TESTIMONY

Prepared for the Subcommittee on Financial Institutions and Monetary Policy

A HOLISTIC REVIEW OF REGULATORS: REGULATORY OVERREACH AND ECONOMIC CONSEQUENCES

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September 19, 2023

It is an honor to appear again before this committee on a critical question: how much big-bank regulation is too much big-bank regulation based not only on what big-bank regulation does to big banks, but also and more importantly on what it does to critical considerations such as shared economic growth and financial resilience. One reason I have so often appeared before this committee and your Senate colleagues is that my career so far spans seven U.S. financial crises. We advised the national commission Congress chartered after the S&L crisis and have since done our best to be as helpful to you and the regulators as we can. My firm advises major bank and nonbank financial services firms, global central banks, investors, and interest groups. In no case do we lobby for any client and the statement I give today speaks only to my own views and that of my firm. I am also the author of, "Engine of Inequality: The Fed and the Future of Wealth in America."[1]

In my testimony today, I will make the following key points:

- The most important criterion by which to judge financial policy is not bank profitability. If banks fade away due to competitive causes, then that is their mortal destiny as private enterprises. If the cost of failure is borne in any way by the public, then the ability of banks to profit with reckless abandon must be curtailed, but attempting to make banks failure-proof is doomed as each effort to do so after each of the crises I've seen has proved each time.
- The way to think about bank regulation is to recognize that banks play a critical role as vital conduits of equitable growth and macroeconomic security. As a result, policy must be calibrated not just to maximize a singular goal such as fortress banking, but also to optimize financial stability in broader pursuit of what the law setting the Fed's charter rightly calls "general welfare."[2]
- Optimizing financial stability is impossible wearing banking blinders. The U.S. financial system is uniquely dependent on nonbank financial intermediation – so called "shadow banks."[3] Finance

abhors a vacuum as much as physics. If one sector cannot meet the market's needs at a market price, then another will step in to serve that market even if regulators wish no one would do so because the market is unduly risky or predatory. The bank-centric rules promulgated after the 2008 crisis directly caused the explosion in U.S. nonbank financial services, a transformation my firm anticipated as early as 2011.[4] Still more powerful and systemic, nonbanks are likely as a result of this batch of new rules a decade later because market dynamics are changed only by virtue of still more embedded power outside the regulatory perimeter.

- Evaluating the impact of bank-centric rules requires not only a focus on the broader financial system, but also on their cumulative impact—what this panel and the Fed have rightly called "holistic" analytics. Rules that push one way imposed at the same time as rules that push in the opposite direction either end up moving the system nowhere or, worse, in wholly unintended directions. This was already evident in 2015, when my firm produced another report focused on the cumulative impact of the Basel III capital and liquidity rules in the context of the Fed's ultra-unconventional monetary policy.[5] Rules now will have the same cross-cutting effects, heightened by the "higher for longer" context wholly omitted in any of the agencies' assessments.
- It is clear that the raft of new, bank-centric capital and resolution proposals and of rules still to come has not been constructed with the best possible or even a good, credible effort to anticipate cumulative macroeconomic and systemic consequences. As a result, perverse effects are already all too evident. These perverse consequences will quickly and significantly impair financial stability and sustained, shared growth, as the discussion of key proposals provided below will make all too clear.
- It is more than possible to prevent perverse consequences without unduly "light-touch" bank regulation. Solutions include far tougher rules founded not on thousands of micro-managing pages, but instead on the 21st-century prompt, corrective action (PCA) recommended as early as 2011 and again this year by the General Accountability Office (GAO).[6] The PCA triggers give banks certainty about supervisory intervention when key guardrails are breached and ensure both real-time supervisory accountability and market discipline. Both are sorely missing from the banking system for all but the smallest banks. New PCA triggers will correct for this, especially if paired with immediate FDIC repairs that rebuild a credible resolution construct that no longer depends on the public purse Congress has handed over to the FDIC and the Federal Reserve. The focus must immediately shift from making banks impregnable – a doomed prospect – to making them resolvable without bailout. The newly proposed resolution construct makes sense, but none of it will matter if the FDIC fails to build demonstrable capability to act quickly and decisively when a complex failure seems likely. Neither the FDIC's reports after recent failures[7] nor Chairman Gruenberg's recent remarks[8] address how the FDIC will shore up its evident inability to resolve a troubled mid-size bank, let alone one with global systemic significance (i.e., a GSIB). Congress gave the FDIC the tools it needs in Title II of Dodd-Frank,[9] but the FDIC has failed over a decade later to put them in its kit or learn how to use them.

