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Banking Policy Issues in the 115th Congress

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Summary

The financial crisis and the ensuing legislative and regulatory responses greatly affected the banking industry. Many new regulations—mandated or authorized by the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203) or promulgated under the authority of bank regulators—have been implemented in recent years. In addition, economic and technological trends continue to affect banks. As a result, Congress is faced with many issues related to the bank industry, including issues concerning prudential regulation, consumer protection, "too big to fail" (TBTF) banks, community banks, regulatory agency design and independence, and market and economic trends. For example, the Financial CHOICE Act (H.R. 10) proposes comprehensive reform to the financial regulatory system, and includes provisions related to many of these banking issues.

Prudential Regulation. This type of regulation is designed to ensure banks are safely profitable and unlikely to fail. Regulatory ratio requirements agreed to in the international agreement known as the Basel III Accords and the Volcker Rule are examples. Ratio requirements require banks to hold a certain amount of capital on their balance sheets to better enable them to avoid failure. The Volcker Rule prohibits certain trading activities and affiliations at banks. Proponents argue the rules appropriately balance the need for safety and soundness with regulatory burden. Opponents argue that current rules are overly complex, unduly burdensome, and difficult to enforce.

Consumer Protection. Certain laws and regulations protect consumers from unfair, deceptive, or abusive acts and practices. Regulations promulgated by the Consumer Financial Protection Bureau (CFPB) and the Durbin Amendment—which directs regulators to restrict interchange fees charged to merchants—are contentious issues in this area. Observers disagree over whether CFPB regulations appropriately balance the benefit of protecting consumers and the potential costs of unnecessarily burdening banks and restricting credit availability. Observers also disagree over whether the Durbin Amendment corrects monopolistic pricing by issuing banks and network providers, or instead creates market distortions by interfering with market pricing.

"Too Big To Fail" Banks. Regulators also regulate for systemic risks, such as those associated with TBTF financial institutions that may contribute to systemic instability. Dodd-Frank Act provisions include enhanced prudential regulation for TBTF banks and changes to resolution processes in the event one failed. Proponents of these changes assert they will eliminate or reduce excessive risk-taking at, and bailouts for, these large banks. Opponents assert that market forces and bankruptcy law are more effective and less distortionary than the new regulations and resolution authorities.

Community Banks. The number of relatively small and simple banks has declined substantially in recent decades. Some analysts assert market forces and removal of regulatory barriers to interstate branching and banking are having a large effect, given that small banks are exempt from many recent regulations and have been consolidating for decades. Others assert small institutions have limited resources and are being unnecessarily burdened by regulation, especially because such banks are unlikely to contribute to systemic risk.

Regulatory Agency Design and Independence. How regulatory agencies are structured and promulgate rules are also issues. Some assert that financial agencies' relatively high degree of independence from the President and Congress results in too little accountability in rulemaking; thus, their leadership structures, funding, and rulemaking procedures should be altered. Opponents of such measures maintain that financial regulator independence should be maintained because it allows regulations to be promulgated by technical experts with some insulation from political considerations.

Recent Market and Economic Trends. Changing economic forces may also pose issues to the banking industry. Increases in regulation could drive certain financial activities into a relatively lightly regulated "shadow banking" sector. Innovative financial technology may alter the way certain financial services are delivered. Interest rates are likely to begin rising soon after a long period of low rates, which could present risks to banks. Competition and regulatory differences between banks and nonbanks with different charter types is an ongoing issue.

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Introduction

Banks play a central role in the financial system by connecting borrowers to savers and allocating capital across the economy.[1] As a result, banking is vital to the health and growth of the U.S. economy. In addition, banking is an inherently risky activity involving extending credit and taking on liabilities. Therefore, banking can generate tremendous societal and economic benefits, but banking panics and failures can create devastating losses. Over time, a regulatory system designed to foster the benefits of banking while limiting risks has developed, and both banks and regulation have coevolved as market conditions have changed and different risks have emerged. For these reasons, Congress often considers policies related to the banking industry.

Recent years have been a particularly transformative period for banking. The 2008-2009 financial crisis threatened the total collapse of the financial system and the real economy. Many assert only huge and unprecedented government interventions staved off this collapse.[2] Others argue that government interventions were unnecessary or potentially exacerbated the crisis.[3] In addition, many argue the crisis revealed that the financial system was excessively risky and the regulatory system had serious weaknesses.[4]

Many regulatory changes were made in response to perceived weaknesses in the financial regulatory system, including to bank regulation. Congress enacted the Dodd-Frank Wall Street Reform and Consumer Protection Act (P.L. 111-203; Dodd-Frank Act) in 2010 with the intention of strengthening regulation and addressing risks. In addition, U.S. and international bank regulators agreed to the Basel III Accords—an international framework for bank regulation—which called for making certain bank regulations more stringent.

In the ensuing years, some observers have raised concerns that the potential benefits of the regulatory changes (better-managed risks, increased consumer protection, greater systemic stability, etc.) are outweighed by the potential costs (e.g., reduced credit availability for consumers and businesses, and slower economic growth). Meanwhile, market forces and economic conditions continue to affect the banking industry coincident with the implementation of new regulation.

This report provides a broad overview of selected banking-related issues, including prudential regulation, consumer protection, "too big to fail" (TBTF) banks, community banking, regulatory agency structures and independence, and recent market and economic trends. It is not an exhaustive look at all bank policy issues, nor is it a detailed examination of any one issue. Rather, it provides concise background and analyses of certain prominent issues that have been the subject of recent discussion and debate. In addition, this report provides a list of Congressional

[1] Generally, this report uses the term "bank" interchangeably to mean (1) a depository institution insured by the Federal Deposit Insurance Corporation or (2) a parent bank-holding company of such an institution. A distinction will be made when the policy issue is applicable only to a specific type of institution or if a distinction is otherwise necessary. Credit unions—although also affected by several of the policy issues covered—are not the focus of this report, and the term "bank" should not be interpreted as including those institutions, unless otherwise noted.

[2] Testimony of Treasury Secretary Timothy F. Geithner, in U.S. House Financial Services Committee, *Financial Regulatory Reform*, September 23, 2009, at https://www.treasury.gov/press-center/press-releases/Pages/tg296.aspx.

[3] John B. Taylor, *Responses to Additional Questions from the Financial Crisis Inquiry Commission*, Stanford University, November 2009, at http://web.stanford.edu/~johntayl/Responses%20to%20FCIC%20questions%20John%20B%20Taylor.pdf.

[4] Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report*, January 2011, pp. xv-xxviii, at https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

Research Service reports that examine specific bills, including the Financial CHOICE Act (H.R. 10) and bills proposing to provide regulatory relief for banks.

Comprehensive Financial Regulatory Reform in the 115th Congress

The Financial CHOICE Act (H.R. 10), sponsored by Chairman Jeb Hensarling, was ordered to be reported by the House Committee on Financial Services on May 4, 2017. A similar version of the bill was previously introduced in the 114th Congress (H.R. 5983) and combined new provisions with bills that had previously seen legislative action in the 114th Congress as stand-alone bills. The bill, as amended, is a wide-ranging proposal with 12 titles that would alter many parts of the financial regulatory system, including the regulation of banks. Provisions related to banking are contained throughout the bill, including in Titles I, III, V, VI, VII, IX, and X, and many of those are related to policy issues covered in this report.

Prudential Regulation

Bank failures can inflict large losses on stakeholders, including taxpayers via government "safety nets" such as deposit insurance and Federal Reserve lending facilities. Furthermore, some argue that in the presence of deposit insurance, commercial banks may be subject to *moral hazard*—a willingness to take on excessive risk because of external protection against losses.[5] In addition, failures can cause systemic stress and sharp contraction in economic activity if they are large or widespread. To make such failures less likely—and to reduce losses when they do occur—regulators utilize prudential regulation. These "safety and soundness" regulations are designed to ensure banks are safely profitable and to reduce the risk of failure. This section provides background on these regulations and analyzes selected issues related to them, including

- regulatory requirements related to capital ratios, including leverage ratios and risk-weighted capital ratios; and
- restrictions on permissible activities, such as the Volcker Rule (which restricts proprietary trading).

Background

A bank's balance sheet is divided into assets, liabilities, and capital. Assets are largely the value of loans owed to the bank and securities owned by the bank. To make loans and buy securities, a bank secures funding by either issuing liabilities or raising capital. A bank's liabilities are largely the value of deposits and borrowings the bank owes savers and creditors. Capital is raised through various methods, including issuing equity to shareholders or issuing special types of bonds that can be converted into equity. Importantly, capital—unlike liabilities—does not require repayment of a specified amount of money, and so its value can fluctuate.[6]

Banks profit in part because many of their assets are generally riskier, longer-term, and more illiquid than their liabilities, which allows the banks to earn more interest on their assets than they pay on their liabilities. The practice is usually profitable, but does expose banks to risks that can potentially lead to failure. While the value of bank assets can decrease, liabilities generally cannot. Capital, though, gives the bank the ability to absorb losses. When asset value declines,

[5] Moral hazard is discussed further in the """Too Big to Fail" Banks" section.

[6] Federal Deposit Insurance Corporation (FDIC), *Risk Management Manual of Examination Policies: Section 2.1 Capital*, pp. 2-3, at https://www.fdic.gov/regulations/safety/manual/section2-1.pdf.

capital value does as well, allowing the bank to meet its rigid liability obligations and avoid failure.[7]

Based on these balance sheet characteristics, failures can be reduced if (1) banks are better able to absorb losses or (2) they are less likely to experience unsustainably large losses. To increase the ability to absorb losses, regulators can require banks to hold a minimum level of capital, liquidity, or stable funding. These levels are expressed as ratios between items on bank balance sheets and are called *regulatory ratio requirements*. To reduce the likelihood and size of potential losses, regulators prohibit banks from activities that could create excessive risks, implementing *permissible activity restrictions*.

Banks have been subject to ratio requirements for decades. U.S. bank regulators first established explicit numerical ratio requirements in 1981. In 1988, they adopted the Basel Capital Accords proposed by the Basel Committee on Banking Supervision (BCBS)—an international group of bank regulators that sets international standards—which were the precursor to the ratio requirement regime used in the United States today.[8] Those requirements—now known as "Basel I"—were revised in 2004, establishing the "Basel II" requirements that were in effect at the onset of the crisis in 2008. In 2010, the BCBS agreed to the "Basel III" standards.[9] Pursuant to this agreement, U.S. regulators finalized new capital requirements in 2013, with full implementation expected by 2019;[10] finalized a liquidity requirement for large banks in 2014, with full implementation expected in 2017; and proposed a funding ratio for large banks in 2016.[11]

Restrictions on permissible activities have also evolved over time and generally were made more stringent following the crisis to address potential weaknesses. Historical examples of such restrictions are found in Sections 16, 20, 21, and 32 of the Banking Act of 1933 (P.L. 73-66)—commonly referred to as the Glass-Steagall Act. Glass-Steagall generally prohibited certain deposit-taking banks from engaging in certain securities markets activities associated with investment banks, such as speculative investment in equity securities. Over time, regulators became more permissive in their interpretation of Glass-Steagall, allowing banks to participate in more securities market activities, directly or through affiliations. In 1999, the Gramm-Leach-Bliley Act repealed two provisions of Glass-Steagall, further expanding permissible activities for certain banks.[12]

The financial crisis elevated the debate over what activities banks should be allowed to engage in. Certain provisions in Dodd-Frank placed restrictions on permissible activities to reduce banks'

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[7] Ibid.

[8] Susan Burhouse et al., *Basel and the Evolution of Capital Regulation: Moving Forward, Looking Back*, Federal Deposit Insurance Corporation, January 14, 2003, at https://www.fdic.gov/bank/analytical/fyi/2003/011403fyi.html.

[9] Bank for International Settlements, Basel Committee on Banking and Supervision, "Results of the December 2010 meeting of the Basel Committee on Banking Supervision," press release, December 1, 2010, at http://www.bis.org/press/p101201a.htm.

[10] The Office of the Comptroller of the Currency and The Board of Governors of the Federal Reserve System, "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule," 78 *Federal Register* 62018-62073, October 11, 2013.

[11] Board of Governors of the Federal Reserve System, FDIC, and Office of the Comptroller of the Currency, "Agencies propose net stable funding rule," press release, May 3, 2016, at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20160503a.htm.

[12] CRS Report R44349, *The Glass-Steagall Act: A Legal and Policy Analysis*, by (name redacted), (name reda cted), and (name redacted) .

riskiness.[13] Section 619 of Dodd-Frank—often referred to as the "Volcker Rule"—differs from Glass-Steagall provisions in important ways. However, it was generally designed to achieve a similar goal of separating *proprietary trading*—owning and trading securities for the bank's own portfolio with the aim of profiting from price changes—from depository banking.

Regulatory Ratio Requirements[14]

Banks are required to satisfy several different regulatory ratio requirements. A detailed examination of how these ratios are calculated is beyond the scope of this report.[15] This examination of the policy issue only requires noting that capital ratios[16] fall into one of two main types—a leverage ratio or a risk-weighted ratio. A leverage ratio treats all assets the same, requiring banks to hold the same amount of capital against the asset regardless of how risky each asset is. A risk-weighted ratio assigns a risk weight—a number based on the riskiness of the asset that the asset value is multiplied by—to account for the fact that some assets are more likely to lose value than others. Riskier assets receive a higher risk weight, which requires banks to hold more capital—to better enable them to absorb losses—to meet the ratio requirement.[17]

In regard to the simple leverage ratio, most banks are required to meet a 4% leverage ratio. The required risk-weighted ratios depend on bank size and capital quality (some types of capital are considered to be less effective at absorbing losses than other types, and thus considered lower quality). Most banks are required to meet a 4.5% risk-weighted ratio for the highest-quality capital and a ratio of between 6% and 8% for lower-quality capital. Banks are then required to have an additional 2.5% of high-quality capital on top of those levels as part of the "capital conservation buffer."[18] The largest banks are required to hold more capital than smaller, less complex banks. These ratios for large banks will be covered in the "Enhanced Prudential Regulation" section below.[19]

Some observers argue that it is important to have both a risk-weighted ratio and a leverage ratio because the two complement each other. Riskier assets generally offer a greater rate of return to compensate the investor for bearing more risk. Without risk weighting, banks would have an incentive to hold riskier assets because the same amount of capital must be held against risky and

[13] The degree to which the expansion of permissible activities contributed to the crisis is a contested issue. A detailed analysis of the causes of the crisis is beyond the scope of this report.

[14] This section was adapted from text authored by Sean Hoskins as a section entitled "Leverage Ratio as an Alternative to Current Bank Regulation" found in CRS Report R44631, *The Financial CHOICE Act in the 114th Congress: Policy Issues*.

[15] For more information on regulatory requirement ratios, see CRS Report R44573, *Overview of the Prudential Regulatory Framework for U.S. Banks: Basel III and the Dodd-Frank Act*, by (name redacted).

[16] For brevity and clarity, this report will focus on capital ratios, which all banks are required to meet. The largest banks have to meet higher capital ratios, as well as liquidity and net stable funding ratios. The concepts detailed here involving the use of weighted ratios as opposed to the simple leverage ratio also apply to liquidity and stable funding ratios. The difference is that instead of being weighted based on risk, balance sheet items are weighted based on their liquidity in liquidity ratios and based on their stability in stability ratios.

