STATEMENT OF

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BEFORE

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OF THE HOUSE COMMITTEE ON FINANCIAL SERVICES

UNITED STATES HOUSE OF REPRESENTATIVES

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# A HOLISTIC REVIEW OF REGULATORS: REGULATORY OVERREACH AND ECONOMIC CONSEQUENCES

# MARGARET E. TAHYAR BIOGRAPHY

My name is Margaret E. Tahyar, known as Meg, and I head the Financial Institutions Group at Davis Polk & Wardwell LLP where I have been a partner for 26 years and where I have toiled in the field of banking regulation for 34 years. I am one of the co-authors of the law school textbook, *Financial Regulation and Policy* (Barr, Jackson, Tahyar, 3rd Edition, Foundation Press 2021). In addition to my day job as a partner at Davis Polk, I have, in the past, taught as an adjunct professor at Harvard Law School and Columbia Law School. I represent a large range of financial institution clients of all sizes and business models. I am here today in my individual capacity and not on behalf of any client. The views I express are my own, and not necessarily those of Davis Polk, any client or any other organization with which I have been affiliated.

## Introduction

Chairman Barr, Ranking Member Foster, and members of the Subcommittee on Financial Institutions and Monetary Policy, thank you for asking me to discuss the four overlapping recent regulatory proposals by the Federal Reserve, the OCC and the FDIC.[1] I would note that there are three additional proposals, the modernization of the Community Reinvestment Act, which is public and pending finalization, the proposed changes to the GSIB capital buffer, and pending revisions to the Bank Merger Guidelines, not yet public, which will also interact with these four proposals.[2]

My bottom-line message is that there is no person in the world, not in the private sector, not at the agencies, not in this Committee, not among the academics, think tank policy experts or public policy advocates, who truly understands how these complex proposals interact with each other and, even more importantly, with credit extension, capital formation, the U.S. economy or the role of the U.S. dollar. The future role and structure of the American banking and financial sector is at stake. It is reasonable and wise to implement changes to the regulatory and supervisory framework in light of lessons learned from the bank failures and market turmoil in March of this year. But, these changes should be based on empirical data and carefully considered. Reforms should be targeted to address the real lessons learned, so that they achieve the right policy goals with as much regulatory efficiency as possible. The hugely complex constellation of interrelated proposals, which could radically change the U.S. financial sector, should not be rushed into place out of concern for political timelines.[3] There needs to be a holistic review of how all of the proposals work together with a clear vision of what policy goals are desired and with real cost benefit analysis taking into account the social and economic impacts.

As an example of the complexity, our recently published reference tool for the Basel III end game clocks in at over 240 pages.[4] That is much less than the 1,087 pages of the proposal itself but it is still the longest and most complex memo we have ever written.[5] This complexity, plus the fact that there are six other interrelated proposals, means that time is too tight for the public to meaningfully comment on the many proposals and for Congress to fulfill its oversight role, even with the 120-day comment period.

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[1] Federal Reserve, FDIC, OCC, *Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity*, 88 Fed. Reg. 64028 (proposed July 27, 2023) available at https://www.govinfo.gov/content/pkg/FR-2023-09-18/pdf/2023-19200.pdf; Federal Reserve; Federal Reserve, FDIC, OCC, *Long-term Debt Requirements for Large Bank Holding Companies, Certain Intermediate Holding Companies of Foreign Banking Organizations, and Large Insured Depository Institutions* (proposed Aug. 29, 2023), available at: https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230829a1.pdf, *hereinafter* Long-term Debt Requirements NPR; FDIC, *Resolution Plans Required for Insured Depository Institutions with $100 Billion or More in Total Assets; Informational Filings Required for Insured Depository Institutions with At Least $50 Billion but Less Than $100 Billion in Total Assets* (proposed August 29, 2023), available at: https://www.fdic.gov/news/board-matters/2023/2023-08-29-notice-dis-b-fr.pdf; Federal Reserve, FDIC, *Guidance for Resolution Plan Submissions of Domestic Triennial Full Filers* (proposed Aug. 29, 2023), available at: https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230829b1.pdf; Federal Reserve, FDIC, *Guidance for Resolution Plan Submissions of Foreign Triennial Full Filers* (proposed August 29, 2023), available at: https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230829b2.pdf.

