Americans for Financial Reform Education Fund

January 22, 2019

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Docket ID OCC-2018-0037 (OCC); Docket No. R-1628 (Federal Reserve); RIN 3064-AE96 (FDIC)

Docket No. R-1627. RIN 7100-AF20 (Federal Reserve)

RE: Proposed Changes to Applicability Thresholds for Regulatory Capital and Liquidity Requirements. Prudential Standards for Large Bank Holding Companies and Savings and Loan Holding Companies.

To Whom It May Concern:

Americans for Financial Reform Education Fund (AFR) appreciates the opportunity to comment on the above referenced proposed rules by the Board of Governors of the Federal Reserve (the Board), the Office of the Comptroller of the Currency, and the Securities and Exchange Commission (collectively, the Agencies). AFR is a coalition of more than 200 national, state, and local groups who have come together to advocate for reform of the financial industry. Members of AFR include consumer, civil rights, investor, retiree, community, labor, faith based, and business groups.[1]

One of the many reasons AFR opposed the Economic Growth, Regulatory Relief, and Consumer Protection Act (hereafter, S.2155) was that the legislation inappropriately and unjustifiably increased the mandatory threshold for implementation of enhanced prudential standards to large banking institutions.[2] However, S 2155 continues to permit substantial discretion to the Federal Reserve and other banking regulators to maintain appropriate standards at large banks. Unfortunately, after reviewing the two complementary proposals referenced above, we agree with Governor Brainard's assessment that, when proposing these rules, the Agencies went

[1] A list of coalition members is available at: http://ourfinancialsecurity.org/about/our-coalition/
[2] Americans for Financial Reform, Letter to U.S. Senate regarding S.2155, March 5, 2017. Available at https://bit.ly/2p3O2YX.

beyond the statutory mandate in S.2155 to weaken important regulatory requirements and supervisory tools at some of the largest banks in the United States.[3]

Under this proposal, the fifteen domestic banks that fall in categories III and IV, ranging from $100 to $700 billion in total assets, would be subject to weaker prudential standards relating to regulatory capital, liquidity management, stress testing, countercyclical buffers, and counterparty risk—requirements that have become international standards since the last crisis. Combined, the banks affected by the proposals hold over $3 trillion in assets.

Beyond the specific proposals to weaken prudential standards in these proposals, elements of the Federal Reserve proposal also signal the intent of regulators to base differentiation in regulatory standards on risk factors than differ significantly from size thresholds. We are concerned that such changes will make it easier for banks to arbitrage their exposure to different prudential rules, and will make the application of such rules less transparent to the public.

The size categories laid out in the rule imply that regulators will permit banks to grow as large as $700 billion while following rules significantly less strict than those that apply to G-SIBs. The proposal also implies that banks could grow in excess of $700 without becoming eligible for the most stringent prudential standards. As discussed below, we believe that size is the single best indicator of the economic importance of a bank and that the complexity metrics used in the Proposed Rule risk unjustifiably lowering prudential standards for extremely large banks.

Finally, as we evaluate these proposed rules in the context of recent proposals by the Agencies, as well as announced future proposals such as new rules governing foreign banking organization, it becomes increasingly clear that the Agencies have embarked on a deregulatory approach that goes beyond the claims of a simple refinement of regulations or a "recalibration without relaxation," as Vice Chair Quarles reportedly described it.[4] [5] It instead appears that the Agencies are engaged in an across-the-board weakening of important aspects of the post-crisis regulatory framework that has supported the second-longest economic expansion on record.[6]

Such an across-the-board weakening of regulatory standards does not appear justified by macro-economic arguments. Under post-crisis capital, liquidity, and stress testing requirements the banking sector has supported the economic expansion and job growth with ample credit availability, including loan growth that exceeds long-term averages. At the same time, banks have also enjoyed prosperity with record profits 63 percent above their pre-crisis high.[7]

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[3] Brainard statement https://bit.ly/2QQ6kIU

[4] https://www.ft.com/content/8ba206f4-f4c0-11e8-ae55-df4bf40f9d0d and here

[5] As Sheila Blair and Gaurav Vasisht put it, "In recent months, regulators have proposed to reduce liquidity buffers of banks with as much as $700 billion in assets, dilute the strength and frequency of stress tests, water down the Volcker Rule prohibition on risky trading and cut leverage capital requirements for corporate derivatives exposures. Pressed by lobbyists and others, regulators are now contemplating a further weakening of the surcharge on the eight systemically important banks." Sheila C. Bair and Gaurav Vasisht, "The Shutdown Isn't the Only Threat to the Economy," *The New York Times*, January 10, 2019. Available at: https://nyti.ms/2FkzsGH.

