CENTER FOR CAPITAL MARKETS COMPETITIVENESS

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Ms. Ann Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Enhanced Disclosure of the Models Used in the Federal Reserve's Supervisory Stress Test, Docket No. OP-1586; Stress Testing Policy Statement, Docket No. OP-1587; Policy Statement on the Scenario Design Framework for Stress Testing, Docket No. OP-1588

Dear Ms. Misback:

The U.S. Chamber of Commerce created the Center for Capital Markets Competitiveness (CCMC) to promote a modern and effective regulatory structure for capital markets to fully function in a 21st century economy.[1] The Chamber and CCMC strongly believe that financial regulations and supervisory practices must be well-reasoned and properly calibrated, so as to ensure that our financial system is optimally positioned to serve U.S. businesses, consumers, and the broader economy.

We appreciate the opportunity to comment on three proposals intended to increase the transparency of supervisory stress testing conducted as part of two related exercises: the Dodd-Frank Act Stress Test (DFAST) and the Comprehensive Capital Analysis and Review (CCAR). We commend the Federal Reserve for undertaking a thoughtful reassessment of the program. CCMC believes stress testing can promote the safety and soundness of individual institutions and the overall resiliency of the banking system. However, we believe it has been applied in manner that has distorted financial activities, harmed the ability of firms to efficiently deploy capital, concentrated risk, imposed undue and unnecessary burdens, and constrained

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1 The U.S. Chamber of Commerce is the world's largest business federation, and represents the interests of more than three million businesses and organizations of every size, sector, and region.

U.S. businesses' access to credit. We believe that the proposals represent a good first step in restoring balance by addressing some of the problems posed by the stress tests and improving the utility of this supervisory tool.

Our primary concerns with the stress testing program, and the changes outlined in the three proposals, are as follows:

1. The opacity of the stress testing regime has precluded a rigorous, public evaluation of how the exercise may be impacting financial markets, access to credit, and the broader economy. Evidence that stress testing may be driving steep declines in small business lending merits the utmost concern.

2. CCMC concurs that enhanced transparency will bolster the credibility of stress testing, help the public better evaluate the results, and provide critical information and insight. To achieve these goals, the Federal Reserve should subject its economic scenarios, models, and other material parameters to the well-established notice-and-comment process under the Administrative Procedure Act.

3. While efforts to increase transparency in stress testing are appropriate and well-justified, serious problems will remain. The Federal Reserve should continue to develop and implement substantive improvements to the program, including:

    a. Reassess the necessity and marginal benefit of CCAR's qualitative assessment of a firm's capital planning processes;

    b. Address the requirement that firms assume they will continue to make planned discretionary capital distributions despite the onset of a severely adverse operating environment; and

    c. Consider adjusting the CCAR process to a two-year cycle.

Discussion

1. Increased Transparency Would Inform Consideration of Supervisory Stress Tests' Broader Economic Consequences

Small businesses are a key driver of job creation, innovation, and economic growth. In this context, CCMC is deeply concerned by the state of small business lending in the United States. According to Federal Deposit Insurance Corporation (FDIC) the total balance of small business loans across all FDIC-insured institutions **declined 13 percent** between 2008 and 2017.[2] Similarly, the number of small business loan originations reported under the Community Reinvestment Act **declined 41.4 percent** between 2008 and 2016.[3] These declines do not appear to reflect a lack of demand: the Federal Reserve Banks' 2016 survey of small business access to credit found serious shortfalls in small business financing, despite "widespread demand."[4] Furthermore:

- **60 percent** of small business applicants received less than the amount for which they applied.

- **25 percent** of applicants were unable to obtain any financing at all.

- **25 percent** of small businesses that did not apply for financing reported they were either too discouraged, or that the cost of credit was too high.[5]

Small businesses depend on access to financing to get started, sustain operations, manage cash, make payroll, and create well-paying jobs. The U.S. Chamber of Commerce's survey of small business executives details the extent to which small businesses depend on credit, and bank lending in particular:

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2 Federal Deposit Insurance Corporation, Loans to Small Businesses and Farms, FDIC-Insured Institutions, 1995-2017, *available at* https://www.fdic.gov/bank/analytical/qbp/timeseries/small-business-farm-loans.xls (defining small business loans as commercial and industrial (C&I) and commercial real estate (CRE) loans less than $1 million).