The rest of this testimony will focus on key, holistic aspects of pending rules in the context of those the Federal Reserve[10] and FDIC have signaled are next.[11] To do so, I do not detail each proposal and its isolated impact, but look at key consequences and how the sum total of rules now and to come affect them. I conclude with specific policy recommendations and welcome questioning today and any thereafter from this panel's staff.

Unintended, Perverse Consequences

Credit Availability

Much has been said about the extent to which more costly bank regulation, especially higher capital standards, adversely affects credit availability and thus macroeconomic growth. The banking agencies acknowledge this as a possible problem in the capital proposal's impact analysis,[12] but go on to say not only that overall credit availability is likely to be materially unaffected without any particular problems for borrowers other than – maybe – low-and-moderate income (LMI) mortgage borrowers. I have spent a good deal of time criticizing the FRB in particular and the banking agencies in general for policy conclusions premised on aggregate analytics.[13] I thus will not repeat the overall – one might say – aggregate – analytical flaw in looking only at sum total data in the absence of broader cumulative regulatory-impact analyses. Suffice it to say as I here will show that, while the banking agencies' proposals may not harm credit availability in aggregate, they will redistribute who provides and thus who gets debt financing.

There are many reasons for this in the proposals, but one warrants particular attention before turning to credit-market disaggregated conclusions: the "higher-of" requirements related to calculating risk-based capital for credit-risk exposures. Current capital standards allow the largest banks to use internal models, but only when results demand more capital than the agency-prescribed standardized approach (SA). Why they do so warrants discussion, but the new approach contains a still more puzzling provision: it requires covered banks to hold the higher of the lengthy revisions to the old SA included in the proposal or the old, unchanged SA even though the agencies state that they have done a Herculean job deciding on all the new SAs as better risk measures sure to reduce the risk of financial crises.

A Herculean task to be sure – it took the banking agencies six years from the final Basel SA changes to come up with their own.[14] Why then the complete lack of confidence in the new SA? Banks can't dodge it because they won't be allowed to use internal models, so the anti-arbitrage rationale behind the current "higher-of" standard makes no sense, especially if the banking agencies up the supervisory game as they sincerely promise.

Either the proposal makes sense or it doesn't. Trying to have it all ways all at the same time speaks to the agencies' own uncertainty about their methodology no matter the staunch confidence they voice about its certain, benign effects on growth and financial stability. At the least, the agencies can and should be expected to come up with one standardized capital approach, not subject banks to unnecessary burden and put credit availability for key communities at still more risk.

What does this "higher-of" construct along with the cumulative impact of all the other rules mean in the credit market? It is more than clear that banks already play minor roles in many key arenas even though gathering deposits and making loans is core to both our understanding of and the legal definition of the "business of banking."[15] So-called "private credit" – i.e., loans from private-equity firms – is already a booming business of at least $1.4 trillion,[16] with these ever-ambitious and often-conflicted firms anticipating it to grow to $40 trillion in just five years.[17] The sector is indeed so dominant that banks are already trying to ride private-equity coattails to get at least a bit of corporate-lending business back.[18]

Nonbanks taking over for banks across the credit market due to capital costs is nothing new, making it still more surprising that pending rules discount any potential adverse effect as the rules grow still more stringent. After the new regulatory framework took hold in the early 2010s, nonbanks quickly took over

for banks in what was once bread-and-butter banking: mortgage lending. Now, nonbank mortgage originators control 50.9 percent of the overall market[19] and 79 percent of government lending.[20] Auto loans are also increasingly provided by nonbanks that are often dealers with significant conflicts of interest that may well ensure a lower-income borrower gets a loan, but the borrower may also pay directly or indirectly a lot more for the car. When banks got out of the personal installment-loan business in large part due to capital costs, payday lenders stepped right in. Credit there is; costs direct and indirect to borrowers and communities are the key difference.

There is nothing per se wrong with nonbank lending, but nonbank lending outside the reach of safety-and-soundness and consumer-protection standards poses not only these direct economic-inequality risks, but also significant indirect ones. Financial crises do the greatest damage to those least able to bear them. Further, retail borrowers may well continue to get loans after banks disappear due to capital costs, but new lenders are likely to charge a good deal more than banks not because of regulatory requirements, but due to uncompetitive markets and exemptions from an array of risk-management and community-development obligations.