[6] https://www.nber.org/cycles.html

[7] Source: FDIC Quarterly Banking Profile https://www.fdic.gov/bank/analytical/qbp/

The easing of regulation contemplated here and in other areas such as the eSLR, stress testing, and Volcker Rule proposals seems particularly ill suited to this point in the economic cycle. In 2018, the Federal Open Market Committee continued its policy of "normalization," and increased the fed funds rate target in four occasions[8] [9] while continuing to unwind its balance sheet.[10] The pro-cyclical deregulation contemplated in these proposals would be moving in the opposite direction. As note in the interagency proposal, the potential impact of the proposed rules would: "lower capital requirements … by approximately $8 billion, or 60 basis points of total risk-weighted capital;"[11] "reduce the liquidity buffers held at affected holding companies;"[12] and "[modestly increase] the likelihood of experiencing material financial distress during a period of elevated economic stress or market volatility."[13] It is unclear why these additional risks would need to be taken.

Since the financial crisis, the banking sector and the financial system have built greater loss absorbency, with no evidence of a negative impact on either bank lending, job creation, or economic growth. These enhanced prudential standards may seem redundant in good economic times, but as Governor Brainard recently noted, "If we learned anything from [the last financial crisis] is that we must be especially vigilant to safeguard the resilience of our financial system in good times when vulnerabilities may be building."[14]

Below, we provide more detailed comments on the two proposals in question.

JOINT AGENCY PROPOSAL: Applicability Thresholds for Regulatory Capital and Liquidity

Scoping Criteria:

Question 1: The agencies invite comment on the advantages and disadvantages of assigning a category of standards to a subsidiary depository institution based on the category assigned to its top-tier parent holding company.

We oppose separating the category designation for a subsidiary depository institution from the designation of its top-tier holding company. Categories should be assigned based on the aggregate consolidated activities of the entire banking institution. Separating designation of a subsidiary institution from the consolidated group as a whole assumes that risk will not be transferred between entities within a holding company. This assumption did not hold true during the financial crisis and we do not believe it will hold true during future periods of financial stress given the state of current financial regulatory safeguards.

[8] https://www.federalreserve.gov/monetarypolicy/policy-normalization.htm
[9] https://www.federalreserve.gov/monetarypolicy/openmarket.htm
[10]https://www.cnbc.com/2018/12/19/fed-chief-powell-says-he-doesnt-see-the-fed-changing-its-strategy-for-shrinking-the-balance-sheet.html
[11] Interagency proposal, at 66038.
[12] Ibid. at 66039.
[13] Ibid. footnote 63.
[14] https://www.federalreserve.gov/newsevents/speech/brainard20181207a.htm

Question 3: The agencies invite comment on the advantages and disadvantages of using size thresholds to tailor capital and liquidity requirements.

We believe that asset size is the single clearest and most important element of bank significance to the financial system and the broader economy. (This is especially true when off balance sheet assets are incorporated into bank size metrics, as occurs with the Supplementary Leverage Ratio). The paper by Amy Lorenc and Frank Zhang cited in Footnote 24 of the Proposal clearly demonstrates that financial distress at larger banks is far more correlated with macroeconomic outcomes than stress at smaller banks. This accords with common sense. Each dollar of bank assets represents a dollar of credit extended to the economy that may be withdrawn or go unsupported if a bank becomes distressed. Furthermore, bank size is directly related to the difficulty of resolving a failing bank, and Deposit Insurance exposure during such resolutions. Regulators are often forced to resolve large banks through the acquisition of the distressed bank by a still larger bank, a method that contributes to financial contagion and concentration of market power in the financial system.

