witnesses today include: Mr. Oliver Ireland. He is a Partner of Morrison & Foerster; Mr. Deron Smithy, Executive Vice President and Treasurer, Regions Bank; Mr. Mark Olson, former member of the Board of Governors of the Fed, no stranger to this Committee, co-chair of the Bipartisan Policy Center Financial Regulatory Reform Initiative's Regulatory Architecture Task Force; and Mr. Simon Johnson, Ronald A. Kurtz Professor of Entrepreneurship, MIT Sloan School of Management.

We welcome all of you. All of your written statements will be made part of the record. We will start with you, Mr. Ireland.

STATEMENT OF OLIVER I. IRELAND, PARTNER, MORRISON & FOERSTER

Mr. IRELAND. Thank you, Chairman Shelby and Ranking Member Brown, Senators on the Committee. I am a Partner in the Financial Services practice at Morrison & Foerster, as Chairman Shelby mentioned. I spent 26 years before going into private practice with the Federal Reserve System, 15 of those as an Associate General Counsel at the Board in Washington, where one of my focuses was the issue of systemic risk and how to address systemic risk.

I had personal experience with a number of severe market events ranging from the Chrysler bailout in 1980 through the thrift crisis and other events along the way, including the failure of Continental Illinois Bank while I was at the Federal Reserve Bank of Chicago.

In the private sector, working since then, I was working with Bear Stearns and the Reserve Funds, both of whom were sort of central players in the financial crisis, and so I saw it up close from the other side.

We are here to discuss the issue of an appropriate regulatory regime for regional banks. That issue is tied, I think, inexorably to the so-called doctrine of too big to fail that sometimes is viewed as flowing out of the Continental Bank failure and was evident in the bailouts of banks as well as other institutions in the recent financial crisis.

Too big to fail is a bad policy. It creates moral hazard that distorts markets, and it is just plain unfair.

Dodd-Frank, quite correctly I think, attacks too big to fail, but I think it does so with too broad a brush. The example that has been shown here or referenced here, the 165 rules that trigger off a $50 billion asset threshold for certain mandatory requirements pick up a large number of regional banks that do not pose the same kind of systemic risks that other banking institutions impose. In doing so, they impose costs on those banks with traditional models of taking deposits, making loans, and they affect regional economies and households that use those banks' services by increasing the costs for those banks.

A recent OFR report studying the systemic risk of banks over $50 billion showed wide disparities in risk by a factor of over 100. I think a better measure, which is basically the measure used by the OFR, of systemic risk is a measure that came out of the Basel Committee on Bank Supervision in 2013 that looks at size, which is, admittedly, an important issue, interconnectedness, substitutability, cross-jurisdictional activity, which may actually have a little bit less effect in domestic economies, and complexity as factors.

A similar system could be structured for identifying important banks that threaten systemic disruptions in the U.S. economy and could be applied to U.S. banking institutions. It would require some tailoring to do so.

Adopting such an approach, however, would require changes to Dodd-Frank. The lockstep required enhanced prudential standards or more stringent prudential standards under Dodd-Frank would require amendments to provide the regulators with additional flexibility.

I would not suggest, however, that we codify any particular scheme. The Basel scheme is a good approach. I think it is better than the $50 billion. It represents current thinking. Thinking in this area is evolving as academics and supervisors alike study the issues, and I think we want to develop a system that is flexible going forward so that regulators can address risks in whatever size banks pose those risks, while at the same time not unnecessarily burdening banks that do not present the same level of risk.

Thank you.

Chairman SHELBY. Mr. Smithy.

STATEMENT OF DERON SMITHY, TREASURER, REGIONS BANK, ON BEHALF OF THE REGIONAL BANK GROUP

Mr. SMITHY. Thank you, Chairman Shelby, Ranking Member Brown, and Members of the Senate Banking Committee. My name

is Deron Smithy, and I am the Treasurer of Regions Bank, a $120 billion bank based in Birmingham, Alabama. I appreciate the opportunity today to speak to the Committee about enhanced standards and the systemic risk designation.

Dodd-Frank established a $50 billion asset threshold for systemically important financial institutions, or SIFIs, a label that subjects banks to more stringent regulatory oversight and costs regardless of their business model or complexity.

I am appearing today in my capacity at Regions Bank and as a representative of the Regional Bank Group, a coalition of community-based, traditional lending institutions that power Main Street economies.

Regions Bank, which has branches in 16 States, has a simple operating model that focuses on relationship banking, matching high-quality customer service with industry expertise. Regions serves a diversified customer base with over 450,000 commercial clients, including 400,000 small business owners and 4.5 million households. Collectively, the banks in our group operate in all 50 States and have credit relationships with more than 60 million American households and more than 6 million businesses. Yet, in aggregate, our assets are less than 2 percent of GDP, roughly equivalent of the single largest U.S. bank.

Regional banks are funded primarily through core deposits, and we loan those deposits back into the communities that we serve, competing against banks of all sizes.

Regional banks are not complex. We do not engage in significant trading or international activities, make markets in securities, or have meaningful interconnections with other financial firms.

It is appropriate for the Committee to consider whether a $50 billion threshold is the best way to define a SIFI. More stringent regulatory oversight should focus on those firms whose individual stress or failure trigger or deepen financial crisis or destabilize the economy.

Dealing with the issues of systemic risk is crucial. We do not want another financial crisis. Yet an overly broad definition that captures traditional lenders has consequences as well. These rules have a direct impact on a bank's strategic direction, including its appetite for specific products and its ability to support local economic activity through lending.

The direct costs as well as management's time and attention to meet these rules create a disproportionate burden on regional banks. Collectively, the incremental cost of regulatory compliance exceeds $2 billion annually.

Regional banks seek a regulatory framework that helps the country promote economic growth in tandem with safe and sound banking practices. Thirty-three banks are currently SIFIs, placing the same baseline burden on regional banks and money center banks alike. While the regulators occasionally tailor rules for the SIFI class, it is important to note that with an automatic threshold or floor, the tailoring operates as a one-way ratchet only. This floor separates regional banks from many of its competitors.

Now that more data is available regarding the scope of the Dodd-Frank regulation and the nature of systemic risk, the Committee can determine whether there is a benefit to having regional banks

automatically subjected to this oversight regime. The recent Office of Financial Research study using systemic indicators gathered by the Federal Reserve highlights the gulf between money center and regional banks. The top six banks had an average systemic score of 319, more than 25 times higher than that average of the regional banks of 12. Altering the threshold in a common-sense manner will not obstruct regulators' discretion to stop risky behavior or weaken their supervisory powers. Even absent systemic designation, protective regulatory guard rails that have evolved since the financial crisis would remain in place for regional banks, including the capital planning and stress testing activities started before Dodd-Frank.

An activity-based approach would establish a fairer method for supervising banks, and it would strengthen regulators' ability to better tailor rules and deploy their own resources where they are needed. Regulators have used factors including size, complexity, interconnectedness, global activity, and substitutability to determine how firms might impact financial stability. And like the OFR study, they reached the conclusion that regional banks are fundamentally different than complex banks.

In the end, an improved regulatory system better aligned with bank complexity and risk would ensure safety and soundness while promoting U.S. economic growth and job creation.

Thank you again for the opportunity to testify before the Committee today, and I look forward to your questions.

Chairman SHELBY. Mr. Olson.

STATEMENT OF MARK OLSON, CO-CHAIR, BIPARTISAN POLICY CENTER FINANCIAL REGULATORY REFORM INITIATIVE'S REGULATORY ARCHITECTURE TASK FORCE

Mr. OLSON. Thank you very much, Mr. Chairman, Ranking Member Brown, Members of the Committee. Thank you for inviting me to be here, and as you indicated, Mr. Chairman, I am enjoying the chance to come back to familiar territory.

I am here today representing the Bipartisan Policy Center with my colleague, Richard Neiman, former superintendent of banks for the State of New York, who co-chaired this with me.

As you suggested to Senator Brown, this is a bipartisan effort, and I think bipartisanship in looking at this issue is particularly important. And thank you, Mr. Chairman, for including our entire report for the record. We are appreciative of that.

My primary focus today will be on the $50 billion threshold for the so-called bank SIFIs. Some of the discussion that we have heard already this morning focuses on that, but there are a number of issues that we think are critical here. I would just highlight that there are two that we think are particularly important: number one, to provide a greater flexibility, and to use that as a presumption and not as a hard line. And I think the flexibility here is particularly important.

There are a number of issues that we have with the current $50 billion. Number one, and as you pointed out very clearly, Mr. Chairman, it is arbitrary. We remember the discussion of providing some separation between the very largest institutions so that we did not have a moral hazard issue, and that I think was significantly what allowed the Congress to decide to put it at $50 billion.

It clearly includes institutions that are not systemically important, and I will come back briefly to that point in a minute.

Number two, it only considers size, and size alone, and one of the things that has happened in the 5 years, I think, since the passage of Dodd-Frank is that we have learned a lot about how we can measure and evaluate systemic risk exposure.

Importantly, it is not indexed. Fifty billion 5 years ago will be an increasingly small number relative to the banking industry and relative to the overall economy. And yet when it is in the statute, it is something the regulators cannot ignore.

Importantly, it diverts scarce assets. This is true for the financial institutions, particularly the regional institutions that are most affected by it. But it is also true—and I feel very strongly about this point from the regulatory point of view. The bank examiners with the sophistication and the skill sets to be able to evaluate stress test, for example, or living wills are not a fungible commodity. There are not a lot of them. And it is very important that that group be focused on the institutions that are truly systemically important. And for those reasons, we are suggesting, number one, we are putting in a soft line, a $250 billion suggestion. We are not wedded to that. We just think it should be above the 50. But, very importantly, we think it should be a presumption as opposed to an absolute so that financial institutions who are at that size but not strategically important, as measured by the regulators, would not be—could be so recognized.

Also, one other issue that we did talk about, Mr. Chairman, is that we had suggested that there would be—an idea that we think is worth pursuing is to have at least a task force looking at a trial run on consolidating the examination forces of the Federal regulatory agencies, and I could pursue that question if there is interest.

Thank you.

Chairman SHELBY. Explain that.

Mr. OLSON. We are suggesting—in our report we included a recommendation that through the FFIEC there is a test plan to consolidate for examination purposes the examination forces of the Federal regulators, Federal banking industry regulators.

Chairman SHELBY. Professor Johnson.

STATEMENT OF SIMON JOHNSON, RONALD A. KURTZ PROFESSOR OF ENTREPRENEURSHIP, MIT SLOAN SCHOOL OF MANAGEMENT

Mr. JOHNSON. Thank you, Senator.

In the run-up to the crisis of 2007, the Federal Reserve did very badly. It had a great deal of discretion over how to watch for risks in the financial system, and it failed in those tasks almost completely with regard to not only the largest financial institutions in the country but also some of the medium-size firms, including National City Bank in Cleveland.

As a result—and I think sensibly—Congress in the Dodd-Frank Act gave some rather more specific instructions to the Fed to encourage them to focus their attention. This includes the issue which we are discussing today, Section 165(a)(1), which reads, "The Board of Governors shall establish prudential standards," and then

paragraph (a) says, that "are more stringent," and that "increase in stringency," based on some considerations that are specified later in the statute that include exactly the issues you discussed in your hearing last week and that have been foreshadowed here today: risk, complexity, derivatives, and so on.

Now, I understand there is concern about this threshold of $50 billion, and I think that is a good discussion, and I think it is very good that you are holding the hearing, Senator. But I think if we are going to discuss numbers, we should be talking about exposures, risk exposures, total balance sheet size, which includes, of course, not just on-balance-sheet assets but also off-balance-sheet assets. Now, that includes different things for different banks. For some of the global megabanks, it is derivatives. Frankly, the derivative positions that some of these guys are carrying relative to their capital bases is very scary. I do not think that regional banks are in that kind of business, but they do have a risk exposure, a credit exposure, an asset size that is larger than just the stated asset number. The statute, I think unfortunately, has been interpreted as meaning only on-balance-sheet assets.

So if you are going to talk about size, let us talk about exposures, and let us be careful in terms of how we define that. Obviously, if you are just going off to on-balance-sheet, what you are doing is creating an incentive for various kinds of financial firms to shift their business off balance sheet and to get around any kind of threshold or safeguard that you create in that way.

Now, I have looked at the banks that would fall in the 50 to 100—I really do not think you should go to $250 billion in terms of a limit. Bear Stearns, when it failed—remember, early 2007?—had a balance sheet of under $400 billion. If you allow people with a balance sheet of 250, that is a risk exposure. I mean, I can take you through the banks in the 350 to 400 range. That is basically saying to the Fed, "Eh, do not worry about the Bear Stearns-type category." I do not think that is the message you want to be sending to them.

I have gone through and I put in my testimony in Section B if you look at all 10 of the bank holding companies that were between $50 and $100 billion in terms of total assets, at the end of 2013—and I did that because that is the last year for which we have the systemic risk reports that the Fed now requires. If you look at those 10, 4 of them actually had a total exposure—what I am talking about—over $100 billion. That is a substantial financial institution. Of the remaining six, two are subsidiaries of large non-U.S. banks that just failed the stress test administered by the Fed.

Now, the foreign banks are not here to speak for themselves today. I understand that. I do not think they are lacking in resources to be able to handle the stresses. I mean, these are gargantuan organizations. They failed the stress test because they are not paying attention and they are not showing respect. So I do not think you want to let them out on their own.

Of the remaining four, two of them had total exposure between $95 billion and $100 billion. That is pretty close to $100. So now we are talking about Huntington Bancshares in Ohio and Zions Bancorporation. Well, you probably saw the coverage in the Wall Street Journal on Monday about Zions Bancorporation and the very

big gap in their understanding of risk between the view of the Fed. Now, that is a fascinating set of problems right there. So perhaps we are talking about moving Huntington Bancshares up to a different category, and that is an interesting discussion.

Please, do not go back to the situation which we had before of just letting the Fed decide. Let the Fed have discretion. Let the Fed choose the criteria. The Fed did not get it right. On a bipartisan basis they did not get it right pre-2007. Please do not do that again. Please do not go to a limit of $250 billion. That will be ignoring the Bear Stearns-type problem.

I think we should also recognize and hopefully discuss today variation within the regional bank models. I mean, in terms of the regional banks, the standard classification we are all using now, I guess, PNC and U.S. Bank are pretty substantial. They are as large relative to other banks as Continental Illinois was when it failed in the mid-1980s. And on the other end, we have banks like Huntington that are genuinely small banks and I think, you know, have a case for being regarded as being simpler and in some sense safer for themselves and safer for their shareholders. Their shareholders should be appreciative of the additional risk management measures that have been put in place as a result of Dodd-Frank.

Thank you very much.

Chairman SHELBY. Thank you, Professor Johnson.

I will direct my first two questions to Mr. Ireland and Mr. Olson. As I mentioned in my opening statement, a recent report by the Office of Financial Research, OFR, uses different quantitative criteria to determine whether a bank is systemically important. Do you agree that the criteria-based analysis cited in the OFR report is a more appropriate way to determine systemic risk than the current $50 billion asset threshold? Mr. Ireland?

Mr. IRELAND. Absolutely. The asset threshold, quite frankly, does not make any sense. The reason you rescue banks in various times is not because of their assets, but because of their liabilities and who they might threaten if they go down. It is not the asset size.

Chairman SHELBY. It is about their risks they take.

Mr. IRELAND. It is the risks they take and the risks that they are going to transmit to the rest of the economy. And the OFR criteria that are based on the Basel criteria look at those transmission channels and rate banks based on those transmission channels. I think that is a much more precise approach to dealing with the issue.

Chairman SHELBY. Governor?

Mr. OLSON. Mr. Chairman, I would agree, but I would put it in a slightly different context. It seems to me what the OFR new standards are is an example of some of the thinking and some of the tools that are now used to evaluate and measure risk exposures in a variety of ways that have happened since Dodd-Frank and since the passage of the bill and 165. So what we are seeing now, that is a good example, and there are a number of others, both of the U.S. regulators and international regulators, of how they have measured risk, although there is—to take into consideration the complexity, for example, the substitutability, the suitability, and other factors like that that really determine what the risk exposure is.

Chairman SHELBY. I will tailor this question to Mr. Ireland and Mr. Smithy. Last week, we heard from the regulators here that they are tailoring Section 165 standards based on a bank's size. In your opinion—and start with Mr. Ireland and then Mr. Smithy—have the regulators "tailored" sufficiently to address differences in systemic risk here?

Mr. IRELAND. No. No. I think there are differences, and you see in the number of rules tiers where things become more—requirements become more rigorous as you go up in size. But those differentiations are very crude, and I do not think they really reflect the differences in risk, particularly the scope of differences that you see outlined in that OFR report.

Chairman SHELBY. Mr. Smithy, do you have an opinion?

Mr. SMITHY. I would agree with Mr. Ireland that whereas the Fed has used efforts to tailor, it has been in one direction. It has been up. Again, they have used asset thresholds rather than always a range of practices. Range of practice would be more beneficial in determining how the risk should be tailored to the regulation.

I would also say that the issue at its heart is that they cannot tailor down, *i.e.,* a $51 billion bank has to be treated——

Chairman SHELBY. It is arbitrary, is it not?

Mr. SMITHY. It is. It has to be treated with higher prudential standards than a $49 billion bank even though the risks of those two institutions may be very similar.

Chairman SHELBY. Mr. Smithy, we have heard testimony that the regional bank model is simpler than that of the Nation's largest banks. The OFR study shows systemic risk scores that vary by a factor of over 125 ranging from 0.04 to 5.05. That is a good range there. Regions Bank scored 0.11 on the scale, which is about 2 percent of the systemic risk measure assigned to the highest scoring bank. Nonetheless, your bank is considered to be systemically important because it has more than $50 billion worth of assets, not necessarily because it is risky.

Mr. SMITHY. Right.

Chairman SHELBY. Please explain how your bank's business model differs from the Nation's largest banks and why that matters here.

Mr. SMITHY. Sure, Mr. Chairman. We are a very simple, straightforward business model. We take deposits and we focus on lending in our local communities.

Chairman SHELBY. Most of the regional and smaller banks, is that what they basically do?

Mr. SMITHY. Yes, sir.

Chairman SHELBY. OK.

Mr. SMITHY. And so what differs from our balance sheet and the risks inherent in our balance sheet versus some of the larger, more complex banks, the G–SIBs, is that we do not have complex trading activities. The largest single risk we take is credit risk. That is the risk we understand. We know how to manage it. We underwrite that every day. And we use our deposits, and 80 percent of the deposits—or, actually, almost 90 percent of the deposits that we take in are used to fund lending activities; whereas, for some of the G–SIBs, that number is closer to 60 percent. Less than 1 percent of

our balance sheet risk or the risk we take is related to broker-dealer activities or derivatives activities; whereas, that number is closer to 20 percent for the G–SIB banks.

Chairman SHELBY. Governor Olson, according to your testimony, you spent a year and a half researching and assessing the effectiveness of Dodd-Frank, and one of the things that you concluded is that the $50 billion threshold is arbitrary. I think most people agree with that. Can you comment on how you reached that conclusion? And based on your experience—and you are a former Member of the Board of Governors of the Federal Reserve—would the regulators have sufficient information to assess whether a bank is systemically important if the $50 billion threshold were changed?

Mr. OLSON. Mr. Chairman, regarding the first part of your question, how we arrived at that, together with the sponsors that were working with us, Richard Neiman and I interviewed maybe 50 to 100, somewhere in that range, people representing academia, representing the financial community, many, many, many former regulators, representing of the consumer interests, and others, and focusing—our task force focused on the issue of architecture. And we found no advocates for maintaining the $50 billion threshold as a measure of when there is systemic risk. And so that was one of the first and easiest issues that we put forward.

In fact, some of us old-timers who have been around a long time suggested that, back in the day, that probably would have been handled through a technical corrections bill following in the next Congress or two Congresses later because it did seem to us pretty obvious.

To the second part of your question, the bank regulators have almost unlimited access to the banks themselves and have a lot of ability to look at risk exposures. For example, in relation to the previous comments that we heard here, for example, as early as 15 years ago when I was on the Fed Board, the bank regulators were looking at off-balance-sheet on a consolidated basis. So in terms of looking at capital adequacy and the measures of the manner in which they were looking at it, we had the ability to look at it very thoroughly.

So the ability is there. What we are asking for now is the flexibility.

Chairman SHELBY. Governor, do you believe that raising the $50 billion threshold would hinder the Federal Reserve's ability to tier its supervisory regime?

Mr. OLSON. That raising it would hinder their ability? Raising it would not hinder.

Chairman SHELBY. Would not. You believe that in the $50 billion threshold would hinder?

Mr. OLSON. No, I do not, Mr. Chairman, but I would like to add to that that we are also stressing that there ought to be an element of flexibility in terms of where that threshold is.

Chairman SHELBY. Thank you.

Senator Brown?

Senator BROWN. Thank you. Interesting discussion.

A question for you, Mr. Johnson. And, Mr. Smithy, thank you for joining us, and I have a couple questions for you.

Professor Johnson, most people agree that Senate drafters of Dodd-Frank set the threshold at $50 billion because they wanted to avoid creating the moral hazard associated with a market perception that an institution is too big to fail. Is that an appropriate line to achieve that goal?

Mr. JOHNSON. Yeah, I think that was a very good idea, Senator. The problem, for example, with the Basel Committee criteria that we are discussing that defined these—they currently have 30 G–SIBs, the global systemically important banks—is that this is the too-big-to-fail crowd. If that is the list that people in the market know have Government support, that is a very dangerous notion around the world. In the United States, we have a more diverse financial system. It was a good idea to have a threshold below, definitely below where the more intense too-big-to-fail issues are so you can look carefully—you do not have to spend all your resources on these mid-size banks, but you have to pay attention to them because, in particular, the interaction in some of these banks and some of the really big too-big-to-fail banks, that is where a lot of the damage happened last time and would happen again.

Senator BROWN. Implicit in that action would no one really—no one in the market really believes that Huntington or Regions or M&T are systemically such that they are too big to fail, that the Government would bail out, correct?

Mr. JOHNSON. That is exactly my understanding, Senator, that if you take Huntington, for example—not to pick on them, but just as the name has come up—I do not think they are too big to fail. They are, however—they have, it is true, crossed this category where Congress asked the Fed to pay more attention, and the Fed is paying more attention. And I guess one of the banks in this category appreciate the attention.

Senator BROWN. Mr. Smithy, you mentioned M&T Bank's compliance costs. Tell me about Regions' compliance costs last year, and where do other members of your coalition of many banks, a dozen, a couple dozen, where do the other members of your coalition fall on that spectrum?

Mr. SMITHY. So, Senator, we mentioned in the testimony that for the group that we represent, there is greater than $2 billion annual cost for compliance—or an increase of $2 billion versus the period——

Senator BROWN. Spread over how many banks?

Mr. SMITHY. Spread over 20 banks. So M&T cites roughly a $400 million, a little over, cost for compliance. I would say Regions number is closer to $200 million, but, Senator, those are just the direct costs. And I think one of the more important elements of this are the indirect costs, which are management and the board's time and attention away from serving the needs of our customers and serving our communities as well as the enhanced supervisory standards create increases or higher capital levels and liquidity levels at that level, at the $50 billion level, that we must adhere to through CCAR and LCR, that frankly means there is less of those resources available for lending. And for a company like Regions, that standard being lifted would likely liberate as much as 10 percent additional capacity for lending, which could be $8 to $10 billion.

Senator BROWN. OK. Thank you. That is helpful.

We understand that in banking, or perhaps like in all things, time is money. I talked with Comptroller Curry last week about the fact—and had a number of conversations with him, private and public—tend to like—not to like business lines that do not bring in revenue, understandably, and compliance costs certainly are that. He spoke a lot about, you know, a risk officer and about someone, if—I think it is probably safe to say if Nat City in Cleveland had had a risk officer of the stature of some other leading bank officers and executives sitting at the table with similar compensation and similar authority and similar gravitas, Nat City would not have gotten in the problems it did, and while Nat City still survives inside PNC, it did great damage to the city I live in and many others in Ohio.

I guess the point is that strong rules and risk management can ensure that practices that are profitable in the short term do not become harmful in the long term. I know you agree with that, but I think it is something important to emphasize.

Let me more specifically, Mr. Smithy, ask you about some of the more onerous rules, what you think are the most onerous rules for Regions. Governor Tarullo emphasized stress testing as the biggest issue for regional banks. Which rules do you find are the most onerous? Speak specifically of your Alabama bank, if you will, not so much the coalition. So speak about the onerous rules for you, and then if you would, broaden that. Is that what your coalition banks would say, too? Is that true for your coalition members? Give us some very specific rules that cost you, that you think are onerous, that you think cost you too much.

Mr. SMITHY. So, Senator, at the $50 billion level, we are subject to enhanced standards, which, again, as I mentioned, includes stress tests, which frankly we think are a good idea. I will fully stipulate that pre-crisis the banking industry was in greater need of enhanced risk management practices and stronger internal modeling, stronger capital planning activities.

I think the stress test that emanated from the original SCAP and have evolved into CCAR are a good thing. As a matter of fact, we built our whole entire capital planning process and strategic planning process around the stress testing framework.

Where it becomes——

Senator BROWN. If I could interrupt for a moment, would the other 19 banks pretty much say what you said in your coalition about stress tests?

Mr. SMITHY. I think they would largely agree, yes.

Senator BROWN. OK. Proceed. Sorry.

Mr. SMITHY. Where it becomes more challenging or restrictive is, as part of the CCAR process, there is a stress test that the Fed conducts on banks, and there is an outcome from that stress test in terms of losses. And at the end of the day, our capital levels that we must manage to, despite what we calculate internally, the binding constraint becomes what the Fed calculates for us. And so one of the challenges—there are certain asset classes and products where the Fed sees risk just inherently higher than do the banks.

A specific example would be commercial real estate, for example, and that is one that is—there is a much larger loss content for

commercial real estate loans in the Fed's models than they are for bank models.

So what does that mean? Well, that means that as a bank that must supply capital and liquidity to that business, A, we have to decide whether or not at that level of capital allocation it is worthwhile for us to be in those businesses, if we can make money in those businesses. And so the extent that that loss estimation, again, becomes our binding constraint, we have to decide whether or not—that we can allocate capital. And if we decide that we cannot and make money in that, then that activity gets increasingly pushed out of the regulated space and into the shadow bank market. And then one has to question whether or not the same level of needed liquidity will always be available.

Another example that I would give you is around—I was recently in western Tennessee in our Memphis office meeting with a group of bankers that cover our Ag lenders, and they were citing that internal policies to match the cost of providing those services, liquidity and capital, were increasing the cost on Ag lenders, and that made for some very difficult conversation—excuse me, Ag borrowers, and it made for some very difficult conversations with those long-time customers.

But, again, those are just some examples as to us being subjected to the internal stress test. Not only the test but the capital levels that come from that and the enhanced liquidity standards has a real cost to our customers, and it can affect whether or not we think we can be in those businesses strategically.

Senator BROWN. Thank you.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Crapo.

Senator CRAPO. Thank you, Mr. Chairman.

Last September, I asked Federal Reserve Governor Tarullo about increasing from $50 billion the current asset threshold for systemically important financial institutions, and he stated at that time that the Fed is open to considering a higher threshold "up to the largest bank" level. His answer reinforces my opinion that the $50 billion threshold is arbitrary and that Congress needs to determine a new threshold based upon the policy we intend to achieve.

With the remaining time I have in this question segment, I would like to explore the merits of either increasing the threshold to the $250 billion level, which Mr. Olson supports, or using an activity test, which I understand you are proposing, Mr. Smithy. And so why don't we start with you, Mrs. Why would an activity test be a better metric to use to determine systemically important financial institutions than a numerical threshold?

Mr. SMITHY. Well, again, it is the arbitrary nature, Senator, of the numeric threshold that we oppose. We think the activity-based approach uses the data that the Fed has calculated and provides transparency as to what are the sources of risk that not only the institutions need to consider in managing, but also the regulators. It helps provide a road map for them in determining where they should divert their resources to make sure that their regulatory efforts are commensurate with where the risk is occurring in the economy.

We do believe that ultimately there might be a correlation of size and those risk factors that above a certain size their size and risk seems to be more correlated. I am not sure exactly where to draw that line.

Senator CRAPO. That was going to be my next question.

Mr. SMITHY. But, again, I think you have the data and the OFR has the data. Now, we may argue about the elements of the data, and it may evolve over time. But you have the framework within which to determine where to draw the line if ultimately we do want to have an asset threshold.

Senator CRAPO. Well, thank you.

Mr. Olson, could you comment on that and also explain how the Bipartisan Policy Center arrived at the $250 billion threshold as the best approach?

Mr. OLSON. Let me take the latter first.

Senator CRAPO. Sure.

Mr. OLSON. We emphasized that the $250 billion is a suggestion, and we got to that point because many of us have worked on legislation over the years and have seen legislation come together and think it is unlikely that Congress would make a change without putting a number in. So we put a number in that we thought would be high enough to isolate the very largest and most systemically important institutions while limiting the ones, particularly the regional banks, that do not have that same criteria.

But we were quite clear that if there was a more appropriate number in there, we would be willing to go with that number, assuming also that there is some flexibility attached to it, so that it is a presumption as opposed to a hard line. And I think that is the real key, is making sure that you have that flexibility.

I think below that number, you have got—and especially if it is a hard-line number, you have a phenomenon that we have seen in a number of cases where it distorts markets. In other words, financial institutions will fight to keep below that line, and once they cannot keep below it, they may make a large addition in order to become larger to spread out the additional overhead costs of being a so-called bank SIFI. And so the combination of those is what we had in mind.

Senator CRAPO. Well, thank you. And just to clarify, if we adopted any number, whether it be $250 billion or we stayed at the $50 billion, isn't it correct that the banks that would be exempt under that numeric threshold are still subject to safety and soundness regulation on very——

Mr. OLSON. Not only safety and soundness, but they could be designated as being covered as a bank SIFI by the—the regulators still have the option based on the activity test, as you suggested, they could be considered systemically important.

Senator CRAPO. So the real question we are trying to get at here is whether an institution is a risk to the system, not whether they should be exempt from regulation.

Mr. OLSON. That is correct. And just as a reminder, banks over $10 billion are required to have stress tests, and I will support Mr. Smithy on that comment. I think the advent of that kind of stress testing and any sort of a model that institutions are using has been a very important step forward in supervision.

Senator CRAPO. Thank you.

Chairman SHELBY. Senator Warner.

Senator WARNER. Thank you, Mr. Chairman. Thank you for holding this hearing. And, you know, I agree with Mr. Olson. If we are going to be able to proceed on this, we need to find some bipartisan compromise to make sure we get it right, and I particularly appreciate the work of the Bipartisan Policy Center.

I will start with you, Mr. Olson. And I agree that the $50 billion number is a bit arbitrary, but wouldn't you concur—or what would you think if it was a $250 billion institution that had a great deal of geographic concentration? If that institution failed, while it might not bring down the national economy, it could have systemic effects at least on a regional basis, could it not?

Mr. OLSON. Concentration risk is a very significant risk, and it could be concentration geographically or concentration by loans. So, yes, very much so. We have seen in the Ag crisis and the oil crisis, we have seen times before where that issue was very important.

Senator WARNER. I agree with you on the notion that you want to have a line but not have it a hard-rule line, but oftentimes that is always a presumption going up and never a presumption coming down. How would we make sure that that presumption kind of ran in both directions?

Mr. OLSON. You would not—I think none of the Members of this Committee would be surprised, but it will come as no surprise to, I think, the Members of this Committee that the regulators pay a lot of attention to what the Congress thinks. And if the Congress makes a signal independent of the legislation, that will be heard and remembered.

Senator WARNER. Although I would simply point out that I think this Committee and all of us who were involved in carefully tried to draw a pretty firm line that said, particularly for smaller institutions, they ought to get a little more regulatory relief, and under the guise of best practices those practices have crept down even below the $10 billion.

Mr. Smithy, one of the things I have tried to get at, your concerns—what I hear more often from my regionals is sometimes less about actual capital standards or liquidity ratios, but actually just the cost of all the compliance, not so much the operating costs but just the costs of dealing with all the regulators. When you say that $200 million cost for your institution, can you break that out in terms of kind of actual personnel dealing with the regulators versus business costs, business model changes?

Mr. SMITHY. Well, a fair amount of that is increased spending on systems and technology. There are roughly 100 people that work on, let us say, the CCAR process, which is one element of stress testing. There is another probably 10 or so that work on liquidity stress testing, and those are increasingly becoming more integrated. So there is certainly a direct cost from personnel.

There is probably another 150 people around the organization that have a part in that process, but it is not their full-time job.

So I would say that there is a lot of technology spend, a lot of models that have been built, infrastructure, the control environment. There is, you know, a quality program that we have put

around the whole process to ensure that it is a properly controlled environment. And so there are many layers to that cost.

Senator WARNER. I guess what I am more—I am sympathetic to trying to cut down some of these layers, trying to cut down some of the compliance costs, but without sacrificing the standards. So let me go to you, Professor Johnson. Would you not see that there could be things we could do? For example, I think Mr. Olson's suggestion of a consolidated exam schedule is a great notion. But what I hear constantly from institutions is that they have got one set after another of regulators coming in, and that drives up the cost tremendously.

You know, I really question in a plain-vanilla institution whether we ought to have—the living will process makes sense, but the idea that the living will process ought to be done repeatedly if you are not changing your business model? Are there other places where we might be able to give, even with your, I think, appropriate focus, daily liquidity capital ratio requirements that take a lot of time? I do not even think the regulators can look at it on a daily basis. But would you even as an advocate of tight reform be willing to look at areas where we might be able to drive down compliance costs but still keep appropriate prudential standards?

Mr. JOHNSON. I think these are all good questions, Senator. I think the regulator has considerable discretion to tailor, and that is what they told you last Thursday. I read the transcript of that hearing fairly carefully, and I think consolidated examinations to some degree would be a good idea. Please do not forget that the FDIC's back-up examination authority has turned out in the past to be very useful as a safeguard, both for with regard to the system and also with regard to shareholders and creditors, and, of course, the Deposit Insurance Fund, which is on the hook when a lot of these smaller banks fail.

So I think reducing compliance costs where it makes sense is sensible. I am very encouraged, though, by what Mr. Smithy said, and I think also what the Chairman said, which is Congress mandated some better risk management practices, and they have been adopted by many banks willingly, and they make very good use of them. And I do not think their shareholders would want to go back.

So when we talk about the cost of compliance, I think we should also break out that part which is now best practice, as you called it, Mr. Chairman, and that part which you might regard as being a bit too much if you are $50 billion. Do you need to do a living will every year? That is a good question.

If you get up to $200, $250, $300 billion, I think you should be paying very close attention. We have had some rather bad experiences with banks, both of that size in terms of nominal dollars and that size relative to the scale of the economy. You look at percent of GDP, what was Long Term Capital Management, what was Continental Illinois? It is exactly when you are getting up into that level, 150, 200, 300, that is when the Fed should be paying attention.

Senator WARNER. Thank you, Mr. Chairman.

Chairman SHELBY. Senator Corker.

Senator CORKER. Thank you, Mr. Chairman, and I want to thank all of our witnesses for being here.

Mr. Johnson, welcome back. I know you are gladly playing the skunk-at-the-party role here. It is good to have you here again.

There has been a too-big-to-fail discussion here today that has been odd to me, and I would like to ask for a brief comment of all of the witnesses. I realize that people's memories fade, and over time things change, but over the next decade or so, let us say, if one of our larger institutions failed, is there any question that they would be—their equity would be wiped out, their boards would be wiped out, and their executives would be wiped out, their junior debt would be wiped out? Is there any question in your minds about that?

Mr. IRELAND. No. What happens in—

Senator CORKER. Well, that is good enough.

[Laughter.]

Mr. SMITHY. No, Senator, not in my mind.

Senator CORKER. Well, why do we keep using that word? I find it misleading to the public and misleading in a debate when, in essence, they would be wiped out. So, Mr. Johnson, go ahead.

Mr. JOHNSON. So, Senator, I am on the FDIC Systemic Resolution Advisory——

Senator CORKER. Is it yes or no, first?

Mr. JOHNSON. The answer is no.

Senator CORKER. You do not think they would be wiped out?

Mr. JOHNSON. Not necessarily. No, that is the problem, Senator. This problem is not over. Their probability they would be wiped out is higher. I will grant you that. Dodd-Frank has made some progress, yes.

Is the answer to your question an unequivocal yes? Unfortunately not. That is a very, very big problem. I think it is a problem for the regional banks also because of spillover dangers from these, too big to fail could have on the regional banks that we should not want.

Senator CORKER. Yeah, well, what I find fascinating is all the regional banks use these words, "too big to fail." I was with a group of them the other day, the 10 to 50s, and really was disappointed by their presentation. So they do not—they use these words, "too big to fail." I disagree. I think if a large bank failed today, they would be in essence wiped out. Would their drive-in window still exist? Yes. Would their building still exist? Would their management be there? No. Would their equity be gone? Yes.

So it is interesting. None of the regional banks want to be systemically important, and yet they keep using this pejorative term, "too big to fail." So I would just like to understand—not from you—where that is coming from.

Mr. Smithy, can you share—I find that to be an odd place for people to be.

Mr. SMITHY. Well, Senator, as I stated, I do not think that too big to fail is indeed true in the context of whether or not management would be wiped out, equity of investors would be wiped out. I spend——

Senator CORKER. That is fairly painful, is it not?

Mr. SMITHY. That is the most painful thing that could happen, and as a Treasurer whose job is to ensure, you know, proper liquid-

ity and capital for the institution, which is the lifeblood of the business, it is death of the business.

Senator CORKER. Let me just make a statement, and I know my time is going to run out. The way this debate all started, the ICBA came in and wrote a letter before we even had a bill, and they supported Dodd-Frank before Dodd-Frank existed, because basically what they thought was going to happen is they were going to get them, not us. They were going to get them, not us.

And, obviously, what happens is over time the smaller institutions do get engulfed in all this, and that is what has happened, and certainly there are some things that need to be resolved, and I agree with that.

I do think the $50 billion threshold that—look, one of the things that is most strange about serving in the Senate is you realize we just make this stuff up, right? I mean, somebody decided 1 day it was 50, and that is what it was.

On the other hand, Mr. Ireland, I do have a degree of trepidation in punting again to the regulators. We did so much of that during Dodd-Frank, and so the qualitative piece is interesting to me. But I am not sure I want to punt again, I am sorry, especially not to FSOC, which I do not even really believe is functioning. I believe it is stovepipes of nothingness. It is not functioning the way that it should.

So I have got concerns about that. Everybody obviously wants the level to be $10 billion above wherever they are, right? I mean, if you are at 50, you want it at 60. If you are thinking mergers and you are at 90, you want it at 120.

So, I mean, everybody wants the number to be just above where they are and yet people keep using this too-big-to-fail piece, which, again, I find fascinating.

I will remind people that TARP was spent on banks of varying sizes. That is a United States citizen risk when that occurs.

So I would just close with this. I have got 16 seconds over. I am very open to making changes. I think we should make changes. What I am not interested in making changes is groups of people coming in saying, "Get them, not us. We are not them." And this lobbying effort that is taking place, to me, is not healthy. To me, what we need is a healthy financial system, and I do not think we are focused on that right now. We are focused on groups of people who want relief, some of which is well deserved. And I think the 50 is too low. But I am more interested in making sure we have a stable financial system which creates—which means we have banks at all levels that are regulated properly. And I do not see that as being what is taking place here now.

So, Mr. Chairman, I appreciate you helping illuminate that with this hearing, and I look forward to working with you.

Chairman SHELBY. Senator Warren.

Senator WARREN. Thank you, Mr. Chairman. Thank you all for being here today.

After the financial crisis, Congress decided that the bigger banks should be subject to more oversight than the smaller banks. Congress drew the dividing line at $50 billion in assets, a threshold that left out all but about 40 of the 6,500 banks in the country. And then after drawing that line, Congress explicitly gave the Fed

the discretion to tailor how those standards applied among that small group so that the biggest and the smallest could be treated differently.

Now, I know some people in the banking industry want to completely exclude even more banks from Dodd-Frank's stricter scrutiny, but the alternatives to the current $50 billion threshold raise a whole new set of problems.

Professor Johnson, we have heard today one suggestion is to replace the $50 billion threshold with a multi-factor test so that the Fed would have to do an intensive study of every bank to determine whether they should be subject to higher standards or not. So I want to ask: Do you think that is a workable solution?

Mr. JOHNSON. No, Senator. I think the Fed has a very bad track record in applying exactly that confused, multiple-criteria set of issues. They could have done that before the crisis. They had a responsibility, clear legal responsibility to do it before the crisis, and they did not. So I do not think it is a good idea to ask them to do again what they previously failed to do spectacularly.

Senator WARREN. All right. Thank you. It seems like we have some evidence. We have tested that approach. And it seems like this particular proposal would require the Fed to spend a lot more time on an administrative task, leaving it a lot less time to spend on actually regulating and supervising the riskiest banks, which was exactly the point of Dodd-Frank.

Now, the other proposal that has been talked about today is simply to raise the threshold to some higher number, like $100 billion or $250 billion. And the main argument I hear in support of that is banks with about $50 billion in assets would not pose any systemic risk if they failed. I think that is what we have heard repeatedly today.

You pointed out, Professor Johnson, that a $50 billion on-book bank can actually be a $100 billion off-book bank, posing much higher risk, but I want to focus on another aspect.

We learned or should have learned in the 2008 crisis that several banks can find themselves on the verge of failure at the same time. So, Professor Johnson, do you think it would pose a systemic threat if two or three banks with about $50 billion on-book in assets were on the verge of failure?

Mr. JOHNSON. Absolutely, Senator. In fact, the typical pattern of financial crises around the world—I used to be the chief economist at the International Monetary Fund. The typical pattern around the world is exactly what you talked about, which is you have some smaller financial institutions that are failing together, have very highly correlated portfolios, and then the thing starts to snowball and you bring down a really big financial player, one of the biggest banks in that market. Then you have got a full-blow financial crisis.

So I think the scenario you are talking about is exactly typical experience of financial crisis always and everywhere.

Senator WARREN. So when we are talking about the risks that the $50 billion banks pose to the economy, we need to consider that not just one bank could go south at a time, but that two or three or four could be following similar business practices, get caught short at the same time, which would pose a much bigger risk to

the economy. So it looks like to me we can use one of two approaches:

We can draw the line somewhere, like $50 billion, and then rely on the Fed to use its discretion to tailor its supervision appropriately and to consider the risks that these banks may pose not only individually but also may pose together.

Or we can raise the threshold number; we can cut loose all the banks that are smaller than $100 billion or $250 billion on-book, and who knows how much additional risk they have got off book, and hope that two or three of them do not make the same mistakes the way the banks did in 2008, when they nearly brought down the whole economy and had to be bailed out.

You know, me? I would rather err on the side of being careful and covering a few banks that may not pose as much risk rather than running the risk of another crisis that plunges our economy back into recession. And since the American taxpayers are on the hook when the economy starts to implode, I suspect that most of them would prefer that Congress be careful as well.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Rounds.

Senator ROUNDS. Thank you, Mr. Chairman.

Mr. Olson, I have to share with you, I had 2 years in which we participated in activities at the Bipartisan Policy Center and the Governors Council, and I found the approach to be enlightening and I found it to be encouraging when we could come together and find ways in which on a bipartisan basis we could impact policy change at the national level. And listening to the testimony here among all of you, it has been enlightening to me today.

I just want to just come up an analysis to begin with in terms of where I want to go with this, and then I would like your thoughts on this.

The designation of a bank as systemically risky has a wider ripple effect across the economy as a whole, and I know that we are talking right now simply about the safety of the bank and about whether or not we could have a catastrophe on our hands if the banks were to fail. But last week, when we talked to the regulators, they were basically telling us that we did not have to worry and that they knew what they were doing when it came to regulating the banking industry.

I think they were well intentioned. I think they really do believe that they have things under control. But what I want to know is when we talk about their decisions and the impact they have not just on the banks but on the economy as a whole and how it affects the borrowers and access to credit, to me their answers were troubling, because it seemed as though we were looking at this in a vacuum.

I think the regulatory decisions they make do not just occur in that vacuum and that they have a real effect on real people that need access to capital and credit.

For example, when a bank is forced to hire more compliance officers or retain more capital, it makes fewer loans. And I think that is what Mr. Smithy is suggesting. This means that there is less money available for small business owners to start and expand businesses.

If we take a look at what is happening to our economy since the beginning of a recovery and what appears to be not a robust recovery, I wonder whether or not a lot of that has to do with literally a regulatory hand on the top of the ball which is sitting in the water, holding it down from where it would otherwise be.

So, with that, I am just curious, because, Mr. Smithy, you have talked about the impact that it has had on your bank, but from 2009 to 2013, your risk management expenses, I believe under your testimony, you indicated that it had doubled. Now you have indicated that your costs are somewhere around $200 million.

But what did it do to your ability to make loans? I mean, I think there is an impact there. Would you care to share a little bit about what the impact has been on your bank's ability to make loans?

Mr. SMITHY. Sure. I would add one other stat that is very interesting. We now have more people in our organization devoted to compliance-related matters than we do for commercial lending.

Senator ROUNDS. As a matter of fact, I think across the financial institution world, right now we are talking about since 2009, I think the number I heard was 300,000 more people employed in financial services, and it is in compliance is where they are at rather than in the production side of things.

Mr. SMITHY. And, again, Senator, I would stipulate that we have learned a lot through the process. We are better at understanding the risks we take. It is better controlled. We have better concentration risk management practices in place. There has been, you know, modeling enhancements that have come out of the crisis and the stress testing framework that I would submit helps us make better decisions. But at the end of the day, it is the fact that we have to keep capital and liquidity in surplus to guard against risks that we think are remote, and that is capital and liquidity that cannot be used to make those loans, you are suggesting.

Senator ROUNDS. I think there seems to be a sense that $50 billion was arbitrary and that it is a matter of trying to find the right number. But also we have heard testimony today that it should be based upon the activity that is being involved, and that would be perhaps a better model.

But, Mr. Olson, I am curious. Under the proposal that have looked at, how do we know that if we allow more of an opportunity for the regulator to make those decisions that we do not end up with a regulatory process which is even more challenging with regard to trying to figure out what the regulator is going to want this year versus next year versus the following year? And just how much tether should we have on a regulator to make those demands upon the banking industry or the individual banks that they are looking at?

Mr. OLSON. A very important fundamental question, Senator. And having been on both sides, having been a banker and having been a bank regulator, being a banker, among other places, in Fergus Falls, Minnesota, and being a bank regulator with the Fed, one thing that becomes very clear when you become a regulator is that Congress has given a very specific mandate to the regulators. Your responsibility is the financial institutions' safety and soundness and compliance with laws and regulations. That is the rule.

So the balance between what is the appropriate regulatory regime and legal regime is the responsibility of the policymakers, which is the Congress. That to me is why we are having—why it is important to have hearings like this, especially in light of a major piece of legislation, much of which is supported by the Bipartisan Policy group in terms of its overall effect. But looking at that balance is really key.

Senator ROUNDS. Thank you.

Thank you, Mr. Chairman.

Chairman SHELBY. Senator Scott.

Senator SCOTT. Thank you, Mr. Chairman. Thank you for those serving on the panel this morning giving us an opportunity to have insight into your perspective. I certainly appreciate the academic perspective of Professor Johnson on the impact of this new regulatory environment.

I, on the other hand, am a small business owner, and so for me, I look at the perspective of how all this comes down to the end user, the person, Mr. Smithy, who comes into your bank looking for a loan. In South Carolina, I think you guys have about $1.2 billion of outstanding loans. What that means to me is that the ability for small business owners to invest, to innovate, and, more importantly, to create jobs is visible through the number of dollars in outstanding loans to small business owners in my State who are better prepared to make sure that our economy continues to grow. And I am a believer that we need to have responsible regulations. My thought is that we do not need to have irresponsible levels of regulations. I am on the Finance Committee as well, so I have headaches many days of the week.

But I will suggest to you, as I did to Governor Tarullo, that the Basel and Dodd-Frank standards that come with the SIFI designation is like a tax on labor and capital, and that tax has a dynamic negative growth effect on our economy. And you have said it a number of ways, Senator Rounds, I think Senator Warner asked a similar question. And my question really goes to the impact on small business owners like myself in this climate. You said that there were approximately—your compliance costs were a little over $200 million. You have 150 compliance officers. And then your last comment was not shocking, but it should be shocking, I think, to those who are not familiar with the impact of the Dodd-Frank regulatory environment. You now have as many folks working on the regulatory side as you do on the lending side. That suggests to me that perhaps the climate that you are working in is not conducive for actually having an impact on the economy through lending money. You are almost a company that now exists to a large extent for providing a conversation with the compliance officers. That does not make a lot of sense to me.

Mr. SMITHY. Well, obviously we would agree. I think we, too, are supportive of banking practices that promote stability in the communities that we serve and give us an opportunity to serve those customers and the communities' needs.

I think, again, we would fully stipulate that there has been a lot of improvement in internal practices, what might be deemed as compliance but are risk management practices that help us better serve the customer.

What I would say, though, is being deemed systemically important adds another layer of cost and oversight to that process that we think is not commensurate with the risk that we pose to the system, and so, therefore, it inhibits our ability to, as you say, focus on innovation, focus on technology, and focus on serving the needs of those customers. I would agree with you.

Senator SCOTT. Mr. Smithy, I do appreciate the fact that one of your opening comments was the fact that it was important for the stress test and the opportunity to make sure that you are safe and sound, those were important characteristics moving into the regulatory conversation. So I really appreciate the fact that you are not suggesting that there should be no regulations or that even enhanced regulation has not been beneficial to the industry. But the fact of the matter is that there has to be some threshold where it makes sense. Is that an accurate statement?

Mr. SMITHY. That is a fair assessment.

Senator SCOTT. Mr. Ireland, I see you shaking your head over there a little bit, and I will tell you that, to me, right now the SIFI threshold is too low, it appears, and we are making regional banks act like and think like and hire like it is a G–SIB. It is a large bank with operations that are so complex and so interconnected that the oversight, the enhanced oversight is absolutely necessary and that there is really no impact on the economy or on consumers. That just seems to fly in the face of reality. I assume that is a part of the——

Mr. IRELAND. I think that is right. I think, you know, as attractive as thresholds may be as a legislative solution, they are not consistent with practices, and the banking models are very, very different The risks they pose to the economy are very, very different, and they need to be treated accordingly to avoid creating what economists will often call "dead costs," which are compliance costs that do not reduce risk, that are merely there for compliance purposes and do not foster better banking.

Senator SCOTT. Let me use my last 13 seconds for Mr. Olson, because you just hit the nail on the head, which is the dead costs. We have finite resources available without any question. And so from my perspective, I would love to hear—as a former official at a bank, a regulatory agency, can you comment on why it is important for regulatory efficiency that we have a more meaningful way of figuring out where not to waste these very limited resources?

Mr. OLSON. Senator, that is a good question. It is the inverse of the squeaky wheel gets the oil. What we should be doing is concentrating these finite resources where the real risk exposures are. Right now all the wheels are getting the same amount of oil in a significant way, and there is a limitation, and I will defer to my former colleague Ollie Ireland in terms of in his testimony where he said that tailoring alone cannot address this issue. It will take a change in legislation. And he is better qualified to address that than I am, as I am not a lawyer. And so putting the resources in the right place is important.

I would also like to add that I have, as a former banker and a regulator, tremendous respect for the people who are now the examiners in the field. If I can have 20 seconds, Mr. Chair, I would just say that one of my burning memories is an examiner coming

to me and pointing out one of the most highly respected people in our community, and he brought in the file, and he said, "This person is going to fail." And I said, "No way. I know him too well, and I am too good a banker. He is not going to fail."

Well, I do not have to tell you what happened. He failed. And I have never—that has been a lesson to me on the importance of getting the input from the regulator examiners that can spot anomalies.

Senator SCOTT. Yes.

Mr. OLSON. Which is what the regulators do best. Thank you.

Senator SCOTT. Thank you, Mr. Olson.

Thank you, Mr. Chairman, for the extra time.

Chairman SHELBY. Thank you, Senator Scott.

Mr. Ireland, in your testimony you stated that the Fed "can establish asset thresholds above $50 billion for the application of some, but not all, of these enhanced prudential standards." Could you clarify where the Fed is limited by statute to tailor Section 165 regulations? Just for the record.

Mr. IRELAND. 165(a)(2)(B), asset threshold for application of certain standards, "The Board of Governors may, pursuant to recommendation by the Council"—this is the FSOC Council—"in accordance with section 115, establish an asset threshold above $50 billion for the application of any standard established under subsections (c) through (g).", which omits subsection (b), which specifies a number of standards. And so the $50 billion threshold for the (b) standards, which include risk-based capital, liquidity, overall risk management, resolution plan, concentration limits, and so on, are tied expressly to the $50 billion threshold.

Chairman SHELBY. Thank you.

Mr. Olson, in your written testimony, you recommend indexing the $50 billion threshold in Dodd-Frank to economic growth or a similar metric. Last week, Fed Governor Tarullo right here indicated that he would support indexing the thresholds set in Dodd-Frank. Why do you think it is important to index with Dodd-Frank?

Mr. OLSON. Senator, as the economy grows and as times change, and particularly with the impact of inflation, what is a $50 billion threshold in 2010 will be a fraction of that in 2030. And yet the threshold should move in concert with some other metric.

We are suggesting the metric being the size of the economy. It could be GDP. It could be the size of the banking industry or the financial services sector, but it is important that it be indexed.

Chairman SHELBY. Mr. Smithy, it is my understanding—and correct me if I am wrong on this—that when assessing systemic risk, the OFR-described methodology looks at the banks' interconnectedness as one of the factors which ought to address the concerns of several smaller banks bringing the system down. Are you familiar with that? Is that right?

Mr. SMITHY. Yes, I am, Mr. Chairman.

Chairman SHELBY. Is this correct?

Mr. SMITHY. That is correct.

Chairman SHELBY. Thank you.

Senator Brown.

Senator BROWN. Thank you, Mr. Chairman.

Dr. Johnson, I have long believed, as I know you have, and I have heard the Chairman speak about it often, that banks need more and better quality capital, that much of what happened to the bank in my city, National City, and banks all over the country, if they had been better capitalized, the problems would have been less severe.

Mr. Smithy said—and I appreciated your comments in response to my question earlier—that Dodd-Frank is not flexible enough because it does not relieve banks from capital and liquidity rules, and that capital and liquidity, therefore, insufficient capital and liquidity, if you will, inhibit lending.

Respond to that, if you would, Professor Johnson, on his comments about capital and liquidity and what it means for his bank. And if you would also tell us—answer a couple more questions. Are regional banks subject to any capital rules other than Basel III? And are these rules appropriate for these banks? If you would take all three of those.

Mr. JOHNSON. I think Mr. Smithy should speak about his bank, but in terms of the general pattern of the rules and the tiering of the system and also, I think, very much this is about the flexibility of the Federal Reserve, Basel III is an international agreement that sets some floors, and then the Fed has chosen how to build on top of that. And they absolutely have focused their attention on the largest, most complex, most interconnected financial institutions, which makes a lot of sense.

Now, the capital requirements are higher than they used to be across the board above some minimum size, and that also seems appropriate, Senator. In fact, I rather like the Brown-Vitter legislation that would set an even higher and more demanding capital requirement with a step up at $50 billion, I believe, and another step up at $500 billion in terms of total assets.

So I think that the capital requirements and the way they are being applied are appropriate. I think they are appropriate for the regional banks. The Fed has—and other regulators, but the Fed is in the lead here—a lot of flexibility in terms of how it applies them, and I do not think that they are too high. If anything, they are too low.

Senator BROWN. Thank you. A question about stress tests for Mr. Olson and Mr. Ireland and Professor Johnson. Yesterday's Wall Street Journal had a story that was cited earlier about Zions disagreement with the Fed about how much value their CDOs would lose in a financial crisis. Zions says the number is zero; the Fed says the number is 400. Mr. Olson, starting with you, and then—I am sorry, Mr. Ireland, then Mr. Olson, then Professor Johnson. If the Fed and the bank disagree on risk, who should win that argument?

Mr. IRELAND. Ultimately, the Fed has to win that argument.

Senator BROWN. Governor Olson?

Mr. OLSON. The Fed will win that argument without——

Senator BROWN. The question was: Who should win that argument?

Mr. OLSON. And I am not at all familiar with the individual circumstance of the individual bank other than what I read. But at the end of the day, the regulator will prevail in a stress test.

Senator BROWN. OK. I asked who should win the argument, not who will win the argument.

Mr. OLSON. It should be a balance, actually, because there are—the stress tests are—all of the stress tests have a certain amount of assumptions in them. So you have to go back, and you have to look at each of the assumptions, and it is the responsibility of the bank to defend all of the assumptions that they have made in that test procedure.

And so it needs to be an ongoing dialogue. It cannot just be an up-or-down.

Senator BROWN. Professor Johnson?

Mr. JOHNSON. Well, my colleagues have been very positive about the Fed and the Fed judgment when talking about setting criteria and so on. I am a bit more skeptical of the Fed's judgment. But my skepticism is a little one-sided. I think what we have seen based on that track record over the past, let us say, 20 years is they have tended to defer too much to industry assessments, and they have tended to understate losses. There are not that many instances we have seen where the Fed has got it wrong exaggerating how bad things are going to be. If anything, they tend to downplay the potential losses.

So I thought that article was really very interesting, and I think that is a big flag for anyone involved with Zions. The Fed is saying this on the basis of information and data and experience, and the Fed does not tend to over exaggerate the losses in these kinds of situations. Their bias has rather, unfortunately, historically been to defer to the industry.

Senator BROWN. Governor, do you want to speak to that?

Mr. OLSON. Yeah. Senator, I respectfully disagree. Having been on the other side of that table and having been on the side of the regulator listening for the 5 years that I was on the Fed Board, the banks telling us that we are too strict and too hard on them, his statement is clearly an overstatement.

Mr. JOHNSON. Senator, then how do we explain what happened in the run-up to 2007, the massive losses across the board in the financial system and the collapse of National City Bank, among other things?

Senator BROWN. Governor Olson was there right before that happened, my understanding, 2006.

Two more questions. Mr. Ireland, I thought I heard you say the Fed cannot lift the threshold of living wills. Is that correct? Is that what you said?

Mr. IRELAND. I think the—I read to you from the statutory language. I find the statutory language a little bit confusing myself, but one of the listed criteria or requirements in subsection (B) which is not accepted is resolution plans. And so it appears that they cannot lift the resolution plans if they are adhering to that statutory language.

Senator BROWN. Professor Johnson, I have one other, but go ahead.

