Remarks on Key Issues Facing Financial Institutions

Paul Saltzman

All too often, the debate surrounding the lessons learned from the subprime mortgage crisis, and the regulatory framework needed to mitigate against future crises, is filled with distractions, populist rhetoric, revisionist history, and a reliance on false narratives. Much like Grover Cleveland's non-existent illegitimate child, there are too many untested and unchallenged foundational assertions that are repeated over and over and taken as truths by the media, by politicians, and even by regulators. Events such as the October 1, 2013, Brookings-Hoover conference on the financial crisis allow us to close that awareness gap, to debate and challenge each other respectfully, and to share thoughts regarding how best to achieve what we all want to achieve, which is to create a stable financial system without inhibiting the critical role that banks, and large banks in particular, play in facilitating economic recovery.

In this chapter, I'd like to share three things. First, I'll describe The Clearing House, which I lead. Second, I will endeavor to dispel some misunderstandings and mischaracterizations of the industry's position on certain key macroprudential rules. And last, I'll offer some recommendations and observations about how to improve both the pace and the quality of Dodd-Frank rulemaking.

Not too many institutions actually can lay claim to a direct connection to our nation's Founding Fathers. In 1841, eight years before his passing, Albert Gallatin, the treasury secretary under presidents Jefferson and Madison, proposed the idea of New York banks getting together to solve large payment flows. The idea was the establishment of a consortium of private banks, where each bank would place funds proportionate to its capital, and through which their books would be debited and credited in relation to all member banks. Gallatin's idea was based on the structure at the time of the Bank of England and was a model for how private participants can work together to solve systemic crises. Twelve years later, in 1853, the New York Clearing House was incorporated, becoming the

nation's first banking association, the largest payment processor in the world, and the oldest payments company in the United States.

The Clearing House (TCH) recently sponsored a conference with Columbia University focused on the role of private market participants in promoting stability in the banking system from 1853 to 1913. Fast forward 160 years, and The Clearing House now operates under a dual corporate structure: The Clearing House Payments Company and the Association. The Clearing House Payments Company owns and operates the critical infrastructure of our nation's payment system, along with the Federal Reserve. It operates three core products and clears almost $2 trillion a day. It's not a central counterparty—it is a payments processor, despite the name. It owns and operates CHIPS (Clearing House Interbank Payments System), a large-value payment system, the ACH (Automated Clearing House) small-value payment system, and a check imaging business.

Recently, The Clearing House was designated as a systemically important financial market utility (SIFMU) by the Financial Stability Oversight Council (FSOC)—interestingly enough, only in its capacity as owner and operator of CHIPS. The FSOC avoided the characterization of The Clearing House Payments Company in its entirety because of issues associated with the small-value payments system.

Leveraging that infrastructure, The Clearing House is working on a number of groundbreaking initiatives involving mobile payments, medical payments, and P2P (person-to-person) payments and recently launched a transformational initiative to deal with the safety and soundness of the mobile payments architecture.

In addition to its role serving the nation's payments infrastructure, The Clearing House Association provides thought leadership on the most important issues facing the banking industry today. Its membership consists of eighteen large and diverse commercial banks, ranging from large, systemically important globally diverse firms to super-regionals, regionals, and seven foreign banking organizations. It operates on a strong consensus basis. Although not every issue affects every particular member, there is an undeniable commonality of interests among the membership when it comes to finalization and implementation of all financial rules and regulations, especially macroprudential rules, which affect markets and products beyond the firms that are particularly targeted.

A few words about macroprudential regulation. It's clear that an evolution in the approach to banking regulation is occurring. Every major rule that comes out of the Fed cites macroprudential and systemic goals

as its underlying motivation. This approach, shifting from a microprudential focus, which is concerned with the safety and soundness of individual banks, to focusing more on systemic risks, is understandable. But it is striking that, as Kevin Warsh has pointed out,[1] there is so little debate and even less quantitative and empirical analysis about the risks of this paradigm shift. Simply put, macroprudential regulation comes with macroeconomic risks. Unlike microprudential mistakes, macroprudential mistakes are likely to involve macroeconomic consequences.

Moreover, there is real risk that macroprudential regulation can quickly transform, either explicitly or implicitly, into a form of industrial policy that favors certain markets, businesses, or products. In that regard, I commend to your attention an op-ed by Professor John Cochrane on this very point.[2]

And last, by definition, macroprudential regulation suffers from an inherent flaw. It focuses on the tail risk and the lowest common denominator. By definition, it embraces a one-size-fits-all regulatory methodology. This is especially interesting because most of the macroprudential rules deal with regulation of a bank's balance sheet, which, by definition, is inherently idiosyncratic. No individual G-SIB (global systemically important bank) or D-SIB (domestic systemically important bank) is like any other. And this tension probably explains why the rulemaking process has been a challenging endeavor. Fitting square pegs into round holes is never an easy task.

