SENT VIA EMAIL TO REG.COMMENTS@FEDERALRESERVE.GOV

October 5, 2018

Ms. Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue N.W.
Washington, D.C. 20551

Re: Regulations Q, Y, & YY: Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules [Docket No. R-1603 RIN 7100-AF 02]

Dear Secretary Misback:

On September 24, 2018, Better Markets sent a letter to the Vice Chairman for Supervision of the Board of Governors of the Federal Reserve System, Mr. Randal K. Quarles, which is attached below, directly related to the use of Comprehensive Capital Analysis and Review (CCAR) stress tests and other enhanced supervision regulation designed for systemically important financial institutions on non-systemic financial companies. We kindly request our September 24, 2018 letter to be included in the comment file under Docket No. R-1603 RIN 7100-AF 02.

Thank you.

Sincerely,

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President & CEO

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September 24, 2018

The Honorable Randal K. Quarles
Vice Chairman for Supervision
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Implementation of S. 2155: the Economic Growth, Regulatory Relief and Consumer Protection Act

Dear Vice Chairman Quarles,

As you know, there is a great deal of attention focused on the implementation of S. 2155, the Economic Growth, Regulatory Relief and Consumer Protection Act (the "Act"), including an August 17, 2018 letter to you from several Senators, including four members of the Senate Banking Committee (the "August 17th Letter"). Given the economic devastation caused by the catastrophic 2008 crash,[1] which is ongoing for tens of millions of Americans, and the economic, social and political upheavals it caused,[2] we[3] write to urge caution and respond to several unwarranted claims and asserts made in the August 17th Letter and elsewhere.

While many are reflecting on the 10th anniversary of the collapse of Lehman Brothers and the onset of the worse financial crash since 1929, too many are forgetting or ignoring some of the most important lessons of that financial crisis. In particular, without vigilant and independent oversight and regulation, financial institutions of various sizes, activities and complexity, often deeply interconnected and highly leveraged, can build up so much risk, often

[1] See Better Markets, "The Cost of Crisis, $20 Trillion and Counting", July, 2015, available at https://bettermarkets.com/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis-2.pdf and Federal Reserve Bank of San Francisco, "The Financial Crisis at 10: Will We Ever Recover," August 13, 2018, available at https://www.frbsf.org/economic-research/publications/economic-letter/2018/august/financial-crisis-at-10-years-will-we-ever-recover/.

[2] See "Crashed: How a Decade of Financial Crises Changed the World," Adam Tooze (2018).

[3] 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 that protects and promotes Americans' jobs, savings, retirements, and more.

unseen and poorly understood, that they eventually threaten the economic stability of the financial system and the entire country.

While the Act requires regulators to undertake certain actions, it also provides regulators with ample discretion to use their best judgment to ensure the safety, soundness and stability of the financial system. Put differently, the Act does not mandate unwise deregulation that would undermine financial stability, increase the likelihood of future bailouts, and once again harm hardworking Americans who are still paying the bill for the last crash that they did not cause.

The challenge and responsibility of getting this right cannot be understated. As former Senator Ted Kauffman said on the Senate floor during debate over the Dodd-Frank Act, wise regulators are critical bulwarks against the future crashes:

> The [Dodd Frank] financial reform bill places enormous responsibilities and discretion into the hands of the regulators. Its ultimate success or failure will depend on the actions and follow-through of these regulators for many years to come. One of my main concerns is, if we elected another President who believed we should not have regulators and regulation, they would again have the ability to do what they did to cause a meltdown.[4]

Of course, no one wants that to happen or another crash, but those are the stakes as elected officials, policymakers and regulators make decisions regarding financial regulation, including how to best implement the Act.

First, the complaint about the asset threshold being “arbitrary” is specious and fails to recognize that it is merely a trigger for consideration of enhance prudential regulation based on an individualized, multifactor risk analysis[5] that includes sizes, activities, complexity, interconnectedness, leverage and other risk factors. Moreover, any claim of an “understanding,” as stated in the August 17th Letter, that the Act “shifted the assumption that financial companies with less than $250 billion are not systematically risky” is baseless. One need only glance at the list of hundreds of banks receiving TARP money in 2008-2009[6] to quickly see that systemic risks are not limited to only the top dozen banks in the United States. Moreover, banks of all sizes also availed themselves of the Fed’s many emergency rescue

[4] Congressional Record Volume 156, Number 105 (Thursday, July 15, 2010) Available at https://www.gpo.gov/fdsys/pkg/CREC-2010-07-15/html/CREC-2010-07-15-pt1-PgS5870-2.htm.

