TESTIMONY OF DAN MCCARDELL
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THE CLEARING HOUSE ASSOCIATION L.L.C.
BEFORE THE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
COMMITTEE ON FINANCIAL SERVICES
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Chairman Capito, Ranking Member Maloney and members of the subcommittee, my name is Dan McCardell and I am Senior Vice President and Head of Regulatory Affairs for The Clearing House Association L.L.C. I appreciate the opportunity to appear before you today to discuss Section 171 of the Dodd-Frank Act,[1] commonly known as the "Collins Amendment."

Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. It is owned by 24 commercial banks which collectively employ over 2 million people. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing — through regulatory comment letters, amicus briefs and white papers — the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the U.S.

Before I address the topic of today's hearing, let me begin by reiterating our strong support for recent U.S. and international regulatory reform efforts which have substantially increased the quantity and quality of capital that banking institutions are required to hold. Insufficient capital at some institutions clearly contributed to the onset and escalation of the 2007-2009 financial crisis. As discussed below, U.S. banking organizations already have significantly increased the amount of capital they hold as a result of these regulatory reform efforts. Furthermore, we have consistently supported significant and fundamental changes to the financial services regulatory regime in order to establish a regulatory framework that both protects the financial system against potential systemic meltdowns of the type faced in the recent crisis – for example, by increasing capital requirements – and enables the financial system to play its necessary role in fostering economic and job growth.

We are concerned, however, that certain specific aspects of these capital related reforms could ultimately work at cross purposes with these twin policy objectives.

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1 The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (the "Dodd-Frank Act").

For purposes of my testimony today, I will focus on four particular facets of this issue:

1. The Collins Amendment's provision of most significance to our members is its requirement that the Basel I-based minimum risk based capital requirements serve as a floor for U.S. banking institutions subject to the federal banking agencies' Basel II-based internal ratings based and advanced measurement approach. The policy concern that apparently underlay this provision – namely that the Basel II approach may require too little capital – has been separately and more appropriately addressed by other reforms in the regulation of bank capital.

2. The inherently duplicative nature of the Collins Amendment's Basel I floor would therefore only serve to make capital planning needlessly complex in perpetuity and thereby divert significant management and supervisory time and resources.

3. This Basel I floor requirement and the Collins Amendment's much shorter three-year phase-out of certain hybrid capital instruments from inclusion in Tier 1 capital (as opposed to Basel III's 10-year phase-out) could place covered U.S. institutions at a competitive disadvantage *vis-a-vis* their international peers.

4. An implicit assumption in the Collins Amendment's Basel I floor is that more capital is better. As a matter of public policy, capital levels should strike a balance between the mutually important goals of enhancing bank stability and fostering economic growth. There is a significant under-appreciation of the trade-offs between ever higher capital requirements, including as result of the Collins Amendment's Basel I floor (and the Basel Committee's surcharge on global systemically important banks – the so called "G-SIBs"),[2] and the risk of reducing economic and job growth and pushing financial transactions to the shadow banking sector.

We believe that it is also important to note that since the introduction of the original Basel I capital framework in 1988, international capital standards have undergone an evolutionary progression towards more risk sensitivity, greater recognition and incorporation of market risk related provisions, and substantial increases in the quantity and quality of capital. The Basel II proposals finalized in 2006 introduced more risk-sensitive definitions and methods for calculating risk weighted assets. Based on the lessons learned from the financial crisis, the Basel II.5 framework finalized in 2009 addressed important market risks through incremental capital charges for trading book assets such as securitized credit products and securitization positions in calculating risk weighted assets. The Basel III proposals adopted in 2010

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2 *See* Basel Committee, *Global Systemically Banks: Assessment Methodology and the Additional Loss Absorbency Requirement – Rules Text* (November 2011). The Basel Committee's G-SIB surcharge approach and underlying methodology has also been specifically endorsed by the Federal Reserve in the 165/166 NPR.

incorporated other lessons learned from the financial crisis by, among other things, establishing a regulatory mandated Common Equity Tier 1 ("CET1") ratio, establishment of more stringent limitation on so-called "lesser assets" and their deduction from CET1, narrowing the definition of permissible capital instruments, and introducing regulatory liquidity ratios. As such, the evolution in capital requirements as reflected by the international Basel accords demonstrates that 'smarter' standards such as increased risk sensitivity, improvements in the quality of capital and the recognition of the crucial role played by liquidity may very well be as important, from a policy perspective, as simple increases in the amount of capital required to be held by banking institutions.

