PUBLIC CITIZEN Protecting Health, Safety and Democracy

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Office of the Comptroller of the Currency
Legislative and Regulatory Activities Division
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Board of Governors of the Federal Reserve System
Ann E. Misback, Secretary
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Federal Deposit Insurance Corporation
Robert E. Feldman, Secretary
Attention: Comments/Legal ESS
550 17th Street, N.W.
Washington, D.C. 20429

Fed Docket Nos. R-1627/ 1628

OCC Docket ID OCC-2018-0037

FDIC RIN 3064-AE96

Dear Officers,

On behalf of more than 500,000 members and supporters of Public Citizen, we offer the following comment on two companion proposals regarding new risk-based categories and associated prudential standards for large U.S. banks. The proposals, jointly issued by the Federal Reserve Board (Board, Fed) the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC), implement Section 401 of S. 2155, formally known as the Economic Growth, Regulatory Relief, and Consumer Protection Act. The proposals also amend certain prudential standards outside the statutory mandate relating to liquidity, risk management, stress testing, single counterparty credit limits, and capital requirements.

Generally we are concerned that the proposal relaxes safeguards beyond what Congress mandated. Of special concern, the agencies propose to relax liquidity requirements.

Overview

Following the financial crisis of 2008, Congress approved the 2010 Dodd-Frank Wall Street Reform and Consumer Protection Act. This included Section 165, which called for greater prudential standards for those banks with more than $50 billion in assets. There are about 39 such banks, out of a total of more than 5,000 in the United States. Even as the agencies adopted rules for these large banks, they tailored these rules based on size. The largest banks face stricter rules than those near $50 billion.

In 2018, Congress approved S. 2155. This law raises the $50 billion threshold for enhanced supervision to $250 billion. Public Citizen opposed this law. We argued that the failure of one or several of the two dozen banks that would face less scrutiny presented a danger to the economy. For example, the largest loss suffered by the Federal Deposit Insurance Fund was IndyMac, which actually held about $30 billion in assets. Ally Financial which now escapes enhanced scrutiny, received more than $16 billion from taxpayers through the Troubled Asset Relief Program (TARP). Zions, which lobbied against stricter rules a year before the financial crisis, would also escape enhanced scrutiny, and it also received bailout funds. Had regulators applied this enhanced supervision of firms in this range in the early 2000s, it might have prevented the reckless mortgage-making of the likes of CountryWide, which held about $200 billion in assets.

Proponents of the legislation offered no substantial justification for these relaxed standards, including no argument that removing these banks from enhanced supervision would contribute to economic growth. We believe reducing supervision, instead, may imperil the banks along with taxpayers who might be called upon to bail them out again. The American public supports strong Wall Street regulation. The financial crash cost millions of Americans their homes, their jobs and their savings. The conservative Cato Institute issued a poll showing bipartisan support for strong regulation.[1] Public Policy Polling surveyed views on S 2155. Sixty four percent opposed the bill, while only 25 percent support it. Asked if reducing oversight of community banks was worth the price of also reducing oversight of banks with up to $250 billion in assets, 67 percent opposed, while only 17 percent supported this trade off.

We understand that the agencies must oblige congressional mandate, despite the weight of American opinion. As we will discuss shortly, however, we believe the agencies have stepped beyond their statutory obligation to relax supervision, a further affront to American interests.

Proposed Rules

In the proposed rules, the agencies classify banks into four new risk categories. Category I banks are those classified now as U.S. GSIBs, or global systemically important banks. This includes the very largest banks, namely JP Morgan, Citigroup, Bank of America, Wells Fargo, Morgan Stanley and Goldman Sachs. Category II are large banks that are not GSIBs, but have at least $700 billion in assets (or consolidated assets of more than $100 billion and more than $75 billion in foreign-based assets). Category III are those that have more than $250 billion in consolidated assets. Category IV are those banks more than $100 billion and are not in the other categories. We do not object to these categories, although the agencies have provided no clear explanation of why these break points are relevant, or why there should be four categories instead of five, or ten. We ask the agencies to provide such a justification before finalizing the rule.

[1] Wall Street V. Regulators, CATO INSTITUTE (September 189, 2017) https://www.cato.org/survey-reports/wall-street-vs-regulators-public-attitudes-banks-financial-regulation-consumer

We agree that size is the clearest indicator of systemic risk, and that enhanced prudential standards should apply as the size of the bank's assets increase. We note that the agencies have responded to congressional supporters of S. 2155 who complained about arbitrary size demarcations, namely the $50 billion level for enhanced supervision, by creating new arbitrary size demarcations.

