S. HRG. 115–106

FOSTERING ECONOMIC GROWTH: MIDSIZED, REGIONAL, AND LARGE INSTITUTION PERSPECTIVE

HEARING

BEFORE THE

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

ONE HUNDRED FIFTEENTH CONGRESS

FIRST SESSION

ON

EXAMINING THE CURRENT STATE OF MIDSIZED, REGIONAL, AND LARGE INSTITUTIONS, INCLUDING THEIR REGULATORY REQUIREMENTS, IMPACT ON CLIENTS, AND THEIR ROLE IN PROMOTING ECONOMIC GROWTH

JUNE 15, 2017

Printed for the use of the Committee on Banking, Housing, and Urban Affairs

Available at: http://www.fdsys.gov/

U.S. GOVERNMENT PUBLISHING OFFICE

27–425 PDF WASHINGTON : 2017

For sale by the Superintendent of Documents, U.S. Government Publishing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

MIKE CRAPO, Idaho, *Chairman*

RICHARD C. SHELBY, Alabama
BOB CORKER, Tennessee
PATRICK J. TOOMEY, Pennsylvania
DEAN HELLER, Nevada
TIM SCOTT, South Carolina
BEN SASSE, Nebraska
TOM COTTON, Arkansas
MIKE ROUNDS, South Dakota
DAVID PERDUE, Georgia
THOM TILLIS, North Carolina
JOHN KENNEDY, Louisiana

SHERROD BROWN, Ohio
JACK REED, Rhode Island
ROBERT MENENDEZ, New Jersey
JON TESTER, Montana
MARK R. WARNER, Virginia
ELIZABETH WARREN, Massachusetts
HEIDI HEITKAMP, North Dakota
JOE DONNELLY, Indiana
BRIAN SCHATZ, Hawaii
CHRIS VAN HOLLEN, Maryland
CATHERINE CORTEZ MASTO, Nevada

GREGG RICHARD, *Staff Director*
MARK POWDEN, *Democratic Staff Director*

ELAD ROISMAN, *Chief Counsel*
JARED SAWYER, *Senior Counsel*
TRAVIS HILL, *Senior Counsel*

GRAHAM STEELE, *Democratic Chief Counsel*
LAURA SWANSON, *Democratic Deputy Staff Director*
ELISHA TUKU, *Democratic Senior Counsel*

DAWN RATLIFF, *Chief Clerk*
CAMERON RICKER, *Hearing Clerk*
SHELVIN SIMMONS, *IT Director*
JIM CROWELL, *Editor*

C O N T E N T S

THURSDAY, JUNE 15, 2017

FOSTERING ECONOMIC GROWTH: MIDSIZED, REGIONAL, AND LARGE INSTITUTION PERSPECTIVE

THURSDAY, JUNE 15, 2017

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

The Committee met at 9:49 a.m., in room SD–538, Dirksen Senate Office Building, Hon. Mike Crapo, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN MIKE CRAPO

Chairman CRAPO. This hearing will come to order.

Last week, we received testimony on the role financial institutions play in fostering economic growth in local communities. The hearing focused on community lenders, and we heard about the need for additional tailoring, the increasing cost of compliance, and common-sense reforms to rules such as QM, TRID, HMDA, and Volcker.

Today we will hear about the regulatory framework that midsize banks, regional banks, and larger financial institutions face. Midsize and regional banks are often subjected to costly post-crisis rules designed for the most systemically important banks. Many of these rules are applied based on asset thresholds that do not reflect the underlying systemic risk of financial institutions.

While the size of a bank is one factor in measuring systemic importance, there are many other aspects of an institution that are relevant to how difficult the company would be to resolve and how consequential its distress or failure would be to financial markets.

The result is a regulatory regime that is insufficiently tailored for many of the firms subject to it, for example, stress testing. Former Fed Governor Tarullo is among those who have stated that the $10 billion threshold for company-run stress tests is too low. Additionally, CCAR is a very costly, time-consuming process that is overly burdensome, especially for noncomplex regional banks. Another example is the Volcker rule, which has proven far too complicated to implement and incredibly difficult to comply with.

One of my key priorities this Congress is passing legislation on a bipartisan basis to improve the bank regulatory framework and stimulate economic growth. In March, Senator Brown and I began our process to receive and consider proposals to help foster economic growth, and I appreciate all the valuable insights and recommendations that we have received. Also in March, the Federal banking agencies issued their EGRPRA report to Congress with their recommendations.

And earlier this week, the Treasury Department issued the first of its reports examining how best to improve our regulatory framework. The report focused on banks and credit unions and provided a substantial number of helpful regulatory and legislative suggestions corresponding to the President's Executive Order on "Core Principles for Regulating the Financial System".

I commend Secretary Mnuchin and his staff at Treasury for all the work that went into this report and for the thoughtful recommendations they have provided.

I am particularly encouraged by a number of specific recommendations for midsize and regional banks, including changing the $50 billion SIFI threshold; exempting midsize banks from company-run stress tests; exempting banks without significant trading activity from the proprietary trading prohibition of the Volcker rule; and improving the transparency and process of CCAR and living wills.

With the hundreds of recommendations that we have received through our economic growth submission process, the testimony we are receiving at these hearings, the EGRPRA report, and this Treasury report, the Committee has no shortage of ideas to consider as we work to improve our regulatory framework.

As this process continues, I look forward to working with all Members of the Committee from both sides of the aisle to bring strong, robust bipartisan legislation forward.

Senator Brown.

STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. Thank you, Mr. Chairman. Thanks for holding today's hearing. Thank you to the four witnesses for joining us today.

Based on the current Wall Street reform debate, the activity in the House and the report put out by Treasury earlier this week, I am concerned that some seem to have forgotten that we even had a financial crisis a decade ago. I can assure you that families in my home State still remember and continue to live with the consequences of the crisis. I have told this Committee before, but my Zip code in Cleveland where my wife and I live, 44105, in the year 2007, the first half of that year, had more foreclosures than any Zip code in the United States, and I see what a foreclosure on a home means to my neighbors.

That crisis of a decade ago, when the unemployment rate for our Nation reached more than 10.5 percent, we had 14 consecutive years of increasing foreclosures, some 400,000 homes lost in 5 years at the height of the housing crisis in my State. That is to say nothing of the psychological damage caused by lost jobs and children being forced to move away from their friends and families.

Just one example, 17 percent of Ohio homeowners still owe more on their mortgages than their home is worth—the second highest rate in the Nation behind the States of two Members of this Committee, Senator Cortez Masto and Senator Heller.

With these experiences fresh in our mind, Congress passed Wall Street reform, including some of the most sweeping changes to financial regulation in 70 years. Wall Street and its allies are attacking rules like living wills and orderly liquidation that are meant to ensure that a $1 trillion megabank can fail without bringing down the economy with it. At the same time, they attack the capital rules that are meant to reduce the likelihood that banks will fail in the first place.

Let me be clear. Proposals to weaken oversight of the biggest banks have no place in this Committee's process. Wall Street banks caused a financial crisis that cost our economy up to $14 trillion and took $160 billion in taxpayer bailouts. They made the market for the late and unlamented predatory lenders that have left more than one-fifth of Cleveland homeowners still underwater. One-fifth. Letting them run wild again will not help economic growth. It will just put our economy at risk once again.

Having said that, I am optimistic there is room for agreement on a modified regime for overseeing regional banks. This will be the fifth hearing dedicated to the issue of these enhanced prudential standards since July of 2014. The last 3 years, I have been encouraged by steps that the agencies have taken to better tailor standards like stress tests and living wills. We have heard that these two rules plus liquidity requirements may impose the most burdens with the least amount of benefits to financial stability when they are applied to regional banks. I think we all understand that.

We have heard from both midsize banks and their regulators, as the Chairman cited, that changes should be considered to the Dodd–Frank-required stress tests. I look forward to working with the Chairman and our colleagues to explore what might make the oversight regime work better for both midsize and regional banks as long as financial stability and safety and soundness and consumer protections are not compromised.

Let me close with a different topic, if I could, Mr. Chairman, in the last couple of minutes. Wall Street reforms' opponents accuse the law of being too partisan despite the fact that it received Republican votes in both the House and Senate and that it included 15 Republican-sponsored floor amendments. They say it was not well conceived even though we held more than 30 Committee hearings and Chairman Dodd spent months discussing the bill with Republicans on this Committee, some of them still on this Committee. The bill spent more than a month on the Senate floor.

Contrast that, Mr. Chairman, and I want to point out that right now a small group of Republican Senators—maybe a dozen, we read; we do not really know—is crafting a health care bill behind closed doors. They are doing it with no participation from Democrats. As the case with Dodd–Frank, contrast how Democrats passed the Affordable Care Act a number of years ago. It took more than a year, dozens and dozens of hearings in my Committee alone, then the Health, Education, Labor, and Pension Committee. We accepted 150 Republican amendments, open process, lots of debate. But look at what has happened now with the Affordable Care Act.

The Chairman of the Finance Committee—Senator Crapo and I both sit on that Committee, as does Senator Scott. That Committee has no plans to hold even a single hearing on the bill. Both Dodd–Frank and the Affordable Care Act were the product of painstaking legislative work. We were doing our job bipartisanly. We put those together. It put money back in the pockets of American families through lower health care costs and lower credit card and mortgage fees. We owe it to these families on that issue and other issues to have an open and honest debate about the Republican health care bill. There is no sign that Senator McConnell is going to do that. No sign at all.

Nothing could be more important to economic growth than safeguarding the health and the financial well-being of working families. This Committee can play a role in that. I am hopeful that we will.

Thank you.

Chairman CRAPO. Thank you.

At this point we will move to the testimony of our witnesses. Before we do so, however, I want to alert both the witnesses and the Members that we have three votes scheduled at 11 o'clock, so we are going to need to wrap this hearing up by 11 o'clock, which means to my colleagues the 5-minute rule really must be honored, and I will honor it strictly with you. And to our witnesses, sometimes a question comes in right in the last few seconds of the 5 minutes. Please keep your answers brief to that so we can move on and let every Senator have an opportunity to ask questions.

As each of you know, you have been allocated 5 minutes for your oral remarks, and we welcome them. You will also have plenty of opportunities to enhance your testimony in response to questions.

Finally, I wanted to indicate to everyone, I have to testify in the Judiciary Committee in just a few minutes, so I will step out. But I will be back, and I look forward to reviewing and listening to all of your comments.

With that, first we will receive testimony from Mr. Harris Simmons, chief executive officer and chairman of Zions Bancorporation, on behalf of the Regional Bank Coalition.

Following him we will hear from Mr. Greg Baer, president of The Clearing House Association.

Then we will hear from Mr. Robert Hill, chief executive officer of South State Corporation, on behalf of Mid-Size Bank Coalition of America.

And, finally, we will hear from Ms. Saule Omarova—did I get that right?

Ms. OMAROVA. Yes, you did.

Chairman CRAPO. Thank you. Professor of law at Cornell University.

Mr. Simmons, you may proceed.

STATEMENT OF HARRIS H. SIMMONS, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, ZIONS BANCORPORATION, ON BEHALF OF THE REGIONAL BANK COALITION

Mr. SIMMONS. Thank you very much, Mr. Chairman. I appreciate the opportunity to present some views to the Committee this morning. I am Harris Simmons. I am the chairman and CEO of Zions Bancorporation. We are a $65 billion in assets regional bank headquartered in Salt Lake City. We operate across the Western United States, including in the Chairman's home State of Idaho. We particularly focus on small, medium, and mid-market kinds of businesses. We do a lot of commercial lending, the kind of lending that we believe creates a lot of jobs and supports a great deal of economic activity in the Western United States. We serve these businesses, their employees, their owners, and a number of municipalities across the West, many in rural locations, particularly in the Intermountain West.

For the past several years, Zions Bancorporation has been the smallest of the systemically important financial institutions as defined by the Dodd–Frank Act. Sometimes we joke about ourselves as being an "itty-bitty SIFI." And we have felt, I think, perhaps disproportionately, the brunt of the burden of complying with the enhanced prudential standards and other requirements of Dodd–Frank that are applicable to the SIFI group. But that is the common lot of the regional banks generally.

It has forced us to hold capital that is at the north end of our peer group. It has retarded our growth and has hampered the ability of relationship managers, those on the front lines, to serve customers in the manner that they used to be able to do.

In particular, the Comprehensive Capital Analysis and Review process, or CCAR as it is known, has been costly, it has been frustrating, and perhaps most of all, it has been incredibly opaque, and challenging to understand what the evolving requirements have been and what kind of standard is required of us as we think about the economics of our own business. It creates uncertainty, which in turn stifles planning and prudent risk taking.

The liquidity coverage ratio is another feature that is applicable to the SIFI group. In the case of banks under $250 billion but over $50 billion in size, a modified liquidity coverage ratio will become a constraint. I think it has not been particularly constraining. Over the past few years, the industry has been awash in liquidity. But it will become a constraint, and it will become a constraint at the worst possible time. And at a time when liquidity is at a premium, we will find ourselves as an industry withdrawing, and that will not be good for the economy.

Finally, the banking regulatory apparatus has become a Rube Goldberg contraption with overlapping regulators, redundant regulations, such as the various capital regimes, scores of compliance trip wires that cumulatively are overly expensive, sometimes conflicting in their objectives, and they consume an enormous amount of management and board time and resources.

They also have produced a lot of growth in the shadow banking system outside of the regulated banking system. They have, I believe, slowed the housing recovery and resulted in slower capital formation and small business credit availability.

The Treasury Department's outline for reform provides, I think, a great blueprint for beginning to tackle many of these issues, and we look forward to working with other financial institutions and with members of Congress and Members of this Committee in trying to come with solutions that will leave the industry safer and sounder but that will foster economic growth.

Thank you very much.

Senator SCOTT [presiding]. Thank you, Mr. Simmons.

Mr. Baer, you may proceed.

STATEMENT OF GREG BAER, PRESIDENT, THE CLEARING HOUSE ASSOCIATION

Mr. BAER. Thank you, Senator Scott, Ranking Member Brown. I am pleased to appear before the Committee today to discuss how regulatory reform could stimulate economic growth.

I should emphasize at the outset that if the goal is economic growth, it cannot be achieved while excluding large and regional banks from that effort. Community bank relief is warranted, but as the Treasury Department noted in its report this week, community banks hold only 13 percent of U.S. banking assets. The 25 banks that own The Clearing House fund more than 40 percent of the Nation's business loans held by banks and more than 75 percent of loans to households. Large banks originated 54 percent of small business loans in 2015 by dollar amount and about 86 percent by number.

The starting point for any review of the American banking system is one that is extremely resilient. Regulatory changes have helped to increase the quality and quantity of capital. Post-crisis, the aggregate Tier 1 common equity ratio for The Clearing House's 25 banks has nearly tripled and increased from $331 billion to over $1 trillion in capital.

Similarly, U.S. banks now hold unprecedented amounts of cash and cash equivalents to protect against a run. Today such assets compose nearly a quarter of U.S. large bank balance sheets.

While much has been gained in fortifying the Nation's largest banks, some overly stringent capital liquidity, and other rules have diminished their ability to lend and intermediate in financial markets. For example, Fed data show that approval rates for small businesses were just 45 percent at large banks subject to heightened capital requirements for such loans, but 77 and 60 percent, respectively, at CDFIs and small banks.

Similarly, with respect to mortgage lending, our research demonstrates that the Federal Reserve CCAR test is imposing dramatically higher capital requirements on residential mortgage loans than bank internal stress test models or the standardized approach to capital developed by the Basel Committee. As a result, over the past 6 years, residential real estate loans declined 0.5 percent per year at banks subject to the CCAR stress test while they have risen 4.0 percent at banks not subject to the test.

Capital markets have also been affected. Indeed, post-crisis regulation by banking regulators has affected securities markets more than regulation by securities regulators. Bank regulations have made it significantly more expensive for broker-dealers affiliated with banks, which now include all the largest broker-dealers, to hold, fund, and hedge securities positions. And the Volcker rulemakes the holding of market-making inventory a potential legal violation.

The greatest impact has been felt by smaller companies. Issuance of corporate bonds by small and midsize firms has fallen over the past few years even as issuance by larger firms has increased.

Supervision is also playing as large a role as regulation in constraining credit as examiners increasingly dictate how bank resources are to be allocated. For example, leveraged lending is an important type of financing for growing companies, which carry a lot of debt. Based on no empirical evidence, the Federal banking agencies have issued guidance setting arbitrary limits on such lending. Some of the guidance makes little sense. For example, regulators require banks, in evaluating whether a company is leveraged, to assume that all its lines of credit are drawn, which is akin to lowering a consumer's credit score because their credit line has been increased for good payment history. As a result, some Fortune 500 companies with investment grade debt are now deemed by the regulators to be highly leveraged and, therefore, risky.

More broadly, we believe that bank supervision has lost its way post-crisis and requires a comprehensive reexamination. Even as banks have dramatically improved their financial condition, supervisors have transformed supervisory grades from a measurement of financial condition to a measurement of compliance. They have created unwritten rules that lead isolated compliance problems serving as a barrier to expansion, in some cases for years, and particularly for midsize and regional banks.

Another result is simply a massive cost, which must be passed along to consumers, as described in a recent CEO letter to shareholders: "At M&T, our own estimated cost of complying with regulation has increased from $90 million in 2010 to $440 million in 2016, representing nearly 15 percent of our total operating expenses. During 2016 alone, M&T faced 27 different examinations from six regulatory agencies. Examinations were ongoing during 50 of the 52 weeks of the year."

Much of this burden comes as rules that make sense for large complex firms are applied to firms that present few of the same risks. Certainly the answer to a bad rule is not to apply it to fewer people, and there are many rules that fit that description. But there are other rules that make sense for some but not all. My written testimony sets forth numerous rules in both categories and ideas for how they could be reformed.

There is no need for fundamental changes to post-crisis regulation, but there is certainly room for improvement, and particularly if the goal is stronger economic growth.

Thank you.

Senator SCOTT. Thank you, Mr. Baer.

Now, from the great State of South Carolina, Mr. Hill.

STATEMENT OF ROBERT R. HILL, JR., CHIEF EXECUTIVE OFFICER, SOUTH STATE CORPORATION, ON BEHALF OF MID-SIZE BANK COALITION OF AMERICA

Mr. HILL. Chairman Crapo, Ranking Member Brown, Senator Scott, and Members of the Committee, I am Robert Hill, CEO of South State Corporation. I am grateful that your leadership has provided a nonpartisan platform to hear from bankers like myself.

Today I represent my company, South State Bank, and also the Mid-Size Bank Coalition, which is the voice of 78 midsize banks in the U.S. with headquarters in 29 States. Our member banks are primarily between $10 billion and $50 billion in assets and serve customers and communities through more than 10,000 branches in all 50 States, the District of Columbia, and three U.S. territories. Midsize banks most often are the largest local bank serving their community, many for more than a century.

South State specifically was founded in 1933 on the heels of the Great Depression in rural South Carolina. Today we serve communities both large and small in North Carolina, South Carolina, and in Georgia.

In January of this year, our bank crossed the $10 billion in asset threshold, and I have had the opportunity to see firsthand how this threshold is having a negative impact on economic growth.

At South State, not unlike my peers in the coalition, we operate a very simple business model. We offer depository services, and we lend money in local communities. This is very similar to the business model we operated when we were a very small community bank. We have stable deposit funding from our customers, revenues that are driven from traditional banking services, and that are well understood by both our regulators and our management team. And we have never done any proprietary trading.

South State and other midsize banks have prudent business models that contribute to economic growth and support financial stability. Our company never lost money during the financial crisis. We never did subprime lending. We never stopped lending to our customers during the crisis.

As the largest banks in many of our States, midsize banks can have a significant impact on our communities, but some banks are choosing not to cross this huge threshold or cross it and shift their focus from investing in the businesses that they have to investing in the preparation for large bank regulation.

Under Dodd–Frank, crossing the $10 billion in asset threshold has had very harsh implications for midsize banks. This is happening to a segment of our industry not based on risk but based purely on asset size. And I assure you that adding $1 in incremental assets as we cross $10 billion did little to change the risk profile of our company.

While we value many parts of Dodd–Frank and we like the way our industry has been strengthened since the crisis, I have yet to see the value to the public in any appreciable way of the arbitrary $10 billion threshold. These requirements drain resources of midsize banks, divert dollars from investment in our customers to investment in large bank regulation. For example, South State was impacted by over $20 million per year, a significant sum for a bank our size. What impacts did this have on our local communities? For us, that equates to 300 jobs. Approximately 10 percent of our branches were closed, and even more jobs were diverted from lending to regulatory compliance.

As banks that support Main Street and not Wall Street, we need our communities and our communities deserve regulation that encourages prudent behavior and also protects our customer. But we also need to have common-sense regulation that does not impose burdens or slow economic growth in our communities. In our view, we must move away from the Dodd–Frank $10 billion regulatory threshold.

Again, I appreciate the opportunity the Committee has given the Mid-Size Bank Coalition and myself to express these views today.

Senator SCOTT. Thank you, Mr. Hill.

Professor Omarova.

STATEMENT OF SAULE T. OMAROVA, PROFESSOR OF LAW, CORNELL UNIVERSITY

Ms. OMAROVA. Senators, thank you for the opportunity to testify on this important issue.

We are all here today because 9 years after the worst financial crisis in generations, the banking industry is now waging a massive campaign to roll back the Dodd–Frank Act and the entire regime of post-crisis systemic risk regulation. The banks claim that regulation is what directly prevents them from lending to small businesses and struggling families and, thus, prevents them from fostering America's economic growth. You should take these claims with extreme skepticism.

First, it is important to understand what the banking industry really means by growth. What America needs is real economic growth—sustainable, socially inclusive, long-term growth of the real, nonfinancial, sector of the American economy. We need to restore the Nation's eroding industrial base, rebuild and modernize our infrastructure, and create sustainable, well-paying jobs. What we do not need is to have another stock market or real estate bubble fed by cheap credit and speculation in secondary markets.

Yet if Congress, you, deregulate big banks, that is precisely what will grow. Big Wall Street banks derive the bulk of their profits not from small business lending but from massive high-risk trading and dealing in secondary markets. They feed speculation, not real economic growth. That speculation is precisely what caused the latest financial crisis, and it will inevitably cause another one on your watch.

In a strategically savvy move, big banks are aligning themselves with the smaller and midsized and regional banks as far more sympathetic petitioners, almost the Jimmy Stewart bank types. Almost but not quite. Even the tiniest among them have more than $10 billion in assets, and the bigger ones, well over $300 and sometimes $400 billion in assets. True, they are smaller and less dependent on speculative trading than Wall Street megabanks, and perhaps they do deserve a lighter regulatory load. But if trying to help these smaller banks you grant their request for a massive regulatory rollback, the principal beneficiaries of the deregulation will be Wall Street megabanks. Deregulation will reduce smaller banks' compliance costs, but it will also enable megabanks to expand the high-risk speculative trading, which is at the core of financial instability and crisis.

To guard against that, you should require banks to provide concrete evidence that they will actually use their savings from specific deregulatory measures primarily, if not exclusively, to increase lending to productive economic enterprise. At the very least, banks should give you the exact amounts of prudent, productive loans that they were ready to make but were forced to decline solely because they did not have enough money left after paying for regulatory compliance. I doubt that such evidence exists. Yet there is plenty of evidence that all banks, regardless of their size, generate healthy net profits, in fact, to the tune of $175 billion only in 2016 and choose to return the bulk of those profits to their shareholders through dividend payments and share buybacks. Only last year, insured banks paid out $103 billion in cash dividends, an amount second only to the record high of $110 billion in bank dividends paid in 2007, the last pre-crisis bubble year.

High dividends increase banks' stock price and management bonuses, so that is where most of their money seems to go, not to lending or regulatory compliance. That is a far cry from rebuilding America's industrial base or helping struggling American families to get out of poverty.

Unless banks put their own money where their very loud and very well paid mouths are, you should not read their claims about fostering growth as anything more than convenient rhetoric. Indeed, it is much more likely that big banks' massive push for deregulation is driven by their desire to generate high speculative trading profits, increase their executives' bonuses, and return more dividend cash to their shareholders. Right now, all of these things are significantly limited by the Dodd–Frank regime of enhanced prudential supervision, including heightened capital ratios, supervisory stress testing, and living will requirements applicable to large systemically important financial institutions, or SIFIs.

No wonder that the banking industry attacks the key elements of this post-crisis regulatory regime as supposedly arbitrary and insufficiently "tailored" to their unique circumstances. For example, banks are demanding that SIFI designation is conducted on a strict case-by-case basis with every bank getting the same tailored process as MetLife got, and we all know how perfectly efficient and problem-free that process turned out to be. If you allow this to happen, it will effectively kill the entire regime of enhanced SIFI oversight.

The same goes for banks' demands to force the Federal Reserve to publish its stress test scenarios for public notice and comment and to restrict the Fed's ability to conduct and use its own test models. Yes, that will make stress tests fully transparent, just like giving the students exam questions before the exam will make that exam transparent. And it will also make it absolutely useless for its intended purposes. I know better than to give my students such a special gift, and you should know better than to do the same for the banks.

In conclusion, I urge you to keep focus not on what banks want for the sake of their own profitability, but on what the American economy and the American people need: not another speculative frenzy but sustainable, employment-generating growth of the real economy. Financial deregulation will hinder, not foster, such growth.

Thank you.

Senator SCOTT. Thank you, Professor.

And I will just remind all of us that we have votes at 11 o'clock, and our goal is to be out by 11 a.m., so keeping our questions to 5 minutes would be very helpful. I will start off our questions.

Mr. Hill, thank you for being here today. Certainly it is always good to have a homegrown South Carolina product like yourself and your company do very well, and thank you for being here to testify before us today.

I think it is critical that the Committee hears from voices representing all parts of our country. It ensures we get a holistic perspective on how to grow our economy for everyone. That is why I am so glad that Mr. Hill is testifying today. His company, South State Bank, is the largest financial institution headquartered in South Carolina. It has less than $12 billion in assets, but States like mine rely heavily on midsize banks and regional banks to provide small business loans, mortgages, and consumer financial services.

The Dodd–Frank Act created a lot of hoops for companies like South State to jump through. Much of the added regulatory burden is triggered by specific asset thresholds. It seems to me that if you tell someone that they will get hammered by the Federal Government if they hit XYZ number, everyone is going to do all that they can to avoid hitting that number. The collateral damage is to economic growth.

Mr. Hill, can you speak to the distortions in the market and business behavior as institutions approach these thresholds?

Mr. HILL. Yes, Senator Scott. First, I want to thank you for the nonpartisan support of the CLEAR Act, as well as Senators Heitkamp and Moran. It is this type of bipartisan sensible legislation that I do think is moving the ball forward to help deal with some of these issues.

Senator SCOTT. Thank you.

Mr. HILL. The changes as you approach this threshold is versus—I think of a threshold as a small step forward. This is a meaningful leap for a bank of $10 billion. I have been in the business for 30 years. I have dealt with a lot of regulation. I do not ever remember even fathoming the fact that a customer could add one more dollar to a checking account or savings account to take you to $10 billion and you would be saddled with a $20 million burden and be treated as a large bank.

So it is doing two things. It is, one, driving banks out of our industry. Senator Perdue certainly sees it in his State. Senator Tillis, Senator Scott, we certainly see it in ours. They cannot compete, and as you get larger, they realize they do not want to go over that $10 billion hurdle and they elect to exit.

The other is for those that elect to stay in like our company, we are an 80-plus-year-old company. We are vitally important to many of the communities we serve. We wanted to stay in. But try to take the Dodd–Frank Act and put it over a bank with a little bit more than 100 offices compared to a national bank with 5,000 or 6,000. The burden is huge. So it ends up resulting on different forms of behavior. Companies decide to sell, or they have to cut expenses. In our case, we closed 10 percent of our branches. All of that money went toward regulatory reform, and it has taken the attention of our board and our management team and a lot of our employees over 3 years to be able to make this journey. And now we have just crossed it. Now we begin to be treated as a large company.

Senator SCOTT. Thank you, Mr. Hill. Facts and figures aside, at the end of the day I am worried about the Aiken family that is trying to buy their first home or the Nichols small business owner who just survived the flood and is now trying to get back on their feet.

Mr. Hill, what is the impact of enforcing these arbitrary thresholds on economic growth and on the people of South Carolina? Specifically, you mentioned—my words, not yours—$9.9 billion in assets versus $10 billion in assets, 10 percent closing of your locations, maybe up to $20 million of additional regulatory burden. How does that impact the average person in our State looking to borrow money for a home or restore their business after a major flood?

Mr. HILL. Well, the midsize banks fill a very important gap between the smallest banks and the largest banks in our country. Because we are the community bank for South Carolina, we are very focused on communities like Aiken. Many of the large national banks would not know where that community would be. It does two things. One, it drives costs up. That is very simple, very clear. It is 15 to 20 percent. It takes flexibility away. It does not allow us to treat customers uniquely based on their needs, both financially and also their situation. And it paints in a one-size-fits-all regulatory environment.

Senator SCOTT. Thank you, sir.

Ranking Member Brown.

Senator BROWN. Thank you, Senator Scott.

Professor Omarova, the *Wall Street Journal* recently said it is hard to miss how much the Treasury report would benefit top Wall Street banks. That comes from the paper of record, if you will, for Wall Street. By my count, the report includes about two dozen of The Clearing House's recommendations. You talked in your testimony, Professor Omarova, about the argument that rolling back rules for Wall Street banks would help lending. What are the implications of rolling back the capital and the leverage rules and the Volcker rule restrictions against proprietary trading? Would that, in fact, lead to more lending or economic growth?

Ms. OMAROVA. Well, there is absolutely no evidence that it will, in fact, lead to more lending or economic growth. There is a lot of confusion about what capital rules do, because banks always tell us, oh, you know, capital just traps cash and we cannot lend money out. And nothing could be further from truth. Capital is not cash in the vault. It is not some kind of gold that, you know, they have to put away. Capital is just an accounting concept. It is basically shareholders' equity, and banks are forced by regulation to hold these cushions of shareholder equity to protect creditors from losses on their assets. They can get away with much thinner cushions than, you know, a normal company could get away with in the capitalist market because the Government protects creditors of the banks from banks' failure.

And so if you roll back capital requirements, what will happen is that the banks will be able to take more risks. And because banks are privately owned, profit-seeking enterprises, quite legitimately they would look for investments in assets that generate higher returns, which typically entails higher risks. And that is what will happen. There is no evidence that somehow Dodd–Frank Act is what prevents banks from lending. You know, banks choose how to use their cash, and they choose their—for example, they choose to declare dividends out of their cash. And that directly takes away cash from lending.

In my view, basically if we roll back these regulations, what we will have on our hands will be another crisis, and everybody in this room should be warned about that.

Senator BROWN. Thank you.

Let me ask everybody on the panel—and I would prefer a yes or no, and I think you can answer this yes or no. This Committee has talked for some time—and the sitting Chairman was a leader in this issue 3 or 4 years ago—about housing finance reform and its importance to economic growth. I will not ask you for detailed thoughts because that would be a long, long answer from each of you. But if you would answer yes or no, do you think we should have hearings on the topic of housing finance reform and have an open process where you can weigh in and we can discuss it? Mr. Simmons.

Mr. SIMMONS. Absolutely.

Senator BROWN. Mr. Baer.

Mr. BAER. Yes.

Senator BROWN. Mr. Hill.

Mr. HILL. Yes.

Senator BROWN. Professor Omarova.

Ms. OMAROVA. Yes.

Senator BROWN. OK. Thank you. If that is the case for housing reform—I will start again on the left—do you think it should also be the case for the significant changes to health care?

Mr. SIMMONS. It is not the purpose of the hearing, but yes.

Senator BROWN. Mr. Baer.

Mr. BAER. I do not know. It is not my area of expertise.

Senator BROWN. But you are a citizen.

Mr. BAER. I am a citizen who has saved a lot of time in my life by not thinking about health care reform because it is so difficult to understand, and I am sort of full up on bank regulatory——

Senator BROWN. But do you think we should have an open process and discuss it?

Mr. BAER. I think in general open processes are better than closed processes.

Senator BROWN. Mr. Hill.

Mr. HILL. I tend to think health care is important to the vital health of the local economies, and that the more discussion we can have to move that along, the better.

Senator BROWN. Professor Omarova.

Ms. OMAROVA. Absolutely. There must be an open, democratic, and fully vetted process for deciding such an important issue. We all have to know what is going on.

Senator BROWN. OK. Thank you. And if we screw up either effort, whether it is Dodd–Frank, whether it is housing finance reform, whether it is health care, clearly the economy pays a price. I mean, we know that.

Let me ask one last question, Professor Omarova, and give your answer as short as you can in complying with the President's request—the Chairman's request. You are not the President.

[Laughter.]

Senator BROWN. Professor, you said reasonable people may disagree and argue about whether the current size threshold, $50 billion in assets, is the right one or whether a higher or lower number would be more socially beneficial. How do we balance providing—as we talk about tailoring Section 165, as I think we should, how do we balance providing appropriate relief for regional banks against the intent of 165 to mitigate risk to financial stability?

Ms. OMAROVA. Well, that is a complicated question, but the one clear answer is that we should not just simply remove all regulation from regional banks because they are less than $1 trillion in assets. As a group, they still present significant risks. If they fail as a group in a correlated set of failures, that will probably tank regional economies and maybe the national economy.

Think about the S&L crisis in the 1980s. Those were also very small and traditional lenders, and when they were deregulated, those small traditional lenders almost brought down the financial system. And that is what we should think about today. We cannot look at these regionals in isolation. We definitely should think about how to tailor regulatory burden for them, but we cannot just blankly remove all the regulations because they are smaller.

Senator BROWN. Thank you, Mr. Chairman.

Chairman CRAPO [presiding]. Thank you.

Senator Tillis.

Senator TILLIS. Thank you, Mr. Chair, and thank you all for being here. I cannot imagine anyone sitting up at this dais would suggest just a blanket repeal of all regulations. It does not make sense. Regulations exist for a reason. Some of them are good. Some of them are awful. And I think that there are some manifestations of regulations that have been promulgated under Dodd–Frank that are absolutely awful.

Mr. Baer, I want to ask you a question about the concept of tailoring the—instead of these simplistic, you know, $50 billion, $250 billion sorts of thresholds that we create to determine the regulatory burden on the institution, I am more of a proponent of tailoring. I am getting to a point to where the regulatory burden is proportionate to the risk of the target being regulated. Could you give me some thought with respect to the regulatory environment that we have today—most of it is driven by Dodd–Frank; some of it pre-dated it—that you think lends itself to that kind of thought process and the benefits that you think would accrue by doing that?

Mr. BAER. Yes, Senator, sure. I think when it comes to tailoring, you need to think about what risks does the institution present. You know, for example, does it have a capital markets business? Does it have multiple subsidiaries or only one? Is it primarily funded by deposits or is it funded in other ways? Then you think about what rule are we talking about here? Is it a living will? Is it capital requirements? Is it liquidity requirements? And then marry those two up.

So, for example, the notion of having a living will for a small deposit-funded firm which is going to be in any event resolved, you know, under the pre-existing FDIC resolution process does not seem to make a lot of sense.

There may be other rules. I mean, if you believe that there should not be proprietary trading, perhaps some of those rules should continue to apply. But, again, I think you need to make the decision based on firms in categories in terms of the risks they present and then the type of the rule you are talking about.

Senator TILLIS. The other thing that I find interesting, at least in some of the prior committees—I am sorry I was not here earlier; we have got four committees meeting at the same time, so I did not get to hear the testimony. But with an eye toward lean regulation, let us say that we go through that stratification, and we come up with a more coherent way of actually determining what regulatory burdens should be placed on a financial services institution. What about other areas in terms of executing— and this is for anyone, but when I hear the big banks who would be at the highest level and have the highest amount of regs—and I guess in some cases if you get the methodology right, appropriately so. But would it make—how can it possibly make sense to have the stress test submissions be in the hundreds of thousands of pages? I mean, isn't there any thought given to how you create a leaner design around this and get the paperwork and the time and the costs associated with that out of it so that the consumers accrue a benefit, the money is being spent on value to the consumer versus compliance with the Government? Anyone have any opinion on specific things that we could potentially do to reduce that burden?

Mr. BAER. I will just say briefly on CCAR, again, I think the length of the submission should vary with the complexity of the firm. There may be large firms that need very complex submissions. In fact, our view is with respect to the stress test that the DFAST models run by the banks, which are granular down to loan level, are actually appropriate and a better measure of capital perhaps than the opaque model that the Federal Reserve is running. But certainly for less complex firms, I think less burden would be appropriate.

Mr. HILL. Senator, I would just add, if you look at—I could sit down and explain our balance sheet to you in about 5 minutes. It is pretty simple. It does not take complex algorithms and quants to be able to figure out the sensitivity of our company. I think it ultimately comes down to capital, how much you hold—that is what is going to protect all of us when we have the next downturn. And I think the Basel limits, I think looking at capital rules, actually provide much more sound banking practices than some theoretical analysis on sensitivity.

Mr. SIMMONS. I might just add, you know, our CCAR submission runs over 12,000 pages. You reach points of diminishing return pretty quickly in a very straightforward business model. We find the process itself to be useful, but the incredible degree of precision to which the Federal Reserve has pushed this does not yield benefits commensurate with the cost.

Senator TILLIS. We all know that has a disproportionate impact on smaller banking institutions, but all of the regulations that we are heaping on that I think have reached a point of diminishing returns we have got to look at and right-size. There was clearly a risk in 2008 that we had to produce regulations to avoid in the future, but we have clearly gone too far. And I have to take exception with anybody who thinks that everybody who wants a loan can get it today. The reality is a lot of people—it is sort of like people who leave the labor market, and so they are just not searching for work anymore. There are entire business enterprises that are not looking for capital because they do not think they can get it or the cost of getting it is just too great. And it is having a chilling effect on our economic growth. That is one of the reasons why we have such anemic economic growth. And unless we start right-sizing some of these regulations and recognize there is a lot of pent-up demand for capital and that the root of that are a lot of regulations that overreached in Dodd–Frank, then we are not going to get to the sort of economic activity that we need to get to, to then dig ourselves out of this $20 trillion in debt.

On the report, I had a lot of questions to ask you, but I have gone over, and I normally do not go over, Mr. Chair.

Chairman CRAPO. We will take it out of next time.

Senator TILLIS. But there are a number of things that, if I may in follow-up questions for the record, I would like to go into the report itself, and some of the priorities and objectives, we would like your input, because I think this is critically—it is one of the most critical things we can do to really get economic activity where we need it to be.

Thank you all for being here.

Chairman CRAPO. Thank you.

Senator Donnelly.

Senator DONNELLY. Thank you, Mr. Chairman. I actually only have one question, and that would be for Mr. Hill.

Senator Toomey and I have previously introduced a bill to increase CFPB examination thresholds from $10 billion to $50 billion. How would that make things better for your customers—not so much the bank, but what does that do for your customers?

Mr. HILL. Senator, it is a great question. I think that you can take the CFPB, but you can take numerous parts of Dodd–Frank legislation and really kind of put them all under the same umbrella. Removing that $10 billion threshold for the company and also for a customer, it just makes things less complex. If we want to talk about getting more money to Main Street, more money to the individual, having one more regulator is not a way to accomplish that. We have multiple regulators already, and now we will have an additional one now that we just crossed CFPB.

So I think a lot of this is about what makes sense and what simplifies it. We have a very close relationship with our regulators——

Senator DONNELLY. And it would not reduce safety or stability in your organization, would it?

Mr. HILL. No, sir. Our primary regulator is the FDIC. We have a very close relationship. They are in——

Senator DONNELLY. Those are obviously critical elements.

Mr. HILL. Absolutely. And I think they should be. I just think they can be done by our existing regulatory bodies.

Senator DONNELLY. All right. Thank you.

Thank you, Mr. Chairman.

Chairman CRAPO. Thank you, Senator Donnelly.

Senator DONNELLY. I made up for Mr. Tillis.

Chairman CRAPO. You did, and I appreciate it very much.

As I indicated at the beginning of the hearing, we have a hard stop at 11 because we have three votes, and so I appreciate that time. You will get an extra credit.

Senator Kennedy.

Senator KENNEDY. Thank you, Mr. Chairman. I, too, am sorry I am late, but I was not watching "The Price Is Right". I was in a committee, OK?

[Laughter.]

Senator KENNEDY. Mr. Hill, I wanted to—you have been there. Do you still run a bank? I notice you have been president and chief operating officer.

Mr. HILL. Yes, sir. I am actively running the bank day to day and have been for the last 22 years.

Senator KENNEDY. About $8 billion in assets?

Mr. HILL. We just crossed $10 billion in January. We are roughly $11.5 billion today.

Senator KENNEDY. How many people do you have in your compliance department?

Mr. HILL. This is an estimate, but it would be roughly 50 direct employees, but then there are numerous compliance people embedded in our lines of business across our company.

Senator KENNEDY. So some do it full-time, some do it part-time.

Mr. HILL. And some are just in a full-time compliance role, and some are in the active day-to-day administering of the process. And so there is some overlap there. But compared to 5 or 6 years ago, that is probably tenfold.

Senator KENNEDY. OK. That was my question. Tenfold.

Mr. HILL. And if you look at the cost of that—I look at ultimately what does that mean to the customer. I think Senator Donnelly's question was: What does it mean to the customer? What this means to the customer for a mortgage loan is our cost to deliver a mortgage loan is roughly $1,000 more today than it was just a few years ago, mainly because of the increased compliance costs.

Senator KENNEDY. OK. Let me break that down, though. Today you have roughly 50, plus a number of employees that are part-time, if you will, and that is tenfold. OK?

Mr. HILL. Yes.

Senator KENNEDY. How much are you spending on those 50 employees?

Mr. HILL. It would be, you know—I guess it would be in the several million dollars range.

Senator KENNEDY. OK. And do you believe that these additional employees are a direct result of Dodd–Frank?

Mr. HILL. Oh, they are. Yes, sir. To comply with the rules and regulations, two things happened: We had to close ten offices. We saved almost $5 million from closing those ten offices. All that money was spent directly on complying with Dodd–Frank.

Now, there is a lot more than just that $5 million, but that all was directly spent—a large part of that was in process and compliance-related efforts.

Senator KENNEDY. How much did your bank make last year?

Mr. HILL. Our company last year made—this is an estimate.

Senator KENNEDY. Sure.

Mr. HILL. In the $65 million range.

Senator KENNEDY. OK. Has Dodd–Frank helped at all?

Mr. HILL. Yes, sir. I do believe there have been parts of Dodd–Frank that have been positive. I think the most important piece is the capital. The banking industry as a whole is holding more capital today than we did. We are less leveraged as an industry. That is the ultimate safety net. Regulation is not the ultimate safety net. Capital is the ultimate safety net. And banks across the board today are holding more capital—our bank included. But we never levered up like many of the large companies did. We are still holding more capital than we have.