Because this new macroprudential agenda is so important, and because the industry's position on individual macroprudential rules is so often mischaracterized, I'd like to set the record straight with regard to certain key issues on which The Clearing House lobbies.

First up is capital. The Clearing House banks have consistently supported increasing the quantity and quality of capital, certainly relative to pre-crisis levels. On balance, the current approach to capital regulation is comprised of four legs of a table: risk-weighted assets (RWA)-based capital methodologies; the Collins Amendment,[3] which sets minimum overall capital requirements on depository institutions; a leverage ratio

1. See chapter 4 in this volume.

2. John Cochrane, "The Danger of an All-Powerful Federal Reserve," *Wall Street Journal*, August 26, 2013.

3. Section 171, Dodd-Frank Act (Wall Street Reform and Consumer Protection Act of 2010).

as a backstop; and stress testing. Currently, this approach is robust and is headed in the right direction. The Clearing House will continue to offer technical comments or suggestions to improve the regulatory framework, for example, by recognizing the value of mortgage servicing rights and deferred tax assets and by making policymakers aware of the volatility associated with the removal of the accumulated other comprehensive income (AOCI) filter. But these are areas where empirical analysis and scrutiny are critical. And no one should mistake overall constructive suggestions as somehow negating the industry's support for higher and better capital.

Notwithstanding that support, the question of capital and the appropriate levels of capital involves a fundamental trade-off. TCH wholeheartedly rejects the notion, offered by some, that the theoretical framework of Modigliani and Miller applies to real-world bank balance-sheet decisions. The ratio between debt and equity matters. The economic impact is real. And the appropriate capital level needs to be empirically and historically analyzed. Those who present the issue of ever-higher capital levels as a one-sided free option, with no acknowledgment of the economic downsides, are doing a disservice to the debate.

Long-term debt is another issue that is critically important. To be clear, TCH banks support a long-term debt requirement at the holding company level for those banks that, because of their complexity and structure, would likely be recapitalized under the single-point-of-entry approach of Title II. The critical question here is the amount of loss absorbency. To date, empirical research undertaken by The Clearing House suggests that two times tier 1 capital plus a G-SIB surcharge is a reasonable amount to cover all historical losses, including analyses of stress-testing results and a return variability analysis. Based on those three empirical approaches, that is the appropriate level that TCH believes should be implemented.

Regulatory policymakers will soon present two other key questions to the public. One is the question of pre-positioning of assets to facilitate a holding company recapitalization and the other is what to do with the right side of the balance sheet. However constructed, the objective of long-term debt should be to facilitate such a holding company recapitalization and to work in concert with existing capital and liquidity regulations—and not to be a supplemental instrument of regulatory capital.

Another key issue on the macroprudential agenda is the leverage ratio, which is currently the subject of significant proposals in both the United States and Basel. Again, TCH banks support an enhanced supplementary leverage ratio. But it is critical that the leverage ratio function as a

backstop measure and neither be the primary source of capital regulation nor act as the binding constraint. A leverage ratio that acts as a binding constraint will inject perverse incentives for the banking industry to hold riskier assets. The regulatory architecture should continue to embrace risk weightings, notwithstanding their shortcomings.

It is also crucial that the denominator in any leverage ratio calculation be calibrated appropriately. In that respect, the most recent Basel proposals fail to reflect netting and recognize the benefit of collateral. It's critical to get the calibration right. Research from The Clearing House has found that the Basel proposal, combined with a minimum leverage ratio of 5 to 6 percent for US G-SIBs, would make the leverage ratio the binding constraint for approximately 67 percent of US G-SIB assets. TCH's study also found that under a combined US numerator and Basel denominator, the distance to compliance would require $202 billion of additional tier 1 capital or an exposure reduction of $3.7 trillion, equal to 19.6 percent of covered industry exposures. It's difficult to imagine how that amount of deleveraging could have anything but a negative impact on the economy.

It's important to have an effective resolution framework to resolve a systemically important bank without taxpayer-funded support, and for that reason The Clearing House banks strongly support Title II of the Dodd-Frank Act.

Paul Tucker, former deputy governor of the Bank of England, made some very comforting remarks to a question by Gillian Tett of the *Financial Times* at a recent conference.[4] He indicated he firmly believes that if a large, systemically important financial institution in the United States were to fail, it could successfully be resolved under Title II. It wouldn't be pretty, but it could be successfully resolved without any taxpayer-funded support. Although some are calling for a legislative repeal of Title II, and there is a legislative debate about the appropriateness of Title II, we remain steadfastly supportive of it as an effective resolution framework.