[17] FDIC, *Risk Management Manual of Examination Policies: Section 2.1 Capital*, pp. 2-9, at https://www.fdic.gov/regulations/safety/manual/section2-1.pdf.

[18] Federal Reserve Board, *Final Rule on Enhanced Regulatory Capital Standards - Implications for Community Banking Organizations*, July 2013, at http://www.federalreserve.gov/newsevents/press/bcreg/commbankguide20130702.pdf.

[19] The largest banks are also referred to as "advanced approaches banks" (referring to the different approach for capital regulation to which they are subject), which are institutions with at least $250 billion in consolidated assets or on-balance sheet foreign exposures of at least $10 billion.

safe assets. Therefore, a leverage ratio alone may not fully account for a bank's riskiness because a bank with a high concentration of very risky assets could have a similar ratio to a bank with a high concentration of very safe assets.[20]

However, others assert the use of risk-weighted ratios should be limited.[21] Risk weights assigned to particular classes of assets could potentially be an inaccurate estimation of some assets' true risk, especially since they cannot be adjusted as quickly as asset risk might change. Banks may have an incentive to overly invest in assets with risk weights that are set too low (they would receive the high potential rate of return of a risky asset, but have to hold only enough capital to protect against losses of a safe asset), or inversely to underinvest in assets with risk weights that are set too high. Some observers believe that the risk weights in place prior to the financial crisis were poorly calibrated and "encouraged financial firms to crowd into" risky assets, exacerbating the downturn.[22] For example, banks held highly rated mortgage-backed securities (MBSs) before the crisis, in part because those assets offered a higher rate of return than other assets with the same risk weight. MBSs then suffered unexpectedly large losses during the crisis.

Another criticism is that the risk-weighted system involves "needless complexity" and is an example of regulator micromanagement. The complexity could benefit the largest banks that have the resources to absorb the added regulatory cost compared to small banks that could find compliance costs more burdensome.[23] Community bank compliance issues will be covered in more detail in the "Regulatory Burden on Community Banks" section later in the report.

In addition to the specific issue of whether to use both leverage and risk-weighted ratios or just a leverage ratio, the role regulatory ratios in general play in bank regulation is a broader issue. Prudential regulation involves requirements besides capital ratios, such as liquidity requirements, asset concentration guidelines, and counterparty limits. Some argue that capital is essential to absorbing losses and, as long as sufficient capital is in place, banks should not be subject to some of these additional regulatory restrictions.[24] However, others believe that the different components of prudential regulation each play an important role in ensuring the safety and soundness of financial institutions and are essential complements to bank capital.[25]

Finally, whether the benefits of prudential regulation—such as the increase in bank safety and the increase in financial system stability—are outweighed by the potential costs of reduced credit availability and economic growth is an issue subject to much debate.[26] Capital is typically a more expensive source of funding for banks than liabilities. Thus, requiring banks to hold higher levels

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[20] See Chair Yellen's comments during U.S. Congress, House Committee on Financial Services, *Monetary Policy and the State of the Economy*, 114th Cong., 2nd sess., June 22, 2016, at http://www.cq.com/doc/congressionaltranscripts-4915133?2.

[21] House Committee on Financial Services, *The Financial CHOICE Act: A Republican Proposal to Reform the Financial Regulatory System*, June 23, 2016, p. 6, at http://financialservices.house.gov/uploadedfiles/financial_choice_act_comprehensive_outline.pdf.

[22] Ibid., p. 8.

[23] Ibid., p. 6.

[24] House Committee on Financial Services, *The Financial CHOICE Act: A Republican Proposal to Reform the Financial Regulatory System*, June 23, 2016, p. 7, at http://financialservices.house.gov/uploadedfiles/financial_choice_act_comprehensive_outline.pdf.

[25] Federal Reserve Governor Daniel Tarullo, *Financial Regulation Since the Crisis*, Federal Reserve Board of Governors, Speech at the Federal Reserve Bank of Cleveland, 2016 Financial Stability Conference, Washington, DC, December 2, 2016, https://www.federalreserve.gov/newsevents/speech/tarullo20161202a.htm.

[26] Basel Committee On Banking Supervision, *An Assessment of The Long-Term Impact of Stronger Capital And Liquidity Requirements*, August 2010, pp. 1-8, http://www.bis.org/publ/bcbs173.pdf.

of capital may make funding more expensive, and so banks may choose to reduce the amount of credit available.[27] Some studies indicate this could slow economic growth. However, no economic consensus exists on this issue, because a more stable banking system with fewer crises and failures may lead to higher long-run economic growth. In addition, estimating the value of regulatory costs and benefits is subject to considerable uncertainty, due to difficulties and assumptions involved in complex economic modeling and estimation.[28] Therefore, this issue is unlikely to be conclusively resolved quickly or easily.

Legislative Alternatives

If Congress decides to reduce regulatory reliance on risk-weighted ratios, it could provide a statutory exemption for banks that otherwise demonstrate they are operating in a safe manner from being subject to risk-weighted ratios. These banks' regulatory burden could be further reduced by exempting them from other prudential regulation, such as liquidity requirements, stress-testing, and dividend limitations. Exempted banks could include those that satisfy a higher simple leverage ratio, or receive a high safety and soundness rating from the bank's prudential regulator.

Another possible set of changes would be to change the risk weights assigned to specific asset classes. For example, in the case that an asset type was assigned a risk weight that was too high and would likely cause unwanted market distortions, Congress could mandate that asset type be assigned a lower weight.

Volcker Rule[29]

The Volcker Rule[30] generally prohibits depository banks from engaging in proprietary trading or sponsoring a hedge fund or private equity fund. Proponents argue that proprietary trading would add further risk to the inherently risky business of commercial banking. Furthermore, because other types of institutions are very active in proprietary trading and better suited for it, bank involvement is unnecessary for the financial system.[31] Finally, proponents assert moral hazard is problematic for banks in these risky activities. Because deposits—an important source of bank funding—are insured by the government, a bank could potentially take on excessive risk without concern about losing this funding. Thus, support for the Volcker Rule has often been posed as preventing banks from "gambling" in securities markets with taxpayer-backed deposits.[32]

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[27] Douglas J. Elliot, *Higher Bank Capital Requirements Would Come at a Price*, Brookings Institution, February 20, 2013, at https://www.brookings.edu/research/higher-bank-capital-requirements-would-come-at-a-price/.

[28] Basel Committee On Banking Supervision, *An Assessment of The Long-Term Impact of Stronger Capital And Liquidity Requirements*, August 2010, p. 1, at http://www.bis.org/publ/bcbs173.pdf.

[29] This section was adapted from text authored by (name redacted) as a section entitled "Volcker Rule" found in CRS Report R44035, *"Regulatory Relief" for Banking: Selected Legislation in the 114th Congress*, coordinated by (name redacted) .

[30] The rule is named after Paul Volcker, the former Chair of the Federal Reserve (Fed), former Chair of President Obama's Economic Recovery Advisory Board, and a vocal advocate of a prohibition on proprietary trading at commercial banks.

[31] Paul Volcker, "How to Reform Our Financial System," *New York Times*, January 30, 2010.

[32] See, for example, House Financial Services Committee, "Waters: Dodd-Frank Repeal Is Truly the Wrong Choice," press release, June 24, 2016, at http://democrats.financialservices.house.gov/news/documentsingle.aspx?DocumentID=399901.

Some observers doubt the necessity of the Volcker Rule. They assert that proprietary trading at commercial banks did not play a role in the financial crisis, noting that issues that played a direct role in the crisis—including failures of large investment banks and insurers and losses on loans held by commercial banks—would not have been prevented by the rule.[33]

The effectiveness of the Volcker Rule in reducing bank risk is also disputed. While the activities prohibited under the Volcker Rule pose risks, it is not clear whether they pose greater risks to bank solvency and financial stability than "traditional" banking activities, such as mortgage lending. Furthermore, taking on additional risks in different markets might diversify a bank's risk profile, making it less likely to fail.[34] Some suggest that restricting certain activities only at depository bank subsidiaries and allowing them at completely separate nonbank subsidiaries may appropriately protect deposits while allowing diversification in the larger organization.[35]

Some contend that the Volcker Rule imposes a regulatory burden that could affect banks' involvement in beneficial trading activities and reduce financial market efficiency. The rule includes exceptions for when bank trading is deemed appropriate—such as when a bank is hedging against risks and market-making. This poses practical supervisory problems. For example, how can regulators determine whether a broker-dealer is holding a security for market-making, as a hedge against another risk, or as a speculative investment? Differentiating among these motives creates regulatory complexity and compliance costs that could affect bank trading behavior.[36]

In addition, whether relatively small banks should be exempt from the rule is a debated issue. Some observers contend that the vast majority of community banks do not face compliance obligations under the rule and do not face an excessive burden by being subject to it.[37] They argue that community banks subject to compliance requirements, those with traditional hedging activities, can comply simply by having clear policies and procedures in place that can be reviewed during the normal examination process. In addition, they assert the small number of community banks that are engaged in complex trading should have the expertise to comply with the Volcker Rule.[38]

Others argue that the act of evaluating the Volcker Rule to ensure banks' compliance is burdensome in and of itself. They support a community bank exemption so that community banks

[33] House Financial Services Committee, *The Financial CHOICE Act: Comprehensive Summary*, June 23, 2016, p. 81-86, at http://financialservices.house.gov/uploadedfiles/financial_choice_act_comprehensive_outline.pdf.

[34] Anjan V. Thakor, *The Economic Consequences of the Volcker Rule*, U.S. Chamber of Commerce Center for Capital Markets Competitiveness, Summer 2012, pp. 28-30, at http://www.centerforcapitalmarkets.com/wp-content/uploads/2010/04/17612_CCMC-Volcker-RuleFINAL.pdf.

[35] Vice Chairman Thomas Hoenig, *A Market-Based Proposal for Regulatory Relief and Accountability*, FDIC, Remarks Presented to the Institute of International Bankers Annual Conference, Washington, DC, March 13, 2017, at https://www.fdic.gov/news/news/speeches/spmar1317.html.

[36] House Financial Services Committee, *The Financial CHOICE Act: Comprehensive Summary*, June 23, 2016, p. 81-86, at http://financialservices.house.gov/uploadedfiles/financial_choice_act_comprehensive_outline.pdf.

[37] Cecelia A. Calaby, Comment Letter: Proposed Rulemaking Implementing the Provisions of Section 13 of the Bank Holding Company Act of 1956, as Amended (Volcker Rule), American Bankers Association, December 17, 2012, at http://www.aba.com/Advocacy/commentletters/Documents/12312-ABA-letters-Agencies-Finalizing-Volcker-Rule-Proposal.pdf.

[38] Thomas Hoenig, speech at the National Press Club, April 15, 2015, at https://www.fdic.gov/news/news/speeches/spapril1515.html.

and supervisors would not have to dedicate resources to complying with and enforcing a regulation whose rationale is unlikely to apply to smaller banks.[39]

Legislative Alternatives

Several different approaches are available if Congress decided to amend the prohibitions mandated by the Volcker Rule. If it is determined that any ban on proprietary trading by commercial banks is unnecessary, unduly burdensome, or too difficult to enforce, then Congress could repeal the rule and not replace it with different prohibitions. If instead the issue is that the rule as currently formulated is problematic, then Congress could repeal the rule and replace it with different provisions, perhaps similar to those in the Glass-Steagall Act. Finally, if it is only the rule's applicability to small banks that is problematic, Congress could enact an exemption for a certain class of banks.

Consumer Protection

Financial products can be complex and potentially difficult for consumers to fully understand. Also, consumers seeking loans or financial services could be vulnerable to deceptive or unfair practices. To reduce the occurrence of bad outcomes, laws and regulations have been put in place to protect consumers. This section provides background on consumer protection and analyzes issues related to it, including

- whether regulation implemented by the Consumer Financial Protection Bureau (CFPB) has struck the appropriate balance between protecting consumers and the availability of credit; and
- the effects and effectiveness of the Federal Reserve setting debit interchange fees as mandated by the Durbin Amendment in the Dodd-Frank Act.

Background

Financial transactions are subject to various state and federal laws designed to protect consumers and ensure that lenders use fair lending practices. Federal laws and regulations take a variety of approaches and address different areas of concern. Disclosure requirements are intended to ensure consumers adequately understand the costs and other features and terms of financial products.[40] Unfair, deceptive, or abusive acts and practices are prohibited.[41] Fair lending laws prohibit discrimination in credit transactions based upon certain borrower characteristics, including sex, race, religion, or age, among others.[42] In addition, banks are subject to *consumer compliance* regulation, intended to ensure that banks are in compliance with relevant consumer-protection and fair-lending laws.[43]

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[39] Federal Reserve Gov. Daniel Tarullo, "A Tiered Approach to Regulation and Supervision of Community Banks," speech at the Community Bankers Symposium, Chicago, Illinois, November, 7, 2014, at http://www.federalreserve.gov/newsevents/speech/tarullo20141107a.htm.

[40] Consumer Financial Protection Bureau (CFPB), *Laws and Regulations: Truth in Lending Act*, June 2013, at http://files.consumerfinance.gov/f/201306_cfpb_laws-and-regulations_tila-combined-june-2013.pdf.

[41] CFPB, *CFPB Bulletin 2013-07*, July 10, 2013.

[42] FDIC, *Compliance Examination Manual*, September 2015, at https://www.fdic.gov/regulations/compliance/manual/4/iv-1.1.pdf.

[43] CRS Report R42572, *The Consumer Financial Protection Bureau (CFPB): A Legal Analysis*, by (name redacted) .

For many observers, the onset of the financial crisis revealed weaknesses in the regulatory system as it related to consumer protection. A significant factor precipitating the financial crisis was that mortgages were made using arguably deceptive or abusive practices to people unable to repay.[44] In response, the Dodd-Frank Act established the Consumer Financial Protection Bureau (CFPB)—a new regulatory agency focused on consumer protection in financial transactions with wide-reaching authorities to regulate consumer financial products such as mortgages. In addition, the reexamination of the regulatory system was an opportunity to address long-standing issues not directly related to the crisis. The Durbin Amendment, which authorizes the Federal Reserve to regulate debit card interchange fees, was one such measure.

CFPB Regulation[45]

Prior to the Dodd-Frank Act, federal banking regulators—the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation—were charged with the two-pronged mandate of regulating for both safety and soundness (prudential regulation, discussed in previous sections) as well as consumer compliance.[46] The CFPB was established with the single mandate to implement and enforce federal consumer financial law while ensuring consumers can access financial products and services. The CFPB also works to ensure the markets for consumer financial services and products are fair, transparent, and competitive.

To achieve these outcomes, the CFPB was granted certain regulatory authorities over banks, as well as certain other nonbank providers of consumer products and services.[47] Those powers vary based on whether a bank holds more or less than $10 billion in assets. Regulatory authorities related to consumer compliance fall into three broad categories: *supervisory*, which includes the power to examine and impose reporting requirements on financial institutions; *enforcement* of various consumer-protection laws and regulations; and *rulemaking*, which includes the power to prescribe regulations pursuant to federal consumer-protection laws that govern a broad and diverse set of consumer financial activities and services.[48]

For banks with *more than $10 billion* in assets, the CFPB is the primary regulator for consumer compliance, whereas safety and soundness regulation continues to be performed by the prudential regulator. As a regulator of larger banks, the CFPB has rulemaking, supervisory, and enforcement authorities.[49] A large bank, therefore, has different regulators for consumer protection and safety and soundness.