Operational Resilience

The weeds of the capital rules not only have the problematic "higher-of" provision, but also a wholly new framework for operational risk-based capital. While there are many risks for which regulatory capital is a vital panacea, operational risk is not among them.

The proposed approach to operational-risk capital standards makes it still more clear that regulators don't trust themselves or banks and thus deploy the only tool they seem to know – ever-higher capital – no matter the cost and, more importantly, the risk of unintended consequences. The best way to address operational risk is to spend risk-mitigating money, not put it in a capital piggybank regulators can shake to hear coins rattle when they worry even though getting the coins out in a hurry will prove devilishly difficult.

Under the operational-risk proposal, regulators want banks to look back as long as ten years to see how many operational losses they booked, measure business volume over the past three years, ramp up these sums via mysterious "scaling factors," and then somehow discern what operational risk will be in coming years and how much shareholder equity is essential as a buffer against it. Consistent with the proposal's overall disdain for internal models, the current "advanced measurement approach" that has fared well even under acute stress would be eliminated.

Even this, just-the-facts description of the proposal compared to what it seeks to address on the operational-risk front demonstrates the challenge of using backward judgments of different businesses in a prior business model under varying market conditions as a guide to the future. Even if banks learned nothing by what came before and supervisors are wholly oblivious to it – possible as recent events suggest – an ill-calibrated operational-risk capital charge takes money away from contingency planning, insurance, and vital internal controls and inputs based on untested and often-unfounded regulatory assumptions.

There might of course be other operational risks – fraud, malfeasance – that warrant prophylactic funding. But, how does fraud in the past in a business a bank no longer offers or to customers now roundly disgraced predict future fraud exposure? Would it not instead make sense to take hard lessons learned and invest in better governance? Banks are of course sure to be exposed to new scoundrels,

but wouldn't they be better able to withstand them if they and their supervisors do their best to prevent fraud instead of always cleaning up the mess?

Further, natural disasters, governance malfeasance, and fraud are risks long and very successfully judged by actuarial methodologies that differ in form, content, and scope from the retrospective view proposed for operational risk. Insurance rewards us for not smoking – it does acknowledge residual risk if one has smoked, but it not only assumes that no longer doing so means one is healthier, but also that rewarding the policyholder for positive action creates strong incentives to undertake and then continue it. The new operational-risk rule ignores actuarial methodologies with no clue as to why this was done other than that Basel liked its own methodology better. The banking agencies do not much like insurance as a risk mitigant because they think it takes too long for insurers actually to pay valid claims. It may indeed take persistence to get paid for a basement flood, but the proposal presents no evidence that this is also true of big- bank claims nor that the record so bad that it justifies a strong disincentive for adequate up-front third-party, regulated insurance instead of self-insurance via regulatory capital that comes at greater cost and may well be ill-designed to judge real risk.

The same concerns are true of legal risk – that which banks did badly should not be what they continue to do badly if banks build better controls at the behest of supervisors if they will not do so without prompting. There is a good deal of insurance for legal risk, or at least there is for banks without bad records that supervisors can and should discipline with all the tools in their robust toolkit.

Systemic Stability

These operational-risk rules are not only ill-designed, but also very expensive, especially for non-GSIB banks focused on fee-based income that would for the first time be forced under these operational-risk standards. The financial system's plumbing – services such as technology, custody, and payment, settlement, and clearing – have active non-bank competitors on whom core services increasingly depend that are outside the reach of any safety-and-soundness and resolution standards.

One case in point to which Ranking Member Waters has rightly pointed is the pending merger between Intercontinental Exchange (ICE) and Black Knight (BKI).[21] ICE is already systemically-designated in one corner of its business (credit default swap clearing), but will take on a leading role wholly outside this or any other prudential and resolution framework with a merger through which, by its own public statements, would be used to link the capital markets with mortgage finance in unprecedented, risky ways as well as to gain still more market share in core loan-origination, pricing, consumer-facing, and risk-mitigation systems.[22] If something goes wrong with CDSs, energy, or any of ICE's other market-dominant platforms, then something could immediately go wrong also with mortgages because nothing in the bank rulebook limiting inter-affiliate contagion risk applies to ICE. After 2008, it is all too clear that mortgage finance is a systemic arena that must be subject to sound resilience and resolvability standards across its entire infrastructure.

