

MAKING A FINANCIAL CHOICE: MORE CAPITAL OR MORE GOVERNMENT CONTROL?

HEARING BEFORE THE COMMITTEE ON FINANCIAL SERVICES U.S. HOUSE OF REPRESENTATIVES ONE HUNDRED FOURTEENTH CONGRESS SECOND SESSION

JULY 12, 2016

Printed for the use of the Committee on Financial Services

Serial No. 114-96



U.S. GOVERNMENT PUBLISHING OFFICE

25-875 PDF

WASHINGTON : 2018

For sale by the Superintendent of Documents, U.S. Government Publishing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512-1800; DC area (202) 512-1800
Fax: (202) 512-2104 Mail: Stop IDCC, Washington, DC 20402-0001

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CONTENTS

	Page
Hearing held on:	
July 12, 2016	1
Appendix:	
July 12, 2016	65

WITNESSES

TUESDAY, JULY 12, 2016

Allison, John A., former President and Chief Executive Officer, Cato Institute	6
Levitin, Adam J., Professor of Law, Georgetown University Law Center	10
Newell, Jeremy, General Counsel, The Clearing House Association	13
Nussle, Hon. Jim, President and Chief Executive Officer, Credit Union Na- tional Association	8
Pollock, Alex J., Distinguished Senior Fellow, R Street Institute	12
Purcell, Jim R., Chairman, State National Bank of Big Spring, Texas, and Chairman, Texas Bankers Association	15

APPENDIX

Prepared statements:	
Hinojosa, Hon. Ruben	66
Allison, John A.	67
Levitin, Adam J.	70
Newell, Jeremy	92
Nussle, Hon. Jim	116
Pollock, Alex J.	221
Purcell, Jim R.	225

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

Hill, Hon. French:	
Article from the Arkansas Democrat-Gazette entitled, "Four of state's banks generate most profits," dated June 19, 2016	231
Waters, Hon. Maxine:	
Written statement of Americans for Financial Reform	234
Letter to Hon. Jeb Hensarling and Hon. Randy Neugebauer from various undersigned organizations, dated July 11, 2016	248
Letter to Hon. Jeb Hensarling from Steptoe & Johnson LLP, dated July 11, 2016	253

MAKING A FINANCIAL CHOICE: MORE CAPITAL OR MORE GOVERNMENT CONTROL?

Tuesday, July 12, 2016

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 2128, Rayburn House Office Building, Hon. Jeb Hensarling [chairman of the committee] presiding.

Members present: Representatives Hensarling, Royce, Lucas, Garrett, Neugebauer, Pearce, Posey, Fitzpatrick, Luetkemeyer, Huizenga, Duffy, Hurt, Mulvaney, Hultgren, Ross, Pittenger, Wagner, Barr, Rothfus, Schweikert, Guinta, Tipton, Williams, Poliquin, Love, Hill, Emmer; Waters, Maloney, Velazquez, Sherman, Meeks, Scott, Cleaver, Himes, Carney, Sewell, Foster, Kildee, Murphy, Delaney, Sinema, Beatty, and Vargas.

Chairman HENSARLING. The Financial Services Committee will come to order.

Without objection, the Chair is authorized to declare a recess of the committee at any time.

Today's hearing is entitled, "Making a Financial Choice: More Capital or More Government Control?"

I now recognize myself for 3 minutes to give an opening statement.

Regrettably, we remain stuck in the slowest, weakest economic recovery since at least World War II. The economy simply isn't working for tens of millions of working Americans who cannot get ahead and who fear for the future of their families.

Their paychecks remain stagnant, and their savings have declined. They are losing hope.

Why is this happening? One of the principal reasons is the Dodd-Frank Act, a grave mistake Washington foisted upon the American people nearly 6 years ago. Simply put, Dodd-Frank has hurt the economy, hurt consumers, codified bank bailouts, and made our financial system less stable.

It is time for a new paradigm in banking and capital markets. It is time to offer all Americans opportunities to raise their standards of living and achieve financial independence.

In a phrase, we need economic growth for all and bank bailouts for none. There is a better way forward and it is called the Financial CHOICE Act, an acronym standing for Creating Hope and Opportunity for Investors, Consumers, and Entrepreneurs.

The Financial CHOICE Act rests on the belief that a high level of private bank capital is the most basic element in making a financial system healthy, resilient, and reliable for economic growth.

The Financial CHOICE Act will relieve financial institutions from growth-strangling regulations that create more economic burden than benefit in exchange for voluntarily meeting higher, yet simpler, capital requirements.

Our reform stops investors from making risky bets with taxpayer money. It once and for all ends taxpayer bailouts, period.

It is quite simply a market-based, equity-financed Dodd-Frank offramp.

To avail themselves of this exchange, many larger banks will have to raise significant additional equity capital. Most community banks and credit unions will have to raise little to no additional capital.

Under our plan, banking organizations that maintain a simple leverage ratio of at least 10 percent at the time of the election, and have a composite CAMELS rating of one or two, may elect to be functionally exempt from the post-Dodd-Frank supervisory regime of Basel III capital and liquidity standards, and a number of other regulatory burdens that predate Dodd-Frank.

Banking organizations that make a capital election will still be supervised and regulated by the banking agencies, but the presumption will be that such institutions are operating safely and soundly.

Importantly, the CHOICE Act relies upon a leverage ratio approach to measuring capital adequacy rather than the discredited risk-based capital regime advanced by the Basel Committee on Banking Supervision that proved so destructive during the last crisis.

Nothing is riskier than one centralized, politicized, globalized view of financial risk.

While maintaining a large capital buffer does not guarantee that a bank will never fail, it should be noted that among all insured depository institutions that entered 2008 with a leverage ratio of at least 10 percent, 98 percent survived the financial crisis. Of those that did fail, none was of sufficient size or scale to even remotely present any systemic issues.

It is also important to note that a 10 percent simple leverage ratio will provide a far greater capital buffer than required under either Basel or the Dodd-Frank Act.

Seven-plus years of Obamanomics and 6 years of Dodd-Frank have delivered nothing to the American people but stagnant paychecks and diminished savings.

Freeing well-capitalized, well-managed financial firms from the chokehold of an overly intrusive, heavily politicized regulatory regime will help create a healthier economy for all struggling Americans.

I now yield 1 minute to the gentleman from New Jersey, Mr. Garrett, chairman of our Capital Markets Subcommittee.

Mr. GARRETT. Thank you, Mr. Chairman.

I am sure you all know it was Einstein who was credited with saying that the definition of insanity is doing the same thing over and over again while expecting different results.

For too long our financial regulatory system has been governed by global networks of really detached elites who believe they are smarter than the market and the people when it comes to allocating and assessing risk.

Prudential regulator bigwigs that make up the Basel Committee have for years gamed capital standards to ensure that investment flowed into politically favored asset classes, whether it was the debt of nations or the subprime market. And this approach failed spectacularly back in 2008 and in the years since.

But unfortunately, the regulators in the Obama Administration have now doubled down on the failed policy of the past and they expect different results this time.

Today, the risk weight capital regime of Basel is even more complex, more costly, and more risky than ever before, and I have no doubt, if left unaddressed, it will continue to the next crisis as well.

So, fortunately, the CHOICE Act offers us a way out by pointing us towards a system that will allow the people and the markets to determine the risk of financial institutions and make it unlikely that the taxpayers will ever be called on again to bail out Wall Street and the bad decisions of the regulators who oversee it.

And so I look forward to the witnesses today.

And I yield back to the chairman.

Chairman HENSARLING. The Chair now recognizes the ranking member for 5 minutes.

Ms. WATERS. Thank you, Mr. Chairman.

Since the passage of Dodd-Frank, we have seen piecemeal attempts by our colleagues on the other side of the aisle aimed at undercutting Wall Street reform, whether through legislation in this committee or budget riders on the House Floor or through endless, meritless investigations.

There has been a drumbeat of effort aimed at weakening the rules we put forward in response to the worst financial crisis since the Great Depression.

This is all part of a massive deregulatory agenda not to make America great, but to put the needs of special interests above those of working Americans and leave taxpayers footing the bill.

The legislation we will consider today, the wrong CHOICE Act, is the centerpiece of this deregulatory agenda and is the culmination of 6 years of Republican efforts to gut financial reform.

It recycles every bad idea this committee has ever generated, adds a few more bad ideas on top, and creates an omnibus of special interest giveaways that invites the next financial crisis.

The hearing convened today is especially focused on Title I of the wrong CHOICE Act which gives banks a hall pass from Wall Street reform if they achieve a 10 percent capital ratio.

Let me be clear. This idea is not serious. While credible financial reformers have proposed strengthening capital requirements in exchange for some regulatory relief for community banks, this, the wrong CHOICE Act, is not that bill. In fact, it takes the names of true financial experts in vain by stealing their ideas and weakening them. It then tries to rebrand these weak ideas as reform.

Namely, the wrong CHOICE Act contains none of the guardrails of the other proposals, including limits on banks' derivatives activity. It has no caps on bank mergers, meaning big banks will only

get bigger. And the capital standards in this bill are far weaker than those proposed in bipartisan Senate legislation, which itself doesn't also repeal Dodd-Frank as this bill does.

It is why Governor Tarullo of the Federal Reserve, when asked about this legislation, said it would, "incentivize banks to move forward such riskier assets," and that capital levels "would have to be substantially higher to make regulators comfortable."

What's more, this bill makes other radical changes to our financial regulatory framework that would harm consumers and the greater economy by repealing the living wills requirement. It does nothing to shrink mega firms or ensure that they could be resolved if they fail.

And while the bill claims to end taxpayer bailouts, it would actually put us right back to where we were in 2008 when the largest banks had an implicit taxpayer guarantee.

The list goes on. The legislation would repeal the Volcker Rule which prevents banks from gambling with taxpayer money. It would repeal the Financial Stability Oversight Council's (FSOC's) ability to designate our largest, non-bank firms, like AIG, for heightened regulation. It would all but gut the enforcement authority of the Securities and Exchange Commission.

And importantly, the bill would make it nearly impossible for the Consumer Financial Protection Bureau (CFPB) to actually protect borrowers from financial abuse.

Indeed, by turning the bureau into a partisan, gridlocked commission, eliminating its independent funding and bogging it down in onerous cost/benefit analysis, it would render the CFPB totally toothless and unable to protect consumers from predatory mortgages, payday lending, discriminatory automobile financing, forced arbitration contracts or other harmful products and practices.

To me, this does not make good sense. When we have an agency that has returned \$11.4 billion to 25 million consumers in 5 short years, why would anyone want to hamstring its work in this way?

So it is clear to me that this bill is the wrong choice for consumers, for investors, and for the entire financial system. Instead of spending so much time and energy trying to repeal Dodd-Frank, we should be building on its reforms and ensuring that our regulators can implement them effectively.

That is the work of this committee and that is the work that this committee should be focused on.

I thank you and I yield back the balance of my time.

Chairman HENSARLING. The gentlelady yields back.

The Chair now recognizes the gentleman from Texas, Mr. Neugebauer, chairman of our Financial Institutions Subcommittee, for 1 minute.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

The Financial CHOICE Act serves as an important proposal that offers a clear alternative to the complex and faulty regulatory framework banks currently operate under.

The CHOICE Act's capital provisions offer financial institutions the choice of holding higher equity in exchange for less government-directed management of their businesses.

A simple leverage ratio supplants the ill-conceived risk weighting of assets, which leads to asset crowding, political manipulation and incredible compliance costs for community financial institutions.

Risk weighting failed to adequately be a predictor of bank stability during the financial crisis. While the 10 largest banks had tier one capital on the average of 7 percent, their average leverage ratio was below 3 percent.

According to FDIC Vice Chairman Thomas Hoenig, the leverage result will result in a more effective, more efficient, and more cost-effective supervisory regime.

While the leverage ratio will certainly help improve the supervisory regime, one cannot understate the benefits of financial stability that will also result.

As we saw during the financial crisis, run-like behavior was exacerbated by the fears that highly leveraged firms couldn't withstand periods of extreme market stress. Research shows that higher levels of equity funding decreases the danger of runs on banks. There is no benefit to getting to the bank first.

I fully support the shift to a simpler, more stable regulatory framework.

Chairman HENSARLING. The time of the gentleman has expired. We will now turn to our panel.

Our first panelist is Mr. John Allison who comes to us with a 38-year career in banking, the last 19 years as CEO of BB&T, which he helped grow into the 10th-largest bank holding company in America. He also is the recently retired president and CEO of the Cato Institute. Mr. Allison is a Phi Beta Kappa graduate of the University of North Carolina, has a master's degree in management from Duke University, and is a graduate of the Stonier Graduate School of Banking.

The Honorable Jim Nussle was our colleague and served in the House from 1991 to 2007. He served in this institution as the chairman of the House Budget Committee. He was my chairman. We will find out how much he enjoys being on the other side of the witness table today. He also served as the Director of the OMB under President Bush. He is a graduate of Luther College and Drake University Law School.

Mr. Adam Levitin is a professor of law at Georgetown University Law Center. He serves on the CFPB's Consumer Advisory Board. He is a graduate of Harvard Law School, Columbia University, and Harvard College.

Mr. Alex Pollock is a distinguished senior fellow at the R Street Institute. He comes to us with a 35-year banking career, part of it serving as president and CEO of the Federal Home Loan Bank of Chicago. He is a published author, and a graduate of Princeton University, the University of Chicago, and Williams College.

Mr. Jeremy Newell is the executive managing director, head of regulatory affairs, and general counsel at the Clearing House Association. Mr. Newell is a graduate of Yale Law School and is a faculty member of the Banking Law Fundamentals Program at the Berkeley Center for Law, Business, and the Economy, and Boston University Law School.

Last but not least, Mr. Jim Purcell. And for his introduction, I yield to the gentleman from Texas, Mr. Neugebauer.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

Jim Purcell serves as the CEO and the chairman of State National Bank in Big Spring, Texas, which, by the way, is in the 19th Congressional District of Texas. He is also the newest chairman of the Texas Bankers Association. Jim has a great understanding of the issues facing community banks as he has been a community banker for multiple years in the community of Big Spring, Texas, which is a rural community of about 30,000 people.

Jim has been a longtime friend and constituent of mine. And I am thankful for his insight into community banking and the importance of it to those communities, but also to the overall economy. And so I am glad to have Mr. Purcell here with us today, Mr. Chairman.

Chairman HENSARLING. We will now turn to all of our witnesses. Each of you will be recognized for 5 minutes to give an oral presentation of your testimony.

And without objection, each of your written statements will be made a part of the record.

Mr. Allison, we will go from left to right, physically and not philosophically, and we will begin with you. You are now recognized for your testimony.

**STATEMENT OF JOHN A. ALLISON, FORMER PRESIDENT AND
CHIEF EXECUTIVE OFFICER, CATO INSTITUTE**

Mr. ALLISON. Thank you, Mr. Chairman. Good morning.

I have a unique experience. I was heading the lending business of BB&T in 1980 and then CEO in 1990 when we went through another financial crisis, which gives me kind of a different context.

I am absolutely certain that the policies of the Federal Reserve, both the monetary policies and the regulatory policies, were major contributors to the recent crisis.

In regards to regulation, they made three big mistakes. One, they didn't regulate. Two, they encouraged a misallocation of capital to politically correct purposes like affordable housing or in Europe to sovereign debt, and then they got obsessed with Basel in terms of capital standards and they got lost in the mathematics.

Banks and regulators fooled themselves about risk because of the complexity of these mathematical models.

During the crisis this time, they made a really severe mistake, which had a big effect on the economy, and hurts our growth today. In the early crises, the regulators attacked the unhealthy banks and allowed them to fail. In this crisis, they attacked the whole industry.

In the past, BB&T could help our customers through the crisis. We took on a lot of healthy customers of unhealthy banks, but we couldn't do that this time. They forced us to stop doing the kind of lending that allowed us to get through the crisis without any kind of financial problems, without a single quarterly loss.

They stopped what I call venture capital lending. Venture capital lending is where you make a judgment of the individual and the project instead of the mathematics. I did a lot of those loans that have created hundreds of thousands of jobs. And my friend Bernie Marcus, who started Home Depot, has told me that he couldn't

start Home Depot today under the standards that exist. And that has had a big impact on growth.

After the crisis, because the regulators have wanted to keep things tight, they continue to stop venture capital lending and that has kept growth from happening in the economy and it has reduced competition which actually has been a subsidy to big businesses. We have been subsidizing big businesses.

I have a friend who owns a restaurant chain and he talks about how much easier it is in the restaurant chain because nobody is starting up restaurants because they can't get bank financing today.

It has also slowed growth in the economy, lowered productivity, and lowered the standard of living for the average consumer.

It is a big mistake to believe that regulators know the proper level of risk. They had no idea what was going on before the financial crisis. They didn't predict it. In fact, Ben Bernanke said we weren't having a recession after the recession had already started.

Today they are doing exactly the opposite. They have tightened standards way too much and it is hurting the normal growth rate in the economy. They didn't predict the financial crisis. Last year, they didn't predict what was going to happen to energy; energy was a very low-weighted loan from a risk perspective in Basel until this year after the horse was out of the barn.

In my 40 years experience in the banking business, the single-biggest determinant—not the only determinant and not a perfect determinant—of the health and safety of a bank is its capital position. A sound capital position radically reduces the risks of bank failures. Very few banks fail with proper capital.

I strongly believe that capital position has to be understandable, it has to be a clear goal, and it cannot be too complex because I guarantee you the big banks will game the system. They do it every single time. You need a simple, clear standard.

It is interesting that at the end of last year, Citigroup had a leveraged capital ratio, a supplemental leveraged capital ratio of 6.4 percent. I will guarantee you that Citigroup would be a lot less risky if they were forced to have a leveraged capital ratio of 10 percent versus having 10,000 regulators go micromanage Citigroup. I tell you that with certainty.

The opt-out in this bill is very important because it actually creates market pressure to get a rational banking size.

Those of you who are opposed to big banks and too-big-to-fail, this is a way to deal with that problem. There is no way to arbitrarily decide how big a bank will be. But management will manage to the capital standards and get rid of unprofitable businesses, which will be very good for the economy and the market will force banks to do that. Because if you don't opt out, the market will say, hey, you are a high-risk institution.

By the way, that is why some of the big banks will be opposed to this bill.

In the kind of society we have, banks play a critical role of helping businesses get started and helping businesses change their model so they can grow. And we can't do that today.

I can tell you, it is harder to make a small-business loan today than it has been in my 40-plus-year career in banking and that is not good for the economy and it is not good for the consumer.

And the irony is we can actually reduce risk and improve the performance of the economy by having higher capital standards and much less regulation.

[The prepared statement of Mr. Allison can be found on page 67 of the appendix.]

Chairman HENSARLING. Thank you, Mr. Allison.

We now turn to you, Chairman Nussle.

**STATEMENT OF THE HONORABLE JIM NUSSLE, PRESIDENT
AND CHIEF EXECUTIVE OFFICER, CREDIT UNION NATIONAL
ASSOCIATION**

Mr. NUSSLE. Thank you, Mr. Chairman.

And thank you, Ranking Member Waters.

It's great to be back before you. And I want to thank the members of the committee. Thank you for the opportunity to testify and give America's credit unions' perspective and views on Title I of the chairman's Financial CHOICE Act.

I have been at the Credit Union National Association now for almost 2 years. And the constant refrain I hear from my members wherever I go is that they are being crushed by regulations implemented mostly in response to a crisis that they neither caused or contributed to.

And so the time and financial costs of regulatory burden is impeding their ability and credit unions' ability to serve members and is really a leading driver to the credit union consolidation that we see across the country, which has accelerated since 2010 and that consolidation is now at a record pace.

We estimate the regulatory cost to America's credit unions and their members at \$7.2 billion in 2014 alone, which is up from \$4.4 billion in 2010.

And Mr. Chairman, I have attached a regulatory burden study that was done by a third party, that I would be glad to share with the committee, and is part of my written testimony.

This is money that is not being put to use to benefit credit union members, but they are definitely paying for it. If the regulatory burden costs were reduced, credit unions would and could invest more in their members in the communities through better rates on savings and loans, stronger capital positions, and the development of alternative delivery channels.

This would allow credit unions to make an even more powerful impact on the lives of their members and communities.

Credit union executives and board members have a hard time understanding why they must comply with rules designed primarily for the largest financial institutions and abusers of consumers, and have an even harder time understanding why their elected officials have a difficult time doing anything about it.

So we are here to engage in the process, not because this bill will solve all of the regulatory burden challenges facing credit unions, but because we think this is a good place to start the discussion on removing barriers so credit unions can more fully serve their

members. And we hope the committee will engage in this process in a bipartisan manner.

As you know, credit unions are subject to a statutory capital requirement already under the Federal Credit Union Act. In order to be considered well-capitalized for purposes of prompt corrective action, a credit union must maintain a net worth ratio of at least 7 percent. That is 1 percentage point higher, by the way, than the current requirement for banks.

Unlike banks, credit unions are not-for-profit cooperatives and the only source of capital for credit unions is their retained earnings. With this limited ability to raise capital, and given the relatively conservative market strategy which is inherent in credit unions' cooperative structure, many credit unions currently operate with a leverage ratio in excess of 10 percent already.

Title I would create a path forward and would allow for greater operation with that 10 percent.

To give you a sense of how this legislation would impact my credit unions today, nearly 4,000 of the 6,000 insured credit unions have a leveraged ratio greater than 10 percent. This represents about 65 percent of all credit unions. It represents about 62 percent of all credit union assets and serving nearly 60 percent of the 100 million credit union members.

We believe many of these credit unions would take advantage of the regulatory process provided under Section 102, which would include relief from, among other things, NCUA's regulations on interest rate risk, liquidity requirements, and the recently finalized risk-based capital requirements.

So we appreciate that this legislation structures the higher capital threshold as an option rather than a requirement. And we would ask that you resist efforts to require credit unions to hold additional capital because this actually could reduce their ability to lend to credit union members.

Further, such a requirement would be inappropriate and unnecessary for credit unions because they don't really have a history of capital inadequacy.

Nevertheless, providing credit unions relief who have demonstrated with their history of operating with higher capital levels and developing a process for remediation in the event that capital levels fall below 10 percent, I think that strikes an appropriate balance. And we think that is an appropriate part of this legislation.

So we appreciate the committee considering the legislation to provide meaningful regulatory relief for many of the credit unions. We look forward to working with you. We know this is a work in progress and we stand ready to work with you in order to try and accomplish some regulatory relief and remove barriers between our credit unions and our members.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Nussle can be found on page 116 of the appendix.]

Chairman HENSARLING. Thank you, Chairman Nussle.

Professor Levitin, you are now recognized for 5 minutes.

**STATEMENT OF ADAM J. LEVITIN, PROFESSOR OF LAW,
GEORGETOWN UNIVERSITY LAW CENTER**

Mr. LEVITIN. Chairman Hensarling, Ranking Member Waters, and members of the committee, thank you for inviting me to testify today.

It is only possible to evaluate the CHOICE Act's signature Title I regulatory opt-out in the context of the Act's other provisions. This is because the Title I regulatory opt-out would occur against a background of massive, preexisting deregulation for all financial firms irrespective of how well-capitalized they are.

This deregulatory background makes the additional Title I regulatory opt-out all the riskier.

The CHOICE Act has several deregulatory elements that open the door to an enormous amount of additional risk in the financial system even before we get to Title I.

First, the CHOICE Act eliminates key prudential regulations for all firms irrespective of their capital levels. Thus, the CHOICE Act repeals the Volcker Rule, eliminates regulation of critical financial market utilities, and repeals the risk retention requirement for securitizations.

Second, the CHOICE Act virtually eliminates Federal consumer financial protection.

Third, the CHOICE Act would significantly reduce the SEC's deterrence power.

Fourth, the CHOICE Act strips the Federal Reserve and the FDIC of key crisis response tools.

And finally, the CHOICE Act ensures that all Federal regulators will be subjected to constant political interference and congressional micromanagement such that they will not be able to use their remaining regulatory tools effectively.

Now, the CHOICE Act's provisions outside of Title I not only increase the likelihood of a financial crisis through across-the-board deregulation, but they also ensure that crisis resolution will be a disaster.

Title II of the CHOICE Act would eliminate Dodd-Frank's orderly liquidation authority and replace it with an unworkable bankruptcy-based resolution system. This bankruptcy system cannot work. This is because private capital markets are incapable of providing the level of financing that would be required for a bridge company for a large financial institution at a time when markets are frozen and with no notice.

A bridge company might need \$50 billion or \$100 billion of capital the next day. Capital markets have never provided a DIP loan of more than \$9 billion. Only the government unfortunately is capable of coming up with that kind of money.

Even if the CHOICE Act's bankruptcy provision worked, however, it would have the perverse effect of ensuring that Wall Street creditors get paid in full while Main Street creditors, vendors, and retirees, as well as tax authorities, get paid little or nothing. That is just wrong.

Moreover, the CHOICE Act's priority system creates an enormous moral hazard and reduces market discipline because it removes all credit risk on swaps, derivatives, and other qualified financial contracts.

The result will be to encourage excessive use of those products. It is in this context of a denuded regulatory system and a non-functional resolution system that we need to consider Title I of the CHOICE Act.

As a starting point, let me point out that there is no basis whatsoever for the 10 percent leveraged ratio number. It is not supported by any research. As far as I can tell, the 10 percent number is plucked out of thin air and it is grossly irresponsible to use as a basis for a regulatory system.

The particular leveraged ratio number, though, is not the most serious problem with Title I. Title I's simple leveraged ratio is drafted as a single option for all financial institutions, but it actually functions as two distinct options, a quite reasonable one for community banks and a very dangerous one for mega banks.

Community banks are given the choice between a simple leveraged ratio and the Basel III risk-weighted leverage ratios. Now, I have some concerns about the particulars of the CHOICE Act in this regard, but I am generally supportive of allowing community banks to use a simple leveraged ratio. There are a lot of problems with risk-weighted leverage ratios.

The problem, though, the real problem is the deal offered to the mega banks. Mega banks get a much better deal under the CHOICE Act than community banks. Mega banks are allowed to opt out, not only from Basel III, but also from Dodd-Frank's heightened prudential standards.

The danger of letting mega banks substitute higher capital for the multifaceted regulatory scheme of Dodd-Frank is that capital is a necessary, but insufficient protection against financial crises.

Ounce for ounce, capital may be the best protection against firm failure, but requiring only capital is like an Atkins diet for financial institutions. It is not a balanced diet; it is not healthy in the long run.

Indeed, a simple leverage requirement alone actually incentivizes risky bank behavior. It encourages banks to load up on high-risk, high-return assets in order to compensate for the lower return on equity caused by higher capitalization.

To prevent this, capital needs to be combined with other regulatory tools, such as credit exposure limits and liquidity requirement that curb excessive risk-taking.

The choice is not either capital or regulation, but there is another option, there are both.

All told then, the CHOICE Act is a bad choice. It is a recipe for financial disaster. It prioritizes ideologically driven positions over careful and serious policy analysis and reasoning. And the fate of the U.S. economy is too important to stake on an ideological gamble like the CHOICE Act.

[The prepared statement of Mr. Levitin can be found on page 70 of the appendix.]

Chairman HENSARLING. Thank you, Professor Levitin.

Mr. Pollock, you are now recognized for 5 minutes.

**STATEMENT OF ALEX J. POLLOCK, DISTINGUISHED SENIOR
FELLOW, R STREET INSTITUTE**

Mr. POLLOCK. Thank you, Mr. Chairman, Ranking Member Waters, and members of the committee.

Adam, the title of my remarks is, "An Excellent Choice."

Now, let me start with this thought, "Detailed intrusive regulation is doomed to fail." This is the conclusion, in my view correct, of a prominent expert in bank regulation. It is true because nobody knows enough about the future to tell other people what to do about it in a detailed way.

Surely there is a better way to proceed than promoting unfettered bureaucratic agencies trying to do something at which they are doomed to fail.

I believe the CHOICE Act offers the opportunity of a better way precisely by the fundamental choice it provides.

The lack of sufficient capital in banks is a permanent and irresistible temptation to governments to pursue intrusive microregulation. This has an underlying logic to it. After all, in a world in which governments explicitly and implicitly guarantee bank creditors, the government is in effect supplying risk capital to the banks who don't have enough of their own.

However, the greater the equity capital of a bank is, the less rationale there is for the detailed regulation.

This suggests indeed a fundamental and sensible trade-off: more capital, reduced intrusive and onerous regulation.

Want to run on less capital? You get the intrusive regulation.

Thus, the CHOICE Act offers to banks a very logical decision between two options, which I would characterize like this:

Option one, put enough of your equity investors' own money in between your creditors and the risk that other people will have to bail the creditors out if you make mistakes. Mistakes are inevitable when dealing with the future, and this includes mistakes by bankers, by regulators, by central bankers, and by everybody else.

The defense is equity capital. Have enough so the government can't claim you are living on the taxpayers' credit and indeed don't be living on the taxpayers' credit.

Option two, don't get your equity capital up high enough and instead live with the luxuriant regulation of Dodd-Frank as the imposed cost of using the taxpayers' capital instead of your own.

I believe the choice thus offered is a truly good idea. To my substantial surprise, the Washington Post editorial board agrees. They write, "More promising and more creative is Mr. Hensarling's plan to offer relief from some of Dodd-Frank's more onerous oversight provisions for banks that hold at least 10 percent capital. Such a capital cushion can offer as much or more protection against financial instability as intrusive regulations do and do so more simply."

Very true and very well-stated.

Of course, we have to answer the question, how much capital makes the capital high enough?

To consider the matter first in principle, without doubt, there is some level of capital at which this trade-off makes sense, some level of capital at which everyone would agree that the Dodd-Frank burdens become superfluous. But what is the practical level for a rational and realistic trade?

My written testimony discusses numerous bank capital proposals.

And Adam, I think if you consider that you will find that 10 percent fits into a quite elaborate and extensive literature and empirical study of bank capital.

Of course, we do have to make a judgment because there is no pure market test.

The CHOICE Act uses, as has been said, the simple and direct measure of tangible leverage capital. This, in my judgment, is superior to the complex and opaque measures of risk-adjusted assets and risk-based capital. And I explain this further in my written testimony, in particular, that the risk weightings and risk-based capital are bureaucratic compromises, whereas real risk is dynamic and changing.

So for purposes of setting up the choice for banks in the proposed Act, I believe the simplicity of tangible leveraged capital is the right answer.

In sum, the CHOICE Act's proposed choice between option one and option two makes perfect sense. And in my judgment, it ought to be enacted.

Thank you for the chance to share these views.

[The prepared statement of Mr. Pollock can be found on page 221 of the appendix.]

Chairman HENSARLING. Thank you, Mr. Pollock.

Mr. Newell, you are now recognized for 5 minutes.

STATEMENT OF JEREMY NEWELL, GENERAL COUNSEL, THE CLEARING HOUSE ASSOCIATION

Mr. NEWELL. Chairman Hensarling, Ranking Member Waters, and members of the committee, thank you for your invitation today.

My name is Jeremy Newell and I am the general counsel of the Clearing House Association.

Owned by 24 of the largest banks operating in this country, we are a nonpartisan organization that contributes research, analysis, and data to the public policy debate. We welcome this opportunity to discuss how capital and other rules could be rationalized and tailored to better serve consumers' businesses and economic growth while still ensuring the resilience and stability of our financial system.

As a first principle, it is useful to consider these questions in the context of the substantial capital strength of the U.S. banking system today.

The quantity and quality of capital that all banks must hold has increased substantially due to core post-crisis reforms, reforms that we strongly support. For our 24 owner banks, the strongest form of capital has nearly tripled over the last 7 years to more than \$950 billion.

The strength of banks' current capital position was evident in the Federal Reserve's most recent CCAR stress test in which large banks were required to weather an extraordinary hypothetical stress, everything from a sharp 5 percentage point jump in unemployment to an 11,000 point plunge in the Dow, all while continuing to do business as usual.

In last month's results, every single one of the 33 CCAR banks demonstrated that they would exceed the regulatory minimums after that stress, and they did so with substantial capital to spare.

Together, those 33 banks held \$275 billion in common equity tier one capital over and above their required co-stress minimums. Those numbers speak for themselves. The U.S. banking system does not need even more capital.

And yet, there are pending or planned new regulations from U.S. and international regulators that would do just that, including a Basel IV project to rewrite, again, the capital framework, a planned increase in required post-stress capital under CCAR and a new counter-cyclical capital buffer. All are ill-advised.

We should instead be considering the effects of existing rules on economic growth and taking steps to better rationalize or tailor those that have high costs, but only minimal benefits. The CHOICE Act includes several promising ideas to help achieve that objective.

A number of other opportunities to improve regulation in this way are described in my written testimony, so I will focus here on one that may be of most interest as the CHOICE Act would expand its use, and that is the U.S. supplementary leveraged ratio.

The supplementary leveraged ratio measures the capital adequacy of a bank by dividing its capital by its total assets and off-balance-sheet exposures. Although sometimes viewed as an alternative to risk-based capital, the leveraged ratio is in fact also a risk-based measure of capital, albeit it a very inaccurate one.

It assesses the risk of holding every asset to be exactly the same, akin to setting the same speed limit for every road in the world, whether it is a highway or a school zone.

Although the risk weights used and risk-based measures can sometimes be wrong about the risk of an asset, a leveraged ratio is almost always wrong.

This inaccuracy is especially pronounced for banks engaged in capital markets or custodial activities or those holding large amounts of liquidity. All involve large quantities of cash, Treasuries, and other truly low-risk assets which a leveraged ratio penalizes harshly, requiring much more capital than economics or risk would otherwise suggest.

To be clear, the leveraged ratio can be useful as a simple back-stop to other primary measures. But because its one-size-fits-all view of risk is so inconsistent with the actual economics and risks of banking, if it is set at a level that binds, either by choice or by mandate, a leveraged ratio will inevitably alter and distort the allocation of credit to the economy.

Indeed, even at the current 6 percent leveraged ratio that applies to the largest U.S. banks, we already see substantial impediments to banks' ability to support consumers and businesses.

For example, banks are currently holding over \$50 billion in capital against the cash on their balance sheets, capital that could be supporting new loans or other activities.

The current leveraged ratio is also having sizable adverse effects on capital markets and custodial services. An even higher supplementary leveraged ratio would only exacerbate these effects.

Accordingly, while we support the CHOICE Act's goal of reducing unnecessary regulation for well-capitalized banks, we suggest that its use of the supplementary leveraged ratio be reconsidered.

With respect to other elements of the CHOICE Act discussion draft, there are a number of promising ideas, including the basic concept of more tailored regulation for well-capitalized banks, process enhancement to CCAR, and better analysis of costs and benefits in regulation.

I would be happy to discuss these and anything else during Q&A. I look forward to your questions.

[The prepared statement of Mr. Newell can be found on page 92 of the appendix.]

Chairman HENSARLING. Thank you, Mr. Newell.

And Mr. Purcell, you are now recognized for 5 minutes.

STATEMENT OF JIM R. PURCELL, CHAIRMAN, STATE NATIONAL BANK OF BIG SPRING, TEXAS, AND CHAIRMAN, TEXAS BANKERS ASSOCIATION

Mr. PURCELL. Chairman Hensarling, Ranking Member Waters, and distinguished members of this committee, I thank you for the opportunity to come before you to testify.

State National Bank is a time-tried and panic-tested bank that originated in 1909 under the Currie family. It continues to this day. We are about \$300 million. We are in a town of 28,000. We are in rural parts. One of the locations is about 7,000 people and another one, if you take the employees out of the bank, it is probably about 500 people in that location.

I started in bookkeeping after an injury. The doctor told me not to get on a horse for a year or a tractor for a year, and I got into banking.

I don't know if that was a wise choice.

[laughter]

I took the lowest-paying job that was offered to me, it had the fewest benefits, and it was in the coldest part of Texas at Dalhart, Texas, when I started.

It had the largest number of elder statesmen in the bank. All of them wore hearing aids, and some of them used a cane, so I thought that would be a pretty good place to start.

I started in bookkeeping, but I also understood what community banking was because of the efforts of those employees of Citizen State Bank in Dalhart.

But right now, I started in bookkeeping, let us talk about some numbers. In June of 2010 when the Dodd-Frank Act was being finalized, there were 626 FDIC-insured banks in the State of Texas. As of last quarter, the end of March of this year, we were down to 477, a decline of 149 institutions.

That is in a State that has one of the healthiest economies in our country.

Of course, no one is ascribing that the decline of this 24 percent of the banks in the State of Texas was entirely because of the Dodd-Frank Act. But these are the numbers and we certainly do not think it is coincidental to the Dodd-Frank.

As a community banker, my belief is that the Dodd-Frank Act has been negative, not just for community banking, but for large

banks and also medium-sized banks across the industry. It has likely had a negative impact on the country by restraining the bank industry's ability to mediate our depositors' funds into loans and companies and other worthy borrowers as otherwise would have been the case.

For this reason, the Texas Bankers Association strongly supports the Financial CHOICE Act as a path to reform through the option of establishing a capital threshold for relief from the hopelessly complex Basel III requirements and other counterproductive regulations.

This bill would utilize a capital standard of 10 percent which is double the current definition of a well-capitalized bank. A variation of this approach could also be included in a simplified risk-based aspect, as what has been proposed. Or perhaps a component suggested by FDIC Vice Chairman Hoenig, which would incorporate a business activities test.

Four years ago when I testified before this committee, I mentioned that Senator Dodd said, "In a nation with more than 6,000 banks, the bulk of the bill's new regulations apply only to a few dozen of the largest ones, each holding more than \$50 billion in assets."

No prediction could be farther from the mark.

In terms of the former chairman's reference to the total number of U.S. banking institutions, it still is above 6,000, at 6,122, but that is down a staggering 1,708 from the number of U.S. banks just prior to the enactment of the Dodd-Frank Act.

Most alarmingly of all, just three new banks have been chartered since 2010 when the Dodd-Frank Act passed.

Our message to the Congress is drawn from the very outset of seeing how the Dodd-Frank Act was being implemented, has been on the need for additional flexibility so that regulators can tailor policies and examinations to a bank's business model.

What I hear from bankers in Texas and around the country is that the pendulum in bank examination over the past 5 years has been transposed from prudent oversight to compliance overreach. The message is getting through for different things.

Perhaps there is a Dodd-Frank business model that works, but we haven't seen it yet.

I would like to close by saying that we got out of the mortgage business because of high-priced mortgages. We couldn't accommodate the debt-to-income ratios, and for self-employed individuals there is not a way to do it.

In conclusion, Chairman Hensarling and Ranking Member Waters, the Texas Bankers Association appreciates all the work which obviously went into the preparation of this legislation and we look forward to working with you on the reforms on both sides of the aisle.

[The prepared statement of Mr. Purcell can be found on page 225 of the appendix.]

Chairman HENSARLING. Thank you, Mr. Purcell, for your testimony.

The Chair now yields himself 5 minutes for questions.

Mr. Allison, I think I would like to begin with you.

Clearly, we know that our economy continues to suffer. We are limping along at just a little better than 50 percent of our typical economic growth. The real unemployment rate, when you add in those who have dropped out of the labor force, and those who are underemployed, is really about 10 percent.

So the fundamental question, I think, that is posed to us is really, which system will maximize economic growth and minimize systemic risk? And is that system high levels of private equity bank capital or high levels of government control and intrusion?

So you bring almost 4 decades of banking experience to the witness table. You helped build a very small, local, regional bank in to the nation's 10th-largest bank.

In your testimony you say that the financial service industries are now focused on compliance instead of innovation and productivity, that this is paralyzing the industry, speaking of regulation, and slowing innovation, creativity, and economic growth, and that lower-income individuals are the most negatively damaged by this sad situation.

So how is the current regulatory environment harming the economy? And how would the Financial CHOICE Act change that?

Mr. ALLISON. Mr. Chairman, I strongly believe that the current regulatory environment has basically forced bankers to focus on the wrong thing. They are focused internally on a massive set of rules and regulations, a massive set of mathematical formulas, instead of doing what they are supposed to do, which is identify ways to help their clients grow their businesses.

And then because regulators have overreacted, and I have seen this every time, this is the extreme of overreaction in my career, too loose before, too tight now, but keeping banks from doing what banks would naturally do if they were freed up.

Now, would some banks make mistakes? Of course, but if they had the proper capital position, there would be no losses and no risks to the taxpayers.

The banks that failed and got in trouble in the financial crisis were all grossly undercapitalized.

One of the fundamental problems with Dodd-Frank is banks can't be properly capitalized. In response to what Professor Levitin said, they can't be properly capitalized and afford the regulatory costs of Dodd-Frank. So they have a choice and the choice is to be focused on regulation and that is what regulators want them to do, instead of being properly capitalized and really focused on running their business.

I know that we are not making loans that we would have made in my 40-year career, and that is hurting the economy.

Chairman HENSARLING. Let us talk a little bit about systemic risk.

In your testimony, Mr. Allison, I think pretty early in the written testimony, you say, "Investors, rightly so, assumed bank regulators were controlling industry risk and investors were lulled to sleep. Without the perception that regulators knew what the risks were, investors would have studied the industry far more carefully. The market was fooled by banking regulators."

So how does this current regulatory regime take away from market discipline?

Mr. ALLISON. It takes away because the markets naturally believe that regulators have the inside information, that they know what is going on in the industry, they know who is going to fail and they are going to put out some warning in that regard.

In my career, I have never seen the regulators identify a bank that was a bad bank before we already knew it was a bad bank. They are always closing the barn door after the horse is out of the barn.

And today, of course, I think that they have probably reduced the risk of banks failing but at the expense of economic growth. And banks should be taking some risks and a few banks should fail every once in a while.

What we don't want is systematized risk, forcing everybody to the same standards, which is what a Basel does, forcing everybody to take the same risks, which is what affordable housing does, is when you get systematic problems instead of individual failures.

Individual failures are okay, that is what happens in business. It is a mass failure, and you don't have mass failures when banks are properly capitalized.

Chairman HENSARLING. Mr. Pollock, I would like to turn to you now in my remaining time, same theme, which system can reduce systemic risk more.

We have had discussions on risk weighting, and some of our panelists believe that you need risk weighting.

In your testimony, you say, "The deepest problem with risk weightings is that they are bureaucratic while risk is dynamic and changing. Designating an asset as low risk is likely to induce flows of increased credit, which end up making it high risk. What was once a good idea becomes a 'crowded trade,' and what was once a tail risk becomes instead a highly probable unhappy outcome."

So are you saying risk weightings can actually lead to more systemic risk?

Mr. POLLOCK. Yes, Mr. Chairman, I am saying precisely that. And a good example is Greek government debt with zero risk weighting. This was mentioned by several members.

I will just add that the payout of the 2012 restructuring of Greek debt was 25 cents on the dollar, hardly a risk-free outcome.

Chairman HENSARLING. Thank you. My time has expired.

The Chair now recognizes the ranking member for 5 minutes.

Ms. WATERS. Thank you.

Professor Levitin, in defense of Title I of the wrong CHOICE Act, my colleagues in the Majority claim that a simple capital level is easier for regulators to enforce and a better predictor of bank health and stability than the complex systems of accountability in the Dodd-Frank Act and Basel.

They also say it is less politicized and less subject to banks gaming the system.

However, can you discuss how the effectiveness of the capital requirements in the bill would be undercut by the provisions in the bill? For example, the legislation would allow banks to challenge regulators' supervisory decisions, would repeal regulators' independent funding, and would vastly increase the instances where private sector entities could seek judicial review of the independent regulatory decisions.

Wouldn't these provisions make it difficult for regulators to get a clearer view of bank health and take action to remediate banks' pre-failure?

Mr. LEVITIN. They absolutely would. That is why the choice offered in Title I of the CHOICE Act is so problematic. If it was just a freestanding choice without the other provisions in the CHOICE Act, there would be, I think, a reasonable discussion to have about it.

But when it is combined with all the other provisions from the CHOICE Act that basically render Federal regulators completely ineffective, it becomes very dangerous because then we are relying on nothing other than banks' own representation of what their capital is to protect us from a systemic crisis.

Ms. WATERS. So basically, have you concluded that if in fact you eliminate or interfere with regulators' ability to do anything, we would be relying solely on capital representation?

Mr. LEVITIN. That is basically where we end up.

Ms. WATERS. Let me just go further. The wrong CHOICE Act off-ramp is currently based on bank capital on the last day of the quarter. How could this open up the ratio to gaming via capital relief trays? What did we witness during the crisis with instances, including Lehman Brothers' exotic repos, in terms of how this could be disastrous?

Mr. LEVITIN. The problem is the way the CHOICE Act takes its measurement of capital measures it is on a particular day at the end of the quarter. That is a system that is very easily gamable. Lehman Brothers showed the blueprint for it.

Lehman Brothers had a set of transactions called repo 105, where basically on the last day of each quarter, Lehman Brothers would transfer a bunch of assets in a sale where there is an agreement that they were going to repurchase them the next day. And what that meant was on the measurement date, Lehman looked much better capitalized than it in fact was.

So, I have no doubt that aggressive bank lawyers and accountants will be able to come up with ways to end run a measurement system that uses a particular calendar day rather than, say, a running average.

Ms. WATERS. You made an interesting statement when you were talking about the capital market's ability to be able to provide the finance that is needed at any given time. Would you repeat that?

Mr. LEVITIN. Sure. I am by training a bankruptcy lawyer. And I love the bankruptcy system. I have a great opinion of the U.S. bankruptcy courts. I would love to see a bankruptcy system that could handle financial institution bankruptcies.

But here is the problem, and this is not a political opinion, this is just a fact. If you want a bankruptcy to work you need to have financing. You need to be able to pay the bills to keep the lights on, to retain employees, and to be able to keep valuable assets, like contracts.

The CHOICE Act requires that the bridge institution, if it wants to assume any of the financial contracts, the failed bank is going to have to provide assurances that it can actually perform those contracts. Therefore, it needs financing.

It is going to need massive financing. It is not going to need a hundred million or something, it is going to need tens or hundreds of billions if you had a bank like JPMorgan.

Ms. WATERS. But how much is available at any given time?

Mr. LEVITIN. The largest DIP loan, the largest bankruptcy financing, debtor-in-possession financing that we have ever seen from private capital markets was \$9 billion.

Ms. WATERS. And so explain a little bit further how \$9 billion is not enough.

Mr. LEVITIN. If you need, say, \$50 billion, \$9 billion just isn't going to cut it. And \$50 billion might be for just one firm. Suppose you have multiple firms that go down at the same time. There just isn't the ability in private capital markets to come up with that amount of money overnight at a time when there is panic in the markets. That capacity just doesn't exist.

If you want to have a bankruptcy system work for financial institution resolution, it is going to have to involve some sort of government financing.

I know that is anathema to many members, but that is just the plain truth. The system isn't going to work if we rely on private capital markets.

Ms. WATERS. And nothing in this wrong CHOICE Act anticipates that.

Mr. LEVITIN. No, it does not.

Ms. WATERS. Thank you, I yield back.

Chairman HENSARLING. The time of the gentlelady has expired.

The Chair now recognizes the gentleman from New Jersey, Mr. Garrett, the chairman of our Capital Markets Subcommittee.

Mr. GARRETT. I thank the chairman. And I thank the chairman for holding this very important hearing today.

I have a whole bunch of questions, and I'll start with Mr. Newell.

A couple of weeks ago before a Senate Banking Committee, Greg Baer was testifying for the clearinghouses at a hearing. And in his written testimony, he appeared to endorse Title I of Dodd-Frank, and in his written testimony, he appeared to endorse Title II of Dodd-Frank. He went into living wills and core post-crisis reforms and what have you.

In his oral testimony, Mr. Baer also appeared to endorse Title VIII of Dodd-Frank conceding that was even against interest, as he put it, given that clearinghouses were designated as a market utility. I am sure you saw his testimony.

So just to be clear, does the Clearing House, which obviously through its member companies includes some of the largest commercial banks, support, in essence, Title I in Dodd-Frank and Title II of Dodd-Frank as was testified last 2 weeks ago by Greg Baer for the Clearing House?

Mr. NEWELL. Thank you. We certainly support Title II. We think it is an important tool to financial stability.

Mr. GARRETT. Right, and also Title I and VIII that he referenced.

Mr. NEWELL. Yes, as Mr. Baer said, we certainly support the core capital liquidity reforms that have been enacted since the crisis. We continue to think that there are aspects of those rules that frankly provide only minimal benefits, but have high costs, and we think those pieces should be tailored.

Mr. GARRETT. Okay. So let me kick that over to Mr. Allison then. Does it surprise you that the largest banks support Dodd-Frank? And we heard from Mr. Purcell at the other end that maybe with the smaller guys not so much.

Mr. ALLISON. I think the fact is the smaller banks are the real victims of Dodd-Frank. And the healthy banks are the victims of Dodd-Frank.

My bank, BB&T, that went through the financial crisis without a single quarterly loss, has had to incur much more costs than unhealthy banks have because we had to change our basic business model which was local decision-making. We had a series of community banks. We have been hurt much more than Citigroup has.

In addition, the large banks know they can own the system. They have figured it out already and they are going to control the regulatory process in a way. And they also get the biggest benefit. This gets pretty esoteric.

But on capital, for most banks, having more capital is not really expensive because it actually brings down part of your debt cost.

Mr. GARRETT. Right.

Mr. ALLISON. But if you have an implicit government guarantee, like a Citigroup, you don't want more capital because it doesn't bring down your debt cost.

Mr. GARRETT. Right. So the takeaway from the testimony today and 2 weeks ago is that big guys benefit under Dodd-Frank. The smaller guys—Mr. Purcell is nodding his head right now—are the ones who are paying the price.

Let me just say with you, Mr. Allison. We saw a thing behind you, you can't see the screen, earlier, a quote from Governor Tarullo from the Federal Reserve. He says a leveraged ratio was the only requirement that was put in place that banks would be incentivized to move forward towards much riskier assets because their capital requirements wouldn't change.

You have seen Governor Tarullo make those comments. But the problem with Governor Tarullo's comments is that is not the history of the Fed and Basel being able to get that right.

Governor Tarullo over there at the Fed, look, they were wrong when it came to subprime mortgages, saying that they were less risky. They were wrong and he was wrong when talking about Greek debt being less risky than some corporate bonds. And they were wrong and Basel was wrong, too, with regard to things like green bonds issued by the World Bank, that they should be receiving preferable treatment because they are moving towards some sort of social goal.

So doesn't Tarullo totally, absolutely, 100 percent miss the point? If he is worried about banks being incentivized to move riskier assets, should he recognize that they already were encouraged to do under Basel and through the prudential regulators? Isn't that true?

Mr. ALLISON. Absolutely. In fact, one reason BB&T didn't get in trouble is, we didn't manage by Basel. We actually managed by the leveraged ratio. We did Basel because we had to. The banks that got in trouble were managing by Basel.

Mr. GARRETT. And if we moved away from that system where some of the folks like Basel and the elites at the Fed who got it wrong repeatedly, should we move to a system where the markets

make that assessment? And when I say the markets, I am actually saying the people, because the markets are basically made up of the people. Wouldn't the people do a lot better than some opaque system overseas or opaque system here in the United States?

Mr. ALLISON. Absolutely. Also, you have to assume that bankers aren't totally stupid. And if banks were allowed to fail, which I would vote for let banks fail, then the smart banks would survive, so banks care about liquidity. It is just because they have a leveraged ratio isn't the only thing we were going to focus on. We didn't manage against regulatory standards, we managed for our own safety and soundness. We weren't fools.

Mr. GARRETT. Yes. And I see I have 2 seconds left. I will yield those back.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentlelady from New York, Ms. Velazquez.

Ms. VELAZQUEZ. Thank you, Mr. Chairman.

Professor Levitin, you stated in your written testimony that the CHOICE Act will only help mega banks, not community banks. Can you elaborate?

Mr. LEVITIN. Not that it will only help mega banks, it will help both, but it is going to help mega banks more than it will help community banks.

The CHOICE Act lets everyone, mega banks and community banks, opt out of Basel III. But the CHOICE Act also allows mega banks to opt out of Dodd-Frank's heightened prudential standards and out of certain other longstanding provisions, such as the Riegle-Neal deposit concentration cap that limits bank size to 10 percent of deposits in the United States.

So what that means is if you are a mega bank you are getting a better deal under the CHOICE Act. You are getting more for making the election under the CHOICE Act.

And it is pretty astounding to me that one of the benefits you get is that you can grow to more than 10 percent of deposits in the United States. That is just exacerbating the too-big-to-fail problem.

Ms. VELAZQUEZ. Are there better ways to help community banks?

Mr. LEVITIN. Absolutely. A simple way, not necessarily the way I think is optimal, but a very simple way would be just to limit the election in Title I of the CHOICE Act to community banks, to banks with less than \$10 billion of consolidated assets. That would be a very simple fix.

Ms. VELAZQUEZ. Thank you.

And Professor, the Financial CHOICE Act repeals the Volcker Rule, Dodd-Frank's ban on speculative trading in certain investments in hedge funds and private equity funds by banking entities with access to the Federal safety net. Doesn't this repeal expose taxpayers to losses associated with banks' proprietary trading which amplifies the costs associated with the 2008 crisis?

Mr. LEVITIN. It absolutely does. And this is really a mega bank problem. It is not a problem with credit unions or community banks, this is a mega bank problem. And the CHOICE Act repeals the Volcker Rule for all banks irrespective of what their capitalization is. So that is a real concern.

Ms. VELAZQUEZ. Okay. And in 5 short years, the CFPB has already been extremely successful, returning \$11.4 billion to over 25 million consumers. Unfortunately, however, the Financial CHOICE Act guts the CFPB by turning it into a commission, eliminating its independent funding and forcing the bureau to conduct onerous cost/benefit analysis.

How will the changes made by the Financial CHOICE Act make it easier for special interests to challenge its rules and how will the CFPB work across a number of key areas?

Mr. LEVITIN. So the Financial CHOICE Act makes it a lot easier for businesses to bring litigation challenges against CFPB rules. And it is kind of ironic that it does that because the CHOICE Act also slams the door shut to the courts for consumers by taking away the CFPB's power to restrict binding mandatory arbitration.

So here is how the CHOICE Act would facilitate litigation by businesses. It would overturn longstanding Supreme Court precedent about judicial deference to agency decisions, known as the Chevron doctrine. That is a bedrock of administrative law that would be repealed by the CHOICE Act.

That would mean that basically there would be a totally fresh judicial review by non-expert judges of technical expert decision-makings. It would also require agencies, like the CFPB, to go through cost/benefit analysis on pretty much everything.

And that is ironic because you think whether we should use cost/benefit analysis should itself be subjected to cost/benefit analysis. Cost/benefit analysis is not always actually an effective thing. And pretty much the academic consensus on this is for financial regulation cost/benefit analysis is not very appropriate because it is hard to figure in things like systemic risk.

Minuscule chance that we have an absolute meltdown in the economy is just a hard thing to figure into an equation in any kind of scientific way. But having the cost/benefit analysis requirement opens the door for yet another thing that can be challenged by financial institutions that don't like a regulation.

Ms. VELAZQUEZ. Thank you.

Mr. Chairman, I yield back.

Chairman HENSARLING. The gentlelady yields back.

The Chair now recognizes the gentleman from Texas, Mr. Neugebauer, chairman of our Financial Institutions Subcommittee.

Mr. NEUGEBAUER. Thank you, Mr. Chairman.

Mr. Allison, you mentioned that in your former employment at BB&T, you really had to change the whole business model after Dodd-Frank. So now that you have the CHOICE Act you have to sit down and analyze, would we continue to do business under Dodd-Frank or do we take our choice and do the CHOICE Act?

Can you kind of walk us briefly through what that process would look like?

Mr. ALLISON. I think at BB&T it would be a no-brainer because the regulatory cost has been horrendous. It has far exceeded our cost of taxes. It has radically reduced the company's financial performance. We went 20 years with record financial performance every year and Dodd-Frank has hurt healthy institutions.

The fundamental difference is we used to have community banks that we allowed to make local decisions. And one reason we didn't

get in trouble is, we weren't all making the same mistake, whereas large companies, really large companies, BB&T is large, it was a very decentralized company, now we have to make central decisions because the regulators wanted to control us. Right? You can't control local decision-making, even though it produces a better outcome.

If I were still CEO, we had a leveraged ratio over 10 percent at one time, we actually brought it down because the big banks were bringing theirs down under Basel and they were going to buy us unless we brought our ratio down.

So I would do the 10 percent, and I would go back to community banking. It would improve our profitability.

And most importantly, bankers are human beings. We want our communities to do well. I enjoyed helping businesses get started, and we just can't do that anymore.

Mr. NEUGEBAUER. Doesn't it allow you to adapt the bank to your customers rather than adapt your financial institution to the government?

Mr. ALLISON. Exactly. Right now we are totally being driven by what makes regulators happy instead of what makes customers successful.

Mr. NEUGEBAUER. Mr. Purcell, you mentioned something that you and I have had a lot of conversation about, and that is the concern we have about the diminishing number of community banks particularly in Texas. And while that might not be an issue in some of the communities that "over-banked" in the 19th Congressional District, in many cases now in some of our smaller communities, they have one bank or one credit union and some have none.

Do you look at the CHOICE Act as possibly a way to reverse that trend a little bit?

Mr. PURCELL. We would hope that it would be the beginning of the conversation to reverse the trend.

We can agree that things are not real good in the financial industry at this time. And we can look at the numbers and let it frame the story. And when you lose 24 percent of your independent banks and your small-community banks that some no longer have a bank in that community so the community will dry up, it has an astounding effect.

I don't know if it is part of the Basel start that, if we changed the rule for everybody to drive in the United States on the left-hand side like England does, we would have chaos for a good while. And that is kind of what we did when we adopted the Basel Act in that we had a European system that addressed financial systems that weren't anything like ours.

Part of the strength of America and what is the envy of the world in the financial world is that we have community banks that are dealing with people. We don't have to have startup new funds like maybe in Central America for small businesses. We have the infrastructure in place at this time.

But if we don't look at the numbers and work together, when is it enough? Is it after we have lost 50 percent of the family banks? It is pretty tough.

Mr. NEUGEBAUER. If you could start to reverse that trend of the money that you have spent, and you have shared some numbers

with me of what it has cost you to ramp up, to be in compliance with some of the new things that have come out, how does it—

Mr. PURCELL. We have it on our balance sheet that last year we spent about \$300,000 in compliance and we made about a million-and-a-half.

Mr. NEUGEBAUER. Yes. And so what would putting 300,000 more dollars back in your community do for the community in Big Spring?

Mr. PURCELL. We have talked about the Consumer Financial Protection Bureau is to protect the consumer and I am for that. We have to go to school with those or our kids go to school with the kids of the community, we coach baseball, we do all that. But how is it taking care of our customer? And that is who is paying the price, when before we did a balloon mortgage based on the amount that they were paying in rent or how much they could afford and that makes it unsound?

How is it that you treat a family who has been doing business with your bank for four generations and the matriarch comes in and says if I don't send someone in there you better watch him because they will take advantage of you? When you have customers who can mark an "X" because they can't sign their name and you are hurt by the CFPB in the name of helping consumers, but you can't deal with the consumer?

