The Systemic Risk Council

Secretary Steven T. Mnuchin
U.S. Department of Treasury
1500 Pennsylvania Ave., NW
Washington, DC 20220

SUBMITTED VIA FEDEX

September 19, 2017

Re: A FINANCIAL SYSTEM THAT CREATES ECONOMIC OPPORTUNITIES: BANKS AND CREDIT UNIONS (June 2017)

Dear Secretary Mnuchin:

This letter sets out the Systemic Risk Council's response to the U.S. Treasury's June 2017 Report (UST Report)[1] on possible reforms to the regulatory system for banking put in place following the 2008/09 collapse. In a nutshell, we believe that the UST Report includes a number of worthwhile technical reforms and addresses important issues that are largely incidental to stability, but we are concerned that some of the Report's main recommendations would jeopardise the resilience of the financial system, the public finances and the welfare of citizens.

A review makes sense, but stick with the five core pillars of system resilience

As the Systemic Risk Council (SRC) made clear in our letter to G20 Finance Ministers and Governors at the beginning of the year[2], we agree that, some eight or so years on from the worst phase of the crisis, reviewing the reform program makes sense. As signalled then, we doubt the full force of the reforms should apply to groups of small domestic intermediaries that, even when *taken together*, are not significant to the resilience of the financial system. In that spirit, the UST Report identifies possible reforms to the regulation of community banks. We agree with the broad thrust of those proposals.7

The core pillars of the reform program for system resilience

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[1] "A Financial System That Creates Economic Opportunities: Banks and Credit Unions," U.S. Department of Treasury (hereinafter UST Report) (June 2017).
[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

We are less sanguine about several of the ideas for rolling back regulation of banking institutions whose distress or failure, alone or in combination, would entail wider social costs. Given that the UST Report makes over one hundred recommendations, there is a risk of public debate and Congressional deliberation getting lost in the details. When the very stability of the economic system is at stake, it is vital to focus on the big issues. In doing so, we will frame our comments on the UST Report by recalling the core pillars of the program for maintaining a resilient financial system. In our January Letter, we made the following statement, which we stand by:

> "The five pillars of…the reform program have been:
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> 1) mandating much higher common tangible equity in banking groups to reduce the probability of failure, with individual firms required to carry more equity capital, the greater the social and economic consequences of their failure;
> 2) requiring banking-type intermediaries to reduce materially their exposure to liquidity risk;
> 3) empowering regulators to adopt a system-wide view through which they can ensure the resilience of all intermediaries and market activities, whatever their formal type, that are materially relevant to the resilience of the system as a whole;
> 4) simplifying the network of exposures among intermediaries by mandating that, wherever possible, derivatives transactions be centrally cleared by central counterparties that are required to be extraordinarily resilient; and
> 5) establishing enhanced regimes for resolving financial intermediaries of any kind, size, or nationality so that, even in the midst of a crisis, essential services can be maintained to households and businesses without taxpayer solvency support—a system of bailing-in bondholders rather than of fiscal bailouts.
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> Those regulatory reforms have been accompanied by some major developments in the practice of prudential supervision, notably regular stress testing of key intermediaries and service-providers. As well as being directed to the central issue of whether firms can survive in severe adverse scenarios, stress testing has brought much greater transparency to prudential judgments and, therefore, is helping to improve the quality of public debate on financial stability policy.
>
> In the considered view of the Systemic Risk Council, these five pillars remain as vital as ever."[3]

Of those core policies and measures, all except the fourth are relevant to the current UST Report. Judged against them, the Report contains welcomed proposals for improving the functioning of

[3] *Id*.

the Financial Stability Oversight Council (FSOC), but is worrying when it airs the following reforms:

- an 'off-ramp' from regulation for large firms that have low measured leverage;
- diluting the 'supplementary leverage ratio';
- diluting stress testing of core intermediaries;
- subjecting independent financial regulators to the standard regime for regulatory cost-benefit analysis; and
- excluding the FDIC from the supervision of firms' resolvability.

The remainder of this letter expands upon those specific issues.

<u>Financial Stability Oversight Council</u>

As we said in January,

> "[E]ach G20 country needs a financial stability body that can ensure that system-wide regulatory policies are determined and implemented promptly in a joined-up way in the face of evolving threats."[4]

For the U.S., that body is currently the FSOC. In establishing a committee of agencies under the Treasury Secretary, the US did not go as far as some other G7 countries in providing for a unified financial stability policy, but did improve upon the previous President's Working Group. Design faults have, however, impaired the FSOC's work, including:

- not all of its member agencies have an explicit statutory responsibility to ensure financial stability, which should be remedied by Congress if it wishes to instill a sense of common purpose amongst multiple, sometimes competing authorities[5];
- uncertainty as to whether the chair of an agency exercises his or her FSOC vote as an individual, bound by FSOC's statutory objectives, or as the representative of the agency she or he leads, which should be remedied in order to clarify accountabilities to Congress and to reduce bickering within agencies; and
- inefficiencies, leading to risky delays and unwarranted complexity, when FSOC's

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[4] *Id*.