Bank asset size is also less susceptible to manipulation than other types of metrics used to measure bank risk to the economy. The major means of manipulating or concealing bank size is through off balance sheet exposures or commitments, but regulators and accountants have developed reasonably effective indicators for such exposures. In contrast, other measures designed to assess complexity can often be shifted by changing bank business models or through financial engineering.

An issue that is frequently raised in relation to bank size are "threshold effects". Due to changes in prudential requirements at specific size thresholds, banks may be discouraged from expanding beyond a certain size. However, especially for multi-hundred billion dollar banks it is far from clear that such threshold effects should be a matter of concern to regulators. There is evidence that declining returns to scale set in as banks reach significant size levels.[15] Further, allowing banks to grow to very large sizes likely has negative effects on market competition and incentives. Should banks cease expansion at a large size threshold, then other smaller banking organizations can grow to take advantage of these credit intermediation opportunities.

We would thus strongly encourage the Agencies to emphasize size in setting applicability thresholds for prudential requirements. We are concerned that the size thresholds used in the Proposed Rule imply that regulators would permit banks to grow to $700 billion or even larger without imposing the highest levels of prudential oversight.

[15] Minton, Bernadette and Stulz, René and Taboada, Alvaro G., Are the Largest Banks Valued More Highly? (July 12, 2018). Fisher College of Business Working Paper No. 2018-03-012. Available at SSRN: https://ssrn.com/abstract=3213623 or http://dx.doi.org/10.2139/ssrn.3213623

Cross Jurisdictional Activity and Other Indicators

The Proposed Rule gives cross jurisdictional activity an especially important role in determining prudential standards, as $75 billion in cross jurisdictional activity is necessary before a bank below $700 billion in size is classified as Category II. As compared to previous foreign exposure measures, cross jurisdictional activity is redefined here to include both assets and liabilities. However, assets and liabilities from derivatives exposures would not be included in the cross-jurisdictional activity metric (CFR 66030).

We are concerned that this may lead banks to substitute derivatives activities for other forms of cross-jurisdictional transactions. Further, such cross-border derivatives activities may create significant issues in bank resolution. For example, it may be more difficult to recover derivatives collateral posted to foreign CCPs. Derivatives conducted through foreign subsidiaries or with foreign counterparties may be exempted from risk safeguards imposed by derivatives market regulators. We urge regulators to include derivatives exposures in cross jurisdictional activity metrics.

Question 7: The agencies are considering whether Category II standards should apply based on a banking organization's weighted short term wholesale funding, nonbank assets, and off-balance sheet exposure, using a higher threshold than the $75 billion that would apply for Category III standards, in addition to the thresholds discussed above based on asset size and cross-jurisdictional activity.

We favor regulators taking this approach. Especially since Category II determines the application of full liquidity requirements such as the LCR and NSFR, the level of short term wholesale funding and nonbank assets seem highly relevant to whether Category II requirements should apply. Furthermore, a high level of these three metrics would tend to increase both the complexity of bank supervision and the difficulty in resolving a bank safely.

Proposed Regulatory Framework – Capital

Question 18: Under the current capital rule, the agencies apply certain provisions, such as the supplementary leverage ratio and countercyclical capital buffer, based on the same applicability thresholds as advanced approaches capital requirements. The proposal would establish different applicability thresholds for the supplementary leverage ratio and countercyclical capital buffer by including them as Category III standards, while advanced approaches capital requirements would apply only as Category I and II standards. This approach would increase the risk sensitivity of the framework and allow for the retention of key elements of the capital rule for banking organizations subject to Category III standards without requiring them to comply with advanced approaches capital requirements more broadly. However, it also increases the complexity of the capital rule.

We strongly favor the retention of the supplementary leverage ratio and countercyclical capital buffer for Category III banks. Dropping these requirements would represent a significant shift in the prudential framework toward less stringent capital requirements. It is also at odds with any possible interpretation of Congressional intent in S. 2155, since that legislation specifically retains the $250 billion size threshold that marks Category III banks. We believe that the markets have already adjusted to the use of the Supplementary Leverage Ratio for banks of $250 billion and over as these banks have been reporting SLR data for some years now. We also do not see how the retention of these existing requirements for such banks would increase the complexity of capital rules, particularly in comparison to the numerous other increases in complexity that are created by this Proposed Rule.

