June 21, 2019

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

Re: Prudential Standards for Large Foreign Banking Organizations; Revisions to Proposed Prudential Standards for Large Domestic Bank Holding Companies and Savings and Loan Holding Companies, Docket No. R-1658 and RIN 7100-AF45

Dear Ms. Misback:

Better Markets[1] appreciates the opportunity to comment on the notice of proposed rulemaking captioned above ("Proposal" or "Release"),[2] issued by the Board of Governors of the Federal Reserve System ("Board"), regarding revisions to enhanced prudential standards for large foreign banking organizations ("FBOs"). The standards in the Proposal are substantially similar to standards proposed by the Board in 2018 that would apply to large, domestic bank holding companies ("Domestic EPS Proposal").[3]

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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 84 Fed. Reg. 21,988 (May 15, 2019).

3 Prudential Standards for Large Bank Holding Companies and Savings and Loan Holding Companies, 83 Fed. Reg. 61,407 (Nov. 29, 2018). Better Markets hereby incorporates by reference the comment letter submitted in response to the Domestic EPS Proposal, as well as comment letters submitted on prior proposals related to enhanced prudential standards. Better Markets, Comment Letter on Domestic EPS Proposal (Jan. 22, 2019), https://bettermarkets.com/sites/default/files/Better%20Markets%20Comment%20Letter%20Fed%20Enhanced%20Prudential%20Standards%20Proposal.pdf; Better Markets, Comment Letter on Proposal Regarding Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations (Apr. 15, 2013)

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Unfortunately, like the Domestic EPS Proposal, the current Proposal is a dangerous step backwards and includes a number of de-regulatory provisions that, by themselves and in concert with other sweeping de-regulatory initiatives, pose a significant threat to financial stability and safety and soundness. Those changes ignore the lessons learned in the crisis, particularly about the potential vulnerability of FBOs, and conflict with the letter and spirit of the Dodd-Frank Act which was passed in response to the crisis. Moreover, they lack any persuasive policy rationale, as banks are thriving, the financial markets are robust, and the current regime has proven its worth in shoring up our financial system, including by decreasing the risks posed by foreign banks operating in the U.S., and better protecting it from the ravages of another financial crisis.

The Agencies should be particularly mindful here regarding foreign banking organizations. It is one thing to put hardworking Americans and taxpayers at risk for the activities of domestic banks that at least theoretically support the U.S. economy, jobs, and growth. It is another thing altogether to put Americans and U.S. taxpayers at risk from the activities of foreign banks, which largely benefit foreign citizens and ship their revenues and profits overseas. It is particularly pernicious to **substitute U.S. taxpayers for foreign taxpayers as the source of bailout funding for foreign banks,** which we witnessed in 2008-2009.

Although far from alone, Deutsche Bank is the leading example. In fact, Deutsche Bank's U.S. subsidiary, Taunus, was the single largest foreign bank recipient of bailout support during the crash, amounting to more than $350 billion.[4] If the U.S. government had not provided those bailouts, then Taunus would have had to seek support from its parent company in Germany, Deutsche Bank.[5] However, because Deutsche Bank itself was on the verge of collapsing into bankruptcy due to its own reckless and irresponsible conduct, it would not have been able to provide such support and would have had to seek a bailout from the German government and German taxpayers before bailing out its U.S. subsidiary.[6] Thus, the U.S. bailout of Deutsche Bank's U.S. operations effectively substituted U.S. taxpayers for German taxpayers in bailing out this foreign banking operation.[7]

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https://bettermarkets.com/sites/default/files/documents/125-%20FRS-%20CL-%20Enhanced%20Prudential%20Standards-%204-15-13.pdf; Better Markets, Comment Letter on Proposal Regarding Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies (Apr. 30, 2012), https://bettermarkets.com/sites/default/files/documents/FRS-%20CL-%20Enhanced%20Prudential%20Standards%204-30-12.pdf.

4 Letter from Dennis M. Kelleher, President & CEO, Better Markets, to the Honorable Randal K. Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System (Sept. 24, 2018), https://bettermarkets.com/sites/default/files/Ltr%20to%20Fed%20VC%20Quarles%20re%20Implementation%202155%209-24-18%20FINAL.pdf.

5 Id.

6 Id.

7 Id.

Moreover, Deutsche Bank and Taunus were particularly irresponsible regarding their capital reserves and their failure to comply with U.S. regulations. For example, at the time of the crash in 2008, Taunus had **negative** capital.[8] Moreover, after receiving a generous bailout from U.S. taxpayers to save it from its reckless conduct, rather than comply with U.S. bank capital requirements, it reorganized its operations to avoid the requirements, resulting in its U.S. operations having a Tier 1 risk-based capital ratio of **negative 6.37 percent**.[9] This is, in part, what required the Agencies to impose capital and liquidity requirements on FBOs in the first place, which this Proposal is now seeking to weaken without taking any of these facts into account.[10]

Deutsche Bank was not an isolated incident; foreign banks operating in the U.S. were key actors before, during, and after the 2008 financial crisis, engaging in high-risk activities, suffering existential instability, and requiring massive bailouts from the U.S. government and taxpayers. In fact, fully **nine of the top 20** largest users of Federal Reserve emergency lending facilities were foreign banks.[11] Moreover, ten of the top 16 beneficiaries of the AIG bailout, which paid its counterparties 100 cents on the dollar, were foreign banks.[12]

These facts should be uppermost in the minds of regulators who propose to lower the standards for foreign banks operating in the U.S., particularly when no persuasive factual and legal basis is proffered and when the result will be to substitute U.S. taxpayer for foreign taxpayers in bailing out foreign banks.

INTRODUCTION AND SUMMARY

The stated goals of the Proposal are to (1) reduce compliance costs and streamline regulatory requirements for FBOs, (2) in a manner that would "reflect" amendments made by the Economic Growth, Regulatory Relief and Consumer Protection Act ("S. 2155"), signed into law on May 24, 2018.[13] Broadly speaking, S. 2155 raised the asset-based threshold for the required application of enhanced prudential standards to FBOs from $50 billion to $250 billion, and eliminated most enhanced prudential standards for FBOs with fewer than $100 billion in assets. However, it also gave the Board broad discretion to continue to apply "any" enhanced prudential

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8 Marc Jarsulic & Simon Johnson, How a Big-Bank Failure Could Unfold, N.Y. TIMES (May 23, 2013), https://economix.blogs.nytimes.com/2013/05/23/how-a-big-bank-failure-could-unfold/.

9 Supra, note 4.

10 Id.

11 *The U.S. Bailed Out Foreign Banks in 2008 & Shouldn't Have to Do That Again*, BETTER MARKETS BLOG (Jan. 23, 2014), https://bettermarkets.com/blog/us-bailed-out-foreign-banks-2008-shouldn%E2%80%99t-have-do-again.