[5] The UST Report uses the standard categorization of US financial regulators into 'banking regulators', 'market regulators' and so on, but this is deeply misleading. The so-called market regulators are the only authorities with jurisdiction over many broker dealers and derivatives traders. Unless those intermediaries were required to be so small and simple that very simple regulatory constraints on their balance sheets sufficed to deliver safety and soundness, they warrant some type of prudential supervision. Supervision of holding companies is not an adequate substitute because it is *individual legal entities that fail*.

member agencies are required to embark upon joint rule-writing but with each producing its own draft version and the group then negotiating (as if they were a mini-legislative assembly rather than agencies with powers delegated by Congress)[6].

The UST Report does address the third of those problems, proposing that Congress empower FSOC to designate a lead regulator where there are potentially conflicting or overlapping jurisdictions.[7] The concern that lies behind this proposal – the complexity and redundancy of the financial regulatory architecture – is serious and, of course, long-standing.[8]

But the proposal is not yet sufficiently fleshed out. The awkward truth is that, given the multiplicity of agencies and the blurring of boundaries between banking and capital markets, almost anything of significance in the US financial regulatory system has an element of joint jurisdiction. That being so, the UST Report's proposal could lead to FSOC becoming a specialist assembly for allocating regulatory responsibilities. We suspect that it would be hard to pull that off without rationalising the regulatory architecture itself.

A more modest approach would be as follows. Where Congress had stipulated that a rule be agreed amongst and issued by a number of agencies, FSOC could be given a power:

a) to appoint a lead agency to draft the rule and respond to comments from the other agencies, and
b) to sign off on the rule itself where necessary to mitigate a threat to stability before it is too late.

Office of Financial Research

FSOC's work and role is currently supported by the Office of Financial Research (OFR). The UST Report recommends that OFR become a regular part of the Treasury Department, under the Secretary's control and subject to the Treasury Department appropriations and budget process.[9]

The central issue here is whether or not legislators wish to retain a continuous capability, outside of the individual regulatory agencies, to analyze risks to the financial system as a whole, based

[6] *See* The Systemic Risk Council, Letter to the House Financial Services Committee (June 9, 2014), *available at* http://systemicrisk.wpengine.com/wp-content/uploads/2014/06/SRC-Ltr-to-HFSC-re-FSOC-Bills-6-9-2014-final.pdf.
[7] UST Report, *supra* note 1, at 30.
[8] *See* "Reshaping the Financial Regulatory System: Long Delayed, Now Crucial" The Volcker Alliance (2015), *available at* *https://www.volckeralliance.org/sites/default/files/Reshaping%20the%20Financial%20Regulatory%20System%20-%20The%20Volcker%20Alliance.pdf;* "The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure" The Department of the U.S. Treasury (March 2008), *available at* https://www.treasury.gov/press-center/press-releases/Documents/Blueprint.pdf.
[9] *Id*.

on an ability to fill the gaps in statistical reports to those sector-specific regulators. The SRC believes that that function needs to exist somewhere in government. At present it is provided by OFR, which is overseen by (and so can be steered by) FSOC, and the budget of which is subject to consultation with the FSOC chair.[10]

If, instead, OFR becomes a regular part of Treasury, it is likely that the function will wither as the priorities and interests of successive Treasury Secretaries shift away from stability. If that prediction were to come true, we would expect the Federal Reserve to fill the gap.

<u>An 'off ramp' for big and complex banking institutions</u>

So far as financial stability is concerned, the UST Report raises the possibility of very large and complex banks being exempted from much of the regulatory and supervisory apparatus if they seem super-resilient on the basis of a single measure, the leverage ratio.[11] This features in the Financial CHOICE Act that has been passed by the U.S. House of Representatives and currently awaits consideration by the U.S. Senate.[12]

The underlying motives are worthwhile: promoting super-resilience and reducing bureaucracy. It might well have merit for community banks, credit unions and other very small intermediaries that are not highly interconnected with the rest of the system. But when it comes to large and complex firms, with their interconnectedness, significance to the economy and political influence, such an approach would carry great risks: a point which we do not expect the industry to broadcast or lobbyists to explain to Congress.