You start looking at a check box and every peg has to have a square hole for a square peg.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Georgia, Mr. Scott.

Mr. SCOTT. Thank you very much, Mr. Chairman.

This is, in my opinion, a very dangerous bill and it could very well place our economy in a very dangerous situation.

And of course, I say that with all due respect to my distinguished chairman who is a friend; we have worked together on many things.

But let me tell you the two most dangerous parts of this bill, to me. The first one is in Title I and this overzealous effort to get out from under the regulatory regime of the Federal Reserve and to use just this arbitrary, out-of-the-sky 10 percent to apply in the place of a very good regime that we worked out. As the chairman knows, we both were here together working on Dodd-Frank and both Republicans and Democrats realized we had to do something.

And so we came up with this plan to be able to perform with certain types of capital requirements that the Fed would place there and the ability to come back and do annual stress tests, to take a peek-a-boo every now and then to see and make sure things were going right.

Now, why did we do that? The reason we did that was because Lehman Brothers was gaming the system in a manner and in a way that they very well will do again under the chairman's bill. Danger number one.

Danger number two, to remove the Volcker Rule? I don't know that people understand what the Volcker Rule is. But the Volcker Rule prohibits banks from using their customers' deposits. Everybody sitting here has a bank account. We go and we make our de-

posits. You mean to tell me we want to give away for the banks to be able to take our deposits and make risky bets on those? No.

That is a dangerous situation, so dangerous that if you recall such a situation happened with the London Whale. Remember that? They went in, they used.

And so this bill comes about in a way and in a manner, and I am sure he has good intentions, but on those two counts alone, to remove Volcker and to get the Federal Reserve and give an offramp to get out beyond rules and regulations that have worked very well and have produced a very stabilizing situation.

So with all due respect, I think it is a dangerous bill and also a dangerous area.

Now, Mr. Levitin, let me ask you, where am I going right here, where am I going wrong? What is your take on this? And where did the 10 percent come from? And wouldn't you think it would put us in a terrible situation if we go back to letting banks use their depositors' money, their customers' to make risky bets?

Mr. LEVITIN. I think your analysis is spot on. I want to be really clear, the Volcker Rule does not prohibit banks from using deposits to make loans.

Mr. SCOTT. Federally insured.

Mr. LEVITIN. Right. They are allowed to make loans, but they are not allowed to go and speculate on stocks for their own account using customers' money.

So it is a limitation on some of the riskier investment activities of banks.

Regarding the 10 percent, with all due respect to Alex here, the 10 percent figure has absolutely no basis. If you look at the Republican memorandum on the CHOICE Act, there is only one citation, it is to a speech by Andrew Haldane, who is the chief economist at the Bank of England.

Mr. Haldane, however, does not endorse 10 percent. That number is derived from a reading of a graph of his, which is not a statistically significant graph, for figuring out whether 10 percent is the right number. And Mr. Haldane actually says you need capital and a whole bunch of other things, such as better regulatory tools. So it is hardly an endorsement of 10 percent.

Now, Mr. Pollock in his written testimony and in an op-ed, I think it was in American Banker, cites a number of studies that have a range of percentages. And one of those he cites is by Professor Charles Calomiris for 10 percent. The thing is that is not what Professor Calomiris actually wrote.

Professor Calomiris used 10 percent as an illustration of how CoCo bonds work. He was not endorsing 10 percent as being the right number. So there is no one out there who has actually said 10 percent is the right number.

Chairman HENSARLING. The time of the gentleman has expired. The Chair now recognizes the gentleman from Missouri, Mr. Luetkemeyer, chairman of our Housing and Insurance Subcommittee.

Mr. LUETKEMEYER. Thank you, Mr. Chairman.

Mr. Nussle, you haven't had anybody ask you a question yet, so I am going to try and start with you right quick here.

How many credit unions went under in 2008 as a result of the crisis?

Mr. NUSSLE. Year by year, the way I would put it is about 1,900 since the crisis in that—

Mr. LUETKEMEYER. Okay, that is a consolidation, though, right?

Mr. NUSSLE. Correct, that is everything.

Mr. LUETKEMEYER. Okay. My question would be—

Mr. NUSSLE. Oh, during the actual—

Mr. LUETKEMEYER. Yes, how many went under as a result of being undercapitalized?

Mr. NUSSLE. I'm sorry. At that time, it was, I think, about 167 if I remember correctly.

Mr. LUETKEMEYER. Okay. All right, very good. So you believe that the 10 percent—you made a good point a while ago with regards to the 10 percent number in that 4,000, roughly two-thirds of your members already are at 10 percent.

And of that hundred-and-some, how many of them were capitalized at 10 percent or more, do you know off-hand?

Mr. NUSSLE. No, I don't know right off-hand.

Mr. LUETKEMEYER. Okay. That would be a great number to get back to us with. I would sure appreciate if you would because it would certainly give us some ammunition to refute Professor Levitin.

Mr. NUSSLE. Sure, I would be happy to.

Mr. LUETKEMEYER. My good friend sitting next to me, Mr. Schweikert, has all kinds of data which will shoot down Mr. Levitin's comment here in a minute, but I will let Mr. Schweikert be able to load his gun on that.

A quick question for Mr. Purcell and Mr. Pollock and Mr. Allison's standpoint that we continue to be concerned about 10 percent being a magic number that suddenly banks don't have to be regulated anymore, suddenly they are going to be the Wild, Wild West, they will be able to do anything they want to do.

There are still going to be a lot of regulations on the banks, are there not? The regulators, they are going to come in, there are still a lot of things that they can come in and examine and put pressure on banks to do.

Mr. Pollock, do you want to give me a quick answer?

Mr. POLLOCK. That is absolutely right, Congressman.

Mr. LUETKEMEYER. Mr. Purcell?

Mr. PURCELL. That is correct. They will still be there.

Mr. LUETKEMEYER. Mr. Allison?

Mr. ALLISON. That is correct, and markets regulate, too.

Mr. LUETKEMEYER. Absolutely.

Mr. ALLISON. Markets discipline everything else in the economy and we don't have massive wipeouts in the other segments of the economy. The one segment of the economy that had big problems is the one that is the most regulated. Surprised?

Mr. LUETKEMEYER. And one of the arguments, I think, for doing this is that—and we were considering this, I am one of the subcommittee Chairs and so we were working very closely with the chairman on the bill, is that looking at it and saying, well, it is not necessarily for every bank. The big banks may not want to do this, but they are only capitalized at 6 percent. And Mr. Newell has al-

ready made the comment that it is going to be very difficult for them to get there.

Our hope was that this will be for the community banks, which Professor Levitin said that for anybody under 10, that would be a great idea.

So if we can give them the relief that they need, and let me just give you a reason why I think this is very important.

In my State of Missouri at the end of 2015, 26 of 44 banks under the size of \$50 million, now, that is the little, bitty guys, but they take care of a community, \$50 million bank, 26 of the 44 lost money last year. So that tells me we have 26 banks that are in a bubble. They are getting ready to either get closed or they are going to get merged. Now, that is communities that are going to be hurt by having that happen.

And why? It is because of compliance costs. And this bill tries to take care of helping the smaller community banks reduce some of their compliance costs.

And again, it is not for everybody. It is an individual decision that they make. I can see where if a bank wants to go out and purchase another bank, wants to merge, they may drop underneath the 10 percent for a while until until they can get their capital back up or have an influx of capital to make it happen, you want to grow your bank, and if you want to get down to 10 percent and you are at 9½ right now, maybe you will contract your bank to get down there to get underneath some of this.

It is an incentive to manage your bank in a different way. It is not an incentive to get away with something wrong. Examiners are still going to come in and look at you, right? They are still going to manage what you try and do.

It is interesting to see the perspective sometimes of some of the decisions here, but it is not a get-out-of-jail-free card. It is another management tool for banks and credit unions to be able to better manage themselves in their communities and with their asset liability makeup.

Mr. Allison, you also made a comment with regards to regulation causes less competition. Would you like to elaborate on that a little bit? Because I think that is important from the standpoint of the regulations which most of the community banks are going through right now.

Mr. ALLISON. In the banking industry obviously it causes less competition by driving community banks out of business. But in the economy, banks generate a lot of competition.

We are venture capital lenders. We start a lot of small businesses and we particularly help a lot of small businesses change their business model and grow. And I personally did that a lot.

Those loans don't necessarily fit the regulatory model even though the history of their losses is very low. A properly financed institution, capitalized institution can afford to do that. We did that at BB&T and had no trouble during the financial crisis.

Today, we are a strong bank, we can't do that anymore.

Mr. LUETKEMEYER. The thing about the capital that we need to remember, it is just like if you make a loan to an individual, they have to have equity in their business or in their home, that is what this capital is to a bank. It is the equity in there that gives you

the cushion to be able to withstand whatever crisis, whatever problems, just like a homeowner or just like a business would have to overcome.

With that, I yield back to the chairman.

Chairman HENSARLING. The time of the gentleman has expired. The Chair now recognizes another gentleman from Missouri, Mr. Cleaver, ranking member of our Housing and Insurance Subcommittee.

Mr. CLEAVER. Thank you, Mr. Chairman.

And I thank you and the ranking member for the hearing.

We have six witnesses. I want to ask each of you a yes-or-no question.

And I will start with you, Mr. Allison.

Did you have any idea that prior to the passage of Dodd-Frank, this committee held 41 hearings related to financial reform?

Mr. ALLISON. I knew you had some hearings; I didn't know exactly what the hearings were.

Mr. CLEAVER. Mr. Nussle, did you have any idea that the committee held five markups on provisions included in Dodd-Frank?

Mr. NUSSLE. I recollect that ballpark figure, yes.

Mr. CLEAVER. Mr. Levitin, did you have any idea that over 55 hours of markup debate was held?

Mr. LEVITIN. I did not know the specific number of hours.

Mr. CLEAVER. Mr. Pollock, did you know that there were 120 Republican amendments considered in Dodd-Frank?

Mr. POLLOCK. I know that the Dodd-Frank discussions were extensive and lengthy and very partisan, as was the final vote.

Mr. CLEAVER. Mr. Newell, there were 134 Democratic amendments. Were you aware of that?

Mr. NEWELL. I am not sure I was aware of the exact number, but that is certainly consistent with my memory.

Mr. CLEAVER. Mr. Purcell, do you have any idea of how many hours this committee spent in debate on Dodd-Frank?

Mr. PURCELL. I am not sure of the exact hours, I know there was quite a bit. But now that we have a history of what has been accomplished, maybe we need to spend some more time on it.

[laughter]

Mr. CLEAVER. We are today—48 hours.

Now, spending a lot of time and doing all these things I have asked you about doesn't necessarily mean the bill is perfect and the fact that we are imperfect humans means that rarely are we going to have perfect legislation.

I also believe we need to do something about the community banks. But I don't want anybody to get the impression that this was just thrown together and there was not a lot of thought into it. And in spite of thought, we can still make mistakes.

But sometimes when we get into these hearings, the impression is sent out that it was just kind of run in and do something quickly.

And I have one question for Mr. Nussle, because this is the part of my colleagues' legislation that I am confused about.

There is concern, and I heard it all along as well as from a friend and homeboy from Missouri, Mr. Luetkemeyer, that Dodd-Frank is

putting small banks out of business and so we need to pass this bill to stop that. Is that pretty much what you think?

Mr. NUSSLE. No, I wouldn't say it is the only, there are lots of factors that go into reasons why, and I can only speak for credit unions, of why there has been consolidation, why there has been challenges.

But there is no question that regulatory burden has added to a lot of the consolidation speed, the quantity of regulations that all credit unions, all small institutions have to be mindful of.

There are 222 rules that have passed from 15 different agencies representing over 6,000 pages in the Federal Register. And I don't care what size institution you are, you have to know all of that. And that adds to the consolidation and the challenges that I think are out there.

So I wouldn't say it is the only thing, Congressman, but it certainly is a huge part of it.

Mr. CLEAVER. Yes, because if that is a consideration at all in the legislation, if we need to curb concentration in the banking industry, this legislation actually repeals the limits on mergers, including the one that no bank can hold more than 10 percent of the insured deposits in the country.

So if this bill is passed and we are removing these limits, doesn't that encourage consolidation?

Anybody?

Mr. LEVITIN. I think it gives a green light to consolidation and for the largest banks to become even larger. It is pretty surprising to me to see that the 10 percent cap would be removed in the bill because that is something that benefits only, by definition, the very largest banks in the United States.

Mr. CLEAVER. Do the rest of you agree?

Mr. POLLOCK. I don't agree. I think the most important point of the bill is to make the smaller banks and all banks more competitive, freer, and well-capitalized to take away using the taxpayers' capital. When those banks are freer and more energetic, they obviously have a more successful future.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Michigan, Mr. Huizenga, chairman of our Monetary Policy and Trade Subcommittee.

Mr. HUIZENGA. Thank you, Mr. Chairman.

I am going to move quickly and I will resist the temptation of asking you each a yes-or-no question about whether you knew of that pay ratio, Volcker Rule, conflict minerals, most of Title IX, SEC reserve funds and the Durbin amendment were all airdropped in without a single hearing or discussion here publicly. But we can leave that for another time.

I do, Mr. Allison, want to talk a little bit about this 10 percent leveraged ratio being plucked out of thin air, I believe as was put forward.

I, too, was a part of the discussion as to what that leveraged ratio should be. And I am curious, would it surprise you to learn that according to the FDIC data that 98 percent of the insured depositories that entered the crisis with a leveraged ratio of 10 percent or better weathered the storm and of those that did fail none

of it was of sufficient size or scale to present any kind of systemic risk? Would that surprise you at all?

Mr. ALLISON. No, it doesn't. Being in the industry, the single factor, and there are other factors that you can look at, is strong capitalized banks very seldom fail, and a leveraged ratio of 10 percent is kind of a rule of thumb. I think there is some science behind it.

But it is one that has had very good success with the industry over a long period of time.

Mr. HUIZENGA. And you can feel free to answer this. I am curious, Mr. Pollock, as well. I was stunned by this notion of it doesn't really matter what the effects of regulations, the cost/benefit analysis shouldn't be done. Do you care to address that at all?

Mr. POLLOCK. Thanks, Congressman. I think cost/benefit analysis is essential to any regulatory regime, as is appropriate governance of regulatory bodies and their control by the elected representatives of the people.

If I could, Congressman, could I just point out on this question of 10 percent, that the International Monetary Fund recently conducted a large study in which they conclude that 15 to 23 percent risk-based capital would have avoided creditor losses. That doesn't mean bank failures, that means no losses to creditors. In the vast majority of banking crises, they continue, this range is consistent with a 9.5 percent total leverage exposure. That is to say—

Mr. HUIZENGA. I'm sorry, could you repeat that? It almost sounds like the IMF agrees with this committee that—

Mr. POLLOCK. It does.

Mr. HUIZENGA. —10 percent would be sufficient.

Mr. POLLOCK. Their number is 9.5 percent, which I think it would be fair to say is pretty close to 10.

Mr. HUIZENGA. Interesting, okay. Well, I think it's fair enough to say that this wasn't plucked out of thin air. It clearly was debated, and has been debated by academics for a long time as well.

I do want to also hit on another issue here in my remaining 2 minutes here. I Chair the Monetary Policy and Trade Oversight which has oversight of the Fed.

The Federal Reserve, in my opinion—I wasn't here for the creation of it; I am just trying to clean up the mess of Dodd-Frank—really has become a super regulator under Dodd-Frank. And I think it is blurred, unfortunately, that line between regulator and monetary policy.

And either Mr. Allison or Mr. Pollock, one, how does the Fed basically virtually control every major corner of the financial services space right now?

Mr. ALLISON. They definitely control it and it's definitely dangerous. You definitely should separate monetary policy from regulatory policy.

Clearly during the financial crisis, they made many decisions that weren't related to monetary policy, but individual Federal Reserve Governors who were involved in the process didn't want their bank to get in trouble and so they made decisions to protect that bank maybe at the expense of monetary policy and maybe at the expense of the economy.

Remember, these are human beings who who don't want to look bad. And I think mixing regulation and monetary policy is a really bad format.

Mr. HUIZENGA. Should they be able to shield those regulatory activities from the American people and frankly congressional oversight by sort of hiding behind this cloak of independence?

Again, just so I am clear with my friends on the other side, we are not talking about monetary policy independence; we are talking about regulatory independence that they somehow have magically no oversight.

Mr. ALLISON. I can't see any reason why you would want the Fed not to be responsible to Congress in the same way that any other agency is. And regulation is regulation. It is just like any other agency.

Mr. HUIZENGA. I am going to ask Mr. Pollock here for the last 15 seconds.

Mr. POLLOCK. I just want to agree with my colleague and you, Congressman, that the Federal Reserve, like every public servant, needs to be accountable in its actions and, in my judgment, in all of its actions.

Mr. HUIZENGA. With that, I will do the equivalent of a mic drop and yield back.

[laughter]

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from California, Mr. Sherman.

Mr. SHERMAN. Mr. Chairman, we worked together to try to stop the TARP bailout, but Congress passed the law.

In 2007, we had a loose regulatory system that provided enormous capital to the subprime mortgage market. The only way to prevent the next bailout is to make sure that too-big-to-fail is too-big-to-exist.

I agree with you that just a host of regulations of the giant financial institutions won't by themselves work and is a departure from free market capitalism. Free market capitalism is there is never an institution that can call this government and tell us we have to bail them out, otherwise they are going to take the country down with them. And free market capitalism does recognize that at times a bank will fail. But it needs to fail as an independent entity, not drag our entire economy with them.

Mr. Chairman, I note with regret that your bill removes rather than strengthens the Frank and Sherman provisions on credit rating agencies. These are the agencies that destroyed our economy. They gave AAA to Alt-A and the reason they did it is because they are selected and paid by the issuer.

This makes as much sense as a baseball league where the umpire is selected and paid by one of the teams.

Mr. Levitin, I am trying to understand how the chairman's proposal would work. Imagine two well-run banks, one continues to be well-run and somehow meets the 10 percent capital, and the other one decides on a high-risk, high-bonus strategy. They double what they pay on deposits, so they attract an awful lot of FDIC-insured deposits and they invest in junk bonds, Willard, the guy in my dis-

strict who makes really bad pizza, but he is willing to pay 20 percent for an expansion loan, and Zimbabwe bonds.

As you understand this statute, that bank, as long as it had been well-run in the past, the bank could have 10 percent capital and devote all of its lending to those categories of high-risk instruments?

Mr. LEVITIN. That is correct. So the CHOICE Act requires that at the time that a bank makes its selection to go to the 10 percent capital that it have a CAMELS rating, that is a basically bank safety and soundness rating of one of the highest two levels.

Mr. SHERMAN. Right.

Mr. LEVITIN. But thereafter, there is no requirement that it maintain that CAMELS rating. Its CAMELS rating could go down to the bottom.

Mr. SHERMAN. So at least for a few years, my Zimbabwe bonds could be doing very well and I could be getting enormous, enormous bonuses as an executive of this bank. I could be taking in deposits, there would be a line of people to give me FDIC-insured deposits at double the prevailing rate. And if the Zimbabwe bonds go down, I retire to Aruba and the FDIC takes over.

If only I had a plan as to how to execute this, I might cosponsor the bill.

But I want to move on, and I think this just illustrates that no exact amount of capital is enough if you allow the bank, having passed one test, to then have its executives go into a high-risk direction. If you are going to go in a high-risk direction you need more than 10 percent capital.

But Mr. Nussle, the purpose of this hearing is to focus on more capital, more capital for financial institutions and more capital, and that allows you to be able to lend capital to businesses in our districts.

If a credit union thought, hey, we would like to expand, we would like more capital, we would like to issue subordinated debt, in order to do that, would the Federal Government interfere with those efforts to get more capital?

Mr. LEVITIN. Yes.

Mr. SHERMAN. Would they prohibit those efforts to get more capital?

Mr. NUSSLE. As you know, yes, they would.

Mr. SHERMAN. So instead of the Federal Government—so with other parts of the financial institutions area, we in 2008 gave them capital. With regard to credit unions, we prohibit you from raising capital in the private sector.

Mr. NUSSLE. Yes, our capital is from our own retained earnings.

Mr. SHERMAN. And that is the only place and you are not allowed to go to—

Mr. NUSSLE. Zimbabwe.

Mr. SHERMAN. —to those who would invest in—

Mr. NUSSLE. We don't go to Zimbabwe, Congressman.

Mr. SHERMAN. Okay. So Zimbabwe bonds yes, subordinated debt for credit unions no. Okay, thank you.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Wisconsin, Mr. Duffy, chairman of our Oversight and Investigations Subcommittee.

Mr. DUFFY. Thank you, Mr. Chairman.

And welcome, panel.

I missed some of the first part of your testimony. I was at a Transatlantic Group meeting with some of the elected officials from the European Union, which makes me think that our U.S. regulatory system is becoming more like the European regulatory system where we have a one-size-fits-all paradigm which I don't think actually works very well.

So just quickly, 22,000 pages of new regulation in Dodd-Frank. Does anyone on the panel think that this is going to stop too-big-to-fail, Dodd-Frank?

Mr. Newell, you do?

Mr. NEWELL. Yes, I do. I would point to two things. First, more generally and it is often overlooked, the substantial increase both in the capital liquidity position of the largest banks at first made it much less likely that they would fail. And second, we now have today both the legal and operational framework that will assure that even the largest bank can be resolved in an orderly fashion without posing risks to the taxpayer or to the financial system more broadly.

Mr. DUFFY. Okay. And I would just note that I think your position is even disagreed with by my friends across the aisle, Democrats. It has been a bipartisan issue that too-big-to-fail hasn't ended. This is not just a Republican issue. Even Democrats admit that their bill hasn't ended too-big-to-fail. It has become a common talking point from the left.

Elizabeth Warren still talks about too-big-to-fail. And so if Dodd-Frank was the end of it, you are even in disagreement with some of the Democrats who agree that they haven't accomplished that goal, which was the auspices for this massive new regulation.

We had bank failures, taxpayers bailed them out, Americans were angry, and so Democrats said let us end too-big-to-fail and this is the bill that is going to do it. A massive new regulation that actually doesn't resolve the problem that they set out allegedly to fix.

So I think it is pretty unique. Mr. Hensarling's bill here has a little bit different approach, giving banks the choice to hold more capital in exchange for less regulation.

And the debate today is, as you are seeing it break down, is between regulators and capital. Can regulators stop the next crisis or can capital stop the next crisis?

Did regulators fail in the last economic crisis of 2008, Mr. Pollock?

Mr. POLLOCK. Yes, without a doubt, and not only in this country.

Mr. DUFFY. But around the world. Mr. Allison?

Mr. ALLISON. Absolutely they failed. And I do not believe we have solved the too-big-to-fail problem. Under the exact same circumstances, the regulators today would act to save the biggest. They shouldn't, but they would.

Mr. DUFFY. Mr. Nussle?

Mr. NUSSLE. Yes, our model, because it is locally controlled and members manage it, it is inherently more conservative. And so I think it is not only a failure generically of regulators and I suppose policymakers, having been one of them myself, but it is also, I

think, a failure of the way we do business if in fact the chairman's right that we are trying to balance the need for growth with inherent risk.

Assuming that one entity in Washington can manage all of that without the involvement of consumers, without the involvement of real people and the market making that decision, I think that is inherently problematic.

So I think it is more than just a failure of the regulators in that instance.

Mr. DUFFY. But regulators are human, right?

Mr. NUSSLE. Correct.

Mr. DUFFY. Humans make errors. And whether you are a regulator or a banker, you will make mistakes. And the way you blunt those mistakes is holding more capital.

Is that a fair assessment, Mr. Pollock?

Mr. POLLOCK. Yes, it is. It is so fair that I say it in my written testimony.

[laughter]

Mr. DUFFY. That is very well said.

I only have a minute left. So quickly, Mr. Allison, would you agree that banking regulations increased from 1997 to 2008?

Mr. ALLISON. Oh, yes. Banking regulation increased exponentially. It was things like the Patriot Act and the Privacy Act and Sarbanes-Oxley. You can count the pages, it was a massive increase in regulation. There was no deregulation of the banking industry. That is an absolute myth.

Mr. DUFFY. So even with more regulation, we still had the failure. And I think that point needs to be made.

One of my concerns is risk weighting. Is it fair to say with risk weighting that through regulation we will consolidate risk not just in one bank, but across the banking sector? So mortgage-backed securities, we say they are safe or today we will say that government debt is safe, causes systemic potential risk throughout the whole banking system.

Mr. Pollock?

Mr. POLLOCK. I think that is true. I think a wonderful example, which we haven't mentioned today, is the risk weighting applied to Fannie Mae and Freddie Mac under the U.S. capital standards, in which their debt and even their preferred stock were given extremely low capital risk weightings and induced an excess flow of credit with disastrous results.

Mr. DUFFY. Well said, and I think diversification across the industry, which is outside then risk weighting, would make a lot of sense to make sure we don't have systemic failures in the future.

My time is up, I yield back, Mr. Chairman.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from New Mexico, Mr. Pearce, for 5 minutes.

Mr. PEARCE. Thank you, Mr. Chairman. I appreciate the opportunity to ask questions.

So Mr. Purcell, if you did not have one regulation coming from the Federal Government, would you choose to make discriminatory loans?

Mr. PURCELL. No. The success of our community and the success of our business means that we have to serve everyone. If our community doesn't do well, we do not do well.

Mr. PEARCE. What is the demographic in Big Spring? By the way, I live in Hobbs, so Big Spring was always a vacation destination for us. We read the billboard and thought that it was actually a big spring. It is just a big spring for our area.

Mr. PURCELL. It is kind of like banking. It used to have a big spring.

Mr. PEARCE. Yes. So what is the demographic in Big Spring?

Mr. PURCELL. It is probably 50/50.

Mr. PEARCE. Actually, I just looked it up on the internet. It is 53 percent minority and 44.7 Anglo. So I don't think you could even stay in business.

I know that I am not in the retail banking business, but I am in a retail business. I have to sell myself. My district is 60 percent minority. So this idea, among many outlandish comments, comes from Mr. Levitin saying financial liberty also apparently includes the right to engage in discriminatory lending.

And I just find that absolutely incredible that it would be in print, because I look at New Mexico and a businessman could not stay in New Mexico, and I suspect in west Texas, if they discriminated because that is at least half and maybe more of the market and every one of the single towns.

On page five, you suggest that you all have gotten out of the mortgage lending. So since you, who used to provide loans, mortgage loans, to the full spectrum of your community are not in the business, who provides those mortgage loans and how satisfactory is it?

Mr. PURCELL. Actually, the ones that provide the mortgage loans now for the larger mortgage loans, there is a market for that that would be called a prime mortgage. However, the ones that in the rural area it would be below \$50,000, it is owner-financed, there may be a few loan sharks out there that will do one at 15 or 20 percent, but the banks have pulled back from that.

Mr. PEARCE. So basically the bottom end of the spectrum is ill-served because of what the Dodd-Frank regulations did. It did it in our State, too. In my district, 50 percent of the houses are trailer houses and so the people in that spectrum, you just can't find lending for it because the geniuses on Wall Street are certainly not going to come out there. And Dodd-Frank, regardless of what everything else it does, benefits the big players, not the small players.

Now, the people getting out, your report talks about the bankers getting out of the business, why are they getting out? Just two or three main reasons.

Mr. PURCELL. One, the amount of paperwork. And then if you are wrong, it used to be if you had a pattern or practice, you had something that regulators would get onto you, now it is one single occurrence and that is pretty substantial.

If you comply with all of the mortgage lending and someone wants to borrow \$25,000, do you think they are going to read the 125 pages of pre-notice?

Mr. PEARCE. Yes. So basically, people are getting out because it is complex.

Now, again, among the comments that Mr. Levitin makes, he says that in unfettered markets the bad will drive out the good as consumers cannot readily distinguish good actors from bad actors.

Mr. Allison, do you find that the consumers are that unknowledgeable?

Mr. ALLISON. I think that is absurd.

Mr. PEARCE. I think it is absurd, too. Because what actually happens is what Mr. Purcell was talking about. The regulations drive out the people who will bring honesty and transparency. And the people who live there are the ones who will get lawyers and beat the system and they will come in and they will stick you.

And so all the stuff that the regulations from the left tell us are going to happen, actually it is not going to happen under a free market, it is going to happen under the regulatory processes put in place by the Dodd-Frank. And they come up with ludicrous suggestions like those in this amazing report.

I yield back, Mr. Chairman.

Chairman HENSARLING. The gentleman yields back. The Chair now recognizes the gentlelady from New York, Mrs. Maloney, ranking member of our Capital Markets Subcommittee.

Mrs. MALONEY. Thank you.

Mr. Newell, some people claim that the problem with the risk-weighted capital requirements before the crisis was that the risk weights were inaccurate. They treated certain mortgage debt and sovereign bonds as safer than they actually turned out to be.

But under the chairman's bill, the solution is a leveraged ratio which means even less accurate risk weights.

Isn't the better solution to inaccurate risk weights more accurate risk weights?

Mr. NEWELL. Yes. And in fact, the problem with the leveraged ratio is the one that you point out. It effectively treats the risk of all assets exactly the same, which, of course, isn't true in fact. So it results in measurements that aren't accurate.

Certainly risk weights can be wrong. And Greek bonds and other examples have been provided today.

But again, I think the better answer there is to improve the risk weights. I think part of that is improving the process at the Basel committee and here in the United States to make sure that we have better transparency and public debate and less politicization of those risk weights.

I would also say that we are in a better position today than we have been in the past because of the CCAR stress testing exercise. And again, what that really is is a dynamic annual assessment of the risk of each individual asset in a crisis. And so in that sense, it is as much an annual stress test of the risk weights as it is a stress test of the banks.

And for those reasons, again, I guess the one thing I would also mention is it is important to step back and just think about what the impact of moving to a higher leveraged ratio is.

Here at the Clearing House we did just some very preliminary estimates, again. And those showed that if the entire U.S. banking industry were to move to a 10 percent supplementary leveraged

ratio, whether that is by choice or by mandate, the current capital in the U.S. banking system would support \$4.8 trillion less in loans and other economically productive activities than it currently supports today. So that is a very real and significant impact.

Mrs. MALONEY. And I would like to ask Professor Levitin, the chairman's bill would exempt banks with a leveraged ratio of over 10 percent from any and all regulations addressing capital or liquidity.

In your view, does this dramatically roll back the banking regulators' authority? Doesn't this leave the regulators with even less authority to maintain the safety and soundness of banks than they had before Dodd-Frank?

Mr. LEVITIN. Absolutely. There is a question about how broadly the language in the bill should be interpreted. But I think arguably it would prevent regulators from ordering prompt, corrective action because that is based on capitalization levels.

Basically, the regulators could not tell a firm that was headed for a collision that it needs to raise more capital pronto. I don't think they would have that ability under the CHOICE Act.

Mrs. MALONEY. Do you think it is dangerous to prohibit the banking regulators from imposing liquidity requirements on any subset of banks, no matter how well-capitalized?

Mr. LEVITIN. I think it is absolutely reckless.

Mrs. MALONEY. Thank you, okay.

Also, Mr. Newell, the chairman's bill would repeal Dodd-Frank's orderly liquidation authority, which is intended to give regulators the authority to safely unwind the Nation's biggest banks.

I am concerned that even with the 10 percent leveraged ratio in the chairman's bill, repealing the orderly liquidation authority would leave our financial system dangerously exposed to another Lehman Brothers.

What is your viewpoint on repealing the orderly liquidation authority? Does this make it less safe? Does it make it safer or less safe?

Mr. NEWELL. Yes, so we would not support repeal of the Title I regime. We think that it would make the financial system less safe.

Again, we think Title II is a very important tool to make sure that under any circumstances a large firm can be resolved in an orderly fashion, again, without putting the taxpayers at risk.

Certainly, bankruptcy always should be the preferred option. And indeed, that is why we support the enhancements to the bankruptcy code included in the discussion draft. But it is very important to have Title II as a backstop.

And I would say, again, that really is in the interest of financial stability. It is, at the end of the day, the very largest banks that actually bear the cost of the Title II regime. Under the Fed's TLAC rule, the largest banks are going to have to hold \$1½ trillion in total loss absorbing capacity, which is to say equity and long-term debt.

If a large bank would go into failure, it is the shareholders and long-term debt holders of that bank who have to absorb the losses.

And then, again, in the incredibly unlikely circumstance if there were to be a shortfall in the orderly liquidation fund, it is the banks that have to fund that.

So, again, we support Title II and that is notwithstanding the fact that banks are first, second, and third in line in terms of bearing the costs of that regime.

Mrs. MALONEY. We now use the leveraged ratio as a backup. And going back to that in my remaining seconds, in your view, does using a 10 percent leveraged ratio as the primary capital requirement make the financial system safer or does it encourage banks to get rid of their safest assets and load up on riskier assets?

Mr. NEWELL. Yes, so it uses a primary measure, particularly at that level. It would have exactly that sort of effect of misincentives. It would discourage lower-risk assets and encourage higher risk.

Mrs. MALONEY. Thank you.

Chairman HENSARLING. The time of the gentlelady has expired.

The Chair now recognizes the gentleman from Arizona, Mr. Schweikert.

Mr. SCHWEIKERT. Thank you, Mr. Chairman.

Forgive my tone or my frustration because I have heard a few things here that have made me realize how few have actually read the legislation. Because a couple of the comments that have bounced around here are bordering on absurd if you have actually read the language.

I accept the fact that to many of my brothers and sisters on the other side, Dodd-Frank is a faith-based text. But a little intellectual consistency here of, one time we will have an argument here of how we need to lower down payments to spur the economy and help home buyers, oh, but over here we want more. Just a little intellectual consistency.

Mr. Allison, I want to walk through just a couple, and work with me because I want to be intellectually credible, not sarcastic.

But in function, we are having an argument here of what makes a financial institution more robust, paper and file cabinets put in by dozens and dozens if not tens of thousands of regulators around the Nation. So regulators sitting in a bank or cash sitting in a bank?

How many regulators were sitting in IndyMac the very day it went under? Wasn't it in the hundreds?

Mr. ALLISON. My view is the regulators very, very seldom identify problems in advance. As I said, in my career I have never seen a case of that. But they are so lost in the trees they can't see the forest.

Capital reduces the risk of banks, things like cash and liquidity.

And also, this kind of bizarre motivation that bankers don't care how healthy their banks are, this idea that we are all trying to make money and go off to the Caribbean. That is crazy.

Are there a few bankers who do that? Yes. Will markets clear them out in a short period of time if the government doesn't bail them out? Yes.

BB&T has been in business since 1872. We care about the safety and soundness; we don't need the regulators to tell us about that stuff. That is what we do. And we know about it because that is what we do.

Mr. SCHWEIKERT. And Mr. Newell, I am going to ask you on this one. In some of the comments, and tell me if I am misinterpreting what you said, aren't you conflating the risk-weighting mechanics

with cash? Because you are almost making an argument that is saying it is our risk-weighting mechanics, because we are so brilliant we absolutely know what tomorrow's black swan is, not to grab a Taleb quote but what tomorrow's black swan is where cash is the ultimate flexible repairer of sins.

Did I misunderstand you what you said a moment ago?

Mr. NEWELL. Yes, well, keep in mind here what we are talking about is capital, right, and the amount of capital that you need to hold against a given asset, right?

Mr. SCHWEIKERT. But, no, back up with me. First on the risk weighting, the belief that we are all so brilliant now that somehow we know what tomorrow's cascade event that damages the banking system, and therefore we can build a risk-weighted model that gets it right where at least cash always gets it right.

Mr. NEWELL. Yes. So what I would say there, so certainly, right, we are not always going to get every single risk weight right, which is why I think we should be having continual discussions, Basel in here.

Mr. SCHWEIKERT. But if it is not going to get right, isn't cash the ultimate—

Mr. NEWELL. The problem is—

Mr. LEVITIN. Clarification—

Mr. SCHWEIKERT. We will come back to you, Professor.

Mr. NEWELL. The problem is, when you are talking about cash under the leveraged ratio, right, it is always going to get it wrong, right? The way to think about the leveraged ratio, what it says is every single asset gets a hundred percent risk weight.

Mr. SCHWEIKERT. No, no, no, that is not, no, that is absolutely, that is not—okay.

Mr. Allison, we have this conversation and I am actually one of those who do believe the money-centered banks, we have too much concentration in our financial markets. Isn't the most rational way to reduce the size of a money-centered bank is not the crazy theory of let us go in and break up a bank because we are all so brilliant we will know what business units actually can stand and serve the economy, but compete away part of their largeness and you need a vibrant, flexible, regional, local banking system to do that competition?

Mr. ALLISON. Absolutely. And the large money banks are uncomfortable with this because what they are really going to do, instead of raising more capital, is they are going to shrink. And the assets are going to be redistributed to companies that can use them better and produce better returns.

So the subsidy that too-big-to-fail creates for the large banks is going away out of this process. That is why they are uncomfortable with it and why they would rather have Basel and risk-based because they have a much bigger chance of beating that system because they are great at mathematics. They have a lot of Ph.D.s in mathematics.

So yes, there are problems with the leveraged ratio, but there are a lot more problems when you can game the system.

Mr. SCHWEIKERT. I know we are almost out of time.

And Professor, I promise this summer I will look for some of your reviewed articles and read them because I have never read your

stuff before. But I have binders of this type of material of every institution that failed in 2008 and their ratios. And binder after binder, I will see that you get some of it.

Thank you, Mr. Chairman. I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentlelady from Ohio, Mrs. Beatty.

Mrs. BEATTY. Thank you, Mr. Chairman.

And thank you, Ranking Member Waters.

Let me also thank the panelists. While I was not here earlier, I had the privilege to watch by video much of the discussion.

And in reviewing the discussion draft which I did read of the Financial CHOICE Act, I have to admit that I didn't get very far into it before it gave me great pause and that I had a lot of concerns.

As a matter of fact, when I first started reading it on page one, the fact that the short description of the Financial CHOICE Act found on the first page in its statement that says that this bill repeals the provisions of the Dodd-Frank Act that make America less prosperous, less stable, and less free, I started asking myself this question, how is America less prosperous now than it was prior to the passage of Dodd-Frank?

How is America less stable now than it was before the passage of the Dodd-Frank? How is America less free now than it was prior to the passage of Dodd-Frank?

And certainly not to be sarcastic, but when I think about specifically if these ideas are part of the GOP's platform for financial regulatory reform heading into this fall and into the 115th Congress, how does this legislation make America great again, and how is America greater now than it was prior to the Dodd-Frank?

When I look at the data, Mr. Chairman, the Consumer Financial Protection Bureau has returned over \$11 billion to over 25 million consumers, has the longest streak of private sector jobs growth we have had in 76 months, over 14 million jobs created, the Dow Jones average is up over 80 percent, and I could keep going and going.

So Mr. Levitin, when I think about the author of the Financial CHOICE Act, it frequently cites Federal Deposit Insurance Corporation Vice Chairman Thomas Hoenig's proposal for regulatory relief and a simple 10 percent capital leveraged ratio as evidence of broad support for the ideas being proposed in this bill.

Also, his regulatory relief proposal did not depend strictly on the size of the bank, but on the activity and the complexity of the bank.

In addition to keeping a 10 percent equity-to-capital ratio, the vice chairman's proposal would require banks to effectively hold zero trading assets or liabilities. Does the Financial CHOICE Act also include this requirement for regulatory relief?

Mr. LEVITIN. No. The Financial CHOICE Act does not include many of the protections that Vice Chairman Hoenig retains in his proposal.

For example, the Volcker Rule would remain in place under Vice Chairman Hoenig's proposal. It is gone in the CHOICE Act.

Mrs. BEATTY. Okay. The proposal would also require banks to have virtually no derivative positions. Does the Financial CHOICE Act also include this requirement in the regulatory relief?

Mr. LEVITIN. No, it does not. And the Financial CHOICE Act is really about capital and nothing more.

And just a clarification that unfortunately Mr. Schweikert is not here for, capital is not the same as cash. Capital can be in illiquid assets and that is one of the problems with the CHOICE Act is it does not require any liquidity for large financial institutions. You can have a solvent institution that fails because it is illiquid.

Mrs. BEATTY. So if a bank is heavily engaged in derivative trading, a practice that Warren Buffet stated in his 2002 letter to shareholders as time bombs for the economic system and described them as financial weapons of mass destruction, is it possible they could get regulatory relief under the Financial CHOICE Act?

Mr. LEVITIN. Absolutely. And under the Financial CHOICE Act, banks would be incentivized to load up on the riskiest derivative positions possible. This is what Mr. Newell was saying.

When you have just a simple leveraged ratio, there is the incentive to pursue riskier assets in order to maximize the return on equity.

And then when you add in Title II of the CHOICE Act, which basically removes all credit risk from derivative contracts by ensuring that they are going to get paid a hundred cents on the dollar in a bankruptcy, why wouldn't you pursue those derivative contracts if you are a bank?

And in fact, you can structure your loans through derivative contracts and get better treatment that way.

Mrs. BEATTY. Okay, thank you very much.

Thank you, Mr. Chairman.

And thank you, Ranking Member Waters.

Chairman HENSARLING. The gentlelady yields back.

The Chair now recognizes the gentleman from California, Mr. Royce, chairman of the House Foreign Affairs Committee.

Mr. ROYCE. Thank you, Mr. Chairman.

Mr. Chairman, banks with stronger capital positions maintain higher levels of lending over the course of economic cycles with those that have less capital on hand. I think the FDIC has noted that better-capitalized banks compete favorably in the market and survive economic shocks without failing or without requiring bailouts.

So I was going to ask a question of Mr. Allison here.

I have been struck by a view which I think is rather myopic, a view from some of the critics of the Financial CHOICE Act who have suggested that the required higher capital levels will result in a sharp contraction in credit availability.

Don't we also have to factor in the sharp reduction in compliance costs that will result from being freed from Basel III and freed from Dodd-Frank's endlessly complex mandates? Isn't that part of the equation here?

And wouldn't it be that what is proposed by the chairman, wouldn't it be so that that would free up these significant resources that would be redirected to lending and redirected to job-creating activities?

Mr. ALLISON. Absolutely. I think today banks are focused on the wrong thing. They are focused on making government bureaucrats happy instead of investing in their business and in their customer base.

So yes, technically, okay, we have to raise more capital. But if that capital can be used productively to grow the economy, that is a good thing. It is just kind of like it is bad for banks to raise capital, that is a pretty strange argument to me.

Today banks aren't doing what they are supposed to be doing because they are trying to make regulators happy instead of making good loans.

Mr. ROYCE. And let me get back to this Basel III aspect of the question I asked about. And I will ask Mr. Purcell and Mr. Nussle.

We have heard you and we have heard others say that the Basel III accord was intended to apply only to large, complex and internationally active institutions. However, the rules released by U.S. regulators would apply certain new capital rules to community banks and to large institutions alike.

And you have the NCUA that has followed suit with its new risk-based rule. So is one-size-fits-all the right approach here?

Mr. PURCELL. It never has been the right approach in that we make up a different part of the economy, I don't even know what some of the ones that claim to be banks are compared to what we do in Big Spring. We don't worry about a lot of the leverages that go, we want to serve our community.

And it isn't just the regulations, it is the customers being afraid of everything they have to go through to be treated like a criminal to apply for a loan. But Basel does not apply to the small banks.

Mr. ROYCE. I want to jump in here on another question to Mr. Newell, if I could.

Because as we just heard, community financial institutions are concerned about Basel III, but you raised something in your testimony that caught my eye. You said Europe is moving ahead with Basel IV discussions, contemplating yet another change to the regulation of bank capital.

From what you know of the proposal so far, what would the impact be on our U.S. institutions? Do we have a seat at this table? Should we have a seat at this table?

Mr. NEWELL. Sure. So I think the impact is very, very likely to be negative. These are actually a series of 11 separate proposals all being hashed out in piecemeal fashion by the Basel committee. We are still waiting to see the final details, but they seem very likely to raise the amount of capital, again, it has to be held against trading activities. It seemed very likely to raise the amount of capital that has to be held against credit card lines, home equity lines, financing lines to businesses.

Again, these are all very, very impactful, important proposals and they frankly are getting no airtime here in the United States, and we don't really have a clear sense of what position the U.S. regulators are going to take there, notwithstanding the fact that they would have very, very serious consequences here in the United States.

Mr. ROYCE. Mr. Chairman, to be frank, I am concerned that while we sit here today discussing what the right capital standards should be for our U.S. financial institutions, foreign regulators are having similar discussions, and they are having theirs behind closed doors.

So what is to stop U.S. regulators from adopting these changes, as they have done with Basel III, these changes from Basel IV that is underway with little notice, with little opportunity for comment, with no opportunity for a cost/benefit analysis?

I yield back, Mr. Chairman.

Chairman HENSARLING. The time of the gentleman has expired. The Chair now recognizes the gentleman from New York, Mr. Meeks.

Mr. MEEKS. Thank you, Mr. Chairman, and Ranking Member Waters.

First, I want to affiliate myself with some of the comments of Mrs. Beatty. Because I don't know who would want to go back to 2008, if that is what make us, that going back, great again, I don't know that.

But I would admit that there are no perfect bills and we can make improvements to all bills, including Dodd-Frank. In fact, this committee could pass comprehensive measures to provide meaningful relief to over 95 percent of banks in the Nation.

And I want to emphasize that we could actually work on measures that can pass both chambers of Congress, both the House and the Senate, and be signed by the President and offer meaningful regulatory relief to almost 6,000 banks in this country, especially small and community and MDIs.

So I am really disappointed that we have been so divided that we will end up accomplishing here nothing at all. At a time we all agree that banks can do more to help revitalize communities, that they need more financial services, and we are all debating proposals that are going far too far that we will never be able to pass and never agree upon, that we are debating something that is far too risky, that are not targeted to community financial institutions and, hence, that cannot gain the great majority and consensus needed to become law at all.

A few days ago I had the privilege of welcoming OCC Comptroller Curry in my district in Queens, New York. We went on a tour and visited small banks in downtown Jamaica, New York, and we made stops at bank branches that had closed, highlighting the challenges that banks are facing today.

We then proceeded to visit community development projects funded by banks through CRA incentives. And as we talked to these community bankers and local economic developers, there is consensus that Congress can do more to help these banks do more in their communities.

And again, I stress that we can provide significant relief today to more than 95 percent of banks in the Nation without repealing the very foundation of the Dodd-Frank Act, which has greatly strengthened our banking sector and capital markets from the riskiest activities that caused the financial crisis in the first place.

Regrettably, Mr. Chairman, I think the CHOICE Act is just far too extreme and goes way wrong and would send a dangerous message to our financial markets. How can we undermine FSOC and our ability to deal with systemic risk and TBFT financial institutions? How can we undermine our ability to have an orderly liquidation authority which is so central in containing contagion?

How can we remove the Volcker Rule for large banks and couple with that the removal of risk weighting, which together are meant to limit the riskiest activities that pose the greatest risks to our banking institutions?

Mr. Chairman, the proposal almost exclusively relies on the leveraged ratio. The leveraged ratio only deals with quantity of assets and is awfully insufficient when it comes to discouraging the riskiest activities and assets that banks are tempted to hold for higher returns.

And the CHOICE Act goes further. It removes the liquidity safeguards that were imposed as one of the great lessons of the failures during the financial crisis. I can hardly comprehend how we could encourage such a dangerous combination of removing all of these crucial safeguards at this time.

Let me just ask Mr. Levitin a quick question.

Banks that get in trouble often do so because they often get too aggressive or too greedy in their banking strategy and take on too much risk. In fact, we have learned from the financial crisis that bankers' behavior toward excessive risk-taking was a major cause of this crisis.

And hence, I am concerned about the message the CHOICE Act would send to bankers about their ability to take on more risk.

Can you comment on how this Act can change risk-taking in banking and why we should be concerned about that?

Mr. LEVITIN. Sure. The CHOICE Act, first of all, makes it possible for all banks, regardless of their capital level, to use depositor funds to speculate on the stock market, to speculate on derivatives because it repeals the Volcker Rule. So regardless of how well-capitalized a bank is, the CHOICE Act frees it up to engage in gambling with insured deposits.

Secondly, because the CHOICE Act uses a simple leveraged ratio without any additional safeguards, it encourages banks to load up on higher-risk, higher-return assets.

There are a lot of problems with risk-weighted capital ratios. I would not disagree with any of the criticisms made of them. But a simple leveraged ratio has its problems, too, and that is why it needs to be combined with other safeguards.

The CHOICE Act, though, relies solely on that, on simple leveraged ratio.

Chairman HENSARLING. The time of the gentleman has expired. The Chair now recognizes the gentleman from Illinois, Mr. Hultgren.

Mr. HULTGREN. Thank you, Mr. Chairman.

And thank you all for being here.

I want to address first questions to Mr. Allison, and I would love to get your response kind of from this last discussion, in your response as well.

But let me ask you a question and then if you can kind of put it together that would be great.

I know on June 15, 2015, there was a letter written to the editor of The Wall Street Journal by FDIC Vice Chairman Hoenig, and he wrote, "Higher capital doesn't contribute to lower lending, the data shows that the opposite is true. Banks with stronger capital positions maintain higher levels of lending over the course of eco-

conomic cycles than those with less capital. Additionally, better-capitalized banks compete favorably in the market and survive economic shocks without or requiring bailouts.”

I would like to hear from you about the long-term growth strategy you put in place for BB&T while you served as its CEO. What decisions did you make leading up to the financial crisis that helped BB&T weather such a severe economic shock? And how much focus did you put into managing BB&T's leveraged ratio?

Chairman HENSARLING. I'm sorry, would the gentleman suspend?

A procedural vote has been called on the House Floor. There are 14 minutes and 16 seconds left. We will continue with the hearing, and perhaps Mr. Pittenger, Mr. Tipton, and Mr. Rothfus could go vote and return immediately. And Mr. Hultgren can continue.

The gentleman may proceed.

Mr. HULTGREN. Mr. Allison?

Mr. ALLISON. Okay. In terms of the question, Professor Levitin assumes that bankers are fools, there is no discipline, we are going to just go take crazy risks. And just because we have a stronger capital position, that is not true.

One reason that BB&T got through the financial crisis is we had a stronger capital position and we chose before the crisis not to do the kinds of loans that were very destructive during the crisis because we knew they wouldn't work out.

So we wanted to be in business for the long term. And we were able and willing, although the regulators wouldn't let us, to lend through the crisis. We had lent through the 1980s crisis, we went through the 1990s crisis. This time they stopped us from doing what we were prepared to do, which was make loans to our customers and get them through the crisis.

Regulators put a lot of people out of business unnecessarily and that is why the crisis ended up being so deep.

Mr. HULTGREN. Thank you.

Mr. Purcell, in practice, do you have an estimate of how many banks would elect to increase their capital to the requisite level to achieve regulatory relief under the CHOICE Act? As we know, raising capital can be expensive, but so is complying with reams of new regulation from Dodd-Frank and Basel.

How would you as a banker weigh these costs and benefits? And what is the process for raising additional capital? Obviously, this varies by institution, but do you think there are willing investors and, as we hear far too often, banking is a tough business nowadays?

So I would like to get your thoughts on how this would impact.

Mr. PURCELL. In rural America, raising capital is not an easy solution. You can retain your earnings and that is something that we have done over the past couple of years in our bank trying to get the capital up to 10 percent. And we are nearly there.

The Texas Bankers Association had a tour and we toured all of Texas in a week's period, went to 17 different locations. And we asked the same question, and it was approximately 50/50; about half of the banks in Texas currently have the 10 percent and there are a number that don't.

But we are still assessing what is satisfied at 10 percent. Should it be 9 percent? But it is not going to be easy. If you are not in a high-growth area, it is not going to be easy to raise capital.

Mr. HULTGREN. Yes, thank you.

Congressman Nussle, if I could address this to you. I wonder, did credit unions play a significant role in causing the financial crisis? If not, why would Democrats force a bill through Congress that subjected you to significantly more stringent regulatory requirements?

Mr. NUSSLE. I am not sure I can respond to the second except to say that I think there is a tendency to apply one-size-fits-all solutions. It just seems to be a tendency of our policy process these days, unfortunately. And I think we were kind of folded into that as a result.

But no, we don't feel like we caused the crisis. Our insurance fund was not impacted by the crisis. We held strong capital ratios. We do now, we continue to do now. We don't raise capital easily and so it is something that is very precious to our institutions. And we have a very conservative model which in and of itself, I think, helps mitigate the risks of some of the other challenges that might be out there that I know Professor Levitin has referred to.

Mr. HULTGREN. Yes. Mr. Nussle, really quickly, do you believe the capital election provision in Title I of the CHOICE Act would provide meaningful regulatory relief to credit unions with the most conservative balance sheets? And what percent of credit unions maintain a simple leveraged ratio at or above 10 percent?

Mr. NUSSLE. We are over 60 percent now and quite a few that are close and I think would move very quickly toward a 10 percent number if in fact that is what is decided.

Mr. HULTGREN. Great, thank you.

Thank you all.

I yield back.

Chairman HENSARLING. The time of the gentleman has expired. The Chair now recognizes the gentleman from Maine, Mr. Poliquin.

Mr. POLIQUIN. Thank you, Mr. Chairman.

Thank you all very much for being here today. I appreciate it.

For those of you who haven't planned your summer vacation to Maine it is not too late.

[laughter]

We are a beautiful State of hardworking people, independent-minded. We have blueberry pie and lobster and moose and the whole thing up there. And our district is very much like yours, Mr. Purcell. We have two population centers: Bangor, with 35,000 people; and Lewiston/Arbor, which we call LA, that has 35,000 people, and we have 400 small towns.

And if you drive through the small towns in our district, what you will find is a police station, usually a volunteer fire department, a little library, a convenience store, maybe a little league field and a community bank or a credit union.

And the communities in these small towns throughout America, not only Maine, revolve around these institutions. It is so important to make sure that we have a government that helps these institutions and not hurts them.

Now, we all know and it has been discussed here today that for years Washington regulators made it very easy for a lot of folks to own homes, buy homes and they couldn't afford them. And then when the real estate market collapsed, it took the economy with it.

And of course, Washington responded the way it usually does—it overreacts and it tries to come in and save everybody with a smothering set of regulations. And they were really designed for these large, money-centered banks, not for our credit unions, not for our small, local banks.

But we are caught in the same net and it is really a shame because now when you travel in our district, just like yours, Mr. Purcell, that you said, you listen to our folks who run credit unions and local banks and they are just unable to make the car loan or a home mortgage, extend the home mortgage or a small-business loan the way they could before, even though they know the families and have for three or four generations.

So what I have found in my work in the private sector is that when regulations go up, costs go up. When costs go up, choice goes down. So it is no wonder that we don't have free checking accounts throughout our industry, this industry, and haven't for a long time. It is no wonder why the monthly fees that your credit union bank or bank charges are going up.

So I would like to extend this question to you, Mr. Purcell.

Most of the community banks, local banks throughout our country and our credit unions have plenty of capital to operate safely and effectively. If the CHOICE Act becomes law, could you be really specific with the folks who are there listening, the folks back in my district in Maine, what behavior might change at your local bank when it comes to services offered, reduction of fees, extension of more credit?

Mr. PURCELL. That is a tough one because I am not sure what all relief is coming with the CHOICE Act.

The 10 percent is attainable, it is realistic to not have a complicated business and have the regulations tailored for our business, I think is extremely important.

I think the attitude of our customers as well as the employees of the institution would be significantly different. If people said you make and you live with your decisions, and if you don't you go out of business, but if we do not change we are going to be absorbed by someone else.

Mr. POLIQUIN. Mr. Nussle, would you mind commenting with respect to the credit unions. And in particular, I am asking, I am not trying to lead the witness, I am really asking you a straightforward question, if there is relief as dictated in the CHOICE Act that has extended to our credit unions, what might you see on the ground with respect to the extension of credit, growing economy, more jobs in these communities?

Mr. NUSSLE. It gives the—certainly having the ability to lend and to have some of those costs that are certainly restricting that at this point in time and as well as just time constraints would make that easier.

But I have an actual—I have talked to a few of my credit unions about this, and interestingly enough, you will find this interesting as almost maybe a case study on how behavior will change.

Already those credit unions that are well-capitalized to above 7 strive for more capital because they see a change in the examinations and the examiners that come through. The higher capital ratio, the more they tend to not be quite as restrictive or concerned.

And so they already see a behavioral change on the part of regulators the more capital that they retain. So it is kind of interesting.

So I think that behavior is going to manifest itself in a law like this as well.

Mr. POLIQUIN. Thank you, gentlemen.

Chairman HENSARLING. The time of the gentleman has expired.

Pending conclusion of the single vote on the Floor, the committee will stand in recess.

[recess]

Mr. HUIZENGA [presiding] The committee will come to order.

And at this point, the Chair recognizes Mr. Ross, of Florida, for 5 minutes.

Mr. ROSS. Thank you, Mr. Chairman.

I want to thank the panel for being here.

Mr. Allison, I agree with you and your opening statement. And I firmly appreciate it. I think that the regulators were asleep at the switch. I think that they forced too many of our lending institutions to use their capital in areas that were not prudent. And that, in and of itself, compiled into a terrible situation for us in 2007.

And here we see an overreaction where we think, well, more regulation because we know best, because we are the regulators. And yet, none of them have spent any time on Main Street, none of them have spent any time trying to be an entrepreneur.

When you state that the founder of Home Depot couldn't start his business today, that is a sad state of affairs for America, a country that was founded on the entrepreneurial spirit that is so dependent on the lifeblood of commerce and the availability of capital.

And so my question to you is, what are the consequences when Washington imposes one-size-fits-all rules that dictate who they can and cannot lend to, no matter their character? Aren't lower-income Americans disproportionately harmed?

Mr. ALLISON. No question. Dodd-Frank has been terrible for low-income Americans. And we are talking about this income gap that is happening in America and we are ignoring the regulatory cause of this. It is not the only cause by any means, but it is definitely a cause.

Mr. ROSS. And when you look at, let us say, 10 percent, for the sake of conversation, for the sake of the CHOICE Act we have said 10 percent capital requirements, but yet we are not saying then you are free and easy. You still have the CAMELS rating that you have to uphold by. And is that not in and of itself an opportunity for the regulatory environment to continue to subjectively prevent a lending institution from exempting themselves, even if they have a 10 percent capital ratio?

Mr. ALLISON. Absolutely. But I will say again, in my years of experience I have seen very few times the regulators actually identified things in advance.

What I think less regulation would lead to is more market discipline.

Mr. ROSS. I agree. And not only that, but if they can leverage that capital that is well over 10 percent being held and they make it available to the consumer, whether it be residential, whether it be consumer, whether it be commercial, whomever, and they make it available at a lower rate and you start spawning investment, then you also create competition. And would it not mean that market discipline would then suggest that, by golly, if X, Y, Z institution is doing this and doing well, why would I not do the same thing and increase my capital reserves instead of saying, well, I will just hold it and play risk because this is what I can get by with with the regulatory environment?