[2] Federal Reserve, FDIC, OCC, *Community Reinvestment Act*, 87 Fed. Reg. 33884 (June 3, 2022) available at https://www.govinfo.gov/content/pkg/FR-2022-06-03/pdf/2022-10111.pdf; Federal Reserve Board, *Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15)* (proposed July 27, 2023) available at https://www.federalreserve.gov/aboutthefed/boardmeetings/frn-gsib-20230727.pdf; Department of Justice, *Antitrust Division Banking Guidelines Review: Public Comments Topics & Issues Guide* (December 17, 2021), https://www.justice.gov/atr/antitrust-division-banking-guidelines-review-public-comments-topics-issues-guide.

[3] I realize that certain elements of the Basel III proposal have been in the works for many years, but the world has changed since 2017 and many elements are new.

[4] Davis Polk & Wardwell, *U.S. Basel III Endgame Proposed Rule* (Sep. 14, 2023), https://www.davispolk.com/sites/default/files/2023-09/us-basel-iii-endgame-proposed-rule.pdf.

[5] Special thanks to my partner Luigi De Ghenghi who led the team that produced the memo.

I want to acknowledge the hard work and good faith of the agency principals and staff who have written these proposals while also dealing with bank failures in a difficult year. But, I remain concerned that none of us fully understands the interrelationships and the impact of what is being proposed. I think that concern is the spirit behind the unusual separate statements by some of the principals.

**Structure and Competitive Position of the U.S. Banking Sector**

The three most important concerns about the impacts of the many proposals are:

- what they might collectively do to the competitive position of the U.S. globally systemic banks;
- how they might bring so much pressure on regional banks that the structure of the U.S. banking sector is permanently changed; and
- how they might impact the scope of the U.S. banking sector.

It is very unclear exactly what policy goals the regulators mean to accomplish and how all of these proposals interrelate.

***Global Competitive Position***

When I began practicing law in the late 1980s, a major concern was the global competitive position of the U.S. banking sector. At that time, large U.S. banks with limitations on geography and product mix were competing against European and Asian universal banks that did not face similar limits. It is hard to believe it now, but the largest U.S. banks were smaller and perceived as less competitive than many of their foreign peers. Today, and in light of changes made since the Great Financial Crisis, the largest U.S. banks are among the strongest and the most competitive in the world. Capital has doubled since the Great Financial Crisis and major technological investments have been made.[6] The U.S. global banks are undoubtedly helped by the large American economy, the position of the U.S. dollar, the deep Treasury market and our large and liquid capital markets. But the American economy is also helped by the international reach of our largest banks, especially at a time when we are near-shoring and rebuilding our industrial base.

And yet, certain elements of the Basel III endgame would disproportionately impact U.S. global banks as compared to their international peers, even setting aside the many ways that the U.S. proposed rule is gold plated relative to international standards agreed to in Basel. For example, the operational risk requirements of the Basel III endgame would be significant and would disproportionately affect U.S. banks.[7]

It seems odd to hobble the U.S. global banks in this way at this time, especially after a generation of work that has strengthened their position. I realize that the U.S. banking agencies may feel bound by agreements they have made in Basel, but I question whether enough analysis has been done on whether operational risk is suited for the American market which,

[6] Testimony of Thomas Michaud Before the U.S. House Financial Services Subcommittee on Financial Institutions and Monetary Policy Hearing on “Federal Responses to Recent Bank Failures (May 10, 2023) *hereinafter* “Michaud Testimony.”
[7] As proposed, these requirements would reflect a cap for the component driven by net interest income but no such cap on the components driven by trading and fee income from activities like capital markets and custodial services.

unlike the European and Asian markets, features larger regulatory fines and a higher degree of fee income.

