International Standard Setting

Preserving Global Consistency through Transparency, Accountability, and Serving Local Interests

American Bankers Association®

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The Core Principles for Regulating the United States Financial System, enumerated in Executive Order 13772, include the following that are particularly relevant to an evaluation of current U.S. participation in international financial standard-setting exercises:

> *(c) foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazard and information asymmetry;*
> *(d) enable American companies to be competitive with foreign firms in domestic and foreign markets;*
> *(e) advance American interests in international financial regulatory negotiations and meetings;*
> *(f) make regulation efficient, effective, and appropriately tailored; and*
> *(g) restore public accountability within Federal financial regulatory agencies and rationalize the Federal financial regulatory framework.*

The American Bankers Association[1] offers these views to the Secretary of the Treasury in relation to the Directive that he has received under Section 2 of the Executive Order.

- **Global standard setting lacks transparency and accountability.**
- **Regulators should publish an ANPR prior to an international standard setting project.**
- **Now is an appropriate time to pause and evaluate the results of post-recession regulations before any further international standard setting.**
- **Peer reviews should be redesigned to focus on objectives, not compliance minutiae.**
- **Regulators should apply international standards consistent with differences in U.S. law, culture, and regulatory structure, tailored to the diverse American banking industry, and implemented to promote economic growth.**

[1] The American Bankers Association is the voice of the nation's $17 trillion banking industry, which is composed of small, regional, and large banks that together employ more than 2 million people, safeguard $13 trillion in deposits, and extend more than $9 trillion in loans.

Introduction

The United States has long been a leader in the promotion of international cooperation and coordination of bank supervision. These efforts have traditionally promoted U.S. and global economic growth and facilitated the ability of American banks to serve the international financial interests of American businesses and individuals. In the process, American banks have been in the vanguard of promoting expansion of financial services trade. In addition to serving the interests of economic growth in the United States, that expansion has also unleashed the global flow of financial resources that have helped lift billions of people out of poverty.

Global standard setting in recent years, while seeking further advances in coordination of international bank supervision, has to a significant degree compromised the essential role that banking has played in promoting economic growth, domestically and around the world. As we review the progress in supervision that has been achieved, it is time to reconsider the overly complex global regime, identifying how it can be improved to be more workable and more supportive of financial services trade and economic progress.

I. Global Problems

A. A Shadowy Process with Clear Consequences

Neither the U.S. Senate nor the House of Representatives have been offered a vote on recent global financial regulatory standards, either as a treaty or an Act of law. Yet, the international standard setters occupy an increasingly important place in determining U.S. domestic policy affecting our entire financial system. Complex financial regulatory models have been implemented entirely by regulatory action, comprising thousands of pages of detailed text, with far-reaching implications for banks and for their customers. While the regulations have generally been published for review and comment before becoming final, adherence to the global blueprints has been resilient.

Public transparency and accountability are sacrificed. Standards are developed at the Basel Committee on Bank Supervision, for example, with little public input. When international agreement is reached and U.S. agencies prepare to implement the standards, the new rules are exposed for public notice and comment under the strictures of the Administrative Procedure Act, but the global plans are accorded deferential treatment by U.S. regulators. They have already made up their minds and committed themselves to the global design that they helped negotiate. The APA process is rendered largely a formality.

Some international bodies, such as the Basel Committee, do issue proposals for a degree of comment. However, these efforts often come relatively late in the process, after the basic framework has been substantially developed, options have been narrowed, compromises have been made, and a bulwark of international commitment to a new regulatory regime has been formed by the regulatory participants.

Moreover, because the discussions usually take place outside of the United States and are described as intended to affect institutions that compete at the *global level*, the vast majority of U.S. banks, and the American public in general, are unaware of the international proposals and do not monitor or participate in the limited international comment opportunity. Neither does it appear that Congress is brought actively into the process before U.S. regulators take up implementation of the agreement.

It is no surprise, then, that the international Basel III capital standards raised a storm of controversy in the U.S. They were formed with no input from Congress, provided very little exposure to comment from much of the U.S. banking industry, and offered no opportunity for input from millions of bank customers who would be significantly affected by higher costs for and reduced access to banking products and services.

Policymakers and the public alike are still trying to address avoidable problems in the Basel III liquidity and capital rules. In previous White Papers (see ABA White Papers on Liquidity and Capital), ABA cited examples where the implementing regulations are inconsistent with U.S. economic and financial interests. The following are notable illustrations.

1. Mistreatment of Deposits

The Basel Liquidity Coverage Ratio (LCR), as implemented in U.S. regulations, mandates the assumption that banks will lose deposits in troubled economic conditions. While that may be the pattern in other parts of the world, the U.S. experience is just the opposite. During the recent recession, U.S. banks saw an influx of domestic deposits by $813 billion from immediately before the start of the recession in December 2007 until its official end in June 2009, as savers looked to banks as a safe haven to place their money.