Mr. ALLISON. Absolutely. It would create more market discipline, more competition between banks. But also by banks being willing to start up more businesses, it would be more competition in the economy as a whole.

We have created a massive subsidy for big businesses. You can't start anything up; therefore, if I am in business I don't have to invest because, hey, I have no new competitors.

Mr. ROSS. And that is a little frightening because we see the government get in the business of business more and more as we move on, whether it be the insurance business, whether it be in the banking business, whatever it may be. If they want to instead tax, take a premium and call it whatever they want, that is what we are going into.

So my question to the panel would be, this Administration has embraced itself since the passage of Dodd-Frank on enhancing access to credit. Is there any evidence that that has been made available prior to the Dodd-Frank passage?

Is there any, whether it be anecdotal or actual, is there any evidence that this Administration has increased access to credit?

Mr. Newell?

Mr. NEWELL. Yes, Congressman, if I may. I think, certainly, because we follow these figures quite closely, you continue to see major headwinds against credit and you especially see that, again to where you started against, in terms of folks who have less than pristine credit and credit availability to them.

I think maybe just one specific example because it is something that we worry a lot about in terms of how the current regulatory regime is driving some of these impacts is the CCAR exercise.

Mr. ROSS. Right.

Mr. NEWELL. The CCAR exercise, because it involves an area that has a very, very large jump in unemployment. What that means is loans to folks or small businesses that are very sensitive to unemployment changes, and those typically tend to be loans to folks of smaller means or smaller small businesses, those are the ones that are actually impacts the most harshly under CCAR. And so that impact can create a very strong disincentive, again, relative to other activities for that kind of activity.

Mr. ROSS. Do you believe that these rules that are being suggested here, the rules for the capital requirements, should apply to smaller financial institutions? Not the ones, there are more community banks, the credit union ones that have a higher capital re-

serve, and yet they are paying probably greater proportionally in compliance costs than the larger institutions. Shouldn't they be susceptible to at least be able to take advantage of this?

Mr. ALLISON. Yes.

Mr. NEWELL. Sure.

Mr. ROSS. Thanks. I realize my time is up.

Mr. POLLOCK. For sure, Congressman.

Mr. ROSS. Thank you all.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from North Carolina, Mr. Pittenger.

Mr. PITTENGER. Thank you, Mr. Chairman.

And I thank each of you for being here today. I have learned a great deal.

I would like to respond to some comments that my loyal opposition made a few minutes ago regarding the merits of the CHOICE Act and whether it is prosperous and stable and free.

And I would think we should consider the present course of our economy with 1½ percent economic growth, 12 to 20 million people who are unemployed or underemployed, it is seasonal factors there, low-income minority individuals or demographic group has risen the least in this economy in the last 7 years. We have 10 percent-plus real unemployment when you consider the underemployed and unemployed.

And they tout 14 million jobs since 2008. That comes to about 160,000 jobs a month. That is below the low end of our recovery in the 1980s where after 2 years we were creating 300,000 jobs and 400,000 jobs and 500,000 jobs and in 1 month a million jobs, growing at 6 percent.

So I would like them to reflect a little deeper on the merits of this current economy and as such the impact that the Dodd-Frank bill has had.

Mr. Purcell, having grown up in Texas, I have an appreciation for the State. And certainly, you are from a rural area.

You did say in your testimony that there have only been three startup banks since 2010. Is that correct?

Mr. PURCELL. To the best of my knowledge, and that wasn't just in Texas; that was in the United States.

Mr. PITTENGER. I believe you are right. But I am glad to have that clarified.

Mr. Purcell, having served on a community bank for a decade, I certainly appreciate the merits of the banking system and the small banks and what they offer. But what would you consider should be done to provide this type of access to capital for small businesses, particularly those that are in rural areas?

How has economic growth been impeded? And what have been the factors that have kept small banks and community banks from having startups for capital to be invested in these types of good businesses?

Mr. PURCELL. I am kind of slow, I am not sure I will get all your questions answered or if I can remember them all. But one thing is you cannot legislate a perfect world. And so for everything that we do, there are going to be consequences because of our actions later on.

But if we look at the history of things, it was not the community banks in rural America that caused the problems, but yet they are sharing the responsibilities for cleaning it up.

We have to have hope, our people have to have hope in the ability to succeed and better themselves, either as an entrepreneur in a new job or in taking care of their family. And once they lose hope, we have a tough battle. And right now there are a lot of people who have lost hope and they don't see any way to comply with all of the regulations, whether it be from the individual in the bank or whether it be from our customers.

Mr. PITTENGER. Thank you.

Mr. Nussle, quickly, I would like to ask you, kind of help me understand the significant role that credit unions played in causing the financial crisis.

Mr. NUSSLE. Of course, we don't feel like we did either. I would share Mr. Purcell's comment on that and feel like we are part of the solution that you should be turning to if we want to create opportunities and jobs.

As you know, people in search of credit are going to go find money. And the question is, do you want them to go through a regulated, safe and sound institution or do you want them to go into a predatory institution or a predatory situation?

And I think what we are doing is we are making it more difficult for the people that we are trying to help, all of us, that you are trying to help to build that credit and establish that credit in a safe and sound way.

Mr. PITTENGER. The enactment of the Dodd-Frank Act clearly has impacted your industry. Would you just give us quickly some salient points to that regard?

Mr. NUSSLE. Since 2010, we have seen about a \$3 billion increase in annual regulatory costs year after year. That is the kind of challenge I said before, all of the different pages of regulations. And whether you are a big institution or a small, you have to comply, you have to look at all of those. Even if you have an exemption as a smaller institution, you have to read all 6,000 pages to find out where your exemption is.

So, it is that kind of thing that makes it difficult to continue to establish and build the credit with the people that you are serving.

Mr. PITTENGER. Thank you, my time has expired.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Pennsylvania, Mr. Rothfus.

Mr. ROTHFUS. Thank you, Mr. Chairman.

And like my colleague from North Carolina, I, too, was struck by some of the suggestions across the aisle that Dodd-Frank has not made us less prosperous. And I think simply put, if you look at the numbers that my colleague was talking about, from North Carolina, this simply isn't your parents' recovery, it is not your grandparents' recovery when you look at the drag that we have had and the average economic growth coming out of recessions and depressions over the last 80 years. And this is anemic growth at 1 percent, 2 percent.

And the differential is fewer jobs, looking at the lowest labor participation rate since 1978 and less income. People aren't getting raises because the economy has not been prosperous.

Indeed, Chair Yellen was here a couple of weeks ago and for the third time talking at length about the "headwinds" that have been facing the economy, often referring to geopolitical events and other uncontrollable external factors.

I contend that many of the headwinds are man-made, anthropogenic to borrow a phrase.

Mr. Allison, in your testimony, you remarked, "One tragic irony is that by tightening lending standards, the Federal Reserve has undermined its monetary policy. They cannot get the money supply to grow because the velocity of money has slowed because banks are only making loans to large businesses." You also add that the Fed is effectively subsidizing large firms.

What are the main provisions in the CHOICE Act that will help to alleviate this self-inflicted constraint on growth?

Mr. ALLISON. The fact that banks can significantly eliminate a big chunk of the regulatory burden will get them back to doing the core lending that they used to do, not just before the financial crisis, but for 40 years.

So banks today are focused on making regulators happy instead of going out and making the kind of loans and they can't literally make the kind of loans that drive the economy.

And I do think it is ironic that the Fed keeps printing money, but it doesn't do anything, because banks are money multipliers by making loans. And they have destroyed the money multiplier.

Mr. ROTHFUS. Yes. With this kind of accommodative monetary policy, you would expect us to be booming.

Mr. ALLISON. We should be booming or maybe highly inflationary. But if you destroy the multiplier, because banks, savings and loans, credit unions can make loans, then the multiplier is collapsed.

Mr. ROTHFUS. You may have noticed a slide on our screen quoting Fed Governor Tarullo that a 10 percent leveraged ratio is too rigid, it can be gained by simply increasing balance sheet risks. But doesn't Mr. Tarullo assume that the stock price of the financial institution would not react to the risk? He would be correct if the Fed keeps bailing out banks. But under CHOICE's bankruptcy regime, wouldn't shareholders face the full risk of their decisions?

Mr. ALLISON. I think you are exactly right. What Mr. Tarullo says is totally wrong. If you had less evidence, if it was clear that the banks could not be bailed out, then markets would discipline banks and they would care how much capital and how much risk they were taking.

And it is also not in the long-term advantage of somebody running a bank to make crazy decisions if they are going to be punished by being allowed to fail.

Mr. ROTHFUS. You would expect those investors to be a form of discipline.

Mr. ALLISON. They discipline all other companies, right? Now, that doesn't mean that there won't be some banks that fail because investors aren't perfect, but investors will be disciplinaries if banks are not perceived to be protected.

Mr. ROTHFUS. Mr. Nussle, credit unions have previously testified that they have had to cease offering certain products and services to their customers as a result of increased regulations. What are some of the products and services that have been most affected?

Mr. NUSSLE. For instance, mortgages. Just take that. Some of the smaller institutions who don't do that many—they are in smaller communities or it is an area that they provide for their members, that is one that I often will hear that is curtailed and severely.

And again, if you are trying to establish credit, if you are trying to buy a home or whatever it might be, that is pretty tough for people in their community to not have that access. So that would probably be the marquee one that I would put out there.

Mr. ROTHFUS. Other remaining products and services they offer, it is generally the case that compliance costs are passed along to customers. If so, to what extent have costs increased for frequently used financial products of the credit unions?

Mr. NUSSLE. Yes, they have to be. Certainly a credit union, while it is a cooperative and is peer-to-peer lending, is members helping members—we have to run a business with a bottom line to be able to maintain safety and soundness. And so, of course, we have to be able to pass on those costs, if incurred, throughout, spread out, whether it is in lower returns on deposits, or it has to be higher rates for lending.

Mr. ROTHFUS. I thank the chairman, and I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentlelady from Missouri, Mrs. Wagner.

Mrs. WAGNER. Thank you, Mr. Chairman.

Thank you all for joining us today to discuss an important topic on how we rethink financial regulation in order to make our system safer and to boost financial growth.

Since Dodd-Frank, we have seen bank small-business loans decline by 11 percent, and 58 percent of startups report unmet financing needs. Consistently, we see the effects of increased bank regulation fall disproportionately, as discussed, on smaller businesses that have few alternative sources of finance. A lot of this comes from what I consider this one-size-fits-all regulation being applied to banks and institutions of all sizes.

Mr. Purcell, what has your institution had to do to ensure compliance with these regulatory mandates? And what kinds of investments have you had to make as a result?

Mr. PURCELL. Our loan demand in Big Spring is not very great right now. We are in the Permian Basin so there has been some stress in the oil- and gas-producing parts of the United States.

We got completely out of the mortgage business because the type of loans that we made did not comply because they were a balloon note.

I had dinner last night with some bankers from Mississippi and there were five there and they said they do not even make mobile home loans now.

Mrs. WAGNER. Unbelievable.

Mr. PURCELL. I don't know what status you are in society, but if you are not receiving the small loans to buy a house or you are

not able to buy a mobile home, I would say that is not helping the low income.

Mrs. WAGNER. So not only is it affecting the cost of compliance for your bank, your institution, you are actually seeing these regulatory burdens, what they mean for actual consumers and your ability to provide them the credit that they need, especially when it comes to small-business loans or small loans of this kind of purchase.

Mr. PURCELL. Yes, ma'am.

Mrs. WAGNER. Mr. Allison, as you operated BB&T during the financial crisis, would you say financial regulation was already highly complex back then? And if you could then go on to comment, have things become more complex?

Mr. ALLISON. Absolutely. The financial industry was the most regulated industry in the United States based on just the number of pages of regulation and the multiple regulators before the financial crisis. It is not surprising the most regulated industry is where we had the biggest problem. And there should be a lesson in that.

But instead of saying, well, hey, maybe these regulations made a mess, we ended up with many, many more regulations that are doing just what you said. It is making it very difficult for banks to make small-business loans and the traditional loans to consumers.

My bank used to do a lot of the real estate kind of financing, small houses, somebody wants to add a carport, can't do it interestingly enough because the consumer compliance rules keep you from helping consumers.

Mrs. WAGNER. So one-size-fits-all on these financial institutions is definitely disproportionately affecting smaller-sized people who want to invest or want to take out a loan. Is that what I am hearing from both of you?

Mr. ALLISON. Yes, it is hurting smaller institutions more. But by the way, I would say a lot of these rules are destructive for everybody, like the tightening of lending standards for traditional mobile homes and things like that. It is actually bad for the economy.

So yes, it is hurting smaller institutions more and a number of these things are bad for everybody.

Mrs. WAGNER. Let me ask, Mr. Allison, the EU is currently undergoing an exercise called a call for evidence and it is looking at all their post-financial-crisis regulations that have been released and how they could be simplified for economic growth.

Additionally, the CHOICE Act offers a simplified approach to capital requirements to replace a myriad of complex Dodd-Frank regulations.

Could you comment, sir, on how moving toward simplification in our financial regulations not only helps make our system safer, but also helps to boost economic growth?

Mr. ALLISON. No question about it. If something is not understandable, is overly complex, then it is easy to screw it up and it is easy to mismanage it. And simplification will allow financial institutions to spend a lot less time on regulation and I think banks would rather have higher, worse, whatever, and more simple regulation because then they can manage against them. And that will allow them to get back to their business instead of focusing on reg-

ulators and the regulatory costs. They can go help people make more successful businesses and happier consumers.

Mrs. WAGNER. Great, thank you, Mr. Allison. I appreciate it.

I appreciate all of your time being here today.

Mr. Chairman, I yield back.

Chairman HENSARLING. The gentlelady yields back.

The Chair now recognizes the gentleman from Kentucky, Mr. Barr.

Mr. BARR. Thank you, Mr. Chairman. And thank you for your leadership in introducing the Financial CHOICE Act.

Mr. Allison, a question for you. As the former CEO of a regional bank, a mid-sized bank, you have a view of the kind of institutions that are smaller than you and the institutions that are larger than you.

So I am interested in your take on the following questions. What kind of a regulatory regime benefits small institutions? Is it a highly regulated environment with high costs? Does that benefit the community bank or does that benefit the larger Wall Street mega banks?

Mr. ALLISON. I started out at BB&T when it was a small bank and then it grew to be a larger bank, so I really have personal experience with that.

The regulatory cost is much higher in a smaller institution because the CEO has to spend his time doing that. The bigger the company gets, the more you can hire other people to do that kind of work. And the CEOs and the relatively small number of people actually impact the productivity of smaller institutions more.

Mr. BARR. So in other words, the more volume, the more complexity of regulation, the better it is from a competitive standpoint for larger institutions.

Mr. ALLISON. Yes. And I think Jamie Dimon basically said that. He basically said Dodd-Frank is a competitive advantage for us. It is probably true.

Mr. BARR. How about orderly liquidation authority that arguably gives larger institutions a funding advantage, do you see that? Does the orderly liquidation authority that is codified in Dodd-Frank, does that help small banks, community banks, or does that help large banks in terms of competitiveness within the banking marketplace?

Mr. ALLISON. It creates the perception of too-big-to-fail. And I think that is why large banks like it, right?

I have to say, I have a very different perspective of the financial crisis. I think big banks should have been allowed to fail. I don't think the world was getting ready to go crazy, it was just a huge flight of quality. Money was going to healthy institutions, away from unhealthy institutions.

Markets can deal with failures, they just can't deal with ambiguity.

Mr. BARR. So what I am hearing you testify today is that Dodd-Frank's regulatory approach has actually helped Wall Street banks and hurt small-community banks.

Mr. ALLISON. It has helped them relatively.

Mr. BARR. Relatively.

Mr. ALLISON. It will help them in the long term because if you destroy the competitors that are coming up, it actually subsidizes them in the long term.

Mr. BARR. Is it fair to say that Dodd-Frank creates an unlevel playing field for larger institutions over smaller community banks?

Mr. ALLISON. It does. And a couple of people have talked about this. Theoretically, a lot of smaller institutions are immune from Dodd-Frank. That is not what is going to happen in the real world.

In the real world, if I am regulating a small institution, I am a regulator, I am going to apply the same rules to that because if a small bank gets in trouble I am going to look bad and I am worried about my career. And so being exempt is a joke.

Mr. BARR. And so since the enactment of Dodd-Frank, there are about 1,500 fewer institutions in America. Has that actually helped to consolidate and concentrate risk as opposed to diffuse risk?

Mr. ALLISON. No question.

Mr. BARR. Okay.

Mr. ALLISON. It has actually increased it.

Mr. BARR. Okay. And finally one final question, what is the greater risk to our financial system, heavily regulated, under-capitalized banks or less regulated and highly capitalized banks?

Mr. ALLISON. No question, less regulated, highly capitalized. And there is a trade-off and I want to reemphasize this: Banks simply cannot afford to pay the regulatory costs of Dodd-Frank and be highly capitalized.

As I mentioned earlier, Citigroup is only at 6.4 percent leveraged capital ratio. The reason the regulators haven't raised it higher is they know it won't work. But they would prefer regulation because that is their job over capital, and there is a definite trade-off.

Mr. BARR. In my final time, Mr. Newell, a question for you.

This relates to Professor Levitin's comments that irrespective of the capital requirement opt-in provision in the Financial CHOICE Act, some of the deregulatory measures that occur in Financial CHOICE, regardless of the choice made by an institution, he contends are destabilizing to the financial system, for example, repeal Volcker, repeal of the risk retention requirement, and some of the changes to the derivatives regulation.

Do you care to respond to those allegations or those arguments?

Mr. NEWELL. Certainly. So I think, with respect to the various provisions of the CHOICE Act, I think some of them are net positive to financial stability, I think some of them are net negative to financial stability. So I think fortunately it really just depends on the individual provision one is talking about.

Mr. BARR. Mr. Pollock, do you think that repeal of Volcker would be destabilizing to the financial system?

Mr. POLLOCK. Congressman, I do not. I don't think Volcker had much to do with the crisis and that the rule didn't have a lot of solid rationale in the first place, so we can get rid of it.

Mr. BARR. Thank you. I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentleman from Colorado, Mr. Tip-ton.

Mr. TIPTON. Thank you, Mr. Chairman. Thank you for your leadership on the CHOICE Act, and I thank our panel for taking the time to be able to be here.

Mr. Purcell, I thought it was interesting as you were talking because you were describing in Texas what we see in my rural district in Colorado, oftentimes as mobile homes are the homes that people have access to, but just looking at the impact on a community, that the rules and regulations that we are seeing under Dodd-Frank.

I assume in your bank—I served on a small-community bank board as well, and we had plumbers, electricians, and home builders all impacted with those mortgage loans that were being made. And you have a collateral of domino effect that actually moves in.

Is there a concern? Because we have had, I think, abundant testimony frankly from Chair Yellen, Governor Tarullo, and all of the Administration officials in terms of the trickle-down effect of rules and regulations.

Right now we are still waiting for 40 percent of Dodd-Frank to be able to come into play. How is this going to have a real impact on those community banks, their ability to be able to make those loans to the communities that frankly right now and be able to but-tress, to a little bit of Mr. Pittenger's comments, of the impacts of an economy that is not working for all Americans? For the first time since we have been keeping statistics, we have more small businesses shutting down than there are new business startups. That typically describes rural America.

Mr. PURCELL. And the shoe hasn't dropped yet because I believe the CFPB is going to start investigating how they can help on the small-business lending and start passing out fines on that, too.

So, if it costs you \$125 or \$130 a loan to make in compliance costs, what do you have to charge a \$500 borrower to get your money back? You are going to lose money on it.

How many businesses can keep going when they lose money? They can't. So the size of the loan keeps growing up to cover those costs and then you have the CFPB coming in saying let us go ahead and attack the small business. It has nothing to do with the economy, it is just that you guys don't know how to loan money. Or better yet, let the Post Office do it.

Mr. TIPTON. Great.

Mr. Allison, would you maybe like to comment a little bit in terms of the impact of those regulations, in terms of startups and small businesses?

Mr. ALLISON. I think they have been traumatic. As I said earlier, I started my career as a small-business lender. That is what BB&T did, that was our core business. We did a lot of what I would call venture capital lending where you make a judgment of the individual and the idea instead of just the numbers.

I was fortunate enough to help a lot of small businesses become bigger businesses. And it is not just startup. There is a moment where a business says, I am going to have two locations or I am going to have a hundred. And at that moment you have to make a judgment call. You cannot do that in today's marketplace.

The way the regulators have tightened lending standards, they would immediately make you charge that loan off or they would re-

quire so much down payment that the guy couldn't do it. It kills that market.

And that market, even though only a small percentage of them get to be bigwigs, that is a huge job creator and really important in terms of prosperity.

Mr. TIPTON. I find it interesting, we have had a lot of commentary, a lot of testimony, your comments here today on the importance of our community banks, our small credit unions, delivering a service to communities.

But Mr. Purcell points out, in Texas they lost 149 community banks. I assume mergers probably took place. Is Dodd-Frank actually driving a self-fulfilling prophecy and rather than eliminating too-big-to-fail actually driving it into a more consolidated market, which is going to create far more challenges, far more risks for the economy as we move forward?

Mr. Allison?

Mr. ALLISON. No question it is encouraging consolidation. And I will have to say this: I am not sure the Fed doesn't like that because the Federal Reserve would much rather regulate a relatively small number of banks which they can have a huge control over than a lot of banks running in a different direction.

So it may not be a conscious policy, but I am almost positive it is an unconscious policy. They like the consolidation process because it gives them more control and that is what they think is good.

Mr. TIPTON. I appreciate that.

And Mr. Chairman, I think as we listen to this testimony, I am hearing stories about communities, I am hearing Home Depot would not start up under the regulatory environment today. I am hearing from credit unions that are saying that they are struggling to be able to provide a service to rural communities.

And I want to applaud your leadership in regards to the CHOICE Act to try and be able to open those markets back up to our local communities to be able to make those real decisions at the local level.

To be able to make something, Mr. Allison, you spoke to in terms of a character loan, people who actually know their customers, to be able to open that economy, that real capital so that we can get this economy moving and let all Americans share in some future prosperity.

I yield back.

Chairman HENSARLING. The time of the gentleman has expired.

The Chair now recognizes the gentlelady from Utah, Mrs. Love.

Mrs. LOVE. Thank you, Mr. Chairman.

I would like to thank all of you for being here today. It is really beneficial for me to hear your expertise and just your experiences in this area.

I want to change gears a little bit and focus on the Volcker Rule.

From its inception, the Volcker Rule has been a solution in search of a problem. It seeks to address the activities that have nothing to do with the financial crisis and the practical effect has been to undermine the financial stability rather than preserve it.

The Volcker Rule will increase borrowing costs for businesses, lower investment returns for households, and reduce economic ac-

tivity overall because it constrains market-making activities that already reduce liquidity in key fixed-income market-making activities.

Repeal of the Volcker Rule, as the CHOICE Act provides, will promote more including the corporate bond markets and will promote more stable financial systems.

So this is my question for Mr. Pollock: Why have the five regulators charged with implementing the Volcker Rule yet to find any connection between the Volcker Rule and the precipitous drop in bond market liquidity?

Mr. POLLOCK. There is something else they haven't found, Congresswoman, which, as you said in the beginning, is a link between the financial crisis and the things prevented by the Volcker Rule in the first place.

If you are committed to the rule, of course, you don't want to find things that are wrong with it. That would be a speculation of mine.

Mrs. LOVE. Okay. Has the Volcker Rule, in your opinion, had any impact on cost of hedging risk? And what consequences does that have for businesses and other customers of banks?

Mr. POLLOCK. I am not an expert on this particular topic, Congresswoman, but I believe that it is true what you say, that whenever you tie up an activity with more and more regulation you are going to create problems that you didn't mean to create, but you have created them anyway.

Mrs. LOVE. Mr. Allison, do you have anything to add to that?

Mr. ALLISON. Yes. I would say, again, it is not my area of expertise, but I would say almost certainly the Volcker Rule has reduced liquidity in bond markets. It would have to because it makes it harder for big banks to hold bond portfolios. So it has definitely reduced liquidity.

Mrs. LOVE. Okay.

Mr. ALLISON. And I would just reemphasize what Mr. Pollock said. There is no evidence that a problem the Volcker Rule was trying to deal with had anything to do with the financial crisis. So why did it get thrown in?

Mrs. LOVE. Okay. So if proprietary trading has no social good or value in creating liquidity and creating markets, why then did Congress exempt U.S. obligations and those of States and municipalities from proprietary trading then?

Mr. ALLISON. Obviously, they believed it really does have some good or they wouldn't have exempted themselves.

Mr. POLLOCK. That is a wonderful rhetorical question, Congresswoman, and you answered your own question.

Mrs. LOVE. Just asking, would you agree that the net effect of post-crisis regulations is to remove productive capital out of the real economy and leave it stranded in government securities?

Mr. ALLISON. No question. The mathematics will support that. But even more important is what I call intellectual capital. And if you have all the brains in the financial services industry, which is a massive, productive industry that creates thousands and thousands of jobs, thinking about regulations, instead of about how to provide better products, how to improve technology, that has a huge impact on economic well-being.

And there has been basically no innovation in the industry since Dodd-Frank. And that is a big cost. There is not just a capital cost on that. A human resource is the most important resource. And we put balls and chains around our human resource.

Mrs. LOVE. Okay. And I just have one more. I guess I would ask the two gentlemen this question again: Are we already seeing the impacts of the real economy, even though many of these regulations are just being implemented? What are your thoughts about what is just being implemented and what the future looks like 5, 10, 15 years down the road?

Understand that my background is, I am a mayor, and I have seen how these community banks have literally built our city. I am not just talking about a teacher who is building an expansion of her school that helps 4-year olds read, but I am talking about people who have built our community.

Chairman HENSARLING. The time of the gentlelady has expired.

Members are advised there is a pending procedural vote on the Floor, with 10 minutes, 13 seconds left.

The Chair will recognize the last Member, Mr. Hill from Arkansas, and then we will adjourn the hearing.

The gentleman from Arkansas is recognized.

Mr. HILL. Thanks, Mr. Chairman, and I thank the ranking member as well for holding this hearing on the CHOICE Act.

I have been in banking on and off in my career for a long time, since the 1970s, since before the Monetary Control Act was passed, Garn-St. Germain, so I have a little experience.

I would like to ask unanimous consent to enter in the record an article from The Arkansas Democrat-Gazette dated 6/19/2016.

Chairman HENSARLING. Without objection, it is so ordered.

Mr. HILL. This article talks about the return on assets of community banks in Arkansas, which 104 banks, by the way that is about half of what it was when I was involved in starting my last company, offered an RoA of 129. Pretty good.

But if you back out the four big banks that are chartered in Arkansas, it is only a .8, 40 basis points less, and that is endemic to the struggle I think that our community banks have in coping with the competitive situation and the costly situation brought about by Dodd-Frank, reducing consumer lending, reducing small-business lending and trying to comply with all the rules.

For even if those small banks are "exempt" from an exam by the CFPB, they are not in any way exempt from the costs and regulations promulgated by the CFPB.

The other thing I wanted to mention before I ask a question is my good friend from Missouri, Mr. Cleaver, went through a long litany and you guys participated in the give-and-take on all the due diligence that had happened before the Dodd-Frank Act was passed by the House and the Senate in 2010.

What he failed to mention, though, is that the Congress commissioned a financial inquiry commission to find out what in fact took place in the financial crisis and make recommendations to this body as to what to do about it. But I would report to you that Dodd-Frank passed 6 months before that commission issued their report. So that is my response to Mr. Cleaver.

I want to talk about the leveraged ratio and get some give-and-take. As I understand in the discussion draft the committee has put out that it uses the supplementary leveraged ratio that Mr. Newell talked about extensively, which includes, of course, off-balance-sheet items.

And for my way of thinking, I think the straight GAAP, tier-one leveraged ratio might be superior and certainly be related to the vast, vast majority of banks in the country. Plus, we can all measure it pretty easily by looking at the call report data.

Mr. NEWELL, would you start on that and comment on that point, please?

Mr. NEWELL. Certainly. And obviously, we have concerns just at the general level with the supplementary leveraged ratio in terms of its inaccuracy.

I guess I would also say, in terms of the off-balance-sheet exposures, there is a very long laundry list of very technical requirements in terms of how you translate all the off-balance sheets and convert them into on-balance-sheet assets for purposes of the supplementary leveraged ratio, which actually makes it, I think, much more complicated and transparent than people might otherwise think.

But I can certainly imagine on the one hand that for smaller banks, like Mr. Purcell's, there is probably not a whole lot of off-balance-sheet exposures that would be worth that incredibly cumbersome exercise.

Mr. HILL. So do you think that perhaps then for smaller banks that don't report on the call report any off-balance-sheet exposure that maybe they could use the more strict tier-one GAAP ratio instead of—

Mr. NEWELL. Yes. I certainly would not think that the complicated conversion would be, add any net benefit.

Mr. HILL. Mr. Purcell, do you want to comment on that?

Mr. PURCELL. For instance, we are probably 9.7 percent on our capital. We do not have the off-balance-sheet problems, and yet the type of bank we are, we are over 30 percent on our risk based because maybe our deposits at Fed may be a little bit suspect, but typically we hold quite a bit of cash and bonds in agencies and government.

But I don't think the off-balance-sheet items will affect us at all.

Mr. HILL. Thank you very much.

Mr. Allison, in looking at the proposed list of regulatory relief that one would get if they held the 10 percent capital ratio, can you think of another area besides the ones that are included in the bill that might be useful?

Of course, we talk about Basel III, we talk about the CFPB, we talk about Volcker, for example. But how about in the non-Dodd-Frank arena, are there things that would benefit our institutions, that there might be some relief there in another area?

Mr. ALLISON. If I were in charge, I would go across the whole spectrum. I think a lot of regulations are counterproductive for the economy and counterproductive for the people they are supposed to help.

So you are making a good step, but I would do more.

Mr. HILL. Thank you.

Thank you, Mr. Chairman.

Chairman HENSARLING. The time of the gentleman has expired. I would like to thank our witnesses for their testimony today.

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 5 legislative days for Members to submit written questions to these witnesses and to place their responses in the record.

I ask our witnesses to please respond as promptly as you are able.

Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

This hearing stands adjourned.

[Whereupon, at 1:26 p.m., the hearing was adjourned.]

A P P E N D I X

July 12, 2016

Representative Rubén Hinojosa
FINANCIAL SERVICES COMMITTEE
"Making a Financial Choice: More Capital or More Government Control?"
Wednesday, July 12, 2016
Rayburn 2128
10:00 AM

Remarks for the Record:

The Financial Choice Act represents a dangerous return to an unregulated and highly susceptible financial services industry that was embraced in the years leading up to, and contributed to the financial crisis of 2008. This bill not only severely constrains our regulators, but also, eliminates common sense protections for the American economy and consumers. Time and time again, we have seen that when we ignore reasonable safeguards and place misguided faith in market discipline to regulate itself or in the ability of new, opaque and sophisticated financial instruments to eliminate risk, we not only create more risk, but, face the increased possibility of financial ruin. We should be working together to strengthen and protect our financial system rather than dismantling the Dodd-Frank Act and the very framework that has made our financial system safer and is our greatest defense against another financial catastrophe.

The Committee on Financial Services

Making a Financial Choice: More Capital or More Government Control

July 12, 2016

John A Allison

I was the longest serving CEO in the US of a major financial institution, BB&T, at the time of the recent financial crisis. BB&T went through the financial crisis without experiencing a single quarterly loss. I had the unique experience and perspective of leading BB&T's lending business during the severe correction of the early 1980's and was CEO during the early 1990's recession.

The Federal Reserve's monetary and regulatory policies were major contributors to the 2007-2009 Great Recession. On the regulatory side an excessive focus on Sarbanes Oxley, the Patriot Act, and the Privacy Act created a total lack of safety and soundness regulation. Investors, rightly so, assumed bank regulators were controlling industry risk and the investors were lulled to sleep. Without the perception that regulators knew what the risk were, investors would have studied the industry far more carefully. The market was fooled by banking regulators.

In addition, the implementation by the banking regulators of the BASEL capital standards increased leverage (less capital) in large financial institutions. Using extremely complex mathematical models, large banks, with support from the banking examiners, convinced themselves they could take high risk with little capital because they could manage the risk. In addition, banking regulators were motivated to underestimate risk for political purposes. A financial institution was required to hold half as much capital for an affordable housing (subprime mortgage) as for a loan to Exxon. In Europe, banks were not required to hold any capital for a loan to Greece.

The financial industry regulators seriously mishandled the 2007-2009 economic correction which is continuing to negatively impact economic growth. The regulators made the correction far worse than it needed to be. During the early 1980's and 1990's recessions the bank examiners let unhealthy banks and savings and loans fail. However, they did not interfere with healthy banks' lending practices. They allowed healthy financial institutions with rational lending standards to continue to make loans and support their customers and also to finance good customers who were leaving unhealthy banks. Unfortunately, this time, the examiners forced healthy institutions like BB&T to unnecessarily put out of business many small businesses who we would have supported and who would be in business today. These businesses would be creating good jobs and economic growth. The regulators destroyed many entrepreneurs unnecessarily.

The banking regulators tightened lending standards at exactly the wrong time. They closed the barn door after the horse was out of the barn. These very tight lending standards remain in place for venture capital small business loans. Venture capital small business loans are when the lender while considering the financial projections primarily makes the loan based on a judgement of the borrower and the concept. In the current regulatory environment, while existing slow growing small businesses can often obtain financing, small business startups are frozen out of the market and highly innovative aggressive expansion plans for existing small firms will not be financed significantly slowing the growth of the firms.

I began my banking career as a small business/middle market lender. I was fortunate to help a number of small businesses which have expanded significantly and created thousands of jobs. These loans which were critical to the growth of these firms could not be made today. Bernie Marcus, the founder of Home Depot, has told me on several occasions that he could not have started and grown Home Depot in the current regulatory environment.

The lack of small business venture capital funding from banks and the inability of banks to finance the expansion of more aggressive entrepreneurs has slowed innovation (in all industries except technology) and thereby significantly reduced competition. Because of the lack of competitive pressure existing firms are not motivated to invest for the future. They would rather cut cost and buy back shares of stock. The effect is to slow the growth in productivity which ultimately determines economic wellbeing because we cannot consume more than we produce. In the financial services industry firms are focused on compliance instead of innovation and productivity.

One tragic irony is that by tightening lending standards the Federal Reserve has undermined its monetary policy. They cannot get the money supply to grow because the velocity of money (the money multiplier) has slowed because bank's are only making loans to large businesses. The Federal Reserve is effectively subsidizing large firms.

Unfortunately, Dodd Frank and the related regulatory regime has not only slowed economic growth, it has not effectively dealt with the issues which caused the financial crisis. The "too big to fail" problem has not been solved.

We all want a safe and sound financial system. However, history shows that it is naïve to believe that excessive regulation will accomplish this goal. The Federal Reserve economist and the banking regulators did not foresee the recent financial crisis. In fact, they made the crisis much worse by using Basel capital rules and risk weighting assets for political not economic reasons (affordable housing, Greek debt). Why would anyone believe regulators will not make the same mistake in the future or the opposite mistake which they are making today by requiring excessively tight standards for small business loans? Markets participants make mistakes, but they pay the price. Government regulators force all firms to make the same mistakes and the whole economy to pay the price.

History has consistently shown that the best method to reduce the risk of bank failures is strong capital positions. During the recent correction, which was the worst recession since the Great Depression, very few properly capitalized banks failed. In my 40 plus year career, I do not know of a single case where banking regulators knew a bank was in trouble before we did and few cases where properly capitalized banks could not handle economic corrections.

By far the most important aspect of this proposed legislation is the provision which allows properly capitalized banks to opt out of the regulatory nightmare which is paralyzing the industry and slowing innovation, creativity and thereby economic growth. Lower income individuals are the most negatively damaged by this sad situation.

For those primarily focused on safety and soundness, there can be a debate about which is the best capital standard. However, it is enlightening to note that after massive regulatory cost and intrusion over almost 8 years, Citigroup has a leverage ratio according to their recent quarterly report of only 6.4%. If I were CEO of Citi I could not sleep at night with this low of leverage ratio. I will state with

certainty after many years in the banking industry that raising Citi's leverage ratio to 10% would reduce the risk of Citi failing far more than hiring 5000 or 10000 more regulators to micromanage the company. It is important that the capital ratio be reasonably simple and understandable or large banks will game the system.

Also, for those who want to break up large banks logically raising capital requirements is a far more rational approach than arbitrarily deciding on a maximum size. Economic analysis will force the banks to decide to divest business segments which do not earn satisfactory returns which will significantly enhance the allocation of resources in the economy.

However, there must be a tradeoff between regulatory cost and stronger capital. Financial institutions cannot survive with the stifling cost of Dodd Frank and higher capital. Interestingly, the regulators know this even though they will not admit it. Why have they not insisted on more capital already? Because they know the regulatory cost/capital equation implied in Dodd Frank will not work. They have chosen more regulation over more capital because that is their job and expands their perceived importance.

The opt out provision instead of a forced strategy is an optimal concept. I believe that markets will quickly conclude that those institutions which do not opt out are weak. Who would voluntarily participate in the regulatory quagmire of Dodd Frank? The opt out process will increase capital in the industry thereby reducing risk. The reduced regulatory cost will make financial intermediaries far more efficient and encourage innovation in the industry. Core financial institutions, such as community banks, will be able to get back to their business of growing their communities.

There are no examples of healthy economies without healthy banks.

Resume:

UNC-Chapel Hill: BS in Business Administration, Phi Beta Kappa, 1971

Duke University: Masters in Management, 1974

CEO BB&T: 1989-2008 (Joined BB&T in 1971)

Chairman BB&T: 1989-2009

Distinguished Professor of Practice: Wake Forest University 2009-2012

President and CEO Cato Institute 2012-2015

Executive in Residence: Wake Forest University 2015-Present

Six Honorary Doctorate Degrees



GEORGETOWN UNIVERSITY LAW CENTER

Adam J. Levitin
Professor of Law

Written Testimony of

Adam J. Levitin
Professor of Law
Georgetown University Law Center

Before the United States House of Representatives
Committee on Financial Services

"Making a Financial Choice: More Capital or More Government Control"

July 12, 2015
10:00 am
Rayburn House Office Building 2128

Witness Background Statement

Adam J. Levitin is a Professor of Law at the Georgetown University Law Center, in Washington, D.C., where he teaches courses in financial regulation, structured finance, contracts, bankruptcy, and commercial law. Among his publications is *Financial Restructuring: Business Bankruptcy in the Modern Commercial World* (Wolters Kluwer 2015).

Professor Levitin has previously served as the Bruce W. Nichols Visiting Professor of Law at Harvard Law School, as the Robert Zinman Scholar in Residence at the American Bankruptcy Institute, as Special Counsel to the Congressional Oversight Panel supervising the Troubled Asset Relief Program (TARP), and on the Consumer Financial Protection Bureau's Consumer Advisory Board.

Before joining the Georgetown faculty, Professor Levitin practiced in the Business Finance & Restructuring Department of Weil, Gotshal & Manges, LLP in New York, and served as law clerk to the Honorable Jane R. Roth on the United States Court of Appeals for the Third Circuit.

Professor Levitin holds a J.D. from Harvard Law School, an M.Phil and an A.M. from Columbia University, and an A.B. from Harvard College. In 2013 he was awarded the American Law Institute's Young Scholars Medal.

Professor Levitin has not received any federal grants or any compensation in connection with his testimony, and he is not testifying on behalf of any organization. The views expressed in his testimony are solely his own.

CONTENTS

I. A SIMPLE LEVERAGE REQUIREMENT ALONE IS INADEQUATE TO ENSURE FINANCIAL STABILITY	5
A. <i>The CHOICE Act Actually Involves Two Choices, One of Which Is Reasonable, and the Other of Which Is Dangerous</i>	5
B. <i>The CHOICE Act's Two-Tracked Approach to Financial Stability Courts Disaster</i>	6
C. <i>Shareholder Discipline Is Ineffective and Often Counterproductive for Managing Risks at Financial Institutions</i>	7
D. <i>The CHOICE Act Does Not Address Illiquidity, Which Is the Immediate Cause of Financial Crises</i>	7
E. <i>The Use of a Simple Leverage Ratio Without Other Protections Incentivizes Risky Bank Behavior</i>	8
F. <i>The CHOICE Act's 10% Leverage Ratio Is Gameable</i>	8
G. <i>There Is No Evidentiary Basis for the Choice of a 10% Leverage Ratio</i>	8
H. <i>The CHOICE Act Eliminates Protections Against Excessive Risk-Taking by Financial Institutions</i>	9
I. <i>The CHOICE Act Eliminates Key Regulatory Tools for Responding to Crises</i>	11
J. <i>The CHOICE Act Ensures that Regulators Will Be Ineffective with Their Remaining Tools by Subjecting Them to Political Harassment and Micromanagement</i>	11
K. <i>The CHOICE Act Is About Helping Megabanks, Not Community Banks; There Are Better Ways to Help Community Banks</i>	12
II. THE CHOICE ACT WOULD EFFECTIVELY ELIMINATE CONSUMER PROTECTION AGAINST SHARP FINANCIAL PRACTICES AND DISCRIMINATORY LENDING	12
A. <i>The CHOICE Act Would Eliminate Effective Federal Consumer Financial Protection</i>	13
B. <i>Elimination of the "Abusive" Standard Will Allow for Sharp Practices that Do Not Meet the Narrow Definitions of "Unfair" and "Deceptive"</i>	13
C. <i>The CHOICE Act Facilitates Discriminatory Lending</i>	14
D. <i>The CHOICE Act Effectively Prevents Regulation of Payday Lending in Any State</i>	14
E. <i>The CHOICE Act Facilitates Risky Mortgage Lending</i>	15
F. <i>The CHOICE Act Will Produce a Brain-Drain at the CFPB</i>	15
G. <i>The CHOICE Act Prioritizes Bank Profits Over Fairness to Consumers</i>	16
III. THE CHOICE ACT'S FINANCIAL INSTITUTION BANKRUPTCY PROPOSAL IS UNWORKABLE, PRIORITIZES WALL STREET OVER MAIN STREET, AND WOULD RESULT IN MORE BAILOUTS	16
A. <i>Bankruptcy Is Not Designed to Handle Systemic Risk Issues, and the Pressures of Systemic Risk Concerns Will Warp the Rule of Law</i>	17
B. <i>The CHOICE Act's Bankruptcy Alternative Will Not Work Because There Is No Liquidity Source for the Bridge Company</i>	17
C. <i>The CHOICE Act's 48-Hour Stay for Qualified Financial Contracts Will Result in Runs and Make It Harder to Sell the Equity of the Bridge Company</i>	19
D. <i>The CHOICE Act Makes No Provision for Resolution of Cross-Border Assets</i>	20
E. <i>The CHOICE Act Has a "Wall Street First" Priority Scheme</i>	20
F. <i>The CHOICE Act Encourages Moral Hazard and Preferential Transfers to Insider Creditors</i>	20
G. <i>Because the CHOICE Act's Bankruptcy Route Is Unworkable, Ad Hoc Bailouts Will Inevitably Happen in Response to Crises</i>	21
CONCLUSION	21

Chairman Hensarling, Ranking Member Waters, Members of the Committee:

Good morning. Thank you for inviting me to testify at this hearing. My name is Adam Levitin. I am a Professor of Law at the Georgetown University, where I teach courses in financial regulation and bankruptcy, among other topics. I am here today solely as an academic who studies financial regulation and insolvency and am not testifying on behalf of any organization or regulated entity. I also have no financial interest implicated by the proposed legislation beyond that of an ordinary citizen.

Today's hearing is on the Financial CHOICE Act, which is billed as an alternative to the Dodd-Frank Wall Street Reform and Consumer Protection Act. The Dodd-Frank Act is overall an excellent piece of legislation that represents a giant leap forward in financial regulation from where the United States stood at the time of the financial crisis. The Dodd-Frank Act is not perfect, however. It does not end too-big-to-fail, and it will not necessarily prevent future bailouts. The CHOICE Act, though, is the wrong solution to Dodd-Frank's shortcomings, and would seriously endanger the U.S.'s financial stability. Simply put, the CHOICE Act is a prescription for a financial crisis.

CHOICE Act represents a choice: a choice to prioritize laissez-faire ideology over careful and serious policy analysis and reasoning. And make no mistake: that laissez-faire ideology translates directly into a massive subsidy for the too-big-to-fail banks and for the bad actors in the financial services industry. However many times the lofty terms "choice" and "hope" and "liberty" and "freedom" and "accountability" are used in the bill's section headings, the CHOICE Act is nothing more than giant giveaway to the biggest banks and to outright fraudsters.

Take, for example, one relatively minor provision in the CHOICE Act, section 335, which would repeal the bipartisan Durbin Interchange Amendment to the Dodd-Frank Act.¹ The repeal of the Durbin Interchange Amendment would result in merchants paying an extra \$8 billion a year in debit card swipe fees to the 110 largest banks. Much of that extra \$8 billion in additional fees will get passed through to consumers in the form of higher prices and worse service. Put another way, section 335 of the CHOICE Act is an \$8 billion annual tax on consumers and merchants that is then handed over to subsidize the 110 largest banks in the United States. How is consistent with ending too-big-to-fail? The CHOICE Act would actually *subsidize* too-big-to-fail megabanks.

And what about the 12,138 community banks and credit unions that are not affected by the Durbin Interchange Amendment's price caps? The CHOICE Act leaves them to compete on an uneven playing field against the megabanks.² The CHOICE Act would make it harder for community banks and credit unions to compete for deposit business by ensuring that the megabanks could use swipe fees to fund rewards programs to attract consumers and thus dominate the deposit market. (Don't think for a second that those rewards you get are "free"—there's no such thing as a free lunch in finance.) So there is a choice here: a choice to subsidize the megabanks at the expense of Main Street, consumers, community banks, and credit unions. This provision, in a nutshell, captures the hypocrisy of the CHOICE Act. The CHOICE Act is a choice of Wall Street over Main Street, a choice to favor megabanks over community banks, and a choice to favor predatory financial firms over consumers.

¹ CHOICE Act § 335.

² James DiSalvo & Ryan Johnston, *How Dodd-Frank Affects Small Bank Costs*, Fed. Reserve Bank of Phila. Research Dept., 14 16-17Q1 2016 (finding that "evidence does not support the claim that competitive forces have effectively imposed the interchange ceiling on small banks").

The CHOICE Act is a lengthy piece of legislation, and I do not attempt to critique it provision-by-provision in this testimony. Instead, my testimony focuses on the first three titles of the CHOICE Act, with occasional reference to provisions in other titles because the effect of these titles can only be understood when viewed together.

Title I gives highly capitalized banks the ability to opt-out of Basel III capital and liquidity requirements and the Dodd-Frank heightened prudential standards systemic risk regulatory system. While I believe there are serious problems with the proposed trade off of higher capital requirements for other types of prudential regulation, it is important to recognize that title I of the CHOICE Act cannot be sensibly analyzed in isolation from the CHOICE Act's other provisions. Not only does title I of the CHOICE Act remove regulators' ability to mitigate systemic risk from many of the largest banks, but title III of the CHOICE Act strips away effective consumer protections, giving unscrupulous financial institutions free rein to engage in predatory, but unsustainable lending practices, as happened in the run-up to the 2008 crisis. When a systemic crisis occurs, as it inevitably will under a CHOICE Act regime, title II of the CHOICE Act ensures that the result will be an unmanageable mess that will ultimately result in a messy bailout, as title I denies regulators key crisis response tools. The CHOICE Act throws fuel on the fire while taking away the fire department's hoses. In short, the CHOICE Act is a recipe for financial disaster.

I. A SIMPLE LEVERAGE REQUIREMENT ALONE IS INADEQUATE TO ENSURE FINANCIAL STABILITY

The signature provision of the CHOICE Act is the replacement of a host of regulatory requirements designed to ensure against the failure of systemically important financial institutions with a simple, rather than a risk-weighted leverage requirement. That simple leverage requirement is a ratio of 10% "tangible equity" to "leverage exposure",³ which is nothing more than the Basel III "Supplementary Leverage Ratio" (SLR).⁴

Specifically, the CHOICE Act would permit banks and credit unions with an SLR of at least 10% and a composite CAMELS rating of 1 or 2 to elect to be exempted from various regulatory requirements, including Basel III capital and liquidity standards, deposit concentration limits, and the "heightened prudential standards" applicable to larger financial institutions under section 165 of the Dodd-Frank Act, namely living wills, periodic credit exposure reports, credit exposure limits, short-term debt limits, internal risk committees, and (for non-banks) stress tests.

A. The CHOICE Act Actually Involves Two Choices, One of Which Is Reasonable, and the Other of Which Is Dangerous

Although the CHOICE Act is structured as a single opt-out provision, it is important to recognize that the CHOICE Act is actually proposing *two separate regulatory tradeoffs* because only the megabanks are subject to the Dodd-Frank heightened prudential standards:

³ CHOICE Act §§ 101-102. It's ironic that the CHOICE Act section 335 proposes the repeal of the Durbin Interchange Amendment as an improper intervention in the market through price caps, yet imposing a similar type of fiat regulation in terms of financial institution capital requirements.

⁴ The numerator in the CHOICE Act's ratio is tangible equity—Common Equity Tier 1 plus additional Tier 1 capital (and Trust Preferred Securities for smaller banks), while the denominator is the "total leverage exposure" as defined in 12 C.F.R. § 3.10(c)(4)(ii). This is just the "Supplemental Leverage Ratio" of 12 C.F.R. § 3.10(c)(4).

- (1) For community banks, the CHOICE Act would allow the use of the 10% SLR in lieu of the Basel III capital and liquidity standards. This means that community banks could use a simple leverage ratio instead of a risk-weighted leverage ratio.
- (2) For megabanks, the CHOICE Act would allow the use of the 10% SLR in lieu of the Basel III capital and liquidity standards *and the Dodd-Frank heightened prudential standards*.

Recognizing that there are these two separate tradeoffs within the CHOICE Act is key to seeing the CHOICE Act's problems. The first trade, that of a simple leverage ratio for risk-weighted leverage ratios and only for community banks, has much to commend it, although I believe it could be better designed. A simple leverage ratio has much to commend it over a risk-weighted leverage ratio because it can be less gameable and distortionary if designed well. (Unfortunately, the CHOICE Act's leverage ratio is not well-designed, as discussed below.) Likewise, the use of a leverage ratio like the SLR that includes off-balance sheet exposures, is a better measure than one that only looks to on-balance sheet exposures, given the frequent reality of implicit recourse in the financial system.

But the second trade, that of a simple leverage ratio for risk-weighted leverage ratios *and* relief from the Dodd-Frank heightened pleading standards is hugely problematic and is an unnecessary and dangerous giveaway to the megabanks. Ounce for ounce, the best approach to safety and soundness is requiring more equity. But it does not follow that the best regulatory approach is *only* a simple equity requirement. An effective financial regulatory system incorporates a strong capital requirement with a comprehensive range of other safety-and-soundness tools. Thus, other proposals for higher leverage requirements, such as the Brown-Vitter bill in the Senate⁵ and FDIC Vice-Chairman Hoenig's regulatory relief plan, would maintain additional regulatory safeguards against excessively risky business practices. Strong capital requirements are a necessary, but not sufficient condition for ensuring systemic financial stability.

B. The CHOICE Act's Two-Tracked Approach to Financial Stability Courts Disaster

For both community banks and megabanks, the CHOICE Act sets up a two-tracked approach to financial regulation: a track of financial institutions subject to a Basel III and a paired-down Dodd-Frank Act and a track of financial institutions that opt out of Basel III and the Dodd-Frank Act altogether. This is a remarkably bad idea that courts disaster not just for the opt-outs, but for those institutions that remain subject to the manqué Dodd-Frank regime. If an opt-out institution fails, the effect will not just be borne by its shareholders. Instead, it may well drag down financial institutions that have *not* opted out of the Dodd-Frank regulatory regime and are relying on ex-ante regulation for safety-and-soundness, not on higher capital levels.

In other words, the CHOICE Act does not prevent systemic externalities. Instead, it relies on nothing other than blind ideological faith on opt-out institutions not failing. If history has taught us anything it is that there are lots of ways for a financial institution to fail. Either all financial institutions need to be under the Dodd-Frank regulatory regime or they all need to have higher capital levels. The CHOICE Act's pick-your-own-adventure approach, however, could result in the worst of both worlds.

⁵ Terminating Bailouts for Taxpayer Fairness Act of 2013, S.798 (113th Congress).

C. Shareholder Discipline Is Ineffective and Often Counterproductive for Managing Risks at Financial Institutions

The CHOICE Act relies on shareholder discipline rather than on regulators to ensure that the financial institutions that opt out of Dodd-Frank do not take on excessive risks. While I share some of the CHOICE Act's sponsors' skepticism of the effectiveness of financial regulators,⁶ relying on markets alone to discipline risk-taking is unrealistic. Financial institutions, particularly large, complex ones, have opaque balance sheets that make it hard for the market to know what a financial institution is up to until it is too late. Market discipline for financial institutions is often after-the-fact.

Market discipline can also push banks to take on excessive risks because shareholders often prioritize short-term gain over long-term value. Thus, during the housing bubble, Countrywide Financial, one of the most aggressive players in the mortgage market, was the market's darling from 2001 until mid-2007, far outperforming other S&P 500 banks.⁷ In contrast, JPMorgan Chase was more conservative than many of the other large banks, and its stock underperformed that of other S&P 500 banks during the same period.⁸ The market rewarded the risky, and ultimately disastrous strategy. So much for market discipline reliably preventing excessive risk-taking.

There should be no more cautionary words in this regard than those of then-Citigroup CEO Charles E. Prince regarding why Citigroup continued to be long on the housing market despite Prince's doubts, "When the music stops, in terms of liquidity, things will be complicated. . . . But as long as the music is playing, you've got to get up and dance. We're still dancing."⁹ Not long afterwards Citigroup was bailed out.

Market discipline has a role to play in financial regulation, but market discipline alone will result in financial instability. Indeed, market discipline is likely to push firms that opt out of Basel III capital requirements to pursue *greater* risks. Firms that opt out of Basel III under the CHOICE Act will be less highly leveraged than those that remain under Basel III. Opt-out firms will have to compete for capital with firms that are subject to Basel III. Less leveraged firms have lower returns on equity, all else being equal. Therefore, in order to compete for capital with more leveraged firms, a less leveraged firm has to assume greater risks in order to equal the more leveraged firms' return on equity. Put another way, market discipline on share prices is likely to encourage excessive risk-taking at firms that opt-out of Basel III.

D. The CHOICE Act Does Not Address Illiquidity, Which Is the Immediate Cause of Financial Crises

A major shortcoming of the CHOICE Act's opt-out option for all banks is that it only addresses solvency, not liquidity. If the policy goal is to prevent taxpayers from bearing the cost of the failure of systemically important financial institutions, then ensuring that these institutions are unlikely to fail is a good place to begin. A strong equity cushion is the best guard against *insolvency*, but the problem for systemically important financial institutions is not typically insolvency, but *illiquidity*. (Illiquidity ultimately begets insolvency, but it is illiquidity that results in the firm's failure.) While an equity cushion will help reduce ultimate losses from an insolvency, it will not prevent the

⁶ See Adam J. Levitin, *Safe Banking: Finance and Democracy*, 83 U. CHIC. L. REV. 357 (2016).

⁷ William W. Bratton & Michael Wachter, *The Case Against Shareholder Empowerment*, 158 U. PA. L. REV. 653, 716-723 (2010).

⁸ *Id.* at 720-21.

⁹ Stephen Kotkin, *A Bear Saw Around the Corner*, N.Y. TIMES, Jan. 4, 2009, at BU2 (reviewing and quoting from JAMES GRANT, MR. MARKET MISCALCULATES: THE BUBBLE YEARS AND BEYOND (2008)).

market disruption and spillover effects from a firm being illiquid, particularly when paired with the unworkable financial institution bankruptcy system envisioned by the CHOICE Act (discussed below) and the disabling of regulators' emergency response tools (also discussed below). A simple equity requirement does nothing to prevent against illiquidity. Unfortunately, nothing in the CHOICE Act addresses the illiquidity risk, which is the real regulatory problem.

E. The Use of a Simple Leverage Ratio Without Other Protections Incentivizes Risky Bank Behavior

The CHOICE Act gives banks the options of being subject to a simple leverage ratio instead of a risk-weighted leverage ratio. A simple leverage ratio has much to commend it relative to a risk-weighted leverage ratio. Risk-weightings are imprecise (risks do not come only in buckets of 20%, 50%, and 100%, but constitute a spectrum), politicized (e.g., lower risk-weighting for sovereign and mortgage assets), and gameable. A simple leverage ratio avoids all of those problems. On the other hand, a simple leverage ratio incentivizes banks to load on up riskier—and thus higher yielding—assets. This problem with a simple leverage ratio can be mitigated, but only if there are other regulatory tools, such as credit exposure limits and liquidity requirements. The CHOICE Act, unfortunately, would adopt a simple leverage ratio while eliminating the regulatory tools necessary to prevent banks from gaming the simple leverage ratio by seeking out high-risk assets.

F. The CHOICE Act's 10% Leverage Ratio Is Gameable

The CHOICE Act's measure of capital for the 10% leverage ratio is gameable, enabling firms to opt out of Dodd-Frank without really having a 10% leverage ratio on a regular basis. The CHOICE Act measures firms' leverage ratios on the last day of the quarter. This enables a strategy similar to the infamous Lehman Brothers Repo 105, in which assets are moved off-balance sheet just for the day of capital measurement. While the CHOICE Act's leverage exposure measure includes off-balance sheet exposures, I have little doubt that bank lawyers and accountants will find work-arounds through various capital relief trades. A better approach would be to require a running daily average of capital ratios.

G. There Is No Evidentiary Basis for the Choice of a 10% Leverage Ratio

Even if one were to believe that a simple equity ratio alone is the right regulatory approach, there is the subsidiary question of whether 10% is the right level. *There is no basis whatsoever for a 10% number.* The 10% number adopted by the CHOICE Act is apparently indirectly derived solely from research by Bank of England Chief Economist Andrew Haldane.¹⁰ The problem is that the Haldane research does not in fact support a 10% simple leverage ratio, much less as a substitute for other regulatory supervision, and in fact no research supports a 10% leverage ratio. The CHOICE Act's 10% figure is just made up.

The Republican memorandum on the CHOICE Act credits the Haldane research for the proposition that no bank with a simple leverage ratio of over 10% failed or was bailed out in the last financial crisis.¹¹ This is a narrowly correct reading of a *graph* in Haldane's research, but Haldane does *not* draw the conclusion that a 10% level is the right level for a simple leverage ratio. Instead, his point was merely that simple leverage ratios are generally more effective than risk-weighted

¹⁰ House Committee on Financial Services, *The Financial Choice Act: Creating Hope and Opportunity for Investors, Consumers, and Entrepreneurs—A Republican Proposal to Reform the Financial Regulatory System*, June 23, 2016, 36-37 (citing Andrew Haldane, Address at the Federal Reserve Bank of Kansas City's 366th economic policy symposium: *The dog and the Frisbee* (Aug. 31, 2012), available at <http://www.bis.org/review/r120905a.pdf>).

