



The Daily Dish

# A Small Reform that Matters

DOUGLAS HOLTZ-EAKIN, PATRICK HEFFLINGER | MAY 4, 2017

[President Trump is expected to announce his decision](#) on the U.S.'s role in the Paris Climate Agreement next week. According to The Hill, the administration is now moving toward fully pulling the United States out of the agreement all together. [The American Action Forum recently released research](#) which concluded the best path forward for the U.S. would be to stay in the agreement and revise the U.S.'s pledge in order to preserve the U.S.'s foreign policy influence.

[On Tuesday the House of Representatives passed the Working Families Flexibility Act](#). The bill seeks to give employees the option to choose whether to earn paid time off or be paid time-and-a-half when they work overtime, which is defined as anything over 40 hours a week. The bill is sponsored by Rep. Marth Roby (R-AL) who argues many workers would prefer to earn “comp time” rather than simply extra pay so they would have increased flexibility.

## *Eakinomics:*

The Dodd-Frank Act has had a bullseye on its back since its passage, so it is unsurprising that the House Committee on Financial Services introduced legislation that would repeal much of it. The so-called CHOICE Act is advertised to “create hope and opportunity for investors, consumers and entrepreneurs by ending bailouts and Too Big to Fail, holding Washington and Wall Street accountable, eliminating red tape to increase access to capital and credit, and repealing the provisions of the Dodd-Frank Act that make America less prosperous, less stable, and less free.”

There is a time and a place for debate over the merits of its entire 589 pages, but the focus today is in section 152: a short provision focused on amending “operational risk” capital requirements for banks. Operational risk is the concept that regulators use to measure the possibility that a bank’s own actions could lead to losses, as opposed to outside influences from negative economic or market forces. Like other capital requirements, operational risk capital is the increased amount of capital that regulators require banks to hold to cover any such operational losses.

The notion of operational risk and capital held to protect against its losses did not exist prior to 2008. Only with the advent of poor subprime underwriting, problems with securitization, and — especially — the need to settle lawsuits and government penalties has it been implemented and taken on any importance. But from the perspective of 2017, it suffers two flaws. First, it is generally calculated based on banks’ past actions, not on the future outlook. It is not filling the role of providing a cushion against the unforeseen future. Second, it feeds the regulators’ conceit that there is actually a way to identify individual types of risks and calculate the appropriate capital charge for each. In my view, that is two strikes against operational risk capital reserves. And as with other capital charges, operational risk capital results in banks having less capital available to lend out, invest, or return to their shareholders.

The CHOICE Act seeks to eliminate this concept of backward-looking operational risk. Specifically, it mandates that the agencies that oversee banks “may not establish an operational risk capital requirement for

banking organizations, unless such requirement is based on the risks posed by a banking organization's current activities and businesses; is appropriately sensitive to the risks posed by such current activities and businesses; is determined under a forward-looking assessment of potential losses that may arise out of a banking organization's current activities and businesses, which is not solely based on a banking organization's historical losses; and permits adjustments based on qualifying operational risk mitigants.”

Moving from backward-looking to forward-looking assessments of risk is sensible and will create a safer, sounder financial system. It would also free up much needed capital for a small business lending market that still has not recovered since the crisis. Some analysts estimate that [this change could free up over \\$200 billion in capital](#) at just the four largest U.S. banks – a number that could stretch far higher across the entire banking sector.

This is a little legislative language that could go a very long way.