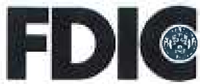

Federal Deposit Insurance Corporation
550 17th Street NW, Washington, D.C. 20429-9990

Office of the Vice Chairman

January 9, 2018

U.S. Senate Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Crapo, Ranking Member Brown, and Members of the Committee,

As a longtime proponent of sensible regulatory relief for community and regional banks, I am pleased that the Committee has advanced S. 2155, the Economic Growth, Regulatory Relief and Consumer Protection Act. Commercial banks are the engines of their local economies and legislation should be designed to encourage their business model.

As S. 2155 moves forward I would like to take the opportunity to share my thoughts with you on the sections related to the leverage ratio and the Volcker Rule. Both are arguably the most significant post-crisis structural changes designed to make the financial system safer and more resilient, and for the sake of the economy their integrity should not be compromised.

First, the incorporation in Section 402 of changes to the supplemental leverage ratio, which only applies to large, internationally-active banking organizations, appears incongruent with a bill that is designed to relieve burden for community and regional banks. For that reason, the exclusion of central bank reserves from the calculation of the supplemental leverage ratio seems out of place as it would allow custody banks, some of the most systemically important banks in the United States, to greatly reduce capital. Custody banks are integral components of the financial system and because of this they must remain pillars of strength. They are highly interconnected to the capital markets and relied upon as safe havens in times of stress. I would emphasize that custody banks were severely undercapitalized during the crisis and as confidence in them ebbed, the government was required to provide emergency lending that reached $60 billion to $90 billion a day to cover funding losses. Therefore, custody banks, like all systemically important banks, should be retaining, not reducing capital.

Since the crisis, custody banks have steadily grown and performed well, posting competitive returns on their equity. All of this questions the necessity to lower their capital. I have repeatedly highlighted the importance of strong levels of capital in globally systemic banks and the direct benefit to worldwide financial stability. There simply is no substitute.

Secondly, regarding Section 203, I agree that the burdens of the Volcker Rule should not be placed onto commercial banks that do not engage in speculative activities. However, while the section is well intentioned, I am concerned that if S. 2155 were enacted with Section 203 as it is currently written, it would severely weaken the safeguards that were designed to protect

depositors and taxpayers. While Section 203 excludes any commercial bank with less than $10 billion of total consolidated assets that has more than 5% of those assets in its trading account, the Section fails to recognize that it would allow speculative activities to occur outside of this account. Also, Section 203 as written would allow a commercial bank to own hedge funds without limits. In a broader context, hedge funds are important financial system participants but also by their very nature are opaque, speculative, and often volatile -- something deposit insurance was never intended to subsidize.

To be sure, I am a strong supporter of allowing commercial banks to enter into swaps and other derivatives to accommodate loan customers or hedge their own risks. I also support the ability of banks to buy and sell securities to manage their day-to-day liquidity needs. This is good for banking and for the economy. Thus, to ease the burdens of the Volcker Rule for commercial banks without undermining the protections it provides for the broader economy, I suggest that these important banking activities be entitled to a safe harbor with zero additional compliance requirements under the Volcker Rule.

Unlike the current rule in which banks have an ongoing burden to demonstrate they are in compliance, a safe harbor would presume compliance, reversing this emphasis. A bank would no longer have to prove to its supervisor that these transactions are not speculative proprietary trading unless there was significant evidence to the contrary identified during the normal supervisory process, no different than the way other applicable laws, rules or regulations are examined. Accordingly, a commercial bank would no longer have to develop, monitor and maintain records beyond what it already routinely uses for everyday compliance for its loan customer accommodation, hedging activities or liquidity management, nor change its existing policies and procedures to meet any of the extra requirements currently imposed by the Volcker Rule.

This approach would restore the longstanding supervisory practice that commercial banks are accustomed to by placing any burden of proof on the supervisor and simultaneously alleviating the ongoing super-compliance concerns voiced by industry. Importantly, this approach also would maintain a vital protection to the safety net and depositors by keeping the Volcker Rule activity prohibitions in effect, introducing compliance requirements only for banks explicitly determined to be engaging in speculative proprietary trading activities.

Experience shows that an outright exemption from the Volcker Rule, as proposed in S. 2155, would heighten moral hazard by allowing proprietary trading and the ownership of hedge funds inside the more than 5,000 commercial banks that would be eligible for the Volcker Rule exemption under Section 203. Placing these activities within a government-insured commercial bank protected by the financial safety net greatly subsidizes this type of risk taking. We have

learned repeatedly that the result of such subsidies is to encourage management to undertake these activities, give them a competitive lower cost of funding advantage, and distort prices, which often ends poorly for banks and the public. Deposit insurance was designed to promote stability, not undermine it by backstopping speculative short-term bets on asset price movements.

We should strive to reduce burden where it is evident that rules and regulations unfairly and disproportionately affect commercial banks, and recently I suggested a path toward that end. However, I am concerned that Sections 203 and 402 of S. 2155 in their current form will remove important safeguards that could jeopardize the strides we have made towards stable, long-term economic growth.

Sincerely,

Thomas M. Hoenig
Vice Chairman