Federal Financial Analytics, Inc.

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Federal Financial Analytics Finds $50 Billion Systemic Rules Cost Regional BHCs $2 Billion-Plus

New Study Shows Systemic Add-On Rules Unnecessary, Create New Risks

WASHINGTON, DC, August 6, 2015 - Federal Financial Analytics, Inc. today released the first study analyzing the direct and indirect costs of systemic-regulatory standards for U.S. bank holding companies (BHCs) with assets over $50 billion that are not large enough, complex enough, or involved in so many non-traditional activities as to pose risks to the overall U.S. financial system and national economy. The study finds that systemic regulation costs regional banks $2 billion per year and could reduce new lending by these banks from 5.7 to 8 percent.

“This cost is significant to each of these BHCs and will require strategic changes that could adversely affect credit availability,” said Karen Shaw Petrou, managing partner of Federal Financial Analytics. “If these costs meaningfully reduced the chances of renewed systemic risk, they would be worth it,” she continued. “However, our study finds that these costs, as well as the indirect ones of systemic standards for smaller BHCs, in fact increase market risk and adversely affect the resolution for some or all of these BHCs, especially in stress scenarios.”

Some have suggested that smaller regional BHCs warrant systemic regulation because many of them could fail at the same time, adversely affecting their regional markets in a systemic fashion or

even threatening national prosperity. This study does not corroborate this concern. Detailing the likely causes of instability or failure to BHCs, this study finds that scenarios in which correlated failures might occur are those in which the overall banking system is under acute stress (e.g., 9/11-style events, natural disaster). Regional BHCs are already under new prudential, risk-management, stress-test, and resolution-planning requirements that significantly increase their resilience not only to events of this sort, but also to more ordinary safety-and-soundness challenges (e.g., economic downturn).

The study notes that forcing regional BHCs to husband capital to meet systemic rules undermines their ability to handle stress through private-sector merger-and-acquisition activities that prevent the need for FDIC intervention, let alone a systemic resolution under the Dodd-Frank Act.

The study also finds that the unintended effects of systemic regulation for these smaller BHCs will accelerate the role played by less regulated "shadow" firms, creating new risks to consumers and, over time, financial stability.

Key points in the new FedFin study include:

- Systemic regulation is warranted where there is systemic risk, but it adds significant cost and reduces the ability of banks to meet market needs when rules are disproportionate to risk. If banks exit traditional lending and deposit-taking services due to heightened, unnecessary regulatory cost, then markets may be under-served and increasingly vulnerable to higher-risk, higher-priced offerings that raise consumer-protection and market-stability risk.

- Due to the absence of like-kind regulation for like-kind financial products, significant market distortions are already evident. Subjecting larger BHCs that are below the GSIB threshold to the additional rules required by the Dodd-Frank Act for BHCs with assets over $50 billion costs these BHCs at least $2 billion a year. This cost could reduce new lending by these banks by 5.7 percent to 8 percent.

- The bulk of this additional cost comes from new capital and liquidity standards imposed on systemic BHCs. The BHCs in this sample generally far exceed minimum capital requirements, but a change in the nominal regulatory threshold determining "well-capitalized" status could still reduce credit capacity.

- Regional BHCs are already subject to stringent stress testing, resolution-planning, credit-exposure limit, and risk-management standards.

- Regulatory add-ons without prudential benefit make it more likely that the FDIC, not the marketplace, will have to rescue a weak or failing regional bank.

- Measuring systemic risk solely by size is no longer viewed as an effective method of determining systemic-risk potential. Many regulators and policy-makers now believe that activities and practices that create undue complexity, contagion, or similar risks are better ways to designate SIFIs regardless of size or charter. Practices that pose complexity, inter-connectedness, substitutability, and related risk are generally absent at the regional BHCs analyzed in this study.

This paper represents the views of Federal Financial Analytics, Inc. Funding for this research was provided by the Regional Bank Coalition, which was not granted editorial authority over the paper's content, methodology, or findings. These are solely the responsibility of Federal Financial Analytics, Inc.

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