12 Id.

13 Pub. L. No. 115-174 (2018).

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standards established under Section 165 of the Dodd-Frank Act to FBOs with assets of between $100 billion and $250 billion.[14]

By reducing the enhanced prudential standards that would apply to large FBOs, the Proposal will unnecessarily increase systemic risk. It is a premature and ill-advised attempt to scale back enhanced prudential standards applicable to some of the largest and most systemically risky FBOs. And the negative impact of the Proposal will be intensified because it will be in addition to a much broader collection of de-regulatory measures now being pursued that collectively pose a substantial threat to financial stability.

The proposed de-regulatory changes are not legally required or even justifiable. S. 2155 conferred broad discretion on the Board to maintain or even fortify the prudential regulation of foreign banks with between $100 and $250 billion in assets. And the underlying motivations for the risk-enhancing aspects of the Proposal—decreasing compliance costs for the industry and streamlining regulation—are considerations found nowhere in the relevant statutory standards governing the Board's exercise of that discretion. The Proposal strays further by downplaying the fundamental purpose of the Dodd-Frank Act, which remains fully intact notwithstanding the passage of S. 2155: The Board's primary mandate in establishing or amending any enhanced prudential standards is to ensure that Americans are protected from the extraordinarily damaging consequences of another financial crisis, **not** to help financial companies, foreign or domestic, make (even greater) profits. The proposed de-regulatory measures are especially inappropriate and unnecessary in light of indisputable evidence that the current framework has a proven track record of strengthening banks and increasing financial stability, while at the same time allowing lending activity to thrive and bank profits to soar to historic levels.

The Release contains little substantive analysis justifying any of its risk-intensifying provisions. Until it can provide credible evidence that weakening the prudential regime will not increase the risk of another financial crisis, and is otherwise appropriate, necessary and consistent with the law, the Board should refrain from diluting the current requirements for the U.S. operations of large foreign banking organizations, especially those with $100 to $250 billion in assets.

BACKGROUND

The 2007-2009 financial crisis was catastrophic for our financial markets, our economy, and millions of American families. In monetary terms, it destroyed $20 **trillion** in GDP.[15] And

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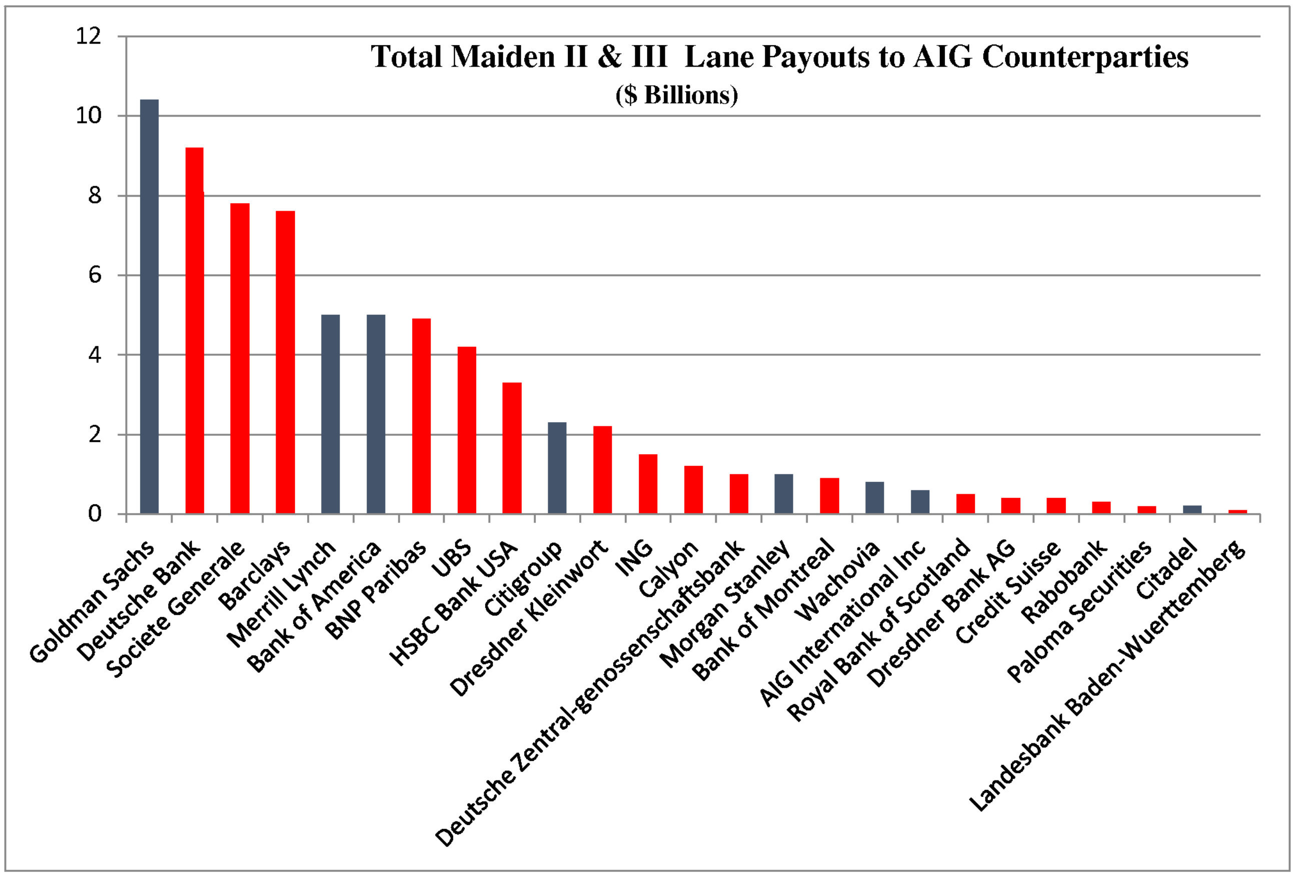
14 Section 165(b)(2) of Dodd-Frank act requires that the Board, in applying enhanced prudential standards to FBOs, take account "the principle of national treatment and equality of competitive opportunity…and…take into account the extent to which the foreign financial company is subject on a consolidated basis to home country standards that are comparable to those applied to financial companies in the United States."

15 BETTER MARKETS, THE COST OF CRISIS, $20 TRILLION AND COUNTING (July, 2015), https://bettermarkets.com/sites/default/files/Better%20Markets%20-%20Cost%20of%20the%20Crisis.pdf.

the human toll resulting from millions of home foreclosures, deep and prolonged unemployment and underemployment, and massive loss of wealth is incalculable, and it continues to be felt today. Moreover, on top of the damage caused by the deep recession, as much as $29 trillion was lent, spent, pledged, committed, loaned, guaranteed, and otherwise used or made available to bailout the financial system during the crisis.[16] Foreign banks were key actors during the financial crisis, engaging in high-risk activities, suffering existential instability, and ultimately requiring massive bailouts. In fact, fully **nine of the top 20** largest users of Federal Reserve emergency lending facilities were foreign banks.[17] And ten of the top 16 beneficiaries of the AIG bailout, which paid its counterparties 100 cents on the dollar, were foreign banks.[18]



16 See JAMES ANDREW FELKERSON, A DETAILED LOOK AT THE FED'S CRISIS RESPONSE BY FUNDING FACILITY AND RECIPIENT, PUBLIC POLICY BRIEF NO. 123 4, LEVY ECONOMICS INSTITUTE OF BARD COLLEGE (2012) ("Levy Report"), https://www.econstor.eu/bitstream/10419/121982/1/689983247.pdf; see also BETTER MARKETS, WALL STREET'S SIX BIGGEST BAILED-OUT BANKS; THEIR RAP SHEETS & THEIR ONGOING CRIME SPREE 1 (Apr. 9, 2019), https://bettermarkets.com/sites/default/files/Better%20Markets%20-%20Wall%20Street%27s%20Six%20Biggest%20Bailed-Out%20Banks%20FINAL.pdf.

