TESTIMONY

OF

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BEFORE THE

UNITED STATES SENATE

COMMITTEE
ON
BANKING, HOUSING, AND URBAN AFFAIRS

HEARING ON

EXAMINING THE REGULATORY REGIME
FOR REGIONAL BANKS

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

The Dodd-Frank Act contains significant reforms that are designed to stabilize and improve the functioning of our financial institutions, financial markets and the markets for financial products and services. These reforms have been supplemented by changes in capital requirements under Basel III. A key focus of these efforts has been to eliminate the phenomenon of financial institutions that are "too big to fail." These institutions must be "bailed out" in times of trouble by the federal government in order to prevent "systemic" problems in the financial system. Historically, federal government intervention in support of

private-sector financial institutions has been limited. In the recent financial crisis, the federal government's actions may be more properly characterized as attempts to stabilize markets as opposed to bailouts of individual institutions. However, individuals often have a negative, visceral reaction to bailouts because they perceive them to be unfair, and policy makers understand that bailouts can create a moral hazard that erodes private market discipline.

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

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

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

> With regard to Continental Illinois, the regulators' greatest concern was systemic risk, and therefore handling Continental through a payoff and liquidation was simply not considered a viable option. Continental had an extensive network of correspondent banks, almost 2,300 of which had funds invested in Continental; more than 42 percent of those banks had invested funds in excess of $100,000, with a total investment of almost $6 billion. The FDIC determined that 66 of these banks, with total assets of almost $5 billion, had more than 100 percent of their equity capital invested in Continental and that an additional 113 banks with total assets of more than $12 billion had between 50 and 100 percent of their equity capital invested.[1]

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

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

Domino risk and panic risk are not necessarily independent of each other. For example, domino risk can itself create or feed a panic. While the failure of

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

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

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

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

Macroeconomic stability is a key goal of prudential regulation. The economic and human consequences of the recent financial crisis and prior financial crises have been enormous, resulting in devastation that can last for years or even generations. Simply refusing to intervene to stabilize the financial system during a financial crisis may not be an acceptable policy choice. At the same time, short-term fixes to prevent or contain an economic meltdown, such as a bailout, can

diminish market discipline and increase risk taking by individual institutions and their counterparties. This erosion of market discipline, or moral hazard, can itself lead to future crises. Ideally, we should foster robust financial institutions and encourage prudent risk taking that reduces the likelihood of future stress and, at the same time, increases financial institutions' ability to withstand the stresses that do arise.

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

Legislators and regulators have attempted to balance these considerations for some time, but a proper equilibrium has proved elusive so far. Dodd-Frank, which was shaped by the experiences of the recent financial crisis, is an effort to recalibrate with a distinct focus on reducing the potential for individual institutions to create systemic problems. One of the main tools in Dodd-Frank that will be used to address systemic risk is the prudential standards for bank holding companies with total consolidated assets of greater than $50 billion established under Section 165. These standards are meant to increase in stringency based on a list of specified factors and other risk-related factors that the Board will consider. In establishing these standards, the Board can differentiate among companies based on their size, complexity and other factors, and, pursuant to recommendations of the Financial Stability Oversight Council, the Board can establish assets thresholds

above $50 billion for the application of some, but not all, of these enhanced prudential standards.

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

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

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

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

Nevertheless, a more bespoke approach to the application of Section 165 and other regulatory requirements does not solve the issue of what the appropriate thresholds are for such requirements to kick in. Bank supervision should always

be, and has historically been, tailored to the risk profiles of specific institutions. As such, special requirements aimed at financial stability and the elimination of "too big to fail" should have limited application for several reasons. First, the identification of an institution as systemically important carries with it the moral hazard that the identified institutions will enjoy a halo effect—that market participants will be more willing to transact with such an institution because of the belief that it will not be allowed to fail. Counterparty confidence based on an institution's reputation for prudential standards is healthy, but confidence based on the perception that an institution will be bailed out by the government is not desirable.

Second, empirical data based on the BCBS risk factor information collected by the Board suggest that the systemic risk scores of banking organizations with over $50 billion in consolidated assets in the United States vary greatly. A study by the Office of Financial Research, which was created by the Dodd-Frank Act, shows scores that vary by a factor of over 125, ranging from 0.04 to 5.05.[4] Moreover, there is a sharp inflection point at around a score of 1.5. The ninth highest scoring banking organization scored 1.48, but the tenth highest scoring bank only scored 0.49. The next highest scoring banking organization scored 0.38. These scores include cross -jurisdictional activity, which may not be as significant in measuring potential effects on U.S. financial stability. The dramatic differences in systemic risk scores suggest that the number of systemically important institutions is limited.

Third, we should continue to provide bank supervisors with the discretion to apply more stringent safety and soundness requirements on particular banking

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

organizations with distinct risk profiles. It is not necessary to adopt requirements with broad applicability to capture a handful of unique organizations.

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

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