So there have been things that have been done that have been vitally important. But to go back to the $10 billion threshold, we are choking out the most vitally important part of our community banking system by having this arbitrary threshold. And it is making people leave the industry or significantly limiting their ability to impact their local community because we are—while we are in the same industry as the large banks, we are really significantly different companies.

Senator KENNEDY. You have been in this business—well, you all have. Has there ever been a time when the Federal Government and its regulation of your industry really did sit down and say what are the costs and what are the benefits and make the sort of calculation that normal people do every day in their business or in their family? Or is that just lip service? Have we ever done it right?

Mr. HILL. Senator, I have been doing this 30 years. I have seen a lot of regulation come and go. Most of it has been constructive. You figure out a way to deal with it. And I have never felt the need to reach out to a Senator about that regulation until now. But this arbitrary $10 billion threshold is a painful process that is costing our consumer and our communities and local economies, and we are overregulating a systemically important part of our economy, which is our community banks.

Senator KENNEDY. Thank you, Mr. Chairman.

Chairman CRAPO. Thank you.

Senator Cortez Masto.

Senator CORTEZ MASTO. Thank you, Mr. Chairman.

I am actually over here in the corner. Good morning. Thank you for joining us.

So let me start off with the first question, and I will open it up to the panel. As a new Senator from the great State of Nevada, I was not here for the debate on Wall Street reform, but let me tell you, as the Attorney General there for 8 years watching as the crisis unfolded and the impact to the State of Nevada, I was paying close attention. If you do not know, it was ground zero for the foreclosure crisis, highest unemployment, more people in foreclosure than, I think, in the rest of the country. At one point in time, 64 weeks, we had the highest rate of foreclosure, highest loan-to-value ratio, 70 percent of homeowners underwater. Devastating.

And so I am curious your thoughts on this. One thing I am concerned about what I have seen is that President Trump's Executive order on financial regulation did not once mention consumer or investor protection. And in looking at the 150-page report that was released by the Treasury Department this week in response to that Executive order, they did not offer one single example where additional protections for students, servicemembers, or seniors were needed.

If we are going to do a wholesale review of financial rules, shouldn't we look at both additional needed protections and regulatory relief? Isn't that the type of balance we should be looking at? I open that up to all of you.

Mr. BAER. Senator, I agree. I think absolutely, you know, any review of post-crisis regulation should include consumer regulation. I think, you know, one issue that we focused on——

Senator CORTEZ MASTO. Not consumer regulation. Consumer protection and regulations to protect consumers.

Mr. BAER. Absolutely.

Senator CORTEZ MASTO. Right.

Mr. BAER. I agree.

Mr. SIMMONS. In my view, a lot of the products—we operate in Nevada. It is Nevada State Bank. And we suffered huge losses, not from mortgages but from financing land improvements and from businesses. And so we certainly experienced a lot of that pain.

There have been a lot of consumer protections put in and many of them probably necessary. We ought to be looking at both. But the combination, the layering of all of this has made this industry increasingly sclerotic and unable to meet the legitimate needs of customers in a way that is sensible and prudent and logical.

And so I think any of us would be open to looking at are there needs for additional consumer protections. That should be on the table. But that is not where the real problem is from the point of view of us who are trying to deliver services to consumers and businesses who are in need of them today.

Senator CORTEZ MASTO. So one of the consumer protections that I thought was very important and I fought for as Attorney General were servicing standards. I think we need those, and I am concerned that there is this idea that we need to do away with them, roll those back somehow. I am curious your thoughts on that.

Mr. SIMMONS. I am not aware of any argument being made by the industry to roll back any protections for consumers in the servicing standards. I do not think that is what we are here to defend.

Senator CORTEZ MASTO. Great. Thank you.

Anyone else have any other comments in general about consumer protection and that should be a part of this discussion?

Mr. HILL. Senator, we are a community bank. We have roughly 700,000 customers. I think the overarching thing for us is doing away with the $10 billion threshold because we are treating community banks like large banks. And I think that consumer protection is a vitally important part of the role for regulatory bodies and also for the banks. But I just think it can be done by our existing regulator. We do not need a new regulator for a community bank with 100 offices to be able to do that. FDIC is in our offices almost year round, knows our company very, very well, and I think it effectively enforces that protection.

Senator CORTEZ MASTO. Thank you.

Dr. Omarova, do you have any comments?

Ms. OMAROVA. I just have a general sort of observation that banks will never publicly say anything against consumer protection per se because that is bad PR, and yet they always admit that the second that regulatory costs increase, they will immediately pass those regulatory costs on to consumers. And then they say, therefore, you should not regulate us because it is costly.

To me, that is not consumer protection. Banks' shareholders, banks' managers, those are the guys who should be eating those additional regulatory costs. To me, that is the essence of consumer protection in practice.

Senator CORTEZ MASTO. Thank you. Go ahead.

Mr. BAER. Senator, not, you know, purely consumer protection, but I do think there is a lot of research to be done, and we have done some research, including a recent edition of our quarterly magazine, around the question of income inequality and bank regulation. I think the evidence shows that one outcome of a lot of the post-crisis rules, including even down to the level of stress testing, where the assumption is that there is a very large rise in unemployment, which tends to cause banks to, you know, more highly price loans to people who are subject to that or are likely to be affected by that spike in unemployment. There has definitely been an increase in the price of credit to people at the lower-income end of the spectrum, and a lot of that in very subtle but very meaningful ways has to do with regulation. And so, yes, consumer protection is really important, but we also think access to credit for consumers, particularly low- and moderate-income consumers, is really important. And that is the reason that we have devoted increasing amounts of our research to it, but we really think others should as well.

Senator CORTEZ MASTO. Thank you. I notice my time is up. Thank you very much for your comments.

Chairman CRAPO. Thank you. And as I have indicated before, we have a hard stop at 11 o'clock. I have not asked my questions yet. That makes three of us if no one else comes. I am going to have Senator Cotton and then Senator Warren go. That will give me a couple of minutes at the end, and maybe I can scoot it a little past 11 and get my 5 minutes in, too.

Senator Cotton.

Senator COTTON. Will I get my bills and amendments voted on earlier if I give my time to you?

[Laughter.]

Chairman CRAPO. Oh, yeah. There is extra credit here.

Senator COTTON. Mr. Hill, I know you have spoken about the various threshold levels, $10 billion, $50 billion, and the burdens those bring. I want to talk a little bit about the arbitrariness of that. Obviously, anytime you pick a number, it is somewhat arbitrary, you know, whether it is the designation for a systemically important financial institution or a speed limit or an age to vote or an age to drink alcohol. But in this field, I mean, what are we talking about here in terms of an institution that might hit a $10 or a $50 billion threshold? Are we talking about thousands or hundreds of thousands of institutions? Or are we talking of a scale of maybe a few dozen?

Mr. HILL. Well, if you look at the 10 to 50 ranks, there are 79 of us.

Senator COTTON. OK. That is what I thought. It would seem that that could be done on a more discriminating basis than an arbitrary threshold, wouldn't it?

Mr. HILL. Yes, sir. It is just not a risk-based approach, and companies—customers are different and banks are different. A risk-based approach versus a one-size-fits-all regulation does not make sense. In my mind, it is quite simple. The role here is risk management. We do not want another financial crisis. And the risks come from the "too big to fail" banks. So, to me, we need to regulate them as one industry, and then outside of that, they are mostly community banks or large community banks like our company. And I think those are very different type banks.

Senator COTTON. So, in principle, you could have a $50 billion bank, or a $500 billion bank for that matter, that is relatively plain vanilla, conservative, and, therefore, not all that risky?

Mr. HILL. Well, I cannot speak to all the 500. I can speak to the 10 to 50s, and I think I can speak to a bank somewhat like Mr. Simmons', which is basically just a larger community bank. But because we have done things right, because we have attracted customers, because we help small businesses, we have grown. And today we are penalized when we take that incremental dollar over $10 billion.

Senator COTTON. And when you say "community bank" there, to be exact, in this context, I think I understand you to mean focusing on the functions that a bank performs.

Mr. HILL. Operating as a community bank. While we are $11.5 billion today, our operating model is the same as it was when we were $400 million. We are just in more communities.

Senator COTTON. Isn't there an old joke about taking it in at 3, lending it out at 6, and hitting the golf course by 3:00?

[Laughter.]

Mr. HILL. I think that was before I joined the industry.

Senator COTTON. But the point being that this risk analysis is primarily—or this analysis should be primarily risk-based, based on the nature of the institutions, or the nature of the functions an institution performs, and, therefore, a relatively large institution can be engaged in relatively low-risk activities. But by the same token, an institution of less than $50 or less than $10 billion, because of the nature of its positions and interlocking counterparties could actually be quite risky. Correct?

Mr. HILL. Correct. And I think just the opposite of that. We want to incent less risk in our financial services industry. So what better way to do that than hold the adequate amount of capital, be in the less risky businesses. We have never done any proprietary trading. So if you are in that business, hold more capital. You are going to have more regulation. But if you do operate a simple business model that positively impacts our community, those are the ones that we have to be careful that we do not go too far. Dodd–Frank did a lot of good things. It overreached in this $10 to $50 billion sector and treated that sector as it does many of the large banks in our country.

Senator COTTON. OK. Just to tie a bow on this part of the conversation, I would say that I think the size of an institution obviously needs to be a part of this analysis, but a simple size-based approach does not seem to make much sense to me. And given the number of institutions we are discussing here, you would think that our financial regulatory agencies could have a more discriminating approach. Again, we are not dealing with, you know, millions of Americans who become 18 years old every year and, therefore, we just have to draw an arbitrary line, even though we all know that some 17-year-olds are very mature and exercise good judgment and plenty of 19-year-olds do not, when you are talking about something on the order of a few dozen institutions that we can take a more sensible and case-by-case approach, with size being one factor in that analysis.

I will yield 40 second back to the Chairman so I can get a chit in the future.

Chairman CRAPO. We will keep that record.

Senator Warren.

Senator WARREN. Thank you, Mr. Chairman.

So after the financial crisis, Congress determined that banks with more than $50 billion in assets—this is about roughly the 40 biggest banks in the country—posed a greater risk to the economy than community banks and credit unions. And so we required the Federal Reserve to apply tougher rules and more oversight to those banks. And now those banks want to eliminate the $50 billion threshold. They want to cut all but the very biggest banks loose from stricter oversight, and they want to restrict the Federal regulators from applying tougher rules except under somewhat more limited circumstances. So, in other words, this is about rolling back a big part of Dodd–Frank, and I just want to take a look at that.

Mr. Simmons, you are the CEO of Zions Bank, which is one of the banks that would avoid tougher rules under the industry's proposal. And in your written testimony, you argue that the current approach covers too many banks given the minimal risks posed by banks like yours, and that we are unnecessarily making it harder for banks like yours to lend. Do I have that about right?

Mr. SIMMONS. Yeah.

Senator WARREN. Yeah, OK. Now, those arguments sounded very familiar to me, so I went back and looked, and it turns out that back in September of 2006, just 2 years before the financial crisis, you were the head of Zions Bank, and you testified before the House Financial Services Committee. Your testimony strongly opposed guidance from Federal regulators that increased the oversight for banks that had a high concentration of commercial real estate loans. Regulators were worried that the banks were overly exposed to one category of lending and that might put them at greater risk of failing. You thought, "Ah, there is no problem." And in opposing the guidance—I want to quote you on this—you said, "The guidance has been proposed at a time when the banking industry is exceptionally healthy."

Another one from you in this testimony: "Commercial real estate loans in particular have performed exceptionally well."

Another one: "By using blanket industry-wide guidance to address concentrations, the regulators risk choking off the flow of credit from banks that are engaging in commercial real estate lending in a safe, sound, and profitable manner."

Now, within 2 years of your testimony, the bank you led, Zions, needed nearly $1.5 billion in taxpayer bailout money to stay afloat. And here is the kicker: That was in part because your bank was highly concentrated in commercial real estate lending, the exact thing that you told Congress was not an issue, nothing to worry about.

So, Mr. Simmons, when you say today that Congress can safely roll back the rules on banks like yours and there will not be any risks to taxpayers, why should anyone believe you?

Mr. SIMMONS. Well, listen, what we are saying is that the enhanced prudential standards in Section 165 of Dodd–Frank are industrial strength and intended, in my way of thinking about this, for institutions that pose a——

Senator WARREN. Mr. Simmons, let me stop you right there because I know we are really trying to do this quickly. I am not asking you to repeat your argument. We have already agreed on what your argument is. The question I am asking, given your previous testimony about how there is no problem here, and then it turned out you needed $1.5 billion in bailout money on exactly the thing you testified was not a problem, I am asking why anybody should believe you when you come in here today and say no problem in this area, let the $50 billion and above banks go ahead. I am just trying to understand why you have any credibility on this issue.

Mr. SIMMONS. Well, listen, because I deal with it every day, and because——

Senator WARREN. Well, you dealt with it every day back when you testified in 2006, and the taxpayers had to pony up $1.5 billion to save your bank.

Mr. SIMMONS. Listen, every large bank took TARP money and without——

Senator WARREN. I am sorry. So your argument is that you were right or wrong——

Mr. SIMMONS. The one large bank that did not receive it, National City, was sold a week later. This was a matter of preserving confidence across the industry. Our capital, our equity capital, always remained above the regulatory minimums.

Senator WARREN. I am sorry, Mr. Simmons. Are you trying to make the argument that you did not have a problem? You know, because actually——

Mr. SIMMONS. We incurred stress, but we never saw equity capital, common equity capital——

Senator WARREN. Let us just be clear about——

Mr. SIMMONS. —decline below the regulatory minimums.

Senator WARREN. ——the problem. The regulators actually went back in 2013 to reexamine their earlier guidance, the guidance you had said was unnecessary, and they found, “During the 3-year economic downturn, banks with high commercial real estate concentration levels proved to be far more susceptible to failure. Specifically, 23 percent of the banks that were highly concentrated in commercial real estate lending,” what you had testified about, “failed compared with only one-half of 1 percent of the banks that were not.”

So I understand we are out of time. I just want to say here, you know, what I notice about this is whenever things are going OK, the banks come in here and say, “Yay, let us reduce the rules, let us let everybody go out. What could possibly go wrong?” And then when things go wrong, banks like yours line up and say to the taxpayers, “Bail me out.”

Our job is to make sure that we do not permit the next failure to happen because it helps short-term bank profits. Our job is to watch out for the taxpayers and the security of this economy.

Thank you, Mr. Chairman. I apologize for going over.

Chairman CRAPO. We are going to put that on your record, too. [Laughter.]

Chairman CRAPO. Just kidding.

Senator WARREN. Well, it is not the first time.

Chairman CRAPO. Thank you. And I will take my questions now. I will try not to go 5 minutes because we do have a vote starting in about 1 minute.

Mr. Simmons, I would like to ask you to finish the comment that you were making just a moment ago with Senator Warren about your equity capital back at the time when the stress started to arise and the collapse in the housing market.

Mr. SIMMONS. Well, listen, capital across the industry has increased dramatically. It has for us. It has more than doubled. It is about 120 percent of what it was back in 2006. Common equity capital, relative to risk-weighted assets, has increased from about 5.5 percent to about 12.2 percent. So we have not only a strong industry, but we have the strongest banking industry in the world. So there is a lot of equity capital in the industry today.

Chairman CRAPO. All right. Thank you. And again, Mr. Simmons, over the past few years, a number of financial regulators have made comments before this Committee supporting changes to the $50 billion SIFI threshold, including Federal Reserve Chair Yellen, former Federal Reserve Governor Tarullo, and former Comptroller Curry, and these are those who are the regulators, in some cases were the regulators who are tasked with getting it right to deal with the risk in our economy.

While there are different views on what to replace the threshold with, it seems to me there is general bipartisan agreement that a bank is not systemically important simply because its assets exceed $50 billion. If the SIFI threshold was amended so that noncomplex banks like Zions were no longer subject to those enhanced standards, how would that impact the broader economy?

Mr. SIMMONS. Well, it would—as I indicated, we have become, I think, as an industry quite—just sclerotic in terms of our ability to do business. I have a letter here from a customer up in Seattle. It says, "When Kerri"—I talked to one of our people up there. "When Kerri Knudsen informed me last week the bank could not provide construction financing for my upcoming development project, I was shocked. The concept that a $3 million construction loan was not possible left me dumbfounded. It leaves me incredulous that a multi-billion-dollar institution is maxed out." It goes on to talk about this. "After 22 years of doing business together, I hit the streets looking for a construction loan."

We find ourselves trying to guess what is in the Federal Reserve's models, in their CCAR models. We know that it is—I mean, we have some vague outline of how—you know, what the results are, but we do not know really how it is treating individual loans. This lack of transparency is my major beef with the CCAR regime. But the overlay of all of these regulations has made it increasingly difficult to do business, and for us, small businesses are sort of our forte, and we feel kind of crippled in terms of our ability to serve them.

Chairman CRAPO. Well, thank you. And I actually get letters and visits from businessmen and women in Idaho who have the same kind of concerns about the inability to get the kind of financing that just seems so obviously appropriate. So I understand the point you are making.

And one other point there quickly. If banks over $50 billion right now were no longer subject to the SIFI thresholds, the $50 billion SIFI threshold, isn't it true that they are still subject to very extensive safety and soundness regulation across the system?

Mr. SIMMONS. Absolutely. Always have been, always will be. And stress testing will remain a central part of what we do.

Chairman CRAPO. And they will still conduct stress tests.

Mr. SIMMONS. Absolutely.

Chairman CRAPO. I wanted to make it clear. Some make it look like there is an exemption of regulation being discussed here. It is a refinement and a tailoring of the type of regulation that we are talking about.

Obviously, my time is up, and I think you heard the bells go off, so this is going to have to be my last question, and this is for you, Mr. Hill. I apologize to the other witnesses. I do have questions for you, too. I will submit those.

But you mentioned in your opening testimony that your bank recently crossed above the $10 threshold and as a result needs to comply with numerous additional requirements, including the Dodd–Frank Act stress test known as DFAST. Can you explain the various steps your bank has had to take to comply with this requirement?

Mr. HILL. Well, I think from a financial perspective, the overall cost is several million dollars, and most of that is in terms of buying very sophisticated models to stress-test our bank under various different circumstances and add the quantitative—the employees who have a quantitative background to be able to do that. And so the ultimate impact is several million dollars, more overhead, more complexity, for a balance sheet that is relatively simple.

Chairman CRAPO. And has that caused the cost of a mortgage to your customers to go up?

Mr. HILL. Our costs of our mortgage loans have risen multifaceted. I do not think you could put it all on DFAST or QM or any others. But when you put all that regulation together that comes with that $10 billion threshold, for every mortgage loans we make it costs us $1,000 more to make it today than it did just a few years ago.

Chairman CRAPO. And who pays that $1,000?

Mr. HILL. It ends up out of the customer's pocket.

Chairman CRAPO. So if we were talking about consumer protection, if we could reduce the cost of that mortgage and still maintain the safety and soundness, would that not be some of the best consumer protection we could achieve?

Mr. HILL. It seems very logical to me, Senator.

Chairman CRAPO. Well, thank you.

And to the others here, I apologize I did not get toy with my questions. I apologize to everybody. Usually we have the time to go on and have even a second round of questions. But today we are wrapping up an Iran sanctions bill, and we are going to be doing the final three votes on it starting right now.

So before I close this hearing, I want to alert all Senators that they should submit their further questions by Thursday, and you will probably receive some further written questions. I urge you to respond to those written questions as promptly as you can.

Again, I want to thank all of you for coming and giving us your time and your advice today. I assure you that both your written and your oral testimony is very thoroughly reviewed and utilized by us, and we are working together to try to build a very strong package.

As you probably are aware, we are not calling it "regulatory reform." We are calling it "economic growth." And we are looking for statutory and regulatory reforms that will help to grow the economy while still maintaining safety and soundness in our financial institutions. I think that is achievable. Thank you for being here to help us on that.

With that, this hearing is adjourned.

[Whereupon, at 11:07 a.m., the hearing was adjourned.]

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

PREPARED STATEMENT OF HARRIS H. SIMMONS

CHAIRMAN AND CHIEF EXECUTIVE OFFICER, ZIONS BANCORPORATION, ON BEHALF OF THE REGIONAL BANK COALITION

JUNE 15, 2017

I. Introduction

Chairman Crapo, Ranking Member Brown, and Members of the Committee, thank you for the opportunity to appear before you this morning. I am Chairman and CEO of Zions Bancorporation, a $65 billion dollar (total assets) bank holding company headquartered in Salt Lake City, Utah. We primarily operate in 11 western States, with local management teams and brand names, from Texas to the West Coast, including the Chairman's home State of Idaho, where we are the third largest bank in the market, and where we have consistently been the largest SBA lender. Indeed, we have a particular focus on serving small and midsized businesses and municipalities throughout the West. We believe we are very good at serving such customers, and are proud to have been consistently recognized by small and middle-market businesses as one of the best banks in the Nation in providing banking services to such clients, as measured by the number of Excellence Awards conferred through Greenwich Research Associates' survey of approximately 30,000 small and middle market businesses across the country each year. Virtually all our banking activities are very traditional in nature, with a straightforward business model that is highly focused on taking deposits, making loans, and providing our customers with a high degree of service. We are primarily a commercial lender, which is to say that we are especially focused on lending to businesses. We provide approximately one-third as much credit to businesses, in loan sizes between $100,000 and $1,000,000, as Bank of America does in aggregate—underscoring our focus on serving smaller businesses in the markets we serve. And we do so without presenting the type of systemic risk that is characteristic of the very largest banking organizations. Together with other regional banks, we are highly focused on delivering credit and depository services to the small and midsized businesses that have been America's engine of economic growth.

Zions Bancorporation has the distinction of currently being the smallest of the Systemically Important Financial Institutions—or "SIFIs"—in accordance with the $50 billion asset threshold for the determination of systemic importance as defined in section 165 of the Dodd–Frank Act. And while we are proud of the services we provide to our customers, and believe we incrementally make a real difference in the local markets in which we operate, we certainly do not consider ourselves to be systemically important to the United States economy. We in fact half-jokingly refer to our company as an "Itty Bitty SIFI," and we see evidence that an increasing number of thoughtful observers, including our own regulators, are of the opinion that we, and other regional banks, are of neither the size, complexity nor critical importance to the workings of the U.S. economy to warrant the scope, intensity and cost of additional regulation that the automatic designation as a SIFI carries with it.[1]

II. Regional Banks Have Simpler Business Models That Fundamentally Pose Less Risk Than the Nation's Largest Money Center Banks

Regional banks overwhelmingly operate with straightforward, traditional business models that focus on receiving deposits and making loans. In my own bank's case, only 4.8 percent of our total assets are financed with short-term nondeposit liabilities. And the great majority of our loans are secured with various forms of collateral, providing a secondary means of repayment. Like community banks, regional banks focus on providing credit not only to consumers, but to small and midsized businesses. For example, in the case of Zions Bancorporation, business loans between $100,000 and $1 million in size comprise 19 percent of our entire commercial loan portfolio, as compared to approximately 2 percent for Citigroup and 7 percent for JPMorgan Chase.

The revenue streams of regional banks are primarily generated through lending spread income and the provision of ancillary services to customers with long-term relationships with the bank. There is much less focus on "transactional" income from trading and capital markets activities. Indeed, approximately 90 percent of the banking industry's total trading income last year was generated by five of the industry's largest banks, each of which is considered by regulators to be a Global Systemically Important Bank (G–SIB), and none of which was a regional institution.

---

[1] See, e.g., remarks of Federal Reserve Board Governor Daniel K. Tarullo in his testimony before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, March 19, 2015.

Using a more fulsome measure of risk than sheer asset size, 2 years ago the Treasury Department's Office of Financial Research (OFR) published a report on the relative systemic risk posed by 33 U.S. bank holding companies.[2] The methodology employed was a systemic risk scorecard developed by the Basel Committee on Bank Supervision (Basel Committee) and published by the Financial Stability Board (FSB), using data provided by bank holding companies on Federal Reserve Form Y-15 with regard to an institution's size, interconnectedness, substitutability, complexity and cross-jurisdictional activities. The highest score, denoted as a percentage, belonged to JPMorgan Chase & Co., with a score of 5.05 percent, followed by Citigroup at 4.27 percent. Applying the OFR/Basel Committee methodology to the two dozen regional banks with assets of over $50 billion, and thus designated as Systemically Important Financial Institutions (SIFIs) under provisions of the Dodd–Frank Act, the aggregate risk score of the regionals as a group (including banks as large as U.S. Bancorp and PNC Financial Services Group, Inc.) is less than the score of either JPMorgan Chase or Citigroup. The very largest banks, which pose the type of systemic risk to the economy that Section 165 of the Dodd–Frank Act was meant to circumscribe, are characterized by not only substantially larger nominal asset exposures than those presented by regional banks, but also by complex—and often global—organizational structures, substantial off-balance sheet and market-making activities, and a high degree of interconnectedness throughout the financial sector and in the larger economy. For example, while JPMorgan Chase & Co.'s balance sheet is 39 times the size of Zions Bancorporation's, it's total payments activity last year was 616 times larger than Zions' levels, and its total derivatives exposures are 5,253 times larger than ours. The same general relative risk exposures characterize the entire regional bank group.

III. The Dodd–Frank Act's Arbitrary Asset Thresholds Are Stifling Our Ability To Serve Customers and Foster Economic Growth

a. Stress Testing and Capital Planning

As a covered institution, or SIFI, under section 165 of the Dodd–Frank Act, Zions Bancorporation is subject not only to the Act's rigorous stress testing (Dodd–Frank Act Stress Test, or "DFAST") requirements, but to the annual Comprehensive Capital Analysis and Review (CCAR) conducted in conjunction with the annual DFAST exercise. The DFAST process is intensive, time-consuming and costly. It involves the development and continual maintenance of sophisticated statistical models designed to project a bank's performance over the course of a hypothetical nine-quarter period of severe economic stress, using scenarios incorporating a variety of macroeconomic variables supplied annually by the Federal Reserve, and supplemented by a bank holding company's own variables and assumptions reflecting any of its idiosyncratic risk exposures. These statistical models are expected to be capable of projecting the likely outcomes and interrelated effects of each line item on a bank holding company's income statement and balance sheet, and the resulting impact on capital levels, based on a granular analysis of a bank's individual assets and liabilities. They must be developed based on historical performance, back-tested, validated, audited, and documented. So-called "challenger" models must also be developed to identify potential weaknesses inherent in the more material primary models. And the entire process must be conducted under a rigorous governance process involving both the bank's management and board of directors.

Each of the bank holding companies required to participate in the Federal Reserve's supervisory stress test exercise furnishes the Federal Reserve with millions of data elements derived from individual loans and other balance sheet items on Form FR Y-14. This data is used both in the banks' internal stress tests and in the Federal Reserve's own models to project risk-weighted assets and capital levels during, and at the conclusion of, the hypothetical period of severe stress in an attempt to ensure that capital levels under stress will not breach minimum regulatory standards. The CCAR exercise builds on the DFAST process by incorporating a firm's projected capital actions over the nine-quarter projection period. The objective is to determine that a bank holding company's projected capital actions would not, during a period of stress such as that reflected in the stress test, impair capital levels below required regulatory capital thresholds.

After evaluating the results of its own and the banks' stress tests and capital plans, the Federal Reserve provides each covered institution with a quantitative assessment of its capital levels.[3] Zions Bancorporation has been a participant in the

[2] Office of Financial Research Brief Series, 15-01, February 12, 2015.

[3] The Federal Reserve also provides large, complex banking organizations (which it generally defines as those with over $250 billion in assets) with a qualitative assessment of stress testing and capital planning processes. Regional banks have previously been given such qualitative as-

CCAR process for the past several years. We have spent well over $25 million in outside consulting feels, and many thousands of hours of management and board time focused on CCAR. We annually submit the equivalent of approximately 12,500 pages of detailed mathematical models, analysis and narrative to the Federal Reserve incorporating our CCAR projections and capital plans. We also complete a mid-year stress test exercise to complement the more intensive annual submission.

I view stress testing as a fundamentally important tool in the management of a bank's risk and the assessment of its capital adequacy. The value of the insights it yields, however, does not increase in linear proportion to the investment made in the exercise, and this is particularly true for less complex regional banking institutions. There are diminishing returns from this exercise for both the banking institutions and the regulators. Former Federal Reserve Governor Daniel K. Tarullo has noted that " . . . 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." [4]

Ideally, the stress testing process should inform management's and the board's thinking about managing credit concentrations, interest rate risk, underwriting standards, pricing, and maintaining an appropriate balance of risks in its portfolio. In our own experience, these objectives are largely thwarted by the reality that the results of the Federal Reserve's internal models trump our own internally modeled results. Although the Federal Reserve has posed no material objection to Zions Bancorporation's qualitative processes in recent CCAR cycles, its own modeled measures of my firm's capital ratios after nine quarters of severely adverse economic conditions have been consistently and materially below our own projected outcomes. Such variances in outcomes beg a reconciliation of the models used by each organization if the results are to be truly useful in the management of the company. And while Federal Reserve officials argue that "transparency around the stress testing exercise improves the credibility of the exercise and creates accountability both for firms and supervisors," [5] they continue to maintain that it is important not to disclose details of their models, lest firms "manage to the test." Certainly it is not difficult to understand a regulator's perspective about this, but the notion that the rules—which are effectively incorporated into those models' algorithms—governing banks' capital distributions to the firms' owners should be kept secret finds little if any parallel in our legal and regulatory system.

This lack of transparency has the effect of creating uncertainty, and because the Federal Reserve's modeled capital results become the "binding constraint" for capital planning by most banks, including my own, we are necessarily led to attempt to "manage to the test"—even if it's not clear how the test works. This uncertainty echoes recent comments by former Federal Reserve Governor Daniel K. Tarullo, who noted that "while enhanced prudential standards are important to ensure that larger banks can continue to provide credit even in periods of stress, some of those same enhancements could actually inhibit credit extension by rendering the reasonable business models of middle-sized and smaller banks unprofitable." [6] Federal Reserve Governor Jerome Powell, Chairman of the Fed's Committee on Supervision and Regulation, recently indicated in a televised interview his desire to have the Fed provide "much more granular information about our expectations for loss rates on particular portfolios, of corporate loans and other types of loans." [7] While any improvement in communicating outcomes is welcomed, real transparency will only be attained when the Federal Reserve publishes details about the actual content and mechanics of the models it uses to effectively govern banks' capital levels, opening them to the kind of outside scrutiny and debate which would inevitably result in stronger modeling processes.

---

sessments; however, the Federal Reserve announced on January 30, 2017, that it would discontinue that practice, while at the same time tightening regulations regarding capital distributions to shareholders without seeking Federal Reserve Board approval.

[4] Former Federal Reserve Board Governor Daniel K. Tarullo, in remarks to the U.S. Senate Committee on Banking, Housing, and Urban Affairs, March 19, 2015.

[5] Federal Reserve Board Vice Chairman Stanley Fischer, speaking at the Riksbank Macroprudential Conference, June 24, 2015.

[6] Former Federal Reserve Governor Daniel K. Tarullo—before the U.S. Senate Committee on Banking, Housing, and Urban Affairs, March 19, 2015.

[7] CNBC, June 1, 2017, Steve Liesman interview with Governor Jerome Powell.

In the absence of such transparency, banks are left to guess what level of capital is required for each type of loan, and indeed for each individual loan, since every loan has a unique blend of borrower strength, collateral support and other characteristics that define risk.

The uncertainty surrounding the Fed's modeling processes in CCAR can cause banks to withdraw or limit certain types of lending. In our own case, we've in particular established limits on construction and term commercial real estate lending that are significantly more conservative than those incorporated in current interagency guidelines on commercial real estate risk management.[8] Another example of the uncertainty around the Federal Reserve's models involves small business loans. The detailed FR Y-14 data templates used for the Federal Reserve's models to capture granular data on collateral values and other factors useful in evaluating potential loss exposures for commercial loans expressly exclude loans of less than $1 million and credit-scored owner-occupied commercial real estate loans, the combination of which comprises a substantial portion of our total loan portfolio. Rather, such loans are reported on a supplemental schedule that includes only the loan balances. We can therefore only suppose that such loans are treated relatively more harshly in the Federal Reserve's models, resulting in uncertainty in terms of how much credit of this type we can afford to grant, and at what price, in order to reduce the risk of a quantitative "miss" in the Federal Reserve's calculation of our required capital.

b. Liquidity Management

Having been designated as a Systemically Important Financial Institution, Zions Bancorporation is also subject to the Modified Liquidity Coverage Ratio. The three primary Federal banking regulatory agencies, in implementing the Basel III liquidity framework, jointly adopted the Liquidity Coverage Ratio (LCR) rule in September, 2014. The rule is applicable to internationally active banking organizations, generally those with $250 billion or more in total consolidated assets or $10 billion or more in on-balance-sheet foreign exposure. At the same time, the Federal Reserve went beyond the Basel Committee's LCR framework, and adopted a somewhat less stringent rule, the Modified Liquidity Coverage Ratio (MLCR), applicable to bank holding companies with $50 billion or more in consolidated assets but that are not internationally active. This quantitative measurement supplements a qualitative liquidity management framework introduced in early 2014 to fulfill Enhanced Prudential Standards requirements, including liquidity standards, required by section 165 of the Dodd–Frank Act. The MLCR requires a bank holding company to hold a narrowly defined portfolio of "High Quality Liquid Assets" (HQLA) equal to or greater than expected net cash outflows over a 21-day period, in accordance with a prescribed set of run-off calculations established in the rule. The qualitative liquidity management framework requires, among other things, monthly internal liquidity stress tests to supplement the prescriptive MLCR in determining the size of the institution's required minimum liquidity buffer. The full extent of the impact of the liquidity rules on SIFIs is almost certainly not fully apparent in the current economic environment. We have experienced a prolonged period of low interest rates without precedent, and liquidity in the banking system has been abundant by virtually any historical measure. But liquidity comes at a cost, and the true cost of these rules will become manifest as interest rates and liquidity levels eventually normalize. While it is important for every depository institution to maintain appropriate levels of reserves to deal with normal fluctuations in cash flows, maintaining additional liquidity buffers as an insurance policy against times of extreme stress is a costly exercise for banks and for the economy at large. Every dollar invested in high quality liquid assets is a dollar that cannot be loaned out and put to more productive use. In times of liquidity stress, the impact will likely be most particularly acute for smaller and middle-market businesses that do not have ready access to the capital markets, and for whom bank credit is their financial lifeblood. As noted earlier. regional banks subject to the MLCR and the additional enhanced prudential liquidity standards imposed by the Dodd–Frank Act provide a disproportionate share of credit to such businesses.

c. Other Consequences of SIFI Designation

Since the financial crisis, Zions Bancorporation has more than doubled its staffing in areas such as compliance, internal audit, credit administration and enterprise risk management. In an effort to manage costs, these increases have been accom-

[8] 5 Office of the Comptroller of the Currency, FDIC and Board of Governors of the Federal Reserve System: Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, December, 2006.

panied by offsetting reductions in other areas of the organization, including many customer-facing functions. Many, though not all, of these increases in risk management staffing are directly attributable to the Enhanced Prudential Standards requirements of the Dodd–Frank Act and other regulatory requirements that have arisen in the wake of the financial crisis. We have also embarked on an ambitious program to replace core software systems, revamp our chart of accounts and establish a data governance framework and organization in order to ensure our ability to meet the substantial data requirements necessary to fully comply with the stress testing and liquidity management protocols applied to SIFIs. While we will derive ancillary benefits from modernizing our systems, ensuring regulatory compliance has been a significant factor in our decision to make these investments which are in the hundreds of millions of dollars in size. Additional investments have been made in software systems directly related to compliance with the Enhanced Prudential Standards. An example is the expenditure of approximately $3 million for software that facilitates compliance with incentive compensation governance requirements. In addition to the software investment, thousands of hours have been spent redesigning incentive plans and validating their compliance with regulatory requirements. We have also spent millions of dollars on the annual production of resolution plans, or "living wills," in accordance with requirements of the Dodd–Frank Act. This is despite the fact that, like other regional banks, we have a simple organizational structure, with a total of 20 (mostly very small) subsidiaries, as compared to an average of 1,670 subsidiaries for each of the Nation's six largest banks.

IV. Alternative Means of Designating Systemic Importance

There is no apparent analytical foundation for the Dodd–Frank Act's establishment of a $50 billion asset size threshold for the determination of an institution's systemic risk. Indeed, there is a lack of consistency in applying the Enhanced Prudential Standards of Section 165 to all insured depository institutions with over $50 billion in assets, with the result that some federally insured depository institutions with total assets greater than those of my own bank holding company are not automatically subject to these rules. For example, USAA, a diversified financial services company with $147 billion in assets, and whose federally insured USAA Federal Savings Bank subsidiary has over $70 billion in assets, is not subject to the requirements of section 165, since USAA is not a bank holding company. Likewise, the Nation's largest credit union, Navy Federal Credit Union, with $81 billion in assets, is not subject to these requirements.

We are supportive of an approach to the determination of systemic importance that removes the hard-coded $50 billion asset threshold currently incorporated in the Dodd–Frank Act, and that substitutes banking regulators' thoughtful and transparent analysis, consistently applied, taking into account not only an institution's size, but its complexity, interconnectedness with the domestic and international financial system, substitutability, cross-jurisdictional activities and any other factors the Congress or regulators may deem relevant. We believe that any such analysis would find that Zions Bancorporation and most, if not all, other regional banking institutions would not be found to be systemically important using such an approach, and that the net benefit to the U.S. economy from redirecting the resources these institutions currently expend on compliance with section 165 requirements to the prudent extension of credit and other banking services to customers would be significant.

V. Other Regulations That Retard the Ability of Regional Banks To Serve Customers and Foster Economic Growth

There are numerous other regulations as well as instances of regulatory guidance, that hamper (or threaten to impair) the ability of regional banks to serve the credit and depository needs of their customers. These include greatly heightened requirements for compliance with Bank Secrecy Act/Anti-Money Laundering regulations and the policing of "our customers' customers"; ambiguous and ever-changing rules with respect to Fair Lending and other anti-discrimination laws; and, highly prescriptive and evolving rules with respect to the governance and oversight of third-party vendor relationships. Two areas seem to me to be especially worthy of concern.

The first pertains to the incredible thicket of regulations that has developed around the issuance of residential mortgages. Mortgage lending has long been subject to a host of laws and regulations. But the additional layers of regulation emanating from the Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (SAFE Act), tighter appraisal standards at a time when there is a nationwide shortage of qualified appraisers, Dodd–Frank's Ability to Repay and Qualified Mortgage Standards, and others, has stifled the ability of many banks to conduct straightforward mortgage operations with traditional mortgage products—even when the resulting mortgage is held in a bank's loan portfolio. These issues have been particularly challenging for self-employed borrowers. In our own case, the cumulative effect of these many rules has dramatically retarded our ability to originate mortgage loans in our smaller branches, resulting in a substantial reduction in the origination of straightforward fixed rate, fully amortizing mortgages in our branch network in recent years.

A second prospective issue which I believe is deserving of Congressional focus arises from outside the traditional bank regulatory establishment, in the form of a new accounting standard on the horizon. Under the Financial Accounting Standards Board's "Current Expected Credit Loss" impairment standard, slated to take effect in 2020, banks and other SEC registrants will be required to set aside loss reserves not only for incurred losses inherent in a loan portfolio, but for all expected future losses, as well. This will be a challenging accounting standard for all lenders to implement, not least because it requires well-documented prognostication about an uncertain future. But the impact on the economy, and on borrowers in particular, is likely to arise from the fact that this accounting standard may be expected to produce the result that lenders will be incentivized to shorten the tenor of loans, such that the period over which losses must be estimated is shortened, and required reserves are accordingly reduced. This would, I believe, provide banks with incrementally more liquid balance sheets, and lower reserve requirements. But this will not be a good outcome for borrowers, who will become less liquid with shorter maturities or face the alternative of higher borrowing costs for longer-duration loans. This will not be a positive outcome for capital formation, which is critical to economic growth.

Thank you very much for allowing me the opportunity to present my institution's views on these important subjects.

PREPARED STATEMENT OF GREG BAER

PRESIDENT, THE CLEARING HOUSE ASSOCIATION

JUNE 15, 2017

Chairman Crapo, Ranking Member Brown, and Members of the Committee, my name is Greg Baer and I am the President of The Clearing House Association and General Counsel of The Clearing House Payments Company. Established in 1853, we are the oldest banking association and payments company in the United States. The Clearing House Association is a nonpartisan advocacy organization dedicated to contributing quality research, analysis and data to the public policy debate.

The Clearing House is owned by 25 banks which provide commercial banking services on a regional or national basis, and in some cases are also active participants in global capital markets as broker-dealers and custodians. Our owners fund more than 40 percent of the Nation's business loans held by banks, which include almost $200 billion in small business loans, and more than 75 percent of loans to households. Reflecting the composition of our membership, throughout my testimony, I will focus on the effects of regulation on U.S. global systemically important banks, U.S. regional banks of all sizes, and the U.S. operations of foreign banking organizations with a major U.S. presence.

After nearly a decade of fundamental and continuing changes to financial regulation, now is an opportune time to review the efficacy of our current bank regulatory framework. My testimony will focus on reforms that could directly and immediately enhance economic growth. Certainly, there are many other areas where reform is urgently needed—for example, the regulatory regimes for anti-money laundering, cybersecurity, the Community Reinvestment Act, and corporate governance, as well as a general breakdown in transparent administrative procedure at the regulatory agencies—but those involve other priorities, and have a more indirect effect on the economy.

I should emphasize at the outset that if the goal of regulatory reform is to prompt economic growth, that goal cannot be achieved while excluding regulation of large and regional banks from that effort. As the Treasury Department noted in its report this week, community banks hold only 13 percent of U.S. banking assets, so reform limited to those firms will not have a significant economic impact. And large banks—defined as those in holding companies with at least $50 billion in assets—originated 54 percent small business loans in 2015 by dollar amount and 86 percent by number.

I. The Case for Reform of Bank Regulation

Room for reform. The starting point for any review of post-crisis regulation is an American banking system that is extraordinarily resilient. U.S. banks now hold substantial amounts of high-quality capital; since the crisis, the aggregate tier 1 common equity ratio of TCH's 25 owner banks nearly tripled to 12.2 percent at the end of last year. In absolute, dollar terms, that is an increase in tier 1 common equity from $331 billion to over $1 trillion. Similarly, U.S. banks now hold unprecedented amounts of high-quality liquid assets (HQLA) to ensure that they can survive a period of persistent liquidity stress (a run, in other words): today, nearly a quarter of U.S. large bank balance sheets consists of cash, U.S. Treasury bonds, and similarly low-risk and highly liquid assets.

