November 20, 2020

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

Re: Amendments to Capital Planning and Stress Testing Requirements for Large Bank Holding Companies, Intermediate Holding Companies, and Savings and Loan Holding Companies– Board Docket No. R-1724 and RIN 7100-AF95

Dear Ms. Misback:

Better Markets[1] appreciates the opportunity to comment on the above captioned proposal ("Proposal" or "Release"),[2] issued by the Board of Governors of the Federal Reserve System ("Board" or "Federal Reserve") regarding amendments to the capital planning and stress testing requirements. The Proposal is predominantly concerned with so-called "conforming" changes to the Board's capital planning and stress testing requirements, in response to more extensive changes to the prudential requirements applicable to larger banks recently promulgated by the Board and other regulators. Nevertheless, there are specific aspects of the Proposal that are unwise and will increase systemic risk. Moreover, as more fully explained below, the Proposal represents a missed opportunity to revisit the recent dangerous deregulation of the Board's capital framework and to restore important requirements that promote bank safety and soundness and systemic financial stability.

BACKGROUND

In early 2009, despite extraordinary government bailouts and other attempts to prop up the financial system, the financial crisis continued to rage because there was a significant degree

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1 Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system, one that protects and promotes Americans' jobs, savings, retirements, and more.

2 85 Fed. Reg. 63,222 (Oct. 7, 2020).

of uncertainty about the actual financial condition of the largest banks.[3] In that environment, the Federal Reserve conducted stress tests of America's largest banks, defined as all banks with total assets greater than $100 billion, and published the results. This proved to be a turning point in the crisis. Most importantly, the publication of the stress test results reduced the rampant uncertainty that had plagued the banking system, which was critical in a crisis environment where many assumed the worst due to lack of information and lack of confidence.[4] Even though the stress tests showed that many of the largest banks needed additional capital to survive the most adverse scenario, they also demonstrated that those capital needs were manageable and indeed all but one of those banks found to need capital were able to raise it from private investors.[5] Recognizing the importance of stress testing to the twin goals of ensuring the capital adequacy of large banks and building public confidence by providing sufficient transparency into their condition, the Dodd-Frank Act required that banking regulators finalize rules requiring that the largest banks undergo regular stress tests. The Federal Reserve implemented robust stress testing rules that were well designed to credibly assess the largest banks' capital positions.[6]

Under the Trump administration, however, the Federal Reserve has weakened stress testing and capital requirements for the largest banks. In December 2017, the Federal Reserve issued a proposal to reveal more information to the banks subject to the stress tests about the models used for supervisory stress tests, which would have the potential to allow banks to game the tests, including by designing products or structuring their balance sheets specifically to weaken the capacity for the stress test to capture their risks, so as to reduce the capital required without reducing their actual risks.[7] In 2018, the Federal Reserve issued a proposal to weaken stress testing and related capital requirements for large banks.[8] In November 2018, the Federal

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[3] Governor Daniel K. Tarullo, Lessons from the Crisis Stress Tests, Remarks at the Federal Reserve Board International Research Forum on Monetary Policy (Mar. 26, 2010), https://www.federalreserve.gov/newsevents/speech/tarullo20100326a.htm.

[4] Governor Daniel K. Tarullo, Lessons from the Crisis Stress Tests, Remarks at the Federal Reserve Board International Research Forum on Monetary Policy (Mar. 26, 2010), ("Second, the results were released at a time when uncertainty about bank conditions was very high, and some market participants feared the worst."), https://www.federalreserve.gov/newsevents/speech/tarullo20100326a.htm.

[5] Governor Daniel K. Tarullo, Lessons from the Crisis Stress Tests, Remarks at the Federal Reserve Board International Research Forum on Monetary Policy (Mar. 26, 2010), https://www.federalreserve.gov/newsevents/speech/tarullo20100326a.htm.