Question 19: What are the advantages and disadvantages of applying the supplementary leverage ratio requirement to banking organizations subject to Category III standards? How do these advantages and disadvantages compare to any costs associated with any additional complexity to the regulatory framework that would result from applying this to banking organizations subject to Category III standards? To what extent would application of the supplementary leverage ratio requirement to these banking organizations strengthen their safety and soundness and improve U.S. financial stability?

As AFR has pointed out in previous letters on the leverage ratio, leverage capital brings critical benefits to financial stability that risk-based capital does not.[16] During the 2008 financial crisis only leverage capital was an accurate predictor of bank distress. Since it requires banks to capitalize off balance sheet exposures, the Supplementary Leverage Ratio (SLR) is a critical form of leverage capital that is significantly more effective than the Tier 1 leverage ratio and is particularly important for larger banks. This is particularly true for Category III banks, which are likely to have significant off balance sheet exposures as over $75 billion in off balance sheet exposures is one of the classification criteria for Category III banks.

Question 20: What are the advantages and disadvantages of not requiring banking organizations subject to Category III standards to recognize most elements of AOCI in regulatory capital? To what extent does not requiring banking organizations subject to Category III standards to recognize most elements of AOCI in regulatory capital impact safety and soundness of individual banking organizations or raise broader financial stability concerns? For example, to what extent would this approach reduce the accuracy of these banking organizations' reported regulatory capital? To what extent does the recognition of most elements of AOCI in regulatory capital improve market discipline and provide for a clearer picture of the financial health of banking organizations?

[16] See e.g. AFR Education Fund's June 25, 2018 letter on the Supplementary Leverage Ratio, available at http://ourfinancialsecurity.org/wp-content/uploads/2018/06/AFR-Education-Fund-Leverage-Ratio-Comment-Letter.pdf

We oppose the Agencies proposal to allow Category III banks to opt out of AOCI capital. Gains and losses in securities held by the bank are a particularly significant source of volatility in bank capital during periods of market stress. This is precisely when it is most important to retain investor confidence in bank solvency. By requiring banks to capitalize these gains and losses, and preventing divergence between accounting and regulatory capital measures in times of stress, regulators provide critical assurance to investors. Capitalization of AOCI is likely to be particularly important in times of rising interest rates and normalization of interest rates, such as the current period. No clear justification is given in the Proposed Rule for diverging from Basel international standards by eliminating AOCI capital requirements for banks over $250 billion.

Question 24: What would be the advantages and disadvantages of no longer applying the countercyclical capital buffer to banking organizations that would be subject to Category III standards? In particular, how would narrowing the scope of application of the countercyclical buffer affect the financial stability and countercyclical objectives of the buffer?

The countercyclical capital buffer is designed as a macro-prudential tool that affects the capitalization of the banking sector generally, rather than a micro-prudential tool aimed at the safety and soundness of individual banks. Thus, its impact should be evaluated in terms of the total assets it would apply to, not risk metrics for each bank individually. Exempting all Category III banks would exempt some $1.5 trillion of BHC assets from application of the countercyclical buffer (based on the current size of the four Category III banks listed in the proposal). An exemption of this size would clearly have a material impact of the ability of the countercyclical buffer to affect the macro outcomes of the financial sector at the peak of the economic cycle. It would significantly weaken the ability to achieve macro-prudential stability and countercyclical objectives of the buffer.

The Liquidity Coverage Ratio and the Net Stable Funding Ratio

The Proposed Rule would significantly reduce liquidity provisioning requirements under the LCR and NSFR for two major categories of banks. Category III banks with less than $75 billion in short term wholesale funding would only be required to hold 70 to 85 percent of the current liquidity requirement, and the liquidity requirements under the LCR and NSFR would be eliminated entirely for Category IV banks.

