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Banking Policy Issues in the 116th Congress

February 21, 2019

Congressional Research Service
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R45518

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SUMMARY

Regulation of the banking industry has undergone substantial changes over the past decade. In response to the 2007-2009 financial crisis, many new bank regulations were implemented pursuant to the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act; P.L. 111-203) or under the existing authorities of bank regulators to address apparent weaknesses in the regulatory regime. While some observers view those changes as necessary and effective, others argued that certain regulations were unjustifiably burdensome. To address those concerns, the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 (P.L. 115-174) relaxed certain regulations. Opponents of that legislation argue it unnecessarily pared back important safeguards, but proponents of deregulation argue additional pare backs are needed. Meanwhile, a variety of economic and technological trends continue to affect banks. As a result, the 116th Congress faces many issues related to banking, including the following:

Safety and Soundness. Banks are subject to regulations designed to reduce the likelihood of bank failures. Examples include requirements to hold a certain amount of capital (which enables a bank to absorb losses without failing) and the so-called Volcker Rule (a ban on banks' proprietary trading). In addition, anti-money laundering requirements aim to reduce the likelihood banks will execute transactions involving criminal proceeds. Banks are also required to take steps to avoid becoming victims of cyberattacks. The extent to which these regulations (i) are effective, and (ii) appropriately balance benefits and costs is a matter of debate.

Consumer Protection, Fair Lending, and Access to Banking. Certain laws are designed to protect consumers and ensure that lenders use fair lending practices. The Consumer Financial Protection Bureau has authorities to regulate for consumer protection. No consensus exists on whether current regulations strike an appropriate balance between protecting consumers while ensuring access to credit and justifiable compliance costs. In addition, whether Community Reinvestment Act regulations as currently implemented effectively and efficiently encourage banks to provide services in their areas of operation is an open question.

Large Banks and "Too Big To Fail". Regulators also regulate for systemic risks, such as those associated with very large and complex financial institutions that may contribute to systemic instability. Dodd-Frank Act provisions include enhanced prudential regulation for certain large banks and changes to resolution processes in the event one fails. In addition, bank regulators imposed additional capital requirements on certain large, complex banks. Subsequently, some argued that certain of these additional regulations were too broadly applied and overly stringent. In response, Congress reduced the applicability of the Dodd-Frank measures and regulators have proposed changes to the capital rules. Whether relaxing these rules will provide needed relief to these banks or unnecessarily pare back important safeguards is a debated issue.

Community Banks. The number of small or "community" banks has declined substantially in recent decades. No consensus exists on the degree to which regulatory burden, market forces, and the removal of regulatory barriers to interstate branching and banking are causing the decline.

What Companies Should Be Eligible for Bank Charters. To operate legally as a bank, an institution must hold a charter granted by a state or federal government. Traditionally, these are held by companies generally focused on and led by people with experience in finance. However, recently companies with a focus on technology are interested in having legal status as a bank, either through a charter from the Office of the Comptroller of the Currency or a state-level industrial loan company charter. Policymakers disagree over whether allowing these

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companies to operate as banks would create appropriately regulated providers of financial services or inappropriately extend government-backed bank safety nets and disadvantage existing banks.

Recent Market and Economic Trends. Changing economic forces also pose issues for the banking industry. Some observers argue that 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. If interest rates rise, it could create opportunities and risks. Such trends could have implications for how the financial system performs and influence debates over appropriate banking regulations.

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Introduction

Banks play a central role in the financial system by connecting borrowers to savers and allocating available funds across the economy.[1] As a result, banking is vital to the U.S. economy's health and growth. Nevertheless, banking is an inherently risky activity involving extending credit and undertaking 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.

The last decade has been a transformative period for banking. The 2007-2009 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 regime governing the financial system had serious weaknesses.[4]

Policymakers responded to the perceived weaknesses in the pre-crisis financial regulatory regime by implementing numerous changes to financial regulation, including to bank regulation. Most notably, Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act; P.L. 111-203) in 2010 with the intention of strengthening regulation and addressing risks.[5] In addition, U.S. bank regulators have implemented changes under their existing authorities, many of which generally adhere to the Basel III Accords—an international framework for bank regulation agreed to by U.S. and international bank regulators—that called for making certain bank regulations more stringent.

In the ensuing years, some observers raised concerns that the potential benefits of those regulatory changes (e.g., better-managed risks, increased consumer protection, greater systemic stability, potentially higher economic growth over the long term) were outweighed by the potential costs (e.g., compliance costs incurred by banks, reduced credit availability for consumers and businesses, potentially slower economic growth). In response to these concerns, Congress passed the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCP Act; P.L. 115-174).[6] Among other things, the law modified certain (1) regulations

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[1] In general, 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, thus the term banks should not be interpreted as including those institutions, unless otherwise noted. For more information on the distinctions between credit unions and banks, see CRS In Focus IF11048, *Introduction to Bank Regulation: Credit Unions and Community Banks: A Comparison*, by Darryl E. Getter.

[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.

[5] For more information on the Dodd-Frank Act, see CRS Report R41350, *The Dodd-Frank Wall Street Reform and Consumer Protection Act: Background and Summary*, coordinated by Baird Webel.

[6] For more information on the EGRRCP Act, see CRS Report R45073, *Economic Growth, Regulatory Relief, and*

facing small banks; (2) regulations facing banks large enough to be subjected to Dodd-Frank enhanced regulation but still below the size thresholds exceeded by the very largest banks; and (3) mortgage regulations facing lenders including banks.

In addition, federal banking regulatory agencies—the Federal Reserve (the Fed), the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC)—have proposed further changes in regulation. Implementing the regulatory changes prescribed in the aftermath of the crisis and made pursuant to the Dodd-Frank Act occurred over the course of years. In recent years—a period in which the leadership of the regulators has transferred from Obama Administration to Trump Administration appointees—the banking regulators have expressed the belief that, after having viewed the effects of the regulations, they now have the necessary information to determine which regulations may be ineffective or inefficient as currently implemented. Recently, these regulators have made of number of proposals with the aim of reducing regulatory burden.[7] A key issue surrounding regulatory relief made pursuant to the EGRRCP Act and regulator-initiated changes is whether regulatory burden can be reduced without undermining the goals and effectiveness of the regulations.

Meanwhile, market trends and economic conditions continue to affect the banking industry coincident with the implementation of new regulation. Some of the more notable conditions include the development of new technologies used in financial services (known as "fintech") and a rising interest rate environment following an extraordinarily long period of very low rates.

This report provides a broad overview of selected banking-related issues, including issues related to "safety and soundness" regulation, consumer protection, community banks, large banks, what type of companies should be able to establish banks, and recent market and economic trends. This report 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 Research Service reports that examine specific issues.

"Safety and Soundness"

Banks face a number of regulations intended to increase the likelihood that banks are profitable without being excessively risky and prone to failures; decrease the likelihood that bank services are used to conceal the proceeds of criminal activities; and to protect banks and their customers' data from cyberattacks. This section provides background on these "safety and soundness" regulations and analyzes selected issues related to them, including

- prudential regulation related to capital requirements and the Volcker Rule (which restricts proprietary trading);

Consumer Protection Act (P.L. 115-174) and Selected Policy Issues, coordinated by David W. Perkins.

[7] A number of these proposals will be discussed later in this report. For examples, see The Federal Reserve Board of Governors, "Federal Reserve Board Asks for Comment on Proposed Rule to Simplify and Tailor Compliance Requirements Relating to the 'Volcker rule'", press release, May 30, 2018, at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180530a.htm; and The Federal Reserve Board of Governors, "Federal Reserve Board Seeks Comment on Proposal to Simplify Its Capital Rules for Large Banks While Preserving Strong Capital Levels That Would Maintain Their Ability to Lend Under Stressful Conditions," press release, April 10, 2018, at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180410a.htm.

- requirements facing banks related to anti-money laundering laws, such as the Bank Secrecy Act (P.L. 91-508); and
- challenges related to cybersecurity.

Background

Bank failures can inflict large losses on stakeholders, including taxpayers via government "safety nets" such as deposit insurance and Federal Reserve lending facilities.[8] 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 use *prudential regulation* designed to ensure banks are safely profitable and to reduce the likelihood of bank failure.

In addition, banks are subject to regulations intended to reduce the prevalence of crime. Some of those are *anti-money laundering* measures aimed at stopping criminals from using the banking system to conduct or hide illegal operations. Others are *cybersecurity* regulations aimed at protecting banks and their customers from becoming victims of cybercrime, such as denial-of-service attacks or data theft.

Prudential Regulation[9]

Banks profit in part because 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.[10] The practice is usually profitable, but does expose banks to risks that can potentially lead to failure.

Failures can be reduced if (1) banks are better able to absorb losses or (2) they are less likely to experience unsustainably large losses. One tool regulators use to increase a bank's ability to absorb losses is to require banks to hold a minimum level of capital. Another tool regulators use to reduce the likelihood and size of potential losses is to prohibit banks from engaging in activities that could create excessive risks. For example, the Volcker Rule prohibits banks from engaging in *proprietary trading*—the buying and selling of securities that the bank itself owns with the aim of profiting from price changes.[11]

The EGRRCP Act mandated certain changes to these prudential regulations, and regulators have proposed changes under existing authorities.[12] Regulators are to promulgate these changes through the rulemaking process in the coming months and years. In addition, whether

[8] For examples, see CRS Report R43413, *Costs of Government Interventions in Response to the Financial Crisis: A Retrospective*, by Baird Webel and Marc Labonte.

[9] This section was authored by David W. Perkins, analyst in macroeconomic policy. His contact information is available to congressional Members and staff through the internal CRS website.

[10] Robert DeYoung and Tara Rice, "How Do Banks Make Money? The Fallacies of Fee Income," *Federal Reserve Bank of Chicago Economic Perspectives*, vol. 28, no. 4 (2004), p. 34.

[11] This report focuses on just two aspects of prudential regulation—capital ratios and the Volcker Rule—that are an area of particular concern in recent policy debates. However, prudential regulation involves numerous requirements besides these, such as liquidity requirements, asset concentration guidelines, and counterparty limits.

[12] For example, the EGRRCP Act created the option for small banks to meet a single, higher leverage ratio to be considered in compliance with all other ratio requirements and exempted them from the Volcker Rule, examined in the "Capital Requirements" and "Volcker Rule" sections that follow. For a detailed examination of the EGRRCP Act, see CRS Report R45073, *Economic Growth, Regulatory Relief, and Consumer Protection Act (P.L. 115-174) and Selected Policy Issues*, coordinated by David W. Perkins.

policymakers have calibrated these regulations such that their benefits and costs are appropriately balanced is likely to be an area of ongoing debate. For these reasons, prudential regulation issues will likely continue to draw congressional attention.

Capital Requirements

A bank's balance sheet is composed of 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.[13] 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 special types of bonds that can be converted into equity.

Banking is an inherently risky activity, because banks may suffer losses on assets but face rigid obligations on the liabilities owed to depositors and creditors. In contrast to liabilities, capital generally does not obligate the bank to repay or distribute a specified amount of money at a specified time. This characteristic means that, in the event a bank suffers losses, capital gives the bank the ability to absorb some amount of losses while meeting its obligations. Thus, banks can avoid failures if they hold sufficient capital.[14]

Banks are required to satisfy several requirements to ensure they hold enough capital. In the United States, these requirements are generally aligned with the Basel III standards developed as part of a nonbinding agreement between international bank regulators. In general, these are expressed as minimum ratios between certain balance sheet items that banks must maintain. A detailed examination of how these ratios are calculated and what levels must be met is beyond the scope of this report.[15] This examination of policy issues only requires noting that capital ratios 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 assets regardless of how risky each asset is. A risk-weighted ratio assigns a risk weight—a percentage 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 meet the ratio requirement.