The Agencies also propose to address specific financial institutions with an additional risk rubric. This rubric consists of size, cross-jurisdictional (foreign) activity, reliance on short-term wholesale funding, nonbank assets, and off-balance sheet exposures. Size is the first and most important indicator, based on the premise that the failure or distress of larger institutions would harm the economy more than the failure smaller ones. Cross-jurisdictional operations is the second most important indicator. A firm with sizeable foreign operations that fails means that more than one national regulatory or bankruptcy regime applies. The interests of the United States may differ than those of another country with issues such as the payment to a financial firm's creditors. The third factor is the financial firm's reliance on short-term, uninsured funding. The financial crisis revealed that many firms relied on overnight credit, such as repurchase agreements, as a daily source of credit. When these firms began to falter, this credit evaporated immediately. In addition, banking organizations that fund long-term assets with short-term liabilities from financial intermediaries may need to rapidly sell less liquid assets to meet withdrawals and maintain their operations in a time of stress. This can lead to fire sales, and depress prices not only at the faltering firm, but across the financial sector. Finally, the agencies will look to the preponderance of non-bank assets. This is a proxy for a bank's complexity. Such activities interconnect the bank with other financial firms, and firms outside the agencies supervisory purview.

We welcome all of these categories for examination. Ideally, banks seeking less oversight will be more judicious about their foreign operations, reliance on short-term funding, and complex investments.

Liquidity

Our most serious concerns regard the proposed reduction in liquidity coverage ratios.

Liquidity refers to the ability sell assets quickly (without the need to discount the price) so as to cover immediate obligations, such as an increase in depositor withdrawals. The financial crisis of 2008 revealed that too many banks lacked both the capital (net worth) to remain solvent, and the liquidity to meet urgent demands from customers. This led the Fed to provide funding across a broad range of firms. Strong liquidity buffers subsequently adopted by regulators were designed to prevent such a bailout in the future.

Under the proposed rule, firms that hold assets between $100 billion and $250 billion in assets, which currently face modest liquidity requirements, would no longer be required to meet the liquidity coverage ratio[2] and the net stable funding ratio[3] Where the liquidity ratio addresses the level of easily sellable assets, the net stable funding ratio addresses the reliability of sources that lend to banks. The Fed estimates that this change would reduce the liquidity buffers at these banks by $34 billion. While we do not support this change, we acknowledge that it reflects the congressional mandate in S. 2155.

But the agencies do not stop at the boundary of this law. Currently, firms with more than $250 billion in assets must maintain liquid assets to cover 30 days of projected cash needs. The agencies propose to

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[2] *Federal Banking Regulators Finalize Liquidity Coverage Ratio,* FEDERAL RESERVE BOARD (Sept. 3, 2014) https://www.federalreserve.gov/newsevents/pressreleases/bcreg20140903a.htm

[3] *Agencies Proposed Net Stable funding Ratio Rule,* FEDERAL RESERVE BOARD, (May 3, 2016) https://www.federalreserve.gov/newsevents/pressreleases/bcreg20160503a.htm

reduce the liquidity coverage ratio to between 70 and 85 percent of the current standard for banks between $250 and $700 billion. This group of banks holds $1.5 trillion in assets. This would reduce liquidity by $43 billion among this class of banks. [4] This expands beyond the congressional mandate, which only addressed banks with less than $250 billion in assets. The agencies claim that they are tailoring the requirements. But these requirements are already tailored for size, complexity and risk profile. The current liquidity ratio was devised after careful analysis. The proposed relaxation includes no economic justification.

There are, in fact, serious risks posed by this relaxation. The institutions in this class suffered significant liquidity stress during the financial crisis. The FDIC and Fed provided funding support along with bailout funds from TARP. From the FDIC alone, this class received more than $125 billion in liquidity support from the FDIC's Temporary Liquidity Guarantee Program alone.[5]

Washington Mutual (WaMu), generally a conservatively run lender, failed for a number of reasons, but the proximate cause involved liquidity. Its mortgages were largely well underwritten; fewer than 20 percent covered houses where the outstanding balance of the mortgage was more than 80 percent of the value of the house. When the secondary market for mortgages collapsed, WaMu was unable to generate cash by selling its mortgages. After Lehman Brothers declared bankruptcy on September 15, 2008, WaMu depositors panicked and began to demand their deposits.[6] With insufficient funds to meet these depositor demands, the firm faced the threat of closure. The FDIC calculated that it would need to advance from its deposit fund $42 billion to meet these customer demands, greater than the balance of the fund itself.[7] In the end, JP Morgan acquired the firm--with government support—exacerbating another problem, namely that banks have become too large to fail and to supervise.

The agencies fail to identify the benefit of reducing the liquidity rules. The Fed notes that the reduction in the liquidity requirement will allow the banks to increase its investments in less liquid assets, which may generate a "modest" increase in revenue. No specific increase is forecast. We believe that the unspecified benefit in the face of a concrete cost does not justify this change. Moreover, bank investment in liquid assets contributes to the economy, such as the purchase of US Treasuries used to finance infrastructure, or corporate bonds that help fund the private sector. The banking sector has not suffered because the liquidity rules. On the contrary, the banking sector has enjoyed escalating and record earnings. In the latest FDIC Quarterly Banking Profile, the sector earned $62 billion, $14 billion or 30 percent more than for the same period in the previous year.[8] Some of this reflected the new corporate tax cut. As Fed Gov. Lael Brainard summarized, this reduction "comes at a time when large banks have comfortably achieved the required buffers and are providing ample credit to the economy and enjoying robust profitability. . . .