In addition, uniquely, the Basel III capital framework in the United States includes a stressed measure of capital, the Stress Capital Buffer (**SCB**), as a substitute for the internationally applicable capital conservation buffer. The amount of a U.S. firm's SCB is dependent on the outcome of annual supervisory stress tests (**DFAST**) conducted by the Federal Reserve, which in turn depends on the scenarios and assumptions mandated by the Federal Reserve. The Federal Reserve has stated that it is considering mandating additional scenarios in the annual stress tests but have not yet released a proposal or modified scenario design framework describing what those additional scenarios or assumptions would be.

No U.S. banking organization that is subject to the SCB requirement can therefore assess what the ultimate, aggregate impact of all the capital-related proposals – Basel III endgame, long-term debt, G-SIB surcharge and, to the extent applicable, additional DFAST scenarios – would be until and unless it knows what changes will be made to the DFAST scenarios. And no assessment of the aggregate impact on the U.S. banking sector versus its international competitors of all these capital-related proposals can be made in the absence of a complete picture of the additional capital and capital buffer requirements resulting from all of these proposed changes. In short, without a complete set of proposals in front of us, there is no way to assess the impact of the proposals on the U.S. banking sector or the broader U.S. financial sector.

***Structure of the Banking Sector: Regional Banks***

There is another way in which the structure of the U.S. banking sector is unique. Most other developed countries have chosen to live with a banking oligopoly. Their banking markets are concentrated into a handful of banks, some of which have assets that are multiples of their economy.[8] That has not been the policy preference in American banking. We did not have nationwide banking until the mid-1990s. There have been deliberate policy choices to encourage a strong market for regional and community banks and to reject a policy of an oligopoly in banking. The implementation of nationwide banking in this country, when it finally happened, was done in such a way as to encourage the growth of regional and super regional banks.

Congress, as recently as 2018, has endorsed the concept of tailoring for regional banks and many of the most onerous regulations do not apply to community banks. We learned in March that asset size alone is not a good proxy for systemic risk and that the rise in the proportion of uninsured deposits at regional banks had created systemic risk. We now know and must deal with the fact that mid-sized regional banks can pose systemic risks and lead to unexpected losses at the FDIC's deposit insurance fund and unexpected surcharges on the banking sector. There have been many reports pointing out the management and supervisory failures that led to those failures.[9] We should also be frank about the fact that the rapid deposit growth from COVID relief programs, as well as the historically rapid increase in interest rates, also

[8] *See* Lisa Jucca, *Credit Suisse puts new dent in Swiss bank armor*, Reuters: Breakingviews (Mar. 17, 2023), https://www.reuters.com/breakingviews/credit-suisse-puts-new-dent-swiss-bank-armour-2023-03-17/.
[9] Federal Reserve, *Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank* (Apr. 28, 2023), available at: https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf; FDIC, *FDIC's Supervision of Signature Bank* (Apr. 28, 2023), available at: https://www.fdic.gov/news/press-releases/2023/pr23033a.pdf.

contributed to these failures.[10] But it is very unclear how the many interrelated proposals link to the actual reasons behind the failures.

Is it the view of the banking agencies that the U.S. economy should have a barbell banking sector where only community banks and GSIBs survive? Or, is it the view of the banking agencies that a strong vibrant regional banking sector is good for our large and diverse economy? Have we given up on a multi-tiered banking sector for a multi-tiered economy? I consistently hear anecdotally from my regional banking clients that they provide services that neither community nor large banks provide, such as lending to small and medium size businesses in smaller cities and collateralized deposits for states, counties and municipalities. It would be good to have empirical policy studies on the role of regional banks, especially in smaller market cities.

As Thomas Michaud, CEO of KBW puts it:[11]

> Over 60% of the deposits in the country are in banks with over $100 Billion in assets. Yet, these banks don't make 60% of the loans to main street America. Many of these loans are made by mid-sized and smaller banks. Deposit flows to banks based on size will ultimately disrupt the availability of credit in smaller communities. Deposits are the fuel that power loan growth.

