



**Testimony of Greg Baer
President
The Clearing House Association**

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Financial Institutions and Consumer Credit**

***At the Hearing Examination of the Federal Financial
Regulatory System and Opportunities for Reform***

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I am pleased to appear before the Committee today to discuss the subject of excessive regulatory discretion. It is one in great need of attention. The due process clause and the Administrative Procedure Act are crucial to the proper administration of government, not only because they guarantee us fundamental regulatory fairness but also because public input and a transparent process tend to produce better regulation. Thus, while the purpose of this hearing is not to identify the post-crisis policies whose costs most exceed their benefits, it could well be, as there is a very strong correlation between policies that are procedurally flawed and those that turn out to be substantively flawed. Certainly, there are post-crisis regulations that, while procedurally unobjectionable, raise clear concerns – the Durbin Amendment and the regulation implementing the Collins Amendment, for example – but my focus today will be areas where reform of process could make a meaningful difference in substance, and yield clear economic benefits.

I should also note that there are certainly many post-crisis regulations that are both procedurally and substantively sound, and have helped to make the U.S. banking system significantly more resilient, and its largest banks resolvable (in other words, not too big or complex to fail). In other testimony and publications, The Clearing House has detailed both the benefits and costs of the post-crisis regime, but my focus today, as noted, is necessarily more on the latter.¹

My testimony will highlight five areas where administrative procedure in banking regulation and supervision has broken down, with adverse consequences for the quality of rules being administered and the ability of our banking system to support economic growth.

1. CCAR

Bank capital levels clearly have risen dramatically and are significantly higher than they were before the financial crisis. The aggregate common equity tier 1 ratio of TCH's 25 owner banks rose from 4.6 percent at the end of 2008 to 12.2 percent at the end of last year. In dollar terms, tier 1 common equity for those banks nearly tripled from about \$331 billion to \$1.013 trillion over the past eight years. We now have a resilient banking system, and capital regulation has played a valuable role in constructing it.

That said, it is important to consider capital standards carefully because they have important ramifications for economic growth. While large banks are currently subject to over 35 different capital requirements, I will focus today on the Federal Reserve's "Comprehensive Capital Analysis and Review" or CCAR, stress test. To be clear, The Clearing House believes that stress testing is the smartest way to evaluate the resiliency of a bank. More static measures are necessarily backward looking and therefore assume,

¹ See https://www.banking.senate.gov/public/_cache/files/53257b19-de9a-4734-8fde-beead88a2de6/440F70F96DF111ADCEF153AFE8650672.062316-baer-testimony.pdf; <http://financialservices.house.gov/uploadedfiles/hrg-114-ba00-wstate-jnewell-20160712.pdf>; and https://www.theclearinghouse.org/-/media/action%20line/documents/volume%20vii/20161201_state-of-american-banking-report_tch.pdf.

for example, that if subprime mortgages have repaid consistently over a period of years, they will continue to do so. Importantly, stress testing also recognizes implicitly the benefits of firm diversification: a given stress might cause losses to certain divisions of a diversified firm but bring gains to others. But there are growing concerns about the Federal Reserve's CCAR exercise – in particular about both procedural and substantive deficiencies in how it is constructed in theory and applied in practice. Because CCAR is becoming a binding constraint for most large banks, and they are changing their portfolios consistent with its implicit mandates, it therefore has considerable economic impact.

Background

The Federal Reserve's stress testing framework attempts to measure the ability of banks to withstand a very severe economic downturn. The quantitative stress test has two components: (i) the Dodd-Frank Act stress tests (DFAST) and (ii) CCAR. Under DFAST, both participating banks and the Federal Reserve each run their own stress test using backward looking assumptions about future capital actions – so-called “company run” and “supervisory” DFAST stress tests. In the company-run DFAST exercise, participating banks use their own models to run separate simulations to determine the effects of various supervisory scenarios, as well their own scenarios, on the bank's capital adequacy – that is, the estimated net losses and resulting reduction in capital of the consolidated BHC under those scenarios. Banks' own DFAST models are subject to an intensive review and approval process, both by compliance and audit teams at the bank and by the Federal Reserve staff. In the supervisory DFAST exercise, the Federal Reserve uses its own models to perform the same exercise.

CCAR builds upon this DFAST framework to calculate post-stress minimum regulatory capital ratios that banks are required to meet. Here, the Federal Reserve uses own proprietary models (i.e., those it also employs under the DFAST supervisory stress test), but runs the test based on the bank's actual proposed capital actions rather than standardized assumptions. After this stress, a large bank must meet a series of capital requirements, including a 4.5 percent common equity tier 1 ratio. And it must do so assuming that it does nothing to shrink its balance sheets, reduce its dividend, or postpone planned share repurchases under severely adverse economic conditions– almost certainly deeply counterintuitive and extraordinary assumptions. Thus, a large bank that passes the CCAR exercise not only has sufficient capital to avoid failure under historically unprecedented adverse conditions – it has enough capital to emerge from such an event doing business as usual, and without taking actions that would be normal (or even compelled) under the circumstances.

For the 2017 exercise, banks must demonstrate how they would perform under a sudden and severe recession and coincident market crisis that features the following:

- A sudden jump in the unemployment rate of 4.2 percentage points (from 4.7 percent to 8.9 percent) during the first 4 quarters of the scenario;

- 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 – roughly a 10,000-point loss on the Dow; and
- For banks with substantial trading and processing operations, the abrupt failure of their largest counterparty.⁴

Collectively, this stress is far more sudden and stressful than the one imposed by the financial crisis of 2007-09, and apparently inconsistent with the Federal Reserve’s own self-imposed standard for the severely adverse stress of being consistent with “post-war U.S. recessions.”² As we have documented in our own research, the severely adverse scenario assumes a recession that includes an increase in the unemployment rate that is more severe than prior years’ scenarios, and considerably more severe than the 2007-2009 financial crisis.³ It is also considerably more stressful than its European stress testing counterpart.⁴

The Federal Reserve does not provide notice and the opportunity for public comment on these stress scenarios. However, since the CCAR process is a year-long cycle and the specifics of the supervisory scenarios change from year-to-year, with banks operating under short deadlines, it is difficult to understand why a full-year CCAR process could not accommodate a 30-day comment period, with 30 days for the Federal Reserve to incorporate and respond to comments.

