July 16, 2020

Via Electronic Mail

Chief Counsel's Office
Attention: Comment Processing
Office of the Comptroller of the Currency
400 7th Street,
SW Suite 3E-218
Washington, DC 20219

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

Robert E. Feldman
Executive Secretary
Attention: Comments/RIN 3064—AF44
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

Re: Regulatory Capital Rule: Temporary Exclusion of U.S. Treasury Securities and Deposits at Federal Reserve Banks from the Supplementary Leverage Ratio for Depository Institutions[1]

To Whom It May Concern:

The Bank Policy Institute[2] appreciates the opportunity to comment on the interim final rule (the "IFR") issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation that permits a depository institution to

[1] Regulatory Capital Rule: Temporary Exclusion of U.S. Treasury Securities and Deposits at Federal Reserve Banks from the Supplementary Leverage Ratio for Depository Institutions, 85 Fed. Reg. 32,980 (June 1, 2020) (Docket No. OCC-2020-0013 and RIN 1557-AE85; FRB Docket No. R-1718 and RIN 7100-AF91; FDIC RIN 3064-AF44).

[2] The Bank Policy Institute ("BPI") is a nonpartisan public policy, research and advocacy group, representing the nation's leading banks and their customers. Our members include universal banks, regional banks and the major foreign banks doing business in the United States. Collectively, they employ almost two million Americans, make nearly half of the nation's small business loans, and are an engine for financial innovation and economic growth.

elect to temporarily exclude Treasuries and deposits at Federal Reserve Banks ("reserve balances") from the calculation of the supplementary leverage ratio (the "SLR").[3] Any depository institution that makes this election must receive approval from its primary Federal banking regulator prior to paying dividends or making certain other capital distributions so long as the exclusion is in effect. The IFR departs markedly from the Federal Reserve's recent interim final rule for bank holding companies, which provided *unconditionally* for the temporary exclusions.[4]

I. Executive Summary and Recommendations

We strongly support the agencies' modifications to the SLR to allow banks to better serve their vital function as financial market intermediaries and support lending to U.S. households and businesses, especially during this critical time. However, we believe that the consequence of the dividend prior approval condition is that few banks will "opt-in" because of the resultant unpredictability of dividend capacity and the inability of the banks to plan and anticipate how opting in would affect their ability to pay dividends. The ultimate result will be largely to moot the IFR by failing to provide the encouragement of bank lending and support for the broader economy that the agencies intended to produce.

Accordingly, our key recommendation is that the agencies should follow the unconditional approach of the Federal Reserve interim final rule and adopt the SLR modifications without the dividend prior approval condition. Other laws and regulations create a sufficient framework to achieve the agencies' supervisory objectives, including to restrict dividends that would be contrary to safety and soundness. Moreover, the dividend prior approval condition would frustrate the essential purpose of the IFR, which is to exclude Treasuries and reserve balances from the SLR denominator in order to promote bank lending during the ongoing health and economic crisis and provide support for the economic recovery. (*See* Section II below).

In addition, we offer two other recommendations. First, as the SLR may not be the binding leverage ratio constraint for many firms, the agencies should consider other adjustments that would support the ability of banks to provide credit to the economy and function as financial market intermediaries, and revisit the calibration of all leverage ratios in the longer-term so that leverage ratios appropriately function as a backstop and not as a binding constraint. (*See* Section III below). Second, the agencies should exclude repo-style transactions backed by Treasuries from the final rule to further support Treasury market functioning and banks' roles as intermediaries to support the broader economy. (*See* Section IV below).

II. The agencies should adopt the SLR modifications without the dividend prior approval condition because it is unnecessary to achieve the agencies' supervisory objectives and it would frustrate the essential purpose of the IFR

The agencies should adopt the SLR modifications without the dividend prior approval condition. This condition is unnecessary because there is already an existing body of law and regulation that governs when a bank can pay a dividend. Furthermore, removal of the dividend condition and adoption

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3 The discussion throughout this letter may refer to "depository institution," "insured depository institution," or "bank," as appropriate. *See* 12 U.S.C. § 1831.

4 *See* Temporary Exclusion of U.S. Treasury Securities and Deposits at Federal Reserve Banks From the Supplementary Leverage Ratio, 85 Fed. Reg. 20,578 (Apr. 14, 2020).

of the other changes would bolster banks' ability to continue to lend to U.S. households and businesses in order to support the economic recovery, which banks have been able to do to-date because of the strong capital position with which they entered the current period of stress.[5]

A. The dividend prior approval condition is unnecessary, because there is an existing body of law and regulation that governs and limits when a bank can pay a dividend

The dividend prior approval condition is unnecessary. An existing body of law and regulation already governs when a bank may pay a dividend and provides the agencies with ample authority to restrict dividends that may be contrary to safety and soundness.

