For the Record

Welcome to the inaugural issue of the The Clearing House's quarterly publication, Banking Perspective*. Each quarter, a different thought leader from our industry will share his or her perspective on vital issues impacting the U.S. banking system. In this issue, TCH Association President and General Counsel Paul Saltzman shares his viewpoint on a macroprudential regulatory framework.*

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There are endless topics one could write about given the degree of change now occurring in the banking industry. What perspective could I offer that hasn't already been written about? What new and insightful revelation could I suggest that would change minds, influence policymakers, and bring about positive change in our bank regulatory system?

I could go positive. Yes, take the high road. I could use the launch of *Banking Perspective* as an opportunity to champion the significant progress we've made in implementing Dodd-Frank's heightened prudential standards for systemically important banks (SIFIs).[1] Perhaps I could point out the myriad of microprudential and macroprudential regulations and new supervisory practices that are in place, or being put in place, to mitigate both the likelihood and consequences of a SIFI's failure.[2] (Financial stability, after all, is the primary purpose of our reform efforts). Or I could emphasize that the United States has nearly completed the world's first resolution framework that allows a troubled SIFI to be safely resolved without any loss to the taxpayer.[3] Better yet, I could provide a litany of factual metrics demonstrating that our banking system is safer and sounder—increases in both the quantity and quality of capital, stricter liquidity standards, enhanced compliance systems, and improved risk-management and governance practices.[4] For a policy discussion that's so critical to the economic well-being of our country, the facts should matter.

But would anyone really listen? Too often, the dialogue about banking regulation isn't really about banking regulation. That's just the surface manifestation of what has become an ideological exchange in which policy arguments about banking regulation become proxies for some underlying political objective—in this case, about the proper role of banks and government in credit extension and risk management decisions. Some even question the very social value of our current financial system.[5] In such a debate, the facts don't seem to matter.

So perhaps I should go negative. Yes, that's the ticket. I could emphasize the risks

of an untested macroprudential regulatory paradigm through which regulators employ a one-size-fits-all approach to addressing systemic risks with little regard to the idiosyncratic differences among those risks. Perhaps I could also question the empirical foundation underlying many of the prescriptive rules designed to micromanage banks' balance sheets, pricing structures, and operating models.[6] Maybe I should call attention to the scholarship that postulates the use of macroprudential regulations to bring about industrial policy, an agenda increasingly filled with "Pigouvian" taxes, surcharges, and attempts to manage "excessive" credit extension and "normative" asset prices.[7]

I've got a good one—"negative externality creep." I could raise concerns about the many well-intentioned regulators, legislators, economists, and academics who have a propensity to muse about second-and-third-order tail risks, but who more often than not understate the *benefits* of the activities they seek to discourage or the true costs of their policy prescriptions.[8] But that's somewhat overstated and likely to generate a good deal of criticism. It wouldn't contribute to a reasoned debate, so it's probably not the right way to go.

So where does that leave me? Worried and concerned.

I worry that, like military generals so often do, our regulatory policymakers are fighting the last war. I'm concerned that too much of our debate is infused with economically populist tendencies borne from (quite understandable) misperceptions and hindsight judgments about crisis-era actions. Very real and transformational changes are now being wrought to our banking system without sufficient deliberation or a true appreciation of the impact these changes are having on real consumers, economic growth, and our prosperity. This is particularly true for the less economically-fortunate among us who need to be enfranchised in the banking system, not channeled away from it.