Not only is this run off assumption wrong in the U.S. experience, it will be harmful in future economic downturns. The counterfactual rigor of the LCR will constrain the ability of the banking industry in a future recession to accommodate the typical deposit inflow.[2]

2. Penalizing Banks for MSA Activity

Under the Basel III capital rules, mortgage servicing assets (MSAs) are deducted from regulatory Tier 1 capital if the bank holds a concentration in excess of 10 percent of Common Equity Tier 1 (CET1) capital. The rules also impose an overall limitation of 15 percent of CET1 on the combined balance of includable MSAs, deferred tax assets, and investments in the common stock of unconsolidated financial institutions. MSAs that are not deducted from CET1 are subject to a 250 percent risk weight. The rules' treatment of MSAs places broad constraints on MSAs that operate to impel a significant reduction in the retail mortgage servicing operations of banks, particularly community, midsize, and regional banks.

[2] American Bankers Association, *Liquidity*, a White Paper Submitted to the U.S. Department of the Treasury, April 2017, p.5. See, http://www.aba.com/Advocacy/Pages/executive-orders.aspx.

Servicing mortgage loans is a specialty of many banks and has provided a strong source of fee income for decades. For even more banks, particularly community, midsize, and regional institutions, mortgage servicing is an important way to maintain valuable long-term customer relationship, while allowing the bank to sell a long term asset to manage its interest rate risk. As a result of these rules, we have seen a larger portion of the mortgage servicing business migrate to non-bank mortgage servicers, a shift of market share that we do not believe was intended by the Agencies. Customers and the long term relationships that they have built with banks should not be penalized by the capital rules' punitive MSA capital treatment.[3]

3. Purposeless Volatility in Capital Accounts

Under the final Basel III rule, banks subject to the Advanced Approaches risk-based capital standards (Advanced Approaches banks) are required to "flow through" to CET1 all unrealized gains and losses (Accumulated Other Comprehensive Income, AOCI) from a banking organization's available for sale (AFS) portfolio. Including unrealized gains and losses in capital introduces purposeless volatility into the capital calculation, unrelated to the actual condition of the bank. It also undermines prudent risk management by penalizing Advanced Approaches banks for holding high-quality liquid assets, in disharmony with applicable liquidity rules. By that same process, this volatility in the bank's capital account adds volatility to the broader economy, to some degree subduing the important role that banks play in moderating the ups and downs of the business cycle.

In recent quarters, AOCI has introduced irrelevant penalties and bonuses into bank capital measurements, penalized by $39.5 billion in fourth quarter 2016, by $3.7 billion in the third quarter, while gaining $10 billion in a capital bonus from AOCI in the second quarter of 2016—all unrelated to the actual financial condition of the industry. This is not sound bank supervision. To take into account the volatility introduced into capital calculations, Advanced Approaches banks now hold "volatility buffers" above any set regulatory capital levels.[4]

B. What Do Specialists in Basel Know about Banking in Kansas?

Implementation of international standards should be generally harmonized around the world, but they do not need to be exactly the same. To enable global implementation, the standards need to focus on big picture principles. When the international standards stray into minute details, they appear more like implementing regulations, a responsibility beyond the jurisdiction or competence of the international standard setters. Only the regulatory bodies in each of the participating nations, operating within the national laws governing the regulatory process, will know how to craft regulations that will correctly implement the standards consistent with the local legal structures and economic configurations. Moreover, nowhere above the national levels can meaningful public input and accountability be found. This is the only way that global standards can credibly conform to local conditions to strengthen the local economy and the banking industry that supports it.

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[3] American Bankers Association, *Capital*, a White Paper Submitted to the U.S. Department of the Treasury, April 2017, p.3. See, http://www.aba.com/Advocacy/Pages/executive-orders.aspx.
[4] *Id*., p.5.

Failure to recognize this has been a major—and growing—weakness in international standard setting. Increasingly, international bodies have developed more and more detailed and prescriptive plans, overreaching their competency and failing to find genuine harmony of principles.

C. Global Peer Review

Some bodies, such as the Basel Committee, have also instituted peer review programs, whereby international teams of regulatory staff review whether participating countries are in fact implementing the minutia of the detailed standards. These programs are designed to "name and shame" jurisdictions into compliance. The concept smacks of global bureaucracies, viewing local realities from several layers of abstraction, with a misplaced focus on details more competently governed by local supervisory agencies.