Whether the benefits of capital requirements (e.g., increased bank and financial system stability) are generally outweighed by the potential costs (e.g., reduced credit availability) is an issue subject to debate.[16] Capital is typically a more expensive source of funding for banks than liabilities. Thus, requiring banks to hold higher levels of capital may make funding more expensive, and so banks may choose to reduce the amount of credit available.[17] Some studies

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[13] Antonio Luis San Frutos Velasco, *How to Read a Bank's Balance Sheet*, Banco Bilbao Vizcaya Argentaria, October 20, 2016, at https://www.bbva.com/en/interpret-banks-balance-sheet/.

[14] Federal Deposit Insurance Corporation (FDIC), *Risk Management Manual of Examination Policies: Section 2.1 Capital*, April 2015, at https://www.fdic.gov/regulations/safety/manual/.

[15] For more a more detailed examination, see CRS In Focus IF10809, *Introduction to Bank Regulation: Leverage and Capital Ratio Requirements*, by David W. Perkins.

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

[17] 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/.

For more information, see CRS Report R44813, *Cost-Benefit Analysis and Financial Regulator Rulemaking*, by David W. Perkins and Maeve P. Carey.

indicate this could slow economic growth.[18] 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.[19] 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.[20]

Lack of consensus also surrounds questions over whether or under what circumstances risk-weighted ratios are necessary, effective, and efficient. Proponents of risk-based measures assert that it is important to use both risk-weighted and leverage ratios because each addresses weaknesses of the other. For example, 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 safe assets.[21]

However, the use of risk-weighted ratios could be problematic for a number of reasons. Risk weights assigned to particular classes of assets could potentially be an inaccurate estimation of some assets' true risk, which could incent banks to misallocate available resources across asset classes.[22] For example, banks held a high level of seemingly low-risk, 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 requirements involve "needless complexity" and their use is an example of regulatory micromanagement. The complexity could benefit the largest banks that have the resources to absorb the added regulatory cost compared with small banks that could find compliance costs more burdensome.[23] (Small or "community" bank compliance issues will be covered in more detail in the "Regulatory Burden on Community Banks" section later in the report.)

Section 201 of the EGRRCP Act is aimed at addressing concerns over the complexity of risk-weighted ratios and the costs they impose on community banks. This provision created an option for banks with less than $10 billion in assets to meet a higher leverage ratio—the *Community Bank Leverage Ratio* (CBLR)—in order to be exempt from having to meet the risk-based ratios described above. Bank regulators have issued a proposal to implement this provision wherein banks (1) below the threshold that (2) meet at least a 9% leverage ratio measure of equity and certain retained earnings to assets and (3) had limited off-balance sheet exposures and limited

[18] For a survey of the academic literature, see Natalya Martynova, *Effect of Bank Capital Requirements on Economic Growth: A Survey*, De Nederlandsche Bank, DNB Working Paper no. 467, March 2015, at https://www.dnb.nl/binaries/Working%20paper%20467_tcm46-319679.pdf.

[19] 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.

[20] Jeffrey N. Gordon, "The Empty Call for Benefit-Cost Analysis in Financial Regulation," *Columbia Law and Economics Accepted Paper No. 464*, July 2014, pp. 4-8.

[21] 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.

[22] Hester Peirce and Benjamin Klutsey, *Reframing Financial Regulation: Enhancing Stability and Protecting Consumers* (Arlington, VA: Mercatus Center at George Mason University, 2016), pp. 13-16.

[23] Rachel Witkowski, "Spare Small Banks the Burden of Complex Capital Rules: FDIC Chief," *American Banker*, November 16, 2018, at https://www.americanbanker.com/news/spare-small-banks-the-burden-of-complex-capital-rules-fdic-chief.

securities trading activity (among other requirements) would qualify for the exemption. The FDIC estimates that more than 80% of community banks will be eligible for the CBLR.[24]

However, this new optional exemption does not entirely settle the issue. One bank industry group has argued that 9% is set higher than is necessary, excluding deserving banks from the exemption.[25] In addition, bills in the 115th Congress, notably H.R. 10, proposed a high-leverage-ratio option be available to banks regardless of size that would exempt qualifying banks from a wider range of prudential regulations.[26] There are also specific policy issues relating to capital requirements for large banks, which are discussed in the "Regulator Proposals Related to Large Bank Capital Requirements" section below.

Volcker Rule

Section 619 of Dodd-Frank—often referred to as the Volcker Rule—generally prohibits depository banks from engaging in proprietary trading or sponsoring a hedge fund or private equity fund.[27] Proprietary trading refers to owning and trading securities for a bank's own portfolio with the aim of profiting from price changes. Put simply, if a bank is engaged in proprietary trading, it is itself an investor in stocks, bonds, and derivatives, which is commonly characterized as "playing the market" or "speculating." The rule includes exceptions for when bank trading is deemed appropriate—such as (1) when a bank is hedging against risks the bank has assumed as a part of its traditional business and (2) *market-making* (i.e., buying available securities with the intention of quickly selling them to meet market demand).

Proprietary trading is an inherently risky activity, and banks have faced varying degrees of restrictions over engaging in this activity for a number of decades. Sections 16, 20, 21, and 32 of the Banking Act of 1933 (P.L. 73-66)—commonly referred to as the Glass-Steagall Act—generally prohibited certain deposit-taking banks from engaging in certain securities markets activities. Over time, regulator interpretation of Glass-Steagall and legislative changes expanded permissible activities for certain banks, allowing them to make certain securities investments and authorizing bank-holding companies to own depositories and securities firms within the same organization.[28] The financial crisis increased debate over whether banks were engaging in unnecessarily risky activities. Ultimately, certain provisions in Dodd-Frank placed restrictions on permissible activities to reduce banks' riskiness, and the Volcker Rule was designed to prohibit proprietary trading by depository banking organizations.[29]

[24] Jelena McWilliams, chairman of the FDIC, *Remarks at the Federal Reserve Bank of Chicago Thirteenth Annual Community Bankers Symposium: Back to Basics*, Federal Deposit Insurance Corporation, Chicago, IL, November 16, 2018, at https://www.fdic.gov/news/news/speeches/spnov1618.html.

[25] Independent Community Bankers of America, "ICBA Statement on Community Bank Leverage Ratio," press release, November 20, 2018, at https://www.icba.org/news/news-details/2018/11/20/icba-statement-on-community-bank-leverage-ratio.

[26] Sections 601, 602 of H.R. 10 (115th Congress). For more information, see CRS Report R44839, *The Financial CHOICE Act in the 115th Congress: Selected Policy Issues*, by Marc Labonte et al.

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

[28] For example, the Gramm-Leach-Bliley Act (P.L. 106-102) repealed two provisions of the Glass-Steagall Act in 1999. For more information, see CRS Report R44349, *The Glass-Steagall Act: A Legal and Policy Analysis*, by David H. Carpenter, Edward V. Murphy, and M. Maureen Murphy.

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

One of the Volcker Rule's proponents' main rationales for the separation of deposit-taking and certain securities investments is that when banks analyze and assume risks, they may be subject to *moral hazard*—the willingness to take on excessive risk due to some outside protection from losses. Deposits are an important source of bank funding and insured (up to a limit on each account) by the government. This arguably reduces depositors' incentive to monitor their banks' riskiness. Thus, a bank could potentially take on excessive risk without concern about losing this funding because, in the event of large losses that lead to failure, at least part of the losses will be borne by the FDIC's Deposit Insurance Fund (which is backed by the full faith and credit of the U.S. government and so ultimately the taxpayer). Thus, supporters of the Volcker Rule have characterized it as preventing banks from "gambling" in securities markets with taxpayer-backed deposits.[30]

However, critics of the Volcker Rule doubt its necessity and efficiency. In regard to necessity, they assert that proprietary trading at commercial banks did not play a substantive role in the financial crisis. They note the rule would not have prevented a number of the major events that played a direct role in the crisis—including failures or bailouts of large investment banks and insurers and losses on loans held by commercial banks.[31] On this point, they also argue that proprietary trading risks are no greater than those posed by "traditional" banking activities, such as mortgage lending, and allowing banks to take on risks in different markets might diversify their risk profiles, making them less likely to fail.[32]

Debates relating to the efficiency of the Volcker Rule involve its complexity, compliance burden, and potential to lead banks to reduce their engagement in beneficial market activities. Recall that the Volcker Rule is not a ban on all trading, as banks are still allowed to trade to hedge risks or make markets. 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 the aforementioned complexity and compliance costs that could affect banks' trading behavior, and so could reduce financial market efficiency.[33]

Another criticism of the Volcker Rule in its original form was that it unnecessarily subjected all banks to the rule and their associated compliance costs. Critics of this aspect asserted that the vast majority of community banks are not involved in complex trading activity, but nevertheless must incur costs in evaluating the rule to ensure they are in compliance.[34]

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

[31] U.S. Congress, House Committee on Financial Services, *Examining the Impact of the Volcker Rule on Markets, Businesses, Investors, and Job Creation Part II*, 112th Cong., 2nd sess., December 13, 2012, p. 2, at https://www.govinfo.gov/content/pkg/CHRG-112hhrg79694/pdf/CHRG-112hhrg79694.pdf.

[32] 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.

[33] Letter from Frank Keating, president and CEO of the American Bankers Association, to the Office of the Comptroller of the Currency (OCC), the Federal Reserve, the FDIC, the Securities and Exchange Commission (SEC), the Commodities Futures Trading Commission (CFTC), February 13, 2012, pp. 1-6, at https://www.aba.com/archive/Comment_Letter_Archive/Comment%20Letter%20Archive/21312ABACommentLetterreVolckerRuleProposal.pdf.

[34] Letter from Christopher Cole, executive vice president and senior regulatory counsel, to the OCC, Legislative and Regulatory Activities, September 19, 2017, at https://www.icba.org/docs/default-source/icba/advocacy-documents/letters-to-regulators/2017/cl091917.pdf?sfvrsn=0.

Both Congress and regulators have recently taken actions in response to concerns over the complexity of the Volcker Rule and its compliance burden for small banks. Section 203 of the EGRRCP Act exempted banks with less than $10 billion in assets that fell below certain trading activity limits from the rule.[35] Independent of that mandate, the agencies that implemented and enforced the Volcker Rule released and called for public comment on a proposal to simplify the rule in May 2018.[36] Under the proposal, the agencies would clarify certain of the rule's definitions and criteria in an effort to reduce or eliminate uncertainties related to how certain trading activity can qualify for exemption. The proposal would also further tailor the compliance requirements facing banks based on the size of an institution's trading activity.[37]

Proponents of the Volcker Rule are generally wary of size-based exemptions. They contend that community banks typically do not face compliance obligations under the rule and do not face an excessive burden by being subject to it. They argue that community banks that are subject to compliance requirements can comply by having clear policies and procedures in place for review during the normal examination process.[38] In addition, Volcker Rule supporters are generally critical of the regulators' proposal, asserting that the changes would undermine "the effective supervision and enforcement" of the rule.[39]

Anti-Money Laundering Regulation[40]

Anti-money laundering (AML) regulation refers to efforts to prevent criminal exploitation of financial systems to conceal the location, ownership, source, nature, or control of illicit proceeds.[41] The U.S. Department of the Treasury estimates domestic financial crime, excluding tax evasion, generates $300 billion in illicit proceeds that might involve money laundering.[42] Despite robust AML efforts in the United States, the ability to counter money laundering effectively remains challenged by factors including (1) the diversity of illicit methods to move and store ill-gotten proceeds through the international financial system; (2) the introduction of new and emerging threats such as cyber-related financial crimes; (3) gaps in legal, regulatory, and

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[35] Section 204 also relaxed certain naming restrictions facing certain investment funds for which a banking entity was an investment advisor. For more information, see CRS Report R45073, *Economic Growth, Regulatory Relief, and Consumer Protection Act (P.L. 115-174) and Selected Policy Issues*, coordinated by David W. Perkins.