Mixed signals are being sent by the regulatory agencies about their views on the future of regional banks. One the one hand, mergers among regional banks who want to grow to fund technology and risk investments are being discouraged by the uncertain future of bank merger policy changes and by the regulatory risk related to the required approvals.[12] On the other hand, the over calibration of the long-term debt and total loss absorbing capital (**TLAC**) requirements, and any pre-mature push to single point of entry (**SPOE**) resolution plans, along with required technology investments, seem to be pushing regional banks into mergers. More long-term debt and TLAC to a broader range of regional banks may be warranted, but let us think carefully about the calibration and timing of the amounts, especially in a time of high interest rates. As has been noted, increases in capital requirements will automatically increase the amount of long-term debt and TLAC.[13]

***Scope of the Banking Sector***

Another question is how the interrelated proposals will impact the scope of the U.S. banking sector. The U.S. banking sector no longer has a majority of the market for mortgage origination, with sharp declines since the Great Financial Crisis.[14] It is unclear whether this shift to a less regulated sector was a deliberate policy choice, a result of market competition or an accident. Most certainly, the choice to impose higher risk weights on mortgages, higher than imposed by Basel, will accelerate that shift. The lack of a preferential risk weight for non-public companies

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[10] *See, e.g.,* Travis Hill, FDIC Vice Chairman, Bipartisan Policy Center, Recent Bank Failures and the Path Ahead (Apr. 12, 2023), https://www.fdic.gov/news/speeches/2023/spapr1223.html.

[11] Michaud Testimony.

[12] It is misleading to state that banking agencies approve virtually all merger applications based on the public record when, behind the veil of confidential supervisory information, banks are discouraged from entering into mergers even before they are announced or are encouraged to "voluntarily" withdraw their applications.

[13] Michelle W. Bowman*, Statement by Governor Michelle W. Bowman on the Proposed Long-term Debt Requirements and Proposed Guidance for Resolution Plan Submissions of Domestic Triennial Full Filers,* (Aug. 29, 2023), available at https://www.federalreserve.gov/newsevents/pressreleases/bowman-statement-20230829.htm.; *See* Long-term Debt Requirements NPR at fn. 83.

[14] *See* Orla McCaffrey, *Nonbank Lenders Are Dominating the Mortgage Market*, Wall Street Journal (June 22, 2021), https://www.wsj.com/articles/nonbank-lenders-are-dominating-the-mortgage-market-11624367460.

also raises the question whether banks will be incentivized to make those types of loans in the future, keeping in mind the increasing role of those types of companies in the U.S. economy. In a similar fashion, the pay day lending sector grew after banking regulators imposed limits on small-dollar borrowing in the aftermath of the Great Financial Crisis, and it is safe to say very few view that as a positive development for consumers. The lesson here is that well-intentioned changes to regulations may inadvertently heighten systemic and consumer risk by pushing products outside the banking sector. Sometimes that shift may be beneficial and sometimes it is not. Systemic risk and run risk may appear in other parts of the financial system, out of sight and out of mind for prudential regulators. The challenge here, as it was before the Great Financial Crisis, is that the mission of each agency is limited to its regulatory perimeter and not to the system as a whole.

**Planning for Bank Failures**

Much of the policy shift and regulatory work since the Great Financial Crisis has been to try to make banks safe to fail. Safe to fail does not mean that a bank failure will be easy or lack pain. It also doesn't mean that there will never be any systemic risk in a bank failure. As FDIC Director Jonathan McKernan has recently stated, "We should acknowledge that bank failures are inevitable in a dynamic and innovative financial system."[15]

Before the Dodd-Frank Act, and then again on a temporary basis during the COVID pandemic, the FDIC had the power to temporarily raise the deposit insurance limit for a fee. There were runs on mutual funds and repos during the Great Financial Crisis but not a run on uninsured deposits of the type we saw in March. Unfortunately, the policy choices around the lack of deposit insurance reform or no longer providing temporary power to the FDIC to raise the deposit insurance limit increase the possibility of more deposit runs in the future. We can expect that more and more small and medium sized businesses have taken the lesson from the March Turmoil that they should be multi-banked.