Macroprudential policy has macro*economic* consequences. Subtle and iterative change can be sequentially and cumulatively transformational. Maybe these trends are more self-evident than I can appreciate. We seem to be shrinking and deleveraging our banking system (while ignoring the resulting effects on growth) and limiting interconnectedness (while ignoring the impact on liquidity) in an attempt to limit contagion and risk.[9] Some appear to want banks to be public utilities, either implicitly through the supervisory process or explicitly through regulations that dictate returns in ways that would be unacceptable in almost any other industry. And ironically, we seem to be doing all this while understating the impact of regulatory arbitrage and the shift of core credit creation and intermediation functions—and systemic risks inherent in those functions—to significantly *less* regulated parts of our financial system.[10]

I worry that bank executives are spending less of their time on the business of banking—creating customer value, managing risk, and identifying threats that could harm their stakeholders. Isn't the best defense a good offense? Isn't the best approach to a safe and sound banking system one that promotes banks that are both safe *and* profitable?

While policymakers debate structural change to our banking system—Volcker, Vickers, Liikanen, Glass-Steagall, and, of course, the "break-up-the-big-banks" proposals—long-lasting and very consequential change is happening all around us. Is anyone addressing the cumulative, big-picture impact of all these reforms?[11] More often than not, questioning the direction of reform gives rise to accusations of an anti-consumer and anti-regulation mindset. Notwithstanding the rhetoric around regulatory capture, the dialogue has simply become too one-sided. Public discourse and private conversation need to *merge* into a transparent, multidisciplinary, and respectful public discussion. Closed feedback loops generate self-fulfilling results, and I'm worried that our bank regulatory policy is being developed in such a way. The comment process seems to be pro forma. Things seem predetermined.

I don't have all the answers, and I'm not sure anyone does. There's little doubt that the banking industry has a public credibility gap to close with nearly every one of its stakeholders. Perhaps too often we cry wolf and fail to properly calibrate the extent of our concerns. Perhaps too often we forget, as an industry, the purpose and sanctity of the banking charter.

I get paid to worry. It's my nature to channel that anxiety, so I'm not going to abandon ship. Hope lies in the simple fact that most policymakers and practitioners are smart, well-intentioned, and agree on what we're all trying to accomplish. No one wants shocks to the system that require extraordinary government action. No one wants a handout, a subsidy, or an unfair advantage that promotes moral hazard and irresponsible behavior. No one wants banks, or any financial institutions, that are too-big-to-fail.

So where do we stand? To borrow a phrase from Churchill, we're not at the "beginning of the end. But it is, perhaps, the end of the beginning."[12] Simply acknowledging that we all want the same thing and are all in this together seems like a good place to begin.

A version of this article with supporting citations can be found at: theclearinghouse.org/bankingperspective . ■

1 *See, e.g.,* Janet Yellen, Vice Chair, Federal Reserve Board, Remarks before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate (Nov. 14, 2013) ("[R]egulators have made considerable progress…[b]anks are stronger today, regulatory gaps are being closed, and the financial system is more stable and more resilient. …Today, banks hold more and higher-quality capital and liquid assets that leave them much better prepared to withstand financial turmoil.").

2 For example, pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), the Federal Reserve has proposed heightened prudential standards that apply to bank holding companies with $50 billion or more in assets that include risk-based capital requirements and leverage limits, liquidity requirements, single counterparty credit limits, overall risk management requirements, resolution plan/living will requirements, and an early remediation framework. *See* Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies; Proposed Rule, 77 Fed. Reg. 594 (Jan. 5, 2012). In addition, with respect to capital, U.S. regulators have now finalized rules implementing the new Basel III capital framework (*see* Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule; Final Rule, 78 Fed. Reg. 62,018 (Oct. 11, 2013)) and implemented a robust framework for capital stress testing (*see* Federal Reserve Board, *Dodd-Frank Act Stress Test 2013: Supervisory Stress Test Methodology and Results* (Mar. 2013)), and are expected to shortly propose rules to apply macroprudential capital surcharges to U.S. global systemically important banks (G-SIBs) (*see* Daniel Tarullo, Remarks at the Peterson Institute for International Economics (May 2, 2013)); Basel Committee on Banking Supervision, *Global Systemically Important Banks: Updated Assessment Methodology and the Higher Loss Absorbency Requirement* (July 2013). The Basel III framework also established significant new prudential requirements with respect to liquidity, which are currently being implemented in the United States. *See* Basel Committee on Banking Supervision, *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools* (Jan. 2013); Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring; Proposed Rule (Oct. 24, 2013).

