Congress of the United States
Washington, DC 20515

May 13, 2019

The Honorable Jerome H. Powell
Chairman
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, NW
Washington, DC 20551

The Honorable Randal K. Quarles
Vice Chair for Supervision
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, NW
Washington, DC 20551

Dear Chair Powell and Vice Chair Quarles,

We write to express alarm at a host of recent deregulatory moves by the Fed that seem to ignore lessons from the 2008 financial crisis and greenlight the same risky financial activity that led to the last crash. In the years following the last crisis, Congress entrusted the Federal Reserve with a range of regulatory tools to stabilize the financial system, insulate taxpayers from the effects of crashes, and institute safeguards against Wall Street excess. In the midst of the greatest economic downturn since the Great Depression, Congress recognized that the economy has historically followed a "boom and bust cycle" pattern, with periods of economic health and stock market exuberance often contributing directly to a laxer regulatory environment, ultimately leading to devastating economic crashes.

On March 6, the Federal Reserve Board announced its decision to maintain the Countercyclical Capital Buffer (CCyB) at its current level of 0 percent. This decision bypassed warnings that we are entering precisely the period in the financial cycle that the CCyB was designed to protect against. After a decade of low interest rates facilitated a gradual economic recovery, asset prices, especially in the commercial real estate market, have reached new highs.[1] Corporate debt has soared to a record-high $6.7 trillion, and observers including former Fed Chair Janet Yellen and

[1] "It's time for the Fed to active safeguards against financial bubbles," *Marketwatch*, 07.31.2018, https://www.marketwatch.com/story/its-time-for-the-fed-to-activate-safeguards-against-financial-bubbles-2018-07-31

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Dallas Fed President Robert Kaplan have begun calling attention to this growing risk.[2] [3] Many economists are concerned that firms might default on this debt as interest rates rise.[4] By failing to heed these warnings and activate the CCyB, the Board of Governors overruled the recommendations of Governor Lael Brainard, Chair Yellen, five Federal Reserve Bank presidents, and a number of regulatory experts.[56] Moreover, according to former Federal Reserve Governor Daniel Tarullo, the Fed's own research has concluded that the largest U.S. firms are "toward the lower end" of the optimal level of capital.[7] The refusal to activate this loss-absorbing equity buffer is a troubling missed opportunity to improve the resilience of the banking sector before the economic cycle turns.

On the same day, the Fed announced that it was eliminating the "qualitative" portion of its stress tests for 2019. Instead, the Fed will examine the capital planning processes at big banks in the normal course of supervision. The announcement was characterized as a "big win for major banks, such as Goldman Sachs Group Inc, Morgan Stanley and JP Morgan, Bank of America and Citigroup."[8] Wall Street banks feared this element of the stress tests because it provided an opportunity for the Fed to prevent shareholder payouts if it found banks' governance and internal controls lacking.

Indeed, big banks have substantially improved their capital planning processes in recent years precisely because stress tests had included this "qualitative portion." Eliminating this aspect of the stress tests severely undermines the utility of the annual exercise. Former investment banker Nomi Prins rightly called the Fed's decision "reckless," and questioned why the Fed would not "retain the option of qualitative oversight, which has turned up red flags in the past."[9] This decision also directly contradicts the Fed's stated desire to improve the "transparency" of stress testing.[10] The Fed has gone to great lengths to provide banks with more information on stress testing scenarios and the Fed's own internal models, potentially giving banks the answers to the test.[11] Yet taxpayers, shareholders, investors, and financial markets will no longer receive an

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[2] "Former Fed Chair Yellen says excessive corporate debt could prolong a downturn," *CNBC*, 12.11.2018, https://www.cnbc.com/2018/12/11/janet-yellen-says-excessive-corporate-debt-could-prolong-a-downturn.html

[3] "Fed's Kaplan calls for vigilance on corporate debt levels," *Marketwatch*, 03.05.2018, https://www.marketwatch.com/story/feds-kaplan-calls-for-vigilance-on-corporate-debt-levels-2019-03-05

[4] "Problem with raising rates: Corporate America has binged on debt," *CNN*, 02.26.2018, https://money.cnn.com/2018/02/26/investing/corporate-debt-rising-rates/index.html

[5] "Seven questions for Janet Yellen on financial stability," *Brookings Institute*, 01.3.2019, https://www.brookings.edu/blog/up-front/2019/01/03/seven-questions-for-janet-yellen-on-financial-stability/

[6] "It's time for the Fed to active safeguards against financial bubbles," *Marketwatch*, 07.31.2018, https://www.marketwatch.com/story/its-time-for-the-fed-to-activate-safeguards-against-financial-bubbles-2018-07-31

[7] "Departing thoughts," Governor Daniel K. Tarullo, 04.04.2017, https://www.federalreserve.gov/newsevents/speech/tarullo20170404a.htm

[8] "Federal Reserve scraps 'qualitative' test for U.S. banks in 2019 stress tests," *Reuters*, 03.06.2019, https://www.reuters.com/article/us-usa-fed-stresstests/federal-reserve-scraps-qualitative-test-for-u-s-banks-in-2019-stress-tests-idUSKCN1QN2PX

[9] "U.S. Bank Regulatory Easing is Negative for Investors and Taxpayers," *Forbes*, 03.07.2019, https://www.forbes.com/sites/mayrarodriguezvalladares/2019/03/07/u-s-bank-regulatory-easing-is-negative-for-investors-and-taxpayers/#ec860fc9a8ea

[10] https://www.cnbc.com/2017/06/01/changes-coming-to-bank-stress-tests-feds-powell-says.html; https://www.federalreserve.gov/newsevents/speech/quarles20181109a.htm

[11] https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190205a.htm

annual public update on the Fed's qualitative evaluation of big banks' capital planning internal controls and governance. The Fed appears to only care about "transparency" when it benefits Wall Street.

