April 14, 2017

The Honorable Mike Crapo, Chairman
The Honorable Sherrod Brown, Ranking Member
Committee on Banking, Housing, and Urban Affairs
United States Senate
534 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Crapo and Ranking Member Brown:

On behalf of the Bipartisan Policy Center, I am pleased to submit four proposals to improve financial regulation to foster economic growth. We applaud your timely request for such proposals as it is increasingly possible to assess empirically how the many policy reforms put into place since the 2007-2008 financial crisis are working in practice.

From its inception in 2012, BPC's Financial Regulatory Reform Initiative has made nearly 200 recommendations focused on promoting financial regulation that appropriately balances the goals of promoting economic growth, financial stability, and the needs of consumers.

Our broad assessment of post-crisis reforms is that they have made the financial system safer and better protected consumers, but as with any major policy change, those reforms also have led to unintended consequences that should be addressed. These unintended consequences include:

- The existence of multiple binding constraints on the business decisions of financial firms, sometimes resulting in "cliff effects" in which the provision of financial services to certain consumers and businesses experiences a sudden and steep reduction due to one or more regulations rather than competitive market factors;
- The migration of certain activities from banks to nonbanks or across borders, and the curtailment of other activities;
- A lack of coordination, and unnecessary duplication and conflict in rules, reflecting the fragmentation of the U.S. financial regulatory structure; and
- Continuing gaps in regulation.

While lending in general has experienced a steady recovery since the financial crisis, BPC's research has concluded that the extension of credit to low- and moderate-income consumers and to new and small businesses has experienced a slower recovery than other market segments.

Implementing the four recommendations included in this letter would begin to address the unintended consequences of post-crisis reforms, boosting economic growth and helping financial institutions better serve their customers, while also giving current and future regulators and policymakers a better sense of what is working and not working in the U.S. financial regulatory system. Although it is difficult to quantitatively assess the full impact of our four recommendations at this time as you requested, we provide our preliminary thoughts on the likely impact on economic growth, consumers, market participants, and financial companies for each recommendation.

Recommendation 1: Conduct Periodic Assessments of the Financial Regulatory Environment

Now that most post-crisis reforms have been implemented, U.S. policymakers are positioned to empirically assess how well those reforms are working in practice. They should evaluate both the intended and unintended consequences of regulation, including: the extent to which regulation is causing certain financial activities and products to no longer be offered, or causing them to migrate from banks to nonbanks; the consequences of the continued fragmentation of the U.S. financial regulatory structure; the impact of multiple binding regulatory constraints on the business decisions of financial firms; and the existence of gaps in regulation.

There are three inter-related and complementary parts to our first proposal.

Formal FSOC Assessment. First, the Financial Stability Oversight Council (FSOC) should coordinate and conduct a formal assessment of the U.S. financial regulatory structure and its impact on the economy of consumers, including businesses. This assessment should include a public call for evidence along the lines of the one initiated by the European Commission in 2015.

Congressional Financial Sector Review Commission. Second, Congress should create an independent Financial Sector Review Commission (Commission) to periodically assess whether the financial regulatory system appropriately balances economic growth, financial stability, and the needs of consumers. The assessment should consider whether additional changes are needed, and evaluate the marginal benefits of those changes. A model for such an assessment is Canada, which conducts a full financial sector review approximately every five years.

The Commission should report regularly to Congress and the public and consider the following questions in formulating its recommendations:

- Are consumers, small and large businesses, and investors well served by the current financial regulatory framework and rules? Do consumers and other potential borrowers have access to affordable credit? What are the economic costs and benefits of regulation, including the impact on access to credit?

- How are different groups of consumers, businesses, and investors being affected differently by financial regulation, and can changes be made to ameliorate any significant negative effects?

- Are there rules that are unnecessarily duplicative, in conflict with each other, or otherwise causing unintended negative consequences?

- Are there significant gaps in regulation?

- Does the U.S. financial regulatory structure unnecessarily limit coordination among regulatory agencies or otherwise result in less-than-optimal outcomes?

- Do policymakers have the data and tools they need to assess (quantitatively and qualitatively) stability, growth, and the needs of consumers, businesses, and investors? Are they encouraged to do so?

- Do regulators have the data and tools necessary to address risky activities, particularly outside of the regulated banking sector?

- To what extent can the costs and benefits of regulation be measured empirically, and when is it appropriate to conduct a cost-benefit analysis?

