BETTER MARKETS

August 3, 2020

The Honorable Jerome H. Powell
Chairman
Federal Reserve Board

Re: The Fed Should Not Be Lowering Capital, Weakening Banks, Causing Systemic Instability, and Making Bailouts More Likely by Lobbying to Gut the Leverage Ratio

Dear Chairman Powell,

As the COVID-19 pandemic-caused health crisis metastasizes across the country, breaking records for infections and deaths in state after state, we agree with you and your colleagues that this is a time of "extraordinary uncertainty" with "considerable risks" to the economic outlook of the Fed. As you know, the pandemic has not only caused the worst economy since the Great Depression of the 1930s, it has inflicted widespread damage in unpredictable and unexpected ways, and will no doubt continue to do so. That's why it is both obvious and critical that the financial protection rules in place must be, if not strengthened, at least not weakened.

That's also why we were surprised and disappointed to hear your comments at your last press conference endorsing the weakening of the tier 1 leverage ratio capital requirements for the largest banks in the country[1] and to read the reports that the Fed's Vice Chairman for Supervision, of all people, was actually lobbying the Congress to do so.[2]

We write to highlight the importance of that leverage ratio, to urge you to reconsider your position, and to not take actions that would weaken this important capital requirement. The tier 1 leverage requirement not only increases financial system stability and reduces the risk of taxpayer bailouts, it facilitates bank lending to

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[1] Bloomberg, "Powell Suggests More Bank Leverage Relief Would Help Borrowers," Eric Martin, July 29,2020, available at https://www.bloomberg.com/news/articles/2020-07-29/powell-suggests-more-bank-leverage-relief-would-help-borrowers?sref=mQvUqJZj.

[2] New York Times, "Republican Stimulus Package May Come With a Benefit for Big Banks," Emily Flitter, Jeanna Smialek, and Peter Eavis, July 27, 2020, available at https://www.nytimes.com/2020/07/27/business/bank-regulations-rollback-stimulus-bill.html.

the productive economy, helping Main Street families and businesses. As Better Markets[3] notes below, industry claims to the contrary are at best misleading or baseless, if not simply false.

Frankly, the Fed knows better, and history will judge such actions very harshly, particularly in light of very recent history. Two overriding lessons of the 2008 financial crash were that

1) strong capital requirements for the largest banks were necessary to promote financial stability and support the economy through times of stress, and

2) risk-based capital measures, while important, are necessary but not sufficient and must be complemented by robust and simple leverage requirements to reduce the possibility that important risks will be missed by a risk-based approach -- as they disastrously were prior to the 2008 financial crisis.

Both of these well-known and indisputable lessons remain crucial as the need for strong capitalization at the largest banks is more important than ever today, given unprecedented uncertainty about the economic outlook and its ultimate impact on banks' financial soundness due to the pandemic. In light of that recent history, this is not simply the wrong time to allow banks to weaken their capital positions, it is the worst possible time to do so.

Indeed, stronger bank capital requirements implemented after the 2008 financial crisis, including leverage-based measures, are a critical reason why Wall Street banks have, to date, been able to support the economy during this pandemic, rather than acting as a drain on it by requiring bailouts and withholding credit as happened in 2008.[4] The self-serving claims by Wall Street's largest, most dangerous banks -- and their trade groups and political allies -- that reducing capital requirements will allow them to increase their lending and better support the economy simply are not supported by independent, data-based evidence. Banks with strong capital positions are best able to support the economy through the cycle by lending to consumers and businesses without increasing the likelihood of a taxpayer-funded bailout.

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[3] Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system, one that protects and promotes Americans' jobs, savings, retirements, and more.

[4] See Dennis Kelleher and Tim Clark, *No Financial Crash Yet Thanks to Dodd-Frank and Banking Reforms*, July 8, 2020, available at https://bettermarkets.com/sites/default/files/Better_Markets_White_Paper_Dodd-Frank_Banking_Reforms%20%289%29.pdf

Moreover, as you know, lowering required bank leverage ratios would not even in itself create an incentive for banks to increase productive lending any more than it would provide an incentive to increase other risk taking. If there is an objective, evidence-based need to create specific incentives for the largest banks to lend more to Main Street families and businesses, or to otherwise grow their balance sheets to serve these customers -- a need for which evidence has not been provided to the public -- any actions taken to that end must be carefully constructed, calibrated and targeted to achieve the specific goals in measurable ways. Of course, any such change would have to be temporary and in place only for the duration of the need created by the pandemic.

