Center for American Progress

1333 H Street, NW, 10th Floor
Washington, DC 20005
Tel: 202 682.1611 • Fax: 202 682.1867

www.americanprogress.org

January 22, 2019

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

Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street, SW
Washington, DC 20219

**RIN: 7100-AF20; 7100-AF21; 1557-AE56; 3064-AE96**

**Docket Nos.: R-1627; OCC-2018-0037; R-1628**

RE: Proposed changes to applicability thresholds for regulatory capital and liquidity requirements; and prudential standards for large Bank Holding Companies and Savings and Loan Holding Companies

Dear Sirs/Madams:

The Center for American Progress ("CAP") welcomes the opportunity to comment on the proposed changes to applicability thresholds for regulatory capital and liquidity requirements and prudential standards for large Bank Holding Companies ("BHCs") and Savings and Loan Holding Companies ("SLHCs").[1] CAP is an independent nonpartisan policy institute that is dedicated to improving the lives of all Americans, through bold, progressive ideas, as well as strong leadership and concerted action.

The proposed rules would substantially weaken certain safeguards put in place following the 2007-2008 financial crisis for many of the largest banks in the country. The class of U.S. banks

[1] This comment letter was adapted from: Gregg Gelzinis, "Danger lurks in latest deregulatory push," *American Banker*, November 13, 2018, available at https://www.americanbanker.com/opinion/danger-lurks-in-latest-deregulatory-push.

impacted by the various regulatory rollbacks included in the proposed rules—those with between $100 billion and $700 billion in assets—collectively hold almost $3 trillion in assets.[2] This class of firms is systemic. The failure of one or many, especially during a period of broader stress in the financial system, could threaten financial stability and trigger or aggravate a financial crisis. To underscore this point, during the crisis they collectively received nearly $60 billion in Troubled Asset Relief Program ("TARP") bailout funds.[3] It is important to keep in mind that these are not community banks. The failure of one of these institutions would represent one of the largest bank failures in U.S. history. Out of the 5,700 banks in the U.S., only eight banks are considered more systemically important than the class of banks impacted by the regulatory rollbacks in this rule.

Some elements of the proposal implement provisions of S.2155, the financial deregulation bill signed into law by President Trump earlier this year, while others go even further.[4] The changes to stress testing, capital requirements, and liquidity rules would reduce the banking sector's ability to withstand bouts of stress in the financial system, elevate the possibility of debilitating bank runs, and increase the chances of another financial meltdown.

Regulators should finalize a rule that applies enhanced prudential standards to SLHCs, but removes the proposed rollbacks of capital requirements, liquidity rules, and stress testing. Regulators must consider ways to strengthen, not weaken, big bank safeguards.

**Liquidity Requirements**

The financial crisis demonstrated the need for robust bank liquidity requirements.[5] Buffers of liquid assets, which can be easily turned into cash, are crucial for mitigating the potential fire-sale risks posed when creditors head for the doors. If banks don't have adequate liquid assets to meet their cash and collateral demands during a period of stress, they have to resort to damaging fire-sales of illiquid assets like loans and certain securities. Fire-sales at these banks would transmit stress to other financial institutions with similar assets, increase costs in funding markets, and threaten the solvency of the bank itself. Moreover, creditors are more likely to pull their cash and run in the first place when they think a bank might not have the liquid assets necessary to pay them back. During the crisis, banks used far too much short-term debt, e.g. repurchase agreements and commercial paper, to fund the longer-term and less-liquid assets on (and off) their balance sheets. This was a particularly acute problem at the largest investment

---

[2] National Information Center, "Holding Companies with Assets Greater Than $10 Billion," available at https://www.ffiec.gov/nicpubweb/nicweb/HCSGreaterThan10B.aspx.
[3] ProPublica, "Bailout Recipients," available at https://projects.propublica.org/bailout/list/index.
[4] *Economic Growth, Regulatory Relief, and Consumer Protection Act*, S. 2155, 115 Cong., 2 sess. (Government Printing Office, 2018), available at https://www.congress.gov/bill/115th-congress/senate-bill/2155.
[5] Daniel K. Tarullo, "Liquidity Regulation," Board of Governors of the Federal Reserve System, November 20, 2014, available at https://www.federalreserve.gov/newsevents/speech/tarullo20141120a%20.htm.