SUMMARY OF THE COLLINS AMENDMENT

As an initial matter, I will begin by summarizing the provisions of the Collins Amendment that are of specific importance to our members. Section 171 of the Dodd-Frank Act requires the federal banking agencies to establish minimum leverage and risk-based capital requirements that apply on a consolidated basis for FDIC-insured depository institutions, depository institution holding companies and covered non-bank financial companies supervised by the Federal Reserve. The Collins Amendment mandates that these minimum leverage and risk-based capital requirements *may not be less than* the generally applicable leverage capital requirements and the generally applicable risk-based capital requirements established by the appropriate federal banking agencies under the prompt corrective action regulations implementing Section 38 of the Federal Deposit Insurance Act, "regardless of total asset size or foreign financial exposure." In addition, these leverage and risk-based capital requirements may not be *quantitatively lowe*r than the generally applicable leverage or risk-based capital requirements in effect on July 21, 2010.

The Collins Amendment has three main consequences.[3] First, it imposes a minimum risk-based capital floor consisting of the Basel I-based requirements, which currently apply to most banking organizations, on large banking institutions that are required to calculate regulatory capital under the Basel II-based internal ratings and advanced measurement approach as adopted in the United States.[4] Under the capital regulations existing prior to the passage of the Collins Amendment, the minimum risk-based capital requirements applicable to banking organizations under the Basel II-based advanced approach could be lower or higher than those pursuant to the Basel I-based rules. If lower for a particular institution, the Collins Amendment would increase minimum risk based capital requirements for that institution compared to what

3 In addition, the Collins Amendment also provides that bank holding company subsidiaries of non-U.S. banking organizations that currently meet their capital requirements based on home-country standards in accordance with applicable Federal Reserve supervisory guidance are required to separately meet U.S. bank holding company capital standards at the relevant subsidiary bank holding company starting in 2015.

4 As implemented in the United States, currently only organizations with $250 billion or more of total consolidated assets or $10 billion or more of non-U.S. exposures must use the Basel II - based internal ratings and advanced measurement approach.

would otherwise apply. Second, because the Basel I standard remains as an indefinite capital floor under the Collins Amendment, U.S. banking institutions subject to Basel II must therefore calculate their capital requirements under both Basel I and Basel II in perpetuity. Third, since capital requirements must be the same for depository institutions as for their holding companies, the Collins Amendment phases-out trust preferred securities, cumulative preferred stock and certain other hybrid capital instruments from inclusion in the Tier 1 capital of most bank holding companies.[5] Prior to the passage of the Dodd-Frank Act, bank holding companies could include qualifying trust preferred securities in their Tier 1 capital, subject to a cap. The phase-out is supposed to occur over a three-year period beginning on January 1, 2013.[6]

THE POLICY CONCERNS THAT APPARENTLY GAVE RISE TO THE COLLINS AMENDMENT'S BASEL I FLOOR – NAMELY, THAT THE BASEL II APPROACH MAY REQUIRE TOO LITTLE CAPITAL – HAVE BEEN SEPARATELY AND MORE APPROPRIATELY ADDRESSED BY OTHER REGULATORY REFORMS RESULTING IN SIGNIFICANT INCREASES IN CAPITAL