Qualitative Assessment

The Federal Reserve’s CCAR process also annually subjects banks to a “qualitative” assessment of their capital planning processes, and prohibits them from distributing capital to shareholders if the Federal Reserve fails them. This process is highly subjective, with the Federal Reserve routinely imposing standards and criteria that it has never communicated, let alone published for notice and comment. Furthermore, the results are effectively unappealable and have major consequences for bank equity prices – meaning that the qualitative assessment gives the Federal Reserve extraordinary power over the banks over which it renders a verdict. Recently, the Federal Reserve has rightly ended the opaque annual qualitative test in favor of the traditional examination process for all but the largest banks subject to CCAR. There is no reason to retain it for anyone.

² See 12 CFR part 252.

³ See The Clearing House, 2016 Federal Reserve Stress Testing Scenarios (March 2016), available at www.theclearinghouse.org/~/-/media/action%20line/documents/volume%20vii/20160316%20tch%20research%20note%20ccar.pdf.

⁴ See The Clearing House, *Comparison Between United States and European Union Stress Tests* (May 2016), available at www.theclearinghouse.org/~/-/media/files/research%20notes/20160518-tch-research-note-ccar-vs-eba-stresstests.pdf.

Objection to Bank Capital Plans under CCAR

Under CCAR, the Federal Reserve may object to a bank's capital plan on the basis of either the quantitative or qualitative assessment. In either case, the supervisory objection, effectively operates as both (i) a cease-and-desist order directing the bank to refrain from engaging in paying dividends or other distributing capital to shareholders, and (ii) a capital directive that requires the bank to increase its capital ratios, even if it is operating above regulatory minimums, and regardless of how far above regulatory minimums it is currently operating. This result effectively divests a bank's board of directors from its traditional (and fiduciary) authority to pay dividends and share repurchases.

CCAR's Impact on Credit Allocation in the Economy

As CCAR is the binding capital requirement, banks will tend to shift lending away from sectors with higher implicit capital requirements under CCAR – that is, sectors that are disfavored by the severe macroeconomic scenarios in the tests – and toward sectors with lower implicit capital requirements. In other words, the CCAR exercise has substantial asset allocation power, and the Federal Reserve's choices with respect to CCAR can and do have a strong effect on the availability of credit.

A recent research note issued by the TCH Research Department shows just how powerful these credit allocation effects of CCAR can be.⁵ The results of that research show that the Federal Reserve's CCAR stress test is imposing dramatically higher capital requirements on certain asset classes – most notably, small business loans and residential mortgages – than bank internal (approved by the Federal Reserve) models and Basel standardized models. For some asset classes – for example, commercial real estate – the Federal Reserve's CCAR stress test produces results similar to the results of the banks' modeled results, and lower capital requirements relative to the relevant standardized model.

By imposing higher capital requirements on loans to small businesses and mortgage loans, stress tests are likely curtailing credit availability to the types of borrowers that lack alternative sources of finance. Both small businesses and the housing sector perform a very important role in the U.S. economy. For instance, small businesses account for more than 40 percent of private nonfarm gross domestic product and the formation of new businesses contribute substantially for the creation of new jobs; large banks originate about half of those loans by dollar amount and substantially more than half by number.⁶ Thus, by curtailing credit to these two key sectors of the U.S. economy, stress tests may be having an adverse impact on economic growth and contributing to the widening of income inequality among households. Conversely, our results also suggest

⁵ See The Clearing House, *The Capital Allocation Inherent in the Federal Reserve's Capital Stress Tests* (January 2017), available at https://www.theclearinghouse.org/~media/TCH/Documents/TCH%20WEEKLY/2017/20170130_WP_Implicit_Risk_Weights_in_CCAR.pdf.

⁶ See <https://www.theclearinghouse.org/eighteen53-blog/2017/march/24-small-business-lending>.

that stress tests impose lower capital requirements for commercial real estate and consumer loans than other capital standards; however, this outcome may reflect large banks' concentration in the lower-risk end of the commercial real estate lending spectrum and still tight consumer lending standards.

Opacity

Given the substantial economic importance and impact of the CCAR regime, one would expect that its key elements would have been subject to a robust and transparent public debate pursuant to the Administrative Procedure Act. But this is not at all the case: the most important drivers of CCAR results are decided by the Federal Reserve without public input and indeed, in some cases, without public access to the decision itself. First, as noted, although the Federal Reserve does at least publish its annual stress scenarios, it does so only in final form, without soliciting public feedback on those scenarios. Second, the Federal Reserve uses its own internal models to estimate stressed credit losses and net revenues but provides virtually no detail regarding the statistical specifications of these models. Nor does it disclose any data on the actual performance of the models it uses in stress testing.⁷

As a matter of basic administrative procedure, the lack of transparency around CCAR's most important aspects is deeply problematic. Imagine, for example, if the IRS were to repeal the tax code and tell you instead that it would determine your tax liability by taking your income information and running it through a secret internal model. Most would find such an idea unfathomable, and yet this process is how the binding capital requirement for our largest banks is actually set.

It is also worth noting that although stress-testing is now a standard supervisory practice globally, the U.S. CCAR exercise is unique in its opacity. Most notably, under both the Bank of England and the European Banking Authority stress testing regimes, models used by participating banks play a key role. In particular, in these jurisdictions banks can take into account their own past loss experience and incorporate differences in business models, which likely results in more accurate bank-specific projections of post-stress capital ratios.

The Bottom Line: Concerns about Accuracy

Given the significant impact that the Federal Reserve's CCAR models have on economic output, it is remarkable how little we know not only about their contents, as noted above, but about their *performance*. Even if one were to grant that the Federal Reserve had reason to keep its models secret (which we do not), nothing stopped it from using those models to perform baseline predictions of losses or revenue, and compare those results with bank results. Thus, we simply have no idea if the Federal Reserve's models – whatever their formulas may be in theory – actually work in practice. It is worth noting that while the GAO conducted a critical review of the Federal Reserve's

⁷ See https://www.aei.org/wp-content/uploads/2017/03/Kupiec_Stress-Test_032017.pdf

CCAR process – taking over two years to do so – that review did not include an analysis of the quality of the models (which it was not permitted to see) or the performance of those models (as either the Federal Reserve has no such data or would not share it).