3 Federal Financial Institutions Examination Council, Community Reinvestment Act National Aggregate Reports, 1 Originations and Purchases for Small Business and Farm Loans, *available at* https://www.ffiec.gov/craadweb/national.aspx.

4 Federal Reserve Banks, 2016 Small Business Credit Survey: Report on Employer Firms (Apr. 2017) at iv, *available at* https://www.newyorkfed.org/medialibrary/media/smallbusiness/2016/SBCS-Report-EmployerFirms-2016.pdf. *But see* Federal Reserve Board, Report to the Congress on the Availability of Credit to Small Businesses (Sept. 2017) at 8, *available at* https://www.federalreserve.gov/publications/files/sbfreport2017.pdf (stating that "[e]vidence suggests that the slow growth in small business credit has reflected continued weak demand."). CCMC respectfully observes this conclusion appears to be based solely on one data set, and is inconsistent with the Federal Reserve Banks' Small Business Credit Survey.

5 Federal Reserve Banks, 2016 Small Business Credit Survey: Report on Employer Firms (Apr. 2017), *available at* https://www.newyorkfed.org/medialibrary/media/smallbusiness/2016/SBCS-Report-EmployerFirms-2016.pdf.

- Of the small businesses that have taken on debt, **66 percent** relied on a private small business loan and **40 percent** plan on applying for a loan or line of credit over the next year.

- **51 percent** of small business executives consider banks to be their ideal credit providers.

- Only **31 percent** of small businesses believe credit conditions are improving.[6]

Insufficient access to credit is devastating to small business success and may explain the severe decline in small business creation in the United States. According to the U.S. Census Bureau, only 414,000 small businesses were founded in 2015 – **a decline of 26 percent** since 2006.[7] Small businesses are vital to job creation, innovation, and economic dynamism, and as the key driver of individual and community economic mobility they are an indelibly linked to the "American Dream." Accordingly, factors that may be contributing to declines in small business creation, including insufficient access to credit, demand careful review by policymakers.

There is mounting evidence that post-crisis financial reforms have depressed small business lending by depository institutions. In recent months, a growing body of scholarly research has specifically considered the potential adverse impact of supervisory stress tests on small business lending. The top-line conclusions of this research are alarming:

- "This paper solidifies the link between declines in bank small business lending and increased regulatory requirements. We provide new evidence that stress tests conducted under Federal Reserve's Comprehensive Capital Analysis and Review (CCAR) led to a decrease in affected banks' credit supply to small businesses." (Cortés, Demyanyk, Li, Loutskina, and Strahan, Oct. 2017)[8]

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6 Ctr. for Capital Mkts. Competitiveness, U.S. Chamber of Commerce, Survey of Small Business Executives (Mar. 30, 2017), *available at* http://www.centerforcapitalmarkets.com/wp-content/uploads/2013/08/Financial-Services-Survey-For-Small-Businesses-Growth-and-Credit-Go-Hand-in-Hand.pdf?x48633

7 Press Release, U.S. Census Bureau, Startup Firms Created Over 2 million Jobs in 2015 (Sept. 20, 2017), *available at* https://www.census.gov/newsroom/press-releases/2017/business-dynamics.html (percentage decline calculated from underlying datasets, found in *Business Dynamics Statistics: Firm Characteristics – Firm Age* in 2015 data table and legacy 1977-2014 data tables).

8 Kristle Cortés, Yuliya Demyanyk, Lei Li, Elena Loutskina, and Philip E. Strahan, Where are the Large Banks? Stress Tests and Small Business Lending (Oct. 2017), *available at*

- "… small business lending in all size categories is statistically significantly less for the stress-tested banks," consistent with the hypothesis that "stress-tested banks reduce the supply of credit, particularly to relatively risky borrowers." (Acharya, Berger, and Roman, last rev. Aug. 2017)[9]

- "Our results show that stress tests are imposing dramatically higher capital requirements on certain asset classes – most notably, small business loans and residential mortgages – than bank internal models and Basel standardized models. By imposing higher capital requirements on loans to small businesses and mortgage loans, stress tests are likely curtailing credit availability for the types of borrowers that lack alternative sources of finance." (The Clearing House, Aug. 2017)[10]