[36] The agencies are the Federal Reserve, OCC, FDIC, SEC, and CFTC.

Federal Reserve Board of Governors, "Federal Reserve Board Asks for Comment on Proposed Rule to Simplify and Tailor Compliance Requirements Relating to the 'Volcker Rule'," press release, May 30, 2018, at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180530a.htm.

[37] OCC, the Fed, FDIC, SEC, and CFTC, "Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds," 83 *Federal Register* 33432-33439, July 17, 2018.

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

[39] Letter from Dennis Kelleher, president and CEO of Better Markets Inc., and Joseph Cisewski, senior derivatives consultant and special counsel, to the Board of Governors of the Federal Reserve et al., October 17, 2018, at https://www.sec.gov/comments/s7-14-18/s71418-4534658-176121.pdf.

[40] This section was authored by Rena S. Miller, specialist in financial economics. Her contact information is available to congressional Members and staff through the internal CRS website.

[41] For more information on AML regulation, see CRS Report R44776, *Anti-Money Laundering: An Overview for Congress*, by Rena S. Miller and Liana W. Rosen and CRS In Focus IF11064, *Introduction to Financial Services: Anti-Money Laundering Regulation*, by Rena S. Miller and Liana W. Rosen.

[42] U.S. Department of the Treasury, *National Money Laundering Risk Assessment 2018*, December 20, 2018, p. 2, at https://home.treasury.gov/system/files/136/2018NMLRA_12-18.pdf.

enforcement regimes; and (4) the costs associated with financial institution compliance with global AML guidance and national laws.

In the United States, the statutory foundation for domestic AML originated in 1970 with the Bank Secrecy Act (BSA; P.L. 91-508) and its major component, the Currency and Foreign Transaction Reporting Act. Amendments to the BSA and related provisions in the 1980s and 1990s expanded AML policy tools available to combat crime, particularly drug trafficking, and prevent criminals from laundering their illicitly derived profits. Key elements to the BSA/AML legal framework include requirements for customer identification, recordkeeping, reporting, and compliance programs intended to identify and prevent money laundering abuses.

In general, banking regulators examine institutions for compliance with BSA/AML. When a regulator finds BSA violations or deficiencies in AML compliance programs, it may take informal or formal enforcement action, including possible civil fines. The BSA/AML policy framework is premised on banks and other covered financial entities filing a range of reports with the Treasury Department's Financial Crimes Enforcement Network (FinCEN), when their clients either engage in suspicious financial transactions, large cash transactions, or certain other transactions. For example, a bank generally must file a Suspicious Activity Report (SAR) if, among other reasons, it conducts a transaction of $5,000 or more that the bank suspects involves money laundering or other criminal activity. A bank must file a Currency Transaction Report (CTR) if it conducts a currency (i.e., cash) transaction of $10,000 or more as to which it has the same suspicions.[43] The accurate, timely, and complete reporting of such activity to FinCEN flags situations that may warrant further investigation for law enforcement.[44]

Whether this regulatory framework adequately hinders criminals from using the banking system to launder their criminal proceeds and whether it does so efficiently without unduly burdening banks are debated issues. One aspect of this debate is whether current reporting requirements are inefficient and overly costly to the banking industry. Some industry observers—including officials from the OCC—have indicated that they believe certain areas of the current framework could be reformed in a way that reduces compliance costs without unduly weakening the ability to prevent money laundering.[45] In contrast, officials from other agencies involved in AML and law enforcement—including FinCEN and the FBI—have stressed the importance of the information gathered under the current reporting requirements in combating money laundering.[46]

Another area of concern involves *beneficial owners*—that is, the natural person(s) who own or control a legal entity, such as a corporation or limited liability company. When such entities are set up without physical operations or assets, they are often referred to as *shell companies*. Shell companies can be used to conceal beneficial ownership and facilitate anonymous financial transactions. In recent years, policymakers have become increasingly concerned regarding potential risks posed by shell companies whose beneficial ownership is not transparent. This is due in part to a series of leaks to the media regarding the use of shell companies to facilitate criminal activity (such as "the Panama Papers") and sustained multilateral criticism of current

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[43] 12 CFR § 21.11(b).

[44] 31 CFR § 1010.311.

[45] U.S. Congress, House Committee on Financial Services, *Financial Industry Regulation: the Office of the Comptroller of the Currency*, 115th Cong., 2nd sess., June 13, 2018.Comptroller of the Currency Joseph M. Otting, *Testimony Before the House Committee of Financial Services*, June 13, 2018.

[46] Julian B. Carter and Peter D. Hardy, *FinCEN, OCC and FBI Offer Diverging Views on AML Reform in U.S. Senate Testimony*, Ballard Spahr LLC, Money Laundering, December 4, 2018, at https://www.moneylaunderingwatchblog.com/2018/12/fincen-occ-and-fbi-offer-diverging-views-on-aml-reform-in-u-s-senate-testimony/.

U.S. practices by the Financial Action Task Force, an international standard-setting body.[47] In May 2018, a new FinCEN regulation came into effect that increased the requirements for banks to conduct customer due diligence (CDD) and ascertain the identity of beneficial owners in certain cases.[48] Central to the CDD rule is a requirement for financial institutions to establish and maintain procedures to identify and verify beneficial owners of a legal entity opening a new account.[49]

If Congress decides that reporting requirements facing banks are not appropriately calibrated, it could pass legislation amending those requirements. For example, Congress could change the CTR or SAR reporting threshold or index the threshold levels to inflation. Certain bills introduced in the 115th Congress would have increased financial transparency and reporting requirements for beneficial owners in other nonbank fields, such as real estate, but could potentially indirectly impact the banking industry as well.

Cybersecurity[50]

Cybersecurity is a major concern of banks, other financial services providers, and federal regulators. In many ways, it is an important extension of physical security. For example, banks are concerned about both physical and electronic theft of money and other assets, and they do not want their businesses shut down by weather events or electronic denial-of-service attacks. Maintaining the confidentiality, security, and integrity of physical records and electronic data held by banks is critical to sustaining the level of trust that allows businesses and consumers to rely on the banking industry to supply services on which they depend.

The federal government has increasingly recognized the importance of cybersecurity in the financial services industry,[51] as evidenced by the inclusion of financial services in the government's list of critical infrastructure sectors.[52] The basic authority that federal regulators use to establish cybersecurity standards emanates from the organic legislation that established the agencies and delineated the scope of their authority and functions. As previously discussed, federal banking regulators are required to promulgate safety and soundness standards for all federally insured depository institutions to protect the stability of the nation's banking system. Some of these standards pertain to cybersecurity issues, including information security, data breaches, and destruction or theft of business records.

In addition, certain laws (at both the state and federal levels) have provisions related to cybersecurity of financial services that are often performed by banks, including the Dodd-Frank

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[47] Financial Action Task Force, *Mutual Evaluation of the United States*, December 2016, at https://www.fatf-gafi.org/media/fatf/documents/reports/mer4/MER-United-States-2016.pdf.

[48] Department of the Treasury, Financial Crimes Network, "Customer Due Diligence Requirements for Financial Institutions," 81 *Federal Register* 91, May 11, 2016, pp. 29398-29458.

[49] Financial Crimes Enforcement Network, "FinCEN Reminds Financial Institutions that the CDD Rule Becomes Effective Today," press release, May 11, 2018, at https://www.fincen.gov/news/news-releases/fincen-reminds-financial-institutions-cdd-rule-becomes-effective-today.

[50] This section was authored by N. Eric Weiss, specialist in financial economics. His contact information is available to congressional Members and staff through the internal CRS website.

[51] Randal K. Quarles, vice chairman of the Federal Reserve, "Brief Thoughts on the Financial Regulatory System and Cybersecurity," speech at the Financial Services Roundtable 2018 Spring Conference, Washington, DC, February 26, 2018, at https://www.federalreserve.gov/newsevents/speech/quarles20180226b.htm.

[52] Executive Order 13636, "Improving Critical Infrastructure Cybersecurity," and Presidential Policy Directive (PPD)-21, "Critical Infrastructure Security and Resilience" (February 12, 2013), at https://www.dhs.gov/sites/default/files/publications/eo-13636-ppd-21-fact-sheet-508.pdf.

Act, the Gramm-Leach-Bliley Act of 1999 (GLBA; P.L. 106-102), and the Sarbanes-Oxley Act of 2002 (P.L. 107-204). For example, Section 501 of GLBA imposes obligations on financial institutions to "respect the privacy of ... [their] customers and to protect the security and confidentiality of those customers' nonpublic personal information."[53] Federal banking regulators require the entities that they regulate to protect customer privacy of physical and electronic records as mandated by the privacy title of GLBA.[54] Federal bank regulators also issue guidance in a variety of forms designed to help banks evaluate their risks and comply with cybersecurity regulations.[55]

Regulators bring adjudicatory enforcement actions on a case-by-case basis related to banks' violations of cybersecurity protocols. Banks often view these actions as signaling how an agency interprets aspects of its regulatory authority. For example, a number of recent consent orders issued by the FDIC have directed banks to perform assessments or audits of information technology programs and management to identify risks and ensure compliance with cybersecurity requirements.[56]

Thus, oversight of financial services and bank cybersecurity reflects a complex and sometimes overlapping array of state and federal laws, regulators, regulations, and guidance. However, whether this framework is effective and efficient, resulting in adequate protection against cyberattacks without imposing undue cost burdens on banks, is an open question.[57] The occurrence of successful hacks of banks and other financial institutions, wherein huge amounts of individuals' personal information are stolen or compromised, highlights the importance of ensuring bank cybersecurity. For example, in 2014, JPMorgan Chase, the largest U.S. bank, experienced a data breach that exposed financial records of 76 million households.[58] However, no consensus exists on how best to reduce the occurrence of such incidents.

Consumer Protection, Fair Lending, and Banking Access

Financial products can be complex and potentially difficult for consumers to fully understand. 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

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53 15 U.S.C. §6801(a).

The term *financial institution* is defined broadly in this provision, and includes banks. 15 U.S.C. §6809(3)(A), defines financial institution as "any institution the business of which is engaging in activities that are financial in nature or incidental to such financial activities as described in Section 4(k) of the Bank Holding Company Act" (12 U.S.C. §1843(k)).

54 15 U.S.C. §6801(b).

55 For example, the bank regulators, through the Federal Financial Institution Examination Council (FFIEC) issue the FFIEC Cybersecurity Assessment Tool to help an institution identify its cybersecurity risks and its ability to address them.

56 For example, see Consent Order FDIC-18-0187b, pp. 7-9; Consent Order FDIC-17-0006b, pp. 14-19; Consent Order FDIC-16-0250b, at https://orders.fdic.gov/s/searchform.

57 For example, see Greg Baer and Rob Hunter, *A Tower of Babel: Cyber Regulation for Financial Services*, Bank Policy Institute, Banking Perspectives, second quarter 2017, at https://www.theclearinghouse.org/banking-perspectives/2017/2017-q2-banking-perspectives/articles/cyber-regulation-for-financial-services.

58 Jessica Silver-Greenberg, Matthew Goldstein, and Nicole Perlroth, "JPMorgan Chase Hacking Affects 76 Million Households," *New York Times*, October 2, 2014, at https://dealbook.nytimes.com/2014/10/02/jpmorgan-discovers-further-cyber-security-issues.

to protect consumers. This section provides background on consumer financial protection and the Bureau of Consumer Financial Protection's (CFPB) authority. The section also analyzes related issues, including

- whether the CFPB has used its authorities and regulations of banking institutions appropriately;
- concerns relating to the lack of consumer access to banking services; and
- whether the Community Reinvestment Act as currently implemented is effectively and efficiently meeting its goal of ensuring banks provide credit to the areas in which they operate.