17 *The U.S. Bailed Out Foreign Banks in 2008 & Shouldn't Have to Do That Again*, BETTER MARKETS BLOG (Jan. 23, 2014), https://bettermarkets.com/blog/us-bailed-out-foreign-banks-2008-shouldn%E2%80%99t-have-do-again.

18 Id.

The Board has a continuing responsibility under the Dodd-Frank Act to exercise its discretionary rulemaking authority to protect and promote financial institution safety and soundness as well as overall financial stability and to prevent another devasting crisis. Given the dismal track record of foreign banks during the crisis, the Agencies must be no less diligent in applying prudential standards to foreign financial institutions as they are in regulating domestic firms.

Preserving the regulatory reforms enacted in the Dodd-Frank Act is especially critical in part because of the difficulty in identifying all sources of systemic risk in advance. The financial crisis certainly illustrated the point. Financial regulators, and in particular banking regulators, have been heavily criticized for failing to fully appreciate the risks facing banks and other entities they supervised. However, in the runup to the crisis, few appreciated these risks and even fewer appreciated the potential consequences, as the housing market was teetering on the brink of collapse, toxic mortgage-backed securities were spreading like a virus, banks and other financial companies were dangerously over-leveraged and undercapitalized, and sophisticated financial companies were blindly accumulating over-the-counter derivatives positions they could not price, trade, or honor, all of which pushed the global economy to the brink of collapse.

This history shows that it will be extraordinarily difficult, even for experienced financial regulators, to predict in advance the precise contours and causes of the next financial crisis. Specifically, it will be nearly impossible to predict in what sector the crisis will originate, through what financial instruments it might spread, and which entities' failures may exacerbate the crisis. As the Congressional Research Service has put it, "[d]efinitively identifying banks that are systemically important is not easily accomplished, in part because potential causes and mechanisms through which a bank could disrupt the financial system and spread distress are numerous and not well understood in all cases."[19] That history and the undeniable lack of clairvoyance should cause all elected officials, policymakers, and regulators to be humble and cautious when deregulating systemically significant financial institutions.

What we do know is that dealing with this uncertainty requires being prepared for any number of scenarios through the application of strong prudential standards, including capital, liquidity, and risk management requirements, coupled with robust stress testing. They not only reduce the risk that banks and other financial firms will fail during periods of economic stress, but—equally important—also ensure that they will be able to continue responsibly serving their core economic functions, such as lending, which can help mitigate the severity of the crisis. Put differently, being strong enough to lend through the cycle enables these financial institutions to navigate a shallow downturn and quick recovery rather than making it deeper and longer as their losses and retrenchment contribute to the downward spiral. Moreover, strong prudential standards

[19] CONGRESSIONAL RESEARCH SERVICE, ECONOMIC GROWTH, REGULATORY RELIEF, AND CONSUMER PROTECTION ACT (P.L. 115-174) AND SELECTED POLICY ISSUES (June 6, 2018) at 35, https://crsreports.congress.gov/product/pdf/R/R45073.

serve to assure markets that large financial companies are strong enough to weather a period of stress.

Thus, attempting to too-finely tailor risk-mitigating prudential standards to precisely match the currently perceived (but possibly erroneous) risk profile of large FBOs is likely to exacerbate the risk and severity of another financial crisis without a persuasive basis or rationale. Instead, the Board should be focused on preserving, if not enhancing, the current enhanced prudential standards to the fullest extent allowed by statute. At the very least, the Board should stay its de-regulatory hand until the current set of prudential standards has been tested through a full business cycle. Certainly, the banks have no basis for complaint, as they continue to reap record-breaking profits and the credit markets are being well-served.

OVERVIEW OF PROPOSAL

The Proposal would create just three categories of large FBOs—omitting the most stringent Category I standards that would apply to globally systemically important banks ("GSIBs") under the Domestic Capital Proposal[20]—and apply differing levels of enhanced prudential standards based on the Board's assessment of the risk profile of the institutions in each category.

- **Category II:** Category II standards would apply to FBOs with $700 billion or more in combined U.S. assets or $75 billion or more in "cross-jurisdictional activity." The current enhanced prudential standards that would be applicable to Category II firms would generally remain in place, with the primary exception being that the Board proposes to eliminate the requirement to conduct a mid-cycle company-run stress test. The Board also proposes changes to application of single-counterparty credit limits, and specifically proposes applying a single-counterparty credit limit of 25% of Tier 1 capital, at the intermediate holding company level, for all Category II and III FBOs each of which may have less than $250 billion in assets, depending on risk factors; currently this particular limit only applies to the intermediate holding companies of FBOs with assets over $250 billion.

- **Category III:** Category III standards would apply to FBOs that are not subject to Category II standards, where the combined U.S. operations of the FBO have $250 billion or more in assets or have $75 billion or more in any of the following indicators: (i) nonbank assets; (ii) weighted short-term wholesale funding; or (iii) off-balance sheet exposures. The current enhanced prudential standards that would be applicable to Category III firms would generally remain in place, with two exceptions. First, Category III firms would not be required to run mid-cycle company-run stress tests; and second, they would only be required to conduct and publish the results of company-run stress tests every other year.

[20] The rationale given for omitting these standards in the Proposal is that the Board's GSIB surcharge rule would not identify any FBO or IHC as a GSIB. Release at 21,993.

- **Category IV:** Category IV standards would apply to FBOs with at least $100 billion in combined U.S. assets that do not meet any of the thresholds for Categories II or III. The Proposal would make a number of changes to the enhanced prudential standards currently applicable to Category IV firms:

    - Internal liquidity stress testing would be conducted less frequently, quarterly instead of monthly.
    - Collateral positions would only need to be calculated on a monthly, rather than a weekly basis.
    - Supervisory stress tests would be conducted only every other year.
    - Firms would no longer need to conduct or publicly report the results of company-run stress tests.

COMMENTS

At the outset, it bears emphasis that some aspects of the Proposal are positive. For example, the Proposal would apply some of the more stringent single-counterparty credit limits to more large FBOs. In addition, the Board proposes to largely maintain the current enhanced prudential standards for Category II and III firms (with some exceptions discussed below). This is appropriate, and Better Markets supports this aspect of the Proposal. While the Board should consider strengthening these prudential standards, at a bare minimum the Board must resist calls to weaken them, particularly where industry relies on long-debunked arguments about compliance costs choking off credit for consumers. In the balance of this comment letter, we focus on the aspects of the Proposal that are counterproductive and inadequately supported.

