Americans for Financial Reform
1629 K St NW, 10th Floor, Washington, DC, 20006
202.466.1885

TESTIMONY OF MARCUS STANLEY, AFR POLICY DIRECTOR

HOUSE FINANCIAL SERVICES COMMITTEE FINANCIAL INSTITUTIONS SUBCOMMITTEE, OCTOBER 21, 2015

Chairman Neugebauer, Ranking member Clay, and members of the Committee, thank you for the opportunity to testify before you today on behalf of Americans for Financial Reform.

AFR opposes HR 2287 (NCUA Budget Transparency Act), HR 2896 (the TAILOR Act), and HR 3340 (the Financial Stability Oversight Council Reform Act). We also have concerns regarding HR 2209 (requiring the treatment of certain municipal debt obligations as level 2A assets under liquidity rules). We have no view on the other bills under consideration today.

I will also briefly discuss two other pieces of legislation, HR 1309 and HR 1550, that while not on today's hearing agenda, are related to bills discussed today and we understand may be marked up by the Committee soon.

<u>HR 2896</u>

This legislation would mandate that Federal banking regulators 'tailor' regulations to the risk profile and business model of regulated institutions. The specific requirements in this legislation are unnecessary, as regulators are already scaling rules to the size and business model of financial institutions. They would also be harmful. HR 2896 does not simply require that regulators tailor their rules to the business model of affected institutions. It also requires that such rules be tailored "in a manner that limits the regulatory compliance impact, cost, liability risk, and other burdens". This deregulatory mandate prioritizes the costs of regulations to financial institutions over the offsetting benefits to consumers and the general public. The retroactive and future application of these vague and sweeping mandates would likely lead to a flood of litigation seeking to reverse financial protections.

Regulators are Already 'Tailoring' Their Rules Based on Financial Institution Characteristics

The failure of large regional commercial banks such as Countrywide, Washington Mutual, and Wachovia was at the center of the 2008 financial crisis. Congress responded in the Dodd-Frank Act by mandating that the Federal Reserve institute a tailored, size-appropriate regime of enhanced prudential controls for banks over $50 billion in size. This mandate is well designed to

ensure that regulators will maintain an appropriate focus on potential risks at the largest few dozen commercial banks in the country.

It is crucial to understand that this Dodd-Frank mandate *already* requires the Federal Reserve to tailor its prudential requirements to the size and business model of the regulated bank. Section 165(a)(1) of the Dodd-Frank Act requires that the Federal Reserve institute prudential standards for banks over $50 billion that are both *more stringent* than the standards applying to banks under $50 billion, and also *increase in stringency* based on the size and business activities of the financial institution. This requirement clearly mandates a scaled 'ladder' of prudential regulations that grow stronger as banks grow in size and risk.

In case there is any doubt of regulatory authority to scale prudential standards appropriately, Section 165(a)(2) explicitly grants the authority to differentiate among companies based on individual-specific risk factors, and to raise the size threshold for most banking prudential standards above the $50 billion line if regulators feel it is appropriate.

The Federal Reserve has in fact scaled its prudential requirements very significantly based on bank size. The most stringent prudential requirements apply only to eight U.S. banks designated as global SIFIs (Systemically Important Financial Institutions), while the full range of crucial rules like liquidity requirements and the leverage ratio apply only to fourteen 'advanced approaches' banks that have $250 billion or more in assets or practice particularly complex business models. In addition to this effort to tailor bank rules to bank size and risk, a recent speech by Federal Reserve Governor Tarullo also indicates that upcoming Federal Reserve rules on non-bank financial institutions such as insurance companies will be tailored to the liability structure and business model of those institutions.[1]

Proponents of changes in Dodd-Frank have often failed to recognize the considerable steps that regulators have already taken to scale regulations to bank size and business model. In some cases this has led to proposals which threaten to cripple the Dodd-Frank mandate to improve regulation of large bank holding companies, and thus reverse much of the progress made toward better risk controls since the crisis. One example of such legislation is HR 1309, not under consideration by the Subcommittee today but due to be marked up next week.