Background

Banks are subject to *consumer compliance* regulation, intended to ensure that banks are in compliance with relevant consumer-protection and fair-lending laws. Federal laws and regulations in this area take a variety of approaches and address different areas of concern. Certain laws provide disclosure requirements intended to ensure consumers adequately understand the costs and other features and terms of financial products.[59] Other laws prohibit unfair, deceptive, or abusive acts and practices.[60] Fair lending laws prohibit discrimination in credit transactions based upon certain borrower characteristics, including sex, race, religion, or age, among others.[61]

The financial crisis raised concerns among policymakers that regulators' mandates lacked sufficient focus on consumer protection. In response, the Dodd-Frank Act established the CFPB with the single mandate to implement and enforce federal consumer financial law, while ensuring consumers can access financial products and services. The CFPB also seeks to ensure the markets for consumer financial services and products are fair, transparent, and competitive.[62]

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.[63] 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 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.

[59] 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.

[60] CFPB, *CFPB Bulletin 2013-07: Prohibition of unfair, Deceptive, or Abusive Acts or Practices in the Collection of Consumer Debts*, July 10, 2013.

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

[62] 12 U.S.C. §5511.

[63] For more information on the CFPB, see CRS In Focus IF10031, *Introduction to Financial Services: The Bureau of Consumer Financial Protection (CFPB)*, by Cheryl R. Cooper and David H. Carpenter.

Consumer Protection, Fair Lending, and CFPB Regulation[64]

Consumer protection and fair lending compliance continue to be important issues for banks for numerous reasons. Noncompliance can result in regulators taking enforcement actions that may involve substantial penalties. In addition, even in the absence of enforcement actions, an institution faces reputational risks if it comes to be perceived as dealing badly with customers. For example, the CFPB maintains a consumer complaints database that makes public consumer complaints against individual companies readily available, potentially affecting prospective customers' decisions on which companies to use for financial services.[65] The recent public reaction to and enforcement actions pertaining to Wells Fargo's unauthorized opening of customer accounts show the importance of strong consumer protection compliance.[66]

Recently, banks and other nonbank financial institutions that provide financial products to consumers (e.g., mortgages, credit cards, and deposit accounts) have been affected by the implementation of new CFPB regulations. For example, banks and other lenders have begun to comply with major new mortgage rules such as the Ability-to-Repay and Qualified Mortgage Standards Rule (ATR/QM) and Truth in Lending Act/Real Estate Settlement Act Integrated Disclosure Rule (TRID). The ATR/QM encourages lenders to gather more information on prospective borrowers than they otherwise might have in order to reduce the likelihood that a borrower would receive an inappropriate loan.[67] TRID requires lenders to provide borrowers with certain information about the mortgages for which they are applying.[68] In addition to these and other new regulations, the CFPB also provides information on its supervisory activities related to banks, such as instances where its examiners found that certain financial institutions misrepresented service fees associated with deposit and checking accounts.[69]

Compliance with these new rules has increased banks' operational costs,[70] which some argue potentially leads to higher costs for consumers in certain markets or a reduction in the availability of credit. Others stress that CFPB's regulatory, supervisory, and enforcement efforts reduce the likelihood of consumer harm in financial markets. Debates about how best to achieve the appropriate balance between consumer protection, credit access, and industry costs are unlikely to be resolved easily, and thus may continue to be an area of congressional interest.

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[64] This section was authored by Cheryl R. Cooper, analyst in financial economics. Her contact information is available to congressional Members and staff through the internal CRS website.

[65] The CFPB consumer complaint database is available at https://www.consumerfinance.gov/data-research/consumer-complaints/.

[66] Alan Kline and Bonnie McGeer, "2018 Bank Reputation Rankings: Who Stood Out, Who Stumbled," *American Banker*, July 1, 2018.

[67]CFPB, "Ability-to-Repay and Qualified Mortgage Standards Under the Truth In Lending Act (Regulation Z)," 78 *Federal Register* 6408, January 30, 2013.

[68] CFPB, "Integrated Mortgage Disclosures Under the Real Estate Settlement Procedures Act (Regulation X) and the Truth In Lending Act (Regulation Z)," 78 *Federal Register* 79730, December 31, 2013.

[69]CFPB, *Supervisory Highlights, Issue 16, Summer 2017*, September 2017, pp. 13-17, at https://s3.amazonaws.com/files.consumerfinance.gov/f/documents/201709_cfpb_Supervisory-Highlights_Issue-16.pdf.

[70] CFPB, *Understanding the Effects of Certain Deposit Regulations on Financial Institutions' Operations*, November 2013, at files.consumerfinance.gov/f/201311_cfpb_report_findings-relative-costs.pdf.

Access to Banking[71]

The banking sector provides valuable financial services for households that allow them to save, make payments, and access credit. Safe and affordable financial services allow households to avoid financial hardship, build assets, and achieve financial security. However, many U.S. households (often those with low incomes, lack of credit histories, or credit histories marked with missed debt payments) do not use banking services. According to the FDIC's National Survey of Unbanked and Underbanked Households, in 2017, 6.5% of households in the United States were unbanked (i.e., did not have an account at an insured institution) and 18.7% of households were underbanked (i.e., obtained financial products and services outside of the banking system in the past year).[72]

Lack of bank access leads some households to rely on alternative financial service providers and consumer credit products outside of the formal banking sector, such as payday or auto title loans. According to an FDIC estimate, 12.9% of households had unmet demand for mainstream small-dollar credit.[73] Certain observers believe that financial outcomes for the unbanked and underbanked would be improved if banks—which may be more likely to be a stable source of relatively inexpensive financial services relative to certain alternatives—were more active in meeting this demand. For this reason, prudential regulators, like the OCC and the FDIC, are currently exploring ways to encourage banks to offer small-dollar credit products to consumers,[74] and other policymakers and observers will likely continue to explore ways to make banking more accessible to a greater portion of the population.

Community Reinvestment Act[75]

The Community Reinvestment Act of 1977 (CRA; P.L. 95-128) addresses how banking institutions meet the credit needs of the areas they serve, notably in low- and moderate-income (LMI) neighborhoods.[76] The federal prudential banking regulators (the Fed, the OCC, and the FDIC) conduct examinations to evaluate how banks are fulfilling the objectives of the CRA. The regulators issue CRA credits, or points, where banks engage in qualifying activities—such as mortgage, consumer, and business lending; community investments; and low-cost services that would benefit LMI areas and entities—that occur within an assigned *assessment area*. These credits are then used to issue each bank a performance rating, from Outstanding to Substantial Noncompliance. The CRA requires regulators to take these ratings into account when banks

[71] This section was authored by Cheryl R. Cooper, analyst in financial economics. Her contact information is available to congressional Members and staff through the internal CRS website.

[72] FDIC, *FDIC National Survey of Unbanked and Underbanked Households*, October 2018, p. 1, at https://www.fdic.gov/householdsurvey/2017/2017report.pdf.

In this FDIC study, alternative financial services providers include money orders, check cashing, international remittances, payday loans, refund anticipation loans, rent-to-own services, pawn shop loans, or auto title loans.

[73] FDIC, *FDIC National Survey of Unbanked and Underbanked Households*, October 2018, p. 10, at https://www.fdic.gov/householdsurvey/2017/2017report.pdf.

[74] OCC, *Core Lending Principles for Short-Term, Small-Dollar Installment Lending*, May 23, 2018, at https://www.occ.gov/news-issuances/bulletins/2018/bulletin-2018-14.html; and FDIC, "FDIC Requests Information on Small-Dollar Lending," press release, November 14, 2018, at https://www.fdic.gov/news/news/press/2018/pr18084.html.

[75] This section was authored by Darryl E. Getter, specialist in financial economics. His contact information is available to congressional Members and staff through the internal CRS website.

[76] For more information on the CRA, see CRS Report R43661, *The Effectiveness of the Community Reinvestment Act*, by Darryl E. Getter.

request to merge with other banking institutions or otherwise expand their operations into new areas. Whether regulations as currently implemented are effectively and efficiently meeting the CRA's goals has been the subject of debate. The banking industry and other observers assert that CRA regulations can be altered in a way that would reduce regulatory burden while still meeting the law's goals. [77] Recently, the OCC and Treasury have made proposals to address those concerns. However, consumer and community advocates argue that efforts to provide relief to banks may potentially be at the expense of communities that the CRA is intended to help.[78]

Treasury made a number of recommendations to the bank regulators for changes to CRA regulations in a memorandum it sent to those agencies in April 2018.[79] Regarding the need for modernization, the memorandum recommends revisiting the approach for determining banks' assessment areas, given that geographically defined areas arguably may not fully reflect the community served by a bank because of technology developments. Treasury also recommends establishing clearer standards for CRA-eligible activities that provide flexibility and expand the types of loans, investments, and services that are eligible for CRA credit. Regarding aspects of CRA compliance that may be unnecessarily burdensome, Treasury recommends increasing the timeliness of the CRA performance examination process. Regarding improving the outcomes that the CRA was intended to encourage, such as increasing the availability of credit to LMI neighborhoods, Treasury recommendations include incorporating performance incentives that might result in more efficient lending activities.[80]

In September 2018, the OCC published an advance notice of proposed rulemaking (ANPR) seeking public comment on 31 questions pertaining to issues to consider and possible changes to CRA regulation. The OCC's ANPR does not propose specific changes, but its content and the questions posed suggest that the OCC is exploring the possibility of adopting a quantitative metric-based approach to CRA performance evaluation, changing how assessment areas are defined, expanding CRA-qualifying activities, and reducing the complexity, ambiguity, and burden of the regulations on the bank industry.[81] The OCC received more than 1,300 comment letters in response to the ANPR that were alternatively supportive or critical of the various possible alterations to CRA regulation.[82]

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77 American Bankers Association, *CRA Modernization: Meeting Community Needs and Increasing Transparency*, December 2017, at https://www.aba.com/Advocacy/Documents/CRA-WhitePaper2017.pdf.

78 Letter from American for Financial Reform et al. to Joseph Otting, Comptroller of the Currency, November 18, 2018, at https://ourfinancialsecurity.org/wp-content/uploads/2018/11/11.14.18-CRA-Comment-Letter.pdf.

79 U.S. Department of the Treasury, "Treasury Releases Community Reinvestment Act Modernization Recommendations," press release, April 3, 2018, at https://home.treasury.gov/news/press-releases/sm0336.

80 U.S. Department of the Treasury, "Memorandum for the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation," April 3, 2018, at https://home.treasury.gov/sites/default/files/2018-04/4-3-18%20CRA%20memo.pdf.

81 OCC, "Reforming the Community Reinvestment Act Regulatory Framework," 83 *Federal Register* 45053, September 5, 2018, pp. 45053-45059.

82 Rachel Witkowski and Kate Berry, "Cheat Sheet: Hopes and Hang-ups on CRA Reform," *American Banker*, November 25, 2018, at https://www.americanbanker.com/list/cheat-sheet-hopes-and-hang-ups-on-cra-reform.

For more information on this issue, see CRS Report R43661, *The Effectiveness of the Community Reinvestment Act*, by Darryl E. Getter.

Community Banks[83]

Although 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 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.

Background

Although there is no official definition of a community bank, policymakers and the public generally recognize that the vast majority of U.S. banks differ substantially from a relatively small number of very large and complex banking organizations in a number of ways. Community banks tend to

- hold a relatively small amount of assets (although asset size alone need not be a determining factor);
- be more concentrated in core bank businesses of making loans and taking deposits and less involved in other, more complex activities; and
- operate within a smaller geographic area, making them 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.