[5] See Better Markets “Fact Sheet: Everything You Need to Know About the $50 Billion Threshold” (November 28, 2016), available at https://bettermarkets.com/sites/default/files/50b%20Fact%20Sheet%20Updated%20Long%20Version%2011.28.16_0.pdf

[6] See, e.g., “Tracking the $700 Billion Bailout,” New York Times, available at http://archive.nytimes.com/www.nytimes.com/packages/html/national/200904_CREDITCRISIS/recipients.html?scp=5&sq=tarp&st=cse.

programs from 2007 through 2012, proving again that systemic and contagion risk was significantly broader than those few banks with more than $250 billion in assets. Finally, regarding the 26 specific banks that will benefit the most from the Act, a Better Markets analysis reveals that they receive more than $2.5 trillion in emergency bailouts during the financial crisis.[7]

Second, the August 17th Letter also urged the Fed to discontinue the use of Comprehensive Capital Analysis and Review (CCAR) stress tests "and other enhanced supervision regulation designed for systemically important financial institutions on non-systemic financial companies." Such an assertion, unsupported by data or analysis, that certain financial institutions are "non-systemic financial companies" should be given no weight by financial regulators. Such an action would be as unwarranted as it would be unwise. As has been detailed and well-recognized in the United States and around the world, stress tests are one of the Fed's most significant and successful post-crash actions. We will not burden you here with the mountain of proof of that (much of it from the Fed itself[8]) other than to refer to scholar Morris Goldstein's amply detailed book "Banking's Final Exam: Stress Testing and Bank-Capital Reform."

Third, after years of falsely claiming that Dodd Frank and the Fed improperly regulate by size alone, it is ironic that the August 17th Letter uses size for what are claimed to be "non-systemic financial companies." This unfounded and inaccurate assertion is made explicit in several sections of the letter, which makes a number of claims about the purportedly arbitrary nature of the $250 billion asset threshold, including:

- "[F]inancial companies do not suddenly become systematically [sic] risky when they cross an arbitrary asset threshold."
- "[Y]ears of the Fed's accumulated data and the very standards it sets for systemic risk thresholds demonstrates that these financial companies do not pose a systemic risk."
- "[R]egional financial companies with more than $250 billion assets [sic] are not systemic as well."

However, the notion that financial institutions with between $100 billion and $250 billion in assets are *by definition* incapable of posing a risk to the financial system is unsupported by evidence, and in fact is directly contradicted by the historical record, as discussed above. It is simply not the case that systemic risk lies only with the tiniest number of the very largest firms. Moreover, big banks in the $100 billion to $250 billion asset range provide critical credit to

[7] https://bettermarkets.com/resources/who-does-s-2155-benefit-recidivist-giant-banks-received-trillions-taxpayer-bailouts

[8] See, e.g., *infra* n. 12 and accompanying text.

large parts of the economy and the failure of one or more of them would have devastating effects on their borrowers, which could well spill over into a larger crisis.

An important lesson of the 2008 financial crisis is that the distress, failure or inability to satisfy the obligations of a mid-to-large size bank at an inopportune time can exacerbate a crisis, ignite contagion and plunge already troubled markets into chaos. Just one example is Countrywide Financial, which had approximately $117 billion in assets when acquired by Bank of America, but which generated $62.9 billion in losses, crippling the bank for years even after it received $45 billion in TARP funds.

As Stanford's Anat Admati, Paul Pfleiderer, and Amit Seru have noted, policymaking based on this flawed assumption "is potentially quite dangerous."[9] Firms with between $50 billion and $250 billion in assets, they note, "are not community banks. The failure of one or more of them will cause significant disruption and collateral harm, particularly in the context of overall market turmoil."[10] Whether or not they "will cause" deleterious consequences, they may and that alone requires the Fed to undertake an individualized risk assessment rather than blindly exempting all such banks due to an uninformative asset size number.

Indeed, history shows the speed with which turmoil among these sub-$250 billion banks can spread through the financial system: "The Savings and Loan crisis along with some other banking crises have also shown that even small institutions that all take similar risks and tend to fail at the same time can be dangerous and costly."[11]

Fourth, while we agree with Federal Reserve Chairman Jerome Powell's testimony before Congress in March that "supervisory stress-testing is probably the most successful regulatory innovation of the post-crisis era,"[12] it is also important to note that the results of the stress tests are only as valid as the assumptions upon which they were based and the rigor with which they are conducted. Financial institutions - including those with hundreds of billions of dollars in assets and were the focus of the Act - face risks that are interlinked and complex. By their very nature, these risks are difficult to predict. For that reason, reliance solely on stress tests can provide regulators with false assurances about the stability of the financial system as a whole, as well as the individual firms operating within it.