Mr. JOHNSON. The regulators have said quite clearly, including last week, that they can tailor resolution planning to a very, very large degree. The one statutory constraint that they feel binding is on the stress test, and participation in the stress testing starts at

$10 billion, as we have discussed, on an annual basis run by the firms. But the semiannual stress testing at the firm level and the annual CCAR, that is a $50 billion requirement right now.

Senator BROWN. Last question, Mr. Chairman, and thank you for your indulgence.

Both Governor Olson and Mr. Ireland said that raising the threshold or eliminating it entirely would conserve regulators' scarce resources. I hear that argument a lot with community banks. I generally believe it. Simplifying the larger banks so that they are no longer too big to regulate would also, I think it goes without saying, help agencies better allocate their resources. So my last question, Professor Johnson: Do you think that regulators, regional banks, and taxpayers would benefit from the proposal that I offered sometime ago, the Brown-Kaufman bill—Senator Shelby supported it as an amendment on the Senate floor; Governor Tarullo has spoken out about it—to cap banks' nondeposit liabilities at 3 percent of GDP? Would that make the situation better?

Mr. JOHNSON. Senator, that would help on a number of dimensions, including enabling regulators to do a better job, but also reducing systemic risk as being measured by—you are all talking about the OFR report. Well, the OFR report, I think you should look at those levels of systemic risk that got around the biggest financial institutions. Those are very scary, Senator, and your Safe Banking Act would exactly address that issue in an indexed fashion, indexing the size of the largest banks to 3 percent of GDP.

Senator BROWN. Thank you.

Thank you, Mr. Chairman.

Chairman SHELBY. Mr. Olson, I noticed recently that some of our largest banks had some trouble meeting their capital standards in the stress test. Did the regional banks overall—maybe I should ask Mr. Smithy this question. Did they have trouble like our biggest banks barely getting over the line on some of the capital and stress test? Mr. Olson, you first.

Mr. OLSON. Mr. Chairman, I apologize. I do not have that information in front of me, so I am not able to answer.

Chairman SHELBY. OK. Mr. Smithy?

Mr. SMITHY. The regional banks did not face as many obstacles, if you will, in meeting their objectives.

Chairman SHELBY. OK. Do you know of any regional banks that—well, "any" is a big word—that failed their test?

Mr. SMITHY. Not to my knowledge this year.

Mr. JOHNSON. Excuse me?

Chairman SHELBY. Do you know, Professor?

Mr. JOHNSON. Yes, Senator. I am just looking at—using the definition of "regional banks" from Mr. Smithy's testimony, and Santander did fail their test. Santander is on the list; they did fail their stress test this year. And we have, of course, also been discussing the situation with Zions, which is also on the list, that barely passed the stress test.

Chairman SHELBY. You know, you have heard it said—and it was said here I believe by Dr. Volcker, and I will paraphrase him—that if you are too big to fail and you are too big to regulate, maybe you are too big to exist. A lot of people have that feeling, I believe, in America.

I thank all of you for your testimony today.

Mr. JOHNSON. Thank you.

Mr. SMITHY. Thank you.

Mr. OLSON. Thank you.

Chairman SHELBY. The Committee is adjourned.

[Whereupon, at 11:37 a.m., the hearing was adjourned.]

[Prepared statements, responses to written questions, and additional material supplied for the record follows:]

PREPARED STATEMENT OF OLIVER I. IRELAND

PARTNER, MORRISON & FOERSTER

MARCH 24, 2015

Chairman Shelby, Ranking Member Brown and Members of the Committee, it is an honor to be here today. My name is Oliver Ireland, and I am a partner in the Financial Services practice at Morrison & Foerster here in Washington, DC. I have worked for over 40 years as a financial services lawyer. I spent 26 of those years in the Federal Reserve System, including over 10 years in the Federal Reserve Banks and fifteen years as an Associate General Counsel at the Board of Governors of the Federal Reserve System ("Board") in Washington. As an Associate General Counsel, I helped establish policies and write rules designed to reduce systemic risk in the financial system and rules to foster consumer protection. During my tenure at the Federal Reserve, I was involved in a number of significant economic events, including the Chrysler "bailout" in 1980 and 1981, the Continental Illinois National Bank and Trust Company ("Continental Illinois") "bailout" in 1984, the Ohio and Maryland thrift crises in 1985, the recapitalization of the Farm Credit System in 1986 and the savings and loan crisis of the late 1980s and the early 1990s. As a private-sector attorney for the past 14 years, I have had the opportunity to work directly with financial institutions as they struggled to cope with the most recent financial crisis and adapt to the new standards and rules that have flowed from the Dodd-Frank Act.

The Dodd-Frank Act contains significant reforms that are designed to stabilize and improve the functioning of our financial institutions, financial markets and the markets for financial products and services. These reforms have been supplemented by changes in capital requirements under Basel III. A key focus of these efforts has been to eliminate the phenomenon of financial institutions that are too big to fail. These institutions must be "bailed out" in times of trouble by the Federal Government in order to prevent "systemic" problems in the financial system. Historically, Federal Government intervention in support of private-sector financial institutions has been limited. In the recent financial crisis, the Federal Government's actions may be more properly characterized as attempts to stabilize markets as opposed to bailouts of individual institutions. However, individuals often have a negative, visceral reaction to bailouts because they perceive them to be unfair, and policymakers understand that bailouts can create a moral hazard that erodes private market discipline.

The origin of the term "too big to fail" is sometimes traced to the rescue of Continental Illinois in 1984 by the Federal Deposit Insurance Corporation ("FDIC"). At the time, Continental Illinois was the 8th largest bank in the United States. In congressional testimony later that year, the Comptroller of the Currency, Todd Conover, suggested that there were 11 banks in the United States that could not be allowed to fail.

The potential for market events, including bank failures, to have a destabilizing effect has been recognized since at least 1873 when Walter Bagehot discussed the characteristics of money markets in *Lombard Street.* Although it is an over-simplification, there are generally two flavors of "systemic" risk-knock-on, or domino, risk and panic risk. Domino risk arises when the failure of one institution triggers the failures of other institutions due to their credit exposure to the failing institution. Panic risk occurs when the failure of a financial institution or other event causes a loss of confidence in financial institutions or assets. As a result, liquidity dries up and asset prices decline due to a lack of buyers. This, in turn, triggers widespread failures that further depress confidence, creating the potential for a downward spiral of increasing scope and severity.

The Continental Illinois bailout has been cited as an example of domino risk. The FDIC in a study described the risks posed by the failure of Continental Illinois as follows:

> With regard to Continental Illinois, the regulators' greatest concern was systemic risk, and therefore handling Continental through a payoff and liquidation was simply not considered a viable option. Continental had an extensive network of correspondent banks, almost 2,300 of which had funds invested in Continental; more than 42 percent of those banks had invested funds in excess of $100,000, with a total investment of almost $6 billion. The FDIC determined that 66 of these banks, with total assets of almost $5 billion, had more than 100 percent of their equity capital invested in Continental and that an additional 113 banks with total assets of more

than $12 billion had between 50 and 100 percent of their equity capital invested.[1]

In *Lombard Street,* Walter Bagehot discussed panics as follows:

> When reduced to abstract principle, the subject comes to this. An 'alarm' is an opinion that the money of certain persons will not pay their creditors when those creditors want to be paid. If possible, that alarm is best met by enabling those persons to pay their creditors to the very moment. For this purpose only a little money is wanted. If that alarm is not so met, it aggravates into a panic, which is an opinion that most people, or very many people, will not pay their creditors; and this too can only be met by enabling all those persons to pay what they owe, which takes a great deal of money. No one has enough money, or anything like enough, but the holders of the bank reserve.
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> . . .
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> If all those creditors demand all that money at once, they cannot have it, for that which their debtors have used, is for the time employed, and not to be obtained. With the advantages of credit we must take the disadvantages too; but to lessen them as much as we can . . .[2]

Domino risk and panic risk are not necessarily independent of each other. For example, domino risk can itself create or feed a panic. While the failure of other types of institutions can create systemic problems and past bailouts have not been limited to banking institutions, banking institutions are particularly susceptible to both forms of systemic risk. This is true because of the very nature and core business of banks. Banking institutions borrow short-term from depositors and other creditors to fund long-term assets. This creates a maturity mismatch that can lead to liquidity shortfalls and deposit runs. In turn, these liquidity crunches lead to fire sales of assets at distressed prices, which erode bank capital and confidence in banks. Depositors and other creditors who lend to banks bear the credit risk that can lead to a domino effect and banks' hard to value loan assets and maturity transformation activities create the potential for a loss of confidence and panic risk.

For these reasons, banking institutions have been the focus of prudential regulation at the Federal level in the United States for over 150 years. Over time, this regulation has been refined to account for the size and complexity of banking organizations; however, the recent financial crisis revealed serious shortcomings in the existing regime. The Federal Government had to intervene to recapitalize large and some small banking institutions, as well as a number of nonbanking institutions. The Dodd-Frank Act represents, in part, an effort to avoid similar bailouts in the future, but there is no simple solution for the too big to fail quandary.

Macroeconomic stability is a key goal of prudential regulation. The economic and human consequences of the recent financial crisis and prior financial crises have been enormous, resulting in devastation that can last for years or even generations. Simply refusing to intervene to stabilize the financial system during a financial crisis may not be an acceptable policy choice. At the same time, short-term fixes to prevent or contain an economic meltdown, such as a bailout, can diminish market discipline and increase risk taking by individual institutions and their counterparties. This erosion of market discipline, or moral hazard, can itself lead to future crises. Ideally, we should foster robust financial institutions and encourage prudent risk taking that reduces the likelihood of future stress and, at the same time, increases financial institutions' ability to withstand the stresses that do arise.

At the same time, financial intermediation, and particularly the extension of credit, is inherently risky. These risks can be mitigated but they cannot be eliminated. To a certain extent, risk taking behavior is beneficial, because it fosters the innovation and economic growth that maximize employment and increase standards of living. There are serious consequences to unnecessarily increasing the costs of financial intermediation or constricting the availability of credit and other financial services that would otherwise be available in a fair and efficiently functioning market.

Legislators and regulators have attempted to balance these considerations for some time, but a proper equilibrium has proved elusive so far. Dodd-Frank, which was shaped by the experiences of the recent financial crisis, is an effort to recalibrate with a distinct focus on reducing the potential for individual institutions to create systemic problems. One of the main tools in Dodd-Frank that will be used to address systemic risk is the prudential standards for bank holding companies with total consolidated assets of greater than $50 billion established under Section

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[1] FDIC, *An Examination of the Banking Crises of the 1980s and Early 1990s, 250 (1997).*

[2] Walter Bagehot, *Lombard Street,* 44 and 46 (1873) (emphasis added).

165. These standards are meant to increase in stringency based on a list of specified factors and other risk-related factors that the Board will consider. In establishing these standards, the Board can differentiate among companies based on their size, complexity and other factors, and, pursuant to recommendations of the Financial Stability Oversight Council, the Board can establish assets thresholds above $50 billion for the application of some, but not all, of these enhanced prudential standards.

Section 165 is clearly designed to apply to large, interconnected banking organizations whose failure could threaten the financial stability of the United States. While Section 165 allows for some flexibility, the $50 billion assets threshold is its most specific differentiator. Other provisions of Dodd-Frank, and other aspects of existing and new regulatory requirements, including, for example, the Volcker Rule and the requirement to use the advanced approaches method in capital calculations, also provide for varying standards based on thresholds tied to the size of the institution or the size of the activity.

Without a doubt, the overall size of a banking institution is a factor in the likelihood that such an institution could pose a risk to the financial stability of the United States. But supervisors globally have increasingly focused on a broader, more nuanced array of systemic risk measurements. They have begun to weight these measures in order to tailor supervisory policies to the activities most likely to affect financial stability. For example, in July 2013, the Basel Committee on Banking Supervision ("BCBS"), which consists of representatives from over two dozen of the world's most economically significant countries, presented five principal factors for identifying global systemically important banking organizations. These factors include size, which for purposes of the BCBS calculations is a measure of total exposures as opposed to total consolidated assets, interconnectedness, substitutability, cross-jurisdictional activity and complexity. The factors other than size are subdivided into component factors and the factors and component factors are weighted. Scores are calculated for each factor by dividing the individual bank score for that factor by the aggregate score, which is the sum of the scores of the 75 largest global banks plus selected additional banks.

Since the factor on cross-jurisdictional activity was included by the BCBS to measure global risks, it is likely that it is less significant for purposes of measuring systemic risks to the U.S. economy. The other BCBS systemic risk factors, coupled with a similar measurement process that is tailored to the U.S. economy, could be used to identify banking organizations that pose systemic risks to the United States. The U.S.-focused scores could then be used by the Board to refine regulatory requirements for and supervisory scrutiny of those institutions. The Board already collects the necessary data on the BCBS factors from bank holding companies with total consolidated assets of $50 billion or more.

Such a tailored approach in the implementation of the Section 165 requirements, capital requirements and potentially other regulatory requirements could prevent the imposition of dead costs—costs that do not reduce an institution's riskiness or the risk to U.S. financial stability or contribute to compliance with other applicable laws and Federal policies—on banking organizations with consolidated assets in excess of $50 billion. In addition, more customized regulation and supervision should result in more effective oversight of banking organizations in the United States, some of which have very different business models. For example, regional banks often fund themselves with core deposits and focus on traditional lending, while other institutions choose to focus more on financial market, or custody and payment activities. Regulatory requirements designed to mitigate the risks related to financial market services are often inappropriate to address the risks related to more traditional banking organizations.

Nevertheless, a more bespoke approach to the application of Section 165 and other regulatory requirements does not solve the issue of what the appropriate thresholds are for such requirements to kick in. Bank supervision should always be, and has historically been, tailored to the risk profiles of specific institutions. As such, special requirements aimed at financial stability and the elimination of too big to fail should have limited application for several reasons. First, the identification of an institution as systemically important carries with it the moral hazard that the identified institutions will enjoy a halo effect—that market participants will be more willing to transact with such an institution because of the belief that it will not be allowed to fail. Counterparty confidence based on an institution's reputation for prudential standards is healthy, but confidence based on the perception that an institution will be bailed out by the Government is not desirable.

Second, empirical data based on the BCBS risk factor information collected by the Board suggest that the systemic risk scores of banking organizations with over $50 billion in consolidated assets in the United States vary greatly. A study by the Office of Financial Research, which was created by the Dodd-Frank Act, shows scores

that vary by a factor of over 125, ranging from 0.04 to 5.05.[3] Moreover, there is a sharp inflection point at around a score of 1.5. The ninth highest scoring banking organization scored 1.48, but the tenth highest scoring bank only scored 0.49. The next highest scoring banking organization scored 0.38. These scores include cross-jurisdictional activity, which may not be as significant in measuring potential effects on U.S. financial stability. The dramatic differences in systemic risk scores suggest that the number of systemically important institutions is limited.

Third, we should continue to provide bank supervisors with the discretion to apply more stringent safety and soundness requirements on particular banking organizations with distinct risk profiles. It is not necessary to adopt requirements with broad applicability to capture a handful of unique organizations.

Moving to such a tailored, risk-based approach to the supervision and regulation of banking organizations under Section 165 would require statutory changes. For example, the Board would need to be granted the ability to set different thresholds, including thresholds based on factors other than total consolidated assets, for all of the prudential requirements in Section 165. I believe that legislative changes should stop short of attempting to codify any particular risk evaluation system, such as the BCBS systemic risk scoring system. The understanding, identification and management of risk in banking organizations, and in the economy more broadly, are dynamic and changing. Codification of even current thinking runs the risk of leaving the financial system unprepared for new risks as they develop in the years to come.

Finally, I recognize that granting regulators greater discretion to limit the application of Section 165, and potentially other regulatory requirements, does not guarantee that regulators will exercise that discretion in a way that will reduce the costs and burdens of traditional banking organizations. These institutions have more than $50 billion in assets, but they do not present the same risks to the U.S. economy as other larger, more complex banking organizations. I am not sure that there is a neat way to put a statutory floor on supervision and regulatory requirements that does not run the risk of creating loopholes; however, congressional oversight can help ensure that these requirements remain tailored to the actual risk presented.

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[3]OFR Brief 15–01 (Feb. 12, 2015), available at *http://financialresearch.gov/briefs/files/OFRbr-2015-01-systemic-importance-indicators-for-us-bank-holding-companies-fig-1.pdf.*

Testimony of

Deron Smithy

Treasurer

Regions Bank

On Behalf of

The Regional Bank Group

Before the

United States Senate

Committee on Banking, Housing, and Urban Affairs

Hearing on

"Examining the Regulatory Regime for Regional Banks"

March 24, 2015

Introduction

Chairman Shelby, Ranking Member Brown and Members of the Senate Banking Committee, my name is Deron Smithy and I am the treasurer of Regions Bank, a $120 billion bank based in Birmingham, Alabama. I appreciate the opportunity today to speak to the Committee about enhanced prudential standards and the systemic risk designation. The Dodd-Frank Wall Street Reform and Consumer Protection Act established a $50 billion asset threshold for designating systemically important financial institutions, or SIFIs, a label that subjects bank holding companies to more stringent regulatory oversight and costs regardless of their business model, complexity or risk profile. These are issues of critical importance to Regions Bank.

I am appearing today in my capacity at Regions Bank and as a representative of the Regional Bank Group, a coalition of community-based, traditional lending institutions that power Main Street economies.

It is appropriate for the Committee to consider whether a $50 billion threshold is the best way to define a SIFI, particularly since more stringent regulatory oversight should focus on those firms whose individual stress or failure might trigger or deepen a financial crisis or destabilize the economy. This does not describe regional banks despite our importance as lenders in many communities. Regional banks fund ourselves primarily through core deposits and we loan those deposits back into our communities, where we are important sources of credit to small and medium-sized firms and we compete against banks of all sizes in our markets. Regional bank are not complex: we don't engage in significant trading or international activities, make markets in securities, or have meaningful interconnections with other financial firms.

Dealing with the issues of SIFIs is crucial to the stability of the financial markets and national economy; we do not want to repeat the events that led up to the recent financial crisis and recession. Yet, an overly broad definition that captures traditional lenders has consequences too. These rules have a direct impact on a bank's strategic direction including its interest in specific product lines and asset classes; moreover, these rules can reduce a bank's ability to support local economic activity through lending. The impact in cost and time to meet all of the more stringent standards is a disproportionately larger burden on the regional banks. For regional banks, the incremental costs of regulatory compliance to meet the more stringent rules far exceed a billion dollars collectively.

What regional banks seek is a regulatory architecture that helps the country promote economic growth in tandem with safe and sound banking activities. Thirty-three banks are currently SIFIs, placing the same baseline burden on regional banks and complex money center banks. While the regulators occasionally tailor rules for the SIFI class, it is important to recognize that with an automatic threshold, the tailoring operates only as a one-way ratchet up. Because the threshold for more stringent rules exists as a floor, it separates regional banks from many of their peers and competitors, while occasionally adding new requirements for the most complex firms. Moreover, the expansion of reporting requirements—as with liquidity and capital rules—effectively undoes many of the benefits, in cost and compliance, of existing tiering.

Now that more data is available about the scope of the Dodd-Frank regulatory regime and the nature of systemic risk, it is appropriate to question whether there is a commensurate benefit to having regional banks automatically subjected to this oversight regime. This is apparent in the recent Office of Financial Research's (OFR) study that used systemic indicators that the Federal Reserve has gathered from banks. Altering the threshold in a common sense manner will not remove regulators' discretion to stop risky behavior or weaken their supervisory powers. Even absent systemic designation, protective regulatory guardrails that have evolved since the financial crisis would remain in place for regional banks, including the capital planning and stress testing processes started before Dodd-Frank. Regional banks also would remain subject new Basel III standards as well as Consumer Protection Financial Bureau (CFPB) oversight.

By holding this hearing, the Committee recognizes the validity of reevaluating the $50 billion threshold for SIFI status and more stringent regulation. Creating a dynamic, business activity-based approach in its place would not only establish a fairer method for supervising banks, but it would strengthen regulators' ability to appropriately tailor rules and deploy their own resources to match differences among banking organizations. Regulators have used activity-based factors—including size, complexity, international activity and substitutability—in other contexts to determine how firms might impact the stability of the financial system. And these instances have led to far different and nuanced conclusions than the asset-only $50 billion line.

In the end, an improved regulatory system tailored to bank complexity and risk would ensure safety and soundness while promoting U.S. economic growth and job creation.

Regions Bank

Regions Bank is a community-focused, diversified lender that operates in sixteen states and offers a full range of consumer and business lending products and services. Regions has a simple yet effective model that focuses on relationship banking through high quality customer service coupled with industry expertise. Regions provides banking services to hundreds of thousands of businesses and to millions of households that benefit people who live in all types of communities and with all types of borrowing and saving needs. Even in a time of slow economic growth, Regions is moving forward and making progress. Simply put, Regions is growing loans and adding customers. And it is investing

in its operations and technology infrastructure to offer better services and meet changing regulations.

TABLE 1. Regions Bank Key Facts

Loans/Rank	$77 billion/13th
Commercial Loans	$48 billion
Consumer Loans	$29 billion
Branches/ATMs	1,666/1,997
Commercial Customers	450,000
Small Business Customers	400,000
Households	4.4 million
Deposits/Rank	$94 billion/14th
Employees	23,723

Regions' commercial focus is on small and medium-sized businesses that are dependent on traditional bank credit for financing. Regions' balance sheet includes $48 billion in commercial loans; it serves 450,000 commercial customers overall, including 400,000 small business owners. These clients live and operate businesses both in rural communities and major metropolitan areas. In serving its corporate, middle market and small business customers, Regions competes against all types of banks, from the largest national banks to smaller community banks. Several years ago it might have competed against one or two banks when renewing loans or seeking to make a new loan, its bankers now regularly face four to five competitors. This is especially true in the small business and middle market spaces, where Regions competes fiercely against regional and community lenders.

The consumer bank serves more than 4 million households and holds $29 billion in consumer loans on its balance sheet. Regions strives to meet the financial needs of all types of consumers in its markets—from those who need short-term credit and check-cashing services to higher income customers relying on Regions wealth management services. In fact, Regions has significantly grown its product suite in the past several years and innovation—both in how Regions interact with customers and the services offered—is as critical to its business success as is strong customer service and the development of long-term relationships with its clients. Regions' mortgage business reflects its conservative banking principles. Regions only originates mortgages through its own bankers and exited the subprime business ahead of the credit crisis. As early as the summer of 2007, Regions developed a flexible customer assistance program (building on our responses to Hurricane Katrina).

Regional Bank Group

Regions Bank is part of the Regional Bank Group, a coalition of firms with assets of greater than $50 billion that share a common, traditional domestic banking business model: they take deposits and make loans to consumers and small and mid-sized

businesses. While regional banks are integral parts of the communities that they serve, their balance sheets reflect the relative simplicity of their businesses. Nearly two-thirds of their assets are loans. Regional banks hold very few trading or other complex assets, like derivative contracts, and have minimal exposure to credit default swaps (Regions Bank has none at the moment). On average, such instruments comprise less than one percent of the total assets of each bank. Regional banks are a meaningful part of the banking community in all 50 states. However, as individual banks, their size is modest in relation to the banking sector and overall economy. For example, no regional bank has national deposit shares equal to 3% of the total and most have a market share of less than 1%. In aggregate their assets are less than 2% of U.S. GDP, a total roughly equivalent to the single largest U.S.-based G-SIB.

TABLE 2. Regional Bank Group Facts

- Operate in all 50 states and serve local communities in more than 23,000 branches and offices
- Hold one-fifth of U.S. banking deposits
- Extend financial services to more than 60 million households, more than half of all U.S. households
- Originated more than $500 billion mortgage loans (about one of every seven mortgages)
- Provided more than $300 billion in other consumer lending
- Are important sources of credit to small and mid-sized businesses, including
  - Commercial and industrial loans: $442 billion
  - Small business loans (loans of <$1mm): $50 billion
  - Small Business Administration loans: $1.7 billion
  - Farm loans: $6 billion

The arbitrary $50 billion threshold creates a false barrier among traditional banks and it pulls some of those banks into the same regulatory architecture as more complex, interconnected financial firms. The similarity in the business model of traditional banks can be measured by various activity-based metrics, including how they fund and their lending focus.

TABLE 3. Banking Metrics, Firms with >$10 Billion in Assets

	Banks with assets >$10 billion but <$50 billion (50 banks)	Regional Banks
Loan-deposit ratio	85%	85%
Loan-asset ratio	65%	65%
Commercial & Industrial loans, as % of all loans	19%	24%
Funding: deposits as % of liabilities	86%	88%
Trading Assets	<1%	<1%

Source: SNL

Regional banks compared to complex firms

Indeed, funding sources, including the use of core deposits versus short-term borrowings, underscore the different operating models between regional banking organizations and more complex firms. This issue is a top priority for regulators; the FSOC's *2014 Annual Report* lists "short-term wholesale funding markets" as the first on its list of emerging threats and topics for reform. Regional banks rely on core deposits, not short-term borrowings, to fund their operations. Core deposits are equal to 72% of assets compared to just 29% for the U.S. G-SIBs. Other metrics further differentiate lending-focused regional banks and complex, interconnected firms. Two-thirds of regional bank assets are loans compared to less than half of the assets of the four largest bank holding companies. The distinctions can be measured in the structure and scope of operations, including non-bank activities (such as trading and market-making) and international operations, as well as complexity of the firms and their interconnections.

Consider the differences between regional banks and the eight U.S. bank holding companies that are G-SIBs:

- Regional banks are more likely to engage in traditional lending.
  - Regional banks have a loan-to-deposit ratio of 88% and net loans and leases represent 65% of assets compared to 61% and 25% for the G-SIBs.
- Regional banks are less complex.
  - Their broker-dealer assets account for less than 1% of total firm assets compared to close to 20% for the G-SIBs.
  - Looking at it another way, the six largest U.S. banks have three times as many subsidiaries as the next 44 banks.
- Regional banks are U.S. institutions.
  - Less than 1% of their deposits and loans are outside the U.S., while the corresponding numbers are 28% and 18% for the G-SIBs.[1]

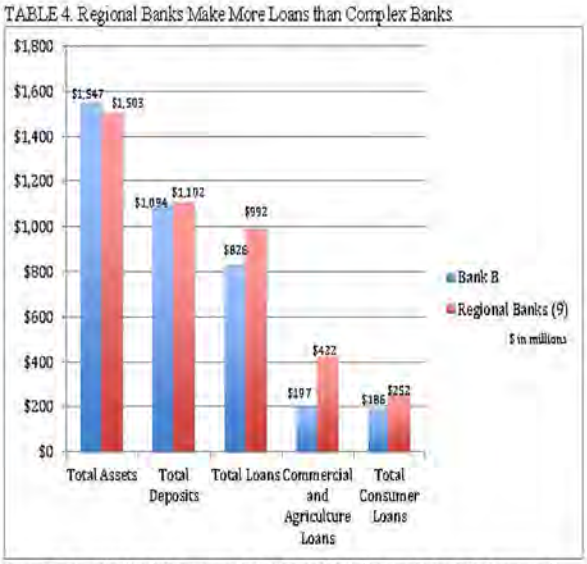
Business model differences also result from where regional banks do business; they serve a diverse set of communities, from large urban centers to mid-sized cities and small towns and rural America. Three-fourths of all regional bank branches are outside of the country's ten largest metropolitan areas, compared to just over half of the branches at the four largest U.S. banks. For Regions Bank, in particular, we serve Americans in midsize and smaller metro markets, and operates in places where our most significant competition comes from community banks. Regions Bank is the community bank in those areas. While Regions is a top ten bank (measured by deposits) in two-thirds of the largest 25 MSAs in its footprint, it also is in nearly all (96%) of the MSAs with less than 100,000 residents and has a strong presence in rural towns and counties in its footprint states.

[1] See for instance, the January 31, 2014 comment letter from several regional banks to the regulators, including to the Federal Reserve on the *Notice of Proposed Rulemaking for the Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards and Monitoring*.

To highlight this diverse footprint and regional bank's commitment to provide banking services in many types of communities:

- A majority of Regions Bank deposits (51%) come from communities that have less than 1 million people; additionally, 5% of our deposits come from rural areas.
  - In contrast, just 11% of the deposits of one of our money-center bank competitor's come from metro areas with populations below 1 million.
  - They collect just 0.3% of their deposits from rural communities.
- 60% of Regions Bank branches are in communities or metropolitan areas of less than 1 million.
  - In comparison, just under 30% of the branches of a big-bank competitors are in communities of less than 1 million people.
  - Nearly 10% of our branches are in rural counties, while 1% of the money center competitor's branches are in rural counties.

TABLE 4. Regional Banks Make More Loans than Complex Banks



Source: SNL. Regional banks include: U.S. Bancorp, PNC, SunTrust, Fifth Third, Regions, KeyCorp, M&T, Comerica, and Huntington. [Banks selected based on availability of regulatory data from SNL.]

In addition, Regions has loaned about $1 billion to small business customers in our non-metropolitan communities and is a significant lender to farmers and firms that provide agricultural services. Our $1.2 billion agriculture portfolio makes Regions a top-ten agricultural lender among traditional commercial banks.

Regions Bank competes against banks of all sizes throughout its markets. For example:

- In Birmingham (population: 1.1 million), the market where Regions has the most deposits, the bulk of its competition comes from regional and mid-size banks (assets greater than $10 billion), though one money center and many community banks also have market presences.[2]
- In Tampa (population: 3 million), Regions' third largest deposit market, regional banks and money center banks each have about 40% market share.
- In many of Regions' core markets in smaller metropolitan areas, such as Knoxville (700,000) and Chattanooga, Tennessee (500,000), its competitors are almost exclusively smaller regional banks and community banks.

SIFI Designation

Section 165 of the Dodd-Frank Act directs the Board of Governors of the Federal Reserve System to establish prudential standards for bank holding companies with total consolidated assets equal to or greater than $50 billion. It is indisputably clear that there are considerable distinctions among the firms that are considered SIFIs under the Dodd-Frank Act. These 33 firms vary significantly in asset size, business activities, scope, corporate structure and global reach. With regard to assets, the span ranges from just over $50 billion to over $2.6 trillion. The largest provide capital markets, derivatives, asset management, prime brokerage, currency and foreign exchange, trading, payments, deposit taking and lending, while the smaller firms concentrate on traditional banking services, including deposit taking and lending. Corporate structures vary considerably as well. The most complex firms use structures involving tens of thousands of affiliates and subsidiaries while the smaller, domestic firms do not. Finally, the global firms operate in hundreds of countries while many of the other covered entities only operate within the United States.

Title I directs the Federal Reserve to develop prudential standards for covered firms that must be "more stringent" than the standards and requirements applicable to non-covered bank holding companies. These mandated standards include the following: risk and liquidity management requirements; annual stress testing; resolution plan and credit exposure requirements; risk-based capital and leverage limits; and concentration limits. Additionally, the statute gives the Federal Reserve discretion to develop additional prudential standards, including contingent capital requirements, enhanced public disclosures, short term debt limits and such other prudential standards as the Federal Reserve determines are appropriate—on its own or upon recommendation of the Financial Stability Oversight Council (FSOC).

[2] Market share is based on deposits; all data is from SNL.

TABLE 5. Dodd-Frank Act $50 Billion Mandates and Reporting Requirements

Brief Description	Citation and Web Link
Risk management and risk committee requirements: Standards for enterprise-wide risk management, including the appointment of a chief risk officer that reports directly to the board risk committee and CEO. Requirement for a stand-alone risk committee of the board. (Federal Reserve)	12 CFR § 252.33 and Section 165(h) of Dodd-Frank
Liquidity risk management requirements: Specific liquidity risk management requirements for the board, the board risk committee and senior management, including with respect to liquidity risk tolerance levels and the liquidity risk of new business lines and products. (Federal Reserve)	12 CFR § 252.34 and Section 165(b)(1)(A)(ii) of Dodd-Frank
Liquidity stress testing and buffer requirements: Requirement to perform monthly liquidity stress tests and to hold a 30-day liquidity buffer. (Federal Reserve)	12 CFR § 252.35 and Section 165(b)(1)(A)(ii) of Dodd-Frank
Supervisory stress test requirements: Standards for annual stress tests conducted by the Federal Reserve, including public disclosure requirements. (Federal Reserve)	12 CFR §§ 252.41-47 and Section 165(i)(1) of Dodd-Frank
Company-run stress test requirements: Standards for semi-annual company-turn stress tests, including public disclosure requirements. (Federal Reserve)	12 CFR §§ 252.51-58 and Section 165(i)(2) of Dodd-Frank
Resolution planning requirements: Requirement for bank holding companies and nonbank financial companies supervised by the Federal Reserve to submit annual so-called "living wills." (Federal Reserve and FDIC)	12 CFR § 243 and Section 165(d) of Dodd-Frank
Financial Research Fund Assessment: Fee assessment to fund operations of the Office of Financial Research and Financial Stability Oversight Council, as well as certain operations of the FDIC. (Office of Financial Research)	31 CFR § 150 and Section 155 of Dodd-Frank
Federal Reserve Assessment: Fee assessment to fund the expenses of the Federal Reserve's supervision of certain bank holding companies and nonbank financial companies. (Federal Reserve)	12 CFR § 246 and Section 318 of Dodd-Frank
Reporting Requirements Triggered by the $50 Billion Threshold	
Liquidity reporting.	FR 2052b
Reporting on quantitative projections of balance sheet, income, losses, and capital across a range of macroeconomic scenarios and qualitative information on methodologies used to develop internal projections of capital across scenarios.	FR Y-14A
Monthly reporting on loan- and portfolio- level collections.	FR Y-14M
Reporting on various asset classes and pre-provision net revenue.	FR Y-14Q
Reporting for purposes of determining whether a bank holding company is a "global systemically important bank."	FR Y-15

Dodd-Frank Title I requires that all enhanced prudential standard rules must be more stringent for firms above the $50 billion line than firms below it.[3] While banking regulators have some ability to tailor, or tier, rules for firms above the $50 billion line, the actual tiering has been limited and regulators cannot ignore that $50 billion line when making rules. The threshold is an automatic dividing line for macro-prudential rules. Effective tailoring would allow the regulators to vary rules in both directions; however, the $50 billion line serves as a floor so rules can only be adjusted one way. In effect, tiering is a one-way ratchet (adding new requirements for the more complex firms) and the threshold separates regional banks from many of their peers and competitors. The Federal Reserve has used its tailoring authority to adopt and propose more rigorous standards for the largest bank holding companies, such as the enhanced supplementary leverage ratio and the proposed G-SIB capital surcharge. Tiering as it currently exists in Dodd-Frank does not offer appropriate or meaningful relief to traditional lenders now defined as systemic. Moreover, the expansion of reporting requirements effectively undoes many of the perceived benefits, in cost and compliance, of existing tiering. Finally, the Federal Reserve cannot raise the $50 billion threshold on its own; the process must begin with FSOC and only is applicable to a limited set of Title I standards.[4]

TABLE 6. Limited Ability to Raise Section 165's $50 billion threshold

Procedure
After receiving a recommendation from the FSOC, the Federal Reserve may raise the asset threshold that triggers application of the following requirements: resolution planning and credit exposure reporting; single counterparty credit exposure limits; contingent capital; enhanced public disclosures; and, short-term debt limits. Notably, of these standards, the Federal Reserve only has adopted resolution planning requirements.
Limited application
This authority to raise the $50 billion threshold does not apply to the core capital, liquidity and other elements of Section 165. For this reason, the authority has limited value – both because the authority applies to only a single adopted enhanced prudential standard, and because, at the present time, FSOC action for a recommendation would appear to be an unlikely prospect.

It is important to reiterate how reporting requirements erase aspects of tiering and highlight the nature of the one-way ratchet in Title I rulemaking. Regulatory creep is especially present in reporting – new data templates and reporting schedules designed for the most complex firms often become applied to regional banks over time.

[3] Section 165 calls on the Federal Reserve to establish prudential standards for nonbank financial companies designated as systemically important by the FSOC and bank holding companies with total consolidated assets of $50 billion or more. The standards that the Federal Reserve applies under Section 165 must, at a minimum, be "more stringent than the standards and requirements applicable to nonbank financial companies and bank holding companies that do not present similar risks to the financial stability of the United States." Section 165(a)

[4] Section 165(a)(2)(B).

- The liquidity coverage ratio (LCR) reporting is an example of this reporting creep. The final LCR rule (implemented under the Basel framework) required banks with less than $250 billion in assets (so-called modified banks) to calculate their LCR on a monthly basis. However, the Federal Reserve's recent proposal to transition modified banks' reporting (from form 2052b to 2052a) effectively requires regional banks to have the ability to calculate the LCR on a daily basis, thus weakening the tiering in the initial rule. The number of data fields required in the new reporting regime will grow to more than 66,000 (many of which are irrelevant to regional banks) from about 800.
- The Comprehensive Capital Analysis and Review (CCAR) also has evolved into an intensive qualitative exam (besides its quantitative focus on capital levels) with increasing levels of granularity of data templates and growing focus on documentation and process, not outcome.
- The FDIC recently proposed expanding the costs and scope of resolution planning for all institutions greater than $50 billion despite the fact that regional plans are relatively simple and have been accepted by the regulators, while those of the complex banks have been subject to scrutiny and requests for additional submissions so regulators can understand them.[5]

Also, in many cases, regional banks bear some burden of a rule even if it is not directly related to their business models. The Federal Reserve's recent risk-based capital guidelines for global systemically important bank holding companies demonstrate this trend. According to the proposed rule, the risk-based capital surcharges would, under the proposed methodology, only apply to "eight large U.S. bank holding companies." Still, the rule would require all bank holding companies above $50 billion in consolidated assets to conduct a complex analysis to determine if the bank holding companies qualify as G-SIBs. To this end, the Federal Reserve has requested comment as to whether the $50 billion consolidated asset threshold is sufficient or whether "some higher asset threshold be considered."[6] The proper designation matters because regulators have used

[5] Specifically, the FDIC has proposed that two sections of the resolution plan for 2015 will require additional calculations. The first requires the resolution plan to include at least one "Multiple Acquirer Strategy" which must include recapitalization, and one "Liquidation" strategy. These calculations include models on bridge operations during the recapitalization and potential acquisition by another financial institution. The second change requires an institution to conduct a "Least Cost Analysis" to determine which potential resolution plan would have the least potential cost to the deposit insurance fund, including final sale of the institution or liquidation. Each of these new requirements will add significant time and burden on financial institutions to run multiple scenarios for potential sale or liquidation. https://www.fdic.gov/news/news/press/2014/pr14109.html

[6] The proposed rulemaking seeking to establish a risk-based capital surcharge for the "largest most interconnected U.S. bank holding companies and would "require a U.S. top-tier bank holding company with $50 billion or more in total consolidated assets to calculate a measure of its systemic importance" to identify a subset of those companies as global systemically important bank holding companies (G-SIBs). Further, the Federal Reserve has requested comment on additional factors to consider for identification of a bank holding company as a G-SIB. http://www.federalreserve.gov/newsevents/press/bcreg/20141209a.htm

the statutory bright-line threshold in other rule-makings. [See Appendix, Table A] In addition, lawmakers also have tried to use the threshold-designation in other contexts, such as tax policy.[7]

The Costs and Impacts of Systemic Regulation

Regional banks believe that it is time to move beyond the simple asset-only model to determine systemic risk because it does not match the reality of the U.S. banking system. Congress should remove the constraints that inhibit a flexible approach to enhanced regulation aimed at firms that are truly systemic. Quite simply, if a bank is not systemic it should not be regulated as a systemic; ill-suited regulation stifles banks and offers no particular benefits to the customers they serve, taxpayers, or regulators. Rules designed for large, complex firms impose real, burdensome costs when applied to middle-market lenders. They weigh on their ability to operate competitively and could force us to curtail our primary activity, which for Regions Bank and other regional banking organizations is serving retail customers and making consumer and commercial loans to small businesses and midsize firms. As an example, a traditional lending institution with $150 billion in assets might lend an additional $15 billion to customers in the communities where it operates if it was not subject to capital and liquidity buffers mandated by the enhanced prudential regime. Across, the universe of regional banks, that is approximately $250 billion in new lending nationwide. Moreover, overly expansive regulation forces management—as well as the boards of directors—to focus too intently on these issues, distracting them from efforts to build businesses and execute strategic initiatives. Indeed, given regional banks' simpler operations and organizational structures, it is significantly easier for their management, directors, and regulators to understand the risks that they face and the processes used to manage and control those risks. Finally, the costs have competitive implications. Regional banks compete in most markets against community banks (assets less than $10 billion) that are carved out of most regulation and Dodd-Frank costs.[8]

Effective, precise regulation will make the banking system safer; the current system saddles regional banks with excessive costs to implement and follow rules that do not reflect their business models. These costs—both direct and indirect—total hundreds of millions of dollars annually for individual regional banks; they impact productivity and can limit innovation—and these costs are growing more rapidly than other operating expenses for most banks. Regional lender M&T Bank spent $441 million on regulatory compliance in 2014, a four-fold increase over the past three years and seven times the spend in 2007. The regulatory compliance spend accounted for 16% of the company's total operating expense, while it contributed to just 7% of those expenses in 2007. The

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[7] See for instance, President Obama's FY 2016 budget proposal with a bank tax targeted at greater than $50 billion financial firms (https://www.whitehouse.gov/omb/budget/) as well as former House Ways and Means Committee Chairman Dave Camp's tax reform proposal from 2014 (http://waysandmeans.house.gov/news/documentsingle.aspx?DocumentID=370987).

[8] It "is important to emphasize that the majority of the provisions of the Dodd-Frank Act do not apply to community banks at all," former Fed Chairman Bernanke said in a 2012 interview. Ben Bernanke, "Community Banking," Presented at the Independent Community Bankers of America National Convention and Techworld (3.14.12). http://www.federalreserve.gov/newsevents/speech/bernanke20120314a.htm.

growing intensity of the CCAR process is just one particular example. M&T Bank noted that 292 employees worked on CCAR submission, up 56% from 2013, and key governing committees met 74 times in the year nearly double the 2013 meeting load. Again, Regions Bank had similar experiences in preparing and internally vetting its 13,000-page CCAR submission.[9]

Regions Bank has seen similar cost trends, too. Since Dodd-Frank's passage, its risk management spending has more than doubled—an incremental increase that is tens of millions of dollars annually. Regions Bank, for example, has more employees dedicated to regulatory compliance than it has commercial bankers building relationships with clients. While over the past two years, Regions Bank has added hundreds of new associates in the Risk Management and Compliance areas, it also expects its bankers to participate in the supervisory, compliance and regulatory reporting requests from regulators. Regions' programs, undoubtedly, are more comprehensive and sophisticated than earlier; however, it is critical that they are commensurate with a bank's risk profile. In addition to direct costs such as new systemic regulatory fees, including the increased FDIC insurance fund assessment fees, regional banks also have additional expenses for new regulatory reporting, some of which, like Volcker and resolution plan submissions, offer little additional information to regulators about their business models. And not all of the systemic risk provisions have been finalized—and those that have become more detailed and intensive each year—so these expenses can be expected to continue to grow disproportionately when compared to other operating expenses.

Enhanced standards impact the strategic direction and business-line decision-making of regional banks. Risk management and corporate governance rules force company boards of directors, burdened by excessive information that is focused documentation, to stray into decisions that should be better left to executive management or business line managers. In 2014, M&T Bank reported that 190 risk management and governance committees produced 7,600 pages of meeting minutes and its Board of Directors Risk Committee met 18 times and reviewed 4,445 pages of presentation materials. Excessively adverse stress scenarios (without transparent explanations) for certain product categories, such as commercial real estate, far beyond the default rates considered by banks in their own internal models, become an effective tax on an asset class and create a disincentive to lend within that product category. To the same end, uncertainty about the stress scenarios may keep a bank from innovating and entering a new line of business. Liquidity rules highlight the divergent regulatory pressures on banks' finance teams and their bankers and influence business line activity and lending costs. A bank, for instance, might raise debt but instead of deploying it as new capital to meet the growing loan demands of commercial bankers, a treasurer will use that money as the liquidity buffer for existing client relationships because of new LCR rules. At Regions Bank, we have seen how the rigid LCR rules related to commercial relationships increase the cost of the loans that we make to farmers who draw from their lines of credit at occasional intervals related to the seasonal nature of their work.

[9] See 2014 and 2010 M&T Bank annual reports, http://mtb.mediaroom.com/2014AnnualReport and http://mtb.mediaroom.com/2010message

Regional banks incur these new expenses and lending restrictions as they face significant loss of revenue—especially in consumer businesses—totaling hundreds of millions of dollars annually due to new laws and regulations, including the Durbin Amendment. Bright-line asset thresholds designed to separate banks are not sound policy; they can create competitive imbalances that allow some banks to offer products at vastly different prices, thus harming harm certain banks and their customers.

TABLE 7. Select Regulatory Costs, Regions Bank

Risk Management Spending	Expenses more than doubled from 2009-2013, an increase of tens of millions of dollars
Durbin Amendment (interchange revenue)	$170 million in foregone revenue annually
Foregone Revenue, from significant consumer regulation changes	>$100 million annually
FDIC Assessment Fees (new DFA rules and the FDIC's changes to its calculation method	2013 assessment: $125 million 2008 assessment was $15 million
New Federal Reserve Fee	$2.75 million
Select Indirect Costs	
Dodd-Frank Act Implementation Team	A cross functional team of bankers, lawyers, risk managers and finance group associates that meets regularly to identify, track and monitor rules—both activity within the agencies but also the ways that the bank might have to alter its own business, internal control or compliance practices.
Rules	The team, in 2014, identified 469 rules and agency actions to follow ➢ > 40 related to enhanced standards ($50b threshold) or holding company activity ➢ >100 related to Volcker rule or derivatives (although Regions does not engage in proprietary trading and does not have to register as a swaps dealer) ➢ >100 related to mortgage rules and CFPB activity

Robust Supervision Remains

Regional banking organizations are not seeking to avoid rigorous scrutiny or proportional oversight. The Federal Reserve increased its supervision of large bank holding companies prior to the enactment of the DFA, through the creation of new capital planning and supervisory stress testing processes. Changing the threshold does not remove supervisory

discretion; the Federal Reserve's authority for these detailed and rigorous reviews and processes would remain, no matter the systemic designation. These exercises give the Federal Reserve unobstructed views into a bank's activities and balance sheet. Governor Tarullo highlighted the iterative process of the stress tests—and the value of the methods put in place before Dodd-Frank Act—in his February 2014 testimony to the Senate Banking Committee. The "refinements, which have been informed by the extensive commentary and advice we get from the banks, technical experts, [and] policy analysts, continue to improve what I think is the single most important change in supervisory practice since the financial crisis," Tarullo said.[10] The Fed can and should continue CCAR, but at a level commensurate with business model and risk. Moreover, regional banks remain subject to Basel III capital and liquidity requirements and numerous rules that set protective guardrails outside of Title I's enhanced prudential standards, such as the CFPB and new consumer regulations. Finally, the scrutiny includes constant business unit exams by federal and state regulators.

Systemic Risk Reconsidered

As the Committee reexamines elements of Title I of the Dodd-Frank Act, it must consider two critical and linked questions: What is systemic risk? What makes a bank systemically important? When Dodd-Frank was drafted and passed into law these questions got little or no debate. Instead a bright-line threshold was established without trying to establish any clear relation to systemic risk. The mismatch between the goals of regulators and the statutory definition of systemic risk resulted from political objectives when the Dodd-Frank Act was drafted, not economic and business model considerations. "By setting the threshold for these standards at firms with assets of at least $50 billion, well below the level that anyone would believe describes a 'too big to fail' firm, Congress has avoided the creation of a de facto list of too big to fail firms," Tarullo said in 2011.[11] Since then regulators, lawmakers and academics have been able to observe, measure and reconsider systemic risk. The best working definition of systemic risk may be the recently offered by former Federal Reserve Chairman Bernanke said in a May 10, 2013, speech at the Federal Reserve Bank of Chicago, in which he noted that systemic banks are "financial firms whose distress or failure has the potential to create broader financial instability sufficient to inflict meaningful damage on the real economy."[12] At the March 19 Senate Banking Committee hearing on the regulatory framework for regional banks, Tarullo said systemic risk has basically two definitions: (1) whether a particular firm's stress could

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[10] Daniel Tarullo, hearing titled "Oversight of Financial Stability and Data Security," Senate Committee on Banking, Housing, and Urban Affairs (Feb. 2, 2014).

[11] Daniel Tarullo, "Regulating Systemically Important Financial Firms," at the Peter G. Peterson Institute (June 3, 2011); http://www.federalreserve.gov/newsevents/speech/tarullo20110603a.htm.

[12] Ben Bernanke, "Monitoring the Financial System," Presented at the 49th Annual Conference on Bank Structure and Competition sponsored by the Federal Reserve Bank of Chicago (May 10, 2013). Available at http://www.federalreserve.gov/newsevents/speech/bernanke20130510a.htm. He also has weighed in on how to measure systemic risk. In April 2014, at a Brookings Institution event, former Fed chair Ben Bernanke responded to a question about too big to fail regulations by noting that "it's not just size...i think it has to do also with opacity, complexity, interconnectedness, and a variety of other things." Ben Bernanke, "Liquidity and the Role of the Lender of Last Resort," Presented at the Brookings Institution. (Apr. 30, 2014).

"lead to a financial crisis," which he called the traditional view of "too-big-to-fail"; and (2) a firm's "importance to the financial system."[13]

In fact, last July, the Banking Committee Subcommittee on Financial Institutions and Consumer Protection conducted a thorough review of this very matter, in a hearing entitled, "What Makes a Bank Systemically Important?" Four economists presented their views and unsurprisingly offered different areas of focus. Nonetheless, the one consistent point that they made was that the $50 billion threshold was not an adequate or appropriate measurement. After first noting "that size is by no means the only distinguishing feature, and the $50 billion threshold is way too low," Richard J. Herring, a Wharton School professor, said "there has been effort to actually try to devise indicators that would help us to understand what this [systemic risk] category looks like. The most refined set have been produced by the Financial Stability Board…They include size,…interconnectedness, which involves certainly capital market interconnections, cross-border activity; complexity; and the lack of substitutes for the services they provide in the global economy…" Paul Kupiec of the American Enterprise Institute noted that "in terms of size alone as a cut-off… any arbitrary size—there is no science that supports $50 billion …. It doesn't support any number." Senator Sherrod Brown raised similar points in his remarks opening the hearing. To quote extensively, Senator Brown noted:

> The three regional banks headquartered in my home State of Ohio…serve customers throughout the State with other regionals located/headquartered in other States…
>
> These banks operate under a very traditional banking model. The CEO of one of them talked about her bank as a "core funded bank," the term she used. They take deposits, they lend to families and small businesses. Each has assets of over $50 billion, making them subject to enhanced supervision by the Federal Reserve. While non-banks are judged based upon a specific set of criteria, the Dodd-Frank Act requires all banks, as we know, with more than $50 billion in assets to automatically be viewed as systemically important…
>
> Each of these three Ohio banks serves an important role in the communities they serve, but from what I can tell, none of these regional institutions would threaten the United States or global financial system or economy if they were to fail. Many in Washington attack the Financial Stability Oversight Council, or FSOC, for designating institutions as systemic. Let us be clear: the $50 billion line was created by Congress, not by FSOC.[14]

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[13] "Examining the Regulatory Regime for Regional Banks," Senate Banking Committee hearing, March 19, 2014.

[14] Senate Banking Financial Institutions Subcommittee hearing, "What Makes a Bank Systemically Important?" July 16, 2014.) At hearing, Professor Thomson said: "I do not think that having a hard and fast number, a bright-line rule in legislation like the $50 billion or $250 billion, is useful for making the designation."

In drafting some rules, regulators have made distinctions that show they recognize business model differences. They established multiple filing deadlines for resolution plans, primarily based on non-bank assets.[15] Consistent with this view of divergent risk profiles, regulators finalized a leverage rule that only applies to bank holding companies with more than $700 billion in assets or more than $10 trillion in assets under management. Also, the Federal Reserve recently created a Large Institution Supervision Coordinating Committee (LISCC) that seeks to incorporate "systemic risk considerations into the supervision program." The LISCC aims to bring an interdisciplinary "approach to the supervision of … large, systemically important financial institutions." The LISCC does not monitor any regional banking organizations; however, it oversees several nonbank financial firms that recently went through the FSOC designation process.[16] Not all of these methods have been explained publicly—although more transparency from the Federal Reserve on these issues would further refine our understanding of systemic risk. Nonetheless, when these tests are applied to regional banks, the results consistently indicate that such firms, with their traditional banking business models and basic organizational structures, present very little risk to the banking system.

An activity-based approach to systemic risk

Asset thresholds are inherently limited as the determinant of riskiness and can have unintended consequences. Federal Reserve Chair Janet Yellen noted at a recent House Financial Services Committee that any asset threshold contained "elements of arbitrariness."[17] Federal Reserve Governor Daniel K. Tarullo also has questioned the $50 billion threshold for SIFI status established by Dodd-Frank, in part due to his recognition of the common business models of most banks larger than $10 billion in assets. Although these 80 banks "obviously they vary enormously in size, from just over $10 billion in assets all the way up to the very large regional banks with hundreds of billions in assets, Tarullo said in May, "they bridge the $50 billion threshold for enhanced prudential standards established by Dodd-Frank. "Yet, whatever their size, most banking

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[15] Under the Federal Reserve and FDIC's joint regulation implementing the DFA's resolution planning requirements, covered companies with more than $250 billion in total nonbank assets were required to submit their initial resolution plans before other covered firms and generally have been subject to more stringent regulation. The agencies explained in their preamble to the resolution plan rules that this "group comprises the largest, most complex" BHCs. 76 Fed. Reg. 67323, 67330 (2011). Tarullo, in his speeches and testimony, distinguishes between the "largest, most systemically important U.S. banking organizations" (for instance, the G-SIBs) and other banks that merely surpass $50 billion in assets. Two examples are his speech entitled "Toward Building a More Effective Resolution Regime: Progress and Challenges" at the Federal Reserve Bank of Richmond Conference (Oct. 18, 2013). (Available at http://www.federalreserve.gov/newsevents/speech/tarullo20131018a.htm) and his testimony on Dodd-Frank Implementation to the Senate Banking, Housing and Urban Affairs Committee for their hearing entitled "Mitigating Systemic Risk Through Wall Street Reforms" (July 11, 2013). Testimony available at
http://www.federalreserve.gov/newsevents/testimony/tarullo20130711a.htm.

[16] In addition, a Senate proposal to address the risks of large, complex organizations, Terminating Bailouts for Taxpayer Fairness Act (S. 798), introduced by Senators Sherrod Brown (D-OH) and David Vitter (R-LA), proposes a $500 billion threshold, far above the DFA standard, for the highest capital levels.

[17] "Monetary Policy and the State of the Economy," House Financial Services Committee hearing, February 25, 2015.

organizations in this group are overwhelmingly recognizable as traditional commercial banks," he added.[18] Most notably, the Financial Stability Board (FSB) and the Basel Committee for Bank Supervision (BCBS) relied on activity-based measures to identify "Global Systemically Important Banks." The fact that the regulators moved beyond the Dodd-Frank formulation to a multi-factor test is an implied recognition of the fundamental imprecision and limitations of an asset-only method of determining systemic risk. The FSB and BCBS developed the five factor test involving size, interconnectedness, substitutability, complexity, cross jurisdictional activity in order to "reflect the different aspects of what generates negative externalities and makes a bank critical for the stability of the financial system." The assessment was finalized in November 2011 and has been used to assess and identify global systemic banks ever since. The organizations felt that the use of multiple considerations provided a considered examination and that "the advantage of the multiple indicator-based measurement approach is that it encompasses many dimensions of systemic importance, is relatively simple, and is more robust than currently available model-based measurement approaches and methodologies that only rely on a small set of indicators.[19]

As it turns out, the Federal Reserve used a very similar systemic risk assessment test domestically when it issued a rule proposal that would use the assessment test to determine the systemic risk scores of each of the bank holding company designated as SIFIs under the Dodd-Frank Act. The proposal further states that upon determining each firm's "systemic score," those firms whose score exceed a specified level would be assigned a capital surcharge. These surcharges would increase by preset amounts to correspond with any increase in a systemic firm's systemic score.[20] Both Tarullo Comptroller of the Currency Thomas J. Curry highlighted their support for activity-based approaches at the March 19 Senate Banking Committee hearing. Tarullo referenced the activity test when explaining the methods the Federal Reserve uses to supervise the most

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[18] Daniel Tarullo, "Rethinking the Aims of Prudential Regulation," Presented at the Federal Reserve Bank of Chicago Bank Structure Conference (May 8, 2014). Available at http://www.federalreserve.gov/newsevents/speech/tarullo20140508a.htm .