Therefore, community banks may serve as particularly important credit sources for local communities and underserved groups of which large banks may have little familiarity.[84] In addition, relative to large banks, community banks generally have fewer employees, less resources to dedicate to regulatory compliance, and individually pose less of a systemic risk to the broader financial system.[85]

Congress often faces policy issue questions related to community banks. Community bank advocates often assert the tailoring of regulations currently in place does not adequately balance the benefits and costs of the regulations when applied to community banks. Concerns have also been raised about the three-decade decline in the number and market presence of these institutions, and the predominant cause of that decline is a matter of debate.

Reduction in Community Banks

In recent decades, community banks, under almost any common definition, have seen their numbers decline and their collective share of banking industry assets fall in the United States. Overall, the number of FDIC-insured institutions fell from a peak of 18,083 in 1986 to 5,477 in

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[83] This section was authored by David W. Perkins, analyst in macroeconomic policy. His contact information is available to congressional Members and staff through the internal CRS website.

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

[85] 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.

2018. The number of institutions with less than $1 billion in assets fell from 17,514 to 4,704 during that time period,[86] and the share of industry assets held by those banks fell from 37% to 7%. Meanwhile, the number of banks with more than $10 billion in assets rose from 38 to 138, and the share of total banking industry assets held by those banks increased from 28% to 84%.[87]

The decrease in the number of community banks occurred mainly through three methods: mergers, failures, and lack of new banks. Most of the decline in the number of institutions in the past 30 years was due to mergers, which averaged more than 400 a year from 1990 to 2016. Failures were minimal from 1999 to 2007, but played a larger role in the decline during the late 1980s and following the 2007-2009 financial crisis and subsequent recession. As economic conditions have improved, failures have declined,[88] 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.[89] For example, in the 1990s, an average of 130 new banks reported data to the FDIC per year. Through September 30, five new banks reported data to the FDIC in 2018.[90]

Observers have cited several possible causes for this industry consolidation. Some observers argue the decline indicates that the regulatory burden on community banks is too onerous, driving smaller banks to merge to create or join larger institutions, an argument covered in more detail in the following section, "Regulatory Burden on Community Banks."[91] 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 to stay in business. Alternatively, a community 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.[92] Through much of the 20th century, federal and state laws restricted banks' ability to open new branches and banking across state lines was restricted. Thus, many more banks were needed to serve every community. 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).[93] When these restrictions were relaxed, it became easier for community banks to

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[86] These statistics do not account for inflation, which plays a role in growing bank asset sizes. This report focuses on other factors—such as regulatory changes and economies of scale—that may be driving consolidation.

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

[88] Bank failures decreased from a peak of 157 in 2010 to zero in 2018. FDIC, "Bank Failures in Brief," January 23, 2019, at https://www.fdic.gov/bank/historical/bank/.

[89] FDIC Statistics at a Glance, FDIC Historical Trends, at https://www.fdic.gov/bank/statistical/stats/.

[90] FDIC Statistics at a Glance, FDIC Historical Trends, at https://www.fdic.gov/bank/statistical/stats/.

[91] Hailey Ballew, Michael Iselin, and Allison Nicoletti, "Regulatory Asset Thresholds and Acquisition Activity in the Banking Industry," 2017 Community Banking in the 21st Century Research and Policy Conference, St. Louis, MO, October 5, 2017, at https://www.communitybanking.org/~/media/files/communitybanking/2017/session2_paper3_nicoletti.pdf.

[92] 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 (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.

[93] For more on the law's effect on consolidation, see U.S. Government Accountability Office (GAO), *Community*

consolidate or for mid-size and large banks to spread operations to other markets. In addition, there may be economies of scale, not only in compliance, but in the business of banking in general. Furthermore, the economies of scale 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.[94] 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.

Regulatory Burden on Community Banks

Community banks receive special regulatory consideration to minimize their regulatory burden. For example, many regulations—including a number of regulations implemented pursuant to the Dodd-Frank Act—include exemptions for community banks or are otherwise tailored to reduce compliance costs for community banks.[95] Title I and Title II of the EGRRCP Act contained numerous provisions that provided new exemptions to community banks or raised the thresholds for existing exemptions, such as the Community Bank Leverage Ratio and Volcker Rule exemptions discussed above in the "Prudential Regulation" section.[96] In addition, bank regulators are required to consider the effect of rules on community banks during the rulemaking process pursuant to provisions in the Regulatory Flexibility Act (P.L. 96-354)[97] and the Riegle Community Development and Regulatory Improvement Act (P.L. 103-325).[98] 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 and less intensive reporting requirements.[99]

However, Congress often faces questions related to whether tailoring in general or tailoring provided in specific regulations is sufficient to ensure that an appropriate trade-off has been struck between the benefits and costs of regulations facing community banks. Advocates for further regulatory relief argue that certain realized benefits are likely to be relatively small, whereas certain realized costs are likely to be relatively large.[100]

One area where the benefits of regulation may be relatively small for community banks relative to large banks is regulations aimed at improving systemic stability, because community banks individually pose less of a risk to the financial system as a whole than a large, complex, interconnected bank. Many recent banking regulations were implemented at least in part in

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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.

[94] 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.

[95] For more information, see CRS Report R43999, *An Analysis of the Regulatory Burden on Small Banks*, by Marc Labonte.

[96] For examples of threshold changes, see Appendix A of CRS Report R45073, *Economic Growth, Regulatory Relief, and Consumer Protection Act (P.L. 115-174) and Selected Policy Issues*, coordinated by David W. Perkins.

[97] 5 U.S.C. §§601-612. Neither of the terms *significant* or *substantial* in this context is defined in the Regulatory Flexibility Act.

[98] 12 U.S.C. §4802(a).

[99] 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.

[100] CRS Report R43999, *An Analysis of the Regulatory Burden on Small Banks*, by Marc Labonte.

response to the systemic nature of the 2007-2009 crisis. Some community bank proponents argue that because small banks did not cause the crisis and pose less systemic risk, they need not be subject to new regulations made in response to the crisis. Opponents of these arguments note that systemic risk is only one of the goals of regulation, along with prudential regulation and consumer protection, and that community banks are exempted from many of the regulations aimed at systemic risk. They note that hundreds of small banks failed during and after the crisis, suggesting the prudential regulation in place prior to the crisis was not stringent enough.[101]

Another potential rationale for easing regulations on community banks would be if there are economies of scale to regulatory compliance costs, meaning that regulatory compliance costs may increase as bank size does but decrease as a percentage of overall costs or revenues. Put another way, as regulatory complexity increases, compliance may become relatively more costly for small institutions.[102] Empirical evidence on whether compliance costs are subject to economies of scale is mixed,[103] thus consider this illustrative example to show the logic behind the argument. 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.

Due to a lack of empirical evidence of the exact benefits and costs of each individual regulation at each individual bank (and even lack of consensus over which banks should qualify as community banks), debates over the appropriate level of tailoring of regulations is a debate over calibration involving qualitative assessments. Where should the lines be drawn? Should exemption thresholds be set high so that regulations apply only to the very largest, most complex banks? Should thresholds be set relatively low, so that only very small banks are exempt?[104] At what point does a bank cease to have the characteristics associated with community banks? 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 but are also smaller and less complex than the largest, most complex organizations with hundreds of billions or trillions of dollars in assets.[105] Should regulators provide regional banks the same exemptions as those provided to

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[101] 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*, pp. 2-10, December 2012, at https://www.fdic.gov/regulations/resources/cbi/report/cbi-full.pdf.

[102] 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.

[103] 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*.

[104] 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.

[105] 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

community banks? Policymakers, in the 116th Congress, continue to face these and other questions concerning community banks.

Large Banks and "Too Big to Fail"[106]

Along with the thousands of relatively small banks operating in the United States, there are a handful of banks with hundreds of billions of dollars of assets. The 2007-2009 financial crisis highlighted the problem of "too big to fail" (TBTF) financial institutions—the concept that the failure of a large financial firm could trigger financial instability, which in several cases prompted extraordinary federal assistance to prevent the failure of certain of these institutions.[107] In response to the crisis, policymakers took a number of steps through the Dodd-Frank Act and the Basel III Accords to eliminate the TBTF problem, including subjecting the largest banks to enhanced prudential regulations, a new resolution regime to unwind these banks in the event of failure, and higher capital requirements.

This section provides background on these large banks and examines issues related to them, including

reductions in the application of enhanced prudential regulations facing certain large banks made pursuant to P.L. 115-174 and

- changes to capital requirements proposed by regulators that would reduce the amount of capital certain large banks would have to hold.

As regulators implement these statutory changes and their proposed rules move forward, Congress faces questions about whether relaxing these regulations appropriately eases overly stringent requirements or unnecessarily increases the likelihood that large banks take on excessive risks.

Background

Some bank holding companies (BHCs) have hundreds of billions or trillions of dollars in assets and are deeply interconnected with other financial institutions.[108] A bank may be so large that its leadership 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—

Meeting, Chicago, Illinois, October 19, 2015, at https://www.federalreserve.gov/newsevents/speech/brainard20151019a.htm.

[106] This section was authored by Marc Labonte, specialist in macroeconomic policy. His contact information is available to congressional Members and staff through the internal CRS website.

[107] 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 Marc Labonte.

[108] 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.

that the government would feel compelled to avoid that outcome. An institution of this size and complexity is said to be TBTF.

In addition to fairness issues, economic theory suggests that expectations that a firm will not be allowed to fail creates *moral hazard*—if the creditors and counterparties of a TBTF firm believe that the government will protect them from losses, they have less incentive to monitor the firm's riskiness because they are shielded from the negative consequences of those risks. As a result, TBTF institutions may have incentives to be excessively risky, gain unfair advantages in the market for funding, and expose taxpayers to losses.[109]

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; risk can be diversified by spreading exposures over multiple business lines and geographic markets; and a greater array of financial products could be offered to customers allowing a bank to potentially attract new customers or strengthen relationships with existing ones.[110]

These market forces and the relaxation of certain interstate banking and branching regulations described in the "Reduction in Community Banks" section may have driven 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 more than $250 billion in assets, accounting for 40.9% of industry assets. The trend has generally continued, and as of the third quarter of 2018, nine banks held more than $250 billion in assets, accounting for 49.5% of industry assets.[111]

Many assert that the worsening of the financial crisis in fall 2008 was a demonstration of TBTF-related problems.[112] Large institutions had taken on risks that resulted in large losses, causing the institutions to come under threat of failure. In some cases, the U.S. government took actions to stabilize the financial system and individual institutions.[113] Wachovia and Washington Mutual were large institutions that were acquired by other institutions to avoid their failure during the crisis. Bank of America and Citigroup received extraordinary assistance through the Troubled Asset Relief Program (TARP) to address financial difficulties. Other large (and small) banks participated in emergency government programs offered by the Treasury (TARP), the Federal Reserve, and the FDIC.

In response, the Dodd-Frank Act attempted to end TBTF through (1) a new regulatory regime to reduce the likelihood that large banks would fail; (2) a new resolution regime to make it easier to safely wind down large bank holding companies that are at risk of failing; and (3) new restrictions

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[109] 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.

[110] 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/.

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

[112] 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.

[113] 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.

on regulators' use of emergency authority to prevent "bail outs" of failing large banks.[114] In addition, the Federal Reserve imposed additional capital requirements on the largest banks that largely aligned with proposed standards set out by the Basel III Accords, with some exceptions.

To make it less likely that large banks would fail, certain large banks are now subject to an enhanced prudential regulatory regime administered by the Federal Reserve. Under this regime, large banks are subject to more stringent safety and soundness standards than other banks. They must comply with higher capital and liquidity requirements, undergo stress tests, produce living wills and capital plans, and comply with counterparty limits and risk management requirements.