Moreover, we now have in place a comprehensive legal and operational framework that ensures that even the largest and most complex banks can go bankrupt like any other company, without taxpayer support and without risk to the broader financial system, ending too-big-to-fail and replacing moral hazard with market discipline. Markets clearly have recognized as much, as bank holding company debt is now priced on the assumption that bondholders will not be bailed out, and rather will be bailed in in order to recapitalize the institution. [1]

As discussed below, there is considerable evidence that bank capital and liquidity levels have now been pushed beyond what is reasonably necessary for safety and soundness and financial stability purposes. And other restrictions on banking activity have been imposed without sufficient analysis or evidence—and without regard to current capital and liquidity levels. Here, and generally, when I refer to "banks," I am including their nonbank affiliates, which increasingly are now subject to the same restrictions (while providers of financial services that are not affiliated with banks are effectively unregulated).

Need for reform. While much has been gained in fortifying the Nation's largest banks, it is also clear that the banking system is playing an unnecessarily diminished role in fostering economic growth and vibrant capital markets, and that systemic risk is building up outside of the banking system, which has been the sole focus of many post-crisis reforms. A key driver here is the recent sea change in banking whereby large and regional banks generally no longer allocate capital and make business decisions based on their own assessment of economic risk, with regulatory capital as a backstop; rather, because regulatory capital requirements are so high and prescriptive, regulation often dictates how capital—and therefore credit to the economy—is allocated. [2] A similar phenomenon is occurring with respect to post-crisis liquidity requirements.

As described in detail below, there are numerous opportunities to better align existing capital and liquidity requirements with the goal of economic growth—without jeopardizing, and likely enhancing, the strength and resiliency of the financial system. Three areas of regulatory impact highlight the significant potential for reform.

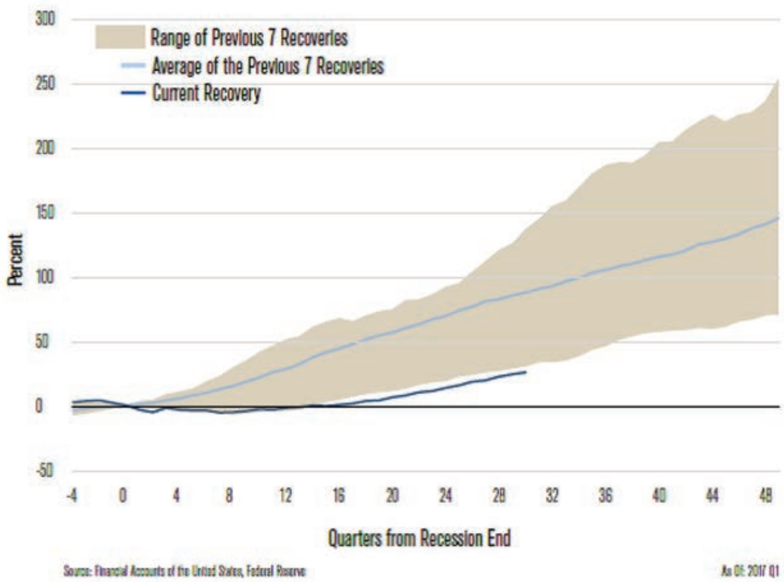
Small business lending. As demonstrated in the chart below from the recent Treasury report, bank lending has lagged significantly in the current recovery.

---

[1] See The Clearing House eighteen53 Blog, "The Canard That Won't Go Away: Correcting the Record (Again)" (April 21, 2017), available at *https://www.theclearinghouse.org/eighteen53-blog/2017/april/21%20-%20icba.*

[2] For example, the recent research by Viral Acharya, et al., finds that banks subject to stress tests have reduced the supply of credit to relatively risky borrowers. In particular, the supply of credit is reduced to large corporate borrowers that exhibit high risk, commercial real estate, credit card, and small business borrowers who also tend to be relatively risky. See Acharya, Viral V., and Berger, Allen N., and Roman, Raluca A., "Lending Implications of U.S. Bank Stress Tests: Costs or Benefits?" (May 23, 2017). Available at SSRN: *https://ssrn.com/abstract=2972919.*

Figure 7: Growth in Bank Lending Since End of Recession



Much of the lag is attributable to small business lending. In April 2017, the Federal Reserve published an inaugural nationwide survey of small business credit conditions, the Small Business Credit Survey (SBCS), which reports widespread evidence of tight credit conditions for small businesses.[3] In particular, according to the results of the SBCS, approximately 36 percent of small businesses reported not having all of their borrowing needs satisfied. More specifically:

- About 60 percent of small businesses reported having faced financial challenges over the past 12 months.
- Of those, approximately 45 percent cited lack of credit availability or ability to secure funds for expansion as a reason.
- About 75 percent of those firms facing financial challenges said they used owners' personal funds to address this problem.
- About 45 percent of small businesses applied for financing over the past 12 months. Of those that applied for credit, 24 percent received none of the funds requested and 36 percent received only some portion of what they requested.

Notably, credit availability for small businesses is tighter at large banks that are subject to the highest capital and liquidity regulations. At these banks, approval rates were just 45 percent for small businesses with less than $1 million in revenues. In contrast, community development financial institutions and small banks reported approval rates of 77 percent and 60 percent, respectively. This fact is significant because, as noted, large banks originate a sizable share of small business loans that cannot realistically be replaced by smaller banks: 54 percent by dollar amount and 86 percent by number of loans.[4]

Moreover, our own research has shown that the U.S. stress tests are constraining the availability of small business loans secured by nonfarm nonresidential properties, which accounts for approximately half of small business loans on banks'

---

[3] See Federal Reserve Banks of Atlanta, Boston, Chicago, Cleveland, Dallas, Kansas City, Minneapolis, New York, Philadelphia, Richmond, Saint Louis, and San Francisco, "Small Business Credit Survey" (April 2017), available at *www.newyorkfed.org/medialibrary/media/smallbusiness/2016/SBCS-Report-EmployerFirms-2016.pdf*.

[4] See The Clearing House eighteen53 Blog, "Myth Versus Reality on Small Business Lending" (March 24, 2017), available at *www.theclearinghouse.org/eighteen53-blog/2017/march/24-small-business-lending*.

books. Our analysis indicates that subjecting a bank to the U.S. supervisory stress tests leads to a reduction of more than 4 percentage points in the annual growth rate of its small business loans secured by such properties, which translates to a $2.7 billion decrease in the aggregate holdings of these small business loans each year on average.

Mortgage lending. Another example of an asset class unnecessarily burdened by post-crisis regulation is home mortgage lending, and here again, capital regulation is a major driver. As demonstrated in our own research, the Federal Reserve's Comprehensive Capital Analysis and Review (CCAR) stress test is imposing dramatically higher capital requirements on residential mortgage loans than bank internal (Federal Reserve-approved) models and the standardized approach to risk-based capital developed by the Basel Committee on Banking Supervision.[5] Indeed, for first-lien mortgage loans, CCAR capital requirements are 45 percent higher than under banks' own projections and 95 percent higher than under the Basel III standardized approach. Because smaller banks are subject to less stringent capital requirements, they can act as a control group in assessing the impact of new regulations on the supply of credit. Between the fourth quarter of 2010 and the end of 2016, residential real estate loans declined 0.5 percent on average on an annual basis at banks subject to the CCAR stress test, while they rose 4.0 percent on average over the past 6 years on an annual basis at banks not subject to that test.

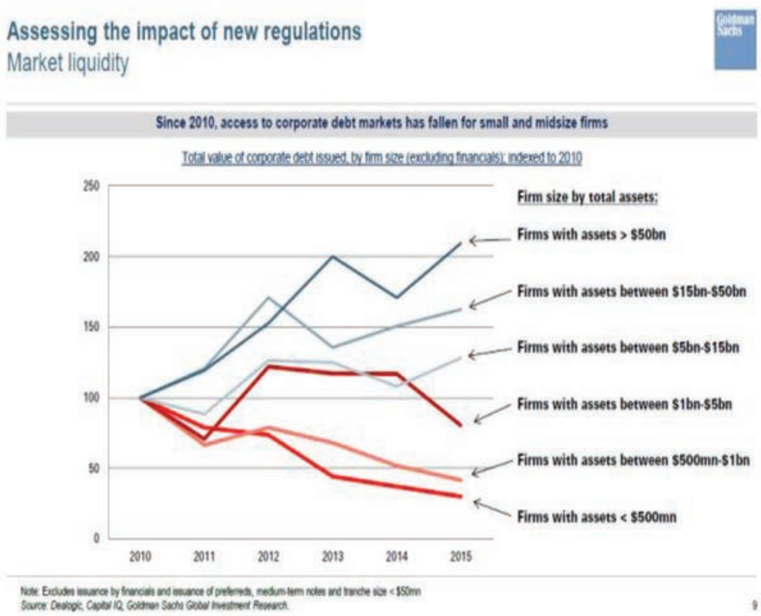
Capital markets. In the United States, much of the lending to the private nonfinancial sector and most of the borrowing by the Government sector occurs outside the banking system, in capital or money markets. Indeed, banks provide only about one-third of credit in the United States. Large bank holding companies facilitate financial market intermediation both by making markets in securities traded in those markets and by providing funding to other market participants who transact in those markets.

Interestingly, post-crisis regulation by banking regulators has affected securities markets more than regulation by securities regulators. In particular, bank regulations have made it significantly more expensive for broker-dealers affiliated with banks—which includes, post-crisis, all of the largest dealers—to hold, fund, and hedge securities positions. Higher capital charges make holding of inventory more expensive, and the Volcker Rule makes holding such inventory a potential legal violation. The surcharge for global systemically important banks (GSIBs) and liquidity rules make securities financing more expensive. It has become more difficult for dealers to hedge the risk associated with holding the inventories of the bonds using credit default swaps.[6]

The greatest impact has been felt by smaller companies, as the capital rules impose lower capital charges on more liquid securities, which tend to be issued by larger companies; broker-dealers, forced to ration their balance sheets, are serving their largest customers first. As shown in the chart below, issuance of corporate bonds by small and midsized nonfinancial firms has fallen over the past few years while issuance by larger firms has risen.

[5] See The Clearing House, "The Capital Allocation Inherent in the Federal Reserve's Capital Stress Test", *https://www.theclearinghouse.org//media/TCH/Documents/TCH%20WEEKLY/2017/20170130__WP__Implicit__Risk__Weights__in__CCAR.pdf.*

[6] Recent research by economists at the Federal Reserve Bank of New York has found that CDS have become much more costly to hold in large part because of the capital that dealers are required to hold against the transaction. Boyarchenko, Nina, Pooja Gupta, Nick Steel, Jacqueline Yen, (2016) "Trends in Credit Market Arbitrage", Federal Reserve Bank of New York Staff Reports No. 784, July 2016, p. 18.



As another example, the efficiency and liquidity of financial markets are maintained by the ability of asset managers to take leveraged positions in mispriced assets to earn a profit when the asset price returns to normal. Such positions are financed in the market for repurchase agreements. Broker dealers are often the intermediary between two financial institutions, engaging in a repo with one and an identical matched repo with another. While such matched transactions are nearly riskless, the leverage ratio requirement forces banks to hold considerable capital against their reverse repos. Moreover, if the net stable funding ratio were adopted as proposed, banks would be required to finance the loans with a material amount of longer-term funding rather than a matched repo borrowing. As explained in a recent TCH research note, these types of requirements make such transactions more expensive, and dealers are passing those costs along. [7]

Thus, more than four-fifths of the respondents to the Federal Reserve's Senior Credit Officer Opinion Survey in June 2015 indicated that liquidity and market functioning in Treasury markets had deteriorated. Over 80 percent of those respondents reporting a deterioration indicated that the most important cause was a decreased willingness of securities dealers to expand their balance sheet for market-making purposes as a result of regulatory change.

II. Reforming Capital Regulation

A. Stress Testing

When enough should be enough. Certainly, a key lesson of the financial crisis is the critical importance of maintaining capital levels sufficient to absorb outsized losses that typically accompany periods of financial stress. Responding to that lesson, banks have significantly increased the amounts of high-quality capital they maintain, and regulators have enacted a range of reforms that require these heightened levels of capital to remain in place over time.

Implementation of Basel III changes has increased the quality of capital, focusing on common equity as opposed to hybrid debt/equity instruments. In the United States, there is an increased and wise emphasis on stressed rather than static measures of capital adequacy—in particular, the Federal Reserve's CCAR exercise

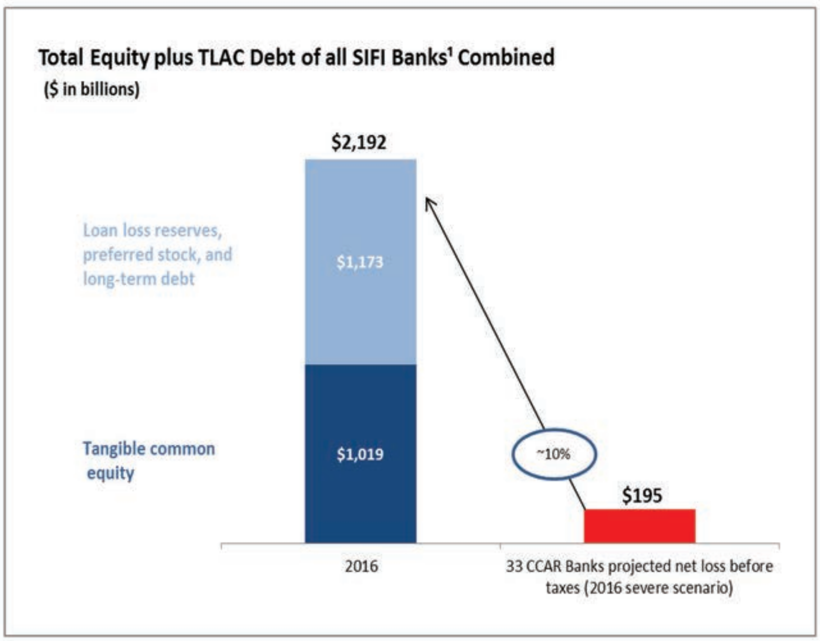
---

[7] See The Clearing House, "Shortcomings of Leverage Ratio Requirements", (Aug. 2016), *www.theclearinghouse.org/-/media/tch/documents/20160809__tch__research__note__leverage__ratio.pdf?la=en.*

and the banks' own internal stress tests. These are important improvements to the bank capital framework that resolve key shortcomings revealed by the financial crisis, and we support them.

Unfortunately, these sensible reforms have been accompanied by other changes to the U.S. capital framework which have introduced a significant degree of unnecessary opacity, subjectivity and uncertainty to capital regulation in the United States. Large U.S. banks today are subject to dozens of different capital requirements. Of those, the Federal Reserve's CCAR stress test and the enhanced supplementary leverage ratio (eSLR) are set at such high levels that they most frequently dictate bank's decision making. In addition, U.S. regulators have consistently implemented capital reforms in a manner that both significantly exceeds agreed-upon international standards and is much more stringent than necessary to support safety, soundness, and financial stability.

Of course, a crucial question is how much capital is enough. TCH's 25 owners hold roughly triple the amount of capital they did pre-crisis, but should it be quadruple, or double? We believe three benchmarks are useful here. First, consider the results of the Federal Reserve's severely adverse scenario under CCAR, which presents for large banks a greater economic and market shock than was present in the global financial crisis. Then, compare the losses projected under that stress scenario to the loss absorbency currently held by those banks, as detailed in the following chart.



In sum, CCAR imposes a stress scenario significantly harsher than the previous financial crisis.[8] Yet as of 2016 tangible common equity was five times the losses implied under that scenario. Total loss absorbency—which includes debt holders who would be "bailed in" as part of a bankruptcy under the Title I living will process or the Title II Orderly Liquidation Process, was ten times those losses.

Consider as a second benchmark JPMorgan Chase, which is universally considered to have had sufficient capital to have weathered the past financial crisis without need for taxpayer assistance, while making two acquisitions and continuing to lend and make markets. Thus, one could reasonably suppose that the amount of capital it held pre-crisis was sufficient (and would have been all the more sufficient if all other firms had held that amount as well). Today, JPMorgan Chase holds dou-

[8] It is worth noting that neither banks nor their regulators place exclusive focus on a single scenario; rather, banks run, and the Federal Reserve monitors, numerous stress scenarios, including ones chosen by each bank to focus on its unique vulnerabilities.

ble the capital it did pre-crisis. More importantly, all large banks are now required to hold similar levels of capital (with some variation based on the size of any GSIB surcharge). And the firms subject to those capital rules today include the largest broker dealers—which is significant, because pre-crisis, monoline investment banks like Bear Stearns and Lehman Brothers were not subject to bank-like capital requirements and operated with a fraction of the capital of large banks.

And consider as a third benchmark long-term debt spreads and CDS spreads of large U.S. banks, which have remained stable over the past five years. While we have not seen a significant financial crisis during this period, we observed a large trading loss at one large U.S. bank in mid-2012, volatility around the Brexit vote in the United Kingdom in the middle of last year, a significant consumer scandal at another large U.S. bank in the second half of last year, and more generally, a fair amount of international political instability in recent months.

There is also reason to believe that higher capital standards have reached levels at which they are having a counterproductive effect. In a recent paper, Sarin and Summers (2016) point out that by several capital markets-based measures, including stock price volatility and CDS spreads, banks appear to be riskier now than they were before the crisis, even as bank capital and liquidity standards have been substantially raised over that same period of time.[9] The authors conclude that the most likely explanation is that banks' franchise values have declined. Specifically, a bank's franchise value depends on its ability to generate earnings and increase those earnings over time. The tightening of regulations that has occurred since the crisis, while increasing loss absorbency, has also reduced the profitability of banks.

While no one would recommend a return to the low and uneven capital levels that existed pre-crisis, or to treating as capital hybrid instruments that did not prove to be loss absorbing, the largest U.S. banks are now overcapitalized by any objective measure. Hundreds of billions of trapped capital is not necessary to meet any quantifiable safety and soundness need, and could be redeployed to furthering economic growth—either through more lending or returning excess capital to shareholders for reinvestment elsewhere.

Potential for reform. The Federal Reserve's stress testing framework attempts to measure the ability of banks to withstand a very severe economic downturn (and, where relevant, a market shock). Under CCAR, the Federal Reserve runs its own proprietary models to determine the effect of various supervisory scenarios on banks' capital adequacy—that is, the estimated net losses and resulting reduction in capital under those scenarios. After this stress, a large bank must meet a series of capital requirements, including a 4.5 percent common equity tier 1 ratio. And it must do so assuming that it does nothing to shrink its balance sheet, reduce its dividend, or postpone planned share repurchases under severely adverse economic conditions—almost certainly deeply counterfactual assumptions. Thus, a large bank that passes the CCAR exercise not only has sufficient capital to avoid failure under historically unprecedented adverse conditions—it has enough capital to emerge from such an event doing business as usual, and without taking actions that would be normal (or even compelled) under the circumstances.

Stress testing is an important tool for assessing the health of the banking system because it incorporates a forward looking, dynamic assessment of capital adequacy, and is therefore less reliant on recent historical performance. However, the Federal Reserve's CCAR stress tests are highly and unnecessarily opaque, relying upon macroeconomic scenarios that are never published for public comment and a series of unidentified models (combined in unspecified ways) that have never been subject to peer review or public comment.

To the best of our knowledge, which is necessarily limited by the opacity of the CCAR process, the accuracy of the Federal Reserve's models, individually and collectively, has never been back-tested. The results of this nonpublic process continue to differ markedly from the results of the banks' own, more robust earnings forecasting models—models that the Federal Reserve itself subjects to rigorous review. (The bank process is part of what is known as DFAST, short for "Dodd–Frank Act Stress Test".) At this point, there is no basis to conclude that the Federal Reserve's models do a better job of projecting losses than the banks' own (Federal Reserve-approved) models.

Both the quantitative test of CCAR and the qualitative test described below also are needlessly complex and consume enormous resources at the largest banks, which resources could be more effectively redeployed; the CCAR annual submissions for the largest banks average in excess of 50,000 pages.

---

[9] See Sarin, Natasha, and Lawrence H. Summers; "Have Big Banks Gotten Safer?", Brooking Papers on Economic Activity, Fall 2016.

Effects on economic activity. Collectively, the opacity, subjectivity, and overall stringency of the CCAR framework act as a significant constraint on lending, economic growth, and liquid capital markets. As we have demonstrated in detailed empirical research, this is largely the result of the excessively high amounts of capital banks are required to hold against their small business lending, mortgage lending, and trading book assets to pass the test.[10] Under banks' own DFAST projections, capital requirements for small business loans and home mortgage loans are 80 percent and 45 percent higher than under the Basel III standardized approach, respectively. For trading assets, the higher capital requirements under CCAR are driven by the Federal Reserve's prescribed global market shock that is part of the CCAR scenarios for banks with large trading operations. However, the market shock also applies to the DFAST stress tests that are calculated using the banks' own models, and the capital requirement for the trading book under CCAR is 20 percent higher than DFAST.[11]

CCAR's excessively high capital requirements for small business loans and home mortgages likely reflect in large part the severity of the stress scenario used in the test. The stress test includes increases in unemployment that are more sudden in some cases more severe than seen in the global financial crisis, and other parameters that go beyond any historical experience.

The inevitable result is that banks are shifting away from cyclically sensitive sectors (where loss of employment is likely to trigger default) like small businesses and households with less-than-pristine credit. Bank behavior is consistent with this set of incentives:

- Small commercial real estate loans, which account for approximately half of small business loans outstanding on banks' books, declined about 2 percent on average over the past 5 years.[12]
- On the residential real estate lending side, home equity lines of credit declined more than 6 percent per year over the past 5 years, despite the significant appreciation in housing prices, and are about 110 basis points more expensive than they were pre-crisis.[13]
- The declines in these categories of lending have been larger at banks subject to CCAR than at banks not subject to CCAR.

Substantial benefits to economic growth could be achieved through three limited reforms to CCAR, all of which would increase banks' capacity and propensity to make these types of loans.

First, banks' more robust, Federal Reserve-approved models should be used to estimate stress losses for purposes of the CCAR quantitative assessment. The Federal Reserve should use its own, more simplified models as a check on the bank models. With the Federal Reserve models no longer binding in the first instance, no concentration of risk or "gaming" concern would prevent their being made transparent. Notice and comment or other peer review would doubtless improve their accuracy.

We note that such an approach is not a theoretical construct, but current practice at the Bank of England where banks' own models play the central role in the United Kingdom's supervisory stress tests.[14] Banks use of their own models motivates them to better develop their own stress scenarios, which are than more tailored to their business models. That said, the Bank of England does not rely entirely on banks own models and has its own suite of models for peer-benchmarking and to ensure consistency of results across participating banks. In adopting the system, the Bank of England has noted that it does not want its own models to drive capital requirements at the risk of stifling stifle innovation in risk management at banks. More generally, if a set of unique models being used is overly conservative, the efficiency of the financial system would be reduced. Conversely, if those models are vulnerable to a particular source of risk, the entire system could be undercapitalized during a period of financial stress.[15]

Second, annual stress test scenarios should be subject to a 30-day public notice and comment period to ensure that they meet the Federal Reserve's identified

---

[10] Capital Allocation in CCAR, supra note 5.
[11] See id.
[12] Capital Allocation in CCAR, supra note 5.
[13] Capital Allocation in CCAR, supra note 5.
[14] See Bank of England (2015) "The Bank of England's Approach to Stress Testing the U.K. Banking System" (October 2015). Available at *http://www.bankofengland.co.uk/financialstability/Documents/stresstesting/2015/approach.pdf.*
[15] See Gallardo, German, Til Schuermann, and Michael Duane (May 2016), "Stress Testing Convergence", *Journal of Risk Management in Financial Institutions* 9, pp. 32–45.

standard—consistency with post-war U.S. recessions. While we believe that standard is sensible, it should be subjected to notice and comment rulemaking.

Third, counterfactual and incorrect assumptions about how banks would behave in a crisis (e.g., continuing share repurchases and balance sheet growth under severe stress) should be corrected.

B. Leverage Ratio

A leverage ratio measures the capital adequacy of a bank by dividing its capital by its total assets (and, in some cases, off-balance-sheet exposures) without taking into account the risk of any particular asset or exposure. Requiring the same amount of capital to be held against every asset makes the holding of low-risk, low-return assets relatively more costly when compared with the holding of higher-risk assets, higher-return assets. Put another way, if a capital regulation requires a bank to hold the same amount of capital against each asset, the bank will by necessity gravitate to relatively higher-risk, higher-return assets.

A leverage ratio can still be a useful tool as a backup measure when banks collectively misunderstand the risk of a certain asset class (as they did with mortgages and mortgage-related securities in the past crisis), but serious problems have emerged for U.S. banks because U.S. regulators have set the minimum leverage ratio for the largest U.S. banks at nearly double the international standard, without adequate analysis of (i) whether such a high leverage ratio is necessary to prevent excessive risk taking or (ii) the impact of such a high leverage ratio on lending, market activity and economic growth. These are the very same banks that provide support to U.S. capital markets and ensure the safekeeping of investor assets, and in the course of doing so hold large amounts of low-risk, liquid assets like central bank placements and Treasury securities.

More specifically Basel III introduced a 3 percent supplementary leverage ratio for internationally active banks, which includes both on-and off-balance-sheet assets. [16] U.S. regulators have not only applied this 3 percent supplementary leverage ratio requirement to all larger banks, but have also imposed a still-higher requirement for U.S. GSIBs—an eSLR of 5 percent at the holding company level and 6 percent at depository institution subsidiaries. [17] Consequently, for several of the largest U.S. banks, the eSLR, as opposed to a risk-based requirement, that acts as a current or potential future binding constraint and therefore affects bank capital and business planning. [18]

The overall impact of the leverage ratio as a measure of capital adequacy, and the resulting misallocation of capital, have increased dramatically in recent years as a result of other regulatory mandates. As noted, large banks presently are required by liquidity regulations to hold about a quarter of their balance sheets in high quality liquid assets (HQLA)—predominantly cash, Treasury securities and other Government securities. Large banks now hold approximately three times as much of these assets as they did pre-crisis. Those assets rightly receive a zero or low risk weight in risk-based capital measures, but the leverage ratio completely ignores their actual risk and requires banks to hold capital against these assets.

Banks with sizeable custody, treasury services or other businesses that employ a servicing business model or take sizeable corporate deposits are particularly affected. In practice, this means that, under the liquidity rules, these banks must hold cash or Treasury securities against these deposits, on the assumption that up to 100 percent of them will run in a crisis (although the outflow rate during the financial crisis was substantially lower) and then hold 6 percent capital against the same cash and U.S. Treasury bills that the regulators require they hold for liquidity purposes. Of systemic concern, these problems are likely to become more pronounced in periods of financial market uncertainty, as institutional investors seek to lower their risk exposure by raising cash and banks must manage the resulting deposit inflows in the most conservative way possible, via placements at the Federal Reserve and other national central banks.

Another issue that has received recent notice is how the supplementary leverage ratio makes it more costly for U.S. banking organizations to provide clearing member services to clients on centrally cleared derivatives. While risk-based capital rules allows banking organizations to exclude from their denominator any initial margin posted by their clients on derivatives transaction—and rightly so, as the bank bears

[16] See Basel Committee on Banking Supervision, "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" (June 2011), available at *www.bis.org/publ/bcbs189_dec2010.pdf.*

[17] See 79 *FR* 187.

[18] See Federal Financial Analytics, Inc., "Mutual-Assured Destruction: The Arms Race Between Risk-Based and Leverage Capital Regulation" (Oct. 13, 2016).

no risk of loss on such margin—the leverage ratio does not. As a result, the leverage ratio exaggerates the exposure amount of these derivatives and effectively requires banks to hold un-economic amounts of capital when providing clearing services to clients. Because of this, at least three major dealers have exited the business. Accordingly, former CFTC Chairman Massad called for the U.S. leverage ratio to be amended to take account of segregated margin. [19]

In sum, under the eSLR, U.S. GSIBs are currently required to trap approximately $53 billion in capital against cash reserve balances deposited at the Federal Reserve, and an additional $15 billion against U.S. Treasury securities. These are assets whose value banks are at no risk of misjudging; capital allocated to them could be far better deployed to lending or supporting market liquidity. Thus, the answer is not to dispense with the leverage ratio but rather to eliminate the enhanced supplementary leverage ratio, and to deduct from the denominator of the supplementary leverage ratio high-quality liquid assets like central bank reserves and Treasury securities, as well as segregated client margin.

It is sometimes said that deducting these assets would begin a "slippery slope." This worry is difficult to understand—bank regulation is replete with line drawing. For example, the liquidity coverage ratio gives 100 percent credit for a central bank reserve or U.S. Treasury security as a liquid asset; this has not created a "slippery slope" whereby loans have been given 100 percent credit as a liquid asset. The Bank of England, on July 25, 2016, began deducting central bank reserves from the leverage ratio denominator for U.K. banks—and no "slippery slope" has emerged whereby it has felt the need to do so for, say, subprime loans. [20]

C. Operational Risk

Large institutions currently are required to build and maintain models to measure operational risk for capital purposes based on a Federal Reserve-approved Advanced Measurement Approach. Because it is exceedingly difficult to base a capital charge on a subjective assessment of the risk inherent in a bank's current operations, these models generally look at past large litigation losses and treat them as a proxy for the risk of something going wrong in the future.

In contrast to international peers, the U.S. banks are often prohibited from excluding losses from their models even when the bank has exited the business line that caused the loss, or sold such business to another institution. (The acquirer also assumes the capital charge associated with the past event, effectively doubling the capital requirement on an aggregate basis.) U.S. banks are prohibited from using expert judgment to lower the output of their model even when factors make certain operational losses less likely in the future, while non-U.S. banks are permitted to make such adjustments. Similarly, banks may put in place a range of other risk mitigants, such as insurance or hedges, but none of these are meaningfully recognized or reflected in the current operational risk capital framework. Finally, for some banks, the regulators add to any modeled results a "supervisory overlay," which is a completely arbitrary add-on presented with no analytical or evidentiary basis.

As a result of all these factors, operational risk capital charges are inflated and extremely sensitive to any data anomalies or extreme events. At least one bank was reported in 2014 to be holding over $30 billion in operational risk capital, [21] and as a general matter, U.S. banks currently hold significantly more operational risk capital than their international counterparts. It is also worth noting that operational risk losses tend to be idiosyncratic and thus uncorrelated, so extraordinarily high capital is being held against a risk that is unlikely to be systemic. (Clearly, some operational risks of the mortgage business did prove correlated during the financial crisis; however, even here, those losses were experienced years after the associated credit and market losses.)

An ongoing Basel Committee review of operational risk capital could rectify these problems if an improved regime could be constructed appropriately and—importantly—adopted by U.S. regulators without "gold plating." The result would be to free up billions of dollars of capital for more productive uses.

---

[19] See Timothy Massad, Keynote Address by Chairman Timothy G. Massad before the Institute of International Bankers (March 2, 2015), available at *www.cftc.gov/PressRoom/SpeechesTestimony/opamassad-13*.

[20] See Bank of England, "Financial Policy Committee Statement and Record From Its Policy Meeting", July 25, 2016 (August 2016), available at *www.bankofengland.co.uk/publications/Pages/news/2016/062.aspx*.

[21] See Peter Rudegeair, *Reuters*, "Trading Scandals, Legal Fines May Ramp Up U.S. Banks' Capital Needs" (June 9, 2014), available at *www.reuters.com/article/us-banks-oprisk-idUSKBN0EK1M520140609*.

III. Reforming Liquidity Regulation

A. Liquidity Coverage Ratio

A key lesson of the financial crisis was the need for banks to maintain sufficient liquidity to survive periods of financial stress. The regulatory response includes Basel III's liquidity coverage ratio (LCR), which requires banks to maintain a sufficient stock of liquid assets to cover a 30-day run on the bank with no access to additional funding, plus a Dodd–Frank Act requirement that large banks conduct liquidity stress tests on a monthly basis across at least overnight, 30-day, 90-day, and 1-year time horizons, and maintain a sufficient "liquidity buffer" based on their expected liquidity needs under these stress tests. These are concrete improvements to the bank liquidity framework, which we generally support.

These regulations have dramatically increased the ratio of HQLA to total assets in the U.S. banking sector. The largest 33 banks held 12 percent of their assets in HQLA in 2008; today they hold 24 percent of their balance sheets in these assets. Compared to the onset of the crisis, this improvement is even more pronounced, with the proportion of HQLA increasing nearly five times since the end of 2006 (i.e., from 5.75 to 24 percent).[22] The question, of course, is whether this large an expansion of bank balance sheets is necessary, and whether it is having unintended effects.

Although the LCR is conceptually sound, in practice it makes assumptions about which liabilities will run, and which assets can be sold, that a TCH study shows have no empirical bases and appear inconsistent with even crisis-era experience.[23] For example, while the LCR assumes that 30 percent of liquidity lines of credit provided to nonfinancial corporations in a future 30-day period of systemic and idiosyncratic stress would be drawn, the highest draw on such lines at large commercial banks (including several that failed or nearly failed) over any month in the financial crisis was 10 percent. While the LCR assumes that 100 percent of the non-operational deposits of financial institutions would be drawn, the worst experience during the crisis was 38 percent.[24]

These seemingly arcane calibration errors have major real-world consequences. In recent years, U.S. companies of all sizes have complained that standby letters of credit are unavailable, or more expensive and difficult to obtain. A major reason is because banks must assume that in crisis those lines will be drawn in amounts three times greater than even the worst historical experience would indicate, and therefore hold cash or cash-equivalent assets to fund those draws. And, in turn, under the leverage ratio, they must hold significant amounts of capital against those riskless or low-risk assets.

B. Net Stable Funding Ratio

The net stable funding ratio (NSFR) is intended to establish a maximum safe amount of liquidity transformation that a bank can engage in by ensuring that banks have sufficient "sticky" liabilities to fund assets that would be unable to liquidate easily over a 1-year horizon. When the NSFR was first proposed by the Basel Committee in 2009, the metric was designed to ensure that a bank with an NSFR greater than 100 percent would be able to weather a 1-year episode of idiosyncratic liquidity stress. The NSFR thereby was meant to be a complement to the LCR requirement, which was designed to ensure that a banking organization could weather a shorter (30-day) but more severe period of stress.

In those initial formulations of the NSFR, the "extended stress" was defined by specific characteristics—for example, "a potential downgrade in a debt, counterparty credit or deposit rating by any nationally recognised credit rating organisation." That benchmark was not included in the final NSFR standard released by the Basel Committee, or in the proposed rule to implement the NSFR in the United States. Nor was any other benchmark included, making it unclear what goal(s) the NSFR is intended to achieve and how it was calibrated.

Moreover, for U.S. banks already subject to the LCR, uniquely stringent liquidity stress testing under the Dodd–Frank Act requirements, a Comprehensive Liquidity Analysis and Review and a U.S.-only short-term-wholesale funding surcharge as part of the GSIB surcharge, it is unclear what additional risk the NSFR would mitigate that is not sufficiently addressed by these requirements.

---

[22] See The Clearing House, State of American Banking (2016) at exhibit 3 (updated).

[23] See The Clearing House, "The Basel III Liquidity Framework: Impacts and Recommendations" (Nov. 2, 2011), available at *www.theclearinghouse.org/-/media/files/association%20documents/20111102__liquid__liquidity%20coverage%20ratio.pdf.*

[24] Id.

The NSFR, if implemented, would significantly inhibit economic growth and liquid financial markets due to its flawed design and lack of transparency with respect to its calibration to ensure its efficiency and effectiveness. As demonstrated in our research, *The Net Stable Funding Ratio: Neither Necessary nor Harmless*, over time, the NSFR, if implemented in the United States, could be expected to significantly limit lending and capital markets activity.[25] If central bank reserve balances and retail deposits shrink in line with the Fed's forecast for policy normalization, and banks shift their funding toward wholesale deposits in line with historical experience many individual banks would not comply unless they took some compensating action. In particular, we show that the annual growth in bank lending would have to be cut by about 3.5 percentage points, to near zero, even to offset only half of the projected decline in the NSFR.

IV. Reforming the Bank Living Will Process

Title I of the Dodd–Frank Act requires each large bank holding company to construct a plan for its rapid and orderly resolution, and requires regulators to review the credibility of that plan.

Regulators have required bank holding companies to file living wills on an annual basis, against ever shifting, often nonpublic standards, even though the regulators have been generally unable to review them and provide feedback within that timeframe. Recognizing that section 165(d) of the Dodd–Frank Act requires the submission of livings wills on a "periodic," not annual, basis, an appropriate and sensible approach is to eliminate the formal requirement for an annual submission in favor of submission cycle that is better tailored to the objectives of the living will process.

The Federal Reserve and FDIC also have required, through the living will process, substantial amounts of liquidity and capital to be pre-positioned—and therefore, trapped—at numerous subsidiaries. The most recent living will guidance issued in April 2016 states that bank holding companies must assume, counterfactually, that a net liquidity surplus in one material entity cannot be transferred to meet liquidity deficits at another material entity (even between branches of the same banking legal entity). Further, the guidance also requires bank holding companies to assume that cash balances held by material entities (including branches of the bank) within their primary nostro accounts with the main bank entity of the firm are unavailable in a stress prior to, and during resolution. The guidance imposes similar requirements with respect to pre-positioning of loss absorbing capital resources at material entities. None of this guidance has been published for notice and comment. Reform here could take the form of a statement that for any firm using the single-point-of-entry resolution strategy and in compliance with the TLAC requirement for holding company loss absorbency, the living will process should not include any incremental liquidity requirement at the operating subsidiary level; for all firms, we would recommend withdrawing the presumption that liquidity cannot be transferred among subsidiaries.

Currently, each Federal (and State) banking agency is authorized to impose its own set of recovery and resolution planning requirements on different parts of a banking organization, leading to an unnecessary amount of duplicative and at times contradictory requirements. Many of these requirements were not subject to a rigorous impact analysis, and are not appropriately tailored. This may also reinforce ring fencing of entities as bank regulators focus only on the entities for which they are responsible.

We would recommend eliminating the separate insured depository institution-level resolution and recovery planning regimes. At a minimum, the agencies should be required to coordinate among themselves to establish a single set of consistent recovery and resolution planning requirements.

V. Reforming Activity Limitations

Post-crisis regulation has included not only capital and liquidity regulation to reduce the risk of bank failure to the taxpayer and the broader system, but also direct limits on bank activities—however well capitalized and funded they are. In some cases, these limits are unjustified.

A. Leveraged Lending

Leveraged lending is an important type of financing for growing companies, which tend to carry a lot of debt. Although these companies therefore represent a greater repayment risk than more established firms, this risk is one that banks have consid-

---

[25] See The Clearing House eighteen53 Blog, "The Net Stable Funding Ratio: Neither Necessary Nor Harmless" (July 5, 2016), available at *www.theclearinghouse.org/eighteen53-blog/2016/july/05-research-note-nsfr*.

erable experience managing. Banking organizations have long played a critical role in arranging, originating, and administering funding for leveraged loans as part of their larger role as credit intermediaries. Following the financial crisis, capital requirements have increased significantly for such loans, as have requirements for modeling their risks.

Nonetheless, the Federal banking agencies have issued guidance setting arbitrary limits on such lending, based on no empirical evidence—in particular, any evidence that the capital supporting such activity is somehow inadequate. It is a classic example of bank regulators substituting their judgment for lenders and markets without any meaningful analysis or evidence. For example, regulators require banks, in evaluating whether a company is leveraged for purpose of the new restrictions, to assume that all lines of credit are drawn, and to ignore cash held by the company. As a result, some Fortune 500 companies with investment grade debt are now deemed by the regulators to be highly leveraged, and thus subject to limits on their bank borrowing.

It also appears that this guidance has been supplemented by further direction, from examiners to banks, to limit lending activities in the area—although the precise details of such direction are unknown as they are deemed by the agencies to be "confidential supervisory information," and therefore immune to public scrutiny.

Of course, these loans are subject to capital requirements, and the regulators have not identified any flaws in those standards (including, in the case of the Federal Reserve, its own CCAR models) that would cause these types of loans to be uniquely undercapitalized. Nor have the agencies presented any data to show that there is an unhealthy concentration of these loans in the banking system. Also, consistent with post-crisis behavior in a range of areas, the banking agencies have implemented these substantial new limits on bank lending through guidance and "frequently asked questions," rather than formal notice-and-comment rulemaking and regulation. They have nonetheless deemed the guidance binding, and enforced it just as if it were a rule.

As a result of the leveraged lending guidance and examiner pressure, banks have been forced to turn away hundreds of millions, perhaps billions, of dollars of loans to growing businesses. Furthermore, there is scant evidence that leveraged lending guidance and subsequent direction have constrained the risk perceived by the Federal banking agencies. Despite any potential concerns regarding poorly underwritten or low-quality loans, a bank-centric approach is simply shifting risk rather than limiting it, and increasing the cost to borrowers, as banks tend to be lower cost providers of credit. Recent research by a team of Federal Reserve Bank of New York economists illustrates that the guidance has had the effect of reducing bank activity in this area, but has also increased nonbank activities, demonstrating limited effectiveness from a macroprudential view.[26] Notably, those nonbanks do not appear to be experiencing the outsized losses that the bank regulators implicitly predicted in forcing banks to abandon much of this lending.

We recommend that the guidance be rescinded immediately and in its entirety, which would provide an immediate boost to economic growth as a large number of growing companies once again became eligible for bank credit.

B. The Volcker Rule

Section 619 of the Dodd–Frank Act (commonly referred to as the "Volcker Rule") generally prohibits U.S. insured depository institutions, U.S. operations of foreign banks and their affiliates from engaging in "proprietary trading" and sponsoring or investing in hedge and private equity funds subject to some limited exceptions, including exceptions for customer-related activities such as market-making. Prior to the enactment of the Volcker Rule, very few of the firms now subject to the Rule engaged in proprietary trading activities. Of those that did, many of them were in the process of divesting or ceasing their proprietary trading activities. Today, trading businesses of covered financial institutions are focused solely on serving client needs and hedging the attendant risk.

The final regulations implementing and interpreting the Volcker Rule are voluminous and complex, contained in 964 pages, including an 893 page preamble. Under these rules, the five U.S. Federal financial agencies charged with implementing and enforcing the Volcker Rule have interpreted it in a highly restrictive way, with a broad spectrum of trading activity (i.e., not only short-term, speculative activities that the Volcker Rule was intended to target) presumed to be prohibited proprietary trading unless proven otherwise.

---

[26] Sooji Kim et al., *Liberty Street Economics*, "Did the Supervisory Guidance on Leveraged Lending Work?" (May 2016), available at *http://libertystreeteconomics.newyorkfed.org/2016/05/did-the-supervisory-guidance-on-leveraged-lending-work.html.*

Market-making. Under the rules, a covered banking entity is required to go to extraordinary lengths to prove that its routine market making and underwriting activities (included related hedging) do not constitute "proprietary trading." The agencies have adopted a broad definition of proprietary trading with strict requirements for permissible activities that could potentially captures legitimate market making in less liquid securities, particularly when markets are under stress and there is less demand. For example, banking organizations are required to strictly limit their inventory to the reasonably expected near-term demand of customers or counterparties. For debt of smaller companies, which may trade only weekly or even monthly (especially during times of stress), banking organizations may be required to unduly limit their positions, thus prohibiting them from taking any action to stabilize markets.