The Collins Amendment's potential increase in minimum risk based capital requirements due to the operation of the Basel I floor is but one of a number of U.S. and international regulatory reform initiatives that that have increased the amount and quality of capital that U.S. banking institutions are and will be required to hold. The final Basel III capital and liquidity frameworks have been the foundation for post-crisis international efforts to address capital adequacy and liquidity risk; the federal banking agencies are moving ahead with the amendments to their market risk capital rules (known as Basel II.5); the federal banking agencies also issued for comment in June 2011 and adopted in final form earlier this week joint guidance on stress testing, have adopted the Capital Plan Rule[7] effective December 30, 2011 which requires that covered banking institutions demonstrate their ability to maintain capital above existing minimum capital ratios and above a Tier 1 common ratio of 5% under both expected and stressed conditions or else face limitations on capital distributions such as dividends and share buy-backs, and pursuant to the Capital Plan Rule, and recently completed the CCAR 2012 review.

The heightened capital requirements under Basel III alone will require U.S. banking institutions to increase the amount of common equity Tier 1 capital by *over 100%* from the amount held at December 31, 2007.[8] In addition, as a result of the imposition of Basel III's

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5 The Collins Amendment's exclusion of trust preferred securities and other hybrid capital instruments does not apply to small bank holding companies with less than $500 million of total consolidated assets or to such securities issued before May 19, 2010 by bank holding companies with total consolidated assets of less than $15 billion as of December 31, 2009.

6 The federal banking agencies have not yet proposed rules as to the specific parameters and schedule of the phase-out implementation.

7 12 C.F.R. § 225.8 *et seq.*

8 For further information regarding how much additional common equity banks will need to hold relative to pre-crisis levels, as well as the data on which this estimate is based, see slides 9 and 13

quantitative, qualitative and risk-weighting requirements, the 7% minimum CET1 ratio under Basel III is equivalent to a 14% Tier 1 common equity capital ratio under the pre-crisis Basel I rules for U.S. banking institutions. If the Basel Committee's proposed G-SIB surcharge is also imposed, it would result in the U.S. banking system holding the equivalent of 16% Tier 1 capital in Basel I terms, or four times the Tier 1 capital required before the crisis in order to be "adequately capitalized" (namely, 4%).[9] The potential targets of the G-SIB surcharge are very likely the same large U.S. banking institutions subject to Basel II and therefore further subject to potential increased minimum capital requirements due to the Collins Amendment's Basel I floor discussed above.

Furthermore, Basel III and related enhancements to the capital framework made under Basel II.5 not only address aggregate capital requirements, but also the specific areas in which excessive risk was thought to be incurred. For example, Basel II.5 dramatically increases – often by 400% or more – the capital charge on trading positions held by large banks.

We believe these substantially enhanced capital requirements, together with the heightened prudential standards mandated by the Dodd-Frank Act, significantly reduce the potential for large banks to pose systemic risks and reduce their probability of failure in light of empirical evidence that shows that banks on a worldwide basis that had capital levels greater than the new Basel III effective CET1 minimum ratio of seven percent did not suffer serious financial distress in the recent crisis. In light of these significant new reforms, any potential increase in capital required by the operation of the Collins Amendment's Basel I floor (and the G-SIB surcharge) would appear to be of little marginal utility in achieving the crucial objectives of protecting the financial system against potential systemic meltdowns of the type faced in the recent crisis and therefore the policy concerns that apparently gave rise to this requirement – that Basel II may require too little capital – have been separately and more appropriately addressed.

THE INHERENTLY DUPLICATIVE NATURE OF THE COLLINS AMENDMENT'S BASEL I FLOOR WOULD MAKE CAPITAL PLANNING NEEDLESSLY COMPLEX IN PERPETUITY

There will also be significant practical challenges in complying with the Collins Amendment's Basel I floor requirements. In order to determine whether they meet the Basel I floor, U.S. banking institutions subject to the Basel II advanced approach will likely need to calculate eight separate capital ratios under two separate and distinct capital regimes — that is, the CET1 ratio, the additional/Tier 1 capital ratio, the total capital ratio and the leverage ratio under both the Basel I- and the Basel II-based rules – compare the results, and abide by the higher of the results under the Basel I- and Basel II-based rules. These banking institutions are and will also be required to separately calculate their capital under stressed scenarios pursuant to