OFR Economic Impact Assessment. Finally, Congress should explicitly authorize the Office of Financial Research (OFR) to independently evaluate and report to Congress on the impact of regulation on economic growth and the impact of the financial system and financial regulation on consumers and businesses. Currently, the OFR's mandate focuses only on financial stability. Congress should ensure that the OFR has full access to all relevant data to conduct its reviews, including access to data collected by other regulators.

Likely impact on economic growth, consumers, market participants, and financial companies
Regulators need to be able to adapt to ever-changing market conditions, technologies, and techniques for participating in markets. A periodic, independent, evidence-based assessment that calls for public evidence would not only create an institutional mechanism for focusing the attention of the public and policymakers on how well the financial regulatory system is working to support the economy, but also provide policymakers with a regular opportunity to improve upon it. For example, the European Union's call for evidence has resulted in a number of potential recommendations to boost economic growth.

Recommendation 2: Review Supplementary Leverage Ratio

The Supplementary Leverage Ratio (SLR) was intended to function as a backstop to risk-based capital requirements, but U.S. regulators have raised it above the minimum standard agreed to by global regulators. This has made the SLR a binding constraint for some banks. The SLR applies capital charges to all assets, even those that are risk-free such as cash held at the Federal Reserve, creating perverse incentives to hold riskier assets.

In some cases, the capital charges are duplicative. For example, bank clients post initial collateral (margin) for derivatives to offset potential future exposures for those transactions. Banks are not allowed to net customers' margin for capital purposes, even when the positions are made through a CCP. Former Commodity Futures Trading Commission (CFTC) Chairman Timothy Massad has said he is concerned that the current SLR definitions do not take collateral posted by customers and held by clearinghouses into account.

Over time, these constraints may impact credit extension. In response to similar concerns, the Bank of England announced last summer that the United Kingdom's leverage ratio requirement would exclude central bank claims, including cash and reserve deposits, from the leverage ratio denominator. The Bank of England further said there would be merit in the Basel Committee allowing for client margin to reduce dealers' potential future default exposures in centrally cleared derivatives transactions.

Regulators should not discourage banks from holding reserves at the Federal Reserve. Similarly, recognizing how posted client margin in derivatives transactions are treated by clearinghouses is indicative of the fact that not all assets are the same.

Congress should ask the Federal Reserve, coordinating with the FDIC and the Office of the Comptroller of the Currency, to review the SLR definitions to assess whether to exempt certain types of nearly risk-free assets—such as reserves held at the Federal Reserve and initial client margin for derivatives transactions—from their currently required capital charges.

Likely impact on economic growth, consumers, market participants, and financial companies
Exempting nearly risk-free assets from leverage ratio calculations would allow financial firms subject to the ratio to extend more credit to borrowers, without obvious harms to financial stability.

Recommendation 3: Create a Consolidated Examination Force Pilot Program
The U.S. financial regulatory system is fragmented, leading to overlapping and/or conflicting rules, gaps in regulation, and inefficiencies. Many banks are subject to regulation from multiple regulators at once, each asking for similar information in different ways, and not always communicating with one another about what they find. One regional bank CEO recently said that in 2016, the bank he heads:

> "… faced 27 different examinations from six regulatory agencies. Examinations were ongoing during 50 of the 52 weeks of the year, with as many as six exams occurring simultaneously. In advance of these reviews, [the bank] received more than 1,200 distinct requests for information, and provided more than 225,000 pages of documentation in response. The onsite visits themselves were accompanied by an additional, often duplicative, 2,500 requests that required more than 100,000 pages to fulfill."

Regulation and the compliance requirements that go with them are necessary for a well-functioning financial system. However, such duplication and lack of coordination only raises costs for banks and their consumers without obvious benefits.

In the Dodd-Frank Act, Congress missed an opportunity to streamline and better rationalize the U.S. financial regulatory structure in a way that would address these issues and reduce costs to taxpayers and financial firms. An ideal solution would consolidate similar supervisory functions at multiple agencies into a single agency, for example.

Such a solution has proven to be politically difficult to achieve in the past. However, many of the benefits of regulatory consolidation could be realized within the existing regulatory structure. To that end, Congress should create a pilot program for a consolidated examination force to improve the efficiency and quality of bank supervision.

