

STATEMENT OF

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FINANCIAL INSTITUTIONS AND CONSUMER CREDIT

HEARINGS ON:

**“EXAMINING THE DESIGNATION AND REGULATION OF
BANK HOLDING COMPANY SIFIs”**

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Chairman Neugebauer, Ranking Member Clay and other distinguished members of the Subcommittee, I am honored to be here with you today. My name is Satish Kini. I am a partner in the Washington, D.C. office of Debevoise & Plimpton LLP and chair of the firm's Banking Group. In my remarks today, I draw on my over two decades of experience counseling financial services firms and banking organizations, including bank holding companies that today are subject to enhanced prudential standards under section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").

From the experience of the financial crisis was born the idea of tiered regulation and supervision, with more stringent standards applying to those financial institutions the potential stress or failure of which could present risks to the financial system or economy as a whole. The two key questions presented by this graduated approach are: first, how to identify those organizations that are systemically important and that, thus, should be subject to enhanced regulation and supervision, and, second, what enhanced requirements ought to apply to these firms.

In my remarks today, I will first discuss the Dodd-Frank Act's \$50 billion asset threshold for imposing enhanced prudential standards on bank holding companies and contrast this approach with the indicator-based methodology adopted by the Basel Committee on Banking Supervision ("Basel Committee"), an international standard-setting body. Next, I will review the enhanced prudential standards applied to bank holding companies at the \$50 billion level under the Dodd-Frank Act and examine how that \$50 billion asset threshold has been exported for use in an array of other contexts. Finally, I will offer some thoughts on alternative approaches to the \$50 billion threshold that Congress could consider.

I. The Dodd-Frank Act’s \$50 Billion Asset Threshold and the Basel Committee’s Methodology for Identifying Systemically Important Banks

In the wake of the financial crisis, global leaders and financial regulators determined that enhanced prudential standards should apply to those financial companies that potentially pose the greatest risks to financial stability.¹ In the United States, Congress adopted Section 165 of the Dodd-Frank Act, which imposes enhanced prudential standards “[i]n order to prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected financial institutions.”² On the global level, the Financial Stability Board and Basel Committee endeavored to develop policy measures designed to mitigate spillover and contagion effects across jurisdictions that could arise from the failure of globally active banks. In each case, relevant authorities first required a process for determining which institutions should be subject to these enhanced prudential standards.

The Dodd-Frank Act’s Asset-Based Approach. The Dodd-Frank Act uses a simple asset-based approach. In particular, Section 165 directs the Federal Reserve to apply enhanced prudential standards to all bank holding companies with total consolidated assets equal to or greater than \$50 billion.³

¹ See, e.g., G20, The Seoul Summit Document ¶ 30 (Nov. 12, 2010) (endorsing “the policy framework, work processes, and timelines proposed by the [Financial Stability Board] to reduce the . . . risks posed by systemically important financial institutions (SIFIs)”).

² Dodd-Frank Act § 165(a). \$50 billion threshold also appears elsewhere in the Dodd-Frank Act, including in Section 155(d) (assessments to fund the operations of the Office of Financial Research and Financial Stability Oversight Council (“FSOC”)); Section 163 (certain special acquisition approval requirements); Section 210 (assessments that the Federal Deposit Insurance Corporation (“FDIC”) may levy in respect of the Orderly Liquidation Authority); and Section 318 (Federal Reserve assessments).

³ The Federal Reserve also is directed to apply such enhanced standards to non-bank financial companies designated as systemically important by the FSOC.

Neither the statutory text nor its legislative history offers a clear explanation for why Congress chose a bright-line \$50 billion asset threshold for application of enhanced standards. To the best of my knowledge, no economic studies or other data were cited by Congress in establishing this threshold. Some commentators have suggested that Congress deliberately chose an artificially low (and, thereby, over-inclusive) threshold not because it believed that \$50 billion necessarily signaled systemic importance, but because it wished to avoid creating a de facto list of “too big to fail” banking institutions.⁴

The flaws in choosing this simple asset-based threshold for application of enhanced prudential standards seem relatively clear. By focusing exclusively on a bank holding company’s asset size, this approach ignores other factors apt to be relevant to determining whether a banking institution should be subject to enhanced prudential standards. Moreover, there is no inherent characteristic measured by an asset-based approach that ensures the bank holding companies captured by the threshold do, in fact, pose the types of risks that the enhanced prudential standards are designed to mitigate. Put differently, no evidence suggests that a bank holding company with \$49 billion in assets suddenly becomes systemically important, and thus deserving of application of Section 165’s enhanced prudential standards, when it grows to \$51 billion in assets. The \$50 billion figure also is static – it does not increase over time, as the economy grows.