Recent research has begun to bear out longstanding reports from market participants that the regulations that implement the Volcker Rule are inhibiting economic growth and reducing market liquidity by constraining the ability of banking groups to buy, sell and underwrite securities, including corporate bonds that could help finance the operations of corporate customers. A Federal Reserve staff study released in December 2016, The Volcker Rule and Market-Making in Times of Stress, finds that the illiquidity of stressed bonds has increased after the Volcker Rule, as dealers regulated by the rule have decreased their market-making activities.[27] Other research indicates that with many brokers constrained in their ability to hold inventory as a result of the Volcker Rule and other post-crisis regulations, the secondary market for smaller issuers' debt has tightened. The impact is that since the enactment of the Dodd–Frank Act in 2010, new debt issuances by smaller firms has generally declined. When lower liquidity puts debt markets out of reach of smaller firms, it impedes their ability and the economy at large to grow.

Notably, Congress specifically exempted market making from the Volcker rule. Fault here thus lies not with the statute but the regime chosen to implement it.

Funds. The Volcker Rule also prohibits banks from engaging in proprietary or speculative trading by investing in private equity or hedge funds, notwithstanding the absence of evidence that such investments contributed to the financial crisis or have otherwise caused outsized losses. While the agencies must implement the statute as Congress has enacted it, they have extended its reach to numerous other types of funds that bear little in relation to either private equity or hedge funds. This has created enormous and unnecessary compliance challenges for institutions with asset management businesses serving customers seeking to save and build wealth, as well as for market making in a number of asset classes, including securitized products, covered bonds, and non-U.S. public funds.

More specifically, the regulation's overly broad definitions of "hedge fund" and "private equity fund" (so-called "covered funds" under the regulations) include vehicles that are not traditionally considered to be hedge funds or private equity funds and require extensive analysis and documentation of a banking entity's determination of whether a particular vehicle is a covered fund or qualifies for an exclusion or exemption. Moreover, the Volcker Rule regulations restricts banking entities from engaging in activities that could promote lending, capital formation and job creation, through investing in vehicles such as certain types of credit funds, infrastructure funds, energy funds, real estate funds and REITs. In addition, the Volcker Rule, as implemented, makes it difficult for a bank-owned asset manager to seed and test new asset management strategies for customers as a result of the 3 percent statutory limits on ultimate bank ownership after an initial 1-year seeding period, the unduly burdensome process for extending the temporary seeding period, and the lack of clarity on use of bank assets to fund separate account seeding structures under the proprietary trading rules. Making the rule more rational through appropriately tailored definitions of "hedge fund" and "private equity fund" and more reasonable ancillary requirements would lead to more efficient regulations, promote lending, capital formation and job creation, and enhance customer offerings and financing opportunities.

Asset-liability management. Firms use portfolios of liquid assets to hedge firmwide risk. These positions are managed by the corporate treasury, not traders in the investment bank; are not short-term trading positions; and are not engaged in to benefit from short-term price movements. Nonetheless, the regulators have imposed the same compliance obligations on this activity.

---

[27] See Jack Bao, Maureen O'Hara, and Alex Zhou (2016), "The Volcker Rule and Market-Making in Times of Stress, Finance and Economics Discussion Series 2016-102". Washington: Board of Governors of the Federal Reserve System, available at *https://doi.org/10.17016/FEDS.2016.102.*

Enforcement. Five U.S. Federal financial agencies are tasked with examining and enforcing compliance with the Volcker Rule, thereby complicating efforts by financial institutions to comply with its requirements on an enterprise-wide basis and to receive interpretive guidance relating to its restrictions.

The whole approach to Volcker Rule compliance differs radically from the standard supervisory paradigm, whereby firms are charged with compliance and subject to enforcement action if they fail to comply. Only with the Volcker Rule have the agencies set themselves on a "pre-crime" mission, performing constant monitoring for compliance.

This "pre-crime" approach is even odder and more unnecessary given a GAO report on proprietary trading during the financial crisis, which demonstrated that proprietary trading was not a cause of the financial crisis.[28] Given the idiosyncratic nature of proprietary trading's losses (and gains), it does not represent a systemic risk, and the prudential risks that both trading and fund activities pose are now subject to significantly higher capital charges under the Basel 2.5 and Basel III reforms. Notwithstanding the relatively low demonstrable risk profile of the activities in question, the regulations have nonetheless implemented a wide-ranging and highly complex set of requirements that have and will continue to impair markets and slow the real economy. These consequences are only exacerbated by the extra-territorial manner with which the agencies have implemented the Volcker Rule's restrictions.

Impact on asset-liability management. The risk of proprietary trading in a corporate treasury function, where assets are held in available-for-sale or held-to-maturity accounts, is remote at best. But the Volcker compliance regime is not tailored to the risk that proprietary trading will actually occur, and therefore corporate treasuries face high burdens in defending business-as-usual activity.

Needed reforms. Given the breadth and scope of these problems, the financial regulators should revise their Volcker Rule regulations to establish simpler criteria for identifying what trading and fund activities are impermissible and a simpler and more reasonable process for conducting examinations and issuing interpretive guidance. They should eliminate the regulation's odd presumption that all trading activity is illegal unless it can be proven to supervisory satisfaction, through detailed analysis and continuous monitoring, to meet a laundry list of specific criteria. Proprietary trading can be easily distinguished by just a few key features. These regulatory changes should be complemented with a shift in the compliance regime from real-time enforcement to traditional reliance on bank compliance and internal audit functions, with examiners reviewing their results; specialized compliance program requirements and unnecessary metrics should be eliminated. The result would be a substantial improvement in market liquidity and investment in funds that promote capital formation and job creation.

VI. Reforming Supervision, Examination, and Enforcement

We believe that bank supervision (as opposed to regulation) has lost its way post-crisis, and requires a comprehensive reexamination. While the link to economic growth in this area is less direct than in the others cited, it is very real.

In sum, three developments have converged to restrict or even halt the ability of many banks to open branches, invest, or merge to better meet the needs of their customers. First, even as banks have dramatically improved their financial condition by increasing their capital, liquidity, and asset quality positions, supervisors have transformed the supervisory scorecard (the CAMELS rating system) from a measurement of financial condition to a measurement of compliance. Second, supervisors have adopted a series of unwritten rules that produce lower CAMELS ratings. Third, supervisors have adopted another series of unwritten, or in some cases written, rules (albeit none with any basis in statute) that translate those low ratings and other supervisory issues into a bar on expansion. The result is a regime, effectively invented by bank supervisors without notice and comment or Congressional input, that makes an examiner's expectations regarding bank compliance matters a fundamental determinant of whether banks can invest and grow.

For perspective, consider that we routinely see serious compliance violations across a wide range of American industries. Those companies are subjected to enforcement proceedings and are required to pay fines and remediate their practices, but no one ever suggests that while those proceedings are pending they should be stopped from opening new franchises, building new plants, developing new drugs, designing new cars, or launching new apps. Yet somehow we have reached the point

---

[28] Government Accountability Office, "Proprietary Trading: Regulators Will Need More Comprehensive Information to Fully Monitor Compliance With New Restrictions When Implemented" (July 2011), available at *www.gao.gov/assets/330/321014.pdf*.

in banking where the punishment for a compliance problem routinely includes, in addition to a vast array of civil and criminal liabilities imposed by a wide array of Federal and State authorities (often by multiple authorities for the same underlying conduct), a prohibition on any type of expansion by the bank. The opportunity lost is not just for the bank but for its customers, and ultimately an economy that relies on its banking system for financing.

Of course, banking is different in the sense that bank deposits are insured by the FDIC. But that gives Government a special interest in the financial condition of banks. As a result, Congress has in limited instances linked expansion to financial condition. As we will see, though, financial condition is no longer what banks are being graded on, and the penalties for a bad grade now vastly exceed what Congress has authorized.

Another result is simply a massive cost, which must be passed along to consumers, as described in M&T Bank's most recent annual report message to shareholders:

> At M&T, our own estimated cost of complying with regulation has increased from $90 million in 2010 to $440 million in 2016, representing nearly 15 percent of our total operating expenses. These monetary costs are exacerbated by the toll they take on our human capital. Hundreds of M&T colleagues have logged tens of thousands of hours navigating an ever more entangled web of concurrent examinations from an expanding roster of regulators. During 2016 alone, M&T faced 27 different examinations from six regulatory agencies. Examinations were ongoing during 50 of the 52 weeks of the year, with as many as six exams occurring simultaneously. In advance of these reviews, M&T received more than 1,200 distinct requests for information, and provided more than 225,000 pages of documentation in response. The onsite visits themselves were accompanied by an additional, often duplicative, 2,500 requests that required more than 100,000 pages to fulfill—a level of industry that, beyond being exhausting, inhibits our ability to invest in our franchise and meet the needs of our customers. [29]

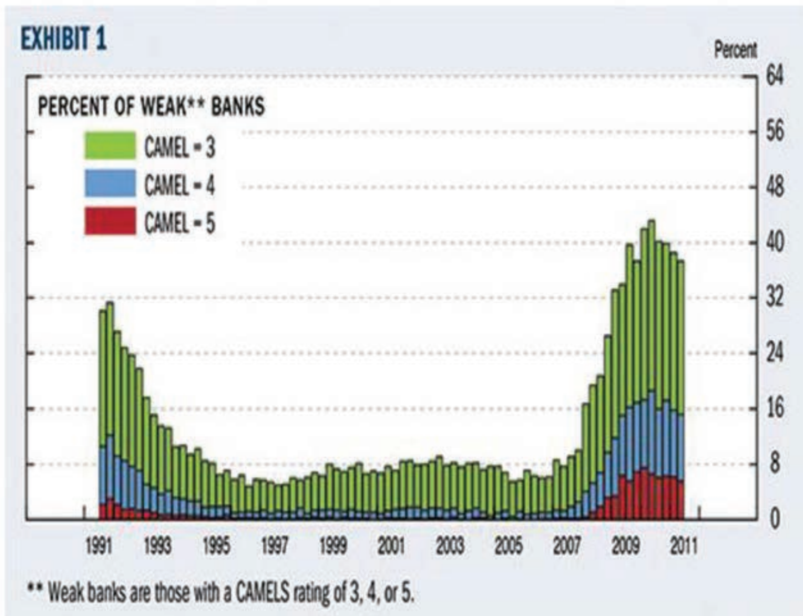
A. CAMELS Ratings

The centerpiece of bank supervision is the CAMELS rating system. It was created by examiners in 1979 as a scorecard to evaluate an institution's "financial condition and operations"—in other words, its safety and soundness. (Interestingly, the creation of the CAMELS system was not specifically mandated by any statute or regulation.) The CAMELS system evaluates a bank across six categories—Capital, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk, especially interest rate risk—and assigns a composite rating, all on a scale of 1 (best) to 5. With the sole exception of a few small changes in 1996 (most notably, the addition of the "S" component), the CAMELS standards have not been materially updated in the almost 40 years since their adoption—not after adoption of the original Basel Accord on capital in 1988, the Basel III regime in 2010, the Comprehensive Liquidity Analysis and Review in 2012, or the Liquidity Coverage Ratio in 2014.

The result is a system that is hopelessly out of date. Detailed capital, liquidity, and other rules have been expressly designed and carefully calibrated to evaluate the key components of the CAMELS ratings: capital, liquidity, and, less obviously, earnings and asset quality, which are now evaluated through stress testing for certain banks. Thus, for example, the published standards that examiners apply in deciding the capital component of the rating do not include consideration of any post-1978 regulatory capital standards—or any market indicators, which also have grown in sophistication over the past 40 years. There is no mention of CCAR, the self-described Comprehensive Capital Analysis and Review. Rather, the published standards speak vaguely of factors like "the ability of management to address emerging needs for additional capital." This is not to say that there cannot be cases where a bank that is deemed well-capitalized under the current 35-plus different capital tests could not, in theory, still require more capital. It is, however, pretty unlikely.

It is worth examining the predictive ability of CAMELS ratings. Consider the number of banks rated as weak (CAMELS 3, 4, or 5 in Exhibit 1).

[29] M&T Bank Chief Executive Office Robert G. Wilmers, 2016 Annual Report Message to Shareholders (Mar. 9, 2017), available at *https://newsroom.mtb.com/document-archive/annual-report-letters/2016-annual-report-message-to-shareholders.htm.*



This chart seems to demonstrate little predictive ability for CAMELS ratings, even when they were focused on financial condition. In 2007, a small percentage was rated as weak, but hundreds failed.

Changing the subject: The move from financial condition to compliance. The appropriate response to the diminished value of CAMELS as a measure of financial condition would have been to decrease its importance in the supervisory process or incorporate better measures of financial condition. To their credit, the Federal Reserve and other banking agencies adopted several crucial post-crisis reforms to improve bank resiliency: most notably, CCAR stress testing, Basel III, and the LCR. However, exactly because more objective, analytically sound standards have overtaken the CAMELS system as a gauge of financial condition, examiners have shifted their emphasis to the one entirely subjective component: management. And not management as viewed through the lens of maintaining sound financial condition, but rather through the lens of "compliance"—not just with laws, but with examiner guidance and criticisms too.

Various "unwritten rules" reportedly have been adopted as part of this shift:

- All components do not count equally toward the composite rating; the management rating counts the most, and it increasingly appears that the composite rating cannot be higher than the management rating. This elevation of management as the "super component" has never been subject to public comment. A 1996 update to the CAMELS standards stated that "the management component is given special consideration when assigning a composite rating." Over time, it has become the dominant consideration.
- The management rating does not depend primarily on the financial condition of the bank (because, if it did, it would track the other ratings), but rather on compliance with banking agency rules and guidance. In practice, any compliance problem resulting in enforcement action or penalty, regardless of its materiality, can result in a downgrade of management; so, too, can unresolved "Matters Requiring Attention" (a confidential examiner criticism).
- Management ratings increasingly are driven by the results of a consumer compliance rating that was adopted as an independent evaluation.

Thus, the examination system has changed from primarily an evaluation of the safety and soundness of an institution to, increasingly, an evaluation of routine compliance matters and the readiness with which management accedes to examiner criticism. And this change has been accompanied by a substantial increase in the consequences of a low rating, with supervisors raising the stakes dramatically. While compliance matters are important, they are not uniquely and exclusively important, and should not pollute a system designed for an altogether different, and vital, safety and soundness purpose.

Consequences. Bankers now routinely refer to being in the "penalty box," where they cannot expand through investment, merger, or adding a branch. Mid-size and regional banks are particularly affected. There are various ways into the penalty box:

- As described above, a "3" rating for management operates as a halt on expansion. Under section 4(k) of the Bank Holding Company Act, a financial holding company whose bank receives a "3" rating for management must receive Federal Reserve approval to expand certain nonbanking activities. Regulators now extend that to almost any type of expansion, or at least to any expedited review of branching or other applications.
- Any AML consent order operates as a multiyear ban on expansion for any purpose, regardless of the seriousness of the conduct motivating the order or the progress made by the firm in remediating it. While consent orders bring to mind large banks in highly publicized cases, small and midsized banks routinely receive such orders.
- A "Needs Improvement" CRA rating also operates as a multiyear ban, regardless of what triggered it or how it is being remediated. While some statutes governing expansion require an assessment of management (for example, the Bank Holding Company Act, governing bank acquisitions), many do not. And of those that do, each speak in particular to "management resources"—presumably, the ability of management to oversee an integration—and not compliance issues. Large banks have sufficient resources to remediate problems in one area while expanding in another area—for example, to remediate an AML issue at an overseas subsidiary while opening a new branch in the Midwest United States.

The results of this new supervisory regime are significant:

- Many banks—of all sizes, but particularly midsized banks—have been blocked from branching, investing, or merging to meet their customers' needs.
- Bank technology budgets often are devoted primarily not to innovation but to redressing frequently immaterial compliance concerns.
- Board and management time is diverted from strategy or real risk management and instead spent remediating frequently immaterial compliance concerns and engaging in frequent meetings with examiners to ensure that they are fully satisfied. Numerous banks report that their boards now spend a majority of their time on regulation and compliance.

Of course, for examiners interested in having their compliance criticisms acknowledged and immediately remediated, this system works well. But as we note, it is not a tool that regulators in any other industry feel they need, and it has important economic consequences.

Recommendations. A few core reforms are necessary. The first is an unequivocal statement that the purpose of a CAMELS rating is to assess the financial condition of the bank from the perspective of its potential risk to the Deposit Insurance Fund. The second is the withdrawal of the Federal Reserve's SR Letter 14-02 and all other restrictions on bank expansion that do not have a basis in statute or a regulation adopted pursuant to the Administrative Procedure Act. The third is a complete overhaul of the CAMELS regime (including its potential replacement) that emphasizes clear, cogent, and objective measures of financial condition over vague, arbitrary, and subjective ones.

B. Tailoring of Enhanced Prudential Standards

As we have described above, post-crisis regulatory reforms have established a myriad of new prudential requirements for banking organizations. The scope of application varies by requirement, but in many cases new regulations have been applied in a uniform fashion to large and diverse cohorts of banks of differing sizes, business models and risk profiles. For example, the Federal Reserve has implemented a number of so-called "enhanced prudential standards" under section 165 of the Dodd–Frank Act (including capital, liquidity, and other requirements) on the basis of asset size thresholds.

While the Federal Reserve has made some effort to tailor its enhanced prudential standards (e.g., by providing for a modified LCR for some firms and recently eliminating the CCAR qualitative assessment for others), it has generally done so based on arbitrary size thresholds rather than careful consideration of the scope and type of regulation warranted by different business models, risk profiles and other more meaningful criteria. And in many cases, the Federal Reserve has established one-size-fits-all rules that are not tailored at all. The result is insufficiently tailored regulatory regime for many banks that imposes unnecessary burdens and unduly limits their ability to lend to and otherwise support businesses and consumers. There is therefore a clear need to review all enhanced prudential standards established under section 165 of the Dodd–Frank Act in order to identify and implement more appropriate and robust tailoring of their scope and extent of application; doing so would better enable banks unduly and unnecessarily burdened by the current regime to lend and otherwise serve customers and the economy.

C. Regulation of Foreign Banking Organizations

Generally outside the notice of policymakers, foreign bank operations in the United States have decreased somewhat in recent years.

Certainly, one cause of this retrenchment has been a delay in foreign banks' recapitalization post-crisis, global economic instability, and a general need to reduce balance sheet size. However, U.S. requirements have been another key driver, as recent years have also seen extensive revision to the rules and regulations governing foreign banking organizations (FBOs) that have U.S. operations. In particular, the Federal Reserve has required that, on the basis of asset size thresholds, many FBOs operating in the United States establish intermediate holding companies (IHCs) through which their U.S. activities must be operated and managed. These IHCs in turn are now subject to a wide range of new prudential requirements, including capital, liquidity, stress-testing, resolution planning and other rules. The resulting regime is one that is simply not appropriately tailored to the varying sizes, business models, and risk profiles of different types of FBOs and the inherently sub-consolidated nature of their U.S. operations.

For example, the stand-alone capital and liquidity requirements applied to the U.S. IHC of an FBO effectively hinder the foreign parent's ability to allocate capital and liquidity across its entire global business. All internationally active banks (whether foreign or domestic) manage their capital and liquidity on a consolidated, global basis, oftentimes acting nimbly to allocate financial resources to geographic locations or business operations where it is needed in a time of stress. Stand-alone U.S. capital and liquidity requirements effectively trap those resources in the FBO's U.S. IHC, making them unavailable for use elsewhere. The U.S. regime, which also mandates stress testing at the IHCs, ignores (and duplicates) similar consolidated requirements imposed on the FBOs by their home country authorities. And of course, for the various U.S. capital and liquidity rules that are applied to the U.S. IHC of FBOs, the general concerns and recommendations that we have highlighted earlier in this paper are just as relevant, and apply equally.

On top of these capital, liquidity, and stress test requirements, the Federal Reserve also has required foreign GSIBs to "pre-position" extraordinarily high amounts of internal TLAC. This stands in contrast to the process described in the FSB's term sheet on TLAC, which the Federal Reserve developed in coordination with foreign supervisors; that process identifies a range of potential internal TLAC requirements, with the precise requirement to be established on an institution-specific basis through collective dialogue among that institution's home and host country supervisors. Instead, the Federal Reserve imposed internal TLAC requirements at the top end of the FSB range, unilaterally. Here, too, the result is insufficiently tailored regulatory regime for many FBOs that imposes unnecessary burdens and unduly limits their ability to lend to and otherwise support businesses and consumers.

VII. Conclusion

Our banking system now stands on a solid foundation of capital and liquidity. That foundation affords us the opportunity to consider whether particular components of the regulatory and supervisory regime are unnecessary, duplicative or more stringent than necessary to achieve safety and soundness and financial stability goals. Considerable economic benefits can be achieved through such a reexamination.

PREPARED STATEMENT OF ROBERT R. HILL, JR.

CHIEF EXECUTIVE OFFICER, SOUTH STATE CORPORATION, ON BEHALF OF MID-SIZE BANK COALITION OF AMERICA

JUNE 15, 2017

Chairman Crapo, Ranking Member Brown, and Members of the Committee, I am Robert Hill, CEO of South State Corporation, which is the holding company of South State Bank. South State, founded in 1933, is headquartered in Columbia, South Carolina, and serves communities in South Carolina, North Carolina and Georgia. In January of this year, our bank passed the $10 billion in assets threshold, which subjects South State to unduly burdensome requirements under the Dodd–Frank Act. In light of this experience, I appreciate the opportunity to present the views of the Mid-Size Bank Coalition of America (MBCA) on the significant compliance burden placed on midsize banks as a result of Dodd–Frank.

The MBCA is the voice of 78 midsize banks in the United States with headquarters in 29 States. MBCA member banks are primarily between $10 billion and $50 billion in asset size, average less than $20 billion, and serve customers and communities through more than 10,000 branches in all 50 States, the District of Columbia, and three U.S. territories. Midsize banks most often are the largest, local bank serving communities, many for more than a century.

Unlike the largest banks in the country, for whom lending is largely automated, midsize banks are run by people who are focused on establishing long-term relationships with our communities and our customers on a daily basis. As a result, we are able to use actual knowledge of our customers and base our credit decisions on intangible factors, such as character and local economic conditions. We have also made the necessary risk and compliance investments that support our business models, which are uniformly based on stable deposit funding, revenues driven by traditional banking activities well-understood by bank management and regulators and limited or no trading operations or market-making activity. In sum, midsized banks have prudent business models that contribute to economic growth and support financial stability. To the extent restraints can be reduced, midsized banks can provide even more credit and support to small businesses and Main Street.

Under Dodd–Frank, crossing the $10 billion in assets threshold has harsh implications for midsize banks. When banks cross $10 billion, they are considered midsized institutions—a designation that introduces an enhanced supervisory approach from regulators. These banks can expect more frequent compliance requirements, which may include full-scope examinations coupled with regular, targeted reviews. In connection with these additional burdens, midsize banks must allocate further resources to compliance, from business units to senior management and the board of directors.

The imposition of these demands does not benefit the public in any appreciable way. These requirements drain resources of midsize banks, and less money is thus available to provide credit to individuals and small businesses in our communities. For example, as a result of this threshold, South State incurs costs over $20 million per year.

In April of this year, the MBCA submitted a letter to the Chairman and Ranking Member urging the Committee to revisit the $10 billion number, an arbitrary figure that does not meaningfully capture systemic risk. In addition to the unfair consequences of using this number that already exists, the MBCA is deeply concerned the figure could become the default threshold for even more rules and regulations in the future.

The MBCA's highest priority would be to eliminate the $10 billion threshold and replace the number with an activities-based standard, which would focus regulation more closely on systemic risk, or, at a minimum, to raise the threshold to an appropriate level. The key sections of Dodd–Frank, which will need to be amended in this regard, are Sections 165, 1025, 1026, and 1075.

As an example, Section 165 imposes a mandatory stress testing burden on banks between $10 billion and $50 billion, known as the Dodd–Frank Annual Stress Test (DFAST). Former Federal Reserve Governor Daniel Tarullo testified before Congress that such testing is not necessary, and, in fact, it is actually a burden on the regulators with no commensurate regulatory benefit. As CEO of an institution that recently passed the $10 billion threshold, I can personally attest to the significant compliance burden that follows and the cost that it entails.

Independent Bank of Texas, an MBCA member bank with assets of just under $10 billion, estimates the cost of implementing the mandatory stress testing required under Section 165, in the event it crosses the $10 billion threshold, would be $5–6 million in the year of implementation and $2–3 million per year thereafter. Independent Bank has stated they will have to add a team of three to four people to manage this process.

All of this cost would be for something Governor Tarullo has testified provides no regulatory benefit. In addition, the current regulatory regime imposed by Section 165 forces midsize banks to divert capital away from the products we offer and the lending that drives growth and development in our communities. The MBCA believes freeing midsize banks from the unreasonable burdens posed by Section 165 should be one of your highest priorities.

To this end, we applaud Senators Moran, Tester, and Heitkamp for sponsoring S.1139, the Main Street Regulatory Fairness Act, which would remove the DFAST mandate currently imposed on banks between $10 billion and $50 billion in assets. As Senator Tester noted, "This bill cuts red tape and makes it easier for Main Street lenders to invest in entrepreneurs, families buying their first home and parents sending their kids to college."

The MBCA also applauds Senators Tester and Moran for introducing the CLEAR Relief Act of 2017, which would provide the Qualified Mortgage protections to loans originated and held in portfolio by banks under $10 billion. The MBCA, however, strongly urges the Committee, as it moves this legislation forward, to not limit this important relief to banks under $10 billion. The rationale for the Qualified Mortgage protections relates to the fact the banks with the status are holding the mortgage loans in portfolio. It has nothing to do with the size of the institution holding the mortgage. Using the arbitrary $10 billion figure once again reinforces this number with no rational basis.

In our market, we have a lot of retirees, who do not have jobs. As a result, they do not meet the QM status requirements. If we are keeping the mortgages on our books, we believe we should be given QM status. Otherwise, it is not just the bank that is impacted, but our consumers are unfairly limited in their choices.

Former House Financial Services Chairman Barney Frank, one of the principal authors of Dodd–Frank, has testified that he supports giving a safe harbor status on loans where the lender retains the risk by holding the loan in portfolio. A loan made by a bank and held to maturity is the strongest possible statement of confidence in the ability of the borrower to repay regardless of the size of the bank.

We have only raised two examples where the $10 billion figure currently imposes—or may impose—an unnecessary burden on midsized banks. But there are a variety of thresholds that need to be eliminated, replaced by an activities-based standard or, at a minimum, raised substantially to capture systemic risk. This is not simply about fairness to midsize banks. It is fundamental to growing our economy.

Recently, the MBCA asked its member banks to submit examples from their customers of specific, real-world customer impacts from the current regulatory system. The examples received included everything from mortgages rejected because of the ability to repay/qualified mortgages requirement to business loans not made. These examples have one thing in common—the absence of economic activity due to unnecessary regulatory requirements, which results in limited to no job creation and growth.

As Main Street banks, we support a regulatory regime that encourages prudent behavior and protects our customers. But we also need common-sense regulation that does not unnecessarily impose burdens and impede the banking services communities need to create jobs and drive economic growth—and this, in our view, requires a move away from the Dodd–Frank $10 billion regulatory threshold. I am happy to answer any questions the Committee may have, and again appreciate the opportunity the Committee has given the MBCA to express its views.

PREPARED STATEMENT OF SAULE T. OMAROVA

PROFESSOR OF LAW, CORNELL UNIVERSITY

JUNE 15, 2017

Dear Chairman Crapo, Ranking Member Brown, Members of the Committee: Thank you for inviting me to testify at this hearing. My name is Saule Omarova. I am Professor of Law at Cornell University, where I teach subjects related to U.S. and international banking law and financial sector regulation. Since entering the legal academy in 2007, I have written numerous articles examining various aspects of U.S. financial sector regulation, with a special focus on systemic risk containment and structural aspects of U.S. bank regulation. For 6 years prior to becoming a law professor, I practiced law in the Financial Institutions Group of Davis Polk & Wardwell and served as a Special Advisor on Regulatory Policy to the U.S. Treasury's Under Secretary for Domestic Finance. I am here today solely in my academic capacity and am not testifying on behalf of any entity. I have not received any Federal grants or any compensation in connection with my testimony, and the views expressed here are entirely my own.

The global financial crisis of 2007–09 has left a deep, crippling mark both on the American economy and on the lives of millions of Americans who lost their homes, their jobs, their savings, and their hopes for a better future. It threw the country into a prolonged economic recession, accompanied by growing levels of poverty, inequality, and political discord. According to an estimate by the Federal Reserve Bank of Dallas, the crisis resulted in an economy-wide output loss of up to $14 trillion, or $120,000 per single U.S. household—both of which amounts will easily double if the broader economic and societal effects of the crisis are permanent. [1] These output losses triggered a familiar vicious circle of economic stagnation and instability. Faced with steadily declining real incomes, Americans are forced to finance their consumption with an increasingly unsustainable debt, which already reached a record $13 trillion mark. [2] Debt overhang depresses consumer spending, which in turn leads to further contraction in production and employment. [3]

Furthermore, neither economists' estimates nor the actual statistics capture the enormous nonpecuniary—or human—costs of the crisis, including the lasting psychological effects of unemployment, underemployment, diminished job security and reduced opportunity. While difficult to quantify, these "hidden" costs of the financial crisis will be borne by the American people for years to come.

Yet, the very same financial institutions whose reckless profit-seeking created the crisis in the first place were largely protected from the downside of their own excessive risk-taking, because the Federal Government was compelled to bail them out. Not only did the 2008–09 bailouts effectively exact "an unfair and nontransparent tax upon the American people" but they also significantly undermined public trust in the American capitalist system, thus undermining the system itself. [4]

In this context, the Committee's current efforts to evaluate the role of financial institutions in fostering America's economic growth acquire particular significance. Promoting sustainable, stable long-term growth is an issue of enormous political as well as economic importance. It is the only way of remedying pervasive socially destructive consequences of the financial crisis: only by deliberately and systematically channeling public and private efforts toward the expansion of productive capacity and employment in the real (i.e., nonfinancial) sector of the national economy can we reverse the crippling effects of the extraordinary wealth transfer from the American taxpayers to the financial industry that the latest crisis laid bare for all to see. There is hardly a greater task facing Congress today, and the Committee's decision to tackle it is a much needed act of public-minded statecraft.

Ironically, however, the financial industry is using this opportunity to mount a massive lobbying effort to achieve the opposite goal: to reverse key post-crisis regulatory reforms enacted with an explicit goal of curbing financial institutions' ability to generate—and then socialize—excessive levels of risk in the financial system. The industry explicitly targets the Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd–Frank Act" or the "Act"), the centerpiece of post-crisis financial regulation reform. [5] In effect, banks are trying to put the Dodd–Frank Act on trial under the rhetorical guise of "fostering economic growth." It is, however, a dangerous misconception to equate economic growth with financial sector deregulation: not only are the two phenomena fundamentally different but, as explained below, they are often mutually exclusive.

It is especially ironic—indeed, astounding—to watch the financial industry complain about its supposedly unbearable regulatory compliance costs, when the industry is doing exceptionally well for itself. All banks and their parent-companies, regardless of size, saw their profits increase steadily during the entire time after the

---

[1] David Luttrell, Tyler Atkinson, Harvey Rosenblum, "Accessing the Costs and Consequences of the 2007–09 Financial Crisis and Its Aftermath", *DallasFed Economic Letter*, Vol. 8, No. 7 (Sept. 2013), available at *https://www.dallasfed.org/research/eclett/2013/el1307.cfm*, at 1-2.

[2] See, Matt Scully, "Trumps' America Is Facing a $13 Trillion Consumer Debt Hangover", *Bloomberg.com* (6 June 2017), available at *https://www.bloomberg.com/news/articles/2017-06-06/trump-s-america-is-facing-a-13-trillion-consumer-debt-hangover?srnd=157391092*.

[3] See, Robert Hockett and Richard Vague, "Debt, Deflation, and Debacle: Of Private Debt Write-Down and Public Recovery" (2013), available at *https://www.interdependence.org/wp-content/uploads/2013/04/Debt-Deflation-and-Debacle-RV-and-RH1.pdf.*

[4] Luttrell et al., supra note 1, at 3.

[5] Dodd–Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (codified at 12 U.S.C. §5301 et seq. (2012)).

Dodd–Frank Act was passed in 2010. In 2016 alone, banking institutions earned a total of $175 billion in net profits.[6] This is not a sign of a struggling industry.

Of course, it may be reasonable, and even desirable from the public policy perspective, to revisit the continuing efficacy of certain post-crisis laws and regulations or to recalibrate their application to certain small, low-risk financial institutions. If carefully designed and thoughtfully implemented, such recalibration may help to increase the availability of affordable local financing to small businesses in some rural and small-town areas. However, even under the best of circumstances, that possibility alone is not sufficient to support a wide-ranging repeal or rollback of the existing financial laws and regulations. Any such measure would directly and disproportionately benefit large, complex, systemically risky megabanks by removing all meaningful constraints on their ability to destabilize the Nation's financial system and, once again, jeopardize American taxpayers' long-term (and even short-term) well-being. It is against this background that the Committee should evaluate every proposal for regulatory reform submitted to it by self-interested industry players.

I. Financial Deregulation Is Likely To Hinder, Not Foster, Real Economic Growth

The starting point of all deregulatory proposals and arguments advanced by the financial industry is a blanket assertion to the effect that financial institutions' core, if not sole, business purpose is to finance America's economic growth. Accordingly, the argument goes, any regulatory constraint on financial institutions' business activities, by definition, restricts their ability "to serve customers, grow the economy and create jobs."[7] Therefore, an implicit conclusion follows, removing such regulatory constraint will necessarily and automatically improve customers' lives, boost the economy, and create jobs.

It is an inherently faulty argument, insofar as these financial institutions—regardless of their size or other attributes—are privately owned firms whose overarching business priority is to maximize their own profits and shareholder returns, not the Nation's macroeconomic goals. It becomes a deliberately misleading and dangerous argument, however, when used by large financial institutions the bulk of whose profits comes from massive secondary-market trading and dealing operations.

The financial industry's argument either inadvertently conflates or deliberately confounds two very different things: (1) actual growth in the real economy, and (2) mere speculation-driven asset price inflation in the secondary markets.

It is indisputable that what America needs is real economic growth: stable and sustainable long-term growth of the real—i.e. nonfinancial—sector of the national economy. We urgently need to grow our Nation's industrial output and capacity, to facilitate employment- and wealth-generating technological advances, to rebuild and modernize the country's physical and social infrastructure. We also need to ensure that the benefits of these real growth-promoting activities are distributed more equally and fairly, so as to restore the lost strength of America's middle class and to enable lower-income American families to move up the ladder of economic and social success. It is this kind of real, sustainable, structurally balanced, and socially inclusive economic growth that is necessary in order to help the country recover from the post-crisis economic recession.

It is also fundamentally different from the mere asset price inflation, or growth in prices at which various already existent assets—stocks, bonds, commodities, real estate, etc.—are traded in secondary markets. Because increases in market value of such tradable assets at least temporarily increase their owners' individual wealth, the aggregate growth in the market value of all such assets is routinely and erroneously taken as a direct indicator of the aggregate economic "wealth" or national economic "growth." Of course, an increase in the current market price of a particular company's stock may reflect, at least in part, an increase in that company's real-life productivity. But it may also reflect merely the generalized expectations of today's stock buyers that those prices will be even higher tomorrow. In that sense, all asset price inflation is inherently speculative: it is not directly or necessarily linked to actual productive gains in the real economy.[8]

---

[6] The total number for 2016 is the sum of the revenant quarterly numbers. See, Federal Reserve Bank of New York, "Quarterly Trends for Consolidated U.S. Banking Organizations", available at *https://www.newyorkfed.org/medialibrary/media/research/banking—research/quarterlytrends2016q4.pdf?la=en.*

[7] Letter to The Honorable Michael D. Crapo and The Honorable Sherrod Brown from Francis Creighton, Executive Vice President of Government Affairs of Financial Services Roundtable (Apr. 14, 2017) [the "FSR Letter"], at 1.

[8] "The Fundamental Logic of Speculative Manias and Crashes Has Been Explained and Documented Many Times". See, Charles P. Kindleberger and Robert Aliber, "Manias, Panics, and

Moreover, speculative asset price inflation, in fact, significantly impedes real economic growth. There are two reasons why that is the case.

First, by making purely speculative investments financially attractive, asset price inflation effectively diverts investment flows away from the primary markets in which companies raise new capital for expanding their productive capacity. Put simply, investors looking to put their money to use in financial markets face two competing choices: asset price speculation (an easy short-term commitment of capital with virtually no "hard" constraints on the upside) or productive investment in the real economy (a long-term commitment of capital with various real-life constraints on potential returns). In that sense, asset price inflation actively undermines the real economy's potential for productive, employment-generating growth that America so desperately needs.

Second, asset price inflation creates instability that directly threatens the economy's ability to operate and grow. When speculation-induced asset price inflation reaches its peak, the inevitable market crash tends to be fast and furious. During these dramatic moments, markets tend to over-correct, sending asset prices far below the levels supported by the "fundamentals." Thus, the ultimate bursting of an unsustainable speculative bubble wipes out not only the artificial, purely speculative gains in asset values but also a lot of real economic wealth. Massive defaults, bankruptcies, business closures, worker layoffs, and other familiar symptoms of a severe "market correction" extinguish both the fruits of the Nation's past and the foundations of its future economic growth and prosperity.

To appreciate these dynamics, one need not go as far back as the Great Depression and the Roaring Twenties that led to it. More recent history provides plenty of evidence to the same effect.

In the era of massive financial sector deregulation, throughout the 1990s and all the way until 2008, America's economic boom was based largely on secondary-market asset price inflation. This trend is particularly visible in the period after the enactment of the Gramm–Leach–Bliley Act of 1999 (the "GLB Act"), which repealed the Glass–Steagall Act's prohibition on combining, under the same corporate roof, traditional banking activities and full-blown dealing and trading in securities and other financial (and even nonfinancial) markets.[9] Throughout the 1990s, large financial institutions—both commercial banks and investment banks—lobbied for this "regulatory relief" from the supposedly outdated Glass–Steagall rules, using the familiar rhetoric of "facilitating economic growth" and providing "more choices" and "better services" to their customers.

Once enacted, the GLB Act unleashed an unprecedented consolidation in the financial services industry and the emergence of a handful of extremely large FHCs that began aggressively growing their large-scale trading and dealing operations in securities, derivatives, short-term money-like instruments, and physical commodities.[10] Their core banking operations, while still a critical point of access to public subsidy, quickly lost their status as the "core" source of profitability.[11] In the short 9 years between the enactment of the GLB Act and the near-collapse of the financial markets in the fall of 2008, these universal megabanks have effectively turned into universal dealers making secondary markets in everything and anything that could be quantified and turned into a trading asset. A result of this unprecedented growth of secondary market speculation was an equally unprecedented asset price inflation—a story aptly told by many an expert already.

For present purposes, however, one point deserves special emphasis: As secondary market trading volume, stock price indices, and financial firms' profits were all going up, domestic industrial production declined, manufacturing jobs were massively outsourced overseas, wages stagnated, and consumer debt (itself converted to a "securitized" trading asset) ballooned. In effect, this "financialization" of the American economy represented an unprecedented transfer of wealth from the real economy to the increasingly speculation-oriented financial sector.[12] The systematic redistribution of wealth from the Main Street makers to Wall Street takers was starkly exposed when the speculative craze—particularly, in mortgage-backed securities,

---

Crashes: A History of Financial Crises" (2005); Erik Gerding, "Law, Bubbles, and Financial Regulation" (2013).

[9] Financial Services Modernization Act (Gramm–Leach–Bliley Act), Pub. L. No. 106-102, 113 Stat. 1338 (1999).

[10] See, Arthur E. Wilmarth, Jr., "The Dark Side of Universal Banking: Financial Conglomerates and the Origins of the Subprime Financial Crisis", 41 *Conn. L. Rev*. 963, 1002–46 (2009).

[11] See, Federal Reserve Bank of New York, "Quarterly Trends for Consolidated U.S. Banking Organizations", Fourth Quarter 2016, available at *https://www.newyorkfed.org/medialibrary/media/research/banking–research/quarterlytrends2016q4.pdf?la=en*, at 13.

[12] See, Thomas Philippon, "Finance Versus Wal-Mart: Why Are Financial Services So Expensive?" *Rethinking the Financial Crisis* 235 (Alan Blinder et al., Eds. 2012).

underlying mortgage loans and houses—finally triggered the world's first truly systemic financial crisis.[13] To protect the economy from collapse, American taxpayers were forced to bail out the same megabanks that fueled—and profited from—the crisis-inducing asset price inflation. Today, financial institutions are doing very well, in terms of profits and returns on their shareholders' equity.[14] But the middle class and poor Americans, whose livelihood is tied to the real economy, continue to bear the full burden of the sluggish post-crisis recovery.

The centerpiece of post-crisis regulatory reform, the Dodd–Frank Act, aims to minimize the likelihood of recurring speculative asset price inflation. Thus, the Dodd–Frank Act established a new systemic oversight body, the Financial Stability Oversight Council (FSOC).[15] The Act mandated enhanced prudential supervision of so-called "systemically important financial institutions" (SIFIs), which includes large bank holding companies (BHCs) with at least $50 billion in assets and certain nonbank financial institutions designated as SIFIs by FSOC.[16] As part of such enhanced prudential supervision, SIFIs are required to maintain higher capital and liquidity buffers, conduct regular stress tests, and prepare and submit to regulators comprehensive resolution plans (living wills).

Among other things, these heightened requirements are designed to limit the ability of large financial conglomerates to create dangerous levels of risk through their massive dealing and trading operations in secondary markets. By restricting SIFIs' ability to fuel destabilizing asset price inflation, the Dodd–Frank regime of enhanced prudential supervision also helps to channel investment away from socially destructive speculation (secondary markets) and toward productive investment in the real economy (primary markets). While it is not commonly perceived or discussed in these terms, this potential "channeling" effect of the Dodd–Frank Act on real economic growth should not be underestimated. Put simply, if investors find fewer lucrative opportunities in speculative assets trading, they will direct more of their money into nonspeculative investments.

It is, therefore, no surprise that large financial conglomerates—Wall Street megabanks that dominate and profit from secondary market trading and dealing activities—are now asking Congress to reverse all of the major post-crisis regulatory reforms that threaten their ability to promote speculative asset price inflation. Rhetorically, these financial institutions are deliberately using the language of "fostering economic growth" and "creating jobs," ostensibly through lending to "small businesses" and "American families." Strategically, they are taking advantage of the fact that many smaller BHCs, regional lenders without meaningful trading operations, voice their own, qualitatively different, concerns about the unintended consequences of applying SIFI regulation to their more traditional banking-based business models. Neither of these clever tactics should sidetrack the Committee in its deliberations on how to foster sustainable, stable growth in the real economy, as opposed to mere speculation in secondary markets.