Additional transparency in the stress testing program would allow experts to perform a substantially more informed assessment of the relationship between stress testing and small business lending. Specifically, greater transparency with respect to the economic scenarios and the Federal Reserve's models will allow for a more detailed exploration of any underlying causality. A complete and accurate understanding of such a relationship is essential if the Federal Reserve is to adequately balance the costs and benefits flowing from its regulatory and supervisory choices – choices including stress test applicability, scenario design, and model development.[11]

2. Additional Steps Should be Undertaken to Promote Transparency

CCMC concurs with the Federal Reserve's conclusion that disclosure in the context of the stress testing entails "significant public benefits," including:

a. Enhancing the credibility of the stress test;

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http://sydney.edu.au/business/__data/assets/pdf_file/0008/337463/Cortes_Stress_tests_SMB_Lending_Oct_30_2017.pdf.

9 Viral V. Acharya, Allen N. Berger, & Raluca A. Roman, Lending Implications of U.S. Bank Stress Tests: Costs or Benefits? (last rev. Aug. 18, 2017), *available at* https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2972919

10 The Clearing House, Staff Working Paper 2017-2: Capital Requirements in Supervisory Stress Tests and their Adverse Impact on Small Business Lending (Aug. 2017), *available at* https://www.theclearinghouse.org/-/media/tch/documents/research/articles/2017/08/capital-requirements-in-supervisory-stress-tests-and-their-adverse-impact-on-small-business-lending.pdf?la=en.

11 CCMC commends the Federal Reserve for its recent efforts to strengthen the process through which it conducts cost-benefit analysis. *See Nomination of Jerome H. Powell: Hearing Before the S. Comm. On Banking, Housing, and Urban Affairs*, 115th Cong. (Nov. 28, 2017) (statement of Jerome H. Powell in response to a question from Sen. Richard Shelby). *See also* Victoria Guida, *Fed adds staff for new office dedicated to gauging economic impact of regulations*, POLITICO, Jan. 18, 2018.

b. Facilitating comments from the public, including academic experts, that could lead to improvements in the program;

c. Helping the public understand and interpret the results of the tests, furthering the goal of maintaining market and public confidence in the U.S. financial system; and

d. Helping financial institutions subject to the stress test understand the capital implications of changes to their business activities.[12]

CCMC believes the proposals are appropriate first steps towards the achievement of these goals. Briefly summarized, the proposals would entail:

a. Issuance of a policy statement governing the development, implementation, and validation of models used in the supervisory stress test.

b. Amendments to the policy statement governing the scenario design frameworks, including 1) clarification of when the Federal Reserve may adopt a change in the unemployment rate in the severely adverse scenario of less than 4 percentage points, 2) clarification of when the Federal Reserve may institute a countercyclical guide for the change in the house price index in the severely adverse scenario; and 3) notice that the Federal Reserve plans to incorporate wholesale funding costs in the scenarios.

c. Enhanced disclosure with respect to the models, including 1) descriptions of supervisory models; 2) modeled loss rates on loans grouped by important risk characteristics and summary statistics associated with the loans in each group; 3) portfolios of hypothetical loans and the estimated loss rates associated with the loans in each portfolio.

However, CCMC strongly believes the scenarios and models should be fully transparent, so as to maximally achieve the significant public benefits of disclosure. CCMC recommends the scenarios and models should be subject to the public notice-and-comment process established by the Administrative Procedure Act. Public

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12 *See* 82 Fed. Reg. 59,547 (Dec. 15, 2017).

participation is essential to well-reasoned decision-making, and regulatory policies should be informed by a clear, transparent, and accountable public record. This principle is the foundation of CCMC's policy recommendations in Federal Reserve Reform: Securing Regulatory Transparency and Accountability.[13]

The Federal Reserve has stated it believes there are material risks associated with full disclosure of the models.[14] CCMC respectfully observes that the likelihood of these risks should be established through a rigorous, public analysis. Furthermore, there is no consideration of the regulatory or supervisory tools available to mitigate those risks.

3. The Federal Reserve Should Continue Efforts to Substantively Improve DFAST and CCAR Processes.

Enhanced transparency in the DFAST and CCAR processes will bolster the credibility of stress testing, help the public better evaluate the results, and provide critical information and insights to the Federal Reserve. However, CCMC believes these proposals should be the first steps in a much broader effort to improve the stress testing program. Three reforms in particular merit thorough consideration.

