THE IMPACT OF THE DODD-FRANK ACT: UNDERSTANDING HEIGHTENED REGULATORY CAPITAL REQUIREMENTS

HEARING

BEFORE THE

SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

OF THE

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THE IMPACT OF THE DODD-FRANK ACT: UNDERSTANDING HEIGHTENED REGULATORY CAPITAL REQUIREMENTS

Friday, May 18, 2012

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
AND CONSUMER CREDIT,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 11 a.m., in room 2128, Rayburn House Office Building, Hon. Blaine Luetkemeyer presiding.

Members present: Representatives Capito, Renacci, Pearce, Luetkemeyer, Huizenga, Duffy, Canseco, Grimm; Maloney, McCarthy of New York, and Scott.

Ex officio present: Representative Frank.

Mr. LUETKEMEYER [presiding]. I think we will begin. Chairwoman Capito and Vice Chairman Renacci will be joining us later, so for now, you get a substitute Chair.

Thank you all for coming this morning.

I believe we have agreed to waive opening statements from both sides? Okay. Everybody is going to waive their opening statement except the ranking member, Mr. Frank, and so we will recognize him for 5 minutes.

Mr. Frank?

Mr. FRANK. Thank you.

I want to address the procedural question here. There are two issues here, procedural and substantive. I don't have any objection to either, but I do think it is important for our commitment to regular order that we be clear about this.

The piece of legislation we are talking about today affects one institution. I have no objection to that, but I must be honest and say I was asked if we could do this in a way that would move quickly, and my answer was, yes, I would like to move quickly, but I think it is important that it be done in the light of day. Frankly, I think, had it not been done this way, somebody might have drawn adverse inferences about the legislation which aren't justified.

I will say that the underlying bill, the trust-preferred, when this amendment was offered—and it was an amendment that came from the Senator from Maine, Senator Collins—I thought it went too far. It was something that was prepared by the FDIC. I thought that for smaller banks, community banks, it was a little bit harsher than it should be right away. So I was, at that time, trying to ame-

liorate it, and I thought the phasing in of the grandfathering was very important.

We now have one bank which misses, I guess, the date by a very small amount of time, and I don't think that does any substantive harm. And, as I said, it was a provision of a bill of which I had some questions. But I did think it was in the interests of all of us to have this done in an open way.

I believe, at the end of this process, it is unlikely that anyone will have substantive objections. I do think we should be asking the regulators. We asked the FDIC, and they told us they had no position on it. I think it is important that that be the case. The FDIC had been a strong advocate of the underlying amendment by Senator Collins, and it, I think, would have been a problem if we had gone ahead and not asked them, because I have had a great deal of respect for the way the FDIC has operated. So we have a view by the FDIC that there is no—they have no objection, they are neutral on the subject. I think it is important to have that out there.

And now, I hope that we will have a conversation. This is an opportunity, if anyone thinks there is anything wrong with this, they have the opportunity to say so. I, myself, have not seen substantive objections that seem to me to have appropriate weight, but I did think it was important that the process be this way. And I would expect, as a result of this hearing, if we don't hear any substantive negative objections, this bill will proceed, it will get voted on, and I think that is the way it ought to be.

Thank you.

Mr. LUETKEMEYER. Okay. With that, we will recognize the ranking member of the subcommittee, Mrs. Maloney.

Mrs. MALONEY. I waive my opening statement and ask unanimous consent to place in the record a statement in support of the bill from the New York Bankers Association; a statement from Sheila Bair, former Chairman of the FDIC; and my own opening statement.

And I want to publicly thank Ranking Member Frank for his commitment to openness, regular order, and a fair voice for everyone, and I also thank him for his leadership in authoring Dodd-Frank and for his leadership in so many areas.

So I thank you, and I yield back.

Mr. LUETKEMEYER. Without objection, it is so ordered.

With that, the balance of the opening statements—anybody else who wants to have one can put them into the record.

But, with that, we will hear testimony from our witnesses here this morning: Mr. Daniel McCardell, vice president and head of regulatory affairs for The Clearing House Association L.L.C.; and Mr. Richard Wald, chief regulatory officer for Emigrant Bank.

Gentlemen, you have 5 minutes. The little machine in front of you there will light up. And please pull the microphone close and speak as clearly as possible.

Mr. FRANK. Mr. Chairman, would you yield to me briefly, just so I can clarify? We have the letter from Sheila Bair. Sheila Bair, when she was head of the FDIC, was the major advocate for this. And we did ask her specifically if she had any comment on the legislation, and, once again, she had no particular comment.

I think it is important to say that she is a strong supporter of the underlying amendment but has no objection nor approval for the bill that we are talking about for the one institution. And given her role in this, and the justified reputation she has for integrity, I think her saying that she has no comment one way or the other is an important piece of this and is in line with what I said earlier.

Mr. LUETKEMEYER. Do you have a letter to that effect?

Mr. FRANK. The gentlewoman—

Mr. LUETKEMEYER. Okay.

Mr. FRANK. That was in the letter. The letter is about the underlying bill, but I think there was some question, would she object to the particular bill—

Mr. LUETKEMEYER. Okay.

Mr. FRANK. —and she has no objection to make to the particular bill. And I will say, from my experience with Ms. Bair, if she doesn't like something, you know about it. She is a woman of very few secrets about her dislikes, and we have benefited from that openness.

Mr. LUETKEMEYER. Okay. Thank you for that clarification.

Mr. McCardell, you are recognized for 5 minutes.

STATEMENT OF DANIEL MCCARDELL, SENIOR VICE PRESIDENT AND HEAD OF REGULATORY AFFAIRS, THE CLEARING HOUSE ASSOCIATION L.L.C.

Mr. MCCARDELL. Thank you.

Mr. Chairman, 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. I appreciate the opportunity to appear before you today to discuss Section 171 of the Dodd-Frank Act, commonly known as the Collins Amendment.

By way of background, The Clearing House was established in 1853 and is the oldest banking association and payments company in the United States. It is owned by 24 commercial banks that collectively employ over 2 million people. The Clearing House is a nonpartisan advocacy organization representing its owner banks on a variety of systemically important banking issues.

Before I address the specific topic of today's hearing, let me begin by reiterating our strong support for recent U.S. regulatory reform efforts which have substantially increased the quantity and quality of capital that banking organizations are required to hold. This is critically important, as insufficient capital at some institutions clearly contributed to the onset and escalation of the financial crisis. As I will discuss, U.S. banking organizations have already significantly increased the amount of capital they hold as a result of these regulatory reform efforts.

We have also consistently supported significant and fundamental changes to financial services regulation in order to establish a regulatory framework that both protects the financial system against potential systemic risks and enables banks to play their critical role in fostering economic and job growth. We are concerned, however, that certain specific aspects of these capital reforms could potentially work at cross purposes with these important policy objectives.

The Collins Amendment does three things of particular importance to our members. First, it imposes a minimum risk-based capital floor consisting of the Basel I base requirements on certain large U.S. banks. Second, these so-called Basel II banks are required to calculate their minimum capital requirements under both Basel I and Basel II in perpetuity. Third, with a limited exception for smaller bank holding companies, the Collins Amendment requires a phaseout of trust-preferred and other hybrid securities from inclusion in Tier 1 capital.

The Collins Amendment's imposition of the Basel I floor is but one of a number of U.S. and international regulatory reform initiatives that have increased the amount and quality of capital that U.S. banks are required to hold. For example, 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 have also adopted the capital plan rule, which requires that covered banks demonstrate their ability to maintain capital above existing minimum requirements under severely stressed conditions.

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 percent from the amount held before the crisis. In addition, as a result of the imposition of Basel III's quantitative, qualitative, and risk-rating requirements, the 7 percent minimum Common Equity Tier 1 ratio under Basel III is equivalent to a 14 percent Tier 1 common equity capital ratio under the pre-crisis Basel I rules.

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 have been incurred. For example, Basel II.5 dramatically increases, often by 400 percent or more, the capital charge on trading positions held by banks.

There will also be significant practical challenges in complying with the Collins Amendment's Basel I floor requirements. As I mentioned, Basel II banks in the United States will be required in perpetuity to calculate their capital requirements under two different regimes. This will entail a significant amount of duplication that we believe will make capital planning a needlessly complex endeavor, as these institutions will need to organize their capital planning policies and procedures and operations around two separate and distinct capital regimes. Significant supervisory resources will also need to be expended by the Federal banking agencies to monitor this duplicative capital exercise.

In addition to these administrative complexities and redundancies, the Collins Amendment's Basel I base floor and 3-year phaseout of hybrid securities could place U.S. institutions at a competitive disadvantage. Other jurisdictions have not adopted the Collins Amendment's approach of imposing a Basel I floor. Accordingly, the potentially higher resulting capital requirements will apply to U.S. banking institutions but not to their overseas competitors.

An implicit assumption underlying the Collins Amendment's Basel I floor appears to be that requiring more capital is always

a better policy outcome. However, we believe that there is a significant underappreciation of the tradeoffs between ever-higher capital levels and the risk of reducing economic and job growth and pushing financial transactions to the shadow banking sector.

In conclusion, we believe that the policy concern that apparently gave rise to the Collins Amendments Basel I base 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 enhancements to both the quantity and quality of capital held by U.S. banking organizations. We 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 United States and internationally are evaluated and considered on an ongoing basis.

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

[The prepared statement of Mr. McCardell can be found on page 24 of the appendix.]

Mr. RENACCI [presiding]. Thank you, Mr. McCardell.

Next, we have Mr. Richard Wald, chief regulatory officer, Emigrant Bank.

You are recognized for 5 minutes.

STATEMENT OF RICHARD C. WALD, CHIEF REGULATORY OFFICER, EMIGRANT BANK

Mr. WALD. Thank you, Mr. Chairman, and members of the subcommittee. Thank you for allowing me this opportunity to provide testimony in support of H.R. 3128.

By way of background, I began my career as an attorney with the FDIC. For the last 20 years, I have been with Emigrant Bank. I currently serve as the chief regulatory officer of Emigrant and the CEO of the residential and commercial real estate lending divisions.

Chartered in 1850 as a mutual savings bank, Emigrant is the oldest savings bank in New York City. Its 32 branches are mostly concentrated in the outer boroughs, where we do most of our residential and small-balance commercial lending. As of today, Emigrant has approximately $10.5 billion in assets and is considered by its regulators to be well-capitalized and in compliance with all regulations. Emigrant has operated with less than $15 billion in assets for most of its history.

The bank supports passage of H.R. 3128 because we believe it is consistent with the original intent of the Collins Amendment to allow institutions with less than $15 billion in assets to continue to include trust-preferreds in Tier 1 capital and, thus, be grandfathered from the bill's limitations. In this regard, the bill furthers the public policy of enhancing credit availability to residential borrowers and small-business owners.