Another major policy goal post-Great Financial Crisis has been to impose losses on bond holders, unlike in the Great Financial Crisis where shareholders were wiped out, but bond holders were not.[16] That goal was achieved in the March Turmoil in that public bond holders were wiped out by receivership or are in the bankruptcy court.[17] This major shift in policy worked and is being further reflected in the agencies' focus on long-term debt and TLAC. The goal is to increase the layer of bail-in debt that can provide a cushion in the event of unexpected losses. What we have learned, however, is that imposing losses on uninsured depositors is not viable because of the risk of runs. Because there is currently no appetite to extend deposit insurance more widely on a permanent basis, the most viable plan seems to be the agencies' long-term debt and TLAC proposals, which I will note have benefited from an advanced notice of proposed rulemaking. Even so, the long-term debt and TLAC proposals need to be carefully calibrated, subject to a long transition and may not make sense for all regional banks.

Another key area of policy reform following the Great Financial Crisis was the requirement for larger banking organizations to prepare resolution plans, known informally as living wills. Living

[15] Jonathan McKernan, *Statement by Jonathan McKernan, Member, FDIC Board of Directors, On Resolution of First Republic Bank*, (May 1, 2023), available at: https://www.fdic.gov/news/speeches/2023/spmay0123.html .
[16] Management, which is dependent on equity compensation, already suffered losses when shareholders were wiped out.
[17] For example, holders of Credit Suisse AT1 bonds took losses ahead of shareholders under the terms of the bonds and were wiped out. *See Explainer: What are AT1 bonds and why are Credit Suisse's wiped out?*, Reuters (Mar. 24, 2023), https://www.reuters.com/markets/why-markets-are-uproar-over-risky-bank-bond-known-at1-2023-03-24/.

wills work because, as former Treasury Secretary Geithner once said, “plan beats no plan.”[18] But, they should not be expected to work perfectly, or to ensure that a bank failure brings no pain. U.S. Army officers are taught that no plan completely survives first contact with the enemy. It is the same with living wills. For me, the critiques some commentators have made on living wills following the March Turmoil are misplaced, especially because they come from those who have not actually read a full living will. Living wills are not designed to prevent bank failures. They also cannot prevent, as we have learned, systemic risk from building up in a system facing rapid change from deposit growth and interest rate hikes.

The way to think about living wills, whether they use SPOE or multiple point of entry (**MPOE**), is as a successful decade long iterative process between the banking sector and regulators that is designed to make the informational flows, operational processes and actual around-the-clock work required in a bank failure flow more smoothly. Some of the wisest changes in the four proposals involve improvements to the content included in living wills and associated capabilities. These include a renewed focus on virtual data rooms, key personnel, key depositors, valuation capabilities and affiliate relationships. That said, Congress should be concerned with the fact that there are two different living wills regimes under two different statutory authorities with different requirements, consequences, timings and standards. Congress should also be concerned about the different standards for credibility in the two different rules and how confidential supervisory capabilities testing could be used as a standard for a credibility review or even enforcement. Every system can be improved after it has had contact with the enemy in battle and the proposals that the agencies have made with respect to living wills have many sensible components to them.

Another question that Congress should be concerned with is whether increasing the frequency of resolution submissions, as proposed by the FDIC, will be effective if banks do not receive timely, constructive feedback. In 2019, the agencies extended the timeframe for living will submissions to two or three years, in part because they acknowledged that an annual submission cycle did not provide sufficient time for the agencies to review plans for firms to address agency feedback.[19] The FDIC is proposing to increase the frequency of resolution submissions to once a year, in addition to the other living wills requirement, and it is reasonable to ask whether that will bring improvements to the system if the iterative process above cannot effectively happen. This may be, in part, an issue of talent management and resources at the agencies.

Resolvability of banks might be improved through an effective implementation of Section 166 of the Dodd-Frank Act, a statutory mandate which has existed since 2010 and which would establish a series of specific remedial actions to be taken by a financial institution that is experiencing distress.[20] If done right, and empirical study is needed here, well-structured early remediation could provide the FDIC with more time to plan for resolution by making sure the agency is brought in earlier. The FDIC similarly may be able to build itself a longer runway by working to increase its access to real-time data on the health of banks.[21] Similarly, it would be