For banks with *$10 billion or less* in assets, the rulemaking, supervisory, and enforcement authorities for consumer protection are divided between the CFPB and a prudential regulator. The

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[44] Martin N. Baily, Robert E. Litan, and Matthew S. Johnson, *The Origins of the Financial Crisis*, Brookings Institution, Fixing Finance Series - Paper 3, November 2008, pp. 16-18, at https://www.brookings.edu/wp-content/uploads/2016/06/11_origins_crisis_baily_litan.pdf.

[45] For more information see CRS Report R42572, *The Consumer Financial Protection Bureau (CFPB): A Legal Analysis*, by (name redacted) . Certain text in this section was adapted from text found in CRS In Focus IF10031, *Introduction to Financial Services: The Consumer Financial Protection Bureau (CFPB)*, by (name redacted) and (name redacted), and the section entitled "CFPB Supervisory Threshold" in CRS Report R44035, *"Regulatory Relief" for Banking: Selected Legislation in the 114th Congress*, coordinated by (name redacted) .

[46] CRS Report R42572, *The Consumer Financial Protection Bureau (CFPB): A Legal Analysis*, by (name redacted) .

[47] CFPB authorities and policy issues related to nonbanks are beyond the scope of this report.

[48] CRS Report R42572, *The Consumer Financial Protection Bureau (CFPB): A Legal Analysis*, by (name redacted) .

[49] Ibid.

CFPB may issue rules that apply to smaller banks, but the prudential regulators maintain primary supervisory and enforcement authority for consumer protection. The CFPB has limited supervisory and enforcement powers over small banks. It can participate in examinations performed by the prudential regulator on a sampling basis. Also, the CFPB may refer potential enforcement actions against small banks to the banks' prudential regulators, but the prudential regulators are not bound to take any substantive steps beyond responding to the referral.[50]

The CFPB has been a controversial product of the Dodd-Frank Act. Some observers question if the CFPB as an institution is structured appropriately to achieve the correct balance between independence on the one hand and transparency and accountability on the other. The CFPB is led by a director rather than a board[51] and is funded by the Federal Reserve rather than the traditional appropriations process. Some argue that a single director leads to a lack of diversity of viewpoints, and that funding outside the traditional appropriations process could result in a lack of accountability at an agency.[52] The CFPB's relatively narrow mandate and the "for cause" removal protection for its director are also contentious issues. However, supporters of the CFPB argue other aspects of its structure provide sufficient transparency and accountability, including the director's biannual testimony before Congress and the cap on CFPB funding. They further argue it is important to ensure the CFPB is somewhat insulated from political pressures and can focus on the technical aspect of policymaking.[53] This issue as it relates to all financial regulators is further examined in the section entitled "Regulatory Agency Design and Independence" found later in this report.

Another policy issue is whether the CFPB's rulemaking and enforcement have struck an appropriate balance between protecting consumers and ensuring that consumers have access to financial products. The CFPB has implemented rules mandated by the Dodd-Frank Act, but regulations it has promulgated under its general authorities—such as oversight of auto lending and a rule that extends credit card-like protections to prepaid cards—are at the center of this debate. Some observers assert lenders have been subject to unduly burdensome regulations and overzealous enforcement by the CFPB, resulting in costs that outweigh the benefits. They argue that CFPB regulation increases the cost of providing certain financial products to the point that institutions reduce the availability of needed credit sources.[54]

Other observers believe the CFPB has struck an appropriate balance in its rulemaking between protecting consumers and ensuring that credit availability is not restricted due to overly burdensome regulations on financial institutions.[55] Analysis of whether or the degree to which

[50] Ibid.

[51] A mortgage company has challenged the constitutionality of the CFPB's structure in a lawsuit that currently is before the full U.S. Court of Appeals for the District of Columbia. See PHH Corp. v. Consumer Fin. Prot. Bureau, No. 15-1177, 2017 U.S. App. LEXIS 2733 (D.C. Cir., February 16, 2017) (granting petition for rehearing by full court and vacating the court's three-judge panel decision in the case). The constitutionality of the CFPB's structure is outside the scope of this report.

[52] Michael S. Barr, "Comment: Accountability and Independence in Financial Regulation: Checks Balances, Public Engagement and Other Innovations," *Law and Contemporary Problems*, vol. 78 (2015), pp. 119-128.

[53] Consumer Financial Protection Bureau, *Financial Report of the Consumer Financial Protection Bureau: Fiscal Year 2016*, November 15, 2016, pp. 65-66, at https://s3.amazonaws.com/files.consumerfinance.gov/f/documents/112016_cfpb_Final_Financial_Report_FY_2016.pdf.

[54] U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, *Assessing the Effects of Consumer Finance Regulations*, Written Testimony of Todd Zymwicki, 114th Cong., 2nd sess., April 5, 2016.

[55] Consumer Financial Protection Bureau, *Financial Report of the Consumer Financial Protection Bureau: Fiscal Year 2016*, November 15, 2016, pp. 8-15, at https://s3.amazonaws.com/files.consumerfinance.gov/f/documents/112016_cfpb_Final_Financial_Report_FY_2016.pdf.

recent rulemakings have restricted the availability of credit is complicated by the concurrent effects of economic conditions and the financial crisis on credit conditions. Also, many significant CFPB rulemakings have been in effect only since early 2014 or later, and the lack of a track record and data is an additional barrier to conclusive examination of the issue.

A third issue is whether the $10 billion asset threshold at which the CFPB becomes a bank's primary regulator for consumer compliance is set at an appropriate level. Many think having two separate agencies handle supervision for prudential regulation and consumer protection compliance would be unnecessarily burdensome for small banks. However, there is disagreement over the size at which that becomes the case. Supporters of raising the threshold argue it would appropriately reduce the regulatory burden on banks that are still relatively small, and "would still be examined by their primary regulators who are required by law to enforce the CFPB rules and regulations," and the change would only mean banks "wouldn't have to go through yet another exam with the CFPB in addition to the ones they already have to go through with their primary regulators."[56]

Critics of raising the threshold argue it exempts large institutions that warrant closer supervision. They note that banks that were "some of the worst violators of consumer protections" in the housing bubble were fairly close to that threshold, with IndyMac at approximately $30 billion in assets being a highlighted example.[57]

Legislative Alternatives

Broadly, if Congress decided to restrict the CFPB's regulatory authority in financial markets, it could alter its mandate, structure, or authorities. If it is determined that the CFPB is overly focused on consumer protection to the extent that it is restricting credit availability, the agency's mandate could be expanded to a dual mandate that includes the goal of expanding consumer credit availability. Agency accountability could be increased by bringing it into the appropriations process or altering features of its leadership (e.g., by removing the director's "for cause" protections or replacing the directorship with a commission or board). In addition, CFPB rulemaking, supervisory, or enforcement authorities could be altered or removed.

Durbin Amendment

When a debit card is used to make a purchase, the merchant making the sale pays a fee that is distributed among the merchant's bank; a network provider that facilitates the transaction; and the bank that issued the debit card, called the issuer. The fee paid to the issuer—known as the *interchange fee*—is compensation for services provided, including facilitating authorization, clearance, settlement, and fraud prevention. Network providers set the rates for interchange fees, acting as an intermediary between thousands of issuers and millions of retailers.[58]

Interchange fees have been a source of tension for decades between merchants—for whom the fees can be a significant cost—and the network providers and issuing banks that benefit from

[56] Attributed to Sen. Pat Toomey by CQ Congressional Transcripts, "Senate Banking, Housing and Urban Affairs Committee Holds Markup on the Financial Regulatory Improvement Act," May 21, 2015, at http://www.cq.com/doc/congressionaltranscripts-4691548?8&search=Re1SwoJi.

[57] Attributed to Sen. Sherrod Brown by CQ Congressional Transcripts, "Senate Banking, Housing and Urban Affairs Committee Holds Markup on the Financial Regulatory Improvement Act," May 21, 2015, at http://www.cq.com/doc/congressionaltranscripts-4691548?8&search=Re1SwoJi.

[58] CRS Report R41913, *Regulation of Debit Interchange Fees*, by (name redacted).

high interchange fees. While issuing banks collect the fees, network providers may also benefit. Higher revenue from debit transactions could lead issuers to encourage their customers to use debit cards. This, in turn, this could lead to more debit transactions that generate revenue for the network providers.[59]

Merchants long asserted that network providers—particularly MasterCard and Visa, which had a very large share of the payment card market—and issuing banks exercised market power to charge rates above market prices and earn monopolistic profits. Several merchant groups filed suits against the two providers, claiming they engaged in anticompetitive behavior. Some of these led to significant settlements.[60] Merchants and other advocates also claimed that provider and issuer market power and anticompetitive behavior harmed consumers as merchants charged higher prices to cover high costs. Network providers and issuing banks argued that prices were set appropriately and reflected all the costs—including fixed costs and card reward programs they claim were overlooked or ignored by critics—involved in facilitating debit card transactions.[61]

Section 1075 of the Dodd-Frank Act—sometimes referred to as the "Durbin Amendment"—addressed this issue by directing the Federal Reserve to regulate interchange fees for banks over $10 billion in assets by ensuring that they are "reasonable and proportional to the cost incurred by the issuer with respect to the transaction."[62] In June 2011, the Federal Reserve issued a final rule pursuant to this provision, limiting interchange fees for banks over $10 billion in assets to a maximum of 21 cents plus 0.05% of the transaction value.[63] Proponents of the measure assert it eliminates anticompetitive pricing to the benefit of merchants and consumers (if the merchants pass on the savings). Opponents assert that regulatory price-setting will result in inaccurate pricing, creating costs and economic distortions in the debit card payment market for large and small banks.[64]

Legislative Alternatives

Congress could repeal the Durbin Amendment if it believes that the regulation creates distortions rather than corrects them. Alternatively, if the concern is that the rule is applied too widely to banks that are too small to warrant a fee limit, the exemption threshold could be raised.

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[59] Benjamin S. Kay, Mark D. Manuszak, and Cindy M. Vojtech, *Bank Profitability and Debit Card Interchange Regulation: Bank Responses to the Durbin Amendment*, Federal Reserve Board of Governors, Finance and Economics Discussion Series 2014-77, Washington, DC, 2014, pp. 1-11, at https://www.federalreserve.gov/econresdata/feds/2014/files/201477pap.pdf.

[60] For example, in 2003 Visa and Mastercard settled a lawsuit brought by Wal-Mart, Sears, and other retailers claiming the networks used market power to set high fees and forced retailers to accept both credit and debit fees. See Jennifer Bayot, "Visa Reaches Settlement in Debit Card Case," *The New York Times*, May 1, 2003, at http://www.nytimes.com/2003/05/01/business/visa-reaches-settlement-in-debit-card-case.html.

[61] Zhu Wand, "Debit Card Interchange Fee Regulation: Some Assessments and Considerations," *Federal Reserve Bank of Richmond Economic Quarterly*, vol. 98, no. 3 (Third Quarter 2012), pp. 160-165.

[62] 15 U.S.C §1693o–2.

[63] Board of Governors of the Federal Reserve System, "Federal Reserve issues a final rule establishing standards for debit card interchange fees and prohibiting network exclusivity arrangements and routing restrictions," press release, June 29, 2011, at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20110629a.htm.

[64] Benjamin S. Kay, Mark D. Manuszak, and Cindy M. Vojtech, *Bank Profitability and Debit Card Interchange Regulation: Bank Responses to the Durbin Amendment*, Federal Reserve Board of Governors, Finance and Economics Discussion Series 2014-77, Washington, DC, 2014, pp. 1-11, at https://www.federalreserve.gov/econresdata/feds/2014/files/201477pap.pdf.

"Too Big to Fail" Banks[65]

Some bank holding companies (BHCs) have hundreds of billions or trillions of dollars in assets and are deeply interconnected with other financial institutions.[66] A bank may be so large that the leadership of the bank and market participants may believe that the government would save it if it became distressed. This belief could arise from the determination that the institution is so important to the country's financial system—and that its failure would be so costly to the economy and society—that the government would feel compelled to avoid that outcome. An institution of this size and complexity is said to be "too big to fail" (TBTF). TBTF institutions may have incentives to be excessively risky, gain unfair advantages in the market for funding, and expose taxpayers to losses.[67] This section provides background on TBTF institutions and analyzes some prominent issues related to them, including

- enhanced prudential regulation for large banks, including *enhanced capital requirements*, *liquidity requirements*, *living wills*, and *stress-testing*; and
- measures taken to reduce market expectation of government support for failing institutions, such as the Orderly Liquidation Authority (OLA).

Background

Several market forces likely drive banks and other financial institutions to grow in size and complexity, thereby potentially increasing efficiency and improving financial and economic outcomes. For example, marginal costs can be reduced through economies of scale; consumers could be offered convenient "one-stop shopping" for a variety of financial products and services; and bank risk can be diversified by spreading exposures over multiple business lines and geographic markets.[68]

These market forces—along with the relaxation of certain regulations—likely drove some banks to become very large and complex in the years preceding the crisis. At the end of 1997, two insured depository institutions held more than $250 billion in assets, and together accounted for about 9.3% of total industry assets. By the end of 2007, six banks held 40.9% of industry assets. The trend has generally continued, and at the end of 2016, nine banks held more than $250 billion in assets, accounting for 50.3% of industry assets.[69]

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[65] Nonbank financial institutions, such as insurance companies, could potentially also be "too big to fail" as defined in this report. If designated as a "systemically important financial institution," a nonbank could—similar to a bank—be subject to enhanced prudential regulation by the Federal Reserve and the Orderly Liquidation Authority of the FDIC discussed in this section. However, nonbank issues are beyond the scope of this report. For more information about broader TBTF issues, see CRS Report R42150, *Systemically Important or "Too Big to Fail" Financial Institutions*, by (name redacted)

[66] A *bank holding company* (BHC) is a parent company that owns at least one subsidiary depository institution and may own many other financial companies of different types, including broker-dealers, asset managers, and insurance companies. All the largest U.S. bank organizations are structured as BHCs, and so institutions with this type of corporate structure are the subject of this section.

[67] William C. Dudley, "Solving the Too Big to Fail Problem," Remarks at the Clearing House's Second Annual Business Meeting and Conference, New York, NY, November 15, 2012, at https://www.newyorkfed.org/newsevents/speeches/2012/dud121115.

[68] Ben S. Bernanke, "*Ending 'Too Big To Fail': What the Right Approach?*" Brookings Institution, Ben Bernanke's Blog, May 13, 2016, at https://www.brookings.edu/blog/ben-bernanke/2016/05/13/ending-too-big-to-fail-whats-the-right-approach/.

[69] Data from FDIC Quarterly Banking Profile Time Series Spreadsheets, at https://www.fdic.gov/bank/analytical/qbp/.