¹¹ *Id.*

leverage ratios at predicting bank failure.¹² He finds statistical significance regarding the use of simple leverage ratios, rather than risk-weighted ratios, as predictors of bank failure,¹³ but nowhere does Haldane suggest that the simple leverage ratio should be 10%. Indeed, Haldane's data are incapable of supporting that conclusion. Haldane's research involved a sample of only 37 banks.¹⁴ Only *one* of those banks had a leverage ratio of over 10%,¹⁵ making it impossible for his data to support any statistically valid claim about a 10% level. Moreover, whether or not banks failed in 2008-2009 did not occur in a vacuum; but for the massive government intervention in those years surely more banks would have failed. And, Haldane's research does not control for the particular regulatory schemes applicable to those banks other than their capital levels. Haldane's research, then, supports the use of a simple leverage ratio, rather than a risk-weighted leverage ratio, but it says nothing about 10% being the proper threshold.

It is also important to note that Haldane does not argue that a simple leverage ratio alone is all that is needed. In the same research relied upon by the Republican memorandum, Haldane outlines five interlaced policy measures needed to achieve financial stability, including "strengthening supervisory discretion" and "regulating complexity explicitly."¹⁶ Thus, Andrew Haldane's work does not support the idea of a leverage requirement of any sort *instead of* other regulation. There is no evidentiary basis for choosing a 10% leverage ratio. It is a number plucked out of the air.

H. The CHOICE Act Eliminates Protections Against Excessive Risk-Taking by Financial Institutions

Another reason the CHOICE Act's reliance on a 10% simple leverage ratio is inadequate is that the CHOICE Act eliminates key protections to ensure that capital adequacy is never put to the test in the first place. Among other provisions, the CHOICE Act:

- exempts nonbank financial institutions that make the capital election from virtually all federal prudential regulation;¹⁷
- repeals the Volcker Rule, which prohibits financial institutions from engaging in proprietary investments using depositor funds.¹⁸ By repealing the Volcker Rule, the CHOICE Act is practically begging financial institutions to engage in high-risk speculative behavior;
- eliminates federal regulators' ability to prescribe risk management standards for critical financial market utilities such as clearinghouses.¹⁹ The Dodd-Frank Act requires most types of swaps to be cleared through clearinghouses.²⁰ Mandated central clearing is preferable to bilateral clearing, it does have the effect of making clearinghouses unique nodes of concentrated risk in the financial system.²¹ A well-managed clearinghouse should be able to manage such risk. Accordingly, the Dodd-Frank Act gave regulators the power to prescribe

¹² Andrew Haldane, Address at the Federal Reserve Bank of Kansas City's 366th economic policy symposium: *The dog and the Frisbee* (Aug. 31, 2012), available at <http://www.bis.org/review/r120905a.pdf>, at 10-11.

¹³ *Id.* at 11.

¹⁴ *Id.* at 10.

¹⁵ *Id.* at 29, Chart 5.

¹⁶ *Id.* at 14.

¹⁷ CHOICE Act § 102(a)(8).

¹⁸ CHOICE Act § 901.

¹⁹ CHOICE Act § 251 (proposing repeal of Dodd-Frank Act title VIII).

²⁰ Dodd-Frank Act section 723.

²¹ Adam J. Levitin, *The Tenuous Case for Derivatives Clearinghouses*, 101 GEO. L.J. 445 (2013).

risk management standards for clearinghouses and similar utilities to ensure that they are well-managed. The tracking of risk and regulation reflects the Spiderman principle of financial regulation: with great risk goes great regulation. Unfortunately, the CHOICE Act keeps the clearinghouse requirement, but eliminates regulators' ability to ensure that clearinghouses are in fact well run. The result is an enormous government handout to the clearinghouses: the clearinghouses receive a legally blessed monopoly, but without any regulatory oversight;

- eliminates the risk retention requirement for securitizations of non-residential mortgage.²² The risk retention requirement is an anti-moral hazard provision that recognizes the temptation of securitizers to use their informational advantage over investors to shift greater risks to investors than the investors realize;
- makes it difficult for U.S. regulators to coordinate with foreign financial regulators for the purpose of monitoring and mitigating threats to financial stability.²³

The CHOICE Act also has numerous provisions that make it difficult for the SEC to pursue enforcement actions and achieve meaningful relief. These provisions reduce the SEC's deterrence ability and thereby embolden financial fraudsters whose malfeasance can reverberate throughout the financial system. Among other provisions, the CHOICE Act:

- requires the SEC to make additional findings before levying civil monetary penalties against issuers.²⁴ Thus, while the CHOICE Act increases financial fraud penalties with the one hand,²⁵ with the other it ensures that those penalties will rarely be imposed.
- repeals the SEC's authority to issue officer and director bans.²⁶ This means that even the worst fraudsters will continue to be able to participate in securities markets.
- eliminates automatic bad actor disqualification from securities law exemptions even for firms that have been *convicted of felonies*.²⁷ Apparently a convicted felon cannot be trusted with the right to vote, but can be trusted with pension funds and retirees' savings.

To be fair, the CHOICE Act arguably requires some degree of additional safety-and-soundness regulation by providing that the 10% simple leverage ratio alternative is available to banks only if they received a CAMELS rating of 1 or 2 as of their last examination before the election.²⁸ The high CAMELS rating requirement, however, applies only to depository institutions, not to non-banks, which do not have CAMELS ratings, and the CHOICE Act exempts non-banks from virtually all regulation by federal regulators.²⁹ Thus, a non-bank financial institution need only meet the 10% capital requirement, nothing more, to avoid the Dodd-Frank heightened prudential standards.

Moreover, the CAMELS rating requirement is a one-time requirement that applies only when the bank elects the alternative ratio. A bank's CAMELS rating could fall thereafter, but it would not be resubjected to the full battery of Dodd-Frank Act regulatory requirements. In short,

²² CHOICE Act § 442.

²³ CHOICE Act § 671.

²⁴ CHOICE Act § 417.

²⁵ CHOICE Act §§ 801-811

²⁶ CHOICE Act § 418.

²⁷ CHOICE Act § 419.

²⁸ CAMELS is an acronym for Capital adequacy, Asset quality, Management, Earnings, and Liquidity.

²⁹ CHOICE Act § 102(a)(8).

the CAMELS rating requirement does not do a lot of work. Under the CHOICE Act, there really is nothing but a cushion of 10% equity standing between a financial institution and failure, even if that failure has systemic consequences.

I. The CHOICE Act Eliminates Key Regulatory Tools for Responding to Crises

The CHOICE Act not only takes away regulators' tools for preventing crises, but it takes away their tools for responding to crises. The CHOICE Act repeals the FDIC's ability to create a widely available program to guaranty the obligations of solvent depositories and their holding companies during times of severe economic stress.³⁰ The CHOICE Act also renders the Federal Reserve's emergency lender-of-last-resort power under section 13(3) of the Federal Reserve Act effectively unusable by requiring the Federal Reserve Board and all federal banking regulators with jurisdiction over the borrower to certify that the borrower is not insolvent at the time of initial borrowing.³¹ Making an affirmative determination of solvency is timely and costly and not something that federal regulators can do on a market-wide scale during a crisis. As a result, if there is a fire in the financial sector, the firemen will be without hoses.

J. The CHOICE Act Ensures that Regulators Will Be Ineffective with Their Remaining Tools by Subjecting Them to Political Harassment and Micromanagement

The CHOICE Act not only takes away key crisis prevention and crisis response tools from regulators, but it also effectively ensures that regulators will not be able to adequately use even the tools they have left. The CHOICE Act ensures regulatory ineffectiveness by creating a system that facilitates political harassment and micromanagement of regulators. To wit, the CHOICE Act includes:

- an unprecedented prohibition against any significant new financial regulations from taking effect unless both Houses of Congress approve within 70 days.³² Given Congressional deadlock, this all but ensures that there will be no further financial regulation, period;
- the elimination of the long-standing Supreme Court precedent that requires courts to defer to the subject-matter experts in regulatory agencies when reviewing agency rulemakings.³³ The lack of judicial deference will encourage financial institutions to bring court challenges to all actions taken by financial regulators;
- an inappropriate cost-benefit analysis requirement for all financial regulatory rulemakings (without even subjecting the cost-benefit analysis requirement to cost-benefit analysis).³⁴ Formal cost-benefit analysis requirements are nothing more than a way to slow the regulatory process and enable court challenges to regulation;

³⁰ CHOICE Act § 241.

³¹ CHOICE Act § 707. I note that this provision is similar to that proposed in the Warren-Vitter bill in the Senate. While the provision has much to commend it in isolation, as it is in the Warren-Vitter bill, it is more problematic when combined with the other provisions of the CHOICE Act that incentivize banks to engage in riskier behavior in the first place.

³² CHOICE Act § 632.

³³ CHOICE Act § 641. Apparently access to the courts is a good thing when it benefits businesses, but not when it benefits consumers. *Cf.* CHOICE Act § 338 (stripping CFPB of authority to limit binding mandatory arbitration).

³⁴ CHOICE Act § 612. Regarding the appropriateness of cost-benefit analysis in financial regulation, see John C. Coates IV, *Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications*, 124 YALE L.J. 882 (2015) (arguing that cost-benefit analysis is only appropriate when its benefits exceed its costs, which are unlikely in the financial regulatory area because of the highly speculative nature of regulations' impacts on the economy).

- a requirement that regulators spend time constantly reviewing past rulemakings with an eye toward deregulation.³⁵

The CHOICE Act would also put all financial regulators onto appropriations,³⁶ creating the possibility of undue political interference with regulation and giving Wall Street a second bite at the apple through backroom influence on the appropriations process. Altogether, then the various provisions of the CHOICE Act will guaranty ineffective regulators. The result will be free rein for Wall Street to engage in systemically risky behaviors.

K. The CHOICE Act Is About Helping Megabanks, Not Community Banks; There Are Better Ways to Help Community Banks

To the extent that the CHOICE Act's 10% leverage ratio alternative is in fact meant to help primarily community banks, I applaud the goal, but I would underscore that there are better and more direct ways to do so. The Basel III capital and liquidity rules are a poor fit for America's community banks, and I support targeted regulatory relief, including different regulatory capital requirements and a separate charter, for community banks, which already struggle to compete in a market where economies of scale are often key. Community banks' operations and risks are simply different from megabanks, and so too should their regulation be different.

The CHOICE Act, however, opens the door not just for regulatory relief for community banks, but also for megabanks. That is particularly dangerous because the regulatory safeguards such as the Volcker Act that the CHOICE Act would eliminate are especially important for megabanks. An easy fix (although probably not the optimal one) would be to restrict Title I of the CHOICE Act to community banks (reasonably defined as having under \$10 billion or, perhaps even under \$2 billion in consolidated assets).

It is hard to believe that the CHOICE Act is really about helping community banks. There's a telltale sign: the CHOICE Act would exempt firms with 10% leverage ratios from the Riegle-Neal Act limitation on a single bank acquiring by merger over 10% of the deposits in the United States.³⁷ That is an exemption that, by definition, can only benefit a megabank. Thus, the CHOICE Act not only disarms financial regulators, but it paves the road for megabanks to get even bigger and riskier.

Title I of the CHOICE Act, then, primes the pump for a financial disaster. Title III, discussed next, pours more fuel on the fire by gutting consumer financial protections. And Title II of the CHOICE Act creates a regime for resolving the mess that will flow from Titles I and III. Unfortunately, that resolution regime is totally unworkable and because it is unworkable, the result will be *ad hoc* bailouts.

II. THE CHOICE ACT WOULD EFFECTIVELY ELIMINATE CONSUMER PROTECTION AGAINST SHARP FINANCIAL PRACTICES AND DISCRIMINATORY LENDING

Consumer spending drives the American economy, and consumer spending goes through the financial system. To the extent that pervasive problems emerge in the consumer finance space, they are likely to cause far-reaching economic problems. Accordingly, strong consumer financial protection is a key component of financial stability. The Dodd-Frank Act achieved a singular

³⁵ CHOICE Act §§ 615-616.

³⁶ CHOICE Act §§ 661-665.

³⁷ CHOICE Act § 102(a)(5) (exemption from section 18(c)(13) of the FDIC Act), 102(a)(9) (exemption from any federal law, rule, or regulation that would impose a deposit concentration limit).

success in this area with the creation of the CFPB, an effective, unconflicted regulator dedicated to consumer financial protection. The CFPB is the only federal financial regulator to finish all of its Dodd-Frank Act rulemakings on schedule, and in just a few years of existence it has already achieved over \$11 billion in consumer relief, benefitting nearly 20 million consumers.³⁸ These results dwarf the relief achieved by nearly a dozen regulators over the course of the previous two decades. In short the CFPB has been a remarkably effective regulator.

A. The CHOICE Act Would Eliminate Effective Federal Consumer Financial Protection

The CHOICE Act would destroy the CFPB. It would do so in the most Orwellian fashion, creating a rebranded “Consumer Financial Opportunity Commission” that has little real ability to undertake any rulemaking or enforcement. Indeed, the proposed Consumer Financial Opportunity Commission would literally fulfill its name—it would ensure that consumers are financial opportunities for businesses engaged in sharp practices. And in such an unfettered market, the bad will drive out the good,³⁹ as consumers cannot readily distinguish good actors from bad ones. This is a market that no honest business should want.

The CHOICE Act destruction of the CFPB begins by changing the CFPB’s structure from that of a single director to a commission. If that were the only change proposed, it would be an issue about which reasonable minds could disagree in good faith. I believe there are good reasons to have a single director, but there are credible arguments that can be made in favor of a commission structure. The problem is that the proposed change in leadership structure is not the only CFPB amendment proposed by the CHOICE Act. When the transformation to a commission structure is coupled with the complete neutering of the CFPB’s rulemaking, supervision, and enforcement powers, intense political interference and micromanagement,⁴⁰ and provisions that will make it impossible for the CFPB to attract highly-qualified personnel, it is clear what is afoot: the CHOICE Act seeks to create an utterly ineffectual consumer financial services regulator so that bad actors will have free rein to take advantage of consumers, with the toothless agency serving as a beard against any constituent political pushback. In other words, the CHOICE Act will take consumer financial protection back to the pre-Dodd-Frank Act days when it did not exist in any meaningful way on the federal level.

B. Elimination of the “Abusive” Standard Will Allow for Sharp Practices that Do Not Meet the Narrow Definitions of “Unfair” and “Deceptive”

To see just how the CHOICE Act neuters the CFPB, consider what the CHOICE Act does with the Dodd-Frank Act prohibition on “abusive” acts and practices.⁴¹ The “abusive” prohibition was one of the more controversial provisions of the Dodd-Frank Act. Critics have questioned what exactly falls within the scope of the abusive prohibition, which is not defined by statute. (The statute imposes restrictions on the CFPB’s ability to make rules designating acts and practices as

³⁸ CFPB, Consumer Financial Protection Bureau by the Numbers, July 21, 2015, at http://files.consumerfinance.gov/f/201507_cfpb_factsheet-by-the-numbers.pdf.

³⁹ George A. Akerloff, *The Market for “Lemons”: Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970).

⁴⁰ The CHOICE Act would subject the CFPB to Congressional appropriations. Although I appreciate the impulse for there to be democratic accountability for regulatory agencies, the appropriations process is not simply about democratic accountability. It is an opportunity for horse-trading, logrolling, and backdoor policy changes. Subjecting the CFPB to appropriations simply ensures that consumer financial protection can be held hostage every budget cycle. That is likely to result in a one-way deregulatory ratchet. The whole reason the CFPB is not currently subject to appropriations is so it will not be dragged down by Congressional dysfunction and politics.

⁴¹ Dodd-Frank Act § 1036.

abusive,⁴² but does not define “abusive” per se.) To date, the CFPB has not finalized any rulemakings under the abusive prohibition, and it has undertaken only a handful of enforcement actions that invoke the abusive standard. The prohibition on abusive acts and practices is a critical gap-filler for the traditional prohibition against unfair and deceptive acts and practices (UDAP). Too many things can fall between the cracks of “unfair” and “deceptive” as currently interpreted. Unfair requires a cost-benefit analysis that allows sharp practices to continue if they benefit *some* consumers even at the expense of others. Deceptive requires an actual misleading statement or omission. That is hardly the universe of sharp practices. For example, consider the following practices that might qualify as abusive, and that should, at the very least, give us pause:

- A lender lending to consumers whom the lender knows cannot repay in full and on-time (likely because the lender receives high rollover or upfront fees or has the ability to sell the loan to a third party);
- A lender whose business model anticipates default rates of over 50%;
- A loan broker steering consumers into higher cost loans when they qualify for lower cost ones because the high cost loan will result in greater compensation for the broker might both qualify as abusive.

There is a reasonable critique of the “abusive” power as drafted, namely that the statute should actually define “abusive”, rather than limit what the CFPB can do in terms of rulemaking. The CHOICE Act, however, does not just restrict the CFPB’s power under 12 U.S.C. § 1131 to undertake rulemakings designating certain acts and practices as “abusive.” Nor does the CHOICE Act tighten the definition of “abusive.” Instead, the CHOICE Act actually makes “abusive” acts and practices *legal* by also repealing 12 U.S.C. § 1136.⁴³ Apparently financial liberty includes the liberty to engage in abusive acts and practices.

C. The CHOICE Act Facilitates Discriminatory Lending

Financial liberty also apparently includes the right to engage in discriminatory lending. Among the most invidious provisions in the CHOICE Act are a trio that would shield discriminatory lenders from legal repercussions. The CHOICE Act would nullify the CFPB’s indirect auto lending guidance and impose an onerous process for any future guidance.⁴⁴ The CHOICE Act would reduce the data collected under the Home Mortgage Disclosure Act, a key anti-discriminatory lending law.⁴⁵ And under the cynical heading of “Right to Lend,” the CHOICE Act would prohibit data collection on small business lending, ensuring that regulators will lack the data necessary to conduct examinations for discriminatory small business lending.⁴⁶ The choice being made by the CHOICE Act is a choice to protect discriminatory lending.

D. The CHOICE Act Effectively Prevents Regulation of Payday Lending in Any State

The CHOICE Act showers love on payday lenders. Section 333 of the CHOICE Act allows states and Indian tribes to opt out of federal out of payday regulation. The opt-out can be renewed perpetually. There are other state opt-out provisions in federal consumer financial protection statutes, but those provisions are designed to allow for *greater* not *lesser* state consumer protection.⁴⁷

⁴² Dodd-Frank Act § 1031.

⁴³ CHOICE Act § 337.

⁴⁴ CHOICE Act § 334.

⁴⁵ CHOICE Act § 1171(c).

⁴⁶ CHOICE Act § 1161.

⁴⁷ See, e.g., 12 U.S.C. § 3804.

More critical, however, is that *lenders in states and Indian tribes that opt-out of federal regulations are still permitted to lend across state lines*. The result is to ensure that federal regulation of payday lenders is ineffective even in states that want regulation. If the issue is states rights, states should be permitted to opt-out of the federal regulation, but lenders should *also* be limited to lending only in-state or within tribal territory. Indeed, if states rights are so important in financial regulation, then Congress should move to overturn the Supreme Court's *Marquette* decision that allowed national banks to export interest rates.⁴⁸

E. The CHOICE Act Facilitates Risky Mortgage Lending

The CHOICE Act also eviscerates consumer protections in mortgage lending. In mortgage lending, the CHOICE Act raises the trigger threshold for what is considered a “high cost” mortgage loan,⁴⁹ and thus subject to additional regulatory protections. It also creates a portfolio lending safe harbor for the Dodd-Frank Act's “ability to repay” requirement.⁵⁰ While portfolio lending does not have the same moral hazard potential as securitization, it does not guaranty an alignment of lender and borrower interests, and even if it did, we know from experience that portfolio lenders can make lots of mistakes—Washington Mutual and Countrywide retained many of their option-ARMs in portfolio, and the entire S&L crisis was about portfolio lenders.

F. The CHOICE Act Will Produce a Brain-Drain at the CFPB

The CHOICE Act not only attacks the CFPB's substantive powers, but it also aims to create a calamitous brain drain at the CFPB. The CFPB has assembled an amazing talent pool, equaled by few, if any government agencies. Part of the attraction of working at the CFPB is its mission-driven culture, but part is undeniably that the CFPB offers more competitive pay. The alternative employment for many CFPB employees is with the private sector financial institutions the CFPB regulates. If the CFPB had to pay regular GS pay scale, as proposed by the CHOICE Act,⁵¹ it would not be able to attract top-flight talent.

Likewise, a key part of the CFPB, as an evidence-driven agency, is its research unit. The CHOICE Act would effectively destroy the CFPB's research unit's ability to get data and thus to attract talented researchers. Section 324 of the CHOICE Act requires that the CFPB (or CFOF) make public all data, studies, and other analysis on which its research papers are based.⁵² It bears underscoring that CFPB research papers are not policy positions, but studies by economists and other scholars who work for the CFPB.⁵³ Those researchers come to the CFPB with the express understanding that they will have to commit a certain percentage of their time to working in support of CFPB regulatory activities, but that they will also have a certain percentage of their time available to purpose research of their choosing, as well as access to the agency's data. This is an incredible draw that enables the CFPB to compete with elite academic institutions for top-flight researchers.

⁴⁸ *Marquette National Bank v. First of Omaha Service Corp.*, 439 U.S. 299 (1978).

⁴⁹ CHOICE Act § 1101-1103.

⁵⁰ CHOICE Act § 1116.

⁵¹ CHOICE Act § 325. It is a mark of the CHOICE Act's sponsors' animus toward the CFPB that the CFPB is singled out among federal financial regulators for a reduction in pay scale.

⁵² CHOICE Act § 324.

⁵³ The official studies the CFPB has put out, such as those required by Congress under section 1028 of Dodd-Frank regarding arbitration, have been scrupulously non-interpretive, but simple presentations of statistical information.

Many data sources that the CFPB has cannot be publicly disclosed as a matter of contract, and the CHOICE Act would make others prohibitively expensive to disclose.⁵⁴ Requiring publication of these data sources means that the CFPB will not be able to publish research papers, and that will create a serious brain drain (and adverse selection) in the CFPB's research unit. The result will be an ineffectual CFPB—just what Wall Street wants.

G. The CHOICE Act Prioritizes Bank Profits Over Fairness to Consumers

Most telling, though, about what really is motivating the CHOICE Act is section 332(b), which provides that the CFPB (or, to be precise, the rebranded Consumer Financial Opportunity Commission) must consider “the impact of such rule on the financial safety or soundness of an insured depository institution”.⁵⁵ “Financial safety or soundness” means profitability—an unprofitable institution is not safe or sound. In other words, the CFPB needs to consider how important an unfair or deceptive practice is to the profitability of an insured depository as part of a rulemaking. The only reason to undertake an unfair or deceptive act or practice, however, is because it is profitable. Thus, if a depository is only profitable because of an unfair or deceptive act or practice, the CFPB will have a difficult time making a rule that can withstand court challenge. This is the equivalent of saying that it is legal to rob people...as long as doing so is critical to your livelihood. The CHOICE Act cannot credibly claim to promote consumer protection when it is giving out free licenses to fleece consumers.

In sum, the CHOICE Act replace a single director with a commission to ensure regulatory dysfunction, mandates a cost-benefit analysis that makes no sense in this context,⁵⁶ legalizes “abusive” practices, it ensures that payday lenders can operate without regulation, reduces the effectiveness of protections against predatory mortgage loans,⁵⁷ effectively prevents the CFPB from policing discriminatory lending, protects all kinds of otherwise illegal acts if they are profitable, and it deprives consumers of their right to a day in court by allowing businesses to forcing them into private arbitration.⁵⁸ This is not consumer protection, but consumer abuse.

III. THE CHOICE ACT'S FINANCIAL INSTITUTION BANKRUPTCY PROPOSAL IS UNWORKABLE, PRIORITIZES WALL STREET OVER MAIN STREET, AND WOULD RESULT IN MORE BAILOUTS

To fully understand the problems created by Title I of the CHOICE Act, it is necessary to understand how they would be resolved. Title I of the CHOICE Act would eliminate a key set of prudential regulations for certain financial institutions. Title III would effectively eliminate consumer financial protection. Combined these titles and other assorted provisions of the

⁵⁴ CHOICE Act § 331. The consumer notification provisions seem to be motivated by a completely unfounded belief that the CFPB has information about individual consumers' spending choices, as opposed to aggregated spending data. If the CFPB—or any government agency—regularly collected information about individual consumer's individual purchases, I would be gravely concerned. But the CFPB's critics simply do not understand the nature of the data the CFPB collects, and have substituted paranoia for facts in this regard. See Adam J. Levitin, *The CFPB's Data Collection Is To Be Applauded*, AM. BANKER, Aug. 18, 2015. See also Hearing Before the Senate Judiciary Committee, Subcommittee on The Constitution, “The Administrative State v. The Constitution: Dodd-Frank at Five Years,” July 23, 2015 (oral testimony and written questions for the record of Prof. Adam J. Levitin).

⁵⁵ CHOICE Act § 332(b). My read is that the statute intends this provision to apply to a generic depository institution, rather than to an actual, specific depository institution, but the drafting is unclear in this regard.

⁵⁶ See Coates, *supra* note 34.

⁵⁷ CHOICE Act § 1101-1103, 1116.

⁵⁸ CHOICE Act § 338.

CHOICE Act guaranty financial crises. Unfortunately the CHOICE Act also strips regulators of key crisis management tools and instead, in title II, naively provides for financial institution resolution to be handled by the bankruptcy courts without any government assistance. The result will be spectacularly messy.

Specifically, the CHOICE Act would replace title II of the Dodd-Frank Act (the Orderly Liquidation Authority title) with a new subchapter V to chapter 11 of the Bankruptcy Code designed for “covered financial corporations”—essentially large financial holding corporations and bank holding corporations. The proposed subchapter V institutes a “good bank/bad bank” structure through bankruptcy: the good assets of the failed institution, along with its “non-capital structure” debt would be transferred to a newly created bridge company (the “good bank”). The bad assets and the capital structure debt would remain with the debtor firm (the “bad bank”). If everything works right, then after the transfer, the good bank should have clearly positive equity value, whereas the bad bank is likely insolvent. The equity of the good bank would then be sold, with the proceeds going to satisfy the claims of the creditors of the bad bank.

A. Bankruptcy Is Not Designed to Handle Systemic Risk Issues, and the Pressures of Systemic Risk Concerns Will Warp the Rule of Law

As an initial matter, it’s worthwhile noting that this structure is basically a codification of the structure used in the *GM* and *Chrysler* bankruptcies.⁵⁹ The adoption of this structure is rather surprising given the criticism of the *GM* and *Chrysler* bankruptcies by Chairman Hensarling when he was serving on the Congressional Oversight Panel for the Troubled Asset Relief Program.⁶⁰

One of the complaints about the *GM* and *Chrysler* were their supposed failure to follow bankruptcy rules of priority. While this criticism is incorrect (the absolute priority rule applies only in a cramdown confirmation, and only to unsecured claimants and equity interests), it underscores a more fundamental point: the bankruptcy system is not designed for dealing with systemic financial crises. When a non-Article III judge with no expertise in the particular debtor firm or in financial markets generally is presented with a situation in which he is told that he has to immediately approve a transaction or else the US economy will collapse, that judge is put in an untenable position and is likely to approve the transaction, whether or not it complies with the law. The rule of law virtues of the bankruptcy system will inevitably become warped when the system is dragooned to handle systemic risks that trump any law. Put differently, it is bad for bankruptcy courts to deal with systemic risk, and it is bad for systemic risk to have bankruptcy courts managing the resolution process.

B. The CHOICE Act’s Bankruptcy Alternative Will Not Work Because There Is No Liquidity Source for the Bridge Company

First and foremost among the problems with the CHOICE Act’s turn to bankruptcy is that the CHOICE Act provides no financing mechanism for the bridge company. *It is impossible to conduct a liquidation or a reorganization without financing.* This is not a matter of opinion. It is something every first-year bankruptcy associate knows. Because there is no provision for reliable financing in subchapter V, it cannot work. Period.

⁵⁹ See Jeffrey McCracken et al. *U.S. Threatens Bankruptcy for GM, Chrysler*, WALL ST. J. Mar. 31, 2009 (describing use of bankruptcy for implementing good bank/bad bank plan).

⁶⁰ CONGRESSIONAL OVERSIGHT PANEL, SEPTEMBER OVERSIGHT REPORT, USE OF TARP FUNDS IN THE SUPPORT AND REORGANIZATION OF THE DOMESTIC AUTOMOTIVE INDUSTRY, Sept. 9, 2009, at 148, 160 (additional views of Rep. Jeb Hensarling).

The bridge company will need liquidity to operate from the very moment it comes into existence. It will need to be able to pay to keep the lights on, retain employees, maintain insurance coverage, pay taxes, etc. The bridge company must have the financial wherewithal to be able to assume the contractual assets of the bad bank. The bridge company is prohibited from assuming any of the bad bank's assets unless it can show that it is likely to be able to perform on any contracts it assumes.⁶¹ Thus, unless the bridge company can obtain financing, the entire structure of the proposed subtitle V bankruptcy proceeding cannot work.

Where will financing for the bridge company's operations come from? It cannot come from the sale of the bridge company's equity, because the proceeds of that equity sale are earmarked by statute for the creditors of the bad bank.⁶² Retained earnings represented another possible source of financing, but they will take too long to accumulate in sufficient volume to finance operations.

Thus, the only way the bridge company can get funding is going to be obtaining a loan from someone, and it will need that funding on day 1 of the bankruptcy. Who is going to make that loan? Perhaps the buyer of the good bank, but that assumes that there is a buyer is waiting in the wings, who just wants to use the bankruptcy process as a way to scoop of the good assets, without the bad ones. That will not be the case in messier situations, and even when there is a stalking horse, few potential buyers will want to extend credit unless they are assured that their purchase bid will be successful.

This leaves the private lending market as a financing source. It is *absurd* to think that private capital markets will be able to underwrite multi-billion dollar loans to a newly established firm with an uncertain equity value on little or no notice at a time when credit markets are in turmoil. In order to operate as a going-concern, a large financial firm needs substantial liquidity. JPMorgan Chase, for example, has around \$500 billion in high quality liquid assets that cover peak short-term cash outflows.⁶³ It is hard to imagine private capital markets coming up with much more than *one one-hundredth* of that within the time necessary.

Many of the assets assumed by the bridge will not be high quality liquid assets, particularly because of the all/or nothing requirement regarding assumption of Qualified Financial Contracts (QFCs)— swaps, derivatives, securities and options contracts, forward and futures contracts, and master netting agreements.⁶⁴ Moreover, outflows are likely to be high given the uncertainty of the bridge company's financial strength; the bridge company will be fighting a run. Even if the bridge company does not have immediate liquidity needs of hundreds of billions, counterparties will run if that funding is not there to provide reassurance. Thus, it's quite reasonable to assume that the bridge company would need a credit facility of tens or even hundreds of billions of dollars to assuage counterparties, and possibly much, much more.

Who is going to make a \$50 or \$100 billion loan on almost no notice at a time when credit markets are in turmoil?⁶⁵ Even in good conditions, with plenty of notice, a loan of that size would be difficult, if not impossible to arrange. Consider: the largest private syndicated loan in history was \$75 billion, raised in November 2015 for AB InBev's takeover bid for SABMiller, and that syndicate

⁶¹ CHOICE Act § 232 (proposed section 1185(a)(6)).

⁶² CHOICE Act § 232 (proposed section 1186).

⁶³ JPMorgan Chase, *Firm Overview*, Feb. 23, 2016, at https://www.jpmorganchase.com/corporate/investor-relations/document/firm_overview_investor_day_2016.pdf.

⁶⁴ CHOICE Act § 232 (proposed section 1188(c)(1)).

⁶⁵ *Bankruptcy Financing Proves Elusive*, N.Y. TIMES, Oct. 13, 2008, at <http://dealbook.nytimes.com/2008/10/13/bankruptcy-financing-proves-elusive/> (noting the difficulty obtaining DIP financing in 2008 when credit markets were frozen).

took *weeks* to assemble for a solvent firm.⁶⁶ The largest private debtor-in-possession financing ever assembled was a mere \$9 billion loan for Energy Futures Holdings in 2014.⁶⁷ It's not reasonable to believe that private markets could produce immediate financing for the bridge company of much beyond \$5-\$10 billion during a crisis, and that is unlikely to be sufficient. Government financing is not an option—the CHOICE Act closes the door on such a possibility.⁶⁸

The bottom line is this: it is not credible to suggest that a financial institution bankruptcy process can work without standby government financing. I recognize that such government involvement is ideologically anathema to many members, but government is capable for bearing certain risks that the private market cannot, and the risk of a need for a massive and immediate liquidity injection into a firm is such a risk. Even if the proposed bankruptcy process were modified to include a standby government financing provision for the bridge company, however, there are still enormous problems.

C. The CHOICE Act's 48-Hour Stay for Qualified Financial Contracts Will Result in Runs and Make It Harder to Sell the Equity of the Bridge Company

The CHOICE Act contemplates a stay of only 48 hours for QFCs.⁶⁹ This short stay creates a number of problems. First, it increases the likelihood of a run on the debtor and the bridge company as soon as 48 hours passes. The bridge company will not be able to consummate a sale of its assets within 48 hours of the filing, which will mean that there is some degree of uncertainty about whether it will ultimately be able to honor its contractual obligations. Faced with this uncertainty (not to mention the bridge company's problems obtaining financing), QFC counterparties are likely to accelerate, terminate, and liquidate their contracts, and once that begins, it will inevitably turn into a run, as no counterparty wants to be the last one left when faced with a firm with uncertain repayment ability.

That means that the bridge company has only 48 hours to decide which QFCs it wishes to assume and which to reject. This is not a realistic timeframe for evaluating which QFCs are valuable and which are not. Consider that a JPMorgan Chase has some \$70 trillion in derivative exposures. It is not possible to sort through those contracts responsibly in 48 hours, particularly when all hell is breaking loose and key managers are spending their time shopping their resumes with other employers.

Further complicating things is that the CHOICE Act requires that the bridge company assume all or none of the QFCs with a given counterparty.⁷⁰ The result will be that the bridge company will have to either assume bad QFCs in order to assume good ones or will have to reject good QFCs in order to avoid bad ones. Either way the bridge company will end up in a substantially weaker financial position. This will reduce the value of the bridge company's equity and thus the return for the creditors of the failed firm whose debts are not assumed.⁷¹

⁶⁶ Alasdair Reilly & Tessa Walsh, *AB InBev backs SABMiller buy with record \$75 billion loan*, REUTERS, Nov. 13, 2015, at <http://www.reuters.com/article/us-abinbev-loans-idUSKCN0T019E20151113>.

⁶⁷ Billy Cheung, *Energy Future Holdings lining up \$9 billion bankruptcy financing*, REUTERS, Mar. 27, 2014, at <http://www.reuters.com/article/us-energy-future-hd-loans-idUSBREA2Q13020140327>.

⁶⁸ CHOICE Act § 707.

⁶⁹ CHOICE Act § 232 (proposed section 1187(a)(3).)

⁷⁰ I note that the CHOICE Act leaves open the question of whether corporate affiliates count as a single counterparty or not.

⁷¹ This all-or-nothing approach undermines the whole good bank/bad bank structure contemplated by subchapter V because the bridge company will not truly be a "good bank," as it will have to assume plenty of bad assets as well as good ones.

D. The CHOICE Act Makes No Provision for Resolution of Cross-Border Assets

Large financial firms often operate internationally and have cross-border assets. Nothing in title II of the CHOICE Act even addresses the problem of assets outside of the United States, which may be a critical component of a financial firm's value. Chapter 15 of the Bankruptcy Code provides a mechanism for international cooperation between U.S. and foreign insolvency proceedings, but Chapter 15 is not designed to move on the same time table as subchapter V, and it is unclear how a foreign regulatory actions, rather than judicial actions would interface with a U.S. legal proceeding. If foreign regulators ring-fence the debtor firm's foreign affiliates (as they are likely to do), substantial value could be lost to foreign creditors. The lack of attention to international restructuring problems is a glaring omission in the CHOICE Act.

E. The CHOICE Act Has a "Wall Street First" Priority Scheme

The CHOICE Act also creates a priority scheme that deviates significantly from traditional bankruptcy law priorities and ensures that Wall Street creditors get paid, while Main Street creditors get "bupkes":

- Only certain types of liabilities can be assumed by the bridge company (and thus paid 100 cents on the dollar). QFCs are eligible for assumption by the bridge company.⁷² In contrast, regular bond debt, deposit liabilities, and debts owed to suppliers, employees, retirees, and judgment creditors cannot be assumed by the bridge company and will be paid pennies on the dollar, if anything. Thus the CHOICE Act makes sure that Wall Street gets repaid, while Main Street does not.⁷³
- When secured debts are assumed by the bridge company, they must be paid 100 cents on the dollar, even if the debts are underwater.⁷⁴ This is a complete deviation from the standard bankruptcy rule that secured creditors are guaranteed a recovery only of the value of their collateral, not of the face amount of their debt.⁷⁵ The result is a huge boondoggle for secured creditors—Wall Street, not Main Street.

F. The CHOICE Act Encourages Moral Hazard and Preferential Transfers to Insider Creditors

Beyond the fundamental viability problems and skewed priority scheme, there are a number of other flaws with the proposed bankruptcy subchapter. These flaws are not fatal to the operation of the proposed system, but are consistent with the overarching theme in the CHOICE Act of interfering with regulators' ability to head off financial crises and enabling "head I win, tails you lose" behavior by financial institutions under the guise of "liberty".

- The CHOICE Act places the decision to file for bankruptcy solely in the hands of the debtor firm.⁷⁶ There is no involuntary bankruptcy allowed under subchapter V.⁷⁷ The management of an insolvent firm has little incentive to file for bankruptcy, however, and every incentive to "gamble on resurrection," when it is insolvent and playing with creditors'

⁷² CHOICE Act § 232 (proposed section 1185).

⁷³ Ironically, a similar problem exists with the FDIC's proposed Single-Point of Entry (SPOE) approach under title II of the Dodd-Frank Act.

⁷⁴ CHOICE Act § 232 (proposed section 1185(c)(3)(A)(i)).

⁷⁵ 11 U.S.C. §§ 506(a), 725, 1129(b)(2)(A).

⁷⁶ CHOICE Act § 232 (proposed section

⁷⁷ CHOICE Act § 232 (proposed section

money. Thus, subchapter V might never be used, or it might only be used once it is too late and the systemic risk has metastasized.

- The CHOICE Act absolves directors of any liability for actions taken in contemplation of or in connection with” a bankruptcy petition or asset transfer to the bridge company.⁷⁸ While this provision might be intended to encourage directors to use subchapter V, it also creates a moral hazard because directors will not have liability for their pre-bankruptcy actions.
- The CHOICE Act prohibits actions to avoid transfers made “in contemplation or connection with” a subchapter V filing.⁷⁹ This means that debtors have free rein to engage in preferential transfers on the eve of bankruptcy. It also facilitates “gold parachute” payments to officers and directors if made in connection with the transfer to a bridge company.

G. Because the CHOICE Act's Bankruptcy Route Is Unworkable, Ad Hoc Bailouts Will Inevitably Happen in Response to Crises

What happens in a world in which Congress has mandated an unworkable bankruptcy process for dealing with the failure of large financial institutions? One of three things:

- The bankruptcy process will be abused as in *GM* and *Chrysler* to achieve the financial stability end sought by whatever administration is in office;
- There will be a questionably illegal bailout, with lots of finger-wagging after the fact, as occurred with the use of the Exchange Stabilization Fund to aid Mexico in 1994;
- Congress will rapidly pass bailout legislation, much as it did with the Emergency Economic Stabilization Act in 2008.

None of these are desirable outcomes. Nobody likes bailouts. But realistically they are inevitable when things get bad enough because no one wants to deal with the political consequences of a true economic meltdown.⁸⁰ The realistic goal is not avoiding bailouts altogether, but finding a predictable legal framework for them that puts as much of the cost as possible on the beneficiaries of the bailout. Insisting on bankruptcy as a bailout alternative is ideologically-driven self-deception. We will end up with bailouts and worse ones that if we had a formalized (if flawed) process like title II of Dodd-Frank.

CONCLUSION

The CHOICE Act is an amalgam of bad choices. It encourages risky behavior by banks and condones sharp and discriminatory practices. It takes away key tools from regulators and ensures that they will be ineffective using their remaining tools because of political harassment and micromanagement. The inevitable result will be another financial crisis, but this time crisis resolution will be handled by a bankruptcy system that is simply incapable of performing the task assigned to it. The result will be chaos and a hastily pieced-together bailout ... and serious economic and political fallout ensuing.

There are sensible reforms to be made to the Dodd-Frank Act, but those sensible reforms are not to be found in the CHOICE Act. Instead, the CHOICE Act is a full course meal of

⁷⁸ CHOICE Act § 232 (proposed section 1183(c)).

⁷⁹ CHOICE Act § 232 (proposed section 1191).

⁸⁰ Adam J. Levitin, *In Defense of Bailouts*, 99 GEO. L.J. 435, 439-40 (2011).

extreme, anti-regulatory ideology and bad choices. Blind faith in “free” markets should not trump sensible regulation. Unfettered financial markets are inherently unstable and foster unfair, deceptive, and abusive practices, precisely because such practices are profitable (at least in the short term). The stability of the U.S. economy—of consumers’ savings and of consumers’ and businesses’ ability to get funding—is simply too important to stake on an ideological gamble like the CHOICE Act.



**Testimony of Jeremy Newell
General Counsel
The Clearing House Association**

Before the U.S. House Financial Services Committee

**At the Hearing *Making a Financial Choice: More Capital or
More Government Control?***

July 12, 2016

Chairman Hensarling, Ranking Member Waters, and members of the Committee, my name is Jeremy Newell and I am Executive Managing Director, General Counsel and Head of Regulatory Affairs for The Clearing House Association. Established in 1853, The Clearing House is the oldest banking association and payments company in the United States. The Clearing House Association is a nonpartisan advocacy organization dedicated to contributing quality research, analysis and data to the public policy debate.

The Clearing House is owned by 24 banks which provide commercial banking services on a regional or national basis, and in some cases are also active participants in global capital markets as broker-dealers and custodians. Our owner banks fund more than 40 percent of the nation's business loans held by banks, including almost \$200 billion in small business loans, and more than 75 percent of loans to households. Reflecting the composition of our membership, throughout my testimony I will focus on the effects of capital regulation on U.S. globally systemically important banks ("G-SIBs"), U.S. regional banks of all sizes, and the U.S. operations of foreign banking organizations with a major U.S. presence.

One might assume that eight years after the financial crisis would be a good time to assess the consequences of the established post-crisis regulation of bank capital. As I will discuss, however, the pace of regulatory change is not slowing, and U.S. and global regulators continue to pursue pending or anticipated proposals – most never envisioned by the Dodd-Frank Act – that would fundamentally rework what has already been done.

These pending regulatory efforts to introduce additional capital and other reforms are difficult to reconcile with the current capital position and resilience of the U.S. banking industry, which is extraordinarily robust, and the existing regulatory framework, which is extensive and stringent. Rather, we believe that now is the appropriate time to pause before considering additional changes and evaluate the effectiveness and real-world consequences of capital reforms that have already been enacted with a view towards identifying: (i) reforms (or aspects thereof) whose benefits do not justify their costs, and (ii) ways in which post-crisis capital rules can be better tailored to the specific risk profiles and business models of different types of banks.

In an effort to illustrate these issues, my testimony will have four parts:

First, an overall description of both the benefits and costs of bank capital, which provides important context for the evaluation of enacted and still-pending capital reforms.

Second, a description of the core post-crisis capital reforms that clearly have made commercial banks more resilient and resolvable, yielding benefits that are worth their economic costs. These benefits are sizeable and quantifiable.

Third, a description of pending or recently enacted reforms that impose meaningful impediments to economic growth and access to credit by consumers and smaller companies, but provide few if any marginal benefits beyond what has already been achieved by the core reforms. In some cases these regulations are flawed conceptually or operationally; in others, their marginal benefit is small because they are duplicative (or triplicative) of other rules. And in many cases, a reform that might be reasonable for some has been applied on a one-size-fits-all basis to banks whose activities pose few if any relevant risks.

Fourth, a description of several key considerations that should inform any effort to reevaluate and better rationalize existing capital requirements and post-crisis bank regulation more broadly.

I. The Benefits and Costs of Bank Capital Regulation

The financial crisis demonstrated that robust capital levels are essential to the resiliency of both individual banks and the larger financial system. The post-crisis regulatory response has rightfully focused on measures intended to improve and sustain the capital strength of the U.S. banking system. Although not a panacea, there is widespread consensus that capital is among the very best tools to protect the safety and soundness of banks, since capital acts as an all-purpose cushion that can absorb any potential losses that a bank might experience, whatever their cause or circumstances. For this reason, The Clearing House has and continues to support robust capital requirements for all banks.

At the same time, just as there are *benefits* to higher bank capital, there are also *costs*. In particular, because equity is more expensive than debt funding, capital requirements constrain the extent to which a bank can make loans or engage in other financial activities that serve the needs of customers and businesses and support and drive economic growth. The more capital that must be maintained per dollar of lending or other activity, the less such activity may be supported per dollar of capital. This dynamic affects not only the *amount* of lending or other activity a bank may do, but also the *type* of lending or activity. This is because when capital and other costs of an asset exceed the return on that asset, it will become uneconomic for banks to engage in the activities that involve that asset. In other words, and simply put, the capital regulation of banks has real

and substantial power to determine *how credit is allocated to the U.S. economy* – both in terms of *who* and *how much*.¹

Given this interplay, it is important that capital regulation balances both the benefits *and* the costs of higher capital; at a certain point the incremental benefits of increasingly higher capital requirements for safety and soundness become attenuated at best, while the negative impact on lending and other key activities that support the economy become substantial and pronounced. It is in the context of finding that appropriate balance in capital regulation that I focus my remarks today.

II. Core Post-Crisis Banking Reforms

Core post-crisis banking reforms have generally sought to achieve two goals: resiliency and resolvability. The former significantly reduces the chance of bank failure through heightened capital, liquidity and other resiliency measures. The latter goal establishes a legal and operational framework that ensures that any bank can fail without systemic impact or taxpayer assistance. Each of these is described in detail below.

a. Improvements to Resiliency through Enhanced Capital

A key lesson of the financial crisis is the critical importance of maintaining sufficient capital and liquidity levels to ensure that banks can absorb outside losses and heightened liquidity demands that typically accompany periods of financial stress. Responding to that key lesson, banks have *significantly* increased the amounts of high-quality capital and liquid assets they maintain, and regulators have enacted a range of reforms that require these heightened levels of capital and liquidity to remain in place over time.

i. Current Capital Levels

The numbers speak for themselves. The aggregate tier 1 common equity ratio of TCH's 24 owner banks rose from 4.6 percent at the end of 2008 to 12.1 percent at the end of last year. In dollar terms, common equity tier 1 capital nearly tripled from about \$326 billion to \$956 billion over the past seven years.

¹ The Bank of England's recent decision to reduce the U.K.'s countercyclical capital buffer (CCyB) to spur economic activity in the wake of Brexit is a good, real-world example of the overall relationship between capital requirements and the ability of banks to lend and support the economy.

As a benchmark for just how resilient large banks' capital positions have come post-crisis, consider the results of the Federal Reserve's stress test exercise (the "Comprehensive Capital Analysis and Review," or CCAR), which attempts to measure the ability of banks to withstand a severe economic downturn. For the 2016 exercise, banks were required to demonstrate how they would perform under a sudden and severe recession and coincident market crisis that featured the following:

- A sudden jump in the unemployment rate of 4 percentage points (from 5 percent to 9 percent) during the first 4 quarters of the scenario, which is nearly twice as severe as the increase that occurred during the 2007-2009 financial crisis (when unemployment increased only 2 percentage points over the first year);
- A sudden decrease in GDP of more than 6 percentage points;
- An abrupt rise in the BBB corporate bond spread;
- A 50 percent drop in the equity market over four quarters, an 11,000 point loss on the Dow;
- For banks with substantial trading and processing operations, the abrupt failure of their largest counterparty; and
- The emergence of negative short-term interest rates.²

After this stress, the 33 banks currently subject to CCAR must meet a series of capital requirements, including a 4.5 percent common equity tier 1 ratio.³ And they must do so assuming they take no action to shrink balance sheets, reduce dividends, or postpone planned share repurchases – almost certainly deeply counterfactual assumptions. Thus, a bank that passes the CCAR exercise must not only have sufficient capital to avoid failure under historically unprecedented conditions – it must have enough capital to emerge from such an event resilient and doing business as usual.

The results of the 2016 CCAR exercise, announced just a few weeks ago, make emphatically clear just how strong the capital position of the U.S. banking system has become. On a quantitative basis, after taking into account the extreme hypothetical downturn and banks' planned capital actions, *every single one* of the

² See Board of Governors of the Federal Reserve System, *2016 Supervisory Scenarios for Annual Stress Tests Required under the Dodd-Frank Act Stress Testing Rules and the Capital Plan Rule* (Jan. 28, 2016), available at www.federalreserve.gov/newsevents/press/bcreg/bcreg20160128a2.pdf

³ The quantitative assessment of a bank's capital plan also requires a tier 1 risk-based capital ratio above 6 percent, a total risk-based capital ratio above 8 percent and a tier 1 leverage ratio above 4 percent.

33 banks subject to CCAR met their post-stress minimums. And they did so with substantial loss absorbency to spare. In the aggregate, on a post-stress basis, the CCAR banks held \$275 billion in common equity tier 1 capital *over and above* their required post-stress minimums. Given the extraordinary amount of capital now held in the U.S. banking system, it is difficult to imagine on what basis one might conclude that either more capital or other regulatory intervention in the balance sheets of our nation's banks is needed at this time.

ii. *Core Capital Regulations*

The level of capital that now exists in the U.S. banking system is not merely a transitory trend; a series of regulatory requirements has helped to drive these changes and will sustain them over time.

Increases in the quality of required capital. The financial crisis taught us that common equity should be the predominant component of tier 1 capital, the strongest class of capital, as it is most effective at absorbing losses. Accordingly, the Basel III capital standards and U.S. implementing rules establish common equity as the predominant component of capital.

Increases in the quantity of required capital. The quantity of required bank capital has also increased substantially. This has been accomplished in two key ways – first, through a significant expansion of the denominator for capital ratios, and second, through a considerable increase in the minimum ratios themselves. In particular, Basel 2.5 more than doubled capital requirements for capital markets assets, and Basel III and U.S. implementing rules require banks to maintain a minimum risk-based common equity tier 1 ratio of 4.5 percent, as well as a “capital conservation buffer” of an additional 2.5 percent – plus an additional capital surcharge for G-SIBs ranging from 1 to 4.5 percent.⁴

Emphasis on stressed rather than static measures of capital adequacy. Capital regulation now emphasizes stress testing to measure banks' capital adequacy. The first stress test deployed by the Federal Reserve was its Supervisory Capital Assessment Program (SCAP) exercise in 2009, which played a crucial role in ending the financial crisis. SCAP was subsequently codified in the form of the Dodd-Frank Act Stress Tests (DFAST) and the CCAR process described above. Although, as noted below, we have serious concerns about how CCAR is applied in practice along with the strong possibility that it may be revised in the near term, we nonetheless believe that it is a core reform as stress testing is an important and necessary tool for assessing the health of the banking

⁴ See 78 Fed. Reg. 62018 (Oct. 11, 2013) (final rule).

system. In particular, stress testing represents a key improvement in capital regulation and supervisory practices because it incorporates a *forward looking, dynamic* assessment of capital adequacy, and is less reliant on static measures and recent historical performance. It also helps to address one of the key criticisms of a risk-based capital framework – which is the concern that risk weights might underestimate the risk of an asset – particularly in a crisis. Stress testing provides a strong and dynamic backstop to guard against that potential worry.

b. Resolvability: A Successful Legal & Operational Framework to Resolve Large Banks without Taxpayer Support

Title I and Title II of the Dodd-Frank Act are core reforms that ensure that any banking organization can be resolved in a way that requires no taxpayer assistance and does not destabilize the broader financial system. For U.S. global systemically important bank holding companies (G-SIBs) engaged in substantial non-banking activities, this required a new framework, described below. For more traditional commercial banks that hold substantially all of their assets with an insured depository institution, the crisis showed that the FDIC possessed the necessary authority and expertise to resolve them, and major changes were not required.

i. The Legal Framework: Titles I & II and Single-Point-Entry Resolution

The Dodd-Frank Act established a legal framework for the resolution of a large banking organization, which the Federal Reserve and FDIC have implemented in a thoughtful way. For most U.S. G-SIBs, this progress includes the single-point-of-entry (SPOE) resolution strategy. Under the SPOE strategy, all of the losses across a U.S. G-SIB would be absorbed by shareholders and creditors of its parent holding company – which would fail and be put into a Chapter 11 bankruptcy. Bankruptcy should always be the preferred method of resolution – or, where circumstances require, an FDIC receivership under Title II of the Dodd-Frank Act.

The two principal benefits of this strategy are that it: (i) makes it legally and operationally feasible to impose losses on holding company debt holders, thereby vastly expanding the loss absorbency of the relevant banks, and (ii) allows the material operating subsidiaries to remain open and operating, thereby minimizing the systemic consequences of a large banking organization failure.

ii. *The Operational Framework: Resolution Stays on Financial Contracts and TLAC*

Two significant developments have greatly enhanced the credibility of SPOE as a resolution strategy.

Resolution Stays on Financial Contracts. One potential shortcoming of the SPOE strategy was identified by regulators and market participants: if the parent holding company enters into a bankruptcy or resolution proceeding, then the counterparties of the holding company's subsidiaries might exercise "cross-default" rights and terminate their derivatives and similar financial contracts with the subsidiaries, and then seize and liquidate the collateral (even though the subsidiaries remain open, solvent, and performing on their contractual obligations). This would drain liquidity from the group in resolution, and the sale of the collateral into the market at a time of stress could have systemic consequences, as it did in the financial crisis.

To prevent this outcome, each U.S. G-SIB (as well as most other G-SIBs globally) has voluntarily adhered to the ISDA 2015 Universal Resolution Stay Protocol,⁵ which provides for the explicit recognition of resolution stays on cross-default rights in financial contracts between and among the world's largest dealer banks. In order to extend this systemic protection beyond dealer bank transactions, the Federal Reserve recently proposed a rule that would generally require G-SIBs to include resolution stays in financial contracts with *all* of their counterparties. The Clearing House strongly supports this proposal, as the inclusion of resolution stays in financial contracts will make it easier to implement an SPOE resolution.

Total Loss Absorbing Capacity. In order for SPOE to be effective, a firm must maintain sufficient loss absorbing capacity that can be bailed-in to recapitalize the firm even after a massive loss, and that bail-in must be operationally feasible. The former is achieved by maintaining, at the holding company level, substantial liabilities that cannot run in stress (basically, equity and long-term debt).

To ensure that sufficient loss absorbency remains in place over time, the Federal Reserve has proposed a "total loss absorbing capacity" (TLAC) rule that would require U.S. G-SIBs to maintain minimum total loss absorbing capacity equal to 21.5 percent to 23 percent of its risk-weighted assets, and 9.5 percent of

⁵ International Swaps and Derivatives Association ("ISDA"), Adhering Parties: ISDA 2015 Universal Resolution Stay Protocol (last updated June. 17, 2016), *available at* <https://www2.isda.org/functional-areas/protocol-management/protocol/22>.

its total assets.⁶ The scale of this reform has not been widely appreciated: *the eight U.S. G-SIBs alone will be expected to maintain, on an aggregate basis, more than \$1.5 trillion in total loss absorbing capacity.*

Operational feasibility is achieved by minimizing the types of other holding company creditors, thereby avoiding disputes among creditor classes in bankruptcy. The Federal Reserve's proposed rule would prohibit nearly all short-term debt or other liabilities at the holding company, and make clear that operating liabilities of subsidiaries are senior to the bail-in/TLAC equity and debt at the holding company. Thus, a U.S. G-SIB's losses can be imposed entirely on the private sector without inducing the holders of the group's short-term debt or financial contracts to run, or the holders of its other operating liabilities to cut off critical services.

Clear Evidence of Success. Investors and markets appear convinced that equity and long-term debt holders are fully at risk in the event of failure, and that government assistance will not be required, or available, to resolve a large banking organization. Put another way, they appear convinced that large banks are no longer "too big to fail." The spreads that debt markets charge large banks have risen dramatically from pre-crisis levels. A Government Accountability Office (GAO) study released in July 2014 stated, "[o]ur analysis provides only limited evidence that large bank holding companies had lower funding costs since the crisis and instead provides some evidence that the opposite may have been true at the levels of credit risk that prevailed in those years."⁷ The GAO found that any premium in the interest rates (that is, lower rates) that banks pay to borrow in the bond market had been significantly reduced, eliminated, or even reversed. Indeed, in half of the 42 models they employed, larger banks actually pay *more* to borrow than mid-sized banks issuing publicly traded debt.

Similarly, the ratings agencies now rate debt in accordance with the market reality reported by the GAO. At the time of the 2014 study, two of the three large rating agencies had already eliminated any "uplift" in ratings of bank holding

⁶ I also note that while we strongly support the TLAC requirement in principle, we do have several key concerns with the specific way in which the Federal Reserve has proposed to implement TLAC in the United States. See Letter from The Clearing House et al. to the Board of Governors of the Federal Reserve System (Feb. 19, 2016), available at www.theclearinghouse.org/issues/articles/2016/02/20160219-tch-comments-on-fed-s-tlac-proposal.

⁷ Government Accountability Office, *Large Bank Holding Companies: Expectations of Government Support (GAO-14-621)* (July 2014) at 46. Academic research on post-crisis conditions is consistent with the GAO's findings. See also Javed Ahmed, Christopher Anderson, Rebecca Zarutskie, *Are the Borrowing Costs of Large Financial Firms Unusual?* (March 12, 2015), available at <http://www.federalreserve.gov/econresdata/feds/2015/files/2015024pap.pdf>

company debt because of anticipated future government support. Since then, the third rating agency has also dropped any uplift for bank holding company debt.

III. Regulatory Measures that Yield Benefits Less than their Economic Costs

For the core reforms described above, it is reasonably clear that their benefits generally exceed their costs. But it is also clear that other current and anticipated regulations – or particular aspects or applications of those regulations – do not meet that test, with costs and consequences that have not been well measured or understood.