Specifically, the bill seeks to establish an additional lookback date for the part of the Collins Amendment that sets the criteria for which institutions are grandfathered. Under Collins, an institution may no longer count its trust-preferreds as Tier 1 capital, eliminating such amount by one-third in each year for 3 years com-

mencing this January. This capital restriction affects all institutions except those with assets under $15 billion as of December 31, 2009.

The Collins Amendment grandfathered these smaller community banks, and while we believe the policy for such grandfathering is sound, it is the lookback date for which assets are measured that needs to be expanded. We believe an additional lookback date of March 31, 2010, is necessary as a matter of promoting credit availability. Every other cutoff date in the Collins is May 19, 2010, or later.

Importantly, Emigrant was briefly and temporarily over the $15 billion asset size on December 31, 2009, because of a prudent, cautious move to increase its liquidity during the height of the financial crisis. During the first quarter of 2008, as the financial crisis appeared to escalate, we analyzed the extent of our uninsured deposits above the $100,000 deposit insurance limit. We determined that we had $2.3 billion in uninsured deposits that were most at risk of being pulled from the bank if the financial crisis worsened. To be extra cautious, the bank borrowed $2.3 billion from the Federal Home Loan Bank of New York at 2½ percent.

Soon after we borrowed these funds, the deposit insurance limit was raised to $250,000. This would have largely eliminated our need for this liquidity insurance. However, these Home Loan Bank borrowings could not be prepaid without penalty except starting during the first quarter of 2010. The penalty on such prepayment would have been $40 million.

We held this liquidity insurance as an asset at the Federal Reserve because of the safety and ease of access of keeping them at the Fed. Ultimately, all of these Home Loan borrowings were repaid during the first quarter of 2010, and we used the assets held at the Fed to retire this borrowing. Thus, by March 31, 2010, Emigrant was once again a sub-$15 billion community bank. Indeed, by the end of that quarter, we had about $13 billion in assets.

So the cruel irony here is that because we were prudent and prepared for a worst-case scenario that never came to pass, we were temporarily above $15 billion in assets on December 31, 2009. Today, we are unable to avail ourselves of the grandfathering provision that was established for community banks like us. Consequently, without the bill, we would be required to begin to eliminate $300 million in trust-preferred from our capital over the course of the next 3 years. In year one alone, we would lose the capacity to originate $2 billion in one- to four-family, bread-and-butter residential real estate loans.

Given Emigrant's role as a 150-year-old community bank primarily serving the outer boroughs of New York City, this would be an odd result and inconsistent with the very purpose of the grandfathering provision of the Collins Amendment—to ensure that community banks like Emigrant could provide sorely needed residential and commercial lending in the communities they serve, especially during these difficult and uncertain economic times.

We thus urge passage of H.R. 3128 in order to address the unintended consequences of the lookback date now in the Collins Amendment. This will allow Emigrant to continue to fulfill its im-

portant mission as a portfolio lender of residential and small business loans in the New York City boroughs.

Thank you for the opportunity to testify, and I would be happy to answer any questions.

[The prepared statement of Mr. Wald can be found on page 32 of the appendix.]

Mr. RENACCI. Thank you, Mr. Wald.

We are now going to recognize Members for 5 minutes each. First, I will recognize myself for 5 minutes.

Mr. Wald, in your testimony, you say that under the Collins Amendment, the bank would be required to eliminate $100 million of the trust-preferred securities that count toward its Tier 1 capital ratios each year for 3 years. How will Emigrant Bank look to replace this Tier 1 capital? Will you raise capital or reduce your assets?

Mr. WALD. As a privately-held institution, it is a little bit more difficult for us to access the equity markets to raise capital. What we have normally done over the years is to build capital the old-fashioned way, through retained earnings.

Mr. RENACCI. Let's assume Emigrant Bank phases out their trust-preferred securities and it cannot replace them with a qualified form of Tier 1 capital. What would that mean for the bank and for its customers? Will you have to cut back on lending, or what would you be doing?

Mr. WALD. As of today, we are already at $10.5 billion. So we we may, in fact, have to face this elimination of trust-preferreds. And, consequently, I think it will impair or curtail lending.

Mr. RENACCI. Okay.

Mr. McCardell, according to the Federal Reserve, 85 percent of bank holding companies with more than $10 billion in total assets included hybrid capital in their Tier 1 capital. Trust-preferred securities accounted for 82 percent of the hybrid capital instruments.

What are the other types of hybrid capital? And what made trust-preferred securities so popular?

Mr. MCCARDELL. Thank you for the question.

Trust-preferred securities were obviously tax-beneficial. They were a hybrid of debt and equity. They provided certain tax benefits. They were useful in terms of using for Tier 1 capital.

That said, since the phaseout, particularly for large banks, since the Collins Amendment, our member banks have basically been required to find other forms of capital to replace that. And our member banks are on track to do so.

Mr. RENACCI. Okay.

How many bank institutions will fall below the minimum amounts of regulatory capital if trust-preferred securities are excluded from Tier 1 capital? Any thoughts or ideas?

Mr. MCCARDELL. I don't have any data on that. Again, I know that our member banks are complying with Collins and are on track to phase out trust-preferred securities and replace those with other forms of capital in Tier 1.

Mr. RENACCI. Okay.

I have no more questions. I am going to recognize Mrs. Maloney for 5 minutes for questioning.

Mrs. MALONEY. I want to thank you for calling this hearing, and I want to thank the panelists today for your testimony.

And I would like to ask Mr. Wald, your testimony states that Emigrant was above the $15 billion threshold for a period of approximately what, 2 years?

Mr. WALD. Yes, for a couple of years.

Mrs. MALONEY. Okay. Can you elaborate on the decisions that made the bank over the threshold?

Mr. WALD. As I said in the testimony, we, and I am assuming a lot of community banks during the financial crisis, were evaluating the extent that they were holding deposits that were above the $100,000 deposit insurance limit. And, obviously, to the extent that those deposits exceeded $100,000, they were the most vulnerable deposits that could leave the institution in the event of a continuation of the crisis.

So what we tried to do was create a replacement liquidity as insurance just in case an event like that did occur. Fortunately, nothing happened. And, in addition, shortly after that, the FDIC recognized that this was a concern, I guess, not only of us but of other institutions, and raised the deposit insurance limit to $250,000.

Mrs. MALONEY. And the assets in your bank are what, $10 billion, $13 billion consistently, basically?

Mr. WALD. We are currently $10.5 billion, projected to be under $10 billion by the end of the year.

Mrs. MALONEY. So during the economic crisis, in probably early 2008, you took steps basically to enhance the finances, the flexibility and the capital to be able to have a greater financial firewall in light of the uncertainty of the times. And it seems like a perfect example here that no good deed goes unpunished. You took steps to protect your depositors, to protect the safety and soundness of your institution and, therefore, the larger economic community, and inadvertently you have been caught in this, what I would describe as an unfair, unintended consequence.

I would like you to describe the consequences of this bill in terms of, first, the number of bank holding companies on which it could confer grandfathered status—or, Mr. McCardell, you might want to weigh in on these questions—second, whether a change in grandfathered status would affect the capital adequacy of such bank holding companies; and, third, the resulting public policy benefits of expanding the scope of the grandfather. And as I understand it, there will be two dates now.

Would you like to elaborate? Either of you?

Mr. WALD. I can only speak to Emigrant itself. We have enough to deal with now with the implementation of Dodd-Frank as it is going forward. But I really don't know whether or not it affects other institutions.

Mr. MCCARDELL. Again, our institutions are adapting.

I would just highlight one additional issue, in fact the core issue that we have with Collins on behalf of our member banks, and that is the transition schedules, in which we see there is a 3-year transition schedule for Collins, and yet a 10-year transition schedule for trust-preferreds under Basel III. We would actually like to see that addressed and perhaps see those two reconciled.

Mrs. MALONEY. Okay.

I have no further questions, and I yield back.

Mr. RENACCI. Thank you, Mrs. Maloney.

Before recognizing the next Member, I want to ask unanimous consent that the following items be made a part of the record: a letter from the American Council of Life Insurers; a letter from the Financial Services Roundtable; and the opening statements of Mr. Bachus, Mrs. Capito, Mr. Hensarling, Mr. Canseco, and Mr. Grimm.

At this time, I recognize Mr. Luetkemeyer for 5 minutes.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

I am just kind of curious, Mr. McCardell, if we don't do anything with this amendment, if this amendment would not pass or would not be implemented, what is the risk that we have?

Mr. MCCARDELL. Our member banks that are the largest commercial banks in the country are complying with Collins; we are on track for that. We are finding new forms of capital to replace trust-preferreds—

Mr. LUETKEMEYER. What kind of capital? When you say new forms, can you explain?

Mr. MCCARDELL. Common equity, for instance, among others, which is the most stable form of—

Mr. LUETKEMEYER. Selling more stock?

Mr. MCCARDELL. Correct.

So we are adapting, our member banks are adapting. Again, I would just flag the issue I mentioned a minute ago, which is the transition schedules, where there is a disparity between the Collins and the Basel III. So suffice it to say that our members are adapting.

Mr. LUETKEMEYER. Okay. My question, though, is, what is the risk if we don't do this?

Mr. MCCARDELL. To our members, we don't see a significant risk.

Mr. LUETKEMEYER. What is the risk if we do it? Is there enhanced risk? Is there less risk?

Mr. MCCARDELL. Again, we did have some issues with Collins, but are on track to comply. I think our banks are doing a good job in moving in a direction to comply with Collins.

Mr. LUETKEMEYER. Okay. I am kind of curious—I think I know the answer, but let me ask you, if a bank goes under and it has trust-preferred securities, where does it stand in the loss column? At what point—is it lost like stockholders, or are they part of the group that would be paid back something?

Mr. MCCARDELL. I believe for trust-preferreds, it is lower than common equity. I would need to confirm that for you. And, again, that is in the process of being phased out right now over the next several years.

Mr. LUETKEMEYER. So that is one of the concerns, I would assume, and the reason for the amendment, in that there is concern that it really isn't equity, that there is some ability to pay it back. The stockholders or whomever has stock in the bank should be the last to realize anything out of it if things go bad. And you should be able to go back to those capital accounts, which are the dollars that are invested in stock, to be able to absorb whatever losses. And if you can't use those trust-preferred securities as something

you can absorb losses with, that, I assume, is why they are no longer treating it as capital. Is that—

Mr. MCCARDELL. I believe that probably was one of the motivations behind Collins.

Mr. LUETKEMEYER. Okay.