banks, including Lehman Brothers, Merrill Lynch, and Bear Stearns, but also applied to flighty uninsured deposits and other short-term debt instruments at commercial banks.[6]

Today, large banks are subjected to new liquidity rules and have significantly improved their liquidity positions compared to the pre-crisis era.[7] The two key liquidity requirements developed following the crisis are the liquidity coverage ratio ("LCR"), which has been finalized, and the net stable funding ratio ("NSFR"), which has yet to be finalized. The LCR requires banks to maintain a buffer of high-quality liquid assets to meet 30 days of cash outflows during a period of stress. The full 30-day LCR applies to banks with more than $250 billion in assets or $10 billion in on-balance sheet foreign exposure, while a less stringent version requiring a 21-day buffer applies to banks with $100 billion to $250 billion in assets.[8] The NSFR takes a longer view and requires banks to better align their funding profile with the liquidity of their assets. The more illiquid a bank's assets, the more stable funding is required. Like the LCR, the NSFR requirement, as proposed, tailors the requirement. The full NSFR would apply to banks with more than $250 billion in assets or $10 billion in on-balance foreign exposure, while a less stringent requirement would apply to banks with $100 billion to $250 billion in assets.

The most concerning element of the proposal would lower these liquidity requirements for banks with between $100 billion and $700 billion in assets. Banks with between $100 billion and $250 billion in assets would no longer face the modified LCR[9] and, once finalized, the modified NSFR.[10] The Fed estimates that this change would reduce the liquidity buffers at these banks by $34 billion. This change implements part of the unwise rollbacks in S.2155. But unlike S.2155, regulators didn't stop there. They also proposed a 15%-30% reduction in the LCR and NSFR requirements for banks with between $250 billion and $700 billion in assets.[11] This would reduce their liquidity buffers by an estimated $43 billion.

Fed Vice Chairman for Supervision Quarles argues that the proposed liquidity changes would only reduce buffers of high-quality liquid assets by 2%-2.5%.[12] This statistic does not tell the

[6] Jonathan D. Rose, "Old-fashioned deposit runs" (Washington, D.C.: Finance and Economics Discussion Series, Board of Governors of the Federal Reserve System, 2015), available at https://www.federalreserve.gov/econresdata/feds/2015/files/2015111pap.pdf.
[7] Janet Yellen, "Keynote address from Janet Yellen on the tenth anniversary of the financial crisis," Brookings Institution, November 19, 2018, available at https://www.brookings.edu/research/keynote-address-from-janet-yellen-on-the-tenth-anniversary-of-the-financial-crisis/.
[8] The prior enhanced prudential standards asset threshold under Dodd-Frank was $50 billion. S.2155 moved that threshold up to $250 billion and gave the Fed the authority to reapply enhanced prudential standards to banks with between $100 billion and $250 billion in assets.
[9] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, "Federal banking regulators finalize liquidity coverage ratio," Press Release, September 3, 2014, available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20140903a.htm.
[10] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, "Agencies propose net stable funding ratio rule," Press Release, May 3, 2016, available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20160503a.htm.
[11] Banks that meet the $75 billion in cross-jurisdictional activity threshold would still face the full LCR and NSFR.
[12] Randal K. Quarles, "Statement on Proposals to Modify Enhanced Prudential Standards for Large Banking Organizations by Vice Chairman for Supervision Randal K. Quarles," Board of Governors of the Federal Reserve

whole story. Vice Chairman Quarles is referring to the reduction of high-quality liquid assets across all firms subject to stress testing, currently those above $100 billion in assets. Importantly, this figure includes G-SIBs, which are not impacted by the proposal. Analyzing the aggregate reduction in liquid asset buffers across all large banks ignores the acute depletion at banks with $100 billion to $700 billion in assets. Cutting the liquidity requirements at all large banks uniformly by 2%-2.5%, while still unwise, would have a very different impact compared to this proposal's targeted 15%-30% reduction among banks with $100 billion to $700 billion in assets. The large dilution of the liquidity requirements at these firms significantly increase their chance of failure during a period of stress in the financial system. If one or multiple of these interconnected firms failed, it would place a serious strain on the banking system—including at the G-SIBs not directly impacted by this rule.

