September 7, 2017

The Honorable Michael Crapo
Chairman, U.S. Senate Committee on Banking, Housing & Urban Affairs
534 Dirksen Senate Building
Washington, D.C. 20510

The Honorable Sherrod Brown
Ranking Member, U.S. Senate Committee on Banking, Housing & Urban Affairs
534 Dirksen Senate Building
Washington, D.C. 20510

Dear Chairman Crapo and Ranking Member Brown:

The Clearing House is writing in response to an unsolicited letter sent to you by Thomas Hoenig, Vice Chairman of the Federal Deposit Insurance Corporation, on July 31, 2017. While it is unclear whether the letter was written on behalf of the FDIC or in his personal capacity, we believe that its reasoning is sufficiently unsound to merit a response.

I. Raising capital requirements (by prohibiting dividends or otherwise) reduces, not increases, lending.

Mr. Hoenig begins his letter by decrying an emphasis on "sound bites rather than substantive public debate" on capital issues. In fact, the question of optimal capital requirements is actively researched and debated by academics, domestic policymakers, and international institutions. At just one academic conference on capital requirements earlier this year, cosponsored by Columbia University and the Clearing House, there were over 70 paper submissions from economists around the world. Of course, capital policy is also being analyzed in numerous other forums – including Congress, where both the Senate and House have held several recent hearings.[1]

[1] For example, recent Senate Banking Committee hearings addressing this topic include Fostering Economic Growth: Regulator Perspective (June 22, 2017), Fostering Economic Growth: Midsized, Regional and Large Institution Perspective (June 15, 2017), Fostering Economic Growth: The Role of Financial Institutions in Local Communities (June 8, 2017), and Fostering Economic Growth: The Role of Financial Companies (Mar. 28, 2017). Similarly, recent House Financial Services Committee hearings addressing this topic include Examining Legislative Proposals to Provide Targeted Regulatory Relief to Community Financial Institutions(July 12, 2017), Examination of the Federal Financial Regulatory System and Opportunities for Reform (Apr. 6, 2017), and The State of Bank Lending in America (Mar. 28, 2017).

Thus, it may not be surprising that the substantive analysis whose absence Mr. Hoenig decries is generally antithetical to a core position he espouses in his letter to you: that large banks can be incentivized to lend more by *increasing* their capital requirements. (Mr. Hoenig implicitly but clearly takes that position by arguing that banks will lend more if they are restricted from paying dividends and thereby forced to hold more capital.) Studies on optimal capital requirements from economists at the Federal Reserve, the Bank of International Settlements, the Bank of England, and the International Monetary Fund – not to mention numerous other academics and independent analysts – all start with the assumption that higher capital requirements raise lending costs and reduce both bank lending and GDP.[2]

Of course, that academic research simply confirms what common sense or any CFO in America could tell you: if you tell a bank that it must hold more capital against a given type of loan, and that its return on equity on that loan by definition will go down, the bank must increase the interest rate on such type of loan or shift that capital to activities that produce a higher ROE.

To come to a different result, Mr. Hoenig proceeds down an odd path. He begins by constructing a strawman, arguing that "despite rhetoric to the contrary, capital is not 'idle' and does not 'inhibit' lending. In fact capital is a fundamental and permanent source of funding that supports lending." But *exactly no one in the world has argued that capital is idle and inhibits lending.* Of course capital supports lending. The actual question is not whether *capital* inhibits lending but whether *governmental capital requirements* inhibit lending – in particular, requirements for a bank to hold more capital than risk analysis would demonstrate to be necessary.

As an analogy, tractors are required for farming wheat. However, a Department of Agriculture requirement that each wheat farm own a specified number of tractors could reduce wheat yields if the required number of tractors were higher than farmers otherwise considered necessary. Because tractors are expensive, costs for wheat farming would go up, and farmers would either raise their wheat prices or shift to other crops and reduce their wheat yields. Of course, back to Mr. Hoenig's strawman, if a U.S. farmer objected to such a requirement, no one would suggest that he or she was contending that tractors were "idle" or "inhibited farming."

As noted above, there is a global consensus that what holds for tractors holds for capital, and that higher requirements (with resulting lower leverage) depress lending: the principal point of academic and policy inquiry at this point is weighing how much a given increase in capital reduces lending and economic growth against how much that increase in capital benefits financial stability.