The Basel Committee’s Indicator Approach. The Basel Committee has adopted a different approach in its efforts to identify global systemically important banks (the so-

⁴ See, e.g., Statement by Mark Olson, Co-Chair, Bipartisan Policy Center Financial Regulatory Reform Initiative’s Regulatory Architecture Task Force, before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Mar. 24, 2015); Federal Reserve Governor Daniel K. Tarullo, “Regulating Systemically Important Financial Firms,” at the Peter G. Peterson Institute for International Economics, Washington, D.C. (June 3, 2011); see also S. Rep. No. 111-176, at 2 (Apr. 30, 2010) (applying heightened prudential standards for bank holding companies with \$50 billion or more in assets, with a graduated approach to the application of such standards “intended to avoid identification of any bank holding company as systemically significant”).

called “G-SIBs”). Specifically, the Basel Committee first identified the aspects and activities of global banking institutions whose failure would be most likely to generate risks to global financial stability. The Basel Committee then developed appropriate metrics, or “indicators,” to measure these aspects and activities on both an individual institutional and a comparative level for the largest global banking institutions.

The specific metrics ultimately adopted by the Basel Committee measure global (or cross-jurisdictional) activity, size, interconnectedness, substitutability, and complexity. The methodology gives equal weight to each of the five categories of systemic importance; with the exception of the size category, the Basel Committee identified multiple indicators within each category. For the size category, the Basel Committee did not measure total consolidated assets but, instead, total exposures. The Basel Committee approach also allows supervisory judgment, within certain limits, to play a role.

Thus, the Basel Committee’s methodology was designed to encompass more dimensions in determining a banking institution’s systemic importance than simply its size (in contrast to the bright line \$50 billion asset-based threshold used in the Dodd-Frank Act). The approach also is designed to be transparent and dynamic, with periodic reviews of the G-SIB list. In developing this approach, the Basel Committee’s stated objective is to give banks “incentives to change their risk profile and business model in ways to reduce their systemic spillover effects.”⁵

II. Enhanced Prudential Measures Applicable to Bank Holding Companies Subject to Section 165 and Broader Uses of the \$50 Billion Threshold

As noted above, Section 165 of the Dodd-Frank Act directs the Federal Reserve to establish “more stringent” standards for bank holding companies that meet the \$50 billion

⁵ Basel Committee, “Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement” 10 (July 2013).

asset threshold than applicable to “bank holding companies that do not present similar risks to the financial stability of the United States.” Section 165’s \$50 billion asset threshold also has been exported to other contexts, without the direction of Congress.

Application of Enhanced Prudential Standards Under Section 165. Section 165 identifies a set of mandatory enhanced prudential standards that apply to bank holding companies that hit the \$50 billion asset threshold. These standards include: risk-based and leverage capital requirements; liquidity standards; risk management requirements; supervisory and company-run stress testing; resolution planning and counterparty exposure reporting requirements; and single counterparty credit exposure limits.⁶ In addition to these mandatory standards, Section 165 grants the Federal Reserve authority to adopt certain additional discretionary standards, including: a contingent capital requirement; enhanced public disclosures; short-term debt limits; and any other standards the Federal Reserve deems appropriate. To date, the Federal Reserve has not adopted any of the enumerated discretionary standards.

Section 165 allows regulators to alter the application of these standards in two ways. First, Section 165 grants the Federal Reserve express authority – either on its own or pursuant to a recommendation from the FSOC – to “differentiate among companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities (including the financial activities of their subsidiaries), size, and any other risk-related factors.” Section 165(a)(2)(A).

This is important, but cabined, authority. In particular, it does not allow the Federal Reserve to raise the \$50 billion threshold or to avoid applying the mandatory

⁶ The Federal Reserve is given discretionary authority, in consultation with the FSOC, to determine that risk-based capital and liquidity requirements are not appropriate given the activities or structure of a particular company, in which case, the Federal Reserve is instructed to “apply other standards that result in similarly stringent risk controls.” Section 165(b)(1)(A)(i). This exception appears designed to address the activities of non-banking organizations, rather than bank holding companies.

enhanced prudential standards to any set of greater-than-\$50 billion asset bank holding companies.⁷ This provision only allows the Federal Reserve to vary application of enhanced prudential standards. Put differently, Section 165 dictates that some level of mandatory enhanced prudential standards must apply to all greater-than-\$50 billion asset bank holding companies, but standards of even further “increase[d] ... stringency” can be fashioned for some subset of these bank holding companies. Section 165(a)(1)(B).