There is little reason to believe that the Federal Reserve’s models are more accurate predictors of stress losses and revenue than banks’ own (Federal Reserve-approved) models. For the large majority of projections, Federal Reserve’s models are based on an industrywide, portfolio-specific, and instrument-specific approach and generally do not incorporate bank-specific effects. For example, the loss given default on a particular type of loan is assumed to be the same for all banks, and does not take into account an individual bank’s own resources and experience in recovering defaulted loans. This will likely generate sizable differences between loan loss estimates from banks’ own models and the projections made by the Federal Reserve. Similarly, in order to model revenue successfully, banks use models tailored to their individual business models.⁸ The Federal Reserve’s ccar models do not do so; instead, the Federal Reserve tries to ameliorate this problem by including time-varying bank risk characteristics as explanatory variables in their revenue models; however, this approach likely harms the predictive accuracy of Federal Reserve’s models.⁹

At least in part because of the simplifying assumptions on Federal Reserve’s models, we observe sizable differences in the projections of stress losses and revenues made by Federal Reserve and banks’ own models each year. For example, the Federal Reserve’s estimates for loan losses (provisions) were \$382B in CCAR 2015 and \$439B in CCAR 2016, while banks’ own estimates were \$324B and \$345B, respectively, or, approximately 18 percent lower than the Federal Reserve’s projections.

Recommendations

To address these and other existing problems with CCAR, we recommend that the Federal Reserve undertake the following changes:

- Subject the annual stress test scenarios to a 30-day notice and comment period under the Administrative Procedure Act;
- Correct counterfactual and incorrect assumptions about how banks would behave in a crisis (e.g., continued dividends and repurchases under severe stress);
- Permanently suspend any action to increase effective post-stress minimum requirements under CCAR (e.g., through incorporation of the GSIB capital surcharge);
- Use banks’ own DFAST results to estimate stress losses for purposes of the CCAR quantitative assessment; restrict use of the Federal Reserve’s own models to a supervisory assessment; and disclose those models to the public to

⁸ See Michael Duane, Til Shuermann and Peter Reynolds, *Stress Testing Bank Profitability*, J.OF RISK MANAGEMENT IN FINANCIAL INSTITUTIONS (2014), Vol. 7(1) at 72-84.

⁹ See Paul Kupiec, *Inside the Black Box: The Accuracy of Alternative Stress Test Models* (2017).

- benefit from peer review; and
- Eliminate the qualitative assessment from CCAR for all banks, returning to the traditional examination process.

We note that pursuant to these reforms, the Federal Reserve would continue to engage in modeling as part of CCAR. Such modeling would inform its oversight of the banks' own models. If a bank's own models were deemed insufficient, the Federal Reserve's model would be offered as evidence in issuing a capital directive or other enforcement action.

Significantly, under this approach, because there would be no concern that all banks would allocate credit according to the Federal Reserve's models (a/k/a "gaming"), there would be no reason for the Federal Reserve's models to remain secret. They could then benefit from peer review by the academic community in a way that bank models (which are proprietary) cannot.

2. CAMELS Ratings

The CAMELS rating system was adopted in 1979, at a time when there was no capital regulation, no liquidity regulation, and no stress testing regulation – in other words, at a time when bank supervision was necessarily highly subjective. That system is now hopelessly out of date. Detailed capital, liquidity and other rules have been expressly designed and carefully calibrated to evaluate the key components of the CAMELS ratings: obviously, capital and liquidity, and less obviously, earnings and asset quality, which are evaluated through stress testing for certain banks. The CAMELS regime thus is now clearly outmoded in design, and has also become punitive and arbitrary in practice.

Outmoded Design

The CAMELS system evaluates a bank across six categories – capital, asset quality, management, earnings, liquidity, and sensitivity to market risk, especially interest rate risk – and assigns a composite rating, all on a scale of 1 (best) to 5. Except for the addition of the "S" component, the CAMELS standards have not been materially updated in the almost 40 years since their adoption – not since adoption of the Basel Accord on capital in 1988, the Comprehensive Liquidity Analysis and Review in 2012, or the Liquidity Coverage Ratio in 2014 .

Thus, for example, the standards that examiners apply in deciding the Capital component of the rating do not include consideration of any post-1978 regulatory capital standards – or any market indicators, which also have grown in sophistication over the past few decades. Rather, they speak vaguely of "the ability of management to address emerging needs for additional capital" and "balance sheet composition, including the nature and amount of intangible assets, market risk, concentration risk, and risks associated with nontraditional activities." Similarly, for the Liquidity component, compliance with the Federal Reserve's self-titled "*Comprehensive Liquidity Analysis and*

Review” is not mentioned in the standards; instead, there are vague conditions such as “access to money markets and other sources of funding” and “the trend and stability of deposits.”

In a speech in 2013, the Federal Reserve Board noted approvingly this state of affairs:

If you look at the criteria for rating capital adequacy under the banking agencies' CAMELS rating system for banks, and under the Federal Reserve's RFI rating system for bank holding companies, you will actually see very few references to minimum regulatory capital. Instead, the focus is on maintaining capital that is commensurate with the overall risk profile of the bank, not just credit risk. This requires both management and the supervisor to have an effective understanding of the banking organization's risk profile, which is central to our supervisory program.¹⁰

This statement is difficult to fathom. The stated purpose of CCAR, DFAST, Basel III, and even the standardized approaches to capital adequacy is *exactly* to ensure that capital is “commensurate with the overall risk profile of the bank.”¹¹ The Federal Reserve has, on numerous occasions, touted CCAR – which, as indicated by its very title, is intended to be a “comprehensive” assessment as a program through which “the Federal Reserve assesses the overall capital adequacy of the firms, including evaluations of whether each firm's capital provides an adequate buffer for the losses that would be incurred during the stress scenarios, whether its risk management and capital planning processes are appropriately well-developed and governed, and how its plans to distribute capital through dividends or share repurchases could affect its ability to remain a viable financial intermediary in the hypothesized scenarios.”¹² Thus, in no sense whatsoever are those capital standards limited to “just credit risk.” While there is a standardized approach to capital solely devoted to credit risk, there are also frameworks for market risk and operational risk for banks for which they are relevant. If there is a part of the

¹⁰ See Sarah Bloom Raskin, Let's Move Forward: The Case for Timely Implementation of Revised Capital Rules (June 6, 2013), available at www.federalreserve.gov/newsevents/speech/raskin20130606a.pdf.

¹¹ Indeed, the Basel Committee has explained that one of the primary purposes and functions of the Basel III capital reforms was to respond to “the need to strengthen the risk coverage of the capital framework” and ensure that all types of risks were reflected and addressed in the bank capital framework. See Basel Committee on Banking Supervision, *Basel III: A global regulatory framework for more resilient banks and banking systems* (rev. June 2011) at 3.