II. The Financial Industry's Deregulatory Proposals Will Not Foster Real Economic Growth

The financial industry has submitted numerous letters and proposals for deregulatory reforms that would ostensibly promote economic growth. A comprehensive or detailed analysis of all such letters and proposals would make my testimony unwieldy. Instead, I will focus on the industry's key deregulatory proposals targeting the Dodd–Frank's regime of enhanced prudential supervision, including the process of SIFI designation and supervisory stress testing. While these proposals offer clear potential benefits from the standpoint of financial institutions' own profitability and stock price (at least in the short run), the financial industry failed to establish how the proposed deregulatory measures would promote sustainable long-term growth of the American economy.

---

[13] See, Saule T. Omarova, "The New Crisis for the New Century: Some Observations on the 'Big-Picture' Lessons of the Global Financial Crisis of 2008", 13 *N.C. Banking Inst.* 157 (2009).

[14] According to official statistics, the top 50 largest BHCs' total net income for the last quarter of 2016 was over $32B, while their average annualized return on equity was above 7 percent. Tellingly, the total quarterly income of just the top six BHCs—JPMorgan Chase & Co., Bank of America Corp., Wells Fargo & Co., Citigroup, The Goldman Sachs Group, and Morgan Stanley—was over $24B. Three of these largest institutions had annualized return on equity of almost 11 percent. Federal Reserve Bank of New York, Quarterly Trends for Consolidated U.S. Banking Organizations, Fourth Quarter 2016, available at *https://www.newyorkfed.org/medialibrary/media/research/banking_research/quarterlytrends2016q4.pdf?la=en*, at 36.

[15] 12 U.S.C. §5321.

[16] 12 U.S.C. §5323; 5325.

A. Rolling Back Enhanced Prudential Regulation Will Promote Speculation-Driven Asset Price Inflation, Not Real Economic Growth

The financial industry's proposals nearly uniformly try to make a case that one of the key impediments to creating American jobs and fostering economic growth is the Dodd–Frank Act's explicit focus on systemic risk prevention. This argument targets the FSOC's general authority to designate SIFIs, the process and criteria for application of enhanced prudential standards, the substance of such standards, and the Federal regulators' ability to exercise discretion in implementing their statutory oversight responsibilities. The principal justification for this sweeping attack on the core features of the post-crisis regulatory regime is that it increases individual financial institutions' costs of compliance, compared to their pre-crisis regulatory compliance costs.

This line of argument lacks merit.

Every regulation, by definition, increases regulated firms' costs of doing business: such costs may include both the direct expenses of complying with regulations and the foregone profits from the prohibited or restricted activities. Child labor laws, environmental regulations, anti-fraud rules all raise costs of doing business for those private firms that stand to profit from activities the society deems undesirable. The mere imposition, via regulation, of additional private costs is not an "unintended consequence" that must be avoided: it is the principal mechanism of protecting the public from potential harm caused by profit-seeking private actors.

The appropriateness of additional private costs of regulation, therefore, must be weighted not against pre-regulation private costs but against potential public costs likely to accrue in the absence of regulation. None of the financial industry's proposals offer any discussion, let alone quantification, of the full public costs of rolling back the Dodd–Frank regime of systemic oversight. In that sense, while styled as public policy proposals, these are merely requests for special private benefits.

The rhetoric of "promoting economic growth" is meant to mask this fundamentally self-interested nature of the financial industry's requests for deregulation. As discussed above, removing prudential restrictions on large financial institutions' risk-taking will hinder, not promote, the kind of real economic growth that the American people so urgently need. It will spur precisely the kind of secondary market speculation and asset price inflation that enriches Wall Street megabanks and further decimates America's real productive capacity.

Notably, all of the financial industry's proposals to roll back Dodd–Frank's enhanced prudential regulation use the same basic rhetorical device: they frame the issue as a clear binary choice between "arbitrary" and "tailored" rules. They claim that existing SIFI determination criteria (in particular, the $50B asset size threshold for treating BHCs as SIFIs), the Federal Reserve's supervisory stress tests, and even the long-standing CAMELS rating system are "arbitrary" and should be either repealed or replaced with something that is "appropriately tailored" to each financial institution's "unique" business and risk profile. [17]

It is not my goal in this testimony to engage in any technical disputes regarding any specific capital requirements or stress test methodologies. My comments go to the overarching misconception that the industry actors' concerted (possibly coordinated?) use of the false dichotomy—"arbitrariness" vs. "tailoring"—engenders.

"Tailored" SIFI Determination Is a Path to Eliminating SIFI Oversight

Generally, setting a specific numeric threshold as a jurisdictional device—i.e., a criterion for subjecting a particular person to a particular set of legal rules—is not "arbitrary," per se. We all live with a myriad of such fundamentally "arbitrary" but practically necessary threshold-based rules every day: the legal age for voting is 18, the legal age for drinking is 21, the individual income tax rates are drawn on the basis of specified income thresholds, and so on. What would happen if we removed all such numerical thresholds as "arbitrary" and replaced them with "tailored" determinations seeking to establish with complete precision every single person's "unique" individual ability to exercise voting rights, consume alcohol, or pay income taxes? In theory, it could make everything better. In practice, however, it would create a far more arbitrary, unpredictable, and chaotic world in which nobody will be able to anticipate—or assess the fairness of—the "uniquely tailored" treatment they receive under voting, drinking, or tax laws. It would also require an enormous amount of Government resources to provide sufficiently individualized and "appropriately tailored" determination of every person's many legal rights and obligations. The sheer cost to the public of giving everyone their own "tailored" law will far out-

[17] See, e.g., Letter to The Honorable Michael D. Crapo and The Honorable Sherrod Brown from The Clearing House (Apr. 14, 2017) [the "TCH Letter"].

weigh any private costs of having to live with "arbitrary" but universally applicable and clearly drawn boundaries.

This simple common-sense logic should be applied to evaluating the financial industry's request to replace the Dodd–Frank's $50B size threshold for treating BHCs as SIFIs with an "indicator-based" regime of specific case-by-case designation. Midsize banks worried about approaching the $50B threshold in the future and regional banks that already qualify as SIFIs based on their asset size are especially keen to see this part of the Dodd–Frank repealed and replaced.

Reasonable people may disagree and argue about whether the current size threshold—$50 billion in assets—is the right one, or whether a higher or a lower number would be more socially beneficial. On the one hand, as midsize and regional banks argue, their traditional lending-based business model does set them qualitatively apart from Wall Street megabanks with massive and systemically risky trading and dealing activities. The fact that the top six megabanks' size is measured in trillions of dollars further underscores that difference. On the other hand, $50 billion is by no means an insignificant number. Only 38 BHCs currently exceed that threshold. It is also instructive to remember that, in the 1980s, savings banks and thrifts—small, local traditional lenders squeezed by competitors—made very similar pleas for regulatory relief. The resulting S&L crisis showed that hasty deregulation of small lending-oriented financial institutions may create significant risks to the system. [18]

These complexities notwithstanding, the existing regime should not be simply replaced with an "indicator-based" system under which the FSOC would be forced to go through a tedious and inevitably contentious exercise of determining whether any particular BHC's scope, scale, nature, and mix of activities warrants a SIFI designation. While this "flexible" and "individually tailored" approach may sound good in theory, it will significantly undermine the entire post-crisis regulatory framework for safeguarding systemic stability. There are three main reasons why that is the case.

First, mandating an individualized SIFI determination procedure for each potentially systemically significant BHC will impose an enormous, and completely unnecessary, financial and organizational burden on FSOC, Federal Reserve, and other regulators. The sheer costs of the "tailored" designation process—hiring and training dedicated personnel and devoting countless amounts of regulators' time and energy to gathering and processing huge amounts of information, most likely over BHCs' constant objections and complaints—will threaten to derail the entire regime of SIFI oversight. It is nearly a certainty that this costly and time-consuming process will effectively preclude both FSOC and the Federal Reserve from exercising their statutory responsibilities as systemic regulators. Notably, financial institutions advocating this measure deliberately ignore these public costs of giving them their own, individually "tailored" supervisory regime. Nor do they undertake to cover all of the additional regulatory costs of the "tailored" SIFI designation process.

Second, individually "tailored" SIFI designation will immediately become vulnerable to the financial industry's other favorite line of attack as being inherently unpredictable, unclear, and nontransparent: in other words, "arbitrary." The very nature of the complex inquiry into various qualitative indicators of systemic riskiness of an individual financial institution is bound to open FSOC to potential allegations of misjudgment, misinterpretation, and misbehavior. The MetLife saga provides a vivid example of that tactic. Given what is at stake for large BHCs, the odds of FSOC being constantly embattled and ultimately incapacitated are unacceptably high. Instituting individually "tailored" SIFI designation process will virtually ensure the next round of industry lobbying, aiming to eradicate the very notion of enhanced SIFI supervision as ostensibly nonadministrable in practice.

Third, there is significant danger that loosening the SIFI designation process, primarily to accommodate the demands of midsize and regional banks and BHCs, will pave the way for large Wall Street megabanks to seek additional deregulatory measures specially "tailored" to enable them to expand their lucrative secondary-market trading and dealing operations. While such activities are precisely what creates unsustainable levels of risk in the financial system, it will be much more difficult for lawmakers and (already significantly weakened) regulators to resist what will likely be framed as simply "further tailoring" of supervisory rules.

Attacks on "Arbitrary" Stress Testing Are Attacks on Supervisory Discretion

Ironically, even as the financial industry ostensibly wants FSOC to exercise individualized judgment instead of applying "arbitrary" generalized rules in the context of SIFI designation, the same industry vehemently attacks the exercise of individ-

[18] See, Federal Deposit Insurance Corporation, "The S&L Crisis: A Chrono-Bibliography", available at *https://www.fdic.gov/bank/historical/sandl/*.

ualized judgment—or supervisory discretion—by the Federal Reserve in the context of supervising SIFIs. The key target of this attack is the post-crisis regime of supervisory stress testing.

The largest megabanks appear particularly determined to limit the Federal Reserve's ability to conduct meaningful Comprehensive Capital Analysis and Review (CCAR), mandated by the Dodd–Frank Act. Among other things, they seek to

- subject the Federal Reserve's annual stress test scenarios to a 30-day notice and comment period under the Administrative Procedure Act;
- restrict the Federal Reserve's ability to use its own independent assumptions in constructing test models;
- mandate advance publication of the Federal Reserve's stress test models for "peer review;"
- restrict the use of the Federal Reserve's own models merely to a "supervisory assessment" of banks' own models; and
- eliminate CCAR's qualitative assessment for all banks. [19]

If implemented, these industry-advocated changes will effectively nullify the CCAR regime. The principal reason for subjecting SIFIs to both internal and supervisory stress tests is to create a reliable early-warning mechanism for identifying potential weaknesses in the firm's capital planning and management. Forcing the Federal Reserve to disclose ahead of time its stress test models will enable financial institutions "to manage to the test," thus defeating the whole purpose of stress testing. Moreover, subjecting its test scenarios or modeling methodologies to public notice and comment will inevitably create unnecessary delays in the implementation of stress tests. It will impose potentially prohibitive additional costs on the Federal Reserve, burdened with the duty to respond to numerous industry comments and criticisms. Finally, relegating the Federal Reserve's models to a mere back-up reference function will render the entire exercise inherently unreliable.

In sum, what the financial industry is advocating here is not a "more robust and transparent" stress testing process, but a de facto sidelining of the Federal Reserve by forcing it to surrender its key supervisory function to SIFIs themselves. Doing so will significantly endanger the country's financial stability and increase the likelihood of another systemic crisis. Accordingly, it will hinder, not promote, America's long-term economic growth.

B. There Is No Evidence That Financial Deregulation Is Necessary To Foster Economic Growth

Financial institutions' deregulatory proposals claim that the post-crisis regime of enhanced prudential oversight directly prevents them from extending more loans to small businesses and struggling American families. They routinely assert that the more stringent capital requirements and the higher costs of regulatory compliance are the principal, if not the sole, reason why banks cannot increase their financing of productive economic enterprise.

Constant repetitions of this blanket assertion are intended to condition the audience—including the Members of this Committee—to associate the rollback of Dodd–Frank (something the financial industry wants) with the creation of domestic manufacturing jobs (something the American people need). It is calculated to propagate dangerous confusion about the real causes of financialization, ongoing erosion of America's industrial base, rising poverty and inequality, and other social and economic ills of the last several decades. In essence, the industry wants us to believe that forcing Citigroup and Bank of America to finance just 5 percent of their multi-trillion-dollar high-risk assets with common shareholder equity is the root of all of the Nation's economic woes.

This is an incredible claim. There are three main reasons why it is fundamentally false:

- First, capital regulation does not reduce banks' cash available for lending: that notion is based on a fundamental misunderstanding of what bank capital is.
- Second, banks are not short of cash necessary to expand their lending: banks' soaring profits and record dividend payments in recent years show there is plenty of cash they could, but choose not to, lend out.
- Third, there is no evidence that banks are striving to increase lending that would foster the economic growth: the industry offers no proof (beyond simple assertions) that individual banks' asset allocation decisions are driven, in any meaningful way, by their desire to raise the rate of growth in the real economy.

[19] See, TCH Letter, supra note 17.

In the absence of such evidence, banks' deregulatory demands should not be taken as bona fide proposals to foster America's long-term economic growth.

Enhanced Capital Levels Do Not Restrain Availability of Credit

Higher capital requirements have nothing to do with reducing money available to banks for lending and productive investment. Capital is not cash in the vault. It is merely an accounting concept, the amount of shareholder equity on a bank's balance sheet: i.e., amount contributed by the bank's shareholders and not borrowed from depositors and other creditors.[20] Banks do not "hold" capital in the same way as they "hold" cash or gold—and in the exact same way as Exxon-Mobil or Microsoft are never said to "hold" their shareholder equity. Capital is simply what the owners of the corporation would receive if the corporation liquidated all of its assets and repaid all of its debts. In that sense, capital is a critical equity cushion that protects corporations'—including banks' and BHCs'—creditors from losses. It is only because financial institutions' creditors are explicitly or implicitly protected from such losses by the Federal Government that banks and BHCs are allowed to operate with much thinner equity cushions than would be sustainable in our free capitalist market.[21]

It is therefore nonsensical to claim that reducing this creditor-protecting, loss-absorbing equity cushion will somehow "free up cash" for bank lending—and, specifically, for lending to small businesses and credit-needy Americans. How much a bank is willing or able to lend is a complex asset allocation decision that is driven primarily by considerations of bank's own profitability: "Should we extend a long-term loan to a risky small startup, or should we use that money to increase our fee revenues from short-term derivatives trading?" The impact of this decision on the bank's regulatory capital ratios or stress test results may be an important factor in its choice between lending and trading, but only insofar as it affects—indirectly and in combination with many other factors—that bank's overall profits.

In other words, capital regulation constrains banks' (individually rational) propensity to choose "high risk, high return" assets and limits their ability to maximize shareholder profits by jeopardizing creditors. These regulatory capital constraints, however, still leave plenty of room for banks to choose whether to finance productive economic enterprise or to channel money into secondary market speculation. To the extent the latter increases short-term shareholder returns, it remains a potentially more attractive choice. The largest banks' massive shift into secondary market trading and dealing, especially after the passage of the GLB Act, aptly illustrates that dynamic.

If Congress grants these largest banks' demands to weaken existing capital requirements, supervisory stress testing, and other elements of enhanced prudential regulation and supervision, it will affirmatively sanction virtually unconstrained growth in the volume and speculative riskiness of banks' trading and dealing activities, not traditional "small-business" lending. That, in turn, will spur precisely the kind of speculation-driven asset price inflation that threatens the stability of the American financial and economic system and undermines the country's long-term economic growth.

Banks Are Not "Short of Cash" for Lending

According to the FDIC statistics, the U.S. banking industry has fully recovered from the crisis and is doing exceedingly well. Thus, in the first quarter of this year, nearly 96 percent of all U.S. insured depository institutions were profitable; their average return on equity stood at a healthy 9.37 percent; and their total quarterly income reached $44 billion, which is 12.5 percent higher than a year earlier.[22] Insured banks' total net income in 2016 exceeded $171 billion.[23] BHCs are also turning handsome profits. For example, in the last quarter of 2016, the total quarterly income of just the top six BHCs—JPMorgan Chase & Co., Bank of America Corp., Wells Fargo & Co., Citigroup, The Goldman Sachs Group, and Morgan Stanley—exceeded $24 billion.[24]

These profits directly increase banks' and BHCs' shareholder equity—the capital cushion that is a subject of so many of the industry's complaints—and are easily available for use in their lending or other growth-promoting activities. However, it

[20] For a discussion of bank capital and a compelling argument that capital requirements should be much higher than they are presently, see Anat Admati and Martin Hellwig, "The Banker's New Clothes" (2013).

[21] See id.

[22] Federal Deposit Insurance Corporation, "Statistics at a Glance", As of March 31, 2017, available at *https://www.fdic.gov/bank/statistical/stats/*.

[23] FDIC Quarterly Banking Profile, Fourth Quarter 2016, available at *https://www.fdic.gov/bank/analytical/qbp/2016dec/qbp.pdf*, at 7.

[24] Federal Reserve Bank of New York, Quarterly Trends for Consolidated U.S. Banking Organizations, Fourth Quarter 2016, available at *https://www.newyorkfed.org/medialibrary/media/research/banking_research/quarterlytrends2016q4.pdf?la=en*, at 36.

appears that a big chunk of these profits is instead being distributed to the banking institutions' shareholders, in the form of cash dividends and share repurchases. Thus, in 2016, federally insured banks alone returned to their shareholders $103 billion in cash dividends,[25] a number second only to the record high of $110 billion in cash dividends they paid in 2007, the last full pre-crisis year.[26]

By any measure, $103 billion is an enormous amount of money that could be used both (1) to increase banks' total loss-absorbing and risk-reducing regulatory capital cushion, and (2) to finance small family-owned businesses, entrepreneurial startups, medium-size industrials, aspiring students, and struggling families. In other words, using $103 billion of banks' profits to increase lending to productive economic enterprise would advance both (1) the public interest in having a safer and more efficient system of credit allocation, and (2) the banks' self-professed interest in fostering economic growth and creating American jobs. Yet, banks chose not to go that socially beneficial route.

It is astonishing to see that, after voluntarily sending all that money to shareholders, the banking industry complains that the additional cost of complying with post-crisis regulations "takes capital away from small business loans, home purchases and other productive uses."[27] "Every dollar spent on hiring compliance attorneys," the argument goes, "is potentially $10 dollars of loans that could be made to improve someone's economic opportunity."[28] As the dividend numbers cited above show, every dollar diverted away from banks' regulatory compliance would most likely improve only bank shareholders' and managers' "economic opportunity." In fact, using the same mathematical logic, it follows that, in 2016 alone, banks have willingly deprived the real economy of a whopping $1.03 trillion in "small business loans, home purchases and other productive uses."

It is not my contention that banks should never declare shareholder dividends. The key point here is that bank dividend payouts expose the fundamental falsity of the industry's claims to the effect that excessive regulatory costs deplete banks' resources and prevent them from financing real economic growth. Banks have plenty of extra money for expanding their lending. They choose not to lend that money, instead "returning capital" to their shareholders. That is because stable and high dividends increase individual banks' stock prices, which directly benefits not only bank shareholders but also their executives and managers. Higher stock price translates directly into higher bonuses. Higher volume of small-business lending does not.

This basic fact about banks' use of available capital may explain why these institutions—particularly, the largest Wall Street megabanks—are waging such an adamant campaign against CCAR, "living wills," and other key elements of the Dodd–Frank's systemic risk prevention regime. Under the current regime, SIFIs' ability to pay shareholder dividends or repurchase their own shares is expressly conditioned on supervisory approval, based in part on the results of the latest stress tests. Not meeting supervisors' expectations, therefore, limits their ability to pay dividends and depresses their stock price. It is telling, for example, that securities analysts and investment advisers have been buzzing about Citigroup's and Bank of America's recent and expected future hikes in dividend payouts after both of these firms performed better in the CCAR tests.[29] As one expert put it, "The ability to pay dividends is currently a hallmark of strength in the sector."[30] Accordingly, deregulatory rollback of the Federal Reserve's stress testing and other prudential regulations is expected to enable Citigroup, Bank of America, and other SIFIs to raise their dividends and share repurchases, thus lifting the value of their stock.[31]

Thus, it appears that market experts have no confusion about the real benefits of massive financial deregulation: it will increase banks' profits, dividend payouts, and stock prices. Whether or not it will also promote the country's long-term economic growth does not seem to be part of the conversation.

---

[25] FDIC Quarterly Banking Profile, Fourth Quarter 2016, available at *https://www.fdic.gov/bank/analytical/qbp/2016dec/qbp.pdf*, at 7.

[26] FDIC Quarterly Banking Profile, Fourth Quarter 2007, available at *https://www5.fdic.gov/qbp/2007dec/qbp.pdf*, at 5.

[27] FSR Letter, supra note 7, at 2.

[28] Id.

[29] See, Gemma Acton, "These Three U.S. Bank Stocks Are My Top Sector Picks", CNBC.COM (22 Mar. 2017), available at *http://www.cnbc.com/2017/03/22/these-three-us-bank-stocks-are-my-top-sector-picks-analyst.html*; Rebecca Keats, Bank of America Declares a Quarterly Dividend, Marketrealist.com (31 Jan. 2017), available at *http://marketrealist.com/2017/01/bank-of-america-declares-a-quarterly-dividend/*; Stone Fox Capital, Citigroup: "Expect Another Big Dividend Hike To Move Stock", Seeking Alpha (4 Jan. 2017), available at *https://seekingalpha.com/article/4078558-citigroup-expect-another-big-dividend-hike-move-stock.*

[30] Stone Fox Capital, supra note 29.

[31] Id.; Keats, supra note 29.

There Is no Evidence That "Fostering America's Economic Growth" Is a Meaningful Factor in Banks' Business Decisions

It is, of course, possible that, while returning massive amounts of capital to shareholders, banks and BHCs are nevertheless genuinely dedicated to their self-declared mission of financing America's real economic growth. Rather than take their word for it, however, the Committee should require specific, robustly documented and empirically supported, evidence that that is indeed the case.

For example, the Committee should ask each financial institution asking for regulatory relief to provide specific, quantified, and fully documented answers to the following questions:

- What was your institution's specific (i.e., quantified) annual contribution to the growth of your local, regional, and/or national economy, in the period between 2010 and 2017 (after the enactment of Dodd–Frank)? What was it in the pre-Dodd–Frank period between 2000 and 2009?
- How much additional annual contribution to the growth of your local, regional, and/or national economy would your institution have made, but was prevented from making directly as a result of [insert a specific regulatory provision of the Dodd–Frank regime]?
- In each year since 2010, what was the aggregate amount of commercial and industrial (C&I) loans that your institution refused to extend, solely because of [insert a specific regulatory provision of the Dodd–Frank regime]?
- Does your institution have an enterprise-wide strategy for facilitating domestic job-creation and promoting the growth of your local, regional, and national economy? What are the core elements of that strategy?
- How often does your institution's Board of Directors and top management discuss the institution's performance in implementing that strategy?

This type of targeted inquiry would help to (1) establish the credibility of the financial industry's claims; and (2) discover the real link, if any, between financial institutions' deregulatory agenda and the country's real economic growth. Presently, none of the financial industry's numerous deregulatory proposals establish that link, relying instead on purely declarative rhetoric. They then demand effective removal of key regulatory safeguards against systemic financial crises, solely on the strength of that rhetoric. Assessing the public costs and benefits of any such deregulatory proposals, however, requires ascertaining that such steps are actually—and not just rhetorically—going to generate substantial growth in the country's real economy.

It is unlikely that any financial institution will be able to produce satisfactory answers to any of these questions. As private shareholder-owned firms, these institutions' primary concern is their own profitability, not the overall performance of the American economy. They simply do not track, and are not equipped to track, the relevant macroeconomic data: measuring and worrying about such data is the Government's responsibility, an inherently public task. That means that determining what should be done to spur America's economic growth—and whether relaxing any of the existing financial regulations should be a part of that endeavor—is also an inherently public responsibility. The financial industry's attempts to usurp or sidetrack the process of public deliberation on such an important matter should therefore be subjected to intense scrutiny.

III. Broader Structural Solutions Are Needed To Channel Capital Into Productive Economic Activity and Sustainable Growth

The Dodd–Frank regime of systemic oversight and enhanced prudential supervision of SIFIs correctly aims to limit potentially destabilizing speculation and asset price inflation in secondary markets. To the extent it strengthens the resilience and stability of our financial system, it lays down an important foundation for the Nation's long-term economic growth. However, simply limiting the opportunities for diverting capital into speculative trading is not sufficient to spur and sustain such growth in practice. It is equally important to ensure that a significantly greater share of available financial capital is actively and consistently flowing into long-term productive investment. In other words, it entails cultivating new sources of, and creating new avenues for profitably deploying, truly "patient" capital.

Abundant patient capital is what enables construction of large-scale physical and social infrastructures, supports transformative R&D projects, generates productivity gains, and creates sustainable well-paying jobs throughout the Nation. By the same token, the chronic shortage of patient capital—and persistent glut of speculative capital—is the key reason for the sluggishness of America's real economy today.

Incentivizing investor "patience" on the scale needed to spur the Nation's long-term economic growth, however, is a difficult task that cannot be reduced simply to a few deregulatory or tax-relief measures. Nor can it be left to the private sector alone. Private investors' time horizons and risk tolerance levels are inherently limited by the finite nature of their economic resources and their biological lifespan. It is fundamentally rational for private investors to prefer shorter-term investments, which entail less unforeseeable future risk and promise returns within such investors' reasonable lifetime horizons. Private investors' short-term bias, therefore, is not a deviation from market rationality; it is a built-in feature of such rationality.

Overcoming investor short-termism and facilitating the formation of "patient" capital requires new, more effective forms of public–private partnership. The public component of such partnership will bring into the investment process a number of unique advantages that public instrumentalities enjoy when they act as market participants: their vast scale, high risk tolerance, lengthy investment horizons, and direct backing by the full faith and credit of the United States. Combining these unique capacities of a public investor with private investors' informational agility, superior knowledge of local conditions, and market expertise will help to channel both private and public resources into the critical growth-inducing projects. This new, patient public–private capital will finance the building of new roads, bridges, high-speed train lines, clean energy networks, and next-generation industrial plants. It will also create new well-paying jobs, offer new educational opportunities, and unleash new entrepreneurial energy of the American people.

My colleague, Professor Robert Hockett, and I have developed a specific proposal for creating this new kind of infrastructural growth-oriented public–private partnership. A White Paper detailing our proposal is attached as an Appendix to this testimony.

It is this kind of programmatic reform—not a massive rollback of the Dodd–Frank Act—that the American economy and the American people need. I urge the Committee to rise to this challenge and not allow banks' self-serving deregulatory demands to distract its attention from what really matters to the American economy and the American public.

Conclusion

Promoting sustainable, socially inclusive long-term growth in America's real economy is a task of enormous public significance. Massive financial deregulation urged by the banking industry, however, will not foster such real economic growth: it will merely spur speculation-driven asset price inflation in secondary markets. That is what generates Wall Street's greatest short-term profits and causes wealth- and growth-destroying systemic crises. Weakening regulatory standards and effectively incapacitating FSOC, the Federal Reserve, the Consumer Financial Protection Bureau, and other Federal regulators will put us much closer to another financial disaster.

Contrary to the financial industry's assertions, massive dismantling of the Dodd–Frank regime of systemic regulation will not benefit small businesses and struggling families across America. There is no evidence that the additional cost of banks' regulatory compliance with post-crisis regulations actually depletes banks' resources and/or diverts them away from productive uses. Despite their complaints about regulatory costs, American banking institutions are highly profitable and awash in cash, which they could use for lending to small businesses but instead choose to return to their shareholders in the form of dividends and share repurchases. Against that background, it is impossible to take the industry's attacks on Dodd–Frank seriously.

The Committee should, therefore, reject the financial industry's unsubstantiated claims and requests for massive deregulation and demolition of the Dodd–Frank Act. The Committee should focus its attention on finding real solutions to the real problems associated with speculative short-termism and persistent misallocation of capital, which impede economic growth. Devising such solutions is challenging but necessary in order to make finance serve the Nation's long-term economic goals.

White Paper in Support of a National Investment Authority

Robert Hockett & Saule Omarova

Cornell Law School, June 2017

Introduction

Since the financial turmoil of 2007-09, policy discussion in the United States has focused increasingly on how to restore America's past productive glory. Decades of erosion to domestic infrastructure and industrial capacity, a corresponding loss of well-paying jobs, and a steady decline in apparent government readiness to tackle big problems – these are among the many factors that have brought persistent economic underperformance, widening income and wealth inequality, and seemingly ever-angrier social and political dynamics to contemporary America.

The solutions to these inter-related problems ride on the ability of the United States to address what we consider to be its single most pressing public policy challenge: the challenge of ensuring structurally balanced, long-term sustainable, socially inclusive economic development in an economy that first "developed" over a century ago.[1] Thinking of "development" and "reconstruction" as processes that only pre-modern, "lesser developed," or recently war-ravaged countries must undergo, we believe, is a mistake – a mistake that has vitiated academic and policy discussion for too long.

National development and reconstruction are forever, and must be forever proactively pursued. Only by continuously facilitating the continuous growth, diversification, and modernization of its "real" economy (as distinguished from its secondary financial markets), and by broadly spreading the benefits of such growth and development, can a nation rebuild, restore, and retain over time its true strength as an economy, as a society, and as a polity.

The project of continuous and inclusive reconstruction and development represents an extraordinary challenge, and demands a correspondingly extraordinary institutional response. This White Paper proposes precisely such a response – an instrumentality specifically charged with coherently fostering and overseeing the continuous and inclusive economic development of the United States. This new instrumentality, which we call a National Investment Authority ("NIA"), will be charged with the critical task of initially devising, regularly updating, and continuously implementing a comprehensive and inclusive long-term developmental strategy for the United States.

Patterned in part after Treasury Secretary Alexander Hamilton's original national development institutions, in part after the Hoover and Roosevelt era Reconstruction Finance Corporation ("RFC"), in part after modern sovereign wealth funds, and in part after contemporary private equity and venture capital firms, the NIA will be an inherently hybrid, public-private entity. By exploiting the unique advantages of the federal government as a market actor – its vast scale, high risk tolerance, lengthy investment horizons, and direct backing by the full faith and credit of the United States – the NIA will help channel private capital and expertise toward publicly beneficial, well diversified, long-term growth-underwriting projects. It will operate as an economy-wide public-private partnership ("PPP")[2] with a radically innovative new twist: it will reverse the usual PPP model of "public money, private management" by drawing freely invested private money to publicly-managed investment vehicles.

Our proposed new arrangement will enable private investors to capture reasonable gains from the provision of currently under-provided, transformative public goods: including, for example, nationwide networks of clean energy provision and state-of-the-art transportation, regional air and water cleaning and preservation programs, systems of ongoing adult education and technical training, and other cutting-edge public infrastructures. By creatively adapting familiar tools of financial and legal engineering, the NIA will remove or mitigate incapacities and risks that currently impede private investment in public goods.

An additional benefit brought by the NIA will be its enhancing the resilience and long-term stability of our financial system. "Getting financial regulation right" is no mere technocratic exercise: it involves critical normative decisions concerning the purposes and social functions of finance. A self-referential financial system, in which disproportionate growth on the part of secondary markets naturally encourages speculative trading in already existent financial instruments rather than patient investment in new productive capacity, inevitably experiences recurrent and highly destructive asset price boom-and-bust cycles – i.e., hyperinflations and debt-deflations.[3] By contrast, reorienting the financial system back toward its primary social function – reliably channeling credit to its most productive non-financial uses – will correct our financial system's regrettably still dysfunctional dynamics.[4]

The NIA we design and propose here amounts to a modality of *collective* action meant to facilitate more effective and remunerative *individual* action. It is a pragmatic and market-friendly institutional solution to the country's heretofore misdiagnosed and unaddressed primary challenge. By bridging now-obsolete and debilitating organizational and conceptual divides, the NIA will fill a critical gap in the current architecture of American public finance.

Functionally situated between the Federal Reserve System (the "Fed"), and the U.S. Department of the Treasury (the "Treasury"), the NIA will discharge tasks that neither the central bank nor the fiscal authority can legitimately perform without overstretching their mandates. It will serve as a separate institutional platform from which to conduct a more cohesive and well-targeted allocation of patient public and private capital toward startups and infrastructures that promise continuous, diversified, and inclusive growth on the part of the national economy.[5]

The paper proceeds as follows. Part 1 briefly explains why an institution like the proposed NIA is required. Part 2 outlines the basic design of the proposed institution. Part 3 addresses the main implementation issues to which the NIA will give rise.

1. *A National Investment Authority: Why*

Continuous development of the national economy amounts to a systemically critical, chronically under-supplied "public good." In that sense, it is precisely the kind of good that requires some form of collective facilitation or inducement to optimal provision.

1.1. "Public Goods": A Brief Reminder

The familiar economist's account of public goods fixates on these goods' "non-rivalrousness" and "non-excludability."[6] The first is that attribute pursuant to which a good's use by one party does not diminish its availability to other parties. The second attribute is that pursuant to which neither a good nor the benefits that it yields can be retained exclusively by one party. Goods with these characteristics tend to go under-provided by private participants in decentralized market economies. Because the gains from the act of providing these goods can be only incompletely captured at best, profit-driven private actors rationally tend not to supply them in quantities sufficient to meet public demand.

The orthodox response to this so-called "public goods problem" is to "socialize" the production and distribution of public goods. In effect, the problem is inarticulately recognized as a collective action problem pursuant to which multiple individually rational decisions (in this case, decisions not to supply what one cannot profit by supplying) aggregate into a collectively irrational outcome (in this case, one in which people in principle could, but in practice do not, produce what they all wish to have).[7]

The solution to this as to any collective action problem lies in collective *agency* – i.e., in action taken by some public instrumentality in the name of us all.[8] The relevant instrumentality typically is presumed to be the fiscal authority – the treasury – which can forcibly collect payments from potentially "free-riding" citizens and use the proceeds to finance the production of non-excludable public goods.

This familiar account of public goods is helpful in illuminating the public goods problem, but is incomplete. It leaves needlessly obscure the critical link between public goods and collective action problems, and accordingly overlooks entire subclasses of what should be thought public goods.[9] The undue narrowness of the orthodox account also precludes it from recognizing the existence of certain *systemically important* public goods that cannot be efficiently provided either by private parties *or* via *familiar fiscal policy channels*.

A more complete and coherent understanding of public goods requires that we think of them in functional terms – as solutions to collective action problems. This turns out to encompass both public goods in the narrower, orthodox sense and many additional goods that are now chronically underprovided – both of which our NIA aims to enable individuals collectively to provide.

1.2. "Public Goods": A Friendly Amendment

Collective action problems arise when it is not individually rational to attempt to supply what is collectively beneficial. This suggests that the relevant "master principle" for policy purposes is the distinction between (1) goods that can be supplied by persons acting in their individual capacities, in un-concerted fashion, and (2) goods that can be supplied only by persons acting in their collective capacities, in concerted fashion.

Situations in which goods can be only collectively supplied include not only cases in which no individual can *capture the benefits* generated by a good – the focus of public goods orthodoxy – but also cases in which no individual can *control the environment* sufficiently to supply the good in the first place. The undersupply of these forms of environmental stability stems from what can be called a "controllability" problem, which constitutes a distinct kind of public goods problem. Our proposal is accordingly designed to address *two* kinds of collective action challenge – what we call "capturability" problems of the kind on which orthodoxy fixates, and "controllability" problems, which orthodoxy overlooks.

With respect to controllability, our aim is to maintain stability among what we have elsewhere called "systemically important prices and indices," or "SIPIs."[10] These are prices that figure pervasively in the formation of other prices, or that are widely employed as benchmarks in other pricing or trading decisions.[11] Examples include certain energy and commodity prices, housing prices, prevailing wage rates, money rental (or "interest") rates, and such popular benchmarks and indices as Libor, the Dow-Jones Industrial Average, and the S&P500.[12]

People acting in their individual capacities cannot control SIPIs. Yet SIPI stability is necessary if patient capital investment in the real economy, as distinguished from speculation on price movements in the financial economy, is to be individually rational. SIPI stability accordingly poses a collective action problem. Hence our NIA is in part meant to exercise collective agency on behalf of us all in maintaining SIPI stability – i.e., in assuring a stable systemic backdrop against which investments of patient capital in the real economy can look less like Russian Roulette.

In the case of capturability, our aim is to render patient capital investment once again rational not so much by maintaining stable background conditions as by enabling individuals to reap reasonable portions of reward for their patient investments that cannot be individually, but can be collectively, parceled. Many goods, for example, yield benefits that materialize over time-horizons that exceed human lifespans. Cases in point include certain kinds of public infrastructure that take long to develop or construct, technological advances rooted in long-term R&D investment, the long-term synergistic knowledge and cultural benefits of widespread higher education, and such ultra-long-term projects as space exploration or medical research.[13]

Considerations of this kind argue for public provision or facilitation of patient capital: provision or facilitation by an "investor" that is inter-generationally composite and perhaps partly made up of investors who are willing to be more patient if guaranteed some portion – some "time slice" – of projected returns.[14] In theory, this could be done partly by a fiscal authority, as sometimes it has been.[15] But the political nature of fiscal authorities can render this theoretically elegant solution less effective in practice.

We think the way to remedy this problem is to treat the provision of trans-temporal public goods as a perpetual, hybrid public-private project. This can be done through two mutually complementary means: First, establishment of an institution whose public managers see with the eyes of a perpetual, transgenerational entity in actively managing, channeling, and rewarding privately supplied capital. And second, developing a distinct kind of financial engineering that synthesizes flows of individually capturable benefits from public goods whose benefits ordinarily cannot, absent such synthesis, be individually captured.

Our proposed NIA seeks to accomplish these goals. Its exercises of *collective* agency are meant to open the door to entire new classes of productive and profitable *individual* agency. This idea is not new to American governance. As we show elsewhere, it lay at the core of Hamilton's institutional design for the then-new American economy. It also animated the mission of the Hoover and Roosevelt era RFC, which during the 1930s and 1940s was by far the world's largest corporation, with a balance sheet dwarfing that of the Fed and of Wall Street. There is more of all this in our scholarly work. Here we now turn to our proposed modern equivalent.

2. *The National Investment Authority: Mandate and Operational Structure*

We have offered a brief diagnosis of America's current economic and political malaise. We have traced it to a gap in the everyday understanding of "economic development," and to corresponding gaps both in our understanding of "public goods" and in our institutions of public finance. That has led us to call for an NIA that will work in coordination with the Fed and the Treasury. We now turn to filling-in that abstract characterization of the NIA by outlining its principal mission and operational modalities.

2.1. Purposes and Functions of the NIA: Overview

The NIA will be a new federal instrumentality that systematically conducts a wide range of financial market activities. These will be explicitly geared to the provision of public goods as defined in the previous Section. The mission is to develop, regularly update, and continuously implement a perpetual economic development strategy for the United States. The NIA will thus amount to a 21st-century version of both Alexander Hamilton's national development bank and the Hoover/Roosevelt era RFC, with the caveat that it views "development" and "reconstruction" as perpetual processes rather than temporary exigencies.

For purposes of operational efficiency, we envisage an institutional subdivision of the NIA into two specialized arms, roughly corresponding to our public goods "controllability" / "capturability" dichotomy above. One arm of the NIA, which we call the National Infrastructure Bank ("NIB"), will focus on pursuing a wide range of credit-mobilization strategies along the lines of the RFC and some of its surviving offspring, including the GSEs.[16]

The other arm of the NIA, which we call the National Capital Management Corporation ("NCMC" or, more colloquially, "Nicky Mac"), will function as an asset manager, in a manner broadly similar to the way in which sovereign wealth funds operate.[17] In each case, the NIA's operating arms will proactively utilize well-established modalities of finance and transact directly in "private" financial markets.

The NIB's primary mode of operation will involve originating, guaranteeing, and maintaining secondary markets for loans to public and private parties undertaking publicly beneficial infrastructure projects. The general idea of establishing some form of "public infrastructure bank" to finance major infrastructure projects is of course not a new one.[18] In contrast to existing proposals, however, the NIB we envision is embedded in a broader and more comprehensive institutional framework dedicated to the formulation and implementation of a continuous and inclusive national development strategy. The scope of the NIB's projects and activities will accordingly extend beyond the finance of traditional infrastructure. By combining its operations with those of the NCMC, the NIB will be able to pursue more ambitious and longer-term developmental goals than simply helping local governments raise money for user-fee generating roads and bridges.

An even more ambitious operating arm of the NIA, we envisage the NCMC as a hybrid between a sovereign wealth fund ("SWF") and a large private equity or venture capital firm. Like the RFC and a typical SWF, the NCMC will be set up as a large, publicly owned, high-profile asset manager. Unlike a SWF, however, it will not simply invest public money in stocks and bonds traded in secondary markets looking for capital appreciation. Instead it will actively solicit, pool, and manage private investors' money along the lines of traditional private equity business models.[19] In a crucial departure from that model, however, the NCMC-managed funds' investment strategies will focus not on short- to medium-term turn-around profits, but on taking long-term equity stakes in potentially growth- and productivity-enhancing public and private projects.

In addition to performing their primary market-levering and market-making roles, both the NIB and NCMC will also play a secondary, but nonetheless critically important, market-preserving role:[20] Securities and other instruments issued by NIB and NCMC will constitute an important new "safe" asset class, a higher-yielding alternative to U.S. Treasury securities.

The availability of this new asset class should significantly alter the dynamics of contemporary financial markets. By attracting large institutional investors' demand away from more speculative privately issued assets, the NIB and NCMC will dissipate, at least in part, a powerful structural incentive for private financial institutions to *supply* such risky assets. In that sense, the NIA, through both of its operating arms, will function as a critically important institutional mechanism for enhancing systemic financial stability, itself a crucial pubic good.[21]

Organizationally, the NIA can be structured in a variety of ways. One possibility would be to mimic the organizational structure of the Federal Reserve System, which comprises twelve regional Federal Reserve Banks – separately incorporated entities with mixed public-private ownership – overseen by an independent federal agency, the Board of Governors of the Federal Reserve System.[22] In direct parallel to that model, the NIA would also constitute a "system" with an independent federal agency – the NIA Governing Board (the "NIA Board") – at the top. The five- or seven-member NIA Board would be appointed by the President. The Board members would have to meet certain statutory qualifications relating to their professional expertise in relevant aspects of finance, law, economics, investment management, or public administration.