The reason that banking regulators have not relied on a single measure of capital adequacy is that both a leverage ratio and a risk-based measure have drawbacks that the other helps to mitigate. For example, a simple leverage ratio creates an incentive for banks to shift from lower- to higher-risk assets in an effort to meet targets for headline returns; because that might be spotted, they will tend to hold the highest yielding assets that are thought to be low risk by the market. A risk-based measure can capture some of those risks, and so temper those incentives.

The other problem with relying solely on a leverage ratio is that banks would seek ways around a simple rule by structuring transactions, claims and obligations in ways that fell outside it or got generous treatment within it. Stipulating that 'everything' must be covered does not get far as it

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[10] Congress created the OFR to provide direct support to the FSOC and instilled the OFR with responsibilities for systemic data collection and analysis. Thus, the mission of the OFR is to promote financial stability by delivering high-quality financial data, standards and analysis for the FSOC. *See* Section 154 of the Dodd-Frank Wall Street Reform and Consumer Protection Act.
[11] UST Report, *supra* note 1, at 53.
[12] H.R. 10, the Financial CHOICE Act of 2017.

simply generates questions about whether an exposure should be included on the basis of the maximum loss it could cause, its current notional value, its market value, or some other metric.

Looking back, that became a major problem by the mid-1980s, with the mushrooming of 'off-balance sheet' finance and derivatives. The remedy, incorporated into the first Basel Capital Accord in 1987, was to apply risk-weights to all exposures. That approach lost its way during the 1990s when a desire for more refined risk-sensitivity led to minimum capital requirements that were far too complicated, and were gamed. Because risk-weights were based partly on banks' own models, for a while capital requirements were effectively handed back to the banks themselves, undermining the very purpose of prudential regulation.

The leverage ratio is designed to help guard against that happening again. But the false turns of the 1990s, and the need to avoid unwarranted complexity, should not blind policymakers to the fatal pitfalls of putting all of their eggs in the leverage-ratio basket. In line with international agreements, the Dodd Frank reforms usefully combined a simple leverage ratio, a somewhat streamlined risk-based ratio and stress testing. It would be a big mistake to rely on any single one of those.[13]

<u>The Supplementary Leverage Ratio</u>

The UST Report proposes that the Supplementary Leverage Ratio (SLR) that currently applies to the largest banks and dealers be adjusted to exclude three types of assets from 'total assets': reserves held with the central bank; US Treasury securities; and initial margin placed with clearing houses.

While a technical case can be made for two of those exemptions (central bank reserves and legally remote initial margin), they risk becoming the thin end of a thick wedge. Once ostensibly riskless assets were excluded, over the years there would likely be an epidemic of lobbying to broaden the exemptions, including securities that were, on some measure, super-AAA. The eventual effect would be to replicate some of the hazards that led to the 2007/08 crisis.

More specifically:

- if Treasuries were to be omitted, capital would not have to be allocated to the interest-rate risks run by some banks; and
- if initial margin held with clearing houses were omitted, it would be vital to ensure that such assets were at all times completely (legally, financially and operationally) ring-fenced from the clearing house itself and invested in short-term Treasury Bills.

[13] For the risk-based ratio, at least some SRC members favour having floors on the risk-weights for the various categories of exposure, so as to put obstacles in the way of banks gaming that part of the regime. This would revert to the spirit of Basel 1.

> Otherwise, those assets would not be risk free. Since almost any transaction can be replicated by a bundle of derivatives, there would be incentives to recast banking in ways that attracted minimal equity requirements; banks would use portfolios of derivatives rather than simpler transaction structures in order to economize on capital.

Separately, omitting those assets from the leverage ratio would be a very big mistake if the ratio were the basis for an off-ramp from, amongst other things, liquidity regulation. That is because all assets, however low their default risk, have to be funded, and if funded by short-term debt, expose a bank to run risk. A 5% SLR permits 95% of banking exposures to be financed by debt without any constraints on the riskiness of the assets or the runnability of the liabilities.

If anything, rather than reducing equity requirements, a case can be made for raising them given the depleted macroeconomic arsenal likely to be available to the authorities when the next recession occurs. To weather future adverse economic shocks, the banking system is likely going to have to rely more on its own resources and less on stimulus from monetary and fiscal policy.

<u>Streamlining stress testing</u>

While we agree with the UST Report that stress testing should not be overly complicated and should be clearly focused on firms' resilience, the UST Report makes two recommendations on stress testing that worry us:

- that the Fed's stress tests be conducted once every two years rather than annually; and
- that stress testing be effected by notice-and-comment rule-making.[14]

Frequency of stress testing

Mandating that a twelve-month gap must be left between stress tests would be hazardous, unless supervisors were empowered to exercise discretionary judgment in conducting *ad hoc* stress tests. The shifts in the domestic and international financial and economic environment that create systemic risks are not polite enough to present themselves to a timetable. The rapid deterioration of the US mortgage markets in the run up to the 2008 crisis testifies to that.