¹² Governor Daniel K. Tarullo, Next Steps in the Evolution of Stress Testing (September 26, 2016), available at <https://www.federalreserve.gov/newsevents/speech/tarullo20160926a.htm>. See also Tim P. Clark and Lisa H. Ryu, CCAR and Stress Testing as Complementary Supervisory Tools, available at www.federalreserve.gov/bankinforeg/ccar-and-stress-testing-as-complementary-supervisory-tools.htm (noting that “[t]ogether [supervisory stress tests and CCAR] allow supervisors to move beyond more traditional static analysis of capital ratios and to conduct a forward-looking evaluation of capital adequacy that incorporates both quantitative analysis and qualitative reviews of large BHCs' capital planning and positions”).

“banking organization's risk profile” that these risk-based capital measures are missing, no regulator has ever identified them.¹³

Indeed, one further weakness of the CAMELS system is that it treats each factor as independent, when in fact they are intensely interrelated. Consider the Federal Reserve’s CCAR stress test, which is effectively a measure of capital adequacy. Both the asset quality and earnings of the firm drive that capital requirement. So, a firm with more risky loans and more capital can perform as well as a firm with less risky loans and less capital. The “A” in CAMELS, taken singularly and literally, suggests that a bank that takes more risk would receive a lower score than one that takes less risk. But, as modern capital measures and stress testing recognize, the reality is far more complex, and demand an assessment that is holistic, not compartmentalized.

Arbitrary Practices

The CAMELS rating system was adopted to evaluate an institution’s “financial condition and operations” – in other words, its safety and soundness. Over time, however, CAMELS ratings have become progressively more arbitrary, subjective and compliance focused. Perhaps because capital, liquidity and other factors are now regulated directly and specifically, the CAMELS rating has come to focus myopically on the one highly subjective factor: Management. Various “unwritten rules” reportedly have been adopted:

- Any compliance problem resulting in enforcement action, regardless of its materiality, results in a downgrade of Management;
- In terms of ratings, “2” is the new “1,” and “3” is the new “2.” Thus any downgrade in management rating will be from a “2” to a “3.”
- An institution with a “3” for Management cannot have better than a “3” Composite rating.

This is not to say that there cannot be cases where a bank that is deemed well-capitalized under 35-plus different capital tests could not in theory still require more capital. It is to say, though, that an examiner making a judgment that those 35-plus tests have proven insufficient with respect to the bank under supervision should face a high bar and, more importantly, have to produce an actual, reasoned, and easily appealable analysis as to why. Nothing can be further from the truth today.

Major Consequences

The stakes for a CAMELS rating were raised significantly in 1999, when the Gramm-Leach-Bliley Act conditioned the ability to continue as a financial holding company on maintaining a CAMELS 1 or 2 rating. (Financial holding companies are those that may exercise certain non-bank financial activities.) Prior to 1999, a supervisor

¹³ It is worth noting that if the sole capital requirement were a leverage ratio, which treats all assets as having the same risk, then a subjective supervisory assessment of capital would be necessary. But that is manifestly not the case currently.

with genuine safety and soundness concerns was required to use the options laid out for it by Congress in statute: namely, the issuance of an order to correct an unsafe and unsound condition or practice – an enforcement action under 12 U.S.C. § 1818 of the FDI Act—or the issuance of a capital directive under 12 U.S.C. § 3909(d)), promulgated under the International Lending Supervision Act of 1983. Both types of orders came with a meaningful ability for the institution to appeal, including a notice of charges and an opportunity for a hearing before an Administrative Law Judge. With enactment of the Gramm-Leach-Bliley Act, both those processes became dead letters with respect to financial holding companies. Regulators had no need to draft a formal notice of charges, or put their allegations to the test in front of a neutral arbiter, when all they had to do was threaten a CAMELS downgrade, or actually execute a CAMELS downgrade.

While only larger banks tend to be part of a financial holding company, mid-sized and small banks are effectively subject to the same restrictions. Regulators call this the “penalty box,” whereby all expansion is halted until compliance violations – generally minor and relevant to only a small part of the organization – stop all expansion for years at a time.

Thus, the CAMELS system has changed from an overall evaluation of the safety and soundness of an institution to an evaluation of routine compliance matters and the readiness with which management accedes to examiner criticism – all as the consequences of a low rating have risen dramatically. That is not to say that compliance matters are not important; it is to say that they should not pollute a system designed for an altogether different, very important safety and soundness purpose, and should not be exempt from legally required procedural requirements. *Nothing better explains the current imbalance in the supervision and regulation process than these changes to the CAMELS regime.*

Relatedly, other supervisory “unwritten rules” have grown up alongside the CAMELS process. For example, expansion is prohibited so long as any consent order is pending. Consent orders cannot be lifted for at least two years, and generally significantly longer. Consent orders and more informal enforcement action often require a bank to hire independent consultants to perform the work of the bank (and the examiner), which further lengthens the remediation process.

The results of this new supervisory regime are significant:

- Banks of all sizes, but particularly mid-sized banks, have been blocked from branching or merging to meet their customers’ needs.
- Bank technology budgets often are devoted primarily, not to innovation, but rather to redressing frequently immaterial compliance concerns.
- Board and management time is diverted from strategy or real risk management and instead spent remediating frequently immaterial compliance concerns, and engaging in frequent meetings with examiners, to ensure that they are fully satisfied.

The unfortunate truth is that examiners have three powerful reasons to ignore market data and regulatory capital ratios in assigning CAMELS ratings. The first reason is to remain relevant. Second, to gain leverage over the firms they examine. Third, to avoid an accusation – either now or in the future – that they were either inattentive or captive. Those are powerful motivations, and perfectly understandable ones. Of course, it is exactly why the CAMELS regime must be upgraded to include clear, objective standards for evaluation.

Lack of Process

Given the potential impact of a CAMELS rating, one might expect banks to appeal adverse ratings frequently. That does not happen, however, for two reasons. First, every banker and bank counsel is taught that “examiners have long memories,” so retaliation is expected as the norm.¹⁴ Second, appeals are made to the same agency that assigned the rating. For example, at the Federal Reserve, the ultimate arbiter in an appeal is a designated Federal Reserve Board Governor, while at the FDIC, appeals are ultimately decided by the agency’s Supervision Appeals Review Committee, which consists of three voting members: one inside FDIC Board member, and one deputy or special assistant to each of the inside FDIC Board members who are not designated as the SARC Chairperson. In addition, the FDIC’s General Counsel serves as a non-voting member of the Committee.