I. THE DE-REGULATORY ELEMENTS OF THE PROPOSAL ARE NEITHER REQUIRED BY, NOR CONSISTENT WITH, SECTION 165 OF THE DODD-FRANK ACT, AS AMENDED BY S. 2155.

A. S. 2155 does not require the Board, which already tailors the application of the prudential standards, to institute the proposed changes.

As it relates to the prudential standards relevant to the Proposal, S. 2155 is relatively narrow in scope and leaves the Board with a wide degree of discretion, provided that it considers the necessary factors set forth in the statute, none of which relate to alleviating industry's compliance burdens.[21] While S. 2155 substantially altered the prudential regulation framework by raising the threshold for the **required** application of enhanced prudential standards to $250 billion and setting an asset floor at $100 billion below which most enhanced prudential regulations no longer apply, it also left the Board's authority over banks in the $100 to $250 range largely intact. In fact, Congress took pains to expressly confer on the Board the discretion to apply, by order or rule,

[21] Pub. L. No. 115-174 § 401(a)(1)(B)(iii).

"any" prudential standard established under Section 165 to "any" bank holding company or bank holding companies with total consolidated assets equal to or greater than $100,000,000,000. The only provisos are that the Board determine that the standards are "appropriate" to mitigating risk and promoting safety and soundness and that the Board consider various risk-related factors relating to the institutions.

The Board need not, and should not, take S. 2155 as an invitation, much less a requirement, to decrease prudential standards and increase risk. Indeed, given the specified criteria ("mitigating risk and promoting safety and soundness"), the better argument would be that the Board should understand that the letter and spirit of the law requires it to only de-regulate with a substantial, sound, and data-driven basis, which is simply not what is being done here.

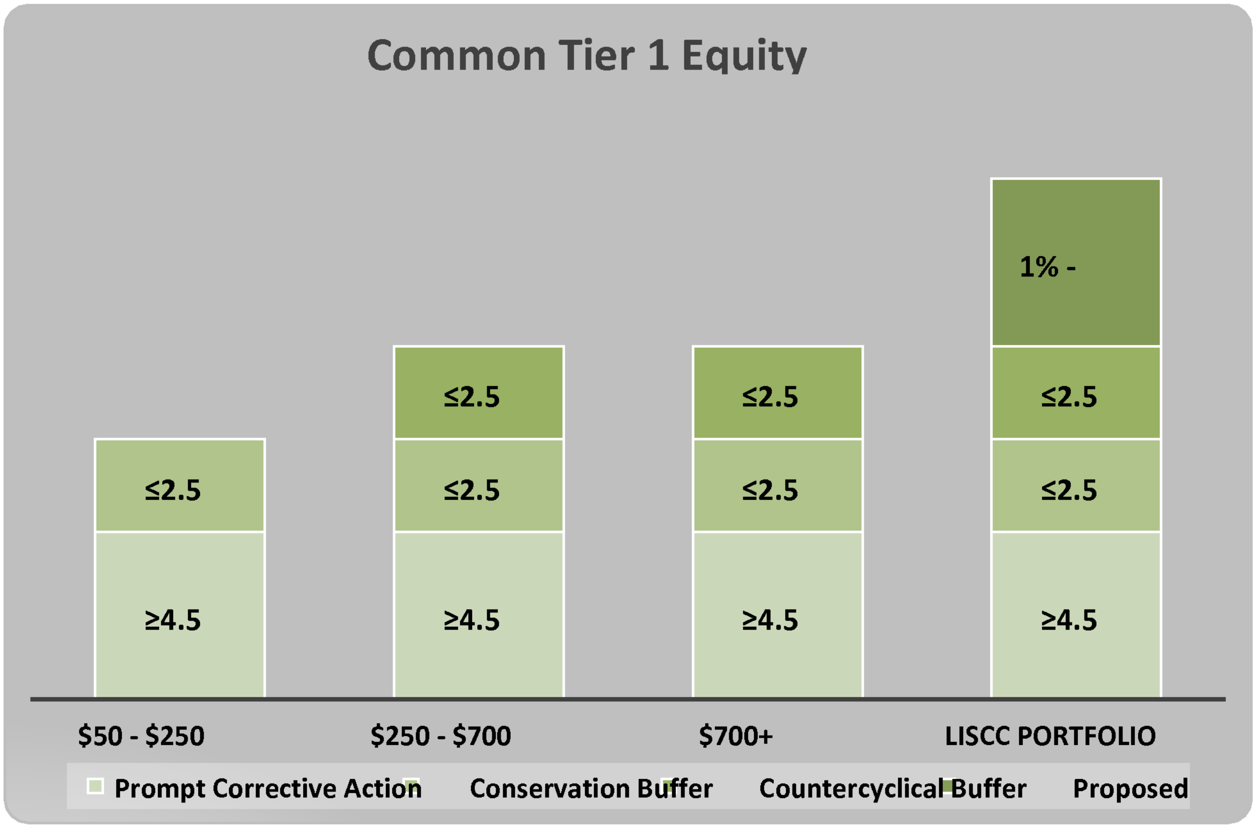
In addition, further changes to the Board's prudential standards are unnecessary insofar as the current enhanced prudential requirements are already "tailored" to the risk-related attributes of firms and classes of firms, as the Dodd-Frank Act originally intended. The Dodd-Frank Act gave the Board discretion to tailor enhanced prudential standards based on a firm's, or category of firms', "capital structure, riskiness, complexity, financial activities…size, and any other risk-related factors."[22] While S. 2155 removes that discretion in favor of a **requirement** that the Board engage in such tailoring, the Release notes the Board had **already** accepted Congress's invitation to tailor its enhanced prudential regulations according to the enumerated factors before enactment of S. 2155.[23]

For example, as detailed by Better Markets,[24] the Board already tailored its approach to tier 1 equity capital requirements:

