AFR Americans for Financial Reform
Education Fund

June 25, 2018

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

RE: Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules (RIN 7100-AF 02)

Dear Ms. Misback:

On behalf of Americans for Financial Reform Education Fund ("AFR"), we are writing to comment on proposed changes (the "proposal") by the Federal Reserve Board of Governors (the "Board") that would modify regulatory capital and stress test rules to merge the current stress testing process with regulatory capital rules by instituting a Stress Capital Buffer (SCB) .[1]

AFR has previously commented extensively on stress test rules.[2] Many of the issues and concerns raised in the previous comment are relevant to questions in this proposal and we will refer back to them in this comment where relevant.

We generally support the core structural change in this proposal -- converting the capital stress generated from regulatory stress testing into a new SCB that is incorporated into the regulatory capital rules and replaces the current capital conservation buffer. We also support the requirement that the new SCB be floored at the current 2.5% level of the capital conservation buffer, so that the shift to a SCB could not reduce current capital requirements as compared to the current capital conservation buffer.

However, we are concerned about several changes proposed in this rule that would have the effect of reducing total capital requirements. We are also concerned about questions in the proposal that seem to indicate additional measures could be added in the final rule which would also represent effective cuts in capital requirements.

This proposal estimates that based on 2015-2017 data, the aggregate effect of the proposed changes would represent an increase of from $10 billion to $50 billion in capital for U.S. Globally Systemically Important Banks (G-SIBs), and a decline of up to $45 billion in non-G-SIB capital. In the proposal to change the enhanced supplementary leverage ratio (eSLR), there is another estimate of capital impacts, which claims that the combination of this SCB proposal and the proposed cuts to the eSLR would reduce aggregate G-SIB capital by $400 million. We

[1] The Americans for Financial Reform Education Fund brings together an unprecedented coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based and business groups. A list of AFR members is available at http://ourfinancialsecurity.org/about/our-coalition/.
[2] Americans for Financial Reform, "Comment on Stress Test Proposal Package", February, 2018. Available at https://bit.ly/2Is44n7

would note that an independent analyst report by Goldman Sachs runs counter to these estimates, and calculates that this SCB proposal alone would increase aggregate distributable capital by $54 billion for G-SIBs (i.e. reduce G-SIB capital by $54 billion).[3]

The difference in these estimates shows the range of impacts this proposal could have, and also the potentially very significant effect of the elements of the proposal that reduce capital for the nation's largest and most systemically significant banks. These elements include:

1) The assumption of a stable balance sheet (constant risk weighted assets) through the stress period.

2) The change from prefunding nine quarters of dividends and share buybacks to pre-funding just four quarters of dividends.

3) The shift from requiring banks to meet Supplementary Leverage Ratio (SLR) requirements under stress to meeting Tier 1 Leverage requirements under stress.

We oppose all three of these changes and, for the reasons explained below, believe all three are analytically unjustified. We are also concerned that other parts of the proposal, most notably Question 23 in the proposal, seem to suggest that additional changes could be made in the final rule that would further reduce stressed capital requirements, perhaps significantly.

Assumption of a stable balance sheet: As we noted in our previous comment on stress test modeling and disclosures, we do not believe that the assumption of a stable balance sheet is stringent enough for the Board to meet its stated goal of ensuring that banks are sufficiently capitalized to continue their credit intermediation function during a recession. First, as noted in the proposal itself, total commercial bank asset size has typically increased even over recessionary periods, indicating that some increase in bank portfolios is necessary to fuel economic growth.[4] Second, a number of factors may lead to unplanned increases in bank portfolio size during a downturn, including greater use of undrawn loan commitments and the sudden shutdown in markets for the sale and distribution of loans.

We would also note that increases in regulatory risk weights may take place during an extended recession which would have the effect of increasing total risk weighted assets.

It would thus be far safer and more conservative to assume some increase in asset size during a recession. Without such an assumption, banks may not have sufficient capital to address unplanned increases in the balance sheet and new demands for credit while maintaining regulatory capital minimums.

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[3] Ramsden, Richard et. al, "CCAR Stress Capital Buffer Proposal Expected to be Constructive for Large Banks", Goldman Sachs Equity Research, April 11, 2018.
[4] See bank assets time series available at https://fred.stlouisfed.org/series/TLAACBW027SBOG

Shift from prefunding nine quarters of dividends and share buybacks to prefunding just four quarters of dividends. During the financial crisis period, dividend payments for most banks were interrupted for a period of at least three full years while banks rebuilt their capital buffers.[5] Dividends for some large systemically significant banks were interrupted even longer. This points to the sensible and properly conservative nature of extending the scope of stress test modeling to at least nine quarters of dividends, as opposed to the four quarters proposed here. This is especially true since the payment of dividends may be helpful in maintaining investor confidence during a crisis.

The proposed rule would also end the pre-funding of share buybacks, on the argument that banks voluntarily halted share buybacks prior to and during the financial crisis, while they did not halt dividends.[6] However, the research cited in the proposal (Hirtle, 2016) does not support the conclusion that it is entirely unnecessary to pre-fund share repurchases.[7] Figure 2 in the cited paper shows that, while share repurchases were halted prior to dividend payments, banks continued share repurchases well into what should have been understood as a period of financial stress. For example, Figure 2 shows that share repurchases actually exceeded dividend payments for large bank holding companies during the first half of 2007, and repurchases remained at a significant level through the first quarter of 2008.

Perhaps even more important, the exclusion of share repurchases in this proposal would represent a significant change from the circumstances that prevailed during the 2005-2009 period covered by the cited research. The exclusion of share repurchases from strict capital planning would give banks an incentive to return money to shareholders through repurchases rather than dividends. The research cited in the proposal hypothesizes that the difference between bank behavior with respect to dividends and behavior with respect to share repurchases is due to the fact that at the time dividends were more expected by the market than share repurchases, and were thus the preferred route to signal credibility to investors. But market expectations can clearly change.