At the same time, TCH is also supportive of other efforts, including the efforts by Hoover and the resolution working group, whether they be legislative or regulatory, to improve the Title I process.[5]

4. Speech by Paul Tucker, deputy governor for financial stability at the Bank of England, at the INSOL (International Association of Restructuring, Insolvency & Bankruptcy Professionals) International World Congress, The Hague, Netherlands, May 20, 2013.

5. See Michael Helfer's remarks, chapter 16 in this volume.

Next to last is liquidity. Another key pillar of a macroprudential agenda is strengthening liquidity requirements, in particular the liquidity coverage ratio (LCR) and net stable funding ratio (NSFR). Here, again, is another positive, constructive story. The Clearing House has consistently supported prescriptive regulations around liquidity. Its research has shown that large banks are more liquid than ever. Since 2010, US commercial banks have reduced their reliance on short-term wholesale funding by almost $250 billion and have increased demand deposits accordingly.

The LCR, generally speaking, is appropriately calibrated, although the failure to treat GSE (government-sponsored enterprise) securities and the Federal Home Loan Bank borrowings should be reconsidered. TCH research has shown that the US banking industry average LCR changed from 59 percent in 2010 to 81 percent at the end of 2012.

On the NSFR, it's critical that the calibrations reflect empirical data and actual experience of liquidity, as well as management actions likely to be taken in the event of a liquidity crisis. Currently, they do not. TCH's recently-released NSFR white paper revealed that the industry-wide NSFR shortfall in the numerator ranges from approximately $1.4 trillion to $2.4 trillion, depending on whether banks are assumed to manage to a 100 percent or a 110 percent NSFR compliance level. Something's not right there, and a Basel Committee re-proposal of the NSFR was certainly called for.

Last, another key macroprudential initiative both in the United States and abroad is the establishment of single counterparty credit limits, which, again, The Clearing House supports. Such a requirement can serve as an important prudential tool to limit contagion and mitigate the effects of a crisis. But it is critically important that single counterparty limits reflect true economic risk. TCH had serious concerns about the approach proposed. It produced a quantitative analysis that demonstrated the flaws and prompted the Federal Reserve to step back and commence an effort to study the impact.

The Clearing House, notwithstanding its brand and approach, makes no apologies for representing the views of its membership to regulators and other policymakers. Some have suggested this is a form of cognitive capture, a derivation of regulatory capture. On the contrary, TCH has offered our support constructively on a host of macroprudential rules and will continue to do the same, and TCH will continue to interact with thought leaders like Brookings and Hoover, and with academics and other professionals, to get it right.

Clearly, both industry and regulators want to get it right, and getting it right will take some time. But there are two points that need to be made in this regard. First, the marketplace has already accelerated the pace of rule implementation, and in many instances firms have already implemented changes, notwithstanding the pace of implementation of Dodd-Frank rules. In other words, much of the "delay" in rulemaking is what some people would call a false negative.

In addition, there are improvements that can be made to enhance the rulemaking process, which The Clearing House and its members would assuredly support. And it's all based on the simple notion that good is better than perfect when perfect takes too much time. The following are a few short recommendations in that regard.

Number one: greater use of advanced notice of proposed rulemakings. There's no reason that these issues should be debated in an opaque way. Regulators should be issuing more Advanced Notice of Proposed Rulemakings, much like the SEC issues concept releases. Let's get the proposals out there, get all the ideas out there, and flesh out the issues.

Second, shorter comment periods. This is something that some TCH members might not necessarily support. But it's clear that during the comment process, work expands to fill the time allotted. Whether it's a 60-day period, a 90-day period, or a 180-day period, the industry will get it done. And if it means enacting rules in a more accelerated pace, TCH and its owner banks will support a shorter comment period.

Third, and perhaps most important: staged implementation. Instead of trying to adopt the perfect rule—whether it be single counterparty credit limits or the Volcker Rule, for example—rules can be implemented in stages, recognizing that the work is not yet finished. Despite the best intentions of the Federal Reserve and all the other dedicated public servants, this is very, very difficult and complex stuff. At times, unfortunately, it appears that politics may be inhibiting free thinking because people are afraid to throw ideas out there.

And last, more transparent empirical analysis. It sounds like a delay tactic, but the fact of the matter is that each of the initiatives that have been described can and should be subject to detailed and rigorous quantitative impact analysis.