Mr. Wald, I know the discussion has been to try and extend the phaseout from 3 years to 5 years. Would that help your situation significantly?

Mr. WALD. I just want to comment, make one point on the question you just asked him, because the trust-preferred was issued at Emigrant's parents' holding company. And all of the proceeds of those trust-preferreds were then downstreamed to Emigrant Bank and the insured bank.

So it actually, with regard to us, because we don't hold those funds at the holding company, it is an additional capital buffer really for the benefit of the FDIC.

Mr. LUETKEMEYER. Okay, so what you are saying is those dollars are actually equity that is in the bank—

Mr. WALD. Exactly.

Mr. LUETKEMEYER. —but they are securities—money has been put in them by their holding companies.

Mr. WALD. Exactly. They are paid in capital at the bank—at our bank.

Mr. LUETKEMEYER. Okay. So if something goes belly up with the bank, where does this put—

Mr. WALD. The FDIC is better off that we had issued those trust-preferreds.

Mr. LUETKEMEYER. Okay. As an examiner, a firm examiner, you can attest to that, I take it?

Mr. WALD. It is held at the bank, not at the holding company. And, in fact, the regulators at any moment could go into any insured bank and tell them not to pay dividends to their holding companies to pay those trust-preferreds. So it is probably at the safest place it could be, if it is at the insured institution.

Mr. LUETKEMEYER. Okay.

That is basically all I have. I thank you, Mr. Chairman. I yield back.

Mr. RENACCI. Thank you.

I now recognize Mrs. McCarthy for 5 minutes.

Mrs. MCCARTHY OF NEW YORK. Thank you, Mr. Chairman, and I thank you for holding this hearing. I think it is important.

When we look at H.R. 3218, in doing some research over the last couple of weeks, we found that not only would it inadvertently disqualify institutions which have been grandfathered under the current date in the statue, and allowing for an additional quarter lookback period would only impact your institution, from what we have heard from the Feds.

Is that your understanding also?

Mr. WALD. I know it affects our institution. I am not sure whether it affects any other institutions. I haven't looked at that.

Mrs. MCCARTHY OF NEW YORK. We have learned that it would not affect any other institution. And for that, I think it is important that you go over the dates again. Because the dates, in my opinion, are what is important here.

When did the bank go above the $15 billion? You mentioned that threshold as a result of the $2.3 billion liquidity loan. And when you paid that loan back—and I think when you said the first quarter, for a lot of people—it was actually the first week in January, wasn't it?

Mr. WALD. The minute we had the opportunity to begin retiring the Federal Home Loan Bank borrowings without penalty, we started.

Mrs. MCCARTHY OF NEW YORK. Correct.

And just following up on a question that one of my colleagues asked you, what is your immediate plan to replace the $100 million of the Tier 1 capital you will lose in 2013?

Mr. WALD. We are always looking at our assets, our liabilities, our capital position. We are currently overcapitalized. It really comes down to credit availability in the communities to whom we lend. And, how is this going to impact our ability to keep lending as vigorously and as safely as possible in those communities? I think that is the real question, and I think that is where it begins to impair our operations.

Mrs. MCCARTHY OF NEW YORK. Just to go back again on the dates, and I know I am harping on the dates, but the dates are actually really important. Because in your testimony, you do have a good timeline on when you borrowed the money to cover during the difficult time that we were all going through and what the intent was in the beginning to have a March 31st date. And if you could go into that a little bit more, I think people would understand it.

Mr. WALD. The borrowings from the Federal Home Loan Bank all occurred during the first quarter of 2008. We retired all of those borrowings during the first quarter of 2010. So that is the period of time, that $2.3 billion is what caused us to get over that $15 billion threshold.

Mrs. MCCARTHY OF NEW YORK. Have you gone back to the $15 billion, have you ever gone over that threshold since?

Mr. WALD. No. No, we haven't. In most of our history—and it is in my testimony—we have been well under $15 billion. We are currently at $10.5 billion now.

Mrs. MCCARTHY OF NEW YORK. With that, I yield back. Thank you, Madam Chairwoman.

Chairwoman CAPITO. The gentlelady yields back.

Mr. Canseco is recognized for 5 minutes.

Mr. CANSECO. Thank you, Madam Chairwoman.

Mr. McCardell, in your testimony you say that the Collins Amendment, combined with higher capital levels under Basel, would push certain products and services to the so-called shadow banking system. And if I am reading your testimony correctly, are you saying that the overlap of Collins and Basel requirements could potentially increase risk in the financial system?

Mr. MCCARDELL. We think there is an overarching risk across the regulatory spectrum that basically too much regulation in the financial sector, while we are highly supportive of higher capital standards, of the demands for higher quality capital, we are fully supportive of regulation which has strengthened the financial system and provided for greater stability, we think there is a risk in there that less-regulated financial institutions, the shadow banking

system, grows and becomes—is less regulated than the banking sector. And we think there are certain risks implicit in that.

Mr. CANSECO. Let's look at the trust-preferred for a second. I want to try to look at it from an investor's point of view. And if I were an insurance company or a mutual fund and I needed to diversify my portfolio or separate accounts, what aspects of the trust-preferred issued by small or regional banks would be attractive for me from an investor standpoint?

Mr. MCCARDELL. To be honest, Congressman, I can't speak to that. Maybe my fellow panelist could. Again, our member banks are in the process of phasing these assets out and are on track for that currently.

Mr. CANSECO. Let's look at it from a perspective of a small or medium-sized bank. What aspects of it would be attractive to an investor to go in if we are doing away with the trust-preferred on Tier 1?

Mr. MCCARDELL. I'm sorry? What aspect of trust-preferreds would be attractive to investors, is that what you are—

Mr. CANSECO. Right. Would it be?

Mr. MCCARDELL. I think the main appeal of trust-preferreds for banks was that they did have a tax advantage status and that they were constructive in that regard for use as Tier 1 capital.

As to the demand for trust-preferreds by investors, I could get back to you on that.

Mr. CANSECO. Okay. I would appreciate it.

Is it prudent to harmonize capital standards for bank holding companies and depository institutions? And aren't there significant differences between holding companies and depository institutions that would call for different capital standards?

Mr. MCCARDELL. We believe that capital standards are harmonized across banks regardless of size today. We think that is positive, we think that is important. And today banks, regardless of size, are basically required to hold the same levels and the same quality of capital. So we do think that is a positive thing.

Mr. CANSECO. But holding companies are very different from the banks that are held within the holding companies.

Mr. MCCARDELL. Correct. And it is at the holding company that those standards are now harmonized.

Mr. CANSECO. Okay. And do you think that is a good thing, that both the holding company and the bank be held to the same capital standards?

Mr. MCCARDELL. Yes, that is the law, and I think it has provided for stronger capital standards and higher quality capital. And we think that has provided for a more stable system already.

I think it is worth noting, by the way, that our member banks today hold approximately 100 percent more capital than they did pre-crisis. So, writ large, we think we are moving in a very positive direction with these higher capital standards.

Mr. CANSECO. In your testimony, you note the importance of capital standards to balance the need between safety and soundness and economic growth. So, in your opinion, does the Collins Amendment meet the standard?

Mr. MCCARDELL. I appreciate the acknowledgement of that. We do think it is an often underacknowledged risk or part of the sys-

tem that there is a balance between stability among the financial system, which we wholeheartedly support, and economic growth and job growth at the other end. And we think at some point, there is a tradeoff.

Again, banks are holding far more capital today, the system is far more robust. Collins arguably has contributed to that. And, again, we think we are in a far better position in terms of capital today.

Mr. CANSECO. So you like that Collins Amendment?

Mr. MCCARDELL. We had some issues, as I mentioned, the transition issues. There were some issues we had under there in terms of applying a mandate to use both Basel I and Basel II methodologies to test capital. But it is the law of the land. Outside of the transition issue, we are supportive.

Mr. CANSECO. Thank you, Mrs. Capito. I see my time has expired.

Chairwoman CAPITO. Yes.

Mr. Grimm is recognized for 5 minutes.

Mr. GRIMM. I would like to thank you, Madam Chairwoman, for holding this hearing.

Panelists, we appreciate you being here today.

I would also like to thank my colleagues on the other side of the aisle, Carolyn Maloney, the gentlelady from New York, as well as the ranking member, Barney Frank, for helping organize and really working together in a bipartisan manner on this issue. So thank you very much to them, as well.

Mr. Wald, a yes-no question, if I may. During the mortgage bubble, did Emigrant sell its loans into the securitization market or offer subprime loans or teaser rates, anything like that?

Mr. WALD. Emigrant is a portfolio lender, and unlike all of the robo-signing issues and other servicing-related issues that you saw some of the larger institutions deal with, we have all of our loan documents in our vault—

Mr. GRIMM. So that would be a very strong "no?"

Mr. WALD. —on 42nd Street. Yes.

Mr. GRIMM. Okay.

Mr. WALD. Yes, it is a strong "no."

Mr. GRIMM. All right. And as you just started to say, I was going to ask you, how about—we hear a lot of problems about the robo-signing, standing issues, loss of loan documents, incorrectly recorded deeds, all of those issues. You don't have any of those problems at your bank?

Mr. WALD. The bank has an unblemished record in that regard.

Mr. GRIMM. Can you tell me a little bit about the local communities in New York City where Emigrant does its lending and how that lending will be impacted if we don't take action today?

Mr. WALD. Most of our branches are in the boroughs. And most of our borrowers are cops, teachers, firemen, or corrections officers. This is the traditional deposit and borrowing base that we—these are our customers. And so, to the extent that our capital has to shrink, obviously those are the types of individuals for whom credit will be less available.

Mr. GRIMM. Obviously, this provision doesn't take effect until January. Why is it important to fix it now?

Mr. WALD. We can't wait until January to manage our balance sheet. We have to look at the future—we know this is coming down the pike, so we have already had to start.

Mr. GRIMM. Have you already experienced any impact?

Mr. WALD. Yes, we have already had to start thinking very carefully about the types of assets that we continue to put on our balance sheet.

Mr. GRIMM. Let me ask you this, if you didn't have this potential threat hanging over your head, would Emigrant be lending more today?

Mr. WALD. Yes.

Mr. GRIMM. With that, I yield back.

Chairwoman CAPITO. The gentleman yields back.

Since I was late—and I apologize for that; it has been kind of a crazy day—I am not going to ask any questions, because I have missed pretty much the substance of the questions. I would probably be repeating myself.

But I want to thank both of the gentlemen for coming today. And I again apologize for starting late, but I think we have gotten a lot of good information.