HR 1309 would in effect eliminate Dodd-Frank Title I requirements for all but the eight US banks designated by international regulators as global SIFIs. These requirements could only be restored if regulators went through a cumbersome multi-year process of designation for each bank to be subjected to enhanced prudential standards. The changes in HR 1309 would not only eliminate key Dodd-Frank requirements to improve risk controls at large banks, but would likely weaken bank oversight even as compared to its pre Dodd Frank level. The HR 1309 requirement

[1] Tarullo, Daniel. "Capital Regulation Across Financial Intermediaries". Speech at the Banque De France Conference Financial Regulation – Stability Vs Uniformity, September 28, 2015.

that the Federal Reserve get approval from two-thirds of financial regulators before full oversight of even a bank holding company would be unprecedented in the history of banking law.

The Federal Reserve is far from the only banking regulator that seeks to tailor its regulations carefully based on financial institution size and business model. To take just one other example, the Consumer Financial Protection Bureau has granted exemptions from various mortgage rules for smaller community banks that hold loans on portfolio, as well as banks in rural areas.

The Sweeping Deregulatory Mandate in HR 2896 Would Be Harmful

HR 2896 does not simply call for regulators to scale rules to the characteristics of regulated entities. It also requires Federal financial regulators to limit regulatory impact, cost, and burdens to regulated institutions in any rule they promulgate. This broad mandate prioritizes reducing the costs of regulation to financial institutions over the offsetting benefits gained for consumers and the general public. It would apply to all regulated entities, and is not limited to community banks. HR 2896 also requires various additional cost-benefit type analyses in which regulators would be required to assess the impact that regulations have on the ability of financial institutions to serve customer needs

In addition, HR 2896 would impose a new statutory requirement for regulators to consider the 'necessity, appropriateness, and impact' of rules for each type of financial institution affected, and also mandates a comprehensive reexamination of all rules passed in the last five years in light of these sweeping new mandates. This requirement is in many ways duplicative of existing statutory requirements under the Economic Growth and Regulatory Paperwork Reduction Act (EGRPRA) which require regulators to review their rules every 10 years to determine whether they are outdated, unnecessary, or unduly burdensome.

While the requirements in HR 2896 may sound reasonable in the abstract, their practical effect would be to layer additional requirements on an already lengthy and cumbersome rulemaking process and to create numerous litigation opportunities for the financial industry to challenge regulations in court based on the extremely broad and vague mandates in the legislation. Since compliance with all regulatory analyses and mandates under HR 2896 would become part of the rulemaking record, any of them could become grounds for a lawsuit based on the contention that the general terms in the legislation had been violated.

Over the past five years, financial regulators implementing the Dodd-Frank Act have conducted an enormous notice and comment rulemaking effort, which has included thousands of meetings with affected institutions and the consideration of many thousands of public comments. It is plainly evident from the existing rulemaking record that regulators have already put large efforts into considering the 'necessity, appropriateness, and impact' of their rules. To pass a broad and sweeping new statutory requirement that regulators reconsider these issues again, and do so in a manner that 'limits' regulatory impact and burdens, is not an effort to improve Dodd-Frank rules.

It is an effort to turn back the clock and restart the process under terms that would be more favorable to industry.

Regulatory unwillingness to address risks and abuses in the financial sector was a major contributor to many past financial crises, including the 2008 financial crisis. Passing HR 2896 would sending a dangerous signal that Congress wished to weaken financial regulation, not strengthen it. And it would give regulated institutions a new set of tools to delay or prevent regulations required by Congress and necessary to protect the public.

HR 3340

HR 3340 would eliminate the independent funding for the Financial Stability Oversight Commission (FSOC) and its research arm, the Office of Financial Research (OFR), subjecting the budget for these agencies to the appropriations process. It would also require that the OFR provide a 90 day notice and comment period prior to issuing any report or rule.

The FSOC and OFR were created as a response to the grave weaknesses in the U.S. system of financial regulation and oversight that were revealed in the 2008 financial crisis. After the Gramm Leach Bliley Act repealed the Glass-Steagall divisions between banking, insurance, and trading markets, the financial system became more highly interconnected, allowing for the rapid transfer of risk between insurance companies, commercial banks, broker-dealers, and large hedge funds.[2] Problems emerging in any one of these sectors can easily impact the others, and if the risks involved are large enough they can threaten the stability of the entire financial system. But even as the financial system grew more deeply interrelated, our regulatory system continued to rely on over a half a dozen separate and siloed financial regulators that often did not share information and failed to spot critical emerging risks.