[19] The Financial Stability Board (FSB) is an international body that was established after the 2009 G-20 London summit in April 2009 as a successor to the Financial Stability Forum (FSF). The Board includes all G-20 major economies and the European Commission. The Department of Treasury, the Board of Governors of the Federal Reserve, and the Securities and Exchange Commission are the U.S. based regulatory bodies that participate in the FSB. The FSB monitors and assesses vulnerabilities affecting the global financial system and proposes actions needed to address them. In addition, it monitors and advises on market and systemic developments, and their implications for regulatory policy. http://www.financialstabilityboard.org/about/history/ The Basel Committee on Banking Supervision BCBS consists of senior representatives of bank supervisory authorities and central banks from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States. It usually meets at the Bank for International Settlements (BIS) in Basel, Switzerland, where its permanent Secretariat is located. http://www.bis.org/publ/bcbs201.pdf

[20] http://www.federalreserve.gov/newsevents/press/bcreg/20141209a.htm The rule proposal sets the G-SIB surcharge at a systemic risk level that is four times times higher than the score of the largest regional bank, fifteen times higher than the typical regional bank and more than thirty times higher than the smallest regional bank.

complex firms and how it might apply the G-SIB surcharge. "What we have in our largest institution portfolio at the Fed [LISCC], are the institutions internationally that have been identified as of global systemic importance," he said. "Now there, as I think you all know, we do distinguish; first off by segregating that group of eight, and have special requirements applicable to them, and secondly, even among those eight, we vary the requirements, for example in our proposal for capital surcharges. So depending on size, complexity, interconnectedness, substitute ability, the proposed surcharge may be greater or lesser, even among those eight banks. Although one may have a different set of views on exactly what the set of criteria are, many people have tried to give their own precise formulas. I think all of those people are engaged in the same exercise, which is to say, 'let's identify the systemic importance of those institutions whose failure would really put the whole system at risk.'" [21]

In addition to assessment methodology in the Federal Reserve's proposed rule for G-SIB surcharges, the Federal Reserve has also used activity-based standards—similar to those in the proposed rule— to conduct statutorily required evaluations of proposed acquisitions by two regional banking organizations. In each transaction, both of which occurred after the passage of DFA, the Federal Reserve had to consider "the extent to which a proposed acquisition, merger or consolidation would result in greater or more concentrated risks to the stability of the United States banking or financial system." The Federal Reserve assessed numerous factors, including: asset size, competition and availability of alternative providers for services, interconnection, complexity and international activity. It further noted that even after the transaction, PNC would not engage in business activities or "participate in markets to a degree that in the event of financial distress…would pose material risk to other institutions." In each case, the Federal Reserve approved the acquisitions, by PNC and Capital One, concluding that there would be no impact on U.S. financial stability. In approving PNC's purchase of RBC Bank, the Federal Reserve found that PNC engages "in a relatively traditional set of commercial banking activities, and the increased size of the combined organization would not increase the difficulty of resolving the organization's activities." [22]

Regional Banks and Systemic Risk

It is clear that regulators have developed more precise and nuanced tests for assessing systemic risk than was the basis for the original Dodd-Frank standard. Beyond determinations about financial stability related to merger activity, the Federal Reserve has gathered systemic risk indicators, similar to ones the FSB used to designate the G-SIBs,

[21] "Regional Banks," Senate Banking Committee Hearing, March 19, 2015; In answering a question from Chairman Shelby at the March 19 hearing, Curry said the stood behind his comments reported in the *American Banker* (September 24, 2014): "Fifty billion dollars was a demarcation at the time [but] it doesn't necessarily mean you're engaged in that activity that they are trying to target. The better approach is to use an asset figure as a first screen and give discretion to the supervisors based on the risks in their business plan and operations...It's just too easy to say, 'This is the cutoff.' I'm a little leery of just a bright line."

[22] Federal Reserve System, Order Approving Acquisition of a State Member Bank (Dec. 23, 2011); http://www.federalreserve.gov/newsevents/press/orders/order20111223.pdf

from the 33 banks under Title I enhanced supervision. Using that data, the Office of Financial Research (OFR) recently published an analysis that once again starkly illustrates the gulf in business activity and potential systemic impact between regional banks and more complex firms. The report concludes that "the largest banks tend to dominate all indicators of systemic importance…" It emphasizes that "some dimensions of systemic importance are not captured by the indicators," highlighting the "extent to which a bank engages in maturity and liquidity transformations" including "funding long-term illiquidity assets with short-term liabilities." As highlighted throughout this testimony this short-term funding issue is not relevant to core deposit-funded regional banks, and, in fact, it is a factor that the Federal Reserve has said it is working on a proposed rule that would address its concerns about funding about complex financial.[23] Tarullo underlined the Federal Reserve's concern about short-term funding—and its relationship to systemic risk—at the March 19 Senate Banking Committee hearing on regional bank regulation.[24]

The OFR study of systemic risk shows scores that range from 505 down to 19. However, the OFR did not publish data on more than 20 banks—including Regions Bank—that it reviewed because their systemic risk scores were so low. The full OFR data table was put into the record at the March 19 Senate Banking Committee hearing; it showed the systemic risk scores U.S. G-SIBs ranging from 505 to 148 while scores of the regional banks ranged from 30 to 4, with most regionals clustered at the lower end. While Tarullo has noted that "sheer size" can sometimes impact a firm's systemic risk, the OFR report shows that asset-size alone is not a consistent indicator of risk. While Regions Bank's assets are one-twentieth of those of JPMorgan Chase's, Regions' overall risk score is one-fiftieth of the more complex firm. (A Barclays analyst also published a set of scores for all banks and that analysis is consistent with the OFR study, an expected outcome because both analyses involve application of the methods prescribed by the FSB and BCBS, and use of common data provided by the banks. [See Appendix, Table B]) The OFR study would further indicate that the typical regional bank does not have sufficient size or footprint where its role in local lending, or credit intermediation, would give it systemic status, especially given the competitive—and substitutable—lending environment and that a regional bank could be easily be resolved by traditional FDIC intervention.

[23] Office of Financial Research Brief Series, "Systemic Importance Indicators for 33 U.S. Bank Holding Companies: An Overview of Recent Data," 15-01. February 12, 2015

[24] "Regional Banks," Senate Banking Committee hearing, March 19, 2015.

TABLE 8. Office of Financial Research: Systemic Risk Indicators

Figure 1. Systemic Importance Indicators Reported by Large U.S. Bank Holding Companies ($ billions)
Systemic risk scores are based on size, interconnectedness, substitutability, complexity, and cross-jurisdictional activities

Bank Holding Company (stock ID)	Size	Interconnectedness			Substitutability			Complexity			Cross-Jurisdictional Activity		2012 Score (percent)
	Total exposures	Intrafinancial system assets	Intrafinancial system liabilities	Securities outstanding	Payments activity	Assets under custody	Underwriting activity	Amount of OTC derivatives	Adjusted trading and AFS securities	Level 3 assets	Foreign claims	Total cross-jurisdictional liabilities	
Weight (percent)	20	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7	6.7	10	10	
JPMorgan Chase & Co. (JPM)	3,570	422	544	599	321,458	21,320	508	68,004	446	67	693	674	5.05
Citigroup Inc. (C)	2,895	421	513	596	300,783	11,096	331	59,472	130	46	839	742	4.27
Bank of America Corp. (BAC)	2,696	294	220	489	83,705	136	390	54,887	203	32	387	246	3.06
Wells Fargo & Co. (WFC)	1,961	110	129	508	28,761	2,400	66	4,680	128	37	70	130	1.72
Goldman Sachs Group, Inc. (GS)	1,518	337	107	310	9,585	866	371	50,355	138	43	347	319	2.48
Morgan Stanley (MS)	1,283	535	182	231	9,812	1,369	262	43,611	316	23	353	470	2.60
U.S. Bancorp (USB)	525	11	22	139	6,918	959	17	106	13	4	3	34	0.35
PNC Financial Services (PNC)	425	18	13	68	2,004	161	10	252	26	11	5	2	0.30
Bank of New York Mellon Corp. (BK)	410	79	230	61	166,279	23,590	6	1,158	39	0	87	164	1.50
HSBC N.A. Holdings Inc. (HSBC)	406	36	55	50	1,061	43	49	5,194	40	4	43	1	0.38
State Street Corp. (STT)	345	30	209	43	59,122	20,411	-	1,141	54	8	47	125	1.48
Capital One Financial Corp. (COF)	336	14	2	94	914	3	2	63	16	4	9	2	0.19

Notes: This list shows BHCs with assets over $250 billion. The eight gray-shaded BHCs were G-SIBs as of 2013. HSBC North America is a holding company for the U.S. operations of HSBC Holdings, plc, incorporated in the United Kingdom.
Sources: Company Y-15 reports, OFR analysis

Besides the immense gaps between the G-SIBs and most regional banks, another striking element of the OFR report is the vast number of zeroes that regional banks score on most of the key systemic measures. Regions Bank, for instance gets a zero on eight of the 12 categories in the Barclays report. Overall, the 20 regionals score a total of 149 zeroes out of the 240 possible categories that are examined. By way of contrast, of the 96 measures applied to the largest eight banks, collectively, they only achieve two total zeroes. These risk assessments ultimately provide greater clarity with respect to the question of whether firms present systemic risk at all. [See Appendix, Tables C-E, for references to the differences among systemic risk among firms with assets above $50 billion.]

TABLE 9. Office of Financial Research: Systemic Importance Score

Bank Holding Company	Size (Exposure) Rank	Systemic Score Rank	2013 BCBS Weighted Score (out of 100%)
JPMorgan Chase & Co.	1	1	5.05
Citigroup Inc.	2	2	4.27
Bank of America Corporation	3	3	3.06
Morgan Stanley	6	4	2.60
Goldman Sachs Group, Inc., The	5	5	2.48
Wells Fargo & Company	4	6	1.72
Bank of New York Mellon Corp	9	7	1.50
State Street Corporation	11	8	1.48
Northern Trust Corporation	23	9	0.49
HSBC North America Holdings	10	10	0.38
U.S. Bancorp	7	11	0.35
PNC Financial Services Group, Inc.	8	12	0.30
Deutsche Bank Trust Corporation	33	13	0.20
Capital One Financial Corporation	12	14	0.19
American Express Company	16	15	0.17
TD Bank US Holding Company	13	16	0.14
SunTrust Banks, Inc.	14	17	0.14
BBVA Compass Bancshares, Inc.	27	18	0.12
BB&T Corporation	15	19	0.12
BMO Financial Corp	18	20	0.12
Ally Financial Inc	19	21	0.11
Regions Financial Corporation	22	22	0.11
Fifth Third Bancorp	17	23	0.10
Unionbancal Corporation	20	24	0.09
Keycorp	24	25	0.08
M&T Bank Corporation	25	26	0.08
Discover Financial Services	30	27	0.06
Santander Holdings USA, Inc.	28	28	0.05
RBS Citizens Financial Group, Inc.	21	29	0.05
Comerica Incorporated	29	30	0.05
Zions Bancorporation	31	31	0.04
Huntington Bancshares Incorporated	32	32	0.04
Banewest Corporation	26	33	0.04

Conclusion

Creating a dynamic, business activity-based approach in the current threshold's place not only would establish a fairer method for supervising banks, but it would strengthen regulators' ability to appropriately tailor rules and deploy their own resources to match differences among banking organizations. Regulators have used activity-based factors—including size, complexity, interconnectedness, global activity and substitutability—in other contexts to determine how firms might impact the stability of the financial system. And like the OFR study, they reached the conclusion that regional banks are fundamentally different than complex banks and individually they don't threaten financial stability. In the end, an improved regulatory system better aligned with bank

complexity and risk would ensure safety and soundness while promoting U.S. economic growth and job creation.

Appendix

TABLE A. Requirements Adopted by Regulators without a Statutory Mandate

Brief Description	Citation and Web Link
Capital Ratio Disclosures: Detailed public disclosure requirements regarding capital ratios, such as the common equity tier 1 capital ratio and the leverage ratio, i.e., Basel III "Pillar 3" Requirements. (Federal Reserve, FDIC and OCC)	12 CFR §§ 217.61-63
Resolution planning requirements for insured depository institutions: Requirement for insured banks to submit so-called "living wills" to the FDIC, separate from the bank holding company living will requirement. (FDIC)	12 CFR § 360.10
Liquidity Coverage Ratio (LCR): Quantitative liquidity standards that require covered institutions to maintain high-quality liquid assets for 30 days of anticipated cash outflows under stress conditions. (Federal Reserve, FDIC and OCC)	12 CFR §§ 249.60-63
OCC Heightened Expectations: Detailed risk management standards for national banks and other OCC-regulated institutions, including detailed requirements for management and the board. (OCC)	12 CFR § 30
Volcker Rule Market-Making: Limits on the ability of banking entities to treat other banking entities with $50 billion or greater in trading assets or liabilities as customers for purposes of the Volcker Rule's market-making exemption. (Federal Reserve, FDIC, OCC, SEC and CFTC)	12 CFR § 248.4(b)(3)
Volcker Rule Quantitative Metrics: Banking entities with $50 billion or greater in trading assets or liabilities required to begin collecting and reporting quantitative metrics as of June 30, 2014, more than two years before other banking entities. (Federal Reserve, FDIC, OCC, SEC and CFTC)	12 CFR § 248.20
Volcker Rule Enhanced Compliance Program: Banking entities with $50 billion in assets or greater are subject to supplemental compliance requirements, including a CEO attestation requirement. (Federal Reserve, FDIC, OCC, SEC and CFTC)	12 CFR Appendix B to Part 248—Enhanced Minimum Standards for Compliance Programs
Intermediate Holding Company Requirement for Foreign Banks: Foreign banks with $50 billion or more in non-branch U.S. assets are required to form intermediate holding companies in the United States. (Federal Reserve)	12 CFR § 252.153 and Section 165(b)(2) of Dodd-Frank
CCAR: Capital planning and public disclosure requirements. (Federal Reserve)	12 CFR § 225.8
FSOC: FSOC uses the $50 billion asset threshold when determining if a non-bank financial institution should be subject to evaluation for SIFI designation. (FSOC)	12 CFR Appendix A to Part 1310
Federal Reserve Consolidated Supervision Framework: The Federal Reserve has adopted an enhanced supervision framework for bank holding companies with $50 billion in assets or greater. (Federal Reserve)	SR 12-17; SR 13-24, and SR 13-23.

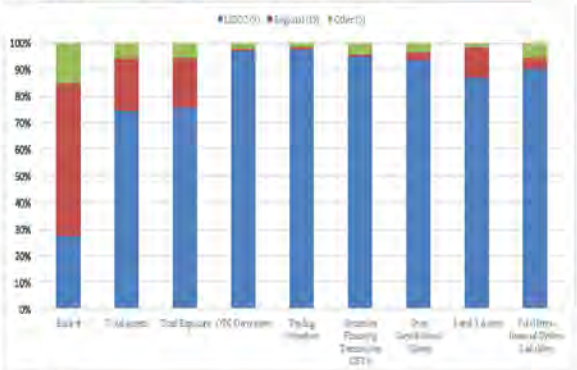
TABLE B. Barclays Systemic Risk Study

Calculating G-SIB Surcharges Using Method 1

Category	Size	Interconnectedness			Substitutability [25]			Complexity			Cross-jurisdictional activity		Total Method 1 Score	G-SIB Surcharge
Systemic Indicator	Total Exposures	Intra-financial system assets	Intra-financial system	Securities outstanding	Payments Activity	Assets under custody	Underwritten transactions in	Notional amount of OTC	Trading and AFS securities	Level 3 assets	Cross-jurisdictional claims	Cross-jurisdictional		
Indicator Weight	20.00%	6.67%	6.67%	6.67%	6.67%	6.67%	6.67%	6.67%	6.67%	6.67%	10.00%	10.00%		
Method 1 Scores														
G-SIBs:														
JPM	78	26	34	27	84	103	55	51	65	56	32	35	**504**	**2.0%**
C	63	26	32	27	79	54	36	45	19	37	39	38	**426**	**2.0%**
BAC	59	18	14	22	22	1	42	41	30	26	18	13	**305**	**1.5%**
MS	28	34	11	10	3	7	28	33	46	19	17	24	**259**	**1.5%**
GS	33	21	7	14	3	4	40	38	20	35	16	16	**247**	**1.5%**
WFC	43	7	8	23	8	12	9	4	19	30	3	7	**171**	**1.0%**
BK	9	5	14	3	43	114	1	1	6	0	4	8	**150**	**1.0%**
STT	8	2	13	2	15	99	0	1	8	6	2	3	**148**	**1.0%**
Non-G-SIBs:														
NTRS	3	3	1	1	9	27	0	0	2	0	1	3	**49**	**0.0%**
HSBC	9	2	3	2	0	0	5	4	6	3	2	0	**38**	**0.0%**
USB	11	1	1	6	2	5	2	0	2	3	0	2	**35**	**0.0%**
PNC	9	1	1	3	1	1	1	0	4	9	0	0	**30**	**0.0%**
COF	7	1	0	4	0	0	0	0	2	3	0	0	**19**	**0.0%**
AXP	4	0	2	7	0	0	0	0	1	0	1	1	**17**	**0.0%**
STI	5	0	0	2	0	0	1	0	2	2	0	0	**14**	**0.0%**
BCOMPS	2	0	0	1	0	0	9	0	0	0	0	0	**12**	**0.0%**
BBT	5	0	1	3	0	0	1	0	1	2	0	0	**12**	**0.0%**
BMO	4	1	0	1	1	1	1	0	2	0	0	0	**11**	**0.0%**
ALLY	3	0	1	5	0	0	0	0	1	0	0	0	**11**	**0.0%**
RF	3	0	0	1	0	0	5	0	1	0	0	0	**11**	**0.0%**
FITB	4	0	1	2	0	1	1	0	1	0	0	0	**10**	**0.0%**
UNBC	3	1	0	1	0	1	0	0	1	2	0	0	**9**	**0.0%**
KEY	3	0	0	1	0	0	1	0	0	2	0	0	**8**	**0.0%**
MTB	2	0	0	1	0	0	3	0	0	0	0	0	**8**	**0.0%**
DFS	2	0	0	3	0	0	0	0	0	0	0	0	**6**	**0.0%**
SHUSA	2	0	0	1	0	0	0	0	2	0	0	0	**5**	**0.0%**
CFG	3	0	0	0	1	0	0	0	0	0	0	0	**5**	**0.0%**
CMA	2	1	0	1	0	0	0	0	0	0	0	0	**5**	**0.0%**
ZION	2	0	0	0	0	0	0	0	0	1	0	0	**4**	**0.0%**
HBAN	1	0	0	1	0	0	0	0	0	1	0	0	**4**	**0.0%**

[25] *Note that the sum of the systemic indicator scores for the indicators in the substitutability category is capped at 100 bps. That is the case for JPM, C, BK and STT.*

TABLE C. Systemic Risk is Concentrated in the Largest Firms



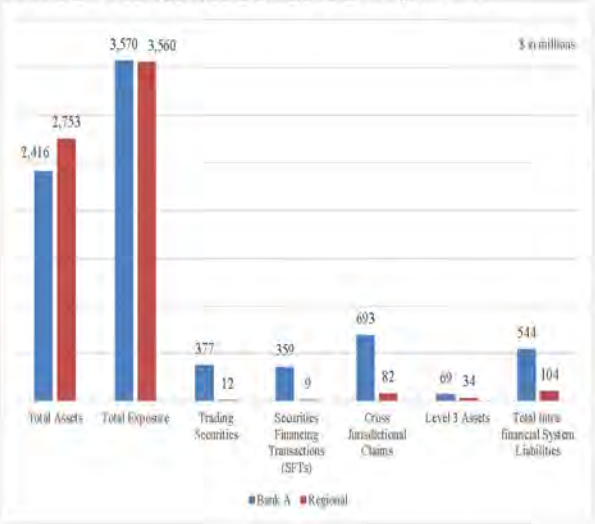
Source: FR Y-15

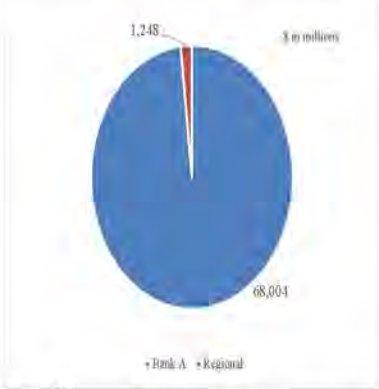
LISCC banks: JPM Chase, Citi, Wells Fargo, Bank of America, Goldman Sachs, Morgan Stanley, State Street, Bank of New York Mellon, and Deutsche Bank

Regional Banks: US Bank, PNC, Capital One, BB+T, SunTrust, TD Bank, Fifth Third, Regions, M&T, Key Bank, Huntington, Zions, Union, BBVA Compass, Santander, Bank of the West, Comerica, BMO Harris, and Citizens

Other banks: Northern Trust, HSBC, American Express, Discover, and Ally Financial

TABLES D and E. Complexity: One G-SIB Compared to Regional Banks





Source: FR Y-15
Regional Banks: US Bank, PNC, Capital One, BB+T, SunTrust, TD Bank, Fifth Third, Regions, M&T, Key Bank, Huntington, Zions, Union, BBVA Compass, Santander, Bank of the West, Comerica, BMO Harris, and Citizens

PREPARED STATEMENT OF MARK OLSON

CO-CHAIR, BIPARTISAN POLICY CENTER FINANCIAL REGULATORY REFORM INITIATIVE'S REGULATORY ARCHITECTURE TASK FORCE

MARCH 24, 2015

Chairman Shelby, Ranking Member Brown, Members of the Committee, thank you for the opportunity to testify. I am honored to appear not only because of the important impact that the Committee's work has on U.S. economic growth, financial stability and consumer protection, but also because of my own time working on the Committee staff, having served as staff director of the Securities Subcommittee.

I appear before you today in my capacity as co-chair of the Bipartisan Policy Center (BPC) Financial Regulatory Reform Initiative's Regulatory Architecture Task Force. I co-chaired this task force with former New York State Superintendent of Banks Richard Neiman and am proud of the work that we accomplished, finding common ground and practical solutions to many complex issues.

Today, I would like to focus on one of our task force's recommendations raising the so-called "bank SIFI" asset threshold from $50 billion to $250 billion, while giving regulators more flexibility to determine whether or not an institution should be subject to more rigorous oversight. We believe this recommendation strikes the right balance between assuring that financial institutions, whose collapse could pose a significant risk to the financial system, receive an appropriate level of supervision and regulation, while not subjecting those that do not meet this standard with needless rules and oversight which may impede economic growth.

BPC was founded in 2007 by former Senate Majority Leaders Howard Baker, Tom Daschle, Bob Dole, and George Mitchell with the idea of finding bipartisan solutions to the complex policy issues facing our country. In 2012, BPC launched the Financial Regulatory Reform Initiative to assess the Dodd-Frank Act: what is working, what is not working, and how financial reform can be improved. Richard and I were asked to analyze and find ways to improve the U.S. regulatory structure. We spent a year-and-a-half researching and assessing this issue. We met with a wide variety of stakeholders, including current and former regulators, financial reform and industry advocates, and academics. We had five guiding principles in our work:

- Clarifying the U.S. regulatory architecture to close gaps that could contribute to a future crisis or financial stress event;
- Improving the quality of regulation and regulatory outcomes;
- Better allocating, coordinating, and efficiently using scarce regulatory resources;
- Ensuring the independence and authority of financial regulators to allow them to anticipate and appropriately act on threats to financial stability; and
- Increasing the transparency and accountability of the regulatory structure.

In April 2014, we released our report: *Dodd-Frank's Missed Opportunity: A Road Map for a More Effective Regulatory Architecture* that included more than 20 recommendations that we believe will help achieve these goals. The full report is included as an addendum to this testimony.

We found a number of areas where we believe Dodd-Frank moved the U.S. financial regulatory structure in the right direction, including eliminating the Office of Thrift Supervision, creating the Consumer Financial Protection Bureau, and paying greater attention to oversight of the financial system as a whole. We also found many ways that the current system could be improved.

A good example was our recommendation to change the asset threshold over which bank holding companies become subject to enhanced supervisory and regulatory requirements. These companies are sometimes called bank SIFIs (systemically important financial institutions) because they face enhanced prudential requirements, similar to those applied to the nonbank SIFIs, which are designated by the Financial Stability Oversight Council (FSOC). In the course or our research, we found little support for the idea that the current asset threshold, set at $50 billion and not indexed for any future growth, was an ideal solution to the real issues it was meant to address.

The Current Threshold is Problematic

There are several problems with the current $50 billion threshold, which I will briefly summarize.

1. *It is arbitrary.* In general, a bank holding company with $49 billion in assets does not suddenly become systemically important, and therefore subject to enhanced prudential standards, when it grows to $51 billion in assets. Different banks have different balance sheet structures and risk profiles and should be

judged accordingly, making the presence of a "solid-line" or binary threshold problematic.

2. *It includes institutions that are not systemically important.* In addition to being arbitrary, the $50 billion threshold captures a number of bank holding companies that few would argue are, individually, systemically important. This is by design. During the crafting of what later became Dodd-Frank, there was real concern that setting a threshold that clearly separated systemic from nonsystemic institutions would reinforce the moral hazard concerns associated with too big to fail. At the time, policymakers worried that banks above the asset threshold might be conferred with unfair benefits relative to those institutions that fell below the line. It has become apparent, however, that the extra oversight that applies to nonsystemic institutions just above today's $50 billion asset threshold is costly—both for regulators to administer and the institutions subject to the regime to comply. The requirements of the new regime include developing living wills and participating in regular comprehensive stress tests, all of which entail substantial compliance costs. Furthermore, the benefits of including these firms, which are now subject to far more robust supervisory regime in the post-crisis world, are smaller than many expected. In his testimony before this Committee last week, Federal Reserve Board Governor Daniel Tarullo said that stress testing requirements, for example, "can be a considerable challenge for a $60 billion or $70 billion bank," but that the benefits gained by including such institutions, "are relatively modest" and that regulators "could probably realize them through other supervisory means."[1]
3. *It focuses only on size.* The size of a bank holding company's balance sheet affects how systemically important it is, but it is far from the only relevant variable. An institution's potential to create systemic risk is also determined by its mix of activities and practices, interconnectedness, term structure of funding, leverage and a number of other factors. One can imagine an institution with well over $50 billion in assets that is well-capitalized, diversified, not overly interconnected and engaged predominantly in low-risk, plain-vanilla activities the failure of which would not pose a significant risk to financial stability. A number of regional banks arguably fall into this category. In his testimony to this Committee last week, FDIC Chairman Martin Gruenberg said that of the 37 institutions above the $50 billion threshold, 20 of them "are diversified commercial banks that essentially take deposits and make loans."[2]

   On the other hand, at certain points during the financial crisis the CIT Group was considered potentially systemically important given its unique position in providing credit to small businesses. During that period, CIT had approximately $90 billion in assets, which would be below even the $100 billion threshold some have proposed.[3] Given that size is not the only factor in determining whether a bank is systemically important, size should not be the only factor used by the law or regulators in determining whether a bank holding company should be subject to enhanced oversight.[4]
4. *It produces undesirable incentives.* A binary threshold based simply on size gives bank holding companies an incentive to either stay below the threshold to avoid extra regulatory requirements or, once they are above the threshold, to become ever larger to spread out the fixed costs of those requirements. If the purpose of these extra requirements is to improve financial stability, then the law should focus on promoting incentives for institutions to engage in less risky activities and practices while still meeting the needs of their customers and forming a foundation for sustainable economic growth.
5. *It is not indexed.* Dodd-Frank as written retains a static, hard-wired $50 billion threshold. Each year, the real value of $50 billion in assets will decline as a

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[1] *Application of Enhanced Prudential Standards to Bank Holding Companies Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, DC,* 114th Cong. (March 19, 2015) (testimony of Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System). *http://www.federalreserve.gov/newsevents/testimony/tarullo20150319a.htm.*

[2] *Examining the Regulatory Regime for Regional Banks before the Committee on Banking, Housing, and Urban Affairs, Washington, DC,* 114th Cong. (March 19, 2015) (testimony of Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation). *https://www.fdic.gov/news/news/speeches/spmarch1915.html.*

[3] CIT Grp. Inc., Quarterly Report (Form 10–Q), at 2 (November 10, 2008). *http://www.sec.gov/Archives/edgar/data/1171825/000089109208005502/e33450_10q.htm.*

[4] Mosser, Patricia. "OFR Brief Examines Data on Systemically Important Bank Holding Companies." *Office of Financial Research,* February 12, 2015. *http://financialresearch.gov/from-the-management-team/2015/02/12/ofr-brief-examines-data-on-systemicallyimportant-bank-holding-companies/.*

share of the economy. Because of this, the current static threshold will capture more and smaller bank holding companies over time since the threshold is not indexed for economic growth, inflation, or any other metric. If a threshold is maintained in statute, it should be automatically adjusted to avoid this effect. If the threshold is indexed, I would suggest indexing it to economic growth rather than inflation since the systemic significance of a bank holding company is tied to an institution's size relative to the economy rather than in relation to consumer prices.

6. *It diverts scarce regulatory resources.* Whether they are funded independently or through Congressional appropriations, financial regulatory agencies face constraints on their budgetary resources. They must prioritize these resources to achieve the greatest benefit they can for the least cost. This is particularly true in a post Dodd-Frank world where regulators have far greater responsibilities and authorities. The current static threshold limits their ability to do so. As an example, a number of critics have argued that the process for creating a living will has been intensive and time consuming for bank holding companies. That is true, but what is much less noted is that they are intensive and time consuming for regulators as well. I do not argue that living wills have not generated benefits, but those benefits are not the same for all institutions regardless of their complexity and size. I think that it makes little sense to tie up a significant share of scare regulatory resources in systemic oversight of institutions that few believe are systemically important.

Rethinking the Bank SIFI Threshold

As is often the case, agreeing on the problems with a system is more difficult than agreeing on a path forward. So it is with the bank SIFI threshold. No regulatory regime will be perfect, but we believe that our BPC task force's recommendation would be a major improvement over the status quo.

Our solution contains two integrated elements. First, we recommended raising the bank SIFI threshold to focus on bank holding companies that are more likely to be systemically important. Specifically, we suggested raising the threshold from $50 billion to $250 billion. We were pleased that, following the release of our report, the idea of raising the threshold was publicly supported by Governor Tarullo, and also from elected officials from both parties.

No matter what level at which one establishes an asset-size threshold, it will be arbitrary and will not by itself take into account the complexity and risk profiles of different bank holding companies. As Comptroller of the Currency Thomas Curry stated in his testimony before this Committee last week, "it is essential for the OCC to retain the ability to tailor and apply our supervisory and regulatory requirements to reflect the complexity and risk of individual banks."[5] Therefore, we also recommended complementing raising the threshold with moving from a binary, "solid-line" threshold to a presumptive, "dashed-line" threshold that allows regulators to have more discretion in applying requirements based on other appropriate risk factors. In effect, bank holding companies with more than $250 billion in assets would be presumed subject to enhanced prudential standards, but would be able to make a case to regulators to leave them out of the enhanced regime if they are well-capitalized and diversified and engaged predominantly in relatively low-risk activities and practices. On the flip side, bank holding companies below the $250 billion asset threshold would be presumed not subject to enhanced prudential requirements, but regulators could include them in the enhanced regime if they determined any such institution to present significant systemic risk factors.

We believe that, taken together, these changes would realize a number of benefits:

1. *They would make the threshold level less arbitrary by making it presumptive.* If regulators have the ability to use some discretion in taking other risk factors into account, the threshold becomes a starting point rather than an absolute.
2. *The threshold would be less likely to capture institutions that pose little systemic risk.* Where the current "solid-line" threshold captures a number of bank holding companies that are not systemically important on their own, the higher threshold removes smaller institutions from the enhanced regime while giving regulators the ability to "capture" any that have high-risk profiles. This can be achieved while reducing unnecessary costs to institutions and regulators with minimal loss of benefits.

[5]*Examining the Regulatory Regime for Regional Banks: Hearing Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, DC,* 114th Cong., 2 (March 19, 2015) (testimony of Thomas J. Curry, Comptroller of the Currency). *http://www.occ.gov/news-issuances/congressional-testimony/2015/pub-test-2015-39-written.pdf.*

3. *The threshold would not be based simply on size.* Making the threshold presumptive allows for other risk factors to be taken into account when determining whether an institution should be subject to enhanced prudential standards.
4. *They would better align incentives with goals.* A higher and presumptive threshold allows for incentives to be geared toward reducing overall systemic risk rather than encouraging institutions to stay below the threshold or grow well beyond it. An institution that is not considered systemically risky just below the asset threshold could presumably grow organically to just above the threshold and not trigger a systemic designation.
5. *The threshold can be indexed.* An indexed threshold will help to ensure that it does not grow increasingly outdated over time. Whatever threshold is set, we recommend indexing it to economic growth or a similar metric.
6. *They focus scarce regulatory resources where they are most needed.* A higher threshold allows regulators to prioritize the use of their resources on the largest and most complex financial institutions, where they can do the most to benefit financial stability.

As the entity most responsible in statute for questions of systemic risk and financial stability, we envision the FSOC as the entity that would make determinations about whether to include institutions below the $250 billion threshold in the enhanced oversight regime or whether to exclude institutions above the threshold from the regime. The FSOC could overturn presumption in either direction via a supermajority vote of the Council. We understand, however, that a case could be made for one or more different ways to overturn presumption, and we are open to other approaches. The specific mechanisms used are secondary to our core recommendations: to raise the threshold and make it presumptive.

Avoiding One-Size-Fits-All Regulation

The bank SIFI threshold issue is an important example of how one-size-fits-all regulation can pose an unnecessary regulatory burden on midsize banks. However, it is not the only one. There are several other actions Congress could take to alleviate unnecessary regulatory burden and improve the quality of supervision for regional banks.

In addition to the prospect of facing enhanced supervisory and regulatory requirements as bank SIFIs, regional banks are already subject to reviews by multiple Federal and State financial regulators as part of the routine examination process. Indeed, the current system is often fragmented, with different agencies often having overlapping and duplicative responsibilities. We believe more coordination and cooperation among the regulators would lead to more efficient and comprehensive examination process.

That is why our BPC task force recommended the creation of a pilot program for a consolidated examination force for banks subject to supervision by the Fed, FDIC, and OCC. Where appropriate, State regulators could also choose to join. This approach would enable examiner teams to take advantage of interchangeable elements offered by each agency, while at the same time, permit the development of specialized examination teams. For example, examiners could specialize in banks of certain sizes or complexity levels, geographic regions, or business lines. To test the feasibility of this idea, our task force recommended that the pilot program be overseen by the Federal Financial Institutions Examination Council (FFIEC).

We believe the pilot could work for banks of any size, but it may be especially appropriate for regional banks given the growth in regulatory scrutiny they have received from regulators. Congress could require the regulators to implement this pilot program and consider expanding it depending on results.

Another issue facing midsize banks has been the propensity to get ensnared by rules designed for larger, more complex financial institutions. Congress was wise to give the Federal Reserve and the FDIC a substantial degree of latitude to engage in such tailoring. We encourage regulators to take advantage of this authority.

The text of Dodd-Frank includes several provisions that allow for and in some cases require agencies to tailor their approach. For example, Section 165 of Dodd-Frank, which deals with developing enhanced supervisory and prudential standards for nonbank SIFIs and bank SIFIs, says that:

> In prescribing more stringent prudential standards under this section, the Board of Governors may, on its own or pursuant to a recommendation by the Council . . . differentiate among companies on an individual basis or by category taking into consideration their capital structure, riskiness, complexity, financial activities (including the financial activities of their sub-

sidiaries), size, and any other risk-related factors the Board of Governors deems appropriate.[6]

The Federal Reserve included 40 instances of the word "tailor" or one of its permutations in its final rule implementing Section 165.[7] The Federal Reserve and FDIC also jointly worked to tailor their requirements for both living wills and stress tests (along with the OCC), scaling them to some degree to account for the size and complexity of the institutions subject to them. And in fact, our recommendation to make the new threshold for banks to be subject to enhanced prudential standards presumptive is very much in keeping with Congress' desire for regulators to tailor.

Regulators can and should use their tailoring authority to adjust their enhanced requirements based on the size, complexity and other risk factors of individual bank holding companies. They has worked to do so, for example by the Federal Reserve creating three effective categories of enhanced graduated requirements for bank holding companies between $50 billion and $250 billion in assets, between $250 billion and $750 billion, and a third category for the 8 largest bank holding companies with more than $750 billion in assets. The agency can accomplish significant benefits through approaches like this. However, tailoring alone will not solve the problems I outlined earlier.

Chairman Gruenberg testified that Dodd-Frank's stress testing requirements are "more detailed and prescriptive than the language covering other prudential standards, leaving the regulators with less discretion to tailor."[8] And Governor Tarullo testified last week that there are certain kinds of prudential regulation that Congress required the Federal Reserve to implement for all bank SIFIs, and that some, such as the application of the Volcker Rule and $50 billion threshold, "bear reexamination."[9] If regulators have determined areas where they believe Dodd-Frank restricts their ability to tailor regulations designed for the largest most complex institutions appropriately for smaller institutions, we as a general principal would support legislative change to enhance regulatory authority to implement tailoring.

From having run a family owned community bank in Minnesota, I know firsthand the value of America's diverse banking system. This diversity, however, makes one-size-fits-all regulation challenging and often unwise. We believe that the reforms we propose—raising the bank SIFI threshold and making it presumptive, encouraging a more coordinated approach to bank examinations, and appropriately tailoring rules—are both prudent and pragmatic. They would result in a more effective and efficient oversight, a safer financial system, and ultimately, a regulatory structure that encourages economic growth.

PREPARED STATEMENT OF SIMON JOHNSON[1]

RONALD KURTZ PROFESSOR OF ENTREPRENEURSHIP
MIT SLOAN SCHOOL OF MANAGEMENT

MARCH 24, 2015

A. Main Points

1) Section 165 of the 2010 Dodd-Frank Act authorizes the Board of Governors of the Federal Reserve System to establish "more stringent" standards and re-

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[6] *Dodd-Frank Wall Street Reform and Consumer Protection Act,* Pub. L. No. 111–203, 111th Cong., Section 165 (a) (2) (A). *http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/html/PLAW-111publ203.htm.*

[7] *Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations; Final Rule.* 79 no. 59 12 CFR 252 (March 27, 2014): 17240. *http://www.gpo.gov/fdsys/pkg/FR-2014-03-27/pdf/2014-05699.pdf.*

[8] *Examining the Regulatory Regime for Regional Banks before the Committee on Banking, Housing, and Urban Affairs, Washington, DC,* 114th Cong. (March 19, 2015) (testimony of Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation). *https://www.fdic.gov/news/news/speeches/spmarch1915.html.*

[9] *Application of Enhanced Prudential Standards to Bank Holding Companies Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, DC,* 114th Cong. (March 19, 2015) (testimony of Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System). *http://www.federalreserve.gov/newsevents/testimony/tarullo20150319a.htm.*

[1] Also Senior Fellow, Peterson Institute For International Economics; and Co-Founder of *http://baselinescenario.com,* a member of the Congressional Budget Office's Panel of Economic Advisors, the Federal Deposit Insurance Corporation's Systemic Resolution Advisory Committee, the Office of Financial Research's Research Advisory Committee, and the Systemic Risk Council (created and chaired by Sheila Bair). All the views expressed here are mine alone. Italicized text indicates links to supplementary material; to see this, please access an electronic version of this document, *e.g.,* at *http://baselinescenario.com.* For important disclosures, see *http://baselinescenario.com/about/.*

quirements for bank holding companies with assets over $50 billion compared with smaller bank holding companies. At the same time, the Fed is granted considerable discretion to determine exactly how to apply these standards, including what requirements are imposed on different size banks (Section 165(a)(2)(A)). (The precise wording of the Act is discussed further in Section C below.)

2) As a matter of practice since 2010, the Fed has not applied one set of standards to all banks with assets over $50 billion. There is substantial differentiation, depending in part on size, but also varying according to factors such business model, complexity, and opaqueness.

3) This differentiation, to date, seems sensible and reasonably robust—subject to the points below. It also appears completely consistent with Congressional intent, expressed through Dodd-Frank and earlier legislation that is still in effect.

4) The Federal Reserve has long had responsibility for the safety and soundness of the American financial system. This role can be traced back to the panic of 1907, which led to the founding of the Fed in 1913. The bank runs and broader economic problems of the 1930s led to a re-founding of the Federal Reserve System, with a clear mandate to prevent the financial system from getting out of control.[2]

5) In the run-up to 2007–08, the Federal Reserve failed: to protect consumers, to understand the buildup of risk around derivatives, to supervise appropriately some large financial institutions then under its jurisdiction, and to keep the system from imploding.[3] These failures were not due to lack of resources or an unawareness of the changes happening within the financial system. Rather there was a deliberate strategy of noninterference, along with many instances of actually encouraging various forms of deregulation that, in retrospect, are clearly understood—including by Fed staff and Governors—as having increased levels of systemic risk.[4]

6) At the time of the discussions and debates that led to Dodd-Frank, Congress had to face the facts: almost all the banking and financial sector regulators had failed in their tasks—some even more spectacularly than had the Fed. (The exception was the Federal Deposit Insurance Corporation, but a decision was taken not to promote the FDIC to the role of system regulator.)

7) With regard to bank holding companies, Congress did not create a new authority for the Fed in Dodd-Frank. Rather Congress re-affirmed the existing broad authority and set some minimum bars—specifying bright lines to define for the Fed which kinds of bank holding companies require more attention, while allowing the Fed to retain a considerable degree of discretion regarding what exactly that attention will involve.[5]

8) At the threshold of $50 billion in total assets, bank holding companies are now required to prepare resolution plans. They must also file an integrated Systemic Risk Report (FR Y–15).

9) Bank holding companies with more than $10 billion in total assets must conduct annual company-run stress tests. Bank holding companies with more than

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[2] On this and broader Fed history, see Peter Conti-Brown, *"The Twelve Federal Reserve Banks: Governance and Accountability in the 21st Century,"* Working Paper #10, Hutchins Center on Fiscal & Monetary Policy at Brookings, March 2, 2015. For the Fed's extensive supervisory mandate in the 2000s, see Heidi Mandanis Schooner, "Central Banks' Role in Bank Supervision in the United States and United Kingdom," Brooklyn International Law Journal, 2003, *available at ssrn.com.*

[3] The Federal Reserve System's own mission statement *has four bullet points.* The Fed disappointed along almost every dimension of these stated goals in 2007–08, with the exception that it kept the payments system functioning.

[4] For the history of deregulation and the role of the Fed, see Simon Johnson and James Kwak, *13 Bankers: The Wall Street Takeover and the Next Financial Meltdown,* Pantheon 2010, particularly chapter 4. Fed chairman Alan Greenspan was a leader in this push for deregulation in the 1980s, 1990s, and into the 2000s but, to be fair, there was a considerable degree of bipartisan consensus on this policy direction.

[5] Dodd-Frank did create a new authority for the Fed *vis-a-vis* nonbank financial companies that are designated as systemic by the Financial Stability Oversight Council (FSOC).

$50 billion in total assets must conduct semiannual company run stress tests and also participate in stress tests run by the Federal Reserve.[6]

10) The Fed already had authority to establish regulatory capital requirements, liquidity standards, risk-management standards, and concentration limits (including single counterparty credit limits). All of these can be and have been tailored as the Fed deems appropriate.[7]

11) There are, of course, costs with running any sensible risk management program. Many of these so-called "compliance costs" are very much in the interests of shareholders—it was deficiencies in or the complete lack of such programs that resulted in heavy losses and significant financial firm failures in the financial crisis. For example, the Dodd-Frank requirement (Section 165(h)) of risk committees for bank holding companies with more than $10 billion in assets seems entirely consistent with the interest of shareholders.

12) Shareholders could, in principle, speak for themselves regarding how much risk management they want and how they would like this to be organized. But we must recognize the limits imposed on shareholder influence over bank holding company management, including through the extensive rules on ownership of banks. These restrictions are, ironically, administered by the Federal Reserve itself.[8]

13) Some recent legislative proposals could increase our deference to the Financial Stability Board (FSB), with regard to either criteria or actual designation of banks as systemically important. This would be unwise. The FSB plays an important role in facilitating communication between regulators, but not all major countries share our concern for or general approach to limiting systemic risk. Relying too much on the FSB would excessively cede U.S. sovereignty to a body with limited accountability. It would also create the possibility of a "race to the bottom", as happened with capital requirements before 2007.

14) Other proposals suggest that the Financial Stability Oversight Council (FSOC) should have to designate banks as systemic in order for them to receive heightened scrutiny from the Fed. This would be a strange arrangement, as FSOC by design includes nonbank regulators, such as the chairs of the Securities and Exchange Commission and the Commodity Futures Trading Commission. Allowing or requiring nonbank regulators to tell a bank regulator which banks to regulate (and potentially how to regulate them) does not seem wise.

15) It would be helpful to require bank holding companies with at least $10 billion in total assets to file a Systemic Risk Report (FR Y–15). This report is concise and provides data on the systemic footprint of a financial institution. Hopefully, bank holding companies put together such data for their own management and investors in any case. Publishing such reports provides a clearer perspective, for regulators and for market participants, on differences in activities and risks across bank holding companies just below and just above $50 billion in assets.

16) Should some bank holding companies with less than $50 billion in total assets be subject to heightened scrutiny, for example due to various off-balance sheet activities? Without seeing Systemic Risk Reports for those firms, it is hard to know.

17) The available Systemic Risk Reports also suggest, at all size levels, it would be sensible to think of bank holding company size more in terms of total exposure (on-balance sheet plus off-balance sheet) as defined in that report, rather than the more narrow measure of total consolidated assets. (More on this in Section B below.)

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[6] Section 165(i)(2) of Dodd-Frank is quite specific on these requirements. However, as applied by the regulators, there is a "substantially abbreviated data reporting template" for the smaller banks; see Thomas J. Curry, *written testimony submitted to this Committee,* March 19, 2015.

[7] *Better Markets,* a pro-financial reform group, has produced *a very useful fact sheet* that shows the main thresholds and how the Fed has chosen to apply them.

[8] See for example, the Fed's 2008 *Policy statement on equity investment in banks and bank holding companies*. On the "many activity restrictions and regulatory intrusions" involved with becoming a bank holding company—owning or controlling a bank—see Saule T. Omarova and Margaret E. Tahyar, "That Which We Call a Bank: Revisiting the History of Bank Holding Company Regulation in the United States," *Review of Banking and Financial Law,* Vol. 31, 2011–2012, available at *ssrn.com.*

B. The Critical Threshold Issue

What if the threshold for enhanced prudential standards were lifted, for example, to $100 billion?

At the end of 2013, there were 10 bank holding companies that had assets between $50 billion and $100 billion.[9] However, a better measure of potential importance to the financial system as a whole is "total exposure" of a bank holding company, as defined in the Systemic Risk Report form. This requires a bank to report both its on-balance sheet and off-balance sheet activities, including derivatives exposures and credit card commitments, in a comparable way.[10] As we learned in 2007 and 2008, off-balance sheet activities are important and can—particularly at a time of stress—have major impact on solvency of financial institutions and on the spillover effects from potential failures.

In the latest available Systemic Risk Reports, from the end of 2013, 4 of these 10 bank holding companies actually had "total exposure" (on- and off-balance sheet) over $100 billion.[11] It is hard to argue that the fate of a bank holding company with a total exposure threshold of over $100 billion is definitely inconsequential to the system as a whole.[12]

Of the six bank holding companies that had under $100 billion in total exposure, two are subsidiaries of large non-U.S. banks that recently failed the stress tests conducted by the Fed.[13] It would seem unwise to suddenly regard those firms as no longer needing more stringent standards than required for smaller and much simpler banks.

Of the remaining four bank holding companies, two had total exposures between $95 billion and $100 billion. This leaves Huntington Bancshares Incorporated with $64 billion and Zions Bancorporation with $75 billion in total exposure.[14]

While some regional banks have relatively simple business models, others are at least partially more complex. For example, 5 of the 10 bank holding companies with under $100 billion in total assets are (*i.e.,* own) registered swaps dealers or have a significant exposure to derivatives.[15]

Regional banks, including those in the $50 billion to $100 billion total asset range, were reportedly involved in lobbying for the repeal of Section 716 of Dodd-Frank, which would have "pushed out" some swaps from their insured bank subsidiaries. The repeal of Section 716 at the end of 2014 is a further reason for the Fed and other regulators to pay close attention to regional banks.

If the discussion turns to considering lifting the scrutiny and reporting requirements for banks having over $100 billion in total assets, then looking at total exposures remains important. In the Systemic Risk Reports for the end of 2013, all of the bank holding companies with over $100 billion in assets actually had total exposure of at least $140 billion.[16]

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[9] This section uses information from the Systemic Risk Reports required by the Fed of all bank holding companies with over $50 billion in total assets; end of 2013 is the latest available. The form is here: *http://www.federalreserve.gov/reportforms/formsreview/FRY15__20120822__f__draft.pdf. The publicly available data can be accessed, by bank, from this Web page: http://www.ffiec.gov/nicpubweb/nicweb/HCSGreaterThan10B.aspx.*

[10] The instructions are here: *http://www.federalreserve.gov/reportforms/forms/FR__Y-1520131231__i.pdf.*

[11] KeyCorp had over $130 billion in total exposure, while BBVA, M&T Bank, and Bancwest had just over $100 billion in total exposure.

[12] Long-Term Capital Management (LTCM), when it was on the brink of failure in 1998, had on-balance sheet assets of around $125 billion, with capital of $4 billion. "But that leverage was increased tenfold by LTCM's off balance sheet business whose notional principal ran to around $1 trillion"; David Shirreff, *Lessons from the Collapse of Hedge Fund, Long-Term Capital Management.*

[13] Santander USA has total exposure of $98 billion and Deutsche Bank (in the United States) has total exposure of over $60 billion. Strikingly, the assets of Santander USA increased from around $77 billion at the end of 2013 to over $113 billion at the end of the third quarter of 2014—an example of how quickly a large global bank can shift business into its U.S. subsidiary. *Too Big to Fail: The Hazards of Bank Bailouts,* by Gary H. Stern and Ron J. Feldman (Brookings, 2004) highlights, among other points, the potential dangers posed by foreign banks operating in the United States.

[14] Zions has had repeated problems with the Fed-run stress tests, barely passing in 2015. Part of the issue appears to be its large portfolio of Collateralized Debt Obligations. See Julie Steinberg, "Zions, Regulators Still at Loggerheads," *Wall Street Journal,* March 22, 2015.

[15] This CFTC list is current as of March 16, 2015: *http://www.cftc.gov/LawRegulation/DoddFrankAct/registerswapdealer.* The OCC latest derivative report shows activities by bank in the third quarter of 2014, *http://www.occ.gov/topics/capital-markets/financialmarkets/trading/derivatives/dq314.pdf.*

[16] It is hard to know what will or will not be regarded as systemic as the next crisis develops. IndyMac Bancorp, which failed in 2008, had assets of just over $30 billion; in retrospect, its

Continued

C. Regulatory Interpretation of Dodd-Frank

Some recent prominent discussion of the Dodd-Frank Act suggests that bank holding companies with over $50 billion are "designated" as "systemic". But this is not what the legislation actually says and this is not how the law has been interpreted by regulators.

Section 165(a)(1) of the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act reads:

> "In order to prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected financial institutions, the Board of Governors shall, on its own or pursuant to recommendations by the Council under section 115, establish prudential standards for nonbank financial companies supervised by the Board of Governors and bank holding companies with total consolidated assets equal to or greater than $50,000,000,000 that——
>
> (A) are more stringent than the standards and requirements applicable to nonbank financial companies and bank holding companies that do not present similar risks to the financial stability of the United States; and
>
> (B) increase in stringency, based on the considerations identified in subsection (b)(3)."

Section 165(a)(2) stipulates that the Board of Governors may "differentiate among companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities (including the financial activities of their subsidiaries), size, and any other risk-related factors that the Board of Governors deems appropriate." And the threshold for applying some standards may be set above $50 billion.

The Federal Reserve appears to have interpreted this and related sections of Dodd-Frank exactly as intended, *i.e.,* as requiring additional scrutiny for bank holding companies over $50 billion, compared with smaller bank holding companies, but *not* as requiring that all bank holding companies over $50 billion be treated the same way.[17]

Martin J. Gruenberg, chairman of the FDIC, confirms that this is how regulators have interpreted the law.[18]

> "In implementing the requirement for resolution plans, the FDIC and the Federal Reserve instituted a staggered schedule for plan submissions to reflect differing risk profiles."

And,

> "The FDIC's stress testing rules, like those of other agencies, are tailored to the size of the institutions consistent with the expectations under section 165 for progressive application of the requirements."

Overall, the Dodd-Frank financial reforms told the Fed to be more careful in its regulation of bank holding companies with more than $50 billion in total assets, but there was definitely no one-size-fits-all requirement. The Fed and other regulators seem to have followed both the letter and spirit of this instruction.

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problems should have been seen at least as an early warning for the rest of the system. Continental Illinois, which failed in 1984, was one of the top 10 banks in the United States, *but its assets were only around $40 billion.* U.S. Gross Domestic Product in 1984, in current prices, was around $4 trillion, so Continental Illinois's balance sheet assets had a book value of about 1 percent of the size of the U.S. economy. In modern terms, this further confirms the notion that we should pay close attention as a bank's size (*i.e.,* total exposures) reaches $150 billion.

[17] Governor Daniel K. Tarullo discussed the Fed's "tiered approach to prudential oversight" most recently in *his testimony before this Committee* on March 19, 2015: *http://www.federalreserve.gov/newsevents/testimony/tarullo20150319a.pdf.*

[18] These quotes are from his *recent testimony to this Committee,* March 19, 2015.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

ARVEST BANK
ASSOCIATED BANK
ASTORIA BANK
BANCORPSOUTH
BANKUNITED
BANK OF HAWAII
BOK FINANCIAL
CENTRAL BANCOMPANY
CITY NATIONAL BANK
COMMERCE BANK
EASTERN BANK
EAST WEST BANK
EVERBANK
FIRSTBANK
FIRST CITIZENS BANK
FIRST HAWAIIAN BANK
FIRST HORIZON BANK
FIRST MIDWEST BANK
FIRSTMERIT BANK
FIRST NATIONAL OF NEBRASKA
FIRST NIAGARA
FLAGSTAR BANK
FIRST NATIONAL BANK
FROST BANK
FULTON FINANCIAL
HANCOCK BANK
INTERNATIONAL BANCSHARES
IBERIABANK
MB FINANCIAL
OLD NATIONAL BANK
ONE WEST BANK
PACIFIC WESTERN BANK
PEOPLE'S UNITED BANK
POPULAR COMMUNITY BANK
RAYMOND JAMES BANK
SCOTTRADE BANK
SIGNATURE BANK
SILICON VALLEY BANK
SUSQUEHANNA BANK
SYNOVUS BANK
TCF BANK
TEXAS CAPITAL BANK
THE PRIVATEBANK
TRUSTMARK
UMB FINANCIAL
UMPQUA BANK
UNITED BANK
VALLEY NATIONAL BANK
WEBSTER BANK
WINTRUST FINANCIAL

M B C A

MID-SIZE BANK COALITION OF AMERICA

March 23, 2015

The Honorable Richard Shelby
Chairman
U.S. Senate Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Shelby:

On behalf of the Mid-Size Bank Coalition of America (**MBCA**),[1] I am writing to comment on reform of the standards for designating systemically important financial institutions (**SIFIs**) that the Committee is considering.

Midsize banks are vitally important to the well-being of communities across the nation. While our balance sheets are modestly larger, our business models closely resemble community banks in that we are known for deep community ties, often times having served our communities for over a century. Our bankers have daily interaction with our customers, offering personalized service and meeting the needs of the local residents and businesses consistent with sound and prudent operation. We take in local deposits and provide traditional banking products such as loans and mortgages to consumers, small businesses and other members of our communities, and have made the risk and compliance investments that support our strategies.

We have learned a letter recently written by the MBCA was cited in support of an argument that the current approach to identifying SIFIs under the Dodd-Frank Act—specifically, the $50 billion threshold—

[1] The MBCA is a non-partisan financial and economic policy organization comprised of 52 midsize banks (each with total consolidated assets between $10 billion and $50 billion). The MBCA's member banks have combined assets currently exceeding $985 billion - with an average size of $19 billion - and, together, employ approximately 155,000 people. Member banks have nearly $775 billion in deposits and total loans of more than $640 billion.

555 South Flower Street, 12th Floor | Los Angeles | California | 90071
Phone: (310) 888-6080

should be left intact. We strongly disagree with this characterization and so write today to set the record straight.

None of our members could be judged, by any conceivable measure, as systemically important. Indeed, based on a recent report of the Office of Financial Research of the U.S. Department of the Treasury, this is true of nearly every banking organization in the United States when holistically assessed in terms of size, interconnectedness, substitutability, complexity, and cross-jurisdictional activity.[2]

Yet, on top of an already robust regulatory and supervisory framework, each of us has been subjected to rigorous stress testing, corporate-governance directives, and other requirements under the Dodd-Frank Act that could be appropriate only for a SIFI. We also have witnessed, in the form of recommended best practices, a persistent trickle-down of other statutory mandates that were aimed exclusively at SIFIs.

The imposition of these demands on midsize banks does not benefit the public in any appreciable way. To the contrary, they are sapping resources that we instead should be deploying to extend credit and entrepreneurially serve our local communities. Rather than loan officers and other customer-service providers, we have been compelled to reallocate our budgets and engage quantitative modelers and banking consultants to prove what is already well known - none of us, individually or collectively, pose even a marginal threat to the financial system.

Our position, therefore, is one simply seeking clarity - clarity that midsize banks are not SIFIs, clarity that statutory or prudential obligations of SIFIs should not be applied to midsize banks, and clarity that none of the statutory or prudential obligations of SIFIs should be indirectly imposed on midsize banks in the form of best practices or otherwise. Further, the low threshold for SIFI designation has multiple unintended consequences. For instance, as a bank approaches the $50 billion threshold, it creates a distortion in planning for natural growth and the associated growth in lending. Bank leadership is forced to consider the significant increase in operating expense imposed by crossing an artificial barrier unrelated to systemic risk.

This clarity, we readily acknowledge, could assume any number of different forms. We look forward to continuing our dialogue with you

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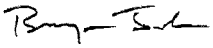
[2] Office of Financial Research. U.S. Department of the Treasury, *Systemic Importance Indicators for 33 U.S. Bank Holding Companies: An Overview of Recent Data* (February 12, 2015).

and others in Congress to ensure that, whatever form is adopted, no misunderstanding about the systemic unimportance of midsize banks and their relationship to the overall financial system will exist. It also would be lamentable, in our view, if any banking organization could be designated as a SIFI simply due to its asset size without any consideration of interconnectedness, substitutability, complexity, or cross-jurisdictional activity. Successfully meeting more of the credit needs of consumers and businesses consistent with longstanding safety and soundness principles, in and of itself, is not indicative of systemic importance.

We greatly appreciate all of your efforts to supply the kind of regulatory relief that will generate meaningful economic growth in our communities, and we look forward to continuing this dialogue.

Sincerely,



Bryan Jordan
Chairman, Mid-Size Bank Coalition of America
Chairman, President, and CEO of First Horizon

555 South Flower Street, 12th Floor | Los Angeles | California | 90071
Phone: (310) 888-6030

Regional Bank Coalition

March 23, 2015

The Honorable Richard Shelby
Chairman
Senate Committee on Banking,
Housing & Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Sherrod Brown
Ranking Member
Senate Committee on Banking,
Housing and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Shelby and Ranking Member Brown:

The Regional Bank Coalition and its members – SunTrust, Regions, Huntington, Fifth Third, Capital One, BMO Financial, BBVA Compass, BB&T, Bank of the West, and American Express – applaud the Senate Banking Committee for holding hearings examining the appropriate regulatory regime for regional banks. Regional banks, which overwhelmingly focus on straightforward lending in communities in all 50 states, believe that regulation based on risk – not arbitrary asset thresholds – will assure bank safety and soundness, unlock economic growth in the communities we serve, and allow regulators to focus their attention on those institutions that do pose systemic risk to the financial system and the economy.

When the Dodd-Frank Act was enacted, it imposed significant systemic risk regulations on regional banks based on an arbitrary asset threshold of $50 billion, rather than taking into account a bank's true risk profile or business model. At the time of its enactment, neither regulators nor Congress had developed a more sophisticated method for measuring systemic risk.