The Chair and the Vice-Chair of the NIA Board would be appointed by the President from among the members of the NIA Board and confirmed by the Senate. The NIA Board members would be appointed for staggered 10- or 12-year terms, to ensure a nontrivial degree of autonomy and strategic continuity in their decision-making. The NIA Board members would be removable by the President only for good cause, which would further enhance the NIA's operational independence from any incumbent administration.

The NIA Board would be charged with formulating a coherent strategy of national economic development, identifying specific developmental priorities over various time horizons, and continuously monitoring the implementation of the strategy by its operating arms – the NIB and NCMC. The NIA Board would directly regulate and supervise the activities of both the NIB and NCMC, each of which would have a separate organizational and legal identity.

For reasons discussed below, we propose to organize the NIB and NCMC as special federally chartered corporations, with the NIA (acting on behalf of the federal government) as their sole voting shareholder. Each of the NIB and NCMC would be governed by its own Executive Board in accordance with the specially tailored principles laid out in their respective corporation charters.

The differences in the strategic focus and core business models of the two corporations, however, would determine important differences in how the NIB and NCMC organize and run their operations.

2.2. Credit Mobilization: The National Infrastructure Bank

As the credit-mobilization arm of the NIA, the NIB will seek to lever private capital by pledging the public's superior risk-absorbing capacity to support investment in critical public infrastructure goods. The NIB will operate through a combination of well-established means, including direct federal grants, loans, guarantees, insurance, securitization, and secondary market-making. In this sense, the NIB will operate along the historically familiar lines of what we elsewhere call the market-*levering* model.[23] Its primary mission – at least initially – will be to amplify and optimize our currently sub-optimal system of public-private cooperation in the field of infrastructure finance. From that perspective, an NIB can be viewed as an infrastructure-specific analogue to the RFC and its surviving offspring, the SBA, the FHA, and the home finance GSEs.

The GSE experience is particularly instructive here thanks to the shared nature of the problems currently plaguing U.S. infrastructure finance on the one hand, and those that plagued U.S home-loan markets before the establishment of FHA and Fannie Mae in the 1930s.[24] Before the establishment of FHA and Fannie Mae under the RFC umbrella, U.S. mortgage markets were localized, small-scale, and illiquid. That raised borrowing costs for homebuyers and prevented the emergence of a well-functioning national market for mortgage finance.[25]

Fannie Mae remedied these inefficiencies by making a secondary market in newly FHA-standardized mortgage instruments and thereby lowering both private lenders' risks and borrowers' costs.[26] By creating a nation-wide market backed by the full faith and credit of the United States, it was able to pool and ensure risk on a much larger scale than could be done by any private lender at the time.[27] The system worked stably and well for its first sixty years, before Fannie was converted to private shareholder ownership not long before the 2008 crash.

The NIB will perform a similar function in today's fragmented and illiquid market for infrastructure finance. This it will do by pooling municipal bonds and their associated default and liquidity risks.[28] Like the early Fannie Mae, the NIB will be initially capitalized by the federal government.[29] State or municipal contributions might also, but need not, be required or solicited.[30]

To lever public money, the NIB will issue series of medium- to long-term bonds, or some mix of debt and non-voting preferred stock.[31] It will commit to pay out returns associated with particular issuances on the strength of (1) user fees and dedicated revenues that could feasibly be levied for the purpose; (2) dedicated pools of collateral, in the manner of the European-style "covered" bonds; and (3) the ultimate full faith and credit of the U.S.[32]

The federal government's full faith and credit backup is a particularly potent factor in this respect. Explicitly backed by the U.S. government, the NIB will be a much larger and more powerful market actor than any private municipal-bond-pooling entity, just as Fannie Mae has always dwarfed all non-federal competitors in the secondary home mortgage markets.

It is reasonable to expect that NIB bonds will attract great interest from large institutional investors – pension funds, investment companies, investment banks, foreign central banks, and SWFs – who will view these bonds as close substitutes for U.S. Treasury securities and GSE-issued "agency securities." As discussed above, this is a factor of considerable significance not only for purposes of financing infrastructure projects but also from the perspective of systemic financial stability.

To enhance the appeal of this new asset class to institutional investors, it will be desirable to grant NIB bonds the same regulatory and discount window treatment that U.S. Treasury securities, agency securities, and some forms of commercial paper currently receive under the applicable risk-based capital adequacy and Fed discounting regimes, respectively.[33] For example, allowing banks and other financial institutions to apply a 20% risk-weight factor to NIB bonds in their portfolios for purposes of calculating regulatory capital will significantly increase demand for, and lower the NIB's cost of issuing, these instruments.

The NIB will use the funds raised through its bond issuances to purchase and pool revenue bonds and project bonds issued by municipalities, public utilities, and other government instrumentalities seeking financing to fund infrastructure projects. The NIB can also purchase and pool qualifying bonds issued by private entities for the purposes of financing publicly beneficial infrastructure projects.[34] It is important that the NIB impose strict eligibility criteria on prospective securities in order to ensure the commercial viability of its core business model. Strict adherence to these criteria will help ensure continuously high demand for NIB bonds from large institutional investors.

Many jurisdictions outside the U.S. are already pursuing similar schemes to finance infrastructure.[35] The European Investment Bank ("EIB") operates much in the manner described above and attracts billions of dollars' worth of private capital to fund European infrastructure projects.[36] The EIB has proved quite effective in tapping the global capital markets as well, selling its bonds to the same pension funds, SWFs, and other financial intermediaries that routinely buy U.S. Treasuries and other global "blue chip" securities – while shying away from U.S. municipal bonds.[37] By tapping into this same market demand, the NIB can channel large quantities of global capital into rebuilding U.S. public infrastructure.

In future, the NIB might develop the capacity not only to pool municipal and other bonds as a secondary purchaser, but also to originate loans for particular infrastructure-related projects.[38] For instance, it might start by extending loans to federal agencies charged with infrastructure-provision – e.g., the Federal Highway Administration – and then radiate incrementally outward by lending directly to states or municipalities in need of further infrastructure funding.

In its lending activities, the NIB will target and prioritize projects that have some national socio-economic significance but face difficulty in securing low-cost financing in traditional markets. Developing its capacities along these lines, the NIB might well ultimately evolve from a pure credit-mobilization vehicle into a full-service project- and infrastructure-finance institution backed by the full faith and credit of the U.S. and, therefore, capable of accomplishing far greater tasks than could any private market actor.

2.3. Asset Management: The National Capital Management Corporation

In contrast to the NIB's focus on credit-mobilization techniques along the lines of the RFC and its housing-finance subsidiaries, NCMC's defining strategy is active asset management deployed as a means of facilitating projects that can potentially transform and "leapfrog" the national economy. NCMC will aim to provide infrastructure that *leads or revolutionizes* markets, in socially beneficial ways, rather than *following* existing markets' immediate dictates. In that sense, NCMC will be providing a truly systemic public good that at present is severely under-supplied.

For example, NCMC might not merely seek to ensure that petroleum is available nationwide but might act systematically to convert the national energy system from petro- to renewable- and hydrogen-based.[39] It might also act not merely to repair or restore existing rail lines or roadways, but to bring high-speed rail networks to well-defined regions like upstate New York, whose multiple small cities could be integrated into more productive metropoles. Given its ambitious reach, NCMC would not rely upon NIB-style debt financing alone but would tap into *more ambitious*, less risk-averse capital of the sort that typically comes from equity investors. To this end, NCMC will operate like an investment management company sponsoring and running one or more private equity funds.[40]

In direct parallel to private equity ("PE") firms, NCMC will act as the sponsor and general partner of each individual fund it sets up.[41] As the fund's general partner, NCMC will contribute some capital of its own, but the greater part of the fund's capital will originate with private investors who become passive limited partners in the same fund. As with many private equity funds, NCMC will require that limited partners agree to "lock up" all or some part of their investment dollars with the fund for some set minimum period of time. NCMC will manage the resultant pool of assets much as any private fund manager would do, assembling a portfolio of promising investment projects which, while involving some risk of not panning out in some cases, will be sufficiently diversified to minimize risk.

Individual investments in the fund's portfolio can be structured in various ways, depending on the nature of the selected projects and NCMC's managerial judgment. For example, the NCMC-managed fund might invest in a mix of assets, including municipal revenue bonds, participating preferred stock of a private company that builds and operates a particular infrastructural project, or equity interests in a special purpose entity set up by several municipalities for a common infrastructure-related purpose. As the fund's manager, NCMC would choose an optimal mix of investments, based on their public significance and commercial viability.

The compensation and profit-sharing structure of the NCMC funds will also track the traditional private equity fund model. Just like any private fund manager, NCMC will charge both a fixed annual management fee and a contingent performance fee known as "carried interest," or "carry."[42] To enhance the attractiveness of the NCMC funds as a new asset class, however, it will be desirable to offer some additional incentives to private investors.

The U.S. government backup can operate as a particularly strong "sweetener" in this respect. Thus, the government might guarantee the return of all or a substantial part of private investors' principal upon the expiration of a specified lock-up period. It might also guarantee a certain minimum rate of return on private parties' investments – either for the duration of the lock-up period, for some shorter period of time, or even for as long as the investor keeps its interest in the fund.

The ultimate sources of the returns generated by NCMC-managed funds will vary depending on the specific natures of the infrastructure projects in which they invest. For example, an ambitious project of intercity light rail construction or a network of hydrogen- or electrically-powered vehicle recharging stations could generate returns through user fees or targeted taxes. Limited partners in the NCMC funds with portfolios containing such direct revenue-producing investments would participate in these easily tracked returns.

In addition to this already familiar method of compensating private investors in public goods, the NCMC will actively utilize advanced financial and legal engineering techniques to synthesize privately payable "equity strips" that reflect otherwise non-capturable public gains from the provision of public goods. Reaping the benefits of scale economies and recapturing positive externalities associated with the state-wide, region-wide, or nation-wide provision of public goods – including the positive effects of NCMC-financed infrastructure projects on employment and income tax revenues – will bolster NCMC's ability to offer or guarantee stipulated returns to private investors in its funds.[43]

Just like real equity returns, these synthetic equity payouts will vary depending on estimates of local, regional, or national macroeconomic impacts of NCMC funds' projects. If, for example, experts calculate that a particular fund's investments will generate an additional 3% in local or regional economic growth over a specified period of time, NCMC would translate the projected gain into a corresponding added return for the fund's limited partners. This method of synthesizing privately capturable profits will add another source of revenue – on top of project-specific user-payment schemes for projects amenable to this form of cost-recovery. It will allow the NCMC to compensate, and further incentivize, those private parties who assist in the funding of economy-transformative infrastructure renewal and expansion.[44]

The profit-sharing component might also be structured in layers, as we describe elsewhere. Under this approach NCMC would present private investors with attractive new investment opportunities that could (1) replicate bonds in their guarantee of principal and possibly some modest rate of return, (2) then offer carry-free equity bands, essentially entitling investors to all net profits, and (3) then offer one or more equity bands entitling investors to predetermined percentages of net profits, possibly capped by specified ceilings.

This is, of course, only a sketch of what the arrangement might look like. The viability of such a tiered profit-sharing model and its precise structure would have to be determined through financial cost-benefit analysis, taking into account all relevant considerations.[45] If properly structured and priced, NCMC funds should be an attractive new asset class available to broad swaths of large institutional investors searching for "safe" assets with higher yields. As noted earlier, it is difficult to over-estimate the significance of creating this new asset class for protecting systemic financial stability.

As the NCMC matures and grows both its expertise and its assets under management, it will broaden the range of projects it can undertake and strengthen its capacity to act in a truly entrepreneurial, forward-looking manner as befits a PE-like market actor. From this perspective, it is easy to imagine the potential for creating a more seamlessly integrated network of public-private venture capital and small business financing.

Thus, various federal venture capital funds and other federal agencies and programs targeting innovative start-ups – for example, the Telecommunications Development Fund ("TDF")[46] and the Small Business Administration ("SBA"), which began as an RFC subsidiary[47] – can be organizationally incorporated into the NCMC structure. The NCMC will also be well-positioned to establish close institutional collaboration and co-financing of innovative research projects with various specialized programs, such as the Defense Advanced Research Projects Agency ("DARPA")[48] and Advanced Research Projects Agency-Energy ("ARPA-E").[49]

Combining multiple federal agencies' financial, scientific, and organizational resources will increase their practical impact as the source of both "smart" *and* "patient" capital, that critical ingredient in the innovation game.[50] The NCMC – and, more broadly, the NIA – will act as the catalytic force behind, and the central node in, this developmental network.[51]

Of course, the degree of practical feasibility and potential efficacy of the NIA and its two operating arms will depend on getting numerous details of their institutional design right. As a practical matter, many of these details, and plans as to how best to proceed, can realistically be expected to take shape only in the process of implementing our broadly outlined proposal. With that caveat in mind, it will nevertheless be helpful to take a preliminary look at some of the key likely features of the NIA's institutional design.

3. The National Investment Authority: Implementation

The preceding discussion invites further inquiry into the NIA's and its two operating arms' organizational structures, internal governance, and public accountability. One might also ask more about the proposed entities' business models. Without claiming to provide full answers to all of these questions, this Part addresses some of the key issues and challenges likely to arise in designing and instituting the NIA.

3.1. Organizational and Personnel Matters

The RFC and SWF experiences offer useful lessons for structuring our proposed NIA. That experience shows that one of the crucial elements of an effective accountability regime is a clear articulation of the public investor-entity's legal mandate and core mission.[52] A direct and deliberate normative framing allows both for effective downstream operationalization of the entity's policy objectives and for robust measurement of its performance and operation.

Establishing a formal organizational hierarchy with clearly delineated lines of authority and functional divisions further bolsters the entity's institutional coherence and ability to achieve its aims.[53] Periodic public reporting of performance results, regular internal and external audits, and reliance on independent advisory or supervisory boards adds another layer of accountability. Finally, individual funds' institutional robustness is "sustained by resourcing each element in the investment process and governance chain with an appropriate time and resources budget."[54]

In short, the SWF experience shows that the institutional strength and coherence of any public investment authority critically affects its operational transparency, public accountability, and political legitimacy. In the context of our proposed NIA system, this lesson has to be applied at the level of each entity: the NIA itself, the NIB, and NCMC.

As discussed above, the NIA Board, an independent federal agency, would have the statutory authority and duty both to identify key national development priorities and to formulate a public investment strategy in accordance with those priorities. To enable the NIA to perform effectively in practice, the SWF experience suggests it is critical to grant it an explicit and unambiguous statutory mandate to develop and implement, on an ongoing basis, a comprehensive program of structurally balanced, sustainable, and socially inclusive economic development. A strong and normatively clear legal mandate is an indispensable foundation of the NIA's political legitimacy – a particularly sensitive issue for SWFs and all other public instrumentalities that act in private markets – and its operational efficiency.[55]

The NIB and NCMC would for their part best be organized as federally chartered government-owned corporations. The U.S. has a long history of chartering special government corporations, many of which operate under unique sets of privileges and constraints.[56] Flexibility in crafting such special privileges and constraints weighs strongly in favor of chartering both NIB and NCMC as such corporations.[57]

This option will allow each of the entities to offer salaries in excess of federal-employee compensation limits and, therefore, attract and retain highly qualified personnel – one of the most critical factors that would determine the level of the NIA's success.[58]

This form of chartering will also free NIB and NCMC from many formal constraints and requirements of the administrative process and shield them from excessive bureaucratic interference. Another significant advantage of this organizational choice is that it can give both NIB and NCMC a greater degree of insulation from direct political pressure.[59] That should encourage the emergence and maintenance of a more focused and mission-oriented institutional culture.

Each of the NIB and NCMC should be governed by its own Executive Board in accordance with the specially tailored principles laid out in its charter.[60] The NIB's and NCMC's Executive Boards should be supported by well-compensated and technically competent professional staffs.[61]

Personnel issues are an important organizational factor in ensuring the NIA's viability. Because the NIA would seek to fulfill its explicitly public – hence, unavoidably political – mission through credit allocation and asset management, it has to combine strong strategic policy-making capabilities with deep technical expertise in financial markets and investments. Expertise in public policy and macroeconomic planning, for example, would be particularly important at the level of NIA leadership. Technical financial-analysis skills and investment management expertise, on the other hand, would be the heightened priority for NIB and NCMC personnel.

There are generally two types of consideration that must be taken into account with respect to the personnel and internal governance of the NIB and, especially, NCMC. On the one hand, it is important to ensure that the NCMC's internal organizational hierarchy enables it to make efficient, internally coherent, coordinated, and timely decisions. To the extent that it runs a *bona fide* asset management business, it has to be structured like one: a relatively lean, well-disciplined, and cohesive team of professionals under the command of the Chair of the NCMC's Executive Board – a high-profile, well-respected, and experienced investment management expert.[62]

On the other hand, both the NCMC and the NIB are federal instrumentalities, which means that their actions must reflect and serve the interests of the public as a whole. Their internal organizational structures and decision-making processes accordingly should not be focused solely on business efficiency: they should also reflect these entities' practical commitment to the public interest, thereby enhancing their legitimacy.

A workable compromise between these two considerations might be to allow some meaningful public input in the appointment process. One route would be to replicate, in modified form, the regional Federal Reserve Banks' current governance structure and establish three classes of Executive Board members.[63] Members of one class – one of whom would be appointed as the Chair – would be selected by the NIA Board. Members of the second class would be selected by private sector business groups: the investment management industry in the case of NCMC, and the broader financial industry in the case of NIB. Members of the third class would be selected by public interest groups, including representatives of the scientific and research communities. All members of the NIB's and NCMC's Executive Boards would have to meet certain statutory criteria specifying relevant expertise.[64]

3.2. Accountability Mechanisms

Accountability is a critical factor in ensuring the NIA's political legitimacy and, ultimately, long-term success. As both the RFC and the SWF experience suggest, the NIA's legitimacy would depend not only on its financial performance but also on the procedural integrity of its operations.

To ensure that the NIA is publicly accountable for its actions, it is important to establish clear lines of internal and external communication, reporting, and auditing. It is also critical that both the NIB and NCMC have clear and enforceable procedural rules for making and vetting investment decisions along the entire organizational chain of command, from the frontline credit analysis and fund management teams all the way up to the Executive Boards. These rules will help to ensure that the entities' business activities are properly insulated from undue influence both by private sector interests and by political incumbents.

With respect to transparency, it would be easy to mandate that the NIA Board submit annual reports to Congress, outlining the basic principles of its developmental program, explaining any changes in or adjustments to its objectives over various time horizons, and describing and analyzing specific actions that the NIA – including the NIB and NCMC – might be taking to implement its strategic objectives.[65] The Chair of the NIA Board, along with the Chairs of the NIB's and NCMC's respective Executive Boards, could also be required to provide annual Congressional testimony on the national development policy.

The NIA Board should be subject to annual audit by the Government Accountability Office (the "GAO"), which conducts audits of federal agencies.[66] In addition, each of the NIB and the NCMC should be subject to annual independent audits of their financial performance and operations. Given the nature of their activities, it may be advisable to set up a special panel to conduct these audits. The special audit panel would include representatives of the GAO and of all major public accounting firms.

As for the integrity of investment decisions, establishing a clear and reliable process for selecting specific projects for NIA financing is of particular importance. The underlying concern here is the ever-present potential for corruption, cronyism, and misuse of funds under these entities' control for the benefit of political incumbents.

Extensive reporting requirements, regular external audits, and various internal controls at the level of each entity in the NIA system should significantly alleviate this concern. Nevertheless, it is vital to put in place robust procedural safeguards with respect to the selection of investments, especially for NCMC's portfolio.

One method might be to require the NIB and NCMC to select individual projects for inclusion in their asset portfolios through public auctions. Any public or private entity with an economically viable plan for providing currently under-provided public goods, discussed above, would have a fair and equal opportunity to apply for the NIA funding. A specially designated committee of the NCMC or the NIB, as appropriate, would conduct a thorough analysis of each proposed project and choose the ones that meet their pre-formulated and transparent internal requirements.[67]

To assist the NIB and NCMC with project selection, it would be desirable to establish an Investment Advisory Committee comprising outside experts in financial management, macroeconomic analysis, urban planning, and other relevant fields. Given its broad collective expertise, the Investment Advisory Committee would be in a position to help the

NCMC and NIB to conduct more comprehensive assessments of investment opportunities. It would also serve as an additional means of ensuring NCMC's and the NIB's public accountability.

To the extent that a significant part of the proposed NIA's mission is to promote sectorally and geographically balanced economic growth, its organizational structure should reflect an explicit focus on regional, as well as national, development. Thus, in another parallel to the Federal Reserve System, it would be important to establish NIA regional offices that work closely with local business communities and public authorities on region-specific needs.

It would make sense to delineate the NIA's regional districts in a manner that maps neatly onto the existing map of Federal Reserve Districts, to maximize potential synergies from close collaboration between regional NIA offices and the corresponding Federal Reserve Banks.[68] Direct regional presence could also significantly strengthen the NIA's political influence and legitimacy.[69]

Finally, to enhance the NIA's external accountability, Congress could establish a special Public Advisory Council (the "Council") specifically charged with representing an explicitly public interest-oriented perspective in the conduct of national developmental policies.[70] The Council would comprise individuals who are independent of both the industry and regulators and who have relevant expertise, a group that would include academic experts and certain public figures (not holding any official post).[71]

The Council would play a primarily advisory and evaluative role, providing an independent perspective on substantive policy issues faced, and strategic decisions made, by the NIA in the course of fulfilling its developmental mandate. The Council would submit mandatory annual reports to Congress, containing its assessments and criticisms – and non-binding recommendations for improvement – of the NIA's articulation and performance of national developmental policy goals. Establishing an institutional channel for inserting public interest into the NIA's political accountability and decision-making structure would serve as a powerful check against the strong pull of industry influence.[72]

3.3. Operational Issues and Business Considerations

In addition to matters of organizational structure and accountability, designing an NIA also requires that some attention be paid matters of initial funding, day-to-day operating, and related business considerations.

Funding for the NIA's operations could come from several sources. During the initial, "start-up" period immediately following its chartering, the NIA will likely rely in part upon Congressional appropriation. This was the RFC's initial funding model, until it became sufficiently profitable as a business enterprise in its own right as no longer to require appropriations.[73] Also as in the case of the RFC, once the NIA builds a portfolio of assets generating interest, dividend, and fee revenues, it will no longer need Congressional appropriations.[74]

A backstop to self-funding might be to designate a certain portion of the Fed's annual profits for contribution to the NIA's budget. This stream of funds would serve to smooth potential fluctuations in the NIA's internally generated returns and to augment its ability to continue financing publicly beneficial economic ventures even during times of economic slowdown. Currently, the Fed turns over significant amounts of its annual profits to the Treasury. In January 2016, it sent $97.7 billion to the Treasury, plus an additional $19.3 billion from its capital surplus account to finance the 5-year highway construction program.[75] Linking Fed profits to the NIA, whose mission is both complementary to that of the Fed and embraces all manner of infrastructure *including* highways, looks all the more intuitively natural against that backdrop.

It probably also makes sense, in this connection, to consolidate the RFC's remaining offspring with the NIA, which in a sense is the RFC's reincarnation. Thus, GSEs such as Fannie Mae, Freddie Mac, and perhaps even Sallie Mae might be brought under the NIB as distinct funds,[76] while the SBA for its part might be brought under NCMC as a specific venture capital fund.

As for how the NIA conducts its actual investment activities over the lifecycles of its investments, several questions will have to be answered. One is the question of who will be making the specific lending and investing decisions. Another is whether, how, and under what conditions various investments should be "exited."

With respect to the first question, it is probably best, at least at the outset, for investment decisions and investing activity to be done "in house." Some readers would perhaps find it tempting to "outsource" at least some of this activity to pre-existing private sector investment professionals. We think this would set the wrong "tone" inasmuch as private sector financial professionals' top priorities always are, understandably enough, profitability and fee-maximization. And this is to say nothing of likely public perceptions of rent-seeking and cronyism. Better, then, to begin with something more like the RFC model.[77]

This does not, however, rule out the NIA's project financing arm – NCMC's – partnering with private sector sources of finance in particular cases. It might well happen in some instances, for example, that a pioneering start-up firm is able to attract private VC funding up to some percentage of initial requirements. In some such cases, NCMC might join – even form, lead, or both – syndicates of investors.

This is not as unusual as it might at first sound. Indeed it is very common, in the so-called "developing" world in particular, for international development banks such as the World Bank, the Asian Development Bank, the Inter-American Development Bank and other such "IDIs" to form syndicates of mixed public and private investors.[78] Indeed, often an initial investment by one of these institutions confers an imprimatur of sorts on the relevant project, catalyzing much more investment from additional sources.[79]

As for the "exit" question, here the answer will probably vary with kinds of investment. In the case of the NIB, things are relatively simple: inasmuch as the buying and selling decisions are made with a view to influencing prices, buying and selling will be done according as the relevant prices continue to require raising or lowering. In the case of NCMC, durations of investments and "exits" therefrom will vary according to type. Some large and enduring infrastructure projects, for example, might be best "spun off" into separate public authorities on the model of the TVA or the Delta Regional Authority, or into carefully regulated, privately-owned utilities, once completed.

Cutting-edge new firms that pioneer the development of new industries with NCMC funding, for their part, might simply pay off their debts to NCMC once up and self-sustainably running. Other such firms that NCMC at first owns might be sold off in IPOs once they are able to manage on their own. And still others might be owned in part by NCMC during their early stages, the shares subsequently sold off on the market or conveyed to NIB.

Again, there are many possibilities here, all of them varying with the particulars of specific imaginable cases. The guiding principle should be one of pragmatism: NCMC will invest in the ways that seem best suited to financing the provision of a great variety of public goods, and will "exit" any particular venture, when its ongoing presence is no longer needed, in whatever manner seems best for the venture itself and for NCMC's ongoing mission.

Where returns to *private* investors in NIA organs are concerned, as suggested earlier these would come from a variety of sources that vary with the kinds of project financed. Variable returns on investments in the NIB, were private investors permitted to participate, would presumably vary with NIB's returns themselves. Returns on investments through NCMC, as noted earlier, would be composite, including a guarantee of principal and interest on the one hand, a variable equity sliver on the other.

In the case of projects that did not prove profitable or generate local, regional, or national economic growth, investment in NCMC would be a bit like investment in U.S. Treasury securities; the return would simply be the coupon. In the case of projects that did prove profitable or generate economic growth, the equity sliver would be proportional to the profit or the growth rate, and funded out of the profit or the augmented tax take as noted above.

Additional inducements to private investors, akin to those currently offered to buyers of Treasuries and Agency securities, will probably also be in order. Hence, earnings on these investments should be untaxed, and the instruments should be treated as government-issued securities for purposes of the Securities Act of 1933. Similarly, investment in these securities should be exempt from portfolio regulation under Section 24 (Seventh) of the National Bank Act of 1863, while the securities themselves should receive zero risk weightings for capital-regulatory – and perhaps regulatorily-recognized collateralization – purposes.[80]

A potentially thorny question is whether to permit the development of a private secondary market in NIA investments. On the one hand, permitting this would presumably allow for more primary investments, as a secondary market enables easy exit and thereby lowers perceived risk. Moreover, deep secondary markets can perform useful "price-discovery" functions, enabling NIA management to lever the knowledge of millions of disaggregated private investors and market analysts in determining the likelihood of success of certain projects.

On the other hand, exit can also be had by conferring on every investor a put – in essence, an unconditional principal redemption right – or through establishment of another fund to purchase from those wishing to sell, rather as Fannie in its first, pre-privatization decades stood as the sole secondary market purchaser or FHA-insured mortgage loans. And private secondary markets' "price-discovery" functions for their part are compromised when excess speculative activity inflates prices far above, or deflates prices far below, anything approximating "fundamental" or sustainable value over certain temporal intervals. We also mustn't forget that even the primary markets in NIA investments will perform price-discovery functions, even if not quite as quickly as would secondary markets.

Our tentative conclusion with respect to secondary trading, is that we should proceed with caution, beginning with no more than a principal redemption right – exercisable at any state or nationally chartered bank[81] – to avoid investor lock-in and thereby induce greater willingness on the part of investors to purchase NIA-issued securities. During this opening period, as investor interest is gauged by investor purchasing and redeeming activity, greater clarity should emerge as to the prospective advantages and disadvantages of permitting private secondary market trading in NIA securities.[82] Also during this period, of course, a corollary entailment will be that NIA securities cannot serve as collateral in Repo or any other transactions, since they will not be assignable.

Conclusion

We have proposed, advocated, and provisionally designed a new public instrumentality – a National Investment Authority – whose mission is situated between those of the Treasury and of the central bank, the Fed. In explaining why such an instrumentality is needed, we have extended, somewhat, the traditional understanding of public goods, and explained why neither the Treasury, the Fed, nor public financing alone is up to the task of supplying the full range of such goods. What is necessary is an institution that combines the comparative advantages of public action with those of private action in the supplying of public goods.

Underlying our proposal is the conviction that America has been faced for some time not only with a "recovery" challenge, but with a longer term "reconstruction" and "development" challenge. We have argued that these terms must be thought of as denoting not merely temporary or exigent circumstances, but forms of action in which societies collectively engage for as long as they "live." Treating development in this way requires that precisely that broadened class of public goods we have characterized be supplied in quantities that maximize the range of productive opportunity open to individual citizens. Our proposed NIA, which combines public and private capital in a manner that levers the comparative advantages of public and private alike, is the means of optimally supplying those goods.

Because such goods' chronic undersupply is the source of our current political and economic dysfunctions, our proposed NIA is also the means of restoring health to our economy and to our polity. It is the "missing link" whose absence accounts for our current travails. The NIA does not represent a "public takeover" or "socialization" of finance. Rather, it is a means by which all of us can collectively supply what no one of us individually can supply, yet which each of us needs. In this sense its purpose is the purpose of democratic government itself. It is that purpose as pursued in the realm of productive market activity.

---

[1] This white paper reduces to their essentials the prompting considerations and basic design features elaborated in our forthcoming article, *Private Wealth and Public Goods: A Case for a National Investment Authority*, 43 J CORP. L. __ (2017) [hereinafter, *NIA*]. It also builds on the principles more fully articulated in our prior research. *See,* Robert C. Hockett & Saule T. Omarova, *The Finance Franchise*, 102 CORNELL L. REV. __ (forthcoming 2017) [hereinafter, *Finance Franchise*]; Robert C. Hockett & Saule T. Omarova, *Public Actors in Private Markets: Toward a Developmental Finance State*, 93 WASH. U. L. REV. 103 (2015) [hereinafter, *Public Actors*]; Robert C. Hockett & Saule T. Omarova, *"Private" Means to "Public" Ends: Governments as Market Actors*, 15 THEORETICAL INQUIRIES IN L. 53 (2014).

[2] The term "public-private partnership" ("P3" or "PPP") refers to a broad universe of diverse and context-specific arrangements. For summaries and assessments of recent P3 arrangements in Europe and elsewhere, see JEFFREY DELMON, PUBLIC-PRIVATE PARTNERSHIP PROJECTS IN INFRASTRUCTURE: AN ESSENTIAL GUIDE FOR POLICY MAKERS (2011); EDUARDO ENGEL ET AL., THE ECONOMICS OF PUBLIC-PRIVATE PARTNERSHIPS: A BASIC GUIDE (2014); E. R. YESCOMBE, PUBLIC-PRIVATE PARTNERSHIPS: PRINCIPLES OF POLICY AND FINANCE (2007); and DARRIN GRIMSEY & MERVYN K. LEWIS, PUBLIC PRIVATE PARTNERSHIPS: THE WORLDWIDE REVOLUTION IN INFRASTRUCTURE PROVISION AND PROJECT FINANCE (2007). In the U.S., P3 models for infrastructure financing are used mainly by individual states and municipalities. *See, e.g.*, George Carollo *et al.*, *White Paper: Public-Private Partnerships for Infrastructure Delivery*, Stanford Collaboratory for

Research on Global Projects, 2013; GOVERNMENT ACCOUNTABILITY OFFICE, GAO-10-728, WASTEWATER INFRASTRUCTURE FINANCING: STAKEHOLDER VIEWS ON A NATIONAL INFRASTRUCTURE BANK AND PUBLIC-PRIVATE PARTNERSHIPS (2010).

[3] For historical analyses of these dynamics, see, CHARLES P. KINDLEBERGER & ROBERT ALIBER, MANIAS, PANICS, AND CRASHES: A HISTORY OF FINANCIAL CRISES (2005).

[4] *See Finance Franchise, supra* note 1.

[5] There is a growing literature on "safe assets," and government liabilities as "safest of the safe." *See*, Marcus Brunnermeier & Valentin Haddad, *Safe Assets*, Federal Reserve Bank of New York, Oct. 17, 2014, *available at* http://www.newyorkfed.org/aboutthefed/pdf/FAR_Oct2014.pdf; Gary Gorton et al., *The Safe-Asset Share*, 102 AM. ECON. REV. 101 (2012); Pierre-Olivier Gourinchas & Olivier Jeanne, *Global Safe Assets*, BIS Working Paper No. 399 (2012), *available at* http://www.bis.org/events/conf120621/gourinchas_presentation_new.pdf; Arvind Krishnamurthy & Annette Vissing-Jorgensen, *The Aggregate Demand for Treasury Debt*, 120 J. POL. ECON. 233 (2012); Garry J. Schinasi et al., *Financial Implications of the Shrinking Supply of U.S. Treasury Securities*, International Monetary Fund, (Mar. 20, 2001), *available at* https://www.imf.org/external/pubs/ft/supply/2001/eng/032001.PDF.

[6] The literature tends to distinguish between goods that bear both of these properties, which it calls "public goods," and goods that bear only the non-excludability property, which it calls "common pool resources." Fish stocks constitute a common pool resource, while the latter constitutes a pure public good. Non-rivalrous but excludable goods are typically called "club goods," while rivalrous and excludable goods are simply "private goods." *See generally* Francis M. Bator, *The Anatomy of Market Failure*, 72 Q. J. ECON. 351 (1958), *available at* https://courses.cit.cornell.edu/econ335/out/bator_qje.pdf; and Paul A. Samuelson, *The Pure Theory of Public Expenditure*, 36 REV. ECON. & STAT. 387 (1954), available at http://www.jstor.org/stable/1925895?seq=1#page_scan_tab_contents. *See also,* JOSEPH E. STIGLITZ & JAY K. ROSENGARD, THE ECONOMICS OF THE PUBLIC SECTOR (4th ed., 2015); HARVEY ROSEN & TED GAYER, PUBLIC FINANCE (2013); LAURENCE S. SEIDMAN, PUBLIC FINANCE (2009); RICHARD A. MUSGRAVE, THE THEORY OF PUBLIC FINANCE: A STUDY IN POLITICAL ECONOMY (1959).

[7] *See,* Robert Hockett, *Recursive Collective Action Problems*, 3 J. FIN. PERSP. 1 (2015).

[8] *Id.*

[9] Generally, a collective action problem is a situation in which multiple individually rational decisions aggregate into collectively undesired outcomes. *See id.*

[10] *See,* Robert Hockett & Saule Omarova, *Systemically Significant Prices*, 2 J. FIN. REG. 1 (2016).

[11] *Id.*

[12] *Id.*

[13] Some have argued, along similar lines, that the legal trust and the business corporation themselves can be helpfully viewed as intergenerational sharing mechanisms that facilitate long-term investment. *See,* Lynn A. Stout, *The Corporation as Time Machine*, 38 SEATTLE U. L. REV. 685 (2015). That argument, however, does not go far in an environment where (1) the managers of investible funds are beholden to investors; (2) investors are rationally impatient capitalists who do not think of subsequent shareholders as their descendants and accordingly demand quick returns; and (3) such returns are more easily generated through speculative market transactions than long-term productive

investments.

[14] Such return may, for example, consist of a guaranteed bond coupon with a regular growth-associated equity-yield add-on. *See infra* Parts 2 and 3.

[15] The "optimal taxation" literature in particular is focused upon this prospect. *See,* Frank P. Ramsey, *A Contribution to the Theory of Taxation*, 37 ECON. J. 145 (1927); Frank P. Ramsey, *A Mathematical Theory of Saving*, 38 ECON. J. 152 (1928); James A. Mirrlees, *An Exploration in the Theory of Optimum Income Taxation*, 38 REV. ECON. STUD. 175 (1971).

[16] *See NIA*, *supra* note 1.

[17] *Id.*

[18] *See, e.g.*, Nation Building Here at Home Act of 2012, H.R. 4352, 112th Cong. (2012), *available at* https://www.congress.gov/112/bills/hr4352/BILLS-112hr4352ih.pdf; National Infrastructure Bank Act of 2007, S. 1926, 110th Cong. (2007), *available at* https://www.congress.gov/110/bills/s1926/BILLS-110s1926is.pdf; National Infrastructure Bank Act of 2007, H.R. 3401, 110th Cong. (2007), *available at* http://www.gpo.gov/fdsys/pkg/BILLS-110hr3401ih/pdf/BILLS-110hr3401ih.pdf; National Infrastructure Development Act of 2007, H.R. 3896, 110th Cong. (2007), *available at* https://www.congress.gov/110/bills/hr3896/BILLS-110hr3896ih.pdf; *Fiscal Year 2016 Budget Overview*, OFFICE OF MGMT. & BUDGET, http://www.whitehouse.gov/omb/overview (last visited July 5, 2015); Joseph Weber, *Obama to Propose $50B in Infrastructure Projects*, WASH. TIMES (Sept. 6, 2010), http://www.washingtontimes.com/news/2010/sep/6/obama-propose-50b-infrastructure-projects/.

[19] *Id.*

[20] For a discussion of market-levering, market-making, and market-preserving roles played by public instrumentalities in private markets, see *Public Actors, supra* note 1 at 122-136.

[21] Systemic financial stability is a public good insofar as it addresses the non-controllability problem, discussed above. *See supra* Part 1.2.

[22] *See,* BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, THE FEDERAL RESERVE SYSTEM: PURPOSES & FUNCTIONS (2016) 9-15, *available at* https://www.federalreserve.gov/pf/pdf/pf_complete.pdf. The third institutional component of the Federal Reserve System is the Federal Open Market Operations Committee. *Id.* at 1.

[23] For a discussion and analysis of the market-levering mode of public participation in financial markets, see *Public Actors*, *supra* note 1 at 131-134. Also *"Private" Means to "Public" Ends*, supra note 1

[24] *See* HEIDI CREBO-REDIKER & DOUGLAS REDIKER, FINANCING AMERICA'S INFRASTRUCTURE: PUTTING GLOBAL CAPITAL TO WORK (2008), *available at* http://www.voltairenet. org/IMG/pdf/Financing_America_Infrastructure.pdf.

[25] See *Public Actors*, supra note 1 at 133-34; and Robert C. Hockett, *Jeffersonian Republic by Hamiltonian Means: Values, Constraints, and Finance in the Design of A Comprehensive and Contemporary American "Ownership Society,"* 79 S. CAL. L. REV. 45, 68-75 (2005) [hereinafter "*Hamiltonian Means*"].

[26] The FHA played the key role in standardizing the currently popular 30-year mortgage loans. *See* sources cited id.

[27] *See Public Actors*, supra note 1 at 150-152; and *Hamiltonian Means*, supra note 25

at 73-75.

[28] *See* Crebo-Rediker & Rediker, *supra* note 24.

[29] All of the current proposals for the creation of a public infrastructure bank similar to the NIB envisaged here require initial congressional capitalization of such a bank, although the precise level of such initial capitalization is a matter of some disagreement among different proposals' authors. *See* Crebo-Rediker & Rediker, *supra* note 24, at 2.

[30] Existing proposals generally do not envision state or municipal contributions to the infrastructure bank's capital.

[31] Preferred stock issued by the NIB would not have any voting or management rights and would function as passive investment instruments in private shareholders' hands.

[32] "Covered bonds" are a form of collateralized bond instrument, with the collateral in question typically guaranteed by a government entity. First developed in Prussia and Denmark during the late 18th century and reminiscent of Alexander Hamilton's "sinking fund" model of public finance, covered bonds have become increasingly popular in Europe over the past several decades as a form of financing public projects. *See, generally,* European Covered Bond Council, ECBC FACTBOOK 2014, *available at* http://ecbc.hypo.org/Content/Default.asp?PageID=501.

[33] The Fed's discounting regime, pursuant to which the central bank monetizes certain eligible forms of commercial paper, is embodied at 12 USC Sec. 372. The FDIC-administered capital-regulatory regime, pursuant to which some forms of safe and/or favored asset are risk-weighted at less than 100%, is embodied at 12 C.F.R. Part 325 (2015).

[34] To avoid favoritism and to minimize potential conflicts of interest in allocating public capital to private enterprise, the NIB would have to institute robust procedural mechanisms for selecting and monitoring individual projects for its portfolio. *See infra* Part 3.

[35] *See, e.g.,* Crebo-Rediker & Rediker, *supra* note 24.

[36] *Id.* The EIB was established in 1958 and is owned and operated by the EU member-states. Its mission is to foster, through a variety of public-private investment partnerships, the continued infrastructural development and economic integration of the European Union. For more on the institution and its history, see http://www.eib.org/.

[37] *See,* Crebo-Rediker & Rediker, *supra* note 24.

[38] *See id.*

[39] Something much like this is behind the 2008 Clean Energy Bank proposals of Senators Bingaman and Domenici and Representatives Inslee and Israel. See The 21st Century Energy Technology Deployment Act, S. 3233, available at https://www.govtrack.us/congress/bills/110/s3233; and H.R. 2212, available at https://www.govtrack.us/congress/bills/111/hr2212; and the Clean Energy Investment Bank Act, S. 2730, available at https://www.govtrack.us/congress/bills/110/s2730/text.

[40] For more on how private equity funds operate, see HARRY CENDROWSKI & LOUIS W. PETRO, PRIVATE EQUITY: HISTORY, GOVERNANCE, AND OPERATIONS (2012); EILEEN APPELBAUM & ROSEMARY BATT, PRIVATE EQUITY AT WORK: WHEN WALL STREET MANAGES MAIN STREET (2014).

[41] In this Article, we use the term "private equity" broadly, to refer both to traditional PE firms and their subset, venture capital firms. Distinctions typically drawn between these two segments of the private fund industry are not relevant for the purposes of our

discussion.

[42] In accordance with the private industry practice, the management fee could be set at the typical level of 2% of private assets under the NCMC's management. The carry charged by private asset managers typically equals approximately 20% of the relevant fund's profits. This common private fund compensation structure is colloquially known as the "two and twenty" system. *See*, Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U.L. REV. 1 (2008).

[43] Even conservative macroeconomic models indicate that the positive employment, GDP-growth, and consequent income tax revenue increases generated by significant infrastructure investment would largely, if not wholly, offset project costs in the low interest-rate environment. *See* Robert Hockett & Robert Frank, *Public Infrastructure Investment, Renewed Economic Growth, and the U.S. Fiscal Position, available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1987656; Robert Hockett, *White Paper in Support of the Nation Building Here at Home Act of 2012*, *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2029239

[44] This ability to replicate private returns from the provision of systemic public goods is even more critical for financing forward-looking infrastructure projects that are not likely to generate sufficient user fee revenues, or are otherwise not amenable to imposition of such fees.