Three keys to performing a regulatory cost-benefit analysis are as follows:

First, each regulation contains mandates and incentives that, while implicit rather than explicit, are nonetheless clear. Bank regulation necessarily favors some activities over others; thus, when regulatory requirements are calibrated at high levels, they create strong incentives for banks to no longer allocate their balance sheets according to actual economic risk but rather according to regulatory requirements. There is a common misperception that banks faced with a higher capital requirement can react in only three ways: (i) accepting a lower return on equity, (ii) shrinking assets across the board, or (iii) increasing prices across the board. Under this view, regulation is agnostic or content neutral. In fact, banks identify the business lines that are causing the higher capital (or other regulatory) charge relative to actual economic risk, and then face a difficult decision of how much of that cost to require the business lines to earn back. For example, we see substantial evidence of this phenomenon in global capital markets businesses, where numerous large banks have either exited businesses entirely or dramatically reduced the amount of capital they are willing to commit to supporting market liquidity. Conversely, we have seen a strong trend globally for large banks to enter or expand private wealth management: this activity does not require significant capital or liquidity, and thus is a business smiled upon by the post-crisis regulatory regime.

Second, in assessing the benefit of a given rule against its cost, it is not sufficient to identify its standalone benefit. What is relevant is its *marginal* benefit – that is, what benefit it adds to the core reforms and others already enacted. For a rational cost-benefit analysis, it is not enough to simply say that a rule has the benefit of reducing the chances of a financial crisis like the last one: the question is what is the *marginal* benefit, given the presence of other rules, and how does it compare to the rule's cost (including that it might increase the chances of a financial crisis that is *unlike* the last one).

Third, in assessing benefits and costs, careful attention must be paid *to whom the rule applies*. This is because, in many cases, regulators have applied a particular reform to a wide range of banks on a nearly uniform basis. Such an approach to regulation, and to macroprudential regulation in particular, is inappropriate and inherently fails to account for the wide variety of business models and practices that exist among individual institutions. The application of prudential standards should not simply be a function of an organization's asset size, but should instead be based on the types of risk being run by the organization, driven largely by the types of activities it engages in. Unfortunately, it is often exactly this untailored, size-based approach that has been applied in practice – much of the post-crisis prudential framework, including the Basel III capital and liquidity framework and the enhanced prudential standards established under Title I of the Dodd-Frank Act, is not appropriately tailored to the diversity of banking organizations and business models that exist in the United States.

With these three kinds of questions in mind, we have identified a range of capital-related reforms that yield benefits incommensurate with their costs. Many involve rules and regulations already enacted, but several involve additional reforms that have been proposed or are anticipated, but have not yet been finalized. All deserve careful evaluation and, where appropriate, revision to ensure an appropriate balance between their benefits and costs.

a. Existing Capital Rules & Mandates

i. CCAR

The U.S. stress test is an important building block of the post-crisis banking regulations and we are, in principle, supportive of rigorous stress tests as a tool to assess the capital adequacy of large banks. At the same time, however, we have growing concerns about the Federal Reserve's CCAR exercise in practice.

The stakes here are significant. CCAR is the binding constraint for most large banks and thus has tangible economic impacts. For example, by more severely stressing unemployment rate changes, the 2016 stress scenarios implicitly discourage small business lending and household lending, as these are the types of loans whose loss rates are most sensitive to increases in unemployment.

One can think of CCAR as having three main components: (i) the stress scenario provided each year; (ii) the process by which the Federal Reserve decides how much each bank will lose, and thus how much capital it will have remaining after undergoing that stress; and (iii) the minimum remaining amount of capital a

bank must have left over after that stress. We have serious concerns with the current opacity of the first two of these components.⁸ Because confidence that CCAR appropriately balances the benefits and costs of higher capital depends, in part, on the reasonableness of both the scenarios and models that are the core of the CCAR exercise, greater transparency and public deliberation around both is needed.

With respect to the stress scenarios, the Federal Reserve's own self-imposed standard states that the severely adverse scenario should consist of "a set of economic and financial conditions that reflect the conditions of post-war U.S. recessions."⁹ The 2016 stress scenarios assume, however, a macroeconomic shock that is considerably more severe than the 2007-2009 financial crisis or prior post-war recessions. In particular, the increase in the unemployment rate in the 2016 scenario is substantially more sudden than what was experienced during the 2007-2009 crisis, which is likely to cause credit losses to accumulate rapidly and in greater amounts over the stress period. Although these scenarios are disclosed each year, they are not subject to prior notice and comment, and therefore neither their reasonableness nor their consistency with the Federal Reserve's own standards is subject to open debate.

Similarly, and in contrast to other jurisdictions, the Federal Reserve uses its own internal model(s) to estimate stressed credit losses and net revenues. These models are enormously important drivers of the CCAR results for each bank. Yet the Federal Reserve provides virtually no detail regarding the specifications of these models – not only are they not subject to public review and comment – they are not even publicly disclosed.

CCAR also provides a useful example of a regulation that generally has been applied uniformly across a large range of banks with differing business models and risk profiles. As a result, and particularly in light of the immense operational and administrative burden that attends participation in CCAR, the various concerns noted are more pronounced for those banks with simpler balance sheets or smaller risk profiles, for whom the benefits of CCAR are likely to be significantly less in practice, while the costs remains substantial.

⁸ As described below, we also have serious concerns with the anticipated future direction of the third component, the post-stress minimum capital requirements.

⁹ See 12 C.F.R. part 252, Appendix A.4.

ii. Supplementary Leverage Ratio

A leverage ratio measures the capital adequacy of a bank by dividing its capital by its total assets. Although the leverage ratio is seen as an alternative to risk-based measures of capital, the leverage ratio is in fact also a risk-based measure of capital, albeit a bad one. It assesses the risk of each asset to be exactly the same – akin to setting the same speed limit for every road in the world. The risk of a Treasury security is deemed the same as that of a loan to a startup with uncertain cash flows. The risk of holding a market-making portfolio of liquid, highly rated bonds is equated to the risk of holding a portfolio of illiquid loans to untested companies.

The inherent inaccuracy of the leverage ratio – and the resulting misallocation of capital – has increased dramatically in recent years as a result of other regulatory mandates. In particular, liquidity rules (principally the liquidity coverage ratio, or “LCR”) now effectively require large banks to hold approximately 30 percent of their balance sheets in high-quality liquid assets (“HQLA”) – predominantly cash, Treasury securities and other government securities. Large banks now hold approximately three times as much of these assets as they did pre-crisis. Those assets rightly receive a zero or low risk weight in risk-based capital measures – but the leverage ratio completely ignores their actual risk – and creates a powerful disincentive to hold low risk assets beyond those required by regulation.

To put this in practical terms, consider the combined effects of regulation on the decision to make a small business loan. That loan must be funded, and unless it is funded with retail or other very “sticky” deposits, the LCR requires the bank to hold HQLA (cash or cash equivalents) against that funding. While this treatment under the LCR may be appropriate, the supplementary leverage ratio requires banks to hold capital against the HQLA – five or six percent in the case of G-SIBs, and three percent in the case of other large banks. This is *not* appropriate, and unnecessarily increases the cost of making the loan.

The impact of the U.S. supplementary leverage ratio is especially pronounced on bank holding companies’ capital markets activities, which are not funded by insured deposits. U.S. capital markets are the deepest, most liquid, and most efficient in the world, allowing U.S. companies as well as the government to finance growth and borrow more cheaply. At the heart of those markets are broker-dealers, which facilitate the issuance and trading of securities, and provide funding to other financial institutions. The broker-dealer business model involves holding well-hedged temporary inventories in low risk assets, as well as standing between borrowers and lenders in offsetting and well-collateralized repo transactions. Both activities earn only narrow margins; promote the liquidity and

efficiency of financial markets; and entail little or no risk. However, both are balance-sheet sensitive; that is, they create assets on the books of broker-dealers – assets that banks now have to fund in material part with expensive equity because of the supplementary leverage ratio requirement. Because of the thin margins earned in financial intermediation, the added cost from the supplementary leverage ratio requirement has a substantial impact on the amount of the activity.

The impact of the U.S. supplementary leverage ratio is also pronounced for those banks that provide custody services, such as the operation of cash management accounts for investment funds and other institutional investors. Such banks are finding it increasingly challenging to accept certain cash deposits from customers, because the U.S. leverage ratio requires substantial capital against the low-risk, liquid assets in which those deposits are temporarily invested – generally cash and U.S. Treasuries. And current and future regulatory focus on this essentially riskless activity may not only impede custody banks' ability to provide traditional custody services – it could also have an adverse impact on financial stability by preventing banks from being able to accept cash deposits from their custodial clients during a crisis, denying those clients a safe haven to preserve their capital and potentially worsening a run on the banking system.

Another problem with the supplementary leverage ratio is the way in which it works in opposition to the regulatory push for central clearing of derivatives. In particular, the leverage ratio requires banks to hold capital against client margin collected and held in a segregated account that unquestionably reduces the exposure of the bank, which ignores the fact that such margin not increases a bank's risk. As a result, it effectively requires banks to hold un-economic amounts of capital when they trade with a client and then clear the trade. Because of this, at least three major dealers have exited the business. Accordingly, CFTC Chairman Massad has called for the U.S. leverage ratio to be amended to take account of segregated margin.

Notwithstanding these significant weaknesses a leverage ratio can, if calibrated appropriately, form a useful part of the larger bank capital framework. As we saw during the crisis, there will be times when banks (and other actors) seriously misjudge the risk of an asset class, and therefore undercapitalize it. Furthermore, if that asset class is illiquid and opaque to the markets (*e.g.*, mortgages or mortgage-backed securities), then market confidence in risk-weighted measures will fall, and markets may resort to leverage measure themselves.

Thus, there is reason to establish a minimum leverage ratio below which a bank cannot fall as a failsafe measure in the event of a widespread failure to measure risk. However, *this ratio should be set as a backstop, and not as the*

predominant capital standard in ordinary circumstances; the latter would drive daily misallocation of capital in the economy, as any measure that ignores risk is bound to do if made a binding constraint. Here, the Basel Committee on Banking Supervision (the “Basel Committee”) appears to have struck a fair balance by adopting a minimum leverage requirement of three percent. For U.S. G-SIBs, however, the U.S. banking agencies have set the ratio at six percent for bank subsidiaries and five percent for the consolidated bank holding company. Thus, banks subject to both the LCR and supplementary leverage ratio are currently required to hold \$53 billion in capital against cash reserve balances deposited at the Federal Reserve, and an additional \$19 billion against Treasury securities. These are assets whose value banks are at no risk of misjudging; the capital allocated to them could be far better deployed to lending or supporting market liquidity.

iii. G-SIB Surcharge

The capital surcharge for G-SIBs is designed to reduce the likelihood of failure such that the expected social cost of a G-SIB’s failure is approximately equal to that of a large, but non-systemically important bank holding company. The Federal Reserve has established a complex methodology to calculate the G-SIB capital surcharge, which The Clearing House has studied in detail. As we summarize in a recently released research paper, the G-SIB surcharge’s calibration has major shortcomings.¹⁰ For example:

The Federal Reserve’s white paper includes the largest 50 banks each quarter..., a sample size that extends to banks that are so small that their experience may not be relevant. For example, at the end of the sample period, the set of 50 banks whose earnings were used to calculate the G-SIB surcharge had assets as low as \$24 billion. However, in a 2014 response to a GAO study, the Federal Reserve expressed the view that it is inappropriate to compare such small banks to G-SIBs. Specifically, the Federal Reserve noted, that “a bank holding company with \$10 billion in assets is too small to make a meaningful comparison to a bank holding company with \$1 trillion in assets... A bank holding company of \$50 billion in assets would provide a more relevant comparison...” For example, the now defunct First City Bancorporation of Texas, one of the ten smallest banks in the sample at \$11.2 billion in assets, failed in the late 1980s because of its concentrated exposure to energy and agricultural markets. It was also geographically highly concentrated, with 59 of its 60 subsidiaries

¹⁰ See The Clearing House, *Overview and Assessment of the Methodology Used to Calibrate the U.S. GSIB Capital Surcharge* (May 2016).

located in Texas. ...[I]nclusion of this bank in the sample accounts for 36 basis points of the G-SIB surcharge for an average G-SIB.¹¹

As noted, the Federal Reserve has stated that the G-SIB surcharge is “designed to reduce a G-SIB’s probability of default such that a G-SIB’s expected systemic impact is approximately equal to that of a large, non-systemic bank holding company.”¹² Thus, by definition, regulatory changes that reduce the systemic impact of a G-SIB’s failure should reduce its G-SIB surcharge, but they do not. A company that holds sufficient TLAC to effectuate a SPOE strategy, agrees to the ISDA protocol, and increases its margin against uncleared swaps and security-based swaps – all measures that regulators have justifiably stated have materially decreased systemic risk – would incur the same G-SIB surcharge as one that did not.

Furthermore, the overstatement of the G-SIB surcharge also contains an implicit mandate: reduce the activities that add to the score, namely, capital markets activities. This mandate derives from the five factors that determine a G-SIB’s surcharge under the binding U.S. standard:

- The *complexity* factor includes almost exclusively securities and derivatives assets held in market making;
- The *inter-connectedness* factor includes almost exclusively dealer-to-dealer trading assets held in order to hedge customer positions held in market making;
- The *cross-jurisdiction* factor includes almost exclusively cross-border dealer-to-dealer trading of the type captured by the interconnectedness factor;
- The *short-term wholesale funding* factor includes almost exclusively the funding of securities positions; and
- The *size* factor is not so exclusively focused on securities activities, but for the largest banks those assets constitute a large percentage of their total assets.

¹¹ *Id.* at 11.

¹² Risk-Based Capital Guidelines: Implementation of Capital Requirements for Global Systemically Important Bank Holding Companies, Proposed Rule, Federal Reserve System, 79 Fed. Reg. 75473, 75475 (Dec. 18, 2014).

Thus, the only effective way for a firm to reduce its G-SIB surcharge is to reduce its market making and other activities that provide market liquidity and generally support capital markets.

Another fundamental shortcoming of the G-SIB surcharge calculation is the simplistic assumption that the social cost of a large bank's failure is a multiple of a firm's "systemic risk indicator score"—the score determined by the five factors listed above without providing any meaningful empirical evidence or analysis that these scores reflect the actual or relative systemic losses that the financial system would suffer upon a particular firm's failure. Not only would different plausible relationships between the score and the cost of failure lead to substantially different surcharges, as shown by the research paper, but other accepted methods of calculating the systemic importance of a bank yield noticeably different results. For instance, a recent IMF study that assessed the largest bank holding companies' contribution to systemic risk found a different ranking of, and less difference between, the largest banks.¹³

iv. Countercyclical Capital Buffer

Perhaps the best example of a post-crisis capital requirement that would fail even the most basic cost-benefit analysis is the countercyclical capital buffer. The countercyclical capital buffer was developed by the Basel Committee and contemplates an additional capital requirement for larger U.S. banks of up to 2.5 percentage points so as to "protect the banking system from the systemic vulnerabilities that may build-up during periods of excessive credit growth."¹⁴ The Federal Reserve has recently issued a proposed policy statement describing when and why it might impose this buffer.¹⁵ That proposal has serious legal and procedural problems, but I will emphasize here its fundamental conceptual problems. This untested capital requirement is simultaneously both too broad and too narrow to be effective as a macroprudential tool to limit the build-up of risks in a credit bubble – too broad, because it would levy a hefty capital charge against all bank activities, not just the ones posing heightened risk, and too narrow, because it would do nothing to address any risks that arise *outside* of the banking system. Indeed, one can imagine that such a capital charge would only

¹³ See "Germany Financial Sector Assessment Program," International Monetary Fund (June 2016).

¹⁴ 78 Fed. Reg. at 62018 (Oct. 11, 2013) at 62038.

¹⁵ See 81 Fed. Reg. 5661 (Feb. 3, 2016); 12 C.F.R. Part 217.

serve to accelerate the build-up of systemic risks by creating strong incentives for risk-taking to migrate outside the banking system.¹⁶

v. *Ring Fencing for Foreign Banks*

Most of the post-crisis reforms have been applied, appropriately, to the U.S. operations of foreign banks. In some cases, however, foreign banks have received treatment that has unnecessarily and adversely affected their ability to assist U.S. customers. Specifically, foreign banks with significant U.S. operations have been required by the Federal Reserve (but *not* the Dodd-Frank Act) to ring-fence their U.S. non-branch assets, place them into a U.S. intermediate holding company (IHC), and then ensure that the IHC meets a variety of capital, liquidity, and other standards. The proposed TLAC rule makes it very difficult to fund the IHC, and other rules have imposed duplication of back office functions.

For foreign banks that largely structure and manage their U.S. operations on a standalone basis and have adopted a multiple-point-of-entry strategy to resolution, such ring-fencing is generally consistent with their business operations and approach to resolution.¹⁷ But many foreign banks manage and operate their U.S. and other subsidiaries on a global, consolidated basis; subjecting such foreign banks to this U.S.-style of mandatory, *ex ante* ring-fencing that has two principal shortcomings.

¹⁶ These flaws are becoming an increasing focus of public discussion: for example, Federal Reserve Bank of Cleveland President Loretta Mester has publicly noted the shortcomings of the proposed countercyclical capital buffer approach in terms of both its unpredictability and uncoordinated nature. See Loretta J. Mester, *Five Points about Monetary Policy and Financial Stability* (June 4, 2016), available at www.clevelandfed.org/newsroom-and-events/speeches/sp-20160604-five-points.aspx (noting that “the need to coordinate countercyclical macroprudential policy actions across multiple regulators in the U.S. adds a complication to effectively using such tools in a timely way” and describing the need to “devise ways to make the macroprudential tools more systematic and less discretionary.” Similarly, Office of Financial Research Director Richard Berner has noted that “[t]argeted policies with clear, direct effects on a financial stability threat ... are preferable to general policies with diffuse effects (such as activating a countercyclical capital buffer).” Richard Berner, *Remarks at the Conference on the Interplay Between Financial Regulations, Resilience, and Growth* (June 16, 2016), available at www.financialresearch.gov/public-appearances/2016/06/16/conference-on-the-interplay-between-financial-regulations-resilience-and-growth.

¹⁷ The multiple-point-of-entry resolution strategy is designed to reduce interconnectivity and facilitate resolution at the host level – a resolution strategy under which the IHC should be resolved separately from its parent financial group, under a process largely led by U.S. regulators.

First, to the extent that foreign banks manage their capital and liquidity on a consolidated basis, these banks retain and rely on the flexibility to shift financial resources within the organization to their location of highest and best use, including – most crucially – to a particular geographic or business operation in times of financial or market stress. Their ultimate strength resides in the ability to obtain support from the necessarily larger consolidated resources of the global enterprise. U.S.-style ring-fencing significantly undercuts this benefit and therefore could actually undermine financial stability. *Second*, ring-fencing has an undesirable effect of layering multiple capital and liquidity requirements on banking organizations, thereby increasing the regulatory burden and complexity.

At a minimum, should U.S. policymakers unfortunately continue down their current path, they should abide by Congress' explicit direction in law to give due regard to the principle of national treatment and equality of competitive opportunity. They should also take into account the extent to which each FBO is subject on a consolidated basis to home country standards that are comparable to those applied to financial companies in the United States. In addition, we would urge policymakers to heed Congress' specific direction to take into account differences among financial institutions based on their systemic footprints and risk profiles.

b. Additional Capital Reforms Pending

Given the extraordinary stringency and complexity of post-crisis regulation, it is somewhat surprising that the pace of regulatory change continues at a high, and continuously more burdensome level. In particular, two additional sets of changes to capital regulation are pending or anticipated, both of which would entail costs well in excess of any potential benefits.

i. Basel IV Changes to Capital Regulation

The Basel Committee has undertaken a new effort, Basel IV, that is directed at further and extensive changes to nearly all aspects of the international capital framework. This ambitious undertaking may be surprising to some, given that the Basel Committee just completed an extensive overhaul of its capital framework – *Basel III*, finalized by the Basel Committee in 2010 and implemented in the United States beginning in 2013.

Basel IV has not been presented for debate in the U.S., but is currently being finalized on an international basis. This is disconcerting as the breadth and scope of the proposed Basel IV revisions is difficult to overstate. For example, Basel IV includes the following separate proposals issued by the Basel Committee over the past year or so:

- Revisions to the standardized approach for credit risk,¹⁸ including:
 - Calibration of new risk weights for exposure classes based on QIS data;
 - Calibration of revised credit conversion factors, which a major determinant of the capital requirements for commitments to lend to both consumers and businesses;¹⁹
- Revisions to the leverage ratio framework;²⁰
- Revisions to the standardized measurement approach for operational risk;²¹
- Fundamental review of the trading book, which includes revisions to the boundary between the banking book and the trading book;²²
- The possible imposition of a step-in risk capital requirement;²³
- Incorporation of minimum haircuts into the capital requirements for certain securities financing transactions;²⁴

¹⁸ Basel Committee, *Second Consultative Document: Revisions to the Standardised Approach for Credit Risk* (Dec. 2015), available at: <http://www.bis.org/bcbs/publ/d347.pdf>.

¹⁹ The Basel SACR's revised CCFs will necessarily lead to increased risk-based capital requirements for certain off-balance sheet commitments. If these same CCFs are ultimately incorporated into the current Basel III internationally agreed upon leverage ratio denominator exposure measure, leverage ratio capital requirements would necessarily increase. We are deeply concerned that this increase would be unjustified and would make the already blunt leverage ratio instrument more of a binding constraint and further depart, as a practical matter, from the Basel Committee's stated policy of the leverage ratio acting as a supplementary, back-stop measure to risk-weighted asset calculations.

²⁰ Basel Committee, *Consultative Document: Revisions to the Basel III Leverage Ratio Framework* (Apr. 2016), available at: <http://www.bis.org/bcbs/publ/d365.pdf>.

²¹ Basel Committee, *Consultative Document: Standardised Measurement Approach for Operational Risk* (Mar. 2016), available at: <http://www.bis.org/bcbs/publ/d355.pdf>; see also Basel Committee, *Consultative Document: Operational Risk – Revisions to the Simpler Approaches* (Oct. 2014), available at: <http://www.bis.org/publ/bcbs291.pdf>.

²² Basel Committee, *Consultative Document: Fundamental Review of the Trading Book: Outstanding Issues* (Dec. 2014), available at: <http://www.bis.org/bcbs/publ/d305.pdf>.

²³ Basel Committee, *Consultative Document: Identification and Measurement of Step-In Risk* (Dec. 2015), available at: <http://www.bis.org/bcbs/publ/d349.pdf>.

- Incorporation of “simple, transparent and comparable” securitization criteria into the capital framework;²⁵
- Introduction of three potential capital floors methodologies to the internal ratings-based approach, including one based on the Standardized Approach as a whole;²⁶
- Review of the credit valuation adjustment risk framework;²⁷
- Revisions to Pillar 3 disclosures requirements;²⁸ and
- Implementation of rules relating to the treatment of total loss absorbing capacity holdings.²⁹

Taken together, these changes would effect a near wholesale revision of the Basel III capital framework, and are being undertaken in a series of separate steps where different elements are finalized at different times rather than through a deliberate, comprehensive and synchronized review.

Both the substance and process of Basel IV present numerous concerns, and The Clearing House believes that there are compelling reasons for the United States to opt out of any changes agreed to as part of Basel IV. For example, although neither the Basel Committee nor U.S. regulators have yet undertaken an analysis of the effectiveness and consequences (intended and unintended) of the Basel III changes, the Basel IV process would substantially reshape, yet again, a large part of that framework. Clearly, it would be more appropriate to meaningfully assess and come to an informed view of the impact of these recent and extensive reforms *before* proceeding to make any further changes.

Similarly, although the Basel Committee has stated that it does not intend for the changes to effectively raise capital requirements in practice, the substance of the various proposals that constitute Basel IV suggest that they would do

²⁴ Basel Committee, *Consultative Document: Haircut Floors for Non-Centrally Cleared Securities Financing Transactions* (Nov. 2015), available at: <http://www.bis.org/bcbs/publ/d340.pdf>.

²⁵ Basel Committee, *Consultative Document: Capital Treatment for “Simple, Transparent and Comparable Securitizations* (Nov. 2015), available at: <http://www.bis.org/bcbs/publ/d343.pdf>.

²⁶ Basel Committee, *Consultative Document: Capital Floors: The Design of a Framework Based on Standardised Approaches* (Dec. 2014), available at: <http://www.bis.org/bcbs/publ/d306.pdf>.

²⁷ Basel Committee, *Consultative Document: Application of Own Credit Risk Adjustments to Derivatives* (Dec. 2011), available at: <http://www.bis.org/publ/bcbs214.pdf>.

²⁸ Basel Committee, *Consultative Document: Pillar 3 Disclosure Requirements – Consolidated and Enhanced Framework* (Mar. 2016), available at: <http://www.bis.org/bcbs/publ/d356.pdf>.

²⁹ Basel Committee, *Consultative Document: TLAC Holdings* (Nov. 2015), available at: <http://www.bis.org/bcbs/publ/d342.pdf>.

precisely that. If bank capital requirements are to be further increased, it would seem that should be done explicitly, and not by accident.

Perhaps mostly concerning, rather than present its Basel IV changes holistically, such that commenters (and the Basel Committee itself) could assess the cumulative impact of these changes in the aggregate, the Basel Committee has issued its proposals and final standards in a piecemeal fashion, with little meaningful assessment or explanation of how they may interact in practice.

ii. Increased Minimum Capital Requirements through CCAR

A second, very significant anticipated change to bank capital regulation is the Federal Reserve's stated plans to substantially raise minimum capital requirements for U.S. G-SIBs by incorporating its G-SIB capital surcharge into CCAR's post-stress minimum capital requirements. Although several Federal Reserve Board members have announced this forthcoming change in rather definitive terms,³⁰ no formal proposal has yet been issued for notice-and-comment, and therefore the Federal Reserve has not yet provided any detail about either its rationale or how it would effectuate such a change.

Whatever the stated objective or method of implementation, however, The Clearing House believes that any such move would be inappropriate and unjustified at this time. As we have noted in a recent letter to the Federal Reserve,³¹ there are multiple reasons that caution against doing so:

- *First*, incorporating the G-SIB surcharge into CCAR would undermine its credibility and integrity as a stress test. According to the Federal Reserve, "[t]he Comprehensive Capital Analysis and Review (CCAR) is an annual exercise by the Federal Reserve to assess whether the largest bank holding companies operating in the United States have sufficient capital to continue operations throughout times of economic and financial stress...."³² As such, it is both a core safety and soundness protection and an important assurance to the investing and voting public about the resilience of the banking system. The incorporation of the

³⁰ Wall Street Journal, *Fed's Tarullo Sees More Changes for Big Banks, Criticizes GOP Capital Proposal* (July 2016), available at: <http://www.wsj.com/articles/feds-tarullo-sees-more-changes-for-big-banks-criticizes-gop-capital-proposal-1467840182>

³¹ See The Clearing House, *Incorporation of the GSIB Surcharge into CCAR*, (June 2, 2016).

³² See <http://www.federalreserve.gov/bankinforeg/stress-tests-capital-planning.htm>.

G-SIB surcharge into CCAR would fundamentally alter its objective, which is to test a bank's resiliency under stress, such that CCAR results for U.S. G-SIBs would provide less meaningful information to banks, investors, and the public about banks' capacity to withstand stress. This outcome would be very unfortunate, as it would undermine a key post-crisis regulatory innovation that has been highly successful in enhancing the resiliency of the banking system and public confidence therein.

- *Second*, incorporating the G-SIB surcharge into the existing CCAR framework would effectively result in "double taxation" of G-SIBs, as the existing CCAR framework already includes unique, incremental assumptions that increase stress loss estimates that apply *only* to G-SIBs. In particular, all eight U.S. G-SIBs are required to assume a counterparty failure scenario, and six of the eight G-SIBs are required to assume an instantaneous global market shock. No non-G-SIB is subjected to either additional stress.
- *Third*, as described above, the Federal Reserve's methodology for calibrating the G-SIB surcharge itself contains significant weaknesses and limitations, and the G-SIB surcharge rule fails to account for continuing regulatory developments that have substantially decreased the systemic risk of GSIBs making its calibration increasingly inaccurate and overstated. Each of these problems in the G-SIB surcharge itself makes its incorporation into CCAR particularly inappropriate.
- *Fourth*, given the substantial real world impact of the G-SIB surcharge itself, particularly as a tax on capital markets activities, incorporating it into CCAR would amplify the current deterioration of market liquidity and the increased likelihood of market volatility associated with the continuing shift from principal- to agency-based intermediation.

Finally, at a more general level, it is difficult to identify the incremental benefits to safety and soundness or financial stability of higher capital requirements for G-SIBS – after all, the Federal Reserve announced just a few weeks ago that all of the U.S. G-SIBs had substantially more capital than necessary to weather, largely unaffected, a recession significantly worse than the recent financial crisis. On the other hand, the potential costs are quite clear – the negative impact to lending and credit availability of increasing G-SIB capital requirements by up to \$222 billion would be substantial. Indeed, it is perplexing to juxtapose, on the one hand, the Bank of England's recent decision to reduce its countercyclical capital buffer requirement, as a means to spur its economy, and on the other, an anticipated decision in the United States to substantially *increase* its

capital requirements notwithstanding continuing concerns about the strength of the U.S. economy.

IV. Key Considerations in Rationalizing and Tailoring the Regulation of Bank Capital

We support efforts to carefully evaluate the current regulatory framework, including capital, to identify areas in which the regulation of banks can be improved and their benefits and costs better balanced. We would suggest that any effort to do so take into account the following key considerations:

- *First*, the importance of identifying areas in which further changes are pending or anticipated, and ensuring that no further action is taken until the cumulative impact and consequences of the very large body of post-crisis rules already enacted are evaluated and understood. We have identified two key examples as pertains to bank capital in Part III (e.g., Basel IV and the increase of minimum capital requirements through CCAR), but there are likely to be others.
- *Second*, the need to identify aspects of those capital regulations already enacted that should be adjusted or improved, so as to ensure that their incremental benefits, relative to the post-crisis framework as a whole, are worth their costs. We have identified a number of these in Part III (e.g., CCAR, the leverage ratio, etc.), but again, there are likely to be others.
- *Third*, the importance of identifying existing capital and other prudential rules that can better tailored to the differing risk profiles and business models of various banks. Opportunities for further tailoring are likely to exist across the broad spectrum of bank types and business models, including community banks, regional banks of various sizes, G-SIBs, and the U.S. operations of foreign banks. And indeed, to the extent that a key objective of that exercise is to ensure that U.S. banks are in a position to efficiently meet the needs of their customers and the U.S. economy as a whole, it is crucial that steps to rationalize and better tailor the regulatory regime across the *entire* U.S. banking system.

* * * * *

Thank you for the opportunity to testify before the Committee today. I look forward to answering your questions.



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TESTIMONY
OF
THE HONORABLE JIM NUSSLE
PRESIDENT AND CHIEF EXECUTIVE OFFICER
CREDIT UNION NATIONAL ASSOCIATION
BEFORE THE
COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES
AT A HEARING ENTITLED,
"MAKING A FINANCIAL CHOICE: MORE CAPITAL OR MORE GOVERNMENT
CONTROL?"

JULY 12, 2016

Testimony
Of
The Honorable Jim Nussle
President and Chief Executive Officer
Credit Union National Association
Before the
Committee on Financial Services
House of Representatives
Hearing Entitled,
“Making a Financial Choice: More Capital or More Government Control?”
July 12, 2016

Chairman Hensarling, Ranking Member Waters, Members of the Committee:

Thank you very much for the opportunity to testify at today’s hearing. My name is Jim Nussle, and I am the president and chief executive officer of the Credit Union National Association (CUNA). CUNA represents America’s credit unions and their more than 100 million members.

Credit unions play an important role in the financial lives of their members. With a mission to promote thrift and provide access to credit for provident purposes, credit unions were first established in the United States more than a century ago. As member-owned and not-for-profit cooperatives, credit unions are the original consumer protectors in the financial services sector. They are regularly commended for their high-quality, member-centric service; indeed, *Consumer Reports* recently identified credit unions as the highest rated sector they had ever reviewed.¹

The purpose of my testimony today is to convey CUNA’s views on Title I of Chairman Hensarling’s Financial CHOICE Act. However, I would be remiss if I did not also discuss why this and other legislation seeking to address regulatory burden are so important to credit unions and the members that they serve.

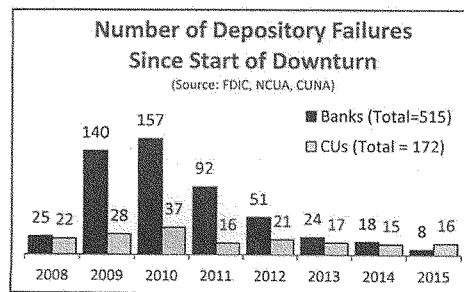
Credit Unions Fared Very Well in the Financial Crisis Because the Cooperative Model Militates Against Excess Risk-Taking

¹ Blyskal, Jeff, “Choose the Best Bank for You.” *Consumer Reports*, available at: <http://www.consumerreports.org/banks-credit-unions/choose-the-best-bank-for-you/> (Dec. 4, 2015).

Credit union boards of directors are generally uncompensated volunteer members of the credit union. This lack of compensation incentivizes them to ensure the credit unions are run for the benefit of the member owners. This lack of compensation incentivizes them to ensure that credit unions are run for the benefit of the member owners. The absence of stock options for senior management and board members, and the absence of pressure from stockholders to maximize profits ensures that management will eschew higher-risk, higher-return strategies and run credit unions for the benefit of members.²

As a result, credit union operations are less risky, and subject to less volatility over the business cycle. For example, from 1992 to 2015, the average annual net charge-off rate on credit union loans was 0.60%, with a standard deviation of 0.22%. In contrast, the similarly computed average at banks over the same period was 0.87%, with a much greater standard deviation of 0.59%.

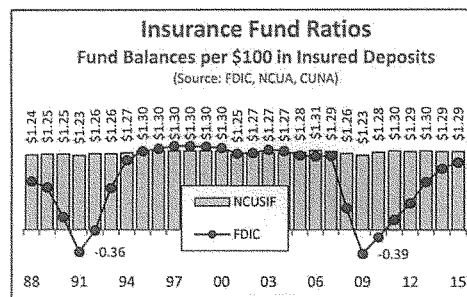
Because of this lower-risk profile, credit union failures tend to be much less common than bank failures. For example, at the beginning of the financial crisis there were 8,504 federally insured banks and 8,101 credit unions. Since the beginning of the financial crisis, credit unions reported a total of 172 failures (a 2.1% failure rate) and banks reported a total of 515 failures (a 6.0% failure rate).



² Edward J. Kane and Robert J. Hendershott, *The Federal Deposit Insurance Fund that Didn't Put a Bite on U.S. Taxpayers*, *Journal of Banking and Finance*, 20 (September, 1996), pp. 1305-1327. Kane and Hendershott describe how the cooperative structure of credit unions presents credit union decision makers with incentives that are strikingly different from those faced by a for-profit financial institution, making it less feasible for credit union managers to benefit from high-risk strategies.

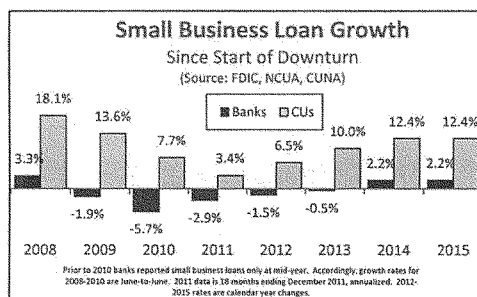
During the crisis, the bank deposit insurance fund operated in the red (for the second time in recent history), while the credit union insurance fund remained well funded—reflected in a fund ratio that has consistently remained above \$1.20 per \$100 in insured deposits.

Credit unions take on less risk, so they tend to be less affected by the business cycle. They therefore serve as an important counter cyclical economic force in local markets, softening the blow of financial downturns in local economies.



Recent history clearly demonstrates that—credit unions were able to continue lending during the recent financial crisis, while other financial institutions failed or had to curtail operations due to damaged balance sheets caused by their less risk-averse practices in the run-up to the crisis.

From June 2007, the onset of the financial crisis, to December 2015, small business loans at credit unions more than doubled—growing by over 130.0% or an average of 10.3% per year. In contrast, such loans at banks actually declined by 10.0% (or -1.2% per year).



Ever-Increasing Regulatory Burden Reduces Credit Union Members' Access to Safe and Affordable Financial Services from Cooperative Financial Institutions They Own

I have been CUNA's CEO for nearly two years, and a constant refrain I hear from our member credit unions is that they are being crushed by regulatory burden that has been imposed in response to a crisis they neither caused nor contributed to. Regulatory burden impedes credit unions' ability to fully serve their members and is the leading driver of credit union consolidation, which has accelerated since 2010 and is now at a record pace. While the top-line data show a healthy, strong and growing credit union sector, credit unions are hiring more compliance officers than loan officers. And, CEOs and volunteer board members tell us they would like to do even more for their members, but are often stifled by new regulatory requirements.

Shortly after I took the helm, CUNA was asked to testify before the Senate Banking Committee. At that hearing, Senators asked us to quantify the costs of regulatory burden on credit unions and we commissioned a study by an independent third-party that had operational expertise in credit unions and banks. (See Appendix I.) The researchers took several credit unions through an intensive process to develop a model to produce a credible estimate of what the regulations are costing credit unions and their members each year. It adds up to about \$7.2 billion in 2014 alone, up from \$4.4 billion in 2010. This is money that is not being put to use to benefit credit

union members, but they're surely paying for it. If credit unions' regulatory burden costs were reduced, they would invest more in their members through better rates on savings and loans, stronger capital positions, and the development of alternative financial product and service delivery channels.

Credit union executives and volunteers have a hard time understanding why they must comply with the rules designed for the largest financial institutions and the abusers of consumers, and have an even harder time understanding why their elected representatives in Congress are not doing anything about it. So, we are here to engage in the process, not because we view the Financial CHOICE Act as a perfect bill and not because we believe it will solve all of the regulatory burdens facing credit unions, but because we think it is a good place to start the discussion on how to remove regulatory barriers so credit unions can more fully serve their members. We hope the Committee will engage in the process on a bipartisan basis.

Title I – Regulatory Relief for Strongly Capitalized, Well Managed Banking Organizations

Title I of the Financial CHOICE Act would create a path for qualifying credit unions and other banking organizations to operate with a reduced regulatory burden. Under Section 101, qualifying credit unions would need to maintain an average leverage ratio (net worth) of at least 10 percent. If a credit union meets this requirement and elects to operate under the provisions of Section 102 of the legislation, it would be exempt from certain provisions of the Federal Credit Union Act, and rules and regulations promulgated by the National Credit Union Administration (NCUA) that address capital or liquidity requirements or standards. The legislation includes processes for credit unions and the NCUA to follow in the event that a credit union's average net worth ratio falls below 10 percent; this process envisions the submission of a net worth restoration plan and provides for the immediate loss of election and corresponding regulatory relief benefits in the event the credit union's net worth ratio falls below 6 percent.

Section 103 directs the Federal Reserve, the Federal Deposit Insurance Corporation and the Office of the Comptroller of the Currency each to study how to design a requirement that banking organizations issue contingent capital with a market-based conversion trigger.

Section 104 directs the Governmental Accountability Office to study the benefits and feasibility of altering the current prompt corrective action rules and replacing the Basel-based capital ratios with the nonperforming asset coverage ratio as the trigger for specific required supervisory interventions.

Under the Federal Credit Union Act, credit unions are subject to statutory capital requirements. In order to be considered well-capitalized for the purposes of prompt corrective action, a credit union must maintain a leverage ratio of 7 percent. This is one percentage point higher than the requirement for banks. Unlike banks, most credit unions' only source of capital is the retained earnings of the credit union. With limited ability to raise capital and given the relatively conservative incentive strategy inherent in credit unions' cooperative structure, many credit unions operate with a leverage ratio in excess of 10 percent. To give you a sense of the portion of the credit union sector affected by this legislation, today 3,975 of the 6,078 insured credit unions have net worth ratios greater than 10 percent. This represents approximately 65 percent of credit unions that hold 62 percent of credit union assets and serve nearly 60 percent of credit union members. We believe many of these credit unions would take advantage of the regulatory relief provided under Section 102, which would include relief from, among other things, NCUA's regulations on interest rate risk, liquidity requirements, and the recently finalized risk-based capital requirements.

We appreciate that this legislation structures the higher capital threshold as an option, and not a requirement. We would resist efforts by Congress or the regulator to require credit unions to hold additional capital because it would take operational decisions out of the hands of credit unions and reduce the ability to lend to credit union members; further, such a requirement would be inappropriate and unnecessary for credit unions because they do not have a history of capital inadequacy. Nevertheless, while we strongly believe all credit unions should receive regulatory relief, providing relief to credit unions that have demonstrated a history of operating at higher capital levels and providing a process for remediation in the event that capital levels fall below 10 percent strikes an appropriate balance. It ensures the continued safety and soundness of the credit union, while at the same time removes barriers that keep credit unions from doing even more for their members.

This legislation recognizes the safe and sound practices in which credit unions already engage and provides incentives for all credit unions to consider maintaining a higher leverage ratio. This would provide an increased buffer against the National Credit Union Share Insurance Fund in exchange for reduced regulatory burden. While we are not in a position to speak on the suitability of this provision for other charter types, given the history and performance of America's credit unions, this option makes a lot of sense for credit unions. We note that several of the provisions in Section 102 would apply only to banks. While we believe that Congress should provide regulatory relief for all credit unions including those with a leverage ratio under 10 percent, within the constructs of this proposal, we encourage the Committee to include additional exemptions from other statutory requirements including (but not limited to) loan maturity limits (Section 1757(5) of the Federal Credit Union Act) and credit union service organization investment limits (Section 1757(5)(D) of the Federal Credit Union Act). Further, we ask the Committee to provide qualifying credit unions relief similar to NCUA's Regulatory Flexibility Program, which was discontinued by former NCUA Chairman Debbie Matz. These are items that NCUA has historically deemed to not pose a significant safety and soundness issue for well capitalized credit unions.

We also encourage the Committee to consider adding NCUA to the list of agencies tasked in Section 104 with conducting studies on contingent capital instruments. While most credit unions are limited to retained earnings to build capital, some credit unions have access to supplemental forms of capital through the low-income designation; further, NCUA is contemplating issuing a supplemental capital rule as discussed by the agency when it finalized its risk-based capital rule. We have contemplated the suitability of a contingent capital instrument in the context of supplemental capital for credit unions; as long as the banking regulators are studying the implication of a contingent capital instrument, it may be worth the effort for NCUA to do the same.

Other Titles of the Financial CHOICE Act

We are also currently reviewing the other Titles of the Financial CHOICE Act. We note that several provisions of Title III, VI and XI reflect legislative proposals that CUNA has supported

in the past. There are also a small number of provisions with which CUNA has very serious concerns. We intend to communicate to the Committee our views on the remainder of the legislation very soon.

Conclusion

We appreciate that the Committee is considering legislation to provide meaningful regulatory relief for so many credit unions. We look forward to reviewing the remainder of the legislation and working with the Committee to remove statutory and regulatory barriers so credit unions can more fully serve their members.

On behalf of America's credit unions and their more than 100 million members, thank you very much for the opportunity to testify today.



Credit Unions' Strongest Advocate™

Regulatory Burden Financial Impact Study

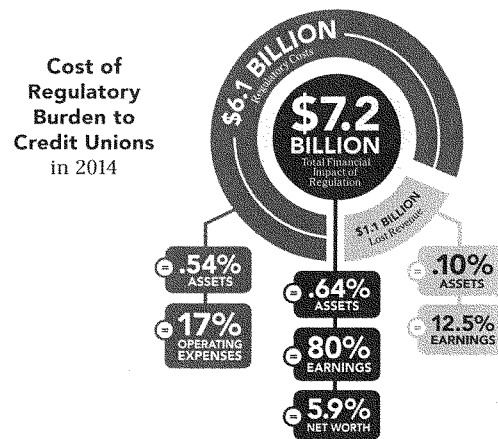
EXECUTIVE SUMMARY

Credit unions recognize that they operate in a regulated industry and must bear reasonable costs of regulation. However, the total financial impact of regulation on credit unions and their members is high and has increased dramatically since the recent financial crisis.

With the support of state credit union Leagues, CUNA commissioned Cornerstone Advisors to perform a rigorous analysis of the current financial impact of regulation on credit unions, and how much it has changed since 2010.

Cornerstone Advisors conducted a two-phased study to gain an in-depth examination and quantify the impact of regulation at small, medium and large credit unions. The study gathered data in terms of increased costs, including staffing, third party expenses and capitalized expenses, and reduced revenue opportunities.

These financial impacts are considerable in terms of the scale of credit union operations.



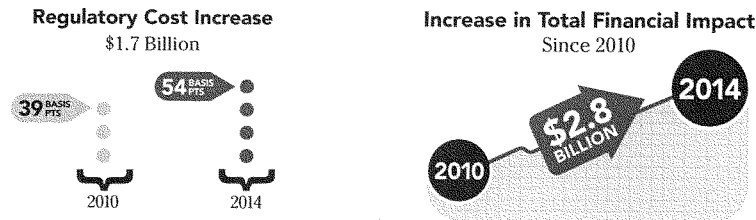
This summary was prepared by CUNA. Readers are encouraged to refer to the full study.

cuna.org/regburden



INCREASE IN REGULATORY IMPACT SINCE 2010

The regulatory cost of 54 basis points of assets in 2014 represents a 15 basis point increase from the 39 basis point cost the study found in 2010. This means that regulatory costs for credit unions in 2014 were \$1.7 billion higher than they would have been without the changes that occurred from 2010 to 2014. Adding the 10 basis point reduction in revenues (\$1.1 billion) yields an increase in total financial impact of 25 basis points (\$2.8 billion), from 39 basis points to 64 basis points.

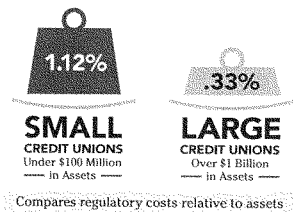


LOST REVENUE

The study considered how revenue has been influenced by regulation, especially by changes in regulation. Participants identified a number of business lines that had been affected by regulatory changes, primarily related to lending and interchange income.

Although, lending revenue has no doubt been affected by regulation, the amount is difficult to accurately quantify. Therefore, the only revenue reduction included in the study is that due to reduced interchange income as a result of the Durbin Amendment to the Dodd Frank Act. This means the study's \$1.1 billion estimate for revenue reduction underestimates the actual amount.

Small Credit Unions Bear the Brunt of Regulatory Burden



REGULATORY IMPACTS AND CREDIT UNION SIZE

The study found dramatic evidence of differential impacts by credit union size. Cost impacts were much stronger at smaller versus larger credit unions. There are basic fixed costs associated with complying with regulations, and at larger credit unions these costs can be spread over a larger asset base. In contrast, adverse revenue impacts were stronger at larger than smaller credit unions. This is because members of larger credit unions are more likely to generate interchange income by using a debit card from their credit union.

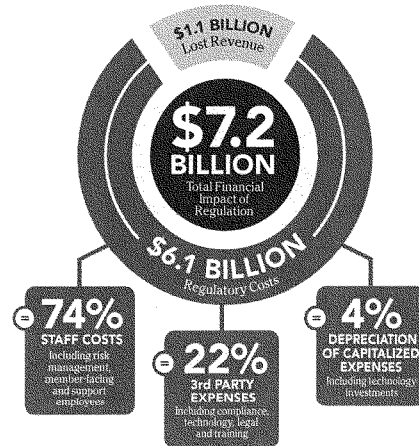
This summary was prepared by CUNA. Readers are encouraged to refer to the full study:

cuna.org/regburden



TYPES OF REGULATORY COST

The study collected data on three types of costs related to regulation: staff costs, third party expenses and depreciation of capitalized costs. For each cost category, care was taken to include only that portion of the costs that are driven by regulatory requirements. For example, for compliance staff, time spent on compliance with internal policies not required by regulation was not included as a regulatory expense.



The largest component of regulatory expense was for staff, at 74% of the total. This is not surprising as compensation typically accounts for about half of total credit union operation expenses.

Of the staff costs driven by regulation, the largest component came in member-facing staff. This suggests that credit unions have to employ more such staff than otherwise, and/or that member facing staff have to divert much of their attention from serving members to complying with regulations.



This summary was prepared by CUNA. Readers are encouraged to refer to the full study.

cuna.org/regburden

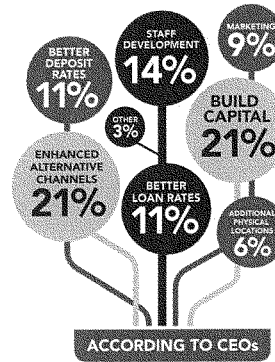


Credit Unions' Strongest Advocate™

STRATEGIC IMPACTS

The study solicited credit union CEOs' views on how the funds devoted to regulation would have been reallocated within the credit union had they not been drained by regulation. Better member pricing, better service delivery, and institutional strengthening topped the CEO's lists.

In addition to extensive data collection, the study solicited participating CEOs' viewpoints of where they had seen the greatest increase in regulatory impact in the areas of greater costs, reduced productivity, and reduced revenues. The greatest cost and productivity impacts occurred in compliance, mortgage and consumer lending and internal audit. The greatest revenue impacts were in mortgage lending, debit interchange and payments.



KEY THEMES

As a result of engaging with credit union executives over several months while conducting the study, Cornerstone Advisors analysts catalogued four key features of how credit unions view the impact of regulation:



CONCLUSION

The study found that the costs that credit unions bear as a result of regulation, even when conservatively measured, are very high, and have increased substantially since the financial crisis and Great Recession. The burden is particularly egregious for smaller institutions.

This summary was prepared by CUNA. Readers are encouraged to refer to the full study.

cuna.org/regburden

Regulatory Financial Impact Study

Report of Findings

February 2016

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**CORNERSTONE
ADVISORS, INC.**

WHERE STRATEGY MEETS EXECUTION

Regulatory Financial Impact Study

Report of Findings

Contents

Executive Summary	2
Assessment Approach and Overall Findings	5
Study Objectives and Approach	5
Overall Findings	8
Detailed Findings and Conclusions	17
Cost Impact	18
Staff Costs	19
3rd Party Expenses	26
Capitalized Costs	27
Lost Revenues	30
Interchange Income	30
Reduction in Originations & Other Services	31
How Regulatory Impact Has Changed from 2010 to 2014	33
Staff Increases: 2010-2014	38
Strategic Impacts	34
Perceived vs Real Impacts	35
Reallocation of Resources	35
Key Participant Comments and Themes	37
Member Impacts	39
Conclusions	44
Area for Further Study	45
Appendix I	47
Appendix II	54



Executive Summary

Credit unions operate in a regulated industry and recognize that there is a related cost of doing business. However, the level of cost that regulation imposes on credit unions is high (when compared to industry earnings and cost base), and has dramatically increased since the recent financial crisis and its aftermath.

While there is recognition in Congress of the adverse effects of regulation, there has been no hard data on the actual costs of regulation. Consequently, the Credit Union National Association (CUNA) commissioned Cornerstone Advisors to conduct the first-ever study to quantify the regulatory cost imposed on credit unions. This report summarizes the findings from the study and describes the impact on credit unions, their members and the communities they serve.

Cornerstone gathered detailed data from 53 credit unions nationwide on the financial impact of regulation today (as measured using 2014 results) as well as the increase in cost since 2010 (the beginning of the Dodd-Frank era.) The study measures financial impact in two ways:

1. **Costs** such as staff, technology and 3rd party support expenses incurred because of regulations
2. **Revenues** not earned because of regulations, such as lost loan production and lower noninterest income

While there is a wide range of regulations, the study focused on the collection of banking and non-banking (e.g., Affordable Care Act, IRS, etc.) regulations that have the highest impact rather than trying to quantify the impact of each and every regulation. We also employed a conservative approach to quantifying the financial impact of regulations on credit unions in the following ways:

- In the data collection process, we instructed credit unions to only include costs and reduced revenues they could reasonably quantify.
- We instructed credit unions not to allocate overhead or other ancillary costs based on the amount of staff time devoted to regulatory impacts.
- We excluded amounts that could not be validated or were incomplete.

Our primary findings are summarized below:

REGULATORY IMPACTS	ANNUAL IMPACT
Annual regulatory cost impacts on the credit union industry – 2014	\$6.1 billion or 0.54% of assets
Lost revenues in the form of interchange income – 2014	\$1.1 billion or 0.10% of assets
Total regulatory Financial Impact on the credit union industry – 2014	\$7.2 billion or 0.64% of assets
Increase in staff time spent on regulatory activities since 2010	91%
Increase in regulatory cost impact since 2010	\$1.7 billion or 0.15% of assets

The median regulatory cost impact was 54 basis points of assets, and the median reduction in revenue was 10 basis points. Applying those findings to total credit union assets in 2014 generates industry wide estimates of \$6.1 billion in regulatory costs and \$1.1 billion of lost revenue, for a total financial impact of regulation of \$7.2 billion. This total regulatory financial impact represents 80% of 2014 credit union earnings (which was 0.80% return on assets) and 5.9% of 2014 industry net worth. The cost impact represents 17% of industry 2014 operating expenses, and the revenue impacts represents 12.5% of credit union earnings.

The estimated revenue impact actually understates the effect of regulation on credit union income. Many credit unions reported that new regulations had reduced loan volumes, especially in mortgages, but they had no way to quantify the amount of reduction. In keeping with our conservative approach to data collection, we did not include any estimate of reduced revenue from lower loan originations. Therefore, the \$1.1 billion estimate of lost revenue understates the actual amount of revenue reduction due to increased regulation.

Of the 54 basis points of assets (\$6.1 billion) devoted to regulatory costs in 2014, 15 basis points or \$1.7 billion was an increase over regulatory costs in 2010, an increase of 39%¹. It is important to note that we found substantial benefits from scale economies and the majority of the industry's growth has been at large credit unions. This concentration of growth likely understates the true industry-wide, additional cost of regulation since 2010. All of the revenue reduction was due to changes since 2010. Therefore, the increase in total regulatory impact from 2010 to 2014 was \$2.8 billion.

The regulatory financial impact to credit unions affected all areas of the institution, with the biggest impacts in Risk Management, Member Services and Lending. The costs in Risk Management are primarily in the form of additional employees and increased legal & advisory expenses to comply with regulations. In Lending and Member Services, the impact represents increased time by member-facing staff on regulatory activities (and less time with members) and higher technology costs to ensure their systems supported new regulations. Credit union-wide, the equivalent of about one staff member's time for every 4 employees is spent on regulatory compliance.

¹ The 39% increase is based on regulatory change in costs from 2010 to 2014 as a percentage of assets. This approach effectively excludes the industry's growth over the last 4 years and allows better measurement of the real impact of regulation since 2010 versus increases due to growth. (The median asset growth for participants was 27% from 2010 to 2014 vs the industry average of 23%) If the industry's growth rate is included in the calculation, the increase in regulatory costs is closer to \$2.5 billion.



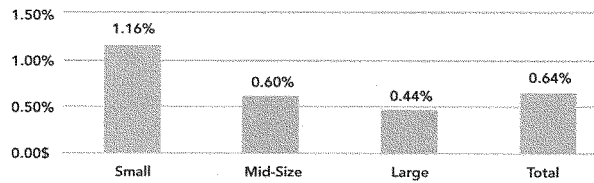
We also evaluated the results based on the size of the credit union:

- Small credit unions (Less than \$115 million in assets)
- Mid-sized credit unions (\$115 million to \$1 billion in assets)
- Large credit unions (>\$1 billion in assets)

When segmented by size, the results highlighted the disproportionate impact on smaller credit unions, as measured by the financial impact of regulation as a percent of assets as shown in the following chart. The median financial impact at the smaller credit unions at 1.16% of assets is two and a half times greater than the 0.44% median impact at larger credit unions. While the relative cost for large credit unions is lower, the dollar impact is significant. As an example, the median cost for a \$1 billion institution equals \$4.4 million compared to a \$1.1 million regulatory cost at a credit union with \$100 million in assets.

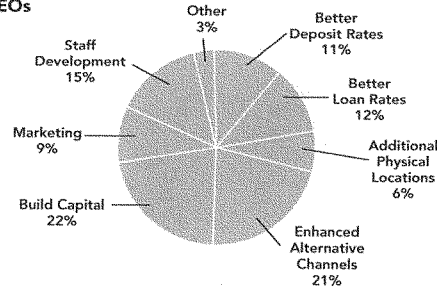
MEDIAN REGULATORY FINANCIAL IMPACT BY ASSET SIZE

(As a % of Assets)



We also asked Credit Union CEOs where the funds would have been reallocated if not spent on regulation. The vast majority of the reallocation focused on increasing member benefit — either in terms of better rates, lower fees, and / or enhanced products & services, as shown in the chart below.

REALLOCATION OF REGULATORY COSTS BY RESPONDENT CREDIT UNION CEOs



Our conservative estimate of the total financial impact of regulation on credit unions of \$7.2 billion can serve as a benchmark against which policy makers can compare the benefits of regulation.



Assessment Approach and Overall Findings

Study Objectives and Approach

Cornerstone Advisors performed a two-phase study to quantify the financial impact of regulations on credit unions. The study focused on extensive data collection to ensure that findings and conclusions are fact-based and supported by analytical rigor.

Objectives and Scope

The study measured regulatory financial impact in two primary categories:

1. **Costs** such as staff, technology and 3rd party support expenses incurred because of regulations
2. **Revenues** not earned because of regulations, such as lost loan production and lower noninterest income

We summarize the findings in each of these categories and in the aggregate. In addition, we quantified the impacts into three groups based on asset size:

- Small credit unions (Less than \$115 million in assets)
- Mid-sized credit unions (\$115 million to \$1 billion in assets)
- Large credit unions (More than \$1 billion in assets)

The study covered all areas of the credit union and looked at regulatory costs as of today (using 2014 data — the most recent full year) as well as the changes to regulatory costs since the enactment of the Dodd-Frank Act (i.e., changes from 2010 to 2014).

While there is a wide range of regulations, the study focused on those banking and non-banking (e.g., ACA, IRS, etc.) regulations that have the highest impact. Rather than quantifying the impact of each and every regulation, we collected data based on the aggregate impact of all regulations for each function or department within a credit union.

Approach

We conducted the study in two phases:

Phase 1 – Initial Deep Dive Analysis of Three Credit Unions

Phase 2 – In-Depth Survey and Data Collection with 53 Credit Unions

Phase 1

The objective of Phase 1 was to identify the key regulations that had the most impact on the credit union industry, how those regulations affected credit union operations and how the effects differed based on the size of the institution. Three credit unions — one in each size group — participated in this Phase.

We conducted detailed interviews with management (including onsite visits), and reviewed credit union information & reports to identify the higher impact regulations that would form the basis for broader data gathering across the credit union industry as part of Phase 2.

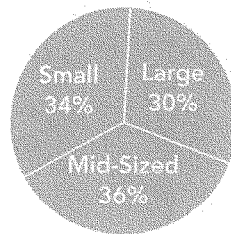
The regulations that had the most impact centered on three main areas:

1. Lending (e.g., Card Act, Qualified Mortgages, etc.)
2. Non-interest income (e.g., Durbin, etc.)
3. Credit union-wide (e.g., IRS, Department of Labor, etc.)