3 The FDIC has stated its preference for a "single-point-of-entry" approach for resolving a failing SIFI under the new Orderly Liquidation Authority under Title II of the Dodd-Frank Act, and is expected to offer further details on this approach in a forthcoming policy statement. *See* Martin Gruenberg, Acting Chairman, Federal Deposit Insurance Corporation, Remarks at the Federal Reserve Bank of Chicago Bank Structure Conference (May 10, 2012). Additionally, the Federal Reserve has noted that it intends to propose a rule in the coming months requiring U.S. based G-SIBs to maintain a minimum amount of loss absorbing capacity (also known as a "long-term debt requirement") to facilitate a single-point-of-entry resolution. *See* Daniel Tarullo, Governor, Federal Reserve Board, Remarks at Federal Reserve Bank of Richmond (Oct. 18, 2013). Recent evidence strongly suggests that the market is clearly recognizing the effectiveness of this new resolution framework and is revising its expectations accordingly. *See* Moody's Investor Service, Press Release (Nov. 14, 2013) ("We believe that US bank regulators have made substantive progress in establishing a credible framework to resolve a large, failing bank. …Rather than relying on public funds to bailout one of these institutions, we expect that bank holding company creditors will be bailed-in and thereby shoulder much of the burden to help recapitalize a failing bank.").

4 For example, the 18 largest U.S. banks have added nearly $450 billion of high-quality capital over the last four years (*see* U.S. Dep't of Treasury, *The Financial Crisis Five Years Later* (Sept. 2013)), and have increased their holding of the highest-quality capital by almost 100 percent since 2008 (*see* Federal Reserve Board, Comprehensive Capital and Analysis and Review, 2013: Assessment Framework and Results (Mar. 2013)). U.S. banks have also increased their holdings of liquid assets and have significantly improved their funding stability since the financial crisis. For example, as illustrated in a study recently released by The Clearing House, as of June 2012 U.S. commercial banks have reduced their reliance on wholesale funding as a percentage of liabilities by 3.6 percentage points ($248 billion) and net short-term funding as a percentage of liabilities by 4.6 percentage points ($584 billion) since 2010. *See* The Clearing House, Assessing the Basel III Net Stable Funding Ratio in the Context of Recent Improvements in Longer-Term Bank Liquidity (Aug. 2013).

5 *See, e.g.,* Simon Johnson, *Break Up the Banks*, The Baseline Scenario (Apr. 20, 2010) (arguing that there are no social benefits to having banks with over $100 billion in total assets).

6 *See, e.g.,* Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring; Proposed Rule (Oct. 24, 2013) (proposing a rule to implement the Basel III liquidity coverage ratio (LCR), which is intended to ensure that banks hold sufficiently high quality liquid assets to meet liquidity needs over a 30-day period of financial stress); Basel Committee on Banking Supervision, Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring (Dec. 2010) (introducing the net stable funding ratio, a metric establishing a minimum acceptable amount of stable funding based on the liquidity characteristics of a bank's assets and off-balance sheet (OBS) activities over a year horizon under stress); Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594, 613 (Jan. 5, 2012) (proposing, as part of a package of rules implementing §§ 165 and 166 of the Dodd-Frank Act, quantitative single-counterparty credit exposure limits); Basel Committee on Banking Supervision, Global Systemically Important Banks: Updated Assessment Methodology and the Higher Loss Absorbency Requirement (July 2013) (outlining the methodology for the capital surcharge to be applied to G-SIBs); Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for Certain Bank Holding Companies and Their Subsidiary Insured Depository Institutions, 78 Fed. Reg. 51,101 (Aug. 20, 2013) (proposing an enhanced supplementary leverage ratio of 5%/6% for U.S. G-SIBs and their bank subsidiaries); Basel Committee on Banking Supervision, Revised Basel III Leverage Ratio Framework and Disclosure Requirements (June 2013) (expanding the assets included in the denominator of the Basel III leverage ratio).