[45] These would include the expected "cost of capital" and "return on investment" calculations that take account of the return-elasticity of investment demand – i.e., the sensitivity of demand for the instrument to the yield of the instrument.

[46] TDF is a federal venture capital fund created in 1996 for the general purpose of financing small businesses developing telecommunications technologies. *See* 47 U.S.C. 614 (2015). TDF's strategy focuses on equity investments in telecommunications start-ups. *See*, S. Jenell Trigg, *Telecommunications Development Fund: Making a Difference?* (2002), *available at* http://www.civilrights.org/publications/1996_telecommunications/section-714.html.

[47] SBA was established in 1953 to facilitate small business formation and growth via the so-called "three Cs" of capital, contracting, and counseling. *See* NIA, supra note 1. Also *About the SBA*, U.S. SMALL BUS. ADMIN., https://www.sba.gov/category/navigation-structure/about-sba.

[48] DARPA, established in response to the Soviet Union's launch of Sputnik in 1957, widely credited with the development of many currently ubiquitous technologies. *See*, *About DARPA*, http://www.darpa.mil/about-us/about-darpa.

[49] ARPA-E, modeled after DARPA, was created in 2007 for the purpose of financing and facilitative transformational energy research.

[50] MARIANA MAZZUCATO, THE ENTREPRENEURIAL STATE: DEBUNKING PUBLIC VS. PRIVATE SECTOR MYTHS 138 (2014) ("In the innovation game, it is critical that finance be 'patient', and be able to accept the fact that innovation is highly uncertain and takes a long time.").

[51] *See* Fred Block, *Swimming Against the Current: The Rise of a Hidden Developmental State in the United States*, 36 POL. & SOC'Y 169 (2008) (advancing the notion of a "developmental network state").

[52] *See NIA*, *supra* note 1.

[53] *Id.*

[54] *Id.*

[55] *Id.*

[56] *See* Lebron v. Nat'l R.R. Passenger Corp., 513 U.S. 374 (1995) (describing the history of Amtrak and other government-chartered corporations). Some of the examples of currently existing federal government corporations include the Export-Import Bank, the Overseas Private Investment Corporation, and the Government National Mortgage Association. For academic analyses of the functions and varied organizational structures of government corporations and quasi-governmental entities, see A. Michael Froomkin, *Reinventing the Government Corporation*, 1995 U. ILL. L. REV. 543 (1995); Anne Joseph O'Connell, *Bureaucracy at the Boundary*, 162 U. PA. L. REV. 841 (2014); Benjamin A. Templin, *The Government Shareholder: Regulating Public Ownership of Private Enterprise*, 62 ADMIN. L. REV. 1127 (2010).

[57] *See, generally,* Kevin R. Kosar, *Federal Government Corporations: An Overview*, Cong. Res. Serv. (June 8, 2011) (describing the administrative flexibility provided by the government corporation form).

[58] *Id.* Government corporations are generally subject to the Government Corporation Control Act, 31 U.S.C. § 1901 et seq. Congress can, and often does, exempt individual government corporations from that statute's provisions. Kevin R. Kosar, *Congressional or Federal Charters: Overview and Enduring Issues* 6, Cong. Res. Serv. (Apr. 19, 2013).

[59] *See,* Kosar, *id.*,at 10-11 (describing the limited administrative and congressional oversight of federal government corporations).

[60] We propose this board structure for the NIB and NCMC both because it mimics the governance structure of private business corporations and in recognition of the significant benefits of incorporating various perspectives and interests in the management of these entities. However, it is possible that a centralized management structure that concentrates decision-making power in the hands of a single administrator directly responsible to the NIA Board would be a more effective alternative. *See,* Kosar, *supra* note 58 at 8-10.

[61] The ability to hire the best and the brightest financial professionals away from the private sector will be key to the NIA's – and specifically NCMC's – success. Several factors are critical in this respect. Thus, each entity in the NIA structure – most importantly, the NCMC – would have to have sufficient financial resources to offer competitive compensation to its executive officers, asset managers, financial analysts, accountants, and other employees. Just as important, however, are various non-pecuniary factors like the entity's bold investment mandate and "elite" status in the federal government hierarchy, an opportunity for ambitious professionals to manage large pools of money while "doing good" for the country, a strong institutional culture that rewards properly channeled ambition and success, etc. While it is hardly realistic to out-compete Wall Street in terms of pay, the same is not necessarily true of other drivers of human behavior, such as professional ambition and civic spirit. Carefully utilizing these incentives could critically boost the NIA's human capital.

[62] As historical experience shows, the successes of many public institutions are often a reflection of their individual leaders' strength of character, personal ambition, and sense of mission. A strong, ambitious public investment entity of the NCMC's caliber needs a strong, charismatic leader committed to public service.

[63] To keep this classified Executive Board from becoming inefficiently large, it would be advisable to limit its overall size to six members – two in each class – with the Chair's

tie-breaking vote.

[64] The "expertise" requirement should be drafted broadly, so as not to limit the pool of nominees to financial industry professionals.

[65] This reporting requirement would be different from, and in addition to, currently existing reporting requirements applicable to federal agencies and government corporations. *See* Kosar, *supra* note 58 at 7-8 (describing annual budget and management reporting requirements for government corporations).

[66] *See*, http://www.gao.gov/about/index.html.

[67] These and other credit and asset allocation decisions would be subject to special internal and external audits.

[68] In the interests of greater efficiency, it may be preferable to have fewer NIA districts, each of which operates in a region comprising several Federal Reserve Districts. For example, the Northeast NIA District would coincide with Federal Reserve Districts 1, 2, and 3. For a map of the twelve Federal Reserve Districts, see https://www.federalreserve.gov/otherfrb.htm.

[69] The RFC's experience is particularly instructive in this respect. *See* NIA, *supra* note 1.

[70] For a discussion of the general model of such a council, see Saule T. Omarova, *Bankers, Bureaucrats, and Guardians: Toward Tripartism in Financial Services Regulation*, 37 J. Corp. L. 621 (2012),

[71] For a general discussion on the process for selecting members of such a Council, see id. at 661-663.

[72] *See id.* at 635-637.

[73] *See NIA*, *supra* 1.

[74] It might also be advisable to establish a protocol pursuant to which local, regional, or national economic growth attributable to NIA investment activity result in an earmarking of corresponding tax revenue increases, pursuant to which some of the increase goes directly to NIA.

[75] *See*, Jim Puzzanghera, *Federal Reserve Sends Record $97.7-billion Profit to Treasury*, L.A. Times (Jan. 11, 2016), *available at* http://www.latimes.com/business/la-fi-federal-reserve-profit-20160111-story.html. In January 2017, the amount remitted by the Fed was $92.7 billion. For the data on the Fed's remittances to the Treasury, see https://www.federalreserve.gov/newsevents/press/other/20170110a.htm.

[76] We say "perhaps even" Sallie Mae because, unlike Fannie and Freddie, Sallie Mae, which was privatized in late 2005, has not been brought back into government conservatorship after nearly failing. "Retaking" it would accordingly raise constitutional takings obstacles.

[77] One advantage that the RFC enjoyed in its time was the recent loss of employment by many investment professionals, along with a certain "national recovery spirit" in the early years of the New Deal. We think, however, that those conditions are not altogether absent today. For one thing, financial sector employment figures are still way down from their peak reached in 2007. For another thing, the nation still awaits real recovery, and we suspect that as quickly as NIA begins to realize its potential it will generate considerable motivation. Finally, as we noted above, compensation for NIA staff will be "respectable" by industry standards, particularly when combined with the esprit generated by beneficial public service.

[78] For a good overview of how the IDIs operate in conjunction with private institutions, see the World Bank webpage, available at http://www.worldbank.org/en/about.

[79] Id.

[80] We hesitate over collateralization purposes because we are undecided, as yet, over whether to permit the formation of a private sector secondary market in these securities.

[81] In effect, this means that NIA securities will be functionally "discountable," save that no literal discounting, as distinguished from mere selling at face value, will take place, since banks will simply purchase the securities and then either hold on to them as assets or redeem them with the NIA or the Fed.

[82] Another relevant consideration here will be whether there are sufficient, or too many, "safe assets" apart from NIA securities to sustain what we decide as a society to constitute the optimal amount of Repo trading. For more on this matter, see *Finance Franchise, supra* note 1.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BROWN FROM ROBERT R. HILL, JR.

Q.1. Your testimonies cited certain metrics for measuring your banks' compliance costs. Of course, there are a variety of ways to measure a bank's costs and compliance burden. To help the Committee better understand the overall compliance burdens on your institutions:

Please provide the ratio of total employees in your bank's workforce to employees.

A.1. In 2009 and 2010, our compliance employees were housed in the Compliance Department. After the enactment of Dodd–Frank, the number of employees dealing with compliance grew dramatically; however, the growth was through employees throughout the bank and company, and not just in the Compliance Department. At the time, we did not endeavor to keep track of the number of compliance-related employees. In the last several years, however, we have endeavored to do so. The data below is a good faith effort to provide the requested numbers, but we would caution that they are conservatively stated in that we have employees in virtually every area of the bank working on compliance issues. As you will see, even on a conservatively stated basis, the number of compliance employees has gone up over eightfold.

	2009	2010	2011	2012	2013	2014	2015	2016
Full time equivalents (FTEs)	700	1,015	1,071	1,324	2,106	2,081	2,058	2,055
Compliance FTEs	6	6	N/A	N/A	N/A	N/A	40	51
Ratio	0.86%	0.59%	N/A	N/A	N/A	N/A	1.94%	2.53%

Q.2. Please provide your bank's compliance costs for each year from 2009 to the present.

A.2. In reviewing the data below, please refer to the response above. As stated above, the data is difficult to capture with total precision. As noted above, the compliance costs in 2009 or 2010 were largely contained in the Compliance Department. Today, they are spread over various areas of the bank and company. Again, this is our good faith effort to be responsive.

	2009	2010	2011	2012	2013	2014	2015	2016
Estimated Total Compliance Costs	$780,000	$840,000	N/A	N/A	N/A	N/A	$5,800,000	$7,500,000

Q.3. Please provide the combined dollar value of your bank's stock dividend payments and share repurchases for each year from 2009 to the present.

A.3. Below is the stock dividend information you requested. In reviewing these numbers, however, there are several factors you should bear in mind so you will know that the growth of the bank and the number of its shareholders has changed dramatically over the course of the years for which you have asked us to provide information. For example, in 2013, the bank almost doubled in size and its number of shareholders, and capital, increased by roughly 40 percent. As a result, the dollar amount of dividends went up significantly. The change did not reflect an equivalent increase in dividend income to individual shareholders; it was simply the function of the bank's growth through acquisition.

	2009	2010	2011	2012	2013	2014	2015	2016
Combined value of stock dividend payments and share repurchases (in thousands)	$8,623	$8,935	$9,856	$11,080	$16,207	$20,702	$25,072	$33,136

Q.4. Please provide your bank's efficiency ratio for each year from 2009 to the present.

A.4. Below is the data on the bank's efficiency ratios for the period in question. As you review this data, you should bear in mind that efficiency ratios are a function not just expenses but also revenue. Thus, as the bank grew through acquisitions, its revenue increased. In other words, it makes comparisons difficult. Further, in 2010, the bank recorded a nonrecurring gain. Absent that gain, the 2010 efficiency ratio would have been 69.89 percent, not 46.68 percent.

	2009	2010	2011	2012	2013	2014	2015	2016
Efficiency Ratio	61.17%	46.68%	68.77%	72.20%	75.85%	71.41%	64.19%	64.16%

Q.5. Please provide your bank's revenue from interchange fees linked to debit cards for each year from 2009 to the present.

A.5. Below is the requested data. As I testified, South State Bank, for the relevant years, was under $10 billion. Thus, the Durbin Amendment interchange fee caps did not affect the bank's interchange fee revenue. Also, as noted above, the bank grew significantly during the time period in question. As a result, the revenue from interchange grew significantly for that reason.

	2009	2010	2011	2012	2013	2014	2015	2016
Interchange Fee Revenue (in thousands)	$3,717	$7,261	$9,467	$11,178	$18,143	$25,192	$27,939	$31,801

Q.6. During your testimony, you said "Under Dodd–Frank, crossing the $10 billion in asset threshold has had very harsh implications for midsize banks For example, South State was impacted by over

$20 million per year, a significant sum for a bank our size. What impacts does this have on our local communities? For us, that equates to 300 jobs. Approximately 10 percent of our branches were closed, and even more jobs were diverted from lending to regulatory compliance."

Your bank appears to have grown from roughly 50 branches before the passage of Dodd–Frank, to about 180 this year, assuming completion of your proposed merger with Park Sterling. The Park Sterling transaction will be the ninth merger or acquisition by your bank of another bank or its branches since the beginning of 2010.

As you know, branch closures can occur for a variety of reasons not related to regulatory costs, for example, in 2010, your bank closed 10 of the 36 branches that it acquired through the purchase and assumption agreement related to Community Bank & Trust, well before you passed the $10 billion threshold. (In another example, you closed two branches in Orangeburg, SC, after acquiring 12 Bank of America branches, reportedly because they were in close proximity to existing South State branches.)

Finally, it appears that you closed 13 of 140 branches in 2015, or about 9 percent, before you crossed the $10 billion threshold, and nine of your 127 branches last year and one so far this year, or about 8 percent of your branches. This compares to 2010, when you closed 10 of 86 branches, a rate of nearly 12 percent.

Please explain the rationale behind the 10 percent closure number that you cited, and please provide supporting evidence that explains why these closures were caused by the various $10 billion thresholds contained in Dodd–Frank, as opposed to other potential factors.

A.6. As it relates to our branch closing strategy, well before officially crossing the $10 billion asset threshold in early 2017, we began estimating the costs associated with, and resources required, to operate a bank with assets over $10 billion. Beginning approximately 3 years ago, we started examining the magnitude of these expenses and thinking through steps to pay for them. In my testimony, I stated that we closed about 10 percent of our branches in order to cover these increased costs of growing to over $10 billion. Closing branches does reduce cost and can help pay for this burden, but this step alone does not pay for the costs of crossing $10 billion. As you can see in the data above, the incremental compliance costs are approximately $6–8 million per year for our company plus we will lose approximately $17 million dollars in interchange income beginning in 2018 due to impact from the Durbin amendment. In total, we will realize an approximate $25 million pre-tax negative impact to earnings by crossing this threshold. On average, it costs us approximately $500,000 annually to operate a branch. If we were to accomplish all of the savings through branch closures alone, we would have to close roughly 50 branches and eliminate over 250 jobs. Whether we close branches or find other ways to pay for these expenses, the burden is considerable. The $25 million represents approximately 15 percent of the net income of our company in 2016.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SASSE FROM ROBERT R. HILL, JR.

[From Robert R. Hill, Jr.—We have prepared responses to many of the follow up questions submitted by Senators Brown, Sasse, and Tillis. Some of the questions pertained to banks larger than South State or touched on macro-economic issues that we did not feel equipped to answer and therefor respectfully did not supply an answer. What follows are the questions to which we do offer an answer.]

Q.3. As you know, Dodd–Frank imposed new stress test requirements on banks above $10 billion.

How should policymakers balance providing more transparency and guidance to regulated entities about passing stress tests, without enabling regulated entities to, as some have suggested, "game" these processes?

A.3. We believe that, in general, policymakers should focus on minimum acceptable capital ratios as opposed to arbitrary stress tests.

Q.4. Do stress tests accurately depict how a firm would perform during a financial crisis? If not, what should be done, if anything, to improve their accuracy?

A.4. To help improve the accuracy of stress tests, focus on the amount of risk weighted assets each firm holds would, in our opinion, be beneficial.

Q.5. Are stress tests properly tailored to match the unique risk profile of smaller financial institutions?

A.5. Stress test are currently structured based on the asset size of financial institutions and do not focus on the risk profile of the institutions. As stated above, focusing on the amount of risk weighted assets each firm holds would more properly align with the institution's risk profile.

Q.6. As you know, House Financial Services Chairman Hensarling's legislation, the Financial CHOICE act—in part—would allow banks to opt-out of various regulatory requirements, in exchange for meeting a 10 percent leverage ratio.

What are the most persuasive arguments for and against relying upon a leverage ratio as a significant means of reducing systemic risk in the financial system?

A.6. The most persuasive argument for relying upon a leverage ratio as a significant means of reducing systemic risk in the financial system is the 10 percent leverage ratio, which is a simple approach and represents a significant amount of capital. The most persuasive argument against relying on the ratio is that the leverage ratio does not take into consideration the risk rating of the assets and the loan loss reserve.

Q.7. Under this legislation, is the 10 percent leverage ratio the right level? If not, where should policymakers set the level at?

A.7. A 10 percent leverage ratio is the right level.

Q.8. What evidence do you find or would you find to be the most persuasive in discerning the proper capital levels under this proposal?

A.8. Different asset categories carrying different degrees of risk, so focusing on risk rating the assets, rather than cash and loans being equal, would seem logical.

Q.9. I'm concerned that our Federal banking regulatory regime relies upon arbitrary asset thresholds to impose prudential regulations, instead of an analysis of a financial institution's unique risk profile.

Should a bank's asset size be dispositive in evaluating its risk profile in order to impose appropriate prudential regulations?

A.9. No, a bank's asset size should not be dispositive in evaluating its risk profile in order to impose appropriate prudential regulations.

Q.10. If not, what replacement test should regulators follow instead of an asset-based test?

A.10. As a replacement test, regulators should focus on the levels of risk based capital and the amount of debt the financial institution has, as better tests for evaluating a bank's Risk Profile.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR TILLIS FROM ROBERT R. HILL, JR.

Q.1. I'm a proponent of tailoring regulations based off of the risk profiles of financial institutions, as opposed to having strict asset thresholds that do not represent what I believe is the smart way to regulate. But, my question here is really about the importance of ensuring that we have a system that is rooted in fundamental, analytical, thoughtful regulation so that we can achieve and execute on goals, whether balancing safety and soundness with lending and growth, or encouraging more private capital in the mortgage market to protect taxpayers and reform the GSEs.

On the latter point, I would like for you to comment on the downstream consequences that the wave of new mandates have on housing finance reform—whether Dodd–Frank, regulatory rules and/or Basel prudential requirements—and, specifically, the ability to bring private capital as we look to reform the GSEs?

A.1. Recent regulatory reform which specifically impacts the mortgage industry has placed a wave of burden and uncertainty on us as originators of mortgage loans. The Dodd–Frank reforms specifically limited access to credit for many borrowers. Borrowers who fit into the credit box of the GSEs are exempt from some of the QM requirements as long as the GSEs are in conservatorship or until 2021. Due to the unknown liability and litigation expenses, our bank has tightened our credit box in our portfolio lending, specifically around the 43 percent DTI.

Basel Requirements have burdened many institutions in their ability to originate new loans which they service themselves. This has forced them to sell loans to aggregators that they would desire to retain as customers and earning assets on the books. These are not large institutions and their holding of MSRs is not a driver of the performance of their institutions, however it is restricting how they do business and forcing them to send more loans to what are likely SIFI.

Other regulations such as TRID, HMDA, and other CFPB enforcement has been implemented with many questions still unanswered. This causes disparities in practices in our industry which put institutions that are playing by the rules at a competitive disadvantage. This lack of clarity has also increased the cost to originate a loan, which today is now above $7,000 where it was close to $4,000 6 years ago. This is increasing the cost to the customer and limiting competition in the mortgage space as it has driven consolidation.

Regulations should be based more on the type of lending that is done and should focus on firms who are purposely defying regulations rather than institutions afraid of clerical errors which can cost exorbitant enforcement fees and personnel costs.

GSE reform is absolutely necessary as we continue to rebuild a sound secondary mortgage market. The GSEs perform a critical task in offering a 30-year fixed option that is liquid and with clear guidelines. The GSEs have done a great job in the past few years of focusing on their customers and what can enable us to lend to more borrowers. The ability of the benefits the GSEs bring the market is imperative to continue into the future. With that said, taxpayers should not be exposed to the risk present in this market and credit risk should be transferred to the private sector. We would hope that the GSEs or their future state can continue with some mandate to offer affordable housing support with low-down payment options and less restrictive credit standards than private entities would likely offer.

Q.2. Can you give me your opinion on where the current credit box is, how consumers get loans both for personal, business, etc., how about in the mortgage space? Is it harder to get a mortgage today versus in years past?

How does this impact underserved and underbanked populations in the U.S.?

A.2. Underbanked and underserved borrowers are not being fully served today. Borrowers with little or no credit are immediately not within the credit parameters set forth by programs offered by the GSEs, FHA, and USDA. The current FICO models reward borrowers with very established credit that underbanked populations do not necessarily possess. Buyback and compare ratio risks from the agencies have forced lenders to place overlays on the agency credit parameters which limit an underserved borrower's ability to find lending options. It is critical for the FHFA to continue to promote access to these programs and find ways to encourage responsible but broad lending across the credit spectrum.

Q.3. Can you tell me how, in addition to other macroeconomic variables that affect lending, the regulatory environment has played a role in lenders' willingness/ability to extend mortgage credit? What needs to change?

I see evidence that suggests that nonbanks now make up the predominate percentage in the mortgage market, what is your view of how this affects the stability of servicing mortgages in a crisis environment and how does this affect access to financing?

A.3. Nonbanks now make up more than 50 percent of originations based on 2016 HMDA data. These loans are typically sold to SIFA institutions and large national servicers. These servicers will continue to be slow to react in a crisis and not able to meet the needs of all customers.

Nonbank mortgage lenders are typically regulated by States and do not receive the scrutiny as a federally regulated bank and enforcement for noncompliance is rare. A smaller nonbank lender offering riskier products that may be taking advantage of borrowers may never see the types of audits a bank does. A bank will err on the side of caution in order to remain in compliance while making decisions that hurts its ability to compete fairly in the marketplace.

Q.4. Just to be clear—from my perspective I'm not advocating to return to the lending standards of the sub-prime/pre-crisis era, but I do believe that we need to evaluate some the regulations such as the use of the False Claims Act, having unified servicing standards, TILA–RESPA, etc., so that we can help expand credit safely to both first-time buyers and refinancers, and I would like your perspective on how we (1) address larger regulatory reform in the banking ecosystem; and (2) how your institutions and similarly situated ones play a role in providing credit to consumers.

A.4. A bank like ours has shown through years of prudent lending, low complaints, and positive financial performance our ability to properly run our business while meeting the lending needs of the communities we serve. We agree that the lending standards pre-crisis were well below where they should have been, however the pendulum has swung too far alongside regulation by enforcement that quite frankly scares prudent lenders like us from offering anything but the basic products for our customers. The uncertainty in recent regulations has forced us to take a competitively disadvantaged position to our nonbank peers. Regulation uncertainty has also put our teams in a position to constantly question what is right or the intent of the law. Loans are taking longer to close, at a higher cost, and with more uncertainty sometimes to the borrower due to recent regulations, namely TRID.

Regulatory reform in the mortgage market should be based not just on size, but on the types of lending. The biggest help that our regulators can give us is clarity. Confusion leads us to always take the most conservative route which has downstream effects such as limited access to borrowers and higher costs to lenders.

Q.14. Are assets alone the single most important factor for determining systemic risk? If not, why use that as a threshold at all?

A.14. Yes, assets are the single most important factor for determining systematic risk, but the focus should be on the type and risk of assets rather than just the total amount of assets.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR BROWN FROM SAULE T. OMAROVA

Q.1. Can you please describe the nature of banking agencies' so-called "safety and soundness" authority? Would you be concerned by any proposals to interfere with the existing safety and soundness regime?

A.1. Ensuring "safety and soundness" of the banking system is, and has always been, the fundamental substantive goal of U.S. bank regulation. In addition to performing vital functions of taking deposits and facilitating payments, banks play a critical role in the transmission of monetary policy. Yet, the very nature of their business makes banks especially vulnerable to runs and other shocks that can quickly bring them down. Traditionally, banks' primary liabilities are short-term (e.g., demand deposits), while their assets are long-term and illiquid (e.g., loans). The concept of "safety and soundness" reflects the long-standing recognition of this built-in vulnerability of the banking business model and the importance of preserving banks' solvency and ability to operate uninterrupted.

Accordingly, Federal and State banking agencies' authority to continuously monitor, evaluate, and act to enhance individual banks'—and the entire banking system's—safety and soundness is very broad. The agencies' mandate to maintain and ensure safety and soundness permeates and underlies the entire regime of U.S. bank regulation and supervision. In that sense, it is difficult to describe precisely the scope or the specific nature of that authority. In effect, every specific rule governing banking institutions' activities represents a particular articulation of the safety and soundness requirement. Moreover, it is impossible to reduce the safety and soundness mandate to any specific, limited, quantifiable factor or rule. It empowers and obligates the regulatory and supervisory agencies to exercise an inherently context-specific judgment as to whether any particular activity, transaction, or business practice potentially threatens stable and reliable operation either of an individual bank or of the banking/financial system more generally. Most, if not all, legal rules applicable to U.S. banks expressly provide for the relevant regulators' authority to make a particularized substantive determination of permissibility or legality of an otherwise permissible action based on its potential safety and soundness consequences.

Put simply, this authority may be analogized to the medical professionals' maxim of "Do no harm." And just like any attempt to limit or qualify that principle would undermine not only the integrity but the very efficacy of medical care, so would any attempt to limit or qualify bank regulators' authority to ensure safety and soundness of the banking system undermine that system's integrity and efficacy.

Reflecting the dramatic lessons of the latest financial crisis, the Dodd–Frank Act strengthened Federal bank regulators' mandate to ensure safety and soundness of the U.S. financial system. The creation of the Financial Stability Oversight Council (FSOC), heightened prudential oversight of certain large bank holding companies (BHCs) and nonbank financial firms designated by FSOC as systemically important financial institutions (SIFIs), mandatory periodic stress testing and submission of "living wills" by large BHCs and SIFIs—all of these post-crisis regulatory innovations are merely an updated version of the centuries-old safety and soundness regime. They constitute a coherent framework for ensuring vital stability of today's complex and dynamic financial system. Regulators need all of these tools to be able to monitor the levels of risk in the financial system and to prevent potentially destructive systemic shocks. Taking away or in any way limiting regulators' and supervisors' flexibility and ability to exercise discretion in determining how and when to act in the name of the safety and soundness of the U.S. financial system would be unacceptably reckless. It will effectively guarantee another systemic financial crisis.

Any legislative reform that seeks to eliminate, limit, or weaken the Dodd–Frank Act's regime of system-wide prudential oversight, therefore, goes directly against the most important public interest in preserving the safety and soundness of the American financial system. The list of such dangerous reforms includes proposals to limit FSOC's power to designate SIFIs and the Federal Reserve's power to supervise them, to lower existing capital adequacy requirements, to make stress testing more easily predictable and thus subject to "gaming,' to replace the Orderly Liquidation Authority, and so forth. None of these proposed reforms will strengthen our financial system. To the contrary, they will make it a lot more vulnerable and dysfunctional.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR SASSE FROM SAULE T. OMAROVA

Q.1. Federal Reserve Governor Powell testified at the April 14, 2016, Senate Banking Committee hearing entitled "Examining Current Trends and Changes in the Fixed-Income Markets". He said that "some reduction in market liquidity is a cost worth paying in helping to make the overall financial system significantly safer."

Is there also a risk that reducing liquidity in the marketplace also makes the marketplace unsafe?

If so, how should regulators discern the difference between an unsafe reduction in liquidity and a safe reduction in liquidity?

A.1. There are trade-offs in every regulatory choice. For example, prohibiting distribution of marijuana protects people from serious drug addiction, but it also reduces availability of marijuana for medical or recreational purposes. How should we discern the difference between an unsafe reduction in availability of marijuana and a safe reduction in such availability? In that context, lawmakers often don't seem to spend too much time on finding the precise scientifically proven level of "safeness" and take a principled normative stand: one public policy goal is more important than the other.

The same logic should apply to this theoretical debate on "safety vs. liquidity" in financial markets. There is no objective, scientific mark for an absolute optimal level of market liquidity. It all depends on the context and the consequences. There was plenty of liquidity in the years before the latest crisis, and then that liquidity evaporated overnight. "Liquidity" was merely another word for unproductive churning and excessive speculation. It was bad for the market and for the American economy. So, clearly, we cannot use the pre-crisis "liquidity" measures as our reference point for "safe vs. unsafe" determinations. That choice is not scientific; it is fundamentally normative. We as a society should make a normative, political choice whether it is more important for us to enable uninhibited financial speculation (for which "market liquidity" is often a euphemism) or to prevent financial crises.

Q.2. As you know, regulators imposed numerous capital requirements after the 2008 financial crisis.

Have Federal regulators sufficiently studied the cumulative impact—including on liquidity in the marketplace—of these various changes?

If not, how should Federal regulators resolve this issue? For example, some have called to delay the imposition of new financial rules and regulations in order to facilitate a broader study of these issues.

A.2. Industry actors' calls for delaying the application of capital rules, ostensibly for the purposes of "studying" their impact, are merely a strategy to avoid higher capital requirements—and thus to continue to operate with high levels of leverage. There is no absolute, scientifically precise level of capital that is perfectly optimal under any circumstance. How much equity (i.e., capital) a particular bank should have at any single point depends on how volatile the value of its assets is—and that can change quickly in response to various internal business decisions and external forces in the markets. That is why, for example, countercyclical capital buffer requirements are especially important: they provide the necessary cushion for absorbing sudden losses when an asset price boom turns to the inevitable bust.

Thus, financial regulators and supervisors should have sufficient flexibility and discretionary authority to determine, on the ground and in the context of a particular institution, whether that institution has sufficient capital to withstand the loss of asset value without hurting its creditors. Regulators and supervisors are best equipped to render such determinations. They should be given a broader authority to do just that. Saddling regulators with the inherently meaningless task of studying "cumulative effects" of all capital requirements on all financial firms will effectively render them incapable of doing their job. The only real-world effect of that strategy will be more leverage, more risk, and more instability in the financial system. No real new knowledge produced as a result of any such studies will be even remotely worth that risk.

Q.3. As you know, Dodd–Frank imposed new stress test requirements on banks above $10 billion.

How should policymakers balance providing more transparency and guidance to regulated entities about passing stress tests, without enabling regulated entities to, as some have suggested, "game" these processes?

Do stress tests accurately depict how a firm would perform during a financial crisis? If not, what should be done, if anything, to improve their accuracy?

Are stress tests properly tailored to match the unique risk profile of smaller financial institutions?

A.3. I discuss the issue of stress tests' transparency at length in my written statement.

To add to that discussion, I would like to emphasize how misguided it is to judge the efficacy or public benefits of stress tests by reference to how "accurately" they depict the actual behavior of any specific firm in an actual crisis. No such predictions or assessments can be made, and that is not the purpose of stress testing.

Stress tests play out a variety of scenarios, including extreme ones, as a way of identifying serious weaknesses in the institution's financial condition and risk management. Going through the process of stress testing is just as important as passing the tests. It is that aspect of stress testing—the dynamic, learning, procedural aspect—that is critical for preserving financial stability more broadly. Forcing the Federal Reserve to be more "transparent" about its methodologies and assumptions will significantly weaken, or even eliminate, that beneficial effect of stress testing. It will only benefit financial institutions, but not the financial system—and not the American economy.

Q.4. As you know, House Financial Services Chairman Hensarling's legislation, the Financial CHOICE act—in part—would allow banks to opt-out of various regulatory requirements, in exchange for meeting a 10 percent leverage ratio.

What are the most persuasive arguments for and against relying upon a leverage ratio as a significant means of reducing systemic risk in the financial system?

Under this legislation, is the 10 percent leverage ratio the right level? If not, where should policymakers set the level at?

What evidence do you find or would you find to be the most persuasive in discerning the proper capital levels under this proposal?

If the leverage ratio was set at the right level, do you find merit in eliminating a significant portion of other regulatory requirements, as with the Financial CHOICE Act? Are there any regulations that you would omit beyond those covered by the Financial CHOICE Act?

What impact would this proposal have on liquidity in the marketplace?

A.4. A straight leverage ratio is important as a useful baseline for judging the level of capital adequacy of financial institutions. Unlike risk-based capital ratios, the leverage ratio does not allow for risk-weighting of asset values, which can be easily and dangerously miscalculated (either intentionally or unintentionally). In that sense, it provides a critical corrective to the malleable risk-based capital ratios.

As explained above, there is no scientifically derived, theoretically "perfect" level of capital for all banks at all times. True, the leverage ratio of 10 percent would be a significant improvement over the current requirement of 5 percent–6 percent at maximum. However, it is not a magical number that will somehow eliminate the need for close regulatory and supervisory oversight, stress tests, and other systemic risk-reducing measures.

To the extent we do have any sort of an "objective" benchmark for judging the functional leverage ratio levels, the market gives us a number much higher than 10 percent. A 10 percent leverage ratio is woefully low compared to the level of equity at nonfinancial firms. Thus, publicly traded nonfinancial firms typically have 30 percent–40 percent in shareholder equity on their balance sheets: i.e., their leverage ratio is in the 30 percent–40 percent range. If a company has less equity, it has to pay higher price for its debt. This is how the free capitalist market operates in the absence of a public subsidy.

Banks enjoy such a subsidy, which is precisely why they prosper with such extremely low levels of true equity. The multifaceted system of bank regulation and supervision exists as the necessary substitute for the missing market discipline. Any attempt to weaken such system of oversight will only free banks to incur more leverage and risk, and to shift the risk and the ultimate losses onto the American taxpayer. A 10 percent leverage ratio will not prevent that result. Perhaps a 30 percent–40 percent leverage ratio would, but even that is debatable.

Q.5. I'm concerned that our Federal banking regulatory regime relies upon arbitrary asset thresholds to impose prudential regulations, instead of an analysis of a financial institution's unique risk profile.

Should a bank's asset size be dispositive in evaluating its risk profile in order to impose appropriate prudential regulations?

If not, what replacement test should regulators follow instead of an asset-based test?

A.5. In my written statement, I discussed at length the reasons why it is fundamentally misleading to characterize asset size-based thresholds for enhanced prudential supervision as "arbitrary." We live with a myriad of "arbitrary" but practically necessary threshold-based rules every day: the legal age for voting is 18, the legal age for drinking is 21, and so forth. If all such numerical thresholds were deemed unacceptably "arbitrary" and replaced with "tailored" determinations of every single person's individual ability to exercise voting rights or consume alcohol, it would create a far more arbitrary, unpredictable, and chaotic world. Nobody would ever seriously propose such a "reform" in the name of "tailoring" law to every person's "unique" circumstances. Similarly, replacing clear bright-line rules by a requirement that Federal regulators assess each financial firm's unique risk profile and circumstances would be impractical and ineffective. Doing so will impose unbearable costs on the public and essentially eliminate the entire regime of enhanced oversight of systemically important financial institutions. That would be an extremely dangerous result.

A better, more pragmatic way to accommodate the inevitable differences between megabanks and smaller institutions, which currently fall into the same SIFI category, could be to allow for a discretionary downward adjustment of the intensity of the enhanced supervision regime for certain institutions, based on a combination of their size and business activities. In other words, it may be desirable to have a formalized process whereby, e.g., a traditional midsized bank with assets above $50 billion could petition the regulators for a lighter regulatory or supervisory treatment. The petitioning bank would have the burden of proving to the regulators why such special dispensation would be reasonable in its case—and why it would not create any unreasonable risks to the safety and soundness of the U.S. financial system.

This approach would properly place the burden of securing a special private benefit (lower compliance costs) on those private entities that seek it, and not on the public that finances Federal regulatory agencies. Moreover, this system would be in line with the fundamental free-market principles: the firms that want to have their own, uniquely tailored law will have to pay for it and bear responsibility for its outcomes.

RESPONSES TO WRITTEN QUESTIONS OF SENATOR REED FROM SAULE T. OMAROVA

Q.1. This Committee heard testimony last week from Professor Adam Levitin that since the Wall Street Reform and Consumer Protection Act, the cumulative pre-tax return on equity in the banking sector has been 225 percent for community banks and 320 percent for megabanks. At the same time, since 2010, real income has actually fallen by 0.6 percent for the average American family. These statistics highlight that banks, and especially large banks, have done very well in the years since the Wall Street Reform Act, while the typical American family's real income is now less than before the bill. In order to grow the economy, wouldn't pursuing policies that increase productivity and lift middle class wages be better than deregulating banks?

A.1. This is absolutely correct. To stimulate healthy long-term growth of the national economy, it is critical to ensure that the maximum number of Americans actually receive wages that are regular, stable, and sufficiently high to enable them to increase their spending—without incurring potentially dangerous amounts of debt. Higher incomes for more ordinary Americans will translate directly into higher demand for consumer goods and services, which will stimulate expansion in production of such goods and services. That, in turn, will translate into broader industrial growth, further job creation, technological innovation, and research and development. It is in that fundamental sense that, ultimately, consumer demand is the key catalyst of the Nation's economic growth.

Importantly, however, financing demand through consumer debt is an unsustainable and extremely dangerous strategy. As the financial crisis of 2007–09 demonstrated, cheap credit booms inevitably lead to wealth-destroying economic crashes. Only by lifting Americans' real income levels can we create the conditions necessary for spurring sustainable long-term growth of the American economy. Currently, Americans are forced to resort to borrowing to make up for their steadily declining real incomes, so that the aggregate consumer debt now stands at a record high of about $13 trillion. Such high debt burden, combined with stagnating wages and continuing erosion of America's manufacturing base, is bound to depress consumer demand and, as a result, hold back economic growth.

Deregulating banks will not remedy this underlying dynamic. Banks currently have plenty of cash available for lending. The real problem here is not some alleged contraction of banks' lending capacity because of regulatory compliance costs: it is the lack of effective and sound demand for credit from over-extended consumers and struggling businesses in the sluggish real economy. Deregulating banks will only enable them to use more of their money for speculative trading, shareholder dividends, and executive bonuses. It will not magically create a robust real economy that can put that cash to productive use.

Q.2. Many of us have come to recognize that the Orderly Liquidation Authority is an incredibly important part of the Wall Street Reform and Consumer Protection Act. Could you please explain why OLA is so important to our constituents, especially those who may be working multiple jobs just to make ends meet?

A.2. The Orderly Liquidation Authority (OLA) is a special new regime for handling the failure of a major financial institution. It was created in response to the financial crisis of 2007–09, which made it clear that large financial firms—banks, securities firms, insurance conglomerates, etc.—are fundamentally different from any regular private company in a free-market economy. When a nonfinancial company fails, the ordinary bankruptcy process—governed by the general Bankruptcy Code and administered by bankruptcy courts—aims to use the company's remaining assets to satisfy claims of its direct creditors: lenders, employees, suppliers, utility providers, etc.

When a large financial institution like JPMorgan or Goldman Sachs fails, however, this time-consuming court-administered process does not work as well. Large financial institutions are highly leveraged, much more so than nonfinancial firms. Their debt obligations are much more varied, complex, and difficult to value. Many of these institutions' creditors trade in financial markets and, therefore, cannot afford to wait for the bankruptcy court to decide how much money they will get from the bankrupt firm. If these trading counterparties don't get paid on time, they may default on their own obligations or try to avoid that by rapidly selling their own financial assets (such as stocks, bonds, etc.): in either case, these creditors' behavior may trigger a dangerous chain reaction. Financial institutions provide services of critical public importance: they are central to the smooth operation of the payments and clearing systems, they manage ordinary Americans' savings and investments, they insure against various risks, etc. The bankruptcy of a large financial institution threatens to disrupt performance of these functions and thus cause much unanticipated distress in the broader economy.

OLA is designed to provide a tailored approach to handling the failure of such an institution. It is simply a special version of corporate bankruptcy, which shifts the primary focus toward minimizing systemic disruptions that are likely to occur when a large, systemically important financial firm goes down. Among other things, OLA enhances the ability of the relevant Federal regulatory agencies to (1) monitor the financial condition, solvency and liquidity of all big banks, investment banks, and other financial firms; (2) mandate that all such financial firms have in place reliable plans for raising money and addressing any sudden shocks to their solvency or liquidity, before such shocks actually hit them; and (3) put in place the necessary "safety net" (i.e., access to last-resort emergency funding, international agreements with other countries' regulators, etc.) to ensure that the failure of a systemically important financial institution does not cause a major breakdown in the provision of financial services to the public.

Put simply, the OLA regime is designed to ensure that, even if a major bank is about to collapse, ordinary Americans can keep going about their daily business without worrying about accessing their cash at ATMs, having their checks cleared, getting their wages deposited and their credit card payments go through. By strengthening the resilience of the financial system to the failure of any single firm, the OLA regime is critical for preventing full-on financial crises and subsequent economic depressions. It is a well-established fact that working-class and middle-class people get hit the hardest by such crises. That means that every hard-working American directly benefits from the existence and proper functioning of the OLA regime and other complementary elements of the Dodd–Frank regulatory system. Repealing or weakening the Dodd–Frank's OLA provisions, by contrast, will weaken and expose the American economy to increasingly frequent and devastating financial crises. Therefore, it is in the interest of every hard-working American to keep the OLA regime in place.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

STATEMENT SUBMITTED BY THE INDEPENDENT COMMUNITY BANKERS OF AMERICA

ICBA
INDEPENDENT COMMUNITY
BANKERS *of* AMERICA®

June 15, 2017

Regulatory Relief for Larger Community Banks Will Promote Economic Growth

On behalf of the more than 5,800 community banks represented by ICBA, we thank Chairman Crapo, Ranking Member Brown, and members of the Senate Banking Committee for convening today's hearing on "Fostering Economic Growth: Midsized, Regional and Larger Institution Perspective."

In recent years, a historic industry consolidation has increased the average asset size of all banks. As a result, community banks have grown larger and many are now beyond the threshold of $10 billion. Yet they retain the key characteristics of a community bank: a vested interest in the success of the communities they serve, a direct knowledge of the borrower and local economic conditions, and the ability to offer customized terms to suit the unique needs of their customers. ICBA is committed to securing regulatory relief for larger community banks, which will strengthen their ability to promote local economic growth and job creation.

ICBA is pleased to offer this statement for the record which describes the larger community bank provisions included in ICBA's Plan for Prosperity.

Capital

Basel III Amendments: Restoring the Original Intent of the Rule. Basel III was originally intended to apply only to large, internationally active banks. Non-systemically important financial institutions should be fully exempt from the rule.

Amend risk weighting to promote economic development. If community banks are not fully exempted from Basel III, ICBA supports restoration of 100 percent risk weighting for acquisition, development, and construction loans. Under Basel III, these loans are classified as high-volatility commercial real estate (HVCRE) loans and risk weighted at 150 percent. ICBA's proposed change would treat these loans the same as other commercial real estate loans and would be consistent with Basel I.