However, many observers assert that when a financial institution exceeds a certain size, complexity, or interconnectedness, the institution—as well as its creditors and investors—may be incented to take on excessive risk. Companies in a market economy are generally restrained in their risk-taking by *market discipline*—market forces create incentives to carefully assess and appropriately manage potential losses. Shareholders and creditors want the likelihood of loss to be appropriately balanced with potential returns. However, banks of a certain size or complexity may create *moral hazard*—a situation in which a person or company is willing to take on outsized risks, because it believes it can profit from the potential gains while being protected from the potential losses.[70]

In the case of large banks, this perceived protection against loss comes from a belief that a large bank will receive government support in the event it becomes distressed. Very large institutions may be deeply interconnected with other financial institutions, and stress at one institution could quickly spread throughout the financial system. The resultant contagion effects could potentially cause devastating economic and social outcomes. If a TBTF bank believed government would intervene in such an event, the TBTF bank may take on excessive risks. Also, a TBTF institution could enjoy lower funding costs than competitors, as investors and creditors also may have expectations of government support for the institution.[71]

Many assert that certain events of the financial crisis of 2008-2009 were a demonstration of TBTF-related problems.[72] Large institutions had taken on large risks, and when they resulted in large losses, the institutions came under threat of failure. In some cases, the U.S. government took actions to stabilize the financial system and individual institutions.[73] Large bank-related actions included capital injections to nine of the largest banks conducted by the Treasury under the Troubled Asset Relief Program, and the government-assisted acquisition of Wachovia by Wells Fargo.[74]

Generally, two approaches have been used through Dodd-Frank provisions and the Basel III Accords to reduce or eliminate the problem of TBTF. One is to reduce potentially excessive risk-taking at large, complex, and interconnected financial institutions—including banks—through *enhanced prudential regulation*. Another is to reduce the need for and market expectations of government support in the event such an institution were failing. Aspects of both of these measures are subject to policy debate.

[70] David C. Wheelock, "Too Big To Fail: The Pros and Cons of Breaking Up Big Banks," *Federal Reserve Bank of St. Louis, The Regional Economist*, October 2012.

[71] William C. Dudley, President of the Federal Reserve Bank of New York, "Solving the Too Big to Fail Problem," Remarks at the Clearing House's Second Annual Business Meeting and Conference, New York, NY, November 15, 2012, at https://www.newyorkfed.org/newsevents/speeches/2012/dud121115.

[72] Neel Kashkari, President of the Federal Reserve Bank of Minneapolis, "Lessons from the Crisis: Ending Too Big to Fail," Remarks at the Brookings Institute, Washington, DC, February 16, 2016.

[73] Such actions included providing emergency funding from the Federal Reserve to Bear Sterns in March 2008, taking Fannie Mae and Freddie Mac into conservatorship in September 2008, and providing a loan and taking an equity stake in AIG in September 2008. See Federal Reserve Bank of New Work, "Timelines of Policy Responses to the Global Financial Crisis," at https://www.newyorkfed.org/medialibrary/media/research/global_economy/Crisis_Timeline.pdf.

[74] The Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report*, January 2011, pp. 371-376, at https://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

Enhanced Prudential Regulation[75]

Enhanced prudential regulation is intended to reduce the likelihood of large bank failure through measures that include higher capital ratios, enhanced liquidity standards, and Federal Reserve stress-testing for the nation's largest banks. As explained in the "Regulatory Ratio Requirements" section, capital ratios are a measure of a bank's ability to absorb losses. Generally, U.S. banks and BHCs holding more than $50 billion in assets are required to hold more capital than other banks.[76] Enhanced liquidity standards require certain large BHCs to maintain enough liquid assets—assets that can be easily converted into cash at low cost—sufficient to cover net cash outflows that might occur during a 30-day period during a time of financial stress.[77] Federal Reserve stress-testing involves the Federal Reserve evaluating the ability of large banks to remain adequately capitalized during hypothetical economic and financial downturns.[78] *Living will* requirements involve periodically preparing resolution plans for review by the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC).[79]

Enhanced prudential regulation is a *rules-based approach* to addressing TBTF problems. One's assessment of the efficacy and efficiency of a rules-based approach is likely to largely depend on one's assessment of whether rules-based or market-discipline-based risk assessments—to whatever degree they may or may not be distorted by TBTF incentives—can more accurately identify risk and incent firms to appropriately react to and manage those risks.

Proponents of enhanced prudential regulation note that market forces failed to restrain large institutions from taking risks leading up to the financial crisis that would ultimately result in the institutions facing failure. Furthermore, proponents argue that even if market participants are better able to identify risk accurately than are regulators, market participants have a higher tolerance for risk than society as a whole because they are unlikely to internalize the systemic risks associated with a TBTF firm's failure. In addition, regulators potentially have greater access to relevant information on risk than creditors and counterparties of large, complex, and potentially opaque firms. Finally, proponents assert that the practices required by the enhanced

[75] Portions of this section were adapted from text found in a section entitled "Regulating TBTF" in CRS Report R42150, *Systemically Important or "Too Big to Fail" Financial Institutions*, by (name redacted)

[76] In addition to the 4% simple leverage ratio required of all banks, certain large banks are subject to an additional *supplementary leverage ratio* ranging from 3% to 6%, depending on their size and the type of bank charter they hold. See FDIC, Federal Reserve System, and Office of the Comptroller of the Currency (OCC), "Regulatory Capital Rules: Regulatory Capital, Revisions to the Supplementary Leverage Ratio," 79 *Federal Register* 57725, September 26, 2014. In regard to risk-weighted ratios, the eight U.S. banks that have been designated as global systemically important banks (G-SIBs) face a capital surcharge that can range from 1% to 4.5%. See Federal Reserve System, "Regulatory Capital Rules: Implementation of Risk-Based Capital," 80 *Federal Register* 49082, August 14, 2015. A large bank also could be subject to a countercyclical buffer of up to 2.5% of risk-weighted assets if regulators deem it necessary. See Federal Reserve System, "Regulatory Capital Rules: The Federal Reserve Board's Framework," 81 *Federal Register* 5661, February 3, 2016.

[77] Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, "Liquidity Coverage Ratio: Liquidity Risk Measurement Standards," 79 *Federal Register* 61440-61442, October 10, 2014.

[78] Federal Reserve Board of Governors, *Dodd-Frank Act Stress Test 2016: Supervisory Stress Test Methodology and Results*, June 2016, pp. 1-2, at https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20160623a1.pdf. The Federal Reserve stress-testing is done in addition to company-run stress testing required of all banks with more than $10 billion in assets.

[79] Board of Governors of the Federal Reserve System and FDIC, *Resolution Plan Assessment Framework and Firm Determinations 2016*, April 13, 2016, p. 1, at https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20160413a2.pdf.

prudential regulation are "best practices" that any sophisticated, well-managed bank should follow to prudently manage risk.[80]

Opponents argue that regulators are not effective in curtailing risk-taking, and point to several potential shortcomings. They cite regulator inability or unwillingness to prevent excessive risk-taking at certain firms leading up to the crisis. In addition, they argue that regulators may have adapted to weaknesses raised by the last crisis, whereas the next crisis is likely to pose a novel set of problems.[81] Some argue that large firms are "too complex to regulate," meaning regulators are incapable of identifying or understanding the risks inherent in complicated transactions and corporate structures.[82] This has implications for whether simple or complex rules would be more effective. One response to addressing this complexity is to make the regulatory regime more sophisticated, but some critics argue that this approach is likely to backfire and simple regulations are more likely to be robust.[83] Others have argued that large firms are "too big to jail," meaning regulators cannot take effective supervisory actions against firms if those actions would undermine the firm's financial health, and thus its financial stability.[84]

Furthermore, critics argue that creating a special prudential regulatory regime is counterproductive. They contend that placing a bank in the regime is signaling to market participants that the bank has a protected status and would not be allowed to fail.[85] Thus, the government is in effect making TBTF status explicit, which potentially exacerbates the moral hazard problem. Instead of increasing the cost of being TBTF, firms in the special regulatory regime could end up borrowing at a lower cost than other firms (because, in effect, these firms would enjoy a lower risk of default).

Even if an enhanced prudential regime worked at reducing large bank risk-taking as planned, from a systemic risk perspective it could partly backfire in other ways. If financial intermediation and risky financial activities are pushed out of banks that are regulated for safety and soundness, the activity may simply migrate to more lightly regulated institutions and markets. The result could be a less regulated, less systemically stable financial system.[86] This issue is discussed in more detail in the "Potential Migration to Shadow Banking" section.

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[80] Professor Simon Johnson, Professor Massachusetts Institute of Technology, U.S. Congress Senate Committee on Banking, Housing, and Urban Affairs, *Examining the Regulatory Regime for Regional banks*, 114th Cong., 1st sess., March 24, 2015, at http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=14d286e0-9c50-4b96-87cf-fe999112550f.

[81] Arthur Wilmarth, "The Dodd-Frank Act: A Flawed and Inadequate Response to the Too-Big-To-Fail Problem," *Oregon Law Review*, vol. 89, April 6, 2011, p. 951.

[82] For example, the six largest BHCs had more than 1,000 subsidiaries each, and the two largest had more than 3,000 each in 2012, and their complexity has increased over time. Only one BHC had more than 500 subsidiaries in 1990, and the share of assets held outside of depository subsidiaries has grown over time for the largest BHCs. See Dafna Avraham, et al., "Peeling the Onion: A Structural View of U.S. Bank Holding Companies," *Liberty Street Economics*, July 20, 2012, at http://libertystreeteconomics.newyorkfed.org/2012/07/peeling-the-onion-a-structural-view-of-us-bank-holding-companies.html#.U-TnELFgi68.

[83] See, for example, Thomas Hoenig, "Back to Basics: A Better Alternative to Basel Capital Rules," FDIC, speech delivered to the American Banker Regulatory Symposium, September 14, 2012.

[84] See U.S. Congress, Senate Judiciary Committee, *Oversight of the U.S. Department of Justice*, 113th Cong., 1st sess., March 6, 2013.

[85] House Committee on Financial Services, *The Financial CHOICE Act: A Republican Proposal to Reform the Financial Regulatory System*, June 23, 2016, pp. 18-20, at http://financialservices.house.gov/uploadedfiles/financial_choice_act_comprehensive_outline.pdf.

[86] Thomas M. Hoening and Charles S. Morris, *Restructuring the Banking System to Improve Safety and Soundness*, Federal Reserve Bank of Kansas City, May 2011, p. 2, at https://www.banking.senate.gov/public/_cache/files/4c250445-e6e7-411a-a4f3-27e657ab9749/33A699FF535D59925B69836A6E068FD0.hoenigtestimony5912ficppm.pdf.

Enhanced prudential regulation of large banks may face similar questions concerning cost and benefit trade-offs covered in the "Regulatory Ratio Requirements" section: the benefits of safer banks and a more stable system may come at the cost of credit availability and economic growth. The issue is further complicated in relation to TBTF banks because if their funding costs are too low in the absence of enhanced regulation, then increasing costs for these institutions may correct a TBTF market distortion.[87]

Finally, observers debate what the appropriate thresholds that trigger enhanced regulation should be. Critics of the $50 billion asset threshold argue that many banks above that range are not systemically important. In particular, critics distinguish between *regional banks* (which tend to be at the lower end of the asset range and, it is claimed, have a traditional banking business model comparable to community banks) and *Wall Street banks* (a term applied to the largest, most complex organizations that tend to have significant nonbank financial activities).[88] Others dispute this characterization, arguing that some regional banks are involved in sophisticated activities, such as being swap dealers, and have large off-balance-sheet exposures.[89] If critics are correct that some banks that are currently subject to enhanced prudential regulation are not systemically important, then there may be little societal benefit from subjecting them to enhanced regulation, making that regulation unduly burdensome to them.

Legislative Alternatives

Opponents of enhanced prudential regulation for large banks offer a variety of alternative policy approaches. Congress could create exemptions from certain enhanced prudential regulations to reduce regulatory burden and increase reliance on market discipline. Some have proposed breaking up big banks, either by establishing asset limits or imposing capital requirements so stringent on banks that reach a certain size that they would have a strong incentive to break up into separate businesses. Another proposed alternative is to impose restrictions on mixing commercial banking and certain investment activities—perhaps similar to those previously required under the Glass-Steagall Act—and so limit how complex an institution can become.

Other proposals are based on the assessment that the enhanced regulation is not problematic per se; rather, that it has been applied too broadly and includes institutions that are not large or complex enough to be considered TBTF. If so, Congress could raise the threshold above $50 billion or switch to a designation process in which banks of a certain size had an opportunity to be assessed more on a case-by-case basis.[90] In addition, some think the regulations as currently

[87] Professor Michael S. Barr, University of Michigan Law School, Testimony to U.S. Congress, House Committee on Financial Services, *Does the Dodd-Frank Act End 'Too Big To Fail'*, 112th Cong., 1st sess., June 14, 2011, H.Hrg 112-37, at http://financialservices.house.gov/uploadedfiles/061411barr.pdf.

[88] See, for example, Deron Smithy, Executive Vice President and Treasurer, Regions Financial Corp., U.S. Congress Senate Committee on Banking, Housing, and Urban Affairs, *Examining the Regulatory Regime for Regional Banks*, 114th Cong., 1st sess., March 24, 2015, at http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=14d286e0-9c50-4b96-87cf-fe999112550f. For empirical evidence on how systemic importance varies across large banks, see Meraj Allahrakha, Paul Glasserman, and H. Peyton Young, *Systemic Importance Indicators for 33 U.S. Bank Holding Companies: An Overview of Recent Data*, Office of Financial Research Brief Series 15-01, February 2015, at https://www.financialresearch.gov/briefs/files/2015-02-12-systemic-importance-indicators-for-us-bank-holding-companies.pdf.

[89] See, for example, Professor Simon Johnson, Massachusetts Institute of Technology, U.S. Congress, Senate Committee on Banking, Housing, and Urban Affairs, *Examining the Regulatory Regime for Regional Banks*, 114th Cong., 1st sess., March 24, 2015, at http://www.banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=14d286e0-9c50-4b96-87cf-fe999112550f.

[90] The Federal Reserve Board of Governors and Financial Stability Oversight Council also have the authority to raise the threshold above $50 billion.

formulated are more burdensome than is necessary, in which case Congress could alter certain regulations to provide regulatory relief, such as by reducing the frequency with which banks are subject to stress tests or must submit living wills—plans to resolve the bank—to the Federal Reserve.