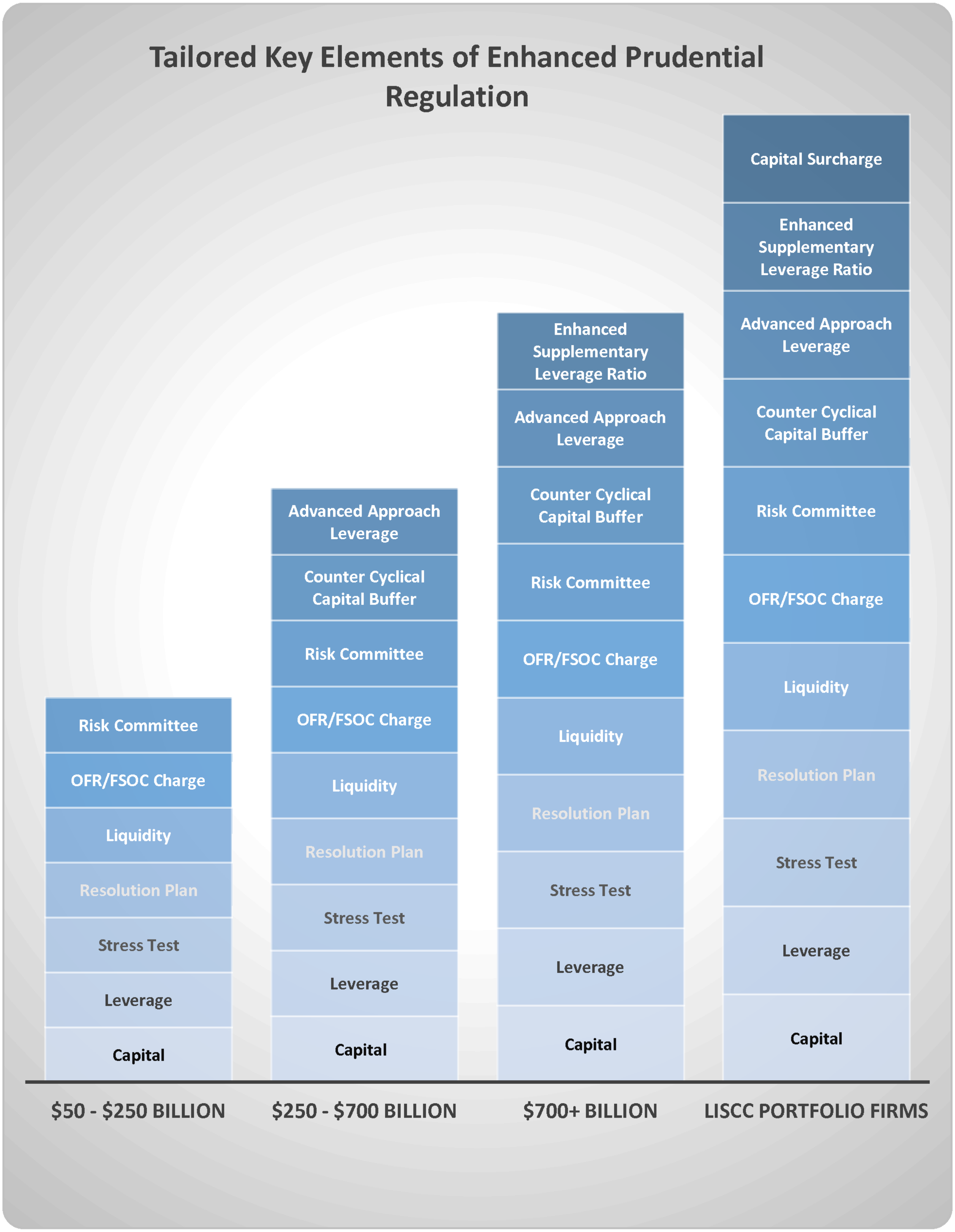
22 Dodd-Frank Act § 165(a)(2)(A).

23 Release at 21,989.

24 See BETTER MARKETS, FACT SHEET: EVERYTHING YOU NEED TO KNOW ABOUT THE $50 BILLION THRESHOLD (Nov. 28, 2016), https://bettermarkets.com/sites/default/files/50b%20Fact%20Sheet%20Updated%20Long%20Version%2011.28.16_0.pdf.



In addition, the Board tailored other key elements of the prudential regulations, applying them based on asset size:


Tailored Key Elements of Enhanced Prudential Regulation
Capital Surcharge
Enhanced Supplementary Leverage Ratio
Advanced Approach Leverage
Counter Cyclical Capital Buffer
Risk Committee
OFR/FSOC Charge
Liquidity
Resolution Plan
Stress Test
Leverage
Capital
$50 - $250 BILLION
$250 - $700 BILLION
$700+ BILLION
LISCC PORTFOLIO FIRMS

Thus, while S. 2155 certainly constrains the Board's future ability to establish non-tailored standards, it imposes no requirement to change the current enhanced prudential standards, because they are already tailored based on the enumerated factors.[25] To the extent they apply to FBOs with consolidated assets above $100 billion, the current enhanced prudential standards are already in full compliance with S. 2155.

Nor does S. 2155's tailoring requirement dictate that enhanced prudential standards have to be tailored to be **weaker** for any firm or group of firms with assets above $100 billion. In finalizing the Proposal, the Board should consider that it can tailor the requirements by **enhancing** them. For example, S. 2155 changed the required frequency of company-run stress testing from "semi-annual," as originally in Dodd-Frank, to "periodic." Of course, "periodic" does **not** necessarily mean "less frequently than semi-annual," so the Board need not finalize the proposed elimination of mid-cycle testing.[26] Instead, and in accord with S. 2155, it could and should retain that requirement or even increase the required frequency of company-run stress testing.

B. <u>The Proposal actually conflicts with the methodology set forth in the Dodd-Frank Act as well as its underlying purposes, and it offers a meaningless impact analysis.</u>

In establishing or revising standards, the Board still must remember that the Dodd-Frank Act was passed to "promote the financial stability of the United States by improving accountability and transparency in the financial system, to end 'too big to fail', [and] to protect the American taxpayer by ending bailouts."[27] These must remain the guiding principles in any implementing regulations: The Board has an overarching duty to protect the stability of the financial system and avert another financial crisis. S. 2155 did not alter these principles.

Specifically, in granting the Board discretion to impose enhanced prudential regulations on FBOs with between $100 and $250 billion in assets, Congress directed the Board to consider whether the application of enhanced prudential standards is necessary to prevent or mitigate risks to U.S. financial stability **or** to promote the safety and soundness of the banking organization, and to consider capital structure, riskiness, complexity, financial activities, size, "and any other risk-related factors that the Board of Governors deems appropriate."[28] This is a reaffirmation of the prudential goals underlying the Dodd-Frank Act.

Unfortunately, in the Proposal, the Board deviates from these requirements and overarching goals. When discussing the risk-enhancing provisions in the Proposal, the Board fails to fully assess **any** of the statutory factors **as required**. For example, in explaining the proposed rollbacks to liquidity stress testing and liquidity risk management for Category IV firms, the Board, in the Impact Assessment of the Release, claims that despite these rollbacks, the Proposal would

25 See id.
26 Pub. L. No. 115-174 § 401(e).
27 Pub. L. No. 111-203 (2010).
28 Pub. L. No. 115-174 § 401(a)(1)(C)((ii).

have "minimal effects on the safety and soundness of these firms and U.S. financial stability."[29] However, the Board offers no evidence or data to support such a bald assertion, which, by definition, makes these conclusions arbitrary and capricious. Indeed, the Board does not provide **any** substantive analysis supporting its assertion that the Proposal will not materially increase systemic risk.