Phase 2

Based on the findings from Phase 1, we sent an in-depth data collection survey to 53 credit unions nationwide. The respondents were evenly distributed across the three size groups:

SURVEY RESPONSE DISTRIBUTION BY ASSET SIZE



The survey covered the two primary impact categories:

1. Costs
2. Lost Revenues

The Cost category captured regulatory staff costs in the credit union. These staffing costs are defined as staff hired specifically to deal with regulatory compliance as well as staff time for other staff to perform regulatory-related activities. In addition, we captured technology and 3rd party service provider costs related to regulatory compliance across the entire credit union. We recognize that not all staff and non-staff costs are regulatory-related. As such and to be conservative, the cost estimate excluded costs related to non-regulatory activities (i.e.,

good business practice). The survey measured the amount of time that credit union staff (e.g., lenders, branch personnel, operations, risk management, etc.) spent on regulatory responsibilities versus their primary roles. As an example, time and resources to conduct reviews for adherence to internal underwriting policies are related to good business practices and processes and are thus not counted as regulatory costs.

We did not include any ancillary costs associated with the staff time driven by regulatory requirements such as occupancy costs or workstations for that staff. We included no allocation of overhead expenses.

Finally, the survey considered Lost Revenues from products and services no longer offered to members due to regulation as well as lower pricing (especially in interchange income) that reduced a credit union's ability to offer the breadth of products / services, better rates, and/or lower fees to members. Although several types of revenue reduction were cited by credit unions, especially in the area of reduced lending due to new regulations, the only revenue reduction that we included in the data analysis was lower interchange fee income. This is because credit unions were unable to definitively quantify the amount of reduced lending.

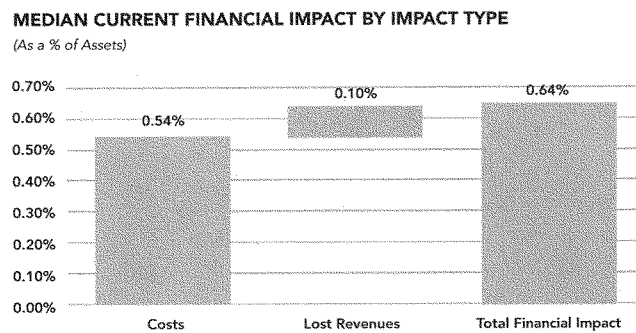
We reviewed the survey results, and incomplete information was discarded to ensure data completeness and consistency. In addition, information from the credit union's call report supplemented the survey responses to ensure data integrity and accurate size groupings. (See appendices for additional information on respondent demographics, an overview of the data collection & validation process and the survey sent to credit unions.)



Overall Findings

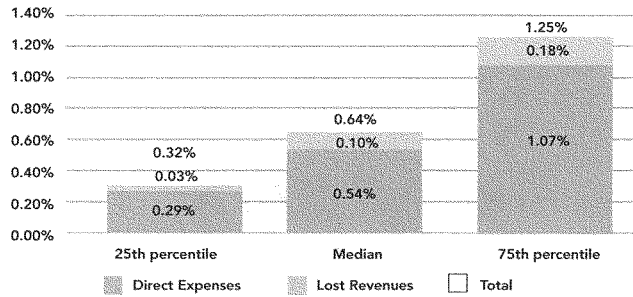
In this section we summarize the overall findings, first in terms of total financial impact, and then for each of the major components of the impact. In the following section, we provide more detail on the findings.

The median total financial impact of regulation for cost and revenue impacts equals 0.64% of assets with regulatory costs representing the bulk of the impact (0.54% of assets), and lost revenue making up the remainder at 0.10% of assets as shown in the chart below:

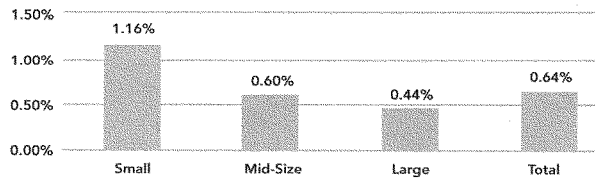


The median amount of 0.64% represents a significant portion of the 2014 industry net income or Return on Assets (ROA) of 0.80%. Even if the impact of Lost Revenues is excluded, the cost impact is about 68% of overall industry earnings and about 5% of the industry's \$123 billion in net worth — representing a significant portion on a credit union's resources. The 0.54% cost impact industrywide equates to over \$6 billion annually, and represents about 17% of the industry's \$34.8 billion in operating expenses.

The amount of regulatory financial impact relative to assets varies considerably around the 0.64% median as shown in the chart below. For a quarter of the credit unions studied, the total impact amounts to 0.32% of assets or less. However, for a quarter of credit unions, the impact of regulation represented at least 1.25% of assets. Most of this variation is driven by differences in the cost component as opposed to revenue impact.

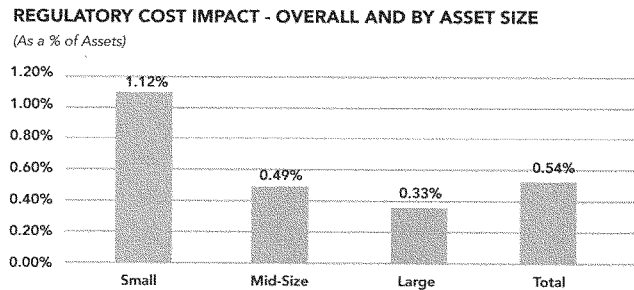
ANNUAL REGULATORY FINANCIAL IMPACT BY IMPACT TYPE*(As a % of Assets)*

This dispersion is attributable to the varying impacts based on the size of the institution. One common theme throughout the findings is that, relative to asset size, small and mid-sized credit unions carry a disproportionately higher cost as illustrated in the chart below. However, even though the financial impact as a percent of assets is relatively lower for larger credit unions, the dollar amounts are substantial. As an example, the median cost for a \$1 billion institution equals \$4.4 million, compared to \$1.16 million regulatory impact at a credit union with \$100 million in assets.

MEDIAN REGULATORY FINANCIAL IMPACT BY ASSET SIZE*(As a % of Assets)*

Cost Impact

The median regulatory cost impact is 0.54% of assets, which equates to \$6 billion annually and is 17% of total industry operating expenses. The cost impact overall and by asset size is shown in the chart below and highlights how the impact skewed much higher for smaller credit unions, where the median impact is over three times higher for small credit unions (1.12% of assets vs 0.33% for large credit unions.)

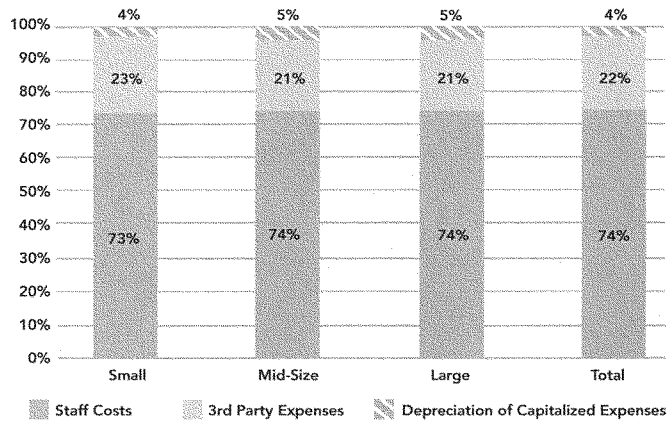


As context, statistics released by the NCUA for 2014 showed the average Return-on-Assets ratio (ROA) and Expense-to-Assets ratio for credit unions with \$10 million to \$100 million in assets as 0.37% and 3.65%, respectively. The median regulatory cost for a small credit union of 1.12% exceeded the average earnings of this size group and represented about 31% of its operating expenses. The impacts are slightly lower for mid-sized credit unions (NCUA grouping of \$100 million to \$500 million), but still substantial (80% of 0.61% ROA.) These credit unions do not expect their regulatory expenses to be zero, but their current levels are substantial and have increased dramatically over the past several years.

Large credit unions have lower relative impact because of their scale (e.g., more members and assets to spread the cost.) However, the absolute dollar amounts are still substantial. A \$1 billion credit union with median regulatory cost of 0.33% would equate to over \$3 million of regulatory-related expenses. Again, this represents a significant amount of dollars that could be reallocated to better serve members, improve savings or loan rates, reduce fees, or build capital.

When reviewing the most prevalent expenses, the majority represents staff costs across the entire credit union (about three-quarters of annual regulatory costs regardless of credit union size). 3rd party expenses include costs such as technology, consultants and outsourced services to meet regulatory requirements, while capitalized expenses are primarily technology spending that is amortized into earnings. The distribution is similar across asset sizes and highlights the need to attract qualified staff to keep up with and manage new regulations, as well as the level of change in technology and processes to comply with new regulations.

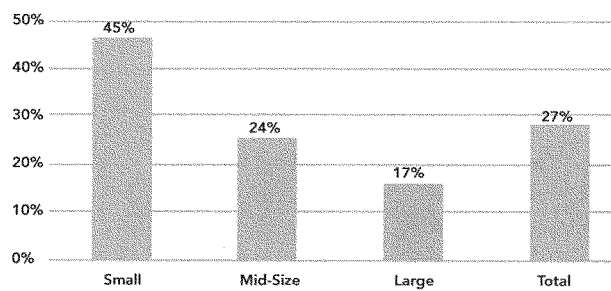
REGULATORY COSTS BY EXPENSE TYPE - OVERALL AND BY ASSET SIZE



Staff Costs

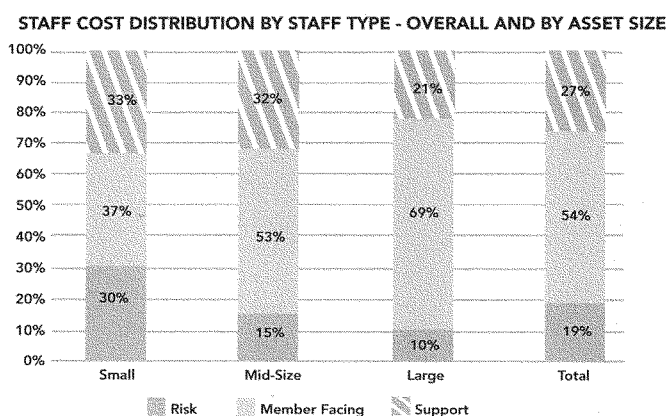
While staff cost is the largest component of regulatory costs, we also wanted to understand the impact relative to overall credit union staffing levels. The chart below shows median values for the proportion of total Full Time Equivalent (FTE) staff in the credit union that are devoted to regulatory activities. Overall, about one in four FTEs focused their time on regulatory compliance.

PROPORTION OF TOTAL FTES DEVOTED TO REGULATORY ACTIVITIES



There are significant differences among the three asset classes, with smaller credit unions devoting almost half of their staff time to dealing with the impacts of regulations. Large credit unions have the scale to better absorb regulatory expenses in general, but this is especially true as it relates to staffing. A significant part of this is due to technology investments that can be made to increase the efficiency of several regulatory-related processes — investments that smaller credit unions often cannot afford.

Regulatory staff cost is not confined to the Risk area (e.g., compliance, internal audit, enterprise risk management, etc.) In fact, areas outside of Risk bear the largest regulatory staff costs. From a departmental perspective, over half of the regulatory staff impact occurs in member-facing groups such as branches, call centers and lenders, as shown in the chart below. While this is somewhat expected given regulatory consumer protections, the amount of re-directed activities toward regulatory compliance is substantial and reduces the amount of time that these member-facing employees spend in solving member needs and problems. This results in either reduced service levels and/or increased headcount. Support areas such as deposit and loan operations, finance, and marketing are impacted primarily by the disclosure and reporting requirements imposed on credit unions.



The distribution of staff costs among Risk, Member Facing and Support varies by credit union size. Compared to their larger counterparts, small credit unions experienced a lower proportion of regulatory staff time in member facing areas, and correspondingly more in the other two categories, particularly in risk areas. This higher mix of Risk staff costs for smaller credit unions highlights their lack of scale in this area. In addition, while their proportion of member-facing regulatory staff is lower, it has an outsized impact on small credit unions' ability to provide basic member services given their overall smaller staff levels. For larger credit unions, their more complex lending mix (particularly in mortgage) and the related regulations account for the higher relative staff costs in member-facing areas.

Lost Revenues

In interviews and on the survey, credit unions described substantial reductions in revenue because of lost loans that otherwise would have been made and on noninterest income lost due to regulatory actions, particularly as it relates interchange income.

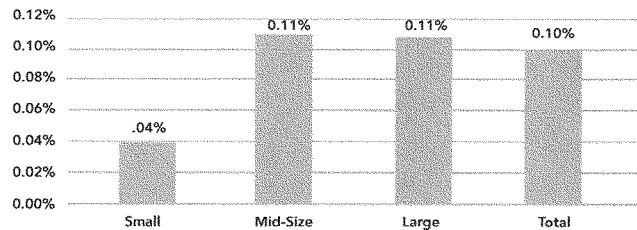
Smaller credit unions indicated significant negative revenue impact as regulatory requirements in areas like mortgages, open-ended lending and international wires forced them to terminate these products and services. The lost revenues are effectively a proxy in this case for a lower level of services to members. Credit unions in low income designated areas are most impacted as these are the type of products and services that members in those communities need.

However, despite identifying the fact that lending volumes and services were reduced, many of the respondent credit unions found it difficult to estimate by how much. In keeping with our conservative approach, although we note that the impact is likely substantial, we did not quantify it.

The area where we could quantify lost revenues was interchange income — which equated to about 10 basis points of credit union assets, as shown in the following chart. The Durbin Amendment had a direct impact on financial institutions over \$10 billion in assets, but also created consequences that negatively impacted credit unions under \$10 billion in assets. Specifically, the amendment created more competition among card processors (e.g., PINless debit, PIN Authenticated Visa Debit (PAVD)), resulting in lower average fees for both PIN and signature transactions. For this impact, we calculated lost revenues by applying the difference in the average transaction fees between 2010 and 2014 to the current transaction volume. While innovation and competition is generally positive, the positive impact has accrued to merchants at the cost of credit unions and ultimately members — in terms of lower capital and fewer investment dollars available to support member growth and needs. In this particular case, larger credit unions had the greater impact given the higher penetration and usage of debit cards by their membership.

LOST INTERCHANGE FEE INCOME - OVERALL AND BY ASSET SIZE

(As a % of Assets)

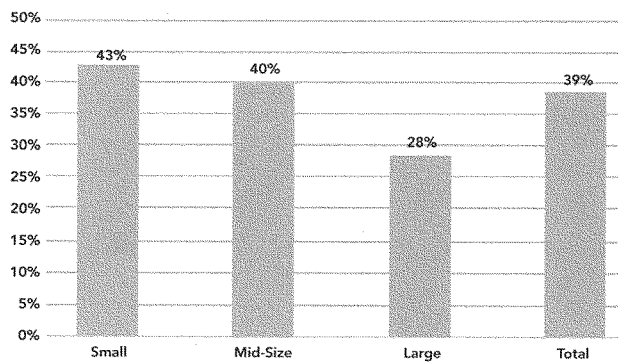


Increased Regulatory Financial Impact Since 2010

In addition to understanding the total regulatory financial impact today, the study also looked at how the financial impact has changed since 2010 when the Dodd-Frank Act was passed. The intent is to highlight how much additional financial impact credit unions incurred when their fundamental business models and mission have not changed much in that time frame.

Regulatory cost impact rose from 0.39% in 2010 to 0.54% in 2014, a 39% increase since 2010 – a large increase given the long history of credit unions and the short time from the Dodd-Frank Act to today. Again, smaller credit unions had the highest percentage increase (43%) due to lack of scale, as shown in the chart below.

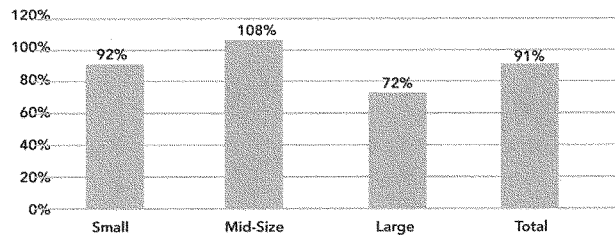
% INCREASE IN REGULATORY COST IMPACT SINCE 2010



To put this increase in context, total industry assets and expenses only increased 21% and 16%, respectively, from 2010 to 2014, while the industry operating expenses as a percent of assets actually decreased from 3.19% in 2010 to 3.05%. In other words, the industry's efforts to be more efficient and productive has been significantly offset by the higher regulatory costs.

Staff cost is the most significant contributor to the increase in regulatory costs. The total staff time spent on regulatory compliance almost doubled since 2010 (91%), as shown in the chart below. Again, the increase in the burden was greatest for small and mid-sized credit unions. The double-digit average annual increase over the last 4 years impacted all credit unions regardless of size and far exceeded credit union growth rates during that same period.

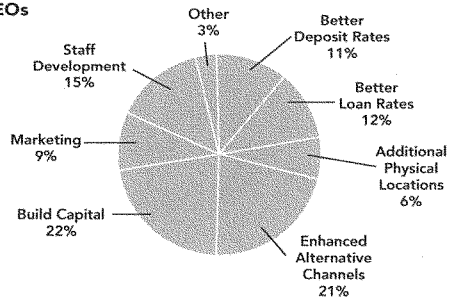
CUMULATIVE CHANGE IN REGULATORY FTES - 2010 TO 2014



Membership and Community Impacts

The resources to support the current regulatory cost could be re-directed to other uses that would benefit the member and the community. We asked the CEOs of the respondent credit unions where they would reallocate those resources, and the vast majority of the responses centered on providing better products / services and rates & fees to members. For larger credit unions, community giveback is also a high priority. The distribution of their responses is summarized in the following chart.

REALLOCATION OF REGULATORY COSTS BY RESPONDENT CREDIT UNION CEOs



Conclusions

The overall regulatory financial impact on the credit union industry is over \$7.2 billion, with \$6.1 billion (or 85% of the total impact) in costs. This is equivalent to 80% of industry earnings and 5.9% of net worth. The cost component of the financial impact equals 17% of industry expenses. All credit unions recognize that they are in a regulated industry and there will be a cost. However, the level of cost that regulations and regulators imposed has dramatically increased since the financial crisis and its aftermath. Annual regulatory costs as a percent of assets increased 39% since 2010 with higher staff and staff time devoted to regulatory activities making up most of that increase.

The percentage cost relative to credit union asset size is heaviest on smaller credit unions. However, the impact in absolute dollars is much higher for larger credit unions. These dollars would be redeployed to better rates / fees and products & services for members as well as community development.

There is no consensus on which regulations impose the greatest cost on credit unions. However, based on free form comments by respondents, four key themes emerged around the greatest causes of their current cost, especially over the past few years:

- Uncertainty and ambiguity around written rules
- Inconsistent application / interpretation of regulations by examiners
- Steady stream of regulations that create high levels of change management (e.g., death by a thousand cuts)
- One size fits all approach to regulation

These themes and the higher regulatory costs today underscore the increased risk in several areas:

- **Operational** – greater complexity in process and higher level of process change and training required
- **Compliance** – more and continuous regulations to track, monitor and incorporate into business processes
- **Strategic** – diverts resources from core mission and reallocates resources away from core business activities

The findings from this study will provide policymakers, credit unions and other stakeholders with the facts to perform a more robust cost-benefit assessment of the regulations (passed and pending) to determine what is an appropriate level of regulatory cost in light of credit unions' current level of regulatory cost and credit unions' mission of community and member service.



Detailed Findings and Conclusions

This section covers more in-depth results for each of the two major regulatory financial impact categories: Costs and Lost Revenues. In addition, it also addresses Strategic Impacts as they relate to resource allocation decisions.

SECTION	DESCRIPTION
Costs	Regulatory-related Staff and 3rd party expenses incurred throughout the major functional areas of the credit unions.
Lost Revenues	Revenue reductions as a result of regulations.
Strategic Impacts	Impacts to the credit union through the viewpoint of the CEOs. Insight on how resources would have been allocated if not for regulatory cost.

The regulatory financial impact estimates are based on data from systems of record from participants and conservatively calculated into quantifiable costs. Outlying data that appeared to be unrealistic due to the abnormally high financial impact was removed from the aggregate data in this study. To further demonstrate the full extent of regulatory financial impact, the study captured specific examples to explain impacts on credit unions and their members in addition to the conservatively quantified estimates. (See appendices for an overview of the data collection & validation process as well as free form comments and themes from respondents to illustrate examples.)

Our industry-wide estimates of the dollar cost and lost revenue impacts of regulation are derived by applying the medians of these impacts (expressed as a percentage of assets) at the study's subject credit unions to total assets for the credit union industry.

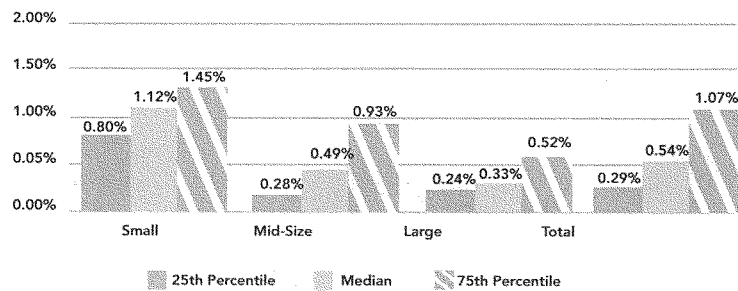


Cost Impact

Regulatory costs represent 0.54% of assets or \$6.1 billion in cost, per the chart below. Scale does matter as seen in the higher relative impact of regulatory costs on smaller credit unions. The median ratio of regulatory costs to assets falls from 1.12% for small credit unions to 0.54% for large credit unions, as shown below. Even the cut-off point marking the lowest 25% of small credit unions in terms of regulatory cost (0.80% of assets) is higher than the cut-off for the top 25% of large credit unions (0.52% of assets.) In other words, over three quarters of small credit unions have higher ratios of regulatory impact to assets than the cutoff for the 25% of large credit unions with the highest ratios of impact to assets.

ANNUAL REGULATORY COST IMPACT - OVERALL AND BY ASSET SIZE

(As a % of Assets)



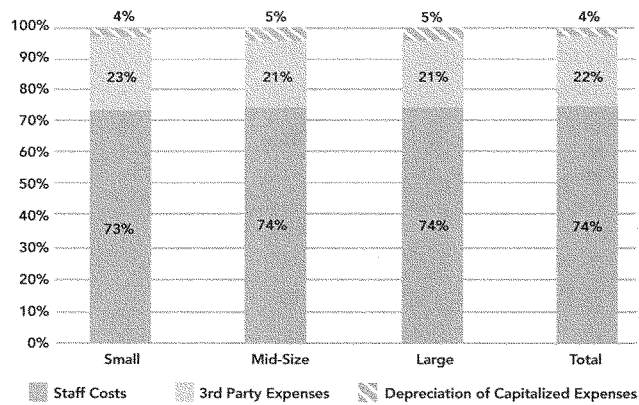
To estimate the cost amounts, we collected regulatory-related expenses across a variety of functions for the full calendar years of 2010 and 2014. We used the 2014 expenses to calculate the current total impact of regulatory cost, while using the 2010 data as a reference to determine how much regulatory expense changed over the last five years since implementation of the Dodd-Frank Act. The data collection also included both aggregate spending and the annual amortization & depreciation for capitalized costs as part of the study.

Regulatory costs are comprised of three primary types of expenses:

- Staff costs
- 3rd party expenses
- Amortization / depreciation for capitalized costs incurred between January 1st, 2010 and December 31st, 2014.

Per the chart below, staff costs make up about three-quarters of the total regulatory costs, with the mix very similar across asset sizes.

REGULATORY COSTS BY EXPENSE TYPE - OVERALL AND BY ASSET SIZE



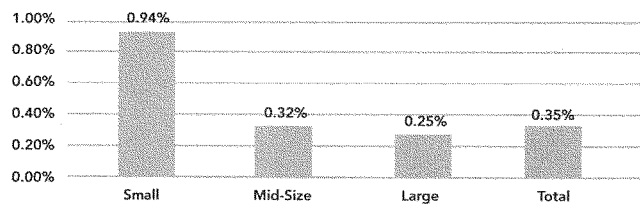
The following is a detailed review of each of the three cost components.

STAFF COSTS

Regulatory staff costs equate to about \$3.9 billion annually, or 0.35% of assets. As a recurring theme, the impact is disproportionately higher for smaller credit unions as staff members usually perform multiple roles including regulatory compliance and these credit unions often cannot afford dedicated regulatory staff. For larger credit unions, the staff necessary to cover necessary regulatory activities can be spread over a larger asset base. The median regulatory staff cost for small credit unions (0.94% of assets) is nearly three and four times larger than mid-sized and large credit unions, respectively.

TOTAL REGULATORY STAFF COSTS - OVERALL AND BY ASSET SIZE

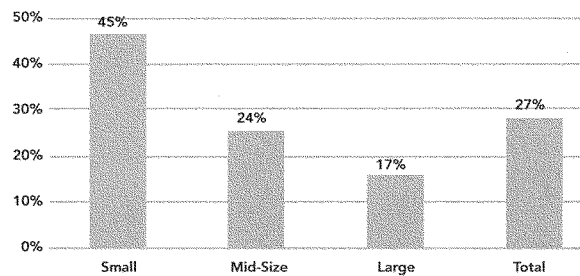
(As a % of Assets)



**Median costs for sub-categories may not add up to the median total cost for the combined category.*

Small credit unions are doubly impacted as they lose interaction time with members and often cannot afford to bring additional branch, lending or member service staff to offset the lost interaction time. This is seen in the chart below where almost half of the small credit union staff time is dedicated to regulatory activities. For the entire study group, about one in four FTEs focus their time on regulatory compliance.

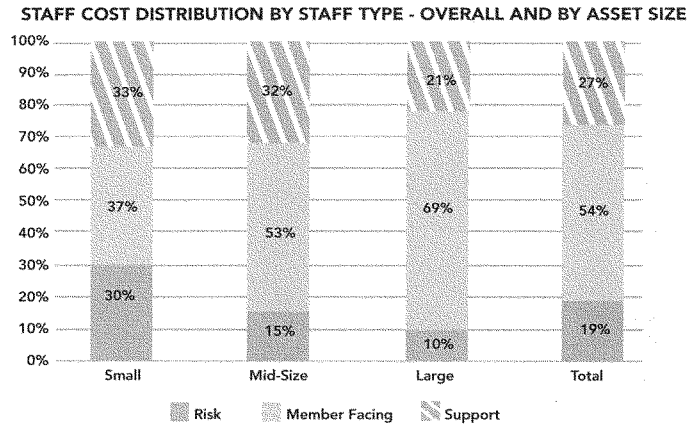
PROPORTION OF TOTAL FTEs DEVOTED TO REGULATORY ACTIVITIES



The study calculated staff costs by estimating the amount of staff and staff time dedicated to regulatory-related activities across all credit union functions and translating that time into cost amounts based on each credit union's average salary and benefit expense. We used three general classifications for the analysis:

1. **Risk Management staff:** Employees who perform the following functions typically associated with regulation – Compliance, Internal Audit, Bank Secrecy Act (BSA) / Anti-Money Laundering (AML), Enterprise Risk Management (ERM), Vendor Management
2. **Member-Facing Staff:** Employees who interact directly with members (e.g., tellers, branch and lending staff) or support a channel that directly interacts with a member (e.g., online banking)
3. **Support Staff:** Employees who do not typically interact directly with members and support the member-facing staff (e.g., finance)

The chart below shows the distribution of staff regulatory costs across the three staff groups, by credit union size and overall. Just over half (54%) of staff costs are incurred in the member facing areas, which not only impacts productivity, but also the credit union's ability to serve its members. Just over a quarter (27%) of regulatory staff costs are in risk management, and just under a fifth (19%) are in support areas.



Risk Management

Our definition of Risk Management includes the following functions:

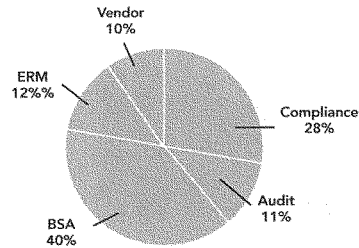
1. General Compliance
2. Internal Audit
3. Bank Secrecy Act (BSA) / Anti-Money Laundering (AML)
4. Enterprise Risk Management (ERM)
5. Vendor Management

The Risk Management staff cost (quantified using salary and benefits) dedicated to regulatory-related activities made up a sizeable contribution to the total staff cost for all credit unions, making up 19% of total regulatory staff costs as shown in the above chart. As with other regulatory related costs, Risk Management staff costs have a disproportionate impact on small credit unions relative to assets. The median Risk Management regulatory staff expense as a percent of assets for small credit unions (0.23%) is five and ten times higher than those of mid-sized (0.05%) and large credit unions (0.02%), respectively. Scale is a significant factor in achieving Risk Management staff leverage.

Not all Risk Management staffs' time is spent on regulatory compliance. Their responsibilities also relate to oversight of general business practices and policies, and their time spent on these activities is excluded from the regulatory cost estimates.

The distribution of regulatory staff costs across the various Risk Management functions is similar regardless of asset size and is shown in the chart below. Bank Secrecy Act and Anti-Money Laundering and General Compliance take up the bulk of staff expense in Risk areas.

DISTRIBUTION OF REGULATORY DIRECT STAFF EXPENSE BY RISK MANAGEMENT FUNCTION



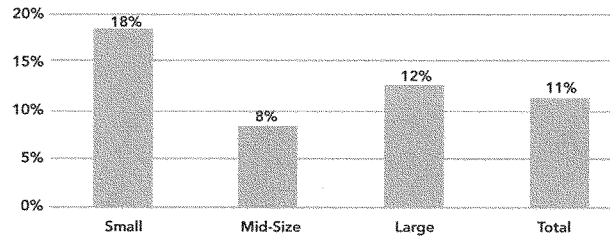
The staff time devoted to BSA compliance is the most significant category, with 40% of the total. Unlike other Risk Management functions, close to 100% of a BSA employee's time is related to regulatory requirements. It is common for financial institutions to centralize this function as much as possible to achieve scale to minimize the impact on other employees such as branch personnel.

Member-Facing Staff

The member-facing staff is the largest contributor to regulatory staff costs, accounting for 54% of total regulatory staff costs — with the highest proportion at larger institutions (69%), which have larger branch networks and staff as well as more member-facing lending personnel. The cost for member-facing staff equals \$2.1 billion in cost, or 0.19% of assets (54% of the overall median regulatory staff costs of 0.35% of assets.) This amount does not include the impact of lower usage of products and services due to less sales and service time spent with members.

When looking at how the amount of regulatory time compares to overall work time, more than 1 in 10 overall or total credit union staff are member-facing staff focused on regulatory requirements rather than serving members. The following chart shows the equivalent member-facing staff performing regulatory activities as a percent of the total credit union staff.

**MEMBER-FACING REGULATORY STAFF AS A % OF CREDIT UNION STAFF -
OVERALL AND BY ASSET SIZE**



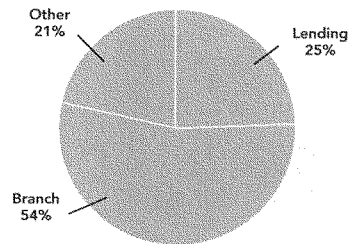
Similar to the Risk Management staff, small credit unions have the highest proportion of member-facing staff performing regulatory tasks. At the credit unions, these activities are typically a portion of an employee's job, and the time on regulatory activities would likely be reallocated from member-facing activities like servicing and sales. As such, these may be considered more "soft costs" that may not show up in earnings, but still have significant economic impact. In addition, these smaller credit unions often cannot afford to hire additional member-facing staff to replace the lost member interaction time.

Within member-facing staff, we grouped them into three general functions:

1. **Lending:** Mortgage, consumer and business lending originations
2. **Branch:** All staff located at branches
3. **Other:** Combination of other activities such as collections, call center and retail administration

The highest portion of member-facing staff costs is in the branches with 54% of the cost as shown below, and this was consistent among all asset classes.

MEMBER-FACING REGULATORY STAFF BY FUNCTION

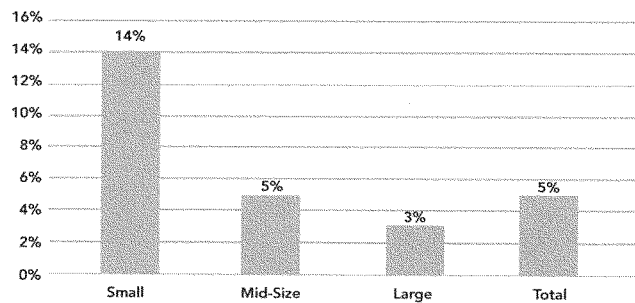


Although the overall allocation was roughly the same regardless of asset size, there was a slight difference observed within the Lending function. Large credit unions reported more regulatory related staff in mortgage originations, while small and mid-sized credit unions showed more allocated to consumer loan originations. This is due to differences in the credit unions' business model and their lending focus, with smaller credit union being less active in mortgage lending.

Support Staff

The staff cost for support staff equals \$1.0 billion in cost, or 0.09% of assets (27% of overall median regulatory staff costs of 0.35% of assets). Again, small credit unions have a higher portion of support staff dedicated to regulatory activities (14%) vs the overall median of 5%. The following chart shows the support staff performing regulatory tasks as a percent of the total credit union staff.

SUPPORT REGULATORY STAFF AS A % OF TOTAL CREDIT UNION STAFF

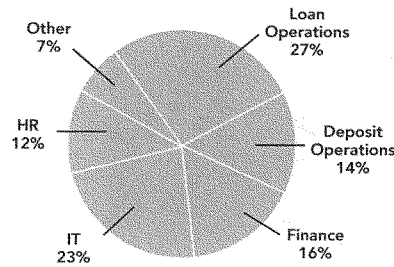


While the difference between small and large credit unions is significant for member-facing staff, it is even more so for support staff. The spread in terms of regulatory staff as a percentage of total credit union staff between large and small credit unions is 11 percentage points (3% vs 14%) for Support staff vs only a 6 percentage point difference for member-facing FTE (12% vs 18%). Support functions are typically more scalable operationally and this translates into the larger difference in the results above. In addition, the scalability is aided by investments in technology that larger credit unions can afford more than their smaller peers.

It would appear the activities associated with regulatory compliance are more easily absorbed in back office, non-member facing positions due to the benefit of scale as described above. In other words, it is better to consolidate regulatory activities wherever possible away from the member so there are more opportunities for member-facing staff to interact with members.

Regardless of asset size, the two largest support areas related to regulatory cost are Loan Operations, which consists of mortgage, consumer and business lending servicing, and Information Technology, as shown in the following chart.

SUPPORT REGULATORY STAFF BY FUNCTION



Loan Operations deal with collections and servicing regulations, while the IT departments focus on implementing new regulatory requirements (e.g., reporting, new controls, etc.) within existing systems or implementing new systems to comply. For example, one participant estimated that approximately 20% of the software releases are related to regulatory and IRS items. Moreover, each release required two staff members to perform testing and updates for 2 – 3 weeks. While the IT employee time dedicated to regulatory related tasks is included in this category, the lost opportunity and delays to perform updates for business applications and its impact is not a quantifiable part of the study.

3RD PARTY EXPENSES

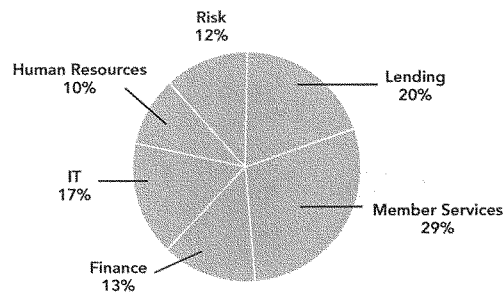
3rd party expenses are the second largest cost category after staff costs, and equate to about \$1.3 billion annually, or 0.12% of assets (22% of overall median regulatory costs of 0.54% of assets.) The 3rd party expenses spanned the entire credit union and covered activities such as Bank Secrecy Act, mortgage originations, online / mobile / ATM support, disclosures, legal and training. (Note that overhead costs such as workstations, supplies, etc. for additional regulatory-related staff are not included in the expense cost calculations due to the study's conservative approach, even though these are real costs related to regulation.)

Survey participants provided 3rd party expense data for almost 30 sub-functions (See Appendix for more details). The following table describes the six broad groups used for analyzing 3rd party expenses, along with the description for each:

PRIMARY FUNCTION	REGULATORY EXPENSE SUB-FUNCTIONS
Lending	<ul style="list-style-type: none"> • Mortgage Originations and Servicing • Consumer Lending Originations and Servicing • Business Lending Originations and Servicing • Credit Administration • Collections • Other Lending Expenses
Member Services	<ul style="list-style-type: none"> • Branches • Retail Administration • Call Center • Online, Mobile and ATM • Disclosures • Deposit Operations
Finance	<ul style="list-style-type: none"> • Finance • Asset Liability Management (ALM)
Information Technology (IT)	<ul style="list-style-type: none"> • IT Expenses (e.g., application updates)
Human Resources	<ul style="list-style-type: none"> • Human Resources Expenses (e.g. Affordable Care Act Compliance, Department of Labor Reporting) • Internal Training (e.g., Training Materials) • External Training (e.g., Conferences, Seminars)
Risk	<ul style="list-style-type: none"> • Compliance • Audit • BSA / AML • Enterprise Risk Management (ERM) • Vendor Management • Legal

The distribution of 3rd party expenses across each of the groups is shown in the following chart.

DISTRIBUTION OF REGULATORY 3RD PARTY EXPENSES BY FUNCTION



The distribution is roughly the same across the three asset size groups. Member Services required higher 3rd party expenses primarily driven by the cost of updating and sending disclosures & branch-related expenses. Although the Finance group was the third lowest proportion of 3rd party expenses, the cost of regulatory reporting compliance was highly emphasized by CFOs — particularly for large credit unions where it accounted for 60% of Finance's regulatory expenses.

CAPITALIZED COSTS

The annual amortization and depreciation expenses for capitalized regulatory costs represent a small component of regulatory costs. These costs are generally technology investments (e.g., licensing fees, computer hardware, etc.) that are amortized over a five year period.

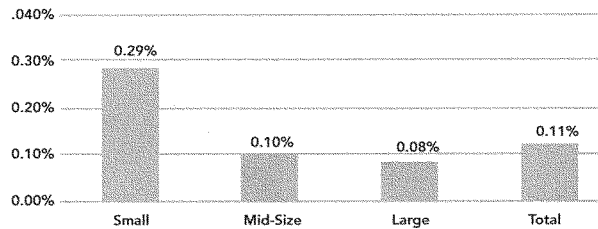
These costs equate to about \$225 million annually, or 0.02% of assets (4% of overall median regulatory cost of 0.54% of assets.) While the annual expense is low, the actual capital expenditure outlay from 2010 — 2014 is significant. Per the chart below, total regulatory capital expenditures over the last 5 years equal 0.11% of 2014 assets, or \$1.2 billion dollars.

Although survey participants provided capitalized costs incurred between 2010 and 2014 for regulatory compliance across the same set of nearly 30 sub-functions as previously referenced, only the annual amortization / depreciation is included in the regulatory costs for 2014. In other words, only one-fifth of regulatory capital expenditures incurred from 2010 to 2014 are included in the annual regulatory costs amounts.

Capitalized costs relative to assets vary considerably by credit union size. They are substantially higher for small credit unions in part due to the fixed costs related to hardware and some software licenses. For example, a server will generally cost the same across all credit unions regardless of size. In fact, the absolute cost may sometimes be higher for smaller institutions since they do not benefit from volume discounts.

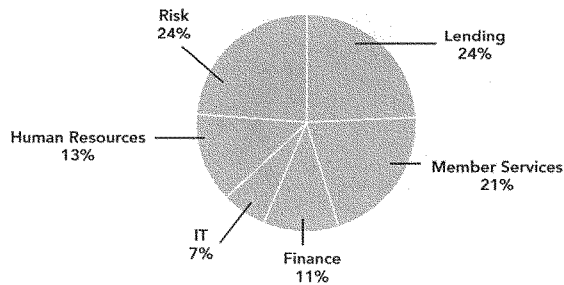
TOTAL CAPITALIZED COSTS FROM 2010-2014 - OVERALL AND BY ASSET SIZE

(As a % of 2014 Assets)

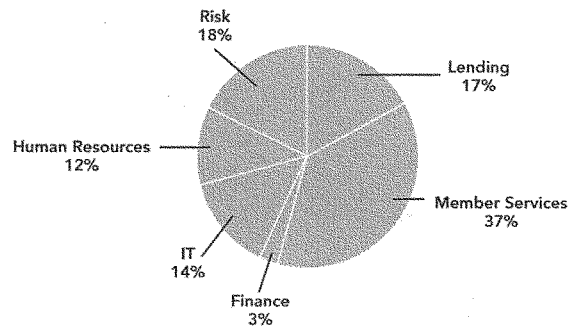


Capitalized costs are grouped into the same six categories as the 3rd party expenses. The distribution of these costs varies by credit union size, as shown in the following charts. The largest credit unions spent a considerable amount of capital expenditures in Lending given their broader and larger lending operations. In total, 25% of the large credit union respondents reported investments of over \$2 million between 2010 and 2014. On the flip side, the proportion of funds invested in Member Services and Risk decreased with asset size due to scale. The relatively higher expenses in the Risk category for small and mid-sized size credit unions relate to investments for compliance, audit and BSA / AML where they combined to represent the majority of the spending in this area. Discontinuing some products and services (given lower relative volumes) to avoid making the required investments contributed to lower non-Risk investments for smaller credit unions.

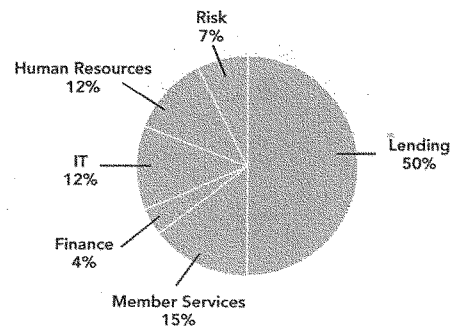
DISTRIBUTION OF CAPITALIZED COSTS BY FUNCTION - SMALL CREDIT UNION



DISTRIBUTION OF CAPITALIZED COSTS BY FUNCTION -
MID-SIZED CREDIT UNION



DISTRIBUTION OF CAPITALIZED COSTS BY FUNCTION -
LARGE CREDIT UNION



Lost Revenues

The survey looked at several sources of lost revenues across credit unions and how the extent of any reductions varied widely based on size, strategy and member base. The study focused on the most notable sources of lost revenue based on feedback in Phase I of the study. The primary sources are as follows:

- Interchange Income
- Qualified Mortgage (QM) Originations
- Multi-Feature Open-End Lending (MFOEL) Originations
- Member Business Lending (MBL) Originations
- Non-Sufficient Funds (NSF) / Overdraft (OD) Income

Although many credit unions described reductions in various types of lending brought about by new regulations, very few were able to quantify the impact. The impact on Non-Sufficient Funds (NSF) / Overdraft (OD) Income is driven primarily by member behavior rather than any specific regulations. The one exception is Regulation E's impact on courtesy pay adoption given confusion by both credit union staff and member as to rules and applicability. However, the impact could not be quantified reasonably. We also asked participants to provide revenue reductions incurred by Wealth Management, Insurance and Mortgage (if a separate affiliate), but results showed minimal impact in these areas.

Based on the difficulty of quantifying most of these effects, and to be conservative in our estimates, the only revenue stream we quantified for lost revenue is interchange income. Our results therefore understate the actual amount by which regulations have reduced credit union revenue.

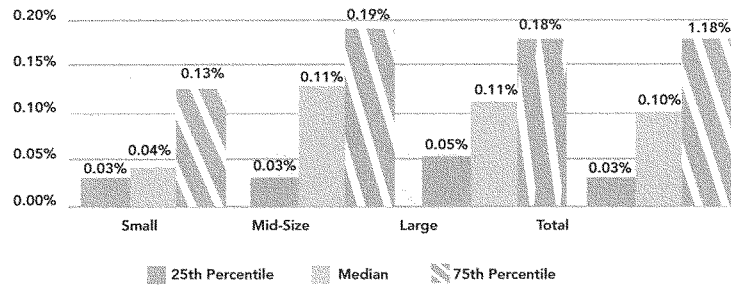
INTERCHANGE INCOME

The only quantifiable contributor to Lost Revenues included in the study is lower interchange fees. The quantifiable impact of Lost Revenues is 0.10% of assets, or \$1.1 billion. This represents 13% of 2014 industry earnings. The analysis used point of sale (POS) transactions and the proportion that are PIN vs signature as provided by the survey participants. It also utilized debit card interchange fees taken from a Federal Reserve study, "Average Debit Card Interchange Fee by Payment Card Network", revised as of May, 2015. Large credit unions generally had more detail regarding interchange transactions than smaller credit unions. Therefore, the total amount of revenue reduction in this category is primarily found in the large credit unions where the data was available. The following chart shows the lost interchange revenues as a percent of assets.



LOST INTERCHANGE FEE INCOME - OVERALL AND BY ASSET SIZE

(As a % of Assets)



The Durbin Amendment had a direct impact on financial institutions over \$10 billion in assets, but also created unintended consequences that negatively impacted credit unions under \$10 billion in assets. Specifically, the amendment created more competition among card processors (e.g., PINless debit, PIN Authenticated Visa Debit (PAVD)), resulting in lower average fees for both PIN and signature transactions. For this impact, we calculated lost revenues by applying the difference in the average transaction fees to the current transaction volume. While innovation and competition is generally positive, the positive impact has accrued to merchants at the cost of credit unions and ultimately members — in terms of lower capital and fewer investment dollars available to support member growth and needs.

It should be noted that total interchange revenues have actually increased through higher card usage volumes to offset the lower per-transaction fee. The lost revenues represent the revenues the credit unions would have earned at the historical rates vs the current lower rates.

REDUCTION IN ORIGINATIONS & OTHER SERVICES

As described above, the survey sought to estimate lost loan originations across mortgages, consumer loans and member business lending (MBL) due to regulations related to Qualified Mortgages (QM), Open-Ended Lending (e.g., CARD Act) and the MBL cap. While several credit unions reported a reduction in originations in one or more of the loan types above, over half of the survey participants (68%) did not report a reduction in originations for one of three reasons:

1. The product was never offered
2. The credit union was not comfortable estimating a fair decrease
3. The impact on originations was considered to be minimal

Any reported impacts were relatively minor. In other words, there is a real impact to individual members who are no longer offered these loan products or could not qualify under the new rules, but the overall impact to the membership is relatively low. (While both survey respondents and the industry as a whole have been vocal about regulatory impacts to member lending, we asked participants to withhold from providing a quantifiable estimate in lost originations if they were not able to do so with reasonable accuracy — consistent with the conservative approach of this study.)

Although the total impact is small, it is critical to note there are individual credit unions where the impact is significant. For example, a large MBL originator very confidently reported a loss of \$150 million in business loans per year, which equates to over \$6 million in lost revenue. The MBL cap severely limited business growth on what they observe to be a relatively low risk portfolio.

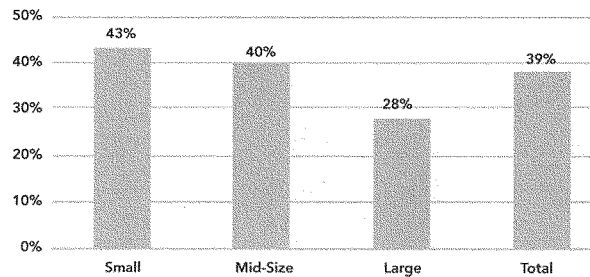
How Regulatory Impact Has Changed from 2010 to 2014

Regulatory changes have put both pricing pressure on revenues while increasing the regulatory requirements around core business processes such as lending, credit administration and financial reporting.

The cost impact of regulation has risen considerably as regulations and more in-depth examinations have been implemented since 2010 — in terms of both external spending and more staff and staff time spent on regulatory compliance. (This analysis excludes any capitalized costs that occurred over the last 5 years.) Regulatory cost impact rose from 0.39% in 2010 to 0.54% in 2014, a 39% increase since 2010 — a large increase given the long history of credit unions and the short time from the Dodd-Frank Act to today.

To put this increase in context, total industry assets and expenses only increased 21% and 16%, respectively, from 2010 to 2014, while the industry operating expenses as a percent of assets actually decreased from 3.19% in 2010 to 3.05%. In other words, the industry's efforts to be more efficient and productive has been significantly offset by the higher regulatory costs.

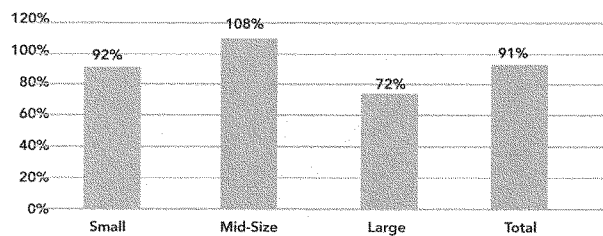
% INCREASED IN REGULATORY COST IMPACT SINCE 2010



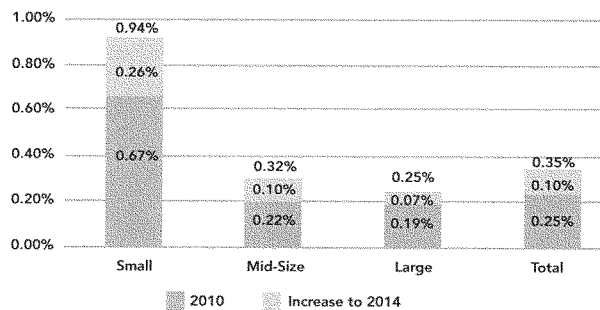
The increase is highest for small credit unions (43%) given the lack of scale. Although large credit unions have the advantage of scale and may have the lowest percentage increase, they incurred the largest total dollar increase over the last 4 years. As an example, a \$1 billion credit union would have been incurring about \$2.6 million annually in regulatory-related costs as of 2010 (based on the study's median calculation). However, that amount would have increased to about \$3.3 million by 2014 to remain compliant. In absolute terms, the \$700,000 increase for large credit unions is more than double the dollar increase of a small credit union. (A \$100 million credit union's regulatory cost would have increased \$340,000 — from \$760,000 in 2010 to \$1.1 million in 2014.)

STAFF INCREASES: 2010-2014

Since 2010, credit unions nearly doubled the FTE for regulatory activities as shown in the chart below. This increase covered both additional staff as well as more time from existing staff spent on regulatory activities. As an example, mortgage processors spend more time on disclosures and other mortgage regulations, with the credit union bringing in more processors to handle the current business (vs hiring a dedicated mortgage compliance person). In other words, the impact was additional headcount and lower productivity.

CUMULATIVE CHANGE IN REGULATORY FTEs - 2010 TO 2014

Moreover, the benefits of scale for support staff played a critical role in limiting the total staff increases for larger credit unions, as shown in the following chart where the increase is 0.26% of assets for small credit unions compared to 0.10% and 0.07% for mid-size and large credit unions, respectively.

CHANGE IN STAFF COSTS SINCE 2010 - OVERALL AND BY ASSET SIZE*(As a % of Assets)*

Regardless of scale, the net increase in staff impact has been a significant hardship for all credit unions. A \$1 billion credit union would have incurred an additional \$1,000,000 in salary and benefits costs per year since 2010 (based on the ten basis point increase from 2010-2014).

Strategic Impacts

In addition to the extensive data collection, the survey solicited respondent CEOs' viewpoints of where they saw the greatest increases in regulatory impacts in terms of increased expenses, reduced revenues, and reduced productivity. We also asked CEOs how their credit unions would have potentially reallocated the resources if those resources were not spent on regulatory activities.

PERCEIVED VS REAL IMPACTS

The perceived impacts to the credit union are nearly unanimous regardless of the asset size. The top three rankings are as follows:

Direct Expenses

1. Compliance
2. Mortgage Lending
3. Internal Audit / Risk Management

Productivity Impacts

1. Compliance
2. Mortgage Lending
3. Consumer Lending

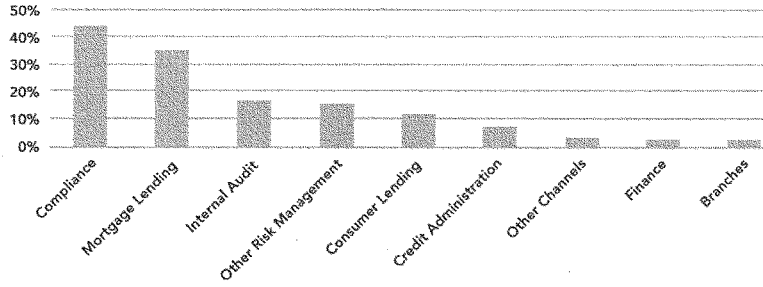
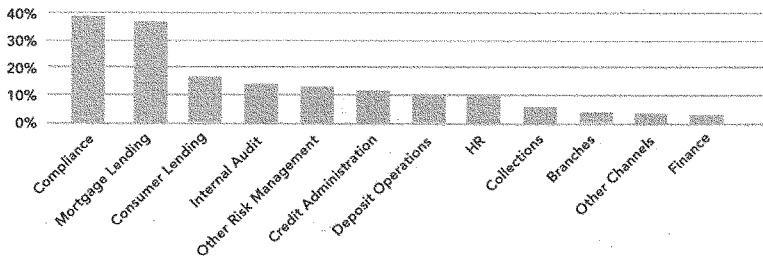
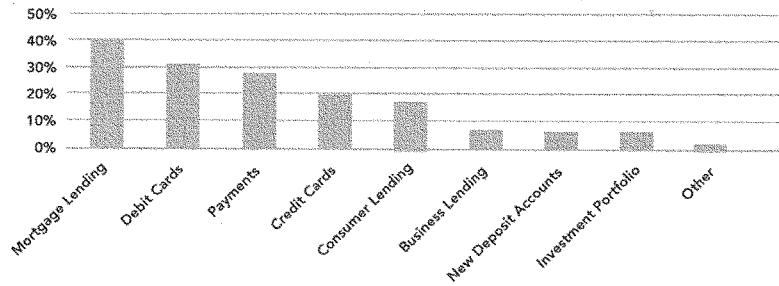
Lost Revenues

1. Mortgage Lending
2. Debit Cards
3. Payments (e.g., NSF, courtesy pay)

There was very little difference when comparing CEO responses across asset classes. The most notable difference was that the large credit union CEOs ranked Mortgage Lending as the highest impact in all three categories. This reflects mortgage lending being a significant part of large credit union's business model, while Compliance costs are more easily absorbed due to scale. The lost revenue related to Debit Cards is directly related to the significant decrease in interchange revenues felt across the industry, as discussed in the Lost Revenues section.

The results of their responses are summarized in the following charts.



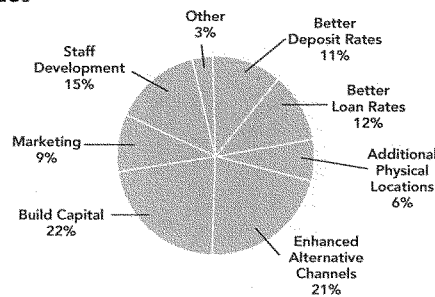
AREAS WITH HIGHEST REGULATORY EXPENSES*(Based on # of CEO selections)***AREAS WITH GREATEST PRODUCTIVITY IMPACT***(Based on # of CEO selections)***AREAS WITH MOST LOST REVENUES***(Based on # of CEO selections)*

The rankings from the CEOs aligned well with the quantified results described elsewhere in this report. The notable exception is that lost mortgage revenues are much more significant in CEO estimation than the data analysis. However, it should be noted that, although many respondents reported reduced originations due to new rules, they are not able to precisely estimate the amount of reduction. Therefore, the results are excluded from the Lost Revenues estimate.

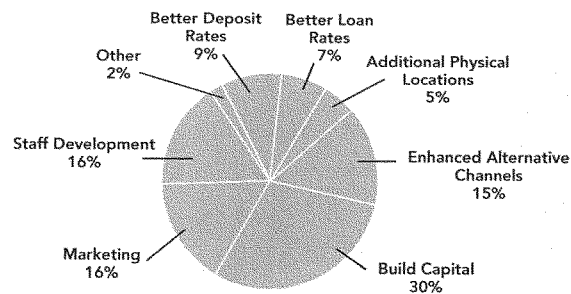
REALLOCATION OF RESOURCES

When it came to how resources would have been reallocated, all credit unions focused on providing value to members and their communities — either through better rates, lower fees or enhanced products, services & delivery channels for convenience. The differences are in which member “value levers” they wanted to focus on. The following charts show how the resources spent on regulatory changes from the last five years would have been allocated based on survey responses from CEOs.

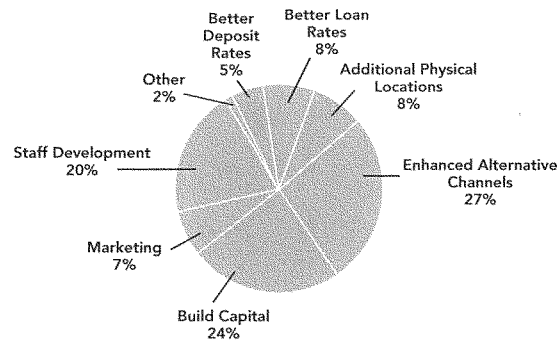
REALLOCATION OF REGULATORY COSTS BY RESPONDENT CREDIT UNION CEOs



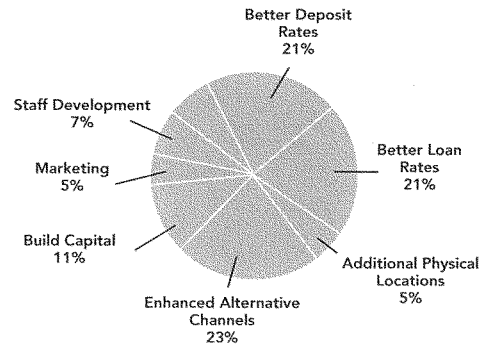
REALLOCATION OF REGULATORY COSTS - SMALL CREDIT UNION CEOs



REALLOCATION OF REGULATORY COSTS - MID-SIZED CREDIT UNION CEOs



REALLOCATION OF REGULATORY COSTS - LARGE CREDIT UNION CEOs



While the bulk of the reallocations directly benefit members, small and mid-sized sized credit unions focused a significant portion of their reallocation on building capital to support lending, safety & soundness, and future investments for member benefit. In other words, building capital benefits members indirectly. Expanding into new channels was an important category for all credit unions to meet member needs and their changing behaviors.