Since then, however, the Federal Reserve, the Financial Stability Board and the Basel Committee for Bank Supervision have used a test that examines five factors to measure systemic risk: size, interconnectedness, complexity, global activity, and dominance in certain customer services, also known as substitutability. The Treasury Department's Office of Financial Research recently applied those factors in examining the riskiness of U.S. banks; their analysis found that the largest global systemically important banks (G-SIBs) had a systemic risk score of 5.05 percent and 4.27 percent. None of the regional banks listed in the report have scores exceeding 0.35 percent.

Regional banks scored well in that analysis because they focus the core of their business on traditional banking activity, not on riskier, more complex lines of business. Regional banks hold assets predominantly in insured depository institutions, have limited broker-dealer or other non-bank operations, do not have significant cross-border operations, and do not rely to a significant degree on short-term wholesale funding.

For example, core deposits, as a percentage of total assets, are, on average, approximately 72% for regional banks, as compared to approximately 29% for G-SIBs. Reverse repurchase agreements average less than 1% for regional banks, as opposed to 15% for G-SIBs. Securities sold or subject to repurchase, as a percentage of total liabilities, are approximately 1% for regional banks, as opposed to 11% for G-SIBs.

Regional banks also hold far fewer foreign deposits and make far fewer foreign loans. They face far less exposure to derivatives, collectively holding approximately 1% of outstanding contracts in the derivatives markets. As the following table makes clear, regional banks' business operations look nothing like those of the globally systemic important banks.

Table: Assets & Liabilities of Regional Banks vs. Systemically Important Banks

	Regional Banks	U.S. G-SIBs
Core deposits, as % of total assets	72%	29%
Reverse repurchase agreements	<1%	15%
Securities sold or subject to repurchase	1%	11%
Foreign deposits	1%	28%
Foreign Loans	<1%	18%
Broker Dealer Assets	<1%	19%
Notional Value of Derivative Contracts, as % of total assets	<54%	2549%

Even though regional banks do not pose a systemic risk to the economy, the Dodd-Frank Act has imposed significant additional capital and regulatory requirements. To be clear, regional banks support robust regulation to assure safety and soundness. But applying regulations meant for globally systemic banks to banks that do not pose the same risk to the economy only diverts capital that could be otherwise spent on traditional lending activities that fuel the economy.

The Regional Bank Coalition supports a tailored, balanced regulatory structure that acknowledges that risk is not measured by asset size alone, but instead accounts for the diversity, resilience, and utility of different banking sectors. We hope the committee will pursue these important reforms, and we would be glad to work with its members as you move forward.

Sincerely,

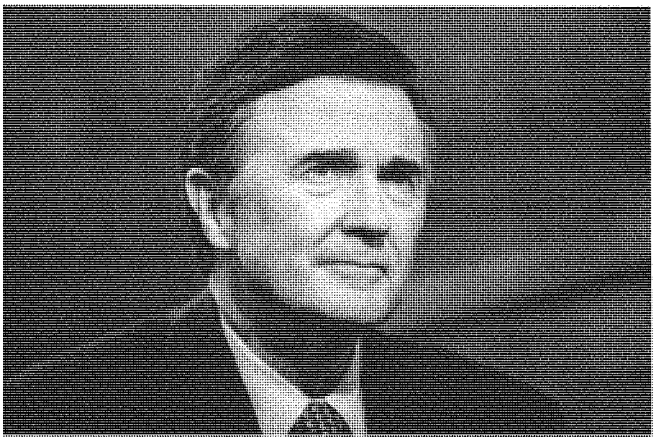
William Moore
Executive Director

THE WALL STREET JOURNAL.
WSJ.com

April 1, 2015, 9:33 AM ET

Fed's Lockhart Endorses Raising $50 Billion Level for Tougher Bank Rules

ByRyan Tracy



Bloomberg News

STONE MOUNTAIN, Ga.—Federal Reserve Bank of Atlanta President Dennis Lockhart said he believes the provision in the 2010 Dodd-Frank law requiring stricter supervision of banks with more than $50 billion in assets should be changed.

Some banks above the $50 billion threshold "individually at least do not represent systemic risk, so I think the threshold should be raised," he told reporters at a conference here. "I don't have a number, but certainly higher than $50 billion."

Mr. Lockhart has some banks in his Fed district, such as Regions Financial Corp. and SunTrust Banks , Inc., that hold more than $50 billion in assets but far less than the largest Wall Street firms. Those firms are among a group of mid-sized banks pushing for legislation that would allow them exemptions from Fed rules forcing banks above $50 billion to pass "stress tests" before paying dividends, write complicated "living wills" to plan for their own demise, and meet other requirements.

Another resident of Mr. Lockhart's district: Sen. Richard Shelby (R.,Ala.), who chairs the Senate Banking Committee and is considering legislation that would alter the threshold and make other changes to the 2010 Dodd-Frank law.

A March hearing called by Mr. Shelby highlighted the tough slog regional banks face in pushing the legislation through Congress, despite endorsements from regulators like Mr. Lockhart.

At the hearing, Fed Gov. Daniel Tarullo reiterated his support for altering the threshold, though he appeared to suggest a narrower approach than he had previously. Democrats, whose support will be necessary for Mr. Shelby to move a bill through the Senate, also were skeptical about the change.

- THE WALL STREET JOURNAL
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- BUSINESS

Deep in the Rust Belt, Regional Banks Fill Industrial Niche

Local lender KeyBank is succeeding by going back to its roots, lending to small and mid-size manufacturers

ENLARGE

Sonja Mathews at a furnace in her family's industrial heat treatment plant in Mentor, Ohio. Her company is growing again after receiving loans from KeyBank. *PHOTO: DUSTIN FRANZ FOR THE WALL STREET JOURNAL*

By
JAMES STERNGOLD
March 26, 2015 10:30 p.m. ET
7 COMMENTS

MENTOR, Ohio—The recession threw up plenty of hurdles for MT Heat Treat, an industrial heat-treatment plant here in the Rust Belt.

It struggled to hold onto employees as revenues fell by nearly half and some customers went bust, said Sonja Mathews, whose family owns the operation. But one problem was unexpected: The banks she thought they could rely on turned them down for loans, even when offered ample security.

"At one time we wanted a $300,000 loan, and for that they wanted almost $2 million in collateral, including this building," she says. "But even with that, they still wouldn't do it."

These days Ms. Mathews, 48 years old, is too busy for bitterness. The giant ovens in the hangar-sized plant are roaring and she is running three shifts, 24 hours a day, thanks to the company's new bank that has kicked in all the financing it needs.

KeyBank, based in nearby Cleveland, provided last year not just an initial $680,000 loan but another $200,000 for a new conveyer system so the company could speed up the heating and hardening process of steel parts. The components are used in everything from industrial machinery to military hardware and power plants.

Such prosaic lending has brought new life to Ms. Mathews' business—and also to her bank.

"They're the kind of client we want now," says Ed Korsok, a KeyBank vice president in Mentor, about 25 miles east of Cleveland, who initiated the relationship as part of the bank's new focus on industrial businesses—right in its backyard.

"For a lot of the big regional banks, the future is a return to the past," says Eric Wasserstrom, an analyst at Guggenheim Securities LLC. "It's more like their traditional lending, more balanced."

Not doing their part

After the recession, some business leaders and lawmakers complained that banks weren't doing their part to fuel economic growth, despite receiving billions of dollars in bailout funds from the government. Bank lending across the country only began a sustained rise in the second quarter of 2012, and has generally accelerated in the past year.

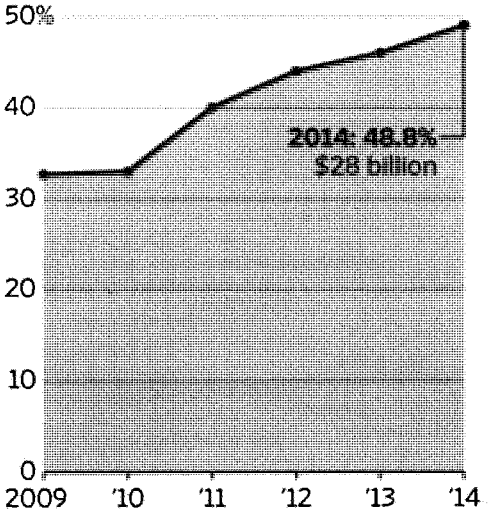
But the lending has not been strong everywhere, or at all banks. Some regional banks had started lending to businesses earlier than their larger counterparts following the recession. Just as importantly, they sharply dialed back their moves into areas like property development and subprime mortgages that often required investments far from home.

To be sure, the volume of commercial and industrial loans at the major Wall Street banks is larger in dollar terms than at regional lenders, but a smaller share of their totals. Bank of America Corp. made $233.6 billion in U.S. commercial and industrial loans in 2014, 26.5% of its total, while Citigroup Inc. made $41 billion, or 6.4% of its total, according to data from the companies.

And while the large firms have tended to put a greater emphasis on other types of credit, such as consumer loans, some regional lenders have increasingly staked their brands on business loans—depending on them far more heavily than larger banks.

Unlocking Credit

Percentage of KeyCorp loans that are commercial and industrial



Source: KeyCorp

THE WALL STREET JOURNAL. ENLARGE

KeyBank's commercial and industrial loans of $28 billion at the end of 2014 comprised 49% of its overall portfolio, while those loans at neighboring Ohio-based bank Huntington Bancshares totalled $19 billion, or 40% of its portfolio.

KeyBank embraced the strategic shift with particular zeal—and a distinct focus on midsized and smaller companies close to its roots in the Rust Belt. As a result, its commercial and industrial loan growth—12.3% in 2014— is outpacing most of its regional banking peers. Fifth Third Bancorp , for example expanded its loan totals by 4% last year while PNC Financial Services Group Inc.grew them by 10%.

KeyBank has returned to what it sees as a more sustainable growth path, bolstered by those rapidly growing loans to manufacturers. Unlike most of the big Wall Street firms, which still rely on a wider range of lending activities, as well as riskier securities trading, KeyBank's success is increasingly tied to commercial loans it makes—many in local communities.

And although it is centered in the Midwest, Key stretches across 12 states, from Maine to Alaska. In July, the bank announced that it had agreed to acquire Pacific Crest Securities, a technology-focused investment bank in Portland.

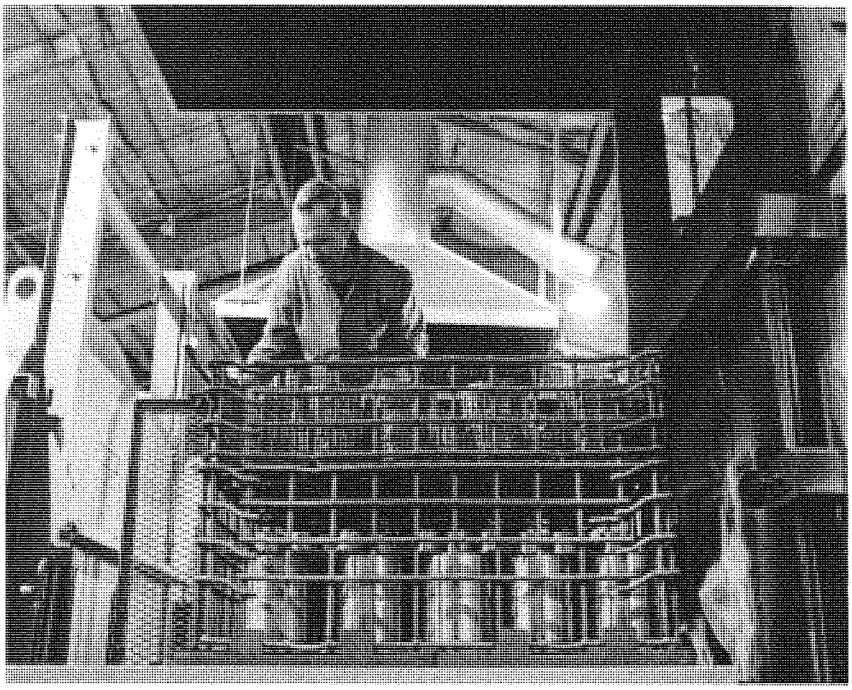
The stock price for KeyCorp, the holding company which consists almost entirely of the banking operation, has beat many of its competitors by refocusing on its home turf. Since the beginning of 2013, shares of KeyCorp are up 68% compared with 40% for the KBW Bank index, which tracks the value of 24 of the largest national and regional banks.
Like many of its peers, KeyBank was hit hard by the financial crisis. The bank suffered more than $3 billion in losses during 2008 and 2009, tied largely to what had been aggressive real-estate lending in distant Sun Belt states like Florida and California.

The bank received $2.5 billion in bailout funds from the government, which it repaid in 2011.

Now, with a renewed focus on the industrial Midwest and renewed interest in old-school metal benders, it has started on what it believes is a steadier and more sustainable earnings trajectory. KeyBank is now wooing middle-market companies in fields like auto components, specialty chemicals and steel-parts fabrication.

The benefits were evident in January, when the bank posted unexpectedly strong fourth-quarter earnings strengthened by double-digit growth in commercial and industrial loans—well ahead of the national rate. Meanwhile, it has cut its commercial real-estate lending in half since the pre-crisis days and exited some niche areas, such as boat loans.

"We've learned our lessons from the downturn," Beth Mooney, KeyCorp's chairwoman and chief executive officer, said in an interview. "We value good execution over fancy strategies."



ENLARGE
A worker inspects a load about to enter the furnace for heat treatment at MT Heat Treat in Mentor, Ohio.*PHOTO: DUSTIN FRANZ FOR THE WALL STREET JOURNAL*

Chris Gorman, president of the Key Corporate Bank—the unit that focuses on commercial and industrial customers—says the bank has added dozens of senior lending officers and has sharply expanded research into important manufacturing sectors. It finds them to be a good bet because they tend to be capital intensive and increasingly are using sophisticated technology in their factories, which is costly but can accelerate growth.

"They've been helped by the fact that the economy is in much better shape today in the Midwest and manufacturing is doing well," says Christopher Mutascio, who follows the bank at Keefe, Bruyette & Woods Inc. "That has really allowed them to benefit more than some others from what they do best."

KeyBank's loans expanded 5.5% in the fourth quarter from the year earlier. But commercial and industrial loans, including the kind made to manufacturers, shot up by 12.3%, to $28 billion. That compares with less than 10% growth in such loans at banks nationally, according to data from the Federal Deposit Insurance Corp. Meanwhile, its commercial real estate and construction loans plummeted to $9.15 billion at the end of the fourth quarter, from $18.5 billion in 2008.

Eduardo Gonzalez is president and owner of the Ferragon Corp., a metal parts fabricator based in an industrial area of Cleveland. Last year, the company took out a loan for $60 million, which will finance the purchase of new equipment that can cut and shape ultra-hard steel for those parts. KeyBank financed more than half of the deal.

"It's the biggest investment we've ever made," Mr. Gonzalez said in an interview at the company's headquarters, where a sign reads "Sell or Starve."

Such a bold move would have been unthinkable just seven years ago, after the recession landed with a thud on his business.

Mr. Gonzalez, a former running back on the University of Michigan football team, said his company enjoyed its best revenues and profits ever in October of 2008, followed immediately by its worst month ever in November of that year.

"It just completely dropped off," Mr. Gonzalez said. "Because we didn't know how deep it would get, we didn't want to overdo the layoffs. But then December was worse than November. We decided we couldn't do layoffs just before Christmas, but then January was even worse still."

Partly by preserving cash, the business stabilized by 2010 and then hit a new growth spurt driven by the resurgent auto industry, which is pushing to increase fuel efficiency in cars and incorporate new technologies. Those efforts require new generations of parts that are stronger but lighter, Mr. Gonzalez said.

Mr. Gonzalez's firm also benefited from the influx of energy companies in the region involved in fracking. Shale oil and gas production sites are enormous consumers of industrial products, such as heavy machinery, pipelines and transportation gear.

These types of business loans aren't necessarily more profitable for KeyBank: commercial and industrial loans were yielding, on average, 3.28% at the end of 2014, compared with 3.8% for commercial mortgages, but the bank now prefers lower risk assets and more predictable earnings.

'Back to the basics'

It is a strategy borne, in part, from necessity. Ms. Mooney says that when she took over as CEO in 2011 she decided the battered bank needed to work harder to find good commercial clients closer to home and build broad relationships with them. "I said it would be back to the basics," she says.

Ms. Mooney was the first woman named chairwoman and chief executive officer of one of the country's 20 largest banks when she was appointed in May 2011.

She is known as a problem-solver who favors working in small incremental steps rather than sweeping new strategies. Like other banks, she says, Key needed to unlearn the kinds of banking activities, such as riskier property lending in far-flung areas, that got it in trouble.

"We want to be where we matter and can get paid for it," Ms. Mooney says, "and be a predictable earner."

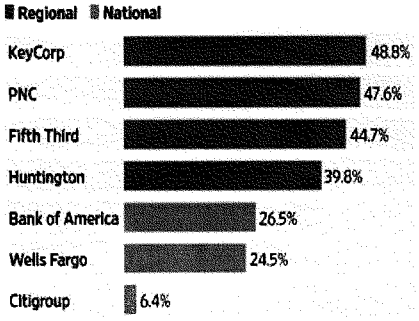
Still, risks remain. The tumble in oil and gas prices has raised concerns that part of the industrial expansion could be threatened—and in turn, ripple through lenders. Already, some U.S.-based energy companies are drilling fewer wells, cutting production and laying off workers.

Mr. Gorman acknowledges the trend could hurt suppliers and perhaps the bank. He notes, however, that its loans directly to oil and gas companies make up only 2% of the total. Mr. Mutascio, of Keefe, Bruyette & Woods, says his concern is not that some of Key's loans might go bad but that its strong loan growth might slow as companies connected to oil and gas production cut investments and borrow less.

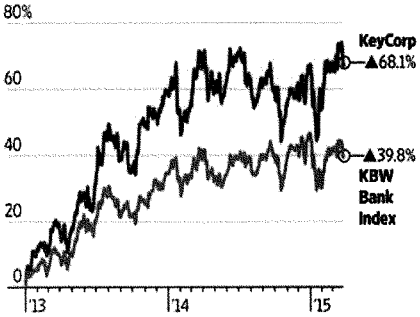
Community Clout

Regional banks have been betting on commercial loans more heavily than their larger counterparts.

U.S. commercial and industrial lending as a percentage of total loans, 2014



Performance of KeyCorp and Keefe, Bruyette & Woods Bank Index



Note: Data for Bank of America, Wells Fargo and Citigroup exclude foreign loans; international loan amounts for the regional banks are not material.
Sources: the companies (loans); FactSet (performance)
THE WALL STREET JOURNAL.

ENLARGE

Mr. Gorman maintains that the industry's prospects remain bright in the long term. Lower energy prices, he argues, are a net plus for the Midwest, since reduced energy costs benefit consumers and the many industries for which energy is a major cost.

"No one would have envisioned how steeply things would go down around here, and how quickly they have come back," says Mr. Gorman.

To be sure, growth in the region is still uneven. Ohio has generally rebounded but some counties near Cleveland are recovering more slowly than the country at large.

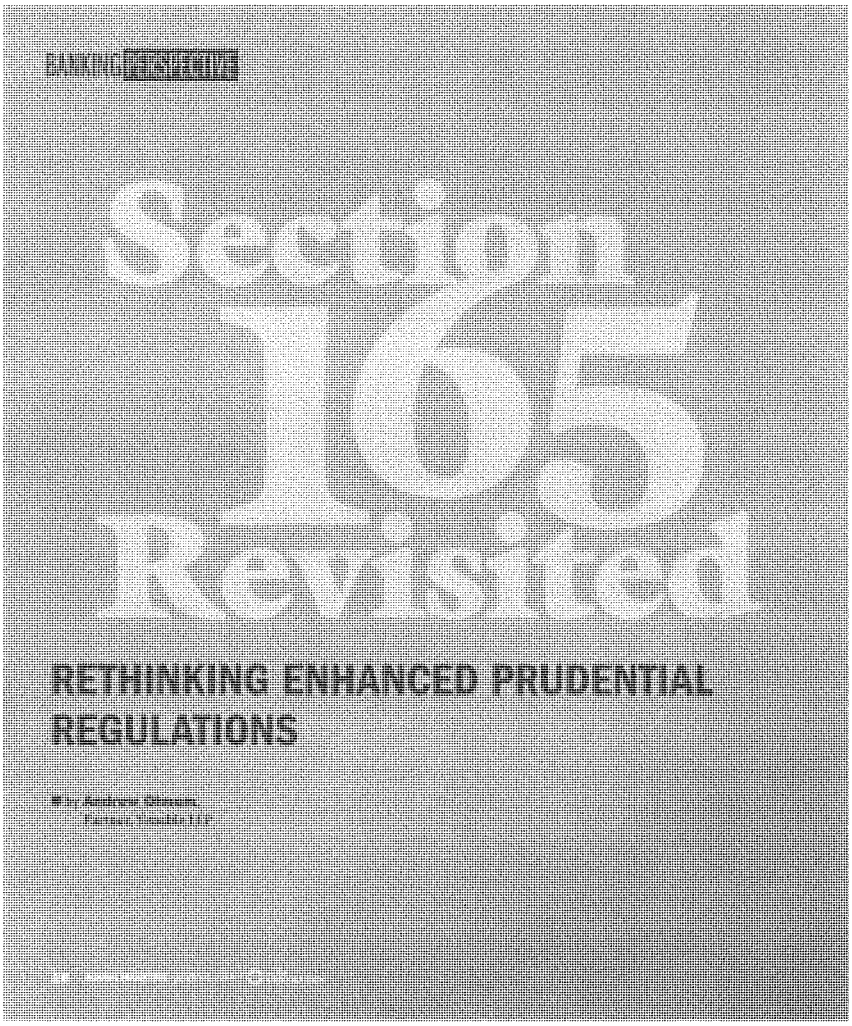
Christine Chmura, who operates an economic-consulting business in Cleveland and Virginia, says that the employment levels around Cleveland remain below their pre-recession levels.

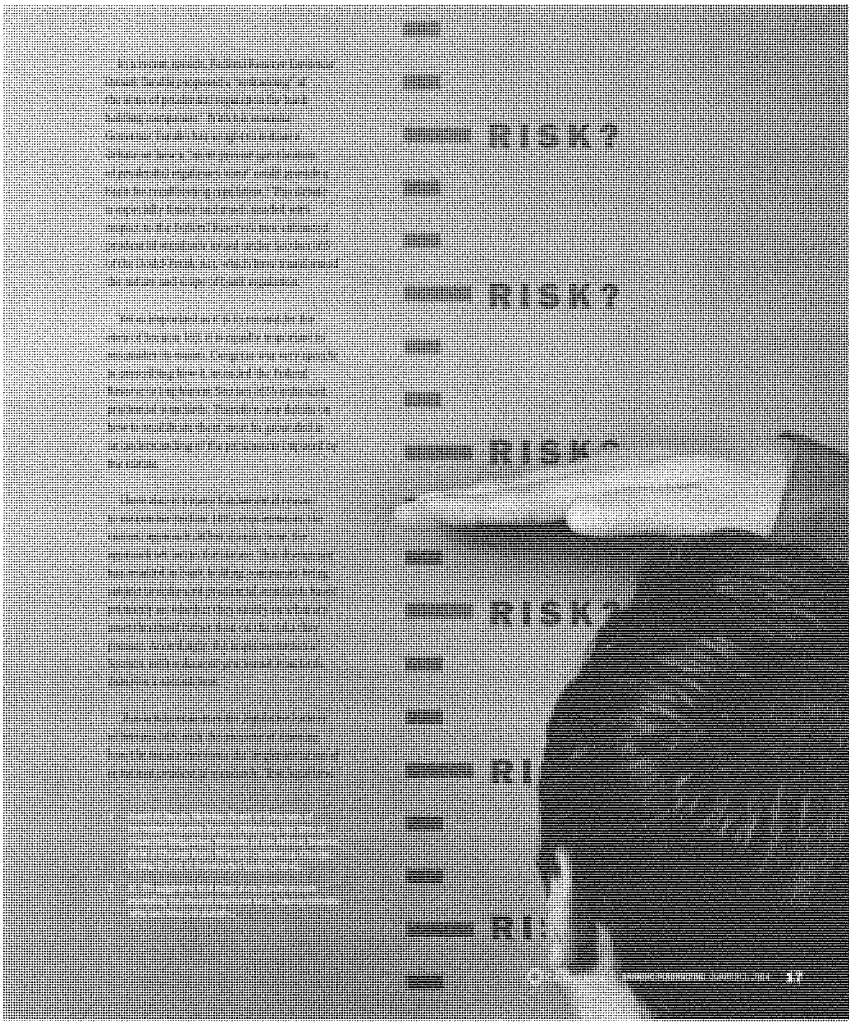
She recalls that, while many mid-sized companies were thriving, the area had lost some of its largest employers years ago, and that it might never recover to the levels from its strongest years. Still, she says, the recent manufacturing comeback has been very positive for the region because the new jobs pay high wages and factories generate additional economic activity.

"Cleveland got hit with a double whammy," says Ms. Chmura. "Vehicle manufacturing was very hard hit, and the overall recession hurt them. But there has been a real resurgence. And manufacturing jobs pay more than other jobs in the Cleveland area."

At the Whirlaway product division of NN Inc., in nearby Wellington, Ohio, sales are back to the pre-recession level and growing rapidly—in part with the help of new investments in equipment to keep up with demand from auto parts concerns, said James R. Widders,the general manager. Those investments were financed in large part by loans from KeyBank.
Whirlaway saw its revenues plunge from $80 million just before the recession to $45 million in 2010, and many workers were put on three- and four-day weeks, says Mr. Widders. But sales are now back to $80 million and Mr. Widders says he expects to reach $100 million annually in two years, thanks to the new equipment he has put in force.

"All these new technologies are just great for us," says Mr. Widders. "The more complicated the part, the better."


BANKING INTERVENTION
Section 165 Revisited
RETHINKING ENHANCED PRUDENTIAL REGULATIONS



history has important implications for how enhanced prudential standards could be recalibrated to be not only more effective but also more consistent with the provisions of Section 165.

Overview of Section 165

Section 165 of Dodd-Frank requires the Federal Reserve to establish enhanced prudential standards for bank holding companies with $50 billion or more in consolidated assets.[3] The Federal Reserve must promulgate enhanced prudential standards for: (1) risk-based capital requirements and leverage limits; (2) liquidity requirements; (3) overall risk management requirements; (4) resolution plans and credit exposure reports; (5) concentration limits; (6) risk committees; and (7) company stress tests.[4] On a discretionary basis, the Federal Reserve may establish additional enhanced prudential standards.[5]

To implement Section 165, the Federal Reserve has issued a series of rules that mostly apply uniformly to bank holding companies that satisfy the $50 billion threshold. These rules have implemented not only the mandatory enhanced prudential standards under Section 165 but also the Federal Reserve's annual Comprehensive Capital Analysis and Review, or CCAR.[6] Additional enhanced prudential standards also apply at other asset thresholds, including at the $250 billion (or $10 billion in foreign exposures), $700 billion (or $10 trillion in assets under custody), and, for foreign banking organizations, $50 billion in U.S. assets levels.[7] The Federal Reserve is expected to issue additional rules using similar asset thresholds.[8] This reliance on asset thresholds, however, is not the approach set forth in Section 165.

The Legislative History

The legislative history of Section 165 begins in the U.S. Senate Committee on Banking, Housing, and Urban Affairs ("Senate Banking Committee"). The provision originated as Section 165 of legislation, S. 3217, the Restoring American Financial Stability Act of 2010 ("RAFSA"), passed by the Senate Banking Committee on March 22, 2010.[9] The provision was amended several times by Congress, but ultimately became Section 165 of Dodd-Frank. The key legislative history lies in how Section 165 was incorporated into RAFSA, but, to fully understand this history, it is first necessary to understand the influence of Senate Banking Committee Chairman Christopher Dodd's discussion draft proposal of November 2009 ("Dodd Discussion Draft").

Dodd Discussion Draft

As Congress began considering financial regulatory reform during the 111th Congress, Chairman Dodd's initial proposal was the Dodd Discussion Draft.[10] Its central reform was consolidation of all prudential regulation into a single regulator, the Financial Institutions Regulatory Administration ("FIRA").[11] This restructuring of financial regulation was designed to streamline financial regulation, as well as to discipline federal banking regulators for their perceived regulatory failures in the lead-up to the financial crisis of 2008.

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3 Section 165 also applies to designated nonbank financial companies. Because the designation of, and application of enhanced prudential standards to, nonbank financial institutions raises numerous and complex issues unrelated to bank holding company regulation, this article focuses solely on the application of Section 165 to bank holding companies.

4 Dodd-Frank Act § 165(a), (h)(2), and (i)(2)(C).

5 Section 165(b)(1)(B) explicitly provides for discretionary standards on contingent capital requirements, enhanced public disclosures, and short-term debt limits.

6 See Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17,240 (Mar. 27, 2014).

7 See *id.* and Regulatory Capital Rules, 79 FR 24528 (May 1, 2014).

8 *See* Daniel K. Tarullo, Member, Board of Governors of the Fed. Reserve System, *Dodd-Frank Implementation*, Testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate (Feb. 6, 2014).

9 *Available at* http://www.gpo.gov/fdsys/pkg/BILLS-111s3217pcs/pdf/BILLS-111s3217pcs.pdf. Restoring American Financial Stability Act of 2010, S. 3217, 111th Cong. (2010) (Hereinafter "RAFSA").

10 *Available at* http://www.lisdc.org/assets/DoddFrankdocs/bill-111th-s3217-discussion-draft.pdf (Hereinafter "Dodd Discussion Draft"). The formal title of the Dodd Discussion Draft was the "Restoring American Financial Stability Act of 2009."

11 Dodd Discussion Draft, Title III.

The Dodd Discussion Draft also would have created the Agency for Financial Stability ("AFS"), which would have been responsible for designating any financial company (whether a bank holding company or nonbank financial company) whose "material financial distress" would "pose a threat to the financial stability of the United States or the United States economy during times of economic stress."[12] Any designated company would have been subject to enhanced prudential standards set by the AFS. These enhanced prudential standards would have been required to be "more stringent than [the standards] applicable to financial companies that do not present similar risks to United States financial system stability and economic growth" and to "increase in stringency with the size and complexity" of the designated financial company.[13]

In devising enhanced prudential standards, the AFS also would have had to take into account a long list of specific factors, including "the amount and types of the liabilities of the company"; "the amount and nature of the financial assets of the company"; "the extent and type of the off-balance-sheet exposures of the company"; the company's relationships with other major financial companies; and its ownership of any clearing, settlement, or payment businesses.[14] As this list demonstrates, these enhanced prudential standards were supposed to reflect a variety of factors, rather than just the amount of assets held by a designated company.

Although the Dodd Discussion Draft failed to garner sufficient support and was never voted on by the Senate Banking Committee, its provisions for streamlining financial regulation under FIRA and its approach to enhanced prudential standards laid the foundation for Section 165.

RAFSA

After abandoning the Dodd Discussion Draft, Chairman Dodd scaled back his reforms and proposed RAFSA in March 2010. Nevertheless, Section 165 of RAFSA reflects many of the same approaches and goals of the Dodd Discussion Draft.

Under Section 165 of RAFSA, the Federal Reserve, like the AFS under the Dodd Discussion Draft, was required to establish enhanced prudential standards for certain financial companies. Section 165 explicitly sets forth the aim of these enhanced prudential standards: "to prevent or mitigate risks to the financial stability of the United States that could arise from the material distress or failure of large, interconnected financial institutions."[15]

RAFSA also established the Financial Stability Oversight Council ("FSOC") and made it responsible for designating the nonbank financial companies that would be subject to Section 165's enhanced prudential standards.[16] Unlike the AFS under the Dodd Discussion Draft, however, the FSOC was authorized to designate only nonbank financial companies because RAFSA explicitly provided that Section 165 applied to all "large, interconnected" bank holding companies with consolidated assets of $50 billion or more.[17]

The $50 Billion Threshold

What was the rationale for the $50 billion threshold? In isolation, it seems very arbitrary and over-inclusive. The reason is that the $50 billion threshold was not designed to identify companies that pose risks to financial stability but rather to advance two other objectives of RAFSA.

First, RAFSA sought to continue the Dodd Discussion Draft's goal of streamlining prudential supervision. However, unlike the Dodd Discussion Draft, which would have eliminated entirely the Federal Reserve's jurisdiction over bank holding companies, RAFSA instead would have reduced the Federal Reserve's jurisdiction to only bank holding companies with consolidated assets of

12 Dodd Discussion Draft §105.

13 Dodd Discussion Draft §107(a).

14 Dodd Discussion Draft §107(b)(3).

15 RAFSA § 165(a)(1) (this language was revised by the conference committee to also cover such risks arising from "ongoing activities" of these institutions). This language also largely mirrors the aim of enhanced prudential standards under the Dodd Discussion Draft § 107.

16 RAFSA § 111; § 113.

17 RAFSA § 312(a).

$50 billion or more.[18] All other bank holding companies were to be regulated by the primary regulator of their depositories, either the OCC or the FDIC.[19]

THE $50 BILLION threshold was not intended to separate companies based on whether they presented risks to financial stability.

According to the Senate Banking Committee Report on RAFSA, the Federal Reserve's jurisdiction over bank holding companies was set at the $50 billion threshold because data demonstrated that "in almost all instances of banking organizations with less than $50 billion in assets, the vast majority of assets are in the depository institution."[20] The aim was to have the Federal Reserve regulate bank holding companies that had securities, insurance, and other nonbank activities and to consolidate the regulation of bank holding companies that had few or no nonbank assets under the OCC or the FDIC. By doing so, RAFSA sought to "enhance the accountability of individual regulators," "reduce the regulatory arbitrage in the financial regulatory system," "reduce regulatory gaps in supervision," and limit the regulatory burden on industry.[21] As this report language reveals, the $50 billion threshold was not intended to separate companies based on whether they presented risks to financial stability. Indeed, the Committee Report states that the Federal Reserve's jurisdiction would "include, but not be limited to, those companies whose failures potentially pose risk to U.S. financial stability."[22]

Because the $50 billion threshold included companies that do not pose risks to financial stability, its use in Section 165 also served a second objective of RAFSA: blunting criticism that any company subject to enhanced prudential standards would be considered systemically significant. Borrowing the $50 billion threshold established for allocating bank holding company regulation advanced this objective because, as noted above, the threshold was not established to determine whether a company presents risks to financial stability. In other words, Section 165 could apply to any "large, interconnected" bank holding company regulated by the Federal Reserve. As a result, it covered companies with a range of risk profiles. By then requiring that the Federal Reserve employ a "graduated approach" in implementing Section 165's enhanced prudential standards to this broad group (see below), RAFSA "intended to avoid identification of any bank holding company as systemically significant."[23]

These rationales for the $50 billion threshold have been obscured because, during the full Senate's consideration of RAFSA, an amendment (the Hutchison-Klobuchar Amendment) was adopted that restored the Federal Reserve's jurisdiction over all bank holding companies.[24] As a result, the $50 billion threshold in Section 165 was no longer congruent with the Federal Reserve's holding company jurisdiction. Because Section 165 was not amended to reflect this change, it has permitted an inference, not supported by the record, that Dodd-Frank deemed any bank holding company with consolidated assets above $50 billion to be systemically significant.

Graduated Approach

Section 165 of RAFSA also imposed specific requirements on the implementation of enhanced prudential standards, whether mandatory or discretionary, for bank holding companies.

First, enhanced prudential standards must be "more stringent than the standards and requirements applicable

18 RAFSA § 312.

19 RAFSA § 313 eliminated the Office of Thrift Supervision.

20 The Restoring American Financial Stability Act of 2010, S. Rep. No. 111-76, at 25 (2010) (Hereinafter "Committee Report").

21 *Id.* at 23, 25.

22 *Id.* at. 23.

23 *Id.* at 2.

24 Senate Amendment No. 3759, 111th Congress.

to nonbank financial companies and bank holding companies that do not present similar risks to the financial stability of the United States."[25]

Second, enhanced prudential standards must "increase in stringency," "tak[ing] into account differences *among*" designated financial companies and bank holding companies subject to Section 165 [emphasis added], based on a series of factors, including: the company's leverage; "the amount and types of the liabilities of the company"; "the amount and nature of the financial assets of the company"; extent of "off-balance sheet exposures of the company"; the "relationships of the company" with other significant financial companies; "the extent to which assets are managed rather than owned by the company"; and any other factors the Federal Reserve deems appropriate.[26] Note that this language refers to "the company" rather than "companies," indicating an individualized approach. The Federal Reserve was also required, to the extent possible, to ensure that small changes in any of these factors do not "result in sharp, discontinuous changes in prudential standards." In addition, the Federal Reserve has to consider any recommendations made by the FSOC.[27]

Third, with respect to foreign-based companies, enhanced prudential standards must give due regard to the principle of national treatment and competitive equity.[28]

Together, these requirements were designed to make enhanced prudential standards reflect the different risks presented by each of the companies subject to Section 165. They also sought to have enhanced prudential standards apply in a linear manner, rather than uniformly.

25 RAFSA. § 165(a)(1)(A).

26 RAFSA § 113: § 165(a)(1)(B), (b)(3).

27 RAFSA § 165(a)(1)(C). The factors the FSOC has to consider in making such recommendations largely mirror the factors Section 165 requires the Federal Reserve to consider when devising enhanced prudential standards. RAFSA § 115.

28 RAFSA § 165(b)(2) (this provision originally required consideration of "competitive equity," which was later modified by the conference committee to "equality of competitive opportunity").

The Committee Report for RAFSA confirms this view. The Committee Report states: "With respect to bank holding companies, the heightened prudential standards would increase in stringency *gradually* as appropriate in relation to the company's size, leverage, and other measures of risk" [emphasis added].[29]

It is important to recognize that because the $50 billion threshold caused bank holding companies that do not pose risks to financial stability to fall under Section 165, RAFSA had to ensure that its enhanced prudential standards did not apply uniformly. Otherwise, non-systemic (or even modestly systemic) bank holding companies would be subject to regulations designed for companies that present material risks to financial stability. To avoid this result, Section 165 had to mandate that the Federal Reserve implement enhanced prudential standards in a graduated fashion based on a variety of risk factors. RAFSA also permitted the Federal Reserve to increase the $50 billion threshold to prevent enhanced prudential standards from being applied to companies that do not pose risks to financial stability.

Senate Floor and Conference Committee

After being approved by the Senate Banking Committee, RAFSA was considered on the floor of the U.S. Senate during April and May of 2010. During this debate, the Hutchison-Klobuchar Amendment was adopted. Also as part of the Senate's consideration of the bill, RAFSA was incorporated as a full substitute amendment into H.R. 4173, the Wall Street Reform and Consumer Protection Act, which had passed the House of Representatives in December of 2009. The Senate passed H.R. 4173, as amended, on May 20, and the bill then proceeded to the conference committee.

During the conference on H.R. 4173, the conference committee agreed to use the Senate passed version of H.R. 4173 (which now consisted of the RAFSA language) as the base text for its compromise legislation. The

29 Committee Report at 2.

conference committee also made several changes to Section 165.[30] These changes included:

- Requiring the Federal Reserve to appropriately "adapt" Section 165's enhanced prudential standards to "any predominant lines of business" of a company.[31]

- Authorizing the Federal Reserve, in a subparagraph titled "Tailored Application," to "differentiate among companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities (including the financial activities of subsidiaries), size and any other risk-related factor the [Federal Reserve] deems appropriate."[32]

- Granting the Federal Reserve the authority to prescribe alternative enhanced capital and leverage requirements for a company that are more appropriate because of a company's structure or activities, including "investment company activities or assets under management."[33]

- Requiring the Federal Reserve to take into account the extent to which a foreign financial company is subject to home country consolidated supervision.[34]

- Clarifying that the Federal Reserve must take into account any "risk-related" factors it deemed appropriate.[35]

These changes further demonstrate that Section 165's enhanced prudential standards were not intended to be applied on a uniform basis, but instead were to reflect the unique risk profiles of companies. Anticipating this tailoring, the conference committee also required the Federal Reserve to consult with any FSOC member before it impose any standards that could significantly impact any subsidiary of a bank holding company regulated by the FSOC member.[36] This provision shows that Congress expected the Federal Reserve to modify enhanced prudential standards to reflect the risk profiles and regulatory regimes of functionally regulated subsidiaries.

The conference committee also sought to further respond to criticism that companies subject to enhanced prudential standards would be deemed systemically significant by broadening the applicability of Section 165. Instead of covering only "large, interconnected" bank holding companies with at least $50 billion in consolidated assets, Section 165 was modified to cover *any* bank holding company satisfying the $50 billion threshold. In addition, the Federal Reserve's authority to increase the $50 billion threshold for certain enhanced prudential standards was eliminated.[37] These changes ensured that Section 165 would technically apply to a broad range of bank holding companies (including companies that are not "large, interconnected" and do not pose risks to financial stability), presumably making it easier for a gradual application of enhanced prudential standards to avoid "identifying any bank holding company as systemically significant."[38]

It should be noted, however, that even though the conference committee technically expanded the applicability of Section 165, it simultaneously expanded the Federal Reserve's authority to provide "tailored application" of standards so that they have little, if any, applicability to bank holding companies that do not pose risks to financial stability.

After the conference report for H.R. 4173 was passed by the Congress, the legislation (renamed as the "Dodd-Frank Act" by the conference committee) was signed into law on July 21, 2010.

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30 The conference committee also clarified and modified several of the factors the Federal Reserve had to consider in prescribing enhanced prudential standards, imposed several new mandates (stress tests; inclusion of off-balance sheet activities in capital requirements) and provided additional authorities (short-term debt limits; leverage limits). Dodd-Frank § 113; §165(g), (i), (j), and (k).

31 Dodd-Frank Act § 165(b)(3)(D).

32 Dodd-Frank Act § 165(a)(2)(A).

33 Dodd-Frank Act § 165(b)(1)(A)(i).

34 Dodd-Frank Act § 165(b)(2)(B).

35 Dodd-Frank Act § 165(b)(3)(A)(iv).

36 Dodd-Frank Act § 165(b)(4).

37 Dodd-Frank Act § 165(a)(2)(B). The standards covered are those for capital requirements, leverage limits, liquidity requirements, and risk management requirements.

38 Committee Report at 2.

Implications of the Legislative History

The above legislative history shows that Congress consistently sought to ensure that Section 165's enhanced prudential standards would be implemented in a "graduated" and "tailored" manner, reflecting the unique risks and business lines of bank holding companies. This was the approach that was contained in the Dodd Discussion Draft, adopted by the Senate Banking Committee and the full Senate, reinforced with additional amendments by the conference committee, and contained in the final bill passed by Congress.

This history has several important implications for rethinking the implementation of enhanced prudential standards for bank holding companies.

- *The use of strict asset thresholds should be reviewed.* Asset thresholds certainly provide a simple and convenient means to implement Section 165. They provide clear lines for determining which enhanced prudential standards apply to which companies. This reliance on asset thresholds, however, strays from the text and intent of Dodd-Frank, which envisioned a far more tailored and risk-based approach.

  The $50 billion threshold is especially problematic. The uniform application of most enhanced prudential standards to any bank holding company with $50 billion or more in assets neglects the fact that, by design, that threshold captures bank holding companies that do not pose risks to financial stability. As a result, the current enhanced prudential standards apply, contrary to the statutory requirements, "more stringent" standards to companies that do not pose risks to financial stability, do not take account of "difference among companies" subject to Section 165, and cause "sharp, discontinuous changes" in standards based on which side of the threshold a company falls.[39]

  In his speech, Governor Tarullo properly recognized these problems and suggested raising the $50 billion threshold. As noted already, such a change with respect to certain standards would require congressional action. However, the same result could largely be achieved simply through a recalibration of enhanced prudential standards to reflect the differences in risks presented by covered bank holding companies as Section 165 envisioned.

  There are other important policy reasons for reviewing strict asset thresholds. A more graduated and tailored approach would help prevent enhanced prudential standards from serving as either unfair competitive burdens or barriers to entry. Bank holding companies with similar risk profiles should not be subject to vastly different regulatory regimes simply because they are on opposite sides of an arbitrary threshold. Conversely, enhanced prudential standards should not impose costs that deter smaller bank holding companies, especially those just below the $50 billion asset threshold, from entering markets simply to avoid triggering new regulatory requirements (unless, in doing so, they create risks to financial stability).

- *Enhanced prudential standards should be more tailored and transparent.* The overreliance on asset thresholds also threatens to dilute the effectiveness of enhanced prudential standards with one-size-fits-all regulation that neglects the diverse and often unique risk profiles presented by bank holding companies. Assets thresholds may make regulation easier to implement, but easy implementation does not necessarily lead to effective regulation.

  Under Section 165, enhanced prudential standards are intended to address risks to financial stability through the clear identification of those risks and the development of specific standards to address them. From a policy perspective, this focus is important because it recognizes the resource constraints faced by regulators and companies. As Governor Tarullo noted in his speech, if regulation is more focused, regulatory costs can be reduced and "supervisory resources can be deployed where their payoff in achieving well-specified regulatory aims will be the

39 Dodd-Frank Act § 165(a) and (b). *See also* Smith, Deron, Treasurer, Regions Bank; On Behalf of The Regional Bank Coalition, testimony May 20, 2014, before the Committee on Financial Services, United States House of Representatives; BBVA Compass Bancshares, Inc. et al., *Comment Letter Re: Notice, Request for Comments – Resolution of Systemically Important Financial Institutions: The Single Point of Entry* (FR Docket No. 2013-30057) (March 20, 2014).

highest."[40] A tailored approach also helps ensure that regulators focus on risks to financial stability and do not use Section 165 to pursue other, non-statutory aims.

Although the Federal Reserve has sought to employ a more tailored approach when exercising its supervisory authorities, this effort, while helpful, neglects the statutory requirements for Section 165 rulemakings and creates a far less transparent regulatory regime.[41] Moreover, companies can play a far more active part in addressing risks if regulatory concerns and expectations are specifically identified in transparent rules. For these reasons, recalibrating enhanced prudential standards to better target specific and identified risks should help improve their effectiveness.

- *Enhanced prudential standards should seek to better accommodate different business models.* The Federal Reserve has indicated that it is considering devising unique enhanced prudential standards for insurance companies and other nonbank financial companies designated by the FSOC, but it has not, with a few exceptions, taken a similar approach with respect to bank holding companies.[42] Section 165, however, provides that enhanced prudential standards must be appropriately "adapted" to each company's "predominant line of business." Indeed, the statute expressly granted the Federal Reserve additional authority to achieve this objective by allowing it to tailor enhanced prudential standards to a company's own unique "individual" business model or to a "category" of business models (*e.g.*, bank holding companies whose operations include significant insurance, custody, or broker-dealer activities).

Strong policy arguments also support this intent of Section 165. Each of the bank holding companies above the $50 billion threshold has its own unique business plan, operations, and funding strategy. This diversity helps companies serve consumers and fosters a more dynamic marketplace. Section 165 recognizes these benefits and seeks to minimize the chances that enhanced prudential standards will undermine the viability of a particular business model.

Most importantly, taking business models into consideration can promote financial stability. Such an approach allows for a diversity of business strategies, especially with regard to risk management, that can help reduce correlations among institutions and improve the resiliency of the financial system to a systemic shock. If, however, uniform and prescriptive enhanced prudential standards cause companies to conform their business models and risk management strategies to satisfy regulatory requirements, it could increase the risk of a systemic shock producing a domino effect.

Rethinking Section 165

It has been four years since the passage of Dodd-Frank, making this an appropriate time to step back and rethink its implementation, as well as its aims. Such a rethinking is especially appropriate for Section 165's enhanced prudential standards, which have been implemented in a broader and more uniform manner than the statute envisioned. Hence, more thought should be given to how Section 165's enhanced prudential standards could be tailored as envisioned by the statute so that they are more focused on achieving its sole statutory aim – preventing and mitigating risks to financial stability. And to the extent that Section 165's implementation requirements, or statutory aim, need refinement or prove unworkable, Dodd-Frank should be amended. Lest we forget, it is ultimately Congress's prerogative to determine both the aims and the means of prudential regulation. ■

40 Tarullo (2014).

41 See The Board of Governors of the Federal Reserve System, Comprehensive Capital Analysis and Review 2014: Assessment Framework and Results 5 (Mar. 2014).

42 79 Fed. Reg. at 17244-45.

M&T Bank Corporation

Robert G. Wilmers
2014 Annual Report Message to Shareholders

February 20, 2015

This past year was far from a typical one, either for U.S. banking or at M&T. The evolving nature of financial industry regulation, the attention paid to infrastructure and regulatory compliance, and the uneven character of the economic recovery, all merit attention.

M&T's 2014 earnings did not match the record level of the previous year. Nonetheless, they remained strong despite elevated expenses, a consequence of investments in our infrastructure and the costs and complexity of responding to evolving regulatory compliance requirements. Our headway in such an environment reflects the core strength and resilience of the company.

Net income prepared in accordance with generally accepted accounting principles ("GAAP") was $1.07 billion for the past year, down 6% from $1.14 billion in the year prior. Diluted earnings per common share totaled $7.42 in 2014, a decline of 10% from the earlier period. Last year's net income, expressed as a return on average total assets and average common equity, was 1.16% and 9.08%, respectively. Comparable figures for 2013 were 1.36% and 10.93%.

Taxable-equivalent net interest income, which is comprised of interest received on loans and investments, less interest paid on deposits and borrowings, was $2.7 billion for 2014, a very slight increase from 2013, owing in part to the continued low interest rate environment, which has remained in place for some 24 quarters. At the end of 2014, total loans were $66.7 billion, an increase of 4% from the end of the previous year. Average interest-earning assets rose by 10% last year, to $81.7 billion. The largest component of that increase was a $4.9 billion or 74% higher level of average investment securities. New regulations require banks like M&T to hold more government-backed securities as a "liquid asset buffer" for times of economic stress. Investment securities made up 13% of total assets at the end of 2014, compared with 10% of assets at the end of the previous year. Those lower yielding investments, purchased with $3.2 billion of borrowings raised in the debt capital markets, were additive to net interest income but negatively impacted our net interest margin. Taxable-equivalent net interest income expressed as a percentage of average earning assets – an important measure of balance sheet efficiency – was 3.31%, a decrease of 34 basis points (hundredths of one percent) from the year before.

As the economy continued to improve during the year, so did the repayment performance of M&T's loan portfolio. Net charge-offs were $121 million, an improvement from $183 million in 2013. Net charge-offs expressed as a percentage of average loans outstanding were 0.19%, which is the lowest figure we've seen since the 0.16% level recorded in 2006, immediately prior to the last financial crisis. M&T's allowance for losses on loans and leases stood at $920 million as of December 31, 2014, representing 1.38% of loans outstanding. The modest $3 million increase in the allowance from the end of the previous year reflects a provision for loan losses of $124 million for 2014, less the $121 million of net charge-offs.

Income from fees and other sources totaled $1.78 billion in 2014, a decrease of $86 million from 2013. The previous year was marked by net securities and securitization gains of $110 million, as M&T repositioned its balance sheet in preparation for our first-time participation in the Federal Reserve's 2014 Comprehensive Capital Analysis and Review ("CCAR") program. Those gains did not reoccur in 2014. Revenues from mortgage banking increased by 10% to $363 million over the past year and trust revenues increased by 2% to $508 million.

As a result of increased expenses arising from our ongoing efforts to upgrade M&T's bank secrecy and anti-money laundering ("BSA/AML") compliance program, in addition to other key investments that position M&T for the new regulatory and operating environment, non-interest expenses increased to $2.74 billion last year, 4% higher than $2.64 billion in the previous year. Contributing to the higher level of expenses was a 4% increase in employee salaries and benefits as well as a 9% increase in other costs of operations.

We continued to grow our capital base in 2014. M&T's Tier 1 common capital ratio, which is the one most closely followed by both regulators and the investment community, increased to 9.83% at the end of the year, an improvement of 61 basis points from 9.22% at the end of 2013, effectively closing the gap with our peer regional and super-regional banks. Our tangible book value per share was $57.06 at December 31, 2014, an increase of 9% from the end of 2013.

PARDON OUR DUST

In the wake of our investments of the past two years, it is tempting to borrow a slogan one sees at stores changing their inventories or displays: "pardon our dust." It implies that change, in some ways difficult and inconvenient, is underway – but that something better is taking shape. That's certainly indicative of what's been going on at M&T.

The year 2014 will be remembered as one in which we turned our focus inward, enhanced our infrastructure and broadened our knowledge base. As discussed in these pages last year, a great deal of work was begun in 2013 to address heightened demands from our regulators. We continued to invest considerable time, money, thought and labor in 2014 to make substantial progress on those efforts, while simultaneously working to build a better, stronger M&T Bank. We have worked on improving technology, risk management and business processes while adding to our ranks of talented personnel. We hired top professionals with expertise in emerging areas of focus. Our technology and banking operations division alone was fortified by key hires with responsibilities spanning development, security, architecture and connectivity. Those additions

included a Chief Technology Officer and an Enterprise Security Officer – new positions that embody the changing nature of our bank and our industry. Fundamentally, we know more about more topics than last year, and collectively we are acutely aware of the path required to succeed in tomorrow's banking industry.

There is no denying that the work undertaken thus far has not been optional – it's work that had to be done. We spent $266 million in 2014 in a broad swath of efforts that will help M&T fulfill its regulatory obligations – an unprecedented amount in unprecedented times. However, our construction efforts have not been limited to regulatory matters, nor does 2014 mark the end of such expenditures. We will continue to invest heavily in data, technology and personnel in 2015 and beyond; these are investments that will enable our colleagues to serve our clients more efficiently while providing the products and services needed to achieve their financial objectives.

The notion of strengthening our foundation is not foreign. There have been seminal moments in our history when we have paused to make significant investments driven by customer needs or movement into new markets. Whenever we grow by way of acquisition, we then busy ourselves by digesting what we've become while trying to make it better. Think of the work we're doing now in much the same way, though in this case we are improving because we expect to continue to grow.

Risk Management Infrastructure: Enhancing our BSA/AML program consumed significant time, energy and money with investments of $151 million last year, in addition to the $60 million spent in the prior year. The systems we began building in 2013 were deployed to great effect this past year. The expanse and depth of our new BSA/AML program is both imposing and remarkable; it ensures that the risk profile of every customer of the bank, old and new, is understood and properly managed.

In 2014, M&T fully implemented a new Know Your Customer program to better assess the potential risks presented by each of our 3.6 million customers and their 5.4 million accounts. This program, which has been in operation for nearly one full year, has been used with 149,065 new customers. We have obtained appropriate additional information, or conducted remediation, as the jargon of BSA/AML would have it, on 671,502 customers and remediated 95% of the existing customers whom our models identified as requiring a higher level of scrutiny. A year ago, the team responsible for researching customers with higher risk profiles reviewed an average of 77 per day; that figure reached a peak of 327, a fourfold increase, stemming from additional resources, as well as enhanced processes and efficiency as the group became seasoned at their task. Our integrated BSA/AML program spans all business units, and no corner of the enterprise lacks oversight or accountability. A rigorous, customized training curriculum was developed to ensure each employee is properly positioned to perform his or her respective duties. Collectively, they spent 91,834 hours in classrooms, person-to-person training and online courses about BSA/AML and related regulations. Each one of our employees understands his or her part in executing this program.

Along with investments in systems and processes, we also invested in talent to support and oversee these efforts. In 2014, 630 colleagues were dedicated to this program, as well as over 300 contractors and consultants; together they occupied nearly 10% of our total office space in downtown Buffalo, where we are already the largest private sector employer.

Our efforts in 2013 were characterized by intensive preparation for the inaugural participation in the CCAR process – which requires each participating organization to project its revenues, credit losses and capital levels under five hypothetical scenarios, two internally developed and three provided by the Federal Reserve. These scenarios include levels of economic indicators such as the real and nominal Gross Domestic Product, the Consumer Price Index, the U.S. unemployment rate, the CoreLogic U.S. House Price Index, the Federal Reserve Board's U.S. Commercial Real Estate Price Index; interest rates: 3-month Treasury rate, 5-year Treasury yield, 10-year Treasury yield, BBB corporate yield, Mortgage rate, and Prime rate; the Dow Jones Total Stock Market Index and the Market Volatility Index, which may be seen in distressed, recessionary environments.

It was heartening to receive no objection to our first CCAR submission when the final results were released by the Federal Reserve in March of last year. Continued investment in 2014 was devoted to making our methodology more comprehensive and efficient. We are keenly aware that the regulatory bar continues to rise – and what was deemed satisfactory one year may not pass muster the next. Hence, we continued to strengthen intellectual capital by directing talent to the CCAR effort, while adding specialized skill sets from outside the organization where needed. This team, dedicated to stress testing and the capital planning process, now includes 91 professionals – an increase of 32% over the team that supported the first submission.

We continue to work on ensuring that our risk management and capital planning practices are comprehensive, that they permeate all parts of our day-to-day business activities and, therefore, are commensurate with our risk profile. During 2014, 292 individuals across the organization, including the CCAR team, were involved in stress testing-related activities – an increase of 56% over the prior year. Given the quantitative emphasis of the exercise, nearly half of the 75 models that support our work were upgraded in response to evolving standards of the Federal Reserve and self-identified areas for improvement. The key governing committees met 74 times during the year to discuss capital and stress test-related topics, compared to 38 times in 2013 – prior to our initial CCAR submission.

In addition to BSA/AML and CCAR, we have invested heavily to comply with other elements of the Federal Reserve's enhanced prudential standards for bank holding companies. Our growing Risk Management division – which numbers 727 colleagues – is more than five times as large as it was in 2009 and 56% larger than in 2013 – at a cost of $181 million, an 84% increase over 2013.

New regulatory standards also require more formal, structured risk management governance; which is furthered by the new systems, models, procedures and policies that allow us to better document the

process used to manage risk. Taken together, 190 committees produce nearly 7,600 pages of meeting minutes annually – more than twice that of five years ago. Last year, the Risk Committee of our Board of Directors met 18 times, while reviewing 4,445 pages of presentation materials.

These are investments befitting an institution of broader size, geography and business model than M&T is currently, and which will undoubtedly serve to meet our own operational and strategic needs for years to come. But they are far from unrelated to problems and challenges faced by the financial services industry as a whole – to protect it from the collateral damage that can be inflicted by opaque systems and transactions, as well as from a growing wave of external security threats.