Addressing TBTF Failures

The TBTF problem can also be addressed by credibly reducing or eliminating the possibility that government will save a failing institution, and ensuring that losses resulting from a failure would be borne by shareholders and creditors. Other industries generally resolve failing firms through bankruptcy. However, some observers assert that part of what makes some financial firms too big to fail is that the bankruptcy process is not amenable to resolving a large financial institution without disrupting the financial system.[91] They argue a firm that dominates important financial market segments cannot be liquidated without disrupting the availability of credit, and the deliberate pace of the bankruptcy process is not equipped to avoid the runs and contagion inherent in the failure of a financial firm. Also, the effects on systemic risk are not taken into account when decisions are made in the bankruptcy process. Government commitments to let financial firms fail may not be credible if that failure is likely to be disruptive and destabilizing to the financial system and the economy.[92]

Another Dodd-Frank reform was the creation of an alternative resolution regime for certain financial firms outside of bankruptcy. An example of such a regime existed prior to the crisis in which the FDIC had the authority to resolve deposit-taking institutions that failed. However, the pre-Dodd-Frank Act authority may not be sufficient to resolve very large banking organizations due to their complex nature. Many of the largest financial institutions are organized as *bank-holding companies* (BHCs)—parent companies that own many (sometimes thousands) of subsidiary companies that include at least one deposit-taking commercial bank as well as other subsidiaries, such as broker-dealers, asset managers, and investment advisors. A BHC could possibly become distressed at the holding-company level, or distress at a non-deposit-taking subsidiary could spread to the holding-company level. In these cases, it is not clear if the authority to resolve deposit-taking subsidiaries could prevent a chaotic, disruptive failure with systemic implications.[93]

The Orderly Liquidation Authority (OLA) created by the Dodd-Frank Act gives the FDIC authority to resolve large BHCs, as well as certain nonbank financial institutions.[94] Proponents argue that such a resolution regime offers an alternative to propping up a failing BHC with government assistance or suffering the systemic consequences of a protracted and messy

[91] Ben Bernanke, Chairman of the Federal Reserve, Testimony to U.S. Congress, House Committee on Financial Services, *Federal Reserve's Perspectives on Financial Regulatory Reform Proposals*, 110th Cong., 1st sess., October 1, 2009, H.Hrg 111-83, pp. 7-8, at http://archives.financialservices.house.gov/media/file/hearings/111/testimony_of_chairman_bernanke.pdf.

[92] Sabrina R. Pellerin and John R. Walter, "Orderly Liquidation Authority as an Alternative to Bankruptcy," *Federal Reserve Bank of Richmond Economic Quarterly*, vol. 98, no. 1 (First Quarter 2010), pp. 1-16, at https://www.richmondfed.org/-/media/richmondfedorg/publications/research/economic_quarterly/2012/q1/pdf/walter.pdf.

[93] Remarks by Martin J. Gruenberg, Acting Chairman, FDIC, to the Federal Reserve Bank of Chicago Bank Structure Conference, Chicago, IL, May 10, 2012, at https://www.fdic.gov/news/news/speeches/chairman/spmay1012.html.

[94] Orderly Liquidation Authority could potentially be used to resolve certain nonbank financial institutions. Because the focus of this report is banking policy issues, it covers issues related to bank holding company resolutions under OLA.

bankruptcy.[95] They point to the similarities between the OLA and the FDIC's resolution regime, and note the successes of the FDIC's resolution process of large depositories—such as Wachovia and Washington Mutual—during the crisis. Those failures arguably were less disruptive to the financial system than the failure of Lehman Brothers—a nondepository that went through the bankruptcy process—even though Wachovia and Lehman Brothers were similar in size.[96] Neither FDIC resolution involved government assistance. Losses were imposed on stockholders and unsecured creditors in the resolution of Washington Mutual.[97] In the case of Wachovia, the FDIC arranged for Wells Fargo to acquire the failing bank.[98]

Critics argue that the resolution of a depository—even a large one—is substantially different from the resolution of a very large, very complex BHC and its affiliated subsidiaries, and voice doubts that the OLA could be used to smoothly resolve such an institution.[99] In addition, critics assert that the OLA gives policymakers too much discretionary power, which could result in higher costs to the government and preferential treatment of favored creditors during the resolution. In other words, it could enable "backdoor bailouts" that could allow government assistance to be funneled to the firm or its creditors beyond what would be available in bankruptcy, perpetuating the moral hazard problem.[100] The normal FDIC resolution regime minimizes the potential for these problems through statutory requirements of least-cost resolution and prompt corrective action, but some expect that a resolution regime for TBTF firms would at times be required to subordinate a least-cost principle to systemic risk considerations.[101] Therefore, a resolution could be more beneficial to creditors than the bankruptcy process.

As an alternative to a special resolution regime, some observers call for amending the bankruptcy code to create a special chapter for complex financial firms to address problems that have been identified, such as a speedier process and the ability to reorganize.[102] To some extent, these concerns are addressed in the bankruptcy code. But unlike Title II, the bankruptcy process

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[95] Sabrina R. Pellerin and John R. Walter, "Orderly Liquidation Authority as an Alternative to Bankruptcy," *Federal Reserve Bank of Richmond Economic Quarterly*, vol. 98, no. 1 (First Quarter 2010), pp. 1-16, at https://www.richmondfed.org/-/media/richmondfedorg/publications/research/economic_quarterly/2012/q1/pdf/walter.pdf.

[96] Wachovia and Lehman Brothers were sequential (46th and 47th largest, respectively) on *Fortune*'s list of the 500 largest companies of 2007. The list can be accessed at http://money.cnn.com/magazines/fortune/fortune500/2007/full_list/index.html.

[97] Federal Deposit Insurance Corporation, "JPMorgan Chase Acquires Banking Operations of Washington Mutual," Press Release PR-85-2008, September 25, 2008.

[98] Scott G. Alvarez, Federal Reserve General Counsel, Testimony to Financial Crisis Inquiry Commission, *The Acquisition of Wachovia Corporation by Wells Fargo and Company*, September 1, 2010, at https://www.federalreserve.gov/newsevents/testimony/alvarez20100901a.htm.

[99] Kwon-Yong Jin, "How To Eat an Elephant: Corporate Group Structure of Systemically Important Financial Institutions, Orderly Liquidation Authority, and Single Point of Entry Resolution," *The Yale Law Journal*, vol. 124, no. 5 (March 2015), pp. 1746-1753.

[100] See, for example, Jeffrey Lacker and John Weinberg, "Now How Large is the Safety Net?" *Economic Brief 10-06*, June 2010, at http://www.richmondfed.org/publications/research/economic_brief/2010/pdf/eb_10-06.pdf.

[101] House Committee on Financial Services, *The Financial CHOICE Act: A Republican Proposal to Reform the Financial Regulatory System*, June 23, 2016, pp. 21-22, at http://financialservices.house.gov/uploadedfiles/financial_choice_act_comprehensive_outline.pdf.

[102] See, for example, Kenneth Scott and John Taylor, "How to Let Too Big to Fail Banks Fail," *Wall Street Journal*, May 16, 2013, p. A15; Hoover Institute, Resolution Project publications, at http://www.hoover.org/taskforces/economic-policy/resolution-project/publications. For a comparison, see Sabrina Pellerin and John Walter, "Orderly Liquidation Authority as an Alternative to Bankruptcy," Federal Reserve Bank of Richmond, *Economic Quarterly*, vol. 98, no. 1 (First Quarter 2012), p. 1.

cannot—for better or worse—base decisions on financial stability concerns or ensure that a financial firm has access to the significant sources of liquidity it needs.[103]

Until a TBTF firm fails, it is an open question as to whether a special resolution regime could successfully achieve what it is intended to do—shut down a failing firm without triggering systemic disruption or exposing taxpayers to losses. Given the size of the firms involved and the unanticipated transmission of systemic risk, it is not clear if the government could impose losses on creditors via OLA without triggering contagion.

Acting as receiver in a future failure, the FDIC could face the same short-term incentives to limit creditor losses in order to contain systemic risk that caused policymakers to rescue firms in the recent crisis.[104] If those short-term incentives spur the receiver to avoid creditor losses, the only difference between a resolution regime and a "bailout" might be that shareholder equity is wiped out, which may not generate enough savings to avoid costs to the government. The Federal Reserve imposes a "total loss absorbing capacity" (TLAC) requirement—a minimum level of capital and long-term debt—on certain large banks in part to create the expectation that shareholders and creditors will bear the losses in a failure.[105] In addition, a mandatory funding mechanism exists in Title II to recoup losses to taxpayers. However, because that mechanism is not "prefunded," there could be at least temporary taxpayer losses.[106]

Legislative Alternatives

Opponents to the OLA assert that large BHCs should be resolved through bankruptcies to instill market discipline in TBTF banks and protect the taxpayers from potential losses, especially if weaknesses related to large BHCs in the bankruptcy process are addressed. If Congress decides to take this approach, it could repeal the FDIC's OLA authorities and amend the Bankruptcy Code.

Community Banks[107]

While some banks hold a very large amount of assets, are complex, and operate on a national or international scale, the vast majority of U.S. banks are relatively small, have simple business models, and operate within a local area. This section provides background on these smaller, simpler banks—often called *community banks*—and analyzes issues related to them, including

- regulatory relief for community banks, and
- the long-term decline in the number of community banks.

[103] Sabrina Pellerin and John Walter, "Orderly Liquidation Authority as an Alternative to Bankruptcy," Federal Reserve Bank of Richmond, *Economic Quarterly*, vol. 98, no. 1 (First Quarter 2012), pp. 5-10, 19.

[104] CRS Report R42150, *Systemically Important or "Too Big to Fail" Financial Institutions*, by (name redacted)

[105] Federal Reserve Board of Governors, "Federal Reserve Board Proposes New Rule to Strengthen the Ability of Largest Domestic and Foreign Banks Operating in the United States to be Resolved Without Extraordinary Government Support or Taxpayer Assistance," press release, October 30, 2015, at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20151030a.htm.

[106] Congressional Budget Office, *Cost Estimate H.R. 4894: A Bill to Repeal Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, May 6, 2016, pp. 1-2, at https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/costestimate/hr4894.pdf.

[107] Portions of this section are adapted from text found in CRS Report R43999, *An Analysis of the Regulatory Burden on Small Banks*, by (name redacted) and (name redacted)

Background

Banks are often classified as community banks based on their total asset size—the value of the loans, securities, and other assets they hold. However, many have observed that most small banks are generally different from large banks in a variety of ways besides asset size. Smaller institutions often are more concentrated in core bank businesses of making loans and taking deposits and less involved in other, more complex activities and products more typically performed by large banks. Small banks also tend to operate within a smaller geographic area. In addition, small banks are generally more likely to practice *relationship lending* wherein loan officers and other bank employees have a longer-standing and perhaps more personal relationship with borrowers. Due in part to these characteristics, proponents of community banks assert that these banks are particularly important credit sources to local communities and otherwise underserved groups, as big banks may be unwilling to fulfill the credit needs of a small market of which they have little knowledge.[108] Finally, relative to large banks, small banks are likely to have fewer employees, to have less resources to dedicate to regulatory compliance, and to individually pose less of a systemic risk to the broader financial system.[109]

There is no standard, commonly accepted definition or asset size threshold of what constitutes a small bank or a community bank. Statutes and regulations identify exempted banks by various asset size thresholds, such as those with under $10 billion or $50 billion in assets. The Federal Reserve defines community banks as those banks with less than $10 billion in assets.[110] The Office of the Comptroller of the Currency (OCC) defines community banks as generally having $1 billion or less in assets.[111] Others define community banks by combining size with a focus on relationship-based services, such as lending, with the local community. The FDIC has a research definition of community banking organizations, which it defines as (1) banks with less than $1 billion in assets as long as the bank makes loans and takes deposits, does not hold a large share of foreign assets, and is not a specialty bank; or (2) banks with more than $1 billion in assets that meet certain criteria, such as having more than one-third of their assets in loans, core deposits equal to at least half of their assets, and a limited geographic presence.[112] By this definition, not all community banks are small banks, although the two are closely related.

Because there is no widely accepted definition, this report uses the terms "small bank" and "community bank" interchangeably, generally referring to relatively small banks focused on serving the credit needs of people and businesses within a particular area using simple financial products.

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[108] FDIC, *FDIC Community Banking Study*, December 2012, at https://www.fdic.gov/regulations/resources/cbi/report/cbi-full.pdf.

[109] Drew Dahl, Andrew Meyer, and Michelle Neely, "Scale Matters Community Banks and Compliance Costs," *Federal Reserve Bank of St. Louis, The Regional Economist*, July 2016, at https://www.stlouisfed.org/~/media/Publications/Regional-Economist/2016/July/scale_matters.pdf.

[110] See, for example, Board of Governors of the Federal Reserve System, *Community Banking*, at http://www.federalreserve.gov/bankinforeg/topics/community_banking.htm.

[111] See, for example, Office of the Comptroller of the Currency (OCC), *Community Bank Supervision: Comptroller's Handbook*, January 2010, at http://www.occ.treas.gov/publications/publications-by-type/comptrollers-handbook/cbs.pdf.

[112] See, for example, FDIC, *FDIC Community Banking Study*, December 2012, at https://www.fdic.gov/regulations/resources/cbi/report/cbi-full.pdf.

Regulatory Burden on Community Banks

A central question about the regulation of banks in general is whether an appropriate trade-off has been struck between the benefits and costs of regulation. The costs associated with government regulation and its implementation are referred to as *regulatory burden*. A regulation could be a net positive for society if the benefits of the regulation exceed the cost. In contrast, regulation could be a net negative if costs exceed benefits—sometimes referred to as *unduly burdensome* regulation. Critics of recent regulation assert that when applied to community banks, certain realized benefits (such as increased systemic stability) are likely to be relatively small, whereas certain realized costs (such as compliance expenses for banks with limited resources and reduced credit for certain communities) are likely to be relatively large.[113]

Other observers assert that the regulatory burden facing small banks is appropriate, and note that small banks are given special regulatory consideration to minimize their regulatory burden. Many regulations, including some regulations resulting from Dodd-Frank, include an exemption for small banks or are tailored to reduce the cost for small banks to comply.[114] In addition, during the rulemaking process, bank regulators are required to consider the effect of rules on small banks under the Regulatory Flexibility Act (RFA) of 1980 (P.L. 96-354)[115] and the Riegle Community Development and Regulatory Improvement Act (P.L. 103-325).[116] Supervision is also structured to pose less of a burden on small banks than larger banks, such as by requiring less-frequent bank examinations for certain small banks.[117]

One argument for easing the regulatory burden for community banks is that regulation intended to increase systemic stability need not be applied to community banks. Due to the role of large institutions in the crisis, policymakers have been particularly focused on the systemic risk posed by large banks and ensuring that they are not "too big to fail."[118] As previously noted, the Dodd-Frank Act attempted to address this problem by imposing heightened prudential regulatory standards on the largest banks relative to small and medium-sized banks. Sometimes the argument is extended to assert that because small banks did not cause the crisis and pose less systemic risk, they need not be subject to new regulations. Opponents of these arguments note that systemic risk is only one of the goals of regulation, along with prudential regulation and consumer protection. They contend that precrisis prudential regulation for small banks was not stringent enough, as hundreds of small banks failed during and after the crisis.[119]

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[113] CRS Report R43999, *An Analysis of the Regulatory Burden on Small Banks*, by (name redacted) and (name redacted)

[114] CRS Report R43999, *An Analysis of the Regulatory Burden on Small Banks*, by (name redacted) and (name redacted)

[115] 5 U.S.C. §§601-612. Neither of the terms "significant" or "substantial" in this context is defined in the Regulatory Flexibility Act.

[116] 12 U.S.C. §4802(a).

[117] For example, see Federal Reserve System, "Inspection Frequency and Scope Requirements for Bank Holding Companies and Savings and Loan Holding Companies with Total Consolidated Assets of $10 Billion or Less," SR 13-21, December 17, 2013, at http://www.federalreserve.gov/bankinforeg/srletters/sr1321.htm.

[118] Gov. Daniel Tarullo, "A Tiered Approach to Regulation and Supervision of Community Banks," speech at the Community Bankers Symposium, Chicago, Illinois, November, 7, 2014, at http://www.federalreserve.gov/newsevents/speech/tarullo20141107a.htm.

