Center for American Progress

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The Honorable Jeb Hensarling
Chairman
United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

The Honorable Maxine Waters
Ranking Member
United States House of Representatives
Committee on Financial Services
4340 Thomas P. O'Neill, Jr. Federal Office Bldg.
Washington, D.C. 20515

Dear Chairman Hensarling and Ranking Member Waters,

This week the U.S. House of Representatives—in a sign of things to come next Congress—will vote to restrict financial regulators' ability to preserve the financial stability of the U.S. economy. H.R. 6392, the "Systemic Risk Designation Improvement Act of 2016[i]," eliminates the Federal Reserve's ability to use an important set of prudential and supervisory tools that were put in place by section 165 of the Dodd-Frank Wall Street Reform and Consumer Protection Act[ii] as a response to the lessons learned in the 2007-2008 financial crisis. These changes reflect a breathtaking degree of historical amnesia, and a willingness to allow the U.S. financial system to recreate excesses that led to the Financial Crisis of 2008 and the Great Recession that it helped create.

Instead of being able to use these enhanced tools in a tailored fashion, to prevent the activities of banks with assets in excess of $50 billion from creating threats to financial stability, the Fed's reach will be sharply limited. Except for the eight largest U.S. banks, currently designated as Global Systemically Important Banks[iii], the Federal Reserve Board's authority will automatically vanish, and can be restored only on a case-by-case basis, with an extraordinary degree of difficulty and delay that is only likely to increase in the future.

If H.R. 6392 becomes law, many large banks with hundreds of billions of dollars in assets, will immediately be exempt from Fed's ability to require:

- Stress tests– Periodic quantitative estimates of the effects of stressed financial market conditions, such as asset price declines, on the solvency of individual banks[iv].
- Liquidity rules – These rules (such as the Liquidity Coverage Ratio[v] and Net Stable Funding Ratio[vi]) reduce the risk that bank creditors will "run" during periods of financial market stress, forcing banks into asset fire sales that further destabilize markets.
- Higher leverage requirements – Rules that require banks to fund more of their assets through the use of stockholder funds, making them better able to absorb losses.
- Resolution plans ("living wills") – Plans that show how a bank can be wound down in an organized manner upon failure, thereby avoiding the need for public bailouts[vii].
- Risk management standards – Requirements that banks form risk committees to self-monitor their ability to survive financial market reversals.

Many banks of the size contemplated for deregulation under this legislation (above $50 billion) played a central role in creating and exacerbating the financial crisis of 2007-2008. They originated large volumes of high risk and predatory subprime and Alt-A mortgages, and packed these bad loans into subprime residential mortgage-backed securities (RMBS). Countrywide, a thrift bank with about $200 billion in assets, was the number three subprime mortgage originator, the number one issuer of subprime RMBS, and the number two issuer of Alt-A mortgages in 2006[viii]. Washington Mutual (WaMu), a thrift bank with about $300 billion in assets, was the number five issuer of subprime RMBS, and the number five issuer of Alt-A mortgages[ix].

Even smaller financial actors played similar roles. New Century Financial Corporation, with assets of only $20 billion, was the second largest originator of subprime mortgages and RMBS in 2006[x]. Other small mortgage banks, such as Fremont, Ameriquest, and Option One were also in the top 10 in both categories[xi].

When the housing price bubble burst, these banks were at the center of the collapse, rescue, and bailout. Countrywide[xii], WaMu[xiii], Wachovia[xiv] and more all experienced large losses. With insufficient equity capital to handle their losses, and lacking liquid assets to handle runs on their short-term funding, they were rescued by merging into other banks. In fact, the rescuing firm itself often required a special deal from the Federal Reserve or a large bailout by the taxpayers to sustain its solvency[xv].

These examples from the financial crisis show that banks of surprisingly modest size can play important roles in the creation of financial instability. As the bipartisan Levin-Coburn Senate Permanent Subcommittee on Investigations report noted, firms like WaMu helped to create instability long before their failure contributed to the sense of panic in U.S. financial markets[xvi]. They failed because they were engaged in high-risk activity which they did not closely analyze or understand, had grossly insufficient equity capital to cover the losses to which they were exposed, and had not positioned their balance sheet to withstand the liquidity crises they faced when they lost access to short-term borrowing in the capital markets.

These failure factors are precisely what section 165 of the Dodd-Frank Act targets and what this first deregulatory opening gambit would undo.

For example, had they been subject to stress tests, regulators should have been able to appreciate their vulnerability to swings in housing prices. Higher equity capital requirements would have given them a greater ability to absorb losses. And they would have been required to maintain adequate liquidity to help them survive an unexpected run on their short-term borrowing. Moreover, they would have had risk committees, who might have cautioned their boards about the dangers to which their businesses were exposed. And they would have had resolution plans in hand, so that upon failure, federal regulators would know how to shut them down, eliminating the need to rapidly engineer government-assisted mergers with large banks.

Taken together, these prudential and supervisory changes would have reduced the scale of their participation in predatory lending and the house price bubble, made their individual collapse less likely, and reduced the likelihood of the crisis itself.