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of the study conducted on behalf of TCH entitled "*How Much Capital Is Enough? Capital Levels and G-SIB Capital Surcharges*" available at [link.] (the "G-SIB Surcharge Study")

9 *See* page 6 of the G-SIB Surcharge Study for further information.

the Capital Plan Rule and the recently proposed stress testing rules under Section 165(i) of the Dodd-Frank Act.[10]

This tremendous amount of duplication makes capital planning a needlessly complex endeavor in perpetuity because institutions will need to organize their capital planning, policies and procedures and operations around two separate and distinct capital regimes. This would also require that a substantial amount of management time and resources be focused on duplicative capital exercises instead of on running the core business of the banking institution – serving its customers by performing crucial financial intermediation and thereby fostering economic and job growth. In addition, significant supervisory resources will need to be expended by the federal banking agencies to monitor this duplicative capital exercise.

THE COLLINS AMENDMENT'S BASEL I-BASED FLOOR AND THREE-YEAR PHASE OUT OF HYBRID SECURITIES COULD PLACE COVERED U.S. INSTITUTIONS AT A COMPETITIVE DISADVANTAGE

Other jurisdictions have not adopted the Collins Amendment's approach of imposing a Basel I-based minimum risk based capital floor to banking institutions that are subject to Basel II-based capital requirements. As such, the potentially higher resulting capital requirements and their potential negative effects discussed below, including the risk of reducing U.S. economic and job growth, will only affect U.S. banking institutions subject to the Collins Amendment.

In addition, the Collins Amendment's phase-out of trust preferred and other hybrid securities from Tier 1 capital will take place over a three-year period while Basel III's phase out such instruments will take place over a 10-year period, in each case, starting on January 1, 2013. U.S. banking institutions subject to the Collins Amendment's three-year phase-out will therefore need to replace such instruments with potentially higher cost capital on a much more compressed timeline than firms only subject to the Basel III 10-year phase-out.

Given these two features of the Collins Amendment, both singly and especially in the aggregate, U.S. banking institutions could be placed at a significant competitive disadvantage *vis-a-vis* their international peers that are only subject to Basel II and Basel III, as applicable.

CAPITAL LEVELS SHOULD BALANCE STABILITY WITH ECONOMIC GROWTH

An implicit assumption underlying the Collins Amendment's Basel I floor appears to be that requiring more capital is always the better policy outcome. As discussed above, banking institutions today already hold substantially higher - and better - quality capital than was required prior to the financial crisis. However, we believe that there is a significant under appreciation of the trade-offs between ever higher capital levels and the risk of reducing

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10 *See* Subparts F and G or the Federal Reserve's notice of proposed rulemaking implementing the enhanced prudential standards and early remediation provisions of Sections 165 and 166 of the Dodd-Frank Act. 77 Fed. Reg. 594 (Jan. 5, 2012) (the "165/166 NPR").

economic and job growth and pushing financial transactions to the shadow banking sector. The imposition of higher capital requirements on large banking institutions, including the Basel I floor of the Collins amendment (and imposition of the proposed surcharge on G-SIBs), is not necessarily a cost-free proposition. Ever higher capital requirements on banking institutions may lead to decreased availability of credit as banking institutions are encouraged to shrink their balance sheets in order to address the effects of the increases.[11] That potential decrease in credit availability will be exacerbated by the new liquidity requirements, which will largely foreclose banks' ability to shrink their balance sheets by reducing the amount of high-quality liquid assets they hold, leaving them with little choice but to reduce lending. These actions by banking institutions could reduce job growth and, more generally, harm the broader economy at a particularly difficult economic juncture while the U.S. economy is still recovering.