[119] An FDIC study found that community banks did not account for a disproportionate share of bank failures between 1975 and 2011, relative to their share of the industry. Because community banks account for more than 90% of organizations (by the FDIC definition, which as noted above is not limited to a size threshold), most bank failures are community banks, however. See FDIC, *FDIC Community Banking Study*, p. 2-10, December 2012, at (continued...)

Another potential rationale for easing regulations on small banks would be if there are economies of scale to regulatory compliance costs. While regulatory compliance costs are likely to rise with size, those costs as a percentage of overall costs or revenues are likely to fall. In particular, as regulatory complexity increases, compliance may become relatively more costly for small firms.[120] To give a simplified example, imagine a bank with $100 million in assets and 25 employees and a bank with $10 billion in assets and 1,250 employees each determine they must hire an extra employee to ensure compliance with new regulations. The relative burden is larger on the small institution that expands its workforce by 4% than on the large bank that expands by less than 0.1%. From a cost-benefit perspective, if regulatory compliance costs are subject to economies of scale, then the balance of costs and benefits of a particular regulation will differ depending on the size of the bank. For the same regulatory proposal, economies of scale could potentially result in costs outweighing benefits for smaller banks. Empirical evidence on whether compliance costs are subject to economies of scale is mixed.[121]

Some argue for reducing the regulatory burden on small banks on the grounds that they provide greater access to credit or offer credit at lower prices than large banks for certain groups of borrowers. These arguments tend to emphasize potential market niches small banks occupy that larger banks may be unwilling to fill, such as low-income or rural communities and other underserved markets. Empirical evidence is also mixed. Data that support these arguments include the fact that community banks held 71% of total deposits in rural counties in 2011, compared with 19% of overall deposits nationwide.[122] Similarly, it is argued that small banks are better situated to engage in types of transactions that depend on "relationship banking" (i.e., personalized knowledge of risks), and that rigid regulations with standardized criteria are not well suited for the relationship banking model.[123]

Due to a lack of a clear, consensus definition, setting exemption thresholds and criteria is an issue of calibration. Should they be set so that regulations apply only to the very largest, most complex banks, as well as internationally active banks with substantial nonbank subsidiaries? Should the thresholds be set relatively low, so that only very small banks are exempt?[124] Often at issue in this debate are the so-called *regional banks*—banks that are larger and operate across a greater geographic market than the community banks that have less than $10 billion or $1 billion in

(...continued)

https://www.fdic.gov/regulations/resources/cbi/report/cbi-full.pdf.

[120] Drew Dahl, Andrew Meyer, and Michelle Neely, "Scale Matters Community Banks and Compliance Costs," *Federal Reserve Bank of St. Louis, The Regional Economist*, July 2016, at https://www.stlouisfed.org/~/media/Publications/Regional-Economist/2016/July/scale_matters.pdf.

[121] For example, see FDIC, *FDIC Community Banking Study*, p. B-2, December 2012; FDIC Office of Inspector General, *The FDIC's Examination Process for Small Community Banks*, AUD-12-011, August 2012; CFPB, *Understanding the Effects of Certain Deposit Regulations on Financial Institutions' Operations*, November 2013, p. 113; and Independent Community Bankers of America, *2014 ICBA Community Bank Call Report Burden Survey*.

[122] See FDIC, *FDIC Community Banking Study*, p. 3-6, December 2012, at https://www.fdic.gov/regulations/resources/cbi/report/cbi-full.pdf.

[123] See Conference of State Bank Supervisors, *An Incremental Approach to Financial Regulation: Right-Sized Regulations for Community Banks*, December 2013, at http://www.csbs.org/legislative/testimony/Documents/An%20Incremental%20Approach%20to%20Financial%20Regulation.pdf.

[124] In an interview with *American Banker*, Sheila Bair, former chairman of the FDIC, suggested a $10 billion threshold for broad exemptions and tailoring. See Rob Blackwell, "The Easy Legislative Fix that Could Save Community Banks," *American Banker*, February 23, 2015.

assets, but also smaller and less complex than the largest, most complex organizations with hundreds of billions or trillions of dollars in assets.[125]

Legislative Alternatives

If Congress decides that additional regulatory relief should be provided for small banks, it could continue to be provided under the current system of ad hoc exemptions. As new laws and regulations are adopted, policymakers can decide to use size-based exemptions or tailoring more often and at higher size thresholds. In addition, exemptions can be retroactively added, or thresholds of existing exemptions could be raised. An alternative to the current system would be a single, consistent exemption based on size or other criteria set by statute. Another would be setting criteria that automatically exempt certain institutions, and granting regulators discretion to exempt any other institutions they deem appropriate.

Reduced Number of Community Banks

Small banks, under almost any common definition, have seen their numbers decline and their collective share of banking industry assets fall in the United States in recent decades. Overall, the number of FDIC-insured institutions fell from a peak of 18,083 in the first quarter of 1986 to 5,913 in 2016. The number of institutions with less than $1 billion in assets fell from 18,045 to 5,799 in that time period, and the share of industry assets held by those banks fell from 72% to 18%. Meanwhile, the number of banks with more than $10 billion in assets rose from 36 to 114 from 1986 to 2016, and the share of total banking industry assets held by those banks increased from 28% to 82%.[126]

The decrease in the number of banks occurred through three main methods. Most of the decline in the number of institutions in the last 30 years was due to mergers, which averaged over 400 a year from 1990 to 2016. Failures were minimal from 1999 to 2007, but played a larger role in the decline during the financial crisis and recession. As economic conditions have improved more recently, failures have declined, but the number of *new reporters*—new chartered institutions providing information to the FDIC for the first time—has been extraordinarily small in recent years and was zero in 2016.[127]

Observers have cited several possible causes for this industry consolidation. As covered in more detail in the previous section, "Regulatory Burden on Community Banks," some argue it indicates that the regulatory burden on small banks is too onerous, driving smaller banks to merge to create or join larger institutions. However, mergers—the largest factor in consolidation—could occur for a variety of reasons. For example, a bank that is struggling financially may look to merge with a stronger bank in order to stay in business. Alternatively, a small bank that has been outperforming its peers may be bought by a larger bank that wants to benefit from its success.

In addition, other fundamental changes besides regulatory burden in the banking system could be driving consolidation, making it difficult to isolate the effects of regulation.[128] Through much of

[125] For example, see Federal Reserve Governor Lael Brainard's Speech, "Identifying Opportunities for Reducing Regulatory Burdens on Community Banks," the Economic Growth and Regulatory Paperwork Reduction Act Outreach Meeting, Chicago, Illinois, October 19, 2015, at https://www.federalreserve.gov/newsevents/speech/brainard20151019a.htm.

[126] Data from FDIC Quarterly Banking Profile Time Series Spreadsheets, at https://www.fdic.gov/bank/analytical/qbp/.

[127] Data from FDIC Statistics at a Glance, FDIC Historical trends, at https://www.fdic.gov/bank/statistical/stats/.

[128] The head of a 2007 interagency study on regulatory burden stated that "it is difficult to accurately measure the impact regulatory burden has played in industry consolidation.... " Federal Financial Institutions Examination Council (continued...)

the 20th century, federal and state laws restricted banks' ability to open new branches and banking across state lines was restricted; branching and banking across state lines was not substantially deregulated at the federal level until 1997 through the Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (P.L. 103-328).[129] These restrictions meant many individual, small banks were needed to serve every community. When these restrictions were relaxed, it became easier for small banks to consolidate or for mid-size and large banks to spread operations to other markets. In addition, there may be economies of scale (cost advantages due to size or volume of output) to banking, and they may be growing over time, which would also drive industry consolidation. For example, information technology has become more important in banking (e.g., cybersecurity and mobile banking), and certain information technology systems may be subject to economies of scale.[130] Finally, the slow growth coming out of the most recent recession, and macroeconomic conditions more generally (such as low interest rates), may make it less appealing for new firms to enter the banking market.

Legislative Alternatives

To the degree that regulatory burden is causing consolidation in the bank industry, regulatory relief for community bank policies such as those discussed in "Legislative Alternatives" found in the section above could potentially address the decline in the number of community banks.

Regulatory Agency Design and Independence

Financial regulatory agencies are invested with the authority to regulate, and most of them are referred to as *independent regulatory agencies*, allowing them to operate with a relatively high degree of independence from the President and Congress. This raises the issue of how they should be held accountable for the regulations they implement and the actions they take. This section provides background on the issue of agency independence and issues related to creating an appropriate degree of accountability, including

- whether the agency is self-funding or funded through appropriations;
- whether the agency is led by an individual or a bipartisan commission;
- what regulatory analysis requirements the agency faces in the rulemaking process; and
- to what extent agency rulemaking is subject to congressional review.

(...continued)

(FFIEC), *Joint Report to Congress: EGRPRA*," July 31, 2007, p. 3, at http://egrpra.ffiec.gov/docs/egrpra-joint-report.pdf. A 2014 study looked at the effect of regulatory burden on new charters and found that at least 75% of the decline could be attributed to macroeconomic conditions; see Robert M. Adams and Jacob P. Gramlich, *Where Are Al the New Banks? The Role of Regulatory Burden in New Charter Creation*, Federal Reserve Board, December 16, 2014, at http://www.federalreserve.gov/econresdata/feds/2014/files/2014113pap.pdf.

[129] For more on the law's effect on consolidation, see U.S. Government Accountability Office (GAO), *Community Banks and Credit Unions: Impact of the Dodd-Frank Act Depends Largely on Future Rule Makings*, GAO-12-881, September 2012, at http://www.gao.gov/assets/650/648210.pdf.

[130] The presence of economies of scale in banking has not been proven and is the subject of extensive research. See, for example, FDIC, *FDIC Community Banking Study*, December 2012, pp. 5-22, at https://www.fdic.gov/regulations/resources/cbi/report/cbi-full.pdf.

Background

Financial regulators conduct rulemaking, supervision, and enforcement to implement law and supervise financial institutions. A list of federal financial regulators is provided in **Table 1**. These agencies—along with certain other regulatory agencies—have been given certain characteristics that generally make them more independent from the President and Congress than most executive agencies. Their independence results from characteristics including their leadership structure, ability to self-fund outside the appropriations process, and rulemaking requirements. While this independence allows technical rules to be designed by experts who are to some degree insulated from political considerations, it also results in rules being implemented by individuals who arguably are not directly accountable to the electorate.[131] Whether an appropriate balance between independence and accountability of these agencies has been achieved is a matter of debate. Some observers argue that better regulatory outcomes would be achieved if agencies were more accountable. Others feel that independence is necessary for agencies to effectively regulate and should not be reduced.

Table 1. Overview of Federal Bank Regulators

Name/Acronym	General Responsibilities
Consumer Financial Protection Bureau (CFPB)	Regulation of financial products for consumer protection
Federal Deposit Insurance Corporation (FDIC)	Provision of deposit insurance, regulation of banks, receiver for failing banks
Federal Reserve System (Fed)	Monetary policy; regulation of banks, systemically important financial institutions, and the payment system
National Credit Union Administration (NCUA)	Provision of deposit insurance, regulation of credit unions, receiver for failing credit unions
Office of the Comptroller of the Currency (OCC)	Regulation of banks

Source: Table compiled by the Congressional Research Service (CRS).

Note: For more information on the roles, duties, and responsibilities of the federal financial regulators, see CRS Report R43087, *Who Regulates Whom and How? An Overview of U.S. Financial Regulatory Policy for Banking and Securities Markets*, by (name redacted) .

Self-Funding Versus Appropriations[132]

Self-funding is one characteristic that provides certain financial regulators with a relatively high degree of independence. The annual appropriations process and periodic reauthorization legislation provide Congress with opportunities to influence the size, scope, priorities, and activities of an agency. However, most federal bank regulators generate income from other sources, such as the collection of fees or assessments from the entities that they oversee, and are not subject to the appropriations process.[133]

[131] CRS Report R43391, *Independence of Federal Financial Regulators: Structure, Funding, and Other Issues*, by (name redacted), (name redacted), and (name redacted)

[132] This section was adapted from text found in CRS Report R43391, *Independence of Federal Financial Regulators: Structure, Funding, and Other Issues*, by (name redacted), (name redacted), and (name redacted)

[133] There are exceptions. CFPB funding is transferred from the Federal Reserve's revenues. The FDIC (for its inspector general) and the National Credit Union Administration (for the Community Development Revolving Loan Fund Program) receive minor funding through the Financial Services and General Government (FSGG) appropriations bill.

(continued...)

Those who believe financial regulator independence has become excessive often assert that ending self-funding and bringing financial regulators into the appropriations and authorization processes would result in a more appropriate level of accountability. Doing so would provide Congress with regular opportunities to evaluate an agency's performance. During these processes, Congress also might influence the activities of these agencies by legislating provisions that reallocate resources or place limitations on the use of appropriated funds to better reflect congressional priorities. Through line-item funding, bill text, or accompanying committee report text, Congress could encourage, discourage, require, or forbid specific activities at the agency, including rulemaking. Alternatively, Congress could adjust an agency's overall funding level if Congress is supportive or unsupportive of the agency's mission or conduct. Thus, congressional control over an agency's funding reduces its independence from (and increases its accountability to) Congress.[134] However, opponents argue that reduced independence would produce worse regulatory outcomes, because—as mentioned previously—it may politicize regulators' policymaking at the expense of allowing experts to write technical rules.

Legislative Alternatives

Congress could end financial regulatory agency self-funding or bring the regulators into the appropriations and authorization processes if it seeks to reduce agency independence and increase accountability to Congress.

Leadership Structure[135]

Each bank regulatory agency was created at a different time and in a different policy context, and so each agency's leadership has different structural features, as shown in **Table 2**. Currently, some regulatory agencies are led by a single leader and some are led by multimember boards. In each case where there is a board structure, the board has a chairman, whose powers vis-à-vis other members vary by agency.

(...continued)

For more information, see CRS Report R43391, *Independence of Federal Financial Regulators: Structure, Funding, and Other Issues*, by (name redacted), (name redacted), and (name redacted)

[134] Michael S. Barr, "Comment: Accountability and Independence in Financial Regulation: Checks Balances, Public Engagement and Other Innovations," *Law and Contemporary Problems*, vol. 78 (2015), pp. 119-128.

[135] This section was adapted from text found in CRS Report R43391, *Independence of Federal Financial Regulators: Structure, Funding, and Other Issues*, by (name redacted), (name redacted), and (name redacted)

Table 2. Bank Regulatory Agency Leadership Structure

Regulator	Type of Agency Head	Selection of Officers
Consumer Financial Protection Bureau	Director, deputy director, and four assistant directors.	The director is presidentially appointed with Senate confirmation. The deputy director and four assistant directors are selected by the director.
Federal Deposit Insurance Corporation	Five-person board composed of three presidential appointees (one of whom is chair and one of whom is vice-chair), the Comptroller of the Currency, and the director of the CFPB.	The three appointees and the positions of chair and vice-chair are presidentially appointed with Senate confirmation.
Federal Reserve Board of Governors	Seven-member board. From the board, a chairman and two vice chairmen are chosen.	Governors, chair, and vice-chairs are presidentially appointed with Senate confirmation.
National Credit Union Administration	Three-member board with chairman.	Presidentially appointed with Senate confirmation. Among the members, the President appoints the chairman.
Office of the Comptroller of the Currency	Headed by the Comptroller, with up to four Deputy Comptrollers.	The Comptroller is appointed by the President with Senate confirmation. Deputy Comptrollers are selected by the Treasury Secretary.