The Chair notes that some Members may have additional questions for this panel, which they may wish to submit in writing. Without objection, the hearing record will remain open for 30 days for Members to submit written questions to these witnesses and to place their responses in the record.

This hearing is adjourned.

[Whereupon, at 11:40 a.m., the hearing was adjourned.]

A P P E N D I X

May 18, 2012

- Of all the provisions included in the Dodd-Frank bill, I am particularly concerned over the new authority to identify "systemically important" institutions

- This process will likely etch "too big to fail" into stone and permanently skew our financial system towards a small number of institutions.

- But I think the greater point to be made here is that the logic behind this new authority is deeply flawed.

- Leading up to 2008, the greatest threat to our financial system was the preponderance of a single asset class – residential mortgages – across *all* financial institutions.

- This contradicts, the logic behind Dodd-Frank which seems to imply the greatest threat pre-2008 were rogue financial institutions acting in isolation.

- However regulators choose to implement this new authority, I feel they've been tasked with a fatally flawed mission, and I remain deeply concerned about this process.

Rep. Grimm Statement for the Record

May 18, 2012 Financial Institutions hearing

Thank you Chairman Capito for calling this hearing to examine the impact of section 171 of the Dodd-Frank Act, known as the Collins amendment, as well as my legislation, HR 3128. I'd also like to thank our witnesses for testifying, especially Mr. Richard Wald, from Emigrant Bank, which has serve my constituents in Brooklyn and Staten Island for over 150 years.

HR 3128 would adjust the date that regulators must use for determining if a bank holding company falls under the exemption in the Collins Amendment which allows them use Trust Preferred Securities from December 31, 2009 to March 31, 2010. In order to be granted the exemption, the institution must have assets under $15 billion on the statutory date.

This change will help to ensure that smaller institutions are not needlessly robbed of capital. Such a loss of capital will have a direct impact on lending capacity. At a time when our economy is still struggling to recover, this loss of lending capacity will ultimately lead to a loss of jobs.

For example, it is my understanding that Emigrant Bank would see it Tier One capital decrease by $300 million. Depending on the types of loans, this could lead to a decrease in the bank's lending capacity in the billions of dollars. This would have a very detrimental impact on my constituents who rely on banks like Emigrant to finance various projects and business throughout the New York area.

I believe that the HR 3128 is a simple, common sense solution and I would like to thank my colleagues for working with me on this issue. Specifically I would like to the ranking member, Mrs. Maloney, as well Mr. King, Mrs. McCarthy, Ms. Hayworth, and Mr. Meeks.

In closing I again thank the Chair for holding this hearing and I yield back the balance of my time.

Congressman Peter King (R-NY), Statement for the Record in Support of H.R. 3128
Financial Institutions and Consumer Credit Subcommittee Hearing
May 18, 2012

Mr. Chairman, thank you for calling today's hearing. I would also like to thank Congressman Grimm and Congresswoman Maloney for introducing H.R. 3128, which would make a technical change to the Dodd-Frank Wall Street Reform and Consumer Protection Act. As a cosponsor of this bill and a Senior Member of the House Financial Services Committee, I would like to go on record in full support of this legislation.

H.R. 3128 would simply adjust the date when financial institutions with assets of $15 billion or more are required to phase out certain forms of capital. This is important because, as currently written, Dodd-Frank captures a smaller, family-owned bank in these regulations. Emigrant Savings Bank is the largest privately-owned bank in the U.S., and typically has assets well below the $15 billion threshold. However, when the financial crisis hit, Emigrant made the prudent decision to take out a $2.3 billion loan to ensure their depositors were secure and the firm was safely liquid. Emigrant did the responsible thing in protecting its clients, but as a result is being severely penalized with new regulations. Because the loan (which was never used) temporarily put the Bank over the $15 billion threshold when Dodd-Frank went into effect, Emigrant now must phase out Trust-Preferred securities to comply with the new law. While public banks can issue stocks or bonds to replace those securities, as a private family-owned business, Emigrant must fund the new capital requirements out of the family's own pocket – at a cost of hundreds of millions of dollars.

Dodd-Frank was enacted to strengthen financial institutions and prevent high-risk behavior, not weaken banks that acted responsibly before, during, and after the crisis. For Emigrant, this new regulation will only hamper the bank's ability to grow and serve customers in the future. It is the only private bank that is being impacted by this regulation, and the date change in H.R. 3128 would only affect this one financial institution that was inadvertently captured. The FDIC, whose jurisdiction this falls under, is comfortable with the date change in Grimm-Maloney bill. Senator Collins, who authored the provision to phase out Trust-Preferred securities for large financial institutions, has also expressed no concerns with the legislation. I hope today's hearing continues to shed light on the need for H.R. 3128, so that it can be passed out of Committee and enacted without delay.

Opening Statement of Ranking Member Carolyn Maloney
Financial Institutions Subcommittee Hearing Entitled, "The Impact of the Dodd-Frank Act: Understanding Heightened Regulatory Capital Requirements"
May 18, 2012

Thank you and welcome to the panel. I want to particularly welcome Mr. Wald who is here on behalf of Emigrant Bank, an institution that is headquartered in New York and which serves so many of my constituents.

There are a number of provisions in the Dodd-Frank Act which were designed to enhance bank capital and ensure that banks have adequate capital cushions including Sections 165 and 171.

At its core Section 171 of the Dodd-Frank Act--which is commonly known as the Collins Amendment after Senator Collins who authored it--recognizes that not all capital should be treated equally.

It has been acknowledged that common equity is the best shock absorber, and that hybrid securities like trust preferred stock do not provide the same type of capital

cushion that other forms of capital, like common stock, can provide.

Trust-preferred stock are instruments that are part equity part debt and usually issued by the bank holding company through a special purpose entity.

Dividends on trust-preferred securities are treated as tax deductible because the holding company makes interest payments on the debt held by the special purpose entity. Deducting these interest payments can lower the institution's overall capital cost and increase after tax earnings.

According to the Federal Reserve, these instruments are used by more than 85% of bank holding companies with more than $10 billion in total assets and 100% of bank holding companies with over $100 billion in total assets. Collectively, these instruments represent 13% of all bank holding company Tier 1 capital.

The Collins amendment is reflective of a lesson we learned from the financial crisis which is that capital matters.

Institutions that are well-capitalized less leveraged, and that have sufficient capital buffers are more likely to survive financial shock.

The Collins Amendment goes a step further to say that it's not just capital that matters, it's what kind of capital the institution is relying on that matters.

But it was recognized that smaller institutions which are more dependent on trust preferred stock may have difficulty replacing TRUPPS with other forms of Tier 1 capital. So the Collins Amendment contains a grandfather clause for institutions under $15 billion.

And it is only because Emigrant Bank was trying to do the right thing, by raising additional capital that it now

finds itself being treated as a much larger institution than it actually is for purposes of Section 171.

Emigrant, which I understand normally operates at around $12-13 billion, raised additional capital in order to ensure that it would weather the financial crisis and come out the other side.

And it was over the $15 billion threshold on December 31, 2009 until it repaid the loan on March 31, 2010.

Several of my colleagues from New York and I have sponsored legislation that would allow the review date for grandfathering TRUPS securities to be either December 31, 2009 ***or*** March 31, 2010 because we think it is unfair that Emigrant which was only temporarily over the threshold, would have to replace its trust-preferred securities when no other institution of the same size does.

The bill does not change the threshold, and it does not change any of the substance of the Collins Amendment.

I supported the Collins Amendment during the Dodd-Frank conference, but I do not believe it was intended to capture an institution of Emigrant Bank's normal operating size.

So I look forward to exploring these important issues with the witnesses here today. I yield back

TESTIMONY OF DAN MCCARDELL
SENIOR VICE PRESIDENT AND HEAD OF REGULATORY AFFAIRS
THE CLEARING HOUSE ASSOCIATION L.L.C.
BEFORE THE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS AND CONSUMER CREDIT
COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

MAY 18, 2012

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 lower* 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

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[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.

CONCLUSION:

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").

Statement of Richard C. Wald
Chief Regulatory Officer, Emigrant Bank
Before the
Financial Institutions and Consumer Credit Subcommittee of the
House Financial Services Committee on
"The Impact of the Dodd-Frank Act: Understanding Heightened Regulatory Capital Requirements."
May 18, 2012

Madame Chairman and members of the Subcommittee, thank you for this opportunity to provide testimony regarding heightened regulatory capital requirements under Dodd-Frank. Specifically, I want to focus my testimony on H.R. 3128 currently pending in this Subcommittee, and urge its speedy approval. H.R. 3128 is an administrative amendment to Dodd-Frank to avoid an unintended and untoward result from the Collins Amendment's retroactive date for measuring certain bank assets.

To introduce myself, I am here representing Emigrant Savings bank, where I have worked for over 20 years, a community bank in the truest sense of the term. Emigrant is the oldest savings bank still operating in New York City. It was chartered in 1850 as a mutual savings bank for the benefit of and principally serving Irish immigrants and has a long and distinguished history of serving the working and middle class communities in the boroughs of New York. Emigrant has approximately $10.5 billion in assets, is considered well capitalized and is in good standing with all of its regulators. I oversee many of Emigrant's home lending and small business lending programs that continue to provide vital liquidity to needy communities, especially those in New York's outer boroughs.

Among other things, the Dodd-Frank Act eliminated Tier 1 capital treatment for Trust Preferred Securities ("TRUPs") for all institutions with $15 billion or more in assets. However, TRUPs issued by institutions with less than $15 billion in assets (as of December 31, 2009) were allowed to continue counting TRUPs as Tier 1 capital. Every other cut off date in the Collins Amendment is May 19th 2010 or later and, after consulting with all involved parties, we have been unable to ascertain any substantive reason for moving the "cut-off" date back to December 31, 2009.

Congress was clearly concerned that this change, known as the Collins Amendment (Section 171), would negatively impact community lenders' abilities to serve communities in need. This concern is shown in the record by the fact that, while the initial "cut-off" for the grandfathered treatment of TRUPs was $10 billion in consolidated assets as of May 19, 2010, the threshold was ultimately increased to $15 billion. This increase was meant to mitigate an adverse impact on the lending capacity of smaller community banks whose parent companies issued TRUPs, including Emigrant, because

of the difficulty these institutions would have of replacing this capital and the subsequent effect that a tightening of local credit would have on the communities that need it.

I am here today because, despite the fact that Emigrant has been under $15 billion in assets for almost all of its existence, it is not considered "grandfathered" under this provision of the Collins Amendment. Therefore, this community bank will lose $ 300 million of capital as follows: beginning in 2013, $100 million of its Tier 1 capital will be required to be eliminated each year for three years. As I will describe more fully below, the net impact of this must be a curtailment, or potentially a roll-back, of lending activity for the Bank, penalizing the communities it serves. In fact in May of 2010 Emigrant's assets were approximately $13 billion, well below the $15 billion threshold.