Moreover, demand in the economy for the products and services that banking institutions subject to higher capital requirements of the surcharge and the Collins Basel I floor are no longer willing or able to provide because of the higher costs imposed by these higher capital requirements will not, of course, simply evaporate. The provision of some of these products and services is likely to shift to the less regulated and less transparent "shadow banking" sector.[12] In view of the shadow banking system's role in lowering credit standards during the last decade,[13] and the absence of regulation and transparency, a migration to that system would have negative implications for the health of the financial system as a whole.[14] Both of these

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11 *See* Douglas J. Elliott, Brookings Inst., *A Primer on Bank Capital* 22 (Jan. 28, 2010), http://www.brookings.edu/research/papers/2010/01/29-capital-elliott ("[H]igher capital levels increase the total expense of operating a bank and making loans, even taking account of the decrease in the cost of each dollar of bank equity and debt due to the greater safety of a bank which operates with more capital. This higher level of expense for the banking system can be offset in part by reducing other expenses, such as compensation and administrative expenses. However, the net effect is still likely to be negative, leading to a need to improve the net return on loans by turning down the least attractive loan opportunities, charging more for those that are taken on, and reducing deposit costs to increase the margin between the interest rates earned on loans and those paid for funding the loans.").

12 *See,* e.g., Kate Berry and Jeff Horwitz, *Regs Push MetLife Out of Banking, into Shadow System*, American Banker (July 2011) (discussing MetLife's decision to sell its bank but to continue writing mortgages). *See also* Thomas F. Cosimano and Dalia S. Hakura, *Bank Behavior in Response to Basel III: A Cross-Country Analysis*, IMF Working Paper (May 2011), at 6 (noting that even modest increases in lending costs as a result of increased capital requirements on banks "could create significant incentives for regulatory arbitrage and a shift away from traditional banking activity to the 'shadow-banking sector'").

13 *See* Financial Stability Board, *Shadow Banking: Scoping the Issues: A Background Note of the Financial Stability Board* (April 12, 2011), at 3, *available at* http://www.financialstabilityboard.org/publications/r_110412a.pdf.

14 *Cf.* Zoltan Pozsar, Tobias Adrian, Adam Ashcraft and Hayley Boesky, *Federal Reserve Bank of New York Staff Reports: Shadow Banking*, Staff Report No. 458, at 24 (July 2010, Revised

outcomes would actually increase systemic risk – quite the opposite of the ultimate goal of the Collins Amendment and the Dodd-Frank Act more broadly. In light of the foregoing, the implicit assumption in the Collins Amendment's Basel I floor that more capital is better is not always correct.

<u>CONCLUSION:</u>

We strongly believe that, in the wake of the 2007-2009 financial crisis, enhanced risk based capital requirements are an important component of the regulatory reform efforts which, from a policy perspective, must be aimed at both protecting the financial system against potential systemic meltdowns and enabling the banking institutions and the financial system to play their necessary role in fostering economic and job growth.

However, we believe that the policy concern that apparently gave rise to the Collins Amendment's Basel I-based minimum capital floor – namely, that the Basel II approach could require too little capital – has been separately and more appropriately addressed by other regulatory reforms that have resulted in significant increases in the both the quantity and quality of capital required. In light of these reforms, the Basel I floor will only serve to make capital planning needlessly complex and thereby diverting significant management and supervisory time and resources due to the inherently duplicative and confusing nature of having to simultaneously measure capital against two separate bench-marks. Moreover, it could place subject U.S. institutions at a competitive disadvantage *vis-a-vis* their international peers. Finally, there is a significant under appreciation of the trade-offs between ever higher capital levels, including as required by the Collins Amendment's Basel I floor, and the risk of reducing economic and job growth and pushing financial transactions to the shadow banking sector.

We strongly urge policymakers in Congress, the Administration and the federal banking agencies to keep these issues in mind as the financial services regulatory reform efforts in the U.S. and internationally are evaluated and considered on an on-going basis.

Again, I thank you for the opportunity to testify before you today and look forward to any questions you may have.

February 2012) (questioning whether the economically viable parts of the shadow banking system "will ever be stable through credit cycles in the absence of official credit and liquidity puts").