Section 165 contains a separate mechanism by which the \$50 billion threshold can be raised, but this mechanism applies only to a discrete subset of the enhanced prudential standards set forth in the statutory provision. In particular, after receiving a recommendation from the FSOC, the Federal Reserve “may” raise the asset threshold that triggers application of the following requirements: resolution planning and credit exposure reporting; single counterparty credit exposure limits; contingent capital; enhanced public disclosures; and short-term debt limits.⁸ Notably, of these standards, only the resolution-planning requirement is a mandatory enhanced prudential standard that has been made applicable to bank holding companies crossing the \$50 billion threshold through a final rule adopted by the Federal Reserve.⁹

The authority to raise the \$50 billion threshold does not apply to the core capital, liquidity, stress-testing, and other elements of Section 165; for these requirements, no regulatory authority to revise the statutory \$50 billion asset threshold exists. Many

⁷ As Federal Reserve Governor Tarullo noted, “all firms” within the universe of banking organizations with \$50 billion or more in assets “are subject to ... enhanced standards.” Statement by Federal Reserve Governor Daniel K. Tarullo before the U.S. Senate Committee on Banking, Housing, and Urban Affairs (Mar. 19, 2015) [*hereinafter* Gov. Tarullo Senate Banking Committee Statement].

⁸ Section 165(a)(2)(B). As noted, raising the \$50 billion threshold requires a two-step process – first, the FSOC must recommend a threshold be raised and, second, the Federal Reserve must determine to act on the recommendation. Neither the Federal Reserve nor the FSOC may act alone in this regard.

⁹ No regulatory attempt has been made to raise the \$50 billion asset threshold for any Section 165 standard.

commentators, including Federal Reserve Governor Tarullo, have openly questioned the value of applying all of these requirements to \$50 billion bank holding companies and have suggested that the threshold for application of these elements of Section 165 ought to be re-examined.¹⁰ For this, Congress would need to act.

To date, the Federal Reserve has used its tailoring authority to increase the stringency of certain enhanced prudential standards. In recent testimony before the Senate Committee on Banking, Housing and Urban Affairs, Federal Reserve Governor Tarullo explained that the Federal Reserve has adopted “what are, in effect, three categories within the universe of banking organizations with \$50 billion or more in assets.”¹¹ At the base level, all banking institutions at or above the \$50 billion asset threshold are subject to enhanced standards. In the second category, the Federal Reserve applies a higher level of prudential standards to bank holding companies with at least \$250 billion in assets or \$10 billion in on-balance-sheet foreign assets (so-called “advanced approaches” banking organizations). Finally, the eight largest bank holding companies are subject to the most stringent set of standards.

The Federal Reserve arguably could do more to tailor the standards that apply to bank holding companies that cross the \$50 billion threshold; as noted, Section 165 gives the Federal Reserve authority to provide meaningful differentiation between and among bank holding companies beyond, and in addition to, the three asset-based buckets it has used. Particularly in the \$50 billion to \$250 billion range, there is no reason under the statute for the same set of enhanced prudential standards to apply, as it largely does

¹⁰ See, e.g., Gov. Tarullo Senate Banking Committee Statement, *supra* note 7 (noting, in particular, the limited benefit of applying stress testing requirements at the \$50 billion asset level); Federal Reserve Governor Daniel K. Tarullo, “Rethinking the Aims of Prudential Regulation,” at the Federal Reserve Bank of Chicago Bank Structure Conference (May 8, 2014) (asking whether “\$50 billion is the right line to have drawn” and questioning the value of resolution planning and stress testing at the \$50 billion asset level).

¹¹ Gov. Tarullo Senate Banking Committee Statement, *supra* note 7.

today, to a \$51 billion bank holding company and to a \$249 billion bank holding company, even though the two may have materially different businesses and risk profiles.

The Federal Reserve could take into account the statutorily enumerated risk-related factors (“capital structure, riskiness, complexity, financial activities (including the financial activities of their subsidiaries), size”), which largely mirror the systemic indicators used by the Basel Committee, to distinguish among \$50 billion-plus bank holding companies. By such means, the Federal Reserve could tailor the enhanced prudential standards applicable to bank holding companies that operate a traditional banking business model of deposit taking and lending. For example, the Federal Reserve could apply qualitative liquidity standards to these bank holding companies, instead of the quantitative liquidity coverage ratio (which I understand requires disproportionate resources for smaller bank holding companies). As another example, the Federal Reserve could reduce the frequency with which resolution plans (or “livings wills”) must be submitted by bank holding companies that operate under a traditional banking model.

The Expanding Use of the \$50 Billion Threshold. Beyond Section 165’s mandate to apply enhanced prudential standards to \$50 billion-plus bank holding companies, that threshold appears to have become a systemic risk lodestar for the federal financial regulatory agencies. The threshold has thus come to be used in contexts not expressly required by the Dodd-Frank Act.