In the absence of macroeconomic evidence that the current liquidity requirements have harmed credit intermediation, it is difficult to see the justification for this significant weakening in liquidity requirements. The LCR rule and the proposed NSFR rule are a complementary set of standards designed to mitigate banks' liquidity risk profile over both the short and the long term. The LCR is a minimum quantitative standard designed to promote short-term resiliency by accumulating enough high-quality liquid assets (HQLA) to navigate at least a one month-period of significant stress. On the other hand, the NSFR is intended to incentivize resiliency over a

time horizon of a year by using funding sources conducive to more stable maturity schedules of assets and liabilities.

As Governor Brainard noted in her dissent,[17] in weakening the LCR rule the proposals go beyond the statutory mandates of S.2155 under the excuse of tailoring a rule that already distinguishes banks based on asset size and foreign exposure.[18] Moreover, the S.2155 did not remove the Board's discretion to apply prudential liquidity standards to large banks with over $100 billion in assets that could pose a risk to the safety and soundness of the financial system.[19] Nevertheless, the proposed rules would reduce the current liquidity requirements for four banks with total assets between $250 and $700 billion and would completely release from the LCR an additional eleven banks with $100 to $250 billion in assets. Combined these fifteen banks account for over $3 trillion in total assets and would see their LCR liquidity buffers reduced by approximately 15 percent.[20]

Historically, financial crises have been marked by liquidity shortfalls that are amplified through the financial system. For this reason liquidity regulation is key to both the success of individual banks and to help secure the stability the financial system. Holding enough highly-liquid assets to meet near-term obligations is crucial for banks to remain viable and to avoid engaging in fire sales during periods of financial turbulence. A mammoth bank with hundreds of billions of dollars in assets engaging in fire sales could lead to a collapse in asset prices—which increases pressures on capital ratios and bank solvency. This would not only reinforce the bank's own need to sale assets to meet outflows but also has systemic spillover effects on other institutions that would see the valuations of their balance sheets affected in turn. The dangers of these dynamics are well known as a Fisher-style debt-deflation spiral.[21]

To this end, the design of the LCR was not merely a theoretical exercise. In creating the quantitative liquidity requirement, the Basel Committee on Banking Supervision took into account many of the actual liquidity shocks that materialized during the last financial crisis. A well-funded stock of HQLA that can be quickly converted into cash to meet liquidity needs, would allow compliant banks a 30-day window to survive or mitigate: runs on retail deposits and short term obligations; potential maturity mismatches; unexpected outflows--including additional collateral requirements--from credit rating downgrades; market volatility that requires additional outflows related to derivative exposures; losses of unsecured wholesale funding capacity; and

[17] https://www.federalreserve.gov/newsevents/pressreleases/brainard-statement-20181031.htm
[18] The full LCR requirement generally applies to advanced approaches organizations and their subsidiary depository institutions with total consolidated assets of $10 billion or more. Banking institutions with $50 billion or more, but less than $250 billion, in total consolidated assets and less than $10 billion in on-balance sheet foreign exposure, are subject to a modified LCR requirement.
[19] 12 U.S.C. 5365(a)(2)(C).
[20] https://www.federalreserve.gov/newsevents/pressreleases/brainard-statement-20181031.htm
[21] Fisher, Irving, "The Debt Deflation Theory of Great Depressions," *Econometrica,* 1 (4):337-57, 1933. Available at https://phare.univ-paris1.fr/fileadmin/PHARE/Irving_Fisher_1933.pdf.

other contractual and contingent outflows.[22] Bear Stearns, Lehman Brothers, and Washington Mutual, for example, all faced one or more of those issues before failing in 2008.[23]

To the degree that the Agencies believe that the Category IV banks exempted from the LCR under this rule have a less complex business model than some of the banks that experienced liquidity pressures during the financial crisis (e.g. engage in less investment banking type activity), the appropriate solution would be to modify and simplify the LCR rather than eliminate it entirely.

The development and implementation of the original LCR rule was one of the key post-crisis regulatory reforms in the internationally agreed Basel III standards and its importance should not be overlooked. Quantitative liquidity requirements similar to the LCR have been found to reduce the probability of runs and improve outcomes compared to both an unregulated benchmark and to capital requirements.[24] Simulations have found that liquidity requirements like the LCR can help curve the systemic contagion of fire sales and act as a more effective first line of defense against financial crises than capital requirements.[25] Other studies indicate that liquidity requirements in the form of cash reserves reduce the likelihood of defaults and liquidity crises.[26] The LCR is also associated with lower bank systemic risk and could have helped predict losses in advance of the 2007 financial crisis.[27] By releasing some of the largest U.S. banks from the LCR rule, the proposed approach largely deviates from the Basel III framework and would erode and call into question U.S. compliance with the global regulatory standards.