Data, Technology and Cybersecurity: Looking back at the last financial crisis, it is evident that transparency and integrity of data on products, portfolios and services within the banking system and their attendant risks were seriously deficient. In its aftermath, governing bodies are requiring banks to provide data on their operations frequently and often on an "on demand" basis. The magnitude of requests has grown significantly since the crisis and now, in addition to just providing answers, work papers and supporting documentation must be made available as well.

Answers to regulatory-related questions can involve an array of bits and bytes, which can be extremely time consuming to fulfill, coming from different corners of the enterprise. Beyond the demands of regulation, it is also clear to us that in the information age, data is the lifeblood of an organization – for customer service, marketing, finance, risk and other functions.

In 2013, business needs, regulations, as well as common sense, stimulated us to begin implementation of an enterprise data warehouse. Beyond the $25 million we have already invested in getting the integrated warehouse up and running, we will continue to work on making the data it houses much more comprehensive and accessible, spending perhaps an additional $20 million annually for the next three years. It will enhance our ability to analyze data for our own use and to better serve our customers, while allowing us to provide better information to regulators. Today, much of this information is maintained in "vertical silos."

Banks are increasingly being defined by their "plumbing," the technology they deploy to serve their customers. In the past year, we have invested in our online banking platform and mobile banking application, enhanced commercial and mortgage lending capabilities and began work on upgrading the operating system that resides on 27,333 personal computers and servers, requiring an investment of $19 million. Investments like these will mean a simpler approach for our clients and an easier experience for our colleagues.

Improving that experience is but one of the priorities for our technology investments. Almost daily we are reminded that the threat of attacks on the systems that have created unprecedented convenience and efficiency, has also left us at risk of novel forms of crime. Indeed, cybercrime is a new global growth

industry. A recent report by the Center for Strategic and International Studies estimates that global cybercrime inflicts losses of up to $400 billion each year, which is almost as much as the estimated cost of drug trafficking. In 2013, more than 40 million individuals in the U.S. experienced the theft of their personal information. Cybercrime, it is estimated, extracts between 15% and 20% of the $2 trillion to $3 trillion in value created by the Internet.

A vast apparatus of nefarious, increasingly complex activities continues to manifest itself in a growing number of ways, threatening the viability of the systems the world uses to conduct commerce. From the petty criminal on a home computer, to organized networks of dedicated hackers, to foreign government-sponsored threats, the various forms of cybercrime are growing rapidly. Government Accountability Office ("GAO") testimony before Congress revealed that in 2007, US-CERT (Computer Emergency Readiness Team) received almost 12,000 information security incident reports. That number had more than doubled by 2009, according to statistics from the GAO, and it had quintupled by 2013. Based upon one study, the number of reported retail customer accounts compromised due to data breaches increased from less than one million in 2012 to over 60 million in 2014. In 2012, M&T reissued 6,955 debit cards to cardholders who had been compromised because of identity theft, either as individuals or because a retailer had been hacked. In 2014, that number had grown to 294,415. Over the same timeframe, the number of cyberattacks on our systems that we have blocked has gone up by 27% and the number of "phishing sites," those set up by fraudsters to trick customers into believing they are logging onto the M&T website, increased by 36%. A recent article in The New York Times on cyberattacks quoted law enforcement officials as saying that the threat of hacking was particularly acute for the health care and financial services sectors, and that the FBI now ranks cybercrime as one of its top law enforcement priorities. Scarcely a week goes by, it seems, without headlines about a cyberattack on a major U.S. corporation.

The payments system, the infrastructure that enables money to move through a modern economy, is a prime target of cybercriminals. Unfortunately, America has fallen behind much of the developed world in modernizing this core system. Money is increasingly moved electronically rather than through the traditional means of checks or cash. As of 2012, while check transactions in the U.S. declined to 15.5% of non-cash payment transactions, in mature markets like Europe they only account for 4.8%. Technology companies, retailers and service businesses have stepped in to attach to the existing payments infrastructure, providing convenient new ways of making payment transactions to their customers. While the innovation that is happening outside the banking industry has the potential to benefit the public, these non-bank entities are not regulated to the same high standards as banks and, ultimately, it is the banking industry that is held responsible for the safety and soundness of the payments system. As such, it behooves the entire banking industry, behemoth banks and community banks alike, to work together with regulators to ensure that America has a payments system that is highly secure and maintains the public trust, yet is open to many forms of innovation.

It has always been our prime objective to secure our clients' financial assets and the bank itself. Not so long ago, ensuring security primarily involved guards, armored carriers and vaults. We still need them, but the focus has shifted decisively to protecting our customers' data and M&T's technological infrastructure from electronic attack. To that end, we added senior cybersecurity experts last year, increasing our staff by more than 20%. We are also partnering with colleges to bring in a pipeline of young talent with the right education in security. We have invested significantly in enterprise fraud technology and enhanced online security – efforts that comprised just a portion of the 46% increase in investment in cybersecurity last year – an investment that will undoubtedly continue to grow in an attempt to stay ahead of rapidly expanding and varied threats. In an era in which the risks of poor cybersecurity are plain, high security standards are no luxury. Indeed, they are crucial to our operations.

New Jersey: There are any number of reasons why it has long made sense for M&T to look to New Jersey should we choose to expand via acquisition. Quite simply, doing so is in keeping with the character of our past three decades of mergers and acquisitions, which have consistently brought us into markets similar to, and contiguous with, those we have served and with which we are familiar – and where a branch network providing our broad range of services would improve the banking options available to households and businesses. By most counts, New Jersey is an attractive market. Its median household income ranks third in the United States, while its median household net worth ranks seventh. Middle market and small businesses, the core of M&T's clientele, are 20% higher per capita than the national average.

The attractiveness of this market underpinned our August 2012 decision to enter into a merger agreement with Hudson City Bancorp ("Hudson City"), believing that we had identified a transaction which made good sense for both parties – and for New Jersey, where Hudson City's branch network is concentrated. Although the effort to complete this transaction has proven to be more of a marathon than a sprint, we're nonetheless dedicated to crossing the finish line – even if it's a bit farther out than we thought. In December, we announced an extension of our merger agreement – the third time we've done so. Still, everything that made our respective organizations a good fit in the summer of 2012 remains true today. Hudson City's credit culture was always consistent with our own conservative approach to credit. The passage of time is proving that to be even more true; in the two and a half years since we announced the merger, the credit characteristics of that portfolio have improved further. The economic benefits that we expected to accrue to both institutions' shareholders hold the same promise. Delays are admittedly frustrating, but this is a merger to which both parties remain deeply committed.

Despite the delay, considerable progress has been made in bringing M&T's community banking model to New Jersey. We opened three new offices there in 2014, in addition to the four already in place. These offices house 129 customer facing employees responsible for commercial banking, residential mortgages, investment securities and wealth management. M&T now has a portfolio of $1.3 billion in loans to small and large companies, commercial real estate developers, auto dealers and residential mortgage customers in the state. It is

interesting to note that there are already 34 of our colleagues serving on 83 not-for-profit boards, which is typical of M&T's community involvement. We are in New Jersey to stay.

So it is that we continue our work in earnest, heartened by the prospects of building a better bank for a better tomorrow. While one can be optimistic, indeed excited, about our future, the realities of the present environment must also be acknowledged. M&T has long been a community bank focused on its customers, employees and shareholders. Our core tenets of serving the financial needs of people in our communities through simple, easily understood products, strong credit standards and an efficient operating model, remain our mission.

Our task now is to complete these transformational efforts and to evolve without sacrificing those guiding tenets that are our hallmark. Rest assured that we will go about them diligently like every other endeavor in our history. We remain confident in M&T's ability to adapt, even as the environment changes around us.

COMPLEXITY NOT SIZE – CONTRASTING BUSINESS MODELS

Although our defining character as a bank that serves its communities may be clear to us, it is no longer the yardstick against which we're measured. There are 33 banks with more than $50 billion in assets in the United States; M&T is the ninth smallest of those banks. Because it exceeds that asset threshold, it is held to many of the same standards as banks with much more complex business models and intricate global exposures. We're expected to maintain a regulatory infrastructure on a scale similar to the large banks – in a sense constructing a super highway to get through a small city. In this context, it seems worthwhile to point out that M&T's estimated annual cost of regulatory compliance rose to $441 million, 16.3% of our total operating expense, an amount that is over four and a half times the level of a mere three years ago. The number of regulatory exams at M&T in 2014, conducted by nine different government agencies, was over 45% higher than in 2012. Our total operating expenses, which excludes intangible amortization and merger-related expenses, increased by 5% in 2014, outpacing our peers significantly, which in turn has led to substantial erosion, temporarily one hopes, of our traditional operating efficiency advantage.

We remain confident that our essential community-oriented business model will continue to serve both our customers and investors well. It is of concern, however, that the distinctive virtues of that traditional model of banking as practiced not just by M&T but the majority of American banks are less than fully appreciated in some important quarters. The imperative of distinguishing between what might be called Main Street and Wall Street banks has been discussed previously in this Message, but it bears repetition, analysis and specific illustration. Simply put, the 6,482 community and regional banks of Main Street have a very different business model than the

five large U.S. banks that dominate the activities traditionally associated with Wall Street.

Main Street banks gather deposits and make loans; they are the primary providers of finance to local businesses in the neighborhoods they serve. Loans comprise 61% of assets at regional banks compared with just 31% for the five large, complex and globally interconnected U.S. bank holding companies. Perhaps no other measure illustrates this point better than the comparison of lending to small businesses. It is interesting to note that last year those five large banks funded 4% of Small Business Administration loans, a subset of loans made to small businesses, while the rest, Main Street banks, funded 96%. Core deposits fund 64% of assets at regional banks; the comparable figure for large banks is just 32%. Here at M&T, some 69% of our assets are simple lending agreements made in the interest of funding commerce and industry as well as the personal needs of individuals, particularly mortgages for their homes and financing for their automobiles. Core deposits fund 75% of our assets. Those five large banks have limited branch networks in smaller and rural communities. Just 55% of these large bank branch offices can be found outside the ten largest metropolitan areas, compared with 73% for regional banks.

Beyond these distinctions, the key feature that differentiates the operating model of most large banks is their involvement in the trading and manufacturing of derivatives – instruments that have long bred complexity and confusion. In fact, five banks accounted for 95% of the $304 trillion of U.S. banking sector derivatives outstanding at the end of September 2014. To put it in perspective, that figure amounts to 16 times the U.S. GDP and 19 times the total banking system assets in the U.S. – eye popping indeed. Even after the crisis and subsequent adoption of the Volcker rule, the five large banks in 2014 still accounted for 90% of total U.S. bank trading revenue while the remaining 6,482 banks accounted for 10%.

The American public's relationship with derivatives is long and well chronicled. Since their creation in 1848, derivatives markets have been afflicted by speculation, lack of transparency and manipulation. Noting the price distortions that wreaked financial havoc on America's agricultural sector during the Great Depression and caused widespread public hardship, President Roosevelt said, "...it should be our national policy to restrict, as far as possible, the use of these [futures] exchanges for purely speculative operations." The Commodity Exchange Act ("CEA") in 1936 required that futures contracts be traded on regulated exchanges, which facilitated transparent price discovery, identification of buyers and sellers, standardization of contracts and adequate capital to support the fulfilment of contractual commitments. Since the use of swap contracts came into being some 34 years ago, they have been progressively exempt from regulation. In 1993, they were officially excluded from the purview of the exchange trading provision of the CEA with its attendant requirements of

transparency and adequate capitalization. It is no surprise this was followed by events such as the bankruptcy filing of Orange County, California in 1994, after losing $1.5 billion on poorly understood interest rate swaps, and losses through derivatives by such major corporations as Gibson Greetings and Procter & Gamble. In 2000, the passage of the Commodity Futures Modernization Act effectively removed the swaps market from almost all pertinent federal regulatory oversight and preempted state rules and regulations. The outcome: the bankruptcy of Jefferson County, Alabama, also a consequence of interest rate swaps, which resulted in increases in sewer rates to its citizens of 7.9% annually; losses incurred by the City of Detroit, which later filed for bankruptcy, on swap contracts connected with pension debt; and payments required to be made by the Denver public school system to terminate complex derivative transactions originally executed with the promise of bolstering its pension fund, among many other instances of large scale impact on the taxpaying public.

Use of credit default swaps ("CDS") to place bets that homeowners would default on their mortgages had devastating consequences to the American public during the last crisis. These "naked trades" by parties witb no exposures to the underlying mortgage loans significantly outweighed the actual amount of mortgage debt outstanding. In 2014, we saw that such wagers were alive and well in other areas of our economy and continued to provide participants with lucrative opportunity for speculation. As a well-known electronics retailer teetered on the brink of bankruptcy, bets made on its eventual fate through the medium of CDS stood at $23.5 billion, dwarfing by 16.8 times the $1.4 billion in debt that the company actually owed to its creditors. These wagers, on whether and when the firm would default on its debt, were facilitated by hedge fund managers, who first sold high premium insurance to those who believed that the company's demise was imminent. Then, they turned around and provided temporary life support in the form of "rescue financing" to keep it alive long enough to pocket the premium. Lack of transparency in these markets makes it very difficult to ascertain the true economic motives and exposure of any parties involved with CDS. One can only sound a sigh of relief that those involved were outside the banking industry, were adequately capitalized and were not wagering with depositors' funds. Such was not the case in 2012, when one of these same hedge fund managers was on the winning side of the "London Whale" trades that resulted in notable losses for one large bank and sparked outrage from regulators and the general public.

The disruptive forces that exist in the derivatives markets will most assuredly endure. Despite their usefulness as a risk management tool to assist those engaged in commerce and industry, derivatives have been a vehicle for speculation and price manipulation almost since their inception. In the absence of effective regulation, their use for speculative endeavors continues to have the potential to damage our financial system.

It is comforting that in the aftermath of the crisis, government agencies have regained the required authority to supervise this $304 trillion market, particularly as it relates to bank holding companies. An indication of the breadth and depth of the regulatory effort is provided by seven federal agencies: the U.S. Securities and Exchange Commission, the Commodity Futures Trading Commission, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Federal Housing Finance Agency, and the Farm Credit Administration, which together issued 81 final rules and an additional 35 proposed rules, totaling by one estimate 11,844 pages in the Federal Register over four years. The complexity, opacity and potential of derivatives to again seriously damage our economy are clearly too great to be ignored.

Even with the benefit of the regulatory efforts mentioned above, one of the hallmarks of derivatives remains their lack of transparency; it is difficult for regulators, investors and others to understand the true exposure of the banks that dominate trading in derivatives and the extent of their interconnectedness. Even with an average of 13 pages of footnotes in the financial statements of the five large trading banks, one is left with far more questions than answers. For example: How does the value of the derivatives change over time? Who are the counterparties and what is their level of creditworthiness? How do the counterparties' risk exposures interconnect them with each other in different global markets? How will the payments and the associated sequence work in the case of a default? Can such mind-boggling numbers even be managed or do the derivatives portfolios ultimately manage us?

Although complexity is often equated with size, that equation is a spurious one – one of the largest U.S. banks has an operating model that is much more akin to Main Street banks than the other large banks. Loans to individuals and commercial borrowers comprise 52% of its assets while 62% of those assets are funded with core deposits and 70% of its branches are located outside the ten largest metropolitan areas. Trading activities comprised just 2% of its revenue last year, yet it has $1.7 trillion of assets. It is interesting to note that this bank was the only one among the largest six U.S. banks whose plan to manage an orderly disposition in the event of distress, was accepted by the regulators – an indication of the simplicity of its business model.

It is only logical that the sophistication and granularity of the quantitative modeling and analytical capabilities required to manage a large trading portfolio, where values change on a daily basis, and traders' compensation systems offer large payouts for short-term performance, differ extremely from those required for a regional bank, whose loan portfolios are held to maturity rather than traded on a daily basis, where the quantity of leverage is transparent, the bearer of risk of loss is clearly identifiable and loan officer compensation programs are more mainstream.

Indeed, rules intended to increase transparency, require adequate capital to honor commitments, and ensure identification of the parties involved through a central clearing system so that failures can be resolved in an orderly manner, are not just logical but long overdue. So the question is not whether, but how. How does one effectively regulate institutions whose defining characteristic is complexity, a feature derived significantly from their domination of the business of manufacturing, trading and selling derivatives in the United States, without burdening the rest of the banking system that is critical to facilitating much-needed economic growth? It seems abundantly evident that in order to maximize effectiveness, regulation should be based on the complexity of business model, and not on the size of institutions.

A TIERED APPROACH TO REGULATION

While banks' business models are different, government's regulation of them is similar. At the same time, compliance has become ever more central to the business of banking.

When the Dodd-Frank Act was written, the principle that size correlates to riskiness was not outlandish. After all, it was the failure (or potential failure) of the largest institutions that threatened the financial system and the economy at large. Size makes for a simple, perhaps too convenient barometer – a bank either has over $50 billion in assets or it doesn't. The complexity and systemic importance of an institution, on the other hand, is far more difficult to ascertain. To avoid subjective debates about which regulations should apply to which institutions, using size as a primary determinant was, perhaps, a practical starting point. However, it is now time to review the objectives of the enhanced prudential standards and allow for the varying supervision needs of organizations with differing levels of complexity. After all, the goal of legislation and regulation is to protect consumers and the economy while facilitating commerce, not hampering it. Indeed, further adaptation of the regulations may be in store based on recent comments made by a member of the Board of Governors of the Federal Reserve System. In suggesting the possibility of a "tiered approach to regulation and supervision of community banks," the Governor noted, "[such banks] have a smaller balance sheet across which to amortize compliance costs."

Adoption of a "tiered approach," based on complexity as opposed to simply size, would be a welcome change while preserving the core intent of the Dodd-Frank regulations to minimize risks to U.S. financial stability. Banks over $50 billion in size are required to go through semiannual stress tests, as well as to annually create so-called Living Wills – instructions on how to effectively wind down an institution if the capital and liquidity rules are insufficient to prevent its demise. Many CCAR standards are better suited to assess, monitor and estimate complex exposures and activities such as trading, derivatives and counterparty risk, which carry a higher level of volatility in stressed environments. Using a standardized approach across the entire

banking industry in these areas creates a risk that banks with simpler business models are not rewarded with lower infrastructure cost. As an alternative to the current approach, the annual CCAR exercise could be replaced with a review of the capital planning program through the normal supervisory teams dedicated to institutions with lower risk operations. This would allow for a more customized approach to determining capital planning and adequacy, commensurate with the complexity of the bank.

For the most part, regional and community banks do not exhibit the maze of interconnectedness through derivative transactions that characterize the largest banks, and have much simpler legal structures, which make them much easier to deal with in case of failure through the traditional and time tested FDIC process. A publication of The Clearing House Association noted, "If you were to add up the legal entities of all of America's regional banks, the total would still be less than the number of legal entities under America's single largest bank holding company." Simple regional banks could be required to update their plan for disposition only if a significant acquisition or other change meaningfully altered their legal structure.

Banks with assets greater than $50 billion are required to hold large stocks of liquid securities under the Liquidity Coverage Ratio ("LCR") rule to satisfy hypothetical funding needs calculated using standardized assumptions provided by the regulators. Unlike large trading banks with volatile balance sheets that rely upon short-term wholesale funding, the balance sheets of regional and community banks are predominantly funded with stable core customer deposits. Given the lower liquidity risk presented by regional banks, it would seem appropriate for the LCR to substantially differentiate them from trading banks with respect to the amount of securities required to be held, and the granularity, frequency and amount of data to be provided to the regulators. Such a tailored approach would satisfy the objective of improving the banking system's ability to withstand increased liquidity needs during stressful economic environments without placing an outsized burden on Main Street banks.

At the heart of the last crisis were incentive compensation systems that encouraged traders to take on undue risk, to earn large sums of money, without having to forfeit any previously earned compensation on trades that subsequently turned out to be excessively risky. In 2014, the average salary and benefits per employee at the five large trading banks was $212,665. While at the rest of the domestic banks with total assets of over $50 billion it was $101,724, or 52% less. One large institution's personnel earned $379,402 per person or nearly four times more than the rest of the banks that did not specialize in Wall Street activities.

Given compensation systems with huge payouts at trading banks, regulators have rightly enacted a series of rules to ensure that incentive programs do not tempt employees into actions that expose

banks to undue risk. However, while these policies are essential to preventing excessive risk-taking by traders, the rules are burdensome for regional bank employees who have little ability to take risk positions that could bring down the bank. By way of example, last year, 2,461 individuals, or 16% of M&T's employee base, fell within the purview of these provisions, requiring that their compensation packages be subject to heightened review. Allowing regional banks to restrict the applicability of these provisions to their executive management team and a handful of other employees, would reduce the burden of compliance, and focus more scrutiny on those individuals within the company who actually have the ability to subject the organization to material risk.

While these are a few examples of what could be done, it is time to review all the impediments to community lending and economic growth that regulations predicated on size, rather than complexity, have created for the banking industry. Complexity, not size, is the defining contributor of significant risk to the financial system and taxpayers. The enhanced prudential standards adopted by the Federal Reserve in February 2014 are not only a logical consequence of the recent financial crisis – they were necessary. Now, regulators and industry together should assess what we have learned since the crisis in an effort to hone the effectiveness of regulating complexity, without burdening simpler business models with disproportionately higher costs of compliance. After all, our economic recovery is still very uneven, and people and communities are still suffering; regional banks need to be supported in their efforts to encourage the type of activity that fosters local economic growth.

ECONOMY – THE BEST OF TIMES AND THE WORST OF TIMES

As focused as one must be on the bank's business and internal operations, one must not forget the larger economy which we are chartered to serve. For some, it is true; the economy has turned, at least for now. To an extent, the financial crisis may seem like a faded memory. On an annualized basis, U.S. real GDP growth has topped the 3% long-term average in four of the past six quarters – the strongest period of sustained growth since 2006. U.S. private sector employers created 2.5 million jobs in 2014 – the strongest year-over-year increase since 1999. The low interest rate environment established by the Federal Reserve, along with the efforts of ordinary people trying to minimize their financial risk, have reduced household debt service burdens to generational lows.

Despite these ostensibly positive trends, for far too many Americans the recovery is something about which they read – a phenomenon affecting other people in other places. While metropolitan areas are doing much better, rural areas continue to struggle. Over the past decade, U.S. employment growth has varied widely between larger urban areas and rural communities. Collectively, U.S. metropolitan areas experienced a 12% increase in private sector employment from 2003-2013 while

non-metropolitan areas recorded just a 5.4% gain. This trend can also be seen in upstate New York, where from January 2003 to November 2014, private employment in metropolitan areas rose by 2.5% compared to just a 0.2% increase in non-metropolitan areas.

More worrisome is the impact of the current, uneven recovery on the economy's future. Tomorrow's generation faces a number of headwinds that will forestall their ability to contribute to the next wave of economic growth. Aggregate student loan debt stands at more than $1.1 trillion, trailing only mortgage debt as the largest form of consumer indebtedness. One consequence of this rising student debt burden is deferment of home ownership – the percentage of 18-to-34 year olds who own homes has continued to decline and stands at 13% compared to over 17% before the crisis.

Contrary to their portrayals in popular media as a group of swashbuckling entrepreneurs, Millennials have actually become less inclined to launch new businesses – the percentage of business owners in that demographic has not been this low since the early nineties. Since 2007, the average net worth of those under 30 has fallen by almost half. Young people who are now entering the workforce with limited professional, financial and entrepreneurial opportunities may unfortunately be losing the most vital and economically productive years of their lives. It follows, then, that the total rate of business creation from 2012 to 2013 continued the downward trend that started in 2011. These are not the signs of the kind of America for which we strive and aspire – one in which opportunity, prosperity and growth are broadly shared.

It is against such a backdrop that one must weigh the unintended consequences of regulation, which burden the institutions that power the core of our local economies in America. One cannot question the applicability or utility of these regulations in improving transparency and reducing opacity in the financial services industry. However, there is a need for balance, where supervision is commensurate with the complexity of an institution's business model.

It is hard not to see the situation in this way: regulators, under the most extreme sort of pressure from elected officials, train their sights on traditional banks, while capital heads elsewhere and with it, the sort of risks Dodd-Frank was meant to mitigate. At the same time, the traditional, so-called real economy recovers in fits and starts and American businesses and consumers struggle to get the credit they need. M&T has been and remains dedicated to serving those credit needs. Doing so will depend, in part, on a supportive regulatory environment, one that is simpler and more predictable, tailored for different types of banks, and premised on a balance between costs and benefits – not for banks or banking but, rather, for the American economy as a whole. The time has come to allow America's community banks to serve their traditional roles of taking deposits and making

prudent loans to the friends and neighbors they know, and not allow misplaced animus and a one-size-fits-all approach to regulation to hinder the American economic recovery finally underway.

In thinking about the banking industry in the overall context of the economy, we should pause to remind ourselves of history. Just as John Maynard Keynes presciently saw that the draconian terms of the Treaty of Versailles could be the harbingers of international instability – and which opened a Pandora's Box from which came economic stagnation, hyperinflation and social instability – so must we be open to similar possibilities when it comes to financial regulation. An overly harsh undifferentiated response could plant the seeds of new problems. As a long time banker, I am hopeful for a return to an intelligible milieu where banks are able to energetically fulfill their roles as facilitators of commerce and of the quality of life in the local communities across our country.

Those of us in the industry share the common goal of legislators and regulators, to create the safest financial system in the world. It pains me to see excessive regulation that might stifle innovation, drive society's best and brightest away from our industry or discourage bankers from fulfilling their role in the economy out of fear of being inordinately fined and sanctioned. Much of what has been done is right, but it can be made better and more effective. The whole system will be better off if all constituents can get past their entrenched positions to just "make it right."

OUR COLLEAGUES

Once again, the 15,782 M&T employees I'm proud to call colleagues demonstrated an ability to adapt to changing circumstances and rise up to conquer new challenges. We asked more of our employees than ever before and they delivered in a way that inspires awe, gratitude and respect. A talented legion of veteran M&T colleagues aided by a corps of newly hired reinforcements worked tirelessly to build a better M&T, often working late into the night or through to the morning no matter the day of the week. Even a historic November storm that battered our home market just before Thanksgiving, dumping almost eight feet of snow in some of our communities and rendering roads impassable, could not keep employees from the office – dozens of the dedicated stayed in downtown hotel rooms and made sure the work got done, not because they were asked to, but because they have a deep, inspiring sense of personal responsibility.

Of course, our colleagues' extraordinary efforts were not limited to the office. We refer here to their commitment, as citizen volunteers and leaders, in our communities. Time and again, they band together to help friends and neighbors – through work in schools, churches, civic organizations, environmental initiatives and many more organizations too numerous to list. The colleagues whom I thank here do not understand such service as a burden, nor as unrelated to their ordinary activities – it is a part of who they are and what they do. Their selfless work defines our company and goes to the heart

of what M&T is and will continue to be: a community bank predicated upon the notion of the collective success of our clients and our colleagues. They are the face of our bank – for our customers and for our communities. They act as owners – in no small part because many are – and their sense of ownership is evident in the quality of and dedication to their work.

A PERSONAL NOTE

Following the Annual Meeting of the Shareholders on April 21, 2015, Jorge G. Pereira will retire as the Vice Chairman of the Boards of Directors of M&T Bank Corporation and M&T Bank. I would be remiss not to offer my special thanks to Jorge for his service. Jorge joined the boards of what were then known as First Empire State Corporation and M&T Bank with me in 1982, and although not an employee or member of management, he has been my close partner and colleague over the past 33 years. At the beginning of that partnership, it was his faith in me that helped provide the combination of confidence and guidance that I needed in my new role as chief executive. Over the years, I was fortunate to be able to rely on his judgment and wisdom; he helped to shape and refine our vision of M&T as a bank whose business would be built on communities and customers, employees and shareholders. In his service on the boards, Jorge gave of his time in a wide range of roles. As M&T's largest individual, non-management shareholder, Jorge added an independent voice to the board's consideration of executive compensation and corporate governance matters, while serving as the lead independent director. We have been supremely fortunate to draw on Jorge's advice and guidance, not least during the challenging years of the past decade. We extend our heartfelt gratitude for his long service, wise counsel and valuable contributions to the success of this company. I will miss him as a colleague – but continue to cherish him as a friend.

Robert G. Wilmers

Robert G. Wilmers
Chairman of the Board and
Chief Executive Officer

From the Columbus Business First
:http://www.bizjournals.com/columbus/blog/2015/02/cleveland-fed-chief-mester-open-to-adjusting.html

Cleveland Fed Chief Mester open to adjusting tiered banking regulation

Feb 5, 2015, 3:12pm EST

Evan Weese
Staff reporter- *Columbus Business First*
Email | Google+ | Twitter | LinkedIn

Federal Reserve Bank of Cleveland President Loretta Mester is supportive of the so-called tiered regulation applied to banks of varying sizes, but says she's open to tweaking the way institutions are classified.

Bankers and some lawmakers, including Sen. Sherrod Brown, D-Ohio, have argued the $50 billion-asset threshold for a bank to be considered systemically important under the Dodd Frank Wall Street Reform and Consumer Protection Act is too low.

Ohio's three regionals —Huntington Bancshares Inc. (NASDAQ:HBAN), **Fifth Third Bancorp** (NASDAQ:FITB) and **KeyCorp** (NYSE:KEY) – all above $50 billion in assets – are classified in a way that their failure would pose a risk to the entire U.S. financial system. It's the same way **JPMorgan Chase & Co.** (NYSE:JPM), with $2.5 trillion in assets, is regulated.

"I think the tiered approach is the right approach, (but) what particular level it is I don't really have a strong opinion on," Mester told reporters after speaking at Wednesday's Ohio Bankers League annual summit. "But I know it's something we are concerned about because we want to make sure we right-size our regulation and supervision to where the risks lie - so I would be open to that, thinking about a higher threshold."

Mester noted many of the new requirements under Dodd-Frank, such as annual stress testing and resolution planning, apply to about only 100 banks with more than $10 billion in assets.

Banks with less than $50 billion in assets are not subject to a minimum liquidity requirement the Federal Reserve approved last year.

Mester acknowledged the actions community banks – those with less than $10 billion in assets – take do not impose costs on the rest of the financial system, "so community banks shouldn't be subject to the same types of macroprudential rules and supervision aimed at the systemically important institutions."

But there's a gray area for regional banks along the lines of Columbus-based Huntington, with $66 billion in assets.

"The regional banks have different business models," Mester said. "Some of them look a lot like community banks, some of them look like just smaller, large banks."

Evan Weese covers funding and capital for Columbus Business First.

STATEMENT OF

GREG BECKER
CHIEF EXECUTIVE OFFICER
SVB FINANCIAL GROUP, INC.

ON BEHALF OF

SILICON VALLEY BANK

U.S. SENATE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

EXAMINING THE REGULATORY REGIME FOR REGIONAL BANKS

March 24, 2015

I. INTRODUCTION AND BACKGROUND ON SILICON VALLEY BANK

My name is Greg Becker, Chief Executive Officer of SVB Financial Group, the parent company of Silicon Valley Bank ("SVB"). I appreciate the opportunity to submit testimony today regarding the need to raise the $50 billion threshold for application of enhanced prudential standards under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), and how, without doing so, SVB and other mid-sized banks will face significant burdens that inherently and unnecessarily will reduce our ability to provide the banking services our clients need.

SVB, which was founded in 1983, provides targeted financial services and expertise to entrepreneurs and companies in the technology, life science and healthcare, private equity and venture capital, and premium wine industries. SVB's core business is centered on traditional banking services, which includes accepting deposits and making loans to the types of rapidly growing small businesses and their investors that are driving innovation and creating jobs.

Throughout the recent economic downturn, SVB was able to lend to its clients while maintaining strong credit quality. In fact, from 2007-2011, SVB increased the amount of total loans it offered by 68 percent—from $4.2 billion to $7.0 billion—with net charge offs averaging less than one percent. Moreover, in the past two years, SVB has increased loans at well over two times the average rate of its peer institutions, while further reducing its net charge offs to approximately 0.32 percent. Taken together, these numbers demonstrate SVB's deep understanding of the markets it serves, our strong risk management practices, and the fundamental strength of the innovation economy. Furthermore, SVB's ability to lend to over 7,800 clients while maintaining strong credit quality reflects our commitment to providing the credit our clients need to grow, innovate, and create jobs.

As SVB continues to expand its role in serving the innovation economy, its total consolidated assets are approaching the $40 billion mark, and with continuing organic growth, we expect to cross the $50 billion threshold–the threshold that triggers application of significant regulatory burdens under the Dodd-Frank Act. These new burdens and the related compliance costs and necessary management time and other human resources are significant, and will require us to divert resources and attention from making loans to small and growing businesses that are the job creation engines of our country, even though our risk profile would not change.

We urge Congress to act quickly to increase the $50 billion threshold and create a new asset-level floor below which enhanced prudential standards will not apply. Without such changes, SVB likely will need to divert significant resources from providing financing to job-creating companies in the innovation economy to complying with enhanced prudential standards and other requirements. In addition, without a "bright-line" floor that sets a line below which enhanced prudential standards would not apply, there is a significant risk of regulatory scope creep that would lead to regulation designed for the largest banks being applied to mid-sized banks, like SVB. Given the low risk profile of our activities and

business model, such a result would stifle our ability to provide credit to our clients without any meaningful corresponding reduction in risk.

In Section II below, we explain the importance of revising the threshold to accommodate the lower risk profile of mid-sized banks and how the current standard is defeating the underlying purpose of the Dodd-Frank Act. Further, in Section III, we highlight the need for establishing a bright-line floor for any such revised standard, which would provide much needed certainty for mid-sized banks like SVB and help avoid regulatory scope creep.

II. THE $50 BILLION THRESHOLD IMPOSES SIGNIFICANT BURDENS ON TRADITIONAL BANKS WITH LITTLE CORRESPONDING REGULATORY BENEFIT

SVB, like our mid-sized bank peers, does not present systemic risks. We do not engage in market making, securities underwriting or other global investment banking activities. We also do not engage in complex derivatives transactions or dealing, offer complicated structured products, or participate in other activities of the sort that contributed to the financial crisis. As noted, SVB's core business is traditional banking – taking deposits and lending to growing companies that drive job creation and the investors in those companies. We have approximately 7,800 lending clients (compared to the millions of clients serviced by the largest banks), and we are able to have a thorough understanding of the nuances of each of their businesses. Because SVB's business model and risk profile does not pose systemic risk, imposing the numerous Dodd-Frank Act requirements that were designed for the largest bank holding companies ("BHCs") would place an outsized burden on us, with minimal corresponding regulatory benefit.

Since the enactment of the Dodd-Frank Act, we have made meaningful investments to our risk systems, hired additional highly skilled risk professionals, and established a stand-alone, independent Risk Committee of our Board of Directors. In addition, we have been conducting a range of different stress tests designed to measure and predict the risks associated with our business in different economic scenarios. As a result of taking these steps, we believe we are effectively managing the risks of our business and reasonably planning for possible unfavorable future business scenarios. Nevertheless, once we cross the $50 billion threshold, the Federal Reserve Board ("FRB") will be forced to alter the regulatory framework that applies to us, even though our risk profile and business model will remain exactly the same. As a result, a number of new requirements would automatically apply to SVB, including:

- The requirement to submit an annual capital plan for the FRB's evaluation under the Comprehensive Capital Analysis and Review ("CCAR") program, which was originally designed for global systemically important banks ("G-SIBs") as a response to the financial crisis.[1]

[1] 12 C.F.R. 225.8.

- Stress testing through the annual supervisory stress tests conducted by the FRB, as well as the semi-annual company stress testing requirements.[2] Governor Tarullo has noted that the annual supervisory stress tests require aggregation and reporting of data that "entail substantial expenditures of out-of-pocket and human resources" beyond the stress testing required of banks with assets between $10 and $50 billion.[3]

- The liquidity coverage ratio, which penalizes banks with a simple commercial lending business models, like SVB, as compared to larger, complex banks with a wide range of business lines.[4]

- The requirement to annually submit a resolution plan (or "living will").[5]

- Additional liquidity and other prescriptive risk management requirements.[6]

Thus, if the $50 billion threshold is not raised, SVB ultimately will be subject to the array of regulatory requirements designed for the largest, most complex banks. The resources necessary to meet these requirements are significant and would lead our compliance costs to dramatically increase – again, despite our fundamental business model and risk profile remaining the same.[7]

We urge Congress to fix this unbalanced regulatory treatment. Setting aside the significant compliance costs that we would incur, regulating SVB in this fashion would, as FRB Governor Daniel Tarullo's stated before this Committee, provide minimal regulatory benefit because the Dodd-Frank Act's enhanced prudential standards are not aimed at, and could be harmful to, a traditional banking business model like that of SVB.[8] In addition,

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2 12 C.F.R. pt. 252, subparts E-F.

3 Statement of Daniel K. Tarullo, *Examining the Regulatory Regime for Regional Banks: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 115th Cong. (Mar. 19, 2015) [*hereinafter*, Tarullo Senate Testimony].

4 12 C.F.R. 217.61-63.

5 12 C.F.R. pt. 243.

6 12 C.F.R. 252.34-35 (Liquidity Risk Management); 12 C.F.R. 252.33 (Risk Governance).

7 One bank that is approaching the $50 billion threshold has said that it expects to incur compliance costs of approximately $10 million per quarter to prepare for crossing the threshold, with ongoing expenses of 75 to 80 percent of that amount thereafter. *First Republic Intends to Grow Well Past $50B, CEO Says*, AMERICAN BANKER (Oct. 17, 2014); First Republic Investor Presentation (Aug. 2014), *available at* http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9MjQ3ODA0fENoaWxkSUQ9LTF8VHlwZT0z&t=1.

8 Tarullo Senate Testimony, *supra* note 3.

Governor Tarullo noted that supervisory stress testing "can be a considerable challenge for a $60 billion or $70 billion bank [with] benefits [that] are relatively modest," and previously has suggested that a more appropriate threshold may be $100 billion.[9]

Governor Tarullo and Comptroller Thomas Curry also have stated that the $50 billion cutoff may not be an adequate gauge of a bank's systemic risk profile. Comptroller Curry explicitly stated that the $50 billion threshold may not "necessarily mean that [a bank] is engaged in that activity" that enhanced prudential standards are designed to limit. In other words, the $50 billion threshold may not get to the root of the problem at all.[10] To this point, when examining systemic importance indicators of the 33 U.S. BHCs with assets of $50 billion or more, the Office of Financial Research highlighted risk scores only for those BHCs with assets over $250 billion, which indicates that only those banks present systemic risk.[11] Further, former Congressman Barney Frank, one of the authors of the Dodd-Frank Act, has argued that the threshold itself should be revisited, and the Bipartisan Policy Center supports raising the threshold to $250 billion.[12]

In addition to these concerns, the current Dodd-Frank Act threshold of $50 billion is driving consolidation in the banking sector, so that larger, combined enterprises can absorb the significant costs associated with crossing the $50 billion threshold.[13] This trend seems

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9 *Id.*; Speech of Daniel K. Tarullo at Fed. Res. Bank of Chicago Bank Structure Conference, Chicago, Illinois, *Rethinking the Aims of Prudential Regulation* (May 8, 2014).

10 *See* Comptroller Thomas Curry, *$50 Billion Cutoff Alone is Inadequate to Gauge Banks' Risk*, AMERICAN BANKER (Sept. 23, 2014).

11 *See* Office of Financial Research, Brief Series 15-01, *Systemic Importance Indicators for 33 U.S. Bank Holding Companies: An Overview of Recent Data* (Feb. 12, 2015).

12 *See* Statement of Congressman Barney Frank, *Assessing the Impact of the Dodd-Frank Act Four Years Later: Hearing Before the H. Comm. on Fin. Servs.*, 115th Cong. (July 23, 2014); Bipartisan Policy Center, *Dodd-Frank's Missed Opportunity: A Road Map for a More Effective Regulatory Architecture* (Apr. 2014), *available at* http://bipartisanpolicy.org/library/dodd-franks-missed-opportunity-road-map-more-effective-regulatory-architecture-2/ (arguing that changing the threshold to $250 billion would permit regulators to focus more resources on a smaller set of institutions that present the greatest potential systemic risk).

13 Several recent transactions point to this trend. Three noteworthy examples are: (1) the acquisition of City National Corporation, with approximately $32 billion in assets at the time the deal was announced, by Royal Bank of Canada (announced on January 22, 2015); (2) the acquisition of IMB Holdco LLC, the parent company of OneWest Bank N.A., with $23 billion in assets at the time the deal was announced, by CIT Group Inc., with approximately $45 billion in assets at the time the deal was announced (announced on July 22, 2014); and (3) the acquisition of Susquehanna Bancshares, with approximately $18.6 billion in assets at the time the deal was announced, by BB&T Corporation, with an asset size of $187 billion at the time the deal was announced (announced Nov. 12, 2014).

contrary to the Dodd-Frank Act's purpose to limit the propagation of "too big to fail" institutions.

III. IN ESTABLISHING A NEW THRESHOLD, CONGRESS SHOULD USE A "BRIGHT LINE" FLOOR TO PROVIDE CERTAINTY TO MID-SIZED BANKS

SVB believes the most important piece of any revision to the $50 billion threshold should be providing a "bright-line" floor, below which enhanced prudential standards would not apply. A "bright-line" would clearly identify banks that do not present systemic risk. A floor would provide certainty to those banks below the threshold, and could help stop the regulatory scope creep of using the $50 billion threshold in rules where the threshold is not mandated by the Dodd-Frank Act. In considering what such a "bright-line" may look like, SVB would like to suggest that the following principles guide Congress' deliberations.

- First, in contrast to the current $50 billion threshold, any bright-line threshold or floor should be designed so that the enhanced prudential standards can be applied only to those banks reasonably likely to present systemic risk.

- Second, consistent with the first principle, the new threshold or floor should be designed to be long lasting. All stakeholders will benefit from an enduring, appropriately calibrated standard that does not need to be revisited in the near term.

- Third, to achieve such a long-lasting threshold, qualitative risk-based factors should be used to determine those banks above the floor that truly present systemic risks and should be subject to enhanced prudential standards. Unlike the approach taken today, using a risk-based approach would provide the FRB with discretion to avoid unnecessarily burdening banks that cross the threshold but are not systemically important.

Using these guiding principles as a baseline, SVB would support a number of solutions for raising the $50 billion threshold.

- Most simply, Congress could raise the current floor. SVB believes a new floor set at a level of at least $100 billion and perhaps as high as $250 billion would be worth considering.

- Another solution could be to establish a threshold derived as a percentage of U.S. gross domestic product ("GDP"), such as 1 percent.[14] This approach has the benefit of establishing a threshold that increases as the U.S. economy grows.

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[14] *Cf.* Governor Daniel K. Tarullo, *Industry Structure and Systemic Risk Regulation*, Brookings Institution Conference on Structuring the Financial Industry to Enhance Economic Growth and Stability (Dec. 4, 2012) (discussing capping non-deposit liabilities by a percentage of GDP).

- SVB also believes that a threshold based on nonbank assets held by a BHC could be used, as nonbank assets could be more likely to indicate heightened systemic risk.

As noted above, we think this threshold should be a floor that clearly demarcates the line below which a BHC simply could not present systemic risks. Then, risk-based factors could be used to determine those BHCs above the floor that warrant – due to their risk profile – the application of enhanced prudential standards.

Most importantly, Congress should strive to balance the regulatory burdens that fall on small to mid-sized banks against their straightforward business models and low risk profile. Failing to achieve the right balance will unnecessarily divert capital, time, and attention, toward unnecessary compliance measures and away from making loans to the small and growing businesses that are the job creation engines of our country.

***

In conclusion, SVB asks Congress to consider the impact of the current $50 billion threshold on mid-sized institutions. The evidence is clear that the Dodd-Frank Act's framework for G-SIBs is not appropriate for SVB and our peers – and that the costs are not just high for us, but for our customers. Once again, we appreciate the opportunity to share our views with the Committee and hope that Congress takes action to lift the current unnecessary burden on mid-sized banks.

THE CATHOLIC UNIVERSITY OF AMERICA
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March 31, 2015

The Honorable Richard Shelby
Chairman, Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, D.C. 20510

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

Re: Examining the Regulatory Regime for Regional Banks

Dear Senators Shelby and Brown:

In conjunction with the Senate Banking Committee's recent hearings on March 24, 2015, please consider the following observations on the regulatory regime for regional banks.

All banks, from the biggest to the smallest, have the potential to disrupt segments of the economy, especially as a bank nears insolvency. For this reason, all banks are subject to extensive regulation, enjoy the benefits of deposit insurance, and are granted access to the Federal Reserve as lender of last resort. The Financial Crisis illustrated the fact that financial distress of a non-bank can also be disruptive. Therefore, when Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank), it gave the Federal Reserve new authority to regulate certain non-bank financial institutions designated by the Financial Stability Oversight Council (FSOC). At the same time, Congress recognized that large bank holding companies can cause greater disruption to the economy than smaller ones, and, therefore, should be subjected to a more rigorous prudential regime than smaller banks. Thus, Dodd-Frank directs the Federal Reserve to subject large bank holding companies with assets of $50 billion or more to greater supervision than that applied to smaller bank holding companies.

While Congress may have mandated that the Federal Reserve enhance its supervision of larger banks, the Federal Reserve had significant and broad supervisory authority over such bank holding companies, and all bank holding companies, long before Dodd-Frank was passed. For example, under the Federal Deposit Insurance Act, the Federal Reserve has broad authority to prevent bank holding companies from engaging in unsafe or unsound banking practices (through a cease and desist order and other administrative enforcement actions). An unsafe and unsound banking practice is any activity that is contrary to prudent standards of operation and poses an abnormal solvency risk. The Federal Reserve has a long history of imposing administrative sanctions on bank holding companies for engaging in unsafe or unsound banking practices.

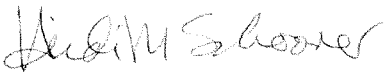
Some legislative proposals would eliminate the automatic designation of large banks to Dodd-Frank's enhanced supervisory regime. Such proposals are troubling for several reasons. First, and most importantly, if Congress were to eliminate the automatic designation of banks with $50 billion or more assets, such a change in the law could signal to the Federal Reserve that Congress is opposed to intensive supervision of such banks. Worse yet, such a change in the law might bring into question the long standing legal authority of the Federal Reserve to utilize its significant discretion to prevent bank holding companies from, for example and as discussed above, engaging in unsafe or unsound banking practices. Second, to the extent that such proposals would vest the FSOC with the authority to determine which banks should be subjected to enhanced supervision, this would create an unprecedented system for determining the appropriate level of bank supervision. I am not aware of any bank supervisory system, in the U.S. or abroad, that utilizes non-bank regulators to determine the appropriate level of bank supervision. While the membership of the FSOC includes several bank regulators, it also includes many members who are not. Third, to the extent that such legislative proposals rely on the Financial Stability Board's (FSB) designation of global systemically important banking organization (GSIBs), this too would be unprecedented given that the FSB is an international coordinating body and not a regulator at all. Finally, requiring a bank-by-bank designation of bank holding companies that "could pose a threat to the financial stability of the United States" (the standard used for nonbanks) ignores our history of bank failure among regional banks. Certain regional banks may not pose a threat to the entire country, but could cause significant distress in particular regions of the country. It would be a mistake to exclude such banks from the enhanced supervisory regime.

In mandating enhanced supervision, Congress was aware of the potential regulatory burden. Thus, Dodd-Frank includes mechanisms to reduce regulatory burden. Section 165 of Dodd-Frank provides that the Federal Reserve may tailor enhanced supervision to companies on an individual basis – it does not require a one-size fits all approach. The Federal Reserve has tailored enhanced supervision in a number of important areas. Dodd-Frank also provides that the Federal Reserve may establish an

asset threshold of more than $50 billion for enhanced supervision that relates to contingent capital, resolution plans, concentration limits, public disclosures, and short term debt limits. The Federal Reserve, however, cannot change the threshold for key risk management requirements: establishment of a risk committee and the annual stress tests. Congress recognized that these elements of enhanced supervision were essential to preventing future crises. In addition, Section 169 of Dodd-Frank directs the Federal Reserve to avoid duplicative requirements (i.e., those that may duplicate requirements from other regulators). In these ways, Dodd-Frank reflects careful consideration of the costs and benefits of enhanced supervision.

For these reasons, Congress should not weaken the enhanced supervisory regime for regional bank holding companies created under Dodd-Frank. Thank you for your consideration of my views.

Sincerely,



Heidi Mandanis Schooner
Professor of Law

March 23, 2015

The Honorable Richard Shelby
Chairman
Senate Committee on Banking,
Housing & Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Sherrod Brown
Ranking Member
Senate Committee on Banking,
Housing and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Shelby and Ranking Member Brown:

As a member of the Regional Bank Coalition, Fifth Third associates itself with their letter for the record. We also appreciate the willingness and indulgence of the Committee, as its Members work towards a better understanding of the issues regional banks face in the post Dodd Frank era. We are grateful for the opportunity to share the Bank's experiences on the wide variety of regulations that have been implemented in recent years.

Fifth Third, based in Cincinnati Ohio, is a typical regional bank: a traditional banking organization that is domestically focused, serving our local communities by providing traditional banking services, primarily deposits, loans, and trust and asset management services. We do not have large trading or capital markets businesses. Most regional banks are not subject to the Basel Globally Systemically Important Banks ("G-SIB") rules. As we discuss in greater detail, Fifth Third's business model is similar to that of community banks, in that its activities consist primarily of making commercial and consumer loans and taking deposits. 98% of our assets are in the insured depository. Furthermore, based on the Fed's FR Y-15 data, Fifth Third is not systemically risky.

This letter relates primarily to the Enhanced Prudential Standards in Section 165 of the Dodd-Frank Act ("DFA"). It is often noted that regulators can and do tailor their expectations reflecting the size and complexity of covered institutions under DFA, and we acknowledge there does appear to be some level of differentiation by regulators. However, more often than not, the instructions and guidance issued to covered institutions apply to all banks with more than $50 billion in assets. Guidance does not define how and where those expectations are tailored. Furthermore, if the Federal Reserve ("Fed") finds that a bank holding company is particularly significant to the financial system, it may apply more stringent standards. However, under the current statutory framework, it may be more difficult legally for the Fed to apply less scrutiny to a bank holding company with more than $50 billion in assets that is clearly not systemically important, such as Fifth Third, even if it were clear that the company presented lower risk than larger, more complex institutions. This "one-way street" in which the Fed can apply more scrutiny, but not less, stems in significant part from the relatively low Section 165 threshold of $50 billion, which casts such a broad net that many regional banks like Fifth Third are needlessly swept up in a one-size-fits-all regulatory framework.

The costs of these activities – both financially, in diversion of resources to them, and in absorbing time and mindshare among management and Board members – are significant, and have a meaningful

impact on day-to-day business operations. Other regional banks face similar challenges, and it is our belief that careful examination of the relative costs and benefits of regulation based on an arbitrarily established $50 billion threshold would indicate many areas that are overly burdensome to regional banks. Supervision could be streamlined without creating danger to the financial system. We believe that a more risk-based approach to supervision should be implemented. Furthermore, we believe that raising the threshold would allow for supervisory discretion for bank regulators to require improvements or to impose higher capital or other measures if necessary for safety and soundness.

Dodd Frank Section 165 requires enhanced prudential standards in five areas, which are addressed below:

1. leverage and risk-based capital;
2. liquidity;
3. overall risk management;
4. resolution planning and credit exposures; and
5. concentration limits.

Item 1: Leverage and Risk-Based Capital

This requirement is primarily manifested through higher risk-based capital standards and through the annual Comprehensive Capital Analysis and Review ("CCAR") process. While we have generally supported higher capital standards, our experience has been that CCAR is an extremely costly exercise relative to the general Dodd-Frank Act Stress Testing ("DFAST") stress tests.

We fully expect that internal stress testing would still be required under the supervisory process. Internal stress testing was taking place at Fifth Third and other similar banks prior to the passage of the Dodd-Frank Act. These internal practices have advanced significantly since the crisis: we expect more of ourselves and regulators have higher expectations than pre- or post-crisis. Regulators would continue to have the supervisory powers to ensure that such institutions' capital planning and capital actions were conducted in a manner conducive to safe and sound operations.

During a Senate Banking Committee hearing on March 19, 2015, Federal Reserve Board Governor Dan Tarullo said, "It is very difficult to customize supervisory stress testing. While some elements of the test, such as the market shock and single-counterparty default scenarios, are applied only to larger firms, the basic requirements for the aggregation and reporting of data conforming to our supervisory model and for firms to run our scenarios through their own models do entail substantial expenditures of out-of-pocket and human resources. This can be a considerable challenge for a $60 billion or $70 billion bank. On the other side of the ledger, while we do derive some supervisory benefits from inclusion of these banks toward the lower end of the range in the supervisory stress tests, those benefits are relatively modest, and we believe we could probably realize them through other supervisory means."

We agree with Governor Tarullo's comments, and note that they are just as true for a $139 billion bank like Fifth Third, which is much closer in size and business model to a $40 billion bank not subject to CCAR than it is to a $2 trillion-plus sized banks with which we share the CCAR burdens and requirements. There are clear economies of scale faced by regional banks in order to comply with a regulatory process designed for institutions exponentially larger, which is further compounded by the fact that we must also pay for the increased supervisory costs.

As noted above, the Federal Reserve's written guidance is tailored neither by size nor complexity. It is written for and applies to all CCAR banks. We do not know what aspects within the written guidance apply to Fifth Third, or to what degree. We learn the outcome of CCAR only once a year and we have no significant insight into how the regulators have actually tailored expectations given that guidance and instructions are written to apply uniformly to all CCAR institutions. Therefore, it is necessary for us to strive to follow and meet the same guidance issued to companies more than 20 times our size.

This is particularly problematic because the CCAR process is consequential, public, qualitative, and, most importantly, binary. We do not know where the expectations end for a bank of our size and simple organizational structure. Resources may be expended indefinitely in order to ensure that we do not end up with an objection to our plans, despite current and stressed capital levels that significantly exceed regulatory capital standards. For the regional banks the review no longer hinges on producing strong capital ratios under stress since almost all regional banks have very strong post-stress capital ratios.

The current CCAR process consumes disproportionate time and resources relative to its benefits. The increasing requirements are the primary drivers of increasing investments, with estimated annual employee-hours at even a relatively small bank like Fifth Third, which is not complex, likely approaching 100,000 a year, many multiples of the originally estimated burden for the regulations when issued. As an example, we have doubled the size of our dedicated central capital planning team each year since 2011, and while we are hopeful we do not yet know whether its size will have created sustainability relative to regulatory expectations. This experience is replicated across model development teams, model validation teams, and other risk and finance areas. The cross-firm horizontal comparison under CCAR also makes it a near-necessity to hire expensive consultants each year to ensure that practices are in line with their other clients, and that we are interpreting new regulatory guidance correctly. We know that our experience of such heavy investments and sustainability issues is replicated at the other regional peers like Fifth Third.

Item 2: Liquidity

Liquidity is another example of the arbitrarily low $50 billion asset threshold anchoring a costly burden that increases our costs of operations and lending. As an institution with less than $250 billion but more than $50 billion in assets, Fifth Third is subject to the "modified" Liquidity Coverage Ratio (LCR) regime. We appreciate that the modified LCR is less burdensome than the full LCR, although it again represents the application of the $50 billion threshold to institutions which do not represent any significant systemic risk to the U.S. financial system. Fifth Third's business model, like other traditional regional banks, is similar to that of community banks, in that its activities consist primarily of making commercial and consumer loans and taking deposits. Sound liquidity risk management is very important to all banks, of all sizes, whether they are $50 billion in assets or $5 billion. Prior to the LCR regulation being issued, Fifth Third and other regional and large institutions had significantly increased their liquidity. The LCR and modified LCR rules are proscriptive and complex, and their requirements increase the need for covered institutions to hold cash or securities which increase interest rate risk. Large systemic banks whose capital markets activities require the holding of more liquidity, whether cash or securities, are less impacted by incremental requirements for liquidity.

The LCR regime arose from an international accord, which subjects U.S. banks above $250 billion to it (so-called "Advanced Approaches" institutions). The Basel accords do not require that the LCR, or a modified version of it, be applied to banks between $50 billion and $250 billion. Regulators can have heightened expectations for larger regional banks than community banks by requiring more comprehensive liquidity management reporting, stress testing, and the like. It may be that regulators

believe they are required to apply a modified LCR to $50 billion banks under Dodd-Frank. If so, this would most effectively be addressed by raising, re-defining, or eliminating the threshold, as noted above for CCAR. Otherwise, we would ask that Congress make clear that the LCR be applied using a more risk based approach. Similar to our recommendation for CCAR, raising the asset threshold or using a non-bank total assets approach would not undermine regulatory authority or safety and soundness. The LCR should be applied where there are necessary public policy requirements and defined reasons for why a $100 billion bank should hold proportionally more liquidity than a $10 billion bank.

Item 3: Overall Risk Management

Supervisory expectations underlying these requirements can be achieved through normal supervisory evaluation processes.

Item 4: Resolution Planning and Credit Exposures

Fifth Third is a Wave 3 Tailored Plan filer for Resolution Planning purposes, the least complex designation among banks required to submit a plan, representing an important form of regulatory differentiation with respect to expectations and burdens. However, we would note that the most recent FDIC guidance on Resolution Planning does not differentiate among filers of various sizes and complexity and imposes requirements for failure scenarios on Tailored Plan filers that are highly unlikely to occur in any failure scenario.

We believe that the initial Resolution Plans represented a useful exercise. The tailoring of expectations for institutions such as Fifth Third were appropriate; while costs were not low they were not unduly burdensome; and they create a benefit (essentially, an owner's manual for the firms and their regulators for use in a failure situation). Having been created, it can be updated as needed, and doing so can become a regulatory expectation. However, Fifth Third's business does not change significantly from year to year. We do not believe it is necessary to completely update all aspects of a Resolution Plan each year, for a bank as straightforward and relatively modest in size such as Fifth Third.

Removing the annual compliance burden of updating lengthy narrative documentation would be of significant benefit to Fifth Third, without significant incremental risk resulting.

Item 5: Concentration Limits

The concentration limits contemplated by Title I of Dodd-Frank present difficult conceptual issues, and this is perhaps why the Fed has not yet issued final rules to implement this requirement. As the Fed continues with its process of finalizing regulations in this area, it will be important to ensure that any requirement does not impose excessive costs on regional banks for little regulatory benefit. Regional banks such as Fifth Third are simple and straightforward in their structure and activities and do not engage in significant amounts of the counterparty-based activities or have the overly complex counterparty relationships towards which the concentration limits are directed. It will therefore be important to ensure that the Fed's concentration limit rules are appropriately tailored to regional banks and do not penalize them as if they were larger, more complex institutions.