The greatest problem in designing an effective regulatory regime for financial stability is, indeed, the impossibility of writing a rule book which relies upon enforcement *after* breaches occur. In the first place, endemic regulatory arbitrage means that the spirit of the rules is unlikely to prevail. Separately, while after-the-fact enforcement against breaches of prudential regulations is important to deter *future* improvidence, it does not help to protect against distress and failure. Supervision is necessary to try to detect the hidden actions that render firms weaker than revealed by standard accounting measures. Ongoing stress testing is very important to

[14] UST Report, *supra* note 1, at 53.

maintaining a resilient system given the challenges in relying on desk-based, purely analytical early-warning systems.

Rule-making or adjudicatory decisions

Requiring each stress test (its scenarios, and the models used) to be conducted under notice-and-comment rule-making would probably kill this new supervisory technique (which might be the objective of some critics).

We will cite two hazards with consulting on the key inputs into stress testing:

- delays caused by legal challenges could leave the scenarios out of date by the time they were applied; and
- revealing the regulator's own models would almost certainly lead firms to reshape their balance sheets *temporarily* so as to come out of the test well: window dressing of the gravest kind.

Stress tests are, in their essence, tools to help supervisors make judgments about whether individual firms meet the criteria to keep their banking licence, an essentially adjudicatory process. They extend and develop the traditional examination process by shifting the focus from backward-looking measures to forward-looking assessments. The last crisis underlined the importance of adopting forward-looking supervision if the big risks to stability are to be mitigated in time.

If, nevertheless, this proposed change were made, it would be prudent: (a) to increase minimum tangible-common-equity requirements considerably, for both the risk-weighted ratio and the leverage ratio; and (b) to intensify supervisory efforts aimed at heading off regulatory arbitrage.

<u>Cost-benefit analysis</u>

The UST Report proposes that financial regulatory rule-making be subject to formal cost-benefit analysis (CBA). There is not a consensus within the SRC as to whether CBA is in principle capable of being applied in the field of stability policy, but there is a shared concern that, depending on how any legislative provisions were framed, it could impair the capacity of independent agencies to fulfil the mission given to them by Congress to preserve a safe and sound system. We would, accordingly, make a few cautionary comments.

Office of Information and Regulatory Affairs

At present, the major financial regulatory agencies are 'independent', in the sense that members of their policy-making bodies have job security and, subject to the law, autonomy in their decisions, helping to insulate them from day-to-day political currents. So long as that remains the case, as we believe it should in the interests of committing to stability, their insulation should extend to their rule-writing. That means that, even if they were required by Congress to conduct formal CBA, their CBA should not be subject to vetting or appraisal by the Office of Information and Regulatory Affairs (OIRA). While appropriate for those executive agencies whose leaders serve at the pleasure of the President of the day, it is inappropriate where Congress has sought to insulate agencies from the Administration's control. It would be a mistake to bring day-to-day political considerations into banking regulation, the allocation of credit and payments services given the short-run popularity of local, regional or nation-wide booms.

Cost-benefit analysis is about forecasting, and stability policy is about insurance

Cost-benefit analysis does not produce certainty. It is about forecasting, with different benefits and costs subject to different sources and degrees of uncertainty. In consequence, it is not simply about choosing discount rates with a view to giving priority to a point estimate (or forecast) of net costs or benefits.

Those general points are especially important in the field of systemic stability, where there is a major question of whether the appropriate measure is a comparison of expected costs and benefits. The costs can be thought of as a flow of insurance premiums that are paid to achieve the benefits of reducing the incidence and severity of crises. In conducting CBA, it is important to compare the *social* costs of the insurance (not the private costs to banks) with the social benefits. Since financial crises can bring not only massive financial and economic costs but can also have destabilising political and constitutional effects, as in 1930s Europe, it is important to keep sight of the big issues.

Ultimately, regulation for stability is about deciding how much society wants to make firms self-insure in order to reduce or eliminate the prospect of taxpayer bailouts. Thus, when the UST Report stipulates that "new rules should be designed to do more good than harm"[15], that does not amount to saying much unless it is reasonably clear how legislators are weighing any trade-off between, say, a greater prospect of booms in the near term and the higher probability of a future crisis being catastrophic. The reason legislators have historically delegated financial system regulation and supervision to independent agencies is to protect against the short-term attractions of giving greater weight to the short-term than to longer-term benefits of stability.