Law Professor Julie Andersen Hill published an article in 2014 in which she analyzed the appeals process at each of the three federal banking agencies¹⁵ Professor Hill explains that the processes and standards governing appeals are far from transparent and that the standards for reviewing appeals differ across the agencies (and with respect to the Federal Reserve, among individual Federal Reserve Banks themselves), leading her to conclude that the appeals process at each agency is “a dysfunctional and seldom used system.”¹⁶ Further, for those few banks that attempt to appeal a supervisory decision, Professor Hill concluded, based on the data that she was able to obtain, that banks seldom win their appeals.¹⁷ Thus, the appeals system is rife with disincentives for financial institutions to pursue remedies against supervisory actions with which they disagree, and it is not surprising how few appeals there are. Indeed, there are so few that the agencies do not even keep good records of them. For example, when Professor Hill attempted to obtain the records of banks’ appeals from the Federal Reserve under FOIA, the agency advised that there were no records available for any appeals between 1995 and 2000.¹⁸

¹⁴ Indeed, in recognition of this tendency to retaliate, the agencies have adopted internal policies criticizing examiner retaliation against institutions for pursuing supervisory appeals.

¹⁵ “When Bank Examiners Get It Wrong: Financial Institution Appeals of Material Supervisory Determinations,” by Julie Andersen Hill, Associate Professor of Law, University of Alabama School of Law (2014) at 14, *available at* www.stlouisfed.org/~media/Files/PDFs/Banking/CBRC-2014/SESSION2_AndersonHill.pdf

¹⁶ *Id.* at 4.

¹⁷ *Id.* at 4.

¹⁸ *Id.* at 4, 64.

Interestingly, the CAMELS rating system has no reference in statute. It was issued by the FFIEC – the umbrella group through which the banking agencies issue call reports and other common forms – pursuant to title X of the Financial Institutions Regulatory and Interest Rate Control Act of 1978, which provides only that the FFIEC “shall establish uniform principles and standards and report forms for the examination of financial institutions which shall be applied by the Federal financial institutions regulatory agencies.” It seems difficult to read "uniform principles and standards" to convey a numerical grading system.

Recommendations

We strongly recommend that Congress repeal the CAMELS requirement for financial holding company status under the Gramm-Leach-Bliley Act and replace it with a requirement allowing the regulators to disqualify a bank from financial holding company status on managerial grounds – after notice and the right to a hearing. We also recommend that the banking agencies replace the current CAMELS system with an entirely different construct, after a notice and comment process under the Administrative Procedure Act. One potential model is the system that the Federal Reserve uses to evaluate bank holding companies.¹⁹

In the interim, existing guidance should be amended to modernize the CAMELS rating system, as follows:

- A bank that is well capitalized under all relevant capital requirements, including its parent holding company’s passage of its most recent CCAR/DFAST stress test if applicable, should be presumed to be “1” rated for purposes of its Capital rating.

¹⁹ Under this “RFI/C(D)” rating system, BHCs generally are assigned individual component ratings for risk management (R), financial condition (F), and impact (I) of nondepository entities on subsidiary depository institutions. The risk management component is supported by individual subcomponent ratings for board and senior management oversight; policies, procedures, and limits; risk monitoring and management and information systems; and internal controls. The financial condition rating is supported by individual subcomponent ratings for capital adequacy, asset quality, earnings, and liquidity. An additional component rating is assigned to generally reflect the condition of any depository institution subsidiaries (D), as determined by the primary supervisor(s) of those subsidiaries. An overall composite rating (C) is assigned based on an overall evaluation of a BHC’s managerial and financial condition and an assessment of potential future risk to its subsidiary depository institution(s). A simplified version of the RFI rating system that includes only the risk management component and a composite rating is applied to noncomplex BHCs with assets of \$1 billion or less. Composite, component, and subcomponent ratings are assigned based on a 1 to 5 numeric scale. A 1 numeric rating indicates the highest rating, strongest performance and practices, and least degree of supervisory concern, whereas a 5 numeric rating indicates the lowest rating, weakest performance, and the highest degree of supervisory concern. See Federal Reserve Supervisory Letter SR 04-18, “Bank Holding Company Rating System,” (December 6, 2004), available at www.federalreserve.gov/boarddocs/srletters/2004/sr0418.htm.

- A bank whose parent holding company has passed its most recent CCAR/DFAST stress test should be presumed to be “1” rated for purposes of its Asset Quality rating.
- A bank’s Management rating shall reflect primarily the risk management practices of the bank, focused on those practices that have a *material* effect on its *safety and soundness*.
- A bank whose parent holding company has passed its most recent CCAR/DFAST stress test should be presumed to be “1” rated for purposes of its Earnings rating.
- A bank that is in compliance with the Liquidity Coverage Ratio, if applicable, should be presumed to be “1” rated with respect to Liquidity.
- A bank’s composite rating should be an average of each of its component ratings, weighted equally.
- Compliance with laws that do not directly affect safety and soundness – including the Bank Secrecy Act and consumer laws – should be dealt with under separate and existing enforcement authority or the Compliance rating.

Consistent with these changes, the banking agencies should also adhere to the statutory standard prescribed by Congress in evaluating acquisitions under the Bank Holding Company Act, mergers under the Bank Merger Act, and branching applications under the International Banking Act, and not pursuant to additional hurdles created by supervisory fiat. The statutory standards here are clear.²⁰ Applications should be

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The Bank Holding Company Act prohibits the Board from approving any acquisitions that would result in a monopoly or substantially lessen competition and requires the Board to consider, among other things, the financial and managerial resources and future prospects of the existing and proposed institutions, the convenience and needs of the community to be served, the effectiveness of the relevant company or companies in combating money laundering, and whether the transaction would result in greater or more concentrated risks to the stability of the United States banking or financial system. *See* 12 U.S.C. § 1842(c). Similarly, the Bank Merger Act provides that the responsible agency shall not approve any proposed merger transaction that would result in a monopoly or substantially lessen competition and requires such agency to take into consideration the financial and managerial resources and future prospects of the existing and proposed institutions, the convenience and needs of the community to be served, the effectiveness of the relevant institutions in combating money laundering, and the risk to the stability of the United States banking or financial system. *See* 12 U.S.C. § 1828(c). Finally, in considering an application by a foreign bank to establish a federal branch or agency in any state outside its home state, as set forth in 12 U.S.C. § 3103(a)(3), the Comptroller of the Currency must determine that the foreign bank’s financial resources, including the capital level of the bank, are equivalent to those required for a domestic bank to be approved for branching under 12 U.S.C. § 36 and 12 U.S.C. § 1831u, which sets forth the criteria that must be considered in evaluating interstate bank mergers. In addition, the OCC must consider the factors that must be considered in evaluating interstate bank merger applications under 12 U.S.C. § 1831u, including consideration of the most recent CRA evaluation of any bank which would be an affiliate of the resulting bank and the record of compliance of any applicant bank with applicable State community reinvestment laws. In addition, each bank involved in the transaction must be adequately capitalized, and the resulting bank must be well capitalized and well managed upon the consummation of the transaction. The Comptroller also must consider the same factors that the Board must consider in evaluating an application for the establishment of a foreign bank office in the United States under the financial and managerial resources of the foreign bank, including the bank’s experience and capacity to engage in international banking. *See* 12 U.S.C. 3105(d).

processed promptly according to those criteria, and arbitrary CAMELS requirements and other supervisory creations should not be imposed.