This problem contributed directly to the financial crisis of 2008 and its disastrous impact on the U.S. and world economy. Commercial and investment banks transferred hundreds of billions of dollars in mortgage risk to an insurance company, AIG, escaping the supervision of banking and securities regulators. AIG eventually received the largest government bailout in U.S. history. Broker-dealers which were not commercial banks, such as Bear Stearns, Lehman Brothers, Morgan Stanley, and Goldman Sachs, were at the center of the Wall Street network that created and distributed the 'toxic assets' central to the crisis. Hedge funds were also key intermediaries in the distribution and structuring of these toxic assets.[3] The failure of a single money market mutual fund, the Reserve Primary Fund, triggered a massive run on prime money funds followed by a government bailout of the entire sector.

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[2] See for example Billio, Monica & Getmansky, Mila & Lo, Andrew W. & Pelizzon, Loriana, 2012. "Econometric Measures of Connectedness and Systemic Risk in the Finance and Insurance Sectors," Journal of Financial Economics, Elsevier, vol. 104(3), pages 535-559.

[3] For one example, see Eisinger, Jesse and Jake Bernstein, "The Magnetar Trade: How One Hedge Fund Helped Keep the Housing Bubble Going", ProPublica, April 9, 2010.

In the Dodd-Frank Act, Congress took a measured approach to addressing the fragmentation of the regulatory system. The Dodd-Frank Act eliminated only one financial regulator (the Office of Thrift Supervision). The other nine financial regulators were directed to coordinate their efforts to address threats to the financial system through a new joint council, the FSOC. To assist the FSOC in its work and also to serve as an early warning system regarding emerging financial risks, the legislation also created the OFR, which has the mandate of independent risk research and oversight.

Based on the input of all ten participating financial regulators, the FSOC has the power to designate large non-banks that play a crucial role in the financial system for heightened oversight by the Federal Reserve. Such oversight applies only to specified financial activities of companies so designated, and may or may not be 'bank like' in nature, depending on what type of supervision is appropriate for a specific company.

The question of exactly which non-banks should be designated as systemically significant and how such institutions should be regulated is a complex and institution-specific question. However, given the central role of non-banks in both the financial crisis and in the modern financial system, the general need for a designation power is clear. Furthermore, the role of the FSOC and OFR in scrutinizing the financial sector for emerging risks, including gathering the necessary information to do so, should not be controversial. Without such a central point for the gathering and analysis of data, the fragmentation of our regulatory system could lead to a repetition of past failures to 'connect the dots' of financial risk.

It should be clear that political independence is crucial to the work of the FSOC and OFR. Without the freedom to scrutinize the financial system for emerging risks, these agencies will not be able to perform their functions properly. While there are many checks and balances built into the process of FSOC designation – including multiple appeal opportunities and the ability to challenge FSOC designation in court – the potential micromanagement of financial risk assessment through the Congressional appropriations process should not be one of them. The importance of impartial risk assessment is the reason why all of our major bank regulators, including the FDIC, OCC, Federal Reserve, and CFPB, are independently funded outside of the Congressional appropriations process. The FSOC and OFR should not be an exception.

The bill's requirement that the OFR solicit public comment prior to issuing reports on financial risk would also limit the independence of the agency and its ability to objectively assess financial risk free of outside pressures from financial institutions that may have a stake in the outcome of OFR research.

In relation to the FSOC's work, I would also like to mention another piece of legislation that, while not explicitly on today's agenda, may also be marked up by the Committee soon.. This is HR 1550, which would create dramatic changes in the process by which FSOC designates major financial entities for enhanced oversight. This legislation would at least double the time it takes

for the Council to designate a large financial firm, from the current two years to at least four years. The legislation formally codifies several requirements that the FSOC assess a company-provided re-structuring plans both prior to designation and on an annual basis post-designation. These and other requirements in the bill could create a situation where a large financial firm that is skilled at manipulating the process could delay increased regulatory oversight almost indefinitely. FSOC designation is already a multi-year process that includes some ten major steps and multiple opportunities for appeal. Given the importance of the FSOC's work, Congress should reject legislation like HR 1550 that would bog down FSOC operations even further.