KEY PARTICIPANT COMMENTS AND THEMES

In addition to soliciting CEOs views on where regulatory impacts had increased the most, and how resources devoted to regulation might have been otherwise invested, the survey provided several opportunities for respondents to enter free form comments to clarify data and to provide context on regulatory impacts. Their key comments are summarized below:

Volume of Regulations

- "From RBC to derivatives, there is constant stream of new proposals that must be evaluated and responded to."
- "Increasing complexity in rulemaking in general requires more resources to analyze and interpret new rules."
- "Increasing regulations are requiring more 3rd party validations/studies to provide the needed documentation for examiners."
- "Prior to 2014 each department head was in charge of compliance that dealt with their own area of responsibility. In 2013 the increase in regulation became too great to handle this way, so a full time compliance officer was hired."
- "Regs change our strategic prioritization and requires frequent re-staging of critical projects. Changes often need to happen at our 3rd party vendors which puts our planned upgrade/enhancement requests at risk."

IT / Vendor Management

- "Our core processor implemented a yearly "regulatory" fee."
- "I have found that the examiners know even less than a small shop does about cyber security."
- "IT spends many hours each month and every year supporting the many requirements of vendor risk management."
- "We were unable to upgrade an ATM to make it compliant with ADA. This ATM was at our one branch which, to save money has had its hours open cut. The ATM was sorely needed but could not be left in service or we could have been fined for it."

Specific Regulations

- "When changes are made to Reg Z, Reg CC, etc we are required to change many down line reporting and operational dashboards. This tends to take precedence over other revenue-producing work."

- "Due to changes in Reg Z, we discontinued the MFOEL product and replaced it with a different product. It took 780 staff hours to decipher the changes and determine the appropriate course of action."
- "Reg E immediately comes to mind in terms of increased training time for our call center employees."
- "Concentration risk limits are in theory just a guideline, however regulators have pushed to tighten the guidelines creating additional consequences like lower loan to share ratios and slower capital growth."
- "BSA/AML Compliance administration is evolving into its own "animal""
- "There is a growing burden related to BSA/CIP regulatory practices that is unfair to credit unions and applicable members both. While the regulations are clear on what is (or is not) required, regulators in practice create an unnecessary and unwarranted burden for credit unions who attempt to effectively serve this demographic of their membership."
- "Health care premiums have increased substantially and we feel it is due to ACA."

Lending

- "Limits on our ability to do modifications have certainly impacted the number of modifications we have been able to do, ultimately resulting in higher charge offs when there may have been a chance to repair the member issue in advance."
- "During 2014, the credit union experienced 5 months of not being able to originate construction and development loans with over \$25 million in lost loan opportunities." (due to MBL cap)
- "All loans are close ended except kwik cash lines of credit. Too much hassle from examiners on the open end so we quit doing them."
- "The Card Act requires us to verify income before extending credit of any kind. We are no longer able to offer secured credit cards to members who are unemployed, even though there is no risk for either the member or the credit union. In 2014 roughly 320 secured card applications were declined for income verification reasons."
- "Operate in low income, credit challenged area. Need to bring on escrow accounting or pay a third party in order to comply with non-QM lending."
- "Do not originate non- QM loans and these were loans that we may have been willing to do prior to the change in regulation."
- "NCUA advised us to discontinue [non-QM loans] due to the regulatory burden."



- "Allowance for Loan loss disclosure changes and the new CECL model are all items that add clarity to valuation however they are considerably late and are very much reactionary at this time. Additionally, there is very little guidance as to the purpose and the expected impact of the CECL model, however there are several expenses associated with CUs trying to learn now in anticipation of changing models in the coming months/years."
- "Bankruptcies are so complex & unclear that the ordinary employee can no longer manage them. Even attorneys can't give clear answers as CFPB complicates bankruptcies."

Regulatory Exams

- "We used to spend about a week for each examination and audit, now with the heightened focus on financial institutions, the areas of examination and audit have expanded to the point where preparation now takes nearly 1 month of time from the relevant parties to have a useful examination."
- "Not knowing a specified time table well in advance causes huge scheduling issues for the smaller credit unions. Vacation schedules get upended, totally inefficient when a person with primary responsibility is not available and the NCUA wants to lower CAMEL ratings due to inadequate answers because the primary person was not there to answer fully."
- "The biggest frustration is the annual review expectations of the regulators on regs such as BSA/AML. We would prefer to risk rate them so if the last audit was clean,we would not audit annually. Wastes audit resources that could be used on higher risk areas."

KEY THEMES

Based on respondent comments, we have identified several key themes as they relate to credit unions' views on the causes and drivers of regulatory costs. There was no consensus on which regulations imposed the most cost increase on credit unions. However, four key themes emerged around the greatest causes of their current impact, especially over the past few years:

- Uncertainty and ambiguity around written rules
- Inconsistent application / interpretation of regulations by examiners
- Steady stream of regulations that create high levels of change management (e.g., death by a thousand cuts)
- One size fits all approach to regulation

Rule Ambiguity and Uncertainty

While the intent of the rules is generally understood, the specifics needed for implementation are often ambiguous with clarifications often coming in piecemeal fashion. Mortgage disclosures are an example. Credit unions need to spend time and resources on re-work to ensure compliance — and (in some instances) realize later that the regulation does not apply to them. The lost productivity and the likely use of external resources to understand new rules contribute to a higher impact.

Examiner Rule-Making

The ambiguity in regulations creates situations where examiners develop their own interpretations of the rules. While this is expected, it is the inconsistency of scope and interpretations among examiners that creates the effect felt by credit unions. The inconsistency mainly manifests itself in situations where examiners have moved from “safety and soundness” to “managing the business”. This occurs when examiners extend beyond findings to prescriptive actions which may not be aligned with best practices or not take into account the trade-offs associated with a prescribed action (i.e., disconnect between real world applicability to the desired outcome.) As an example, at one credit union in our study, an examiner told the credit union to take down its active production systems so that back-ups systems could be properly tested. While testing of back-ups is a good business practice, shutting down production systems to do so is not necessary, and is in fact a bad business practice because of the extremely high risk it creates. While there was good intention, the credit union felt a conflict on how to best comply with the examiner's prescribed action. In this case, one aspect of operational risk was traded-off for higher operational risk in another area as well as higher reputation risk if members can't access their accounts when the production systems are temporarily down.



Steady Stream of Regulations

Credit unions recognize that there will be regulations given the industry they operate in. However, the increased stream of new requirements from multiple sources (e.g., Congress, CFPB, NCUA, state regulators) over the last 5 years resulted in the increased costs from 2010 as discussed earlier. What compounds the impact is the lack of coordination across banking regulations that creates confusion on priorities and overlaps. This does not take into account non-banking regulations that impact all companies (e.g., Affordable Care Act, IRS rules changes, etc.) As an example, disclosures are constantly evolving in terms of the number of disclosures and their respective requirements. This requires multiple functions to be involved for one change (e.g., IT, training, legal, marketing, etc.) and is not the “simple” change that regulation had anticipated.

This “death by a thousand cuts” distracts from the credit union’s core mission — which is to help members and the community....the very thing that many of the regulations are intended to do.

One Size Fits All

While regulations sometimes do take into account threshold size for applicability, the current regulatory environment is very much one size fits all without taking into account the underlying business model and inherent risks of a credit union. While this is readily seen in terms of impact to smaller credit unions, even larger credit unions are impacted. The relevance of a given regulation will vary across credit unions, but the level of effort to analyze and implement is often the same — creating unequal effects across credit unions. “One Size Fits All” also creates unintended consequences. The CARD Act was intended for credit cards but it effectively eliminated Multi-Feature Open Ended Lending (MFOEL) for some credit unions because of the costs to comply. This reduced member products especially for those who are credit-worthy. While some new products were introduced to replace MFOEL, it required incremental resources from the credit union while decreasing service levels to members.

Surveyed credit union executives strongly believe that regulations are often written with a “least common denominator” mindset to protect the public from the small minority of poorly managed or unethical institutions. They believe the trade-off is that it creates an unduly high cost for credit unions whose mission is to help members and whose impact ultimately crowds out net worth that could be passed on to consumers in terms of more competitive pricing and or incremental services.



Member Impacts

Although the main purpose of the study was to quantify the financial cost placed on credit unions due to regulation, the cost ultimately impacts members — either directly or indirectly. Some examples are referenced throughout the report to provide additional context to both credit union and member impacts. In addition to previous illustrations, other impacts include discontinued products and services, increased fees, and general inconvenience. While these implications are not quantified, the credit union participants regularly expressed frustration with the effects felt by members and offered a wide variety of examples.

The most prevalent scenarios relate to the increased cost placed on applying for a mortgage. The limitations on QM may disqualify creditworthy members from obtaining a mortgage that the credit union would certainly make otherwise. Small and mid-sized credit unions in particular had to turn members away because they cannot afford to keep these non-QM loans on their portfolio. The additional rigor placed throughout the process also resulted in costs being passed on directly to members such as increased fees for appraisals. Small credit unions in particular were also forced to stop offering some products such as HELOCs due to the additional regulatory cost associated with supporting them. The greater compliance requirements lengthen the loan processing time and add application requirements for a member — effectively creating a regulatory cost on them, which is clearly not the intent for many of the mortgage regulations.

Another issue that was often referenced as an unintended impact to members was international remittances. Five percent of respondents that offered international remittances in the past discontinued the service altogether when new regulations came out while others increased the fees. For survey respondents still offering remittances in 2014, the average fee to members increased from \$35 to \$50 per transaction to cover the costs of additional compliance.

Lastly, the overall time required for members to perform their banking activities has continued to increase. The above examples of applying for a mortgage and sending an international remittance take considerably more time to complete (if the product / service is offered). Credit unions also noted how long it takes to open a new member account. One credit union in particular has made multiple attempts to streamline the process, but still documented an increase in processing time from 25 minutes to 40 minutes per application today.

See previous section for free form comments from respondents.



Conclusions

The overall regulatory financial impact of regulation on the credit union industry is \$7.2 billion as of 2014, with \$6.1 billion in costs and \$1.1 billion in lost revenue. Due to the study's conservative approach when faced with a lack of adequate data, the \$1.1 billion figure for reduced revenue very likely understates the actual amount. The overall amount is equivalent to 80% of industry earnings and 5.9% of 2014 industry net worth. The cost component represents 17% of industry 2014 operating expenses. Credit unions recognize that they are in a regulated industry and there will be a cost. However, the level of cost that regulations and regulators imposed has dramatically increased since the financial crisis and its aftermath. Annual regulatory costs have increased by 39% since 2010 and staff time devoted to regulatory activities almost doubled in the same period. This higher cost has increased operational, compliance, and strategic risks to credit unions.

The percentage cost relative to asset size is heaviest on smaller credit unions. However, the impact in absolute dollars is much higher for larger credit unions. Surveyed credit union CEOs indicated these dollars would be redeployed to better rates, lower fees, and enhanced products & services for members as well as community development.

The findings from this study will provide policymakers, credit unions and other stakeholders with the facts to perform a more robust cost-benefit assessment of the regulations (passed and pending) to determine what is an appropriate level of regulatory cost in light of credit unions' mission of community and member service.

AREA FOR FURTHER STUDY

One of the areas that could benefit from additional study is lending. CEOs highlighted reduced lending as one of the highest areas of regulatory impact. Determining the extent of the reduction in lending was beyond the scope of this study, and therefore our estimates understate the cost. Policymakers and credit unions would benefit from a rigorous analysis of the impacts on lending from recent regulations — both in terms of total volume and the different impacts across different member segments.

Regulatory Financial Impact Study

Appendix 1

Appendix 1 – Respondent Profile and Data Analysis Approach	48
Respondent Demographics	48
Data Collection and Validation	50
Calculations and Methodology	53
Appendix 2 – Survey to the Credit Unions	54

APPENDIX 1 – RESPONDENT PROFILE AND DATA ANALYSIS APPROACH

This Appendix details the demographics of the participants as well as the data gathering and validation processes.

RESPONDENT DEMOGRAPHICS*Phase 1*

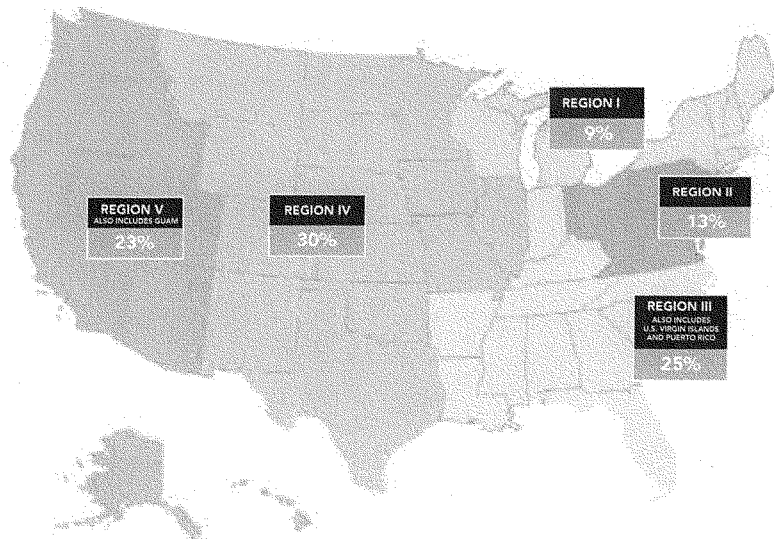
Three credit unions were interviewed for the research in the first phase of the study. The three credit unions were of varying sizes in order to better understand the regulatory impacts felt relative to assets and ensure detailed data collection in the second phase would be relevant to all credit unions.

The smallest credit union is located in the Midwest and had just over \$60 million in assets as of 2014. The mid-size credit union is located in the Southeast and had over \$650 million in assets. Lastly, the largest credit union interviewed is also located in the Midwest with approximately \$1.5 billion in assets.

Phase 2

An in-depth data collection survey was received from 53 credit unions with headquarters across 28 states. A geographic overview of the locations is shown below.

SURVEY RESPONDENT LOCATION BY NCUA REGION

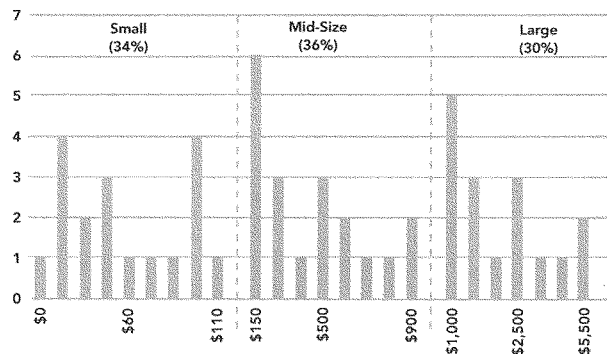


The respondents were evenly distributed across the three size groups based on 2014 year-end assets:

- Small credit unions (Less than \$115 million in assets)
- Mid-sized credit unions (\$115 million to \$1 billion in assets)
- Large credit unions (>\$1 billion in assets)

The distribution of the respondents is shown below.

DISTRIBUTION OF SURVEY RESPONDENTS BY ASSETS (millions)



* There were five credit unions with assets between \$100 million and \$115 million. We defined the small credit union group to include these credit unions because they have far more in common with peers less than \$100 million in assets than those with upward of \$1 billion. This is supported by other demographic data collected such as the number of employees and members. The business strategies, challenges and opportunities — including those related to regulations — are subsequently more appropriate to analyze as a small, rather than mid-sized, credit union for purposes of the study.

Surveyed credit unions had a combined \$50 billion in assets with over 11,000 full-time equivalent (FTE) employees as of 2014. The median asset size for the population was \$293 million while the median number of FTEs was 110. Although one credit union had less than \$500 thousand in assets, all other credit unions ranged from \$15 million to nearly \$6 billion.

The surveyed credit unions serve over 2.5 million members (assuming minimal overlap) with the median reported number of members being over 21,000 as of 2014. Equivalent data from year-end 2010 was also collected to account for changes in assets and members. Most survey participants experienced growth from year-end 2010 through 2014 with a total median asset and member growth of 27% and 23%, respectively. This compares to asset and membership growth rates for all credit unions over the same period of 25% and 10%, respectively.

DATA COLLECTION AND VALIDATION

This describes our approach to data gathering and validating the survey responses. It includes our steps to identifying the appropriate survey questions and approach to validating information. Lastly, it demonstrates our efforts to ensure data integrity and consistency as well as the support process to respondents as they completed the survey.

Phase 1 Research

The three Phase 1 credit unions volunteered to participate and offered considerable staff time to onsite interviews for about two days each. Executives and various subject matter experts provided explanations on how products, services and general business functions were affected by existing regulations.

They also provided clarity on regulations that did not impose significant cost on the organization. Additionally, the volunteers supplied a considerable amount of detail through documentation such as financial reports, strategic plans and project lists. All of the information was reviewed to determine the most appropriate and valuable data that could be collected to represent the credit union industry as part of Phase 2.

Phase 2 Data Collection and Volunteer Education

Data for the study was collected through an online survey. Several steps were taken to ensure data integrity and conservative, accurate results. These efforts spanned throughout the second phase of the study including before and after the survey was available.

To start, a webinar was conducted for credit unions that expressed interest in participating in Phase 2. Part of the session was dedicated to expressing the purpose of the study and expected time commitments. This provided an opportunity for potential volunteers to fully understand the scope and level of effort so they would invest the staff resources necessary to produce accurate information. Based on this webinar, several credit unions elected not to participate because they were not able to provide the level of rigorous data gathering that we needed.

A survey guide was also created with details for all survey sections as well as several examples. Upon release of the survey and survey guide, a second webinar was hosted for credit union volunteers. The purpose was to walk through each section of the survey, answer questions and re-emphasize the conservative approach. In particular, there was a clear message that any request for estimates should only be fulfilled if they felt confident in supplying a reasonable and justifiable answer.

The survey was launched in August and participants had 6 weeks to submit their responses. We provided phone and email support for credit unions to answer any questions during the survey period.

The data for the quantifiable expense and staff costs were collected across nearly 30 sub-functions of the credit unions. We requested this information throughout eight sections of the survey as shown below.

SURVEY SECTION	SUB-FUNCTIONS
Risk Management and Compliance	<ul style="list-style-type: none"> • Compliance • Internal Audit • Bank Secrecy Act / Anti-Money Laundering • Enterprise Risk Management • Vendor Management • Other Risk and Compliance
Lending	<ul style="list-style-type: none"> • Mortgage Originations • Mortgage Servicing • Consumer Lending Originations • Consumer Lending Servicing • Business Lending • Business Servicing • Collections • Credit Administration • Other Lending
Member Services	<ul style="list-style-type: none"> • Branches • Retail Administration • Call Center • Online, Mobile and ATM
Deposit Operations	<ul style="list-style-type: none"> • Deposit Operations
Finance	<ul style="list-style-type: none"> • Accounting / Finance • Treasury / Asset Liability Management
Information Technology	<ul style="list-style-type: none"> • Information Technology
Legal	<ul style="list-style-type: none"> • Legal
Human Resources	<ul style="list-style-type: none"> • Human Resources • Training

The data was aggregated throughout the study to quantify total 3rd party, capitalized and staffing costs. However, the grouping of sub-functions varied depending on the purpose of the calculation. For example, staff costs were consolidated into only three main categories of Risk, Support and Member-Facing. This was fewer than the six categories (Risk, Lending, Member Services, Finance, IT and Human Resources) created for 3rd party expenses due to the different investments observed between the two types of costs.

Data Cleaning

Upon closure of the survey, the information was reviewed and cleaned over a period of 3 weeks. Outliers were identified both relative to peers and relative to its business model. For example, a credit union with a combined estimate of 5 FTEs dedicated to regulatory tasks would be captured as an outlier if they only had 8 total employees even though 5 FTEs is well within the norm for the small credit union asset range. Credit unions with outlier data were contacted in order to validate the responses, better understand why it is accurate or collect updated information if appropriate.

All data was scrubbed prior to calculating expense and revenue impacts. The data scrubbing primarily consisted of removing remaining outliers from the final data set. It should be noted that some outliers were removed even if they were verified by the credit union. This was done in order to ensure the final results would fairly and conservatively represent the broader industry and not be skewed by any unique scenarios. As an example, data for one small credit union indicated nearly 100% of its staff was dedicated to regulatory tasks. However, this was a unique scenario because they relied on assistance from their volunteer board and others in the community where possible.

Lastly, removing outlier data was also done in a conservative manner. This resulted in one of two impacts to the credit union results. For the first impact, such as for interchange, the value would simply be excluded from 25th percentile, median and 75th percentile calculations. The other impact would be the same as a zero value when calculating the overall impact for a given credit union. For example, outlier external training costs would not be included in the total 3rd party expenses; thus lowering the reported regulatory expenses for that credit union.

CALCULATIONS AND METHODOLOGY

There are multiple options to aggregating the many reported data points into a single cost of regulation. Our approach to calculating total impacts and the breakdowns of the two major categories throughout the study primary took a “top down” view of the impacts by focusing on the overall financial impact on a given institution. At the highest level, the total financial impact of regulation is a combination of the two primary categories: Costs and Lost Revenues. This study calculated the total median cost by calculating the median value of the two categories separately and adding them together. This method was selected because it was the clearest identification of how the individually calculated components affect the total impact.

The two main categories were calculated using the combined impacts of their sub-categories. For example, costs are made up of 3rd party, staff costs and capitalized expenses. The median value for the category was calculated by adding the impact of the three sub-categories for each credit union and finding the median of the total. The difference in approach was adopted because this method best represents the experience of the credit union industry. There is a direct relationship between each of the sub-categories that is better normalized when viewing them in aggregate. To continue on the cost example, a credit union may rely more heavily on vendors for audit and compliance purposes, which would increase the 3rd party expenses. However, this would decrease the need for staff and, therefore, have lower staff expenses. Adding the individual elements together prior to calculating total impacts by quartile would account for differences in credit union strategy.

The same approach is applied to all sub-categories of impact. The approach was necessary at the lowest level of detail because there were nearly 30 data points (relatively high number of degrees of freedom) for cost impacts that would require a much larger sample population for more in-depth analysis. For example, the 3rd Party Expenses were a combination of expenses across six main categories (e.g., Lending, Member Services, Finance), but each of those may have also had sub-categories (Lending contains nine data points including mortgage, consumer, business, etc.).

Lastly, some survey questions were asked to provide context, but excluded to avoid “double counting.” For example, one question in the survey asked for the amount of time spent explaining Regulation D to members. However, we assume this time would be accounted for in the functional FTE estimates that were used to calculate regulatory costs. While this may not necessarily be true, excluding the additional time is consistent with our approach of being conservative whenever there was uncertainty.



Regulatory Financial Impact Study

Appendix 2

SURVEY TO THE CREDIT UNIONS

A copy of the survey provided to the credit unions for data collection is available as a separate document.

CUNA Regulatory Burden Survey

Participant Information

Participant Information:*

Your Name: _____

Your Email Address: _____

Name of your institution: _____

Headquarters Location:

[Select State]

NCUA Charter Number: _____

Please select which section to complete:*

If you are unable to finish the section during a single session, click on the link at the top of the page that says "Save and Continue Survey Later". After providing your e-mail address you will be sent a link in an email that you can use to return at your convenience.

- ☐ Section 1 - Overall Regulatory Impact
- ☐ Section 2 - Risk Management and Compliance
- ☐ Section 3 - Lending
- ☐ Section 4 - Member Services
- ☐ Section 5 - Deposit Operations
- ☐ Section 6 - Finance
- ☐ Section 7 - Information Technology
- ☐ Section 8 - Legal
- ☐ Section 9 - Human Resources (HR) and Training

Overall Regulatory Impact

1) Of the items listed below, please estimate the top THREE areas that have experienced the greatest INCREASE IN OPERATING EXPENSES over the past five years due to increased regulatory burden. Rank them from 1 through 3, with 1 being the greatest INCREASE IN OPERATING EXPENSES.

- _____ Compliance
- _____ Internal Audit
- _____ Other Risk Management (excluding Compliance and Internal Audit)
- _____ Mortgage Lending (excluding home equity loans) – originations and servicing
- _____ Consumer Lending (including home equity loans) - originations and servicing
- _____ Finance (including Treasury)
- _____ Credit Administration (including appraisals)
- _____ Branches
- _____ Other Channels (call center, mobile, online, ATM, etc.)
- _____ Deposit Operations
- _____ Collections
- _____ Human Resources (including Training)
- _____ Other: (If Other, please explain below.)

Comments:

2) Of the items listed below, please estimate the top **THREE** areas that have experienced the greatest **REDUCTION IN REVENUE** over the past five years due to increased regulatory burden. Rank them from 1 through 3, with 1 being the greatest **REDUCTION IN REVENUE**.

- _____ Mortgage Lending (excluding home equity loans) – originations and servicing
- _____ Consumer Lending (including home equity loans) - originations and servicing
- _____ Payments (NSF, courtesy pay, etc.)
- _____ Debit Cards
- _____ Credit Cards
- _____ New Deposit Accounts
- _____ Member Business Lending
- _____ Credit Union's Investment Portfolio
- _____ Wealth Management and Insurance
- _____ Other: (If Other, please explain below.)

Comments:

3) Of the items listed below, please estimate the top **THREE** areas that have experienced the greatest **REDUCTION IN PRODUCTIVITY** (e.g., longer cycle times, more time spent on lower value-added activity, etc.) over the past five years due to increased regulatory burden. Rank them from 1 through 3, with 1 being the greatest **REDUCTION IN PRODUCTIVITY**.

- _____ Compliance
- _____ Internal Audit
- _____ Other Risk Management (excluding Compliance and Internal Audit)
- _____ Mortgage Lending (excluding home equity loans) – originations and servicing
- _____ Consumer Lending (including home equity loans) - originations and servicing
- _____ Finance (including Treasury)

_____ Credit Administration (including appraisals)
_____ Branches
_____ Other Channels (call center, mobile, online, ATM, etc.)
_____ Deposit Operations
_____ Collections
_____ HR (including Training)
_____ Other: (If Other, please explain below.)

Comments:

4) Imagine that there had been NO INCREASE in regulatory burden over the past five years. Where would the additional financial and people resources that have been spent on complying with the increased burden of regulations have been allocated instead? (Please allocate to a total of 100%)

187

_____ Build capital
_____ Better deposit rates
_____ Better loan rates
_____ Invest in branches
_____ Invest in new channels like online / mobile
_____ Employee development
_____ Marketing
_____ Other: (Explain Below)

Comments:

Risk Management and Compliance

1) Do you have a separate Compliance department?

- ☐ Yes
- ☐ No

If yes, how many FTEs were in that department in 2010 and 2014, and how much of their time was devoted to regulatory activities?

	Total of FTEs 2010	% of total 2010 FTE time that was Regulatory Related	Total of FTEs 2014	% of total 2014 FTE time that was Regulatory Related
Compliance	<div></div> <div></div>	<div></div> <div></div>	<div></div> <div></div>	<div></div> <div></div>

Comments:

If not, estimate the FTEs that performed Compliance work in 2010 and 2014, and the amount of time devoted to regulatory activities (See Survey Guide for definitions).

	Total of FTEs 2010	% of total 2010 FTE time that was Regulatory Related	Total of FTEs 2014	% of total 2014 FTE time that was Regulatory Related
Compliance	_____	_____	_____	_____
	_____	_____	_____	_____

Comments:

2) Do you have a separate Internal Audit department?

☐ Yes

☐ No

If yes, how many FTEs were in that department in 2010 and 2014, and how much of their time was devoted to regulatory activities? (See Survey Guide for definitions)

	Total of FTEs 2010	% of total 2010 FTE time that was Regulatory Related	Total of FTEs 2014	% of total 2014 FTE time that was Regulatory Related
Internal Audit	_____	_____	_____	_____
	_____	_____	_____	_____

Comments:

If not, estimate the FTEs that performed Internal Audit work in 2010 and 2014, and the amount of time devoted to regulatory activities (See Survey Guide for definitions).

	Total of FTEs 2010	% of total 2010 FTE time that was Regulatory Related	Total of FTEs 2014	% of total 2014 FTE time that was Regulatory Related
Internal Audit	_____ _____	_____ _____	_____ _____	_____ _____

Comments:

3) Do you have a separate BSA / AML department?

☐ Yes

☐ No

If yes, how many FTEs were in that department in 2010 and 2014:

	Total 2010 FTEs	Total 2014 FTEs
BSA/AML	_____ _____	_____ _____

Comments:

If not, estimate the FTEs that performed BSA/AML work in 2010 and 2014 (See Survey Guide for definitions):

	Total 2010 FTEs	Total 2014 FTEs
BSA/AML	_____ _____	_____ _____

Comments:

4) Do you have a separate Enterprise Risk Management (ERM) department?

☐ Yes

☐ No

If yes, how many FTEs were in that department in 2010 and 2014, and how much of their time was devoted to regulatory activities? (See Survey Guide for definitions)

	Total of FTEs 2010	% of total 2010 FTE time that was Regulatory Related	Total of FTEs 2014	% of total 2014 FTE time that was Regulatory Related
ERM	_____ _____	_____ _____	_____ _____	_____ _____

Comments:

If not, estimate the FTEs that performed ERM work in 2010, and the amount of time devoted to regulatory activities (See Survey Guide for definitions).

	Total of FTEs 2010	% of total 2010 FTE time that was Regulatory Related	Total of FTEs 2014	% of total 2014 FTE time that was Regulatory Related
ERM	_____ _____	_____ _____	_____ _____	_____ _____

Comments:

5) Do you have a separate Vendor Management department?

☐ Yes

☐ No

If yes, how many FTEs were in that department in 2010 and 2014, and how much of their time was devoted to regulatory activities? (See Survey Guide for definitions)

	Total of FTEs 2010	% of total 2010 FTE time that was Regulatory Related	Total of FTEs 2014	% of total 2014 FTE time that was Regulatory Related
Vendor Management	_____ _____	_____ _____	_____ _____	_____ _____

Comments:

If not, estimate the FTEs that performed Vendor Management work in 2010 and 2014, and the amount of time devoted to regulatory activities (See Survey Guide for definitions):

	Total of FTEs 2010	% of total 2010 FTE time that was Regulatory Related	Total of FTEs 2014	% of total 2014 FTE time that was Regulatory Related
Vendor Management	_____ _____	_____ _____	_____ _____	_____ _____

Comments:

6) For these functions, how much was spent on 3rd Party Expense in 2010 and 2014? What percent of the spending was devoted to performing “Regulatory Related” work (see Survey Guide)? What was the total of capitalized spending on 3rd parties that was “Regulatory Related” for all 5 years between 2010 and 2014?

	Total 2010 3rd Party Expense	% of total 2010 3rd Party Expense that was Regulatory Related	Total 2014 3rd Party Expense	% of total 2014 3rd Party Expense that was Regulatory Related	Aggregate Capitalized Spending that was Regulatory Related from 2010 through 2014
Compliance	_____ _____	_____ _____	_____ _____	_____ _____	_____ _____
Internal Audit	_____ _____	_____ _____	_____ _____	_____ _____	_____ _____

BSA / AML	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>
Enterprise Risk Management	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>
Vendor Management	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>
Other Risk and Compliance	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>

Comments:

7) Please estimate the impact of making adjustments after a new regulation is initially formalized. New regulations create a dynamic environment for many reasons: uncertainty about applicability to the credit union, lack of specificity that requires additional modification by regulators, varying interpretations by examiners, changes to the regulation even after a compliance date is set, etc. How much internal effort do you typically incur annually to “re-work” after a regulation is first finalized?

Estimated % of regulatory-related resource hours spent on re-work: _____

Estimated % of new regulations where re-work is required: _____

8) The above questions cover the main areas previously identified as having the most regulatory burdens. Please share with us any significant regulatory burden in the Risk Management and Compliance area that we did not cover above.

	Area of Regulatory Burden	Comments
1	_____	_____
2	_____	_____
3	_____	_____

Lending

1) For the following functions, how many FTEs were employed in 2010 and 2014? What percent of that total FTE time was devoted to performing “Regulatory Related” work (see Survey Guide) for each function?

	Total 2010 FTEs	% of total 2010 FTE time that was Regulatory Related	Total 2014 FTEs	% of total 2014 FTE time that was Regulatory Related
Mortgage Originations (excluding 2nd lien / home equity loans)	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>
Mortgage Servicing	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>
Consumer Lending Originations (including 2nd lien / home equity loans)	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>
Consumer Lending Servicing	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>
Business Lending	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>

Business Servicing				
Credit Administration (including appraisals)				
Collections				

Comments:

2) For these functions, how much was spent on 3rd Party Expense in 2010 and 2014? What percent of the spending was devoted to performing “Regulatory Related” work (see Survey Guide)? What was the total of capitalized spending on 3rd parties that was “Regulatory Related” for all 5 years between 2010 and 2014?

	Total 2010 3rd Party Expense	% of total 2010 3rd Party Expense that was Regulatory Related	Total 2014 3rd Party Expense	% of total 2014 3rd Party Expense that was Regulatory Related	Aggregate Capitalized Spending that was Regulatory Related from 2010 through 2014
Mortgage Originations (excluding home equity loans)					

Mortgage Servicing	<div></div>	<div></div>	<div></div>	<div></div>	<div></div>
Consumer Lending Originations (including home equity loans)	<div></div>	<div></div>	<div></div>	<div></div>	<div></div>
Consumer Lending Servicing	<div></div>	<div></div>	<div></div>	<div></div>	<div></div>
Business Lending	<div></div>	<div></div>	<div></div>	<div></div>	<div></div>
Business Servicing	<div></div>	<div></div>	<div></div>	<div></div>	<div></div>
Credit Administration (including appraisals)	<div></div>	<div></div>	<div></div>	<div></div>	<div></div>
Collections	<div></div>	<div></div>	<div></div>	<div></div>	<div></div>
Other Lending	<div></div>	<div></div>	<div></div>	<div></div>	<div></div>

Comments:

3) Under the Qualified Mortgage (QM) rules, have you discontinued or reduced making loans that would have met YOUR underwriting criteria, but that do NOT meet QM requirements? (Select One)

- ☐ Yes, we have discontinued or reduced non QM loans
☐ No, we still make these loans as before

Please estimate the number and dollar amount of additional loan originations you WOULD HAVE MADE if you had not discontinued or reduced non-QM lending.

Estimated originations (\$) of "Lost" Non-QM loans per month: _____

Estimated # of "Lost" Non-QM loans per month: _____

Comments:

4) Do you offer Multi-Feature Open End Lending (MFOEL) to members? (Select One)

- ☐ Yes
☐ No

If not, did you discontinue the product in the last 5 years and why? (Select One)

- ☐ Yes
☐ No

Comments:

For those still offering MFOEL, please estimate how much regulations (e.g., Reg Z, CARD Act) have decreased average monthly origination volumes:

Estimated originations (\$) of "Lost" MFOEL loans per month: _____

Estimated # of "Lost" MFOEL loans per month: _____

Comments:

For those no longer offering MFOEL, please estimate how much monthly loan volume you lost:

Estimated originations (\$) of "Lost" MFOEL loans per month: _____

Comments:

5) Do you offer Member Business Lending (MBL)?

☐ Yes – We offer MBL

☐ No – We do not offer MBL

Are you subject to the 12.25% of assets MBL cap?

☐ Yes – We are subject to the cap

☐ No – We are not subject to the cap because we are grandfathered or have a low income designation

Please estimate how much the Member Business Lending (MBL) cap reduced monthly originations (\$) in 2014 either because your credit union is nearing the cap or the cap discourages investment in this area?

Comments:

6) The above questions cover the main areas previously identified as having the most regulatory burden. Please share with us any significant regulatory burdens in the Lending area that we did not cover above.

	Area of Regulatory Burden	Comments
1	_____	_____
2	_____	_____
3	_____	_____

Member Services

1) For the following functions, how many FTEs were employed in 2010 and 2014? What percent of that total FTE time was devoted to performing “Regulatory Related” work (see Survey Guide) for each function?

	Total 2010 FTEs	% of total 2010 FTE time that was Regulatory Related	Total 2014 FTEs	% of total 2014 FTE time that was Regulatory Related
Branches	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>
Retail Administration	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>
Call Center	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>
Online, mobile, and ATM	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>

Comments:

2) For these functions, how much was spent on 3rd Party Expense in 2010 and 2014? What percent of the spending was devoted to performing “Regulatory Related” work (see Survey Guide)? What was the total of capitalized spending on 3rd parties that was “Regulatory Related” for all 5 years between 2010 and 2014?

	Total 2010 3rd Party Expense	% of total 2010 3rd Party Expense that was Regulatory Related	Total 2014 3rd Party Expense	% of total 2014 3rd Party Expense that was Regulatory Related	Aggregate Capitalized Spending that was Regulatory Related from 2010 through 2014
Branches	_____ _____	_____ _____	_____ _____	_____ _____	_____ _____
Retail Administration	_____ _____	_____ _____	_____ _____	_____ _____	_____ _____
Call Center	_____ _____	_____ _____	_____ _____	_____ _____	_____ _____
Online, mobile, and ATM	_____ _____	_____ _____	_____ _____	_____ _____	_____ _____

Comments:

3) What was your annual debit interchange income in 2010 and 2014?

	2010	2014
Total Point of Sale debit transactions (See Survey Guide)	_____ _____	_____ _____
Total Interchange income	_____ _____	_____ _____

Comments:

4) For debit cards, what was your split between PIN transactions and signature transactions in 2010 and 2014? Each column should equal 100%

	2010	2014
% of PIN debit transactions	_____ _____	_____ _____
% of signature debit transactions	_____ _____	_____ _____

Comments:

5) Do you offer international remittance services to members? (Select One)

☐ Yes – We offer international remittance services

☐ No – We do not offer international remittance services

If not, did you discontinue the service in the last 5 years and why? (Select One)

☐ Yes – We discontinued this service in last 5 years

☐ No – We’ve never offered this service

Comments:

Please estimate how much the international remittance rules have reduced monthly remittance volumes either because your credit union no longer offers these services or the rules discourages significant volumes in this area?

Estimated # of monthly remittances “lost” due to the existence of the remittance rules:

Comments:

What is the fee that you charged your members per international remittance in 2010 and 2014? Please provide an amount for years when the service was offered and “NA” if it was not offered in that year.

	2010	2014
Fee charged to members for an international wire / remittance	<div></div> <div></div>	<div></div> <div></div>

Comments:

6) What was your NSF and OD income in 2010 and 2014?

	2010	2014
Annual NSF income	_____ _____	_____ _____
Annual OD income	_____ _____	_____ _____
Annual Combined NSF / OD	_____ _____	_____ _____

Comments:

7) Please estimate the impact of savings account withdrawal limits (i.e., Reg D)?

	Estimated monthly impact
Estimated monthly number of transfers from savings or money market accounts that were denied due to withdrawal limits	_____ _____
Estimated FTE hours spent monthly explaining Reg D to members	_____ _____

Comments:

8) Privacy rules limit the sharing of information between affiliated companies, which impacts cross-sell capabilities and effectiveness. Please estimate how much privacy and related regulations resulted in lost or lower revenues?

	Estimated Annual revenue impact
Wealth management / investment management	_____ _____
Insurance	_____ _____
Mortgage (if mortgage is a separate affiliate)	_____ _____

Comments:

9) What is your estimated cost of sending required regulatory disclosures?

	2010	2014
Mailing and printing costs for required disclosures	_____ _____	_____ _____
# of members at year end	_____ _____	_____ _____

Comments:

10) The above questions cover the main areas previously identified as having the most regulatory burden. Please share with us any significant regulatory burdens in the Member Services area that we did not cover above.

	Area of Regulatory Burden	Comments
1	_____	_____
2	_____	_____
3	_____	_____

Deposit Operations

1) For the following function, how many FTEs were employed in 2010 and 2014? What percent of that total FTE time was devoted to performing “Regulatory Related” work (see Survey Guide) for each function?

	Total 2010 FTEs	% of total 2010 FTE time that was Regulatory Related	Total 2014 FTEs	% of total 2014 FTE time that was Regulatory Related
Deposit Operations	_____	_____	_____	_____
	_____	_____	_____	_____

Comments:

2) For the following function, how much was spent on 3rd Party Expense in 2010 and 2014? What percent of the spending was devoted to performing “Regulatory Related” work (see Survey Guide)? What was the total of capitalized spending on 3rd parties that was “Regulatory Related” for all 5 years between 2010 and 2014?

	Total 2010 3rd Party Expense	% of total 2010 3rd Party Expense that was Regulatory Related	Total 2014 3rd Party Expense	% of total 2014 3rd Party Expense that was Regulatory Related	Aggregate Capitalized Spending that was Regulatory Related from 2010 through 2014
Deposit Operations	<div></div>	<div></div>	<div></div>	<div></div>	<div></div>

Comments:

3) Please share with us the top three areas of regulatory burden that impact Deposit Operations.

	Area of Regulatory Burden	Comments
1	<div></div>	<div></div>
2	<div></div>	<div></div>
3	<div></div>	<div></div>

Finance

1) For the following functions, how many FTEs were employed in 2010 and 2014? What percent of that total FTE time was devoted to performing “Regulatory Related” work (see Survey Guide) for each function?

	Total 2010 FTEs	% of total 2010 FTE time that was Regulatory Related	Total 2014 FTEs	% of total 2014 FTE time that was Regulatory Related
Accounting / Finance	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>
Treasury / ALM	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>

Comments:

2) For these functions, how much was spent on 3rd Party Expense in 2010 and 2014? What percent of the spending was devoted to performing “Regulatory Related” work (see Survey Guide)? What was the total of capitalized spending on 3rd parties that was “Regulatory Related” for all 5 years between 2010 and 2014?

	Total 2010 3rd Party Expense	% of total 2010 3rd Party Expense that was Regulatory Related	Total 2014 3rd Party Expense	% of total 2014 3rd Party Expense that was Regulatory Related	Aggregate Capitalized Spending that was Regulatory Related from 2010 through 2014
Accounting / Finance	_____ _____	_____ _____	_____ _____	_____ _____	_____ _____
Treasury / ALM	_____ _____	_____ _____	_____ _____	_____ _____	_____ _____

Comments:

3) Please share with us the top three areas of regulatory burden that impact Finance.

	Area of Regulatory Burden	Comments
1	_____	_____
2	_____	_____
3	_____	_____

IT

1) For the following function, how many FTEs were employed in 2010 and 2014? What percent of that total FTE time was devoted to performing “Regulatory Related” work (see Survey Guide) for each function?

	Total 2010 FTEs	% of total 2010 FTE time that was Regulatory Related	Total 2014 FTEs	% of total 2014 FTE time that was Regulatory Related
IT	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>

Comments:

2) For the following function, how much was spent on 3rd Party Expense in 2010 and 2014? What percent of the spending was devoted to performing “Regulatory Related” work (see Survey Guide)? What was the total of capitalized spending on 3rd parties that was “Regulatory Related” for all 5 years between 2010 and 2014?

	Total 2010 3rd Party Expense	% of total 2010 3rd Party Expense that was Regulatory Related	Total 2014 3rd Party Expense	% of total 2014 3rd Party Expense that was Regulatory Related	Aggregate Capitalized Spending that was Regulatory Related from 2010 through 2014
IT	_____ _____	_____ _____	_____ _____	_____ _____	_____ _____

Comments:

3) Please share with us the top three areas of regulatory burden that impact IT.

	Area of Regulatory Burden	Comments
1	____	____
2	____	____
3	____	____

Legal

1) For the following function, how many FTEs were employed in 2010 and 2014? What percent of that total FTE time was devoted to performing “Regulatory Related” work (see Survey Guide) for each function?

	Total 2010 FTEs	% of total 2010 FTE time that was Regulatory Related	Total 2014 FTEs	% of total 2014 FTE time that was Regulatory Related
Legal	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>

Comments:

2) For the following function, how much was spent on 3rd Party Expense in 2010 and 2014? What percent of the spending was devoted to performing “Regulatory Related” work (see Survey Guide)? What was the total of capitalized spending on 3rd parties that was “Regulatory Related” for all 5 years between 2010 and 2014?

	Total 2010 3rd Party Expense	% of total 2010 3rd Party Expense that was Regulatory Related	Total 2014 3rd Party Expense	% of total 2014 3rd Party Expense that was Regulatory Related	Aggregate Capitalized Spending that was Regulatory Related from 2010 through 2014
Legal	_____ _____	_____ _____	_____ _____	_____ _____	_____ _____

Comments:

3) Please share with us the top three areas of regulatory burden that impact Legal.

	Area of Regulatory Burden	Comments
1	____	____
2	____	____
3	____	____

Human Resources

1) For the following functions, how many FTEs were employed in 2010 and 2014? What percent of that total FTE time was devoted to performing “Regulatory Related” work (see Survey Guide) for each function?

	Total 2010 FTEs	% of total 2010 FTE time that was Regulatory Related	Total 2014 FTEs	% of total 2014 FTE time that was Regulatory Related
HR	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>
Training	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>	<hr/> <hr/>

Comments:

2) For these functions, how much was spent on 3rd Party Expense in 2010 and 2014? What percent of the spending was devoted to performing “Regulatory Related” work (see Survey Guide)? What was the total of capitalized spending on 3rd parties that was “Regulatory Related” for all 5 years between 2010 and 2014?

	Total 2010 3rd Party Expense	% of total 2010 3rd Party Expense that was Regulatory Related	Total 2014 3rd Party Expense	% of total 2014 3rd Party Expense that was Regulatory Related	Aggregate Capitalized Spending that was Regulatory Related from 2010 through 2014
HR	_____ _____	_____ _____	_____ _____	_____ _____	_____ _____
Training	_____ _____	_____ _____	_____ _____	_____ _____	_____ _____

Comments:

3) How much external spending on training did you incur in 2010 and 2014 and what portion of training expense was spent on regulatory training (new, update, refresher)?

	2010	2014
Total External Training Spending	_____ _____	_____ _____
Estimated % of external training spending for regulatory training	_____ _____	_____ _____

Comments:

4) On average, what is the estimated annual training days per employee focused on regulatory training and in total?

	2010	2014
Total training days per employee	<hr/> <hr/>	<hr/> <hr/>
% training days that is Regulatory training	<hr/> <hr/>	<hr/> <hr/>

Comments:

5) How much has the Affordable Care Act (ACA) increased costs to your credit union annually?

Annual Increased Cost per Employee from ACA: _____

Comments:

6) The above questions cover the main areas previously identified as having the most regulatory burden. Please share with us any significant regulatory burden in the Human Resources / Training area that we did not cover above.

Additional Regulatory Burden: _____

Comments:

7) The above questions cover the main areas previously identified as having the most regulatory burden. Please share with us any significant regulatory burdens in the Human Resources / Training area that we did not cover above.

	Area of Regulatory Burden	Comments
1		
2		
3		

Thank You!

Testimony of Alex J. Pollock
Distinguished Senior Fellow
R Street Institute
Washington, DC

To the Committee on Financial Services
United States House of Representatives

Hearing on "Making a Financial Choice: More Capital or More Government Control?"

July 12, 2016

An Excellent Choice

Mr. Chairman, Ranking Member Waters, and Members of the Committee, thank you for the opportunity to be here today. I am Alex Pollock, a senior fellow at the R Street Institute, and these are my personal views. I spent 35 years in banking, including twelve years as President and CEO of the Federal Home Loan Bank of Chicago, and then eleven years as a fellow of the American Enterprise Institute, before joining R Street earlier this year. I have both experienced and studied many financial cycles, including the political contributions and reactions to them, and my work includes the issues of banking systems, central banking, risk and uncertainty in finance, housing finance and government-sponsored enterprises, and the study of financial history.

"Detailed intrusive regulation is doomed to fail." This is the considered, and in my view correct, conclusion of a prominent expert in bank regulation, Sir Howard Davies, former Chairman of the U.K. Financial Services Authority and former director of the London School of Economics. Detailed, intrusive regulation is what we've got, and under the Dodd-Frank Act, ever more of it. "Financial markets cannot be directly 'controlled' by public authorities except at unsustainable cost," Davies adds. Surely there is a better way to proceed than promoting unfettered bureaucratic agencies trying through onerous regulation to do something at which they are doomed to fail.

I believe the CHOICE Act offers the opportunity of a better way precisely by offering banks a fundamental choice.

The lack of sufficient capital in banks is a permanent and irresistible temptation to governments to pursue intrusive micro-regulation which becomes micro-management. This has an underlying logic to it. In a world in which governments explicitly and implicitly guarantee bank creditors, the government in effect is supplying risk capital to the banks which do not have enough of their own. Suppose the real requirement in a true market would be for an equity capital ratio of 8% of assets, but the bank has only 4%. The government is implicitly provides the other 4%--or half the required capital. We should not be

surprised when the in effect 50% shareholder demands a significant say about how the bank is run, even if the resulting detailed regulations will not be successful.

However, the greater the equity capital is, the less rationale there is for the detailed regulation. In our example, if the bank's own capital were 8%, the government's effective equity stake would be down to zero. This suggests a fundamental and sensible trade-off: more capital, reduced intrusive regulation. But want to run with less capital? You get the intrusive regulation.

In other words, the CHOICE Act says to U.S. banks: "You don't like the endless additional regulation imposed on you by the bloated Dodd-Frank Act. Well, get your equity capital up high enough and you can purge yourself of a lot of the regulatory burden, deadweight cost, and bureaucrats' power grabs which were all called forth by Dodd-Frank."

CHOICE does not set up higher capital as a mandate or an order to increase the bank's capital. Rather it offers a very logical decision to make between two options. These are:

-Option One: Put enough of your equity investors' own money in between your creditors and the risk that other people will have to bail the creditors out if you make mistakes. Mistakes are inevitable when dealing with the future, by bankers, regulators, central bankers and everybody else. The defense is equity capital: have enough so that the government cannot claim you are living on the taxpayers' credit, and therefore cannot justify its inherent urge to micro-manage.

-Option Two: Don't get your equity capital up high enough and instead live with the luxuriant regulation of Dodd-Frank. This regulation is the imposed cost of in effect using the taxpayers' capital instead of your own to support your risks.

I believe the choice thus offered in the proposed act is a truly good idea. To my surprise, the *Washington Post* editorial board agrees. They write:

"More promising, and more creative, is Mr. Hensarling's plan to offer relief from some of Dodd-Frank's more onerous oversight provisions to banks that hold at least 10 percent capital as a buffer against losses...such a [capital] cushion can offer as much—or more—protection against financial instability as intrusive regulations do, and do so more simply."

Very true, and very well stated.

Making the choice, banks would have to consider their cost of capital versus the explicit costs and the opportunity costs of the regulatory burden. Some might conclude that Option Two will yield higher returns on equity than Option One; some will conclude that Option One is the road to success. I imagine some banks would choose one option, while some would choose the other.

Different choices would create a healthy diversification in the banking sector. They would also create over time a highly useful learning experience for both bankers and governments. One group would prove to be sounder and to make greater contributions to economic growth and innovation. One group would in time prosper more than the other. The other group will end up less sound and less successful. Which would be which? I think the group with more capital, operating in relatively freer markets with greater market discipline, would prove more successful. But we would find out. Future think tank fellows could write highly instructive papers on the contrast.

Of course, to establish the proposed choice, we have to answer the question: how much capital makes it high enough? For a bank to make the deal proposed in the CHOICE Act, it would have to have a tangible leverage capital ratio of at least 10%. That is a lot more than current requirements, but is it enough?

Consider the matter first in principle: without doubt there is *some* level of equity capital at which this trade-off makes sense—some level of capital at which everyone, even habitual lovers of bureaucracy, would agree that the Dodd-Frank burdens become superfluous, or at least, cause costs far in excess of their benefits.

What capital ratio is exactly right can be, and is, disputed. Because government guarantees, subsidies, mandates and interventions are so intertwined with today's banks, there is simply no market answer available. Moreover, we are not looking for a capital level which would remove all regulation—only the notorious overreaction and overreach of Dodd-Frank. For example, the CHOICE Act requires in addition to 10% tangible capital, to qualify for Option One, that a bank must have one of the best two CAMELS ratings by the regulator—"CAMELS" being assessments of Capital, Asset quality, Management, Earnings, Liquidity, and Sensitivity to market risk.

Numerous proposals for the right capital levels have been made. However, the fact that no one knows the exact answer should not stop us from moving in the right direction.

Among various theories and studies, the International Monetary Fund concluded that "bank [risk-based] capital in the 15-23 percent range would have avoided creditor losses in the vast majority of past banking crises," and that this range is consistent with "9.5 percent of total leverage exposure." Obviously, a 10% level is somewhat more conservative than that.

Economist William Cline recently concluded that "the optimal ratio for tangible common equity is about 6.6 percent of total assets and a conservative estimate...is about 7.9 percent."

Paul Krugman proposed a maximum assets-to-capital ratio of 15:1, which is equivalent to a leverage capital ratio of 6.7%. Anat Admati and Martin Hellwig came in much higher, arguing for a leverage capital requirement of 20% to 30%, however with no empirical analysis. Economists David Miles, Jing Yang and Gilberto Marcheggiano estimated optimal bank capital at about 20% of risk-weighted assets, which in their view means a 7% to 10% leverage capital ratio.

In a letter to the *Financial Times*, a group of academics asserted a requirement for 15% leverage capital, but a study by economists Anil Kashyap, Samuel Hanson and Jeremy Stein proposed risk-based capital of 12% to 15%, which means a leverage capital ratio of 6% to 8%. Banking expert Charles Calomiris proposed 10% leverage capital.

All in all, it seems to me that the 10% tangible leverage capital proposed in the CHOICE Act to qualify for Option One is a fair level. It subtracts all intangible assets and deferred-tax assets from the numerator of the ratio, and adds the balance sheet equivalents of off-balance sheet items to the total assets in the denominator. Thus, it is a conservatively structured measure.

In 2012, Robert Jenkins, then a member of the Bank of England's Financial Policy Committee, gave a speech to the Worshipful Company of Actuaries entitled "Let's Make a Deal," which put forward the same fundamental idea as does the CHOICE Act. The proposed deal was a "rollback of the rule book" in

exchange for banks' raising "their tangible equity capital to 20% of assets." He explained the logic as follows:

- "We all agree that too many bankers got it wrong"

- "We acknowledge that too many *regulators* got it wrong"

So, the best solution is to increase the tangible equity and "in return we can pare back the rule book—drastically."

Under the CHOICE Act, in exchange for 10% tangible leverage capital, along with a high CAMELS rating, the deal is, to repeat, not to eliminate all regulation, but to exit from the excesses of Dodd-Frank. We should view Dodd-Frank in its historical context, as an expected political overreaction to the then-recent crisis. Now, for banks taking Option One, there would still be plenty of regulation, but not the notoriously onerous entanglements of Dodd-Frank. In exchange for Jenkins' suggested move to 20% leverage capital, one would rationally eliminate a *lot* more regulation and bureaucratic power—to pare it back, as he says, "drastically." The proposed act is more moderate.

The CHOICE Act uses the simple and direct measure of tangible leverage capital. This is, in my judgment, superior to the complex and sometimes opaque measures of risk-adjusted assets and risk-based capital. Although in theory risk-based capital might have been attractive, in fact its manifestations have been inadequate, to say the least. Risk adjustments assume a knowledge in regulatory bureaucracies about what is more or less risky that does not exist—because risk is in the future. They are subject to manipulations and mistakes, and more importantly, to political factors. Thus, for example, Greek sovereign debt was given a zero risk weighting, and ended up paying lenders 25 cents on the dollar. The risk weightings of subprime MBS are notorious. Fannie Mae and Freddie Mac debt and preferred stock were given preferential risk weightings which helped inflate the housing bubble—a heavily political decision and a blunder.

The deepest problem with risk weightings is that they are bureaucratic, while risk is dynamic and changing. Designating an asset as low risk is likely to induce flows of increased credit which end up making it high risk. What was once a good idea becomes a "crowded trade." What was once a tail risk becomes instead a highly probable unhappy outcome.

Of course no single measure tells us all the answers. Of course, managing a bank or supervising a bank entails understanding multiple interacting factors. But for purposes of setting up the choice for banks in the proposed act, I believe the simplicity of tangible leverage capital is the right answer.

In my judgment, the proposed choice between Option One and Option Two makes perfect sense. It definitely takes us in the right direction and ought to be enacted.

Thank you again for the chance to share these views.

Testimony of

Jim R. Purcell

Chairman, State National Bank of Big Spring

Big Spring, Texas

and

Chairman, Texas Bankers Association

before the

Committee on Financial Services

U.S. House of Representatives

July 12, 2016

Chairman Hensarling, Ranking Member Waters, distinguished members of the Committee on Financial Services, my name is Jim Purcell, and I am Chairman of the State National Bank of Big Spring. This year, I also have the honor of serving as Chairman of the Texas Bankers Association, which is the largest and oldest of the nation's 50 state banking associations.

In another capacity, State National Bank of Big Spring is the bank plaintiff in the principal case challenging the constitutionality of the Dodd-Frank Act, but I am not appearing here today in that capacity. That case, I might add however, remains pending in federal court in the District of Columbia after the Circuit Court of Appeals recently affirmed the parties' standing to bring the suit.

The State National Bank of Big Spring opened in 1909 as a family-owned bank. Today, the bank operates in three offices, has total assets of \$321 million, and is the only bank

headquartered in the west Texas town of Big Spring, which has a population of approximately 28,000. Certainly we are a community bank as that phrase is generally understood, but I want to mention that we also remain a family-owned bank with Mr. John Currie still providing valued input as our Chairman Emeritus. That is a unique and often overlooked factor in the understanding and regulation of the banking industry.

I am a first generation banker and started my banking career in 1975 after an accident resulted in a doctor telling me I was not to get on a horse or a tractor for at least a year. After various interviews, and for reasons I'm still not sure, I chose the lowest paying job, with the fewest benefits, at a location which is one of the coldest places in Texas. It was at the Citizens State Bank in Dalhart, which also had the oldest group of officers of anyplace I interviewed. But they were very tied into the local community and I quickly learned that that's what made them successful bankers.

Since I started my career in bookkeeping, let me start with some numbers. In June, 2010, when the Dodd-Frank Act was being finalized, there were 626 FDIC-insured banking institutions in Texas. As of the last quarter reported by the FDIC (March 31, 2016), we are down to 477 or a decline of 149 institutions in a state with one of the healthiest economies in the country.

Now, of course, no one is ascribing this 24-percent decline solely to passage of the Dodd-Frank Act, but these are the numbers and we certainly do not think this result is a coincidence. As a community banker, my belief is that the Dodd-Frank Act has been very negative not just for community banks but across the entire industry. More importantly, it has likewise had a negative impact on the country by restraining the banking industry's ability to intermediate our depositors' funds into loans for individuals, businesses, and other worthy

borrowers as would have otherwise been the case. In other words, it is an across-the-board problem for small, large and medium-sized banks.

For this reason, the Texas Bankers Association strongly supports the Financial Choice Act as a path to reform through the option of establishing a capital threshold for relief from the hopelessly complex Basel III requirements and other aspects of counterproductive regulation. The bill would utilize a capital standard of ten percent, which is double the current definition of a "well-capitalized" bank,¹ for purposes of establishing the threshold for the lesser regulatory structure. We are still in the process of analyzing the feasibility of that number across the full range of Texas banking institutions. One approach meriting further exploration is a leverage test that would include a simplified risk-based aspect (as distinct from Basel III) and perhaps a component, as has also been suggested by FDIC Vice Chairman Hoenig, which would incorporate a business "activities" test.²

As recently outlined in Congressional testimony, the American Bankers Association pointed out that U.S. regulators participated in the international discussions establishing the new Basel requirements without full input as to how the Basel plans would affect U.S. institutions, markets, and the overall economy, and that by the time that implementing regulations were proposed, U.S. regulators considered themselves committed to the global Basel plan. The problem, of course, is that the community bank model with thousands of small local institutions is unique to the United States. It simply makes no sense for the banking regulators to take the

¹ FDIC Reg. 325.103(b)(1)(iii).