**Accumulated Other Comprehensive Income ("AOCI") opt-out**

The proposed rule would also allow banks with between $250 billion and $700 billion in assets to opt-out of a requirement that ensures their capital levels reflect the unrealized losses and gains of certain securities, including available-for-sale debt portfolios.[13] This requirement stems directly from lessons learned during the financial crisis, when bank capital levels did not necessarily reflect the mark-to-market losses banks experienced on their available-for-sale portfolios.[14] This capital accounting treatment painted an unrealistically rosy picture of banks' loss absorbing capacity. Regulators estimate that this change would make the capital positions at these banks look $5 billion better, without actually improving their capacity to absorb losses. As interest rates continue to rise, and the fair value of debt securities in the available-for-sale portfolio decreases, the $5 billion figure will also rise. Moreover, during a period of instability in the financial system similar to 2007-2008, it is clear the impact on reported capital would be significantly higher than the current $5 billion impact presented by regulators. This is certainly not the right statistic to use when evaluating this proposal and clearly regulators are rejecting some of the lessons learned during the crisis. At the very least, regulators should provide the public with the projected impact of this change on the reported capital ratios of these banks under a severely adverse scenario.

The AOCI opt-out is simply another data point in a concerning trend towards weaker big bank capital requirements over the past two years. Other proposed rules advanced by regulators would significantly reduce G-SIB leverage requirements[15] and would weaken the assumptions used in the stress tests[16], leading to a net reduction in capital at the largest banks in the country.

---

System, October 31, 2018, available at https://www.federalreserve.gov/newsevents/pressreleases/quarles-opening-statement-20181031.htm.

[13] Banks that meet the $75 billion in cross-jurisdictional activity threshold would not be allowed to opt-out.

[14] Lael Brainard, "Statement on Proposals to Modify Enhanced Prudential Standards for Large Banking Organizations by Governor Lael Brainard," Board of Governors of the Federal Reserve System, October 31, 2018, available at https://www.federalreserve.gov/newsevents/pressreleases/brainard-statement-20181031.htm.

[15] Board of Governors of the Federal Reserve System, "Rule proposed to tailor 'enhanced supplementary leverage ratio' requirements," Press Release, April 11, 2018, available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180411a.htm.

[16] Board of Governors of the Federal Reserve System, "Federal Reserve Board seeks comment on proposal to simplify its capital rules for large banks while preserving strong capital levels that would maintain their ability to

These efforts to water down the loss-absorbing equity buffers at big banks come at a time when regulators should be increasing capital requirements. Significant research shows that capital requirements are at or below the bottom of the socially optimal range and the costs of having too little capital are substantially higher than the costs associated with too much capital.[17] Beyond this line of research, the economy's position in the business cycle warrants an increase in capital. As highlighted by the Fed's recently released financial stability report, nonfinancial sector leverage is near its 20-year high, credit quality has deteriorated, and valuations across many asset classes are stretched.[18] In the 9th year of the post-crisis economic expansion, risks are developing under the surface. Now is the time to act in a prudent, countercyclical manner by tightening bank capital requirements and other safeguards. Loosening them, as envisioned in these proposed rules, would be dangerously procyclical.