Legislative Proposals

There are a number of proposals that we believe the committee should consider in its deliberations. Congressman Blaine Luetkemeyer (R-MO) has reintroduced his measure from last year. This bill utilizes a relatively comprehensive set of factors reflecting systemic importance – size being one of those factors, but also including factors relating to interconnectedness, substitutability, activity and complexity. Based on the Fed's FR Y-15 data, we would note that Fifth Third's "score" on these

measures would be approximately 10, whereas the U.S. threshold for triggering capital surcharges is 130 and the highest scoring institution in the U.S. has a score of approximately 500. In other words, Fifth Third's systemic importance is essentially undetectable relative to other institutions judged to be systemically important using a method designed for that purpose. Regional banks of Fifth Third's size have similar very low scores. These factors are viewed as sufficiently representative of systemic importance that they are used as the foundation for the application of capital charges and other measures for GSIB, and have been developed for that purpose since the arbitrary $50 billion size threshold was introduced in Dodd-Frank.

Congressman Steve Stivers (R-OH) is working on a bill that uses non-bank assets to determine a SIFI designation. Such a measure, which is modeled after what the regulators currently use for defining eligible tailored plan filers, would also likely ensure that any resulting threshold measures would not capture traditional regional banks that do not present the systemic risk targeted by Section 165. Fifth Third supports these approaches and would encourage you to examine them as well.

Conclusion

We believe that the benefit of such onerous regulations that section 165 of Dodd Frank imposes on regional banks do not justify the costs, and that the benefits can be gained through other supervisory means.

Less costly and unnecessary regulation for regional banks would free up regulatory resources that, if necessary and appropriate, could be utilized in a more productive manner with respect to ensuring that truly systemically important institutions do not pose or create threats to the U.S. and global financial system. Every dollar that we spend on regulations that do not add value by improving safety and soundness lowers the amount of capital we can lend to our customers and grow the economy. Every $100 million of regulatory expense reduces lending by nearly $1 billion that we, as regional banks can lend to businesses that are growing and adding new jobs. We look forward to further dialogue on these matters and appreciate your thoughtful consideration of these issues.

Sincerely,

Tayfun Tuzun
Executive Vice President and
Chief Financial Officer

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April 2, 2015

The Honorable Richard Shelby
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Committee on Banking, Housing, and Urban Affairs
United States Senate
534 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate
534 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Shelby and Ranking Member Brown:

We applaud your leadership in holding hearings examining the U.S. Systemically Important Financial Institutions (SIFI) designation process under Section 165 of the Dodd-Frank Act. While this issue is of significant importance to regional and mid-sized domestic banks, it is equally important to foreign banks operating within the United States. This is because the $50 Billion SIFI Threshold has been applied on the basis of a foreign banking organization's global assets, not its U.S. assets. As a result, a significant number of foreign banks that are large globally, but small locally, come within the U.S. SIFI definition, despite posing little, if any, risk to the financial stability of the U.S. As the Committee considers revisiting this threshold, which we support, we would ask that you also consider how best to address its application to foreign banks operating in the U.S.

The IIB represents internationally-headquartered banking and financial institutions from over 35 countries around the world doing business in the U.S. IIB members generally conduct banking and non-banking operations in the U.S. through branches of the parent bank and wholly-owned insured depository institutions and non-bank subsidiaries, such as broker-dealers, investment advisers and insurance companies.

U.S. Operations of Foreign Banks

In the aggregate, foreign banks' U.S. operations have approximately $5.5 trillion in assets, fund 25% of all commercial and industrial bank loans made in this country and contribute to the depth and liquidity of U.S. financial markets. For example, U.S. broker-dealer subsidiaries of foreign banks account for

nearly one-third of all U.S. dollar denominated securities underwritten in this country. Our members operate in all 50 states and Puerto Rico, employ more than 200,000 individuals, and contribute more than $50 billion each year to the economies of major cities across the country in the form of investments, employee compensation, donations to local and national charities, tax payments to local, state and federal authorities, and other operating and capital expenditures. As the Federal Reserve Board acknowledged in connection with promulgating its final rules under Section 165, the presence of foreign banking organizations in the U.S. "has brought competitive and countercyclical benefits to U.S. markets." [1]

Individually, foreign banks' U.S. business models are diverse and, similar to U.S. banks, vary considerably in size and complexity. An overwhelming majority of these operations are focused principally on wholesale lending, conducted in many instances through a single U.S. branch. Others follow a more traditional, retail bank model, through their U.S. insured bank subsidiaries, and are comparable to similarly-scaled U.S.-headquartered banks. Yet others engage principally in capital markets activities.

Current Application of the SIFI Threshold to Foreign Banks

Section 165 requires the application of enhanced prudential standards to "bank holding companies with total consolidated assets equal to or greater than $50,000,000,000"[2] (the "$50 Billion SIFI Threshold"). For this purpose, the term "bank holding companies" includes all foreign banks with banking assets in the U.S. [3]

The Dodd-Frank Act does not prescribe how the $50 Billion SIFI Threshold should be applied to foreign banking organizations. The federal regulators have, nevertheless, interpreted "consolidated assets" to mean global consolidated assets, thus catching within its net those foreign banks with U.S. operations based on their global assets, as opposed to their U.S. assets. As a result, foreign banks that are large globally in that they meet the $50 billion consolidated assets threshold but have relatively few assets in the U.S. are, solely by virtue of their global assets, deemed to be U.5. SIFIs.

For example, using worldwide assets as a basis for applying enhanced prudential standards under Section 165, creates a situation in which approximately three-quarters of the foreign banks subject to Section 165 have under $50 billion in U.S. assets. This is particularly concerning as the statute indicates the intent of Section 165 is to "prevent or mitigate risk to the financial stability of the United States."[4]

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[1] 79 Fed. Reg. at 17266.

[2] 12 U.S.C. § 5365(a)(1).

[3] Specifically, by virtue of the definition provided in Section 102(a)(1) of the Dodd-Frank Act, a foreign bank is a "bank holding company" for purposes of Section 165 if it (i) has a U.S. bank subsidiary, and therefore is itself a bank holding company within the meaning of the Bank Holding Company Act, or (ii) maintains a federal- or state-licensed branch or agency (or has a commercial lending company subsidiary in the United States) and therefore is treated as a bank holding company for purposes of the Bank Holding Company Act pursuant to section 8(a) of the International Banking Act of 1978 (12 U.S.C. § 3106(a)).

[4] 12 U.S.C § 5365(a)(1).

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We would submit that a bank with less than $50 billion in U.S. assets poses little to no risk to the financial stability of the U.S.

While it is true that the Federal Reserve has tailored the Section 165 implementing regulations, this tailoring as applied to foreign banks nevertheless requires foreign banks to comply, in the first instance, with enhanced regulatory requirements based on their global footprint, with individual tailoring applied based on their U.S. footprint. We would submit that the $50 Billion SIFI Threshold and the subsequent tailoring based on U.S. assets comes with consequences. It serves as a deterrent to foreign banks expanding in or even entering the U.S. market, which would, in the aggregate, have an impact on lending and U.S. employment. Rather than prevent systemic risk, this approach can potentially create greater risk, in that there would be a greater concentration among U.S. banks if foreign banks were to pull back from the U.S.

Moreover, the over-inclusive application of the $50 Billion SIFI Threshold misallocates scarce regulatory resources, requiring bank regulators to expend precious regulatory "capital" on banks that pose little, if any, risk to the financial stability of the U.S.; resources that can be better utilized elsewhere. Indeed, in his recent testimony before the Senate Banking Committee, Federal Reserve Board Governor Tarullo noted with respect to supervisory stress tests, that the "benefits are relatively modest, and we [the Federal Reserve] believe we could probably realize them through other supervisory means."[5] Governor Tarullo further noted that "[W]hile it is sensible to limit mandatory measures for classes of firms where most banks in that class are unlikely to present a particular kind of risk, it would be very ill-advised to preclude supervisors from requiring such measures of firms where that risk may become more of a concern."[6] The IIB strongly agrees.

Conclusion

In conclusion, the IIB strongly recommends that, in connection with any revision to the $50 Billion SIFI Threshold that the Committee may consider, it should also consider how best to address its application to foreign banks operating within the U.S.

Thank you for considering our views.

Sincerely yours,

Sarah A. Miller
Chief Executive Officer

[5] Statement by Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate (March 19, 2015) at 8.

[6] Id.

Economic Policy Program
Financial Regulatory Reform Initiative

Dodd-Frank's Missed Opportunity: A Road Map for a More Effective Regulatory Architecture

April 2014

BIPARTISAN POLICY CENTER

Economic Policy Program

Financial Regulatory Reform Initiative

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The Financial Regulatory Reform Initiative (FRRI) is co-chaired by Martin Baily and Phillip Swagel. Composed of five task forces, FRRI's goal is to conduct an analysis of Dodd-Frank to determine what is and what is not working along with recommendations to improve the system.

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This white paper is the product of the BPC's Financial Regulatory Reform Initiative. The findings and recommendations expressed herein do not necessarily represent the views or opinions of the Bipartisan Policy Center, its founders, or its board of directors.

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Executive Summary

The existing structure, or architecture, for regulating financial firms in the United States has evolved over time, largely due to ad hoc responses to financial crises (see Figure 1). In the aftermath of the most recent crisis, the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) continued this pattern and made some needed refinements to that structure. These refinements include: the creation of the Financial Stability Oversight Council (FSOC) to facilitate information-sharing and coordination among the various financial regulators; the consolidation of the Office of Thrift Supervision (OTS) with the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Federal Reserve; and the establishment of a new agency dedicated solely to consumer protection, the Consumer Financial Protection Bureau (CFPB).

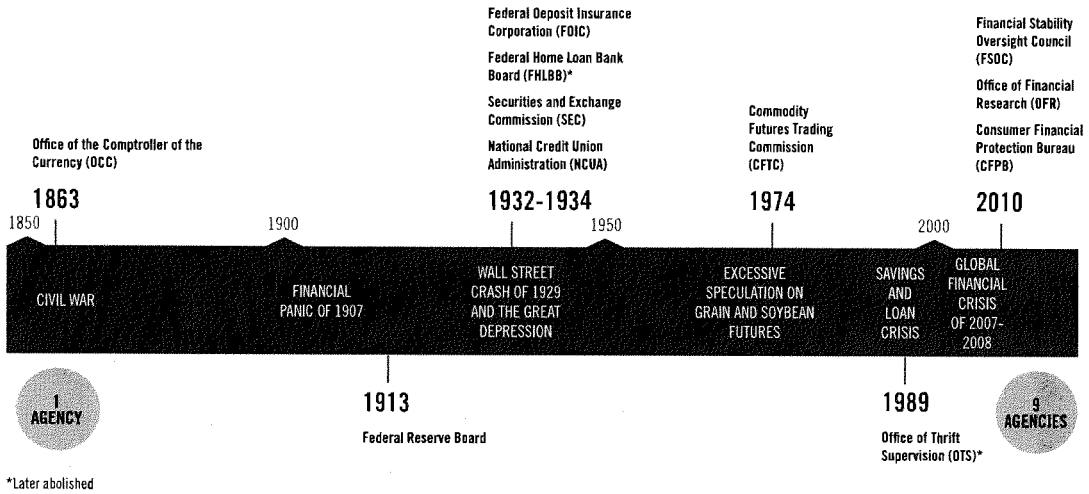
However, certain weaknesses of the U.S. financial regulatory architecture that were highlighted by the crisis either were not addressed or were inadequately addressed by Dodd-Frank. Today, the U.S. financial system remains too fragmented, with gaps in regulation that contribute to systemic risk and inefficiencies in both government and private markets. For example, the separation of securities and commodities regulation creates conflict between agencies and inefficiency for institutions that must comply with two sets of similar rules for similar activities. Likewise, the separate regulation of banks and their parent holding companies can produce regulatory overlap, especially in those cases in which a holding company is in essence a corporate shell for the bank. Furthermore, the United States is one of the few remaining major industrialized countries that does not regulate the business of insurance on a national basis. This complicates coordination with international insurance authorities and impedes national platforms for serving consumers more effectively and efficiently. Finally, the new FSOC is a positive first step toward better regulatory coordination, but it is too large, cumbersome, and weak to effectively coordinate and rationalize the regulatory actions of independent agencies.

Fragmentation in the U.S. financial regulatory structure contributed to the most recent financial crisis. For example, the lack of comprehensive oversight of the mortgage market, from the underwriting process through the securitization of mortgage loans, was at the heart of the crisis. Opportunities for regulatory arbitrage, particularly in the establishment and operation of thrift holding companies, further amplified these problems. Such problems can be substantially mitigated through improvements to the existing regulatory regime.

Past proposals for greater rationalization of the U.S. financial regulatory architecture typically have foundered as a result of three major forces:

1. The natural resistance to changing existing regulatory agencies, both federal and state, because existing stakeholders are familiar and comfortable with the system at the time;

Figure 1. Agency Creation Timeline



*Later abolished

2. Stakeholders unwilling to concede advantages they gain from the status quo, even if such advantages may be inefficient or lead to inequitable treatment; and

3. Jurisdiction divided among multiple congressional committees, each of which historically has been interested in preserving its existing jurisdictional authority.

All of these factors influenced the extent to which Dodd-Frank was able to alter the U.S. financial regulatory architecture. Nonetheless, the task force believes that the financial crisis demonstrated a pressing need for more fundamental reform. Some of these reforms could be phased-in to allow stakeholders to better understand and adapt to the new structure. It is true that past and current political realities make any structural change difficult. That said, the United States needs a financial regulatory system that is both effective and efficient, and one that will not be a significant contributor to the next crisis.

This paper presents a road map for how to achieve a more rational and effective financial regulatory architecture over time in line with important, basic principles. These guiding principles include:

- Clarifying the U.S. regulatory architecture to close gaps that could contribute to a future crisis or financial stress event;
- Improving the quality of regulation and regulatory outcomes;
- Better allocating, coordinating, and efficiently using scarce regulatory resources;
- Ensuring the independence and authority of financial regulators to allow them to anticipate and appropriately act on threats to financial stability; and
- Increasing the transparency and accountability of the regulatory structure.

The task force proposes six major areas in which to improve the quality of the U.S. regulatory architecture and achieve better regulatory outcomes for both financial institutions and the end users of financial services:

1. Improved quality of examinations. Enhance the quality of prudential supervision by taking the following steps:

    a. Create a pilot program, coordinated by the Federal Financial Institutions Examination Council (FFIEC), for a **consolidated examiner force** for insured depository institutions. Over time, such an approach would enhance supervision and improve the caliber of examiners through continuing, specialized training and higher compensation.

    b. **Transition to a consolidated examination force** by combining the prudential banking agencies into a single, unified bank prudential supervisory agency.

    c. Set standards to **improve the compensation of bank examiners**.

d. **Encourage colleges and universities to set up specialized undergraduate and master's degree programs for bank examiners** to raise the profile and skill level of bank examiners as a profession.

2. New architecture. Create a new, consolidated regulatory structure with cleaner lines of responsibility, reduced duplication of efforts, and more effective oversight by both macro-prudential and micro-prudential supervisors with clearer lines of accountability through the following actions:[1]

   a. Create a new **Prudential Regulatory Authority** (PRA) to be the primary micro-prudential regulator and supervisor for safety-and-soundness purposes, including setting basic capital, liquidity, and risk management standards. The PRA would consolidate the supervisory and examination authority of the OCC, FDIC, and Federal Reserve into a unified prudential regulator for all banks and thrifts as well as their holding companies.

   b. Make the Federal Reserve Board (FRB) **the primary macro-prudential supervisor**, responsible for overseeing financial market trends, activities, products, and practices that might pose a systemic risk to financial stability. The FRB would have full access to data on supervision and systemic risk issues through the PRA and Office of Financial Research (OFR), and it would have a backup, macro-prudential supervisory role for all systemically important financial institutions (SIFIs). The FRB would also be the **unified, financial-stability regulator for systemically important non-bank non-insurer financial institutions**, including retaining its role as the primary supervisor for financial market utilities (FMUs).

   c. Preserve the FDIC's primary role as an **insurer and resolution agency**, while retaining its role of backup supervisor for all banks and thrifts for which it insures deposits.

   d. Create a new **Federal Insurance Regulator (FIR)**, the primary responsibility of which would be to improve the regulation and supervision of insurance companies that elect to hold a new national insurance charter to better serve their customers with a nationwide or global platform. This new national charter would be mandatory for insurance companies that are designated as SIFIs and optional for other companies.

   e. **Phase out the thrift charter** in favor of a **single, modern federal banking charter** designed to meet the needs of all consumers of banking products and services on a competitive basis.

   f. Allow the chair of the FRB to **fill vacancies for the position of vice chairman for supervision**, absent a nomination by the president.

3. FSOC and OFR. Give the FSOC and OFR, two new macro-prudential agencies created by Dodd-Frank, the independence and authority necessary to effectively identify and prevent systemic risk.

    a. **Enhance the FSOC's macro-prudential authority** by giving it authority to set minimum heightened standards and safeguards on systemically risky activities and practices for member agencies.

    b. Make joint rule-writing more efficient and timely by **empowering the FSOC to adjudicate rulemaking disputes** among member agencies.

    c. Focus regulators on the most systemically important institutions by **raising the threshold from $50 billion to $250 billion for automatically applying heightened prudential standards to banks**, and by **making the threshold presumptive**.

    d. **Adjust FSOC voting membership** to align the FSOC's mandate more closely with its membership.

    e. **Improve the accountability and transparency** of the FSOC.

    f. **Make the OFR truly independent** and capable of providing objective, timely research and analysis on systemic risk issues to the FSOC, regulators, Congress, and the public by **removing it from the Treasury Department** and establishing it as an independent entity.

    g. Grant **more independence to the FSOC and OFR** by giving them greater control over their budgets.

    h. **Centralize data collection in the OFR** to improve regulatory efficiency.

    i. Improve the ability of regulators to foresee threats to financial stability by **establishing a financial war-gaming center** within the OFR.

4. Capital Markets Regulator. Create a single, modern **Capital Markets Authority** (CMA) to oversee the fair and efficient functioning and competitiveness of U.S. capital markets. The CMA would be established through the merger of the Securities and Exchange Commission (SEC) and Commodity Futures Trading Commission (CFTC).

5. Funding. Give all agencies **independent and appropriate funding** by removing their funding from the congressional appropriations process.

6. Cross-border impact assessments. Mandate that the **FSOC study all rulemakings with cross-border impacts and then make recommendations to Congress and the regulators** that would address impacts on financial stability, economic growth, competitive opportunities, and international cooperation.

The task force's plan is aimed primarily at reforming the federal financial regulatory system, while preserving the best features of the dual banking system that has served the country well for more than 150 years. The reforms proposed to the federal regulatory structure are achievable and consistent with the dual banking system. Moreover, the reforms would benefit state regulators by giving them more options to access and leverage federal resources and avoid unnecessary overlap and duplication.

Taken as a whole, the task force's recommendations will make the U.S. financial regulatory system more efficient, accountable, rational, resilient, and better able to identify and respond to future threats to financial stability and economic growth. The recommendations will close current regulatory gaps and contribute significantly to enhanced safety and soundness of individual financial institutions and the financial system as a whole. They will put the U.S. financial regulatory system more on par with other developed countries' regulators on critical cross-border issues embedded in a global financial system. Finally, by collectively strengthening the U.S. financial regulatory architecture, these recommendations will help ensure that the United States maintains its standing as the world's preeminent provider of financial services.

Introduction

This paper proposes a new structure for the U.S. financial regulatory system. To some, this may seem unnecessary after the 2010 passage of the Dodd-Frank Act, which made significant changes to the U.S. regulatory architecture following the financial crisis. In fact, Dodd-Frank focused more on expanding regulatory authority than making the overall structure more efficient or eliminating overlapping jurisdictions. As one analysis put it, Dodd-Frank "will do little to streamline the fractured financial regulatory framework."[2] In short, it was a missed opportunity.

There are many reasons that the opportunity to rationalize and strengthen the U.S. regulatory structure was missed. Resistance to change and the desire of regulatory agencies, Congress, and the financial industry to protect their existing turf and relationships makes consolidation difficult. For some, other provisions in Dodd-Frank were more important and did not warrant fighting a politically difficult battle to achieve consolidation.

The recommendations in this report are offered in the context of sparking an objective and long-overdue policy debate on the type of financial regulatory architecture that best meets the needs of a dynamic financial system upon which the United States relies for economic growth and job creation.

This aspiration may seem lofty given the number of major proposals to change the U.S. financial regulatory architecture that have foundered over the past few decades. Yet, what is politically impossible today may become feasible when an unexpected financial or market event changes the political dynamics in Washington. This report presents a series of practical recommendations that deserve the attention and consideration of policymakers, financial regulators, and the public at large. In some cases, these recommendations can be implemented by regulators without legislative action, while other recommendations provide new ideas for Congress and other stakeholders to consider. As a whole, these recommendations would substantially improve the performance of the U.S. financial regulatory system, enabling it to support greater financial stability and a dynamic, growing economy.

Roads Not Taken

The financial crisis generated numerous recommendations to reform the U.S. financial regulatory system. Two influential plans from the crisis period were the "Blueprint for a Modernized Financial Regulatory Structure,"[3] written in 2008 by the Treasury Department under then-Secretary Henry M. "Hank" Paulson Jr., and the "Financial Regulatory Reform: A New Foundation" white paper, produced in 2009 by the Treasury Department under then-Treasury Secretary Timothy Geithner.[4] In 2010, Chairman Christopher Dodd of the Senate Banking, Housing and Urban Affairs Committee integrated key concepts from both plans and included additional ideas when he introduced the Restoring American Financial Stability Act (RAFSA), which would have authorized a single, modern bank regulator.[5] Each of these three frameworks influenced the eventual Dodd-Frank legislation that was signed into law in July of 2010, and are discussed in greater detail in Appendix B. However, other recommendations in these reports worthy of greater consideration were largely ignored.

Listed below are several of the more consequential changes contemplated by the Paulson, Geithner, and RAFSA frameworks that were not included in Dodd-Frank. Taken together, these "roads not taken" would fundamentally change America's financial regulatory system. This report draws from several recommendations made by these three plans.

Combined Capital Markets Regulator

Dodd-Frank "missed a great opportunity to merge the SEC and CFTC," said Senator Mike Crapo (R-ID), ranking member of the Senate Banking Committee.[6] Although the Geithner white paper called for the CFTC and SEC to make recommendations designed to harmonize their working relationship, the Paulson Blueprint was the only one of the three plans to recommend merging the two agencies into a single capital markets regulator.

The idea is not a new one. When the CFTC was created in 1974 to be a futures industry version of the SEC, the agency was short on resources and staff compared with the SEC. Conflicts quickly arose, and the two agencies have fought a number of jurisdictional and court battles in the intervening years.[7]

"The existence of a separate SEC and CFTC is the single largest structural defect in our regulatory system," said House Financial Services Committee Chairman Barney Frank when he introduced a bill to merge the two agencies in late 2012, shortly before he retired.[8] Proponents of a merger believe it would help to plug regulatory gaps and streamline rulemaking by unifying functions in one agency.[9] They also point out that the markets regulated by the two agencies have converged as, for example, many securities-based products are now being traded on futures exchanges.[10] Others believe the cultures and philosophies of the two agencies are too different,[11] and a merger would actually add to the

number of regulatory requirements on financial institutions. The SEC falls under the jurisdiction of the Senate Banking and House Financial Services committees, while the Senate and House Agriculture committees have jurisdiction over the CFTC. Appropriations for the two agencies are separated into different appropriations subcommittees in the House, while both agencies are funded by a single appropriations subcommittee in the Senate. The resulting and continuing turf battles have made the establishment of a single, modern capital markets regulator in line with most other advanced nations a politically heavy lift.[12]

Single Prudential Regulator

The Paulson Blueprint called for the creation of a new Prudential Financial Regulatory Agency that would place all federal prudential regulation of institutions with explicit government guarantees, including insurance companies that opted for a national charter, under a single roof. The Geithner white paper proposed the creation of a National Bank Supervisor that would combine the responsibilities of the OCC and OTS into a single agency that would supervise all federally chartered depository institutions. While Dodd-Frank did transition many responsibilities of the OTS into the OCC, the Federal Reserve also expanded its supervisory authority over large, systemically important banks.

Some advocate for a "twin peaks" approach wherein financial regulation is managed by two agencies with separate missions and functions: a prudential regulator and a business conduct regulator. The United States mixes a functional approach—where regulators have responsibility for the types of business that institutions conduct—with an institutional approach, where regulation and supervision is divided according to the legal status of regulated institutions.[13] The Paulson Blueprint called for more of a "three peaks" approach that also included market stability responsibilities at the Federal Reserve.

The world's most economically advanced countries have adopted a variety of approaches to financial regulation, ranging from an integrated approach with a single regulator handling both prudential and business conduct regulation, to more fragmented models like the U.S. structure. While there is no definitive evidence that any one model is better than another, a 2009 paper by Martin Neil Baily (who serves as co-chair of the BPC's Financial Regulatory Reform Initiative) and Adriane Fresh argues that the most important attribute of a good regulatory structure is the ability for regulators to work together to ensure that the institutions they regulate do not take excessive risks.[14] The paper also suggests that a high level of communication among agencies, well-thought-out consolidation and execution of reform, and sufficient authority for regulators to take effective action in a timely manner are the key characteristics of a sound regulatory regime.

Independent Funding of Agencies

Since the passage of Dodd-Frank, regulatory agencies have been criticized for missing study and rulemaking deadlines and for failing to uncover problem areas like the collapse of MF Global and Bernard Madoff's Ponzi scheme. The SEC and CFTC, both of which have budgets subject to congressional appropriations, argue that they have significantly more work to do in a relatively short period of time, and insufficient funds and staff to fulfill their full range of duties.

Neither the Paulson Blueprint nor the Geithner white paper called for independent funding for the CFTC or SEC, or for the merged entity that the Blueprint proposed.

Increased Federal Insurance Regulation

While Dodd-Frank established the Federal Insurance Office (FIO), Congress, in deference to state insurance regulators, did not give the FIO the power to write rules, regulate insurance companies, or offer a national insurance charter. The Paulson Blueprint went further than Dodd-Frank by recommending the creation of an optional federal insurance charter that would be regulated through an Office of National Insurance (ONI).[15] Under the Blueprint's plan, the federal regulator would have authority to preempt inconsistent state laws and regulations. The Geithner white paper was open to a federal charter, listing six principles under which it would support the creation of a federal insurance regulator.[16]

Legislation also was introduced in Congress to create an optional national insurance charter. The National Insurance Act of 2007—sponsored by Sen. John Sununu (R-NH) and Sen. Tim Johnson (D-SD)—for example, would have established an Office of National Insurance run by a commissioner with the power to supervise, regulate, and register insurance self-regulatory organizations. Among its other provisions, the bill sought to authorize the ONI director to appoint the ONI as receiver for failed national insurers and establish a National Insurance Guaranty Corporation to provide benefits to life insurance policyholders of institutions in receivership.[17]

Phase-out of the Federal Thrift Charter

At one time, banks and thrifts (also known as savings and loans) had quite different missions. Congress created a federal thrift charter in 1933 with the goal of providing more stable financing for residential mortgages. Over time, however, the distinction between banks and thrifts has blurred considerably. The Paulson Blueprint called for a two-year phase-out of the federal thrift charter, because it is "no longer necessary to ensure sufficient residential mortgage loans are made available to U.S. consumers."[18] The Geithner white paper also proposed eliminating the thrift charter, but with no specific time frame.[19]

Evaluation of Dodd-Frank Act Regulatory Architecture Changes

With this background, the task force members sought to determine which structural reforms Dodd-Frank got right, where it needed to go further, and which additional reforms are needed that were not addressed in the Act.

What Dodd-Frank Got Right

The financial crisis revealed a number of glaring gaps and confusing, overlapping jurisdictions within the U.S. regulatory structure. The regulation of the mortgage industry and the securitization of mortgages is perhaps the most glaring example. Dodd-Frank made progress toward rationalizing and filling some of those gaps, but many still remain today.

CREATION OF FINANCIAL STABILITY OVERSIGHT COUNCIL (FSOC)

There was general post-crisis agreement that regulators needed to better coordinate with each other, and improve their ability to diagnose and address systemic threats, particularly those in areas outside of the banking sector that had been less regulated. Composed of ten voting and five non-voting members, the FSOC's purpose is to bring together the knowledge and expertise of federal and state financial regulators with the goal of preventing or mitigating future crises.[20] By adopting the recommendations in this report to improve the effectiveness of the FSOC, the Council has the potential to be one of the more important structural reforms in Dodd-Frank.

CREATION OF THE OFFICE OF FINANCIAL RESEARCH (OFR)

To best perform its systemic risk oversight functions, the FSOC needs access to high-quality information about risks in the financial sector and an independent voice to put such knowledge into the proper context. The OFR was created within the Treasury Department, with limited autonomy, to support the FSOC with just those functions. It is too soon to tell how effective the OFR will be, in part because the agency is still in its formative period, and in part because a definitive judgment on its effectiveness will not be possible until another financial crisis. Nonetheless, as is the case with the FSOC, the task force believes the OFR could function better and recommends several steps toward that end. Like the FSOC, a properly constructed OFR has the potential to be a great asset in helping to keep the U.S. financial system safer and more stable.

CONSOLIDATING CONSUMER PROTECTION FUNCTIONS

Consumer protection functions prior to the crisis were spread across multiple regulatory agencies, which were later criticized for neglecting to use their authority to protect consumers from the toxic mortgage products that proliferated in the earlier part of the 2000s. Critics argued that prudential regulators would always place their safety-and-soundness responsibilities ahead of consumer protection, so the two functions needed to be separated to ensure a strong, consistent regulatory voice for consumers. Dodd-Frank achieved this to a large extent through the creation of the CFPB.

The BPC's September 2013 report that analyzed the early work of the Bureau found areas deserving of praise and other areas where the CFPB could improve.[21] For example, the report cited the CFPB's work in writing rules for qualified mortgages, remittance transfer, and credit card ability-to-pay, as well as the process it followed. In addition, the report remarked favorably on how quickly the CFPB was able to set itself up and meet statutory deadlines. The report recommended changes in the Bureau's process for issuing guidance, its policy of inviting enforcement personnel into the supervisory process, and improving communications with covered entities and partner regulatory agencies.[22]

DISSOLUTION OF THE OFFICE OF THRIFT SUPERVISION (OTS)

Shuttering the OTS and moving its functions to the OCC, FDIC, CFPB, and Federal Reserve Board of Governors strengthened the regulatory system by removing an agency that had failed to adequately supervise some of the nation's largest savings and loans. Some of the companies—like AIG—that were supervised by the OTS had diversified structures with only a relatively small share of assets in their thrift subsidiaries. Others, like Washington Mutual, were primarily thrifts and clearly within the authority of the agency.

Initially created in 1989 to replace the Federal Home Loan Bank Board in the wake of the savings and loan crisis, the OTS initially gained a reputation for aggressively shutting down failed thrifts. However, since the OTS was funded by assessments from the institutions it regulated, it had a perceived incentive to take a light touch with those institutions responsible for its budget.[23] Over time, the financial industry also realized that Congress had created an alternative structure for savings and loan holding companies that was less restrictive than the bank holding company structure. A number of institutions elected through "charter-shopping" to become thrift holding companies, which resulted in the OTS acting as the consolidated supervisor for large non-bank firms. By 2007, the OTS oversaw some of the most notorious failed and troubled firms of the crisis era, including AIG, Countrywide, IndyMac, and Washington Mutual. The majority and minority staff report of the U.S. Senate Permanent Subcommittee on Investigations wrote that the failure of Washington Mutual, "stemmed in part from an OTS regulatory culture that viewed its thrifts as 'constituents,' relied on bank management to correct identified problems with minimal regulatory intervention, and expressed reluctance to interfere with even unsound lending and securitization practices."[24]

Where Dodd-Frank Did Not Go Far Enough

FSOC AUTHORITY

The new FSOC has the potential to better focus regulators on identifying and preventing systemic risk. However, Dodd-Frank gave the FSOC too little statutory power. While the FSOC can designate non-bank SIFIs and recommend policy actions to its member agencies, it cannot require those agencies to take policy actions or set standards. This structure reflects the tension inherent in a Council composed of regulators that each has its own independent authority. However, as long as such a fragmented financial regulatory structure exists, it is appropriate to expand the FSOC's ability to coordinate rule-writing and to provide that its recommendations must be implemented by member agencies when a supermajority of the Council agrees that such a reform is needed. While such changes would impinge on the independence of FSOC members at the margins, they also would enhance coordination and cooperation among financial regulatory agencies and ensure that major policy reforms rooted in maintaining financial stability and avoiding systemic risks are implemented in a timely manner.

OFR INDEPENDENCE AND POWERS

Like the FSOC, the OFR can have a positive impact on identifying and preventing systemic risk. The agency can cast a wide net as it attempts to see potential financial stability problems on the horizon. However, the ultimate effectiveness of the OFR has yet to be proven. It is critical that it have the necessary independence and requisite powers to act as necessary to fulfill its mandates as free from political influence as possible.

FEDERAL INSURANCE REGULATION

Dodd-Frank created the FIO as the first federal agency with the responsibility to monitor the insurance industry, coordinate federal efforts to develop federal policy on prudential aspects of international insurance matters, and recommend to the FSOC that it designate an insurer as systemically risky. Two insurance companies, AIG and Prudential, already have been designated by the FSOC as SIFIs, making them subject to regulation by the FRB.[25] Other insurance companies could also be designated as SIFIs. Dodd-Frank did not, however, give the FIO the power to regulate insurance companies, write rules, or grant them a national charter.[26]

Creating the FIO gave the federal government an independent ability to evaluate the condition of the insurance industry. However, the law otherwise creates an odd structure under which most insurers will remain under the jurisdiction of state regulators, but a few systemically important insurers will be regulated concurrently by the states and the Federal Reserve Board. This bifurcated regulatory structure for insurers that are designated for supervision by the FRB creates a potential for conflicting and overlapping federal and state regulation. It also places responsibility on the FRB to regulate companies engaged in the business of insurance, which differs substantially from that of banking. In lieu of this structure, the task force believes Congress should create a federal chartering and regulatory structure that would be mandatory for insurers designated as SIFIs and optional for those

insurers that would want to operate from a national platform to serve their customers more efficiently and effectively. The new national charter would be overseen by a federal insurance agency with regulatory and supervisory powers, and expertise in the business of insurance.

Where Dodd-Frank Did Not Act

A more problematic subject in looking back at the financial crisis is where Dodd-Frank chose not to act at all. Whether because of political difficulty, competing priorities, basic policy disagreement, or simple miscalculation, these areas represent future potential dangers that have not been sufficiently addressed by policymakers.

CONSOLIDATION OF FEDERAL BANKING REGULATION

If a criticism of U.S. banking regulation before the crisis was that it was too fragmented, it is especially interesting to note that Dodd-Frank eliminated only one agency—the OTS—while creating three new ones: the CFPB, FSOC, and OFR. While each of these actions individually was defensible, the task force believes that Dodd-Frank missed an opportunity to rationalize and streamline the banking regulatory system to make it simpler, more accountable, and more effective for all stakeholders—and less prone to contribute systemic risk.

IMPROVED QUALITY OF BANK EXAMINATIONS, TRAINING, AND COMMUNICATIONS

One of the consequences of the fragmentation of the U.S. financial regulatory system is overlap and duplication in examination forces. Agencies that conduct similar exams may have a different, and potentially conflicting, examination focus, and they are forced to re-create operational and human resources functions. Expertise and specialized knowledge at one agency may not be shared with others that could make use of it. Such inefficiencies are both wasteful and confusing for stakeholders in the bank examination process, and a new approach is warranted.

Part of that new approach should include improving the quality of communications and interactions with state banking regulators, which are coming under increased budgetary pressures with respect to hiring and retention. Better sharing of information and leveraging of key expertise and knowledge for the benefit of state regulators will enhance the entire financial regulatory system.

CONSOLIDATION OF CAPITAL MARKETS REGULATION

The separation of capital markets regulation in the United States into separate agencies—the CFTC and SEC—has been less justifiable with each passing year. The increasingly blurred lines between futures and securities trading have fueled turf battles that have characterized the relationship between the two agencies over the years. A different turf battle, this one among the agriculture, financial services, and banking committees in Congress, has left numerous proposals to merge the two agencies without enough political

support to pass. The potential gains from creating a single capital markets regulator in a modern economy warrant reconsideration of the merger of the two agencies. The United States is the only Organisation for Economic Co-operation and Development (OECD) nation with a regulatory system that features this particular historical aberration.

INDEPENDENT AND APPROPRIATE FUNDING

U.S. financial regulatory agencies were created as independent entities to shield them from political pressures and enable them to make decisions with the long view in mind. An agency cannot be truly independent, however, while remaining dependent on Congress for its funding. While the federal banking agencies have an independent funding source, the CFTC and SEC still rely on congressional appropriations and have been chronically underfunded.[27]

In addition to ensuring that all agencies are on equal footing with independent funding sources, funding should be levied appropriately in order to prevent charter-shopping. While the OTS, noted for attracting regulated entities with its light-touch regulation, was eliminated by Dodd-Frank, the potential for future charter-shopping should be addressed when designing optimal funding regimes.

Recommendations

This report presents a series of practical recommendations that deserve the attention and consideration of policymakers, financial regulators, and the public at large. In some cases, these recommendations can be implemented without legislative action, while other recommendations provide actions for Congress to consider. As a whole, these recommendations would substantially improve the performance of the U.S. financial regulatory system, enabling it to support greater financial stability and a dynamic, growing economy.

Recommendation #1: Improve the Quality of Prudential Supervision

Banks and thrifts, and their holding companies, are subject to examination by multiple federal and state financial regulators.[28] Supervision conducted at the level of individual institutions is the foundational safeguard provided by the financial regulatory system. Prudential supervision ensures that financial institutions are sufficiently capitalized, are not engaging in activities that are too risky, are liquid enough to meet their obligations, and are otherwise safe and sound. The Basel Committee on Banking Supervision wrote that "the key objective of prudential supervision is to maintain stability and confidence in the financial system, thereby reducing the risk of loss to depositors and other creditors."[29] And, as FDIC Vice Chairman Thomas Hoenig has said, "The best way to judge a firm's risk profile is through the audit and examination process."[30]

The current examination system, however, is often fragmented, with overlapping and duplicative responsibilities. A banking group that consists of a parent holding company, a subsidiary national bank, and subsidiary broker dealer would be subject to examinations by the Federal Reserve Board (for the holding company), the OCC (for the national bank), the FDIC (as the insurer of the national bank), the CFPB (for the national bank),[31] and the SEC (for the broker dealer). If the holding company also owned a state-chartered bank, then that bank would be subject to examination by the state and either the FDIC or a Federal Reserve Bank, depending on whether the state bank is a member of the Federal Reserve System or not. Each of these agencies has a specific mission and focus, leading examiners for the agencies to pursue different objectives. There is an opportunity for greater coordination and cooperation among the federal prudential banking agencies since they share a common safety-and-soundness goal and have limited resources.

While these agencies do not require exactly the same personnel and resources—the OCC's examiners, for example, need to know more about the intricacies of large bank commercial activities and lending and less about community banking than do the FDIC's—there is

considerable overlap. Some coordination occurs among these agencies today, but there is also duplication of expertise, human resources, operations, planning, management, and other functions. In addition, differing budget cycles within the agencies can complicate the ability of the agencies to allocate examination personnel in a complementary manner.

Moreover, more could be done to improve the quality of supervision. Increased compensation and training opportunities for examiners, along with a career path that is better defined by universities and regulators, for example, can help ensure that the overall quality of prudential examination is improved broadly and over the long term.

The task force therefore makes four main recommendations to improve the quality of prudential supervision:

Recommendation 1(a): Establish a Pilot Program for an Enhanced, Consolidated Examination Force for Insured Depository Institutions and Depository Institution Holding Companies

The task force recommends the creation of a pilot program for a consolidated examination force for the institutions subject to supervision by the three federal prudential banking agencies (the FRB, FDIC, and OCC). Such a program would improve and enhance the efficiency and quality of the examination and supervision of insured depository institutions and their holding companies through better coordination and training with improved efficiencies. **To test the feasibility of a consolidated examination force, and to identify and address the variety of operational issues associated with this concept, the task force recommends that the pilot program be overseen by the FFIEC.**

It is suboptimal for the various prudential banking agencies to share a similar safety-and-soundness function, yet operate independently. The task force believes the efficiency and quality of examination and supervision of insured depository institutions and their holding companies could be improved through the creation of a consolidated examination force for the institutions subject to supervision by the three federal banking agencies (the FRB, FDIC, and OCC). This approach contemplates an integration of examination personnel and related human resources functions under the direction of a "supervisory" committee within the FFIEC that would provide a coordinated examination focus for examiners. It would not, at this stage, impact the existing rule-writing or enforcement responsibilities of the respective agencies. However, the federal banking agencies would be able to draw from a common set of examiners with consistent training and uniform, dedicated expertise.

This approach would enable examiner teams to take advantage of interchangeable elements offered by each agency. At the same time, it would permit the development of specialized teams. For example, examiners could specialize in banks of certain sizes and complexities, geographic regions, or predominant lines of business (e.g., agricultural loans, small-

business lending, commercial real estate, and derivatives). This would provide a greater opportunity, for example, for an examiner who typically examines small, state-chartered agricultural banks in Minnesota to do the same for small, nationally chartered banks in Nebraska or Kansas.

The overall quality of bank examinations also would be improved by a series of other actions, described below, that are designed to provide a clearer, more rewarding career path for examiners.

Upon the eventual consolidation of prudential bank regulatory agencies, a fully consolidated bank examination force promises several advantages over the current, more fragmented system:

- Uniform standards for training and management of examiners and supervisors should lead to more consistent and translatable examination results and expectations, as well as streamlining the process for both regulators and financial institutions.
- Consolidation should improve communication among supervisory teams since examiners would be trained under a common framework and be overseen by a unified committee of supervisors drawn from the three agencies. Since financial stability can be threatened by a lack of communication among agencies, the advantages of this structure should be substantial.
- Integrating key support operations—such as hiring, training, compensation, and promotions—for examiners should make the management of the examination force more efficient and less costly compared with sustaining the same functions at multiple agencies.
- Consolidated budgeting for examiners and examinations would enable the agencies to better coordinate and apply examiner teams to particular lines of business or institutions.
- Regulators could better leverage their specialists, whose expertise would be usable across a wider set of institutions. This would improve the overall quality of examination teams, because those teams would be able to draw on a wider variety of experiences and best practices.
- Human capital among examination teams would be developed by providing greater opportunities for career advancement, consistent and higher compensation standards, and a better-defined and supported career path.
- As the Paulson Blueprint stated, "a more efficient, and thus competitive, system for federal banking supervision of state chartered-banks should effectively focus examination resources and avoid duplication."[32] The quality of state regulation would be significantly boosted by allowing individual states to leverage federal examination teams to assist in state examinations. State agencies often cannot afford to employ

multiple specialists or do not have the overall level of resources available to the federal agencies. To the extent that the federal examiner training and procedures incorporate individual state supervision objectives, state bank supervisors may elect to put greater reliance on accepting a federal examination in lieu of a separate state examination.[33] Federal regulators would also benefit from better information-sharing with states through this process.

These proposals exist in harmony with the dual banking system. The task force believes that the existence of both federally chartered and state-chartered banks provides great benefits, offering more choices for consumers and allowing for greater policy innovation by individual states. The consolidated examination force envisioned here will provide more and better resources to both state and federal jurisdictions, thereby improving the quality of supervision across the board.

INTERAGENCY MAKEUP

While the task force is proposing a consolidation of the safety-and-soundness examination process, the plan does not contemplate the incorporation of CFPB, CFTC, or SEC examiners in this consolidated examination force.[34]

The CFPB employs supervisors as well, but approaches examinations with a focus on consumer protection and activities rather than on safety and soundness and individual institutions. The CFPB was established by Dodd-Frank as an independent, standalone agency to allow it to pursue supervision according to a different set of goals. Therefore, while the task force recommends that the CFPB's Division of Supervision, Fair Lending, and Enforcement work closely with the consolidated examination force, the CFPB's examiners should not be included in the force.

The CFTC and SEC do not conduct examinations for institutional safety and soundness. Therefore, the two capital markets regulators also would not be included in this consolidated examiner force. They should, however, maintain and expand a dialogue with the prudential banking agencies on matters of mutual interest to the extent permitted under laws regarding the sharing of confidential bank supervisory information.

DEVELOPMENT AND COORDINATION OF THE PILOT PROGRAM

The FFIEC was established in 1979 to better coordinate principles, standards, and report forms among the financial banking agencies. The FFIEC's membership now includes the CFPB, FDIC, FRB, National Credit Union Administration (NCUA), OCC, and a state banking regulator selected by the Conference of State Bank Supervisors (CSBS). The chairmanship of the Council rotates every two years among its members. The FFIEC already conducts training for multiple agencies, with a focus on continuing education.[35] The FFIEC is designed to foster cooperation among its member agencies. Although not statutorily powerful, it has achieved some success in areas such as standardizing examination procedures and forms,[36] issuing joint policy statements,[37] and creating its IT Examination HandBook.[38]

For the purposes of the pilot program, the FFIEC should establish a Committee on Bank Supervision, the members of which would be the heads of supervision for the three

prudential banking agencies and the FFIEC's state banking regulator. The associate director of the CFPB's Division of Supervision, Enforcement, and Fair Lending would be included on the committee as a non-voting member, since the CFPB's examination staff would not participate in the pilot, but the Bureau's input would nevertheless be valuable. This Committee on Bank Supervision would be responsible both for building and executing the pilot program, and for laying the groundwork for full consolidation following the creation of the consolidated prudential regulator described in Recommendation 2. Specifically, the Committee should:

- Establish consistent supervisory priorities, protocols, and procedures that examination teams should learn and use;
- Develop one- and two-year plans for the process leading to completion of the examination force within a consolidated Prudential Regulatory Authority;
- Update or create as necessary any memoranda of understanding between bank regulators and the SEC, CFTC, and CFPB, on how each can and will leverage its expertise and knowledge to produce better bank examinations;
- Write and execute a memorandum of understanding between each prudential regulator and the OFR that would designate the OFR as the lead coordinating agency in data-collection efforts and would delineate the authorities and responsibilities of each agency in that process; and
- Work with state banking supervisory agencies to create memoranda of understanding on the interaction and responsibilities of state and federal regulators regarding banks for which there is mutual interest.

Concurrent with these steps, the FFIEC should work with the CSBS to define an initial scenario for a trial of a limited consolidated examination team. The pilot should:

- Be geographically limited, likely to one or two state(s);
- Include examinations of banks of different sizes, levels of complexity, and charters (i.e., at least one bank each that has a national charter, is a state-chartered member of the Federal Reserve System, and is a state-chartered non-member of the Federal Reserve system);
- Include examiners with jurisdiction from each of the agencies involved in the pilot, where each of the agencies would have overlapping jurisdiction with at least one other agency;
- Assign leadership of each examination team to a representative from the primary regulator—including both federal and state agencies—of the institution the team will examine;
- Ensure that each examination produces a single, combined report that is available to all agencies that participate in a particular exam;

- Involve a range of specialized experts from each agency;
- Be supported by funding and personnel resources contributed by participating agencies in proportion to the share of total assets being examined in the pilot program for which each agency is the primary regulator;
- Require post-mortem analysis after each examination to identify strengths and weaknesses in the examination process, ways to improve future examinations, and whether having direct access to the consolidated examiner pool and reports is beneficial to the agencies without primary supervisory authority over a given bank; and
- Conclude within a set time period (e.g., after two years).

The FFIEC's mission to better coordinate the examination process for financial institutions is a good fit for this task. And, setting up a program among multiple agencies and jurisdictions would be quicker and easier than creating a new body for the same purpose since the FFIEC includes each of the agencies that would participate in the pilot program, including a member that represents state regulators. Creating a consolidated examination force pilot program, however, will require the members of the Council to allow the FFIEC to properly coordinate the program.

At the conclusion of the pilot program, the FFIEC should adjust its proposed policies as warranted by its experiences.

Recommendation 1(b): Transition to Consolidated Examination Force

By the conclusion of the pilot, legislation will be necessary to formally consolidate the targeted agencies. For the transition, the task force recommends that the FFIEC be empowered to coordinate implementation of the consolidation through the Committee on Bank Supervision.

During the transition, the FFIEC would be responsible for setting employee policies and standards, conducting training for the group of examiners, and coordinating other common human resources and operational functions. Each of the three prudential bank regulatory agencies would have full and equal access to final examination reports produced by the consolidated force.

Since the overall quality of banking supervision in the United States relies heavily on how well state supervisory agencies do their work, the task force recommends that state agencies be allowed to augment their capabilities by requesting the use of examination teams and specialists from the consolidated examination force. State agencies would also have access to data and examination reports where appropriate. In exchange, those state agencies would be expected to contribute resources to the examination pool that is proportional to the benefits they derive from it. The terms of such arrangements would be

negotiated through memoranda of understanding between individual states and the FFIEC, and could include the contribution of funding, state examiner time, or other required resources.

As part of its coordinating role, the FFIEC should report on its efforts to improve the quality of bank supervision through these recommendations in its annual report to Congress. Similarly, the Congress should conduct regular oversight hearings to assess the progress made with this and other recommendations in this report.

Recommendation 1(c): Improve Examiner Compensation

The task force proposes that the Committee on Bank Supervision set market-influenced compensation goals for bank examiners.

As private-sector salaries in financial services have increased over the past few decades, it has become increasingly difficult for financial regulators to attract and retain the best and brightest. High-quality financial regulation requires a regulatory corps able to adapt its oversight commensurate with, and as rapidly as, the pace of innovation and other changes in industry practices. Although steps have been taken over the years to increase compensation for examiners, it has not increased at the same rate as those in the private sector. The subject should be regularly revisited and assessed using an objective, fact-based process.

A review of White House Office of Personnel Management data shows the following ranges, means, and medians for examination personnel at seven federal financial regulatory agencies:[39]

	CFTC	CFPB	FDIC	FHFA	NCUA	OCC	SEC
High Salary	$226,000	$245,000	$246,000	$255,000	$247,000	$260,000	$201,000
Low Salary	$63,000	$40,000	$50,000	$84,000	$47,000	$49,000	$83,000
Mean	$122,000	$109,000	$113,000	$151,000	$100,000	$122,000	$140,000
Median	$122,000	$103,000	$114,000	$147,000	$96,000	$120,000	$147,000

Personnel at these independent agencies are paid at a higher rate than employees on the federal government's General Schedule (GS) pay scale. The Financial Institutions Reform, Recovery and Enhancement Act of 1989 (FIRREA), gave the above regulators minus the CFPB the authority to set their own compensation schedules to keep them more competitive with private-sector salaries.[40] The CFPB was added to the list upon the passage of Dodd-Frank.

Similar individualized, anonymous data on examiner salaries is unavailable for the Federal Reserve Board and Federal Reserve Banks. However, 11 of the Reserve Banks provided BPC with salary ranges for their examination personnel. A comparison of their salary practices shows the following:[41]

Federal Reserve Bank	Low Salary	High Salary
Atlanta	$45,000	$171,000
Boston	$56,000	$203,000
Chicago	$38,000	$193,000
Cleveland	$37,000	$221,000
Dallas	$48,000	$158,000
Kansas City	$38,000	$144,000
Minneapolis	$43,000	$163,000
New York	$58,000	$371,750
Philadelphia	$40,000	$137,000
Saint Louis	$37,000	$159,000
San Francisco	$49,000	$324,000

Federal government salaries likely will never equal that of top private-sector jobs; nor should they. There are inherent differences between public-sector and private-sector employment. Private companies, particularly on Wall Street, tend to offer higher salaries for competitive purposes, but they also can subject employees to less job security and higher stress levels. Federal government jobs tend to offer substantive work, greater relative security, work-life balance, and a sense of public service at lower salaries. Nonetheless, compensation levels for federal examiners should be at a level sufficient to attract and retain high-quality individuals who are looking for long-term public-service careers.

The Committee on Bank Supervision should set compensation goals with these criteria in mind for each of the consolidated examination force agencies and review them annually to adjust rates accordingly.

Recommendation 1(d): Launch New Degree and Training Programs

The task force recommends that the Committee of Bank Supervision work with multiple colleges and universities to set up specialized undergraduate and master's degree programs for bank examiners.

In addition to training better supervisors, specialized undergraduate and graduate programs for examiners would raise the profile of examination as a career and allow degree seekers to be better prepared to hit the ground running when they join agencies.

Thousands of people in the United States are employed as bank examiners, an increasingly complex profession that requires technical proficiency and specialized skills and knowledge. The high demand for quality personnel is expected to grow in the coming years, because many current examiners are approaching retirement[42] and because Dodd-Frank and other financial regulatory reforms require greater supervisory efforts.[43]

The Committee on Bank Supervision will be best positioned to understand the needs of federal and state regulators and should develop a suggested curriculum for such a degree program with interested higher-education institutions. The FFIEC should also create processes to help place degree candidates and recipients with the FFIEC's member agencies for internships and career-path jobs. The FFIEC should set numerical goals for:

- The number of colleges and universities offering undergraduate and master's degrees in bank examination;
- The number of slots offered by federal financial regulatory agencies for bank examination degree-holders;[44] and
- Dates by which such goals should be achieved and how to accomplish them.

The task force's recommendation would complement current in-house training efforts by FFIEC member agencies, rather than replace them. While ongoing training should be the part of any regulatory agency, focused university training will ensure that people who decide to pursue bank examination as a career are better prepared for agency positions from day one.

Recommendation #2: Create a New Structure for Prudential Regulation

The task force recommends a new structure for prudential regulation that will result in each bank, bank holding company, and federally chartered insurance company having a single prudential regulator.

The current U.S. financial regulatory system is the result more of accretion than design. The system evolved over time, largely in response to individual financial crises, and with insufficient regard to questions of coordination and cooperation. As a result, the United States has a fragmented financial regulatory structure, which contributed to the financial crisis in part because individual regulators focused attention on their respective missions and no single regulator was charged with monitoring the financial system as a whole. The FSOC and OFR are designed to address part of this problem. Yet, additional steps should be taken to provide for greater coordination and cooperation among regulators. The

recommended consolidated examination force is an interim step toward a fuller reorganization of the U.S. banking regulatory system that will be more responsive to current market conditions. A structure where a single banking agency is responsible for prudential regulation will be more accountable to all stakeholders, including the public, regulators, and industry.

The task force proposes a new model under which:

- All individual banks and thrifts and their holding companies would be supervised and regulated by a new Prudential Regulatory Authority (PRA). The PRA's jurisdiction would include all banks—including systemically important banks (SIBs)—and thrifts, and their holding companies. The PRA would be the primary micro-prudential regulator and rulemaking body for individual financial institutions and holding companies. This would complement the Federal Reserve's repurposed role of focusing on more systemic, macro-prudential threats to the U.S. financial system.
- The FRB would retain its important role as a financial stability and macro-prudential regulator for systemic risk, and have the power to recommend enhanced prudential standards for financial institutions as part of its macro-prudential role. Working with an enhanced FSOC and OFR, the FRB would focus its efforts on monitoring and identifying market trends, activities, and conditions that need greater systemic attention by a macro-prudential regulator able to look across individual institutions. The Federal Reserve would also have full and immediate access to all PRA exam reports and data for use in achieving its financial stability and other goals. The Federal Reserve would be the unified financial stability regulator for systemically important non-bank non-insurer financial institutions, including retaining its role as the primary supervisor for FMUs. The agency would transfer its remaining supervisory authority for banks and thrifts, and their holding companies, to the PRA.
- The FDIC would focus on its current roles as depository insurer and resolution authority and transfer its primary supervisory authority over state non-member banks to the PRA. The FDIC would have backup supervisory authority over all institutions that it insures and full and immediate access to all exam reports and data.
- A single federal insurance regulator would oversee and supervise a modern national insurance charter that would be mandatory for all insurance companies designated by the FSOC as SIFIs, but be optional for all other companies that wanted to meet the needs of their customers from a single national charter and one set of regulations.

The task force believes these changes would result in clearer lines of authority and greater transparency; greater focus, efficiency, and accountability; cost savings; and improved quality of financial supervision. Such changes would also lead to better regulation and regulatory outcomes for all stakeholders and for the U.S. economy.

Recommendation 2(a): Create a New Prudential Regulatory Authority

The task force recommends establishing a new Prudential Regulatory Authority (PRA), which would combine the OCC with the existing primary bank supervisory authority of the Federal Reserve and FDIC.

The idea that the U.S. financial regulatory system is too fragmented is not a new one. The FDIC once compiled a list of 24 major proposals for regulatory restructuring that had been made since the 1930s, none of which were implemented.[45] Inertia and turf battles between agencies and congressional committees are among the dynamics that make significant changes to the regulatory structure difficult.

The financial crisis temporarily changed those dynamics and made some optimistic that a more streamlined regulatory structure could be achieved in what later became the Dodd-Frank Act. While Dodd-Frank eliminated one agency, the OTS, it created three new ones: the CFPB, FSOC, and OFR. Despite eliminating the OTS, Dodd-Frank kept responsibility for prudential regulation in the hands of multiple agencies.

Greater consolidation of prudential regulation would benefit the U.S. regulatory structure in a number of ways. First, it would reduce the likelihood of gaps that inevitably form over time as the result of market dynamics and innovation, changes to statutes, interagency conflicts, and poor communication. A single prudential regulator would not be immune from these problems, but it should be better able to limit them through easier communication and a more rapid response in a crisis.

A second set of advantages of a single prudential regulator are similar to those already outlined in the task force's recommendation on a consolidated examination force. The efficiencies and other benefits of consolidating training, human resources, and other operational functions could be fully realized by joining them into a unified structure.

Third, a single prudential regulator would limit future opportunities for regulatory arbitrage. Dodd-Frank eliminated the OTS in part because some firms elected for a thrift charter in order to engage in a wider range of activities and to fall under the jurisdiction of an agency that did not have sufficient resources to effectively supervise all of its institutions. Subjecting all FDIC-insured banks and their holding companies to the same rules and requirements makes it harder to game the system.

Fourth, having a single prudential regulator makes it easier to assign responsibility for the successes and failures of supervision. This is particularly important for policymakers considering changes and to the public in demanding high-quality regulation.

One criticism of consolidating supervision is that it can lead to groupthink and reduced innovation that can be mitigated by competition between multiple agencies. Such concerns are a danger at any organization, each of which should work to encourage new ideas, diversity, and appropriate management and processes to account for them. It is not clear,

however, that a fragmented structure does not create the same dangers with fewer benefits. Multiple U.S. regulatory agencies, for example, were of a similar mind that risky pre-crisis practices in the mortgage finance industry were not likely to lead to a financial crisis. The task force believes the better solution is to set clear lines of responsibility for those agencies within the regulatory structure and to ensure an appropriate balance of authority and resources for agencies responsible for macro- and micro-prudential issues.