[6] BETTER MARKETS, SPECIAL REPORT, TEN YEARS OF DODD-FRANK AND FINANCIAL REFORM; OBAMA'S SUCCESSES, TRUMP'S ROLLBACKS, AND FUTURE CHALLENGES 31 (July 21, 2020), https://bettermarkets.com/sites/default/files/images/BetterMarkets_DoddFrankReport.pdf.

[7] Enhanced Disclosure of the Models Used in the Federal Reserve's Supervisory Stress Test, 82 Fed. Reg. 59,547 (Dec. 15, 2017); Policy Statement on the Scenario Design Framework for Stress Testing, 82 Fed. Reg. 59,533 (Dec. 15, 2017); Stress Testing Policy Statement, 82 Fed. Reg. 59,528 (Dec. 15, 2017); Better Markets Comment Letter on Stress Test Disclosures (Jan. 22, 2018), https://bettermarkets.com/sites/default/files/FRS%20-%20CL%20-%20Stress%20Testing_0.pdf.

[8] Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules, 83 Fed. Reg. 18,160 (Apr. 25, 2018); Better Markets Comment Letter on Regulatory Capital, Capital Plan and Stress Test Rules (June 25, 2018), https://bettermarkets.com/sites/default/files/Better%20Markets%20CL%20to%20Fed%20-%20Cap%20buffer%20and%20stress%20testing%206-25-18.pdf; .

Reserve issued proposals that would reduce the frequency of stress tests for many large banks.[9] These efforts culminated in a final rule issued by the Federal Reserve on November 1, 2019, weakening this critical reform ("2019 Stress Test Rule").[10] These and other changes to the stress testing regime threatened to snatch defeat from the jaws of victory given that everyone including Wall Street's biggest banks subject to the tests recognized them as a very successful and effective post-crisis reform that has made the banks more resilient.[11]

The 2019 Stress Test Rule reduces the frequency of stress tests across the board. For globally systemically important banks ("GSIBs"), the largest and most systemically significant banks, as well as banks with over $700 billion assets, the rule eliminates the requirement of a mid-year, company run stress test—these banks are now only required to conduct one company-run stress test per year. Banking organizations with assets between $250 billion and $700 billion must only publicly disclose company-run stress tests every other year. And finally, banking organizations with $100 billion to $250 billion in assets (referred to as "Category IV firms" in the 2019 Stress Test Rule) will not be required to conduct company-run stress tests using the Federal Reserve's scenarios at all and will only be subject to supervisor-run stress tests every other year.

These reductions in the frequency and public disclosure of stress testing at large banks will reduce the flow of important information about the resilience of banks, undermine the credibility of the stress tests that are conducted, and weaken public accountability of the regulators administering the tests. In addition, the weaker stress testing regime will undermine the broader capital planning framework, as the stress test results serve as an important component of a bank's required stress capital buffer.

SUMMARY OF THE PROPOSAL

The Proposal states that its purpose is to modify the capital plan rule requirements and the stress capital buffer requirements to make them consistent with the changes made by the tailoring framework for Category IV banking organizations. In particular—

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9 Prudential Standards for Large Bank Holding Companies and Savings and Loan Holding Companies, 83 Fed. Reg. 61,408 (Nov. 29, 2018); Better Markets Comment Letter on Enhanced Prudential Standards (Jan. 22, 2019), https://bettermarkets.com/sites/default/files/Better%20Markets%20Comment%20Letter%20Fed%20Enhanced%20Prudential%20Standards%20Proposal.pdf; Statement on Proposals to Modify Enhanced Prudential Standards for Large Banking Organizations by Governor Lael Brainard (Oct. 31, 2018), https://www.federalreserve.gov/newsevents/pressreleases/brainard-statement-20181031.htm.

10 Prudential Standards for Large Bank Holding Companies, Savings and Loan Holding Companies, and Foreign Banking Organizations, 84 Fed. Reg. 59,032 (Nov. 1, 2019).

