BIPARTISAN POLICY CENTER

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"Examining the Regulatory Regime for Regional Banks"

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

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

Today, I would like to focus on one of our task force's recommendations raising the so-called "bank SIFI" asset threshold from $50 billion to $250 billion, while giving regulators more flexibility

to determine whether or not an institution should be subject to more rigorous oversight. We believe this recommendation strikes the right balance between assuring that financial institutions, whose collapse could pose a significant risk to the financial system, receive an appropriate level of supervision and regulation, while not subjecting those that do not meet this standard with needless rules and oversight which may impede economic growth.

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

- Clarifying the U.S. regulatory architecture to close gaps that could contribute to a future crisis or financial stress event;
- Improving the quality of regulation and regulatory outcomes;
- Better allocating, coordinating, and efficiently using scarce regulatory resources;

- Ensuring the independence and authority of financial regulators to allow them to anticipate and appropriately act on threats to financial stability; and
- Increasing the transparency and accountability of the regulatory structure.

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

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

A good example was our recommendation to change the asset threshold over which bank holding companies become subject to enhanced supervisory and regulatory requirements. These companies are sometimes called bank SIFIs (systemically important financial institutions) because they face enhanced prudential requirements, similar to those applied to the nonbank SIFIs, which are designated by the Financial Stability Oversight Council (FSOC). In the course or our

research, we found little support for the idea that the current asset threshold, set at $50 billion and not indexed for any future growth, was an ideal solution to the real issues it was meant to address.

The Current Threshold is Problematic

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

1. It is arbitrary. In general, a bank holding company with $49 billion in assets does not suddenly become systemically important, and therefore subject to enhanced prudential standards, when it grows to $51 billion in assets. Different banks have different balance sheet structures and risk profiles and should be judged accordingly, making the presence of a "solid-line" or binary threshold problematic.

2. It includes institutions that are not systemically important. In addition to being arbitrary, the $50 billion threshold captures a number of bank holding companies that few would argue are, individually, systemically important. This is by design. During the crafting of what later became Dodd-Frank, there was real concern that setting a threshold that clearly separated systemic from non-systemic institutions would reinforce the moral hazard concerns associated with "too-big-to-fail." At the time, policymakers worried that banks above the asset threshold

might be conferred with unfair benefits relative to those institutions that fell below the line. It has become apparent, however, that the extra oversight that applies to non-systemic institutions just above today's $50 billion asset threshold is costly. both for regulators to administer and the institutions subject to the regime to comply. The requirements of the new regime include developing living wills and participating in regular comprehensive stress tests, all of which entail substantial compliance costs. Furthermore, the benefits of including these firms, which are now subject to far more robust supervisory regime in the post-crisis world, are smaller than many expected. In his testimony before this Committee last week, Federal Reserve Board Governor Daniel Tarullo said that stress testing requirements, for example, "can be a considerable challenge for a $60 billion or $70 billion bank," but that the benefits gained by including such institutions, "are relatively modest" and that regulators "could probably realize them through other supervisory means."[1]

3. It focuses only on size. The size of a bank holding company's balance sheet affects how systemically important it is, but it is far from the only relevant variable. An institution's potential to create systemic risk is also determined by its mix of activities

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

and practices, interconnectedness, term structure of funding, leverage and a number of other factors. One can imagine an institution with well over $50 billion in assets that is well-capitalized, diversified, not overly interconnected and engaged predominantly in low-risk, plain-vanilla activities the failure of which would not pose a significant risk to financial stability. A number of regional banks arguably fall into this category. In his testimony to this Committee last week, FDIC Chairman Martin Gruenberg said that of the 37 institutions above the $50 billion threshold, 20 of them "are diversified commercial banks that essentially take deposits and make loans."[2]

On the other hand, at certain points during the financial crisis the CIT Group was considered potentially systemically important given its unique position in providing credit to small businesses. During that period, CIT had approximately $90 billion in assets, which would be below even the $100 billion threshold some have proposed.[3] Given that size is not the only factor in determining whether a bank is systemically important, size should not be the only factor used by the law or regulators in determining whether a bank holding company should be subject to enhanced

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

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

oversight.[4]

4. It produces undesirable incentives. A binary threshold based simply on size gives bank holding companies an incentive to either stay below the threshold to avoid extra regulatory requirements or, once they are above the threshold, to become ever larger to spread out the fixed costs of those requirements. If the purpose of these extra requirements is to improve financial stability, then the law should focus on promoting incentives for institutions to engage in less risky activities and practices while still meeting the needs of their customers and forming a foundation for sustainable economic growth.

5. It is not indexed. Dodd-Frank as written retains a static, hard-wired $50 billion threshold. Each year, the real value of $50 billion in assets will decline as a share of the economy. Because of this, the current static threshold will capture more and smaller bank holding companies over time since the threshold is not indexed for economic growth, inflation, or any other metric. If a threshold is maintained in statute, it should be automatically adjusted to avoid this effect. If the threshold is indexed, I would suggest indexing it to economic growth rather than inflation since the systemic significance of a bank holding company is tied

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

to an institution's size relative to the economy rather than in relation to consumer prices.