In fact, the Board's "impact assessment" is wholly inadequate, taking up less than one full page in the Release. In briefly discussing the proposed changes in turn, it merely reiterates the same unsupported claims that the Proposal will have minimal effects on financial stability, averring that the Board expects the changes to have "no material impact" on capital levels and no material "affect" on liquidity buffers or firms' exposure to liquidity risk.[30] Nowhere does the Board provide a factual basis for these conclusions, which would appear on their face to render them arbitrary and capricious.

At the same time that the Board fails adequately to evaluate the factors required under S. 2155, it chooses to weigh a variety of factors that are not in the statute and that actually conflict with the intent of the statutory language if not its plain meaning. The Release explains that the Proposal is based on the Board's desire to "update, reduce unnecessary costs associated with, and streamline regulatory requirements," and it repeatedly embraces the goal of reducing "compliance costs."[31] But those factors are conspicuously absent from Section 165 of the Dodd-Frank Act, both as originally adopted and as amended in S. 2155, and they cannot justify the de-regulatory elements of the Proposal.

As demonstrated below, the implications of the Proposal on safety and soundness and systemic stability are very troubling. The threat is especially serious because the specific de-regulatory measures in the Proposal are elements of a much larger collection of dangerous de-regulatory steps that the Board and the prudential regulators have already taken or plan to take in the future.

II. THE PROPOSAL WILL UNDERMINE THE STABILITY OF OUR FINANCIAL SYSTEM.

A. Reducing the frequency of stress testing for Category II and III firms would be a mistake, weakening a critical tool for assessing safety and soundness and diminishing transparency.

A particularly troubling aspect of the Proposal is the potential reduction in the frequency and transparency of company-run stress tests for the largest FBOs. Currently, covered firms are required to conduct a mid-cycle company-run stress test in addition to the annual company-run stress test. However, under the Proposal, Category II firms would only be required to conduct

29 Release at 22,010.
30 Id.
31 Id. at 21,990; 22,002; 22,010.

company-run stress tests annually, and Category III firms would only be required to conduct and publish their stress test results every other year.[32] As noted above, this is not a statutorily required change—S. 2155 only states that company-run stress tests be conducted "periodically," which would certainly encompass semi-annual or even quarterly tests.

These are dangerous changes to the stress testing regime and they ignore or downplay the actually vital role that stress testing plays not only in identifying potentially unstable firms and heading off safety and soundness problems, but also in enhancing transparency and providing market participants and the public at large with accurate information about the risks that may be accumulating—or waning—in the financial system. In a healthy economy, they give regulators, and the firms themselves, valuable information about firms' ability to weather stress so that corrective action can be taken if needed. During a period of economic stress, when the slightest sign of trouble can lead to a vicious panic cycle that turns the downturn into a crisis, stress tests can provide much needed assurances. This is what happened in May 2009: panicky markets were reassured by the results of the stress tests conducted on the 19 largest U.S. banks.[33] This helped prevent the crisis from devolving into a depression—and stress tests may make the difference in preventing the next economic downturn from becoming another $20 trillion crisis (or worse).

However, stress tests are only as useful as they are credible. During periods of economic distress, conditions can change rapidly. A test conducted nearly a year earlier may not reassure markets that a firm can withstand current, deteriorated conditions, much less one conducted nearly two years earlier. The Board proposes to reduce the frequency of stress testing based on nothing more than the unsupported assertion that, in "the Board's experience, the mandatory mid-cycle stress test has provided modest risk management benefits and limited incremental information to market participants beyond what the annual company-run stress test provides."

Yet the Board has insufficient experience to assess the necessity of conducting mid-cycle stress tests in addition to the annual stress tests. The current stress testing regime has only been in place in a period of economic growth and continued financial stability. Until the economy goes through an actual period of stress, downturn, and recovery over a full business cycle, it is impossible to assess the utility of the mid-cycle stress tests. Without actual evidence that mid-cycle stress tests do not provide sufficiently useful information in a time of actual stress, the Board must not change the frequency of the conduct and publication of stress tests for Category II and III firms and would not appeared authorized to do so under the law.

B. **The proposal to significantly weaken enhanced prudential standards for Category IV firms could be disastrous.**

The Board proposes to significantly weaken the enhanced prudential standards for Category IV firms—those firms with $100 to $250 billion in assets that are not Category II or III

32 Release at 22,001.

33 MORRIS GOLDSTEIN, BANKING'S FINAL EXAM: STRESS TESTING AND BANK-CAPITAL REFORM 2(2017).

firms. The changes the Board proposes would reduce the frequency of internal liquidity stress testing from monthly to quarterly, reduce the frequency of the calculation of collateral positions from weekly to monthly, reduce the frequency of supervisory stress testing from annual to biennial, and **completely eliminate** the requirement to conduct and publish the results of company-run stress tests.[34]

These reductions in enhanced prudential standards are particularly unwise since, as noted above, the current requirements have yet to be tested over the course of a full business cycle. If the Board eliminates or reduces them for some of the largest FBOs operating in the country, it will be tempting fate. In the next period of significant stress, regulators and the public will be significantly hampered in understanding the liquidity and overall health of these firms.

Moreover, these are not small or insignificant firms. Recall that the smallest among this class of banks is over twice the size of the $50 billion dollar banks that automatically required enhanced prudential regulation under the Dodd-Frank Act as originally enacted. Indeed, a bank holding company with $100 billion in assets is a larger institution than **over 99% of the domestic bank holding companies in the country**. And as the Board notes, the characteristic of FBOs presents unique dangers:

> [T]he funding models of many foreign banking organizations presented unique vulnerabilities, as they relied on dollar-denominated short-term wholesale funding obtained in the United States to fund their global investment activities. Disruptions in the U.S. wholesale funding market limited the ability of these firms to satisfy liquidity demands, as some of them lacked adequate risk-management practices to account for the liquidity stresses of individual products or business lines, had not adequately accounted for draws from off-balance sheet exposures, or had not adequately planned for a disruption in funding sources. As a result, many experienced significant distress and required unprecedented liquidity support from U.S. and home-country authorities. For example, analysis using Federal Reserve Board data on Term Auction Facility usage in 2008 and 2009 finds that **approximately 40 percent of foreign banking organizations borrowed from the facility during the financial crisis**. Furthermore, on average, U.S. branches of foreign banking organizations that used the facility funded approximately 10 percent of their assets through the Term Auction Facility during this period.

Put differently, without these U.S. rescue programs, a fair number of foreign banks operating in the U.S. likely would have failed, triggering a cascading crisis that would have been disastrous. Nevertheless and despite these unique, very substantial risks (which in fact recently materialized), the Board proposes to significantly reduce the enhanced prudential standards that would apply to some of the largest FBOs.

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[34] Release at 61,420.

The disparate treatment of the Category IV firms poses yet another problem. Under the Proposal, the treatment of Category II and III firms is substantially similar, but the standards for Category IV firms are **significantly** weaker than for the other two categories.[35] In a period of economic stress, markets will perceive that there is significantly more information available about the present health of the Category II and III firms than the Category IV firms, and will also know that the Category 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. To avoid this scenario, the Board must significantly strengthen the proposed Category IV standards so that they more closely match the Category II and III standards. Otherwise, the changes may actually precipitate runs when stresses build and investors simply do not have enough confidence in these institutions.