However, just before enactment of the Collins Amendment, and Dodd-Frank as a whole, this measurement date for determining grandfathered status, i.e. whether an institution had less than $15 billion in assets, was moved retroactively from May 19, 2010 to December 31, 2009. There is no legislative history that explains or justifies what amounts to a 6 month retroactive change in the "look back" date. But for institutions which otherwise would have enjoyed grandfathered status under the Collins Amendment, this change has the potential to make a challenging operating environment even more difficult.

Emigrant's primary businesses today remain the same as they have been for decades: we are a portfolio lender, originating loans on 1-4 family properties in all five boroughs of New York, consisting of full documentation residential mortgages that we hold on our own balance sheet and agency loans, as well as mortgages on small mixed-use and multi-family apartment buildings. In addition, Emigrant has 32 branches in the New York metropolitan area. Many of its deposit relationships with its customers span decades, and in some cases, generations.

The Bank has a strong retail presence in providing deposit and lending services in many communities that have often been neglected by the other larger financial institutions in New York City, particularly in the outer boroughs where most of our branches are located. In this regard, we have consistently scored high marks on our state and federal Community Reinvestment Act examinations and the FDIC has praised us for our "innovative and flexible" lending products.

Primarily to bolster our lending capacity, beginning in 2003, Emigrant's holding company, Emigrant Bancorp, issued a total of $300 million in TRUPs. The issuance of these TRUPs were reviewed and approved by the Bank's regulators and the funds were permitted to be included by the Bank's parent as Tier 1 capital. Emigrant was one of approximately 650 bank holding companies that issued TRUPs from 1996 to 2009. Many of these issuers were like Emigrant: community banks with holding companies that sought low cost capital in order to enhance their retail lending programs. Like Emigrant, many of these holding companies downstreamed the TRUPs proceeds to their depository institution subsidiaries. Once the proceeds were held at the institution level, they were used to support lending and investment activities, while providing an additional capital buffer for the benefit of the FDIC insurance fund.

Among other things, the Dodd-Frank Act, through what is known as the Collins Amendment (Section 171), eliminated Tier 1 capital treatment for TRUPs over a three year period beginning in 2013. However, TRUPs issued by certain grandfathered institutions (those with less than $15 billion in assets as of December 31, 2009) may continue to count TRUPs as Tier 1 capital. For reasons I will explain, despite the fact that Emigrant has been under $15 billion in assets for almost all of its existence, it is not considered "grandfathered" under this provision of the Collins Amendment.

Congress was clearly concerned about which institutions would be entitled to "grandfathered" status of this provision of the Collins Amendment, principally given the impact this provision would have on community lenders. The initial "cut-off" for the grandfathered treatment of TRUPs was $10 billion in consolidated assets as of May 19, 2010. This threshold was ultimately increased to $15 billion to lessen the adverse impact this would have on the lending capacity of smaller community banks whose parents issued TRUPs, including Emigrant, because of the difficulty these institutions would have of replacing this capital in the equity markets during a period of economic distress. In fact in May, 2010 Emigrant's assets were approximately $13 billion, well below the $15 billion threshold.

However, just before enactment of the Collins Amendment, and Dodd-Frank as a whole, this measurement date for determining grandfathered status, i.e. whether an institution had less than $15 billion in assets, was moved retroactively from May 19, 2010 to December 31, 2009.

Emigrant is one such institution that has been adversely affected by this 2009 "look back" date. Because of an effort to be exceedingly cautious with regard to addressing its liquidity during the peak of the financial crisis, Emigrant had more than $15 billion in assets on December 31, 2009 but significantly less than $15 billion when Dodd-Frank was enacted. Thus, it lost the grandfathered status it otherwise would have enjoyed because the "look back" date was retroactively changed to December 31, 2009, fully 6 months prior to the enactment of Dodd-Frank.

Why was Emigrant temporarily above this $15 billion threshold? As the financial crisis escalated in 2008 Emigrant performed an analysis of its uninsured customer deposits (those exceeding $100,000) and determined that amount to be $2.3 billion. To be extra cautious, Emigrant then borrowed $2.3 billion at an average rate of 2.5% from the Federal Home Loan Bank of New York for a minimum of two years. Soon after Emigrant borrowed these extra funds, the FDIC insured deposit cap was raised to $250,000. Thus, the Bank moved decisively to insure it would have adequate liquidity even in the event of a panic. While the need for these funds was largely obviated by this increase in FDIC insurance, the penalty for prepayment prior to 2010 would have been approximately $40 million.

These excess liquidity borrowings were primarily held on deposit at the Federal Reserve as liquidity insurance (the Bank bore a negative spread on these holdings during this period). These borrowings temporarily increased the Bank's asset size to slightly more

than $15 billion at the end of 2009. By March 31, 2010, after the Bank repaid its borrowings with the Federal Home Loan Bank, Emigrant's total assets were well under $15 billion.

Thus, Emigrant's prudent action to solidify its liquidity and safety and soundness during the height of the financial crisis has had the unintended, detrimental effect of causing it to forfeit its ability to use its TRUPs as capital available to support the community lending it pursues like so many other community banks under the statute's grandfathering provision. The Bank's TRUPs, because of the retroactive measurement date, would be rendered ineligible as Tier 1 capital under the Collins Amendment beginning in 2013, even though by March, 2010, and since then, its assets have been well below the $15 billion threshold for grandfathering established under the Collins Amendment. In enacting a cut-off date that was 6 months prior to Dodd-Frank's enactment, the drafters failed to anticipate that some community banks may have prudently taken out liquidity insurance, thus temporarily enlarging their asset base and causing them to forfeit grandfathered status that could have allowed them to continue to enhance their consumer lending in the communities in which they operate.

Specifically with regard to Emigrant as a community bank, the elimination of its TRUPs could have potentially serious consequences for its lending programs. The elimination of $300 million in TRUPs as Tier 1 capital would subtract $6 billion in lending capacity (new loan growth) on residential loans (those assets with a 50% risk weighting). Assuming a conservative mix of originations of residential and small balance commercial mortgages (each with a 50% risk weighting), at least $4.5 billion in lending capacity for its traditional customer base could ultimately be eliminated once the Collins Amendment is fully phased-in.

At a time in the economic cycle when more, not less, community lending is needed, a reduction in lending capacity for Emigrant – an 160 year-old community bank with an approximate size of $10.5 billion in assets – could not have been the intended result when the "look back" date for grandfathering under this provision of the Collins Amendment was pushed back 6 months prior to the statute's enactment. It is respectfully submitted that H.R. 3128 is fully consistent with the clear intent of the exception for community banks with asset levels under $15 billion, and furthers the public policy of enhancing credit availability to residential borrowers and small business owners.

Enacting an alternative "look back" date of March 31, 2010 – in addition to the existing look back of December 31, 2009 – will prevent this unfair, unintended, counterproductive and counterintuitive economic result from unfolding. This change will simply provide for greater community lending at a time in the economic cycle when it is sorely needed.

I would like to thank the Subcommittee again for providing us this opportunity to testify on this important legislation.

NYBA

Statement of the New York Bankers Association
Before the
Financial Institutions and Consumer Credit Subcommittee of the
House Financial Services Committee
On the
Dodd-Frank Act's Collins Amendment

May 18, 2012

The New York Bankers Association appreciates the opportunity the Subcommittee has provided to offer this statement for the record on the impact of the Collins amendment with regard to bank holding company capital on the banking industry of New York State. Our Association strongly supports appropriate levels of bank and bank holding company capital requirements as a very important step in maintaining the stability of our nation's banking and financial system. Ensuring that banks hold an appropriate amount of capital allows them to absorb losses that may arise during future economic downturns.

As the Subcommittee is aware, the Dodd-Frank Act contains a significant number of provisions requiring increased capital in the banking industry generally and in systemically important financial institutions specifically. In addition, bank regulators have been extraordinarily vigilant in recent years in demanding increased capitalization of individual institutions during the examination process, and the Basel II international bank standard-setting process with regard to bank capital is well advanced. Nevertheless, one provision of the Dodd-Frank Act continues to be problematic. The Collins Amendment applies to bank holding companies the capital standards applicable to their subsidiary banks in spite of the very different corporate structures and economic roles played by holding companies. The amendment prohibits the use of trust-preferred securities and securities issued to the Treasury Department in return for TARP funds from inclusion in bank holding company Tier 1 capital. Our Association opposed this amendment at its adoption and urged that it be dropped during the conference on the bill. The amendment ignores the Federal Reserve System's "source of strength" doctrine, which encourages increased capitalization by holding companies in order that a holding company be available to strengthen the finances of its subsidiary banks. Trust preferred securities were acceptable at the holding company level for many years because they provided exactly the type of increased financial cushion and greater flexibility in capitalizing subsidiaries that regulators of holding companies felt necessary.

The amendment, which has not yet become effective, will have a deleterious effect on the capital adequacy of a number of bank and thrift holding companies, including those controlling many community banks and savings institutions. It would require diversified bank holding companies, savings and loan holding companies, and systemically-designated nonbank financial companies to comply with the capital rules initially developed for insured banks in the 1980s. This may well result in standards that are inappropriate to the activities and risks of those firms that may engage in a range of

financial and commercial activities not permitted for insured banks. More generally, banking firms and the financial markets are dynamic and innovative. Flexibility is needed to adapt to capital rules over time to mitigate risks from new products and instruments.

The Collins Amendment, by freezing in place as a floor previously existing bank capital standards may also undermine the ongoing efforts of our financial regulators to modernize and strengthen international capital standards. In effect, the amendment would be a step backwards to codify the existing, outdated Basel I capital requirements at a time when the U.S. is working with other nations to strengthen capital requirements on a global, internationally-coordinated basis. These global efforts are designed to strengthen capital requirements in light of lessons learned from the recent financial crisis. At this juncture, it seems unwise to hinder U.S. participation in global discussions to build stronger capital buffers into the global financial system by mandating U.S. capital requirements in legislation.

The amendment also causes a number of unanticipated consequences, some of which can only be described as unfair. One particularly egregious example of such a consequence involves bank holding companies that, as of December 31, 2009, had total consolidated assets in excess of the $15 billion trigger in the amendment, but that had significantly less than $15 billion as of the March 31, 2010 call report, the date of adoption of the Collins Amendment and the date of passage of the Dodd-Frank Act. One holding company of which we are aware found itself in exactly that position as a result of actions it took in early 2008 to enhance its financial firewalls in light of the uncertainty in the markets at that time. In a perfect example that "no good deed goes unpunished," the very actions that enhanced the holding company's safety and soundness have inadvertently resulted in its being subject to the Collins amendment.