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[4] *Proposed Changes to Thresholds for Regulatory Capital and Liquidity Requirements*, FEDERAL REGISTER (Dec. 21, 2018) https://www.govinfo.gov/content/pkg/FR-2018-12-21/pdf/2018-27177.pdf

[5] *Statement by Martin Gruenberg, Meeting of FDIC Board of Directors*, FDIC (Nov. 20, 2018) https://www.fdic.gov/news/news/speeches/spnov2018a.pdf

[6] Kimberly Amadeo, *Washington Mutual and How it Went Bankrupt,* THE BALANCE (Dec. 4, 2018) https://www.thebalance.com/washington-mutual-how-wamu-went-bankrupt-3305620

[7] *Proposed Changes to Thresholds for Regulatory Capital and Liquidity Requirements*, see footnote 27, FEDERAL REGISTER (Dec. 21, 2018) https://www.govinfo.gov/content/pkg/FR-2018-12-21/pdf/2018-27177.pdf

[8] *Quarterly Banking Profile*, FDIC (Third Quarter, 2018) https://www.fdic.gov/bank/analytical/qbp/2018sep/qbp.pdf

[There is] little benefit to the institutions or the system from the proposed reduction in core resilience that could justify the increased risk to financial stability and the taxpayer."[9]

We oppose the reduction in liquidity coverage ratio requirements.

Capital Requirements

The Fed also proposes to permit banks with between $250 billion and $700 billion in assets to ignore rules that require their capital levels to reflect the unrealized losses and gains of certain securities. Capital refers to the value of the firm's assets less the value of its liabilities. Assets may include investments whose values may change, such as from the time they were acquired. In some cases, this value may be higher than the purchase price, in some cases, it may be lower. Leading to the financial crisis, firms claimed to hold assets valued well beyond their true value. When some were forced to sell those assets to meet urgent funding obligations, the reduced sale price revealed a banking sector woefully undercapitalized. This undermined confidence in the banking sector's funders, such as its bondholders and other creditors.

To address this problem, the banking agencies finalized a rule in 2013 to make the nature of capital more transparent. This required inclusion of unrealized gains and losses in an accounting called "accumulated other comprehensive income" (AOCI). This serves as an early alert for problems. Eliminating this rule would end this early alert. Not only would this mean that failures could be precipitous, but creditors may be more concerned about lending to banks, and charge higher interest.

We oppose elimination of the AOCI accounting for this class of banks.

Stress Tests

The agencies also propose to reduce the frequency of stress testing. Regulators use "stress" tests to examine how a bank would perform under certain adverse conditions, such as a decline in employment. Ideally, a bank can remain solvent and liquid in periods of stress, and remain a robust lender to the economy. Without frequent stress tests, the public and market will not have a current outlook of the bank's stability. With infrequent stress tests, banks may take unnecessary risks during the gaps between tests, exacerbating their problems. Good times may lead to over confidence. In the years before the financial crisis, few market observers predicted a precipitous decline. The stress tests represents a discipline to prepare for such declines.[10]

Congress left the frequency of stress tests to the discretion of the agencies in S. 2155. We believe the agencies should maintain frequent stress tests and oppose the proposal to reduce them.

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[9] *Statement of Governor Lael Brainard,* FEDERAL RESERVE BOARD (Oct. 31, 2018) https://www.federalreserve.gov/newsevents/pressreleases/brainard-statement-20181031.htm

[10] Nellie Laing, *Well Designed Stress Test Scenarios are Important for Financial Stability*, BROOKINGS INSTITUTE, https://www.brookings.edu/research/well-designed-stress-test-scenarios-are-important-for-financial-stability/

Conclusion

In addition to specific concerns about liquidity, capital and stress tests, we are concerned with the general deregulatory tenor of this rule as well as the rules that have been forthcoming in the last two years.

While the two rules at issue here may not collapse the regulatory architecture that currently covers a profitable and productive financial sector, the agencies seem to be playing a dangerous game of Jenga. At some point, removal of one of the building blocks may lead to a serious problem. It is instructive that many of these rules do not enjoy the support of key officers, such as FDIC member Martin Gruenberg and Fed Gov. Brainard. Were the agencies simply responding to sober data analysis and congressional mandate, we believe adjustments would win unanimous support.

There will be another financial crisis. The timing may unpredictable. But when investigators look back at the source of that crisis, they will inevitably find that financial firms exploited deregulation. We urge the agencies to maintain strong rules. At a time when the economy is growing, that unemployment is low, that bank profits are setting record, regulators should be looking at strengthening, not weakening Wall Street rules.

For questions, please contact Bartlett Naylor at bnaylor@citizen.org.

Sincerely,

Public Citizen