C. The likely impact of the Proposal must be evaluated in light of the broad deregulatory movement now underway.

The Board must consider the impact of the Proposal not only in isolation but also in light of the overall environment that currently prevails, which is decidedly deregulatory. The Proposal is part of a long series of statutory and regulatory measures that will collectively and substantially weaken the framework of reforms adopted in the Dodd-Frank Act, thus increasing the likelihood, proximity, and severity of another devastating financial crisis. For example, the Board, OCC, and FDIC have recently proposed changes to the thresholds for application of certain capital and liquidity requirements to FBOs, using the same three categories of banks set forth in the Proposal.[36] In addition, the Board and the other prudential regulators have previously issued numerous de-regulatory proposals, including proposed changes to the current requirements governing resolution planning,[37] bank capital, capital planning, and stress testing,[38] as well as a proposal to modify the enhanced supplementary leverage ratio—a release deemed so dangerous and unnecessary that the

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35 The weakening of standards for the Category IV banks is even more pronounced when considered in conjunction with the changes in the companion proposal addressing capital and liquidity standards issued by the Board, the FDIC and the 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 Fed. Reg. 17316 (Apr. 19, 2018).

36 Proposed Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements for Certain U.S. Subsidiaries of Foreign Banking Organizations and Application of Liquidity Requirements to Foreign Banking Organizations, Certain U.S. Depository Institution Holding Companies, and Certain Depository Institution Subsidiaries, 84 Fed. Reg. 24,297 (May 24, 2019).

37 Resolution Plans Required, 84 Fed. Reg. 21,600 (May 14, 2019).

38 Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules, 83 Fed. Reg. 18,159 (Apr. 25, 2018). Better Markets also provided details on the dangerous deregulatory environment in its response to this proposal. See Letter from Dennis M. Kelleher, President and CEO, Better Markets (Jun. 25, 2018), https://bettermarkets.com/sites/default/files/Better%20Markets%20CL%20to%20Fed%20-%20Cap%20buffer%20and%20stress%20testing%206-25-18.pdf.

FDIC refused to join in its issuance.[39] And yet additional de-regulatory measures are forthcoming. As the Wall Street Journal has recently reported, "regulators say they are moving as fast as they can on more than 30" deregulatory changes, and they are being spurred in their efforts by the industry and lawmakers with an ambitious deregulatory agenda.[40]

Because the Proposal would operate in conjunction with these other deregulatory initiatives, it would pose a comparatively greater threat to the regulatory framework that helps protect and preserve the stability of our financial system. Just as the benefits of a single new regulation must be evaluated not only in isolation but also in terms of the larger benefits of the entire framework of which it is a part, the threats and risks of a single de-regulatory measure must also be viewed in terms of the overall impact of a collection or series of related deregulatory measures. This deregulatory context intensifies the threat of any single proposal that seeks to unwind, rollback, or dilute the measures that were carefully put in place to prevent and mitigate any future financial crisis.

III. OTHER POLICY CONSIDERATIONS—INCLUDING THE SUCCESS OF THE CURRENT REGULATORY FRAMEWORK AND THE ROBUST STRENGTH OF THE CREDIT MARKETS—WEIGH HEAVILY IN FAVOR OF MAINTAINING OR ENHANCING PRUDENTIAL STANDARDS.

A. The current framework has substantially increased financial stability.

The Release appropriately acknowledges the extraordinary success of the current standards:

> Post-crisis financial regulations have resulted in substantial gains in resiliency for individual firms and for the financial system as a whole. Foreign banking organizations' U.S. operations have become less fragmented and maintain more capital and liquidity in the United States. In addition, the U.S. operations of foreign banking organizations subject to enhanced prudential standards generally have made significant improvements in risk identification and management, data infrastructure, and controls. **These improvements have helped to build a more resilient financial system that is better positioned to provide American consumers, businesses, and communities access to the credit they need, even under challenging economic conditions.**[41]

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39 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 Fed. Reg. 17316 (Apr. 19, 2018).

40 Andrew Ackerman & Gabriel T. Rubin, Rewrite of Bank Rules Advances Slowly, Frustrating Republicans, WALL. ST. J. (June 10, 2019), https://www.wsj.com/articles/rewrite-of-bank-rules-bogs-down-11560159001.

41 Release at 21,990 (emphasis added).

In other words, the Board acknowledges in the Release that the current regime is working exactly as intended by leading to a safer, more resilient financial system that is able to serve the real economy.

Further, the true test of the current regulatory framework will not be complete until our economy has completed a business cycle. In short, in the face of ample evidence of the success of the current standards, and before the conclusion of a full business cycle, any proposal to weaken them without persuasive, credible evidence that such action will not unnecessarily increase the risk and severity of another financial crisis would be an abuse of the Board's discretion under S. 2155.

B. Large financial institutions require no regulatory relief, as banks are thriving and credit markets are robust.

For years, the industry has been crying wolf about the supposed burdens of the Dodd-Frank Act and implementing regulations, continuing a long tradition of baselessly warning that regulation will prohibitively increase costs, stifle markets, and suppress economic growth.[42] This pattern has continued with virtually every rule that has been implemented under the Dodd-Frank Act, which has been met with warnings that the implementation of robust, risk-mitigating rules will be too burdensome for financial firms and ultimately detrimental for American investors and consumers.

However, only in the world of the industry's self-serving claims and those of its allies does the responsible financial regulation mandated by the Dodd-Frank Act spell doom for the financial industry and the consumers and businesses who depend on it. In reality, as the Board notes in the Release, post-crisis financial regulations "have resulted in substantial gains in resiliency for individual firms and for the financial system as a whole."[43] At the same time, Governor Brainard explained in dissenting from the Proposal, currently "large banks have comfortably achieved the required buffers and are providing ample credit to the economy and enjoying **robust profitability**."[44] As the American Banker, a trade publication, concluded, while some have

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42 Marcus Baram, *The Bankers Who Cried Wolf: Wall Street's History Of Hyperbole About* Regulation, HUFFPOST (June 21, 2011), https://www.huffingtonpost.com/2011/06/21/wall-street-history-hyperbole-regulation_n_881775.html.