The PRA would be responsible for safety-and-soundness regulation of commercial banks and thrifts, and their holding companies. Consolidated supervision and regulation of holding companies and their bank or thrift subsidiaries is particularly appropriate for those banking organizations in which the bank is the principal operating entity and the holding company is merely a shell. Consolidated supervision of holding companies and their bank or thrift subsidiaries also is appropriate for other larger organizations since it would eliminate the potential for conflict or overlap in the regulation and supervision of the parent company and a subsidiary bank or thrift.

Federal Reserve and FDIC supervisory responsibilities for member and non-member state banks would be shifted to a state banking division within the PRA to minimize disruption. A small bank division inside the PRA would focus on banks and thrifts with assets less than $10 billion.

The PRA would be governed by an independent five-person board, the members of which would be subject to staggered five-year terms and Senate confirmation, and no more than three of whom could belong to a single political party. Board structures are advantageous because, among other things, they better allow for differing points of view, are more stable, and have a larger capacity than single-director agencies. However, there are real disadvantages to the board structure, including the potential for more gridlock. To avoid that outcome, the task force recommends a structure that includes a relatively strong chairman. First, the president would be able to appoint as chairman any board member who has been confirmed to that post. This is similar to the current SEC model. In addition, the chairman would have the ability to cast the deciding vote in a case where the board vote results in a tie. Finally, the staff of the PRA would report to the chairman. Taken together, these provisions would reduce gridlock and help make the PRA a more effective agency.

The PRA would fund itself through an equitable assessment regime similar to that of the OCC, which bases assessments on the total assets of supervised institutions.[46] Unifying all bank supervision in a single agency will limit the problem of charter-shopping that can lead regulators to relax oversight to prevent institutions they supervise from switching charters to fall within the jurisdiction of another agency.

The new structure for prudential supervision recommended in this report works in harmony with the dual banking system. Today, state banks do not pay fees to the FDIC or Federal Reserve for their federal examinations of state-chartered banks. That state of affairs should continue after federal supervisory authority for state banks transfers to the PRA. The Federal Reserve and FDIC will have full and immediate access to the examination output of

the PRA, but will no longer need to support the supervisory staff that they do today. Therefore, it makes sense for the FDIC and Federal Reserve to fund the PRA's cost of supervising state-chartered banks currently supervised by those two agencies.

Finally, the PRA would inherit the OCC's current seat on the Basel Committee on Banking Supervision, while the FDIC and FRB would retain their membership on the same body.

Recommendation 2(b): Focus the Federal Reserve on Systemic Risk and Macro-Prudential Supervision

The task force recommends focusing and enhancing the Federal Reserve's responsibility for financial stability and systemic risk through a more clearly defined role for macro-prudential regulation and supervision.

Having transferred its primary supervisory authority of bank and thrift holding companies to the PRA and of SIFI insurance companies to a new federal insurance regulator, the task force envisions the Federal Reserve increasing its focus as a macro-prudential regulator.[47] In this capacity, the Federal Reserve monitors activities, trends, and emerging issues in the financial system as a whole, adjusting its management of the economy based on the results of more focused macro-prudential surveillance and standard-setting. A memorandum of understanding should be reached with the PRA, CFPB, and OFR so that the Federal Reserve has full and immediate access to relevant data to support its systemic oversight and monitoring of the economy. In addition, the FRB would retain supervisory powers over financial market utilities that conduct payment, clearing, or settlement activities; its authority to serve as a source of liquidity in extraordinary times; and its conduct of monetary policy.

Although primary supervisory authority would be transferred from the Federal Reserve, the agency would retain backup supervisory authority over systemically important banks and insurance companies, and their holding companies. When the FRB deems it necessary for financial stability purposes, the agency would have the authority to examine an institution by sending in a supervisory team of its own. As noted above, the Federal Reserve also would have the ability to recommend heightened prudential standards for financial institutions as part of its own heightened macro-prudential role.

Recommendation 2(c): Focus the FDIC as insurer and resolution authority

The task force recommends that the FDIC be more focused on its role as insurer and resolution agency, and not on its role as a primary, day-to-day supervisor of state-chartered, non-member banks.

The FDIC serves a critical role as deposit insurer. In Dodd-Frank, the agency was given a significantly larger role in the recovery and resolution of large bank and non-bank

institutions. BPC's Failure Resolution Task Force largely commended the FDIC in its approach to handling their new resolution authority under Title II of Dodd-Frank.[48] Transferring primary bank supervisory authority to the PRA will better focus the FDIC on these two important functions, while empowering the agency with backup supervisory authority will ensure it has access to information about the health of the institutions it insures through the Deposit Insurance Fund (DIF).

To properly perform these functions, the FDIC must have a good understanding of the condition of insured institutions. However, it does not follow that the agency must be the primary regulator and supervisor of a subset of state-chartered banks to access such information. Indeed, the FDIC does not now have primary authority over banks that control most of the deposits it insures through the DIF. The FDIC and PRA should develop a memorandum of understanding, similar to that between the PRA and Federal Reserve, making certain the FDIC has full and immediate access to all PRA data required to fulfill its two primary roles.

In addition, the FDIC should retain backup supervisory authority over all the institutions that have depositors that are covered by the DIF. In practice, this means that the FDIC would be able to conduct an on-site review of an institution that it believes is at risk of failure—necessitating an FDIC resolution proceeding—or of triggering the FDIC's use of the DIF to keep the institution's depositors whole. The FDIC's examination priorities in this area, however, should be focused on troubled banks that do or might present a danger of losses to the DIF.

Recommendation 2(d): Authorize New Federal Insurance Charter and Regulator

The task force recommends the creation of a new federal insurance charter and Federal Insurance Regulator (FIR), which would be the primary insurance regulator for any insurance company designated as systemically important by the FSOC or any company that opts for a national insurance charter to better serve its customers.

Dodd-Frank created the FIO as the first federal agency with the responsibility to monitor the insurance industry, but did not give it the power to regulate insurance companies or write rules.[49] Two insurance companies, AIG and Prudential, already have been designated by the FSOC as SIFIs. At least one other insurance company, MetLife, is being considered for designation, and others could be in the future.

Creation of the FIO was an appropriate step to give the federal government a better insight into the insurance industry. However, the designation of insurers for supervision by the FRB, whether as a result of being designated as SIFIs or structured as thrift holding companies, creates a system in which some insurers will be subject to supervision by both states and the FRB. This creates a potential for conflict and competitive inequality, especially because the focus and policies of state insurance regulators and the FRB differ in many respects.

And, it creates a situation where SIFI and other insurance companies face the extra costs of federal regulation[50] without the benefits that normally go with it, such as being subject to consolidated regulation by a single federal agency rather than multiple state regulators.

The FIO is a first step toward a more rationalized national insurance regime, something that almost all other developed economies have. The presence of large firms that have been designated as systemically important begs the question of why the United States does not also have a national charter and federal regulator with rulemaking and enforcement authority and a detailed knowledge of the insurance industry. This is especially true for those insurance companies designated by the FSOC as systemically important, but also for others that want to opt-in based on business strategy, customer services, and other considerations. A 2013 report by the Financial Stability Board (FSB) noted that the U.S. system is fragmented domestically, which affects America's ability to speak with a single voice in international insurance forums:

> The architecture for insurance supervision in the US, characterized by the multiplicity of state regulations, the absence of federal regulatory powers to promote uniformity and the limited rights to pre-empt state law, constrains the ability of the US to ensure regulatory uniformity in the insurance sector. While the FIO represents the US on international insurance matters and negotiates covered agreements, only the states have the authority (but are under no legal obligation) to implement laws that are consistent with those agreements and international standards.[51]

In response, the FSB recommends that:

> US authorities should promote greater regulatory uniformity in the insurance sector, including by conferring additional powers and resources at the federal level where necessary. The FIO should enhance its monitoring of the sector through increased use of non-public information, and be further strengthened to be able to take action to address issues and gaps identified.[52]

Systemically important insurance companies should be subject to federal regulation, but such regulation should not apply bank-centric rules to insurance companies, a point acknowledged by the Federal Reserve Board when it promulgated its final rule on heightened prudential standards for large banks under Sec. 165 of Dodd-Frank on February 18, 2014.[53] Insurance regulation needs to take into account the significant differences in the business models, balance sheets, revenue streams, and risk profiles of insurance companies from banks and other financial institutions. For example, the term-structure of liabilities for an insurance company is very different from that of a bank, which would argue for a fundamentally different approach to determining appropriate levels of capital and liquidity requirements for each.[54]

This is not to say that insurance companies cannot generate systemic risk. However, an FIO 2013 report noted that:

> Financial stability concerns arise more often when traditional insurers engage in non-traditional activities, such as derivatives trading, securities lending, or other shadow banking activities, or when they offer products that have features that make them susceptible to runs.[55]

Macro-prudential oversight of the insurance industry can help to identify systemic risk that may be created within that sector, such as those that emanated from AIG prior to the financial crisis.

The FIO report further "recognized uniformity as a central concern regarding the current system of insurance regulation in the United States. ... The impact of this lack of uniformity is felt acutely in both prudential matters and in certain areas of marketplace oversight. To address the inefficiencies and lack of uniformity in the state regulatory system, federal involvement will be necessary."[56]

The task force agrees in general with the Paulson Blueprint and the proposed National Insurance Act of 2007 that an optional national insurance charter should be established. Any insurance company that opted into the national charter would be regulated by the FIR, which would replace the FIO, instead of by one or more state insurance regulators. The FIR would be given authority similar to other financial regulatory agencies to supervise and to write and enforce rules and regulations on its chartered entities. Insurance companies designated by the FSOC as SIFIs would be required to adopt the national insurance charter and would be supervised and regulated by the FIR. Implementation of this recommendation will put the U.S. financial regulatory system on an equal footing with most other G20 countries and allow for more focused regulation of insurance.

Recommendation 2(e): Phase Out the Thrift Charter

The task force recommends the phase-out of the thrift charter after three years in favor of a modern banking license designed to meet the dynamic needs of all consumers of bank products and services.

Both commercial banks and non-banks originate mortgages, so the need for a separate legal charter has been overtaken by marketplace developments. In addition, Dodd-Frank contained provisions that removed several of the remaining advantages that thrifts enjoyed compared with banks. These changes include subjecting thrift holding companies to formal capital requirements, giving banks parity with thrifts in the ease of establishing branches, and making state consumer financial laws apply to subsidiaries of federal thrifts.[57] Dodd-Frank also closed the OTS, the agency that had provided consolidated regulation to thrift holding companies and their subsidiaries, and divided the OTS's responsibilities among the FRB, OCC, FDIC, and CFPB.

However, some gaps remain between the federal thrift and bank charters. Dodd-Frank, for example, still permits thrift holding companies to engage in some activities that are

impermissible for banks, such as real estate development and management. Moreover, Dodd-Frank left in place portfolio and lending limits of federal thrifts, a disadvantage to the thrift charter—and one that could pose risks in restricting the ability of thrifts to diversify their holdings.[58]

The federal thrift charter was created in 1933 to increase the availability of residential mortgage liquidity. Changes in the marketplace and in statute over time have eroded the logic for retaining a separate federal thrift charter, and the advantages to financial institutions in opting for a thrift charter. Both the Paulson Blueprint and Geithner white paper recommended the eventual elimination of the charter and, in the interests of simplifying the U.S. regulatory structure, the task force agrees. Therefore, the task force proposes that the thrift charter expire three years after the PRA begins operation, to be replaced by a new, single federal banking charter with broad consumer and commercial banking powers that is fully empowered to meet the needs of all potential bank customers.

Recommendation 2(f): Allow the chair of the Federal Reserve Board to fill the position of vice chairman for supervision absent a presidential nominee

The task force recommends that the chairman of the Federal Reserve Board be allowed to fill vacancies for the position of vice chairman for supervision, absent a nomination by the president, with an acting vice chairman.

Earlier, the task force recommended that the Federal Reserve be focused on macro-prudential supervision. The position of vice chairman for supervision at the FRB that was created in Dodd-Frank should accordingly be updated to reflect this change. Therefore, the vice chairman for supervision should be given direct responsibility for implementing and overseeing the FRB's new macro-prudential mandate, including its backup supervisory role.

Further, it is incumbent upon the president to nominate someone to fill the role of vice chairman for supervision at the FRB. The position, created on July 21, 2010, has yet to see a single nominee nearly four years later. There is no persuasive reason for this delay in giving the FRB the focus and leadership on systemic risk it needs, as well as the necessary financial stability supervision to fulfill its new oversight role for all of finance, not just the banking system.

Filling this position is important for the quality of supervision in general, and particularly so to implement the task force's plan to improve upon the current system. Therefore, the task force recommends that Congress give the FRB's chairman the authority to name an acting vice chairman from the roster of existing Senate-confirmed FRB governors at any time the position of vice chairman for supervision is vacant and no one has been nominated by the president to fill the position. A different person subsequently nominated by the president and confirmed by the Senate would replace the acting vice chairman.

Recommendation #3: Better Address Systemic Threats by Empowering the FSOC and OFR

The powers of the FSOC need to be clarified to ensure greater accountability and the Council's ability to fulfill its statutory mandate under Dodd-Frank.

The creation of the FSOC and its research arm, the OFR, are potentially positive features of the Dodd-Frank Act. Prior to the crisis, U.S. regulators were too often either unaware of systemic threats to the financial system, or unable to build consensus for corrective action around known risks.

The reasons for this were more complex than negligence. For example, the doctrine of prompt corrective action (PCA) was at the heart of the Federal Deposit Insurance Corporation Improvement Act of 1991, key legislation that was passed to attempt to correct the mistakes that led to the savings and loan crisis. PCA mandated progressively higher penalties on banks as their capital ratios got worse in an attempt to quickly stop institutional deterioration. The use of PCA was an important tool for regulators, who generally believed that bank safety and soundness degraded over time as the result of deteriorating asset quality. Regulators realized during the crisis of 2007 and 2008 that PCA was insufficient because asset quality can worsen rapidly and unexpectedly. More, better, and timelier information on the health of financial institutions proved to be necessary. Accordingly, the FSOC and OFR were given macro-prudential roles in the U.S. regulatory system. However, neither entity has yet to fulfill its promise, in part because of limitations Dodd-Frank made on their respective authorities.

The FSOC's ten voting and five non-voting members are a broad representation of bank and non-bank regulatory entities that includes agencies that do not regulate any institutions designated as systemically important, or requiring enhanced supervision for systemic purposes. The FSOC has been meeting since October 2010 and has designated three non-bank institutions—first AIG and GE Capital,[59] and then Prudential[60]—as SIFIs and recommended that the SEC implement additional regulations on money market mutual funds.[61] Despite these actions, the Council's effectiveness in achieving its mandate has so far been largely untested.

The FSOC is charged with serving as an information-sharing and regulatory policy-coordinating body for its members agencies. The FSOC has generally held meetings monthly instead of quarterly as statutorily required, showing that the body appears to have become a useful forum for agencies to discuss issues of mutual concern. However, it is not evident that this dialogue is producing greater coordination or cooperation among member agencies. In fact, there is at least anecdotal evidence of significant competition among regulators in this post-Dodd-Frank period.[62] The ability of the FSOC to fill a greater coordination role is limited by the fact that each member of the FSOC remains an independent agency, and the FSOC has little ability to require its members to take any specific actions they don't want to take. The FSOC does have the authority to override

actions by CFPB, but the standard for exercising that authority is very high.[63] The FSOC also has the power to recommend actions to its members related to specific activities and products. An agency, however, is not required to accept any such recommendation.

An example of the FSOC's recommendation authority occurred in connection with the regulation of money market mutual funds. When the SEC could not reach agreement on a package of additional regulations to apply to money market mutual funds, then-SEC Chairman Mary Schapiro worked to convince the FSOC to propose recommendations for a package of reforms.[64] The SEC sought public comment on this issue, but has yet to take action on the matter.

In the end, the effectiveness of the FSOC and OFR cannot be gauged until it can be seen how the regulatory apparatus will respond and adapt to a future, potentially different kind of crisis. However, there are steps that can be taken to help improve our chances of better anticipating, preventing, or mitigating the impact of that next crisis.

Recommendation 3(a): Grant the FSOC authority to set standards and safeguards on activities or practices that present systemic threats

The task force recommends that the FSOC's authority under Section 120 of Dodd-Frank be strengthened to give it the power and responsibility to impose "heightened standards and safeguards" when a supermajority of the Council determines that an activity or practice likely poses a significant threat to our financial system.

Given the enormous economic and social costs associated with financial crises, the FSOC was vested with authority to respond to substantial threats to the financial system. Section 120 of the Dodd-Frank Act allows the FSOC to recommend that its member agencies adopt "new or heightened standards and safeguards" for "a financial activity or practice ... if the Council determines that the conduct, scope, nature, size, scale, concentration, or interconnectedness of such activity or practice could create or increase the risk of significant liquidity, credit or other problems spreading."[65] As noted earlier, the FSOC used this authority when it recommended that the SEC adopt further reforms to address the systemic risk posed by money market mutual funds to the financial system.

Yet, the power to recommend is not the power to require action. FSOC member agencies are not required to follow the recommendations of the Council, which must rely on the moral suasion to convince an agency that receives recommendations to act on them. If the safety and soundness of the financial system is to be given the priority it should have, the FSOC should have the authority to act to respond to systemic threats.

Therefore, the task force recommends that the FSOC's authority under Section 120 be expanded to require member agencies to implement heightened standards and safeguards when an activity or practice constitutes a significant threat to the financial system. Such

authority could have been used in the 2000s, for example, to improve loan underwriting standards that had deteriorated so much prior to the financial crisis or to raise capital and/or liquidity. This authority will not stop every systemic threat, but it will give regulators another tool to prevent them.

Recommendation 3(b): Empower the FSOC to mediate disputes among member agencies

The task force recommends that in cases where two or more agencies charged by Congress with writing rules or regulations cannot agree on a final rule more than 180 days after their congressionally mandated deadline for doing so, the determination of the final rules or regulations will be made by a vote of the FSOC.

Dodd-Frank mandated numerous instances where two or more agencies were required to jointly write and promulgate rules and regulations. Perhaps the most famous case was the so-called Volcker Rule regulations, with Congress giving rulemaking responsibility to five different agencies.[66] Regulators missed the deadline for adopting final rules to carry out the Volcker Rule by more than two years,[67] and the new regulations will now go into effect in 2015, three years after the deadline set in Dodd-Frank.[68] At one point in the process, it appeared possible that the regulators would issue multiple, potentially conflicting Volcker Rule regulations, an outcome opposed at the time by BPC's Capital Markets Task Force.[69] While joint rulemakings have the advantage of drawing on multiple perspectives, too many times the process has resulted in interagency friction and missed deadlines.

Section 112 of the Dodd-Frank includes as a duty for the FSOC to "facilitate information sharing and coordination among the member agencies and other Federal and State agencies regarding domestic financial services policy developments, rulemaking, examinations, reporting requirements, and enforcement actions."[70] In addition, Section 119 gives the FSOC authority to recommend a method to resolve disputes among two or more agencies.[71] Any recommendations of the FSOC, however, must be requested by at least one of the agencies involved in a dispute and are non-binding on the agencies.

The task force recommends giving the FSOC more active power to resolve disputes. In cases in which two or more regulators miss statutorily imposed deadlines for agreeing on rules or regulations by more than 180 days, the resolution of such interagency disputes would move into the hands of the FSOC. Each agency responsible for the joint rulemaking would be required to submit its proposed rule to the FSOC. The FSOC chair would have the option of advocating one of the options submitted by an agency or submitting an alternative proposal that combines elements from two or more proposed rules. The FSOC members would then vote on the set of options, using approval voting to decide on the final rule or regulation.[72]

In practice, this proposed authority should never have to be used. The threat of having rulemaking authority taken out of their hands should be a powerful incentive for agencies to reach agreement among themselves before deadlines elapse.

Recommendation 3(c): Focus regulators on institutions that pose the greatest potential systemic risk.

The task force recommends raising the threshold from $50 billion to $250 billion for bank holding companies to be subject to enhanced supervision due to their systemic importance, and to make the threshold presumptive.

Dodd-Frank automatically subjects all bank holding companies with more than $50 billion in assets to heightened prudential standards. The structure for this regulation is similar to that for non-banks that have been designated as SIFIs. This provision was put into place so that banks and non-banks that could generate substantial risk to the financial system by their failure would have a different and enhanced level of regulation applied to them.

Enhanced prudential standards for the largest, most systemically important financial institutions are appropriate. However, the task force believes that banks of about $50 billion are generally not systemically important—or at the least the threshold is arbitrary and does not take other important factors into account—and therefore the threshold for automatic application of heightened prudential standards is too low. The size of a bank's balance sheet is one important factor in determining the systemic risk it can generate. Adjusting the threshold should allow regulators to focus more resources on a smaller set of institutions that presents the greatest potential systemic risk.

The task force therefore recommends a new threshold for designating bank holding companies for enhanced regulation be set at $250 billion, above which institutions are generally more likely to be systemically risky than institutions of $50 billion in size.[73] Since this new threshold is also arbitrary, the task force recommends adding regulatory flexibility in applying it to individual institutions. Therefore, the new line at $250 billion would not be an automatic threshold like the current $50 billion line.[74] Instead, institutions above $250 billion would be presumed to be systemically important, but could bring evidence to appeal their designations to the FSOC. Similarly, institutions below $250 billion would be presumed to not be systemically important, but the FSOC could designate them as SIFIs based on available evidence. In weighing evidence in either situation, the FSOC would use a process similar to the three-stage process it uses in deciding on non-bank SIFI designations. The FSOC would consider five factors in determining whether an institution is systemically risky: an institution's size, interconnectedness, substitutability, leverage, liquidity risk, and maturity mismatch.[75] A vote to overturn this "positive" or "negative" presumption for institutions either below or over the $250 billion line would require a two-thirds vote of FSOC membership, the same as it is now for designation of non-bank financial institutions.

Recommendation 3(d): Realign Voting Membership of the FSOC

Dodd-Frank was right to include input from a wide variety of sources on the FSOC, but including ten members with equal votes (aside from the chairman) was more a concession to political reality than a recipe for an efficient structure. For example, while it is useful to have representation on the FSOC from the NCUA, it makes little sense for the NCUA to have a vote equal to the Federal Reserve on all matters before the Council, particularly when the NCUA does not oversee a single institution that meets the criteria established by Congress or the FSOC as requiring enhanced supervision due to systemic importance.

To align the Council's membership more closely with its mandate, the task force recommends that the following changes be made to the FSOC's voting membership:

1. The director of the OFR should become a voting member. As part of the task force's plan to make the OFR more independent and powerful, it makes sense to raise its profile within the FSOC and give it more say on macro-prudential matters.
2. The director of the FIR should replace the FIO director on the FSOC and become a voting member. With the elevation of the FIO to the status of a full-fledged regulatory body with oversight of a national insurance charter, the FIR should be similarly elevated to voting status within the FSOC, particularly since it will have jurisdiction over at least two SIFIs.
3. The chair of the NCUA should become a non-voting member. Credit unions are an important part of the U.S. financial system, but they generally are small and do not figure into macro-prudential discussions. To the extent they do, a credit union voice will still be represented on the FSOC, but without a vote.
4. The director of the PRA should replace the director of the OCC.
5. The chair of the new capital markets regulator should replace the chairs of the SEC and CFTC.

Taken together, these actions would result in an FSOC with the same number of voting members as it has today, but better focused on macro-prudential issues. The FSOC would have one fewer non-voting member than it has now.

Recommendation 3(e): Improve FSOC Accountability and Transparency

Because of the new powers the task force recommends conferring on the FSOC, the task force believes it is particularly important to improve the Council's accountability and transparency. The task force recommends fully implementing the GAO's 2012 recommendations to accomplish this goal.[76] These recommendations include creating a process for better communicating its discussions to the public; developing and utilizing advisory committees as authorized under Dodd-Frank and as envisioned by the FSOC's 2010

Dodd-Frank implementation plan;[77] performing economic impact assessments on non-bank SIFI designations; improving its strategic-planning and performance-measurements systems; and assigning accountability for monitoring recommendations made in the Council's annual reports. The use of more open forums to discuss FSOC business would also be helpful. The FSOC should also consider releasing additional details about the closed-door conversations that occur during their regular meetings, much like the Federal Reserve does when it release detailed minutes from its Federal Open Markets Committee meetings.

Recommendation 3(f): Provide Greater Independence to the OFR

The task force recommends that the OFR be removed from the Treasury Department and established as an independent entity to maximize the OFR's ability to identify systemic threats in an unbiased and independent manner.

The OFR was set up as an office within the Treasury Department. In fact, the Treasury's organizational chart shows the director of the OFR reporting to the undersecretary for domestic finance.[78] While this structure may seem to guarantee that the OFR would be at least to some degree captive to the culture and outlook of the Treasury Department, the OFR has latitude to determine with how much independence it will act.[79] The OCC is set up as a separate bureau within Treasury, but it has a long tradition and history of operating independently from the Treasury with respect to the regulation and supervision of national banks.

U.S. financial regulators were set up as independent agencies to give their decision-making a measure of insulation from political influence. Because the OFR has the responsibility to provide unbiased information and critical analysis and insights to the FSOC and other regulatory agencies, freedom from politics is perhaps more important for it than any other agency.

Because of its unique role among financial regulators, it is critical that the OFR be established structurally in a way that allows and encourages it to offer objective, thoughtful, far-seeing, and timely analysis and recommendations that are as free from political influence as possible. The task force therefore recommends that the OFR be removed from the Treasury Department and set up as an independent entity. This action would allow the OFR to speak unambiguously with its own voice on systemic, macro-prudential matters.

The OFR should also consider whether it should remain headquartered in Washington, DC. It may be that locating in New York—or Boston, Chicago, or San Francisco—would give the OFR the best perspective on its portfolio of issues. The OFR should choose its headquarters—and potentially regional, satellite offices—based in large part on which location gives it the best opportunity to attract and retain top-level talent, whether from the academic, private-sector, or nonprofit communities. Such considerations are one reason the Federal Reserve maintains a strong Reserve Bank in New York. Over the years, there have

been many talented people who would have had no interest in working in Washington at the Federal Reserve Board who did decide to work for the Federal Reserve Bank of New York.

Recommendation 3(g): Grant greater independence for OFR and FSOC budgeting

The task force recommends that a two-thirds vote of the FSOC be required to veto the OFR's budget.

The OFR is responsible for setting the budgets for itself and the FSOC. Dodd-Frank gave authority to the OFR to assess SIFIs at a level to cover that budget, with the assessment schedule subject to approval of the FSOC.[80] So, while the OFR and FSOC have control over their own funding, it is subject to a check by FSOC members.

Such checks are important to promote accountability. However, if the OFR acts in the independent role that the task force envisions, it is conceivable that it will at times publish opinions and observations that are critical of FSOC member agencies, which could cause those agencies to want to limit the OFR's budget. In the interest of ensuring the independence of the OFR, the task force recommends that a two-thirds vote of the FSOC be required to veto the OFR's budget, rather than requiring a simple majority of FSOC members to approve it.

Recommendation 3(h): Centralize data collection

The task force recommends that the OFR be designated as responsible for coordinating the collection of all financial data by independent financial regulatory agencies. Such collection should be done in consultation with other regulators to ensure that a comprehensive suite of data is collected. This change would create a single point of contact for data collection for regulated entities and help to minimize overlapping, redundant, and conflicting data requests.

The fragmented nature of the U.S. financial regulatory system can lead to a lack of coordination among agencies in a variety of functions, including data collection from regulated entities. Overall regulatory effectiveness would be improved, and confusion among regulators and regulated entities reduced, by allowing the OFR to take a leading role in data collection across agencies.

Recommendation 3(i): Create a financial war-gaming center[81]

The OFR is charged with "seeing around corners" to help regulators understand and predict which current risks could lead to future scenarios of financial distress or crisis. The U.S. military performs a similar function in the national security field; it must anticipate where future threats to American security may arise in the near- and longer-term.

The Pentagon has numerous tools at its disposal to help it better understand and predict such threats, one of which is war-gaming, in which theories about threats and responses can be tested routinely in a simulated environment. The OFR should borrow a page from military planners and create a financial war-gaming center, which would bring together thought leaders from academia, the private sector, government agencies, and think tanks to simulate and respond to potential systemic threats.

A war-gaming center's first mission would be to model scenarios based on a continuous and broad horizontal review of potential long-term market risks. It should pay attention to risks that could give rise to high-impact events, including low-probability "black swan" events. The center's second mission would be to identify risks of regulatory failure, including gaps in oversight and risks of regulatory capture. Finally, the center would help the OFR present options to policymakers, regulators, and market participants to respond to potential emerging risks. In theory, this kind of analysis would help all stakeholders to adjust before more drastic and potentially costly actions are necessary.

Although it is impossible to accurately and precisely anticipate all future risks, a financial war-gaming center would make stakeholders more aware of emerging risks and help them to communicate better and think more creatively in real time about those risks. The more thinking that can be done about threats before they occur, the better chance both policymakers and regulators have to be prepared for future systemic stress events.

These steps will improve the OFR's efficiency and ability to provide the best possible information and recommendations to the FSOC and our other financial regulators.

Taken together, these recommendations will add "teeth" to enhance the critical functions of the FSOC and OFR, improve regulatory efficiency, and maintain a proper balance between the FSOC and OFR, and the FSOC's member agencies.

Recommendation #4: Create a Single Capital Markets Regulator

The task force recommends the creation of a single, modern Capital Markets Authority that operates across the equities and futures markets for all capital market instruments and providers.

Calls in recent decades to merge the CFTC and SEC into a single capital markets regulator have been numerous. The logic for doing so has become harder to refute since it has been more difficult to clearly define the space supervised by each agency since Congress created the CFTC as a separate agency in 1974. Innovations and techniques have cross-pollinated and blurred the line between securities and futures trading, leading to turf battles between the two agencies and confusion among those regulated by them. Disagreements between the two agencies can cause friction with U.S. trading partners. The United States is the only OECD country without a single capital markets authority. International cooperation is

increasingly important and being able to speak with a unified voice on such issues on the global stage is a worthwhile and achievable goal. The task force believes, therefore, that there is little benefit to keeping the CFTC and SEC as separate entities. Furthermore, significant gains for the financial system, financial institutions, and their customers would be realized by the merger of the two agencies. As the Paulson Blueprint stated:

> Product and market participant convergence, market linkages, and globalization have rendered regulatory bifurcation of the futures and securities markets untenable, potentially harmful, and inefficient. The realities of the current marketplace have significantly diminished, if not entirely eliminated, the original rationale for the regulatory bifurcation between the futures and securities markets.[82]

The reasons a merger has not taken place are well known. The SEC is, like most financial regulators, under the purview of the Senate Banking Committee and House Financial Services Committee, while the CFTC is subject to the jurisdiction of the Senate Agriculture Committee and the House Agriculture Committee. While the overlap of securities and futures markets is substantial, each pair of committees is understandably reluctant to cede its authority in an area that impacts its different constituencies.

Although past attempts at a merger have shown it to be politically difficult, political realities can unexpectedly shift, particularly in response to financial crises. Moreover, the potential advantages to a merger are significant and include: a clearer regulatory structure for U.S. capital markets; eliminating the ongoing friction between the CFTC and SEC; a single U.S. capital markets voice in international negotiations; and more efficient markets from reducing duplicative oversight requirements.

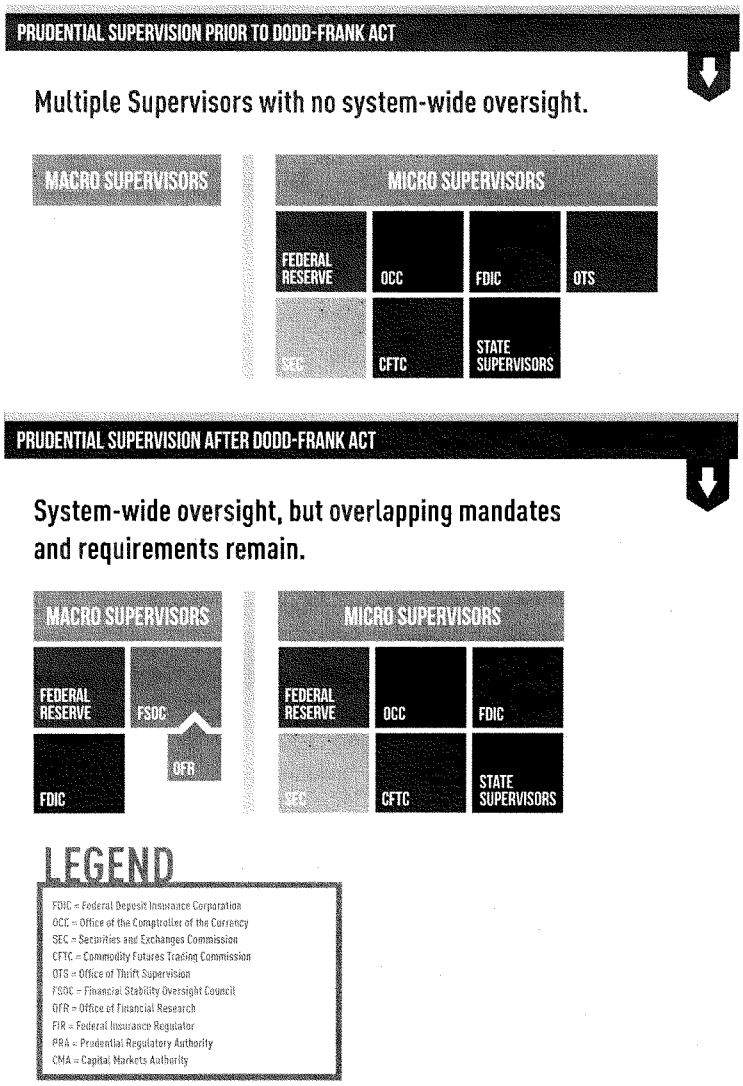
The task force, therefore, recommends that the CFTC and SEC be merged into a single Capital Markets Authority within two years. The merged entity would retain the commission structure that is familiar to both agencies and adopt the nomination rules of the SEC, which allows for presidential appointment of its chair from existing, Senate-confirmed regulators rather than requiring a separate nomination and confirmation for the chairmanship required under the Commodity Futures Trading Commission Act. The new CMA would fall under the jurisdiction of the Senate Banking and House Financial Services committees, as most of the trades the agency would oversee would traditionally fall into the category of financial services.

As an interim step toward full consolidation, **the task force also recommends that the CFTC and SEC immediately begin to conduct their board meetings jointly**. This will allow the two agencies to better prepare for the logistical and cultural changes that will be necessary to effectuate the merger. It also will help to achieve the goal of speaking with a unified U.S. voice on capital markets regulatory issues at an international level.

Proposed Task Force Structure

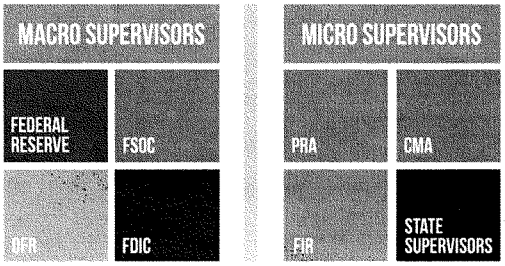
The two figures on the following pages depict key aspects of the U.S. regulatory architecture in three stages: prior to the Dodd-Frank Act; the current, post-Dodd-Frank structure; and the new structure recommended by the task force. Figure 2 shows changes in agency responsibility for micro- and macro-prudential regulation. Figure 3 describes changes to the regulation of selected kinds of financial activities over the same stages. The task force's plan results in a more streamlined regulatory structure that is more conducive to financial stability and economic growth.

Figure 2. Prudential Supervision[83]



PRUDENTIAL SUPERVISION PROPOSED BIPARTISAN SOLUTION

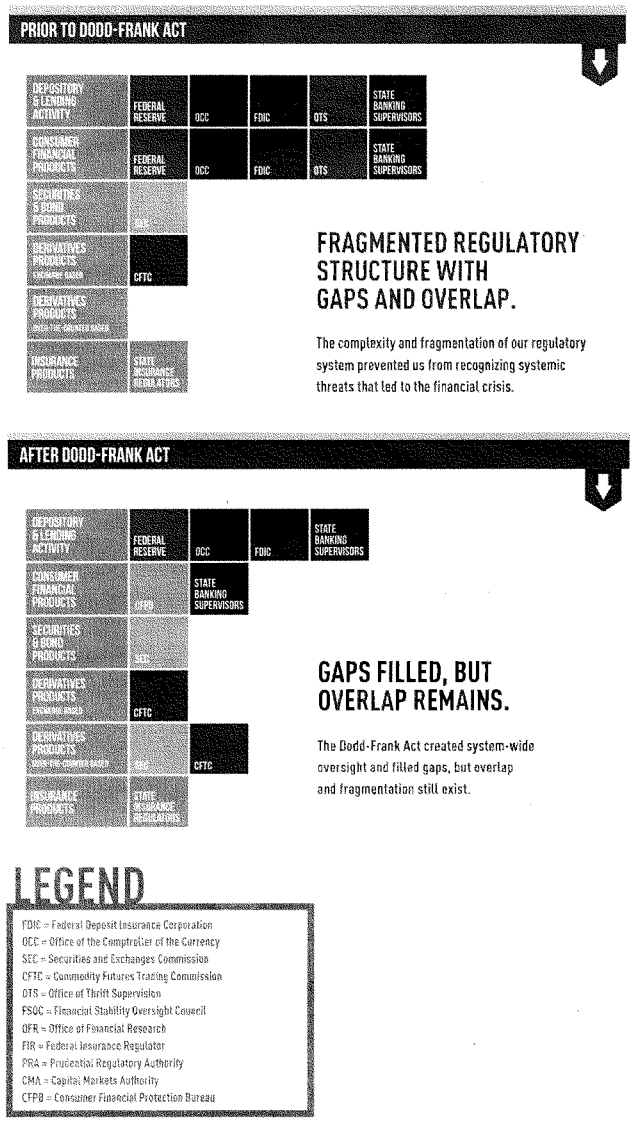
A streamlined solution putting oversight with fewer supervisors eliminates complexity and encourages efficiency.



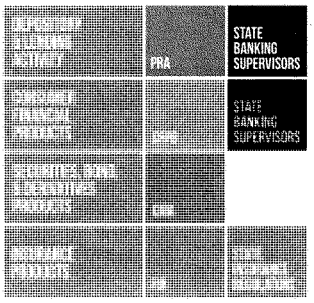
LEGEND

FDIC = Federal Deposit Insurance Corporation
OCC = Office of the Comptroller of the Currency
SEC = Securities and Exchanges Commission
CFTC = Commodity Futures Trading Commission
OTS = Office of Thrift Supervision
FSOC = Financial Stability Oversight Council
OFR = Office of Financial Research
FIR = Federal Insurance Regulator
PRA = Prudential Regulatory Authority
CMA = Capital Markets Authority

Figure 3. Regulation of Financial Activities and Products[84]



PROPOSED BIPARTISAN SOLUTION



STREAMLINING REGULATION

BPC's plan consolidates and empowers regulatory agencies with clear lines of jurisdiction. This approach reduces complexity and inefficiency, and ensures a safer financial system.

LEGEND

FDIC = Federal Deposit Insurance Corporation
OCC = Office of the Comptroller of the Currency
SEC = Securities and Exchanges Commission
CFTC = Commodity Futures Trading Commission
OTS = Office of Thrift Supervision
FSOC = Financial Stability Oversight Council
OFR = Office of Financial Research
FIR = Federal Insurance Regulator
PRA = Prudential Regulatory Authority
CMA = Capital Markets Authority
CFPB = Consumer Financial Protection Bureau

Recommendation #5: Ensure Independent Funding for All Financial Regulatory Agencies

The task force recommends that the SEC and CFTC fund themselves through the existing SEC fee and assessment structure, with any excess funds being returned to the Treasury.

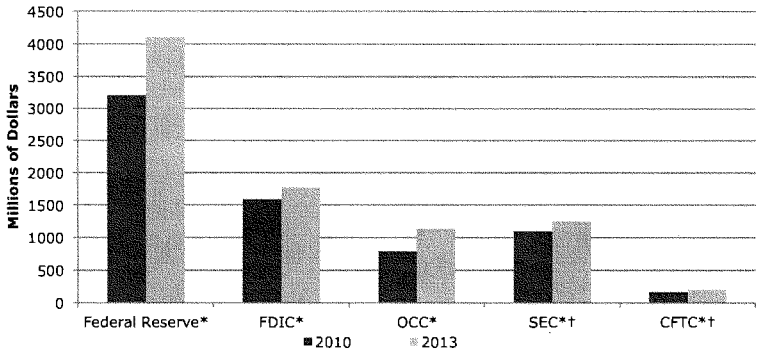
The U.S. financial regulatory system was deliberately constructed to give a significant degree of independence to its constituent agencies, in large part to insulate them from political influence, especially during times of crisis. It is difficult, however, for an agency to remain free of such political influence without independent funding.

The Federal Reserve can generate the money it needs through its income from seigniorage, interest on foreign currency investments held by the Federal Reserve system, fees received for services provided to depository institutions, and interest on loans to depository institutions. An agency like the OCC levies assessments on the national banks it regulates to fund itself. By contrast, the CFTC and SEC are funded through the appropriations process, with the assessments and fines they collect returned to the Treasury rather than being used to fund those agencies. This has resulted in both agencies being underfunded.

In its proposed Fiscal Year (FY) 2014 budgets, the CFTC requested $315 million, while the SEC requested $1.674 billion.[85,86] The budget agreement reached by House and Senate leaders in January of 2014 for the FY 2014 budget contained far less for each agency: $215 million for the CFTC and $1.35 billion for the SEC.[87] These numbers represent increases of less than 5 percent for the CFTC and about 2 percent for the SEC over their FY 2013 budgets.[88] These two agencies faced further cuts in FY 2013 from sequestration. The SEC's FY 2013 budget was cut by $66 million, from $1.321 billion to $1.255 billion, while the CFTC's FY 2013 budget was cut by about $11 million, from $205 million to $194.6 million.[89]

The budgets of the SEC and CFTC have grown slowly since the financial crisis. From 2010 to 2013, the CFTC's budget grew by about 16 percent, while the SEC's grew by about 14 percent. This is especially slow in light of the financial crisis and the substantial new responsibilities assigned to each agency by Dodd-Frank. Each agency's budget has increased more slowly than the FRB or OCC, which increased their budgets by 28 percent and 44 percent, respectively, from 2010 to 2013. The growth of each is shown in Figure 4 below.[90]

Figure 4. Financial Regulator Operating Budgets, 2010-2013



* Actual operating expenses, 2010-2012. Budgeted operating expenses, 2013.
† Figures account for sequestration reductions in operating budget.

Many, including former CFTC Chairman Brooksley Born and former SEC Chairman William Donaldson, argue that to truly be independent, financial regulators require independent funding not subject to congressional appropriation.[91] Former SEC Chairman Mary Schapiro has urged congressional leadership to allow the agency to independently fund itself through the fees it collects, which typically exceed appropriations by a substantial margin.[92] Former CFTC Chairman Gary Gensler testified that his agency had jurisdiction over a futures market five times larger than in the 1990s and now oversees a swaps market eight times larger than the futures market, all with a budget only 8 percent greater than in the 1990s.[93] In February 2013, acting SEC Chair Elisse Walter said the SEC would not be able to adequately address the issues mandated to it by Dodd-Frank without a significant budget increase.[94]

Opponents of independent funding argue that past agency failures and inefficiencies justify greater congressional funding oversight; that hiring more regulators would produce unnecessary red tape and cost for institutions and investors; and that funding the CFTC through user fees would be a backdoor tax increase.[95]

While these concerns are valid to a point, their impacts should not be overstated. Agencies like the FRB and OFR, which already have independent funding authority, must still report regularly to Congress, which can legislate changes in the way financial regulators are funded and governed and has done so. Overzealous regulation should always be a concern, but so too should too-lax regulation, specific instances of which contributed to the financial crisis. Finally, it is important that agencies fund themselves only to the extent necessary to complete the work Congress has asked of them.

The task force agrees that independent financial regulators must have sufficient resources to complete the job that Congress has given the through the Dodd-Frank Act and other

actions. The task force also believes that the creation of independent financial regulators was a wise and essential element of a well-functioning financial regulatory structure. Therefore, **the task force recommends that the SEC and CFTC be given the authority by Congress to collect and keep funds generated through fees and assessments to fund their own operations.** The merged capital market regulator that the task force recommends should be funded by adjusting existing SEC assessments to match budget needs rather than establishing new assessments and fees in areas overseen currently by the CFTC.

Recommendation #6: Improve International Cooperation and Cross-Border Regulatory Outcomes

The task force recommends that the FSOC review all provisions of Dodd-Frank that have extraterritorial effects and make recommendations to the Congress and/or financial regulators for actions to prevent unnecessary and avoidable negative impacts on international cooperation, financial stability, competitive opportunity, and economic growth.

Financial markets are global in their reach, so the actions of regulators in one country affect financial institutions in multiple jurisdictions. The actions of U.S. regulators carry special weight around the globe due to the reach of U.S. markets and U.S.-based financial institutions. Dodd-Frank raised a number of important issues about the extraterritorial application of U.S. law that to date have not been adequately considered by regulators or policymakers.

Confusing, duplicative, or contradictory regulations can have a negative impact on growth and the operation of global capital markets. Foreign governments have been critical of U.S. regulators for what they see as an insufficient effort at coordinating rulemaking in a number areas, including implementation of the Federal Reserve's rules on Foreign Banking Organizations.[96] Lack of cooperation can lead to "ring-fencing" of financial institutions in a way that "comes at a cost for banking groups and the efficiency of the overall global financial system."[97] The Financial Stability Board (FSB) wrote on the subject of over-the-counter (OTC) derivatives reform that:

> Uncertainties about the treatment of cross-border activity...under various jurisdictions' regimes continue to be a concern for market participants as regulatory requirements take effect. ... [I]n light of the global nature of OTC derivatives markets, cross-border coordination is needed to avoid unnecessary duplicative, inconsistent or conflicting regulations. Where there are conflicts, inconsistencies and gaps in the regulation of cross-border OTC derivatives activities, this may incentivize market participants or infrastructure providers to reorganize their activity along jurisdictional lines. Regulatory impediments to cross-border activity might reduce market participants' opportunities to trade and affect market functioning. Similarly, a

> failure to resolve barriers with respect to trade reporting ... would undermine authorities' capacity to monitor domestic and global markets.[98]

U.S. regulators have their own criticisms of foreign regulators, of course. It is not the purpose of this report to adjudicate which side is right and wrong in each case. What is important is that U.S. regulators work in good faith with their counterparts in other jurisdictions to harmonize and make the regime of international regulation most effective and supportive of economic growth, safety and soundness, and consumer protection. The task force joins the FSB in urging, "regulators in all jurisdictions to clarify their respective approaches to cross-border activity, and for authorities to work together to resolve conflicts, inconsistencies and gaps."[99]

The task force's recommendation envisions the FSOC's conducting its review and making its recommendations as part of the Council's broad mandate for macro-prudential supervision and surveillance across markets.

Issues for Future Consideration

The regulatory architecture of the U.S. financial system is a complex subject with many variables. The task force considered many of these questions in the course of developing this report, but offered recommendations on only a select number of the more pressing issues we studied. There are a few outstanding issues, however, that the task force believes should be more fully considered in the future when more information and perspective is available to do so.

Investor protection: The first is whether it would make sense to move investor protection responsibility from the SEC to the newly created CFPB. The "twin peaks" model of financial regulation vests safety-and-soundness responsibilities within one agency and business conduct oversight in another. Investor protection, as consumer protection, falls under business conduct, and moving jurisdiction for it to the CFPB may make for a cleaner, more philosophically coherent regulatory structure. The task force, however, thought it would be better to wait to determine the wisdom of such a move, giving the CFPB more time to develop.

Governance structure for financial regulators: Another issue that has received much attention in the past few years is whether financial regulators should be run by commissions or single directors. The task force has proposed the creation of a PRA with a commission, but that does not necessarily mean that a commission structure would be the best choice for every agency.

The FDIC is unique among financial regulators in that, by statute, two of its members are from other agencies: the directors of the CFPB and OCC.[100] The FDIC had a three-person board until 1989, when the director of the OTS and a newly created vice chairman were added to the board. Among the options for changing the FDIC's leadership structure would be to go back to a three-person board, make the current five-member board independent without membership from other agencies, or change it to a single-director structure. If the current five-person board remains, the director of the OCC would be replaced by the chairman of the PRA in the task force's plan, and the CFPB director would remain. One could also ask if a member of the FRB should be one of the FDIC's board members instead.

By statute, one of the FDIC's board members must have state bank supervisory experience.[101] The task force believes this requirement brings a much-needed perspective to the FDIC's board. With the Federal Reserve taking on a stronger macro-prudential role in the task force's plan, lawmakers should consider whether the FRB should also have a requirement that one of its governors must have state bank supervisory experience.

Conclusion

The financial crisis revealed serious weaknesses in the U.S. financial regulatory structure. Fragmentation led to gaps in oversight and regulation, duplication of efforts, and lack of clarity for stakeholders. The Dodd-Frank Act attempted to address some of these issues and has made progress in actions such as eliminating the OTS and consolidating business conduct regulation in the CFPB.

Much more progress, however, must be made. Further consolidation of prudential bank examination teams and regulatory agencies would improve the quality, efficiency, and accountability of the supervision of financial institutions. A single capital markets regulator with independent funding would mean greater efficiency, reduced friction, and a clearer U.S. capital markets voice for domestic and international stakeholders. An optional national insurance charter paired with a new and knowledgeable federal regulator would rationalize oversight of large, national insurance companies and put the U.S regulatory system on an equal footing with other countries in this area. Finally, while the creation of the FSOC and OFR were positive steps, the two entities need to be redesigned in a way that will allow them to effectively fulfill their mandates and realize their full potential.

There is a growing realization that Dodd-Frank missed a major opportunity to further consolidate and streamline the U.S. financial regulatory structure to enhance the financial markets that support the economy. The task force realizes that some of the recommendations presented in this report will be politically difficult to put into effect in the short-term. It will be far more problematic, however, if policymakers and stakeholders are forced into making such tough decisions during or after another financial crisis that results in part from defects in the current regulatory architecture. Instead, policymakers should act sooner rather than later to improve and strengthen the financial system through the adoption of these, and potentially other, carefully considered recommendations.

Appendix A: A Brief History of the U.S. Financial Regulatory System

The United States has consistently crafted its federal financial regulation structure in response to current problems or crises without much serious reflection on whether the various parts of that structure interact appropriately.[102]

The foundation of the U.S. financial regulatory structure began with the debate over the creation of a central bank. In 1791, the United States was a fragile collection of states that were heavily indebted and dealing with high levels of inflation. In response, Congress established 20-year charters for both the First Bank of the United States and the Second Bank of the United States. The debates over the creation of both institutions were contentious and, by 1836, political forces had shifted and eliminated the Second Bank. The need for a central bank would not be seriously revisited until the 20th century, and during that time, the United States experienced financial crises in 1873, 1884, 1893, and 1907.[103]

A combination of factors, including the pressing need to finance the Civil War and inconsistent state bank regulation, led to the passage of the National Bank Act of 1863. The Act, one of the signature economic policies of the Lincoln administration, created a federal charter for "national banks" and brought with it the nation's first federal regulator: the OCC.

The financial crisis of 1907 revived the debate over the need for a central bank. In that year, the failure of the Knickerbocker Trust Company triggered bank runs across the nation, and confidence in the system was restored only after financier J. Pierpont Morgan stepped in to provide needed liquidity. While Morgan was able to stem this financial panic, there was broad realization that a new financial regulatory structure was needed. This led to the passage of the Federal Reserve Act of 1913.

Such a commitment to central banking had been in place for hundreds of years in other countries. For instance, the Swedish central bank (Riksbanken) has operated since 1609. The Bank of England was created in 1694, and the French central bank, Banque de France, was established under Napoleon Bonaparte in 1800.

The creation of the third central bank in U.S. history was a major turning point in the government's role in the financial system. A hybrid of public and private enterprises (the regional Federal Reserve Banks are private, non-governmental entities), the Federal

Reserve System gained political independence and power since its creation. However, the Fed was widely criticized for not only failing to stop, but having accelerated the financial panic of 1929, which culminated in the Great Depression.[104]

The Great Depression catalyzed a series of major financial regulatory reforms, the legacy of which still shape our financial market structure today. That crisis led to the passage of legislation such as the Banking Act of 1933, also known as the Glass-Steagall Act, which established the FDIC and deposit insurance; the Securities Act of 1933 and the Securities Exchange Act of 1934, which were passed to combat the fraud and poor record-keeping of companies selling stock; and the Federal Home Loan Bank Act of 1932, which created the Federal Home Loan Bank System, a parallel structure to the Federal Reserve System for thrifts.[105]

After the New Deal reforms, it took more than 20 years for new major banking legislation to materialize. In 1956, the Bank Holding Company Act was passed to prevent the rise of financial conglomerates. The Act gave the power to regulate bank holding companies to the FRB. That law, however, only prohibited affiliations between banks and commercial firms if there was more than one bank in the organization. The Bank Holding Company Act Amendments of 1970 were passed to extend the law's prohibitions to companies that controlled just a single bank.[106]

The regulation of financial instruments also has followed the crisis-response model. While regulation of grains and other commodities had been in place as early as 1848, it was record-high prices in commodities in 1973 and 1974 combined with concerns about excessive speculation and price manipulation that led to passage of the Commodities Exchange Act and the creation of the CFTC to provide greater regulatory oversight of these evolving markets.[107] With the increasing sophistication of financial products, the regulation of contracts under the CFTC's jurisdiction has only grown in importance.

The S&L crisis that began in the 1980s set in motion the widespread failure of savings and loan associations, also known as thrifts. In response, Congress enacted two major pieces of legislation: The Financial Institutions Reform, Recovery and Enforcement Act of 1989 and the Federal Deposit Insurance Corporation Improvement Act of 1991.[108] These new reforms eliminated the former federal thrift regulator, the Federal Home Loan Bank Board, for failing to better supervise thrifts leading up to the crisis. In its place, Congress established the OTS, which chartered, supervised, and regulated all thrifts from 1989 until its elimination in Dodd-Frank. Further, these reforms merged the insurance fund for thrifts and banks, and created a procedure called "prompt corrective action" that required the FDIC to take increasing regulatory action as the condition of a bank worsened. These laws also required the FDIC to implement a least cost resolution process and generally prohibited open-bank assistance, with the caveat of a systemic risk exception.[109] That exception would not be triggered until the most recent financial crisis.

A few years later, Congress passed the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994, which fundamentally altered the U.S. banking industry by allowing

banks to more easily operate in multiple states. This federal response that lifted geographic restrictions on banks has been described as the final act in a lengthy effort by states to ease and lift such restrictions. For instance, in 1975, only 14 states permitted banks to have branches statewide, and no state allowed out-of-state bank holding companies to buy intra-state banks. By 1990, 47 states permitted banks to have branches statewide, and 49 states allowed out-of-state bank holding companies to buy intra-state banks.[110]

This changed the landscape of finance in the United States, resulting in a wave of financial institution mergers. While nearly 15,000 regional and local banks and thrifts existed in 1990, that number shrank to roughly 8,000 by 2009.[111] In the process, the largest banks continued to grow both in size and in relative share of assets of the financial system.

In another move intended to deregulate the financial industry in order to spur greater innovation and growth, Congress passed the Gramm-Leach-Bliley Act (GLB). [112] In 1999, GLB repealed sections 20 and 32 of the Glass-Steagall Depression-era separation of commercial and investment banking and allowed insurance and banking companies to affiliate.[113] One of the major theories underpinning GLB was the desire to create "financial supermarkets" where consumers could enjoy the benefits of economies of scale and scope that supporters argued were created by larger financial institutions.

Appendix B: How a Fragmented Regulatory System Contributed to the Financial Crisis

Even the best designed regulatory systems become less effective over time as financial markets adapt to changing customer needs and technological advances. This dynamic especially applies when overseeing global financial markets that have in recent decades experienced rapid innovation, evolution, and growth. The coverage that national regulators have over all aspects of the global financial system, and the accurate knowledge of, and insight into, how financial markets and firms operate and behave continually erodes over time because of these changes. This erosion ultimately leads to gaps in regulatory oversight and to a regime that cannot prudently, optimally, and at times effectively or efficiently, regulate financial firms and markets.

Many observers have argued that the biggest regulatory gaps were found in the so-called "shadow banking" system, which steadily grew in the years leading up to the crisis. The sector comprises a wide array of non-bank companies that provide bank-like services. Examples include money market mutual funds, broker-dealers, non-bank mortgage loan originator, payday lenders, hedge funds, and private label loan securitizers. One study estimates that shadow bank liabilities reached $22 trillion in mid-2007, before falling by about $5 trillion by 2011. Bank liabilities have grown steadily since the roughly $14 trillion they measured in 2007, so that today they outpace shadow banking liabilities for the first time since the mid-1990s.[114] Because shadow banks are not fully licensed commercial banks, these companies are not subject to some or all of the rules put in place to ensure the safety and soundness of banks with whom they compete daily.

Shadow banking institutions also do not have access to the Federal Reserve's discount window and government-guaranteed insurance on deposits. The absence of these stabilizing factors is perhaps the primary reason that several major components of the shadow banking system faced collapse during the height of the financial crisis. Market participants and regulators lacked a full understanding of the systemic risk posed by these components. Federal regulators intervened in response to the crisis to prop up a number of shadow banking sectors—for example, by guaranteeing money market mutual fund shares and bringing the largest broker-dealers into the regulatory safety net through acquisitions of broker-dealers by banks, or by broker-dealers electing to become bank holding companies.

They did so in order to stabilize the broad financial system, leading many to question whether these sectors already were covered by an implicit federal government safety net (the "too-big-to-fail" problem).

In other cases, gaps can open and widen over time in the more regulated space of commercial and consumer banking. Mortgage lending by banks, thrifts, and state-licensed loan originators, for example, has long been subject to extensive but fragmented oversight and regulation. That did not stop major problems from originating within each area, however, as regulators either did not see or fully understand the problems that were developing in the housing markets prior to the financial crisis, or do enough to mitigate their impact. There was no entity responsible for looking at potential problems that might be building across multiple sectors of the entire financial system.