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2 *See* Basel Committee on Banking Supervision, *An assessment of the long-term economic impact of stronger capital and liquidity requirements* (2010); Brooke, M. et al., *Measuring the macroeconomic costs and benefits of higher UK bank capital requirements* (2015); Dagher, J., et al., *Benefits and costs of bank capital* (2016); Federal Reserve Bank of Minneapolis, *The Minneapolis plan to end too big to fail* (2016); and Simon Firestone, Amy Lorenc & Ben Ranish, *An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the US* (2017).

II. Barring returns of capital to shareholders would yield less, not more, lending.

Mr. Hoenig states, "Four of the 10 BHCs will distribute more than 100 percent of their current year's earnings, which alone could support approximately $537 billion in new loans to Main Street." Unpacking his statement a bit, he appears to be suggesting that if the largest banks were required to retain all their earnings, rather than paying them out in dividends and share repurchases, then they would make $537 billion more in loans.

We are assuming here that the Vice Chairman isn't arguing that such banks should never be allowed to make any payments to shareholders, as that would obviously cause their share prices to fall to zero. Rather, we assume that he is proposing to prohibit the ten largest banks from paying dividends or engaging in share repurchases until their capital ratios increase by approximately 1½ percentage points (the increase in the aggregate tier 1 capital ratio of the 10 largest banks that would occur if they retained their approved distributions for 2017).[3]

Of course, while banks would initially achieve that higher level of capitalization through the government-forced retention of earnings, at that higher level of capitalization banks' return on equity would be lower. As a result, investors would shift away from the banking system, and the level of equity invested in the banking system would move back to, or lower than, its current level. To remain compliant with the higher capital requirement, banks would simultaneously reduce their assets. Thus, the capital in the banking system at this higher level of capital requirements – if the level of capital in the banking system were to remain unchanged relative to its current level and not actually fall – would support 13 percent *less* lending than currently.[4] That is, there would be *less* bank credit available to support business and household investment.

III. Large U.S. banks are not undercapitalized.

Mr. Hoenig's second core point is that large U.S. banks are undercapitalized and in need of additional capital, and that therefore his proposed capital increase is warranted.

First, Mr. Hoenig cites his own "Global Capital Index" to support an assertion that "the largest, most complex and systemically important banks are less well capitalized than all other smaller banks in the U.S." He fails to explain a crucial component of his index: it assumes that all assets should have the same capital requirement. Thus, his index measures capital adequacy on the assumption that a subprime loan and a Treasury bill should be treated as equally risky. In

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[3] Mr. Hoenig provides information on planned payouts to shareholders for the top 10 bank holding companies but not the U.S. GSIBs, and data on equity and assets for the U.S. GSIBs but not the top 10 bank holding companies. For our estimate of Hoenig's proposed increase in capital requirements and the resulting decline in lending, we have calculated the tier 1 capital and risk weighted assets for the top 10 bank holding companies at the end of 2016 which we combined with Hoenig's data on planned payouts for those firms.

[4] The 10 largest banks had $1,028 billion in tier 1 capital at the end of 2016. Those banks, in aggregate, have a tier 1 risk-based capital ratio of 13.6 percent. At 13.6 percent, $1,028 billion supports $7.56 trillion in lending. But if capital requirements are raised, leading the banks to maintain capital ratios of 15.2 percent (the ratio that would result if the banks retained all their planned disbursements in 2017 and left their assets unchanged), $1,028 billion in capital would support $6.55 trillion in lending, which is 13 percent less than $7.56 trillion.

other words, his index is a leverage ratio, and not a particularly sensible one. For the current debate, this matters because complex and systemically important banks are primary dealers in U.S. Treasuries, intermediate in the government securities and corporate bond markets, and engage in repo financing for asset managers. These large firms, unlike smaller banks, are also subject to liquidity requirements – e.g., the Liquidity Coverage Ratio – that require them to hold large amounts of high-quality liquid assets (primarily in the form of cash and U.S. Treasuries). For both reasons, large banks therefore hold disproportionate amounts of safe, highly liquid assets – assets that are less likely to default and far easier to sell than loans or other illiquid assets that represent the vast majority of small banks' balance sheets.

Thus, larger banks, by business model and regulation, will always tend to do relatively worse under a leverage ratio that ignores the fact that a large percentage of their assets are low-risk and liquid, and do relatively better under risk-based measures that acknowledge that fact. As the Department of Treasury recently explained:

> Because the leverage ratio requires the same amount of capital irrespective of an exposure's risk profile, a binding leverage ratio generally encourages firms to invest in higher risk assets (which are generally associated with higher yields) than they would if risk-based capital rules were their binding constraint. These incentive issues are generally more significant for banks subject to higher liquidity requirements and whose business models involve intermediating low risk assets such as cash and government-related securities than for banks whose business models are predominantly focused on higher yielding lending activities.[5]

Historical experience confirms that the leverage ratio is an inferior measure of bank risk.[6] When the tier 1 capital ratio (a risk-based measure) and the leverage ratio are both used to predict bank failures during the great financial crisis, a low tier 1 ratio predicts failure, but a *high* leverage ratio predicts failure. Mathematically, a bank with a low tier 1 ratio and a high leverage ratio must have a riskier portfolio.