We also strongly recommend that the Federal Reserve publish for notice and public comment, and submit any final rule to the Congress pursuant to the Congressional Review Act, the contents of its Supervisory Letter 14-2. That guidance, which the Federal Reserve has clearly treated as a regulation, includes a wide range of supervisory limits and conditions on bank expansion that have no basis in law.

3. Living Wills

Title I of Dodd-Frank requires large banks to construct a pre-packaged bankruptcy plan under the Bankruptcy Code, and requires regulators to review the credibility of that plan. This requirement is an important and altogether appropriate one. The required review, however, has been translated into a shadow regulatory regime, almost entirely opaque, and with real economic consequences. While any regulatory review of a bankruptcy plan will necessarily have subjective elements, and require some element of confidentiality, many requirements imposed under the living will process are unnecessary and even counterproductive under the resolution regime accepted by those same regulators.

Most U.S. G-SIBs have based their living will on the single-point-of-entry (SPOE) resolution strategy.²¹ Under the SPOE strategy, all 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 or an FDIC receivership under Title II of Dodd-Frank. The two principal benefits of this strategy are (i) making 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) allowing the material operating subsidiaries to remain open and operating, thereby minimizing the systemic consequences of a large banking organization failure.

The Federal Reserve has made SPOE a viable option through its Total Loss Absorbing Capacity Rule, which requires U.S. G-SIBs to hold massive amounts of capital or long-term debt at the top-tier holding company level.²² Under the rule, each U.S. G-SIB is required to maintain minimum total loss absorbing capacity equal to 21.5 percent

²¹ All but one of the U.S. G-SIBs have now publicly adopted the SPOE bail-in strategy as their preferred resolution strategy under the U.S. Bankruptcy Code and are otherwise expected to be resolved with an SPOE strategy under Title II of the Dodd-Frank Act. These U.S. G-SIBs have adopted the SPOE strategy in their living will plans: Bank of America Corporation; The Bank of New York Mellon Corporation; Citigroup Inc.; The Goldman Sachs Group, Inc.; JPMorgan Chase & Co.; Morgan Stanley; and State Street Corporation.

²² The Federal Reserve's TLAC rule also requires the U.S. IHCs of non-U.S. G-SIBs to maintain substantial amounts of internal TLAC that can be utilized to recapitalize the U.S. IHCs should they become troubled. See Total Loss-Absorbing Capacity, Long-Term Debt, and Clean Holding Company Requirements for Systemically Important U.S. Bank Holding Companies and Intermediate Holding Companies of Systemically Important Foreign Banking Organizations, 82 Fed. Reg. 8266 (Jan. 24, 2017).

to 23 percent of its total risk-weighted assets, and 9.5 percent of its total assets. *The eight U.S. G-SIBs alone are expected to maintain, on an aggregate basis, more than \$1.5 trillion in total loss absorbing capacity.* The scale of this reform has not been widely appreciated. Furthermore, a protocol entered into among the major dealer G-SIBs, the ISDA 2015 Universal Resolution Stay Protocol, prevents close-out of derivatives at the subsidiary level based on a holding company bankruptcy, thereby eliminating the largest possible source of systemic instability (witness, Lehman Brothers) from a holding company bankruptcy.²³ In order to extend this systemic protection beyond dealer bank transactions, the Federal Reserve, FDIC and OCC have proposed a rule that would generally require G-SIBs to include resolution stays in financial contracts with all of their counterparties, and we urge them to finalize that rule promptly.²⁴

Despite the fact that these banks have credible living wills based on an SPOE strategy, the FDIC and Federal Reserve are imposing massive costs on some firms – and their customers – by effectively requiring them to structure themselves almost as if the SPOE strategy did not exist. In other words, the regulators seem to be requiring substantial liquidity and capital to be pre-positioned – and therefore, trapped – at material subsidiaries on the assumption that each such subsidiary will be resolved independently. This is the antithesis of the SPOE strategy outlined in the approved plans.

By way of example, the most recent living will guidance issued in April 2016 requires each of the largest U.S. banking organizations to determine its Resolution Liquidity Adequacy and Positioning, or RLAP, as well as its Resolution Liquidity Execution Need, or RLEN.²⁵ RLAP requires the firm to estimate standalone liquidity needs of each material subsidiary for 30 days of stress, and ensure liquidity is either pre-positioned in the subsidiary or otherwise available at the parent as HQLA to meet deficits. RLEN requires the firm to further account for the estimated liquidity needed post-bankruptcy filing to support the surviving or wind-down subsidiaries. The guidance states that firms must assume that a net liquidity surplus in one material subsidiary cannot be moved to meet liquidity deficits at another material subsidiary. The guidance imposes similar requirements with respect to pre-positioning of loss absorbing capital resources at material subsidiaries. Not only are these overly prescriptive liquidity and capital pre-

²³ 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>

²⁴ Restrictions on Qualified Financial Contracts of Systemically Important U.S. Banking Organizations and the U.S. Operations of Systemically Important Foreign Banking Organizations; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions, 81 Fed. Reg. 29,169 (proposed May 11, 2016) (the Federal Reserve’s proposal); Mandatory Contractual Stay Requirements for Qualified Financial Contracts, 81 Fed. Reg. 55,381 (proposed Aug. 19, 2016) (the OCC’s proposal); and Restrictions on Qualified Financial Contracts of Certain FDIC-Supervised Institutions; Revisions to the Definition of Qualifying Master Netting Agreement and Related Definitions, 81 Fed. Reg. 74,326 (proposed Oct. 26, 2016) (the FDIC’s proposal).

²⁵ Similar guidance was issued just last week to the largest foreign banks operating in the United States.

positioning requirements antithetical to the underlying premise of the SPOE strategy, they also interfere with, and indeed may even supersede, other existing liquidity regulations, at high cost to the efficiency with which firms operate, and the efficiency with which they can serve their clients. The appropriate remedy here is clear: any firm using the single-point-of-entry resolution strategy and in compliance with the TLAC requirement for holding company loss absorbency, the living will process should not include any incremental liquidity or capital requirement at the operating subsidiary level.