In other words, the analytical techniques that feed into CBA rely on a value judgment already having been made by legislators that they want the core of the financial system to be resilient. For that reason, it is important that any CBA provisions in this area are framed in a way that reduces the chances of the courts substituting their view of the substance (as opposed to the law)

[15] UST Report, *supra* note 1, at 62.

for that of the regulators or their Congressional overseers. It is equally important that regulators adopt only those measures judged necessary to deliver the desired resilience on an ongoing basis.

The FDIC's involvement in the Living Will process

Currently the Federal Reserve and the FDIC have joint authority for oversight and regulation of intermediaries' Living Wills under Title I of Dodd-Frank.[16] The UST Report proposes that the FDIC be removed from this function.

That would make no sense at all unless the UST were in due course to favour of abolishing the resolution regime contained in Title II of Dodd-Frank, which itself would be a grave mistake (see below).

Assuming Title II survives, it would be strange for the agency charged with its operation to have been formally removed from the process of overseeing the resolvability of firms and groups that it might end up having to resolve. Were that to become the formal state of affairs, it is hard to envisage anything other than the Federal Reserve (and possibly the firms themselves) involving FDIC in the process informally. Given that the FDIC is the only US agency with experience in resolving financial intermediaries, and bearing in mind its outstanding reputation around the world, it would be perverse for the Federal Reserve not to turn to it.

But the broader and bigger point concerns the UST Report's apparent signal that the Treasury Department is seriously contemplating abolishing Title II, leaving the American people wholly reliant on the bankruptcy process to maintain stability and to protect the public finances in the wake of distress amongst major intermediaries. Since the question is scheduled for coverage in one of Treasury Department's subsequent reports, we make only a few headline points here:

- As it stands, the US bankruptcy code could not conceivably cope with the failure of a large financial intermediary. Even if obvious technical deficiencies were fixed, as is proposed, views are mixed (to put it mildly) on whether a bankruptcy process could minimize the social costs of firm failure.[17]
- Notwithstanding the Chapter 11 bankruptcy process for non-financial businesses being the envy of the world, no U.S. court has experience in managing the chaos that can be unleashed by some financial-firm failures, where (for the very largest firms) the President would almost certainly need to explain what was going on to, and cooperate with, his global peers.

[16] *Id*. at 68.
[17] Gordon, Jeffrey N. and Roe, Mark J., "Financial Scholars Oppose Eliminating 'Orderly Liquidation Authority' as Crisis-Avoidance Restructuring Backstop" (May 23, 2017). *Available at* https://ssrn.com/abstract=2979546.

- For those kinds of reasons, and given the lack of an international treaty on bankruptcy, no other jurisdiction with a major financial center is relying on a straightforward bankruptcy procedure for the orderly resolution of financial firms.
- If the U.S. decided to rely upon a process that the rest of the world concluded could not (or was unlikely to) work, foreign regulators and governments would almost inevitably have to consider whether to put a strong ring-fence around the local operations of US-domiciled groups, risking an outbreak of financial-services tit-for-tat regulatory protectionism. (Even if that prospect did not materialise, the uncertainty while foreign regulators worked out what to do would be damaging.)

That is not to say that the UST Report does not raise some serious points. For example, the Living Wills required by Title I of Dodd-Frank seem to be bizarrely long and detailed. But that might be because they are designed to cope with a bankruptcy process that, at least currently, has fatal flaws when it comes to large and complex financial intermediaries.

We look forward to considering carefully the Treasury Department's report on this issue later in the year.

Summary and conclusions

If there is another major financial crisis over the next 10-25 years, let alone sooner, the likely political backlash would be so great that the basic fabric of our market economy and the system of republican democracy could be in jeopardy. While the UST Report contains many fine suggestions on matters that are technical or not central to stability, it also either promotes or gives an airing to proposals that would seriously reduce the resilience of the financial system and expose the public to unnecessary risk and hardship. Implementing them would amount to gambling on the questionable assumptions that loosening the constraints on banking would boost short-term credit growth; and that any such boom would bring benefits to parts of the community that would outweigh the longer-term and economy-wide risks for the nation as a whole.

While an effective financial system *is* essential to growth and prosperity, of all the countries in the world it seems unlikely that the U.S. – and, in particular, its conversion of technological innovation into economy-wide productivity growth – is being held back by lack of finance. The other planned Treasury Department reports, including the one covering the system of housing finance, which might divert private resources from productive investment, should at least be completed before firm plans are made to roll back the system-resilience provisions of the Dodd-Frank reform program.

Yours sincerely,

Sir Paul Tucker, Chair

On behalf of the Systemic Risk Council
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