To make it easier to wind down complex BHCs with nonbank subsidiaries, the Dodd-Frank Act created the Orderly Liquidation Authority (OLA), a resolution regime administered by the FDIC that is similar to how the FDIC resolves bank subsidiaries.[115] This replaced the bankruptcy process, focused on the rights of creditors, with an administrative process, focused on financial stability, for winding down such firms. To date, OLA has never been used.

Implementing Statutory Changes

The Dodd-Frank Act initially applied enhanced prudential regulation requirements to all BHCs with more than $50 billion in assets, although more stringent standards were limited to banks with more than $250 billion in assets or $10 billion in foreign exposure, and the most stringent standards were limited to U.S. globally systemically important banks (G-SIBs), the eight most complex U.S. banks.[116]

Subsequent to the enactment of Dodd-Frank, critics of the $50 billion asset threshold argued that many banks above that size are not systemically important and that Congress should raise the threshold. In particular, critics distinguished between *regional banks* (which tend to be at the lower end of the asset range and, some claim, 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).[117] Opponents of raising the threshold disputed this characterization, arguing that some regional banks are involved in sophisticated activities, such as being swap dealers, and have large off-balance-sheet exposures.[118]

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[114] For more information, see CRS Report R42150, *Systemically Important or "Too Big to Fail" Financial Institutions*, by Marc Labonte.

[115] For more information on OLA, see CRS In Focus IF10716, *Orderly Liquidation Authority*, by David W. Perkins and Raj Gnanarajah and CRS Report R45162, *Regulatory Reform 10 Years After the Financial Crisis: Systemic Risk Regulation of Non-Bank Financial Institutions*, by Jay B. Sykes.

[116] Currently, the U.S. G-SIBs are JP Morgan Chase, Bank of America, Wells Fargo, Citigroup, Goldman Sachs, Morgan Stanley, Bank of New York Mellon, and State Street. For the full list of all G-SIBs, see http://www.fsb.org/wp-content/uploads/P161118-1.pdf.

[117] 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 https://www.govinfo.gov/content/pkg/CHRG-114shrg94375/pdf/CHRG-114shrg94375.pdf.

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.

[118] 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

In response to concerns that the enhanced prudential regulation threshold was set too low, P.L. 115-174 exempted banks with between $50 billion and $100 billion in assets from enhanced prudential regulation, leaving them to be regulated in general like any other bank. Under the proposed rule implementing the P.L. 115-174 changes, the Fed has increased the tiering of enhanced regulation for banks with more than $100 billion in assets.[119] The proposed rule would create four categories of banks based on size and complexity, and impose increasingly stringent requirements on each category. From most to least stringent, Category I would currently include the eight G-SIBs, Category II would include one bank, Category III would include four banks, and Category IV would include 11 banks.[120] Compared with current policy, banks in all categories would face reduced regulatory requirements under this rule, other proposed rules,[121] and forthcoming rules required by Section 402 of P.L. 115-174, if finalized. In addition, P.L. 115-174 created new size-based exemptions from various regulations, increasing the tendency to subject larger banks to more stringent requirements than smaller banks. These changes include exemptions from the Volcker Rule and risk-weighted capital requirements for banks with less than $10 billion in assets (meeting certain criteria).[122]

Proponents of the changes assert they provide necessary and targeted regulatory relief. Opponents argue they needlessly pare back important Dodd-Frank protections to the benefit of large and profitable banks.

Regulator Proposals Related to Large Bank Capital Requirements

As discussed in the "Capital Requirements" section, all banks must hold enough capital to meet certain capital ratio requirements. Broadly, those requirements take two forms—risk-weighted requirements and unweighted leverage requirements.[123] In addition, a small subset of very large and very complex banks also face additional capital ratio requirements implemented by the U.S. federal bank regulators. The Federal Reserve has made two proposals to simplify and relax certain aspects of these additional requirements, and these proposals are subject to debate.

All banks must hold additional high-quality capital on top of the minimum required levels—called the *capital conservation buffer* (CCB)—to avoid limitations on their capital distributions, such as dividend payments. In addition, certain large banks are subject to the Federal Reserve's stress tests, the results of which can lead to restrictions on the bank's capital distributions. Stress tests are intended to ensure that banks hold enough capital to withstand a hypothetical market stress scenario, but arguably have the effect of acting as additional capital requirements with which banks must comply.

Cong., 1st sess., March 24, 2015, at https://www.govinfo.gov/content/pkg/CHRG-114shrg94375/pdf/CHRG-114shrg94375.pdf.

[119] Board of Governors of the Federal Reserve System, "Prudential Standards for Large Bank Holding Companies and Savings and Loan Holding Companies," 83 *Federal Register* 61408-61425, November 29, 2018.

[120] Federal Reserve, *Board Memo: Notices of Proposed Rulemaking to Tailor Prudential Standards*, Appendix, October 31, 2018, at https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20181031a3.pdf.

[121] OCC, Federal Reserve, *Regulatory Capital Rules*, April 19, 2018, at https://www.gpo.gov/fdsys/pkg/FR-2018-04-19/pdf/2018-08066.pdf.

[122] For more information, see CRS Report R45073, *Economic Growth, Regulatory Relief, and Consumer Protection Act (P.L. 115-174) and Selected Policy Issues*, coordinated by David W. Perkins.

[123] Those ratios include a minimum 4% leverage ratio and respective risk-weighted ratios of 4.5% for the highest-quality capital measure, and ratios of 6% and 8% for capital measures that include additional capital or capital-like instruments. For more information, see CRS In Focus IF10809, *Introduction to Bank Regulation: Leverage and Capital Ratio Requirements*, by David W. Perkins.

Advanced approaches banks must maintain a fixed minimum *supplementary leverage ratio* (SLR), an unweighted capital requirement that is more stringent than the leverage ratio facing smaller banks because it incorporates off-balance sheet exposures. A Congressional Research Service (CRS) analysis of large holding companies' regulatory filings indicates that, currently,[124] 19 large and complex U.S. bank or thrift holding companies are classified as advanced approaches banks.[125]

G-SIBs must meet fixed *enhanced SLR* (eSLR) requirements, which sets the SLR higher for these banks. In addition, the G-SIBs are subject to an additional risk-weighted *capital surcharge* (on top of other risk-weighted capital requirements that all banks must meet) of between 1% and 4.5% based on the systemic importance of the institution. Whether these requirements are appropriately calibrated is a debated issue.

Proponents of recalibrating some of these capital requirements argue that those requirements set at a fixed number—including the CCB and eSLR—are inefficient, because they do not reflect varying levels of risk posed by individual banks. Recalibration proponents also argue that compiling with these requirements in addition to stress test requirements is unnecessarily burdensome for banks. Opponents of proposals to relax current capital requirements facing large and profitable banks assert that doing so needlessly pares back important safeguards against bank failures and systemic instability.[126]

In response to concerns that fixed requirements do not adequately account for risk differences between institutions, the Fed has issued two proposals for public comment that would link individual large banks' requirements with other risk measures. One proposal would make bank CCB requirements a function of their stress tests results,[127] and the other proposal would link large banks' eSLR requirements with individual G-SIB systemic importance scores.[128] The Fed estimates that the new CCB requirement would generally reduce the amount of capital large banks would have to hold, but that some G-SIBs would see their required capital levels increase.[129] The Fed estimates that the new eSLR requirement would generally reduce the amount

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[124] The bank regulators have proposed a rule as part of the implementation of the EGRRCP Act that would add new classifications for banks currently classified as advanced approaches banks and change the regulations facing this group of banks. See OCC, the Board of Governors of the Federal Reserve System, and FDIC, "Proposed Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements," 83 *Federal Register*, pp. 66024-66036, December 21, 2018.

[125] CRS was unable to locate an official published list of advanced approaches banks. Instead, CRS searched the filings of large holding companies with more than $50 billion in assets and found that 18 filed Reporting Form FFIEC 101 that is required of advanced approaches banks in 2018, and 1 holding company surpassed the $250 billion asset threshold at which holding companies classify as advanced approaches banks during 2018.

[126] For example, see Letter from Americans for Financial Reform to OCC Legislative and Regulatory Activities Division, June 25, 2018, at https://ourfinancialsecurity.org/wp-content/uploads/2018/06/AFR-Education-Fund-Leverage-Ratio-Comment-Letter.pdf.

[127] Board of Governors of the Federal Reserve System, "Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules," 83 *Federal Register*, pp.18162-18163, April 25, 2018.

[128] Board of Governors of the Federal Reserve System and OCC, "Regulatory Capital Rules: Regulatory Capital, Enhanced Supplementary Leverage Ratio Standards for U.S. Global Systemically Important Bank Holding Companies and Certain of Their Subsidiary Insured Depository Institutions; Total Loss-Absorbing Capacity Requirements for U.S. Global Systemically Important Bank Holding Companies," 83 *Federal Register*, pp. 17320-17321, April 19, 2018.

[129] Memorandum "Proposed Rule Regarding the Stress Buffer Requirements," from Federal Reserve staff to Federal Reserve Board of Governors, April 5, 2018, pp. 15-16, at https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180410a1.pdf.

of capital held by G-SIB parent companies by $400 million and the amount held by insured depository subsidiaries by $121 billion.[130]

What Companies Should Be Eligible For Charters[131]

To legally operate as a bank and perform the relevant activities, an institution generally must have a charter granted by either the OCC at the federal level or a state-level authority. In addition, to engage in certain activities, the institution must have federal deposit insurance granted by the FDIC. Currently, these requirements raise a number of policy questions, including

- whether companies established primarily as financial technology companies should be able to receive a national bank charter, as has been offered by the OCC; and
- whether the application process and determinations made by the FDIC as they relate to institutions seeking a specific type of state charter, called an *industrial loan company* (ILC) charter, is overly restrictive.

Background

An institution that makes loans and takes deposits—the core activities of traditional commercial banking—must have a government issued charter. Numerous types of charters exist, including national bank charters; state bank charters; federal savings association charters, and state savings association charters (saving associations are also referred to as *thrifts*).[132] Each charter type determines what activities are permissible for the institution, what activities are restricted, and which agency will be the institution's primary federal regulator (see **Table 1**). One of the main rationales 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.[133]

The differences between institution business models and the attendant regulations are numerous, varied, and beyond the scope of this report. The issues examined in this section arise from each charter's granting an institution the right to engage in certain banking related activities, and thus generating the potential benefits and risks of those activities. Broadly, these issues relate to questions over whether companies that differ from traditional banks should be allowed to engage in traditional banking activities given the types and magnitudes of benefits and risks the companies might present.

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[130] Memorandum "Joint Notice of Proposed Rulemaking to Modify the Enhanced Supplementary Leverage Ratio Standards Applicable to U.S. G-SIBs and Certain of Their Insured Depository Institution Subsidiaries," from Federal Reserve staff to Federal Reserve Board of Governors, April 5, 2018, pp. 15-16,

[131] This section was authored by David W. Perkins, analyst in macroeconomic policy. His contact information is available to congressional Members and staff through the internal CRS website.

[132] Credit unions are also deposit-taking and loan-making institutions that require a federal or state charter and deposit insurance. However, they differ from banks in a number of ways, including being non-profit institutions, and so are not discussed in this report. For more information on credit unions, see CRS Report R43167, *Policy Issues Related to Credit Union Lending*, by Darryl E. Getter and CRS In Focus IF11048, *Introduction to Bank Regulation: Credit Unions and Community Banks: A Comparison*, by Darryl E. Getter.

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

Table 1. Regulatory Agencies for Bank-Charter Types

Regulatory Agency	Regulator For
Federal Reserve (Fed)	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
Bureau of Consumer Financial Protection (CFPB; consumer protection only)	Rulemaking: All banks Primary Supervision and Enforcement: Consumer businesses of banks with more than $10 billion in assets

Source: CRS, with information drawn from agency websites.