Multiple and sometimes overlapping examination teams from several agencies also presented difficulties in identifying risks leading up to the financial system. Banks were supervised prior to the crisis by the FRB, OCC, FDIC, OTS, and state regulators, and sometimes by more than one at a time. This fragmented structure raised the amount of communication required if these agencies were to properly share their knowledge, specialized training, and other expertise to be most effective in spotting signs of trouble at supervised institutions.

Three examples of how regulatory gaps and lack of regulatory coordination contributed to the financial crisis are highlighted below.

The Mortgage Market and Securitization

The volume of poorly underwritten mortgages skyrocketed in the middle of the 2000s and was a major cause of the financial crisis. Subprime loans, which made up about 15 percent of mortgage originations in 2001, increased to nearly 50 percent of total originations by 2006, not coincidentally the peak of the housing price bubble.[115] This boom in borrowing was facilitated by low interest rates, a surge in home equity loans, and new mortgage products that only made sense assuming a perpetual increase in housing prices.[116]

The growth in subprime mortgage lending also was due to the absence of uniform lending standards and comprehensive oversight of the mortgage lending industry. It has been estimated that a majority of the subprime loans originated in 2004 and 2005 were originated by state-licensed lenders that were not subject to the supervision and regulation of the federal banking agencies until near the end of the housing boom.[117] For example, the FRB waited until 2007 to exercise its authority under the Home Ownership and Equity Protection Act of 1994 to propose rules to limit unfair and abusive lending practices.[118]

The risk inherent in these poorly underwritten loans was then spread throughout the financial system as investors purchased securities backed by subprime loans. A number of large financial institutions securitized these subprime mortgages, in many cases substantially underestimating the chances the securitized bonds could drop significantly in

value. Ratings on these securities, provided by SEC-recognized rating agencies, also failed to reflect the risk inherent in the bonds. Falling prices after 2006 unraveled the convoluted and poorly understood threads that held together the U.S. mortgage securitization market through the mid-2000s. The amount of outstanding private-label mortgage debt, which peaked in 2007 at $2.2 trillion, stood at a mere $909 million in early 2013.[119] Although some regulators warned that a housing bubble was forming, their agencies either did not fully appreciate the extent of the problem, or did not act on their knowledge in a timely fashion.

In some cases, problems were directly within the purview of bank supervisors. Large bank holding companies had "roomfuls of regulators" overseeing them for safety and soundness, from multiple federal and state agencies.[120] These regulators, unfortunately, failed to understand the risk associated with some of the complex new financial products that undergirded the complex system of mortgage originations and securitizations, and at the time lacked the authority to take corrective action when they did understand the risks.

When GLB was enacted, Congress gave the FRB umbrella regulatory powers over holding companies and their non-banking subsidiaries. While there were some limits on this authority, it does not appear that between passage of GLB and the financial crisis, the FRB ever exercised that authority. If it had, it might have noticed how undercapitalized the investment arms of bank holding companies were, and that, in turn, might have been a signal to the SEC to reconsider its own position on capital for those investment banks not owned by bank holding companies.

To be fair, many financial institutions involved in the same markets often failed to recognize the same risks. Moreover, especially for the larger financial institutions, more than one regulatory agency had overlapping jurisdiction, and none of them had clear authority. This fragmentation made it difficult for any agency or individual to understand the broader market holistically or to coordinate appropriate interagency communication to address growing problems.[121]

In other cases, issues originated outside of the regulatory umbrella. As noted above, independent mortgage originators not subject to federal regulation originated more than one-half of subprime loans in 2004 and 2005.[122] Here again, federal regulators were not in a good position to understand the full scope of what was taking place in markets they did not directly regulate. Inconsistent communication among state and federal regulators further contributed to the problem.

OTC Derivatives

Derivatives—financial transactions based on the value of an asset or other entity—have existed for hundreds of years. Farmers, for example, have hedged the value of their crops through futures markets. Many such transactions are executed in regulated markets, with futures trading on exchanges and insurance policies subject to numerous rules and

regulations. And, the transactions involve assets or entities owned by the buyer of the derivative.

During the 1980s, 1990s, and 2000s, old rules that discouraged or prohibited speculative derivatives were gradually liberalized to allow their trade OTC (i.e., outside of regulated exchanges). An effort to bring such derivatives under the jurisdiction of the CFTC was explicitly blocked by the Commodity Futures Modernization Act of 2000. By one estimate, the value of the OTC derivatives market grew from its inception in the 1980s to about $24.7 trillion in mid-2012, while at the same time its credit risk equivalent was about $3.6 trillion.[123]

Substantial systemic risk was created by certain segments of this OTC derivatives market, notably those built on mortgage-based collateralized debt obligations and credit default swaps, which brought AIG to the brink of collapse before the federal government stepped in to save it. Few if any firms trading some of the more exotic derivatives had a full understanding of this market and its web of interconnections to other parts of the financial system and, because oversight of the OTC derivatives market was prohibited by statute, neither did regulators. Mortgage-based derivatives as a whole amplified the impact of the collapse of housing prices.

Oversight of Thrift Holding Companies

Prior to the savings and loan crisis of the 1980s, thrifts and thrift holding companies were overseen by the Federal Home Loan Bank Board. That crisis led to the creation of a new regulator for savings and loans and their holding companies, the OTS within the Treasury Department. When the OTS was created, however, Congress did not equalize the supervisory structure for savings and loan holding companies with the structure applicable to bank holding companies. Unlike bank holding companies, savings and loan holding companies were permitted to engage in a wider range of activities, including commercial activities and insurance. Moreover, savings and loan holding companies were not subject to fixed capital standards. This created an opportunity for "regulatory arbitrage" as some firms saw the acquisition of thrifts as a means to gain access to the federal safety net without facing the same activity constraints and costs associated with owning a bank and being regulated as a bank holding company by the Federal Reserve Board. For some of these holding companies, such as AIG, the thrift it owned was a small fraction of its overall business. A 2007 GAO report on improving coordination among the OTS, Federal Reserve, and SEC stated that while most firms overseen by the Federal Reserve and SEC were primarily engaged in banking and securities, respectively, "a substantial minority of the firms the OTS oversees—especially the large, complex ones—have primary businesses other than those traditionally engaged in by thrifts, such as insurance, securities, or commercial activities."[124]

As a relatively small agency that depended upon assessments for its operating funds, OTS also was subject to the potential for "regulatory capture" by larger thrifts. For example, a

February 26, 2009, audit report by the Treasury Department's Office of the Inspector General criticized the OTS's supervision of IndyMac Bank. The report said that OTS examiners did not look into IndyMac's controls to manage aggressive growth or loan underwriting; improperly allowed IndyMac to record a transfer payment as having been available earlier than it was to allow the thrift to report that it was well capitalized; and failed to take prompt corrective action to try to remedy the situation when it should have.[125] Earlier in the 2000s, the OTS and some of its examiners expressed concern with IndyMac's subprime lending, lax underwriting standards, and lack of adequate capital. However, the agency did not require that action be taken and, after the housing market had begun to collapse in 2007, the OTS said that the thrift's subprime lending was within its guidelines.[126] To one degree or another, the OTS also proved ineffective in its oversight of Washington Mutual, AIG, Countrywide, and others.

These three examples—the mortgage market and securitization, the regulation of OTC derivatives, and thrift holding company supervision—highlight the dangers of a fragmented regulatory system. Multiple and, at times, competing regulatory agencies can lead to poor communication, weakening of regulatory standards, overlapping and inefficient jurisdictions, and an inability to see the full picture of what is happening in markets. Further, these issues can be exacerbated when federal and state regulatory agencies do not coordinate their efforts and effectively communicate with one another.

In short, the fragmented structure of U.S. financial regulation was one of the several and varied causes of the financial crisis. This fragmentation manifested in a number of ways, including contributing to a system in which:

- No single entity was responsible for looking for problems in the overall financial system (i.e., there was no macro-prudential regulator);
- Systemically important portions of the shadow-banking system existed outside of the regulatory system, where many of the activities that led to the financial crisis originated. Many of these institutions had to be brought into the system during the crisis to prevent them from failing and causing significant collateral damage;
- Regulators were specifically prohibited from overseeing OTC derivatives market, which grew rapidly in the lead-up to the crisis;
- Multiple and sometimes overlapping supervisory teams made it more difficult for regulatory agencies to share relevant knowledge and expertise; and
- Some agencies were susceptible to regulatory capture due to lack of sufficient resources, the way they were funded, and the ability of financial institutions to switch charters led to regulatory arbitrage.

Appendix C: Recent Crisis-Related Proposals

This section contains a comparison of key provisions in the Dodd-Frank Act with how the issues those provisions were intended to address were handled by the Paulson Blueprint, the Geithner white paper, and RAFSA (Senate Banking Committee).

Dodd-Frank Reforms

The Dodd-Frank Act made a number of important changes to U.S. regulatory architecture, primary among them:

CREATION OF A FINANCIAL STABILITY REGULATOR

Each of the three major proposals agreed on the need for increased focus on the overall stability of the financial system. The Paulson Blueprint recommended that the Federal Reserve be given this responsibility with a revised mandate. The Geithner and Dodd frameworks both pushed for creation of a council of regulators to perform this role. This latter approach was eventually incorporated into the Dodd-Frank Act with the creation of the FSOC.

One of the FSOC's mandates is to identify and respond to risks to financial stability. Another is to promote information-sharing and coordination among the members of the Council. Membership includes the secretary of the Treasury, who chairs the FSOC; the heads of the CFPB, CFTC, FDIC, FRB, Federal Housing Finance Agency (FHFA), NCUA, OCC, and SEC; and an independent member with insurance expertise.

Providing support for the FSOC is the OFR. Housed at the Treasury Department, the OFR is responsible for conducting research to improve the quality of financial data available to policymakers, particularly for the purposes of analyzing financial system stability.

The Geithner white paper recommended authorizing the FSOC to collect information, while RAFSA specifically established the OFR for that purpose. The Paulson Blueprint did not address this issue.

CREATION OF A CONSUMER PROTECTION REGULATOR

The growth of systemic risk in the years leading up to the crisis came in part from toxic financial products like negative-amortization mortgages and so-called "liar loans" that originated to a significant extent outside of the safety-and-soundness focus of regulators.[127] In response, each of the three plans recommended the creation of a separate business conduct, or consumer protection, agency that would be responsible for identifying and monitoring such risk exposures in the economy.

The result was the creation by Dodd-Frank of the CFPB with a single director. An independent agency housed within the Federal Reserve, the Bureau took over consumer protection functions from pre-existing regulators, and was given an independent funding stream to carry out its mandate.

There has been a strong push since the passage of Dodd-Frank to modify the governance and funding of the CFPB. A group of 44 senators signed a letter to President Obama that supported subjecting the agency to congressional appropriations and replacing its single director with a bipartisan commission structure, much like the CFTC and SEC.[128] Advocates for a strong CFPB argued that such changes would neuter the agency's effectiveness. After a protracted debate the Senate eventually confirmed Richard Cordray to be the Bureau's director by a vote of 66-34 on July 16, 2013.[129]

TERMINATION OF THE OFFICE OF THRIFT SUPERVISION

Each of the three plans called for an end to the OTS, an agency widely criticized for the poor quality of its regulation leading up to the crisis. The Paulson Blueprint recommended transitioning the federal thrift charter to a national bank charter over two years, while the Geithner white paper and RAFSA recommended eliminating the charter altogether. Dodd-Frank merged most of the OTS into the OCC, but preserved the thrift charter. Some argue that the law removed much of the charter's appeal, so that it will fade away by itself over time.

ALTERING THE FEDERAL RESERVE'S POWERS

The FRB's authority was greatly expanded under Dodd-Frank. The FRB became the systemic risk regulator and now has regulatory control over all bank and non-bank SIFIs at the holding company level. While the FSOC has the authority to designate SIFIs, only the FRB is empowered to regulate them. The Federal Reserve also was given regulatory authority over all thrift holding companies, which were previously under the jurisdiction of the OTS. Their number includes many insurance companies that have thrift subsidiaries. In addition, the large investment banks and others like Goldman Sachs, Morgan Stanley, and American Express that became bank holding companies during the financial crisis are now under the FRB's authority as bank holding companies. As SIFIs they would remain under the FRB's authority even if they tried to "de-bank" and change their holding company status.

The Federal Reserve Board did pay some price for the emergency actions it took during the crisis. Although the task force believes the FRB's invocation of its emergency powers to an unprecedented degree helped to save the economy from a depression, many of its moves were nonetheless unpopular. Dodd-Frank placed several restrictions on regulators' future authority, including limiting emergency lending to programs and facilities with "broad based eligibility," and requiring greater transparency on the part of the FRB. And, as previously mentioned, the Act took away the FRB's consumer protection responsibilities and transferred them to the new CFPB. However, the Act placed the CFPB structurally within the Federal Reserve Board, although with a large degree of independence from it.

FEDERAL INSURANCE OVERSIGHT

A greater realization of the importance of systemic risk in the financial system led many to argue that the insurance industry must be monitored as part of the FSOC's mandate. In addition to including a member with insurance expertise on the FSOC, Dodd-Frank created the FIO, housed at the Treasury Department, to monitor all aspects of the insurance industry. While the agency does not have regulatory power, it helps identify gaps in regulation for the FSOC and assists in international negotiations on insurance matters.

Appendix D: Task Force and the Process for Writing the Report

THE REGULATORY ARCHITECTURE TASK FORCE

The co-chairs of the Regulatory Architecture Task Force are:

- **Richard H. Neiman**, Vice Chairman, Global Financial Services Regulatory Practice at PricewaterhouseCoopers, former New York Superintendent of Banks, and former member of the Troubled Asset Relief Program (TARP) Congressional Oversight Panel; and
- **Mark Olson**, Chairman of Treliant Risk Advisors, former Governor of the Federal Reserve Board, and former Chairman of the Public Company Accounting Oversight Board.

Special thanks to those connected with BPC's Financial Regulatory Reform Initiative who helped inform and guide us through this process, including: Co-Chairs **Martin Baily** and **Phillip Swagel**; BPC staff **Aaron Klein**, **Justin Schardin**, **Shaun Kern**, and **Peter Ryan**; and senior advisors **Jim Sivon**, partner with Barnett Sivon & Natter, PC, and **Greg Wilson**, Wilson Consulting.

BACKGROUND ON THE PROCESS FOR DEVELOPING THIS REPORT

The task force co-chairs developed its conclusions based on their extensive experience in state and federal regulation of financial institutions, as well as information-gathering sessions with a wide variety of public and private sectors experts, agencies, organizations, and individuals. The task force benefited greatly from these meetings, and the co-chairs are indebted to all who met with them. However, the co-chairs alone are responsible for the conclusions and recommendations in this report.

DISCUSSION QUESTIONS

To maintain a consistency of conversation, the task force used the document below as a starting point for discussion at the information-gathering meetings that it held.

Topic 1: Overall Regulatory Structure Post Dodd-Frank

Understanding that we can't approach questions of regulatory architecture from a blank slate, we'd like to start by discussing the current status of our regulatory structure, post-Dodd Frank. What do you think is and is not working in our current regulatory structure?

What, if any, positive changes did Dodd-Frank make to the regulatory structure?

What, if any, negative changes did Dodd-Frank make?

What, if any, gaps in regulatory architecture still exist post Dodd-Frank? What remedies are needed?

Part of Dodd-Frank was an attempt to fill gaps which were thought to exist in the regulatory structure, such as with AIG, the shadow-banking sector, or non-regulated consumer finance companies. However, in trying to fill these gaps some have suggested that the law created a regulatory structure that has significant amounts of overlapping authority. We'd like to discuss a few areas where there may be overlapping authority, but feel free to add others. For each one, do you think overlap exists, and if so, in what ways is it positive or negative?

- Among federal and state bank regulators?
- Between the CFPB, bank regulators, and federal and state enforcement agencies on consumer regulation and supervision?
- Between the SEC and CFTC?
- Between FSOC and its members?
- Between the Federal Reserve as systemic risk regulator and other regulators?
- Between OFR and financial regulators for data on systemic risk and the standardization of data across regulators going forward?
- Other?

We have a dual regulatory system for both banking and securities and a pure state-based system for insurance companies, although Dodd-Frank has potentially altered that for systemically designated companies. What steps, if any, do we need to take to ensure the proper balance and degree of coordination and cooperation between federal and state regulators for:

- Banking?
- Insurance?
- Securities?

One of Dodd-Frank's signature accomplishments was the creation of the Financial Stability Oversight Council (FSOC). After two years in existence, what is your view of the role the FSOC is playing to fulfill its mandate on financial stability, and how can it be improved?

- Do you agree with the decision to have the Treasury Secretary Chair FSOC?
- Do you think FSOC operates with the right degree of transparency?

- Is FSOC working to balance its financial stability responsibilities with the need to promote economic growth and innovation?
- Other thoughts on FSOC?

Topic 2: Changes to the Existing Structure

Assuming there is no fundamental overhaul of the U.S. regulatory architecture in the near term, what short-term steps should be taken to improve its effectiveness and the quality of regulatory outcomes?

- Which of those recommendations can be done without legislation?
- Which require legislation?

In the medium to longer-term, how can the U.S. financial regulatory architecture be improved to ensure greater effectiveness and better regulatory outcomes? Some specific ideas which have been suggested include:

- Merging the SEC and CFTC into one capital markets regulator
- Consolidating the federal bank regulators
  - If you favor this, would you keep the role of deposit insurance separate?
  - Would you also keep monetary policy separate?
  - Would there be a continued dual role of Federal Reserve and FDIC for annual resolution planning?
- Changes to the newly created CFPB?
- Other ideas?

Topic 3: Ways to Improve Regulatory Quality

For all the various financial regulatory agencies, do we have the proper balance of independence and accountability with respect to funding sources, governance, and desired outcomes? What works and what needs to be improved?

What needs to be done to ensure that regulatory skills and resources keep pace with industry skills and resources to maintain both quality supervision and a healthy financial system?

What can be done to ensure better coordination among international regulators and greater consistency of global standards and practices with domestic (i.e., U.S.) laws and regulations?

What steps can be taken, if any, to avoid unnecessary complexity, duplication, and regulatory gridlock?

The Government Accountability Office (GAO) has issued numerous reports on regulatory architecture, the most recent of which calls for more formal coordinating mechanisms among regulators, better cost-benefit analyses in line with OMB best practices, and greater use of alternative approaches to regulation. Do you agree with these findings?

- If so, how would you go about addressing them?
- If not, why?

Endnotes

[1] Macro-prudential regulation involves oversight geared toward ensuring the safety of the overall financial system, while micro-prudential regulation refers to supervision through monitoring the safety and soundness of individual financial institutions.

[2] Cheyenne Hopkins, "Reg Reform Bill Misses Opportunity to Overhaul Agencies," *American Banker*, May 21, 2010. Available at: http://www.americanbanker.com/issues/175_98/reg-reform-1019553-1.html and http://law.fordham.edu/faculty/19917.htm.

[3] The Department of the Treasury, "Blueprint for a Modernized Financial Regulatory Structure." March 2008. Available at: http://www.treasury.gov/press-center/press-releases/Documents/Blueprint.pdf.

[4] The Department of the Treasury, "Financial Regulatory Reform, A New Foundation: Rebuilding Financial Supervision and Regulation," June 17, 2009. Available at: http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf.

[5] Restoring American Financial Stability Act (S. 3217), 111th Congress, introduced April 15, 2010. This bill passed the Senate and was later integrated with House-passed legislation in conference to produce the Dodd-Frank Act.

[6] Michael Crapo, opening statement from "Examining the Fiscal Year 2012 Budget for the Securities and Exchange Commission," hearing before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, March 10, 2011. Available at: http://www.gpo.gov/fdsys/pkg/CHRG-112shrg66723/html/CHRG-112shrg66723.htm.

[7] Jerry W. Markham, "Merging the SEC and CFTC – A Clash of Cultures," Florida International University College of Law Legal Studies Research Paper No. 10-53, November 2010.

[8] House Committee on Financial Services, "Frank and Capuano Introduce Legislation to Merge the SEC and CFTC," press release, November 29, 2012.

[9] Ronald D. Orol, "Stars are lining up for merging SEC and CFTC," *The Wall Street Journal* Marketwatch, January 26, 2009. Available at: http://articles.marketwatch.com/2009-01-26/news/30800480_1_cftc-commodity-futures-trading-commission-futures-products.

[10] Markham, supra note 6.

[11] As one illustration, the Paulson Blueprint recommended that the SEC change its rules-based regulatory approach to a principles-based approach like the CFTC's.

[12] Din El Boghdady, "Proposed exchange merger brings renewed call to consolidate SEC and CFTC," *Washington Post*, December 21, 2012. Available at: http://articles.washingtonpost.com/2012-12-21/business/36017655_1_sec-and-cftc-exchange-merger-dodd-frank.

[13] Adriane Fresh and Martin Neil Baily, "What does international experience tell us about regulatory consolidation?" Pew Financial Reform Project, September 21, 2009. Available at: http://www.brookings.edu/~/media/Research/Files/Reports/2009/9/21%20consolidation%20baily/0921_consolidation_baily.PDF.

[14] Fresh and Baily, supra note 12.

[15] Treasury Blueprint, supra note 2, at 126-129.

[16] A New Foundation, supra note X,at 41-42.

[17] The National Insurance Act of 2007, S. 49, 110th Congress (2007).

[18] Treasury Blueprint, Ibid., p. 96.

[19] A New Foundation, Ibid., pp. 32-33.

[20] The voting members of the FSOC are the Treasury secretary; the heads of the CFPB, CFTC, FDIC, Federal Reserve Board, FHFA, NCUA, SEC; and an independent member with insurance experience. Non-voting members are the directors of the OFR and FIO, a state insurance commissioner, a state banking supervisor, and a state securities commissioner.

[21] Richard Fischer and Eric Rodriguez, "The Consumer Financial Protection Bureau: Measuring the Progress of a New Agency," The Bipartisan Policy Center, September 2013. Available at: http://bipartisanpolicy.org/library/report/consumer-financial-protection-bureau.

[22] Following the release of the BPC report, the CFPB announced it would no longer bring enforcement personnel to supervisory exams. See Alan Zibel, "Consumer Regulator to Stop Bringing Lawyers to Firm Exams," *The Wall Street Journal*, October 9, 2013. Available at: http://online.wsj.com/news/articles/SB10001424052702304520704579125930135610624.

[23] Financial Crisis Inquiry Commission, "The Financial Crisis Inquiry Report," February 25, 2011, p. 54. Available at: http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

[24] "Wall Street and the Financial Crisis: Anatomy of a Financial Collapse," U.S. Senate Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, Majority and Minority Staff Report, April 13, 2011, p. 5. Available at: http://www.hsgac.senate.gov//imo/media/doc/Financial_Crisis/FinancialCrisisReport.pdf?attempt=2.

[25] "Basis for the Financial Stability Oversight Council's Final Determination Regarding Prudential Financial, Inc.," September 19, 2013. Available at: http://www.treasury.gov/initiatives/fsoc/designations/Documents/Prudential%20Financial%20Inc.pdf. And: "Basis for the Financial Stability Oversight Council's Final Determination Regarding American International Group, Inc.," July 8, 2013. Available at: http://www.treasury.gov/initiatives/fsoc/designations/Documents/Basis%20of%20Final%20Determination%20Regarding%20American%20International%20Group,%20Inc.pdf.

[26] 31 U.S.C. Section 313 (c).

[27] See generally Peter Ryan, "The Omnibus Spending Bill Highlights Contrasts in the Autonomy of Federal Regulators," Bipartisan Policy Center, January 22, 2014. Available at: http://bipartisanpolicy.org/blog/financialreform/2014/01/22/omnibus-spending-bill-highlights-contrasts-autonomy-financial-regulators.

[28] As opposed to regulation, which entails writing and enforcing rules, supervision involves on-site examinations of financial institutions.

[29] Basel Committee on Banking Supervision, "The relationship between banking supervisors and banks' external auditors," January 2002, p. 8. Available at: http://www.bis.org/publ/bcbs87.pdf.

[30] Thomas M. Hoenig, "Financial Oversight: It's Time to Improve Outcomes," remarks to the AICPA/SIFMA FSA National Conference, November 30, 2012.

[31] The CFPB conducts examinations on banks and credit unions, but only those with more than $10 billion in assets. See: 12 U.S.C. Section 5515 (a).

[32] Paulson Blueprint, Ibid., p. 99.

[33] Some federal agencies currently make training available to state supervisors. In 2012, for example, 458 instances of training across a variety of subjects was offered by the FFIEC through the FRB and FDIC with state sponsorship. This represented about 14 percent of the FFIEC's training slots for the year. See FFIEC Annual Report 2012, p. 9. Available at: http://www.ffiec.gov/PDF/annrpt12.pdf.

[34] The plan does not include the NCUA's examiners in its consolidation because of the significant differences in the business models of credit unions and banks and—since the consolidated examination force is contemplated as an interim step toward consolidation of the FDIC, FRB, and OCC—it would be inconsistent to bring the NCUA into the first stage of that transition.

[35] Information on FFIEC examiner education is available at: http://www.ffiec.gov/examiner.htm.

[36] For an analysis of some of the early successes and failures of the FFIEC, see Robert J. Lawrence, "Origin and Development of the Examination Council," February 1992, pp. 15-24, and the joint report of the Banking Agency Office of Inspector General of the Treasury Department, FDIC, and Federal Reserve, "Joint Evaluation of the Federal Financial Institutions Examination Council," June 21, 2002, pp. 10-15. Available at: http://www.fdicoig.gov/evaluations/02-003E.pdf.

[37] See, for example, the FFIEC policy statement on prudent commercial real estate loan workouts. Available at: https://www.ffiec.gov/press/pr103009.htm.

[38] The IT Examination HandBook InfoBase is available at: http://ithandbook.ffiec.gov/.

[39] Figures are rounded to the nearest thousand dollars.

[40] 12 U.S.C. Section 1833b.

[41] BPC did not receive data from the Federal Reserve Board or the Federal Reserve Bank of Richmond. Comparing data among the Reserve Banks is difficult since each has different titles for its examiners. Therefore, any attempt at grouping the data in this table into consistent job categories requires subjective judgments. Figures are rounded to the nearest thousand dollars.

[42] See, for example, "An International Review of OCC's Supervision of Large and Midsize Institutions: Recommendations to Improve Supervisory Effectiveness," December 4, 2013, p. 1. Available at: http://www.occ.gov/news-issuances/news-releases/2013/nr-occ-2013-184a.pdf.

[43] The Bureau of Labor Statistics projected job growth for financial examiners of 27% from 2010-2020, a faster than average pace. See: http://www.bls.gov/ooh/business-and-financial/financial-examiners.htm.

[44] The FFIEC should also encourage and work with states to create slots for degree-holders.

[45] Rose Marie Kushmeider, "The U.S. Financial Regulatory System: Restructuring Federal Bank Regulation," *FDIC Banking Review*, 2005, Vol. 17, No. 4, pp. 25-9. Available at: http://www.fdic.gov/bank/analytical/banking/2006jan/article1/article1.pdf.

[46] A description of the OCC's 2013 fee structure is available at: http://www.occ.gov/news-issuances/bulletins/2012/bulletin-2012-40.html.

[47] Macro-prudential regulation refers to oversight of the financial system as a whole, while micro-prudential regulation refers to the safety and soundness of individual financial institutions.

[48] See: John F. Bovenzi, Randall D. Guynn, and Thomas H. Jackson, "Too Big to Fail: The Path to a Solution," Bipartisan Policy Center, May 2013. Available at: http://bipartisanpolicy.org/sites/default/files/TooBigToFail.pdf.

[49] The FIO's authority includes recommending the designation of insurers as SIFIs, to coordinate federal efforts to develop federal policy on prudential insurance policy, and representing the United States in the International Association of Insurance Supervisors. A full list of authorities can be found in 31 U.S.C. Section 313 (c).

[50] For example, the Federal Reserve is responsible for setting capital and other heightened prudential standards for SIFI insurance companies.

[51] Financial Stability Board, "Peer Review of the United States," August 27, 2013, pp. 36. Available at: http://www.financialstabilityboard.org/publications/r_130827.pdf.

[52] Ibid.

[53] Governor Daniel Tarullo, Memo to the Board of Governors of the Federal Reserve System, "Final rules to implement the enhanced prudential standards of section 165 of the Dodd-Frank Act," p. 22. Available at: http://www.federalreserve.gov/aboutthefed/boardmeetings/memo_20140218.pdf.

[54] See: Aaron Klein, statement to the Subcommittee on Financial Institutions and Consumer Protection of the Senate Committee on Banking, Housing and Urban Development, "Finding the Right Capital Regulations for Insurers," Hearing, March 11, 2014. Available at: http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=b08b03f0-5f62-4faf-820c-be9e9967fd7d.

[55] Federal Insurance Office, U.S. Department of the Treasury, "How to Modernize and Improve the System of Insurance Regulation in the United States," December 2013, p. 63. Available at: http://www.treasury.gov/initiatives/fio/reports-and-notices/Documents/How%20to%20Modernize%20and%20Improve%20the%20System%20of%20Insurance%20Regulation%20in%20the%20United%20States.pdf.

[56] Ibid. pp. 63, 65

[57] Jim Sivon, "The Status of the Federal Thrift Charter Post-Dodd-Frank," Barnett Sivon & Natter, *Our Views*, August 2011. Available at: http://www.bsnlawfirm.com/newsletter/OP0811_4.pdf.

[58] Ibid.

[59] FSOC, "Financial Stability Oversight Council Makes First Nonbank Financial Company Designations to Address Potential Threats to Financial Stability," July 9, 2013. Available at: http://www.treasury.gov/press-center/press-releases/Pages/jl2004.aspx.

[60] FSOC, "Basis for the Financial Stability Oversight Council's Final Determination Regarding Prudential Financial, Inc.," September 19, 2013. Available at: http://www.treasury.gov/initiatives/fsoc/designations/Documents/Prudential%20Financial%20Inc.pdf. Prudential lost its appeal to the FSOC of its SIFI designation, and later decided not to pursue court action to overturn it. See Sarah N. Lynch, "Prudential says it will not appeal U.S. council's systemic tag," Reuters, October 18, 2013. Available at: http://www.reuters.com/article/2013/10/18/us-prudential-fsoc-idUSBRE99H11620131018.

[61] FSOC, "Proposed Recommendations Regarding Money Market Mutual Fund Reform," November 2012. Available at: http://www.treasury.gov/initiatives/fsoc/Documents/Proposed%20Recommendations%20Regarding%20Money%20Market%20Mutual%20Fund%20Reform%20-%20November%2013,%202012.pdf.

[62] The Volcker Rule's regulations, assigned to five different agencies, took more than three years to be finalized, and there have been well-publicized clashes between agencies, such as between the SEC and CFTC on cross-border swap issues. See for example: Victoria McGrane and Scott Patterson, "Regulators Clash Over Volcker Definitions," *The Wall Street Journal*, October 22, 2012. Available at: http://online.wsj.com/news/articles/SB10001424052970203400604578072824053423376.

[63] 12 U.S.C. Section 5513 (c) (3) (A). The FSOC may issue a stay of, or set aside, a CFPB regulation by a 2/3 vote of members then serving.

[64] The FSOC proposed three alternatives for money market mutual funds: a floating net asset value (NAV), a stable NAV and NAV buffer and "minimum balance at risk," and a stable NAV and NAV buffer with other measures. See http://www.treasury.gov/initiatives/fsoc/Documents/Proposed%20Recommendations%20Regarding%20Money%20Market%20Mutual%20Fund%20Reform%20-%20November%2013,%202012.pdf.

[65] Public Law 111-203, 124 Stat. 1408-1410, July 21, 2010. Available at: http://www.gpo.gov/fdsys/pkg/PLAW-111publ203/pdf/PLAW-111publ203.pdf.

[66] The five agencies were the CFTC, FDIC, FRB, OCC, and SEC.

[67] 12 U.S.C. Section 1851 (b) (2) (A).

[68] 12 U.S.C. Section 1851 (c) (1).

[69] See: Martin Baily, John Coffee, Jim Cox, Annette Nazareth, Jonathan Macey, and Phillip Swagel, letter to Tim Geithner, Thomas Curry, Ben Bernanke, Martin Gruenberg, Elisse Walter, and Gary Gensler, December 20, 2012. Available at: http://bipartisanpolicy.org/sites/default/files/Volcker%20Letter%20Final_0.pdf.

[70] Public Law 111-203, 124 Stat. 1395, July 21, 2010.

[71] Ibid., 124 Stat. 1408.

[72] In an approval vote is one in which voters may "approve" as many voting options as they would like, and the one that receives the most votes is declared the winner. In this case, tie votes among members of the FSOC would be broken by the vote of the FSOC chair.

[73] According to data at the National Information Center of the Federal Reserve System, 13 U.S. bank holding companies held assets of greater than $250 billion as of December 31, 2013. Available at: http://www.ffiec.gov/nicpubweb/nicweb/top50form.aspx. The characteristics the FSOC considers when deciding whether to designate non-bank financial institutions as SIFIs includes size, interconnectedness, substitutability, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny. Such factors apply well when assessing the systemic risk posed by banks as well. For a review of the FSOC's process for non-bank designation process, see for example: Arnold & Porter LLP, "FSOC Issues Final Rule for Making 'Systemically Important' Designations," April 2012. Available at: http://www.arnoldporter.com/resources/documents/Advisory%20FSOC_Issues_Final_Rule_for_Making_Systemically_Important_Designations.pdf.

[74] Implicit support for a new threshold level may be found in the proposed rules implementing the Basel Committee's liquidity coverage ratio framework released by the Federal Reserve Board on October 24, 2013. The rules propose to apply to internationally active banking organizations with $250 billion or more in consolidated assets or $10 billion or more in on-balance sheet foreign exposure. Bank holding companies or thrift holding companies that did not have significant insurance or commercial operations would be subject to a less stringent set of rules. See: http://www.federalreserve.gov/newsevents/press/bcreg/20131024a.htm.

[75] 12 CFR Part 1310, p. 15. Available at: http://www.treasury.gov/initiatives/fsoc/documents/nonbank%20designations%20-%20final%20rule%20and%20guidance.pdf. Since the task force's plan recommends a consolidated prudential regulator, the sixth factor used by the FSOC in reviewing potential non-bank SIFI designations—existing regulatory scrutiny—would not be relevant to bank SIFI designation decisions.

[76] See U.S. Government Accountability Office, "Financial Stability: New Council and Research Office Should Strengthen the Accountability and Transparency of Their Decisions," September 2012. Available at: http://www.gao.gov/assets/650/648064.pdf.

[77] Financial Stability Oversight Council, "Dodd-Frank Wall Street Reform and Consumer Protection Act Integrated Implementation Roadmap," October 1, 2010, slide 7. Available at: http://www.treasury.gov/initiatives/Documents/FSOC%20Integrated%20Roadmap%20-%20October%201.pdf.

[78] Organization chart for the U.S. Department of the Treasury's Office of Domestic Finance, as of December 12, 2012. Available at: http://www.treasury.gov/about/organizational-structure/offices/Documents/Domestic%20Finance%20Org%20Chart.pdf.

[79] The OFR's director's congressional testimony, for example, does not need to be submitted for approval to like other offices within executive branch departments. See: 12 U.S.C. Section 5343 (d).

[80] U.S.C. 12 Section 5345 (d).

[81] Portions of the text for this recommendation are drawn from a speech given by Richard H. Neiman, one of the co-authors of this report, at the Levy Economics Institute of Bard College to the 19th Annual Hyman P. Minsky Conference on the State of the U.S. and World Economies, on April 14, 2010. Available at: http://www.dfs.ny.gov/about/speeches/sp100414.htm. An editorial by Mr. Neiman with a similar theme also appeared in the *American Banker* on March 23, 2010, link unavailable.

[82] Paulson Blueprint, Ibid., p. 106.

[83] The NCUA, which supervises federal and federally insured credit unions, is not shown here since the task force is not recommending any changes to its current supervisory responsibilities.

The Consumer Financial Protection Bureau (CFPB), which regulates consumer financial products, is not included here since it is not a prudential regulator.

"State Supervisors" in this figure refers to banking, insurance, and investment supervisors in the individual states. Each state differs in its allocation of responsibility to its financial regulators.

Bank holding companies with total consolidated assets of $50 billion or more, and designated non-bank financial companies, must submit resolution plans to the Federal Reserve Board and the FDIC. As a result, the FDIC is depicted here as having both micro- and macro-supervisory roles.

The OFR is displayed as a subsidiary of the FSOC under the current system, reflecting the fact that a) its director reports to the chairman of the Council, and b) the OFR's principal function is to provide research to the FSOC. By contrast, the OFR is represented as separate entity under the task force proposal, reflecting its recommendation that the OFR be made fully independent of the Department of the Treasury.

[84] The NCUA, which supervises federal and federally insured credit unions, is not shown here since the task force is not recommending any changes to its current supervisory responsibilities.

Investment and securities products are also regulated by state supervisors. These supervisors are not displayed in this figure.

[85] Commodity Futures Trading Commission, FY 2014 President's Budget and Performance Plan, p. 2. Available at: http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cftcbudget2014.pdf.

[86] U.S. Securities and Exchange Commission, FY 2014 Congressional Budget Justification,

[87] Joe Morris, "US regulators 'funded at a level to fail,'" *Financial Times*, January 19, 2014. Available at: http://www.ft.com/intl/cms/s/0/ee99cec0-7f15-11e3-8642-00144feabdc0.html?siteedition=intl#axzz2r9CuENDc&_cldee=anNjaGFyZGluQGJpcGFydGlzYW5wb2xpY3kub3Jn.

[88] Peter Ryan, Ibid."The Omnibus Spending Bill Highlights Contrasts in the Autonomy of Federal Regulators," Bipartisan Policy Center, January 22, 2014. Available at: http://bipartisanpolicy.org/blog/financialreform/2014/01/22/omnibus-spending-bill-highlights-contrasts-autonomy-financial-regulators.

[89] Lynch, Sarah N., "Wall Street regulators face budget crunch under new spending deal," *Reuters*, January 14, 2014.

[90] Peter Ryan, supra note 79.

[91] Born, Brooksley and William Donaldson, "Self-funding of regulators would help fiscal mess," *Politico*, March 10, 2013. Available at: http://www.politico.com/story/2013/03/self-funding-of-regulators-would-help-fiscal-mess-88666.html.

[92] SEC Chairman Mary Schapiro, Letter to Senate Minority Leader Mitch McConnell, April 15, 2010. Available at: http://www.sec.gov/news/speech/2010/spch041510mls-mcconnell-letter.pdf.

[93] CFTC, Testimony of Chairman Gary Gensler before the US House Appropriations Subcommittee, April 12, 2013. Available at: http://www.cftc.gov/PressRoom/SpeechesTestimony/opagensler-139.

[94] SEC, Testimony on "Wall Street Reform: Oversight of Financial Stability and Customer and Investor Protections," February 14, 2013. Available at: http://www.sec.gov/news/testimony/2013/ts021413ebw.htm.

[95] Andrew Ackerman, Budget Seeks CFTC User Fee, More Funds for Regulators," *The Wall Street Journal*, February 13, 2012. Available at: http://online.wsj.com/article/SB10001424052970204883304577221100617958514.html.

[96] Michael Barnier, letter to Federal Reserve Board Chairman Ben Bernanke, April 18, 2014. Available at: http://www.federalreserve.gov/SECRS/2013/April/20130422/R-1438/R-1438_041913_111076_515131431183_1.pdf.

[97] Katia D'Hulster and Inci Otker-Rober, "Ring-fencing Cross-Border Banks: An Effective Supervisory Response?" Internatioanl Monetary Fund – Monetary and Capital Markets Department and World Bank; January 24, 2014, p. 1. Available at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2384687.

[98] Financial Stability Board, "OTC Derivatives Market Reforms: Sixth Progress Report on Implementation," September 2, 2013, pp. 5-6. Available at: https://www.financialstabilityboard.org/publications/r_130902b.pdf.

[99] Ibid., p. 6.

[100] 12 U.S.C. Section 1812 (a) (1).

[101] 12 U.S.C. Section 1812 (a) (1) (C).

[102] See, e.g., Treasury Blueprint, Ibid.

[103] Federal Reserve Bank of Philadelphia, "The Second Bank of the United States. A Chapter in the History of Central Banking." Available at: http://www.philadelphiafed.org/publications/economic-education/second-bank.pdf.

[104] Ben Bernanke. (2000). *Essays on the Great Depression*. Princeton, NJ: Princeton University Press.

[105] Four notable sections of the Act—sections 16, 20, 21, and 32—required the separation of commercial and investment banking activities. Some of these sections remain in place today, though much attention is given to the Gramm-Leach-Bliley Act's repeal of sections 20 and 32. Section 20 allowed banks to affiliate with organizations

"engaged principally" in underwriting securities, while the repeal of Section 32 enabled commercial banks and investment banks to share board directors, officers, and employees. However, these repeals did little other than codify where courts, regulators, and market participants had already gone. For example, the merger of Citicorp and Travelers Group was essentially approved by federal regulators before Gramm-Leach-Bliley was enacted. In September 23, 1998, the Federal Reserve approved Travelers Group Inc.'s application to become a bank holding company by acquiring Citicorp. The Gramm-Leach Bliley Act was signed by President Bill Clinton on November 12, 1999. Though the merger of Travelers and Citicorp was approved, the Bank Holding Company Act still required the merged entity to divest impermissible business lines within two years, with the Federal Reserve Board having the to extend the conformance period to no more than five years. It was widely expected at the time that the Federal Reserve would have extended this conformance period to the maximum five years. The Federal Reserve's actions placed further pressure on Congress to consider reforms that ultimately were incorporated into Gramm-Leach-Bliley. For a more thorough analysis from the time, see http://www.stblaw.com/google_file.cfm?TrackedFile=4B46116306DFF48682B3&TrackedFolder=585C1D235281AED996A07D5F9F9478AB5A90188899.

[106] Saule T. Omarova and Margaret E. Tahyar. (2011) "That Which We Call a Bank: Revisiting the History of Bank Holding Company Regulation in the United States." Page 25. Available at: http://www.bu.edu/law/central/jd/organizations/journals/banking/archives/documents/volume31/BankHoldingCoRegulation.pdf.

[107] Commodity Futures Trading Commission, "Mission & Responsibilities." Available at: http://www.cftc.gov/About/MissionResponsibilities/index.htm.

[108] For an overview of these two laws, see FDIC Public Information Center, "History of the Eighties—Lessons for the Future," Volume I, pp. 100-5. Available at: http://www.fdic.gov/bank/historical/history/87_136.pdf.

[109] Federal Deposit Insurance Corporation, "History of the Eighties—Lessons for the Future." Chapter 7. Available at: http://www.fdic.gov/bank/historical/history/235_258.pdf.

[110] Jith Jayaratne and Philip E. Strahan, "The Benefits of Banking Deregulation" FRBNY Economic Policy Review. December 1997. Available at: http://www.nyfedeconomists.org/research/epr/97v03n4/9712jaya.pdf.

[111] Senate Permanent Subcommittee on Investigations Report, "Wall Street and the Financial Crisis: Anatomy of a Financial Crisis" April 13, 2011. Page 15. Available at: http://www.levin.senate.gov/imo/media/doc/supporting/2011/PSI_WallStreetCrisis_041311.pdf.

[112] The Financial Services Modernization Act of 1999, Pub. L. 106-102.

[113] Conference of State Banking Supervisors, Banking Law 101, Gramm-Leach Bliley Act of 1999. Available at: http://www.csbs.org/bankinglaw101/Wiki%20Pages/Gramm-Leach-Bliley%20Act%20of%201999.aspx.

[114] Zoltan Pozsar, Tobias Adrian, Adam Ashcraft, and Hayley Boesky, "Shadow Banking," Federal Reserve Bank of New York, Retrieved September 16, 2013. Available at: http://www.newyorkfed.org/research/epr/2013/0713adri.pdf.

[115] Martin Neil Baily, Robert E. Litan, and Matthew S. Johnson, "The Origins of the Financial Crisis," Brookings Initiative on Business and Public Policy, November 2008, p. 14. Available at: http://www.brookings.edu/~/media/research/files/papers/2008/11/origin%20crisis%20baily%20litan/11_origins_crisis_baily_litan.pdf.

[116] Ibid, p. 17.

[117] Ibid, p. 41.

[118] Ben S. Bernanke, "Semiannual Monetary Policy Report to Congress" before the Committee on Financial Services, U.S. House of Representatives, July 18, 2007. Available at: http://www.federalreserve.gov/newsevents/testimony/bernanke20070718a.htm.

[119] Matthew Goldstein, "The Amazing Shrinking Pile of Non-Agency Mortgage Debt," Reuters, March 8, 2013. Available at: http://blogs.reuters.com/unstructuredfinance/2013/03/08/the-amazing-shrinking-pile-of-non-agency-mortgage-debt/.

[120] Baily, Litan, and Johnson, Ibid., p. 40.

[121] Ibid.,p. 41.

[122] Ibid.

[123] Bank for International Settlements, "Statistical release: OTC derivatives statistics at end-December 2012," May 2013. Available at: http://www.bis.org/publ/otc_hy1305.pdf. The market value is the cost of replacing extant OTC derivatives contracts, while the credit risk equivalent accounts for "netting" of contracts that cancel each other out.

[124] "Agencies Engaged in Consolidated Supervision Can Strengthen Performance Measurement and Collaboration," US Government Accountability Office, March 2007, p. 5. Available at: http://www.gao.gov/assets/260/257558.pdf.

[125] "Safety and Soundness: Material Loss Review of IndyMac Bank, FSB," Office of the Inspector General, Department of the Treasury, February 26, 2009, pp. 15-16. Available at: http://www.treasury.gov/about/organizational-structure/ig/Documents/oig09032.pdf.

[126] Ibid., pp. 18-22.

[127] Negative amortization loans are those in which monthly payments are not enough to cover the loan's interest, leading to an increase in the amount of principle owed on the loan. A liar loan is a mortgage loan in which the income and asset claims of the borrower are not verified by the lender or mortgage originator. The market for these and other risky mortgage products were cases of bad underwriting that relied on ever-rising home prices to avoid collapse.

[128] Senator Richard Shelby, "44 US Sens. to Obama: No Accountability, No Confirmation," letter and press release, May 5, 2011. Available at: http://www.shelby.senate.gov/public/index.cfm/newsreleases?ContentRecord_id=893bc8b0-2e73-4555-8441-d51e0ccd1d17.

[129] U.S. Senate roll call vote record, 113th Congress, 1st Session, Vote Number 174. Available at: http://www.senate.gov/legislative/LIS/roll_call_lists/roll_call_vote_cfm.cfm?congress=113&session=1&vote=00174.

RESPONSE TO WRITTEN QUESTION OF CHAIRMAN SHELBY FROM OLIVER I. IRELAND

Q.1. Mr. Ireland, during the hearing there was disagreement as to whether the Federal Reserve has the authority to establish an asset threshold above $50 billion for certain prudential standards, specifically, resolution plans. Please explain why you believe the Federal Reserve does not have the authority to establish a higher threshold for resolution plans.

A.1. As I noted in my testimony, the language of Section 165 of the Dodd-Frank Act on the Federal Reserve's authority to establish an asset threshold above $50 billion for certain prudential standards, such as resolution plans, is confusing. Section 165(a)(2)(B) states:

> (B) ADJUSTMENT OF THRESHOLD FOR APPLICATION OF CERTAIN STANDARDS.—The Board of Governors may, pursuant to a recommendation by the Council in accordance with section 115, establish an asset threshold above $50,000,000,000 for the application of any standard established under subsections (c) through (g).

While this language authorizes the Federal Reserve Board to set higher thresholds for standards established under subsections (c) through (g), it does not authorize the Board to set higher thresholds for standards established under subsection (b).

Subsection (b) states:

> (b) DEVELOPMENT OF PRUDENTIAL STANDARDS.——
>
> (1) IN GENERAL.——
>
> (A) REQUIRED STANDARDS.—The Board of Governors shall establish prudential standards for nonbank financial companies supervised by the Board of Governors and bank holding companies described in subsection (a), that shall include——
>
> (i) risk-based capital requirements and leverage limits, unless the Board of Governors, in consultation with the Council, determines that such requirements are not appropriate for a company subject to more stringent prudential standards because of the activities of such company (such as investment company activities or assets under management) or structure, in which case, the Board of Governors shall apply other standards that result in similarly stringent risk controls;
>
> (ii) liquidity requirements;
>
> (iii) overall risk management requirements;
>
> (iv) resolution plan and credit exposure report requirements; and
>
> (v) concentration limits.

To the extent that the Board is following the mandate in Section 165(b)(1)(A)(iv) in establishing standards for resolution plans, it is not authorized to establish a higher threshold under Section 165(a)(2)(B) above.

Confusion arises however, when Sections 165(a) and 165(b) are read in conjunction with Section 165(d) which provides:

(d) RESOLUTION PLAN AND CREDIT EXPOSURE REPORTS.——

(1) RESOLUTION PLAN.—The Board of Governors shall require each nonbank financial company supervised by the Board of Governors and bank holding companies described in subsection (a) to report periodically to the Board of Governors, the Council, and the Corporation the plan of such company for rapid and orderly resolution in the event of material financial distress or failure, which shall include——

(A) information regarding the manner and extent to which any insured depository institution affiliated with the company is adequately protected from risks arising from the activities of any nonbank subsidiaries of the company;

(B) full descriptions of the ownership structure, assets, liabilities, and contractual obligations of the company;

(C) identification of the cross-guarantees tied to different securities, identification of major counterparties, and a process for determining to whom the collateral of the company is pledged; and

(D) any other information that the Board of Governors and the Corporation jointly require by rule or order.

Simply put, Section 165(a)(2)(B) allows the Board to establish higher thresholds for resolution plans created under Section 165(d) but not for resolution plans created under Section 165(b) even though both of these provisions require the creation of resolution plans. The inconsistency in the language of these sections is clear.

We note that in adopting resolution plan requirements the Board used the $50 billion threshold. While it asserted the right to set a higher limit under section 165(d),[1] it did not choose to do so, nor did it explain why it did not.

While canons of statutory construction and *Chevron* deference could lead to a conclusion that a higher threshold set for resolution plans under Section 165(d) by Board regulation would be valid, the conflicting statutory language with respect to this requirement and other requirements of Section 165 should be revised to remove the uncertainty created by the inconsistency.

[1] 76 Fed. Reg. 67,323, 67,334, n.16 (Nov. 1, 2011).

RESPONSE TO WRITTEN QUESTION OF SENATOR REED FROM MARK OLSON

Q.1. The Bipartisan Policy Center has recommend the creation of a pilot program, which calls for a consolidated examination effort that would put together examiners from each of the OCC, Federal Reserve, and FDIC into one unit that could issue single examination reports for banks. Could you explain why the Bipartisan Policy Center is in support of this proposal?

A.1. Thank you for that question, Senator. I and Richard Neiman, my colleague as co-chair of BPC's Regulatory Architecture Task Force, made and support this proposal because it would improve the quality of bank supervision on numerous levels, and would do so in a way that would benefit all stakeholders. Specifically, a program of consolidated examination task forces would improve communication among prudential regulators, better coordinate and more efficiently use scarce regulatory resources, reduce the supervisory burden on both banks and agencies, allow State regulators to leverage Federal resources while preserving the dual banking system, and put better and more actionable data more quickly into the hands of regulators.

As you know, banks and thrifts, and their holding companies, are subject to examination by multiple Federal and State financial regulators. Prudential supervision ensures that financial institutions are sufficiently capitalized, are not engaging in activities that are too risky, are liquid enough to meet their obligations, and are otherwise safe and sound. The current examination system, however, is fragmented, with overlapping and duplicative responsibilities. A banking entity that consists of only a parent holding company and a subsidiary national bank, would be subject to examinations by the Federal Reserve Board (for the holding company), the OCC (for the national bank), and the FDIC (as the insurer of the national bank), just for solvency regulation. If the holding company also owned a State-chartered bank, then that bank would be subject to examination by the State and either the FDIC or a Federal Reserve Regional Bank, depending on whether the State bank is a member of the Federal Reserve System or not. Each of these agencies has a specific mission and focus, leading examiners for the agencies to pursue different objectives. There is a significant opportunity for greater coordination and cooperation among the Federal prudential banking agencies since they share a common safety-and-soundness goal and have limited resources.

Proposed solution

Our proposed solution is to create a pilot program for a consolidated examination force with participation from the three Federal prudential banking agencies (the Federal Reserve, FDIC, and OCC). The pilot program would be directed by a new supervisory committee within the Federal Financial Institutions Examination Council (FFIEC), an agency designed to foster cooperation among its member agencies, including the three prudential bank regulators. The voting Members of the Committee would be the heads of supervision of the three prudential banking agencies and the FFIEC's State banking regulator.

The supervisory committee would select a group of banks of varying characteristics (*e.g.,* size, complexity, type of charter, and State of domicile) to participate in the pilot program. For each institution, the committee would create a consolidated examination task force made up of examiners from each agency with jurisdiction for that institution. The task force would be led by the institution's primary regulator, but examiners from each participating agency would work together to:

- Develop a single set of supervisory questions to ask an institution;
- Jointly examine each institution; and
- Ensure that each examination produces a single, combined report that is available to all agencies that participate in a particular exam.

A task force could be assigned to conduct a full examination of an institution, or could be assigned to conduct a more targeted examination, such as for risk management or Volcker Rule compliance. Further, State banking regulatory agencies would be invited to participate in task forces that are assigned to institutions within their respective States, allowing them leverage Federal resources to an extent they would not otherwise be able.

The committee would be responsible both for building and executing the pilot program in a way that tests its effectiveness under a variety of conditions, including coordinating consistent supervisory priorities, protocols and procedures for examination task forces and otherwise ensuring coordination among participating agencies. The committee would also be responsible for assessing the pilot program's effectiveness and making recommendations to improve the operation of consolidated examination task forces.

A well-designed and pilot program would realize a number of advantages:

- Consolidation would improve communication among supervisory teams since examiners would be trained under a common framework and be overseen by a unified committee of supervisors drawn from the three agencies. Since financial stability can be threatened by a lack of communication among agencies, the advantages of this structure should be substantial.
- Regulators could better leverage their specialist personnel, whose expertise would be usable across a wider set of institutions. This would improve the overall quality of examination teams, because those teams would be able to draw on a wider variety of experiences and best practices.
- The quality of State regulation would be significantly boosted by allowing individual States to leverage Federal examination teams to assist in State examinations. State agencies often cannot afford to employ multiple specialists or do not have the overall level of resources available to the Federal agencies. To the extent that the Federal examiner training and procedures incorporate individual State supervision objectives, State bank supervisors may elect to put greater reliance on accepting a Federal examination in lieu of a separate State examination.

Federal regulators would also benefit from better information-sharing with States through this process.

- Consolidated budgeting for examiners and examinations would enable the agencies to better coordinate and apply examiner teams to particular lines of business or institutions.
- Uniform standards for training and management of examiners and supervisors should lead to more consistent and translatable examination results and expectations, as well as streamlining the process for both regulators and financial institutions.
- Human capital among examination teams would be developed by providing greater opportunities for career advancement, consistent and higher compensation standards, and a better-defined and supported career path.
- Integrating key support operations—such as hiring, training, compensation, and promotions—for examiners should make the management of the examination force more efficient and less costly compared with sustaining the same functions at multiple agencies.
- It would enable examiner teams to take advantage of interchangeable elements offered by each agency. At the same time, it would permit the development of specialized teams. For example, examiners could specialize in banks of certain sizes and complexities, geographic regions, or predominant lines of business (*e.g.,* agricultural loans, small-business lending, commercial real estate, and derivatives).

These proposals exist in harmony with the dual banking system. The task force believes that the existence of both federally chartered and State-chartered banks provides great benefits, offering more choices for consumers and allowing for greater policy innovation by individual States. The consolidated examination force envisioned here will provide more and better resources to both State and Federal jurisdictions, thereby improving the quality of supervision across the board.

A pilot program would improve and enhance the efficiency and quality of the examination and supervision of insured depository institutions and their holding companies through better coordination and training with improved efficiencies.

RESPONSE TO WRITTEN QUESTION OF SENATOR VITTER FROM MARK OLSON

Q.1. Mr. Olson in your written statement you described the complications with the arbitrary SIFI threshold of $50 billion and presented different ideas to overcome this arbitrarily threshold.

What threshold amount or formula would you propose for small or community banks where the current threshold is at $10 billion?

A.1. Thank you for that question, Senator. Although I and Richard Neiman, my colleague as co-chair of BPC's Regulatory Architecture Task Force, did not make a specific recommendation regarding a threshold for community banks, I believe that the principles we articulate in reference to the so-called "bank SIFI" threshold apply here as well.

In short, financial regulatory agencies should focus a greater share of their scarce resources on the institutions and activities most likely to produce systemic risk that might threaten financial stability. While any threshold will inherently be arbitrary, it is clear that the risk presented by smaller banks that are well-managed, well-capitalized and engaged predominantly in plain-vanilla activities is significantly lower than that presented by larger banks with high-risk profiles. Regulators can and should tailor their regulation to account for these differences.

We also believe that there is a need to index any threshold of this type. Currently, these thresholds in Dodd-Frank are static, meaning that over time, their real value will decline relative to a number of economic measures. In effect, a static $10 billion threshold will capture more small banks over time much the same way that a dollar buys less than it did 20, 50, or 100 years ago. We believe these thresholds should be indexed to GDP or perhaps the overall size of the banking industry, rather than to a metric like inflation. This is because the most relevant criterion in determining a bank's impact on the financial system is how significant that bank is relative to the economy or the financial system rather than the purchasing power of a dollar.

RESPONSE TO WRITTEN QUESTION OF SENATOR REED FROM SIMON JOHNSON

Q.1. I think it may surprise most of my colleagues to learn that the employees at the regional Federal Reserve banks are not currently subject to the ***same*** ethics laws that other Government employees are subject to. Do you think that the employees at the regional Federal Reserve banks should be subject to the same ethics laws that Government employees are subject to, such as the ban on accepting gifts from regulated entities?

A.1. Yes, employees at the regional Federal Reserve banks should be subject to the same ethics laws as all other Government employees, including the ban on accepting gifts from regulated entities.

The Federal Reserve System is an important part of the American Government. Within the Fed System, the Federal Reserve banks operate as important components of policymaking and implementation. People working in these banks are essentially Government employees, with all the responsibilities that this entails.

Through some quirks of legal and political history, some Federal Reserve employees are not treated the same as other Government employees, for example with regards to ethics law. This is a problem that should be addressed. The current situation only undermines the legitimacy and the effectiveness of the Fed.