First, the Federal Reserve should reassess the necessity and marginal benefit of CCAR's qualitative assessment of a firm's capital planning processes. In January 2017, the Federal Reserve revised its capital plan and stress testing rules to exempt "large and noncomplex" firms from the CCAR qualitative assessment and, accordingly, the potential for objection to an annual capital plan on the basis of qualitative deficiencies.[15] This relief was predicated on the burdensome nature of the qualitative component and recognition that the strength of a firm's capital planning process could be adequately assessed through a targeted horizontal review conducted as part of the normal supervisory process. This logic is equally applicable to all CCAR firms, whose capital planning processes are similarly capable of such evaluation.

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13 Ctr. for Capital Mkts. Competitiveness, U.S. Chamber of Commerce, Federal Reserve Reform: Securing Regulatory Transparency and Accountability (Summer 2016). Other commentators have suggested that public notice-and-comment, in addition to being good policy, may be legally required by the Administrative Procedure Act. *See* Comm. on Capital Mkts. Regulation, The Administrative Procedure Act and Federal Reserve Stress Tests: Enhancing Transparency (Sept. 2016), *available at* http://www.capmktsreg.org/wp-content/uploads/2016/10/Final_APA_Fed_Stress_Test_Statement1.pdf.

14 82 Fed. Reg. 59,547, 59,548 (Dec. 15, 2017). *See also* Governor Daniel K. Tarullo, Speech at the Yale University School of Management Leaders Forum (Sept. 26, 2016), *available at* *https://www.federalreserve.gov/newsevents/speech/tarullo20160926a.htm*.

15 82 Fed. Reg. 9,308 (Feb. 3, 2017).

At a minimum, the Federal Reserve should reconsider the use of arbitrary asset thresholds to determine eligibility for exemption from the qualitative assessment and objection. CCMC strongly believes that arbitrary and static asset thresholds are incompatible with a well-reasoned and properly tailored system of prudential regulation. This is especially true given the availability of far more sophisticated methodologies to assess *risk* – the mitigation of which is the explicit purpose of the qualitative evaluation.[16]

Second, the Federal Reserve should undertake to rectify one of the most deeply flawed assumptions in the CCAR exercise: the requirement that firms assume they will continue to make planned discretionary capital distributions despite the onset of a severely adverse operating environment.[17] This assumption is unrealistic and contrary to prudent risk management. Furthermore, it is unreasonable to assume that a firm would breach its regulatory capital requirements by voluntarily paying dividends or repurchasing its shares.[18]

Finally, the Federal Reserve should consider adjusting the CCAR process to a two-year cycle. CCMC believes the annual stress test exercise, coupled with the ability of the Federal Reserve to review capital plans more frequently in the case of extraordinary events, will fully preserve the Federal Reserve's ability to identify and mitigate risk to individual institutions and the financial system.

CCMC continues to be concerned that the design and implementation of stress tests could create uniform risk management practices, rather than allowing for diverse practices or calibrating the tests to the unique situation of a bank. CCMC is concerned that this may lead to a concentration of risk that may be harmful during a period of financial stress. CCMC recommends that this issue be reviewed and addressed.

Conclusion

CCMC appreciates the opportunity to comment on the proposals to increase transparency in the DFAST and CCAR supervisory stress test exercises. Stress testing

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16 *Id.* at 9,312.

17 Federal Reserve Board, Comprehensive Capital Analysis and Review 2017: Summary Instructions for LISCC and Large and Complex Firms (Feb. 2017) at 8-9, *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20170203a4.pdf.

18 CCMC further notes that as a consequence of recently enacted changes to the Internal Revenue Code, including the loss of net operating loss carryback provisions, the impact of the planned capital actions assumption is magnified as projected losses in the stress periods would increase.

plays an important role in efforts to promote financial stability and improve the resiliency of the banking system. Stress tests should give banking regulators insight into an entity and provide an understanding of a firm's risk management and resiliency. However, as currently implemented, the stress testing regime has unintentionally harmed the ability of firms to deploy capital, distorted financial activities, and possibly concentrated risk. Stress tests have also imposed undue and unnecessary burdens, and unjustifiably constrained U.S. businesses' access to credit. We commend the Federal Reserve for taking the first steps to improve this important process. We appreciate the consideration of our views, and look forward to working together on additional common-sense reforms.

Sincerely,

Tom Quaadman