Several specific statutory and regulatory provisions already govern when a bank may pay a dividend and when supervisory approval is required.[6] National banks are subject to, under the National Bank Act and related OCC regulations, an earnings test that governs and limits their ability to pay dividends based on their earnings and dividends for the current year and retained earnings from the prior two years.[7] State member banks are made subject to the national bank earnings test by the Federal Reserve Act and implementing regulations.[8] Depending on state law, state nonmember banks may be subject to these or similar tests that govern when they can pay dividends as a matter of state law.

These existing tests are already a meaningful constraint on dividends in a stressed environment such as the one we are currently experiencing. As profits decrease, banks naturally will have less capacity or no capacity to pay dividends as a result of the earnings test (without prior agency approval).[9] In the ordinary course, it is this test that determines the dividend capacity banks and, in the case of a bank that is a subsidiary of a holding company, limits the ability of a bank to up-stream a dividend to its parent.

In addition, historically banks have satisfied their capital buffer requirements in full and therefore are not subject to dividend constraints under the Basel III capital buffer framework. Nevertheless, capital buffers also provide an important constraint on subsidiary banks' ability to make dividend payments to the holding company. Indeed, the entire point of the capital conservation buffer (the "CCB") is to govern when a bank must reduce its dividend and adopt capital conservation measures, including during a period of financial stress.[10] The CCB thus was designed exactly for the type of

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[5] See Federal Reserve Board, Supervision and Regulation Report (May 2020), at 3, https://www.federalreserve.gov/publications/files/202005-supervision-and-regulation-report.pdf.

[6] *See* 12 C.F.R. part 3, subparts H and I; 12 C.F.R. § 5.46; 12 C.F.R. part 5, subpart E; 12 C.F.R. part 6; 12 C.F.R. part 208, subparts A and D; 12 C.F.R. part 303, subpart K and § 303.241; 12 C.F.R. § 324.405. Statutory limits on dividends may apply as well. *See, e.g.,* 12 U.S.C. §§ 56, 59 and 60; 12 U.S.C. §324; and 12 U.S.C. §1828(i)(1).

[7] 12 U.S.C. § 60; 12 C.F.R. § 5.64.

[8] 12 U.S.C. § 324; 12 C.F.R. § 208.5.

[9] *See* Francisco Covas, "A Few Observations on Bank Dividends," BPI (June 18, 2020), https://bpi.com/a-few-observations-on-bank-dividends/.

[10] *See* Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule, 78 Fed. Reg. 62,018, 62,022 (Oct. 11, 2013).

situation banks are facing today and to dictate when banks can pay dividends, including to ensure capital conservation in times of stress.

Similarly, if the agencies are concerned about pressure on subsidiary banks to pay dividends to their parents to fund capital distributions to shareholders of the bank holding company, an additional layer of capital buffers exists at the holding company level that is similarly intended to reduce capital distributions and promote capital conservation, including during periods of financial stress.[11] Capital buffers at the holding company level, including the stress capital buffer set by the Federal Reserve's stress test, serve as an important, additional constraint on the ability of banking organizations to make capital distributions to third-party shareholders.

Lastly, we note important features of the earnings dividend limitations that Congress has established by statute for national banks that are totally absent in the proposal. They are objective and transparent. The *ad hoc* restriction added as a condition for leverage ratio relief, which is entirely subjective, defeats both purposes.

In addition to the statutory and regulatory regimes described above, the agencies have other authorities to take actions with respect to individual banks' practices that pose safety and soundness concerns for a particular institution.[12] Further, there is an entire regime in place—namely the prompt corrective action framework—that governs whether banks can pay dividends based on their capital levels; a bank that is not at least adequately capitalized under the prompt corrective action framework faces automatic restrictions on dividends.[13]

B. The dividend prior approval condition will have unintended consequences and will impede the ability of banks to support the economy

We believe it is important to exclude Treasuries and reserve balances temporarily for a number of reasons in the current economic crisis.[14]

First, reserve balances, which, as a general matter, must be held almost entirely by depository institutions, are much higher now than what was expected when the SLR was calibrated, and reserve balances could rise even further. Higher reserve balances increase leverage capital requirements, which to some extent reduce banks' ability to lend and act as financial intermediaries. Second, imposing excessive capital requirements on banks for holding Treasuries or reserve balances penalizes banks for acquiring safe assets with the deposits that result from the Federal Reserve's balance sheet expansion

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11 *See* 12 C.F.R. § 217.11.

