The Systemic Risk Council

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

SUBMITTED VIA FEDEX

February 21, 2018

Re: S. 2155, the Economic Growth, Regulatory Relief and Consumer Protection Act

Dear Senators Crapo and Brown,

This letter sets out the Systemic Risk Council's comments on S. 2155, the Economic Growth, Regulatory Relief and Consumer Protection Act (the "Bill"). We have kept our comments as short and to the point as possible, covering only the proposals (a) to raise the balance-sheet-size threshold for treating an intermediary as 'systemic' to $250bn; and (b) to exclude banks' deposits with the Federal Reserve from the leverage ratio.

Relaxing the threshold for intensive supervision

The Bill proposes relaxing the threshold for intensive supervision from total assets of $50bn to $250bn. The Systemic Risk Council (SRC) shares with the Bill's sponsors a desire to release small, local banks from onerous requirements, in the interests of enabling effective competition and of remaining consistent with commercial freedom where social costs are not at issue.

That said, we believe the proposed replacement threshold of $250bn to be too high. It effectively assumes that banking distress will harm the economy only when massive banks fail. History, in the US and elsewhere, shows that to be untrue. When multiple medium-sized banks fail, the damage to the economy can be severe.

In a similar spirit, the SRC opposes the proposal that stress-testing of significant intermediaries be moved away from an annual cycle. Conditions in the economy and financial markets shift too much too quickly for that to be safe or prudent. Were Congress to put regular stress-testing on, say, a two-year or longer cycle, the SRC urges legislators to introduce a power for any individual federal banking regulator to conduct ad hoc stress tests in cases where it believed that such tests were warranted by threats to the stability of the financial system or by an increase in uncertainty about the resilience of the banking system.

Supplementary Leverage Ratio

As the Committee knows, the requirement that banks keep their leverage (broadly the ratio of total assets to equity capital) below a certain level was introduced because of the risks in relying on a risk-weighted minimum capital requirement. Those risks arise because of the mistakes that can be made by regulators and bankers in gauging the riskiness of particular assets and exposures. In particular, reliance of banks' internal models gives bankers incentives to shade down their estimates of risk, effectively leaving them the choice of how much capital to carry to back their business. Given that the whole purpose of bank regulation is to overcome the problem of the social costs of banking distress and failure exceeding the private costs to bankers and their equity holders, allowing the banks to essentially self-regulate their capital would be perverse.

In consequence, the leverage ratio was introduced as a backstop. The more that individual banks stretch the limit of the risk-weighted ratio, the more the backstop will bite. That is the point.

The central feature of the leverage ratio is that it makes no distinction between assets and exposures. The Bill proposes that policy depart from that simple system. In particular, it proposes that reserves (broadly, deposits) held by banks with the Federal Reserve should be excluded from 'total assets'. There are further suggestions that initial-margin moneys placed by banks with central counterparty clearing houses (CCPs) should also be excluded.

This would, we fear, be the thin end of the wedge. The history of bank regulation in the US is of progressive dilutions of core regulatory requirements over a number of years, leaving the banking system as a whole vulnerable to crisis. Preserving the principle that 'total assets' means total assets is important if the American people (and wider world) are to be adequately insulated against financial instability.

More specifically, the SRC recognises that there are special circumstances where reserves should be excluded from 'total assets' in order to remove a binding constraint on quantitative easing (QE)[1]. But SRC believes that such relaxations of regulatory requirements should be temporary and clearly necessary. Those legislators who were concerned about QE should be wary of making a permanent change to the leverage ratio that would make QE easier for the central bank. The final version of Basel 3 provides for such temporary relaxations, but does not make them a permanent feature of the system.

On the question of initial margin moneys (IM) placed with CCPs, SRC recognises that these exposures are low risk where two conditions hold: (a) that the IM is held bankruptcy remote from the clearing house, and (b) that the IM is invested on behalf of the banks in very low-

[1] Technically, the central bank cannot use QE to create more reserves than is consistent with the leverage ratio. That is because where QE is used to buy securities from non-banks, the total assets of banks are increased, raising actual levels of leverage.

risk assets such as Treasury Bills. But even then these exposures are not risk-free, because banks' rights to the segregated assets could be challenged in the event of CCP distress or bankruptcy.

We would make one final comment on this issue. It is sometimes suggested that the leverage ratio is fundamentally ill-suited to custody banks, essentially on the grounds that the services they provide are conducted off-balance sheet. Of course, to the extent that such services are provided on a pure agency basis, there is no balance sheet activity and, thus, the leverage ratio would be irrelevant. In fact, a material source of custody banks' profits come from providing services to their clients via their balance sheets: trading revenue and net interest margin. Those are unavoidably risky. Given the extraordinary concentration of the US custody business, itself a source of systemic vulnerability, it is immensely important that the custody banks be super resilient. Relaxations designed to help them could lead to perverse effects. If the leverage ratio bites, they could act as agents on-placing customer deposits with other banks (or in Treasury Bills or funds) rather than always taking them onto their own balance sheets.

Summary

The Bill is predicated on an assumption that the Dodd-Frank reforms overshot. On some fronts, particularly as concerns truly small banks, SRC agrees. But relative to the period when the financial regulatory reform was designed and legislated, certain aspects of the global environment have deteriorated. In particular, as we have pointed out previously[2], whenever the next recession comes, the adverse effects on borrowers and the financial system are likely to be worse than we are used to because the monetary policy arsenal is depleted and the scope for timely fiscal stimulus is likely constrained. Given those conditions, if the Dodd-Frank reforms were to be recalibrated, minimum capital requirements should be higher, not lower.

The SRC accordingly urges Congress to be cautious in extending prudential regulatory relaxations to medium-sized and large banks. In particular, we recommend that:

- the threshold for applying enhanced prudential standards not be raised as far as $250bn;
- the stress testing requirements of significant intermediaries not be moved away from an annual cycle; and, if such change is made, that it be coupled with a grant of authority to banking regulators to conduct ad hoc stress tests in cases where any one of them believes that such tests are warranted by threats to the stability of the financial system or by an increase in uncertainty about the resilience of the banking system; and

[2] The Systemic Risk Council, Statement to the Finance Ministers, Governors, Chief Financial Regulators, and Legislative Committee Leaders of the G20 Countries (Feb. 27, 2017), *available at* http://4atmuz3ab8k0glu2m35oem99-wpengine.netdna-ssl.com/wp-content/uploads/2017/02/Systemic-Risk-Council-Policy-Statement-to-G20-Leaders.pdf.

- the supplemental leverage ratio not be changed to exclude IM placed with CCPs; and
- the reserves held by banks with the Federal Reserve be excludable from 'total assets' only as a temporary measure where necessary given the mechanics of monetary policy.

Yours sincerely,

Sir Paul Tucker, Chair

On behalf of the Systemic Risk Council
www.systemicriskcouncil.org