Source: CRS; U.S. code accessed through http://uscode.house.gov/.

Different arguments are made in favor of which leadership structure would be most appropriate for the various agencies. Vesting power in a board arguably encourages a diversity of views to be represented, which may lead to more durable policy decisions. On the other hand, vesting power in one individual arguably could create stronger, more unified leadership and a single point of accountability, perhaps leading to faster and more numerous decisions.[136]

Different leadership structures also raise issues related to the independence versus accountability trade-off. Where an agency is headed by a single individual, the appointee's views are more likely to reflect the views of the appointing President and his or her party; the leadership is unitary and no consensus is necessary.[137] In contrast, the collegial structure is thought to increase the independence of an agency from the President.[138] Therefore, observers who believe agencies should have more independence from the President are often proponents of replacing the leadership structure at agencies headed by a director with multimember commissions.

Other characteristics of leadership positions may enhance independence from Congress and the President. For example, independence is thought to increase when leadership term length exceeds the length of a presidential term and is staggered and nonrenewable; when nominees are required to have issue expertise; and when agency heads can be removed only "for cause."[139] The leadership of financial regulatory agencies generally has such features, although notably the Comptroller of the Currency does not have "for cause" removal protections.

[136] CRS Report R43391, *Independence of Federal Financial Regulators: Structure, Funding, and Other Issues*, by (name redacted), (name redacted), and (name redacted)

[137] Such an appointee's term might exceed the appointing President's term, however, and the appointee's policy preferences might not match those of the incoming President.

[138] For a discussion, see Rachel Barkow, "Insulating Agencies: Avoiding Capture Through Institutional Design," *Texas Law Review*, vol. 89, no. 1 (November 2010), p. 15-41.

[139] Ibid.

Legislative Alternatives

Congress could change financial regulatory agencies' structures in various ways to alter the balance between agency independence and accountability. For example, Congress could make agencies headed by a director more accountable by eliminating "for cause" removal protections or replacing the director with a multimember board or commission.

Cost-Benefit Analysis Requirements[140]

One method of maintaining accountability is statutorily requiring agencies to perform a *cost-benefit analysis (CBA)*—a systematic examination, estimation, and comparison of the economic costs and benefits potentially resulting from the implementation of a proposed new rule—as part of the rulemaking process. In this way, the agency demonstrates that it has given reasoned consideration to the necessity and efficacy of a rule and the effects it will have on society.[141]

However, a fully quantified and monetized analysis with results that have a high degree of precision is not always feasible. Predicting future outcomes requires making assumptions that are subject to a degree of uncertainty. Accounting for human behavioral responses to a regulation poses challenges. Some effects are difficult to quantify and monetize. Relevant data are not always available and accurate. This raises questions about the appropriate scope, level of detail, and degree of quantification that should be required of analyses performed in the rulemaking process.[142]

Overly lenient requirements could risk overly burdensome regulation with limited benefit being implemented by an unaccountable agency without due consideration of consequences.[143] On the other hand, overly onerous analytic requirements could risk impeding the implementation of necessary, beneficial regulation because performing the analysis would be too time-consuming, too costly, or simply not possible.[144]

Debate over appropriate CBA requirements for financial regulators involves an additional complication. Currently, most financial regulators, as independent regulatory agencies, are not subject to certain executive orders, such as E.O. 12866, which directs the CBA performed by most executive departments and agencies.[145] This exemption generally gives financial regulators a relatively high degree of discretion in the parameters of the CBAs they perform. However, experts disagree over whether greater discretion for financial regulators is appropriate.

Some observers assert financial regulators should not be subject to a rigid legal structure when performing CBA. They claim that attempts to quantify the effects of financial regulation are

[140] For more information see, CRS Report R44813, *Cost-Benefit Analysis and Financial Regulator Rulemaking*, by (name redacted) and (name redacted) .

[141] Eric A. Posner and E. Glen Weyl, "Benefit-Cost Paradigms in Financial Regulation," *Coase-Snador Institute for Law and Economics Working Paper No. 660*, March 2014, p. 3.

[142] Jonathan S. Masur and Eric A. Posner, "Unquantified Benefits and the Problem of Regulation Under Uncertainty," *Cornell Law Review*, vol. 102 (August 17, 2015), pp. 5-9.

[143] Robert W. Hahn and Cass R. Sunstein, "A New Executive Order for Improving Federal Regulation? Deeper and Wider Cost-Benefit Analysis," *University of Pennsylvania Law Review*, vol. 150 (2002), pp. 1489-1505.

[144] Thomas O. McGarity, "Some Thoughts on 'Deossifying' the Rulemaking Process," *Duke Law Journal*, vol. 41 (1992), pp. 1385-1398.

[145] CRS Report R44813, *Cost-Benefit Analysis and Financial Regulator Rulemaking*, by (name redacted) and (name redacted)

imprecise and unreliable.[146] These attempts entail making causal assumptions that are contestable and uncertain, and often face issues concerning data availability and accuracy. Also, financial regulation intends to induce behavioral, microeconomic, and macroeconomic responses, and these effects may be harder to quantify than regulations in other industries that lead to more measurable effects.[147]

Others assert that financial regulators should be subject to stricter CBA requirements than they are now. They argue that requisite, quantitative CBA—when it might yield a wide range of estimates or disagreements over accuracy between technical experts—is necessary because it disciplines agencies in regard to what rules they implement, and allows for an objective assessment of whether a regulation is likely to achieve its goals and at what cost.[148] Some claim that the challenges of performing CBA for financial regulations are not greater than for regulations for other industries, arguing that estimations of benefits and costs—although challenging—are possible.[149]

Legislative Alternatives

Congress has several alternatives available if it decided to change CBA requirements for financial regulators. Congress could require that certain effects—such as those on financial product cost or national employment—be examined as part of the analyses. Similarly, Congress could require a certain degree of quantification be part of the analysis. In addition, certain findings in these CBAs could trigger a requirement to get a waiver from Congress before the rule can go forward. Another alternative would be to authorize the President to extend executive orders related to CBA to independent regulatory agencies, including subjecting the CBAs to review by the Office of Information and Regulatory Affairs.

Congressional Review[150]

The Congressional Review Act (CRA) provides a mechanism to increase banking regulatory agencies' accountability. CRA is an oversight tool that Congress can use to invalidate a final rule issued by a federal agency. It was enacted in response to concerns expressed by Members of both parties about Congress's ability to control what many viewed as a rapidly growing body of administrative rules.[151] Many felt that as Congress delegated more power to agencies to implement law, the traditional oversight tools Congress possessed were not adequate.

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[146] John C. Coates IV, "Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications," *Yale Law Journal*, vol. 124 (2015), pp. 885-902.

[147] John H. Cochrane, "Challenges for Cost-Benefit Analysis of Financial Regulation," *The University of Chicago Journal of Legal Studies*, vol. 43 (June 2014), pp. S87-S102.

[148] Cass R. Sunstein, "Financial Regulation and Cost-Benefit Analysis," *Yale Law Journal Forum*, January 22, 2015, pp. 263-267.

[149] Eric A. Posner and E. Glen Weyl, "Benefit-Cost Paradigms in Financial Regulation," *Coase-Snador Institute for Law and Economics Working Paper No. 660*, March 2014, p. 7-8.

[150] This section was adapted from text authored by Christopher Davis as a section entitled "Congressional Review of Federal Financial Agency Rulemaking" found in CRS Report R44631, *The Financial CHOICE Act in the 114th Congress: Policy Issues*.

[151] The Congressional Review Act was enacted on March 29, 1996 as part of the Small Business Regulatory Enforcement Fairness Act (SBREFA), Title II of P.L. 104-121, 110 stat. 868. The act is codified at 5 U.S.C. §§801-808. For more information on the act, see CRS Report R43992, *The Congressional Review Act (CRA): Frequently Asked Questions*, by (name redacted) and (name redacted) .

The CRA requires agencies to report to Congress on their rulemaking activities and provides Congress with a special set of expedited parliamentary procedures that can be used to consider legislation striking down agency rules it opposes. These "fast track" parliamentary procedures, which are available primarily in the Senate, limit debate and amendment on a joint resolution disapproving a rule and ensure that a simple majority can reach a final up-or-down vote on the measure. Members of Congress have specified time periods in which to submit and act on a joint resolution of disapproval invalidating the rule. If both houses agree to such a joint resolution, it is sent to the President for his signature or veto. If a CRA joint resolution of disapproval is enacted, either by being signed by the President or by being enacted over his veto, the agency final rule in question "shall not take effect (or continue)."[152] The act also provides that if a joint resolution of disapproval is enacted, a new rule may not be issued in "substantially the same form" as the disapproved rule unless the rule is specifically authorized by a subsequent law. The CRA prohibits judicial review of any "determination, finding, action, or omission under" the act.[153]

Observers have argued that the structure of the CRA disapproval process often renders the CRA largely unworkable as an oversight mechanism. A President is most likely to veto a joint resolution that attempts to strike down a final rule proposed by his or her own Administration or by a like-minded independent agency, and a supermajority is necessary to override a presidential veto—something that has been historically rare.[154] Therefore, Congress typically has the opportunity to successfully block rules from taking effect only in periods between the start of a new Administration—and only when the new Administration's regulatory policy positions are more aligned with those of the sitting Congress than those of the previous Administration—and the expiration of the specified time period Congress has to act on a CRA resolution. The beginning of the 115th Congress generally meets those criteria, and 14 disapproval resolutions had been enacted as of May 18th, 2017, but only one disapproval resolution had been enacted in the preceding 20 years.

Legislative Alternatives

If Congress decided to alter the CRA disapproval mechanism, it could change it from a resolution of *disapproval* to a resolution of *approval*. Such a change would mean that instead of rules automatically going into force unless Congress enacted a measure stopping them, some or all rules would become effective only upon the enactment of a law approving them. This mechanism would increase congressional oversight of which regulations would go into effect, but may politicize or unduly slow the promulgation of technical rules that would, on net, benefit society.

Market and Economic Trends

In addition to issues related to regulation, banking is also continually affected by market and economic conditions and trends. This section analyzes certain issues related to trends that may concern banks, including

- migration of financial activity from banks into nonbanks or the "shadow banking" system;

[152] 5 U.S.C. §801(b)(1).

[153] 5 U.S.C. §805.

[154] Since 1789, 37 of 44 Presidents have exercised their veto authority a total of 2,572 times. Congress has overridden these vetoes on 110 occasions (4.3%). For more information, see CRS Report RS22188, *Regular Vetoes and Pocket Vetoes: In Brief*, by (name redacted) .

- increasing capabilities and market presence of financial technology ("fintech");
- increasing interest rates in the future; and
- competitive and regulatory issues related to institutions with different charters but similar business models—such as banks, thrifts, and credit unions.

Because these issues involve the interactions between several broad market forces, specific legislative alternatives will not be examined in this section.

Potential Migration to Shadow Banking

Credit intermediation is a core banking activity and involves transforming short-term, liquid, safe liabilities into relatively long-term, illiquid, higher-risk assets. In the context of traditional banking, credit intermediation is done by taking deposits from savers and using them to fund loans to borrowers. Because bank assets are illiquid, an otherwise-solvent bank might experience difficulty meeting short-term obligations without having to sell assets, possibly at "fire sale" prices. Also, if depositors begin to feel their deposits are not safe, many of them may choose to withdraw their funds at the same time. Such a "run" on a bank could cause it to fail. Long-established government programs mitigate liquidity- and run-risk. The Federal Reserve is authorized to act as a "lender of last resort" for a bank experiencing liquidity problems, and the FDIC insures depositors against losses.[155] Banks are also subject to prudential regulation—as discussed in the "Prudential Regulation" section—to ensure that risks are well managed and kept at reasonable levels.

However, certain financial markets and instruments allow nonbank institutions to also perform similar credit intermediation to banks. Some observers are concerned that this nonbank credit intermediation—sometimes called *shadow banking*—poses significant risks, because it can be performed without the government "safety nets" available to banks or the prudential regulation required of them.[156] The lack of an explicit government safety net in shadow banking means that taxpayers are less explicitly or directly exposed to risk, but also means that shadow banking may be more vulnerable to a panic that could trigger a financial crisis. Furthermore, some argue that the increased regulatory burden placed on banks in response to the financial crisis—such as the changes in bank regulation mandated by Dodd-Frank or agreed to in Basel III—could result in a decreasing role for banks in credit intermediation and an increased role for relatively lightly regulated nonbanks.[157]

Many contend the financial crisis demonstrated how these risks in the shadow banking sector can create or exacerbate systemic distress. Money market mutual funds are deposit-like instruments that are managed with the goal of never losing principal and that investors can convert to cash on demand. Institutions can also access deposit-like funding by borrowing through short-term funding markets—such as by issuing commercial paper and entering repurchase agreements. These instruments can be continually rolled over as long as funding providers have confidence in the solvency of the borrowers. During the crisis, all these instruments—which investors had

[155] David Luttrell, Harvey Rosenblum, and Jackson Thies, *Understanding the Risks Inherent in Shadow Banking: A Primer and Practical Lessons Learned*, Federal Reserve Bank of Dallas, Staff Papers, No. 18, November 2012, pp.1-6.

[156] For more information on shadow banking, see CRS Report R43345, *Shadow Banking: Background and Policy Issues*, by (name redacted) .

[157] Thomas M. Hoening and Charles S. Morris, *Restructuring the Banking System to Improve Safety and Soundness*, Federal Reserve Bank of Kansas City, May 2011, p. 2, at https://www.banking.senate.gov/public/_cache/files/4c250445-e6e7-411a-a4f3-27e657ab9749/33A699FF535D59925B69836A6E068FD0.hoenigtestimony5912ficppm.pdf.

previously viewed as safe and unlikely to suffer losses—experienced run-like events as funding providers withdrew from markets.[158] Also, nonbanks can take on exposure to long-term loans through investing in mortgage-backed securities (MBS) or other asset-backed securities (ABS). During the crisis as firms faced liquidity problems, the value of these assets decreased quickly, possibly in part as a result of fire sales.[159]

Since the crisis, many regulatory changes have been made related to certain money market, commercial paper, and repurchase agreement markets and practices. However, some observers are still concerned that shadow banking poses risks. Furthermore, because banks now face more stringent prudential regulation, certain credit intermediation activities may "migrate" to nonbanks and the shadow banking system, where institutions are less burdened by regulation.[160]

Financial Technology, or "Fintech"[161]

Fintech usually refers to technologies with the potential to alter the way certain financial services are performed. Banks are affected by technological developments in two ways: (1) they face choices over how much to invest in emerging technologies and to what extent they want to alter their business models in adopting technologies, and (2) they potentially face new competition from new technology-focused companies. Such technologies include online marketplace lending, crowdfunding, blockchain and distributed ledgers, and robo-advising, among many others. Certain financial innovations may create opportunities to improve social and economic outcomes, but there is also potential to create risks or unexpected financial losses.