We believe the Board should continue to require banks to prefund share buybacks and should extend the four quarters of prefunding required in this proposal.

Shift from Supplemental Leverage Ratio (SLR) to Tier 1 Leverage Ratio: In the current stress test and capital planning process, banks are required to meet the required SLR of 3 percent after projected stress losses. This proposal does include a Stress Leverage Buffer along with the SCB to represent the requirement that banks meet leverage capital requirements as well as risk-

[5] Schwartz, Nelson and Eric Dash, "Banks Poised to Pay Dividends After Three Year Gap", New York Times, January 13, 2011. Available at https://nyti.ms/2KlAG3w
[6] CFR 18163 and footnote 20.
[7] Hirtle, Beverley, "Bank Holding Company Dividends and Repurchases During the Crisis", Federal Reserve Bank of New York Staff Report 666, Revised April, 2016. https://nyfed.org/2KapUBd

weighted capital requirements when under stress. However, the relevant leverage buffer is based on Tier 1 leverage instead of the supplementary leverage ratio.

The difference between Tier 1 leverage and the SLR is very significant. The Tier 1 leverage ratio includes only on-balance sheet assets, while the SLR includes exposures that are technically off balance sheet but may result in risk exposure to the bank (e.g. may return to the balance sheet under stress). Many of the risks that materialized during the 2008 financial crisis were technically off balance sheet but in fact returned to create losses to the bank.

By effectively removing the stressed SLR requirement and replacing it with a stressed Tier 1 leverage requirement, the proposal would significantly reduce stress leverage requirements. Of course, banks must still meet the SLR requirement on a spot basis (they must still be in excess of the SLR and relevant eSLR in order to meet capital distribution pre-requisites). However, technically off balance sheet risk exposures would no longer be subject to stress test modeling under this proposal. Not only would this reduce the effective stress on the bank, it reduces regulatory flexibility in stress test scenario design and stress test modeling. We strongly oppose this change.

Responses to Questions

Question 5: How should the Board contemplate the appropriate level of the countercyclical capital buffer in light of the proposal?

When set, the countercyclical capital buffer should be incorporated directly into the spot capital requirements as an additional add-on to the base capital requirement and the stress capital buffer. We strongly disagree with the idea that the countercyclical capital buffer is repetitive or redundant when combined with the stress capital buffer. The stress capital buffer is a modeling exercise while the countercyclical capital buffer is a direct add-on intended to force banks to hold additional capital at peak periods of the economic cycle. As discussed in AFR's previously submitted comment on stress testing (*supra* note 2), it is far from clear that the current stress testing process is fully effective as a counter-cyclical measure. Furthermore, the difference between the methods of calculation and application of the countercyclical capital buffer and the stress buffer would render them complementary in any case.

Question 6: What aspects of the calculation of the stress buffer requirements could be modified to increase the effectiveness of the proposal in ensuring that firms maintain stress buffer requirements that are appropriately sized to withstand stressful economic and financial conditions while permitting such firms to continue lending and supporting the real economy?

See the discussion above. We suggest that the Board assume at least some growth of risk-weighted assets during a stress period, incorporate share repurchases into capital planning and extend the capital planning period beyond four quarters, and base the Leverage Capital Buffer on the SLR instead of the Tier 1 leverage ratio.

Question 23: What, if any, other changes to CCAR or the capital plan rule should the Board consider? For example, what advantages or disadvantages would be associated with:

- *i. Removing or adjusting the provisions that allow the Board to object to a large and complex or LISCC firm's capital plan on the basis of qualitative deficiencies in the firm's capital planning process;*
- *ii. Publishing for notice and comment the severely adverse scenario used in calculating a firm's stress buffer requirements;*
- *iii. Providing additional flexibility for a firm to exceed the capital distributions included in its capital plan if its earnings and capital ratios are above those in its BHC baseline; or*
- *iv. Providing additional flexibility to a firm to increase the planned capital actions above what was included in its original capital plan based on the results of the supervisory stress test or request for reconsideration?*

Taking these questions in order:

i. It is crucial that the Board maintain the capacity to object to LISCC firm's capital for qualitative deficiencies in capital planning. Numerous elements of the stress test modeling process depend directly on the capacity of large banks to aggregate and model their risks. If such capacity is deficient, the balance sheet data and (especially) the trading loss data submitted to the Board may be false and misleading, rendering results of the stress test doubtful at best. A qualitative assessment of the firm's planning capacities is therefore a critical part of the stress testing process.

ii. We do not believe it would be helpful to subject key elements of the stress test to direct lobbying and possible legal challenge as would occur through the notice and comment process. This issue is discussed in our previous comment on stress testing. Opening the detailed scenario or the details of the stress test models to notice and comment challenge is likely to lead banks to delay or overturn changes in the stress tests that reflect current market conditions, as occurred for GSE stress tests prior to the financial crisis. It is also likely to lead to a "model monoculture" where banks align their risk decisions closely to Federal Reserve models.

iii. This proposal already substantially increases the flexibility granted to individual bank holding companies to interact with the Federal Reserve and either lobby to change its stress capital buffer or to adjust its capital plan. Increasing such flexibility still further by permitting the firm to exceed planned capital distributions would be entirely inappropriate.

Thank you for the opportunity to comment on these proposals. If you have questions, please contact AFR's Policy Director, Marcus Stanley, at marcus@ourfinancialsecurity.org or 202-466-3672. Thank you for your attention to this letter.

Sincerely,

Americans for Financial Reform Education Fund