A high capacity for banks to absorb liquidity shocks and remain viable helps create a more resilient financial system, mitigates moral hazard, and contributes to isolate the real economy from downturns in the financial sector. With all these concerns in mind, we urge the Board to use its statutory discretion to maintain a strong LCR rule for all banks over $100 billion in assets; a rule that would help ensure that, as Governor Tarullo said, “the liquidity positions of our banking firms [and the resiliency of the financial system] do not weaken as memories of the crisis fade.”[28]

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[22] Ibid.
[23] https://pubs.aeaweb.org/doi/pdfplus/10.1257/jep.23.1.77; http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf
[24] Diamond and Kashyap 2016. At: https://www.nber.org/papers/w22053
[25] Cifuentes, Rodrigo, Gianluigi Ferrucci, and Hyun Song Shin, “Liquidity Risk and Contagion,” *Journal of the European Economic Association* 3, no. 2/3 (2005): 556-66. http://www.jstor.org/stable/40004998.
[26] Calomiris, C W, Heider F, and M Hoerova, (2014), “A Theory of Bank Liquidity Requirements,” Columbia Business School Research Paper No. 14-39. Available at https://www0.gsb.columbia.edu/faculty/ccalomiris/papers/Theory%20of%20Bank%20Liquidity%20Requirements.pdf.
[27] Du, Brian, How Useful Is Basel III's Liquidity Coverage Ratio? Evidence from U.S. Bank Holding Companies (November 30, 2016). European Financial Management, Forthcoming. Available at SSRN: https://ssrn.com/abstract=2879127
[28] https://www.federalreserve.gov/newsevents/pressreleases/bcreg20131024a.htm

Net Stable Funding Ratio (NSFR): The Agencies are also proposing to sharply restrict the applicability of the NSFR rule in a similar manner to the LCR—another capricious aspect of the proposals that finds no statutory justification in S.2155.

The financial crisis exposed the vulnerabilities of individual firms and the financial system to the liquidity risk related to overreliance on short-term wholesale funding and other unstable sources that might dry exactly when they are most needed and exacerbate a liquidity crunch. The original NSFR rule is one of the "key reforms," as the Basel Committee on Banking Supervision presented it, to help ensure that, in addition to be better positioned to withstand short runs, banks can also survive funding stress over a period of a year. The example of Lehman Brothers reminds us how successive disruptions to fragile funding sources can erode a firm's liquidity and capital positions, despite continuing to meet immediate liquidity needs for several months. A strong NSFR rule would reduce the likelihood that large banks might fail due to those liquidity concerns and would strengthen the resiliency of the financial system.

The NSFR rule waiting to be implemented was specifically tailored to apply in full to the largest banks with over $250 billion in assets, while minimizing compliance requirements for smaller banks and *excluding* community banks. The Agencies do not even include an impact assessment of reducing the requirements of the upcoming NSFR rule—since it has not been implemented and banks are not currently complying with its requirements.[29] Given the importance of the NSFR, we oppose watering down the upcoming rule and encourage the Agencies to finally implement the rule as it was prepared. After a period of compliance, the Agencies can then assess the strengths and weakness of the rule and make a more informed decision about potential tweaks. We also encourage the Federal Reserve Board to apply the NSFR standard to the eleven banks with more than $100 billion in assets out of the sixteen banks that would be released.[30]

FEDERAL RESERVE BOARD PROPOSAL: **Prudential Standards for Large Bank Holding Companies**

A number of the questions in this proposal, notably those related to scoping criteria for the various prudential categories, are very similar to questions in the Joint Agency proposal. For example, Question 1 on the advantages and disadvantages of size thresholds for tailoring in this proposal is very similar to Question 3 in the Joint Agency proposal which also asks about size thresholds and is answered above. Similarly, questions on LCR and NSFR liquidity requirements are implicitly answered above.