² FDIC Vice Chairman Thomas Hoenig, *A Conversation about Regulatory Relief and the Community Bank* (2015) at www.fdic.gov/news/news/speeches/spapril1515.html.

capital rules developed as part of a program to unify capital standards for the largest banks in the world and apply them to every bank in the United States.

Four years ago, when I last had the opportunity to testify before this committee, I cited this comment from Senator Dodd that: “in a nation with more than 6,000 banks, the bulk of the bill’s new regulations apply only to a few dozen of the largest ones, each holding more than \$50 billion in assets.”³ No prediction could be further off the mark. In terms of the former Chairman’s reference to the total number of U.S. banking institutions, it is still above 6,000 (6,122), but that is down a staggering 1,708 from the number of U.S. banks just prior to the enactment of the Dodd-Frank Act. Most alarmingly of all, just three new banks were chartered since 2010, which has been the consistent pattern over the six years since adoption of the Dodd-Frank Act.

As we view it, the Financial Choice Act outlines meaningful direction for reform, but in the face of these numbers and in full candor, we need to do much more and need to do it much sooner than can reasonably be anticipated from this starting point. Our message to Congress, as drawn from the very outset of seeing how the Dodd-Frank Act was being implemented, has been on the need for additional flexibility so that regulators can tailor their policies and examinations to a bank’s business model. What I hear from bankers in Texas and around the country is that the pendulum in bank examinations over the last five years has been transposed from prudent oversight to compliance overreach.

In that connection, we are also glad to see H.R. 2896, the Taking Account of Institutions with Low Operation Risk Act (TAILOR Act) of 2015, as introduced by Rep. Scott Tipton

³ *Five Myths about the Dodd-Frank Act*, Washington Post (Nov. 19, 2011).

included in the Financial Choice Act. That legislation is designed to have regulatory actions oriented to a bank's business model and risk profile regardless of asset size.

Perhaps there is a post-Dodd-Frank business model that works by spreading the ever-rising costs of regulatory compliance over a growing or more affluent customer base, but that doesn't work for banks located in small towns and rural areas. The CFPB website says "We are the Consumer Financial Protection Bureau, a U.S. government agency that makes sure banks, lenders, and other financial companies treat you fairly."⁴ But how is it "fairer" to force our customers to go elsewhere for their real estate loans as a consequence of the fact that our mortgage platform did not fit the Dodd-Frank/CFPB profile of a "Qualified Mortgage"?

The problem for us, and I am sure many others, is that our borrowers generally sought relatively small mortgages for their properties which meant that the loan's costs and fees had to be spread across a smaller principal balance. Even though we did not charge any application fees, origination fees, or any other type of fee, these were 5-year balloon notes which typically meant they would fall into the disfavored "high-cost" definition. In addition, we ran into obstacles arising from the regulation's definition of maximum debt-to-income ratios for borrowers. The end result, at least for us, was that due to the increased regulatory burden and potential liability, State National Bank of Big Spring ceased making what we always deemed very good and certainly very fair mortgage loans for the good of both our customers and the broader community.

In conclusion, Mr. Chairman, the Texas Bankers Association appreciates all the work which obviously went into the preparation of this legislation and we look forward to working

⁴ www.consumerfinance.gov.

with all members of the committee to advance the regulatory reforms which would allow our industry to get back into the business of making loans as best tailored for our individual communities. We appreciate that there are many important issues coming before Congress, but in another week or so it will have been six years since the Dodd-Frank Act was signed into law. The result has been, from the standpoint of Texas banks, more obstacles to lending, increased costs, and less ability to serve customer needs.

"Four of state's banks generate most profits"

By David Smith

Arkansas Democrat-Gazette

June 19, 2016

Four of the largest banks in Arkansas are so profitable that they are masking the overall profitability of the state's banking industry, an executive with the Federal Reserve Bank of St. Louis said last week.

The 104 banks in Arkansas have a combined average return on assets -- which is net income as a percentage of assets -- of 1.29 percent, a healthy indicator.

Banks with a return on assets of 1 percent or higher are considered to be performing well. Only a third of the state's banks have a return on assets of 1 percent or better.

But if four banks -- Bank of the Ozarks of Little Rock, Centennial Bank of Conway, First Security Bank of Searcy and Simmons Bank of Pine Bluff -- are removed from the equation, the other 100 banks in the state have a return on assets of only 0.89 percent, said Julie Stackhouse, senior vice president with the St. Louis bank.

Bank of the Ozarks earned about \$55 million, Centennial about \$43 million, First Security about \$26 million and Simmons about \$26 million in the first quarter. If Arvest Bank of Fayetteville, which made \$22 million, is included, the remaining 99 banks earned only about \$78 million in the first quarter.

"We know a few banks in Arkansas are really generating a lot of profits," Stackhouse said.

What that highlights, Stackhouse said, is the challenge smaller banks in Arkansas are facing to generate profits.

"Community banks will need to find a way to continue to be profitable even though their [size] is really starting to become a factor," Stackhouse said.

Still, banks in Arkansas generally are doing well, said Garland Binns, a Little Rock banking attorney.

"I believe banks in Arkansas are performing comparably with banks in other states," Binns said.

Banks nationally have a return on assets of almost 1 percent, according to the Federal Deposit Insurance Corp.

There are other issues also impacting community banks, Stackhouse said. The extended low interest rates environment is a challenge to relatively small community banks, she said.

The cost of meeting regulatory requirements is higher, she said. And banks are having a difficult time attracting high-quality management to their towns who can lead the bank in the future, she said.

"It makes it incredibly important that the board of directors and their leadership team plan for how to address the challenges in the years ahead," Stackhouse said. "Ideally building a pipeline of talent is the most effective way to address these challenges."

A year from now, there won't be much discernible difference, because changes are moving so slowly, Stackhouse said.

"But the board must understand that succession needs to exist and that that is part of the responsibility of a board," Stackhouse said. "Honestly, though, that's still tough. We've seen for many decades that family members often would move into leadership roles. That's not as common today so that makes the job of that board of directors even more difficult."

The St. Louis bank has concerns about some current lending practices nationally, Stackhouse said. Regulators are monitoring commercial real estate lending closely, she said.

"There has been a pretty quick ramp-up in [commercial real estate loans]," Stackhouse said. "We want to be sure that a couple things are occurring."

One concern is that a bank's board of directors and management team consider how the bank is underwriting these loans, conservatively or aggressively, Stackhouse said. Secondly, regulators are asking boards where banks are aggressively increasing commercial real estate loans to determine how much risk will be allowed, she said.

Binns noted that the FDIC released a report recently that also indicated there was a concern about the volume of commercial real estate loans.

"What they are saying is that the risk is there [for something to go wrong]," Binns said. "For instance, if there was a change in the economy in a region, that might impact the performance of some of those loans."



July 12, 2016

Dear Representative,

On behalf of Americans for Financial Reform (AFR),¹ we are writing to express our very grave concerns about the “Financial CHOICE Act” and to urge you to oppose this measure. Passage of this legislation would have a devastating effect on the ability of regulators to protect consumers and investors from exploitation and the economy from financial risk. It would expose consumers, investors, and the public to greatly heightened risk of abuse in their regular dealings with the financial system, and our economy as a whole to heightened risk of instability and crisis.

This bill goes far beyond repealing major parts of the new Dodd-Frank protections passed in the wake of the disastrous financial crisis of 2008. It would also eliminate regulatory powers that long pre-date Dodd-Frank, making financial regulation significantly weaker than it was prior to the 2008 crisis.

Proponents of the Financial CHOICE Act claim that certain portions of the bill actually improve financial protections. This claim is deeply misleading. In fact, the so-called protections in the bill are in many cases simply more disguised deregulation. For example, the bill exempts banks that meet a 10 percent leverage capital ratio from a broad range of laws and risk controls dating back in many cases many decades before the 2008 financial crisis. While increasing leverage capital would be a positive development, under the bill banks would then be exempted from a slew of rules designed to control risks that the moderately higher level of capital required in this bill cannot address. Banks which took advantage of this provision would almost certainly present a far greater risk to the public – and this legislation would strip regulators of their ability to address those increased risks.

The nearly 500 pages of this legislation range across every area of financial regulation, from the powers of the Consumer Financial Protection Bureau (CFPB) to protect consumers, to control of risks at big banks, to legal accountability for financial wrongdoing, to the ability of regulators to defend their actions from lawsuits by big banks. In all these cases, the net effect of the Financial CHOICE Act would be to reduce accountability and oversight, and increase risks to the public. Below, we provide additional discussion of some key features of the bill.²

The Bill Puts Unprecedented Limits On Regulators’ Capacity to Oversee Wall Street

Title VI of the Financial CHOICE Act contains a set of drastic new analytic, legislative, and legal requirements that financial regulatory agencies must fulfill before enforcing any new

¹ Americans for Financial Reform is an unprecedented coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups. A list of coalition members is available at <http://ourfinancialsecurity.org/about/our-coalition/>.

² This letter focuses on AFR’s major objections to the bill as a whole and does not address every provision in the 498-page draft that AFR opposes.

financial rules. These requirements go far beyond any reasonable attempt to improve regulatory procedures and create unprecedented roadblocks to effective action. Indeed, these changes would reduce the effective authority of Federal financial regulators to its weakest point since prior to the Great Depression.

Subtitle A contains a host of new analytic requirements a financial regulatory agency must complete before any rulemaking, any one of which could be material for a lawsuit by Wall Street interests seeking to block new rules. Section 612 of the bill contains several dozen new analyses an agency must perform to justify a rulemaking, some of which are so broad and vague that they create metaphysical questions about whether they could ever be completely satisfied. For example, the legislation requires regulators to quantitatively measure all “anticipated direct and indirect” effects of a new regulation before it is implemented, and to perform an “assessment of all available alternatives to the regulation.” Since all requirements in Section 612 are statutory, each would create a new tool for industry lawyers to file a lawsuit to stop a regulation.

Subtitle B would require explicit approval by both houses of Congress of any significant new financial regulation. This unprecedented new requirement would make Wall Street oversight by administrative agencies subject to the same paralysis we see in Congress.

Subtitle C would eviscerate longstanding Supreme Court precedents requiring courts to defer to subject-matter experts in regulatory agencies when deciding anti-regulation lawsuits. Instead, courts would be required to judge “de novo” claims involving the justification for and technical details of the regulation, reversing the precedent of more than three decades under the *Chevron* doctrine. This means that in any lawsuit claiming that a regulatory action was unjustified, the judge would be encouraged to substitute his or her views for that of the regulatory agency. These three subtitles in combination would create practically insurmountable barriers to completing any new rulemaking that was opposed by any financial entity with the resources to mount a lawsuit challenging the agency’s implementation of any of the numerous new requirements in Subtitle A.

In addition to these provisions, Subtitle E of Title VI and Section 312 would also eliminate the long-standing practice of independent funding for banking regulators. This practice is intended to shield financial regulators from the political pressures that can be brought to bear by well-funded financial interests through the appropriations process. Subtitle F would also impose major new barriers to international coordination between regulators.

Bill Would Drastically Weaken Consumer Protections

In the five years since the CFPB was established, the agency has made enormous strides in ensuring that the financial marketplace is fair to consumers. Its rules and supervision have already begun to reform the industry’s conduct, making banks and other financial services companies more attentive to consumers’ rights, and the agency’s supervision and enforcement actions have returned more than \$11 billion to consumers’ pockets.

But the Financial CHOICE Act includes a series of legislative attacks that would greatly weaken and in some cases cripple the agency’s ability to protect consumers. In addition to the barriers to all financial regulatory agency rulemaking created by Title VI of the bill, which apply to the

Bureau as well, Title III of the bill weakens the CFPB's structure and authority in several important ways:

- Section 311 of the bill would change the structure of the CFPB from its current, effective single-director structure to a less effective five-member commission. A recent market analysis concluded "that shifting the CFPB's governance from a directorship to a commission would double the bureau's already elongated rulemaking timeline [and] cut its enforcement activity by 50% to 75%."³ CFPB supporters strongly and overwhelmingly agree that moving to a commission would dramatically diminish its ability to fulfill its consumer protection mission.⁴
- Section 328 of the bill would eliminate the CFPB's examination and enforcement authority for more than half of the banks it currently supervises.
- Section 337 of the bill would repeal the CFPB's authority to stop abusive acts and practices in consumer finance, literally striking the prohibition on abusive acts and practices from the U.S. Code.⁵
- Section 314 of the bill would jettison as a practical matter the CFPB's administrative enforcement process by giving industry defendants the option to move proceedings to federal court, losing the efficiency and specialization of the administrative adjudication process.
- Section 316 would confuse the CFPB's statutory purpose and mandate the creation of an unnecessary, duplicative bureaucracy within the agency.⁶

Beyond weakening CFPB authorities, the bill also seeks to directly block CFPB efforts to protect consumers in a number of key areas:

- Section 333 of the bill would allow a state to block implementation of new rules the CFPB is developing to protect against payday loan abuses for a period of five years. This proposed rule is designed to prevent abuse by ensuring that small dollar loans are made

³ Ben Lane, Are Richard Cordray's days as CFPB director numbered?, *Housing Wire* (Jun. 3, 2016), <http://www.housingwire.com/articles/37193-are-richard-cordrays-days-as-cfpb-director-numbered?eid=331536434&bid=1423800>.

⁴ Letter to Congress: AFR and 340 Organizations Urge Congress to Support the CFPB (Feb. 27, 2015), <http://ourfinancialsecurity.org/2015/03/letter-to-congress-afr-and-341-organizations-urgecongress-to-support-the-cfpb/>; Letter To Congress: AFR, 75 Organizations Urge Congress To Reject HR 1266 (Sep. 29, 2015), <http://ourfinancialsecurity.org/blogs/wpcontent/ourfinancialsecurity.org/uploads/2015/09/HR-1266-Oppo-Letter-9.29.151.pdf>.

⁵ Letter to Congress: AFR, 42 Organizations Call on Congress to Preserve the CFPB's Authority to Stop Abusive Financial Practices (May 20, 2016), <http://ourfinancialsecurity.org/2016/05/letter-congress-afr-42-organizations-call-congress-preserve-cfpbs-authority-stop-abusive-financial-practices/>.

⁶ Letter to Congress: AFR Opposes H.R. 5211, Legislation to Weaken the CFPB (June 21, 2016), <http://ourfinancialsecurity.org/2016/06/letter-congress-afr-opposes-hr-5211-legislation-weaken-cfpb/>

only to those who can afford to repay them. States should not be able to deny their residents the protection of this basic federal standard.⁷

- Subtitles A, B, and D of Title XI of the bill would exempt a wide range of mortgages from new “Qualified Mortgage” rules designed to prevent the consumer abuses seen in the subprime mortgages that contributed so greatly to the 2008 financial crisis. These sections would exempt mortgages held on bank portfolios – including those originated by the largest Wall Street banks – from consumer protections. Loans to purchase manufactured housing would also lose consumer protections.
- Section 338 of the bill would prevent implementation of the CFPB’s proposed rule against forced arbitration clauses. These clauses deny consumers access to the courts to remedy financial abuses they have suffered.⁸ It is ironic that this legislation, which does so much to assist large financial companies in using lawsuits to overturn rules, would block consumer access to the courts.
- Section 334 of the bill seeks to stall the CFPB’s enforcement of anti-discrimination laws in the auto industry, thereby allowing racial discrimination in auto lending to go unchecked.⁹
- Section 327 of the bill would, as a practical matter, end the meaningful release of information about consumer complaints, eliminating an important public resource for understanding and avoiding consumer abuses.

In addition, Section 325 of the bill would require paying CFPB employees less than employees of all other federal financial regulators, undermining the agency’s capacity to attract and retain highly-qualified financial professionals. Section 326 would weaken the CFPB’s research and analysis capacities, and Section 331 of the bill would effectively bar the CFPB from collecting personally identifiable information (PII) even when that information is needed for bank supervision and law enforcement. Such a requirement would make bank examinations impractical and for that reason it applies to no other bank regulator. The provision is also unnecessary given that the CFPB already has extensive procedures in place to protect PII. And even this does not exhaust the list of unfounded and counterproductive attacks on the CFPB in Title III of the bill.

The Bill Would Significantly Increase the Threat of “Too Big To Fail”

⁷ Letter to Congress: AFR, 268 Groups Call On You To Oppose HR 4018 and Support a Strong Payday Rule (Dec. 15, 2015), <http://ourfinancialsecurity.org/2015/12/letter-to-congress-212-groups-call-on-you-to-oppose-hr-4018-and-support-a-strong-payday-rule/>.

⁸ Letter to Congress: Reject Proposals That Interfere with CFPB’s Authority on Mandatory Arbitration (May 19, 2016) (AFR and 70 organizations), <http://ourfinancialsecurity.org/2016/05/letter-congress-2-2/>.

⁹ Letter to Congress: AFR, 65 Organizations Urge Congress to Stand Against Discriminatory Auto Lending and Reject HR 1737 (Nov. 16, 2015), <http://ourfinancialsecurity.org/2015/11/letter-to-congress-afr-65-organizations-urge-congress-to-stand-against-discriminatory-auto-lending-and-reject-hr-1737/>.

During the 2008 financial crisis, regulators provided unprecedented assistance to the largest Wall Street firms, using the excuse that they lacked the necessary tools to liquidate a failing financial firm without creating unacceptable economic fallout. Title II of the Dodd-Frank Act removed this excuse by creating an Orderly Liquidation Authority (OLA) under which the FDIC could take a large financial firm into receivership, liquidate the firm while limiting economic fallout using a temporary Treasury credit line, and hold the executives, directors, and officers of the firm responsible for reckless decisions leading to the firm's failure.

Title II of the Financial CHOICE Act *completely eliminates* the Dodd-Frank liquidation authority. Subtitle C replaces it with a procedure that would grant special privileges under the bankruptcy code to large financial institutions and their key directors. Dodd-Frank's OLA contains specific provisions to hold executives and directors accountable for actions connected to a company's failure. By contrast, the special privileges granted in the Financial CHOICE Act would completely immunize the directors of a failing financial company from personal liability for actions in connection with the bankruptcy.

By depriving the court of crucial elements of its supervision over a failing financial company, this section would also allow a large financial institution to avoid creditor claims that would apply to any normal company entering bankruptcy. It also appears likely that the rapid process laid out in Subtitle C could be inadequate to address financial instability resulting from the failure of a large financial firm, in that it provides no liquidity support and the firm might not be sufficiently restructured to remedy the issues that led to its failure. This would again leave regulators without necessary tools to address the failure of giant financial firms.

Other provisions in Title II of the Financial CHOICE Act would dismantle the oversight system set up in the Dodd-Frank Act to ensure that regulators were able to detect and act upon threats to financial stability posed by large financial firms before they posed a major threat to the economy, and before such financial giants could try to hold up the public for a bailout:

- Section 211 of the legislation would strip the Financial Stability Oversight Council (FSOC) of most of its powers, including the power to designate extremely large non-banks such as the insurance giant AIG for increased regulatory oversight. During the 2008 financial crisis, AIG received the largest public bailout in U.S. history.
- Section 211 also makes the FSOC practically unmanageable by reducing its funding, opening all of its meetings to hundreds of attendees, and more than doubling its voting membership.
- Section 251 of the bill would eliminate Dodd-Frank provisions for increased oversight of giant financial market utilities such as derivatives clearinghouses that are crucial to financial stability.

The Bill Gravely Weakens Financial Oversight In Other Ways

The issues above hardly exhaust the ways in which the Financial CHOICE Act would weaken and undermine regulation of Wall Street. To take just a few examples:

- Title IX of the bill repeals the Volcker Rule, a signature achievement of the Dodd-Frank Act. The bill's repeal of the Volcker Rule would allow banks to once again conduct proprietary financial gambles with depositors' money;
- Section 468 of the bill would create a major gap in U.S. oversight of the critical market for financial derivatives by forcing U.S. regulators to defer to foreign oversight of derivatives transactions conducted through offshore subsidiaries of U.S. banks. Over half of the multi-trillion dollar U.S. derivatives market – a market critical in triggering the 2008 financial crisis – is conducted through such foreign subsidiaries;
- Subtitle B of Title IV of the bill contains over a dozen provisions weakening key protections for investors, ranging from protections for pension funds seeking to ensure that their private equity fund investments are honestly managed and excessive fees are not charged, to protections for stockholders seeking information on executive compensation.
- Section 325 of the bill would repeal Dodd-Frank's requirement that bank debit card fees charged by banks with more than \$10 billion in assets be limited to the reasonable cost of the transaction. Even those who favor repeal of this regulation agree that this would allow the nation's largest banks to charge retailers and customers an additional \$6 – \$8 billion per year in card fees.¹⁰ It would do nothing to aid community banks, which are not covered by the rule and have actually increased their share of debit transactions since the regulation was implemented.¹¹

Regulatory Improvements Claimed By Proponents of the Bill Would Be Ineffective

Advocates of the Financial CHOICE Act falsely claim that several sections of the bill improve financial protections. A prominent example is Title I of the bill, which exempts banks which choose to meet a 10 percent leverage capital ratio from a broad range of laws and risk controls. Their claim that maintaining a 10 percent leverage ratio will be so effective in protecting against irresponsible bank risk-taking that no other risk controls are necessary is patently false.

Currently, the six largest U.S. banks have an average leverage ratio of approximately 6.5 percent, so it is accurate that a 10 percent leverage ratio would require them to raise a moderate but still significant level of additional capital, and that would be positive.¹² However, these leverage ratios are not discounted for the riskiness of bank assets or activities, so banks could still take potentially enormous financial risks while maintaining a 10 percent leverage ratio. Because of

¹⁰ Todd Zywicki, et al., *Price Controls on Payment Card Interchange Fees: The U.S. Experience* (June 4, 2014), http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2446080

¹¹ James Disalvo & Ryan Johnston, Federal Reserve Bank of Philadelphia Research Department, *Banking Trends* at 4 (First Quarter 2016), https://www.philadelphiafed.org/-/media/research-and-data/publications/banking-trends/2016/bt-how_dodd_frank_affects_small_bank_costs.pdf?la=en.

¹² Supplementary leverage ratios drawn from Q4 2015 earnings reports of JP Morgan, Bank of America, Wells Fargo, Citibank, Goldman Sachs, and Morgan Stanley.

the exemptions contained in this bill, regulators would be stripped of almost all the tools they use to address these risks:

- Under Section 102(a)(1) of the bill regulators would be forbidden to require additional capital for especially risky bank activities that might create higher losses. They would also be forbidden to impose any liquidity requirements at all, even though liquidity failure (the lack of cash to meet current obligations) directly causes bank failure.
- Under Section 102(a)(2) of the bill, regulators would be required to let even the riskiest banks pay out capital to stockholders, rather than reserving it to cover potential losses, even if they saw that banks were undertaking activities that risked large future losses.
- Under Section 102(a)(3) of the bill, regulators would actually be *banned* from taking into account the risk the bank's activities posed to the financial stability of the United States. This would harmfully restrict regulators' ability to examine risks resulting from activities of non-bank subsidiaries of a bank holding company. Regulators would also be forbidden from preventing bank mergers that led to the creation of "too big to fail" entities or had an unacceptable effect on competitiveness in the banking system.

Other elements of the bill would weaken regulatory tools still further. Exempting banks from such a wide range of risk-related rules would leave bank examinations as the only possible tool for addressing risks at major banks. But Subtitle H of Title XI of the bill would also gut the authority of bank examiners to take any action on risk-related issues, permitting banks numerous appeals and back doors before any finding of a bank examiner could be judged valid.¹³

To make matters worse, loopholes included in the legislation make it uncertain that banks would even have to maintain a true 10 percent leverage ratio. For example, Section 105(5)(B) of the bill defines the "Quarterly Leverage Ratio" that qualifies a bank for the sweeping set of exemptions under the rule as the capital ratio on the "last day of the quarter," meaning that a bank could qualify for exemptions by meeting new capital standards only four days out of an entire year.

While we support higher leverage capital ratios for banks, it is absurd to suppose that the leverage requirement included in this bill would protect the public from risks to the financial system under a regulatory regime where regulators were systematically barred from taking action to control bank risks.

Title VIII of the bill, which increases maximum civil monetary penalties for various types of financial misconduct, is also held up as an example of increased financial sector accountability under the Financial CHOICE Act. It is a positive step to increase these penalties, as current statutory penalties are significantly outdated. But other elements of the bill will work against any increased accountability by reducing the ability of regulatory agencies to hold wrongdoers accountable through civil proceedings.

¹³ AFR Letter to Congress Opposing the Exam Fairness Act (June 10, 2015), <http://ourfinancialsecurity.org/wp-content/uploads/2015/07/AFR-HR-1941-Letter-Final-7.28.15.pdf>.

For example, Sections 413 to 417 of the bill would greatly weaken the ability of the Securities and Exchange Commission (SEC) to win administrative cases. Section 416 which would allow a defendant to opt-out of the administrative process in favor of court enforcement, while Sections 418 and 419 of the bill would greatly narrow the SEC's ability to bar individuals found guilty of wrongdoing from working in a wide range of Wall Street jobs.

Numerous other provisions in the bill reduce individual accountability still further: Section 449 of the bill would eliminate a Dodd-Frank provision that required regulators to place controls on short-term bonuses for traders and executives at big Wall Street banks to prevent them from collecting bonus pay for actions that later caused catastrophic losses. This opens the door to a return of the short-sighted Wall Street bonus practices that helped cause the financial crisis.

Section 447 of the bill would also limit the degree to which bonus pay that had been collected based on misrepresentations of company profits could be clawed back from executives. Section 1111 of the bill limits the ability of bank regulators to address criminal activities in banks. And as discussed above, the entire Title VI of the bill would act to prevent regulators from implementing rules addressing new forms of financial sector wrongdoing.

In sum, the Financial CHOICE Act would be an unprecedented blow to effective oversight of the nation's financial sector and to the protection of ordinary consumers, investors, and members of the public who depend on the fairness, transparency, and stability of the financial system. We urge you to reject it.

Thank you for your consideration. For more information, please contact AFR's Policy Director, Marcus Stanley at marcus@ourfinancialsecurity.org or 202-466-3672.

Sincerely,

Americans for Financial Reform

Following are the partners of Americans for Financial Reform.

All the organizations support the overall principles of AFR and are working for an accountable, fair and secure financial system. Not all of these organizations work on all of the issues covered by the coalition or have signed on to every statement.

- AARP
- A New Way Forward
- AFL-CIO
- AFSCME
- Alliance For Justice
- American Income Life Insurance
- American Sustainable Business Council
- Americans for Democratic Action, Inc
- Americans United for Change
- Campaign for America's Future
- Campaign Money
- Center for Digital Democracy
- Center for Economic and Policy Research
- Center for Economic Progress
- Center for Media and Democracy
- Center for Responsible Lending
- Center for Justice and Democracy
- Center of Concern
- Center for Effective Government
- Change to Win
- Clean Yield Asset Management
- Coastal Enterprises Inc.
- Color of Change
- Common Cause
- Communications Workers of America
- Community Development Transportation Lending Services
- Consumer Action
- Consumer Association Council
- Consumers for Auto Safety and Reliability
- Consumer Federation of America
- Consumer Watchdog
- Consumers Union
- Corporation for Enterprise Development
- CREDO Mobile
- CTW Investment Group
- Demos
- Economic Policy Institute
- Essential Action

- Green America
- Greenlining Institute
- Good Business International
- Government Accountability Project
- HNMA Funding Company
- Home Actions
- Housing Counseling Services
- Home Defenders League
- Information Press
- Institute for Agriculture and Trade Policy
- Institute for Global Communications
- Institute for Policy Studies: Global Economy Project
- International Brotherhood of Teamsters
- Institute of Women's Policy Research
- Krull & Company
- Laborers' International Union of North America
- Lawyers' Committee for Civil Rights Under Law
- Main Street Alliance
- Move On
- NAACP
- NASCAT
- National Association of Consumer Advocates
- National Association of Neighborhoods
- National Community Reinvestment Coalition
- National Consumer Law Center (on behalf of its low-income clients)
- National Consumers League
- National Council of La Raza
- National Council of Women's Organizations
- National Fair Housing Alliance
- National Federation of Community Development Credit Unions
- National Housing Resource Center
- National Housing Trust
- National Housing Trust Community Development Fund
- National NeighborWorks Association
- National Nurses United
- National People's Action
- National Urban League
- Next Step
- OpenTheGovernment.org
- Opportunity Finance Network
- Partners for the Common Good
- PICO National Network
- Progress Now Action
- Progressive States Network

- Poverty and Race Research Action Council
- Public Citizen
- Sargent Shriver Center on Poverty Law
- SEIU
- State Voices
- Taxpayer's for Common Sense
- The Association for Housing and Neighborhood Development
- The Fuel Savers Club
- The Leadership Conference on Civil and Human Rights
- The Seminal
- TICAS
- U.S. Public Interest Research Group
- UNITE HERE
- United Food and Commercial Workers
- United States Student Association
- USAction
- Veris Wealth Partners
- Western States Center
- We the People Now
- Woodstock Institute
- World Privacy Forum
- UNET
- Union Plus
- Unitarian Universalists for a Just Economic Community

List of State and Local Partners

- Alaska PIRG
- Arizona PIRG
- Arizona Advocacy Network
- Arizonans For Responsible Lending
- Association for Neighborhood and Housing Development, NY
- Audubon Partnership for Economic Development LDC, New York NY
- BAC Funding Consortium Inc., Miami FL
- Beech Capital Venture Corporation, Philadelphia PA
- California PIRG
- California Reinvestment Coalition
- Century Housing Corporation, Culver City CA
- CHANGER NY
- Chautauqua Home Rehabilitation and Improvement Corporation, NY
- Chicago Community Loan Fund, Chicago IL
- Chicago Community Ventures, Chicago IL
- Chicago Consumer Coalition
- Citizen Potawatomi CDC, Shawnee OK

- Colorado PIRG
- Coalition on Homeless Housing in Ohio
- Community Capital Fund, Bridgeport CT
- Community Capital of Maryland, Baltimore MD
- Community Development Financial Institution of the Tohono O'odham Nation, Sells AZ
- Community Redevelopment Loan and Investment Fund, Atlanta GA
- Community Reinvestment Association of North Carolina
- Community Resource Group, Fayetteville AR
- Connecticut PIRG
- Consumer Assistance Council
- Cooper Square Committee (NYC)
- Cooperative Fund of New England, Wilmington NC
- Corporacion de Desarrollo Economico de Ceiba, Ceiba PR
- Delta Foundation, Inc., Greenville MS
- Economic Opportunity Fund (EOF), Philadelphia PA
- Empire Justice Center NY
- Empowering and Strengthening Ohio's People (ESOP), Cleveland OH
- Enterprises, Inc., Berea KY
- Fair Housing Contact Service OH
- Federation of Appalachian Housing
- Fitness and Praise Youth Development, Inc., Baton Rouge LA
- Florida Consumer Action Network
- Florida PIRG
- Funding Partners for Housing Solutions, Ft. Collins CO
- Georgia PIRG
- Grow Iowa Foundation, Greenfield IA
- Homewise, Inc., Santa Fe NM
- Idaho Nevada CDFI, Pocatello ID
- Idaho Chapter, National Association of Social Workers
- Illinois PIRG
- Impact Capital, Seattle WA
- Indiana PIRG
- Iowa PIRG
- Iowa Citizens for Community Improvement
- JobStart Chautauqua, Inc., Mayville NY
- La Casa Federal Credit Union, Newark NJ
- Low Income Investment Fund, San Francisco CA
- Long Island Housing Services NY
- MaineStream Finance, Bangor ME
- Maryland PIRG
- Massachusetts Consumers' Coalition
- MASSPIRG
- Massachusetts Fair Housing Center
- Michigan PIRG

- Midland Community Development Corporation, Midland TX
- Midwest Minnesota Community Development Corporation, Detroit Lakes MN
- Mile High Community Loan Fund, Denver CO
- Missouri PIRG
- Mortgage Recovery Service Center of L.A.
- Montana Community Development Corporation, Missoula MT
- Montana PIRG
- New Economy Project
- New Hampshire PIRG
- New Jersey Community Capital, Trenton NJ
- New Jersey Citizen Action
- New Jersey PIRG
- New Mexico PIRG
- New York PIRG
- New York City Aids Housing Network
- New Yorkers for Responsible Lending
- NOAH Community Development Fund, Inc., Boston MA
- Nonprofit Finance Fund, New York NY
- Nonprofits Assistance Fund, Minneapolis MN
- North Carolina PIRG
- Northside Community Development Fund, Pittsburgh PA
- Ohio Capital Corporation for Housing, Columbus OH
- Ohio PIRG
- OligarchyUSA
- Oregon State PIRG
- Our Oregon
- PennPIRG
- Piedmont Housing Alliance, Charlottesville VA
- Michigan PIRG
- Rocky Mountain Peace and Justice Center, CO
- Rhode Island PIRG
- Rural Community Assistance Corporation, West Sacramento CA
- Rural Organizing Project OR
- San Francisco Municipal Transportation Authority
- Seattle Economic Development Fund
- Community Capital Development
- TexPIRG
- The Fair Housing Council of Central New York
- The Loan Fund, Albuquerque NM
- Third Reconstruction Institute NC
- Vermont PIRG
- Village Capital Corporation, Cleveland OH
- Virginia Citizens Consumer Council
- Virginia Poverty Law Center

- War on Poverty - Florida
- WashPIRG
- Westchester Residential Opportunities Inc.
- Wigamig Owners Loan Fund, Inc., Lac du Flambeau WI
- WISPIRG

Small Businesses

- Blu
- Bowden-Gill Environmental
- Community MedPAC
- Diversified Environmental Planning
- Hayden & Craig, PLLC
- Mid City Animal Hospital, Phoenix AZ
- UNET

July 11, 2016

The Honorable Jeb Hensarling
House of Representatives
Chairman, Financial Services Committee
2129 Rayburn House Office Building
Washington, DC 20515

The Honorable Randy Neugebauer
House of Representatives
Chairman, Subcommittee on Financial Institutions and Consumer Credit
2129 Rayburn House Office Building
Washington, DC 20515

Dear Chairmen Hensarling and Neugebauer:

We are writing to urge you to reconsider legislation to repeal financial reforms that are critical to U.S. businesses and our customers. The debit card fee and rule reforms prescribed in Section 1075 of the Wall Street Reform and Consumer Protection Act have provided significant relief to Main Street businesses from anti-free market practices employed by global credit and debit card brands.

As cornerstones in the business community, we are staunch supporters of free enterprise, and generally do not support any market intervention unless markets are not functioning efficiently. Credit and debit card acceptance is a prime example of a non-functioning marketplace.

In an age where electronic payments have become virtually ubiquitous, very few businesses can choose not to accept credit and debit cards and still remain competitive. This dynamic has enabled global card brands to leverage a business model whereby they can change the rules of card acceptance at any moment. In many instances, these rule changes constitute an enormous free market intrusion and overstep by limiting the flexibility of card acceptors to make decisions about how to best run their businesses and serve their customers.

The competitive gap between international and U.S. payment card acceptors is growing every day that the U.S. market fails to move toward a more transparent, equitable, and free market for card acceptance. There are several reforms still needed in the credit card marketplace to improve payment acceptance as the United States continues to adopt new and innovative ways to pay in the mobile and e-commerce spaces. Debit card reforms have been a major step in the right direction, and any removal of those reforms would be a monumental step in the wrong direction for U.S. businesses and consumers.

Our undersigned companies oppose any efforts to repeal debit card fee and rule reforms, including the recently introduced legislation (H.R. 5465) to dismantle the substantial progress debit reforms have made in correcting in part an otherwise non-functioning, and largely non-transparent card acceptance marketplace in the United States. We strongly urge you to reconsider the inclusion of any debit reform repeal language with your committee's ongoing efforts to modify the current financial regulatory landscape, and encourage you to remove Section 335 from the Financial CHOICE Act. Existing debit card fee reforms matter a great deal to our individual businesses.

Sincerely,

6040 LLC
7-Eleven, Inc.
Ace Energy
Aloha Petroleum, Ltd.
Alon USA
AMC Entertainment Inc.
American Airlines
Andronico's Community Markets
Appleseed IGA
Barnes & Noble Education
B&B Theatres
Bealls Inc.
Best Buy Co., Inc.
Boscov's Department Store LLC
Bow Tie Cinemas
BrandsMart USA
Broadway Truck Stops
Brookshire's
Casey's General Stores, Inc.
Celebration! Cinema
Cinemagic Stadium Theaters
Cinemark USA, Inc.
Columbiana Foods, Inc.
The Convenience Group, LLC
CST Brands, Inc.
Cumberland Farms, Inc.
CVS Health
Davis Oil Company
Deluxe Truck Stop
Detroit Travel Center
Dhaliwal & Associates, Inc.
Dillard's, Inc.

Encore Franchises, LLC
E-Z Mart Stores, Inc.
Fast Food Stores
Fausto's Food Palace, LLC
Fiesta Foods
Foot Locker, Inc.
Fresh by Brookshire's
Friedman's Freshmarkets
Gate Petroleum Company
GCM The Big Store
GE Foodland, Inc.
Georgia Theatre Company
Giant Eagle, Inc.
Goetz Companies
Goody Goody Liquors, Inc.
Greater Chicago I-55 Truck Plaza
Harkins Theatres
Harps Food Stores, Inc.
The Home Depot
The Hub Convenience Stores, LLC
The Hub Restaurant Group, LLC
JCPenny
J&T Business Management
Jubitx Corporation
Kenly 95 Petro
The Kent Companies
Kings Liquors, Inc.
Knowlan's Super Markets dba Festival Foods
Kohl's Department Stores, Inc.
The Kroger Co.
Kum & Go
Kwik Chek Food Stores
Kwik Trip
L Brands
Liberty Petroleum Distributors
Longhorn Liquor
Lowe's
Lynchburg College Campus Store
Mackenthun's Supermarkets, Inc.
Malco Theatres
MAPCO
Martin's Supermarkets
The Markets, LLC.
Maverick, Inc.

Metropolitan Theatres Corp.
Nelson Coleman Jewelers
Nordstrom
Old Port Card Works
Old Port Candy
Pacific/ArcLight Cinemas
Pilot Flying J Travel Centers
Potash Markets
Premiere Cinema Corp.
Publix
Puckett Food Stores, Inc.
RaceTrac
Ralston Discount Liquor
Red Lobster
Regal Entertainment Group
Ricker's
Roselynn Inc.
Quik Trip
QVC, Inc.
Sapp Bros. Travel Centers, Inc.
Sears
Sheetz, Inc.
ShowBiz Cinemas
Southern Theatres
Southwest Airlines
Spec's Wines, Spirits & Finer Foods
Speedway LLC
The Spinx Company
Spring Market
Sprint Food Stores, Inc.
Square One Markets Inc.
Super 1 Foods
Target
TravelCenters of America
Twin Liquors
Varsity Bookstore
Verc Enterprises
Village Commons Bookstore
Walla Walla's Harvest Foods
Walmart
Wakefern Food Corp.
Wawa, Inc.
WB Liquors of Texas
White's Travel Center LLC

252

Wingert's Food Center
Wray's Food & Drug

CC: House Leadership
Members of the United States House of Representatives

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July 11, 2016

Chairman Jeb Hensarling
Chairman
House Committee on Financial Services
2228 Rayburn House Office Building
Washington, DC 20515-4305

Dear Chairman Hensarling:

On behalf of the National Association of Convenience Stores (NACS) and the Society of Independent Gasoline Marketers of America (SIGMA),¹ thank you for the opportunity to comment on the discussion draft of the Financial Choice Act. NACS and SIGMA have grave concerns about the current draft of the Act because it includes a provision to repeal debit swipe fee reform, also known as the Durbin Amendment.²

Debit swipe fee reform has succeeded in addressing a damaging failure in the debit card market — a lack of competition that has led to inflated prices for retailers and consumers alike. These comments will briefly walk through the problems that made reform necessary as well as the clear, unassailable benefits that reform has brought. Overall, however, we cannot overstate the importance of maintaining these reforms. The convenience store and fuel retailing industry handles approximately one of every 30 dollars spent in the United States, processing over 73 billion payment transactions per year. Debit swipe fee reform has a huge impact on many of those transactions. As such, it is the top public policy issue facing our industry and the top public policy issue we have ever faced. Our thoughts on other aspects of the draft legislation so pale in comparison to the importance of debit swipe fee reform that we will not bother to discuss them in these comments. We cannot begin to have a conversation about potential changes to the Dodd-Frank Wall Street Reform Act if there is any potential threat to debit swipe fee reform. We hope that the draft Financial Choice Act will be revised to remove any reference or changes to debit swipe fee reform so that we can engage in a constructive discussion of other public policy provisions in this area.

¹ NACS is an international trade association representing the convenience store industry with more than 2,200 retail and 1,800 supplier companies as members, the majority of whom are based in the United States. SIGMA represents a diverse membership of approximately 260 independent chain retailers and marketers of motor fuel. The convenience store industry as a whole operates approximately 154,000 stores across the United States.

² Sec. 1075, Wall Street Reform and Consumer Protection Act: Reasonable Fees and Rules for Payment Card Transactions.

Background on Debit Cards

In order to discuss debit swipe fee reform, it is helpful to have some background on the history of these payment cards. The debit card had a forerunner which was known as an automated teller machine (ATM) card. Banks pioneered the ATM card in the late 1960s and early 1970s, but the cards really proliferated in the 1980s. The reason banks wanted ATMs – and the cards to operate them – was that they faced high costs when their customers wanted access to the funds they kept in their bank accounts. Prior to the ATM, there were two principal ways that consumers accessed their funds: 1) withdrawals of cash; and 2) writing a paper check. When customers withdrew cash, the banks faced high costs including having enough physical branches to meet customers’ demand for access to their money and they needed to pay tellers to complete these transactions. These arrangements caused particular logistical problems on Friday afternoons and paydays when large numbers of customers would visit bank branches at the same time.³ The result was not only that the bank had to have large numbers of tellers on duty at those times but also that customers became frustrated with the wait times. And, all of these transactions happened with paper withdrawal slips completed by customers and tellers. Processing all that paper added cost to the process as well.

Paper checks did not provide banks with the level of relief they may have hoped from the many costs of in-person withdrawals. Processing the paper was still expensive and, until the last few years, the original paper check had to be physically processed through the relevant Federal Reserve bank in order to fully complete the transaction. Paper checks were an expensive way for customers to access their funds as well.

ATMs, however, helped solve many of these cost issues. They replaced paper processes with electronic processes. The ATMs reduced the number of bank branches and tellers that banks needed to service their customers. And, ATMs could function around the clock so they reduced the Friday afternoon lines that frustrated bankers and their customers. By giving customers cards with magnetic stripes and personal identification numbers (PINs), those customers could access their funds at their convenience.

What those ATMs and cards did not do, however, was replace the need for checks. People still needed access to their funds in stores when they did not have sufficient cash (or did not want to use cash). Bankers reasoned that if people could have electronic access to their funds in stores, they would have no need to write checks. That was the origin of debit cards, which were also and continue to be referred to as “check cards.” The debit card allowed customers the convenience of a check at the store (and more) and gave the banks an electronic transaction which was much cheaper for them to handle than the paper check.

³ See e.g., Bernardo Batiz-Lazo, *The Atlantic*, A Brief History of the ATM (Mar. 26, 2015), available at <http://www.theatlantic.com/technology/archive/2015/03/a-brief-history-of-the-atm/388547/> (noting that “The most successful early deployments took place in Europe, where bankers responded to increasing unionization and rising labor costs by soliciting engineers to develop a solution for after-hours cash distribution... The ATM freed the average consumer from lengthy queues for services that had previously been limited to bank hours.”).

This was so important as a way to help banks cut their costs that financial incentives were provided to many merchants in order to give those merchants an incentive to install the necessary hardware to be able to accept debit cards at their points of sale. For other merchants, the transactions were free. There was, in fact, vibrant debate among the banks and debit networks as to whether there should ever be any swipe fees associated with debit transactions and, if there were, whether those fees should flow from merchants to the bank issuers of cards or whether those fees should flow from the bank issuers of cards to the merchants that deployed the equipment to accept the cards (which is the direction those fees flow on ATM transactions themselves).

Ultimately, the decision was for fees (if there were any) to flow to bank issuers, but the fees were very low for many years. Into the mid-1990s, for example, the fees for most debit networks remained about five cents per transaction. At that point, however, Visa began to institute a new strategy. Visa saw debit cards as similar to its credit cards and wanted to dominate the debit business in the way it had come to dominate the credit card business. Visa executives decided the way to do that was to guarantee banks that issued cards with its logo larger revenues, through swipe fees, than those issuers would get from other debit networks. The strategy worked. Visa drove swipe fees higher and higher – and banks issued more and more debit cards with the Visa logo on them. MasterCard and other debit networks have never really recovered from the head start Visa got with this strategy. Visa dominates debit cards today far more than it dominates credit cards. But, the fees it sets for card-issuing banks were not established based on a need or a cost or fraud or any reason other than Visa saw an opportunity to grab market share and took it.

Addressing Price-Fixing and Market Failure

Visa's ability to dominate debit cards was made possible by credit cards. By the mid-1990s, credit cards had become an essential part of everyday commerce in the United States. Visa and MasterCard both had market power in the credit card market and had become well-established as household names. Visa's plan to become dominant in debit cards relied upon merchants paying large fees to bank issuers through swipe fees – and Visa had a way to do that. Visa required that any merchant that wanted to accept its credit cards was required to also accept its debit cards. Visa knew that credit cards were firmly entrenched and consumers wanted to use them. Merchants knew this as well and figured they had to go along because they could lose customers to their competitors if they didn't take the customer's preferred credit card.

In antitrust law, what Visa did was referred to as "tying." Visa tied acceptance of one product (credit cards) to acceptance of another product (debit cards). There was a lawsuit over this and it resulted in the largest antitrust settlement in U.S. history at that time (\$3 billion) and an order that Visa and MasterCard could no longer tie credit and debit card acceptance. But the suit took until 2003 to conclude and, by that time, debit card usage had become so popular in its own right that not much changed. Visa and MasterCard continued to drive up debit swipe fees throughout the 2000s.

But what are these swipe fees? These are the fees that the bank that issued the card charges. Why do Visa and MasterCard have anything to do with these fees? After all, Visa and MasterCard do not

coordinate what fees banks charge consumers on checking accounts or what interest rates banks pay or charge customers. On every other fee and rate, banks compete with each other. That is how a capitalist economy works. Prices get set through competitors independently determining their own prices. They have incentives to push their prices as low as they can in order to take customers (and market share) from their competitors.

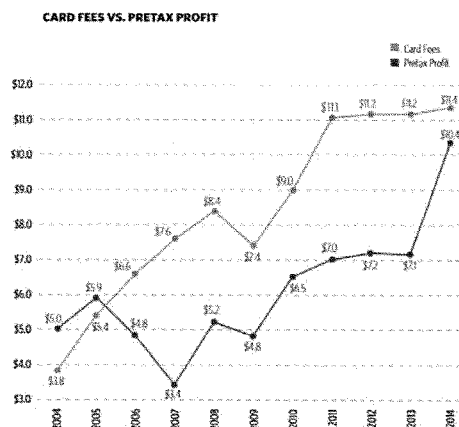
Swipe fees do not operate in a competitive market. Visa and MasterCard each set the fees for their card issuing banks—and those banks all charge the schedule of fees as set by their networks. The banks do not compete with each other on price. That fixing of prices completely undercuts the way that prices are disciplined by competition in a capitalist economy. But, the dynamic of having two dominant card networks arguably makes the price fixing even worse. Visa wants banks to issue more of its cards rather than MasterCard's cards. MasterCard wants just the opposite. They each try to do this by setting their schedule of swipe fees that the banks will receive on debit transactions higher than the other network. The result is not only price-fixing but an upward spiral of price-fixing.

And, U.S. retailers are particularly vulnerable to the upward spiral of price-fixing because the U.S. retail market is so fiercely competitive. In many ways, U.S. retail is the envy of the world. Prices are transparent, and businesses compete hard for customers. In our industry, motor fuel prices are advertised on large signs that are visible to everyone as they drive past our stores. We have found that customers will turn across a busy street to save one cent per gallon on gasoline – and will drive miles out of their way to save three to five cents per gallon even though they may burn fuel driving that distance, which ultimately costs more than they will save. Because of this competitiveness, retailers will do just about anything to retain and increase their customers. This includes doing what they can to accept payment the way their customers want to pay. Economists with the Kansas City Federal Reserve have studied this dynamic and concluded that one reason Visa/MasterCard and their banks are able to fix fees at such a high level is that retailers are trying to take customers from each other all the time.⁴ They know, and customers know, that customers have become conditioned to pay with their cards. So, retailers will pay supra-competitive fees that in many cases exceed their profits to try to keep their customers. As long as the fees don't actually put them out of business, retailers have to take the fees the networks fix.

That vicious dynamic has made swipe fees the second largest operating cost for U.S. retailers (second only to labor). And, for more than a decade, swipe fees have been the fastest-growing cost for U.S. retailers – growing faster than everything from health care to energy costs – and it's not even close. For the convenience store industry, we have now spent the past decade paying more in swipe fees than we have collected in pre-tax profits. The costs are staggering. In 2014, for example, the industry paid \$11.4 billion in card fees compared to \$10.4 billion in pre-tax profits.⁵

⁴⁴ See generally Fumiko Hayashi, Federal Reserve Bank of Kansas City, *A Puzzle of Card Payment Pricing: Why Are Merchants Still Accepting Card Payments?* (Dec. 28, 2004), available at <https://www.kansascityfed.org/publicat/psr/rwp/WP04MerchCardAcceptance12-28-04.pdf>.

⁵ NACS, *State of the Industry, Annual Report 2014*.



That is the central problem that debit swipe fee reform addressed. Spiraling price-fixed fees undercut any semblance of a functioning market. Reform was necessary.

The Reforms

There were two primary changes brought about by debit swipe fee reform.⁶ The first limited price-fixing to a reasonable level and the second protected competition among debit networks for handling transactions.

The changes to swipe fee pricing are often misunderstood. The law only applies to debit swipe fees that are centrally price-fixed by the card networks. Any bank that competes by setting its own fees rather than being part of the network price-fix is not subject to fee regulation. That means any bank can voluntarily exempt itself from the fee regulation. And, that is in addition to the vast majority of banks (more than ninety-eight percent of them) that are already exempt from fee regulation because they have less than \$10 billion in assets. For those very large banks that do want to participate in the card network swipe fee price-fix, they are limited to the Federal Reserve's regulation on how much price-fixing is reasonable. One could argue that no price-fixing at all is reasonable or should be allowed, but the Federal Reserve provided far more room than that to the networks and banks. The Fed limited price-fixing to twenty one cents, plus a one cent fraud prevention adjustment plus 0.05 percent of the transaction amount to cover all of the mean bank's fraud losses.⁷ That has resulted in an average debit

⁶ Sec. 1075, Wall Street Reform and Consumer Protection Act: Reasonable Fees and Rules for Payment Card Transactions.

⁷ See 12 C.F.R. § 235.7; Federal Reserve, Final Rule, Debit Card Interchange Fees and Routing, 76 Fed. Reg. 43394, 43467 (July 20, 2011), available at <https://www.gpo.gov/fdsys/pkg/FR-2011-07-20/pdf/2011-16861.pdf>.

swipe fee for covered issuers of twenty-four cents per transaction. Given that more than ninety percent of these transactions cost less than two cents for an issuing bank to authorize, clear and settle, they are looking at profit margins of more than one thousand percent.⁸ The Fed's regulation, thereby, limits price-fixing, but it doesn't limit it much.

The second change brought by swipe fee reform is purely pro-competitive. Card networks charge their own fees to merchants on debit transactions. Those fees are over and above the swipe fees charged by card issuing banks. By the 2000s, the major card networks had worked to push their competitor debit networks like Star, Pulse, NYCE, Shazam and others out of the debit routing business. This was often done through financial deals with the largest handful of U.S. banks. Buying competition out of the market was driving small debit networks out of business. Debit reform put a brake on this trend by ensuring that there remain at least two competitive options of networks on debit transactions that the customer purchasing that service (the merchant) could choose.⁹ This part of the reforms does nothing more than ensure that competition among debit networks will be protected into the future.

Success of Debit Swipe Fee Reform

Given the problems with debit swipe fees prior to reform, the changes predictably have been successful. Price-fixing, for example, has been a bit more limited. Unfortunately, it still goes on. Visa and MasterCard continue to price the fees that their banks charge on all debit transactions. We had hoped some banks would choose to leave the price-fixing system, but the fees that the Fed's regulations allow are still too high to give banks any real incentive to end price-fixing. But, there are at least some guardrails on price-fixing and that is an improvement.

And, there is more competition and innovation among networks. Smaller debit networks have expanded their offerings so that they can handle transactions through a variety of authentication methods. Visa and MasterCard have done the same. These innovations were long overdue and provide more competitive choices. There remain issues to be resolved as Visa and MasterCard continue to try to find ways to evade competition and constrain merchants so that they cannot make competitive choices, but we remain hopeful that the regulators and congressional oversight will ensure that, over time, competition does fully take hold among debit networks without interference by Visa and MasterCard.

All of this has meant that the amount of unnecessary friction and cost in debit transactions has been reduced. And that, after all, ought to be the goal of any payment system – reducing friction and cost so that transactions are more efficient. Economist Robert Shapiro has found that these changes resulted in consumer savings of \$5.8 billion and merchant savings of \$2.6 billion in the first year of debit

⁸ It is interesting to note that when forced to compete (if only a little bit) by debit reform, banks have found ways to make debit transactions more efficient, which means they pocket even more of the debit swipe fees they collect. See Merchant Advisory Group, *Volume and Cost Trends in the Debit Card Industry* (2015) (finding that between 2009 and 2013, issuers' self-reported average cost of handling debit transactions had decreased by 42%, from 7.6 cents to 4.4 cents).

⁹ 12 C.F.R. § 235.7; 76 Fed. Reg. at 43468.

reform alone.¹⁰ And, efficiency has other benefits as well. Consumers pay more when lower prices give them more purchasing power. Those benefits supported an additional 37,000 jobs in the first year of reform alone as well. Moody's has found that these savings have helped shield consumers from the higher prices they would have paid from other business costs going up – and that merchants were not pocketing savings from reform.¹¹ In our industry, gas prices provide a clear lesson of how consumers benefit when retailers' costs are reduced. Over the last few years, gas prices have fallen dramatically from as much as \$4 per gallon to, at times, about half that amount. Lower business costs for retailers help consumers save throughout the economy.

Debit card issuing and usage has continued to flourish. While some banks had argued that debit cards would not be offered anymore, that has proven false. And, of course, that false criticism flies in the face of the history of debit cards which were (and remain) a cost saving benefit for banks even if no swipe fee revenue had ever been associated with them. The Philadelphia Federal Reserve found that banks with less than \$10 billion in assets had benefitted from reform by increasing their market share and continuing to charge about the same rates for debit transactions that they did prior to reform.¹² The GAO and Federal Reserve Board made similar findings.¹³

One additional note is that some falsely claimed that swipe fee reform could reduce consumer access to free checking. Such a claim is nonsensical as free checking has its own market dynamics based on banks competing for individual customers. That is why, for example, free checking fell dramatically from 2009 to 2010 – the financial crisis upended the market dynamics in that market. Nonetheless, some made that silly claim and it has proved false – though some critics still try to point to the 2009 number for free checking (one year before reform was passed and two years before it went into effect) to show a false premise that cannot be shown by real facts. The simple fact is that more consumers have access to free checking today than did when debit reform was passed. For 2010, when reform became

¹⁰ Robert J. Shapiro, Sonecon, LLC, *The Costs and Benefits of Half a Loaf: The Economic Effects of Recent Regulation of Debit Card Interchange Fees* (Oct. 1, 2013).

¹¹ Moody's Investors Service, *New Debit Rules Hurt Banks and Reshape the Payment Processor Market* (June 20, 2012) at 10.

¹² James DiSalvo and Ryan Johnston, Federal Reserve Bank of Philadelphia Research Department, *Banking Trends: How Dodd-Frank Affects Small Bank Costs* (1st Quarter 2016).

¹³ See e.g., Government Accountability Office, *Community Banks and Credit Unions: Impact of the Dodd-Frank Act Depends Largely on Future Rule Makings*, GAO-12-881 (Sept. 2012); Board of Governors of the Federal Reserve System Report, *Average Debit Card Interchange Fee by Payment Card Network* (May 1, 2012).



law, the American Bankers Association found that 53 percent of Americans had free checking.¹⁴ For 2015, the American Bankers Association found that 61 percent of Americans had free checking.¹⁵

* * *

The bottom line is that debit swipe fee reform was and remains desperately needed.¹⁶ This sensible reform, which merely limited price-fixing and increased competition, has been a clear success. Repealing it would only take the country backwards. It would leave Visa and MasterCard free to price-fix fees that banks charge without limitation. It would dramatically curtail competition among debit networks. And, repeal would increase costs for everyday consumers and merchants thereby depressing sales and hurting the economy. In short, repeal would be a lose-lose-lose proposition. Only the largest 20 or so debit-issuing banks along with Visa and MasterCard would really benefit. Everyone else, including small banks, would be worse off after repeal.

NACS and SIGMA urge you in the strongest terms to remove the repeal of debit swipe fee reform from the Financial Choice Act before it is introduced as a bill.

Best Regards,

Douglas S. Kantor

Cc: Members, House Financial Services Committee

¹⁴ ABA Survey Shows Majority of Bank Customers Pay Nothing for Monthly Bank Services (Oct. 7, 2010), <http://www.prnewswire.com/news-releases/aba-survey-shows-majority-of-bank-customers-pay-nothing-for-monthly-bank-services-104516904.html>.

¹⁵ American Bankers Association, Survey: Most Americans Pay Nothing for Bank Services (Aug. 18, 2015), available at <http://www.aba.com/Press/Pages/081815SurveyonBankCosts.aspx>.

¹⁶ Notwithstanding the success of debit swipe fee reform, U.S. merchants continue to pay some of the highest debit swipe fees across the globe. For example, in 2015, U.S. merchants paid almost 4 times more per debit card transaction than merchants in Belgium, Hungary, Iceland, Poland, and Spain—and 3.5 times more than merchants in the U.K. See Federal Reserve Bank of Kansas City, *Credit and Debit Card Interchange Fees in Various Countries August 2015 Update*, available at https://www.kansascityfed.org/~media/files/publicat/psr/dataset/intl_if_august2015.pdf; The Cost of Accepting Credit Card Payments: NA vs EU, available at <http://www.valuepenguin.com/interchange-fees-na-vs-eu> (last visited July 9, 2016).