Potential benefits from fintech are greater efficiency in financial markets that creates lower prices and increased customer and small business access to financial services. These can be achieved as innovative technology replaces traditional processes that have become outdated. For example, automation may be able to replace employees, and digital technology can replace physical systems and infrastructure. Cost savings from removing inefficiencies may lead to reduced prices, making certain services affordable to new customers. Some customers that previously did not have access to services—due to such things as lack of information about creditworthiness, or geographic remoteness—could also potentially gain access. Increased accessibility may be especially beneficial to traditionally underserved groups, such as low-income, minority, and rural populations.[162]

Fintech could also create or increase risks. Many fintech products have only a brief history of operation, so it can be difficult to predict outcomes and assess risk. It is possible certain technologies may not in the end function as efficiently and accurately as intended. Also, the stated aim of a new technology is often to bring a product directly to consumers and eliminate a "middle-man." However, that middle-man could be an experienced financial institution or

[158] CRS Report R43345, *Shadow Banking: Background and Policy Issues*, by (name redacted) .

[159] Craig B. Merrill, Taylor D. Nadauld, René M. Stulz, and Shane M. Sherlund, *Why were there fire sales of mortgage-backed securities by financial institutions during the financial crisis*? Fisher College of Business Working Paper 2013–03–02, Ohio State University, 2014.

[160] Tobias Adrian, Adam B. Ashcraft, and Nicola Cetorelli, *Shadow Bank Monitoring*, Federal Reserve Bank of New York, Staff Report No. 638, September 2013, p. 10.

[161] See more information on fintech, see CRS In Focus IF10513, *Introduction to Financial Services: "Fintech"*, by (name redacted) .

[162] John C. Williams, President of the Federal Reserve Bank of San Francisco, *Fintech The Power of the Possible and Potential Pitfalls*, Speech at the LendIt USA 2016 Conference, San Francisco, CA, April 12, 2016, at http://www.frbsf.org/our-district/press/presidents-speeches/williams-speeches/2016/april/fintech-power-of-the-possible-potential-pitfalls/.

professional that can advise consumers on financial products and their risks. In these ways, fintech could increase the likelihood that consumers engage in a financial activity and take on risks that they do not fully understand.[163]

Certain innovations can likely be integrated into the financial system with little regulatory or policy action. Technology in finance largely involves reducing the cost of producing existing products and services, and the existing regulatory structure was developed to address risks from these financial activities. Existing regulation may be able to accommodate new technologies while adequately protecting against risks.[164] However, there are two other possibilities. One is that some regulations may be stifling beneficial innovation. Another is that existing regulation does not adequately address risks created by new technologies.

Some observers argue that regulation could potentially impede the development and introduction of beneficial innovation. Companies incur costs to comply with regulations. In addition, companies are sometimes unsure how regulators will treat the innovation once it is brought to market.[165] A potential solution being used in other countries is to establish a regulatory "sandbox" or "greenhouse" wherein companies that meet certain requirements work with regulators as products are brought to market.[166]

Some are concerned that existing regulations may not adequately address certain risks posed by new technologies.[167] Regulatory arbitrage—conducting business in a way that circumvents unfavorable regulations—may be a concern in this area.[168] Fintech potentially could provide an opportunity for companies to claim they are not subject to certain regulations because of a superficial difference between how they operate compared to traditional companies.

Another group of issues posed by fintech relates to cybersecurity. As activity increasingly utilizes digital technology, sensitive data are generated. Data can be used to accurately assess risks and ensure customers receive the best products and services. However, data can be stolen and used inappropriately, and there are concerns over privacy issues. This raises questions over ownership and control of the data—including the rights of consumers and the responsibilities of companies in accessing and using data—and whether companies that use and collect data face appropriate cybersecurity requirements.[169]

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[163] U.S. Government Accountability Office, *Financial Technology: Information on Subsectors and Regulatory Oversight*, GAO-361, April 2017, pp. 8-9, 34-35, 45, at https://www.gao.gov/assets/690/684187.pdf.

[164] Larry D. Wall, *Avoiding Regulation: Fintech versus the Sharing Economy*, Federal Reserve Bank of Atlanta: Notes From the Vault, September 2016, at https://frbatlanta.org/cenfis/publications/notesfromthevault/09-avoiding-regulation-fintech-versus-the-sharing-economy-2016-09-29#_edn5.

[165] Brian Knight, *Regulating Fintech: Creating a Regulatory Regime That Enables Innovation While Providing Appropriate Consumer Protection*, Mercatus Center at George Mason University, Reply Comment: "Supporting Responsible Innovation in the Federal Banking System: An OCC Perspective," May 12, 2016, at https://www.mercatus.org/system/files/Knight-OCC-Comment-v1.pdf.

[166] Rob Nichols, CEO American Bankers Associate, Testimony to U.S. Congress, House Committee on Financial Services, *Examining the Opportunities and Challenges with Financial Technology (FinTech): The Development of Online Marketplace Lending*, 114th Cong., 2nd sess., July 12, 2016, at http://financialservices.house.gov/uploadedfiles/hhrg-114-ba15-wstate-rnichols-20160712.pdf.

[167] U.S. Department of the Treasury, *Opportunities and Challenges in Online Marketplace Lending*, May 10, 2016, pp. 19-25, at https://www.treasury.gov/connect/blog/Documents/Opportunities_and_Challenges_in_Online_Marketplace_Lending_white_paper.pdf.

[168] Greg Buchak, Gregor Matvos, and Tomasz Piskorski, et al., *Fintech, Regulatory Arbitrage, and the Rise of Shadow Banks*, National Bureau of Economic Research, Working Paper 23288, March 2017, pp. 1-6, at http://www.nber.org/papers/w23288.pdf.

[169] John C. Williams, President of the Federal Reserve Bank of San Francisco, *Fintech The Power of the Possible and*

(continued...)

Rising Interest Rate Environment

The Federal Reserve's monetary policy response to the financial crisis, the ensuing recession, and subsequent slow economic growth was to keep interest rates unusually low for an extraordinarily long time. It accomplished this in part using unprecedented monetary policy tools such as *quantitative easing*—large-scale asset purchases that significantly increased the size of the Federal Reserve's balance sheet.[170] Recently, as economic conditions have improved, the Federal Reserve has begun to raise its target rate, and increased attention has been given to how and when the Federal Reserve will normalize monetary policy.

A rising interest rate environment—especially following an extended period of unusually low rates achieved with unprecedented monetary policy tools—is an issue for banks because they are exposed to *interest rate risk*. A portion of bank assets have fixed interest rates with long terms until maturity, such as mortgages, and the rates of return on these assets do not increase as current market rates do. However, many bank liabilities are short-term, such as deposits, and can be repriced quickly. So although certain interest revenue being collected by banks is slow to rise, the interest costs paid out by banks can rise quickly. In addition to putting stress on net income, rising interest rates can cause the market value of fixed-rate assets to fall. Finally, banks incur an opportunity cost when resources are tied up in long-term assets with low interest rates rather than being used to make new loans at higher interest rates.[171]

The magnitude of interest rate risks should not be overstated, as rising rates can increase bank profitability if they result in a greater difference between long-term rates banks receive and short-term rates they pay—referred to as *net interest margin*.[172] Nonetheless, banks and regulators recognize the importance of managing interest rate risk, carefully examine the composition of bank balance sheets, and plan for different interest rate change scenarios.[173]

While banks are well practiced at interest rate risk management through normal economic and monetary policy cycles, managing bank risk through the next period of interest rate growth could be more challenging because rates have been so low for so long and achieved through unprecedented monetary policy tools. Because rates have been low for so long, many loans made in different interest rate environments that preceded the crisis have matured. Meanwhile, all new loans made in the last eight years have been made in a low interest rate environment. This presents challenges to getting a mix of loans with different rates. In addition, because the Federal

(...continued)

Potential Pitfalls, Speech at the LendIt USA 2016 Conference, San Francisco, CA, April 12, 2016, at http://www.frbsf.org/our-district/press/presidents-speeches/williams-speeches/2016/april/fintech-power-of-the-possible-potential-pitfalls/.

[170] A detailed discussion of the Federal Reserve and monetary policy is beyond the scope of this report. For more information on these issues, see CRS Report RL30354, *Monetary Policy and the Federal Reserve: Current Policy and Conditions*, by (name redacted)

[171] William Bednar and Mahmoud Elamin, *Rising Interest Rate Risk at U.S. Banks*, Federal Reserve Bank of Cleveland: Economic Commentary, Number 2014-12, June 24, 2014, at https://www.clevelandfed.org/newsroom-and-events/publications/economic-commentary/2014-economic-commentaries/ec-201412-rising-interest-rate-risk-at-us-banks.aspx.

[172] Hesna Genay and Rich Podjasek, "What Is the Impact of a Low Interest Rate Environment on Bank Profitability?" *Chicago Fed Letter*, Federal Reserve Bank of Chicago, No. 324 (July 2014).

[173] Donald L. Kohn, "Focusing on Bank Interest Rate Risk Exposure," speech at the FDIC's Symposium on Interest Rate Risk Management, Arlington, VA, January 29, 2010.

Reserve has used new monetary policy tools and grown its balance sheet to unprecedented levels, accurately controlling the pace of interest rate growth may be challenging.[174]

Charters and Competition

An institution that makes loans and takes deposits—the core activities of traditional commercial banking—can have one of several types of charters, including a national bank charter, a state bank charter, a federal savings association (also called a "thrift") charter, or a credit union charter. Each charter type determines what activities are permissible for the institution, what activities are restricted, and which agency will be the institution's primary regulator (see **Table 3**). A rationale for this system is that it gives institutions with different business models and ownership arrangements the ability to choose a regulatory regime appropriately suited to the institution's business needs and risks.[175]

Table 3. Regulatory Agencies for Bank-Charter Types

Regulatory Agency	Regulator For
Federal Reserve	Bank holding companies and certain subsidiaries Savings and loan holding companies State banks that are members of the Federal Reserve System U.S. branches of foreign banks Foreign branches of U.S. banks
Office of the Comptroller of the Currency (OCC)	National banks Federally chartered thrift institutions
Federal Deposit Insurance Corporation (FDIC)	Federally insured depository institutions, including state banks and thrifts that are not members of the Federal Reserve System
National Credit Union Administration (NCUA)	Federally chartered or insured credit unions
Consumer Financial Protection Bureau[a]	Rulemaking: All banks Primary Supervision and Enforcement: Consumer businesses of banks with over $10 billion in assets

Source: Congressional Research Service (CRS), with information drawn from agency websites and financial regulatory legislation.

a. Consumer Financial Protection Bureau regulates for consumer protection only, not prudential or systemic risk regulation.

The differences between institution business models and the attendant regulations are numerous, varied, and beyond the scope of this report. This examination of the issue only requires noting that (1) under each charter, an institution is subject to regulatory treatment and restrictions that differ from other charter types in certain ways and (2) these various institutions are to some degree in competition with each other for business, because although the business models may

[174] Stephen D. Williamson, "Monetary Policy Normalization in the United States," *Federal Reserve Bank of St. Louis Review*, vol. 97, no. 2 (Second Quarter 2015), pp. 87-108.

[175] Federal Financial Institutions Examination Council, *Interagency Statement on Regulatory Conversions (FIL-40-2009)*, July 7, 2009.

vary, all involve taking deposits and making loans.[176] As a result, each type of institution has a stake in proposed changes to regulation related to all charter types. Institutions may assert some regulation that they are subject to puts them at a competitive disadvantage, whereas the other types of institutions oppose these assertions. Often, an effort by institutions of one type to relax their regulations will be resisted by institutions of other types.

The friction between credit unions and community banks is an illustrative example. The two types of institutions are similar in certain ways—notably, they typically serve a small group of customers and engage in relationship banking, which involves familiarity with customers and local market conditions. However, there are key differences. For example, credit unions are not-for-profit cooperatives with the purpose of serving the financial needs of members. Banks provide services to the general public for profit. On the basis of the differences, regulation of credit unions and banks differs. For example, credit unions face limits on the amount of member business lending they can do, whereas banks have no equivalent limitation. Meanwhile, banks are subject to regulatory evaluation under the Community Reinvestment Act (P.L. 95-128) to determine how well they are meeting the credit needs of the community in which they operate. When credit unions advocate for easing business lending restrictions, banks object, arguing that it would allow credit unions to engage in activity beyond their mandate and expand into a business line more appropriate to banks. When banks argue that the Community Reinvestment Act should be extended to other types of institutions, credit unions object, arguing they already serve the credit needs of the community.[177]

These regulatory differences between these institutions are just two of many examples of institutions with different charter types disagreeing on what appropriate regulation should be. A broader and long-standing issue underlying these debates is to what degree the government should offer different charters—with different benefits and responsibilities—for businesses that engage in similar activities and whether the difference between the charters should be narrowed.[178] The banking regulators try to minimize their regulatory differences through joint rulemaking and coordination through the Federal Financial Institutions Examinations Council—an interagency body that prescribes uniform principles, standards, and report forms—and commercial banks and thrifts no longer have separate regulators. However, differences remain between their regulations that Congress has considered addressing.

CRS Legislative Resources

A comprehensive listing and analysis of all proposed legislation related to bank issues is beyond the scope of this report. However, such information can be found in other CRS products, including the following:

[176] Richard Anderson and Yang Liu, *Banks and Credit Unions: Competition Not Going Away*, Federal Reserve Bank of St. Louis, The Regional Economist, April 2013, at https://www.stlouisfed.org/~/media/Files/PDFs/publications/pub_assets/pdf/re/2013/b/Banks_CreditUnions.pdf.

[177] CRS Report R43167, *Policy Issues Related to Credit Union Lending*, by (name redacted).

[178] For example, see Simon Kwan, *Bank Charters vs. Thrift Charters*, Federal Reserve Bank of San Francisco, April 24, 1998, at http://www.frbsf.org/economic-research/publications/economic-letter/1998/april/bank-charters-vs-thrift-charters/; and Rose M. Kushmeider, *The U.S. Federal Financial Regulatory System: Restructuring Federal Bank Regulation*, FDIC Banking Review, January 19, 2006; and Simon Kwan, *Bank Charters vs. Thrift Charters*, Federal Reserve Bank of San Francisco, April 24, 1998, at http://www.frbsf.org/economic-research/publications/economic-letter/1998/april/bank-charters-vs-thrift-charters/.

- CRS Report R44839, *The Financial CHOICE Act in the 115th Congress: Selected Policy Issues*, by (name redacted) et al. This report examines H.R. 10 introduced in the 115th Congress. H.R. 10 is a comprehensive financial regulatory reform proposal, and contains provisions related to banking issues, including provisions found in Titles I, III, V, VI, VII, and IX. Many of these provisions are similar to those found in other bills.
- CRS Report R44035, *"Regulatory Relief" for Banking: Selected Legislation in the 114th Congress*, coordinated by (name redacted). This report examines numerous bills related to regulatory relief for banks introduced in the 114th Congress.
- CRS Report R41350, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Background and Summary*, coordinated by (name redacted). This report examines provisions enacted into law in the Dodd-Frank Act, and provides background and analysis of these reforms to the financial regulatory system that are in place today. Provisions related to banking are found in Title I, II, III, VI, X, and XIV.

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