Incredibly, H.R. 6392 would instantaneously do away with these practical, effective constraints on the sources of financial instability.

What is amazing, though, is that this legislation is being sold as a doing something helpful for the regional and community banks. Far from it. Regulators today tailor their regulation and supervision to banks of different sizes. The $50 billion threshold established by the Dodd-Frank Act was intended to ensure the step up into heightened supervision would come both at an appropriate stage in terms of broader risk, but also was flexible enough to allow for gradual scaling to the needs and risks of different size institutions.

If this risk-increasing, irresponsible piece of legislation is the opening gambit of an upcoming rewrite of the post-crisis rules, then the American economy and taxpayers are surely in for trouble.

And in fact, this legislation cannot be considered in isolation. It must be evaluated against the backdrop of upcoming changes to policy and personnel that may be put in place by President-elect Trump.

For example, under H.R. 6392, the Financial Stability Oversight Council could restore these necessary protections only by engaging in a process designed to be slow and difficult. But further changes to this process, contemplated by House Financial Services Committee Chairman Jeb Hensarling's "Choice Act[xvii]," would render it nearly unusable.

Moreover, if President-elect Trump were to put in place regulators that shared the libertarian perspective that dominated regulators prior to the financial crisis – and which some of his advisers appear to share as well – then Wall Street would be right back in the business of conducting its own supervision and oversight. Basically, this is right back where we started before the 2008 financial crisis wreaked havoc with the U.S. economy, the federal budget, and American middle class economic security, the very havoc that President-elect Trump capitalized on in this election.

Sadly, this vote is a sign of things to come, and consideration in the halls of Congress cannot be with a business-as-usual mindset. It should be of deep concern that the next Congress will seek to undo large swaths of the progress made by the Dodd-Frank Act. This bill is only the beginning. Anyone in Congress concerned with preventing a repetition of the recent financial disaster must re-orient themselves immediately to the new environment they face. Failing to do so would be a betrayal of every American who lost a job, a home, savings, or hope for the future in the last financial crisis.

Sincerely,

Marc Jarsulic
Vice President
Economic Policy

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[i] Systemic Risk Designation Improvement Act of 2016, H.R. 6392, 114 Cong. 2 sess. (Government Printing Office, 2016).
[ii] Dodd Frank Wall Street Reform and Consumer Protection Act, H.R. 4173, 111 Cong. 2 Sess. 124 Stat. 1376–2223, (GPO, 2010)

[iii] Financial Stability Board, "2015 update of list of global systemically important banks (G-SIBS)," November 2015, available at http://www.fsb.org/wp-content/uploads/2015-update-of-list-of-global-systemically-important-banks-G-SIBs.pdf

[iv] See Federal Reserve Board, "Stress Tests and Capital Planning," June 2014, available at https://www.federalreserve.gov/bankinforeg/stress-tests-capital-planning.htm.

[v] See Federal Reserve Board, "Federal Banking Regulators Finalize Liquidity Coverage Ratio," Press release, September 3, 2014, available at https://www.federalreserve.gov/newsevents/press/bcreg/20140903a.htm.

[vi] See Federal Reserve Board, "Agencies Propose Net Stable Funding Ratio Rule," Press release, May 3, 2016, available at https://www.federalreserve.gov/newsevents/press/bcreg/20160503a.htm.

[vii] See Federal Reserve Board, "Resolution Plans," June 2016, available at https://www.federalreserve.gov/bankinforeg/resolution-plans.htm.

[viii] 2008 Mortgage Market Statistical Annual published by Inside Mortgage Finance Publications Inc. Copyright 2008.

[ix] Ibid.

[x] Ibid.

[xi] Ibid.

[xii] "Countrywide, GMAC Posts Big Losses on Mortgages," Reuters, April 29, 2008, available at http://www.cnbc.com/id/24366255

[xiii] Peter S. Goodman and Gretchen Morgenson, "Saying Yes, WaMu Built Empire on Shaky Loans," *New York Times*, December 27, 2008, available at http://www.nytimes.com/2008/12/28/business/28wamu.html.

[xiv] David Ellis, "Wachovia suffers nearly $24 billion loss," *CNN*, October 22, 2008, available at http://money.cnn.com/2008/10/22/news/companies/wachovia_results/?postversion=2008102207.

[xv] Each referenced rescuing firm, Bank of America, J.P. Morgan, and Wells Fargo, received TARP funds via the Capital Purchase Program. See U.S. Department of the Treasury, "Capital Purchase Program," October 2015, available at https://www.treasury.gov/initiatives/financial-stability/TARP-Programs/bank-investment-programs/cap/Pages/overview.aspx.

[xvi] Senate Permanent Subcommittee on Investigations, "Wall Street and the Financial Crisis: Anatomy of a Financial Collapse," Majority and Minority Staff Report, April 13, 2011, available at http://www.hsgac.senate.gov//imo/media/doc/Financial_Crisis/FinancialCrisisReport.pdf?attempt=2.

[xvii] The Financial Choice Act of 2016, H.R. 5983, 114 Cong. 2 sess. (Government Printing Office, 2016).