To give a few examples:

- The \$50 billion asset threshold has been used as a proxy for complexity and the need for enhanced compliance obligations under the final regulations implementing the Volcker Rule. Under those final rules, banking entities with \$50 billion or greater in assets are subject to additional compliance requirements, including a CEO attestation obligation. 12 CFR Part 248, App. B.
- The Federal Reserve has determined to apply its Comprehensive Capital Analysis and Review (“CCAR”) – its annual capital planning and capital

assessment exercise – to bank holding companies at the \$50 billion level. 12 CFR 225.8.¹²

- The Comptroller of the Currency has adopted heightened risk-management and corporate governance standards for all insured national banks and federal savings associations with consolidated assets of \$50 billion or greater. 12 CFR Part 30.
- The FDIC has required all insured depository institutions with greater than \$50 billion in assets to submit resolution plans to the FDIC for orderly resolution under the Federal Deposit Insurance Act.

The end result appears to be (a) a continued proliferation of the \$50 billion asset threshold in a range of contexts, and (b) the imposition of a broad range of regulatory requirements – beyond Section 165’s enumerated enhanced prudential standards – on bank holding companies (and their subsidiaries) once they cross the \$50 billion mark. The impact of these requirements is magnified because various of the enhanced prudential standards are coupled with extensive reporting requirements, which place disproportionate strains on the resources of smaller banks (and arguably are not necessary to mitigate risks to financial stability).¹³ The imposition of these various requirements on \$50 billion asset bank holding companies results in real regulatory costs that – because the \$50 billion threshold does not appear to have a firmly grounded and well-articulated relationship to systemic risk – do not generate commensurate systemic risk mitigation benefits.

The expanding use of the \$50 billion threshold highlights the merits of re-examining whether this threshold is appropriately set and whether a different threshold is

¹² It is worth noting that the CCAR is used by the Federal Reserve as the risk-based capital enhanced prudential standard applicable to \$50 billion to \$250 billion bank holding companies. *See* 79 Fed. Reg. 17240, 17246 (Mar. 27, 2014) (the Federal Reserve’s final rule implementing enhanced prudential standards under Section 165).

¹³ *See, e.g.*, FR Y-14A (annual reporting on certain balance sheet, income, and capital projections); FR Y-14M (monthly reporting on loan and portfolio-level data); FR Y-15 (annual reporting of consolidated systemic risk data).

warranted. Of course, a revision of Section 165's threshold would not automatically alter these other uses of the \$50 billion test, but it may cause regulators to rethink their reliance on this standard both for existing regulatory requirements and for future rules.

III. Potential Alternatives to the \$50 Billion Asset Threshold in Section 165

The policy goals of a framework for enhanced prudential standards should be: first, to identify as accurately as possible those banking organizations most likely to pose significant risks to financial stability and, second, to apply appropriately calibrated prudential standards to the risks posed by these organizations.

From the perspective of these policy goals, bank holding companies ideally should be designated for application of enhanced prudential standards based on the risks they present to the financial stability of the United States, with only those that present truly systemic risks subject to appropriately enhanced measures. To achieve this goal, it may be useful for the systemic risk designation process to be informed by additional criteria of systemic importance beyond mere asset size.

Of course, there may be multiple paths to achieving this goal. For example, the asset-based threshold could be completely scrapped in favor of an entirely indicator-based approach, as deployed by the Basel Committee. Alternatively, some elements of the asset-based threshold could be usefully retained, such as where an asset-based threshold triggers a nuanced indicator-based review but does not automatically result in the application of enhanced prudential standards to a bank holding company or where some minimum asset-based threshold serves as a floor and removes institutions below this threshold from systemic consideration and regulation.

Both House Bill H.R. 1309, the Systemic Risk Designation Improvement Act of 2015, sponsored by Representative Luetkemeyer, and the Senate bill, the Financial Regulatory Improvement Act of 2015, sponsored by Senator Shelby, move away from the exclusively asset-based approach of the Dodd-Frank Act and incorporate the Basel

Committee's indicator-based approach for determining which bank holding companies should be subjected to enhanced prudential standards. In both cases, the apparent aim of these proposed provisions is to enact a designation process that incorporates a more thoughtful assessment of the specific risks posed by individual bank holding companies than the \$50 billion asset threshold currently employed by Section 165. In my view, such efforts to revise the current enhanced prudential standards framework and to ensure enhanced prudential measures are applied in a more tailored fashion to bank holding companies that could potentially pose real risks to the U.S. financial system deserve serious consideration.

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I am happy to respond to any questions. Thank you.