7 *See, e.g.,* Jeremy Stein, Governor, Federal Reserve Board, Remarks at the Federal Reserve Bank of New York (Oct. 4, 2013) ("[I]f the associated externalities are deemed to create significant social costs, the goal of regulatory policy should be to get private actors to internalize these costs. At an abstract level, this means looking for a way to impose an appropriate Pigouvian (i.e., corrective) tax on the transactions."); John Cochrane, *The Danger of an All-Powerful Federal Reserve*, The Wall Street Journal (Aug. 26, 2013) (discussing whether the Federal Reserve will pursue a "macroprudential policy" to monitor the financial system and actively intervene in a broad range of markets to pursue financial and economic stability).

8 *See, e.g.,* Daniel Tarullo, Governor, Federal Reserve Board, Opening Remarks at the Board of Governors of the Federal Reserve (Oct. 24, 2013) ("I believe that among our highest remaining priorities should be more macroprudentially informed regulatory measures to address the tail risk event of a generalized liquidity stress by forcing some internalization of the systemic costs of this form of financial intermediation.").

9 *See, e.g.,* The Clearing House, Assessing the Supplementary Leverage Ratio (Sept. 20, 2013) (finding that recent changes to the denominator proposed by the Basel Committee – if combined with the U.S. proposal to raise the minimum leverage ratio for U.S. G-SIBs to 5% and 6% for their bank holding companies and insured depositary institutions, respectively – would make the leverage ratio the binding constraint for 67% of U.S. G-SIB assets, reintroducing into capital regulation the very concerns that caused regulators to develop risk-based measures in the first place); *see also* The Clearing House, Single Counterparty Credit Limits: The Clearing House Industry Study (July 2012) (assessing the impact on the financial sector of the Federal Reserve's proposed single-counterparty credit limit rules).

10 *See, e.g.,* Ezra Klein, Bring Shadow Banking Into the Light, BLOOMERG BUSINESSWEEK (Nov. 11, 2013) ("The global assets of the so-called shadow-banking industry are estimated to have been more than $60 trillion at the end of 2011, making it about half the size of the traditional banking sector."); Paul Tucker, Deputy Governor, Bank of England, Interview with The Financial Times (Oct. 17, 2013) (warning it would be "absolutely dangerous" if the economic fragility of banks was recreated outside the mainstream banking sector, and that regulators need to "up their game" in overseeing shadow banks

as risky pools of assets build up beyond the heavily scrutinized world of traditional banking); Financial Stability Board, *Strengthening Oversight and Regulation of Shadow Banking; Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos* (Aug. 29, 2013) (calling for further measures to address growing shadow banking risks in securities lending and repos).

11 *See, e.g.,* the Dodd-Frank Act, Pub. L. No. 111-203, § 619 (also known as the "Volcker Rule"); *Independent Commission on Banking, Final Report Recommendations (Sept. 2011)* (also known as the "Vickers Report"); *High-level Expert Group on Reforming the Structure of the EU Banking Sector, Final Report (Oct. 2012)* (also known as the "Liikanen Report"); The 21st Century Glass-Steagall Act of 2013, S. 1282, 113th Cong. (2013); Daniel Tarullo, Governor, Federal Reserve Board, Remarks at the Brookings Institution Conference on Structuring the Financial Industry to Enhance Economic Growth and Stability (Dec. 4, 2012) (discussing a potential cap on any single banking organization's non-deposit liabilities as a fraction of U.S. gross domestic product).

12 *See* Winston Churchill, Speech at the Lord Mayor's Day Luncheon at the Mansion House (Nov. 9, 1942).