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[18] *See* Zachary A. Goldfarb, *Treasury’s Timothy Geithner finds his footing,* The Washington Post (June 7, 2011), https://www.washingtonpost.com/business/economy/geithner-finds-his-footing/2011/05/24/AGY0CSLH_story.html.
[19] Federal Reserve, FDIC, *Resolution Plans Required*, 84 Fed. Reg. 59194 (Nov. 1, 2019) available at https://www.govinfo.gov/content/pkg/FR-2019-11-01/pdf/2019-23967.pdf.
[20] David Portilla, *The March 2023 Banking Sector Turmoil: Policy Considerations for the Regulation of Large Banking Organizations*, American Bar Association (Aug. 28, 2023), https://www.americanbar.org/groups/business_law/resources/business-law-today/2023-august/march-2023-banking-sector-turmoil/.
[21] *See* Jelena McWilliams, FDIC Chairman, From Principles to Practice: Improving and Modernizing Bank Supervision, Federal Reserve Board Conference on “Bank Supervision: Past, Present, and Future” (Dec. 11, 2020) (“[A] modernized and automated data system would also improve the ability of supervisors to identify bank-specific and system-wide risks sooner and more efficiently.”).

helpful if the FDIC would finalize its 2013 proposal on the use of an SPOE strategy to resolve systemically important financial institutions.[22]

**Conclusion**

There are too many proposals happening at the same time with too many unintended consequences for the economy and the financial sector. It is unreasonable to think that there is enough time for Congress to engage in effective oversight and for the private sector and public advocates to seriously engage. Every policy choice requires a balancing of costs and benefits, which is the key job of the regulators acting under Congressional oversight. What exactly is the endgame here and what exactly are the goals for the banking and broader financial sector? Who is watching over the system as a whole?

In the appendix to this written testimony, I have listed more technical questions and pointed out some of the unintended interactions in the proposals for which comments are all due on November 30th. There are many more like these that could be gathered.

[22] FDIC, *Resolution of Systemically Important Financial Institutions: The Single Point of Entry Strategy*, 78 Fed. Reg. 76614 (Dec. 18, 2013) available at https://www.govinfo.gov/content/pkg/FR-2013-12-18/pdf/2013-30057.pdf.

**Appendix: Examples of Interactions in Recent Regulatory Proposals that Deserve a Closer Look**

1. Increases to risk-weighted assets under the Basel III endgame proposal would require firms to hold more TLAC and long-term debt by increasing the denominator of the risk-based TLAC and long-term debt ratios. Furthermore, firms that are already subject to the TLAC rule would have their TLAC amounts subject to an additional haircut under the long-term debt proposal.

2. Relationship and overlap between various aspects of the Basel III endgame proposal – e.g., operational risk, expected shortfall methodology underlying market risk – and the annual DFAST scenarios and assumptions mandated by the Federal Reserve. Are there risks that are being capitalized twice on a stressed basis?

3. How does the biennial cycle proposed for IDI Rule living wills intersect with the 165(d) Rule triennial cycle? Who files when and are MPOE filers doing extra work because of the submission cycle mismatch?

4. Why do MPOE filers need to do a quasi-least cost test under the 165(d) Rule guidance even though they are not required to under the IDI Rule proposal? How can the least cost test be calculated theoretically in the absence of bids?

5. Why are there two living wills rules under two separate legal regimes? What is the point of asking banks that have an SPOE plan to also prepare a bridge bank plan?

6. How does the gold plating for residential mortgage risk weights in the Basel III endgame proposal interrelate to the declining position of the U.S. banking sector in the mortgage markets and how does it interrelate to the pending Community Reinvestment Act proposal?

7. When will the Department of Justice release revised Bank Merger Guidelines so that their interaction with the four proposals can be assessed?

8. How does the gold plating for residential mortgage risk weights in the Basel III endgame proposal interrelate to the need for more low and moderate housing in many parts of the U.S.?

9. How was the long-term debt amount calibrated for regional banks under the proposal? Why is it the same as the amount as required for U.S. intermediate holding companies of foreign GSIBs?

10. Why do the capital rules discourage credit to small and medium-sized entrepreneurs by avoiding preferential risk weights for exposures to non-public companies? Why are non-public companies, some of which are quite large, seen as riskier than public companies?

11. How does the gold plating for risk weights for non-public companies relate to the higher growth in large, non-public companies and the decline in public companies over the last several years?