**Stress Testing**

In addition, the proposal would implement another provision in S.2155 by reducing the frequency of stress tests for banks with between $100 billion and $250 billion in assets from annually to every other year. The stress testing regime, which helps determine whether banks have enough equity capital to absorb losses during a severe economic downturn, has proved to be a powerful regulatory tool over the past decade. Earlier this year, the Fed set forth a concerning proposal that would loosen certain assumptions used in the stress tests.[19] The Fed's proposal would reduce the number of quarters of required prefunded dividends and remove the assumption that a bank's balance sheet increases, instead holding it constant. Those adjustments, if finalized, would lower the required capital buffers for banks of this size. Further eroding the stress testing regime for these banks by reducing the frequency is a mistake. When analyzing this decrease in bank oversight, and other changes in the proposal, it's important to remember that these are not small community banks. They are among the top 25 largest U.S. banks, out of more than 5,700 in the country, and the failure of one of them would constitute one of the largest bank failures in U.S. history.

Stress tests help provide creditors and the broader public a sense of confidence in the stability of the banking system. If the banking system experienced turmoil in a year that these banks were not stress tested, creditors and the public may feel that they don't have an up-to-date picture of the banks' health. If a bank of this size, like Countrywide, was stress tested in 2006, would creditors have trusted those results a year and a half later? This could exacerbate a panic and lead to more flighty creditors, stressing the liquidity positions of these banks. For this reason,

---

lend under stressful conditions," Press Release, April 10, 2018, available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180410a.htm/.

[17] See for example, "Simon Firestone, Amy Lorenc, and Ben Ranish, "An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the US" (Washington: Board of Governors of the Federal Reserve System, 2017), available at https://www.federalreserve.gov/econres/feds/files/2017034pap.pdf.

[18] Board of Governors of the Federal Reserve System, "Financial Stability Report" (Washington, D.C.: 2018), available at https://www.federalreserve.gov/publications/files/financial-stability-report-201811.pdf/.

[19] Board of Governors of the Federal Reserve System, "Federal Reserve Board seeks comment on proposal to simplify its capital rules for large banks while preserving strong capital levels that would maintain their ability to lend under stressful conditions," Press Release, April 10, 2018, available at https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180410a.htm.

the changes to stress testing frequency for these banks could compound the risk of the liquidity changes in this proposal.

Another problem with this change is that bank capital requirements will be determined, in part, through the stress tests as implemented by the stress capital buffer proposal.[20] Outdated projected loss figures would lead to stress capital buffer requirements that don't adequately reflect the current potential vulnerabilities of the bank's balance sheet in years without stress tests. Banks may also use this to their advantage by increasing their risk-taking during years in which they aren't stress tested.

The Fed has the authority to continue annual stress testing for these firms, as S.2155 calls for these firms to be stress tested "periodically".

In addition, firms with $100 billion to $250 billion in assets would no longer engage in company-run stress testing if this proposal is finalized. Distinct from the supervisory stress tests, the tests performed by companies themselves—using scenarios provided by regulators—have improved the internal risk management capabilities of large banks. Prior to the passage of S.2155, banks above $10 billion in assets were subject to this requirement. S.2155 raised the asset threshold 25x to $250 billion but gave the Fed authority to reapply this standard to banks above $100 billion in assets. The Fed imprudently has not exercised this authority and the proposal keeps the $250 billion threshold for company-run stress testing in place.[21]

**Regulatory Categories**

The proposal would create a new four-tier framework for applying certain prudential regulations to banks and SLHCs of different sizes and risk profiles. Category I includes firms that qualify as U.S. G-SIBs; Category II includes firms with more than $700 billion in assets or more than $75 billion in cross-jurisdictional activity; Category III includes firms with more than $250 billion in assets or that trigger certain nonbank asset, wholesale funding, or off-balance sheet exposure thresholds; and Category IV includes firms with between $100 billion and $250 billion in assets. These new categories would replace the current three-tier framework for banks above $100 billion in assets.[22]

Setting aside the prudent decision to integrate SLHCs, the four new categories do not meaningfully change the different regulatory groupings of banks compared to the current three-tier structure. In essence, only two banks are located in a different grouping than they are today.[23] Category IV banks are the same as the current $100 billion - $250 billion in assets tier, with one addition; Category III banks are the equivalent of advanced approaches firms that do