In the final concerning move of March 6, the Financial Stability Oversight Council (FSOC) voted unanimously to factor in the "likelihood of distress" and conduct burdensome analytical requirements before designating nonbanks as systemically important financial institutions (SIFI).[12] These changes are substantively problematic and are designed to tie the FSOC's hands when using its designation authority to combat systemic risk. It takes many years for the Council to (i) undergo the analytically rigorous process of designating a SIFI, (ii) for the Fed to develop tailored enhanced prudential standards that fit the SIFI's risk-profile, and (iii) to allow the SIFI to come into compliance. There is no regulatory metric or market-based measure that accurately predicts the likelihood of distress years in advance.

During the 2007-2008 financial crisis, designating AIG or Lehman Brothers when they were likely to experience distress—just weeks or months before they failed—would have done nothing to prevent their collapse or mitigate its devastating economic impact. The change violates the spirit of the Dodd-Frank Act statute, which directs the FSOC to assume financial distress at the firm when undertaking the designation process. Moreover, analytical cost-benefit requirements like the ones included in the FSOC's proposal are susceptible to manipulation by industry and tend to exaggerate costs while underestimating the considerable public benefits of preventing another financial crisis. [13]

This latest proposal is one in a long line of concerning actions undertaken by the Council. Last October, FSOC controversially removed the SIFI designation from Prudential Financial, thus freeing all nonbank institutions from the heightened scrutiny that comes with SIFI designation. Critics charged that FSOC's decision "will revive the shadow banking system by recreating the two-tier regulatory system which will incentivize the migration of risk from the higher regulated banking system to the unregulated shadow banking system." [14]

It was additionally distressing to see the Fed follow its actions on March 6 with yet more deregulation on April 8, when the Fed announced a proposal to allow banks to submit less frequent living wills, and to allow large foreign banks such as Santander and BNP Paribas to opt out of important capital requirements. One of the designers of the stress test system at the Fed immediately warned against this "serious misstep," writing: "[Relaxing stress tests] was unnecessary and will make it harder for the Fed's bank supervisors to effectively oversee the nation's largest banks."[15]

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[12] The Chair of the Federal Reserve is a voting member of the FSOC.

[13] "Cost-Benefit Analysis of Financial Regulation: Case Studies and Implications," *Yale Law Journal*, January 2015, https://www.yalelawjournal.org/article/cost-benefit-analysis-of-financial-regulation

[14] "FSOC rescinds Prudential's systemically important financial institution designation," *Pensions & Investments*, 10.17.2018, https://www.pionline.com/article/20181017/ONLINE/181019862/fsoc-rescinds-prudentials-systemically-important-financial-institution-designation

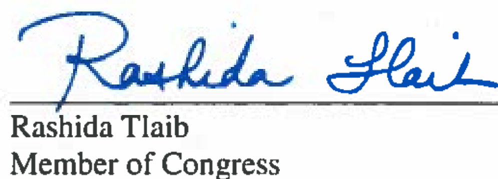
[15] "Is the Fed in retreat?," *Politico*, 04.09.2019, https://www.politico.com/agenda/story/2019/04/09/federal-reserve-stress-tests-banks-000889

Unfortunately, the short memories of many on Wall Street and in Washington were on display last year, when Congress commemorated the 10th anniversary of the financial crisis by passing S. 2155 which weakened Dodd-Frank protections against some of the biggest financial institutions in the country. It is incumbent upon independent regulators at the Federal Reserve to interpret regulatory discretion from Congress responsibly, and continue to monitor the risks we are seeing in the financial sector vigilantly. A number of rules mandated by the Dodd-Frank Act, such as an executive compensation rule, are still not finalized nearly ten years after Dodd Frank's enactment. Instead, the Fed has swiftly implemented S. 2155's deregulatory provisions. In fact, the Fed has gone further than required in relaxing post-crisis rules. In October, the Fed issued a proposal that would significantly lower liquidity requirements, and remove certain capital requirements, for banks with up to $700 billion in assets.[16]

The Fed's decision to engage in three deregulatory moves in the span of two hours on March 6, along with a range of deregulatory proposals advanced over the past 18 months, reflect a "pro-cyclical" bias. Rather than using the economic research and regulatory expertise at its disposal to temper the "pro-cyclical" instincts exhibited by the Trump administration and 115th Congress, the Fed is joining with Congress in deregulating major financial institutions and inviting more risky financial activity. We urge you to reverse course, and enact protections that will prevent another crash.

Sincerely,

Jesús G. "Chuy" García
Member of Congress



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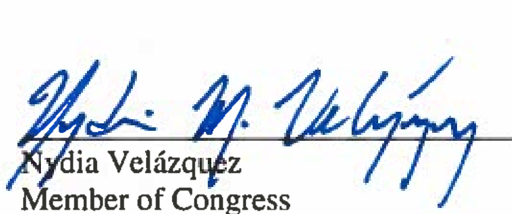

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[16] "Danger lurks in latest deregulatory push," *American Banker*, 11.13.2018
https://www.americanbanker.com/opinion/danger-lurks-in-latest-deregulatory-push

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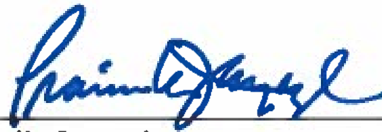

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