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VICE CHAIRMAN

November 30, 2015

The Honorable Richard Shelby
Chairman
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, DC 20510

The Honorable Sherrod Brown
Ranking Minority Member
Committee on Banking, Housing and Urban Affairs
United States Senate
Washington, DC 20510

Dear Chairman Shelby, Ranking Member Brown and Members of the Committee,

As you work to address the regulatory burden of American banks, I am writing to provide my own views in the hopes that relief can be provided in a manner that is meaningful without compromising bank safety and soundness or weakening financial system protections. I draw my recommendations from more than four decades in bank supervision as the President of the Federal Reserve Bank of Kansas City and now as the Vice Chairman of the FDIC.

There is no question that some classes of banks face significant compliance burdens that are disproportionate to their risk and business model. However, in the effort to cull incommensurate regulations, I strongly caution against easing or repealing rules that are appropriately calibrated to the risk that specific bank practices pose to the financial system and broader economy.

Volcker Rule

One of the most important provisions of law that I urge be preserved without exemption or repeal is Section 619 of the Dodd-Frank Act -- the so-called Volcker Rule that prohibits banks with funding subsidized by the FDIC and the Federal Reserve from engaging in high-risk trading activities and investment strategies.

The Volcker Rule represents an important step toward limiting insured banks from proprietary trading, thereby moderating the incentives for speculation with subsidized funding from insured deposits and ready access to central bank liquidity. Some say that the Volcker Rule poses onerous and costly operational compliance burdens on community banks, so these smaller banks should be exempt. However, the reality is that the vast majority of community banks have virtually no compliance burden associated with implementing the Volcker Rule. Not only do these banks not have proprietary trading operations, but they generally have no trading positions of any kind. In addition, community banks generally do not invest in any private-label securitizations, let alone more complicated hedge funds or private equity funds.

As existing bank regulatory agency guidance[1] already details, community banks with less than $10 billion in total assets are already exempt from all of the Volcker Rule compliance requirements if they do not engage in any of the covered activities other than trading in certain government, agency, state, and municipal obligations. This is the case for the vast majority of community banks.

For the banks under $10 billion that do engage in traditional hedging activities, Volcker Rule compliance requirements can be met by simply having clear policies and procedures that place appropriate controls on the activities -- and which are required regardless of the Volcker Rule. The existence and appropriateness of such policies and procedures can be verified by examiners as part of the regular exam process, and would not require extra compliance assistance from consultants.

Finally, some banks under $10 billion do engage in less-traditional activities that may be restricted by the Volcker Rule. For these banks, there would be some initial compliance requirements to determine their status. These banks represent less than 400 of a total of approximately 6,400 smaller banks in the US. And of these 400, most will find that their trading-like activities are already exempt from the Volcker Rule. However, we have already found a few smaller banks that do engage in riskier activities that should not be backstopped by the taxpayer. For example, we have found small banks investing in collateralized debt obligations, trading equity options, and investing in collateralized loan obligations and auction rate securities. We were even informed of some small bank holding companies that invested in hedge funds as a regular part of their investment selection prior to the passage of the Volcker Rule.

On balance, therefore, exempting smaller banks from the Volcker Rule should not be considered as regulatory relief or a technical adjustment. Exempting smaller banks from the rule would allow them to engage in risky trading and investment activities financed by taxpayer subsidized funds. And an exemption would not serve any practical or public value, nor would it provide meaningful regulatory relief for the vast majority of traditional community banks because they do not engage in the activities that the Volcker Rule restricts.

Regulatory Relief for Traditional Banks

This is not to say that traditional community banks are free of compliance burden. Their burdens come from a range of other regulations -- not from the Volcker Rule -- and they demand our attention. What my experience in bank supervision tells me is consistent with what I hear from many bankers taking deposits and making loans in their communities: the regulations and supervisory requirements that burden them are not the same ones that apply to complex institutions that do both trading and banking. As such, I have suggested that the focus of regulatory relief be directed at bank activity and complexity, and less on bank size. I have

[1] https://fdic.gov/regulations/reform/volcker/summary.html

recommended establishing by statute – not by discretion of regulators on a case-by-case basis – the following objective set of specific criteria for eligibility for relief that emphasizes the importance of strong equity capital and the core commercial banking model. Under the plan, a bank would be eligible for regulatory relief if:

- it holds no trading assets or liabilities,
- it holds no derivative positions other than interest rate and foreign exchange derivatives,
- the total notional value of all its derivatives exposures - including cleared and non-cleared derivatives - is less than $3 billion, and
- it maintains a ratio of Generally Accepted Accounting Principles equity-to-assets of at least 10%

Statutorily defining eligibility for regulatory relief specifically around all four of these criteria – which importantly include at least 10 percent equity capital – reflects the longstanding business models of traditional commercial banks. And because these criteria are objective, they can be enforced with less of an imposition on the banks through off-site call report monitoring and the regular exam process.

Within this framework, then, we can outline meaningful regulatory relief for those well capitalized, more traditional banks that is consistent with safety and soundness:

- Exempting these traditional, solidly capitalized banks from all Basel capital standards and associated capital amount calculations and risk-weighted asset calculations.
- Exempting these banks from several entire schedules on the call report, including schedules related to trading assets and liabilities, regulatory capital requirement calculations, and derivatives.
- Allowing for greater examiner discretion and eliminating requirements to refer "all possible or apparent fair lending violations to Justice" if judged to be minimal or inadvertent.
- Establishing further criteria that would exempt eligible banks from appraisal requirements
- Exempting eligible banks, if applicable, from stress testing requirements.
- Where judged appropriate, allowing for an 18-month examination cycle as opposed to the current required 12-month cycle for traditional banks.
- Mortgages made by these traditional banks that remain in the banks' portfolio would be a qualified mortgage loan for purposes of Dodd-Frank Act.

This proposal, however, would not repeal or create exemptions to reforms, such as the Volcker Rule, that are judged necessary to curb the excesses of the most complex banks that have used the federal safety net to expand, with highly leveraged financing, into areas well beyond traditional banking at a debilitating cost to the American public.

Finally, I want to make clear that regulatory relief cannot be justified for banks that do not have sound capital levels. Regulatory relief must be commensurate with a bank's risk profile, and that includes its capital as well as its business model. Banks that have at least 10 percent tangible equity have a lower rate of bailout or failure[2], and well capitalized banks maintain lending levels[3] over the course of a cycle. Therefore, their position gives regulators, investors, and the public the necessary assurance that it is safe to ease their regulatory burden. Banks with less than 10 percent equity – that is, those that fund their operations with more than 90 percent borrowed money – do not have that stability and thus are more reliant on the safety net, are more likely to be costly to the deposit insurance fund, and are not as well positioned to contribute to the economy during downturns.

As you move forward with consideration of regulatory relief, please let me know if you or your staff have any questions or would like to discuss.

Sincerely,

Thomas M. Hoenig

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[2] Failed bank capital levels: https://www.fdic.gov/about/learn/board/hoenig/Failed%20Bank%20Capital%20Ratios%20at%20YE%202007_03%2026%202015.pdf

[3] Capital and lending: https://www.fdic.gov/about/learn/board/hoenig/Lending%20through%20the%20cycle.pdf