HR 2287

HR 2287 would require the National Credit Union Administration (NCUA) to make drafts of their agency budget publicly available for comment, and to respond to or incorporate such public comments in their final agency budget.

This requirement goes well beyond budgetary transparency, which the NCUA already provides. We believe the budgetary requirement in HR 2287 is inappropriate for a public regulatory entity. The NCUA has the crucial role of safeguarding the taxpayer guarantee of publicly insured credit union deposits. It is not a self-regulatory body, and requires a reasonable degree of independence from those it regulates.

While credit unions certainly did not cause the 2008 crisis, it is still important to remember that significant public action was required during that period to rescue the credit union system. This included the seizure and closure of several large credit unions and the issuance of over $30 billion in government guaranteed bonds to provide resources to stabilize the system.[4] Cuts in NCUA resources and staffing between 2000 and 2009, in part due to pressure from regulated entities, apparently contributed to failures in oversight of the credit union system. It is clear that there is a strong public stake in the proper regulation of credit unions. As the provider of that regulation the NCUA must serve the broader public and not simply regulated entities that may have a stake in taking inappropriate risks using publicly insured deposits.

HR 2209

HR 2209 would mandate that banking regulators classify investment grade, readily marketable municipal debt obligations as level 2A liquid assets under the Liquidity Coverage Ratio (LCR) rule. Outside of cash and Treasuries, this is the safest and strongest liquidity categorization available under the rule.

When the LCR rule was passed, many commenters raised questions as to the regulatory classification of municipal debt obligations under the rule. AFR shares those concerns. In our comment we questioned whether it was appropriate to treat municipal bonds differently than

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[4] Maremont, Mark and Victoria McGrane, "Credit Unions Bailed Out", Wall Street Journal, September 25, 2010.

investment grade corporate bonds, and advised regulators to reconsider whether there was some subset of municipal debt obligations which could be treated similarly to investment grade corporate bonds under the rule.

HR 2209 does include several important safeguards, including specifying that municipal debt must comply with regulatory standards defining 'liquid' and 'readily marketable', and must also be investment grade. These safeguards provide some protection against problems that could arise if banks were permitted to include illiquid municipal debt obligations in their liquidity pool. However, despite these safeguards and our concerns regarding the treatment of municipal debt in the initial LCR rule, we are concerned that HR 2209 goes too far in directly mandating regulatory treatment of municipal debt as Level 2A liquid assets.

As a general matter, we have concerns about micromanaging regulators as regards this kind of detail in important rules. This is particularly true given that in this case the Federal Reserve has acted already to improve the treatment of municipal debt under the LCR rule. Earlier this year, the Federal Reserve proposed to reclassify investment grade and readily marketable municipal debt as a Level 2B liquid asset, equivalent to investment-grade corporate bonds.[5] This is similar to AFR's recommendation in our comment to regulators.

Adding to our concern about micromanagement, the effect of the LCR rule on the municipal debt market appears to be limited. The LCR rule went into effect at the beginning of this year. Year to date, the return on municipal debt has averaged 3.66 percent. This would represent the lowest annual average return (and therefore the highest valuation) for municipal debt in some 50 years, since the mid 1960s.[6] While this is admittedly a rough metric, it is difficult to see that the advent of the LCR rule has significantly impacted the market. According to data from the Office of the Comptroller, banks hold less than 10% of municipal debt and banks fully affected by the LCR rule hold less than 5%, making it plausible that the LCR rule has limited market impact.

Thank you for the opportunity to testify. I am happy to answer further questions, and in the future can be contacted at marcus@ourfinancialsecurity.org or (202) 466-3672.

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[5] Federal Reserve System, "Liquidity Coverage Ratio: Treatment of U.S. Municipal Securities as High Quality Liquid Assets", RIN 7100 AE-32, Federal Register, Vol. 180 No. 102, Thursday May 28, 2015.

[6] Based on the Bond Buyer GO 20-Bond Municipal Bond Index Weekly Data, as of October 15, 2015, available at https://research.stlouisfed.org/fred2/series/WSLB20/ .