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

Rethinking the Bank SIFI Threshold

As is often the case, agreeing on the problems with a system is more difficult than agreeing on a path forward. So it is with the bank SIFI

threshold. No regulatory regime will be perfect, but we believe that our BPC task force's recommendation would be a major improvement over the status quo.

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

No matter what level at which one establishes an asset-size threshold, it will be arbitrary and will not by itself take into account the complexity and risk profiles of different bank holding companies. As Comptroller of the Currency Thomas Curry stated in his testimony before this Committee last week, "it is essential for the OCC to retain the ability to tailor and apply our supervisory and regulatory requirements to reflect the complexity and risk of individual banks."[5] Therefore, we also recommended complementing raising the threshold with moving from a binary, "solid-line" threshold to a presumptive, "dashed-line" threshold that allows regulators to have more discretion in applying requirements based on other appropriate risk factors. In

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

effect, bank holding companies with more than $250 billion in assets would be presumed subject to enhanced prudential standards, but would be able to make a case to regulators to leave them out of the enhanced regime if they are well-capitalized and diversified and engaged predominantly in relatively low-risk activities and practices. On the flip side, bank holding companies below the $250 billion asset threshold would be presumed not subject to enhanced prudential requirements, but regulators could include them in the enhanced regime if they determined any such institution to present significant systemic risk factors.

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

1. <u>They would make the threshold level less arbitrary by making it presumptive</u>. If regulators have the ability to use some discretion in taking other risk factors into account, the threshold becomes a starting point rather than an absolute.

2. <u>The threshold would be less likely to capture institutions that pose little systemic risk.</u> Where the current "solid-line" threshold captures a number of bank holding companies that are not systemically important on their own, the higher threshold removes smaller institutions from the enhanced regime while giving regulators the ability to "capture" any that have high-risk profiles. This can be achieved while reducing unnecessary costs

to institutions and regulators with minimal loss of benefits.

3. The threshold would not be based simply on size. Making the threshold presumptive allows for other risk factors to be taken into account when determining whether an institution should be subject to enhanced prudential standards.

4. They would better align incentives with goals. A higher and presumptive threshold allows for incentives to be geared toward reducing overall systemic risk rather than encouraging institutions to stay below the threshold or grow well beyond it. An institution that is not considered systemically risky just below the asset threshold could presumably grow organically to just above the threshold and not trigger a systemic designation.

5. The threshold can be indexed. An indexed threshold will help to ensure that it does not grow increasingly outdated over time. Whatever threshold is set, we recommend indexing it to economic growth or a similar metric.

6. They focus scarce regulatory resources where they are most needed. A higher threshold allows regulators to prioritize the use of their resources on the largest and most complex financial institutions, where they can do the most to benefit financial stability.

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

Avoiding One-Size-Fits-All Regulation

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

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

cooperation among the regulators would lead to more efficient and comprehensive examination process.

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

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

Another issue facing midsize banks has been the propensity to get ensnared by rules designed for larger, more complex financial institutions. Congress was wise to give the Federal Reserve and the

FDIC a substantial degree of latitude to engage in such tailoring. We encourage regulators to take advantage of this authority.

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

> In prescribing more stringent prudential standards under this section, the Board of Governors may, on its own or pursuant to a recommendation by the Council … differentiate among companies on an individual basis or by category taking into consideration their capital structure, riskiness, complexity, financial activities (including the financial activities of their subsidiaries), size, and any other risk-related factors the Board of Governors deems appropriate.[6]

The Federal Reserve included 40 instances of the word "tailor" or one of its permutations in its final rule implementing Section 165.[7] The Federal Reserve and FDIC also jointly worked to tailor their requirements for both living wills and stress tests (along with the

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

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

OCC), scaling them to some degree to account for the size and complexity of the institutions subject to them. And in fact, our recommendation to make the new threshold for banks to be subject to enhanced prudential standards presumptive is very much in keeping with Congress' desire for regulators to tailor.

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

Chairman Gruenberg testified that Dodd-Frank's stress testing requirements are "more detailed and prescriptive than the language covering other prudential standards, leaving the regulators with less discretion to tailor."[8] And Governor Tarullo testified last week that there are certain kinds of prudential regulation that Congress required

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

the Federal Reserve to implement for all bank SIFIs, and that some, such as the application of the Volcker Rule and $50 billion threshold, "bear reexamination."[9] If regulators have determined areas where they believe Dodd-Frank restricts their ability to tailor regulations designed for the largest most complex institutions appropriately for smaller institutions, we as a general principal would support legislative change to enhance regulatory authority to implement tailoring.

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

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