As a result, our Association strongly supports H.R. 3128, a bill that would address this glaring injustice by providing the opportunity for bank regulators to value the consolidated assets of bank holding companies subject to the Collins Amendment either as of December 31, 2009 or March 31, 2010. This very targeted provision would permit a holding company to avoid the disallowance of a significant portion of its capital base within the next three years even as institutions of comparable and even larger sizes can maintain the same liabilities as capital. We urge that the Subcommittee recommend passage of H. R. 3128.

Capital requirements need to be enhanced to help provide additional flexibility to individual institutions and help prevent another financial crisis. To be effective, however, capital requirements must be carefully crafted and applied so as to avoid hindering economic growth, the viability of our financial institutions and other unintended consequences. While there seems no likelihood that the Collins Amendment will be repealed, we urge that at least one of its unintended consequences be effectively and expeditiously addressed by the passage of H.R. 3128.

Thank you for the opportunity to submit this statement. We are available to respond to any additional questions that the Subcommittee may have.

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May 17, 2012

Congresswoman Maloney
2332 Rayburn HOB
Washington, DC 20515

Dear Congresswoman Maloney,

Thank you for requesting my views on the Collins Amendment and the need for stronger capital requirements to support the US financial system.

Prior to the financial crisis, the FDIC fought a lonely battle against the so-called Basel 2 advanced approaches which would have permitted large banks to significantly reduce their capital levels based on their so-called sophisticated risk management systems and models. The FDIC was able to successfully delay implementation of this flawed bank capital standard, but we were literally alone in our opposition. But because of our efforts, FDIC insured commercial banks maintained significantly higher capital levels than did investment banks and European institutions which took on leverage levels of 30 to 1 and higher using Basel 2 as their capital framework.

The Collins amendment was designed to ensure that never again would bank regulators be permitted to lower capital levels for large banks based on flawed notions of their greater "sophistication" and "risk management" capabilities. Appropriately, regulators are constrained from lowering the capital requirements of large, powerful banking organizations to levels below those generally applicable to smaller banks. As we are now seeing first hand with JPM Chase's escalating trading losses, bank risk management systems, and models in particular, are inherently unreliable for setting regulatory capital minimums.

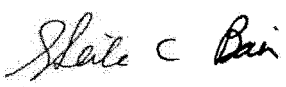
The Collins amendment also requires bank holding companies to have capital as strong as the FDIC insured banks which they own to ensure that they can be a source of strength for those banks. And specifically, Collins bans prospective use of trust preferred securities as Tier 1 capital by bank holding companies. During the crisis, trust preferred securities had no loss absorbing capacity, and the debt-like priority status of these instruments impeded efforts to recapitalize bank holding companies with new common equity investments. Research by the FDIC shows that allowing trust preferred securities to count as capital cost the FDIC billions of dollars.

It is unbelievable to me that in the wake of the 2008 crisis, when taxpayer bailouts were needed to prevent the failure of insolvent financial institutions and when we had a Great Recession because thinly capitalized financial institutions had to dramatically pull back credit lines and stop lending to preserve the little capital that they had, that organizations representing big banks would advocate to this Committee that Dodd Frank capital requirements should be weakened. They use that old saw that higher capital requirements will hurt lending when in fact excess leverage in the financial sector was the primary cause for the recession and the millions of jobs that were lost. They make wildly inflated claims about the adverse impact higher capital requirements will have on economic growth, when all responsible, independent studies have shown the impact to be marginal and far outweighed by the benefits of a more stable financial system.

Higher capital requires bank owners to put more of their own skin in the game to support bank lending and investment activity. As such, it serves to constrain excess risk taking through economic incentives as opposed to prescriptive regulations. For this reason, there is wide support for higher capital across the political spectrum.

I hope the Committee will reject the industry's specious arguments and keep the Collins amendment -- the only concrete provision in Dodd Frank to strengthen capital--intact. Anyone who cares about protecting taxpayers should ignore the self-interested requests of big bank interest groups to let them take on more leverage. With a highly unstable situation in Europe and fiscal uncertainty at home, big banks should be focusing on building additional capital cushions, not lobbying Congress to let them get back to their pre-crisis ways.

Sincerely,



Sheila C. Bair
Former Chairman
FDIC

ACLI
Financial Security...for Life.

American Council of Life Insurers (ACLI) Statement for the Record
House Financial Services Committee
Subcommittee on Financial Institutions and Consumer Credit
"The Impact of the Dodd-Frank Act: Understanding Heightened Regulatory Capital Requirements"

May 18, 2012

Thank you Chairman Capito and Ranking Member Maloney for convening today's hearing on heightened capital standards required under section 171 of the Dodd-Frank Act (DFA). The American Council of Life Insurers (ACLI) is pleased to submit this statement for the hearing record expressing the concerns of the life insurance industry about implementation of section 171.

The ACLI is a national trade association with over 300 member companies representing more than 90 percent of the assets and premiums of the life insurance and annuity industry in the U.S. ACLI member companies provide the products that protect against life's uncertainties, helping individuals and families manage the financial risks of premature death, disability, long-term care, and retirement. More than 75 million American families, nearly 70% of households, rely on life insurers' products for their financial and retirement security. In 2010 alone, American families received $58 billion in life insurance death benefits, $70 billion in annuity payments, $16 billion in disability income insurance benefits, and $7 billion in long-term care insurance benefits.

Unlike nearly all other financial institutions, life insurers are predominantly focused on the long term. Life insurers must manage the policy premiums and investments entrusted to them by their customers to meet obligations to those customers over multiple decades. The fundamental business model of a life insurance company does not involve high risk or short term profit seeking.

Capital Standards Appropriate for Banks are Not Appropriate for Life Insurers

Life insurance companies, including those that are or are held by depository institution holding companies, are vastly different than banks. We believe that any capital standards established under section 171 must recognize the fundamental differences between life insurance companies and banking organizations. As noted in a 2002 joint report of the staff of the Federal Reserve Board and the National Association of Insurance Commissioners (NAIC) on risk-based capital, the different capital approaches for insurance companies and banks reflect the "inherent differences between the insurance and banking industries." As was further noted in that report, the "two frameworks differ fundamentally in the risks they are designed to assess, as well as in their treatments of certain risks that might appear to be common to both sectors." "The effective capital charges cannot be harmonized simply by changing the nominal capital charges on an individual basis," the report states. Rather, the different capital approaches "arise from fundamental differences between the

two industries, including the types of risk they manage, the tools they use to measure and manage those risks, and the general time horizons associated with exposures from their primary activities."

By way of example, it is worth noting that current Federal Reserve Board capital rules do not account for the fundamental differences between life insurers and banks. Bank Holding Company (BHC) rules do not sufficiently account for insurance-related assets and liabilities, nor do they sufficiently account for instances where a company engages in other nondepository activities. BHC rules do not appropriately account for the unique nature of various life insurer products, such as variable annuities supported by separate account assets. Similarly, the bank risk-based capital formulas provide no weightings for insurance risks, such as exposure to mortality losses or fluctuations in claims reserves.

The fundamental differences between the insurance industry and the banking industry must be taken into account in the design of capital standards under section 171.

Federal prudential regulators acknowledged basic differences between insurance and banking companies in their Joint Notice of Proposed Rulemaking (JNPR) last year. Supplementary Information section I.E. of the JNPR, entitled "Effect of Section 171 of the Act on Certain Institutions and Their Assets," discusses the fact that certain depository institution holding companies and nonbank financial companies designated for supervision by the Federal Reserve Board under section 113 of the DFA that are subject to section 171 have not previously been subject to these bank capital requirements, and may hold assets that do not have a specific risk-weight assigned to them under generally applicable bank risk-based capital requirements. Section I.E. notes that under existing bank risk-based capital requirements, assets that do not have a lower risk-weight (i.e. 0 percent, 20 percent or 50 percent) assigned to them will by default be assigned a 100 percent risk-weight. It states further that, going forward, there may be situations where exposures of a depository institution holding company or a nonbank financial company, or affiliates of such companies, do not fit within the terms of the existing bank risk-weighting categories but also impose risks that are not commensurate with the risk-weight otherwise specified.

Specifically, section I.E. states:

For example, there are some material exposures of insurance companies that, while not riskless, would be assigned to a 100 percent risk weight category because they are not explicitly assigned to a lower risk weight category. An automatic assignment to the 100 percent risk weight category without consideration of an exposure's economic substance could overstate the risk of the exposure and produce uneconomic capital requirements for a covered institution.

This is a very important observation and one that should guide any rulemaking under section 171. As was indicated in the 2002 joint report of the Federal Reserve Board and the National Association of Insurance Commissioners on risk-based capital, the differences between bank capital rules and the insurance industry's risk-based capital rules cannot be harmonized simply by changing the nominal capital charges on individual assets. Simply put, the existing components of capital in the bank risk-based capital rules do not align with the elements of capital in the risk-based capital regime applicable to insurance companies.

The application of bank rules to insurers ultimately leads to poor outcomes, both for regulators and private industry. Forcing an insurer to unnaturally contort itself to fit within bank standards would provide a completely inaccurate and misleading picture of the company to regulators. Insurance companies are not banks. The liabilities and obligations of the two types of entities are very different, and so their capitalization and reserving requirements must be very different as well.

Existing Insurance Capital Standards Should be Considered Equivalent

ACLI believes that any capital rules applied to insurance companies as a result of section 171 must take account of the different asset and liability categories in an insurance operation. We believe the best way to accomplish this is to recognize and accept to the greatest extent possible insurer risk-based capital standards as equivalent for this purpose. As noted above, doing so would be in keeping with the past findings of the Federal Reserve Board and NAIC on this very issue.

In addition, ACLI believes that regulators should identify asset classes that are held by insurers that have no banking-industry equivalent and therefore do not fit within the terms of the existing bank capital risk weightings. Doing so will illustrate that such asset classes should not be automatically assigned a 100 percent risk weight category, but instead should be given special consideration because they are, in fact, necessary and appropriate classes of assets to be held by life insurers. Separate account assets are one example of an insurer asset class with no comparable match in the banking world. As such, they must be given special consideration when applying section 171.

Finally, a number of our member companies are concerned that banking regulators implementing section 171 may require the use of Generally Accepted Accounting Principles (GAAP). Presently, many insurers prepare financial statements using Statutory Accounting Principles (SAP) and we believe that they should be allowed to continue to do so under section 171 rules.

Thank you for convening this important hearing and highlighting the potential impacts of the section 171 rulemaking process. We appreciate your consideration of the views of ACLI and its member companies.