Finally, the agencies take an extraordinarily broad, counterfactual view of what constitutes a “material entity” at which both capital and liquidity must be prepositioned for resolution purposes. The agencies generally define a material entity to include any subsidiary that is significant to the activities of a critical operation or core business line of the firm. But this definition is far too broad. At a minimum, a material entity for this purpose should include only entities whose failure would impose systemic consequences or result in a material loss to the organization’s insured bank affiliate.

Most remarkably, none of these requirements have been put out for public comment (or submitted to the Congress under the Congressional Review Act), although they meet every criterion for a rule. RLEN and RLAP are creations of the supervisory process, and have no grounding in law or regulation. Moreover, the details of the requirements are designated as “confidential supervisory information,” and thus any public complaint about their contents is, in the view of the agencies, a federal crime.

If notice and public comment were permitted, we would argue that the extraordinary costs of entity-level requirements are unwarranted given the absence of any benefit. Furthermore, we believe that such requirements are actually counterproductive to resolution: trapped liquidity cannot be used by the holding company in recovery or the resolver in resolution to be sent to the entity actually experiencing trouble in the way that holding company liquidity can.

4. Supervisory Involvement in Bank Corporate Governance

Another area that has become subject to increasing and alarming levels of supervisory intrusion, opacity and subjectivity is bank corporate governance. There is little public appreciation for the extent to which regulators and supervisors now seek to influence, or even dictate, aspects of the governance of banks’ boards of directors and management. These actions, which can be more akin to conservatorship than traditional examination, can take various forms:

- In some cases, examiners attend board of directors or board committee meetings, which both chills candid discussion and inevitably shifts the agenda from corporate strategy and economic risk to regulatory topics.
- Even where examiners do not attend meetings, they insist on detailed minutes for all board and many management committee meetings.

- These minutes are used by examiners to grade how well the participants are performing, in the entirely subjective opinion of an examiner. The result can be junior examiners quizzing Fortune 500 CEOs and other seasoned directors on whether they are asking enough questions at board of director meetings.
- Examiners insist on votes at management committees that operate by consensus.
- Examiners have decided views on the appropriate jurisdiction of board committees – often insisting, for example, that the Risk Committee assume the most authority – and management committees.
- Examiners often assert that the positions of chairman of the board and chief executive officer should not be held by the same person. Boards make this judgment as a fundamental exercise of their fiduciary duties to shareholders. Shareholders are frequently asked through the proxy shareholder proposal process whether such a structure should be adopted. Nevertheless, regulators have forced this structure in some institutions and have raised the possibility of imposing such a requirement generally.
- Examiners have decided views on reporting lines within management and to board of directors.
- Examiners require banks to expend extraordinary resources conducting due diligence on vendors, many of whom pose little or no safety and soundness risk.
- Examiners generally view it as necessary for the board of directors to review in depth the remediation of any compliance violation, regardless of materiality.

These regulatory positions invariably have two things in common: (i) they are not based on any study or analysis – e.g., which structures performed best in the financial crisis, or over some longer period of time; and (ii) they are generally not subject to public notice and comment. Also, in many cases, these views vary by examination team. So, for example, while it may well be true that banks perform better when the head of compliance reports to the chief risk officer rather than the chief legal officer – and that is decidedly the current regulatory view – we are aware of no analysis or study demonstrating as much. The question of splitting the CEO and chairman position is obviously one debated across all industries, many of them heavily regulated, but it is only bank regulators who have chosen to substitute their views for those of the board and shareholders.²⁶

²⁶ For example, the OCC has noted that “some national banks have split the roles of Board Chairman and Chief Executive Officer,” and so “[w]e should consider whether this structural change by some national banks makes sense for all federally supervised banks, or at least the largest most complex ones.” Comptroller of the Currency Thomas J. Curry, *Remarks Before The Clearing House Annual Conference* ((Nov. 30, 2016) at 6, available at www.occ.gov/news-issuances/speeches/2016/pub-speech-2016-149.pdf). This notion is hard to reconcile with the National Bank Act, which states that, as a default matter, “[t]he president of the [national] bank shall be a member of the board and shall be the chairman thereof.” 12 U.S.C. § 76.

Of course, one could observe that bank management and boards simply should say no to such mandates. Here, the relationship to CAMELS and other “unwritten rules,” and the absence of any meaningful appeals process, is highly relevant. A bank resisting examiner mandates risks a “3” management rating, a refusal to lift a consent order that is blocking any expansion, or some other version of regulatory penalty box.

Consequently, we hear frequently from bank management that more than half of board of director time – and in some cases, significantly more – is devoted to regulation and compliance, as opposed to innovation, strategy, risk and other crucial topics. Examiner pressure has bank boards and management frequently driving with a rear view mirror, focused on ensuring remediation with past problems, frequently immaterial, rather than anticipating future risks. It also inappropriately blurs the distinct roles of board and management on which U.S. corporate governance is based. These regulatory mandates often impose on directors a range of responsibilities and duties that are effectively management, rather than oversight. Last year, The Clearing House published a report on the proper role of the board that included an annex that summarized all the matters that regulation or guidance requires a bank board or committees to review; this annex was 144 pages long.²⁷

For example, bank boards of directors are required or generally expected to:

- Approve and periodically review the liquidity risk-management strategies, policies, and *procedures* established by senior management (12 CFR 252.34(a)(2));
- Approve written *policies and procedures* for insurance and annuity *sales programs* (BHC Supervision Manual, Section 3950.0.4.1);
- Approve a *list of appraisers* as part of the loan or appraisal policy (SR 97-25; SR 95-51);
- Approve the *choice of and networking agreements with* third parties providing retail nondeposit investment products (Comptroller’s Handbook, Retail Nondeposit Investment Products);
- *Establish* dual controls and separation of duties for funds transfer systems (FFIEC Information Technology Handbook, Wholesale Payment Systems Booklet); and
- *Ensure* that vendors to which collective investment fund management functions are outsourced perform in a safe and sound manner in compliance with applicable laws and policy guidance (OCC Bulletin 2011-11 (March 29, 2011)).

If a goal is for banks to refocus on lending and economic growth, a good start would be for the banking regulators to undertake a wholesale review of all the formal or informal corporate governance guidance they have issued (generally, without notice and

²⁷ <https://www.theclearinghouse.org/sitecore/content/tch/home/issues/articles/2016/05/20160505-tch-publishes-the-role-of-the-board-of-directors-report>

comment) to determine what level of examiner intervention in the governance and management of banks is appropriate. We would strongly urge that such a review be undertaken pursuant to the Administrative Procedure Act, so that public comment could inform that process.