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[29] Interagency Proposal, footnote 58.

[30] The Net Stable Funding Ratio proposal would apply a modified ratio to institutions with more than $50 billion and less $250 billion in total assets. The sixteen banks—combining for over $2 trillion in assets—are those included in Category IV and "Other Firms" (with over $50 billion total assets), according to a chart released by the Federal Reserve Board. See: Board of Governors of the Federal Reserve System, "Federal Reserve Board invites public comment on framework that would more closely match regulations for large banking organizations with their risk profiles," Press Release, October 31, 2018. Available at https://bit.ly/2HcaHOI.

Alternative Scoping Methodology – G-SIB Surcharge Score

Question 6: What are the advantages and disadvantages to use of the scoring methodology and category thresholds described above relative to the proposed thresholds?

We strongly discourage the Board from using the G-SIB surcharge score rather than the main proposed thresholds to scope the prudential categories in the rule. Since only about 20 percent of the G-SIB surcharge is determined by bank size, the use of the G-SIB surcharge would cause bank classifications to be even less influenced by size than they would be under the main scoping methodology in the proposal. In theory, trillion dollar banks might be classified as Category IV entities if the G-SIB surcharge was used. Use of the G-SIB surcharge would also encourage banks to develop business models in which they deployed very large amounts of assets while attempting to minimize other G-SIB metrics such as payments activities, derivatives, and securities holdings. While this regulatory pressure to concentrate in commercial banking might be beneficial in some ways, it might also bias bank economic choices in unpredictable ways that do not seem to be anticipated in the proposal.

Fundamentally, the G-SIB score is aimed at determining *global* significance of a bank and is thus not appropriate for large domestic banks. There is a large gulf between G-SIB scores for the largest U.S. commercial banks and the most complex and global banks designated as G-SIBs. To take just one example, in 2016 U.S. Bancorp had a Method 1 G-SIB score of just 43 while State Street, the smallest G-SIB, had a G-SIB score of 149, almost four times higher. This is without any regulatory pressure to lower G-SIB scores on the part of U.S. Bancorp (since it was far from the relevant threshold in 2016). If the G-SIB score was salient to large regional banks then U.S. Bancorp could well lower its score even further.

Category IV Prudential Standards

Question 20: What are the advantages and disadvantages of conducting a supervisory stress test every other year, rather than annually, and eliminating the company-run stress testing requirement for these firms? How should the Board think about providing these firms with additional flexibility in their capital plans?

Question 21: The proposal would revise the frequency of supervisory stress testing for firms subject to Category IV standards to every other year. What would be the advantages or disadvantages of the Board conducting supervisory stress tests for these firms on a more frequent basis?

We strongly oppose moving to an every other year schedule for supervisory stress testing of Category IV banks. The CCAR capital planning process was put in place in large part due to the experience of the financial crisis. During 2007-08 banks distributed tens of billions of dollars in capital to investors in dividends and share buybacks rather than retain earnings to ensure they would stay solvent through financial stress. Those capital distributions eventually had to be replaced by TARP capital injections from taxpayers. Moving supervisory stress testing to an

every year schedule would risk repeating this experience. Granted, banks would still have to do capital planning on an annual basis, but the failure to update supervisory loss estimates determining the stress capital buffer requirement for the bank could make a major difference to how much capital banks would be permitted to distribute during the opening phases of a market downturn. It is crucial that forward-looking supervisory estimates of losses be based on current data. To again use the example of the 2008 crisis, imagine, for example, failing to update loss estimates for mortgage backed securities between 2006 and 2008. Such a failure would clearly lead to a major reduction in the effectiveness of capital planning and capital requirements. Yet the shift to every-other-year supervisory stress testing seems to indicate supervisors are comfortable with such a scenario.

The elimination of company-run stress test requirements will further reduce the information supervisors have available to judge risks to the bank during periods in which markets are rapidly changing.

Thank you for the opportunity to comment on these Proposed Rules. If you have questions, please contact Marcus Stanley, AFR’s Policy Director, at 202-466-3672 or marcus@ourfinancialsecurity.org

Sincerely,

Americans for Financial Reform Education Fund