OCC "Fintech" Charter

Recent advances in technology, including the proliferation of available data and internet access, have altered the way financial activities are performed in many ways.[134] These innovations in financial technology, or *fintech,* have created the opportunity for certain activities that have traditionally been the business of banks to instead be performed by technology-focused, nonbank companies.[135] Lending and payment processing are prominent examples. This development has raised questions over how these fintech companies should be regulated, and the appropriate federal and state roles in that regulation. One possible, though contested, proposal for addressing a number of these questions would be to make an OCC national bank charter available to certain fintech companies.

Many nonbank fintech companies performing bank-like activities are regulated largely at the state level. They may have to obtain lending licenses or register as money transmitters in every state they operate and may be subject to the consumer protection laws of that state, such as interest rate limits.[136] Proponents of fintech companies argue that subjecting certain technology companies to 50 different state level regulatory regimes is unnecessarily burdensome and hinders companies that hope to achieve nationwide operations quickly using the internet.[137] In addition, a degree of uncertainty surrounding the applicability of certain laws and regulations to certain fintech firms and activities has arisen. For example, whether federal preemption of state interest rate limits

[134] A more detailed analysis of fintech issues is presented in the "Financial Technology, or "Fintech"""section of this report.

[135] Additional issues related to financial technology's effects on banks but not necessarily related to chartering issues, are discussed in the "Financial Technology, or "Fintech""" section in this report.

[136] Arthur S. Long, Jeffrey L. Steiner, and James O. Springer, *National Bank Charters for Fintech Firms*, Harvard Law School Forum on Corporate Governance and Financial Regulation, August 22, 2018, at https://corpgov.law.harvard.edu/2018/08/22/national-bank-charters-for-fintech-firms/.

[137] Brian Knight, "Why State-by-State Fintech Oversight Doesn't Work," *American Banker*, September 6, 2016, at https://www.americanbanker.com/opinion/why-state-by-state-fintech-oversight-doesnt-work.

apply to loans made through a *marketplace lender*—that is, online-only lenders that exclusively use automated, algorithmic underwriting—but originated by a bank faces legal uncertainty due to certain court decisions, including *Madden v Midlands*.[138]

One possible avenue to ease the state-by-state regulatory burdens and resolve the uncertainties facing some fintech firms would be to allow those firms that perform bank-like activities to apply for and (provided they meet necessary requirements) to grant them national bank charters.[139] First proposed in 2016 by then-Comptroller of the Currency Thomas Curry,[140] and following subsequent examination of the issue and review of public comments,[141] the OCC announced in July 2018 that it would consider "applications for special purpose bank charters from financial technology (fintech) companies that are engaged in the business of banking but do not take deposits."[142]

OCC argues that companies with such a charter would be explicitly subject to all laws and regulations (including those that preempt state law, a contentious issue addressed below) applicable to national banks. The OCC stated that fintech firms granted the charter "will be subject to the same high standards of safety and soundness and fairness that all federally chartered banks must meet," and also that the OCC "may need to account for differences in business models and activities, risks, and the inapplicability of certain laws resulting from the uninsured status of the bank."[143] Thus, the argument goes, establishing a fintech charter would mean a new set of innovative companies would no longer face regulatory uncertainty and could safely and efficiently provide beneficial financial services, perhaps to populations and market-niches that banks with traditional cost structures do not find cost-effective to serve.

Until the OCC actually grants such charters and fintech firms operate under the national bank regime for some amount of time, how well this policy fosters potential innovations and benefits while guarding against risks is the subject of debate.[144] Proponents of the idea generally view the charter as a mechanism for freeing companies from what they assert is the unnecessarily onerous regulatory burden of being subject to numerous state regulatory regimes. They further argue that this would be achieved without overly relaxing regulations, as the companies would become

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[138] 786 F.3d 246 (2nd Cir. 2015). A detailed legal analysis of this issue is beyond the scope of this report. For a detailed examination of marketplace lending, including regulatory and legal uncertainties, see CRS Report R44614, *Marketplace Lending: Fintech in Consumer and Small-Business Lending*, by David W. Perkins. For a detailed legal examination of federal preemption of state law in banking, see CRS Report R45081, *Banking Law: An Overview of Federal Preemption in the Dual Banking System*, by Jay B. Sykes.

[139] The OCC has the authority to charter national banks (see 12 U.S.C. §27) including special purpose banks that, as described by the OCC's Licensing Manual, "may offer only a small number of products, target a limited customer base, incorporate nontraditional elements, or have narrowly targeted business plans." (See Office of the Comptroller of the Currency, *Comptroller's Licensing Manual: Charters*, September 2016, p. 50.)

[140] Comptroller of the Currency Thomas Curry, "Regarding Special Purpose Charters for Fintech Companies," remarks at Georgetown University Law Center, Washington, DC, December 2016, at https://www.occ.treas.gov/news-issuances/speeches/2017/pub-speech-2017-48.pdf.

[141] OCC, *Exploring Special Purpose National Bank Charters for Fintech Companies*, December 2016, at https://www.occ.gov/topics/responsible-innovation/comments/special-purpose-national-bank-charters-for-fintech.pdf.

[142] OCC, "Policy Statement on Financial Technology Companies Eligibility to Apply for National Bank Charters," July 31, 2018, p. 1, at https://www.occ.gov/publications/publications-by-type/other-publications-reports/pub-other-occ-policy-statement-fintech.pdf.

[143] OCC, *Comptroller's Licensing Manual Supplement: Considering Charter Applications From Financial Technology Companies*, July 2018, p. 3, at https://www.nacha.org/system/files/resources/OCC-Fintech-Charter-July-2018.pdf.

[144] Andrew J. Nard et al., "OCC: Fintechs May Now Apply for Bank Charters," *Financial Services Perspectives blog by Bradles Arant Boult Cummings LLP*, August 1, 2018, at https://www.financialservicesperspectives.com/2018/08/occ-fintechs-may-now-apply-for-bank-charters/.

subject to the OCC's national bank regulatory regime and its rulemaking, supervisory, and enforcement authorities.[145] Opponents generally assert both that the OCC does not have the authority to charter these types of companies, as discussed below, and that doing so would inappropriately allow marketplace lenders to circumvent important state-level consumer protections.[146]

The OCC's assertion that it has the authority to grant such charters has been challenged. Shortly after the initial 2016 announcements that the OCC was examining the possibility of granting the charters, the Conference of State Bank Supervisors and the New York State Department of Financial Services sued the OCC to prevent it from issuing the charters on the grounds that it lacked the authority to do so.[147] A federal district court dismissed the case after concluding that because the OCC had not yet issued charters to nonbanks, the plaintiffs (1) lacked standing to challenge the OCC's purported decision to move forward with chartering nonbanks, and (2) had alleged claims that were not ripe for adjudication.[148] Subsequent to the OCC's July 2018 announcement, state regulators have again filed lawsuits.[149]

Industrial Loan Company Charters

Industrial loan companies (ILCs) hold a particular type of charter offered by some states that generally allows ILCs to engage in certain banking activities.[150] Depending on the state, those activities can include deposit-taking, but only if they are granted deposit insurance by the FDIC. Thus, ILCs that take deposits are state regulated with the FDIC acting as the primary federal regulator. Importantly, a parent company that owns an ILC that meets certain criteria is not necessarily considered a BHC for legal and regulatory purposes.[151] This means ILC charters create an avenue for commercial firms (i.e., companies not primarily focused on the financial industry, such as manufacturers, retailers, or possibly technology companies) to own a bank. Nonfinancial parent companies of ILCs generally are not subject to Fed supervision and other regulations pursuant to the Bank Holding Company Act of 1956 (P.L. 84-511).

A commercial firm may want to own a bank for a number of economic reasons. For example, an ILC can provide financing to the parent company's customers and clients and thus increase sales

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[145] Testimony of Nathanial Hoopes, executive director of the Marketplace Lending Association, U.S. Congress, House Committee on Financial Services, Subcommittee on Financial Institutions and Consumer Credit, *Examining Opportunities and Challenges in the Financial Technology ("Fintech") Marketplace*, 115th Cong., 2nd sess., January 30, 2018, pp. 9-10, at https://financialservices.house.gov/uploadedfiles/hhrg-115-ba15-wstate-nhoopes-20180130.pdf.

[146] Conference of State Bank Supervisors, "CSBS Responds to Treasury, OCC Fintech Announcements," press release, July 31, 2018, at https://www.csbs.org/csbs-responds-treasury-occ-fintech-announcements.

[147] Conference of State Bank Supervisors, "CSBS Files Compliant Against Comptroller of the Currency," press release, April 26, 2017, at https://www.csbs.org/csbs-files-complaint-against-comptroller-currency, and Karen Freifeld, "NY Regulator Sues U.S. OCC Over National Charters for Online Lenders," *Reuters*, May 12, 2017.

[148] Conference of State Bank Supervisors v. OCC, No. 17-0763, 2018 WL 2023507 at *6-9 (D.D.C. Apr. 30, 2018).

[149] Conference of State Bank Supervisors, "CSBS Sues OCC Over Fintech Charter," press release, October 25, 2018, at https://www.csbs.org/csbs-sues-occ-over-fintech-charter, and Jonathan Stempel, "New York Sues U.S. to Stop Fintech Bank Charters," *Reuters*, September 17, 2018, pp. at https://www.reuters.com/article/us-usa-treasury-fintech-lawsuit/new-york-sues-u-s-to-stop-fintech-bank-charters-idUSKCN1LU21O.

[150] As of January 2018, seven of states—California, Colorado, Hawaii, Indiana, Minnesota, Nevada, and Utah—offered ILC charters. See James R. Barth and Yanfei Sun, *A New Look at the Performance of Industrial Loan Companies*, University of Utah, Utah Center for Financial Services, January 2018, p. 12, at https://lassonde.utah.edu/wp/wp-content/uploads/2018/10/ILC_REPORT_BARTH_2018.pdf.

[151] James R. Barth and Yanfei Sun, *A New Look at the Performance of Industrial Loan Companies*, pp. 19-20.

for the parent.[152] In recent decades, household-name manufacturers have owned ILCs, including but not limited to General Motors, Toyota, Harley Davidson, and General Electric.[153] However, while they can generate profits and potentially increase credit availability, ILCs pose a number of potential risks.

The United States has historically adopted policies to generally separate commerce and banking, because allowing a single company to be involved in both activities could potentially result in a number of bad outcomes. A mixed organization's banking subsidiary could make decisions based on the interests of the larger organization, such as making overly risky loans to customers of a commerce subsidiary or providing funding to save a failing commerce subsidiary. Such conflicts of interest could threaten the safety and soundness of the bank. Relatedly, some have argued that having a federally insured bank within a commercial organization is an inappropriate expansion of federal banking safety nets (such as deposit insurance). Certain observers, including community banks, have concerns over whether purely commercial or purely banking organizations would be able to compete with combined organizations that could potentially use economies of scale and funding advantages to exercise market power.[154]

These arguments played a prominent role in the public debate that was sparked when Walmart and Home Depot made unsuccessful efforts to secure an ILC charter between 2005 and 2008.[155] Amid this debate, the FDIC imposed a moratorium in 2006 on the acceptance, approval, or denial of ILC applications for deposit insurance while the agency reexamined its policies related to these companies.[156] That moratorium ended in January 2008. Subsequently, concerns over ILCs led Congress to mandate another moratorium (this one lasting three years, ending in July 2013) on granting new ILCs deposit insurance in the Dodd-Frank Act.[157]

No consensus has been reached on the magnitude of these risks and validity of the concerns surrounding deposit-taking ILCs. Recently, two financial technology companies, Square and SoFi, have applied for ILC charters and renewed debates over ILCs. Even though the moratoriums on granting ILCs deposit insurance have expired, the FDIC has not approved any new ILC applications since the 2013 expiration.[158] However, since becoming FDIC chairman in June 2018, Jelena McWilliams has made statements indicating that under her leadership the FDIC will again consider ILC applications.[159] Given the interest in and debate surrounding this charter type, policymakers will likely examine questions over the extent to which ILCs create innovative sources of credit and financial services subject to appropriate safeguards or inadvisably allow

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[152] Kenneth Spong and Eric Robbins, "Industrial Loan Companies: A Growing Industry Sparks Debate," *Federal Reserve Bank of Kansas City Economic Review*, Fourth Quarter 2007, p. 43.