11 *See,* Federal Reserve Bank of Boston, Conference Stress Testing: A Discussion and Review (comments of Dennis Kelleher) (Jul. 9, 2019), https://bettermarkets.com/sites/default/files/Stress_Testing_A_Discussion_and_Review_Kelleher.pdf; *see also* Statement by Governor Lael Brainard (Oct. 10, 2019), https://www.federalreserve.gov/newsevents/pressreleases/brainard-statement-20191010.htm.

- Dispensing with projections based on Board scenarios. The Proposal would remove the capital plan rule requirement that firms calculate forward-looking projections of capital under scenarios provided by the Board. Category IV banks would still be required to submit a capital plan annually, but they would no longer be required to calculate estimates of projected revenues, losses, reserves, and pro forma capital levels using scenarios provided by the Board. These banks will still be required to submit to the Federal Reserve an annual capital plan including analysis based on their internal stress testing.

- Less granularity in firm-developed projections. Under the Proposal, firms would no longer be required to submit their internally-developed, forward-looking projections in the same form or with the same granularity as currently required, reducing the information the Federal Reserve will receive about conditions in the banking system and giving these banks more "flexibility" as they develop their capital plans.

- Only semi-annual updates to the stress capital buffer ("SCB"), except for the component based on planned dividends. Under the Proposal, the portion of the stress capital buffer representing the decline in the CET 1 ratio would be calculated only every other year, in accordance with the reduction in the frequency of supervisory stress tests. In years when a firm does not undergo a supervisory stress test, it would receive an updated SCB requirement, but that updated requirement would only reflect changes in the firm's planned common stock dividends for the four quarters covered by the SCB that year, as shown in its annual capital plan submitted to the Board.

- Optional participation in off-year supervisory stress tests. The Proposal would give firms the option to participate in the supervisory stress test and to receive a fully updated SCB requirement in the alternate years in which they are not scheduled to undergo a supervisory stress test. The Federal Reserve will also maintain the option to require these banks to undergo a stress test in these alternate years, should they choose to.

- Excluding expected material business plan changes. The Proposal would clarify the Board's current approach by providing that the Board and firms would *exclude* the impact of unconsummated material business plan changes in the projections used in supervisory (and company-run) stress tests, although it notes that such factors would continue to be required in a firm's capital plan.

- Savings and loan holding companies. The Proposal would make certain technical and conforming changes to the stress test rules applicable to savings and loan holding companies.[12]

[12] The Release also invites comment on the broader issue of whether the requirements in the capital plan rule, including the stress capital buffer requirement, should be applied to large savings and loan holding companies ("SLHCs"). *See* Release at 63,226. Clearly the answer is yes. The regulatory approach to

COMMENTS

The Proposal represents essentially the next step in the Federal Reserve's misguided and ill-conceived project to weaken the robust capital planning and stress testing frameworks established in the aftermath of the 2008 crisis and the passage of the Dodd-Frank Act—frameworks that have undoubtedly made the financial system safer. The net effect of this Proposal, in conjunction with an earlier parade of de-regulatory rules, including the introduction of the SCB that has weakened stress tests for all banks, is a less credible stress testing program; less frequent supervisory stress testing among Category IV firms; less rigor in the capital planning process; and less frequent updates to Category IV banks' SCB, which will create confusion and undermines the critical element of consistency and comparability across firms subject to the stress test that has been and should remain a hallmark of the Fed's stress testing program.

These de-regulatory measures are unwise on their face, and recent experience simply re-enforces the point. The COVID-19 pandemic has battered the nation's economy and stressed all financial markets, but it has not led to a wave of bank failures, largely as a result of the robust regulatory framework implemented in the wake of the last crisis that the Federal Reserve and other regulators are now working to undo. Thus, the Fed appears intent on eroding regulatory protections (and cementing those erosions in place with this Proposal) that have proven their merit, all without any persuasive justification or showing that such relief for these very large Category IV banks is necessary or likely to provide countervailing benefits other than the ostensible and questionable social benefit of "reducing the regulatory burden" on these banks.