43 Release at 61,409.

44 Lael Brainard, Member of the Board of Governors of the Federal Reserve, Statement on Proposals to Modify Enhanced Prudential Standards for Large Banking Organizations (Apr. 8, 2019) (emphasis added), https://www.federalreserve.gov/newsevents/pressreleases/3B1F641BEB4A485B994EBC38165F0F3B.htm; see also Renae Merle, Fed Proposes Easing Post-Crisis Rules for Big Banks, WASH. POST (Apr. 8, 2019) (noting criticism of Proposal based on the fact that "the banking industry is already reporting record profits without a rollback of the rules."), https://www.washingtonpost.com/business/2019/04/08/fed-proposes-easing-post-crisis-rules-big-banks/?utm_term=.1ce17bd1861d..

argued that the Dodd-Frank Act has increased the cost of consumer lending and cut off access to credit,

> the available data indicates otherwise. Consumer credit has roared back in the six years since Dodd-Frank, with a 46% jump in outstanding consumer credit to $3.8 trillion. . . . [T]he fact remains that mortgage, auto and credit card lending have all gone up since 2010. [Mortgage] lending standards are as loose as they've been since the downturn. . . . Auto lending has been on a tear since the financial crisis . . . . Credit card lending has returned to pre-crisis levels with total lending hitting an all-time high of $996 billion. . . .[45]

Additional data confirm that these trends have continued.[46] In short, there is widespread agreement that not only is the current robust regulatory regime working exactly as intended for the American public by leading to a safer, more resilient system that is able to serve the real economy, **but it has done so while allowing large banks to turn huge if not historic profits.**

In response to the Proposal, affected industry participants will surely implore the Board to abandon those proposed provisions that would strengthen the current regime and to embrace those proposals that would weaken it along with even more deregulatory changes. The Board should reject these entreaties. The post-Great Depression financial reforms, adopted amidst industry warnings about potentially disastrous consequences, instead accompanied a thriving financial system for decades, much like the current robust regulatory regime has accompanied a sharp upturn in lending activity and the performance of financial companies. Meanwhile, the deregulatory regime that began in the 1980's led to a catastrophic and costly crisis less than a decade after its completion in 2000.

Between robust regulation and weakened regulation, it is clear that the former leads to financial stability and broad economic prosperity while the latter leads to economic devastation, not only for Americans but also for the very banks that seek regulatory relief. In crafting final rules, the Board should trust the facts and discount the industry's complaints and predictions. The wolf that forever lurks beyond the door is not prudential regulation; it is the high risk behavior of the largest Wall Street banks seeking ever higher profits, even if they are ultimately at the expense of the American people.

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45 Kate Berry, Four Myths in the Battle over Dodd-Frank, AMERICAN BANKER (March 10, 2017), https://www.americanbanker.com/news/four-myths-in-the-battle-over-dodd-frank (emphasis added).

46 Rachel Witkowski, Bank Earnings More than Double Thanks to Tax Cut, AMERICAN BANKER (Feb. 21, 2019) (noting that "[b]ank profits remained near historic highs," and that "loan growth continues to be a positive story for banks" with a "4.4% rise in loan balances" amidst improving credit quality and declining charge-offs.), https://www.americanbanker.com/news/bank-earnings-more-than-double-thanks-to-tax-cut.

IV. NO INDUSTRY EVIL REQUIRED; JUST THE SIREN SONG OF COMPETITIVE PRESSURES

Importantly, the sort of excessive risk-taking that can lead to financial crisis, which enhanced prudential standards are intended to rein in, do not require evil actors or motives in the industry. It is the nature of markets and financial firms, individually and collectively to take on risk in pursuit of higher short-term profits. This impulse is especially powerful where the cost of failure is likely to be externalized if, for example, there is an expectation that failing firms will be bailed out by taxpayers. That is the unsettling, but undeniable, truth behind former Citigroup Chief Executive Officer Chuck Prince's infamous and much misunderstood quote in July 2007:

> When the music stops, in terms of liquidity, things will be complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing.[47]

Translation: When a financial institution and its peer group are making lots of money doing roughly the same thing (**meaning**, the market "music" is playing), they have to keep doing the same thing ("dancing") or their revenues, profits, bonuses and stock will go down **relative** to their peer group.

While doing otherwise may be tolerated by a board and stockholders for a short time, it will not last long as revenues, profits, and share prices drop relative to their peers. That is why Mr. Prince was right: "as long as the music is playing, you've got to get up and dance" or you will be replaced with someone who will.

That is the (oversimplified) history of Morgan Stanley in the 2000s. John Mack was CEO until ousted in 2001, when Paul Purcell was appointed CEO. Morgan Stanley then pursued a business diversification strategy, seeking relatively stable revenues and profits from a broad mix of businesses that avoided the high-risk, high leverage and high return trading gambling that was taking off at its rivals. As its revenues, profits, bonuses, and share prices lagged behind its rivals, the board ousted Mr. Purcell and in June 2005, brought back Mr. Mack as CEO, clearly with the mandate to catch up with its rivals by doing what they were doing.

As the Siren Song of deregulatory music played, he got Morgan Stanley up and dancing to the tune of big proprietary trading, structured products, and subprime mortgage activities. However, just a little over two years later in the fall of 2007, Morgan Stanley was forced to begin recognizing gigantic proprietary trading losses at the same time it was forced to take substantial subprime-related write downs, which eventually were cumulatively so crippling that Morgan Stanley was on the verge of failure in the days following Lehman's bankruptcy and required a bailout by the Fed to survive.[48]

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47 See Michiyo Nakamoto and David Wighton, Citigroup chief stays bullish on buy-outs, FIN. TIMES (July 9, 2007), https://www.ft.com/content/80e2987a-2e50-11dc-821c-0000779fd2ac.

48 An internal Board email from September 20, 2008, shows that Morgan Stanley indicated they could not open the following Monday, and that Goldman Sachs, hearing this news, admitted that it was

To his credit, Mr. Mack recognized what had happened and in 2009, embraced financial reform, regulation, and regulators. In fact, he went so far as to say

> **[w]e cannot control ourselves**. You [lawmakers and regulators] have to step in and control the Street. Regulators? We just love them.[49]

This cautionary tale and the broader history before, during, and after the 2008 crash demonstrate why banking regulators and supervisors as well as oversight, regulation, and enforcement generally are so critically important. Put differently, they have to step in and slow the tune if not change the song or stop the "music" altogether, regardless of how much "dancing" the private sector is doing or wants to do.

Without regulators taking such independent and, at times, unpopular actions, the public interest is subordinated and exposed to the erratic and volatile dynamics of the marketplace, with devastating crashes the inevitable result.

<u>CONCLUSION</u>

We hope you find these comments helpful.

Sincerely,

Dennis M. Kelleher
President & CEO

Stephen W. Hall
Legal Director & Securities Specialist

Jason Grimes

"toast" unless it could convert to a bank holding company. Better Markets Press Release, Email Shows Goldman Admitted It Was "Toast" (Sept. 21, 2018), https://bettermarkets.com/newsroom/email-shows-goldman-admitted-it-was-toast.

49 *Regulators? We Just Love 'em, says John Mack*, THE EVENING STANDARD (Nov. 19, 2009), https://www.standard.co.uk/business/regulators-we-just-love-em-says-john-mack-6744822.html (quoting John Mack) ("We cannot control ourselves. You have to step in and control the Street. Regulators? We just love them."); see also Dealbook, *Morgan Stanley's Mack: 'We Cannot Control Ourselves,'* N.Y. TIMES (Nov. 19, 2009) (same), https://dealbook.nytimes.com/2009/11/19/morgan-stanleys-mack-we-cannot-control-ourselves.

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