[20] Ibid.
[21] Currently, no banks would trigger the Category III non-asset thresholds.
[22] Today, banks above $100 billion are generally grouped into 3 tiers for regulatory purposes: (i) G-SIBs, (ii) $250 billion+ in assets or $10bn+ in on-balance sheet foreign exposure, and (iii) banks with $100 billion - $250 billion in assets.
[23] Northern Trust is now in a category of its own (Category II) and American Express (Category IV) is no longer in a tier with "advanced approaches" firms.

not qualify as G-SIBs, with two subtractions; Category II is occupied by only one bank, which is currently an advanced approaches bank that does not qualify as a G-SIB; and Category I consists of G-SIBs. To underscore how little the proposed categories change the current regulatory tiers, only one bank is in a different tier than would be dictated by its asset size. That is to say the proposed non-asset metrics, while receiving much rhetorical attention, are only triggered by one bank. Ironically, that is one fewer bank than currently triggers the on-balance sheet foreign exposure metric used to complement asset-size thresholds under the existing three-tier framework. For all of the misguided rhetoric opposing asset-size thresholds, it is more predictive of regulatory tier under the proposal than it is under today's framework.

The proposed categories are less important than the stringency of regulation that applies to banks within the categories. Regulators may not have meaningfully changed the groupings of banks, but as this comment letter outlines, regulators did roll back many important post-crisis rules that apply to banks in certain categories.

**Conclusion**

The Fed should finalize a rule that applies enhanced prudential standards to SLHCs and rescind the proposed rules' provisions that weaken capital requirements, liquidity rules, and stress testing. Unfortunately, regulators are unlikely to do so and have made it clear that more deregulatory rules are on the way. The Fed announced that new rules for large foreign banks and for living wills requirements will be proposed in the near future.[24]

It's important consider the cumulative impact of these and other financial rollbacks. Regulators have already proposed to lower big bank leverage requirements[25], weaken the Volcker Rule[26], loosen certain stress testing assumptions, and have released all systemically important nonbanks from enhanced oversight.[27] To make matters worse, risks are currently building in the financial system as the economy moves towards the end of the economic cycle.[28] Policymakers should be issuing proposals that build on the progress of financial reform.[29] Instead, workers, families,

---

[24] Randal K. Quarles, "Notices of proposed rulemaking to tailor prudential standards," Memorandum, October 24, 2018, available at https://www.federalreserve.gov/aboutthefed/boardmeetings/files/board-memo-20181031.pdf.
[25] Gregg Gelzinis, "This is not the time to loosen rules on bank capital," *MarketWatch*, May 2, 2018, available at https://www.marketwatch.com/story/this-is-not-the-time-to-loosen-rules-on-bank-capital-2018-05-02.
[26] Gregg Gelzinis, "Hollowing out the Volcker Rule" (Washington, D.C.: Center for American Progress, 2018), available at https://www.americanprogress.org/issues/economy/reports/2018/10/03/458638/hollowing-volcker-rule/.
[27] Gregg Gelzinis, "CAP Statement on FSOC's Vote to Deregulate Prudential Financial: Decision 'Decreases the Resiliency of the U.S. Financial System'" *Press Release*, October 17, 2018, available at https://www.americanprogress.org/press/statement/2018/10/17/452160/statement-cap-statement-fsocs-vote-deregulate-prudential-financial-decision-decreases-resiliency-u-s-financial-system/.
[28] Gregg Gelzinis, "It's time for the Fed to activate safeguards against financial bubbles," *MarketWatch,* August 2, 2018, available at https://www.marketwatch.com/story/its-time-for-the-fed-to-activate-safeguards-against-financial-bubbles-2018-07-31.
[29] Gregg Gelzinis, Andy Green, and Marc Jarsulic, "Resisting Financial Deregulation" (Washington, D.C.: Center for American Progress, 2017), available at https://www.americanprogress.org/issues/economy/reports/2017/12/04/443611/resisting-financial-deregulation/.

savers, and taxpayers will bear the burden of policymakers' decision to move in the opposite direction.

Sincerely,

[redacted]

Gregg Gelzinis
Research Associate
Center for American Progress