The Federal Reserve has seen first-hand how unexpected developments can wreak havoc on the economy in relatively short order—COVID-19 went from nonexistent to necessitating a massive economic shutdown in order to try to prevent the spread in a matter of less than three months. And it has seen how the rules the Federal Reserve is now dismantling have at least so far kept the financial system from collapsing despite the economic damage wrought by the pandemic.

In light of these developments, we urge the Federal Reserve to take this opportunity to revisit, and ultimately rescind, the deregulatory rule changes that unnecessarily and unjustifiably are increasing risk to the financial system. And specifically, for the reasons we explain below, the Federal Reserve should withdraw this misguided proposal. Further, all banks subject to the SCB should be subject to the same stress tests carried out concurrently to ensure consistent and comparable implementation of regulatory capital requirements.

SLHCs in this area should parallel the approach to large bank holding companies, not only to ensure the stability of large savings and to protect the financial system overall but also to prevent the regulatory arbitrage that disparate regulatory requirements applied to similarly situated financial institutions inevitably engenders.

I. THE FEDERAL RESERVE MUST REVISIT ITS DANGEROUS ROLLBACKS OF THE STRESS TESTING AND CAPITAL PLANNING REQUIREMENTS

While the Proposal itself is focused on conforming changes to the stress test and capital planning framework for Category IV firms, it presents an opportunity for the Federal Reserve to revisit its flawed and dangerous rollback of requirements in these areas.[13]

As shown by prior experience during the global financial crisis of 2008-2009, and in the more than ten years since, stress tests are an essential component of the regulatory framework, both for addressing financial crises and for reducing the likelihood that insufficiently capitalized large banks will propagate or contribute to exacerbating a downturn turning it into a crisis. However, stress tests are only useful if they are credible and viewed as such. In rapidly changing economic conditions during a period of market distress, tests conducted up to two years earlier, as planned for Category IV banks in this Proposal, will not be sufficiently current and are unlikely to be considered credible. As Federal Reserve Governor Lael Brainard has pointed out:

> The stress testing-based regulatory capital regime applied to Fannie and Freddie before the crisis offers a sobering reminder of the dangers of failing to update stress tests in the face of changing market practices and emerging risks.[14]

And as another expert observer cautioned specifically with respect to biennial stress tests:

> Doing stress tests less frequently, such as only once every two years, would not be frequent enough to meaningfully promote financial stability. First, firms make choices about dividends and share repurchases at least once a year. Capital planning which should incorporate projected capital positions and risks to those positions should not be done less frequently than decisions about shareholder payouts.[15]

The Proposal, in conjunction with other rules weakening the stress testing and capital regime[16], threatens to significantly weaken one of the critical pillars needed to protect the

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13 Such a reassessment is especially appropriate in light of the recent election, which represented a repudiation of the Trump administration and its industry-friendly, deregulatory approach that benefited Wall Street at the expense of Main Street.

14 *Cf.* Lael Brainard, Member of the Board of Governors of the Federal Reserve, Remarks at the Global Finance Forum, Safeguarding Financial Resiliencies Through the Cycle, at 7, 10 (Apr. 19, 2018), https://www.federalreserve.gov/newsevents/speech/files/brainard20180419a.pdf.

15 NELLIE LIANG, BROOKINGS INST., HIGHER CAPITAL IS NOT A SUBSTITUTE FOR STRESS TESTS (2017), https://www.brookings.edu/wp-content/uploads/2017/04/es_liang_stresstests_04-24-17.pdf.

16 These other related rule changes, which have already significantly weakened the stress testing program and capital planning requirements for all large banks, not just those with between $100 and $250 billion, include: eliminating the so-called 'qualitative objection' in CCAR; eliminating a post-stress leverage requirement when implementing the stress capital buffer (SCB); changing the stress test assumptions about capital distributions to assume banks only pay out 4 quarters of planned dividends rather than 9 quarters of planned dividends and common stock buybacks; eliminating the reasonable assumption that banks balance sheets might grow during a downturn (just as they have

financial system and support the economy by promoting financial resilience at large banks through inevitable periods of economic downturn and severe stress.