Additional Capital for Small Bank Holding Companies: Modernizing the Federal Reserve's Policy Statement. The Federal Reserve Board should be required to revise the Small Bank Holding Company Policy Statement — a set of capital guidelines that have the force of law. The Policy Statement, which makes it easier for small bank and thrift holding companies to raise additional capital by issuing debt, should be revised to increase the upper asset limit from $1 billion to $10 billion. Qualifying bank and thrift holding companies must not have significant outstanding debt or be engaged in nonbanking activities that involve significant leverage.

One Mission. Community Banks.®

Repeal Collins Amendment for Non-SIFIs. The Collins Amendment to the Dodd-Frank Act (Section 171) was originally intended to equalize large bank and community bank capital treatment. In practice, however, the amendment limits regulators' discretion in implementing Basel III and has proved to be a stumbling block to simpler capital rules for community banks. ICBA supports an exemption under the Collins Amendment for non-systemically important financial institutions (non-SIFIs).

Accredited Investor Definition. Regulation D should be reformed so that anyone with a net worth of more than $1 million, including the value of their primary residence, would qualify as an "accredited investor." The number of non-accredited investors that could purchase stock under a private offering should be increased from 35 to 70.

Systemically Important Financial Institutions

More Accurate Identification of "Systemic Risk." The current threshold of $50 billion for the identification of "systemically important financial institutions" (SIFIs) under Title I of the Dodd-Frank Act is too low and sweeps in too many banks that pose no systemic risk and therefore do not need to be subject to higher prudential standards. A higher threshold and a more flexible SIFI definition under Title I would more accurately identify those institutions that pose systemic risk.

Stress Tests. Non-SIFIs should be exempt from stress test requirements. Larger community banks with assets well above the current stress test threshold of $10 billion in assets pose no systemic risk and therefore should not be required to perform costly and time-consuming stress tests. Some community banks have indicated compliance with these stress testing requirements can cost several million dollars on an annual basis.

Volcker Rule. Non-SIFIs should be exempt from the Volcker Rule prohibition against proprietary trading. Applying the Rule to non-SIFIs carries unintended consequences that threaten to destabilize segments of the banking industry.

Net Stable Funding Ratio. The asset threshold for banks subject to the rule should be raised from $50 billion to $100 billion.

Small Business Lending

Eliminate Burdensome Data Collection. ICBA supports full repeal of the statutory authority (Dodd-Frank Section 1071) for new small business loan data collection requirements. This provision, which will require the costly reporting of information regarding every small business loan application, will drive community banks out of small business lending and reduce access to credit.

Mortgage Lending

Safe Harbor for Portfolio Loans. Loans originated and held in portfolio by banks with less than $50 billion in assets, including balloon mortgages, should be granted "qualified mortgage" (QM) safe harbor status from the underwriting requirements of the ability-to-repay rule. When a community bank holds a loan in portfolio, it has a direct stake in the loan's performance and every incentive to ensure it is properly underwritten, affordable, and responsibly serviced.

HMDA Relief. A recent Home Mortgage Disclosure Act (HMDA) rule more than doubled the number of data fields lenders must report in connection with every loan application, forcing community banks to overhaul their systems and retrain staff at significant cost. ICBA supports repeal of the Dodd-Frank authority for expanded HMDA reporting. In addition, the loan-volume threshold for HMDA reporting should be increased to 1,000 closed-end mortgages and 2,000 open-end lines of credit. ICBA's recommended threshold would provide relief for many more small lenders without significantly impacting the mortgage data available to the CFPB or impairing the purpose of the HMDA statute.

Escrow Relief. Banks with assets of less than $50 billion should be exempt from escrow requirements for loans held in portfolio. Such banks have direct stake in protecting their collateral by ensuring taxes and insurance are paid on a timely basis.

Appraisals. In recent years, appraisal requirements have become more costly, and rural America is experiencing a critical shortage of appraisers. When a mortgage is held in portfolio, a bank should be able to substitute an in-house "property evaluation" for a full residential property appraisal completed by a licensed appraiser.

Preserve Community Bank Mortgage Servicing. Simplified servicing regulation would help preserve the important role of community banks in servicing mortgages and deter further industry consolidation, which is harmful to borrowers. The "small servicer" upper limit should be raised from 5,000 loans serviced to the greater of 30,000 loans serviced or $5 billion in unpaid principal balance on loans serviced.

Capital Requirements for Mortgage Servicing Rights. For banks with assets of $50 billion or less, reverse the punitive Basel III capital treatment of mortgage-servicing rights (MSRs) and allow 100 percent of MSRs to be included as common equity tier 1 capital.

Examination and Supervision

Higher Threshold for CFPB Exams. All banks with assets of $50 billion or less should be exempt from examination and enforcement by the CFPB and instead be examined and supervised by their prudential regulators for compliance with consumer protection regulation. This change would allow the CFPB to better target their resources.

Exam Cycle. A two-year exam cycle for well-rated banks with up to $5 billion in assets would allow examiners to better target their limited resources toward banks that pose systemic risk. It would also provide needed relief to bank management for whom exams are a significant distraction from serving their customers and communities.

CRA Thresholds: The Community Reinvestment Act (CRA) asset thresholds should be modernized. The "small bank" limit should be raised from $305 million to $1.5 billion, and the "intermediate small bank" limit should be raised from $1.2 billion to $5 billion. The current thresholds do not reflect consolidation in the community banking industry and should be increased. Community banks prosper by reinvesting local deposits and serving all customers in their communities. Too frequent or intrusive CRA exams are unnecessary and force banks to expend resources that could otherwise be dedicated to serving customers.

Modernizing the Bank Secrecy Act. ICBA recommends raising the currency transaction report (CTR) threshold from $10,000 to $30,000 and indexing future increases on an annual basis for inflation. The current threshold, set in 1970, is significantly dated and captures far more transactions than originally intended. A higher threshold would produce more targeted, useful information for law enforcement. In addition, beneficial ownership information should be collected and verified at the time a legal entity is formed by either the Internal Revenue Service or other appropriate federal or state agency, rather than by financial institutions. This would provide uniformity and consistency across the United States.

SEC Rules

Sarbanes-Oxley Section 404(b) Relief. Provide an exemption from internal control audit requirements for banks with a market capitalization of $350 million or less. The current exemption applies to any company with market capitalization of $75 million or less. Because community bank internal control systems are monitored continually by bank examiners, they should not have to sustain the unnecessary annual expense of paying an outside audit firm. This provision would substantially lower the regulatory burden and expense for small, publicly traded banks without creating more risk for investors.

Community-Based Funding Sources

Promote Use of Reciprocal Deposits. Reciprocal deposits allow a community bank to accept a deposit that exceeds the $250,000 insurance limit by distributing it through a network of banks and receiving reciprocal deposits from other banks in the network. This solution allows a large local depositor – such as a local government or foundation – to obtain insurance coverage and allows banks to accept an equivalent amount of deposits to support local lending.

Reciprocal deposits are defined as "brokered deposits" by the FDIC and for this reason could result in higher FDIC insurance premiums and a lower CAMELS rating for banks that hold them. Legislation is needed to provide a targeted exception for reciprocal deposits from the definition of a brokered deposit.

Studies have shown that reciprocal deposits act similarly to other core deposits: They are from local customers, earn the local interest rate, and are a stable source of funding. Because reciprocal deposits are wrongly governed by the law on brokered deposits, it is difficult for community banks to utilize their full potential.

Closing

Thank you again for convening today's hearing. ICBA encourages the Senate Banking Committee to take up legislation that embodies the provisions discussed above. We look forward to working with the Committee to craft meaningful regulatory relief for all community banks in the weeks ahead.

STATEMENT SUBMITTED BY THE AMERICAN BAMKERS ASSOCIATION

June 15, 2017

Statement for the Record

On behalf of the

American Bankers Association

before the

Committee on Banking, Housing and Urban Affairs

United States Senate

American Bankers Association

Statement for the Record

On behalf of the

American Bankers Association

before the

Committee on Banking, Housing and Urban Affairs

United States Senate

June 15, 2017

Chairman Crapo, Ranking Member Brown, and members of the Committee, the American Bankers Association (ABA) appreciates the opportunity to submit this written statement for your June 15 hearing: "Foster Economic Growth: Midsized, Regional and Large Institution Perspective." The ABA is the voice of the nation's $17 trillion banking industry, which is composed of small, midsize, regional and large banks that together employ more than 2 million people, safeguard $13 trillion in deposits and extend over $9 trillion in loans. The diversity in ABA's membership reflects the great and needed diversity of the banking system that is designed to meet the ever changing needs of our complex economy. It is this diversity that enables the industry to provide greater access to credit at lower borrowing costs to hundreds of millions of consumers, support growth and prosperity opportunities for our local, state and national economies, and support cutting edge technology that provides secure and innovative financial services.

Our members have long advocated regulatory relief and other proposals that would help the industry better serve consumers and our local communities. On April 12 of this year, we were pleased to send Committee members specific proposals in response to the joint request for ideas that would stimulate economic growth and community development.[1] Building on this, on June 8, ABA Chairman Dorothy Savarese, Chairman, President and CEO of the Cape Cod Five Cents Savings Bank, appeared before the Committee to provide testimony on the need for regulatory relief for community financial institutions.[2]

Many of the specific suggestions for regulatory and legislative reform highlighted both in Ms. Savarese's testimony last week and in our April 12, 2017 submission to the Committee are equally applicable across ABA's membership. In particular, calls for reforms that would encourage, not hinder, safe and sound mortgage lending, tailor regulations according to the risks and business model of the bank, modernize regulations governing stable deposit gathering, and better focus of Consumer Financial Protection Bureau's (Bureau's) initiatives and oversight would be welcomed by all in the banking industry.

[1] See: www.aba.com/Advocacy//ABASubmissionforCrapoBrownLegislativeProposals.pdf
[2] See: http://www.aba.com/ABATestimony060817.pdf

In testimony, and in comments to the Treasury Department and the regulatory agencies, ABA has consistently made it clear that the growing volume and complexity of bank regulation is negatively impacting the ability of banks of all sizes to meet customers' and communities' needs. That is why ABA is very pleased to further this discussion with the submission of this statement.

We agree on the need for strong regulation. Indeed, lawmakers, regulators and bankers themselves took important steps after the crisis to improve safety and soundness of the industry. But included in the more than 25,000 pages of new and proposed rules implementing the Dodd-Frank Act (DFA) are requirements that are harming the ability of banks to serve creditworthy customers and our communities.

It is encouraging to hear lawmakers of both parties and the Administration acknowledge the need for common-sense changes—regulatory calibrations that can kick-start our economy while maintaining a financial system that is safe, sound and resilient. ABA has, and continues to support, several legislative proposals as part of our Blueprint for Growth plan that would improve the regulatory environment and our overall economy. For example, ABA strongly supports:

- The TAILOR Act (S. 366), introduced by Senator Mike Rounds (R-SD), that would empower the regulators to "tailor" regulatory actions so that they apply only when required by the bank's business model and risk profile. Time and again, we hear from bankers wondering why the complex set of rules, reporting requirements, and testing that are imposed upon the largest, most diverse and global institutions become the standard applied to all institutions in the country. The key to stimulate economic growth and community development is to stop treating all banks as if they were the largest, most complex institutions. Financial regulation and examination should not be one-size-fits all.

- Bipartisan legislation (S. 828) introduced by Senators Mike Rounds (R-SD) and Mark Warner (D-VA) that would expand banks' abilities to count municipal securities as high quality liquid assets under the Liquidity Coverage Ratio. This legislation could be further improved by removing similar impediments that discourage banks from accepting municipal deposits.

Since the enactment of the Dodd-Frank Act and its statutory size thresholds, banking regulators have relied heavily on the single criterion of asset size of financial institutions as a proxy for systemic risk, creating regulatory "cliffs" whereby all institutions over a certain size are regulated and supervised the same. We have seen this not only with regulations specifically implementing the DFA, but more broadly in all areas of prudential supervision. Although size-only regulation may be a simpler method for supervising financial institutions, it is inappropriate and needlessly burdensome for many financial institutions with noncomplex operations and business models, thereby increasing costs and reducing products and services available to bank customers. In short, economic growth in our communities suffers.

As noted, our industry is composed of small, midsize, regional and large banks. Some hold state charters, others national charters. Some are commercial banks, others savings associations. Some are publicly owned, others family-owned, and still others are mutually owned by their customers. Some are diverse in their specialization, from agriculture banks, to trust companies, to wealth management, to banks that emphasize business lending. Unfortunately, the trend in bank regulation over the last several years has been to standardize or homogenize the industry in many instances, making banks look more and more alike, when in fact the U.S. has a highly diversified industry—diversity that is necessary and desirable for supporting our highly diversified $19 trillion economy.

For example, the provisions in the DFA labeling all banks with $50 billion or more in assets as "Systemically Important Financial Institutions" or SIFIs, were put in place without consideration of the diversity in business models—and risk posed—of the financial institutions. In fact, the roughly 38 financial institutions that currently qualify as SIFIs differ significantly in asset size ($63 billion to over $2.5 trillion), scope of business activities, corporate structure and global reach and impact. This diversity of risk and business model, and the inappropriateness of regulating these institutions in the same manner, has led former Federal Reserve Board Governor Daniel Tarullo and former House Financial Services Committee Chairman Barney Frank (D-MA) to comment on the arbitrary nature of the $50 billion threshold for SIFIs and recommend that it be reconsidered.

Aside from this threshold, there are a host of other new regulatory requirements that apply to banks that cross the $10 billion asset threshold that are equally as arbitrary and unnecessary—such as stress testing and additional examination from the Bureau. Moreover, although the DFA and implementing regulations do provide some discretion for tailoring certain regulatory requirements, the regulators more often than not have increased the use of thresholds rather than put that discretion to use. For example, in a recent Advanced Notice of Proposed Rulemaking several agencies proposed subjecting financial institutions with more than $50 billion in assets to greater cybersecurity compliance requirements regardless of the risks posed by a potential breach of its systems to the financial system—unnecessarily covering many regional banks.[3]

"Tailored" Regulation is the Best Solution

Legislation has been introduced to increase many of these thresholds, and in the short-term this may provide relief for some institutions, but thresholds of any type are arbitrary and a poor substitute for effective regulatory policy. Rather than adding more thresholds, what is needed are better overall principles for bank regulation. The best solution is to tailor regulations according to the risks and business model of the bank. This is the most effective model for bank regulation because it encourages diversity of business models while

[3] See: https://www.occ.gov/news-issuances/news-releases/2016/nr-ia-2016-131a.pdf

providing a regulatory program best adapted to the risks of each bank. Pending legislative action, the regulators should use their discretion under current law to tailor regulations appropriately.

As the report *A Financial System That Creates Economic Opportunities Banks and Credit Unions* released on June 12 by the Treasury Department notes, effective financial regulation should focus on risk rather than solely the size of the institution: "Most critically, regulatory burdens must be appropriately tailored based on the size and complexity of a financial organization's business model and take into account risk and impact."[4] ABA supports the Treasury Department's conclusion, and believes it is imperative that regulations be tailored to the size and complexity of the institution's business model.

We will encourage the Treasury Department and the prudential regulatory agencies to apply these principles to both existing rules and new regulatory initiatives moving forward. In particular, ABA has called for a review and reform of basic capital and liquidity regulations which affect banks throughout their operations and have a profound impact on the overall economy.[5] The requirements for capital and liquidity affect both the amount of financial services banks can provide and the form that these services take. Unnecessary or arbitrary requirements ultimately limit the economic growth and prosperity opportunities for our local, state and national economies.

Many useful ideas for better tailoring the scope and design of the regulatory framework now in place are offered in the Treasury report for consideration and implementation by the bank regulatory agencies. These include recommendations regarding adjustments to capital rules that carefully focus on risk, revising the calculation of liquidity to avoid future liquidity stresses, simplifying the process of producing and reviewing living wills so that banks can focus on the business of banking, and refining the Volcker Rule to better target the risky activity sought to be limited. We look forward to working with the Treasury Department and the banking agencies to craft better approaches to achieving regulatory safety and soundness objectives without jeopardizing banks' role in economic activity.

Legislative Proposals to Improve the Regulatory Environment

Even if progress can be made on the regulatory front, in many cases legislative changes will be necessary. As the Committee moves forward in considering regulatory relief legislation, in addition to Senator Rounds's TAILOR Act (S. 366) and the bipartisan legislation introduced by Senators Rounds and Warner (S. 828), ABA encourages you to consider the following:

- Rep. Blaine Luetkemyer's (R-MO) Systemic Risk Designation Improvement Act (H.R. 6392, 114th Congress) which would authorize the Federal Reserve Board to subject a bank holding company to

---

[4] See: https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf Page 9
[5] See: http://www.aba.com/Issues/Documents/ABA-White-Paper-Regulatory-Capital-Standards.pdf and See http://www.aba.com/Advocacy/LetterstoCongress/Documents/LiquidityReport-ABA-March2017.pdf

enhanced supervision and prudential standards if it makes a final determination that material financial distress at the bank holding company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of its activities, could threaten the financial stability of the United States. This legislation would provide a true risk-based analysis to systemic importance determinations and would ensure that regulatory supervision is appropriately tailored to a financial institution's risk profile.

- S. 1139, introduced by Sens. Jon Tester (D-MT), Jerry Moran (R-KS), and Heidi Heitkamp (D-ND) would provide relief from the DFA stress tests, reducing the mandated frequency of testing for all institutions and removing many from the stress test process altogether. The DFA, without real analysis, inserted artificial asset thresholds within the regulatory system. ABA has long sought reform of the stress test process as it imposes excessively heavy burdens on institutions for which stress tests are superfluous or not well suited. The legislation takes a critical first step to reform this process and we urge the Committee to do more to broaden this relief further.

- In addition, as you review DFA, we would urge you to examine Section 1071. This section of DFA requires the Bureau to prescribe rules for collecting and reporting data on lending to minority-owned and women-owned small business. Unfortunately, this data collection—similar to the data collected under the Home Mortgage Disclosure Act—over-simplifies the nature of the small business lending environment, and will mislead community leaders, government entities and creditors from identifying the business and community development needs and opportunities for local small businesses. Moreover, there has been no analysis of whether this new data collection duplicates existing data on small business lending collected by the Small Business Administration (SBA) and the banking agencies pursuant to the Community Reinvestment Act. Perhaps, most troubling is there has been no analysis of its impact on economic growth given the potential negative effects this may have on a local community. The considerable burdens associated with this data collection and reporting regime would add significant costs and unnecessary red tape to small business lending, discouraging a primary engine for economic growth. Compliance with this rule will impede the individualized approach banks take when lending in their local communities due to potential fair lending liability concerns.

  A full repeal of this Section 1071 is warranted. Absent this, the Bureau and the SBA should be required—before the Bureau is authorized to prescribed any rule for collecting and reporting loan data—to conduct a joint-study to determine whether the proposed collection would be duplicative of existing data collections and to determine whether the costs for such data collection exceed potential benefits. The agencies should also be required to submit a report to Congress on their findings along with their recommendations, if any, for prescribing rules for the collection and reporting of minority-owned and women-owned small business loan data.

- Legislation that streamlines the rules for Currency Transaction Reporting by establishing an exception for very well-known customers and raising the current threshold for filings from $10,000 to $20,000.

<u>Conclusion</u>

Rules and requirements surround every bank activity. When it works well, bank regulations helps ensure the safety and soundness of the overall banking system. When it does not, it constricts the natural cycle of facilitating credit, job growth and economic expansion. Finding the right balance is key to encouraging economic growth and prosperity.

We are now in the eighth year of post-DFA regulation; more than 25,000 pages of new and proposed regulations have been promulgated since enactment of this law covering capital, liquidity, risk-management, stress testing, failure resolution, business processes, compensation, loan-loss reserves, as well as rules and standards for specific product lines, such as mortgages and derivatives. Taken together, and with the experience of several years of application of the new regulatory regimes, it is clear that there have been negative unintended consequences impacting consumers and the economy. It is appropriate for Congress to review bank regulations, particularly the DFA, before the unintended consequences become impossible to reverse.

ABA hopes that you will consider the legislative proposals and other recommendations included in this statement as part of your overall regulatory relief effort. We look forward to working with you and members of the Committee to enact legislation that will ensure the banking industry's ability to facilitate economic growth and prosperity.

Thank you for the opportunity to express the views of the American Bankers Association.

STATEMENT SUBMITTED BY FIFTH THIRD BANK

FIFTH THIRD BANCORP

Greg D. Carmichael
President & CEO

June 14, 2017

The Honorable Mike Crapo
U.S. Senate
239 Dirksen Senate Office Building
Washington, DC 20510

The Honorable Sherrod Brown
U.S. Senate
713 Hart Senate Office Building
Washington, DC 20510

Dear Chairman Crapo and Ranking Member Brown:

Thank you for holding a hearing entitled, "Fostering Economic Growth: Midsized, Regional and Large Institution Perspective" on June 15th, 2017. I respectfully ask that this letter be entered into the Congressional Record in connection with the June 15th hearing.

Incidentally, June 15th also marks Fifth Third Bank's 158th anniversary in Ohio. Fifth Third Bank is proud to call Ohio home. Our team members live, work and raise families here. Within our 10-state footprint, we bank close to 4 million consumer households, employ over 18,000 thousand people, and have financed millions of homes.

We are committed to our communities as demonstrated by Fifth Third's landmark announcement of a five-year, $30 billion commitment to low- and moderate-income borrowers and communities from 2016 to 2020. This agreement, which is the largest community development plan initiated by a regional bank in recent history, includes $11 billion in mortgage credit access, $10 billion in small business loans, and $9 billion in community development lending and investments such as affordable housing and pre-development loans. To best ensure that this $30 billion allotment positively impacts the communities we serve, Fifth Third has also formed six community advisory forums to facilitate an open dialogue with local community leaders. To date, Fifth Third has already lent or invested nearly $8 billion, putting us on pace to exceed our goals by the end of 2020. In addition, Fifth Third has committed $158 million in community programming initiatives, including $93 million in philanthropic donations and sponsorships, $23 million for new branches in low- and moderate-income or high minority communities, and $20 million in housing related investments.

Regional banks use customer deposits to fund lending to local consumers and businesses. We operate in a specific region, usually in a small group of states, connecting with local leaders, employers, and consumers. Nonetheless, our traditional community-based business model has been threatened by a one-size-fits-all regulatory regime that emerged out of Washington in the aftermath of the financial crisis. However well intentioned, the existing regulatory framework has resulted in three key unintended consequences by: (1) limiting our ability to offer innovative and beneficial products and services for our customers, (2) giving an unfair advantage to less regulated financial services providers and creating more risk for the financial system as a whole, and (3) failing to appropriately distinguish less complex regional banks from large complex financial institutions.

Each of these unintended consequences individually results in a drag on economic growth through unrealized lending and constrains innovation by regional banks. In the aggregate, these unintended consequences are making our financial system more risky by shifting traditional banking activities such as lending to less regulated non-bank entities. While we do not believe that was the legislative intent behind the laws that got us here, it certainly is the regulatory outcome and the reality we face in our business every day.

Inability to offer certain products and services. The current regulatory framework and the design of stress testing leaves the regulated entities in the dark about how the regulators model credit risk, creating uncertainty and reducing regional banks' capital allocation to expand lending in certain areas. This has been particularly troubling for small business credit. While small businesses are the primary source of job formation in the economy creating two out of every three new jobs,[1] research conducted by the National Federation of Independent Business revealed that 60 to 70 percent of small business customers are unable to secure the financing they need from traditional lenders.[2] Whereas in the past regional banks have relied on deep relationships with small business clients to make lending decisions, regulators now focus on single loan arrangements without taking into account those broader relationships.

That is just one example of how the post crisis zero-tolerance regulatory environment limits the ability of regional banks to develop and offer new product and service solutions to our customers. As a result, certain product offerings are moving to sectors that have higher cost of capital and limited regulatory oversight.

Increased systemic risk. Regional banks' business models rely on community connections and a broad set of information to assess risks associated with our customers' transactions. This consumer- and community-focused banking tends to create a more stable financial outcome in stressed environments and reduce overall risk in the financial system. The regulatory focus on risk exposures associated with single products ignores the deep relationships we have with our borrowers which gives us a distinct advantage to manage risk compared to single product non-bank lenders and even much larger banks. The reliance of non-bank entities on capital markets for their funding needs creates pro-cyclical liquidity risk that is counter to the fundamental benefit of an insured depository system. When regional banks retreat from certain banking relationships, the ensuing inefficiencies in capital allocation negatively impact economic growth and lead to increased systemic risk.

Failure to distinguish regional banks. Regulations that treat regional banks similarly to the large Wall Street banks are fundamentally flawed. In size alone, the assets of just one Wall Street bank equal that of 20 or so regional banks.[3] Our risk models are exponentially different: according to a 2015 study by the Office of Financial Research at the U.S. Treasury Department, Fifth Third Bancorp is 50 times less systemically risky than the largest Wall Street bank.[4]

---

[1] *See* generally, U.S. Department of Labor, Bureau of Labor Statistics at https://www.bls.gov, and Small Business Administration, Office of Advocacy at https://www.sba.gov.
[2] *See* generally, the National Federation of Independent Business at https://www.nfib.com.
[3] *See* U.S. Treasury Department, Office of Financial Research at https://www.financialresearch.gov/briefs/files/2015-02-12-systemic-importance-indicators-for-us-bank-holding-companies.pdf
[4] *Id.*

As a community lender and service provider, we do not believe that an artificial $50 billion threshold to automatically make banks like Fifth Third systemically important and subject to enhanced prudential regulation is warranted. A regulatory framework based on the nature, scope, size, scale, concentration, interconnectedness, and mix of bank activities would be a more appropriate measure.

As both the U.S. Congress and U.S. Department of Treasury take renewed interest at how regional banks are regulated, our request is simple: please let us serve our customers and communities without the added burden of regulations that are unnecessary or inappropriately designed for our business model. A tailored regulatory framework would allow us to continue doing the right thing for our customers, lending to businesses that grow the economy, and creating jobs for local communities. We welcome an opportunity to engage with you on these issues.

Thank you for your consideration.

Greg D. Carmichael
President and CEO
Fifth Third Bancorp

BCBS Systemic Importance Indicators Reported by Large U.S. Bank Holding Companies ($ billions)*

Bank Holding Company	Size	Interconnectedness			Substitutability			Complexity			Cross-Jurisdictional Activity		2013 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.	3,570	422	544	599	321,458	21,320	508	68,004	446	69	693	674	5.05
Citigroup Inc.	2,895	421	513	596	300,783	11,096	331	59,472	130	46	839	742	4.27
Bank of America Corp.	2,696	294	220	489	83,705	136	390	54,887	203	32	387	246	3.06
Wells Fargo & Co.	1,961	110	129	508	28,761	2,400	86	4,880	128	37	70	130	1.72
Goldman Sachs Group, Inc.	1,518	337	107	310	9,585	866	371	50,355	138	43	347	319	2.48
Morgan Stanley	1,283	535	182	231	9,812	1,369	262	43,611	316	23	353	470	2.60
U.S. Bancorp	525	11	22	139	6,918	959	17	106	13	4	3	34	0.35
PNC Financial Services	425	18	13	68	2,004	161	10	252	25	11	5	2	0.30
Bank of New York Mellon Corp.	410	79	230	61	166,279	23,590	6	1,158	39	0	87	164	1.50
HSBC N.A. Holdings Inc.	406	36	55	50	1,061	43	49	5,194	40	4	43	1	0.38
State Street Corp.	345	30	209	43	59,122	20,411	-	1,141	54	8	47	125	1.48
Capital One Financial Corp.	336	14	2	94	914	3	2	63	16	4	9	2	0.19
TD Bank U.S.	277	15	5	8	2,393	10	-	151	18	2	35	1	0.14
SunTrust Banks, Inc.	229	3	1	50	644	64	11	183	15	3	2	2	0.14
BB&T Corp.	212	1	10	69	972	35	6	59	4	2	1	1	0.12
American Express Co.	177	7	37	162	144	-	-	42	4	-	30	20	0.17
Fifth Third Bancorp	174	4	9	38	1,187	240	5	64	7	0	4	1	0.10
BMO Financial Corp.	163	16	1	26	5,245	257	8	22	11	0	7	6	0.12
Ally Financial Inc.	153	6	17	108	290	-	-	62	9	0	2	2	0.11
UnionBanCal Corp.	146	10	6	20	1,058	120	-	64	8	2	2	3	0.09
RBS Citizens Financial Group, Inc.	146	4	4	1	2,816	7	-	43	1	0	2	1	0.05
Regions Financial Corp.	146	1	7	27	755	22	45	74	5	0	1	0	0.11
Northern Trust Corp.	142	44	12	16	32,997	5,576	-	255	12	0	28	51	0.49
Key Corp.	134	6	1	26	984	82	5	62	2	3	2	0	0.08
M&T Bank Corp.	105	2	5	22	1,594	101	26	21	1	0	0	0	0.08
Bancwest Corp.	103	1	8	12	443	3	-	16	1	0	1	1	0.04
BBVA Compass Bancshares, Inc.	101	4	2	13	199	3	80	18	1	0	1	2	0.12
Santander Holdings USA, Inc.	98	4	0	12	24	-	-	18	12	0	4	1	0.05
Comerica Inc.	98	8	4	17	246	53	1	21	2	0	2	2	0.05
Discover Financial Services	96	7	0	74	321	-	-	12	1	0	0	0	0.06
Zions Bancorp.	75	3	3	11	437	3	0	3	3	1	0	2	0.04
Huntington Bancshares Inc.	65	2	0	16	303	80	1	8	3	1	1	-	0.04
Deutsche Bank Trust Corp.	64	20	26	12	58,495	-	-	14	0	0	4	0	0.20

* Basel Committee on Banking Supervision
Sources: Company Y-15 reports, OFR analysis

STATEMENT SUBMITTED BY THE INSTITUTE OF INTERNATIONAL BANKERS

INSTITUTE OF INTERNATIONAL BANKERS

299 Park Avenue, 17th Floor
New York, N.Y. 10171
Direct: (646) 213-1147
Facsimile: (212) 421-1119
Main: (212) 421-1611
www.iib.org

Sarah A. Miller
Chief Executive Officer
E-mail: smiller@iib.org

June 14, 2017

The Honorable Mike Crapo
Chairman
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

The Honorable Sherrod Brown
Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate
Washington, DC 20510

Dear Chairman Crapo and Ranking Member Brown:

In relation to the Committee's upcoming hearing on Fostering Economic Growth: Midsized, Regional and Large Institution Perspective, the Institute of International Bankers (IIB)[1] would like to share its views on the application of the enhanced prudential standards ("EPS") prescribed under Section 165 of the Dodd-Frank Act to internationally-headquartered banks ("international banks") with operations in the U.S. Of particular concern, interpreting the $50 billion "total consolidated assets" test prescribed by Section 165 (the so-called "SIFI Threshold") to require application of EPS based on an international bank's *global* total consolidated assets has significantly adverse consequences for international banks and their ability to participate in U.S. markets, serve U.S. businesses and consumers, and contribute to U.S. economic growth. These effects are exacerbated by the manner in which the EPS have been implemented through Subparts L through O of the Federal Reserve's Regulation YY.[2]

Measuring the SIFI threshold on the basis of international banks' global assets has resulted in four times as many international banks being subject to Section 165 EPS than U.S.-headquartered bank holding companies ("BHCs") – approximately 110 international banks are

[1] IIB represents internationally-headquartered banks with operations in the U.S. Our members' U.S. operations perform a vital role in providing credit to U.S. businesses and liquidity to U.S. financial markets. Collectively, our members' U.S. operations hold approximately $5 trillion in bank and nonbank assets, fund 27% of all commercial and industrial bank loans made in the United States, constitute three of the top ten U.S. agriculture lenders and funded 71% of U.S. infrastructure loan volume over the last five years. Our members contribute to the employment of hundreds of thousands of employees in the United States, in the financial sector and related service sectors. As providers of credit and other financial services in the United States, our members add diversity and competitiveness to the U.S. financial services markets, help U.S. businesses grow and promote U.S. and international financial stability.

[2] 12 C.F.R. §§ 252.120 – 252.158.

INSTITUTE OF INTERNATIONAL BANKERS

subject to EPS in some form, compared to 26 U.S. BHCs.[3] Of these 110 foreign banks, 59% (65) have less than $10 billion in assets in their combined U.S. operations ("CUSO") and 79% (87) have CUSO assets of less than $50 billion. This is particularly concerning as the SIFI threshold was created to "to prevent or mitigate risks to the financial stability of the United States . . .".

The overinclusion of international banks, results in their spending considerably more time complying with EPS than is warranted or necessary in light of the risks they pose to U.S. financial stability. For example, all of these international banks are required to file a living will, even though many have no "critical operations" in the U.S., and their "material entities" are inconsequential to the financial stability of the United States. This approach serves to divert resources from lending and financial market activities that support U.S. economic growth.

The impact is especially profound for international banks required to establish a U.S. intermediate holding company ("IHC") to hold all of their U.S. bank and nonbank subsidiaries. The IHC is then subjected to capital, liquidity, stress test, risk management and related requirements under generally applicable rules.

For those international banks subject to the IHC requirement, the creation (i.e., restructuring of their U.S. non-branch operations) to form an IHC resulted in considerable cost. However, it is the application of capital, liquidity and stress testing standards applied to the IHC on a standalone basis that has had an even greater impact. These requirements also serve as a deterrent to other international banks (not currently required to form an IHC) expanding their U.S. operations.

We have seen a decline in the U.S. assets of international banks of approximately $500 billion in 2015. We estimate a further decline in their U.S. assets of approximately $150 billion in 2016. While this decline is attributable to the application of EPS to international banks in general, it is more acute with respect to those international banks required to form an IHC.

Requiring an international bank's IHC to meet capital and liquidity standards in the U.S. on a standalone basis (without regard to the capital held by the parent) is duplicative of home-country requirements. It effectively "ring-fences" the U.S. bank and nonbank operations of an international bank's IHC in the United States, and causes international banks to hold even higher consolidated capital. In this regard, the impact is greater than on U.S. BHCs which are not "ring-fenced" and are able to apply the enhanced capital and liquidity requirements under Section 165 on the basis of their global operations. These requirements have resulted in international banks

[3] It is frequently stated that there are a total of 38 banking organizations covered under Section 165. This figure is based on the 26 U.S. BHCs and the 12 U.S. intermediate holding companies, which international banks with $50 billion or more in U.S. non-branch assets are required to establish under Regulation YY and ignores the large number of international banks with less than $50 billion in U.S. non-branch assets that have global assets of $50 billion or more and therefore also are covered.

INSTITUTE OF INTERNATIONAL BANKERS

withdrawing assets, personnel and product offerings from the U.S. market. And rather than increasing financial stability, it arguably has worked to undermine it as a result of less diversity and greater concentration in U.S. markets.

As we indicated in our letter to you of April 14, 2017 in response to the Committee's call for proposal to foster economic growth, IIB supports:

- modifying both the threshold for application of the Section 165 EPS and the application of the standards themselves to more accurately reflect the risk a firm poses to the U.S. financial system; and

- with respect to international banks, basing these assessments on their U.S. operations.

Importantly, these approaches are reflected in the recommendations included in the report released by the Treasury Department on June 12th pursuant to Executive Order 13772.

We appreciate your consideration of our views and would welcome the opportunity to discuss them with you further.

Sincerely,

Sarah A. Miller

Sarah A. Miller
Chief Executive Officer

STATEMENT SUBMITTED BY TEXAS CAPITAL BANK

Statement for the Record
Keith Cargill, President and CEO
Texas Capital Bank
before the
Committee on Banking, Housing, and Urban Affairs
of the
United States Senate
June 15, 2017

Thank you for holding this hearing on the role midsized financial institutions play in the U.S. banking system. I am the President and CEO of Texas Capital Bank, a mid-sized bank focused primarily on serving the needs of privately-owned/family-owned middle market commercial businesses in Texas. Our headquarters is in Dallas, with offices in Austin, Fort Worth, Houston, and San Antonio. In addition to serving our commercial customers in Texas, we operate four national lines of business that provide specialized products to customers in Builder Finance, Lender Finance, Mortgage Finance, and Premium Finance.

Founded in 1998, our business model is focused on organic growth, credit quality, and recruiting and retaining experienced bankers with strong personal and professional relationships in the community. We have benefitted from the success of our model since inception, producing strong loan growth and favorable loss experience amidst a challenging environment for the banking industry nationally. We started with $80 million in start-up capital, and through organic growth, we are now a $20 billion asset bank. We are proud of our success in helping our customers succeed, but lament that the regulatory environment post-Dodd-Frank Act has inhibited our ability to even better serve our customers.

We are an active member of the Mid-Size Bank Coalition of America (MBCA), a segment of financial institutions that are invaluable to our economy. Our banks are large enough to finance investment that is beyond the scope of most community banks and credit unions, but unlike the largest institutions, we are committed to serving local and mid-size businesses.

Our portfolio, like many other MBCA members, is focused on lending to this vital business segment which accounts for most of the job growth in the United States. It is imperative that we be permitted to compete on a level playing field with Wall Street and larger regional banks to ensure this segment of the economy is well served. For the largest institutions, the extensive and costly regulatory Dodd-Frank provisions are less burdensome and therefore disadvantage us in competing in the market place as we strive to serve this important customer segment. Application of these onerous standards to mid-size banks is not justified from a systemic risk standpoint and it creates a material financial hardship and competitive disadvantage.

Six years ago, we made the decision to affirmatively engage in the federal policy arena to be a voice for our clients and to advocate for streamlined policies that provide for a robust economic climate. This includes reducing regulatory burdens across all industries. Most of our clients are enjoying healthy economic outcomes, but the legislative gridlock and uncertain regulatory environment are impinging on their growth – they do not feel confident enough in the future economic climate to invest in new hires, equipment, and technology. Many of the Members of this Committee on both sides of the aisle are committed to easing these burdens on small and mid-size businesses, and we applaud your work in this area.

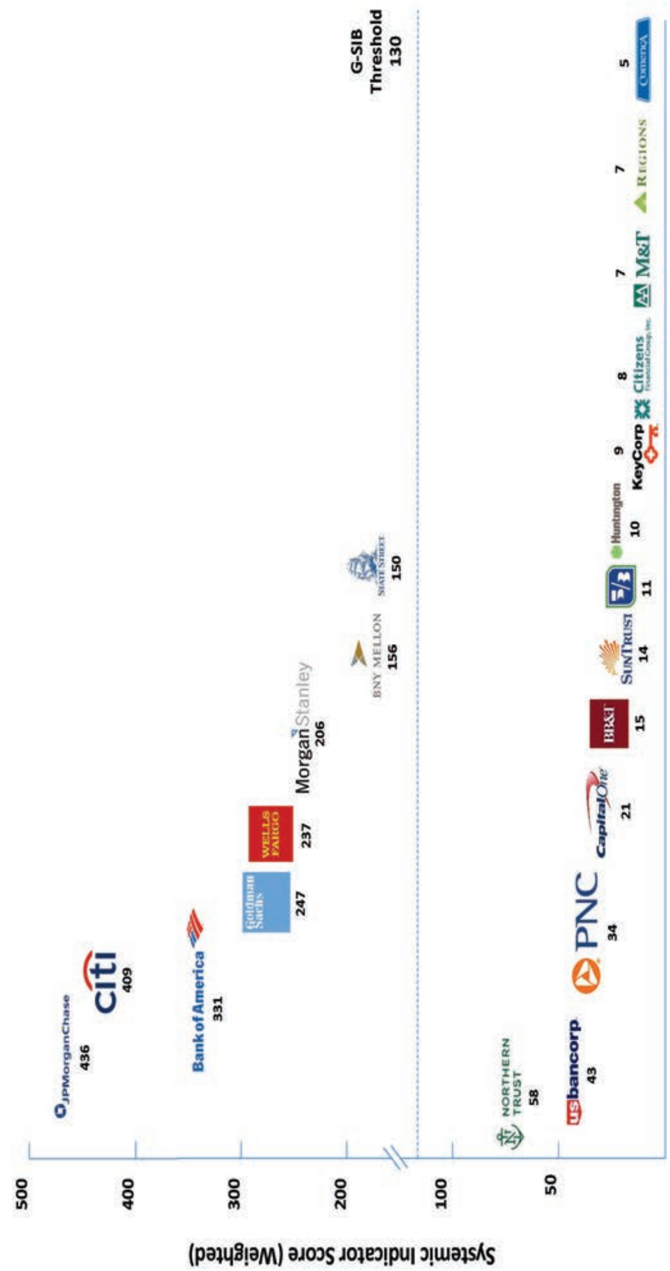
We are also appreciative of this Committee exploring, on a bipartisan basis, economic growth initiatives within its jurisdiction and holding this and other hearings to vet a myriad of proposals to foster growth. As an MBCA member institution, we echo the concerns articulated by Mr. Hill about "arbitrary thresholds" and the very material costs imposed on institutions when those lines are approached or crossed. We agree that a top priority for the Committee should be increasing the $10 billion threshold for CFPB examination authority of "very large banks" in sections 1025 and 1026 to $50 billion. We are currently subject to examinations and audits from five separate regulators, many of which perform overlapping examinations and audits. As a predominantly commercial lender, almost none of our portfolio involves direct to consumer lending.

In addition to the provisions highlighted in Mr. Hill's testimony, we would respectfully ask the Committee to consider a significant increase in the SIFI designation of $50 billion in assets. Although almost all MBCA institutions are significantly below $50 billion in assets, most of us, including Texas Capital Bank, are de facto held to the costly and time consuming enhanced supervision level. This is a function of "regulatory creep" whereby regulators assume a "best practice" or overly conservative default posture, applying those more stringent standards. Mid-size banks in this country are not "systemically important." Indeed, if any of us were to fail, our clients would be impacted, but that would be the extent of any economic fallout.

We strongly urge the Committee to explore increasing the SIFI cap to the highest possible amount, but at a minimum, to raise the amount to no less than $150 billion, and to apply the higher new cap as a clean floor for SIFI designation. We oppose an alternative activities-based test because, if given discretion to evaluate risk using somewhat subjective criteria, the same dynamic that we have currently experienced with the SIFI threshold would likely be present with an activities-based test. The natural instinct of regulators will be to assume a very conservative position in this regard, and we fear the ultimate outcome would be uneven and limited relief. The Committee may wish to explore an increased hard cap coupled with an activities-based standard for institutions with assets above the new SIFI threshold, but in our experience, it is imperative that there is a firm numerical threshold for mid-size and community banks.

Thank you for the opportunity to submit this statement and we look forward to working with the Committee to identify proposals to help foster economic growth.

GSIB SCORES



Source: Systemic indicator scores are estimated using the Method 1 Approach under the Federal Reserve's GSIB surcharge rules and data reported on the Federal Reserve's Banking Organization Systemic Risk Report (FR Y-15) as-of September 30, 2016. Denominators are USD as-of December 31, 2015.