The failure of so-called "risk-based" regulatory capital requirements -- which, as the Fed well knows, systematically failed to capture the actual riskiness of many of banks' riskiest positions -- was a key contributor to banks' crippling weakness and for some their outright collapse in the last crisis. That's why it was so critically important to establish the requirement that those banks ***also*** meet a simpler, more straightforward minimum leverage ratio. Such leverage ratios require no judgments, no guesswork, no complicated models and, among other things, are much more difficult for banks to manipulate, understate or miscalculate. Thus, the leverage ratio requirement directly addressed one of the most important deficiencies in the pre-crash financial protection architecture for the country's biggest banks.

It is important to recognize, however, that risk weights and a leverage ratio each have distinct benefits and shortcomings, which is why an appropriate capital regime requires both. By acting together, better designed and stronger post-crisis, risk-based requirements complemented by simple leverage-based requirements -- and stress testing -- have dramatically strengthened U.S. banks and provided the foundation for them to support an historically long period of economic expansion.[5]

With regard to the critical role of stress testing, as you are well aware, two of the very changes the Fed recently made to weaken the Fed's stress testing program -- specifically, not including a post-stress leverage requirement in the stress capital buffer and changing the stress test calculations so as to no longer assume banks' balance sheets might grow in a crisis -- have been exposed as dangerous by the current situation. Some of the largest banks' balance sheets are growing during this time of crisis, as had appropriately been assumed in Fed stress tests for years prior to the recent changes. And if there is in fact a perceived need to reduce bank leverage requirements during this crisis to support bank customers and the economy, then there is also a need for a post-stress leverage buffer, which banks could build up in good times to have sufficient capital during periods of stress to be able to provide that support.

[5] Id.

The Board of Governors should revisit implementation of the stress capital buffer and address these changes and others, which have not only undermined the credibility of the Fed's well-respected stress testing program, but have also significantly lowered effective capital requirements for the largest U.S. banks. Making such changes without the benefit of having seen the performance of the stress tests through a full business cycle was not well considered, but going forward with their implementation now -- in the middle of a pandemic -- would be a knowingly dangerous mistake.

Finally, contradicting the ostensible rationale for lowering the leverage ratio, Wall Street's largest banks have claimed they have ample capital both to continue to serve customers and to pay out tens of billions of dollars of capital to shareholders via dividends. Frankly, it is impossible to reconcile the confidence of such claims with the unprecedented uncertainty in the outlook caused by the pandemic. Nonetheless, if one were to assume these statements were accurate, it cannot also be true that there is a need to weaken critically important capital requirements. After all, if they need more capital to support Main Street families and businesses, they could just voluntarily and unilaterally stop ejecting capital via dividends, immediately increasing the amount of available capital substantially.

This contradiction shines a clear light on what is really going on here: industry claims that weaker capital requirements for Wall Street banks are "needed" are nothing more than those banks' latest opportunistic attempt to gut key capital requirements and increase their leverage. As they have done since the beginning, Wall Street's biggest banks and their trade groups continue to try to use the pandemic as a pretext[6] to get elected officials, regulators and policymakers to deliver the deregulatory wish list they have been lobbying for since 2010. Such actions would needlessly increase the danger to the public at the very same time the American people are being asked to make tremendous sacrifices to fight the pandemic.

There is no independent, credible evidence to support claims of a need to weaken capital standards at this time. However, there is clear evidence that doing so would expose taxpayers to a heightened probability the banks could contribute to deepening the economic damage caused by COVID-19 and need another bailout as they did in 2008. If the banks believe what they are claiming, they should put their money where their mouth is and stop shoveling capital out the door via dividends and redirect those billions to support the real economy.

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[6] See Better Markets, *Wall Street Biggest Banks Shamelessly Trying to Use Coronavirus to Get Federal Reserve to Weaken Rules,* March 2, 2020, available at https://bettermarkets.com/newsroom/wall-street-biggest-banks-shamelessly-trying-use-coronavirus-get-federal-reserve-weaken

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