The examination force would make up an interagency team of supervisory staff from the three prudential banking agencies: the Federal Reserve Board, the FDIC, and the OCC. The agency that serves as a bank's primary regulator would lead the team, which would jointly examine a bank, asking a single set of questions and issue a single examination report that would be available immediately to each participating agency. State regulators would be invited to participate, which would give them access to the expertise and specialized resources of federal agencies. No agency that did not already have jurisdiction over a bank would be included in an examination team assigned to that bank.

To test the feasibility of the examination force, the pilot program should be implemented by the Federal Financial Institutions Examination Council (FFIEC), an existing body designed to foster coordination among financial regulators. The pilot would allow the FFIEC to develop interagency standards to further improve communication and coordination.

The FFIEC and its member agencies could establish and conduct a pilot program under existing law. If they do not, Congress should pass legislation ensuring that those agencies do so.

Likely impact on economic growth, consumers, market participants, and financial companies
A consolidated examination force should reduce unnecessary compliance costs for financial firms, allowing them to focus on lending and other economically productive activities and reduce costs to consumers and other market participants.

Recommendation #4: Direct the CFPB to Address Problems Accessing Credit
While lending, in general, has steadily increased since the 2007-2008 financial crisis, affordable credit has been difficult to access for certain segments of consumers and businesses. In particular, small business and mortgage lending have been slow to recover. And since many entrepreneurs use home equity to fund start-up companies, mortgage lending is a substantial driver of economic dynamism.

The Consumer Financial Protection Bureau (CFPB) may be able to alleviate some of these issues without negatively impacting financial stability.

A number of factors—such as the CFPB's Qualified Mortgage rule, requirements to repurchase certain loans, and litigation fears—have tightened standards for mortgage credit and increased the cost of consumer banking. According to one estimate, another 5.2 million mortgage loans would have been made between 2009 and 2014 if credit standards had been similar to those that prevailed in 2001, well before the crisis.

The reliance in lending decisions on FICO scores as a guide to a borrower's creditworthiness can contribute to "cliff effects," in which credit access faces a deep contraction not tied to competitive market factors. Rather than a gradual decrease in lending as credit risk increases, consumer lending has dropped off more precipitously, as FICO scores of 660 and 700. This suggests that regulation is a significant factor in mortgage-lending decisions. There is also evidence of cliff effects in credit card lending, where consumers with lower FICO scores have opened a smaller share of new accounts since the crisis.

With the rise of "big data," alternative to FICO scores to evaluate creditworthiness could be useful to gauge the ability of borrower to repay loans. The CFPB was wise to recently issue a formal request for information on the potential effectiveness of alternative credit-scoring models, and Congress should encourage the agency to energetically pursue this line of inquiry.

Moreover, if an action taken by the CFPB is likely to restrict consumers' access to credit, then the CFPB should develop and publish metrics for determining whether the restriction is part of an intended regulatory response (such as reducing the availability of credit cards with high credit lines for college students or applicants under the age of 21) and when it has an unintended consequence (such as restricting access to responsible products for college students who are trying to build a credit history). When issuing rulemaking or guidance that would restrict the availability of credit products or product features, the CFPB should indicate the steps it is taking, if any, to identify and address the credit needs of the affected population and ameliorate the impact.

Likely impact on economic growth, consumers, market participants, and financial companies
These actions will create opportunities for consumers to access affordable credit without creating undue risk. In particular, addressing mortgage and credit card lending should help entrepreneurs to start and grow small businesses and create jobs.

In closing, these four recommendations are drawn from a series of seven major BPC reports to improve the regulation and supervision of financial services and better serve consumers and the economy. BPC's Financial Regulatory Reform Initiative, co-chaired by Martin Baily of the Brookings Institution and Phillip Swagel of the University of Maryland—has issued reports on resolution planning, systemic risk, capital markets, consumer protection, regulatory architecture, insurance, and the role of large banks in the economy.

Our 2016 report, "Did Policymakers Get Post-Crisis Financial Regulation Right," concluded that: "It is time for policymakers to assess the cumulative impact of the regulations on the condition of the financial system, economic growth, and all end-users of financial services including consumers, small and large businesses, and investors."

For your reference, we are enclosing a copy of all of BPC's past recommendations for financial services regulatory reform as well as copies of our white papers. Proposed legislative language for the above recommendations is also included. Thank you for your consideration. We welcome the opportunity to work with you and your congressional colleagues in the future.

Respectfully,

Justin Schardin
Director, Financial Regulatory Reform Initiative
Bipartisan Policy Center