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The Honorable Sherrod Brown
Ranking Member
Senate Banking Committee
713 Hart Senate Office Building
Washington, DC 20510

Dear Senator Brown,

You had requested my views on S. 2155, the "Economic Growth, Regulatory Relief and Consumer Protection Act". At the outset, I would like to commend the Senate Banking Committee leadership for developing this legislation on a bipartisan basis, and proceeding in the traditional way with hearings and a markup. I appreciate that much work has gone into negotiating its provisions, and I am highly supportive of most of them, particularly those reforms which give relief to community and regional institutions, as well as changes that would give consumers more control over their credit information.

Regrettably, the bill also includes Section 402 which would significantly weaken a key constraint on the use of excessive leverage by the largest financial institutions in the US. In these times of market volatility, I would strongly urge the Senate to reject this provision as imprudent and short-sighted. Now is the time we should be bolstering bank capital levels, not chipping away at them.

Banks operated with far too little capital during the run up to the 2008 financial crisis. In setting capital requirements, regulators erroneously judged certain activities -- for instance mortgage securities, derivatives, and European sovereign debt -- as having little, if any risk. Banks piled into these activities because regulators let them lever returns with borrowed money. The consequences were catastrophic.

Because their judgments about risk were so wide of the mark, regulators have made greater use of non-risk weighted standards since the crisis. The most important of these is the "supplemental leverage ratio" or "SLR" -- a relatively simple metric which sets minimums for big banks' common equity as a percentage of their total assets and certain off-balance sheet exposures. In the US, the SLR has been set at 5% for the largest banking organizations (6% for their insured bank subsidiaries).

Section 402 is a seemingly innocuous provision which would exempt from the SLR deposits held at central banks by "custodian" banks. This includes deposits at the Federal Reserve (Fed), as well as the central banks of other Organization for the Economic Cooperation and Development (OECD) members such as Turkey and Greece.

As originally introduced, Section 402 was limited to three so-called "custodian" banks, specialized banks which safeguard customer assets but do not engage in traditional commercial banking. However, during the markup, the Senate Banking Committee loosened the definition of "custodian" bank, potentially creating a gaping loophole as any bank arguably serves as "a custodian" of depositor money. Most big banks will likely press the Fed to let them benefit from Section 402, given the huge competitive advantage it would bestow. Data from the Federal Deposit Insurance Corporation (FDIC) indicate that capital reductions for some banks could approach 30%.

The laudable goal of the sponsors of S. 2155 is to support economic growth. But it seems Section 402 will simply give banks more incentives to take on additional leverage by parking money with central banks, not making business and consumer loans. They can arbitrage the near-zero interest rates they pay on deposits with the 150 basis points they can get at the Fed. That's a nice, tidy margin that will grow even wider as the Fed raises rates this year.

Central bank deposits do not support lending in the real economy. They do include the extra reserves created by central banks when they intervene in the markets through things like quantitative easing, the practice of buying government and private securities to increase the money supply. If the goal of S. 2155's supporters is to facilitate monetary interventions, then that should be made clear. However, even assuming that is the purpose, there is no need for Section 402. The Fed already has substantial flexibility to temporarily ease capital requirements during times of economic stress. The Basel Committee, an international regulatory forum which includes central bank supervisors, has said that in times of *exceptional macroeconomic circumstances* central banks should have the flexibility to *temporarily* remove reserve deposits from the leverage ratio calculation to facilitate such interventions. Only the Brexit-challenged Bank of England has removed central bank deposits from its leverage calculation. Notably, it also made an upward adjustment in its ratio to mitigate the reduction in capital levels, something which S. 2155 does not do.

More fundamentally, why does Congress want to start designating banking activities as low or no risk, when expert financial regulators were so spectacularly wrong prior to the crisis? The SLR's key strength is that it does *not* reflect government judgments about risk. Central bank deposits may seem low risk, but where does this slippery slope end? The Treasury Department wants US government securities also removed from the leverage ratio, notwithstanding their significant interest rate risk. What's next? Housing agency debt? How about AAA corporate bonds? To the extent these instruments compete with central bank deposits for banks' liquid investments, Section 402 will put them at a competitive disadvantage unless they get similar treatment. It will also alter the competitive landscape as it provides a special capital break for big banks that does not apply to smaller institutions, an ironic result for a bill designed to help community and regional banks.

Before concluding, I would like to address some of the confusion surrounding this change, not surprising given the complexity of bank capital regulation. Assets of pension funds, mutual funds, endowments and other bank clients that are held in custody and invested under the control of those clients are already excluded from the SLR. Losses on those assets fall to the clients, not the bank. The SLR applies to funding, be they deposits or other borrowings, over which banks have control. Even though custody banks may not operate as traditional commercial lenders, they are highly systemic and have significant operational risk with many trillions under custody. They can also suffer losses on their investment portfolios, as they did during the crisis. As Federal Deposit Insurance Corporation (FDIC)

Vice-Chair Tom Hoenig has pointed out, custodian banks were borrowing from the Federal Reserve $60 to $90 billion dollars a day to cover funding shortfalls during that tumultuous time.

In the years following the crisis, custodian and other large, systemic banks have grown and remained profitable notwithstanding toughened capital rules. Indeed, the higher capital standards we imposed in the US relative to Europe have been key to our faster economic recovery. It is true that during times of market stress, deposits significantly increase at custodian banks. But this is true of all banks -- FDIC insured deposits went up dramatically during the crisis. This is why risk-based capital rules have built in counter-cyclical buffers, and there would certainly be no harm in Congress recognizing the authority of bank regulators to provide capital accommodation in times of severe stress when deposits are increasing dramatically as investors seek out safety. This is authority I believe they already have.

Government judgments favoring one asset class over another inevitably distort markets. I would strongly encourage Congress not to embark down this path. The responsibility -- and accountability -- for capital rules should rest with the Fed and other bank regulators. Weakening capital rules now will undermine the resiliency of the banking system and heighten the risk of bank failures during the next downturn. This current recovery is already long in the tooth by historical standards. For now, growth is strong and banks are profitable, but that will eventually change. If anything, Congress should be encouraging banks and their regulators to increase capital buffers.

You had also requested my views on other aspects of S. 2155. As previously indicated, outside of Section 402, I am highly supportive of this bill with two caveats. First, in limiting the application of Enhanced Prudential Standards (EPS) Congress should take care not to weaken pre-Dodd-Frank authorities to utilize forward-looking supervisory tools and protect the deposit insurance fund. You would not want to inadvertently weaken supervisory tools that existed prior to the crisis. Second, I am troubled by Section 109 which would exempt many more lenders from escrow requirements for high-cost mortgage loans. Mandatory escrow of insurance and taxes for borrowers with troubled credit histories provide both consumer and safety and soundness benefits. Borrowers who have difficulty managing their finances may well have trouble making these essential payments on their own, forcing them to turn to high cost lenders to cover those costs when they come due, or worse, defaulting on their mortgage obligations. Moreover, administrative costs of escrow requirements are not high and certainly less than costs associated with default. To both protect consumers from the loss of their homes as well as the FDIC-insured banks from mortgage defaults, I would encourage Congress to leave current escrow requirements alone.

Sincerely,

Sheila C. Bair

CC: The Honorable Mike Crapo, Chairman, Senate Banking Committee