If banks lose business to nonbanks because banks are unable to persuade customers to use their services, so be it. But banks are outflanked by nonbanks largely because the market is rigged by force of rule. FDIC Chairman Gruenberg recently said that his prime concern is making banks as safe as possible and, if the shadows lengthen, over to the Financial Stability Oversight Council and the global Financial Stability Board for something systemic sometime.[23] This is a short-sighted view of a financial system at ever greater risk by virtue of the changing nature of banking in response to new rules and resulting risk migration.

However, heightened systemic risk as a result of new rules is not only a sin of omission, but also of commission based on what is actually proposed. One of the oddest aspects in the capital rules is the decision to leave as is a capital tool the Federal Reserve established and now ignores even though other nations have shown its beneficial effect when banks come under stress. Based on the correct view that banks should be sources of counter-cyclical credit availability and market liquidity, the Basel Committee in 2011 established a counter-cyclical capital buffer (CCyB).[24] The Fed's own version of the CCyB acknowledges Basel's valiant effort to thwart boom-bust cycles, but goes on to set so vague a CCyB as to make it clear that none will ever be triggered unless the Fed is in the mood.[25]

When Basel in 2022 looked at CCyBs across the globe, it found that buffers regulators clearly released rather than those they just hoped banks might breach preserved continuing capital adequacy under even acute stress such as the 2020 pandemic.[26] Basel's report thus concludes that buffers that cannot be breached are buffers in name only, contributing to banks that run for cover under stress and thus accelerate financial instability or macroeconomic woes.

Resolvability, Not Impregnability

The analysis above focuses principally on proposed capital rules because capital standards drive return on equity (ROE), ROE drives investor behavior, and investor behavior not only strongly influences c-suite decision-making, but also and inexorably the prospects for long-term franchise value. If ROE falls short, then banks face existential crises and they thus make the decisions investors favor within the capital parameters regulators demand. However, all the capital and all of the other rules in all of the massive books the agencies craft cannot and will not ensure bank survival; indeed, sometimes they make it less likely not because a bank is under-capitalized by the rulebook, but because it is non-viable when the rulebook gets risk wrong and powerful competitors are exempted from it.

If banks were regular companies, then failure whether due to rules or missed opportunities should be subject to market discipline. However, banks are not regular companies because, as noted, they have unique taxpayer privileges designed to backstop their key deposit-taking and lending activities and thus to safeguard growth and stability. As a result, it is fit and proper for the Federal Reserve and FDIC to require banks to plan for resilience under stress and orderly resolution without bailout in extremis.

However, all of the resolution planning banks can and should be vigorously required to conduct and test is pyrrhic in the absence of demonstrable FDIC resolution capability. Sadly, there is no denying that the FDIC cannot resolve troubled regionals. The Silicon Valley and Signature failures should have been handled in due course under regular FDIC intervention – preferably before collapse as the law allows. Were this insufficient, then the FDIC could have used its orderly liquidation authority (OLA) if the case was truly systemic and neither the Fed nor FDIC could figure out another way. Under either regular resolution or orderly liquidation, shareholders and uninsured depositors would have suffered and that is all to the good of a disciplined financial system.

Six weeks later when the FDIC had ample notice that First Republic was in acute distress, it still did not know what to do in the face of a mid-size bank resolution. It thus sold the failed bank to JPMorgan, making the world's biggest bank still bigger and even more profitable. Bully for them; not so much for disciplined resolution.

And, as it turns out, the FDIC's Silicon Valley Bank resolution was even more badly designed than immediately clear. Here, though, it shares blame with the Fed. Of the three failed banks, SVB was the only one with a parent holding company. Why Signature and First Republic were allowed such light-touch regulation in the absence of a parent company is a question I recommend that Congress quickly consider, but the facts on the ground are that SVB had a parent holding company and that parent holding companies are supposed to be a "source of strength" for subsidiary insured depository institutions.