Statement of The Financial Service Roundtable
Subcommittee on Financial Institutions and Consumer Credit
of the
Committee on Financial Services
U.S. House of Representatives
on
The Impact of the Dodd-Frank Act:

Understanding Heightened Regulatory Capital Requirements
May 18, 2012

Executive Summary

Four years after the global financial crisis, significant steps have been taken to strengthen the U.S. financial system and U.S. financial institutions. The Dodd-Frank legislation requires a myriad of new heightened regulatory standards for participants in the financial markets designed to avoid future financial crises of the magnitude experienced recently. Increased minimum capital levels are an important requirement of Dodd-Frank, but they are only one of many safeguards contained in the legislation. All of the new required regulations are intended to work together to both reduce the probability of a failure of a systemically important financial institution (SIFI) and, in the unlikely event of a failure, substantially reduce the potential impact spreading across the financial sector. The meaningful progress made to date toward these goals can be summarized in five areas:

First, the probability of a failure of a large firm has been significantly reduced. Dodd-Frank imposed a great variety of new requirements and restrictions regarding the size, business activities, capital, liquidity, governance and risk management practices of financial institutions. The intensity of supervision by the prudential regulators has risen substantially. Examinations of all areas of impacted financial institutions are more numerous and far more thorough than in the past. New regulatory rules and proposed rules will ensure thorough and active supervision in the future. It should be noted that the industry is currently providing constructive comments and feedback regarding the proposed rules to ensure the final outcomes are effective, make our financial system safer and stronger, and do not hinder the economy or the global competiveness of financial institutions in the U.S.

Second, there is greater oversight of the industry and the financial markets by new regulatory entities. There are several new regulatory organizations designed to monitor risks to the stability of the financial system. While still in the early stages of organizing and developing their missions, these entities have the

opportunity to play a critical role in avoiding another broad financial crisis. The Financial Stability Oversight Council (FSOC) was created by Dodd-Frank and is responsible for overseeing the level of risk throughout the financial system and for identifying and heading-off emerging trends that could grow to be a threat to financial stability. FSOC is not alone in its new risk monitoring responsibilities. The Federal Reserve also has created its own new Office of Financial Stability Policy and Research; the FDIC has created its new Office of Complex Financial Institutions; and a powerful new agency, the Office of Financial Research (OFR), has been charged with measuring and monitoring risk in the financial system.

Third, the systemic impact of a failure of a financial institution is greatly reduced if not completely eliminated under current law. Dodd-Frank gave regulators a much more robust set of tools for resolving a failed institution in an orderly manner. Title II of Dodd-Frank created a new resolution authority vested in the FDIC. This new resolution regime is designed to ensure that the failure of any financial institution deemed systemically important could be swiftly isolated and then resolved without contagion effects that could negatively impact other companies or the broader economy, which in turn could lead to a systemic crisis. Furthermore, large financial firms are now required to annually submit resolution plans, so-called "living wills," that will be approved by both the FDIC and the Federal Reserve. These plans will provide roadmaps to the FDIC for effectively resolving a failed institution, further ensuring minimal disruption to the financial markets in the remote event of a large financial institution failure.

Fourth, most institutions considered systemically important have strengthened their balance sheets, improved their capital and liquidity planning and positions, enhanced their internal governance and risk management capabilities, and upgraded their underwriting policies and practices on their own accord. These efforts started almost immediately after the crisis and well before most of the roughly 400 new Dodd-Frank rules become fully effective. Many firms have increased capital to record levels that exceed Basel III expectations. During the last four years, the largest U.S. banks have increased Tier I capital, the "safest" form of capital for a bank to have on its books, by 50 percent. Additionally, financial services investors have demanded greater transparency, more pertinent information, and higher levels of accountability from management teams, thereby instilling greater market discipline as well. As a result of these actions, large financial institutions are much stronger today, and they have reduced both their risk tolerance and their risk profile, and thus their potential systemic impact.

Fifth, Dodd-Frank expressly prohibits the use of taxpayer funds for the purpose of preventing the liquidation of a financial institution. Section 214 of

Title II of the Dodd-Frank Act clearly states this new prohibition to protect taxpayers.

The probability that a SIFI will fail is significantly diminished

The probability that a systemically important financial institution (SIFI) will fail has diminished significantly since the financial crisis. As noted above, larger financial institutions – by their own volition – have taken significant steps to de-risk their balance sheets and their businesses since 2008. Furthermore, the Dodd-Frank legislation calls for many new and enhanced regulatory rules that will provide managements and regulators with a set of standards and tools that will build additional safeguards into the financial system, allowing for potential emerging risks to be identified and managed much earlier.

These new regulatory safeguards include:

- **Increased regulatory capital**: There are multiple efforts to increase regulatory capital at both banks and nonbanks, not only to create a higher cushion for greater loss absorption in the event of a problem but also to ensure higher quality capital going forward (i.e., greater reliance on common equity as a standard). Internationally, the Basel Committee on Banking Supervision (BCBS) promulgated new guidelines for internationally active banks in 2011 after several years of debate. These guidelines call for a higher minimum level of Tier 1 common equity of 7.0 percent. These reforms also include raising risk-weightings for traded assets, creating a new capital counter-cyclical buffer on top of new minimums, and introducing a new international leverage ratio similar to the one in place in the United States before the crisis, only higher

  Meanwhile, the U.S. version of the new Basel III guidelines will be released for comment in the coming months, according to the latest statement from Federal Reserve officials. Even before these rules will be proposed, most of the largest financial firms are well on their way to meeting the new Basel III requirements on their own ahead of schedule.

- **Capital planning**: As a complement to new and higher capital standards, the Federal Reserve initiated new capital planning requirements for bank holding companies with assets of $50 billion or more in 2011. These new capital plans will be submitted annually by large financial institutions and will be subject to intense review by the Federal Reserve as part of its more holistic supervisory oversight. Moreover, they are designed to be more forward-looking and closely integrated with related new stress testing requirements, also mandated under Dodd-Frank.

These new capital plans are becoming an integral part of the Federal Reserve's supervisory arsenal and impose strict regulatory oversight of planned capital distributions. In effect, they will create a high hurdle for any firm that wishes to distribute capital (e.g., earnings in the form of dividends back to shareholders), with the Federal Reserve using severe economic scenarios upon which to base their judgment about the viability of capital distributions. In addition, firms subject to the capital planning rule are required to report significant new and detailed data, including granular information about their loan and investment portfolios on a monthly/quarterly basis to enhance Federal Reserve monitoring.

- **Stress testing**: Building on the Federal Reserve's stress tests of the 19 largest bank holding companies after the crisis, Dodd-Frank mandates a twice yearly rigorous stress testing exercise against at least three economic scenarios. These rigorous new stress testing requirements will now cover even more financial institutions with the results closely monitored by the Federal Reserve. There also is a requirement for firms to publicly disclose information regarding their results.

- **Liquidity**: For the first time, the Basel Committee and U.S. regulators are moving to impose new short-term and long-term quantitative liquidity requirements on large financial firms. The primary purpose of the new rules is to increase resiliency of the banks and lower systemic risk. As the crisis clearly demonstrated, large financial firms often become illiquid before they become insolvent, so new liquidity rules are also designed, in part, to reassure creditors.

  The Basel Committee and the Governors and Heads of Supervision (GHOS) of the G20 nations are considering two proposals and expect to have a final proposal later this year that would be coupled with its new capital guidelines. The first is the Liquidity Coverage Ratio (LCR), which is designed to ensure a more than adequate supply of liquidity for each covered firm during a 30-day period of liquidity stress. The second is the Net Stable Funding Ratio (NSFR), which is designed to ensure a better asset and liability duration match on a company's balance sheet within a one-year framework. Both of these measures are subject to further examination and possible further revision at the international level.

  In addition, the new enhanced prudential standards in the proposed rule for Sec. 165 of the Dodd-Frank Act impose stringent new requirements for liquidity risk management by both boards and management teams. Provisions included in the Federal Reserve's liquidity rules for SIFIs

include: the development of liquidity risk measurement and reporting systems; daily detailed cash flow projections; monthly liquidity stress testing; the establishment of a board approved liquidity buffer; maintenance of a board approved contingency funding plan, and; specific limits such as concentrations of funding, the amount of funding that matures in various time horizons, and off- balance sheet exposures that could create funding needs in times of crisis.

- **Single Counterparty Credit Limits:** The Dodd Frank Act calls for enhanced rules that will limit the total amount of credit exposure to any single counterparty to 25% of an institution's capital and surplus. This limit is intended to ensure that the risk of institutions in the financial markets to one another will remain at manageable levels, thereby reducing the risk of systemic problems spreading from one financial institution to other market participants.

- **Early remediation**: Building on the "prompt corrective action" provisions in law that apply to all insured banks, the Dodd-Frank Act also included a new section applying "early remediation" to bank holding companies subject to Federal Reserve oversight. The comment period has recently closed on the Federal Reserve's proposed rule, and our detailed comments about this new provision are contained in the same joint trade letter referenced above.

  In short, Sec. 166 of the Dodd-Frank Act mandates a new early intervention program by the Federal Reserve, based on a four-stage approach to surveillance, initial contact with a firm that may trip any number of pre-determined surveillance metrics, and then a staged approach to joint supervisory and company actions. This new early remediation regime is designed for swift and forceful intervention before a company gets to be a significant or unmanageable problem, with the goal of restoring the firm as a "going concern" as opposed to a "gone concern" requiring its orderly liquidation. This is another powerful supervisory tool, whose sole purpose is fast and sweeping action to mitigate the risk from a potential failure of a large or interconnected company, which in turn could threaten the stability of the financial system and the economy.

- **Concentration limits**: The Dodd-Frank Act also included new absolute size limits for a banking system that is the least concentrated one of any G20 nation. It imposed a new 10 percent cap on the domestic liabilities of banks, and mandated that the Federal Reserve issue regulations to implement this new concentration restriction and size limitation with respect to its merger and acquisitions approvals.

These heightened prudential standards will significantly reduce the risk profile of large financial services institutions. It should be noted, however, that if the requirements are carried too far, adverse economic consequences (such as decreased credit availability or increased product costs) could far outweigh the marginal benefits. These consequences have been discussed frequently by many policymakers and industry leaders over the past few years. The Financial Services Roundtable has catalogued over 100 reports and studies about the cumulative weight of new rules on the industry and economy.