II. THE PROPOSAL, INCLUDING THE OPTIONAL ALTERNATIVE-YEAR SUPERVISORY STRESS TESTS, WOULD UNDERMINE CROSS-BANK CONSISTENCY AND COMPARABILITY AND THE CREDIBILITY OF STRESS TEST-BASED CAPITAL REQUIREMENTS FOR CATEGORY IV FIRMS

The Federal Reserve proposes to allow Category IV firms, which under the 2019 Deregulatory Rule will only have to undergo a supervisory stress test every other year, to use the results of stress tests carried out every two years to set the SCB capital requirement, while Category I, II and III banks will have their SCB requirement updated by a new supervisory stress test annually. Furthermore, the Proposal would anomalously allow a Category IV bank to opt-in to a supervisory stress test in a year in which they would ordinarily not be subject to a supervisory stress test. The Release explains that such a firm "may prefer to receive an updated stress capital buffer requirement in a year in which it would not generally be subject to the supervisory stress test."

This approach is flawed on multiple levels. First, the Proposal fails to explain why a banks' preferences should be a compelling consideration or deciding factor in implementing capital regulations.[17] More importantly, these aspects of the Proposal could result in dangerous uncertainty about the financial strength of Category IV banks, and will destroy the benefits that have come from being able to compare consistently estimated financial resilience under stress across all large banks in the stress tests.

Under the Proposal, Category IV banks' regulatory capital requirement (its stress capital buffer) and reported stress-based capital position will not be comparable with Categories I, II and III during the year when the stress test is not run for Category IV banks. Indeed, at the extreme, a bank with $251 billion in assets and a bank with $249 billion in total assets will be in different categories and as a result of this Proposal capital positions under the SCB regulatory requirement will not be consistent or comparable, unless the category IV bank had exercised its option to have the stress test updated in the 'off-year'.

Moreover, even within Category IV, if some banks exercise the option for the annual update and others do not, the reported capital positions and capital requirements will not be consistent or comparable even within Category IV because they will be based on inconsistent measures of capital needs. This actively undermines the ability of the public to compare banks' financial strength and directly weakens the oft-claimed benefit that the Federal Reserve's stress

for many banks during the COVID pandemic); allowing banks to increase capital distributions above what they had projected in their required capital plan submissions without first seeking approval from the Fed; and, as already noted in this letter, increasing disclosure about the Fed's stress test modeling practices, which can undermine its effectiveness and also increase systemic risk.

[17] Release at 63,225.

test promotes market discipline by providing consistent and comparable information about how the banks might fare under stress. This Proposal actively undermines market discipline and could sow considerable confusion, potentially at the worst possible time, during a downturn.

On its face, the option to request an annual update may *appear* to be a laudable provision, since it potentially increases the frequency of stress testing. In reality, it is a one-sided benefit to the banks. Because it is optional, it will not ensure stress testing with adequate frequency. Moreover, it will further undermine the credibility of the stress tests for Category IV firms, as firms will only exercise that option if it benefits them, creating uncertainty and potentially intensifying concerns about banks that elect not to undergo off-year supervisory stress tests.

As Better Markets pointed out when it commented on the 2019 Stress Test Rule:

> Under the Proposal, the treatment of Category I, II, and III firms is substantially similar, but the standards for Category IV firms are significantly weaker than for the other three categories. In a period of economic stress, markets will perceive that there is significantly more information available about the present health of the Category I, II, and III firms than the Category IV firms, and will also know that the Category I, II, and III firms were subject to more stringent liquidity and stress testing standards than Category IV firms. In a stressed environment, that could lead to a widespread loss of confidence in the stability of this entire class of banks, 25 of them representing $3.7 trillion in combined assets.[18]

The Proposal would compound this situation, where the stale stress tests of Category IV firms are unlikely to be viewed as credible and will reduce consistency and comparability both in 'normal times' and in a crisis situation. As noted above, a Category IV firm will likely only opt-in to an off-year stress test if it believes it can benefit from it by reducing its required SCB.