It is worth noting that even as a leverage ratio, Mr. Hoenig's "Global Capital Index" is an odd construct. First, Mr. Hoenig uses a denominator calculated using European (IFRS) not U.S. (GAAP) accounting, because European rules allow less netting of derivatives risk. Netting is more reflective of the true economic risk of the positions, and thereby requires less capital than grossing up the positions. But even European regulators that utilize IFRS accounting standards do not base minimum leverage requirements on a purely IFRS denominator; their requirements are based on a Basel leverage ratio that "achieves international consistency in exposure measurement" without regard to the accounting standard (*i.e.,* U.S. GAAP or IFRS). By both using IFRS *and* not making an adjustment, Mr. Hoenig's index inflates the assets, and thereby reduces the reported capital ratios of banks that trade derivatives – namely, large U.S. banks.

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[5] Department of Treasury, *A Financial System that Creates Economic Opportunities: Banks and Credit Unions* (June 2017) at 51.

[6] *See* Francisco Covas & Bill Nelson, *Shortcomings of the Leverage Ratio, available at* www.theclearinghouse.org/-/media/tch/documents/research/articles/2016/08/20160809_tch_research_note_leverage_ratio.pdf

Second, Mr. Hoenig attempts to suggest that the payment of dividends and making of repurchases in large amounts is *per se* inappropriate, and therefore should be banned. He notes with alarm that in 2017, the ten largest bank holding companies will distribute, in aggregate, 99 percent of their net income on an annualized basis, and states that "such massive distributions of capital provide no base for their future growth."

Logic would suggest that the "base for their future growth" would be determined by how much capital banks *hold*, rather than how much they *distribute*. In other words, a bank (or any other company) that already has a lot of capital would presumably distribute more of its earnings than one that doesn't have a lot of capital. So, a good question would be: how much capital did they finish with, after distributing 99 percent of their net income? Answer: *a lot.*

- The aggregate tier 1 capital ratio for banks is currently at its highest level over the 20 years for which we have data, 45 percent higher than its pre-crisis norm. For banks with assets greater than $50 billion, the number is 60 percent higher.

- All of the largest U.S. banks passed the Federal Reserve's stress test just three months ago. That test forces them to assume loss rates consistent with a severe recession and financial crisis, and specifically determines the appropriateness of the capital distributions that Mr. Hoenig seeks to prohibit.

- As Mr. Hoenig surely must know, distributions this year were higher than previous years because the banks have been building up capital to meet post-crisis requirements and been restricted by CCAR and other requirements from distributing more. In fact, according to NYU data, as of January 2017, the annual dividend payout ratios of money center and regional banks ranked only 66th and 50th, respectively, across all U.S. industries.[7] So, not "massive," but relatively small.

Of course, future loan growth will be determined not only by how much capital banks hold but also by how much banks can leverage that capital. As discussed above, prohibiting banks from paying shareholders until banks' capital ratios are higher is an increase in capital requirements and hence a reduction in the amount by which banks can leverage their capital. That reduction will lead to less, not more, lending.

In closing, it is worth noting that some at the FDIC have contributed to the substantive analysis of these issues. Indeed, a recent FDIC working paper by three FDIC researchers, entitled *Proving Approval: Dividend Regulation and Capital Payout Incentives,* specifically examines how bank regulators can best promote optimal capital policies by controlling the supervised banks' dividend policies.[8] In the section "An imperfectly informed regulator," the

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[7] *See Dividend Fundamentals by Sector, available at* http://pages.stern.nyu.edu/~adamodar/New_Home_Page/datafile/divfund.htm.

[8] *See* Levent Guntay, Stefan Jacewitz, & Jonathan Pogach, *Proving Approval: Dividend Regulation and Capital Payout Incentives* (Nov. 2015), *available at* www.fdic.gov/bank/analytical/cfr/2015/wp2015/2015-05.pdf

researchers point out that society is worse off if a regulator restricts dividend payments from a well-capitalized bank that he incorrectly identifies as undercapitalized. We agree.

Sincerely,

Greg Baer
President
The Clearing House Association