There is far greater regulation and oversight of the financial industry and markets today than before the crisis

In addition to the enhanced regulatory standards, Dodd-Frank created the FSOC for the purpose of holistically monitoring the level of risk in the financial system and to watch for emerging trends that could grow to be a threat to financial stability. The members of the FSOC are the heads of the major regulatory agencies charged with overseeing the various aspects of the financial industry. This gives the FSOC both a unique and unprecedented view across all of the financial markets and the activities of institutions operating in those markets.

The FSOC has three new powers at its disposal: 1) the authority to monitor financial markets for risk through its new Office of Financial Research (OFR); 2) the ability to recommend enhanced prudential standards for all companies covered by Title I of the Dodd-Frank Act, which are "more stringent" and "increase in stringency" based on risk; and 3) the authority to designate nonbank financial institutions as systemically important and subject them to new and enhanced regulation and supervision by the Federal Reserve Board.

This past month, the FSOC published its final rule for the designation of nonbank firms that may pose a threat to the financial stability of the U.S. economy. Already, all bank holding companies (BHCs) with total assets of $50 billion or greater will be subject by law to the new enhanced prudential standards mandated in Title I, or roughly the top 34 BHCs currently operating in the United States. Treasury Secretary Timothy Geithner has publicly stated that he fully expects the FSOC to make its first batch of designations of nonbanks before the end of the year. This move will subject some still unknown number of firms to the Federal Reserve oversight for the first time under its new financial stability mandate.

The financial crisis was so severe in part because there was not a regulatory oversight body with either the mandate or capability to monitor risk in and across the broad financial system. The FSOC was designed to fill this critical void,

which should enable regulators to spot problems in the system earlier and at individual institutions sooner, before they become systemically threatening.

However, FSOC is still in its early stages. To be truly effective at reducing systemic risk, FSOC must coordinate with existing regulators and exercise greater transparency with the public.

In addition to FSOC, other agencies have also been charged with monitoring systemic risk and preventing the collapse and contagion effects of the failure of a large financial company. The Federal Reserve, the OCC, the FDIC, and the FSOC, all have similar mandates, but a variety of different policy and regulatory tools to significantly decrease the probability of large failures in the future that in turn would have a material impact on financial stability or the broader U.S. economy. Additionally, the Office of Financial Research (OFR) has broad powers to collect, analyze and standardize data with respect to systemic risk.

FSOC and the regulators are in the process of designing this new regulatory regime with new rules and processes, while the industry is actively engaged in providing constructive comments to avoid unintended consequences that would unnecessarily hamper healthy economic growth or the competiveness of U.S. financial markets. As Federal Reserve Governor Daniel K. Tarullo stated just last week: "the post-crisis regulatory reform program has been substantially directed at the too-big-to-fail problem, and more generally at enhancing the resiliency of the largest financial firms."[1]

A failed SIFI will have significantly less systemic impact today than before the crisis

In the unlikely event that a large, systemically important firm fails, the Dodd-Frank legislation provides important new powers and tools in Title II (Orderly Liquidation Authority (OLA)) to the regulators for "resolving" the failed institution without damaging the financial system and without the contagion of significant problems spreading to other firms. Importantly, Section 214 of the Dodd-Frank Act clearly states that taxpayer money *cannot* be used to resolve a failed institution, and if there are costs incurred by the FDIC that are not recovered through resolution, then the FDIC will recover those costs from the industry through special assessments.

The Federal Reserve and the FDIC also have promulgated final rules under Sec. 165 of the Dodd-Frank Act that require large banks and any designated nonbanks

[1] Daniel K. Tarullo, Governor, Federal Reserve Board, "Regulatory Reform since the Financial Crisis," Council on Foreign Relations, New York, New York, May 2, 2012.

to craft resolution plans that will require annual review and approval by both regulators (known as "living wills"). Both the Federal Reserve and the FDIC must approve these new plans separately. These resolution plans will provide a roadmap to the FDIC for winding up the activities of a failed company in an orderly fashion. Furthermore, the approval process for the plans will provide the regulators with an opportunity to proactively require changes in an institution's organizational structure or business model to the extent a firm's current structure would materially impede a resolution.

Key elements of the SIFI resolution plans and the new orderly liquidation powers granted to the regulators are:

- **Resolution Plans:** must be submitted annually and approved by both the Federal Reserve and the FDIC. Each annual report must contain the following extensive information:
  - Executive summary;
  - Strategic analysis, including capital needs, funding requirements, and specific actions to be taken, implementation processes;
  - Corporate governance, including internal controls, management responsibilities, data requirements, and risk management;
  - Organizational structure, including legal entities, balance sheet and off-balance sheet information, exposures, and counterparties;
  - Management information systems (MIS), including system requirements and access by regulators;
  - Interconnections and interdependencies, including foreign operations; and
  - Contacts.

- **Orderly Liquidation Authority:** The FDIC now has new orderly liquidation authority to resolve a large and failing bank holding company or other nonbank financial firm. The FDIC created a new internal Office of Complex Financial Institutions to manage both the resolution planning review and its new liquidation authority. In addition to the resolution plans submitted by individual firms, the FDIC will have its own internal plans for resolving individual firms based on those submissions.

  Title II provides for an elaborate mechanism to make the decision to put a financial firm through the orderly liquidation authority process, if normal bankruptcy is not a viable option. If the Federal Reserve Board, in consultation with the Secretary of the Treasury (who must also consult with the President), the FSOC, and the FDIC (the latter two by a two-thirds vote) find that a financial firm presents a systemic threat arising from its pending

insolvency, then the FDIC effectively can seize the institution and resolve it in an orderly manner under its new powers.

Large financial institutions are stronger, and better capitalized, with better risk management

The vast majority of large financial institutions today – banks and nonbanks – have significantly strengthened their balance sheets, bolstered their capital and liquidity positions dramatically, and instituted enhanced risk management standards including better underwriting practices. They reacted almost immediately after the financial crisis, and they moved well in advance of hundreds of rules being in place.

A new study by the Financial Services Roundtable – *Financial Services: Safer and Stronger in 2012* highlights the enhanced safety of the financial system, especially in the banking sector. This stronger balance sheet strength comes as a result of a combination of actions by individual firms on their own and the impact of the Federal Reserve's new capital planning and stress testing requirements. Compared to pre-crisis levels, banks will hold about 100 percent more capital, or roughly $500 billion to $550 billion more, under Basel III, and this will be significantly higher quality capital given the emphasis on the greater loss absorption of common equity.

A few data points on capital and other measures support the undeniable fact that our financial system is safer and stronger today than before:

- **Capital has increased significantly**: Most large financial institutions have significantly increased their capital strength to record levels since the crisis, and many actually exceed Basel III expectations.
  - From September 2007 to September 2011, FDIC-insured U.S. banks increased Tier 1 capital by 24 percent, to $1.217 trillion from $982 billion. Tier 1 is considered the "safest" form of capital for a bank to have on its books, consisting primarily of common equity;
  - The largest U.S. banks increased capital *by even more*. During the same four-year time period, U.S. banks with more than $10 billion in assets increased Tier 1 capital to $858 billion as of 2011 from $574 billion – a significant 50 percent increase;
  - By the end of 2010, the average Tier 1 capital ratio (capital to risk-weighted assets) for the largest 18 U.S. banks was 12.2 percent – well

above previous supervisory benchmarks, according to the Federal Reserve of San Francisco.

- **Risk management has been enhanced**: Most large financial institutions have significantly enhanced their enterprise-wide risk management frameworks and capabilities since the crisis, including more active board oversight, the adoption of risk appetite statements, regular use of stress testing and forward-looking capital planning, and more interactions with supervisors on risk in general.
- **Credit underwriting standards have improved**: Most large banks have completely overhauled their credit underwriting standards and practices. As a result, loan quality measures for the industry have improved dramatically over the last three years.
- **Proprietary trading has been restricted**: Most large banks have exited "pure" proprietary trading for their own account, while continuing to meet the needs of their customers and make markets. With the so-called "Volcker rule" still in the rule-making phase and not yet final, most large banks have overhauled their policies and processes in anticipation of a final rule, even though at this moment there are still significant concerns, unanswered questions, and unknown consequences for both financial institutions and their end-user customers, including especially foreign governments, about the potential impact of this proposed rule on financial markets, competitiveness, and market-making to support economic growth on a sustained basis.
- **Balance sheets have been de-leveraged**: Most large financial institutions have significantly de-leveraged their balance sheets since the crisis. As a result of the intense and priority focus of regulators on greater capital and liquidity buffers to absorb future potential losses, combined with the increased use of stress testing, most large banks in particular have much stronger and more resilient balance sheets today than they did before the crisis. Many have even collapsed off-balance sheet entities common before the crisis onto their balance sheets as part of this process of improving balance sheet strength to even stronger positioning in the markets.

Taxpayers are fully protected now, unlike before the crisis

Finally, Dodd-Frank expressly prohibits the use of taxpayer funds for the purpose of preventing the liquidation of a financial institution. Section 214 of Title II of the Dodd-Frank Act is very clear in stating this prohibition.

Furthermore, the language goes on to state that all funds used in the liquidation of

a financial institution shall be recovered from the disposition of the financial institution's assets or, alternatively, will be paid by the financial sector through assessments. These assessments would be in addition to the normal FDIC assessments that fund the deposit insurance fund and paid exclusively by the banking industry. The U.S. taxpayers do not fund the FDIC. Other portions of Title II of the Dodd-Frank Act also stipulate harsh outcomes for the shareholders, management, the Board, and certain creditors of a failed institution.

Summary

In summary, the U.S. financial system has been greatly strengthened by a combination of sweeping legislative, regulatory and industry changes.

First, the probability of any singular failure of a large, financial services firm has been reduced significantly through a combination of provisions in the Dodd-Frank Act, new actions by the financial regulators, and actions taken by financial institutions themselves.

Second, there is far greater oversight of the financial services industry by the new Financial Stability Oversight Council and the existing regulators, who have new and significantly enhanced powers of regulation, supervision, and enforcement. Moreover, there is much the FSOC can do to do a better job of coordination of rules and actions by the various regulators in addition to being far more transparency to the public about its agenda and its actions.

Third, the impact of any potential failure having a systemic impact has been greatly reduced, thanks to the provisions in Title II of the Dodd-Frank Act, which not only grant sweeping new authority to the Federal Reserve and the FDIC, but also ensure that taxpayers will never again have to pay for the failure of a large financial institution.

Fourth, most large financial institutions since the crisis have significantly strengthened their balance sheets, roughly doubled their capital and liquidity buffers, and upgraded their risk management capabilities. Moreover, they have done so before most of the more important Dodd-Frank rules have been finalized and well in advance of Basel III reforms even being introduced officially by U.S. regulators.

Finally, the Dodd-Frank Act explicitly prohibits taxpayer funds from being used in the event of the failure of a major financial institution.

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