In "normal" conditions, Category IV banks that perceive a possible benefit, such as a lower SCB capital requirement, will choose to opt in to the alternate year stress test if that benefit outweighs the costs of executing the stress test. Banks that do not perceive a benefit, or in a worse case may wish to avoid public disclosure of stress test results that could indicate a deterioration in their financial strength since the prior year, will not opt in. This ensures uncertainty and could indicate negative information about any bank choosing not to opt in during a normal year when others are opting in. The public will wonder why they aren't opting in when others are. And the only available disclosure about the potential effects of a stressful environment will be a year old and based on a stale scenario.

This could be even more pronounced in a stressed or crisis environment, in which there is already likely to be a high degree of uncertainty about the health of firms. Market participants

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18 Better Markets Comment Letter on Enhanced Prudential Standards (Jan. 22, 2019), https://bettermarkets.com/sites/default/files/Better%20Markets%20Comment%20Letter%20Fed%20Enhanced%20Prudential%20Standards%20Proposal.pdf.

are likely to assume that Category IV banks that have **not** opted into an off-year stress test have suffered a setback, may have an inadequate stress capital buffer, and would have to increase their buffer if they submitted to a stress test. Such a perception, whether justified or not, may jeopardize the standing of such firms, potentially causing a pullback by depositors, creditors, and counterparties from these firms and endangering their ability to survive a crisis.

Finally, while firms that have opted into off-year supervisory tests **may** be perceived, based on a stress test scenario, as having sufficient capital, that is by no means a guarantee. In some cases, especially in stressed conditions, the market may suspect that the circumstances allowing a firm to benefit by opting into an off-year stress test were transitory. Or the market may believe that the firm has gamed the ability to opt-in to an off-year stress test to lower its SCB below what it "should" be, thus camouflaging weaknesses in its capital position. Therefore, the market may be skeptical of even those firms that have opted in to an off-year test.

In any event, simply put, allowing firms to game the frequency of stress testing for their own benefit will undermine the credibility of stress testing for Category IV firms.

III. THE FEDERAL RESERVE SHOULD NOT MAKE CHANGES TO ITS CAPITAL PLANNING GUIDANCE WITHOUT EXPLAINING THE CHANGES IT IS PROPOSING AND A RATIONALE FOR THOSE CHANGES

The Release also includes a request for comment on the Federal Reserve's capital planning guidance. Unfortunately, the Release provides little by way of information that would be relevant to anyone seeking to respond to this request for comment. The Release does not explain what specific aspects of its capital planning guidance are even under consideration. Nor does it explain why it is considering modifying the guidance, except for the observation that some "aspects of the guidance have not been updated since the 2007-2008 financial crisis."[19] This lack of detail surrounding the request for comment is especially problematic because, as the Release states, it is, at least in part, the Federal Reserve's own experience that is driving its request for comment:

> The revisions made to the Board's regulations in the recent tailoring and stress capital buffer rules and experiences with capital planning during the Coronavirus Disease 2019 event (COVID event) also motivate seeking public input at this time.[20]

Unfortunately, the Release goes on to provide no further detail regarding these factors or why more specifically they are prompting a possible re-evaluation of the guidance. Moreover, the Federal Reserve is (or should be) well aware that the "COVID event" is not yet over, and there may be further related experiences that should inform views on current capital planning guidance.

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[19] Release at 63,227.
[20] Release at 63,227.

Even accounting for the preliminary nature of a request for comment, withholding information about what is motivating the request for comment deprives the public of necessary information to provide informed comment, and any potential revision to the guidance will be worse off for it. The Federal Reserve should not make or propose any changes to its capital planning guidance until it has provided more detail about what specific guidance it is reviewing, its rationale for re-examining that guidance, and the reasons its intended changes are warranted.

CONCLUSION

We hope you find these comments helpful.

Sincerely,

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