[153] James Barth et al., "Industrial Loan Companies: Where Banking and Commerce Meet," *New York University Salomon Center and Wiley Periodicals*, 2012, pp. 2-8.

These ILCs have generally become closed voluntarily (or otherwise become inactive) or converted to more traditional bank charters.

[154] Kenneth Spong and Eric Robbins, "Industrial Loan Companies: A Growing Industry Sparks Debate," pp. 57-64.

[155] Ibid., p. 57.

[156] FDIC, "Moratorium on Certain Industrial Loan Company Applications and Notices," press release, July 28, 2006, at https://www.fdic.gov/news/news/press/2006/pr06073a.html.

[157] James R. Barth and Yanfei Sun, *A New Look at the Performance of Industrial Loan Companies and Their Contribution to the U.S. Banking System*, June, 15, 2018, p. 6.

[158] Lalita Clozel, "Square's Bid to be Industrial Bank Inflames ILC Debate," *American Banker*, September 6, 2017.

[159] Rachel Witkowski, "Bold Agenda for New FDIC Chief: ILC Decisions, Pot Banking and More," *American Banker*, June 19, 2018, at https://www.americanbanker.com/news/bold-fdic-agenda-for-new-chief-ilc-decisions-pot-banking-and-more.

commercial organizations to act as banks with federal safety nets while exempting them from certain bank regulation and supervision.

Market and Economic Trends[160]

In addition to regulation issues, market and economic conditions and trends continually affect the banking industry. This section analyzes such trends that may affect banks, including

- migration of financial activity from banks into nonbanks or the "shadow banking" system;
- increasing capabilities and market presence of financial technology or fintech; and
- a higher interest rate environment following a long period of extraordinarily low rates.

Nonbank Credit Intermediation or "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 performed by taking deposits from savers and using them to fund loans to borrowers. Nonbank institutions can also perform similar credit intermediation to banks—sometimes called *shadow banking*—using certain instruments such as money market mutual funds, short-term debt instruments, and securitized pools of loans. When illiquid assets are funded by liquid liabilities, an otherwise-solvent bank or nonbank might experience difficulty meeting short-term obligations without having to sell assets, possibly at "fire sale" prices. If depositors or other funding providers feel their money is not safe with an institution, many of them may withdraw their funds at the same time. Such a "run" could cause an institution to fail.

Long-established government programs mitigate liquidity- and run-risk in the banking industry. 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.[161] Banks are also subject to prudential regulation—as discussed in the "Prudential Regulation" section. However, nonbank intermediation is performed without the government safety nets available to banks or the prudential regulation required of them.[162] The lack of an explicit government safety net in shadow banking means that taxpayers are less explicitly or directly exposed to risk, but it also means that shadow banking may be more vulnerable to a panic that could trigger a financial crisis.

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 decreased role for banks in credit intermediation and an increased role for relatively lightly regulated nonbanks.[163]

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[160] This section was authored by David W. Perkins, analyst in macroeconomic policy. His contact information is available to congressional Members and staff through the internal CRS website.

[161] 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.

[162] For more information on shadow banking, see CRS Report R43345, *Shadow Banking: Background and Policy Issues*, by Edward V. Murphy.

[163] Thomas M. Hoening and Charles S. Morris, *Restructuring the Banking System to Improve Safety and Soundness*, Federal Reserve Bank of Kansas City, December 2012, pp. 2-3, at https://www.fdic.gov/about/learn/board/

Many contend the financial crisis demonstrated how risks to deposit-like financial instruments in the shadow banking sector—such as money market mutual funds and repurchase agreements—can create or exacerbate systemic distress.[164] 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 borrowers' solvency. During the crisis, all these instruments—which investors had previously viewed as safe and unlikely to suffer losses—experienced run-like events as funding providers withdrew from markets.[165] Moreover, 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.[166]

Since the crisis, many regulatory changes have been made related to certain money market, commercial paper, and repurchase agreement markets and practices. For example, in the United States, certain money market mutual funds now must have a *floating net asset value*. Among other benefits, this may signal to fund investors that a loss of principal is possible and thus reduce the likelihood that investors would "run" at the first sign of possible small losses.[167] However, some observers are still concerned that shadow banking poses risks, because the funding of relatively long-term assets with relatively short-term liabilities will inherently introduce run-risk absent certain safeguards.[168]

Financial Technology, or "Fintech"

As discussed above, *fintech* usually refers to technologies with the potential to alter the way certain financial services are performed.[169] 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 if innovative technology replaces traditional processes that are outdated or inefficient. For example, automation may be able to replace employees, and digital technology can replace physical

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restructuring-the-banking-system-05-24-11.pdf.

[164] For example, see Gary B. Gorton and Andrew Metrick, "Securitized Banking and the Run on Repo," *National Bureau of Economic Research*, vol. Working Paper 15223 (August 2009), pp. 1-6.

[165] CRS Report R43345, *Shadow Banking: Background and Policy Issues*, by Edward V. Murphy.

[166] Craig B. Merrill et al., *Why Were There Fire Sales of Mortgage-Backed Securities by Financial Institutions During the Financial Crisis*? Fisher College of Business Working Paper no. 2013–03–02, Ohio State University, 2014.

[167] Securities and Exchange Commission, "SEC Adopts Money Market Fund Reform Rules," press release, July 23, 2014, at https://www.sec.gov/news/press-release/2014-143.

[168] 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.

[169] See more information on fintech, see CRS In Focus IF10513, *Financial Innovation: "Fintech"*, by David W. Perkins.

systems and infrastructure. Cost savings from removing inefficiencies may lead to reduced prices, making certain services affordable to new customers. Some customers who previously did not have access to services—due to such things as the 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.[170]

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 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.[171]

Policymakers debate whether (and which) innovations can be integrated into the financial system without additional regulatory or policy action. Technology in finance largely involves reducing the costs or time involved in providing existing products and services, and the existing regulatory structure was developed to address risks from these financial products and activities. Existing regulation may be able to accommodate new technologies while adequately protecting against risks.[172] 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. For example, 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.[173] 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 under a less onerous regulatory framework.[174] In the United States, the CFPB has recently introduced a sandbox wherein companies can experiment with disclosure forms.[175]

[170] 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/.

[171] 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.

[172] 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.

[173] 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.

[174] 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.

[175] Consumer Financial Protection Bureau, "CFPB Office of Innovation Proposes 'Disclosure Sandbox' for Fintech Companies to Test New Ways to Inform Consumers," press release, September 13, 2018, at

Some are concerned that existing regulations may not adequately address certain risks posed by new technologies.[176] Regulatory arbitrage—conducting business in a way that circumvents unfavorable regulations—may be a concern in this area.[177] 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 with traditional banks.

Another group of issues posed by fintech relates to cybersecurity (for general issues related to cybersecurity, see the "Cybersecurity" section above). As financial activity increasingly uses 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.[178]

Higher 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.[179] Recently, as economic conditions improved, the Federal Reserve took steps to normalize monetary policy such as raising its target interest rate and reducing the size of its balance sheet.[180]

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

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https://www.consumerfinance.gov/about-us/blog/bcfp-office-innovation-proposes-disclosure-sandbox-fintech-companies-test-new-ways-inform-consumers/.

[176] 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.

[177] Greg Buchak et al., *Fintech, Regulatory Arbitrage, and the Rise of Shadow Banks*, National Bureau of Economic Research, Working Paper no. 23288, March 2017, pp. 1-6, at http://www.nber.org/papers/w23288.pdf.

[178] 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/.

[179] 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 Marc Labonte.

[180] The Federal Reserve's most recent monetary policy statement issued on January 30, 2019, indicated that that pace of normalization may slow and that another target interest rate increase was not imminent. See The Federal Reserve, "Federal Reserve Issues FOMC Statement," press release, January 30, 2019, at https://www.federalreserve.gov/newsevents/pressreleases/monetary20190130a.htm.

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.[181]

The magnitude of interest rate risks should not be overstated, as rising rates can potentially 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*.[182] However, thus far into the Federal Reserve interest rate normalization process, this has not materialized. During 2018, the difference between long-term rates and short-term rates has generally decreased (known as a *flattening of the yield curve*).[183]

Whatever changes may occur to various interest rates in the coming months and years, banks and regulators typically recognize the importance of managing interest rate risk, carefully examine the composition of bank balance sheets, and plan for different interest rate change scenarios.[184] While banks are well-practiced at interest rate risk management through normal economic and monetary policy cycles, managing bank risk through a 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 past 10 years were made in a low interest rate environment. This presents challenges to banks seeking to hold a mix of loans with different rates. In addition, because the Federal 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.[185]

CRS Resources

Table 2. CRS Products Related to Banking Topics

Topic	Product
Capital Requirements	CRS In Focus IF10809, *Introduction to Bank Regulation: Leverage and Capital Ratio Requirements*, by David W. Perkins
Volcker Rule	CRS In Focus IF10923, *Financial Reform: Overview of the Volcker Rule*, by Rena S. Miller
Anti-Money Laundering	CRS Report R44776, *Anti-Money Laundering: An Overview for Congress*, by Rena S. Miller and Liana W. Rosen
	CRS In Focus IF11064, *Introduction to Financial Services: Anti-Money Laundering Regulation*, by Rena S. Miller and Liana W. Rosen
Financial Cybersecurity	CRS Report R44429, *Financial Services and Cybersecurity: The Federal Role*, by N. Eric Weiss and M. Maureen Murphy

[181] 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.

[182] 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).

[183] For example, see Federal Reserve Bank of St. Louis Economic data, 10-Year Treasury Constant Maturity Minus 3-Month Treasury Constant Maturity, at https://fred.stlouisfed.org/series/T10Y3M.

[184] 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.

[185] 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.

Topic	Product
CFPB	CRS In Focus IF10031, *Introduction to Financial Services: The Bureau of Consumer Financial Protection (CFPB)*, by Cheryl R. Cooper and David H. Carpenter
Community Reinvestment Act	CRS Report R43661, *The Effectiveness of the Community Reinvestment Act*, by Darryl E. Getter
Community Banks	CRS Report R43999, *An Analysis of the Regulatory Burden on Small Banks*, by Marc Labonte
	CRS Report R45051, *Tailoring Bank Regulations: Differences in Bank Size, Activities, and Capital Levels*, by David W. Perkins
Large Banks/Enhanced Prudential Regulation	CRS Report R42150, *Systemically Important or "Too Big to Fail" Financial Institutions*, by Marc Labonte
	CRS Report R45036, *Bank Systemic Risk Regulation: The $50 Billion Threshold in the Dodd-Frank Act*, by Marc Labonte and David W. Perkins
Fintech Related to Banking	CRS Report R44614, *Marketplace Lending: Fintech in Consumer and Small-Business Lending*, by David W. Perkins
	CRS Report R45427, *Cryptocurrency: The Economics of Money and Selected Policy Issues*, by David W. Perkins

Source: CRS.

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Acknowledgments

Raj Gnanarajah made helpful and insightful suggestions throughout the report. Jay Sykes provided legal discussion related to the *Madden v Midland* case and state regulators' lawsuits pertaining to the OCC fintech charter.

Disclaimer