MEMORANDUM

To: Members of the Committee on Financial Services

From: FSC Majority Staff

Date: July 7, 2016

Subject: July 12, 2016, Full Committee Hearing Entitled "Making a Financial Choice: More Capital or More Government Control?"

The Committee on Financial Services will hold a hearing at 10 a.m. on Tuesday, July 12, 2016, in Room 2128, Rayburn House Office Building, entitled "Making a Financial Choice: More Capital or More Government Control?" This will be a one-panel hearing with the following witnesses:

- John Allison, Chairman of the Executive Advisory Council of the Cato Institute's Center for Monetary and Financial Alternatives and former Chairman and CEO, BB&T
- Jeremy Newell, Executive Managing Director, General Counsel and Head of Regulatory Affairs, The Clearing House Association LLC
- Alex Pollock, Distinguished Senior Fellow, R Street Institute
- Jim Purcell, Chairman, State National Bank of Big Spring and Chairman of the Texas Bankers Association
- Adam Levitin, Professor of Law, Georgetown University Law Center

Under the Financial CHOICE Act, a discussion draft of which was released to the public on June 23, 2016, banking organizations (including both banks and credit unions) that maintain a leverage ratio of at least 10 percent and have a composite CAMELS rating of 1 or 2, at the time of the election, may elect to be exempted from a number of regulatory requirements, including the Basel III capital and liquidity standards and the "heightened prudential standards" applicable to larger institutions under section 165 of the Dodd-Frank Act. The proposal thus offers financial institutions of all shapes and sizes a Dodd-Frank "off-ramp," but only if they are strongly capitalized and, in the view of federal regulators, well-managed.

The leverage ratio used to assess capital adequacy under the Financial CHOICE Act is more stringent than the risk-based capital regime traditionally favored by global banking regulators and embodied in the successive iterations of the Basel capital accord. Unlike Basel's risk-weighted capital requirements, a leverage ratio measures a bank's capital against its total assets, without incorporating subjective regulatory judgments about the relative riskiness of those assets.

Critics of measuring capital adequacy according to a leverage ratio argue that itis too blunt an instrument, because there is no "penalty" for holding risky assets if those assets are not adjusted for relative risk. Far better, these critics say, to rely upon the Basel regime in which regulators calibrate "risk weights" on specific asset classes and require banks to hold greater capital against assets deemed by the regulators to carry greater risk.

Proponents of using a leverage ratio to measure capital adequacy point out that the Basel approach of setting bank capital levels according to regulatory risk-weights has been tried before – with less than optimal results. In the run-up to the financial crisis, the Basel regime treated toxic mortgage-backed securities and Greek sovereign debt as essentially risk-free, which encouraged financial firms to crowd into these assets and caused risk to be highly correlated among institutions and across geographical borders. Thus, under this view, rather than containing risk, Basel helped concentrate it. Rather than making banks safer, the Basel rules made them more fragile.

A copy of the discussion draft of the CHOICE Act is available at the following link: http://financialservices.house.gov/uploadedfiles/choice_act-_discussion_draft.pdf.

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