Congress said so after a raft of bank failures in the 1980s and 1990s and, when the law's drafting came under legal attack, did so again with more express and direct source-of-strength standards enacted in the Dodd-Frank Act.[27] Still, SVB's insured depository was turned into a piggybank for the parent holding company. Not only did SVB's parent company escape orders to support its subsidiary bank or backstop the FDIC as the law not just allows but demands, but the parent company is also still very much operating on behalf of its shareholders. Recently,[28] SVB's still-extant VC-affiliate participated in a deal to buy some of the subsidiary bank's dud loans. They, doubtless better than anyone and especially the FDIC knew what they were buying.

Instead of getting what it can from the holding company, the FDIC is charging other banks a special assessment to top up its coffers.[29] Instead of reviewing its failure to use the source-of-strength doctrine to protect the FDIC and the Fed did not even mention this sin of omission in its SVB mea culpa.[30]

The new resolution proposals are intended to force banks to file credible living wills and, should they fail to do so, finally face serious franchise-value consequences.[31, 32] This is fine as far as it goes even though more than a bit in the proposals goes too far. The banking agencies have also issued a proposal imposing long-term debt (LTD) requirements on regional banks akin in many ways to the total loss-absorbing capital (TLAC) imposed on U.S. GSIBs and certain foreign banks doing business here.[33] This proposal adds an important buffer of private debt ahead of the public purse, but regulators have to have the will to pull the TLAC trigger for the buffer actually to serve its purpose and insulate taxpayers. Given that the FDIC and FRB have so far failed their duties under existing resolution rules, their ability to make good use of LTD and TLAC is very much uncertain.

Policy-Action Recommendations

The analysis above focuses on the holistic impact of rules proposed so far, but there are several other strategy-critical ones in the works. Most notably, these include changes to large-bank liquidity standards likely to significantly hike short-term liquidity standards in an effort to force better readiness against the social-media, "viral" run to which the banking agencies attributed a good part of recent failures. Importantly, liquidity standards rely on large holdings of "high-quality liquid assets" (HQLA) that in turn require capital under both the risk-based rules discussed above and continuing leverage standards now made tougher for many regional banks. The LTD requirements also require more liabilities that must be invested in assets for banks to have a hope of profit, with these assets also requiring risk-based and leverage-ratio capitalization. In short, the more the banking agencies raise capital, liquidity, and resolution-related debt standards, the higher the capital burden and the larger the odds of reduced credit availability for borrowers who must depend on banks, still worse economic inequality, greater migration to unregulated nonbank financial entities, and heightened operational risk.

The banking agencies appear to believe that they can counter all this with tougher resolution standards, but these have their own perverse consequences in the midst of this holistic whole and are, as noted,

still of uncertain value given the FDIC's limited resolution capabilities and the Fed's unbridled willingness to serve as a lender of first resort for banks and nonbanks as the situation seems to move it.

Given the challenges to passing substantive financial-services reform in this and, indeed, all the Congressional sessions I have observed, I urge the subcommittee to press hard for:

- far more rigorous, disaggregated quantitative and qualitative impact analyses in major bank-regulatory releases, with full disclosure of all quantitative forecasts and qualitative assumptions. Further, any assertion that a new rule is worth all costs because it averts financial crises must take the full financial system and the potential for risk migration and arbitrage clearly into account;
- new PCA standards delineating key levels of capital, liquidity, and long-term debt that define when banks and their holding companies are demonstrably resilient, adequately resilient, weak, fragile, and likely to fail. These thresholds can and should include additional indicators of risk such as percentages of uninsured deposits, unrealized losses, risk concentrations on both the liability and asset side, and severe credit delinquencies and default. Credible penalties should apply as banks slip below the demonstrably-resilient threshold, with the whole approach quickly proposed for public notice and comment;
- an immediate inquiry by Congress or the GAO into why statutory source-of-strength requirements were not deployed when SVB failed; and
- a near-term call for the FDIC to appear before the subcommittee to assess the extent of the agency's actual, ready, and effective resolution capabilities without resorting to systemic designation and, should this be required, under OLA.

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[33] FDIC, FRB, and OCC, Notice of Proposed Rulemaking, Long-term Debt Requirements for Large Bank Holding Companies Regulations P, LL, and YY: Certain Intermediate Holding Companies of Foreign Banking Organizations, and Large Insured Depository Institutions, (Proposed August 29, 2023) (to be codified at 12 C.F.R § 5 and 34 and 12 C.F.R § 216, 217, 238, and 252), available at https://www.fdic.gov/news/board-matters/2023/2023-08-29-notice-dis-a-fr.pdf.