5. Community Reinvestment Act

The Community Reinvestment Act was enacted by Congress in 1977 to encourage financial institutions to help meet the credit needs of their local communities.²⁸ Congress enacted the CRA in response to concerns that federally insured banking institutions were not making sufficient credit available in the local areas in which they were chartered and acquiring deposits.²⁹ Consequently, the CRA was enacted to reaffirm the obligation of financial institutions “to help meet the credit needs of the local communities in which they are chartered, consistent with the safe and sound operation of such institutions.”³⁰ The CRA requires federal banking regulators to conduct examinations to regularly assess the records of banks in terms of meeting local credit needs and requires those records to be taken into account when institutions apply for charters, branches, mergers, acquisitions, and other applications that require regulatory approval.³¹

The legislative history of the CRA demonstrates that it was motivated by Congressional concern with “redlining” – the practice by “banks and savings and loans [in which they take] their deposits from a community and instead of reinvesting them in that community . . . actually or figuratively draw a red line on a map around the areas of their city, sometimes in the inner city, sometimes in the older neighborhoods, sometimes ethnic and sometimes black, but often encompassing a great area of their neighborhood.”³² The purpose of the Act was thus to require “private financial institutions [to] play the ‘leading role’ in providing the capital required for ‘local’ housing and economic development needs.”³³ Indeed, “the overwhelming focus of the legislative history of the CRA was on the need to preserve local communities through recognition of the fact that depository institutions could invest in their local communities and still make a profit.”³⁴

²⁸ P.L. 95-128, 12 U.S.C. §§ 2901-2908.

²⁹ Congressional Research Service, “The Effectiveness of the Community Reinvestment Act,” Darryl E. Getter, Specialist in Financial Economics (January 7, 2015).

³⁰ 12 U.S.C. § 2901.

³¹ See 12 U.S.C. §§ 2901, 2903.

³² See “The Community Re-Investment Act of 1977: Its Legislative History And Its Impact On Applications For Changes In Structure Made By Depository Institutions To The Four Federal Financial Supervisory Agencies,” Warren L. Dennis, *citing* Statement of Senator Proxmire, Congressional Record, daily ed., June 6, 1977, at S.8958, available at: <http://faculty.msb.edu/prog/CRC/pdf/WP24.pdf>

³³ See *id.* *citing* Statement of Senator Proxmire, Hearings on S.406, at 1.

³⁴ Joseph Moore, *Community Reinvestment Act and Its Impact on Bank Mergers*, 1 N.C. Banking Inst. 412, 415 (1997), *citing* 123 CONG. REC. 17,631 (1977) (*statement of Sen. Proxmire*); See

Thus, under the CRA, the ratings are defined as to an “outstanding [or satisfactory, or needs to improve] record of meeting *community credit needs*.”³⁵ The statute directs the agencies to “assess the institution’s record of meeting *the credit needs* of its entire community, including low- and moderate-income neighborhoods....”³⁶

While the CRA has proven controversial over the years, until relatively recently, it could fairly be said that the agencies had implemented it in a way that gave banks clear incentives to lend to underserved communities, and clear benchmarks for determining whether they were doing a satisfactory or outstanding job of doing so.³⁷ More recently, however, regulators have increasingly included in their assessments other criteria, and in particular, consumer compliance or other violations outside the scope of the CRA. The result of this departure from the letter of the law undermines the larger objectives of the CRA itself.³⁸ A company doomed to a “needs to improve” rating by virtue of an unrelated compliance issue has no regulatory incentive to engage in additional lending to raise its rating to satisfactory or outstanding. Thus, John Taylor, the head of the National Community Reinvestment Coalition and a staunch proponent of the CRA, recently criticized the regulators’ expansion beyond the original purpose of the CRA to encourage lending in underserved communities. Mr. Taylor stated, “I don’t want the message to the banks to be, ‘It doesn’t matter how good you do on the lending, if you do something wrong in another area, you could fail.’ . . . I think it’s a better idea to ding them, downgrade them, but don’t totally ignore the positive performance. You want to support that.”³⁹

Community Credit Needs: Hearings on S. 406 Before the Senate Comm. On Banking, Housing, and Urban Affairs, 95th Cong. 133 (1977 at 17,633 (statement of Sen. Sarbanes), available at <http://scholarship.law.unc.edu/ncbi/vol1/iss1/23>.

³⁵ 12 U.S.C. § 2906(b)(2) (emphasis added).

³⁶ 12 U.S.C. § 2903 (emphasis added).

³⁷ To assess compliance with the CRA, the federal banking regulators today apply three tests, known as the *lending*, *investment*, and *service* tests. See 12 CFR parts 25, 195, 228, and 345. The *lending* test evaluates the number, amount, and distribution across income and geographic classifications of mortgage, small business, small farm, and consumer loans; the *investment* test grades community development investments in the assessment area; and the *service* test examines retail service delivery, such as the availability of branches and low-cost checking in the assessment area. *Id.* at 3. Small banks are evaluated only under the lending test; intermediate small banks are subject to both the lending and investment tests, while large banks are subject to all three tests.

³⁸ This problem is exacerbated by the fact that CRA ratings are inherently backward-looking, such that the negative consequences of any past issues may persist long after they are successfully remediated and addressed.

³⁹ See Politico Morning Money (March 30, 2017), available at www.politico.com/tipsheets/morning-money/2017/03/brexit-has-broken-219500.

Finally, it seems clear that when a bank commits a sales practice or other consumer law violation, there is no shortage of enforcement agencies and legal regimes available to seek redress and punishment. Adding the CRA to that long list thus has little marginal benefit, and risks undermining its core purpose. Realigning the CRA with its actual language and intent, and eliminating the regulators' subjective and inappropriate extension of the CRA into other areas at their own discretion, would render the CRA both procedurally sounder and substantively more effective.

Conclusion

Thank you again for the opportunity to testify before you today on these important matters. As I mentioned at the start of my testimony, we believe that transparency and public input make for better rulemaking. I would add that your oversight also contributes to better enforcement of the rules. In the case of CCAR, better rulemaking will help achieve better economic outcomes, while in areas like the CRA transparency will help achieve the purposes of the original statute. We believe these goals are achievable without abandoning the many improvements that have been made in supervision and regulation since the financial crisis.

I look forward to answering your questions and continuing to work with you on these and other matters.