12 *See* International Lending Supervision Act of 1983, 12 U.S.C. § 3901, *et seq.*; *see also* 12 C.F.R. part 3 subpart J; 12 C.F.R. § 263, subpart E; 12 C.F.R. § 324.5. A number of other authorities would enable the agencies to limit dividends, including: (i) the ability of the primary federal supervisor to require a bank to enter into a written agreement with respect to dividends, (ii) the authority the primary federal supervisor has under section 8(b) of the Federal Deposit Insurance Act to issue a cease-and-desist order to prevent a bank from taking any action the agency determines to be unsafe or unsound, *see* 12 U.S.C. § 1818(b), (iii) the ability of the primary federal supervisor under the applicable safety-and-soundness regulations to require a bank to submit a safety-and-soundness plan, which presumably could include dividend limits, *see* 12 C.F.R. parts 30, 263 and 308, and (iv) the reservations of authority under the regulatory capital rules *see* 12 C.F.R. § 3.1(d), 12 C.F.R. § 217.1(d), 12 C.F.R. § 324.1(d).

13 12 U.S.C. § 1831o; *see also* 12 C.F.R. part 6; 12 C.F.R. part 208, subpart D; 12 C.F.R. part 303, subpart K; 12 C.F.R. part 324, subpart H.

14 These same reasons, as we have argued previously, also support a permanent exclusion for Treasuries and reserve balances from leverage ratios.

and ultimately results in increased costs to end users (e.g., Treasury holders who want to sell Treasuries to bank intermediaries as occurred in mid-March when the Federal Reserve needed to purchase significant volumes of Treasuries to keep these generally liquid markets functioning).

Without refinements to leverage capital requirements such as the SLR, the expansion of the Federal Reserve's balance sheet reduced the lending capacity of depository institutions to some extent, because leverage capital must be used to support the increase in reserve balances, rather than loans and other economically productive assets.

C. Holding cash and Treasuries should not result in a restriction on the ability of a depository institution to pay a dividend

Holding Treasuries and reserve balances makes a bank safer by making its assets more liquid, and banks generally are holding increased quantities of such assets to support financial intermediation during a health and economic crisis. For example, Covas and Nelson (2016) show that, holding constant a bank's risk-weighted capital ratio, a bank with a larger share of its portfolio invested in non-risky assets and therefore a *lower* leverage ratio was less likely, not more likely, to fail during the 2007-09 financial crisis.[15] This in an additional reason why we believe the dividend prior approval condition is unnecessary.

D. The dividend prior approval condition creates uncertainty that should be avoided

The dividend prior approval condition also includes a highly discretionary and generalized standard that could allow objection on any basis and without procedural protections for affected firms.[16] Moreover, the approval process could be prolonged and the outcome uncertain, hindering planning on multiple levels. It is for these reasons that we believe the IFR, as initially released, will be unable to achieve its objectives; the dividend prior approval condition discourages banks from opting in, which limits the potential benefits of the SLR modifications for the broader economy. The dividend prior approval condition should and can safely be removed so the IFR can achieve its important objective of encouraging banks to provide credit to households and businesses and to continue to support the economic recovery during this period of stress due to the coronavirus event.

III. As the SLR may not be the binding leverage ratio constraint for many firms, the agencies should consider other adjustments that would support banks providing credit to the economy and revisit the calibration of all leverage ratios in the longer-term so that leverage ratios appropriately function as a backstop and not as a binding constraint

Comparable adjustments to the tier 1 leverage requirement (without a dividend prior approval condition) would foster banks providing credit to the economy during this period of stress and support the economic recovery for the same reasons described above with respect to the SLR. More broadly, at the appropriate time, we would ask the agencies to revisit the calibration of capital rules establishing all leverage ratios (both the SLR and tier 1 leverage ratio) to provide permanent adjustments so that

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15 *See* Francisco Covas & Bill Nelson, The Clearing House, Shortcomings of the Leverage Ratio 5 (2016), https://bpi.com/wp-content/uploads/2018/07/shortcomings-1.pdf.

16 The IFR provides that when evaluating a dividend approval request, the primary Federal banking regulator "will consider all relevant factors, including whether the distribution would be contrary to the safety and soundness" of the bank. *See* 85 Fed. Reg. 32,980, 32,989-90.

leverage ratios appropriately function as a backstop and not the binding constraint, including during periods of economic stress. As the agencies have acknowledged, leverage ratios should serve as a backstop to risk-based capital measures and not as a binding capital constraint.

IV. The agencies should exclude repo-style transactions backed by Treasuries from the final rule to further support Treasury market functioning and banks' roles as intermediaries to support the broader economy

The IFR explains that depository institutions would be able to exclude temporarily on-balance-sheet Treasuries that they hold, including Treasuries that they have borrowed and re-pledged in a repo-style transaction, provided such Treasuries are included in the depository institution's total leverage exposure prior to the effect of the exclusion. We support this exclusion and believe any exposure from repo-style transactions backed by Treasuries should likewise be excluded from the SLR to further support Treasury market functioning and support banks' role as financial intermediaries consistent with the intent of the IFR.

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The Bank Policy Institute appreciates the opportunity to provide these comments and would welcome the opportunity to discuss them further with you. If you have any questions, please contact the undersigned by phone 202.589.2533 at or by email at Anna.Harrington@bpi.com.

Respectfully submitted,

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