For this reason, the Dodd-Frank Act relies on a set of interconnected financial stability rules to help reduce risky behavior by banks, make banks more resilient to financial shocks, help regulators detect threats on the distant horizon, and give regulators tools to unwind failing firms quickly. But the interlocking system of financial stability rules will lose their effectiveness

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[9] Letter to Chairman Crapo, March 6, 2018, available at https://www.gsb.stanford.edu/sites/gsb/files/admati-pfleiderer-seru-letter-s.2155-final.pdf
[10] ibid
[11] ibid
[12] https://www.bloomberg.com/news/articles/2018-03-20/fed-still-reigns-supreme-over-banks-despite-dodd-frank-rewrite

if they are dismantled piece by piece, in whole or in part, as could happen with the implementation of the Act.

Fifth, a particularly dangerous suggestion is that implementing the Act should include automatically include a number of foreign banks operating in the US, many of which received very significant bailouts during the financial crisis. In fact, nine of the top twenty largest users of the Fed's emergency lending facilities during the crisis were foreign banks.[13] For example, Deutsche Bank's U.S. subsidiary Taunus, was bailed out with 354 billion American dollars, which saved a bank that otherwise would have failed and required the emergency assistance of German taxpayers.[14] Put differently, the U.S. government substituted US taxpayers for German taxpayers to bail out a German bank and prevent it from failing: because Deutsche Bank itself was in such financial distress and on the verge of failure, it simply did not have the ability to bail out its US operations and, therefore, the German government would have had to first bail out Deutsche Bank so that it could bail out its US subsidiary.

Making matters worse, notwithstanding the lifesaving generosity of the US bailouts, Deutsche Bank then reorganized its US operations in 2010 to avoid US capital requirements (applicable to all bank holding companies in the US), which resulted in its US operations having a Tier 1 risk-based capital of -6.37 percent.[15] This action, among others, necessitated the enactment of the FBO rule and the requirement of intermediate holding companies ("IHCs") for foreign banks in the US.[16]

This history is omitted from the August 17th Letter, which calls on the Fed to ensure that IHCs of foreign banks "receive comparable regulatory treatment to U.S. [bank holding companies] of similar size and risk profile." However, such an action would make the U.S. financial system less resilient, and more susceptible to the importation of risk from foreign banks, as detailed in our letter to the Federal Reserve on the subject of enhanced prudential standards and early remediation requirements for foreign banking organizations and foreign nonbank financial companies. In that letter, we noted:

> Foreign banking organizations play an important role in the U.S. financial system. Their U.S. regulated subsidiaries, and their lightly regulated branch and agency networks, issue large amounts of short-term dollar liabilities, and use the proceeds to lend to U.S. and foreign firms and to buy dollar denominated assets. When these organizations are

[13] https://bettermarkets.com/blog/us-bailed-out-foreign-banks-2008-shouldn%E2%80%99t-have-do-again

[14] https://bettermarkets.com/newsroom/senate-bank-deregulation-bill-will-put-us-taxpayers-hook-bailing-out-foreign-banks-again

[15] See Better Markets comment letter on FBOs, April 15, 2013, available at https://bettermarkets.com/sites/default/files/documents/125-%20FRS-%20CL-%20Enhanced%20Prudential%20Standards-%204-15-13.pdf

[16] See "Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies," December 12, 2012, available at https://www.gpo.gov/fdsys/pkg/FR-2012-12-28/pdf/2012-30734.pdf.

distressed and there are runs on their financing, as was witnessed in 2008-2009, the effects on U.S. financial markets can be significant.[17]

The approach suggested in the August 17th Letter also fails to recognize the unique threat to the American financial system posed by IHCs that are tied to their foreign parent company, which may have a risk profile and contractual commitments to counterparties that are opaque to U.S. regulators. Consequently, "foreign institutions operating in the U.S.," write Admati, Pfleiderer and Seru, must be "regulated according to the risk they pose to the U.S. economy and citizens. The financial entanglement of foreign subsidiaries with their often very large parent institutions must be taken into account in determining the rules, and this means that regulations should be based on the size and systemic risk of the worldwide entity."[18]

Therefore, the Fed must do an individualized assessment of the unique risks each IHC poses to the US before making any determination to apply any of the provisions of the Act to any of them.

In conclusion, as you consider regulations to implement the provisions of the Act, we urge you to continue the policy of subjecting banks of all sizes and risk profiles to sensible and prudent financial protection measures, such as stress testing. And we urge you to reject calls from some quarters to eliminate these measures, a step which may benefit the balance sheets of the banks involved, but also expose the U.S. taxpayer and our financial system to unnecessary risk.

Thank you for your consideration of this letter.

Sincerely,

Dennis M. Kelleher
President and CEO

CC: Chairman Jay Powell
Vice Chairman Richard H. Clarida
Governor Lael Brainard
Ms. Ann E. Misback, Secretary, Board of Governors

[17] See, *supra*, n. 15; see also Crashed, supra n. 2 (detailing foreign distress, dollar demands and swap lines).
[18] See *supra* n. 9.