This is not to deny the potential worth of peer review but rather to suggest that peer review operate within the realms of its potential worth. Instead of evaluating whether each subpart of a standard is being complied with, the focus should be on whether the overall domestic framework is generally aligned with the international objectives. Observations should then be offered in confidence to the national regulators. For example, the United States applies a robust capital adequacy program that precedes and transcends the Basel prescriptions, but which in all ways achieves (and in significant ways exceeds) the goals of the international standards. While a derivation from the details of the international standards, the effectiveness of the U.S. program in meeting—or even exceeding—the objectives of the standards should be recognized.

D. The American Interest

The inappropriate blurring of roles between international standard setting and national rulemaking, particularly with the trend of the former to become too detailed and prescriptive, has resulted in regulations, justified by compliance with international standards, that do not make sense in the U.S. context. The example of the treatment of MSAs is mentioned above. It should be noted that MSAs are an asset unique to the United States, beyond the experience and proficiency of the global standard setting team. The treatment of MSAs highlights the dangers of an international body straying into minutia. It also highlights the duty of U.S. regulators to exercise their responsibility to derivate from prescriptive details of international standards as necessary to apply the global principles more reasonably and effectively to domestic conditions, reflective of risks and conditions that arise locally.

In this context it is also appropriate to recognize that U.S. agencies have freely deviated from international standards to apply *more stringent* requirements in the United States. It is entirely proper for U.S. policymakers to do so where they believe that such requirements serve national needs, including service to American financial services customers and the undergirding of sustained economic growth and progress. Those are policy decisions to be made, reviewed, and revised as appropriate through U.S. policymaking procedures. Unfortunately, in recent years such gilding the lily of international standards has been shrouded in the same limited public consideration that has attended development, evaluation, and implementation of the underlying international standard, without adequate consideration of the impact on customers and the economy.

E. Are We There Yet?

The writer, O. Henry, is credited with the observation that New York will "be a great place if they ever finish it." One feels that way about the global financial standard setting effort, made famous by its numbered sets of capital regimes (Basel I, II, and III, currently bleeding into Basel IV). Besides these capital plans, there are global frameworks for liquidity regulation, credit risk, operational risk, market risk, each with its own subsidiary projects. U.S. regulators have recently pushed back against Basel projects on interest rate risk (long a part of American bank supervision) and step-in risk (concern about bank counterparties and large customers has been another long-time focus of American bank supervisors).

The continuous churning of international standards, besides frustrating potential investors in the industry, draws some of banks' best talent away from promoting business and economic growth into seemingly endless rounds of comment, review, and implementation of new regulatory programs. A similar distraction of talent takes place at the financial agencies.

II. Specific Recommendations

A. The Corpus of Global Standards: Pause and Review

A substantial amount of work has been done in the United States in recent years to make the financial regulatory environment more robust. This work is reflected in new regulations governing capital requirements, liquidity requirements, derivatives infrastructure, resolution planning, mortgage underwriting, and many more. The banking industry has responded by increasing capital and liquidity; building reporting, risk management, and compliance programs and processes; and drafting detailed plans for a bank's demise; among other efforts. President Trump has directed the Secretary of the Treasury to evaluate whether the rules and supervisory measures are resulting in the objectives we are seeking to achieve, including the fundamental objective of promoting economic growth.

A similar assessment should be conducted of the product of global standards. Until such a thorough evaluation has been completed, work on further global projects would be counterproductive.

B. Transparency and Accountability: ANPR—Know Before You Go

We recommend that, before participating in any international financial standard setting exercise, regulators should consult with the public by publishing an Advance Notice of Proposed Rulemaking (ANPR). The ANPR should include the following, among other pertinent matters:

- The specific issues or problems to be addressed by the international standards;

- The nature of the standards being considered for application in the U.S. or affecting U.S. citizens or businesses;[5]
- The various options likely to be considered; and,
- The anticipated impact of such options on U.S. persons, businesses, and the economy in general.

The ANPR process would allow for broad public input on the clearly outlined objectives of the discussions, offering the public—including Congress— crucial opportunity to raise important issues before global negotiations eliminate options and coalesce around suboptimal approaches. We believe that the increased transparency and accountability would improve the quality of international financial standard setting and reduce the likelihood of global standards that are a poor fit for the American economy and the customers of American financial institutions.

C. Adjustments Consistent with Economic Growth

International regulatory standards should be implemented in the United States consistent with the objectives of the standards, but adjusted as necessary to meet U.S. laws and conditions and in a manner that supports economic growth. That includes adequate tailoring of implementing regulations to accommodate and promote the diversity of business models in the U.S. banking industry.

D. Redesign Peer Review

The international peer review program should be redesigned so that it focuses on the objectives of international standards, not on compliance minutiae or matters irrelevant to achieving the objectives. Moreover, peer findings and recommendations should be made directly to U.S. regulatory agencies, on a confidential basis.

[5] ABA also believes that the U.S. regulators should identify which consultative documents, or portions of consultative documents, are *not* being considered for domestic implementation.